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CONSENT RECEIVERSHIPS IN FEDERAL EQUITY PRACTICE

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THE ECONOMIC strains of the past several years, combined with the heavy load of fixed indebtedness accumulated during the years of so-called prosperity, have focused the attention of courts, attorneys, and financiers most acutely and most distressingly on receiverships and corporate reorganizations. In many cases, the only remedy, always a violent one, has been liquidation through foreclosure or bankruptcy. However, contrary to the charge frequently made that the legal system is too rigid to meet changing conditions, the Federal courts have permitted the evolution of a system of consent receiverships, which grant breathing spells to corporations that might otherwise be forced into liquidation with loss to all parties interested.

Because of several decisions in the state courts opposed to consent receiverships, such receiverships, as an equitable remedy, have been developed by, and almost exclusively confined to, the Federal equity courts.[2] This practice has been developed purely out of powers inherent in the equity jurisdiction and independent of any Federal statutory authority. At the outset, such practice was limited to corporations affected with a public interest, such as railroads, but in recent years, the precedent thus

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2 43 Harv. L. Rev. 1298, note 1, and references there cited.

established has been extended to include corporations of more diverse purposes. In fact, it has been suggested that this practice can be more satisfactorily followed in Federal courts than in state courts, because of the greater experience of the Federal courts with such litigation, the comparative uniformity of Federal rules and procedure in all districts, the greater intimacy of relationship between the various district courts, and the greater readiness of the Federal courts to assume ancillary jurisdiction.[3]

Obviously, in order to confer jurisdiction upon the Federal courts, the usual requirements as to diversity of citizenship and amount involved must be observed. Also, as suggested by Tracy,[4] care must be exercised that the bill filed omit any allegation of the insolvency of the defendant in order that, upon filing of consent by the defendant, the defendant will not commit an act that would open the way to the filing of an involuntary petition of bankruptcy.

One of the earliest cases in which the subject arose was that of *Re Metropolitan Railway Receivership*[5] in 1908. On a petition for a writ of mandamus, objection was raised that the court had no jurisdiction to appoint a receiver because the defendant admitted liability and joined in the prayer for the appointment. The court answered the objection in this language:

It is not necessary that the defendant should controvert or dispute the claim. It is sufficient that he does not satisfy it. It might be that he could not truthfully dispute it, and yet, if from inability, or, mayhap, from indisposition, he fails to satisfy it, it cannot be that because the claim is not controverted the Federal court has no jurisdiction of an action brought to enforce it. Jurisdiction does not depend upon the fact that the

[3] Some Legal Phases of Corporate Financing, Reorganization and Regulation, (The Macmillan Company, 1927): "The Foreclosure of Railroad Mortgages in the United States Courts," by James Byrne, pp. 77, 80.

[4] John Evarts Tracy, Corporate Foreclosures, Receiverships, and Reorganizations, (Callaghan and Company, 1929), sec. 33.

[5] 208 U. S. 90.

defendant denies the existence of the claim made, or its amount or validity.

In discussing whether the defendant can waive his right to trial by jury and confer jurisdiction upon a court of equity, Clark[6] comments:

Nevertheless if a court has jurisdiction of the necessary parties and jurisdiction of the subject matter, and general equity jurisdiction to appoint a receiver, then consent is not necessary to give such jurisdiction, but consent may amount to the defendant waiving his right to insist upon the simple contract creditor pursuing his claim in a law case, and such consent may amount to an agreement that the plaintiff's case should be presented in an equity proceeding and that a receiver be appointed.

A recent case in the Circuit Court of Appeals, *Zechiel* v. *Firemen's Fund Insurance Company*,[7] offers confirmation to Mr. Clark's statement by holding,

In the case of corporations, however, the courts have quite generally held that the debtor corporation may waive the taking of judgment and the return of an execution thereon unsatisfied.

From time to time, consent receiverships have been looked upon askance and as collusive and have been attacked both directly and collaterally, largely on the ground that the defendant has consented to the receivership. Admittedly, suspicion has often had some basis. However, as Judge Sibley of the District Court of Georgia said in *Birmingham Trust and Savings Company* v. *Atlanta, Birmingham and Atlantic Railway Company*,[8] a consent receivership, in which a dispute arose over wage scales:

While it appears from the evidence that the receivership was sought by the Railway Company, and from the record that the creditor's principal debt was not due, and that the allegations of its petition were admitted and its prayer for a receivership joined

[6] Ralph E. Clark, A Treatise on the Law and Practice of Receivers, (2d Ed.), I, sec. 188.

