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From the Bankruptcy Courts: The Small Business Investment Company: Power of Federal Injunction Vs. the Bankruptcy Code

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When a business seems to be tottering on the rocks, its chief operating officer often considers chapter 11 as a safe harbor for rehabilitating the company back to financial health. Other alternatives for saving the business also may be explored, thus delaying the decision to seek relief under the Bankruptcy Code. When nonbankruptcy alternatives are considered but found to be unattractive or ineffective, chapter 11 relief may seem even more inviting. However, the delay may frustrate the chief operating officer's quest for reorganization when an event such as the appointment of a temporary receiver by a federal district court intervenes. This scenario seems to have been played out in *United States v. Vanguard Investment Company, Inc.*[1]

Vanguard was licensed in 1970 by the Small Business Administration (SBA) as a small business investment company (SBIC) under the Small Business Investment Act of 1958.[2] In accordance with statutory authority, between 1974 and 1979 the SBA purchased from Vanguard $500,000 worth of preferred stock, as well as subordinated debentures in the face amount of $1,270,000.

TRO and Temporary Receivership

However, on June 11, 1987, the SBA commenced an action against Vanguard in a federal district court in North Carolina alleging that the SBIC committed several regulatory violations and thus should be dissolved and liquidated. On the same day the SBA applied for a temporary restraining order, preliminary injunction, and temporary receivership. On June 16, the district court held a hearing on the motion and entered a temporary restraining order and appointed a temporary receiver. "The June 16, 1987, Order

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[1] 667 F. Supp. 257 (M.D.N.C. 1987).

[2] See 15 U.S.C. § 681(d).

brought Vanguard under the exclusive jurisdiction of the Court and ended the authority of Vanguard's directors, officers, employees, and agents to act on behalf of Vanguard."[3] The parties stipulated that the order would be effective until the preliminary injunction matter was heard and ruled on.

Prior to the hearing on the preliminary injunction, but approximately three weeks after the June 16 order, the president of Vanguard filed a chapter 11 petition on behalf of the corporation without seeking leave of the district court. However, the filing of the chapter 11 petition did not deter the district court from proceeding with the hearing on the preliminary injunction notwithstanding the automatic stay provisions of the Bankruptcy Code enjoining actions against the debtor.[4]

Chapter 11 Petition Was a Nullity

The court's reasoning was predicated on the finding that "actions by any of the suspended directors, officers, or employees purporting to put Vanguard into bankruptcy were a nullity; and therefore, did not invoke the automatic stay provisions of 11 U.S.C. section 362."[5] The court noted that in its June 16 order, the court took exclusive jurisdiction of Vanguard and suspended the authority of all directors, officers and employees to act on its behalf. A temporary receiver was given all authority to act for Vanguard for the purpose of conserving and preserving its assets. The court justified the issuance of such a broad order by citing the Small Business Investment Company Act section that provides that the court "may, to such extent as it deems necessary, take exclusive jurisdiction of the licensee."[6] Accordingly, the president had no authority to file a chapter 11 petition on behalf of Vanguard after June 16 and "his actions were null and void, being without legal effect."[7] The court did not hold that the appointment of a temporary receiver rendered a company ineligible for bankruptcy relief. However, quoting from *Commodity Futures Trading Co. v. FITC, Inc.*,[8] the court observed:

> Once a court appoints a receiver, the management loses the power to run the corporation's affairs. The receiver obtains all the corporation's power and assets. . . . Thus, it was the receiver, and *only* the receiver, who this Court empowered with the authority to place [the debtor] in bankruptcy.[9]

The court in *Vanguard* also cited dicta of the Court of Appeals

[3] 667 F. Supp. at 259.
[4] See 11 U.S.C. § 362.
[5] 667 F. Supp. at 259.
[6] 15 U.S.C. § 687c(b).
[7] 667 F. Supp. at 259.
[8] 52 Bankr. 935, 937-938 (N.D. Cal. 1985).
[9] 667 F. Supp. at 259-260.

for the Ninth Circuit, indicating that leave of the court is required for a corporation to file a bankruptcy petition in the face of a stay issued as part of a temporary restraining order and appointment of a temporary receiver.[10]

What Should Company Have Done?

