QUASI-BANKRUPTCY QUAGMIRES

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I. INTRODUCTION

This article explores the difficulties some entities have encountered in filing bankruptcies and how one organization used extraordinary civil remedies in an attempt to accomplish what a reorganization under chapter 11 of the United States Bankruptcy Code would have provided.

The United States Constitution, Article I, Section 8, provides, in pertinent part, that Congress shall have the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States." It is generally accepted that there is one uniform regime of bankruptcy law throughout the United States – title 11 of the United States Code. However, in the past several years, situations have arisen where bankruptcy protection has been elusive for parties in need of reorganization. What remedies do those unfortunate parties, who either do not qualify under the Bankruptcy Code, or who may qualify, but cannot effectively reorganize under title 11, have? Furthermore, if a receivership under federal law is an option, can it be used as an "offensive" remedy by a debtor against its creditors in an attempt to reorganize outside of title 11?

II. ENTITIES THAT *CANNOT* LEGALLY FILE FOR BANKRUPTCY RELIEF

Certain entities may be precluded by federal law or policy from filing for bankruptcy; and they may be forced to use alternative relief, if available. For instance, the Commonwealth of Puerto Rico found itself in a situation where it could not qualify for relief under chapter 9 of the Bankruptcy Code because 11 U.S.C. §101(52) specifically excluded it from the definition of a State *that may seek relief* under chapter 9, and the law its legislators passed to track the relief afforded to debtors under chapters 9 and 11 of the Bankruptcy Code (the Puerto Rico Public Corporation Debt Enforcement and Recovery Act) was held to be pre-empted by Bankruptcy Code Section 903(1). The latter section specifically bars States (in this context Puerto Rico was included in the definition of a State) from enacting "municipal bankruptcy laws."

In June 2016 the United States Supreme Court upheld lower court decisions which placed Puerto Rico in this "catch-22" (see, *Puerto Rico v. Franklin California Tax Free Trust*, 136 S. Ct. 1938 (2016)). It could not file for relief under title 11 (chapter 9, specifically), nor could it enact its own laws to provide equivalent relief. It stayed in this predicament until Congress passed the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) later in 2016, which created an oversight board and a process for Puerto Rico and its public entities to restructure their debt.

Similarly, businesses that legally, under state law, grow cannabis, manufacture derivates of the plants, sell the product, or lease real or personal property to cannabis related entities have found relief under title 11 to be challenging. The United States Trustee's Office ("UST"), as part of the Justice Department, takes the position that bankruptcy relief is not available to enterprises that violate the Federal Controlled Substances Act (CSA) or whose reorganization efforts depend on funds which can be considered proceeds from such violations.

In 2017, however, a federal district court upheld the attempt of a landlord of a marijuana grower to reorganize in the face of an argument by the UST that the debtor could not clear the hurdle of 11 U.S.C.§1129(a)(3) which requires that a "plan [be] proposed in good faith and not be any means forbidden by law." The court held that the Trustee relied on an extremely broad interpretation of this standard and that the debtor's 100% plan should be confirmed (*In re Cook Investments NW*, 2017 WL 10716993, December 18, 2017, D. Wash). On the other hand, this past December 2018, the United States Bankruptcy Court for the District of Colorado dismissed the chapter 11 case of three affiliated cannabis retail outlets due to the businesses having committed (unprosecuted) violations of the CSA. (*In re Way to Grow Inc, et al*, Jointly Administered as Case No. 18-14330, Order issued on December 14, 2018 at ECF No. 379). Both cases are on appeal, the Washington case in the 9th Circuit and the Colorado case in the district court.

III. ENTITIES THAT *CAN* FILE FOR, BUT *ONLY* WITH RESTRAINTS

The difficulty in accomplishing an effective reorganization due to impediments imposed by federal law and the resulting remedies enacted by the federal court was the ***central issue*** in the recent (and ongoing) federal receivership proceedings of Education Corporation of America and its affiliate Virginia College, LLC (collectively "ECA"). ECA is a nationwide conglomerate of 22 for-profit higher education institutions offering in-person and online programs. Many of its customers are "non-traditional" students who are older

than college-age, unemployed or underemployed and who are seeking job skills in order to find employment or change careers. The campuses are generally leased from landlords across the country.