[7] 61 Fed. (2d) 27.

[8] 271 Fed. 731.

in by the defendant company, the proceeding was not collusive. The debt was a real and valid debt, and its not being due nor reduced to judgment did not necessarily defeat the relief. The allegations as to the condition of the company were true and must have been admitted by a truthful answer. The friendliness of the proceeding did not render it fraudulent.

In support of its decision, the court cited the *Metropolitan Railways Receivership.*[9]

Judge Bourquin of the District Court of Montana has been a vigorous and an aggressive foe of consent receiverships. In the case of *Hardy* v. *North Butte Mining Company,*[10] the court of its own motion issued an order to show cause why an order of appointment for receiver made by a judge sitting in Judge Bourquin's court during his absence should not be vacated. The defendant was a Minnesota corporation owning mines at Butte. On a claim of $6,500.00, the plaintiff filed a bill in equity petitioning for the appointment of a receiver in a Minnesota district court. Two receivers were there appointed, one a clerk in the defendant's office. Ancillary proceedings were brought in Montana. The same receivers were there appointed. Judge Bourquin said:

> This is one of those too common receiverships which, like improvident injunctions, are in abuse of the powers of the courts, work injustice, visit scandal and reproach upon the judiciary, and incite the storms of judicial recall, which persistently lower along the political horizon.

Referring to the fact that no creditor joined in the plaintiff's petition, Judge Bourquin stated:

> Plaintiff has an adequate remedy at law. His tender solicitude for others may be affecting, but appeals none to a court of equity, and "an onion holds the tears which should water his grief."

In vacating the appointment of the receiver, the court outlined the essentials of such appointments:

[9] 208 U. S. 90.
[10] 20 Fed. (2d) 967.

It is a serious matter for a court to oust owners, and possess and operate their properties by the hand, arm, agent, or receiver of the court. The court's discretion to that end should be exercised only on a strong showing in bona fide and genuine litigation, when absolutely necessary to preserve property for those who may ultimately be proven to be entitled to it. Corporations are not entitled to receiverships, save where persons would be; and neither are at liberty to invoke receivership merely to stay creditors' actions, which might be embarrassing, to gain a breathing spell, when debts are pressing and money scarce.

The instant case lacks the necessary elements aforesaid. On the contrary, the suit is friendly, lacks good faith, presents no issue for litigation, is obviously collusive between an amiable creditor and quasi "dummy" plaintiff, and some faction of the corporation, to gain some inequitable advantage and to accomplish some ulterior purpose.

On appeal,[11] Judge Rutkin of the Circuit Court of Appeals, held that an order for appointing a receiver made in a suit within the jurisdiction of the court, and in the exercise of judicial discretion, may not be vacated by another judge sitting in the same court on the same record as having been improvidently named.

Shortly thereafter, the same defendant was before Judge Bourquin in *Central Union Trust Company of New York* v. *North Butte Mining Company et al.*,[12] an action to foreclose a trust deed in which the ancillary receivers, who were joined as defendants, asked that the suits be consolidated and that they remain in possession of the property covered by the trust deed. Judge Bourquin held that the receivers were disqualified for "friendliness" and appointed a local attorney to possess the property under the trust deed.

In *O. M. Spratt Corporation* v. *Public Utilities Consolidated Corporation*,[13] on an application by the re-

11 22 Fed. (2d) 62.

12 26 Fed. (2d) 675.

13 57 Fed. (2d) 908.

ceiver for an order confirming and approving his final report, for his discharge and for exoneration of his bond, growing out of an ancillary proceeding in which the receiver in the primary jurisdiction, Minnesota, had, under order of the Minnesota court, sold all of the property located in Montana, Judge Bourquin discharged the receiver and dismissed the suit, but refused to confirm the final report and to exonerate the bond, adding in language that now has become characteristic:

> This is another of those receiverships akin to that of Hardy's case, . . .[14] which, despite some peculiar aspect, can be, as it should be, summarily terminated without detriment to any, if any, local creditor. Taking the pleadings for it, and that is all before the court, it is a consent receivership without equity, of a piece with like abuses which history records as the prime cause for legislative abolition of courts of chancery in not infrequent instances, and of a piece with analogous practices which incite Congress to limit jurisdiction until . . . federal tribunals inevitably will soon be little more than police courts.

