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North Carolina Receiverships and the new North Carolina Commercial Receivership Act

Related Professionals

Brooks F. Bossong
336.387.5169
bbossong@nexsenpruet.com

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The North Carolina Commercial Receivership Act went into effect a year ago. The Act, codified in Article 38A of Chapter 1 of the North Carolina General Statutes, was the first substantive update to existing North Carolina receivership legislation in years. The receivership legislation prior to January 1, 2021—the date the Act went into effect—was less than a dozen pages in length and had remained relatively unchanged for decades. Prior to the Act, the consensus among creditors rights practitioners was that North Carolina's receivership legislation provided a woefully insufficient framework for the prosecution and administration of modern receiverships.

Q: What is a receivership generally?

A: A receivership is a civil action typically filed in state court by a secured creditor to have a "receiver" – which can be an individual or entity – appointed by the court to take control of and preserve collateral when a loan is in default. When the lender has a blanket senior lien covering all of the borrower's assets, and the borrower is an operating concern, that often means the receiver will be taking over control of the borrower's business operations. Typically, in the receivership context:

- the borrower is an entity – either a corporation or limited liability company;
- some or all of the owners of the borrower entity are involved in managing the entity (either as officers of a corporation or managers of an LLC);
- the owners are usually guarantors of the loan;
- the collateral consists of all or almost all of the borrower entity's assets;
- the borrower entity is an operating concern that's producing income and requires active management/oversight, such as a hotel, an apartment complex, a farm, a chain of convenience stores, a commercial real estate property, or even a specialized manufacturer;
- in contrast to collateral which does not involve an operating concern, such as non-income producing real estate, that a lender can simply

foreclose against without having to worry about preserving going concern value); and

→ the loan is in default.

Q: You said "typically filed in state court," can a creditor bring a receivership in federal court?

A: Yes, a receivership can be brought in a U.S. district court. While federal receiverships are less common than state court receiverships, federal receiverships are useful tools when the borrower owns properties in multiple states. That's because a receiver in federal court can act across state borders, wherever the debtor owns property in the U.S. That feature – a receiver's control over a debtor's property in multiple districts – is specifically provided for in 28 U.S.C. § 754. That's in contrast to a state court receivership in which the receiver's reach is limited to the borrower's assets within the state.

Q: Why is a receivership particularly suited for collateral consisting of an operating concern?

A: It's a matter of preserving the collateral's "going concern" value. If you're the lender and your borrower is a business entity, and your loan to that business entity is secured by all of the business's assets, and that business entity consists of some type of operating concern that's generating cash flow, such as a hotel, apartment complex, farm, commercial real estate property, etc., typically that business is going to retain its value only as a going concern. Remember, the lender's objective is not to have the receiver take over and operate the business long term but, rather, manage the business long enough so that it can be prepared for sale to a third party in order to pay down the indebtedness under the loan. That third-party buyer is going to pay a lot more for a hotel that is operating than a hotel that's been shuttered for months and has no cash flow.

Q: Who picks the receiver?

A: The court appoints the receiver. In practice, the creditor typically selects the receiver but the court has to be satisfied that the receiver is actually qualified to act as a receiver for the particular collateral subject to the receivership. With collateral that consists of an apartment complex, for example, the receiver will be a property management company that has a track record managing such properties in receivership. If the collateral is a hotel, the receiver will be a company that specializes in acting as a receiver for collateral consisting of hotels.

The receiver in the commercial loan context is often an entity -- as opposed to an individual – and, as noted, that receiver entity will have substantial experience acting as receiver for the particular type of collateral at issue. Bear in mind that the receiver will be taking over the management of the collateral—be it a hotel, a farm, or apartment complex—and the receiver will effectively move the borrower management team out of the way and take over the borrower's operations. And for the duration of the receivership proceeding, the receiver will continue to manage the business/collateral until the collateral can be sold and the sale proceeds are applied to the loan balance. That's why it's critical to have the right receiver in place for the particular collateral at issue. As a quick aside, while a receiver in the commercial loan context is usually an entity, receivers can be individuals as well. For instance, there are attorneys in North Carolina who specialize in acting as receivers in the agricultural loan context.

Q: Let's look at this from the perspective of the borrower – what if you're the borrower, a going concern business entity, and you (or rather the business owners) oppose the receivership, how do you—the borrower and its owners--do that?

A: One way is for the borrower to file Chapter 11 – that will stop a receivership proceeding in its tracks. Filing a Chapter 11 is an expensive process. But if the borrower wants to remain in control of its destiny and is confident it can successfully complete a plan of reorganization, Chapter 11 would be the answer.

Q: What if the borrower doesn't want to do something as drastic as filing Chapter 11 – the borrower simply wants to oppose the receivership from its role as the party defendant in the receivership case, is that an option?