What course should the company have taken under the circumstances? The district court answered this question by suggesting that "Vanguard should have moved this Court for leave to file a bankruptcy petition."[11] The court then could have considered "whether Vanguard was entitled to file a bankruptcy petition as a matter of right and whether such petition should be allowed as a matter of equitable discretion."[12] By referring to equitable discretion, the court apparently was relying on the language in *Commodity Futures Trading Co. v. FITC, Inc.*,[13] indicating that while not a common occurrence, a court may preclude bankruptcy relief if compelling circumstances exist. Nonetheless, having acted without authority and in violation of the receivership and temporary restraining order, Vanguard's purported chapter 11 petition was without legal effect and the court did not have to consider whether bankruptcy relief should be available under the circumstances.

Another Approach

The court in *Vanguard* noted that its conclusion would have been the same under a different analytical approach used by the Court of Appeals for the Second Circuit in a similar case. In *United States v. Royal Business Funds Corp.*,[14] the SBA and a SBIC were involved in a dispute and, as a result, the court issued a restraining order. The SBA was appointed as receiver and the SBIC subsequently filed a bankruptcy petition without leave of the court. However, the court in *Royal* did not face the issue whether the bankruptcy petition was null and void as a procedural matter because of the receivership. "Instead the court implied that the procedural validity of the petition filed without leave and in violation of the restraining order is determined by whether the SBIC has the substantive right to enter bankruptcy."[15]

Although in *Royal* the court recognized the general rule that the pendency of an equitable receivership rarely precludes a bankruptcy petition, and that an SBIC receivership is governed by

[10] See SEC v. Lincoln Thrift Ass'n, 577 F.2d 600, 604 n.2 (9th Cir. 1978).
[11] 667 F. Supp. at 260.
[12] *Id.*
[13] 52 Bankr. 935 (N.D. Cal. 1985).
[14] 724 F.2d 12 (2d Cir. 1983).
[15] 667 F. Supp. at 260.

principles applicable to federal receivers generally, nonetheless "a debtor subject to a federal receivership has no absolute right to file a bankruptcy petition. . . ."[16] In *Royal*, the court disallowed the petition based on the circumstances of the case: there were no significant creditors other than the SBA; the debtor consented to receivership leading to further investment by the SBA; the receiver operated the SBIC for more than a year; the petition was filed by the debtor and not creditors; and the debtor offered no reasons justifying the petition.

Factual Basis of Decision

Applying the *Royal* approach, the court in *Vanguard* concluded that the factual circumstances similarly compelled disallowance of Vanguard's purported bankruptcy petition. At the June 16 hearing, Vanguard did not even mention its desire to file a chapter 11 petition although it had known for at least three years that it was in liquidation status with the SBA. Vanguard filed the petition, not creditors. The SBA was Vanguard's only significant creditor. Moreover, the SBA showed that Vanguard violated several SBIC regulations. The court also pointed out that the receiver would be under court supervision and that all parties' rights would be protected. "Vanguard has not pointed to any specific reasons why under the facts of this case, a proceeding in bankruptcy would be fairer or more efficient either to itself or to creditors, than a receivership."[17]

Upon disregarding Vanguard's chapter 11 petition, the court turned to the merits of the SBA's motion for preliminary equitable relief. The court held that the statutory requirements for a preliminary injunction and temporary receivership had been met. Vanguard had violated several regulations regarding capital impairment, failure to make interest payments, and failure to meet financial reporting requirements. "Given the nature of Vanguard's regulatory violations and SBA's long-standing attempts to resolve them, the Court believes it must continue to exercise exclusive jurisdiction over Vanguard and maintain the SBA as temporary receiver."[18]

Conclusion

Prudent directors and officers will consider carefully all alternatives to the filing of a chapter 11 petition with the hope of selecting the most feasible and appropriate avenue for business rehabilitation. However, such delay in

[16] 724 F.2d at 16.

[17] 667 F. Supp. at 261.

[18] *Id.* at 263.

reaching a decision regarding the filing of a chapter 11 petition could become detrimental if a federal equitable receivership is ordered before the filing. This danger is most significant in regulated industries governed by federal statutes that provide for receiverships such as the Small Business Investment Act of 1954. Although a receivership does not, in and of itself, preclude bankruptcy relief, a debtor subject to a federal receivership has no absolute right to file a bankruptcy petition and, depending on the particular circumstances of the case, federal courts have disallowed such petitions purportedly filed on behalf of the debtor. As indicated in *Vanguard*, a federal equitable receivership deprives the directors and officers of the debtor of the power to file a chapter 11 petition on behalf of the company without first moving for leave of the district court to file the petition. Based on *Vanguard* and on the *Royal* method of analysis, such leave will not be granted automatically.