Choosing Between An SEC Receivership And Bankruptcy

By **Reid Skibell and Joseph Gallagher** (March 11, 2021)

A company facing insolvency from a U.S. Securities and Exchange Commission enforcement action has a tough decision to make regarding its options, one that will have lasting consequences.

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Recent cases, such as SEC v. Direct Lending Investments LLC in the U.S. District Court for the Central District of California, have also underscored the importance of those choices.

In situations where there is risk of nonpayment, or where the SEC's potential judgment exceeds the assets available to satisfy it, the SEC's preferred path has increasingly been to force securities defendants into receiverships, which it has typically sought alongside or following asset freezes.

An SEC receiver's job is to halt any ongoing misconduct and to take control of a defendant's assets for preservation, maximization and/or liquidation to ensure there are assets available to satisfy an eventual judgment.

As the SEC has put it: "Courts typically grant broad powers to receivers, including the authority to sue on behalf of the receivership and to gather, manage and liquidate receivership assets on behalf of potential creditors and harmed investors."[1]

If any assets remain following distribution — and usually there are not — they are returned to the defendant, likely leaving those assets subject to additional lawsuits or claims

The SEC's appetite for receiverships seems unlikely to change in the near term. Not only has the commission secured the appointment of receivers in a number of recent cases,[2] it also created the Office of Bankruptcy, Collections, Distributions and Receiverships in the Division of Enforcement in October 2020.

Plainly, the SEC views receiverships as a critical tool in pursuing compensation for injured investors.

There is another option, however, that may leave the company's stakeholders in a superior situation depending on the facts on the ground: bankruptcy. The appointment of a bankruptcy trustee renders a receiver superfluous and thus removes it from the SEC's arsenal.

While a bankruptcy filing would not prevent the SEC from collecting on some or all of a judgment, as the commission would undoubtedly have a seat at the creditors' table, the rules governing a bankruptcy trustee are more well defined, predictable and creditor-friendly than the broad equitable principles that guide SEC receivers.

Though the company is likely to end up in the same place regardless — that is, liquidated — that decision will have important implications for the company's management, employees, vendors and creditors.

The Poorly Defined and Extensive Powers of SEC Receivers

SEC receivers are creatures of equity; they exist pursuant to courts' inherent power to craft equitable relief and further the goals of the federal securities laws.

The SEC's authority to seek a receiver, and in turn for federal courts to appoint one, was confirmed in the Sarbanes-Oxley Act, which amended Title 15 of the U.S. Code, Section 78u(d)(5), to add:

> In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.

An SEC receiver's authority is governed by the judge's order appointing and empowering it, and is loosely informed by a patchwork array of state law, federal common law, and historical practice — some of which is so antiquated that it dates back to railroad receiverships in the early 1900s.

Most decisions by a receiver require judicial approval, which is consistent with the concept that receivers serve as officers of the court. However, both the appointment of a receiver and approval of his or her decisions are subject to an abuse of discretion standard, which is a low bar with a relative dearth of case law even defining what this standard means in the context of a receivership.

While SEC receivers technically owe fiduciary duties to the company that owns the assets they are overseeing, they will often take the position that those assets are properly the property of defrauded investors. Absent outright theft or gross mismanagement by the receiver, these fiduciary duties are of little moment; receivers' true duties are to the court.

In short, SEC receivers have vast powers and authority that are constrained only by the whims of the particular judge overseeing them.

By comparison, bankruptcy trustees are governed by the Bankruptcy Code, which enumerates specific duties and obligations for liquidation and administration, and there is a body of established case law and statutes that sets boundaries upon them.

The Practical Reality: SEC Receivers Pick the Winners and Losers

The fact that receivers are less constrained than bankruptcy trustees is, in and of itself, neither a positive nor a negative for a company embroiled in a dispute with the SEC and facing serious fraud allegations.

Receivers are normally highly sophisticated and experienced professionals with the skills required to manage a company that has assets potentially tainted by fraud. As a condition of consenting to the appointment of a SEC receiver, the subject company may also have input into the choice of a receiver. Both of those are genuine advantages.

However, the strategic dangers for the company's management are significant and, depending on the circumstances, will outweigh those advantages because the SEC receiver is in a strong position — months and years down the road, long after management has left — to choose winners and losers in the assignment of blame and the distribution of assets.

While a bankruptcy trustee is tasked with helping find a fair outcome for creditors while preserving the business if possible, a SEC receiver is not. Fundamentally, the receiver's job is twofold: Preserve assets to satisfy a judgment and root out any ongoing fraud.

Accordingly, the receiver may dig into the business and its operations and thereby reach conclusions about the misconduct that gave rise to the SEC action. That undertaking will turn the receiver into an independent investigator who is empowered to probe into the circumstances of the alleged fraud and to report those findings to the court.

As the new management for the subject company, the SEC receiver — no different here from a bankruptcy trustee — will also control the attorney-client privilege and can choose to waive it in any such reports.

The SEC receiver's conclusions may have implications for civil or criminal charges being pursued against the company's former officers and directors, as well as their reputations. But since the receiver's report will typically be issued after management has departed, they may have no opportunity to provide input or to rebut the findings.