A: While any defendant—and the borrower is a defendant in the receivership case--has the right to raise meritorious defenses and counterclaims, the reality is that almost all commercial loan documents contain receivership as a remedy in the event of the borrower's default. With a receivership provision in the loan documents, the lender doesn't have to show fraud or gross mismanagement by the borrower, just evidence of default. So if the borrower is delinquent in its payments or is in default under some other provision of the loan documents (e.g. failed to maintain insurance on the collateral, failed to pay property taxes on the collateral, refused to provide copies of its financials/tax returns to the lender), default is relatively easy for the lender to prove, and difficult for the borrower to contest, triggering the lender's right to receivership as a remedy.

I should also add that in those cases where the collateral consists of all of the borrower's assets and accounts, the court order appointing the receiver is very comprehensive:

→ It gives the receiver immediate control of the borrower's finances and accounts;
→ It provides injunctive relief (meaning the borrower and its managers are prohibited from interfering with the receiver); and
→ The order will provide that, if necessary, the sheriff is authorized to enter the premises of the borrower, take possession of the personal property collateral, and deliver it to the receiver.

As you can see, a receivership is a powerful tool. If the borrower and its owners do not cooperate in surrendering control of the collateral pursuant to the receivership order, or if they interfere with the receiver, they can be held in contempt of court – individuals violating the order can actually be arrested. A receivership order does have teeth.

Q: If a receivership is difficult to contest, can the borrower and its owners simply consent to the appointment of a receiver to take over the borrower's assets and operations?

A: Yes, in practice, that actually happens quite a bit – the borrower entity and its owners will agree to the receivership before it's even filed. In that case, the parties will submit a consent order for the appointment of a receiver to take over operations, finances, and accounts.

If the borrower and its owners are being particularly cooperative, and the parties get ahead of the curve, sometimes filing the receivership can be avoided by the parties simply entering into a forbearance arrangement. In that instance, the parties will agree that the lender will hold off putting the borrower in receivership in exchange for the borrower satisfying certain terms within certain timeframes, and if the borrower is ultimately unable to satisfy those terms, then the borrower consents to the appointment of a receiver.

But there are times when the borrower and its owners are uncooperative or even refusing to communicate with the lender, leaving the lender with no choice but receivership. In exigent circumstances, a lender can obtain a receivership order from the court without notice to the borrower, so that the borrower does not know the receivership is in place until the receiver's management team (with the deputy sheriff) appears at the borrower's office to take over operations. Typically this is done when the loan is in default and the collateral is being mismanaged by the borrower (or there's evidence that the owners/guarantors are siphoning funds from the borrower). In these circumstances, the borrower and its owners can still contest the receivership in court. But--if the receiver was appointed without notice to the borrower, and the receiver has taken control of the collateral, including the borrower's premises and accounts--the borrower and its owners will be contesting the receivership from a position in which they no longer have possession and control of the collateral.

Q: What is the relevance of the North Carolina Commercial Receivership Act given that North Carolina already had receivership legislation?

A: The Act, which has been in the works for several years, replaced the portion of receivership law pertaining to receivers of corporations. But it did more than merely replace this legislation – the Act provides a detailed, comprehensive framework for the prosecution of receivership proceedings in the commercial context. That's in contrast to the old "Receivers of Corporations" legislation it replaced, which had just 11 sections, was woefully sparse, and simply did not provide adequate statutory guidance. The Act, in contrast, has over 30 sections, provides detailed direction, and eliminates much of the uncertainty that existed prior to the Act.

The Act formally recognizes two forms of receivership, the "general receivership" and the "limited receivership." Under the Act, the general receivership (the more common of the two) is somewhat comparable to having a trustee in bankruptcy taking control of all of the debtor's assets. There's a limited automatic stay so that, once the receiver is appointed, the receiver isn't having to deal with multiple competing creditors—on a piecemeal basis—who are trying to collect from the borrower or repossess portions of the collateral that constitute the receivership property. The receiver is empowered to sell assets free and clear of liens (a thorny issue prior to the Act). The receiver has the power to incur and pay expenses in connection with the receivership property, enter into contracts relating to the receivership property, assert the same rights and claims the debtor has—or had--with respect to the receivership property. For instance, the receiver can sue for and collect debts owed to the debtor in connection with the receivership property, and can settle claims involving the receivership property. Moreover, under the Act, the judge who appoints the receiver retains jurisdiction of the case--as in bankruptcy--so you don't have multiple judges overseeing the case during the course of the receivership proceeding. And receiverships involving over $5 million in assets are assigned to the Business Court.

The overall relevance of the Act is that we now have this detailed, statutory framework providing much needed guidance—in contrast to the minimal framework of the past--so that the receiver's powers are clear and enforceable by the court, thereby enabling the receiver to prosecute the receivership in an organized, comprehensive manner with authority. The receivership, which was a relatively underutilized tool in the past--and I think that was in part because of the gaps and uncertainties under the old legislation—is a very potent tool in the correct circumstances. Since the Act went into effect, we have seen an increased interest and understanding on the part of our lender clients in receivership as a remedy, and we've seen an uptick in receivership activity.