BATTLE OF THE *BAYOU*: PLACING A RECEIVER IN THE RIGHT POSITION DURING A BANKRUPTCY PROCEEDING

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ABSTRACT

Investment Manager, Sam Israel, launched the Bayou Group LLC, a hedge fund, hoping to produce large returns for high net worth investors. After months of losses, it became clear to Israel that Bayou would never garner the types of returns he had promised investors. Instead of altering strategies or closing Bayou, Israel decided to convert Bayou into a Ponzi scheme.

When Ponzi schemes fail, they present unique challenges for courts, regulators, creditors, and interested parties. One choice stakeholders will have to make is whether to appoint a receiver to marshal assets and seek a recovery for defrauded investors and creditors, or whether to place the Ponzi scheme into bankruptcy and seek the appointment of a trustee. Typically, receivers are required to turn over possession to a trustee upon filing for bankruptcy. However, the United States Court of Appeals for the Second Circuit changed this rule when it decided *In re Bayou Group, LLC*.[1]

This Note examines when a receiver is not required to turn over possession to a bankruptcy trustee. The Introduction discusses Bayou Group. Part I of this Note discusses the challenges of Ponzi scheme bankruptcies, the appointment of a receiver, and the appointment of a bankruptcy trustee. Part II discusses the *Bayou* framework. Part III

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1. *See* Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541, 546–47 (2d Cir. 2009) (holding that the United States Trustee failed to meet its "very high" burden that the appointment of a trustee is warranted).

discusses receivership after *Bayou*. Part IV discusses how *Bayou* creates value for bankruptcy estates and when courts are most likely to extend *Bayou*. This Note concludes by summarizing the importance of the *Bayou* decision.

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I. INTRODUCTION

"Suicide is Painless."[2] In 1995, Sam Israel III ("Israel") and another principal launched the Bayou Group LLC ("Bayou").[3] Initially founded with good intentions, Israel hoped the private, pooled investment fund, known as a hedge fund,[4] would produce large returns for high net worth investors.[5] With $300 million in initial investor funds, Israel, along with company CFO, Daniel Marino ("Marino"), promised investors Bayou would be worth $7.1 billion in ten years.[6] Within a few months of opening,

2. Andrew Ross Sorkin, *A Con Man Who Lives Between Truth and Fiction*, N.Y. TIMES (June 25, 2012), https://dealbook.nytimes.com/2012/06/25/a-con-man-who-lives-between-truth-and-fiction/?_r=0.

3. *The Bayou Hedge Fund, Sam Israel and the $450 Million Façade*, HEDGECO (June 16, 2008), http://www.hedgeco.net/hedgeducation/hedge-fund-articles/the-bayhou-hedge-fund-sam-israel-and-the-450-million-facade/.

4. Complaint at 5, S.E.C. v. Israel, No. 7:05-CV-08376 (S.D.N.Y. Sept. 29, 2005), 2005 WL 2544741.

5. *The Bayou Hedge Fund*, *supra* note 3.

6. *Id.*

Bayou sustained trading losses, and it became clear the fund would not garner the kinds of returns that Israel had promised his investors.[7]

Rather than altering Bayou's strategy or closing up the hedge fund, Israel instead chose another alternative.[8] This alternative involved an elaborate façade of lies that lasted almost a decade.[9] Israel started a fake corporation operated by Marino to audit Bayou, produce false documents to investors, overstate Bayou's gains, understate Bayou's losses, and position Bayou in a light that made the fund appear successful to potential investors.[10] Investors were pleased, and Israel and Marino were able to live large while they defrauded investors of money and reaped huge commissions off of the limited number of non-fraudulent transactions Bayou engaged in every day.[11]

"If there is a hell I will be there for eternity."[12] In 2004, although all appeared well to investors at Bayou, Israel tried to make back some of the funds he had lost before investors would notice.[13] Israel was down by more than $100 million and in need of a new investment strategy.[14] Israel befriended a self-proclaimed ex-CIA operative, assassin, arms dealer, and mob associate who promised Israel he could help him get his hands on a high-yield government investment program.[15] Israel diverted more than $120 million of Bayou funds to the self-proclaimed ex-CIA operative and ended up losing control of the funds.[16] The high yield investment program Israel had been promised turned out to actually be a "prime bank" investment fraud scheme.[17] After Israel lost Bayou's funds,[18] Marino

7. *Id*.
8. *Id.*
9. *Id.*
10. *Id.*
11. *The Bayou Hedge Fund*, *supra* note 3.
12. Gretchen Morgenson et al., *Clues to a Hedge Fund's Collapse*, N.Y. TIMES (Sep. 17, 2005), http://www.nytimes.com/2005/09/17/business/clues-to-a-hedge-funds-collapse.html. This quote was written in Marino's "suicide note and confession." *Id.*
13. *The Bayou Hedge Fund*, *supra* note 3.
14. Guy Lawson, *The disgraced Wall Street trader who faked his own death by pretending to jump into a river after 'CIA agent tricked him into handing over millions in world's wildest* con*'*, DAILY MAIL (Aug. 12, 2012), http://www.dailymail.co.uk/home/moslive/article-2185981/Samuel-Israel-Staged-murders-bogus-London-traders-million-dollar-deals.html.
15. *See id.*
16. *See id.*
17. *See* Complaint, *supra* note 4, at 2; *see also How Prime Bank Frauds Work*, S.E.C., https://www.sec.gov/divisions/enforce/primebank/howtheywork.shtml (last visited Jan. 4, 2018) ("Prime bank programs often claim investors' funds will be used to purchase and trade 'prime bank' financial instruments on clandestine overseas markets in order to generate huge returns in

wanted out.[19] Marino decided suicide was his best option and drafted a six-page suicide note and confession detailing the fall of Bayou and the fraud of Israel.[20] However, Marino's suicide attempt was unsuccessful and Marino's suicide note and confessional was recovered by local authorities who tipped off federal investigators.[21]

The U.S. Securities and Exchange Commission ("SEC") began investigating Bayou,[22] and Bayou notified investors the fund was voluntarily liquidating its investments and that all investors would receive a 100% redemption on their investment upon a final company audit.[23] Bayou investors received no such distribution, and Bayou stopped returning phone calls from investors.[24] A group of unsecured, non-redeeming Bayou investors filed a civil complaint against Israel, Marino, and Bayou alleging violations of Section 10(b) of the Securities Act of 1934 and SEC Rule 10b-5, as well as state law fraud and breach of fiduciary duty claims.[25] As part of their complaint, the unsecured, non-redeeming investors sought to appoint a receiver to pursue claims on behalf of Bayou and to develop a plan of distribution for Bayou's investors.[26]

Israel was ultimately convicted of a litany of securities violations in connection with running Bayou's $450 million Ponzi scheme and sentenced to twenty years in prison.[27] Prior to reporting to prison, Israel's GMC Envoy was found on a bridge in upstate New York with the words "Suicide is Painless" written in dust on the hood.[28] Like most dealings related to Bayou, Israel's suicide was just a façade as he was actually on the run hiding out in a Connecticut trailer park.[29] After appearing on

which the investor will share.").

18. *See* Complaint, *supra* note 4, at 2, 4.

19. *See* Morgenson et al., *supra* note 12 (noting that after the failure of Bayou, Mr. Marino considered suicide as evidenced through his six-page suicide note, detailing the demise of Bayou).

20. *See id.*

21. *See id.*

22. *See* Complaint, *supra* note 4, at 10.

23. Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (*In re* Bayou Grp., LLC), 439 B.R. 284, 292 (Bankr. S.D.N.Y. 2010).

24. *See* Jim Fitzgerald, *Bayou pair pleads guilty*, DESERET NEWS (Sept. 30, 2005), https://www.deseretnews.com/article/615154037/Bayou-pair-pleads-guilty.html.

25. *Christian Bros. High Sch. Endowment*, 439 B.R. at 293.

26. *Id.*

27. *See* Sorkin, *supra* note 2.