ECA's revenues flow almost exclusively from tuition and fees paid by students, a significant majority of whom utilize federal grants and student loans. Consequently, ECA participates in student loan and financial aid programs under Title IV of the Higher Education Act of 1965 ("HEA") and administered by the United States Department of Education ("DOE"). These funds are paid to the institution as long as it remains an "eligible institution." However, Section 1002(a)(4)(A) of the HEA *defines an eligible institution as* ***one that has not filed for bankruptcy***. Consequently, if ECA were to have filed under the Bankruptcy Code, it would have been ineligible for future student loan and aid funds; and this would have wrecked any reorganization.

IV. A REMEDY OTHER THAN BANKRUPTCY

ECA's business, which had been failing for several years as the economy has improved and unemployment has been reduced, took a turn for the worse in 2018. In a creative attempt to obtain relief, ECA undertook a two-track strategy in order to "reorganize" its financial affairs.

First, on October 16, 2018 it filed a lawsuit in the United States District Court for the Northern District of Alabama against the DOE asking that the court declare that a proposed restructuring plan will not interfere with its ability to participate in the financial assistance programs regulated by the DOE, that the court issue temporary and preliminary injunctions against landlords and creditors nationwide in order to stay collection and ejectment proceedings and, that the court appoint a receiver over its assets (*Education Corporation of America, et al v. United States Department of Education*, et al, No. 2:18-cv-01698-AKK). The DOE responded with a vigorous opposition and a motion to dismiss which, among other things, asserted that there was no case or controversy between ECA and the DOE because the DOE had not taken any actions adverse to ECA. The court issued a temporary restraining order three days later and eventually conducted a hearing on the DOE's motion to dismiss and ECA's request for a preliminary injunction. Formal creditor participation in this matter was limited to appearances by telephone given the tight timelines, although several landlords objected to a nationwide injunction or a receiver by arguing

that ECA would receive the equivalent of a bankruptcy stay without corresponding obligations and without protections afforded to creditors in bankruptcy. They called ECA's attempt a "quasi-bankruptcy."

On November 5, 2018 the federal court in Alabama issued a memorandum opinion (2018 WL 5786077) in which it dismissed the case on jurisdictional grounds because ECA failed to show actual threatened harm from the DOE that was "concrete and particularized" and "actual and imminent." In other words, there was no case or controversy between ECA and the DOE. The court never reached the "quasi-bankruptcy" issues presented in this case.

Second, at approximately the same time that the Alabama case was filed, ECA took a separate strategy in Macon, Georgia. On October 9, 2018 it was sued by a landlord in state court for rent; and on October 18 it removed the case (based on diversity of citizenship) to federal court. See, (*VC Macon GA LLC v. Virginia College, et al*, 5:18-cv-00388-TES). One day after the Alabama case had been dismissed, ECA moved for the same relief it had sought in Alabama without the government involved. This time, there was more vociferous opposition from creditors, especially landlords who, by this time, had become more fully aware of what was transpiring.

V. THE MACON RECEIVERSHIP, INJUNCTION AND OTHER RELIEF

The federal court in Macon acted swiftly. On November 7, it issued a temporary restraining order staying any threatened or actual creditor actions against ECA, and on November 14, 2018, over creditor objections, it issued an Order Appointing Receiver and Preliminary Injunction which incorporated many of the stay provisions of 11 U.S.C.§362(a) and the typical duties of a chapter 11 bankruptcy trustee. That court found, among other things, that a receiver should be appointed because ECA demonstrated that there was an imminent danger of damage to the business and its stakeholders, that ECA's available legal remedies and less drastic equitable remedies were inadequate to protect its interest and the interest of other stakeholders, and that he probability of harm to ECA and its other stakeholders by denial of appointment of a receiver was greater than the injury to other parties. The Court also determined that ECA demonstrated a substantial likelihood of success on the merits and that it would suffer irreparable injury if the injunction were not

granted and that the injunction would not substantially injure other interested parties. *See* Order Appointing Receiver and Preliminary Injunction (ECF Doc. No. 26).