By virtue of the fact that the subject company is accused of violating the securities laws and may be guilty, SEC receivers are normally appointed where there are insufficient assets available to satisfy the company's creditors in addition to a potential judgment.

A receiver has broad discretion to address this situation through the handling of creditor claims, settling corporate liabilities and deciding whether to institute lawsuits to recover assets.

The appointment of an SEC receiver could thus work against the financial interests of former officers and directors who are looking to the company to advance legal fees to defend themselves, or who may be owed indemnification or compensation under agreements with the company.

SEC v. Direct Lending: A Case Study in the Choice of Winners and Losers

In particular, an SEC receiver can disadvantage creditors relative to bankruptcy, including former management and employees, when distributing assets to satisfy a judgment.

A recent and instructive example is found in SEC v. Direct Lending Investments, which involved a defunct private investment vehicle whose CEO allegedly had engaged in pervasive fraud and overcharged its investors approximately $11 million in fees.

In December 2020, the court approved the receiver's methodology for distributing approximately $285 million in assets, which contained seven classes of claims in order of decreasing priority, with investors coming before general unsecured creditors, indemnification claims by former officers and directors, and claims by three counterparties.

Accordingly, the receiver favored investors over certain creditors in the recovery queue, even though equity holders are traditionally at the end of the line.

The receiver provided no explanation for his treatment of the unsecured creditors. With respect to the last two classes, the receiver noted that he intended to object to their claims in the unlikely event any funds were available for distribution.

Putting aside whether or not the receiver had a basis for opposing the claims, which is a separate issue from priority, his reasoning suggests that their lack of priority was based, at least in part, on the receiver's view that the parties were collectively culpable — morally, if not legally — for the fraud in a way that investors were not:

> I believe that payment in full to DLIF Investors is appropriate prior to any payment being made to Class 5 (Unsecured Creditors), Class 6 (Unliquidated Indemnity Claims) and Class 7 (Counter-Party Claims) of the Distribution Plan as courts commonly prioritize claims of innocent investors in a fraudulent scheme over other non-secured creditors.[3]

Classes 5 through 7 were effectively wiped out based on the receiver's unilateral determination — which was not subject to any standard of proof or due process safeguards — that investors were now elevated to another type of unsecured creditor, and one of which was more deserving of a recovery than general unsecured creditors.

While theoretically possible that some of those creditors could have objected in court to the receiver's prioritization, there was little incentive for them to do so given the costs and limited likelihood of success.

The Direct Lending receiver made a normative determination with respect to Classes 5 through 7 that is at odds with bankruptcy law. Section 501(b) of the Bankruptcy Code allocates creditor/shareholder risk by categorically subordinating most types of legal claims asserted against a debtor by equity holders in respect of their equity holdings.

This provision helps to ensure that unsecured creditors come before investors, irrespective of the perceived equities, in distributing the debtor's assets.

No Going Back After Appointment of SEC Receivers

Companies and their counsel should also be aware that once an SEC receiver has been put in place bankruptcy may no longer be an option. In its 2010 decision in SEC. v. Byers, the U.S. Court of Appeals for the Second Circuit found that "district courts may issue anti-litigation injunctions barring bankruptcy filings as part of their broad equitable powers in the context of an SEC receivership."[4]

This means that once a company is in receivership, it is difficult for any stakeholder to extract the company from it. Other appellate courts have reached a similar conclusion. It is now a regular occurrence for orders appointing an SEC receiver to contain language barring an involuntary bankruptcy filing.

As a result, a company or its creditors hoping to head off the appointment of an SEC receiver will need to win a race to the courthouse. If the SEC obtains a preliminary injunction and an appointment of a receiver, the company and its creditors may lose the later opportunity to seek the protection of bankruptcy.

Conclusion

Filing for bankruptcy is not a one-size-fits-all alternative to an SEC receivership.

Companies must meet the statutory requirements to file for protection under a given chapter of the Bankruptcy Code. They must also balance the risks of both options, including whether cooperation with the SEC through appointment of a receiver would justify losing

control of the company.

If these hurdles are satisfied, though, filing for bankruptcy and availing itself of the well-defined protections of bankruptcy law may be an attractive alternative to a client staring down a singularly focused SEC receiver.

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[1] Investor Bulletin: 10 Things to Know About Receivers, SEC: Investor Alerts and Bulletins (Aug. 25, 2015).

[2] See, e.g., SEC v. Stefan Qin et al., Case No. 20-cv-10849 (S.D.N.Y.); SEC v. SiliconSage Builders, LLC et. al., No. 20-cv-09247-SI (N.D. Cal.); SEC v. TCA Fund Management Group Corp., et. al., No. 20-21964-CMA (S.D. Fla.); SEC v. Kinetic Investment Group, LLC et al., No. 8:20-cv-00394-WFL-SPF (M.D. Fla.).

[3] SEC v. Direct Lending Investments, LLC, No. 2:19-cv-02188 (C.D. Cal. Dec.18, 2020), [Dkt. #321-2], Declaration of Bradley D. Sharp, at 10-11.

[4] S.E.C. v. Byers , 609 F.3d 87, 91 (2d Cir. 2010).