28. *Id.*

29. *See* Bryan Burrough, *A Trader Who Swerved, and Crashed*, N.Y. TIMES (June 30,

America's Most Wanted, Israel turned himself in and was sentenced to an additional two years in jail.[30]

The unsecured, non-redeeming Bayou investors, also known as Bayou's Unofficial On-Shore Creditor's Committee (the "Committee"), held over $130 million in claims against Bayou.[31] Hoping to mitigate the massive losses suffered by investors, the Committee successfully petitioned the court to appoint a federal equity receiver and exclusive managing member to oversee Bayou's business.[32] The Committee searched for a suitable candidate to serve as receiver, and after a thorough diligent search process, appointed Jeffrey Marwil ("Marwil") as receiver and managing member.[33] Shortly thereafter, Marwil caused Bayou to file a voluntary petition for relief under Chapter 11 of the Bankruptcy code.[34] Marwil continued to oversee Bayou as exclusive managing member; however, the United States Trustee filed a motion to appoint a Chapter 11 trustee to oversee Bayou.[35] The SEC, CFTC[36], U.S. Attorney's Office, and the Committee opposed the appointment of a Chapter 11 trustee,[37] and the United States Court of Appeals for the Second Circuit ultimately agreed, holding that a trustee did not need to be appointed and that the receiver could continue to oversee Bayou during bankruptcy.[38]

Section 543 of the Bankruptcy code requires receivers to turnover

2012), http://www.nytimes.com/2012/07/01/business/octopus-looks-at-bayou-hedge-funds-collapse-review.html.

30. Sorkin, *supra* note 2.

31. Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541, 544 (2d Cir. 2009).

32. *Id.*

33. *See In re* Bayou Grp., LLC, 431 B.R. 549, 556 (Bankr. S.D.N.Y 2010).

34. *In re Bayou Grp., LLC*, 564 F.3d at 544.

35. *See* Adams v. Marwil (*In re* Bayou Grp., L.L.C), 363 B.R. 674, 677 (Bankr. S.D.N.Y. 2007), *aff'd sub nom.* Adams v. Maril (*In re* Bayou Grp., LLC, 564 F.3d 541 (2d Cir. 2009); *see also U.S. Trustee Program*, U.S. DEP'T OF JUSTICE, https://www.justice.gov/ust (last visited Jan. 4, 2018) (explaining that the U.S. Trustee Program is the "component of the Department of Justice responsible for overseeing the administration of bankruptcy cases and private trustees").

36. *See generally Mission & Responsibilities*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/About/MissionResponsibilities/index.htm (last visited Jan. 4, 2018) (providing the mission statement of the CFTC). The Commodity Futures Trading Commission (CFTC) is an agency of the U.S. Government that regulates futures trading. *Id*. Created with the enactment of the Commodity Futures Trading Commission Act in 1974, the CFTC aims to protect consumers and the public from abusive practices, including fraud and manipulation in the commodity futures market. *Id.*

37. *See In re Bayou Grp., L.L.C.*, 363 B.R. at 679–80 (affirming the bankruptcy court's denial of the United States Trustee to appoint a Chapter 11 trustee).

38. *In re Bayou Grp., LLC*, 564 F.3d at 544, 549 (affirming the district court's judgment, which affirmed the bankruptcy court's denial of the U.S. Trustee's motion).

possession of any property of the debtor to a trustee upon placing their companies into bankruptcy.[39] The United States Court of Appeals for the Second Circuit changed this rule when it affirmed the district court's finding that the *Bayou* receiver was not required to turn over possession.[40] This Note discusses when a receiver is not required to turnover possession to a bankruptcy trustee and may retain control during a bankruptcy. Part I of this Note discusses the unique challenges Ponzi schemes present during bankruptcy proceedings, the appointment of a receiver, and the appointment of a trustee.[41] Part II discusses the *Bayou* framework and when a receiver is not required to turn over possession.[42] Part III discusses receivership after *In re Bayou Group, LLC*.[43] Part IV discusses how *Bayou* creates value for bankruptcy estates and when courts are most likely to extend *Bayou*.[44] Lastly, this Note concludes by summarizing the importance of the *Bayou* decision.[45]

II. BACKGROUND

A. PONZI SCHEMES AND BANKRUPTCY

Ponzi schemes present unique challenges for courts, regulators, creditors, and interested parties during a bankruptcy proceeding.[46] Unlike typical bankruptcy cases where general unsecured creditors are similarly situated, Ponzi scheme bankruptcy cases involve various types of creditors seeking anything from the recovery of unpaid principal to the payment of expected profits.[47] Meanwhile, trade creditors seek payment for the services they provided, "other creditors may assert breach of contract claims," and federal regulators may seek payment of unpaid taxes or

39. *See* 11 U.S.C. § 543(b)(1) (2012).

40. *See In re Bayou Grp., LLC*, 564 F.3d at 545 (affirming the district court's finding that the receiver's bankruptcy filing "transformed his status from 'corporate governor' to debtor-in-possession" and thus was not under any obligation to turn over the debtor's property to a bankruptcy trustee).

41. *See infra* Part I.

42. *See infra* Part II.

43. *See infra* Part III.

44. *See infra* Part IV.

45. *See infra* Part V.

46. *See* Kathy Bazoian Phelps, *Handling Claims in Ponzi Scheme Bankruptcy and Receivership Cases*, 42 GOLDEN GATE U. L. REV. 567, 568 (2012).

47. *Id.*

fines.[48] For investors who received less than they invested and other creditors of the Ponzi scheme, usually the best source of recovery comes from investors who received more than they invested prior to the scheme's inevitable collapse.[49]

After the inevitable collapse of the Ponzi scheme, investors can be divided into two broad categories: net losers and net winners.[50] Net losers are the "investors who failed to receive a full return, or in [some] cases any return, on their principal investment."[51] The contributions these investors made are used to satisfy other investors' expectations and to pay the next category of investors: net winners.[52] "'Net winners' [are the] 'lucky investors' who received redemption payments [from the Ponzi scheme] that exceed[ed] the value of their principal investments."[53] The primary challenges in administrating investor claims in a Ponzi scheme are:

> (1) how to determine the allowable amount of each claim, taking into consideration the distinction between the unpaid principal portion of the claim and the unpaid expected profits portion of the claim; and (2) how to treat payments previously made to the claimant during the course of the Ponzi scheme.[54]

There are two theories for claim allowance in Ponzi schemes: the "benefit of the bargain" theory and the "net principal" theory.[55] The benefit of the bargain theory directs courts to look at state law when measuring investor claims.[56] Under this theory, courts will look at the Ponzi scheme's investment contract "and its promised rate of return to compute damages."[57] The Ponzi scheme's investment contract is viewed as "lawful

48. *Id*.; *see also* Alistaire Bambach, *Issues that the SEC Confronts in the Liquidation of Hedge Funds*, 22 A. BANKR. INST. L. REV. 125, 127, 129–30 (2014) (discussing obstacles and issues faced by the SEC when liquidating insolvent hedge funds and in bankruptcy proceedings).

49. *See* Marc Hirschfield & George Klidonas, *Avoidance Actions in Ponzi Scheme Bankruptcy Cases*, A.B.A. BUS. BANKR. COMM. 1 (Apr. 2011), https://www.bakerlaw.com/files/Uploads/Documents/News/Articles/BUSINESS/2011/ABA_Hirschfield_Klidonas_April-2011.pdf (discussing how avoidance actions can be powerful tools for trustees in rectifying the detrimental effects caused by Ponzi scheme perpetrators).

50. Jessica D. Gabel et al., *The Collapse of Financial Fraud: Measuring Bankruptcy Avoidance Actions*, 42 GOLDEN GATE U. L. REV. 587, 588 (2012).

51. *Id*.

52. *Id*.

53. *Id.*

54. Phelps, *supra* note 46, at 569.

55. *See* John Clemency & Scott Goldberg, *Ponzi Schemes and Claims Allowance*, 19–NOV AM. BANKR. INST. J. 14 (2000).