To obtain relief from the court's orders, the creditors (predominately landlords) raised issues of personal jurisdiction and due process – how could they be held subject to an injunction and receivership when they had not been served with process and were not named parties. They also argued that the receivership/injunction stripped them of many of the rights they would have had under the Bankruptcy Code. To name a few, there were no deadlines or prerequisites for the equivalent of assuming or rejecting leases (although, to be clear, "assumption" and "rejection" of leases are statutory creations of title 11); there was no explicit direction given to the Receiver to pay rent similar to a trustee's duties under 11 U.S.C.§365(d)(3); there was no process in place for filing or approval of a "restructuring" plan similar to the provisions of chapter 11; there was no claims process similar to 11 U.S.C. §§501-511; and there was no mechanism for a creditor terminating, annulling, modifying or conditioning the injunction similar to 11 U.S.C.§362(d). The court did make it clear from the bench that he expected the Receiver or ECA to pay rent.

The propriety of the receivership and injunction was and remains the greatest point of contention in the Macon case. The creditors generally argued that the receivership could only be used as an ancillary remedy to collection of a judgment, and under no circumstances could it be used offensively by a party. In other words, a party cannot obtain a receivership for itself to marshal its own assets. A receivership was no substitute for a bankruptcy proceeding. In addition, they argued that a nationwide receivership and injunction was overbroad and impermissible because the case was a "local suit" for unpaid rent that implicated no interest other than the plaintiff's in the suit.

ECA responded by pointing out that federal receivership statutes (28 U.S.C. §§ 754 and 1692) provide for nationwide jurisdiction over the receivership estates regardless of who is actually before the court, the court is vested with broad discretion in fashioning the receivership and injunctive relief that it created, ECA's claim of "hardship" supported the appointment of a receiver, and it did not make a difference who asks for a receivership to be instituted – the plaintiff, defendant or other parties.

Surprisingly, no party seriously pursued how Article I, Section 8 of the Constitution precluded (or impacted) the relief sought by ECA or whether the relief granted by the court deprived the landlord creditors of their property without just compensation under the Fifth Amendment of the Constitution. In addition, no party sought to file an involuntary bankruptcy action against ECA.

VI. POSTSCRIPT --THE UNRAVELING OF THE ECA CASE AND THE APPEAL

Before the Court could act on various motions to set aside the receivership and injunction, in early December 2018 ECA lost its accreditation and was placed on a heightened cash monitoring status by the DOE. This dried up its access to additional cash and changed the Receiver's charge from "reorganization" to an orderly liquidation, the sale of ECA's assets (most of which were subject to liens of lenders), and the exit of ECA from the various leased premises. Although a group of landlords appealed the court's receivership/injunction order, they eventually moved to dismiss the appeal. In addition, the Receiver proposed a claims process similar to the bankruptcy regime, so the court will supervise the liquidation of the estate as well as the claim process.

VII. CONCLUSION

Considering that the Macon litigation began when one landlord sued for rent owed on one ECA lease, and blossomed into the offensive use of a receivership and injunction by a debtor against its creditors, creditors should have a cause for concern. The briefs and arguments set forth in the Macon case can certainly provide a template for a landlord, or any creditor, who may face similar circumstances, to combat such situations.

Of course, any creditor, when entering into financial transactions with a party, must consider whether the other party would be subject to bankruptcy, whether it might file under receivership law, and how the creditor may be impacted by either event. While there are public policy restraints to contracting against the applicability of the automatic stay, such restraints may not apply to receiverships instituted by a debtor. *Ipso facto* clause prohibitions are creatures of bankruptcy law, not necessarily general civil law. Perhaps leases or other contracts should contain provisions preventing a party from requesting of a receivership over its own property or seeking an injunction to prevent lawful self-help or judicial actions.

Of course, if, a debtor is subject to a law that does not make it ineligible for bankruptcy, but makes bankruptcy a less desirous alternative, a creditor may file an involuntary case under 11 U.S.C. § 303 so it can obtain the benefits of title 11 and press for fair treatment.

The last chapter has not been written on the cannabis cases (especially if the use and sale of cannabis becomes more frequent) or the ECA type cases (if for-profit schools continue to have financial problems). Be on the lookout for continued litigation. It does not appear that these will be "one-off" situations.