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The North Carolina Commercial Receivership Act: What Creditors Need to Know About the New Statute

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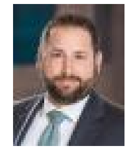

On July 1, 2020, Governor Cooper signed the North Carolina Commercial Receivership Act (the 'Act') into law.

The Act, spearheaded by the Bankruptcy Section of the North Carolina Bar Association, takes effect on January 1, 2021, and provides creditors in North Carolina a more robust, present day receivership remedy.

What is a Receivership?

A receivership is a court proceeding where a receiver (an independent party) is appointed by the court to take temporary control and responsibility of the assets of a business or individual. There are two basic forms of receivership under the Act. The receiver's role in a *general receivership* is very similar to that of a trustee in bankruptcy, acting to preserve assets and oversee a controlled liquidation of the debtor's assets and distribution to creditors. In a *limited receivership* (the default proceeding under the statute), the receiver will only control a portion of the debtor's non-exempt property, as part of a secured creditor's efforts to exercise remedies against collateral. The extent of the receiver's reach in a limited receivership must be specifically identified in an order appointing the receiver.

In general, a receiver can do any number of things, including:

- Manage and operate a business in the ordinary course;
- Take possession of, collect, control, manage, conserve, and otherwise protect receivership property;
- Incur and pay expenses incidental to the exercise of the receiver's powers;
- Obtain financing, which will be paid as an administrative expense of the receivership;
- Assert rights, claims, causes of action, or defenses on behalf of the debtor;
- Demand and file lawsuits for the collection of debts and rents;
- Enter into contracts to assist with liquidation efforts;
- Sell, lease, license, exchange, or otherwise dispose of receivership property with court approval;
- Sell assets free and clear of liens, with liens attaching to sale proceeds (similar to the procedures used in bankruptcy proceedings); and
- In general receiverships, file a bankruptcy proceeding.

A receivership can be a useful tool for various reasons. Sometimes, a creditor may want to prevent an interruption to the debtor's ongoing business operations which typically coincides with initiating a foreclosure action, or they simply don't want to take title to real estate collateral. Appointing a receiver can act as a substitute for a typical foreclosure action and avoid those scenarios, and add another layer of protection where a creditor is concerned about a potential decrease in the value of the collateral. Receiverships immediately remove the debtor from controlling its own assets and provide an avenue for an independent receiver to stabilize a business, investigate malfeasance, and even market and sell the debtor's assets.

How is the receivership initiated?

As the name of the Act implies, receiverships under the newly created statute are only available to *commercial* debtors, and will mostly be applied to corporations, limited liability companies, and partnerships. However, the Act's protections also extend to *individual* debtors, so long as their debts incurred primarily for personal, family, or household use do not exceed 50% of their total debt. There are also limitations that prevent the appointment of a receiver where the debtor is a non-business trust, an estate, an individual in military service, or a state agency.

A receivership commences with the filing of a civil action in state court and can be brought by either a creditor or a debtor. In addition, the action can either be brought ancillary to a pending action (such as part of a lender's foreclosure under a power of sale provision or judicial foreclosure action) or as its own independent action.

Importantly, the Act expands the grounds for when a party may appoint a receiver. Under the old laws, in order to have a pre-judgment receiver appointed, the lender would need to prove its collateral was in danger of being lost, materially injured, or impaired (a relatively steep burden). Under the new Act, a lender can seek the appointment of a limited receiver *pre-judgment* by showing either (i) the collateral is in danger of waste, loss, dissipation, impairment, or a voidable transfer, or (ii) the debtor agreed to the appointment in a deed of trust or another security document. If the creditor wishes to appoint a receiver after a judgment is entered, the bar is even lower. A limited receiver may be appointed *post-judgment* to simply carry out the effect of the judgment, dispose of property pursuant to the judgment, preserve property pending an appeal, or force the application of property to satisfy a judgment. In addition, either a general or limited receiver may be appointed *at any time*, if the debtor is insolvent or in imminent danger of insolvency, the debtor is unable to pay or not paying their debts as they become due, the business debtor is suspended for want of funds, or its existence is terminated or subject to a dissolution proceeding.

Who is qualified to serve as a receiver?

Generally, any person, who is independent to any party in interest, can be appointed as a receiver. Typically, the receiver is going to be a professional, such as an accountant, manager, or attorney who devotes a portion (or all) of their practice to receiverships. While the parties may nominate someone to serve in the role, the receiver must be found to be qualified, and their appointment is subject to court approval.

Once appointed, the new Act allows a single judge to oversee the receivership until it is terminated and the receiver discharged. This provision is one of the hallmark accomplishments of the Act, as it ensures a presiding judge will gain familiarity with a particular case, and preside over all aspects of the case. This critical component ensures the entire receivership process is streamlined.

How is the Act beneficial for creditors?

The ability of the debtor to sell property free and clear of liens (with court approval), provides an enticing mechanism to lenders who wish to avoid the bankruptcy process, but also want to liquidate their collateral without filing a foreclosure action. In general, a debtor's assets may be sold, regardless of whether the sale proceeds satisfy all liens and claims, unless (i) a secured creditor's lien or debtor's claim of exemption will not be paid in full from the proceeds of the sale, (ii) the secured creditor objects to the motion to sell within 14 days, and (iii) the court determines the amount likely to be received by the objecting party would be less than the amount they would likely receive within a reasonable time absent the receiver's sale. If approved and sold, all liens on the collateral would simply attach to the sale proceeds with the same validity, perfection, and priority the lien had prior to the sale – similar to sales authorized through the bankruptcy process.

The Act also consolidates the collection of payments, by requiring all parties indebted to the debtor to pay the receiver directly. This reduces the potential for lost payments and better ensures that rents from income-producing property are accounted for. In addition, if the receivership involves more than $5 million in assets, the case is automatically designated as a "mandatory complex business case," and assigned to the North Carolina Business Court.

Are there any drawbacks?

Similar to bankruptcy proceedings, the entry of an order appointing a receiver creates a limited automatic stay over most receivership property. This automatic stay prevents creditors from filing lawsuits, pursuing possession of collateral, enforcing a judgment, or perfecting liens in receivership property. However, unlike bankruptcy, the limited stay does not prohibit creditors from exercising their right of setoff or enforcing a pre-existing lien with higher priority than the receiver. In addition, general receiverships provide for an expanded automatic stay which contains more onerous restrictions and lasts for up to 60 days following the appointment of the receiver.

The Act also provides for various penalties in the form of sanctions and/or civil contempt for parties who violate the automatic stay provisions. This may include recovery of reasonable attorneys' fees for most violations, and in cases where a creditor's request to appoint a receiver is found to have been made in bad faith, may even include punitive awards.

Conclusion

Receiverships have been around for some time, but, under the new streamlined Act, the process has become more accessible to both debtors and creditors. While the benefits may not fit each and every situation, it can certainly be another valuable tool at a creditor's disposal. With careful planning and implementation, a creditor can leverage the Act to increase their chances of recovery.

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 For further information regarding the issues described above, please contact Thomas C. Wolff.

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