56. *Id.*

57. *Id.*

and consistent with public policy," and the fact that net winners get paid from the losses suffered by net losers is viewed as "a fact of life" that cannot be changed by the court.[58] Net principal theory directs courts to view investor claims as a matter of equity and Ponzi scheme investment contracts as illegal.[59] Investors' claims are limited to the principal amount they invested, and expected profits are eliminated as an element of damages.[60] Profits paid to net winners are viewed as fraudulent transfers and cannot be retained by the net winners because they were paid at the expense of the net losers.[61] Some courts balance both theories when measuring investor claims, "allowing each investor to hold two claims" against the Ponzi scheme.[62] The first claim utilizes the net equity approach, while the second claim utilizes the benefit of the bargain approach.[63] Some courts subordinate the second claim so that investors may not collect on their second claim until all first claim holders are paid in full.[64]

In addition to determining claim allowance, other challenges face courts, regulators, creditors, and investors during a Ponzi scheme bankruptcy.[65] Securities fraud violations typically bar the principals of the company from working in the hedge fund industry; however, there are exceptions to this rule.[66] If a Ponzi scheme's principal has special expertise and is needed to wind up the fund, some courts have let expert principals remain at the fund.[67] If victims or perpetrators are located outside of the United States, courts will have to decide on extraterritoriality issues.[68] If fraudulent transfers were made prior to the Ponzi scheme's inevitable collapse, courts will have to decide whether to request "clawbacks."[69]

58. *Id.*
59. *See id.*
60. *Id.*
61. *See* Clemency & Goldberg, *supra* note 55.
62. *Id*.
63. *See id.*
64. *See id.*
65. *See* Bambach, *supra* note 48, at 125–30 (listing carve outs from investor adviser bars, forum selection, extraterritoriality, taxation, "clawbacks," and safe harbors as some of the challenges the SEC faces as a regulatory agency); *see also* Phelps, *supra* note 46, at 568.
66. *See* Bambach, *supra* note 48, at 125.
67. *See id.* at 125–26 (identifying "two cases involving carve outs from Investor Adviser bars that allowed managers to liquidate their own funds" due to their expertise).
68. *See id.* at 128–29 (noting that issues of extraterritoriality arise because the SEC's jurisdiction does not extend to transactions that occurred outside of the United States).
69. *See id.* at 130 (explaining that "clawbacks" arise when fund receivers try to recover from already paid distributions).

Finally, creditors and regulators will have to decide whether to appoint a receiver to marshal assets and pay defrauded investors or to place the fraudulent investment company into bankruptcy and appoint a trustee.[70]

B. THE APPOINTMENT OF A RECEIVER

A receiver is a person or organization who is appointed by the court to safeguard property that is subject to many diverse claims.[71] Secured creditors, shareholders, or government entities may petition state or federal courts to appoint a receiver and may request that the receiver be granted full or limited power over the estate.[72] Court-appointed receivers are considered officers of the court[73] and may "take custody, manage, and preserve money or property that is subject to litigation" where there is a danger that the property will be wasted, disposed of, or put out of so that when the court renders a judgment, "the property [is] available to accomplish what has been ordered."[74] Once appointed, a receiver is "subject only to the court's direction and control and is a custodian . . . whose functions are limited to the care, management, protection, and operation of the property" of the estate.[75]

70. *See* Alistaire Bambach, *The SEC in Bankruptcy: Past and Present*, 18 AM. BANKR. INST. L. REV. 607, 611–13 (2010) (demonstrating the complex business decision involved in deciding between appointing a receiver or placing a company into bankruptcy with an appointed trustee).

71. *See Receiver*, BLACK'S LAW DICTIONARY (10th ed. 2014).

72. *See, e.g.*, JONATHAN P. FRIEDLAND ET AL., STRATEGIC ALTERNATIVES FOR AND AGAINST DISTRESSED BUSINESSES § 11.1 (database updated Jan. 2017) (discussing who may seek appointment of receivership under state law and the scope of a receiver's power); FRIEDLAND ET AL., *supra* note 72, at § 12.2 (discussing the appointment of receivership under federal law).

73. *See* S.E.C. v. Am. Principals Holding, Inc. (*In re* San Vicente Med. Partners Ltd.), 962 F.2d 1402, 1409 (9th Cir. 1992) (asserting that court-appointed receivers are officers of the court).

74. *Receiver*, WEST'S ENCYCLOPEDIA OF AMERICAN LAW (2d ed. 2005) (defining receivership as an extraordinary remedy and laying out the purpose of receivership and how it comes about).

75. James M. McGee & Ross H. Parker, *Basic Receivership Law/Concepts*, *in* LEGAL ISSUES IN THE TEXAS HOSP. INDUS. ch. 20, at 1 (2015), https://www.munsch.com/portalresource/lookup/wosid/cp-base-4-3334/overrideFile.name=/Parker_StateBarOfTexas_Legal_Issues_In_The_Texas_Hospitality_Industry_Nov2015.pdf (emphasizing the control the court has over the receiver and his or her custodial duties to the estate).

There are two types of court-appointed receivers: general receivers and special receivers.[76] A general receiver controls all of the debtor's property and operates the debtor's business in much the same way as a chapter 7 or chapter 11 trustee.[77] The general receiver is tasked with winding up the debtor's business, selling its assets as a going concern or liquidation, and distributing the proceeds on behalf of the court.[78] A special receiver is only authorized to take control of certain property or businesses of the debtor.[79] The debtor remains in control of property or businesses not subject to the receivership order.[80] An order appointing a special receiver sets out predefined parameters for the receiver, and the "receiver has no authority over components of the debtor's" business or property not listed in the receivership order.[81]

Receivers may be appointed under either state or federal law.[82] A majority of states have enacted statutes authorizing the appointment of a receiver under various circumstances.[83] Under state law, receivers may be appointed in situations of waste or material damage to the property of the debtor,[84] insolvency,[85] fraud,[86] or the mismanagement of corporate assets,[87]

76. *See* Morris A. Ellison et al., *'Tis Better to Receive – The Use of a Receiver in Managing Distressed Real Estate*, AM. C. REAL ESTATE LAWYERS 2 (2017), https://c.ymcdn.com/sites/acrel.site-ym.com/resource/collection/D1CFEE37-A66B-4712-9DFC-6687A87B1FD9/Ellison,_Dudek,_Levine-Tis_Better_to_Receive.pdf (referencing the various types of court-appointed receivers in non-bankruptcy cases).

77. *Id.* (delineating the duty of a court appointed general receiver as controlling all of the debtor's property).

78. *See* Reagan v. Midland Packing Co., 8 F.2d 954, 956 (8th Cir. 1925) (stating the duties and tasks of a receiver appointed by the court); *In re* Newport Offshore Ltd., 219 B.R. 341, 346 (Bankr. D.R.I. 1998) (elaborating on the duties of a general receiver).

79. *See In re Newport Offshore Ltd*., 219 B.R. at 346 (asserting that special receivers have limited control of the assets of the debtor).

80. *See id.* (suggesting that any assets not subject to the receivership order remain in control of the debtor); 16 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 7666 (perm. ed., rev. vol. Sept. 2017).

81. Ellison et al., *supra* note 76, at 3.

82. *See supra* note 72 and accompanying text.

83. *See, e.g.*, DEL. CODE ANN. tit. 8, § 291 (2017) (indicating the procedure for appointment of a receiver in the case of corporate insolvency); N.Y. BUS. CORP. LAW § 1202 (McKinney 2017) (referencing the conditions for appointment of a receiver in corporate dissolution proceedings); OHIO REV. CODE ANN. § 2735.01 (West 2017) (referencing the procedure for appointment of a receiver for issues concerning corporate property); 15 PA. CONS. STAT. § 1767 (2017) (referencing appointment procedures for corporate deadlocks).

84. *See, e.g.*, Park Nat'l Bank v. Cattani, Inc., 931 N.E.2d 623, 626–27 (Ohio App. 12th Dist. 2010) (appointing and allowing a receiver to sell the debtor's property in order to preserve and protect it).

85. *See* Quadrant Structured Prods., Co. v. Vertin, 106 A.3d 992, 1020–23 (Del. 2013)

among other things. States also appoint receivers based on general principles of equity, regardless of whether a debtor is solvent or insolvent.[88] However, courts view the appointment of a receiver over a solvent debtor as a drastic remedy that should only be granted under certain circumstances.[89] The respective ease or difficulty in acquiring a receiver frequently depends on the facts and circumstances of the case,[90] and courts will consider factors such as: (1) the validity of the claim; (2) probability of fraudulent conduct; (3) imminent danger to the property; (4) "inadequacy of available legal remedies;" (5) lack of less drastic equitable remedies; and (6) "the likelihood that appointment of a receiver will do more harm than good," when deciding whether to appoint a receiver.[91]

In federal court, the appointment of a receiver is considered an ancillary form of relief that requires a pending federal court action asserting some other substantive claim.[92] In the underlying action, "the plaintiff must satisfy the requirements of federal subject matter jurisdiction."[93] Typically, creditors satisfy this requirement by showing diversity of citizenship and that the minimum amount in controversy under 28 U.S.C. § 1332 is satisfied.[94] Once federal jurisdiction is established, receivership under the federal rules provides for the management and disposition of distressed property.[95] The appointment of a receiver in federal court is considered an extraordinary remedy, which should be employed with caution and granted only when there is a clear necessity to protect the plaintiff's interest in the property.[96] Federal receivers may take control of and possess the debtor's property and are vested with the power to manage,

(discussing Delaware case law appointing a receiver in connection with corporate insolvency).