Some of Judge Bourquin's most vigorous language appears in *May Hosiery Mills, Inc.* v. *F. & W. Grand* 5-10-25 *Cent Stores, Inc.*[15] In that case, the primary bill was filed in New York where Green, the executive vice-president of the defendant corporation was appointed receiver with the Irving Trust Company of New York as co-receiver. Ancillary proceedings were brought in Montana on a claim of $3,400.00. In refusing to appoint Green, Judge Bourquin said:

> Green is defendant's executive vice-president, in the circumstances an appointment appropriate to the end sought, but obviously impossible, if not downright indecent. . . . It is clear that the proceedings are collusive, sham, fictitious, in bad faith, of ulterior motive, for the benefit of the defendant alone; that there is no showing of necessity in creditor's behalf, no reasonable inference from the facts alleged that without the receivership they would lose a dollar; that plaintiff's case-made has adequate

[14] Hardy v. North Butte Mining Co., 20 Fed. (2d) 967.

[15] 59 Fed. (2d) 218.

remedy at law, and without need to pursue it by scores of counsel in forty jurisdictions, even though at defendant's expense, and is not within equity jurisprudence if within like jurisdiction; that to accomplish the illegal end sought, and as a party to the conspiracy, the aid of the court is solicited; that the latter's co-operation by injunction and receivership would be abuse of the power of the court though within it, in disregard of its right and duty, and perversion of process to the injury of creditors and others without notice and not before the court.

The court then fined the counsel for contempt, adding by way of further criticism:

That New York counsel are leaders and of "Who's Who" is of course. The experience, skill, finesse, effrontery, prestige, and impressive personality of counsel of that rank were necessary to devise the plan and program and impose it upon the courts. Unethical practice is by no means limited to the lesser of the bar. It is ventured that the most subtle and effective ambulance chasers operate on golf links, in the club, at the poker table, behind a smoke screen of claim agents, and in collusion with banks and trust companies who are the ostensible advertisers for business the profit of which is divided. Moreover, like Western Chinamen, all counsel should look alike, in court at least.

To Chief Justice Taft we are indebted for the opinion in the case of *Harkin et al., Receivers* v. *Brundage, Receiver, et al.*,[16] an action brought by the receivers appointed in the state court against the receivers appointed under the equity jurisdiction of the Federal court for the delivery of possession of property belonging to the Daniel Boone Woolen Mills. After a period of internal difficulties, a minority group had filed a stockholders' bill in the state court asking for an accounting and for the appointment of a receiver. The defendant's attorney, representing the majority group, asked for a continuance on the plea that an adjustment was being planned. The continuance was granted. The defendant's attorney then arranged that a non-resident simple judgment creditor file a creditor's bill in the

[16] 276 U. S. 36.

Federal court. The Federal receiver was appointed, a few days after the first hearing in the state court. In the Federal court, the defendant filed its consent to the receiver's appointment. Chief Justice Taft said: The desire of those who represent an embarrassed corporation to seek a refuge from active and urgent creditors under the protecting arm of an officer of the court, leads to strenuous efforts to frame a case which may under equity practice justify a receiver. More than this, circumstances which should have no influence lead the parties in interest to prefer one court to another in the selection of the person to be appointed as receiver with the hope on behalf of those in charge of the embarrassed corporation that the appointment may fall to one whose conduct will be in sympathy with, rather than antagonistic to, the previous management of the corporation, in the hands of which the embarrassment has arisen. As the Court of Appeals says, there should be no "friendly" receiverships because the receiver is an officer of the court and should be as free from "friendliness" to a party as should the court itself.

Justice Taft then ordered the receiver appointed in the Federal court to return the property in his possession to the receiver appointed in the state court upon confirmation of the acts of Federal receiver by the state court.