86. *See* Corzin v. Digiammarino (*In re* Maglione), 559 B.R. 489, 499–500 (Bankr. N.D. Ohio 2016) (discussing Delaware provisions permitting the appointment of a receiver in connection with a fraudulent conveyance).

87. *See* Tate v. Phila. Transp. Co., 190 A.2d 316, 321 (Pa. 1963) (noting that a receiver may be appointed when there has been gross mismanagement).

88. *See id.* at 321, 323.

89. *See id.* at 321.

90. Ellison et al., *supra* note 76, at 4.

91. Waag v. Hamm, 10 F.Supp.2d 1191, 1193 (D. Colo. 1998).

92. *See* Ellison et al., *supra* note 76, at 5.

93. *Id.*

94. *See, e.g.*, Inland Empire Ins. Co. v. Freed, 239 F.2d 289, 290 (10th Cir. 1956) (appointing a receiver where federal jurisdiction was premised on diversity jurisdiction).

95. *See* FED. R. CIV. P. 66 (providing that federal rules regulate federally appointed receivers).

96. *See* Citibank, N.A. v. Nyland (CF8) Ltd., 839 F.2d 93, 97 (2d Cir. 1988).

operate, or sell the debtor's property, even if it is located in multiple states.[97] Federal receivers must follow specific technical requirements.[98] Failure to meet these requirements could result in the receiver being divested of his jurisdiction and control over the debtor's property or businesses.[99]

"[A] receiver's rights, powers, and responsibilities are generally set forth in [a court receivership] order."[100] Receivership orders should describe the receiver's rights and duties as clearly as possible to avoid future disputes.[101] Great care should be taken when drafting a receivership order to make sure the receiver is vested with sufficient power to carry out his duties prescribed by the court.[102] In an equity receivership order, the court removes the company's management from control for fraud or wrongdoing prior to appointing a receiver.[103] While receivers and trustees in bankruptcy share many similar responsibilities,[104] the appointment of a receiver does not prevent a debtor from filing a voluntary petition for relief under the Bankruptcy code.[105] Upon causing a debtor to file for voluntary bankruptcy protection, section 543 of the Bankruptcy code prohibits custodians from retaining control of the debtor's property or businesses.[106] Custodians are required to immediately turn over all of the debtor's property or businesses in his possession to a duly appointed bankruptcy trustee.[107]

97. *See* U.S. Bank Nat'l Ass'n v. Nesbitt Bellevue Prop. LLC, 866 F.Supp.2d 247, 254, 256 (S.D.N.Y. 2012).

98. *See* 28 U.S.C. § 754 (1948).

99. *See id.*

100. Andrew C. Kassner & Howard A. Cohen, *Anything but Bankruptcy!: ABCs, Receiverships and Other Alternatives*, 080405 AM. BANKR. INST. 239 (2005), Westlaw.

101. *Id.*

102. *Id.*

103. *See* Jared N. Parrish, *Innocence Lost: Fraudulent Transfer Actions Against Innocent Investors of a Ponzi Scheme*, 27 UTAH B.J. 11, 11–12 (2014).

104. *See* R. Alexander Pilmer et al., In the Wake of Collapse: *Approaches to Ponzi Scheme Litigation*, KIRKLAND ALERT 2 (Feb. 2009), https://www.kirkland.com/siteFiles/Publications/BFA6C410069121A85A79531FF51D5509.pdf.

105. *See* Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541, 545, 548 (2d Cir. 2009).

106. 11 U.S.C. § 543(a) (1994).

107. Adams v. Marwil (*In re* Bayou Grp., L.L.C.), 363 B.R. 674, 677 (Bankr. S.D.N.Y. 2007), *aff'd sub nom.* Adams v. Marwil (*In re* Bayou Grp., LLC, 564 F.3d 541 (2d Cir. 2009).

C. The Appointment of a Trustee

Typically, debtors are left in possession of their businesses during Chapter 11 reorganizations.[108] Debtors in bankruptcy are expected to act as a fiduciaries,[109] and are expected to act in the best interest of the creditors rather than for the debtor itself.[110] Although there is a strong presumption that debtors are to remain in control during a bankruptcy proceeding, under certain circumstances a bankruptcy court may appoint a trustee.[111] A bankruptcy trustee is a fiduciary and representative to all parties in a bankruptcy estate.[112] Appointed by the Office of the United States Trustee, a trustee has specific obligations during a bankruptcy.[113]

The obligations of a bankruptcy trustee can be divided into two groups: fiduciary obligations and institutional obligations.[114] Fiduciary obligations consist of the "trustee's specific obligations to the bankruptcy court and to the parties" involved in the bankruptcy case.[115] Institutional obligations consist of the trustee's "obligations to the bankruptcy process itself," undertaken regardless of what the trustee's services are in a specific bankruptcy proceeding.[116] Trustees derive their powers from statute.[117] The Bankruptcy code specifically provides the statutory authority under which a trustee may be appointed and the powers he may be vested with.[118] Similar to the appointment of a receiver, the appointment of a trustee is also seen as an extraordinary remedy only available in circumstances where, for a variety of reasons, "the debtor can no longer be trusted to carry out [his] responsibilities as debtor in possession."[119] The appointment of a trustee frequently involves significant delay and expense in the

108. Colin M. Downes, *Appointing Chapter 11 Trustees in Reorganizations of Religious Institutions*, 101 VA. L. REV. 2225, 2228 (2015).

109. Wolf v. Weinstein, 372 U.S. 633, 649–50 (1963).

110. Bank of Am. Nat. Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 444–45 (1999).

111. *See* 11 U.S.C. §§ 1107(a), 1108 (2017).

112. Hon. Steven Rhodes, *The Fiduciary and Institutional Obligations of a Chapter 7 Bankruptcy Trustee*, 80 AM. BANKR. L.J. 147, 148, 155 (2006).

113. *Id.* at 150, 202–03.

114. *Id.* at 147–48.

115. *Id.* at 148.

116. *Id.*

117. *See, e.g.*, 11 U.S.C. §§ 321–322, 701–704 (2017).

118. Robert S. Bernstein, *How, Why, and When to Seek the Appointment of a Chapter 11 Trustee*, BERNSTEIN-BURKLEY, P.C., https://bernsteinlaw.com/publications-list/how-why-and-when-to-seek-the-appointment-of-a-chapter-11-trustee/ (last visited Jan. 6, 2018).

119. Downes, *supra* note 108, at 2229.

administration of a bankruptcy case, which must be offset by potential benefits derived from appointing the trustee.[120]

The Bankruptcy code provides trustees with many tools for obtaining recovery for creditors.[121] Trustees are empowered to take stock of the debtor's financial affairs and initiate litigation if any sum is owed to the debtor.[122] Trustees may initiate preference actions under 11 U.S.C. § 547, avoiding many financial transactions that occurred in the "90 days leading up to the bankruptcy filing," and requesting repayment from any creditor who received money during that period.[123] Bankruptcy trustees may use avoidance rights, allowing them to avoid any fraudulent transfers the debtor made during a statutorily defined period and request repayment from parties that received money.[124] The statutorily defined period varies depending on the jurisdiction and other factors.[125] Trustees have the authority to employ accountants, attorneys, appraisers, auctioneers, and other professionals to help them carry out their duties.[126] Under Section 544, trustees may avoid any transfer of property or obligations incurred by the debtor and bring any action that an unsecured creditor may bring.[127]

Trustees are appointed under Section 1104(a) and 1112 of the Bankruptcy code.[128] Section 1104(a) states that upon request, a court may appoint a bankruptcy trustee "[a]t any time after the commencement of the case but before confirmation of a plan."[129] There are three grounds for appointing a trustee in bankruptcy: (1) for "cause;" (2) "in the interests of creditors, equity security holders, and others;" and (3) as an "alternative to conversion or dismissal."[130]

A trustee may be appointed for cause in cases of "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by

120. *Id.*
121. *See* Pilmer et al., *supra* note 104, at 1–2.
122. *See id.* at 2.
123. *Id*.
124. *See id.* at 2–3
125. *See id.* at 3–4.
126. *See* Norma B. Newman, *The Powers and Duties of a Chapter 7 Bankruptcy Trustee*, MUCH SHELIST (May 26, 2010), https://www.muchshelist.com/knowledge-center/article/powers-and-duties-of-a-chapter-7-bankruptcy-trustee.
127. *See* 11 U.S.C. § 544(a)–(b)(1) (1998).
128. *See* 11 U.S.C. §§ 1104(a)(1)–(2), 1112(b)(1) (2010).
129. § 1104(a).
130. Clifford J. White III & Walter W. Theus, Jr., *Chapter 11 Trustees and Examiners After BAPCPA*, 80 AM. BANKR. L.J. 289, 298–302 (2006).

current management."[131] This list is not exhaustive.[132] If there are reasonably grounds to believe that the management of the debtor is participating in "actual fraud, dishonesty, or criminal conduct in the management of the debtor," the United States Trustee is obligated to move to appoint a trustee.[133] A trustee may be appointed in the interest of creditors, equity security holders, and others only after the court has conducted a cost-benefit analysis, weighing the interests of all constituencies in a bankruptcy proceeding and determining whether a trustee would benefit the estate.[134] Courts may consider factors such as: (1) "the trustworthiness of the debtor;" (2) "the debtor in possession's past and present performance;" (3) "the confidence . . . of the business community and of [the] creditors in present management;" and (4) the "benefits derived" from appointing a trustee, when deciding whether to appoint a trustee.[135] Appointment as an alternative to conversion or dismissal was added as a reason for appointing a trustee by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[136] This type of appointment was designed to provide courts with "additional flexibility in cases that would be subject to conversion or dismissal."[137] In making this decision, courts must decide what is in the best interests of creditors and the estate.[138]

Section 543 of the Bankruptcy code is a turnover provision that requires custodians to deliver property and/or businesses of the estate to a trustee upon placing their companies into bankruptcy.[139] This is done so that the trustee can "monetize the property for the benefit of the bankruptcy estate and its creditors."[140] Custodian is defined under Section 101 of the Bankruptcy code to include a "receiver or trustee of any property of the debtor;" an "assignee under general assignment for the benefit of the debtor's creditors;" or a "trustee, receiver, or agent under applicable law, or under a contract, that is appointed for the purpose of enforcing a lien

131. § 1104(a)(1).
132. *See id.*
133. § 1104(e).
134. *See In re* Ionosphere Clubs, Inc., 113 B.R. 164, 168–69 (Bankr. S.D.N.Y. 1990).
135. *Id.* at 168.
136. White III & Theus, Jr., *supra* note 130, at 301.
137. *Id.*
138. 11 U.S.C. § 1112(b)(1) (2010).
139. 11 U.S.C. § 543(b)(1)–(2) (2010).
140. Cathy Ta, *Bankruptcy Procedure in the Context of Turnover and Preference Law*, 39-SEP L.A. LAW 12, 12 (2016).

against such property, or for the . . . administration of such property."[141] While this provision makes sense in most bankruptcy proceedings, in securities fraud cases, the appointment of a trustee represents a loss of control for the SEC.[142] Receivers are often vetted through a thorough search process[143] and work with the SEC to distribute a recovery to investors.[144] After a debtor is placed into bankruptcy and a trustee is appointed, there is no guarantee that the trustee or the bankruptcy court will cooperate with the SEC's enforcement action.[145] The automatic stay of the bankruptcy court may prevent the SEC from enforcing subpoenas or freeze orders over the debtor.[146] Unlike receivers, trustees are less inclined to work with the SEC to distribute money to investors.[147] In securities fraud cases, keeping a receivership in place as long as possible maximizes value and insures a fair distribution for defrauded investors.[148]

III. THE *BAYOU* FRAMEWORK

A. RECEIVERSHIP BEFORE IN RE BAYOU GROUP, LLC

"The bankruptcy court may not appoint a receiver for the estate in lieu of a trustee."[149] Prior to *Bayou*, bankruptcy courts were reluctant to allow receivers to retain power and act as debtors in possession after filing for bankruptcy protection.[150] Courts had the power to appoint receivers with management powers pre-petition.[151] However, after a bankruptcy

141. 11 U.S.C. § 101(11)(A)–(C) (2016).

142. *See* PHILLIP S. STENGER, RECEIVERSHIP SOURCEBOOK, ch. 11, at 82–87 (2011), http://www.stengerlaw.com/book/the-impact-of-bankruptcy-on-the-s-e-c-receivership/.

143. *See, e.g.*, *In re* Bayou Grp., LLC, 431 B.R. 549, 564–65 (Bankr. S.D.N.Y. 2010).

144. Robert G. Wing & Katherine Norman, *SEC Receivers: What Are They and What Do They Do?*, 20 UTAH BAR J. 6, 22 (2007), http://www.utahbar.org/wp-content/uploads/2017/11/2007_nov_dec.pdf.

145. STENGER, *supra* note 142, at 87.

146. *Id.*

147. *Cf.* Wing & Norman, *supra* note 144, at 21 ("Unlike a bankruptcy trustee, whose powers are governed by statute, the powers of a federal equity receiver are governed by the order of the court appointing him or her and are based on the equity powers of the court.").

148. *Cf.* Bambach, *supra* note 70, at 613 (noting that courts will permit the use of equity receiverships "in a way that maximizes value to defraud investors and the estates a whole").

149. 1 NORTON BANKR. L. & PRAC. 3d § 4:133, Westlaw (database updated Oct. 2017).

150. *See, e.g.*, *In re* Stratesec, Inc., 324 B.R. 156, 158 (Bankr. D.D.C. 2004); *In re* 400 Madison Ave. Ltd. P'ship, 213 B.R. 888, 894 (Bankr. S.D.N.Y. 1997); *In re* Plantation Inn Partners, 142 B.R. 561, 565 (Bankr. S.D. Ga. 1992).

151. *See In re Stratesec, Inc.*, 324 B.R. at 157.

proceeding commenced, that authority was suspended and replaced by the United States Trustee's power to appoint a trustee over the estate.[152] As the United States Bankruptcy Court for the Southern District of Georgia noted, "to permit [a] Receiver to indefinitely remain in possession and to vest him permanently with the duties and powers of a debtor-in-possession goes far beyond the limited relief envisioned by Section 543" and circumvents the administration of a how a Chapter 11 bankruptcy case should be managed.[153]

In *In re Plantation Inn Partners*,[154] the United States Bankruptcy Court for the Southern District of Georgia applied Section 543's automatic turnover requirement to a state-law appointed receiver.[155] In *In re Plantation Inn Partners*, the Debtor, a hotel operator, filed for voluntary Chapter 11 protection, and certain Creditors of the Debtor successfully petitioned the court to appoint a receiver to operate the Debtor's business.[156] The Creditors petitioned the court to excuse Section 543's turnover requirement, and the United States Trustee sought the authority to appoint a trustee under Section 1104 and to require the Receiver to turnover possession of the Debtor's hotels under Section 543.[157] The Bankruptcy Court acknowledged that it would be improper to vest a state-appointed receiver with "the long-term obligations of [acting as] a debtor-in-possession."[158] While Section 543(d) temporarily excuses a receiver's duty to turnover possession, explicit statutory authority prohibits receivers from remaining in possession of a debtor's property indefinitely during bankruptcy.[159] The Bankruptcy Court recognized that the powers of a trustee to recover assets exceeded the powers of a receiver, and ordered the Receiver to turn over possession of the debtor's property to a trustee.[160]

In *In re Stratesec, Inc.*,[161] the United States Bankruptcy Court for the District of Columbia applied Section 543's automatic turnover requirement to a federal-law appointed receiver.[162] In *Stratesec, Inc.*, a federal district