At this moment the latest decision from the United States Supreme Court on this subject occurs in *Michigan* v. *Michigan Trust Company, Receiver,*[17] where the receiver resisted an effort by the State of Michigan to collect a franchise tax. Justice Cordozo held that such tax could be collected, with this comment:

This court has had occasion to point out the abuses that can arise from friendly receiverships forestalling the normal process of administration in bankruptcy and enabling a tottering business to continue while creditors are held at bay. Receivers for conservation have at times a legitimate function, but they are to be watched with jealous eyes lest their function be perverted. For four years the business of this corporation

17 286 U. S. 334, (1932).

was carried on in Michigan by a chancery receiver in the hope that winding up and dissolution would thereby be averted. There should be no shift of the theory of the suit in these, its expiring moments. To protect through a receiver the enjoyment of a corporation privilege and then to use the appointment as a barrier to the collection of the tax that should accompany enjoyment would be an injustice to the State and a reproach to equity.

The latest case of this kind in the Middle West is the Studebaker receivership[18] in which Judge Wilkerson laid down a rule which appeals to sanity in this language:

Sometimes those in interest request that business be continued under such receiverships. Usually provision may be made for that by authorizing the receiver to employ those who are familiar with the business. In some instances the court may deem it advisable, for good cause shown, to name some one connected with the business as a receiver.

In all cases the following rules should be observed: If one receiver is appointed such receiver shall be a person who has no interest, direct or indirect, either as owner, officer, director, stockholder, trustee, officer for agent or trustee, creditor or otherwise in the property in receivership.

Such a person should be some one who has not been nominated or suggested by any one who has any such interest. If two receivers are appointed, at least one of them must have the qualifications above specified. If more than two receivers are named the majority of them must have the above mentioned qualifications.

In equity cases in which the appointment is by consent of the defendant, such appointment shall specify that it is a temporary one and shall provide for a hearing of the application upon such notice as the court may require, at which time every interested person shall have an opportunity to present objections to the application.

[18] Edward Iron Works v. Studebaker Corp. et al., Fed. Dist. Ct. of Nor. Ill., Eastern Div., Cas. No. 13095, in equity.

After the temporary appointment was made, apparently no objections were raised, inasmuch as the temporary receivers appointed were named permanent receivers.

By indirection at least, the recent amendment to the bankruptcy act recognizes the existence of the inherent power resident in the equity jurisdiction of Federal courts to appoint receivers in consent cases by saying:

> For all purposes of this section, claims against a railroad corporation which would have been entitled to priority over existing mortgages if a receiver in equity of the property of the debtor had been appointed by a Federal court at the date of the filing of the petition hereunder shall be entitled to such priority, and holders of such claims shall be treated as a separate class of creditors.[19]

From this wording, it might well be argued that Congress tacitly had recognized the practice of consent receiverships. However, from the decisions quoted it will appear that the courts are extremely reluctant to extend the practice of consent receiverships that have prevailed in railroad cases to ordinary corporations. The same confusion prevails that may be usually noted in the application of an old principle to a new set of facts.

Inasmuch as bankruptcy practice presents ample opportunity for voluntary receiverships, no particular odium should attach to the practice of permitting the defendant in equity to consent to the appointment of a receiver, except for the important distinction that such bankruptcy proceedings are expected to be of short duration and to terminate in liquidation while the equity receivership is anticipated as continuing for a longer period, or, at least, continuing until opportunity is afforded to determine whether the better course would be reorganization or liquidation through bankruptcy, and as terminating, probably, in reorganization rather than in liquidation. On analysis, does it not appear

[19] U. S. C. A., Tit. 11, Ch. 8, sec. 205, C, clause 9.

that the more vital difference between voluntary bankruptcy, a well established and fully legitimated practice, and consent receivership, now under suspicion and attack, is one of the duration of judicial supervision and control? Certainly consent receiverships present an opportunity that has not been and will not be, overlooked to place the defendant corporation in a position to bargain for and to obtain release from long term leases, contracts, and funded indebtedness; but are not the same opportunities, and with even greater freedom available under bankruptcy practice through the frequent resumption of business by parties interested in the original venture? If the courts demand the utmost good faith from all parties concerned, it would appear that the advantages to be obtained through an opportunity for orderly reorganization of a corporation rather than through distress liquidation should overcome the objections to this form of procedure. Probably, in the majority of cases, a consent receivership under proper judicial supervision would result in a larger recovery to creditors of all classes than through distress liquidation.