152. *See id.*
153. *In re Plantation Inn Partners*, 142 B.R. at 564.
154. *Id.* at 561.
155. *See id.* at 563–64.
156. *See id.* at 562.
157. *See id.* at 562–63.
158. *Id.* at 563.
159. *See In re* Plantation Inn Partners, 142 B.R. 561, 564 (Bankr. S.D. Ga. 1992).
160. *See id.* at 565.
161. *In re* Stratesec, Inc., 324 B.R. 156 (Bankr. D.D.C. 2004).
162. *See id.* at 157.

court appointed a pre-petition receiver to oversee the Debtor's property and authorized the Receiver to file a bankruptcy petition on behalf of the Debtor.[163] The Receiver caused the Debtor to file for bankruptcy and petitioned the Bankruptcy Court to retain him as receiver over the Debtor's property.[164] The Bankruptcy Court recognized that it was not allowed to appoint a receiver.[165] Bankruptcy courts may only keep a receivership in place temporarily if the "receivership court is the superior forum for controlling the debtor's property."[166] An active receivership and an active bankruptcy may not coexist; bankruptcy courts must decide which should be allowed to operate and which should be suspended.[167] If a fiduciary is necessary, a trustee should be appointed to oversee the debtor's property.[168] The Bankruptcy Court determined that a fiduciary was necessary, and held that the Receiver was required to turn over possession to a trustee.[169] In a subsequent determination, the Bankruptcy Court held that the Receiver could not retain control as a responsible officer of the Debtor, and was required to turn over possession.[170] The Bankruptcy Court found that it was immaterial that the Debtor's largest creditor supported the appointment of the receiver as a responsible officer and that the appointment of a trustee would be disruptive and expensive.[171]

Section 1104 of the Bankruptcy code states that trustees appointed at the request of the United States Trustee must be disinterested persons.[172] Congress enacted this provision to prohibit any interests materially adverse to the interests of the estate or any one class of creditors from having an influence over the administration of the bankruptcy estate.[173] In pre-*Bayou* receivership cases, court's viewed receiver's fiduciary duties as not obliged to all creditors, debtors, or other parties in interest.[174] Where a disinterested fiduciary was plainly necessary to insure no one creditor was favored in a bankruptcy proceeding, a trustee was appointed to administer the

163. *See id.*
164. *See id.*
165. *Id.*
166. *Id*. at 158.
167. *In re* Stratesec, Inc., 324 B.R. 156, 158 (Bankr. D.D.C. 2004).
168. *Id.*
169. *Id.*
170. *See id.*
171. *See id.*
172. 11 U.S.C. § 1104(b)(1) (2010).
173. *See In re* Big Rivers Elec. Corp., 355 F.3d 415, 432–33 (6th Cir. 2004).
174. *See In re Stratesec, Inc*., 324 B.R. at 158.

bankruptcy proceeding.[175] This view was effectively changed when the United States Court of Appeals for the Second Circuit was tasked with winding up the elaborate façade of Israel, Marino, and Bayou.[176]

B. IN RE BAYOU GROUP, LLC

In *In re Bayou Grp., LLC*,[177] the United States Court of Appeals for the Second Circuit recognized that a receiver could act as a debtor in possession during a Chapter 11 Bankruptcy and is not required to turn over control to a trustee appointed by the United States Trustee.[178] In *Bayou*, the Committee filed a lawsuit against Bayou alleging violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, state law claims of fraud and breach of fiduciary duties, and successfully motioned for the appointment of a federal equity receiver pursuant to Federal Rule of Civil Procedure 66.[179] In the motion, the Committee requested that the United States District Court for the Southern District of New York appoint Marwil and empower him as both pre-petition "federal equity receiver" and "exclusive managing member" of Bayou.[180] Marwil undertook his responsibilities as receiver and managing member and caused Bayou to file a voluntary petition for relief under Chapter 11 of the Bankruptcy code.[181] Following Bayou's bankruptcy filing, the United States Trustee moved to appoint a Chapter 11 trustee pursuant to 11 U.S.C. §§ 543 and 1104(a) claiming that: (1) Marwil qualified as a custodian; (2) Marwil's powers as exclusive managing member was derived from his role as federal equity receiver; and (3) Marwil's role as federal equity receiver terminated after he caused Bayou to file for Chapter 11 Bankruptcy protection.[182]

Federal courts have the inherent equitable authority to appoint "federal equity receivers" and "exclusive managing members" over a corporation.[183] In deriving this authority, federal courts do not exclusively rely on the federal receivership statute; they rely on federal securities law

175. *See id.*
176. *See* Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541 (2d Cir. 2009).
177. *Id.*
178. *See id.* at 549.
179. *See id.* at 544.
180. *Id.*
181. *See id.*
182. *See* Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541, 545–46 (2d Cir. 2009).
183. *Id.* at 548.

statutes and their inherent equitable authority to fashion remedies for violations of the law.[184] The appointment of a "federal equity receiver" is independent from the appointment of "exclusive managing member," and the appointment of "exclusive managing member" carries with it additional fiduciary duties.[185] While receivership ends upon the commencement of a Chapter 11 proceeding, there is a strong presumption that management retains control during a bankruptcy proceeding.[186] This presumption can only be overcome under certain circumstances pursuant to Section 1104 & 1112.[187] The United States District Court for the Southern District of New York denied the United States Trustee's motion to appoint a Chapter 11 trustee, and the United States Court of Appeals for the Second Circuit affirmed the lower court's decision, holding that the appointment of a trustee was not warranted pursuant to 11 U.S.C. § 1104(a).[188]

IV. RECEIVERSHIP AFTER IN RE BAYOU GROUP, LLC

Since *Bayou*, both the United States Court of Appeals for the Second Circuit and the United States District Court for the Southern District of New York have been cited in state and federal receivership cases.[189] Courts have adopted the *Bayou* framework, recognizing that federal receivers are under no affirmative requirement to turn over possession to a trustee upon placing their companies into bankruptcy.[190]

184. Adams v. Marwil (*In re* Bayou Grp., L.L.C.), 363 B.R. 674, 684 (Bankr. S.D.N.Y. 2007), *aff'd sub nom.* Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541 (2d Cir. 2009).

185. *In re Bayou Grp., L.L.C.*, 363 B.R. at 686.

186. *See In re* Ionosphere Clubs, Inc., 113 B.R. 164, 167 (Bankr. S.D.N.Y. 1990) ("There is a strong presumption that the debtor should be permitted to remain in possession absent a showing of need for the appointment of a trustee.").

187. *See In re Bayou Grp., LLC*, 363 F.3d at 547; *see also In re* Shea & Gould, 214 B.R. 739, 742 (Bankr. S.D.N.Y. 1997).

188. *See In re Bayou Grp., LLC*, 363 F.3d at 545–49.

189. *See, e.g.*, *In re* Petters Co., Inc., 401 B.R. 391, 408 n.32 (Bankr. D. Minn. 2009), *aff'd sub nom.* Ritchie Special Credit Invs., Ltd. v. U.S. Tr., 415 B.R. 391 (D. Minn. 2009), *aff'd* 620 F.3d 847 (8th Cir. 2010); S.E.C. v. Byers, 609 F.3d 87, 92 (2d Cir. 2010); JY Creative Holdings, Inc. v. McHale, No. 8:14-CV-2899-JSM, 2015 WL 541692, at *3–4 (M.D. Fla. Feb. 10, 2015).

190. *See, e.g.*, *In re Petters Co., Inc.*, 401 B.R. at 408 n.32; *Byers*, 609 F.3d at 92; *McHale*, 2015 WL 541692, at *3–4.

A. FEDERAL RECEIVERSHIPS AND BANKRUPTCY

In *In re Petters Co., Inc.*,[191] the United States Bankruptcy Court for the District of Minnesota allowed the United States Trustee to use the *Bayou* framework to appoint a receiver as trustee.[192] In *Petters*, the Debtor was a holding company founded by Thomas J. Petters ("Petters").[193] Petters started his business as an investment fund; however, he developed it into a diverse holding company with many subsidiaries.[194] Federal authorities investigated Petters for securities fraud and discovered that his investment fund was actually a Ponzi scheme.[195] A federal receiver was appointed to oversee Petters' businesses, and the receiver caused some of Petters' subsidiary companies to file for bankruptcy.[196] The Receiver's receivership order did not include managerial powers.[197] The United States Trustee moved to appoint the pre-petition Receiver as trustee over the bankrupt subsidiaries, and Petters' creditors filed an objection to the appointment, arguing it placed them at a disadvantage.[198]

The Bankruptcy Court recognized *Bayou* and noted that there was no anomaly with appointing a pre-petition receiver as bankruptcy trustee.[199] The receivership order authorized the Receiver to place the Debtor into bankruptcy and did not expressly prohibit the Receiver from retaining control after filing for bankruptcy protection.[200] The Bankruptcy Court found it immaterial that the United States Trustee argued against this practice in *Bayou* and held that a receiver could be appointed as trustee if he turned over assets for administration by the court prior to retaking possession as a trustee.[201] The United States Court of Appeals for the Eighth Circuit affirmed the Bankruptcy Court's decision, stating that a

191. *In re Petters Co., Inc*., 401 B.R. at 391.
192. *See id.* at 415.
193. *Id.* at 394.
194. *See* Thomas M. Burton, *Petters Gets 50-Year Term for Running Ponzi Scheme*, WALL ST. J. (Apr. 9, 2010), https://www.wsj.com/articles/SB10001424052702304198004575171881879666308 (providing a detailed account of this complex Ponzi scheme).
195. *Id.*
196. *See In re Petters Co., Inc*., 401 B.R. at 394–95.
197. *See id.* at 395 n.3.
198. *See id.* at 395.
199. *See id.* at 408.
200. *See id.*
201. *See id.* at 408–09, 415.

receiver could qualify as a disinterested person as defined in sections 1104(d) and 101(14)(c) of the Bankruptcy code.[202]

In *S.E.C. v. Byers*,[203] the United States Court of Appeals for the Second Circuit extended *Bayou* to pre-petition receivership disputes.[204] In *Byers*, the SEC charged the Defendants with securities fraud.[205] The United States District Court for the Southern District of New York appointed a federal receiver to take control of the Defendants' company and included in its receivership order that the receiver would remain in possession of the Debtor if he caused the Debtor to file for Chapter 11 protection.[206] The Defendants objected to this provision, arguing that the receivership order violated Section 543 of the Bankruptcy code.[207] Citing *Bayou*, the district court noted that it was within the court's inherent equitable authority to appoint a receiver that could act as debtor in possession.[208] While receiverships do not survive bankruptcy, this did not affect the Receiver's role as manager.[209] Management is authorized to act as debtor in possession under the Bankruptcy code, subject to 11 U.S.C. § 1104.[210] The district court rejected the Defendants' objections, holding that the receivership order was lawful.[211] On appeal, the United States Court of Appeals for the Second Circuit affirmed the district court's decision, stating that there is "no reason a district court cannot, pre-petition, appoint a manager for the entities, and there is nothing in the Bankruptcy Code that prevents that manager from continuing after the bankruptcy filing."[212]

In *JY Creative Holdings, Inc. v. McHale*,[213] the United States District Court for the Middle District of Florida recognized that federal receivers are no longer affirmatively required to turn over possession to trustees.[214]

202. *See* Ritchie Special Credit Invs., Ltd. v. U.S. Tr., 620 F.3d 847, 850–51, 856 (8th Cir. 2010).
203. *See* S.E.C. v. Byers, 609 F.3d 87 (2d Cir. 2010).
204. *See id.* at 93.
205. *See id.* at 89–90.
206. *See id.*
207. *See id.* at 93.
208. *See* S.E.C. v. Byers, 592 F. Supp. 2d 532, 538 (S.D.N.Y. 2008), *aff'd* 609 F.3d 87 (2d Cir. 2010).
209. *See id.* at 538–39.
210. *See id.* at 538.
211. *See id.* at 539.
212. S.E.C. v. Byers, 609 F.3d 87, 93 (2d Cir. 2010).
213. JY Creative Holdings, Inc. v. McHale, No. 8:14–CV–2899–JSM, 2015 WL 541692 (M.D. Fla. Feb. 10, 2017).
214. *See id.* at *3–4.

In *JY Creative Holdings*, Creditors sued the Debtor for breaching various loan documents.[215] The Creditors successfully petitioned the court to appoint a federal receiver, and the receivership order granted the Receiver "the power customarily exercised by the [Debtors'] officers and board of directors."[216] The Receiver caused the Debtor to file for bankruptcy without first obtaining consent from the Debtor's board of directors, and the Debtor moved to dismiss the bankruptcy asserting that the receivership order was invalid.[217] Citing *Bayou*, the United States District Court for the Middle District of Florida recognized that receivers have substantial authority over debtors.[218] A bankruptcy court cannot set aside a receivership order authorized by a federal district court.[219] While the Debtor cited a state receivership case that held receivers could not function as corporate officers, the Bankruptcy Court held that the receivership order was valid and refused to dismiss the bankruptcy, stating that "[w]hile the grant of authority [as director to a receiver] may have been unprecedented [pre-*Bayou*], that is no longer the case."[220]

B. STATE RECEIVERSHIPS AND BANKRUPTCY

While receivership is not an independent cause of action in federal court,[221] a majority of states have standalone statutes authorizing the appointment of a receiver.[222] Receivership under state law is distinct from receivership under federal law.[223] Since *Bayou*, courts have refused to adopt the *Bayou* framework for state receivership cases and have required state receivers to turn over possession of a debtor's property to a trustee upon placing the debtor into bankruptcy.[224]

215. *See id.* at *1.
216. *Id.*
217. *See id.*
218. *See id.* at *3.
219. JY Creative Holdings, Inc. v. McHale, No. 8:14–CV–2899–JSM, 2015 WL 541692, at *2 (M.D. Fla. Feb. 10, 2017).
220. *Id.* at *3.
221. *See* Ellison et al., *supra* note 76, at 5.
222. *See, e.g.*, *supra* note 83 and accompanying text.
223. *See* Ellison et al., *supra* note 76, at 3–8.
224. *See, e.g.*, *In re* Roxwell Performance Drilling, LLC, No. 13–50301–RLJ–11, 2013 WL 6799118, at *4 (Bankr. N.D. Tex. Dec. 20, 2013); *In re* Ute Lake Ranch, Inc., No. 16–17054–EEB, 2016 WL 6472043, at *3 (Bankr. D. Colo. Sept. 14, 2016).

In *In re Roxwell Performance Drilling, LLC*,[225] the United States Bankruptcy Court for the Northern District of Texas refused to extend *Bayou* for a state court appointed receiver.[226] In *Roxwell*, a state court entered a receivership order over the Debtor and authorized the receiver to file a petition under the Bankruptcy code on behalf of the Debtor.[227] The receiver caused the Debtor to file for Chapter 11 protection and motioned the court to remain in possession as debtor in possession.[228] The United States Trustee, an equity owner of the Debtor and a creditor of the Debtor, opposed this motion and petitioned the Bankruptcy Court to appoint a Chapter 11 Trustee pursuant to 11 U.S.C. § 1112(b).[229] The Bankruptcy Court distinguished *Bayou*.[230] In *Bayou*, a federal district court appointed a federal receiver, and creditors were pleased with the receiver's services and supported his continuation during bankruptcy.[231] The federal district court expected the Debtor to file for bankruptcy when authorizing the receivership order and retained jurisdiction over the bankruptcy case.[232] While the *Bayou* court construed receiver to mean "the exclusive managing member of a debtor in possession," the *Roxwell* court refused to adopt this construction for state receivership cases and held that the Receiver was required to turn over possession to a court appointed trustee upon causing the Debtor to file for bankruptcy.[233]

In *In re Ute Lake Ranch, Inc.*,[234] the United States Bankruptcy Court for the District of Colorado refused to extend *Bayou* in a state receivership case, even though the receivership order vested the receiver with managerial power.[235] In *Ute Lake Ranch*, a state court appointed a "receiver and custodian" and purportedly granted the receiver broad managerial power over the debtor.[236] The Receiver caused the Debtor to file for Chapter 11 bankruptcy and moved to remain in possession of the

225. *See In re Roxwell Performance Drilling, LLC*, 2013 WL 6799118, at *4.
226. *See id.* at *4–5.
227. *See id.* at * 1.
228. *Id*.
229. *See id.* at *1.
230. *See id.* at *4.
231. *See In re* Roxwell Performance Drilling, LLC, No. 13–50301–RLJ–11, 2013 WL 6799118, at *4 (Bankr. N.D. Tex. Dec. 20, 2013).
232. *See id.*
233. *Id.* at *4–5.
234. *See In re* Ute Lake Branch, Inc., No.16-17054-EEB, 2016 WL 6472043 (Bankr. D. Colo. Sept. 14, 2016).
235. *See id.* at *5.
236. *Id.* at *1.

Debtor as debtor in possession.[237] The United States Trustee filed a motion, arguing the Receiver was a "custodian" and was required to turn over possession to a trustee pursuant to 11 U.S.C. § 543.[238] The Bankruptcy Court recognized that under *Bayou*, federal receivers are not considered "custodians" and are not affirmatively required to turn over possession to trustees.[239] However, the Bankruptcy Court distinguished *Bayou*.[240] While the federal receiver in *Bayou* was appointed pre-petition to serve as federal equity receiver and as managing member, the state receiver in *Ute Lake Ranch* petitioned the court for managerial power after he determined the Debtor's assets should be liquidated.[241] The *Bayou* receiver was appointed pursuant to federal securities law and the court's inherent equitable authority, while the *Ute Lake Ranch* receiver was only appointed pursuant to a state receivership statute.[242] The Bankruptcy Court noted the differences in authority between state and federal receivership orders and held the *Ute Lake Ranch* receiver was required to turn over possession of the Debtor's property to a trustee appointed by the United States Trustee.[243]

V. APPLICATION OF THE *BAYOU* FRAMEWORK

Bayou is an important tool for bankruptcies involving Ponzi schemes and securities fraud. Ponzi schemes present many unique challenges for courts, regulators, creditors, and interested parties.[244] Even though one of the debtor's businesses may be fraudulent, the debtor's other subsidiaries may be legitimate businesses that were only tarnished by the previous management's misconduct.[245] While Ponzi schemes focus on victims, defrauded investors are not the only creditor constituency in a Ponzi scheme. Trade creditors, secured creditors, and unsecured creditors may all have legitimate claims against a Ponzi scheme's bankruptcy estate and are also victims in the Ponzi scheme.[246] Ponzi schemes are typically complex

237. *See id.* at *1–2.
238. *Id.* at *2.
239. *Id.* at *3.
240. *See In re* Ute Lake Branch, Inc., No, 16-17054-EEB, 2016 WL 6472043, at *3–5 (Bankr. D. Colo. Sept. 14, 2016).
241. *See id.* at *1–3.
242. *See id.* at *3–4.
243. *See id.* at *5–7.
244. *See* Bambach, *supra* note 48, at 125.
245. *See, e.g.*, *In re* Petters Co. Inc., 401 B.R. 391, 410–14 (Bankr. D. Minn. 2009).
246. *Cf.* Phelps, *supra* note 46, at 568 (elaborating on how Ponzi schemes involve various

and involve many constituencies.[247] To wind up a Ponzi scheme and obtain a recovery for creditors, special knowledge and expertise of the debtor is needed. Since management is often barred from operating the debtor or incarcerated, selecting a person to wind up a Ponzi scheme requires a thorough and diligent search process.[248]

By recognizing that federal receivers are not affirmatively required to turn over possession to a trustee upon filing for bankruptcy protection, *Bayou* tackles many of these challenges and attempts to maximize recovery for all creditors and stakeholders. Appointing either a receiver or a trustee is an "extraordinary remedy."[249] Both appointments create additional costs for the bankruptcy estate and disrupt the management of the debtor's property.[250] Unnecessary costs or changes of control can be detrimental to the bankruptcy estate and can drive down recovery for victims. Receivers often possess special knowledge and expertise about the debtor's affairs and are selected only after a thorough and diligent search process.[251] By retaining a receiver as debtor in possession, victims and creditors retain a "known quantity" to help administer the bankruptcy estate.[252] If creditors

creditor types, all of which have valid claims against a debtor as a defrauded investor, and all of which may or may not be similarly situated); Bambach, *supra* note 48, at 127, 129–30 (discussing various issues in Ponzi schemes that work to affect the rights of various defrauded investors, including forum selection, foreign investments in domestic funds, taxation resulting in delayed payment to investors, and "clawbacks" of fraudulent transfers by recovering prior distributions of investors).

247. *See* Surendranath R. Jory & Mark J. Perry, *Ponzi Schemes: A Critical Analysis*, FIN. PLANNING ASSOC. (last visited Oct. 13, 2017), https://www.onefpa.org/journal/Pages/Ponzi%20Schemes%20A%20Critical%20Analysis.aspx (explaining the complexity present in Ponzi schemes and the numerous individuals that become involved in such schemes from their inception until the time debtors engaging in the fraudulent investments get caught).

248. *Cf. In re* Bayou Grp., LLC, 431 B.R. 549, 556, 564–65 (Bankr. S.D.N.Y 2010) (explaining that under certain circumstances, unlike the situation in Bayou, one debtor's appointed receiver may not always be equally suited to serve as that same debtor's sole managing member).

249. Citibank, N.A. v. Nyland (CF8) Ltd., 839 F.2d 93, 97 (2d. Cir. 1988) (quoting Chambers v. Blickle Ford Sales, Inc., 313 F.2d 252, 260 (2d Cir. 1968)); Downes, *supra* note 108, at 2229.

250. *See* Downes, *supra* note 108, at 2228–29.

251. *Cf. In re Bayou Grp., LLC*, 431 B.R. at 556, 565 (explaining how in seeking the appointment of a receiver, a group mostly consisting of defrauded creditors in *Bayou* employed a creative strategy involving a thorough research process for candidates best suited to serve, which wound up benefitting both the estate and the Chapter 11 case).

252. *Cf. In re Bayou Grp., LLC*, 431 B.R. at 565 (citing to Adams v. Marwil (*In re* Bayou Grp., L.L.C.), 363 B.R. 674, 688 (Bankr. S.D.N.Y. 2007), *aff'd sub nom.* Adams v. Marwil (*In re* Bayou Grp., LLC, 564 F.3d 541 (2d Cir. 2009)).

are pleased with a receiver's services and support his continuation during a bankruptcy, it makes little sense for the court to add costs, require the receiver to turn over possession, and start fresh with a newly appointed bankruptcy trustee.

Bayou will likely be extended in federal receivership cases that involve fraud. Unlike state law, receivership is not an independent cause of action in federal court.[253] To petition a federal court to appoint a receiver, some other substantive claim must be pled that is entitled to relief in federal court.[254] Courts view the power to appoint a receiver as independent from the power to appoint a manager.[255] The power to appoint a receiver is derived from the federal receivership statute, while the power to appoint a manager is derived from federal securities laws and the court's inherent equitable authority to fashion remedies for violations of the law.[256] Management is expected to be disinterested and owe fiduciary duties to all of the debtor's stakeholders and creditors.[257] While receivership does not survive bankruptcy, there is a strong presumption that management should retain possession during a bankruptcy as debtor in possession.[258]

When deciding whether to extend *Bayou*, courts will look to the receiver's receivership order.[259] While courts recognized that receivers are not affirmatively required to turn over possession during a bankruptcy,

> The courts who denied the United States Trustee's motion for the appointment of a trustee found [the appointed receiver] to be diligently exercising his fiduciary duties . . . [and] by obtaining the appointment of a known quantity in [the receiver] (whom [was] put forward only after conducting a thorough search process) and . . . prevent[ing] his replacement in the crucial early stages of the anticipated chapter 11 case . . . ensured [a] . . . strong central fiduciary "during a corporation's most troubled hour," . . . from start to finish, uninterrupted, having become better informed about the [debtor] than any other non-insider. That benefit significantly exceeded the cost of litigation . . . .

Id.

253. *See* Ellison et al., *supra* note 76, at 7.

254. *See id.*

255. *See, e.g.*, *In re Bayou Grp., LLC*, 564 F.3d at 545.

256. *Cf.* Adams v. Marwil (*In re* Bayou Grp., L.L.C.), 363 B.R. 674, 682–83 (Bankr. S.D.N.Y. 2007), *aff'd sub nom.* Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541 (2d Cir. 2009) (elaborating on how a corporate governance appointment is not made according to federal receivership statutory authority alone but also made in accordance with both the court's inherent authority and federal securities law).

257. *See id.* at 682.

258. *See In re* Ionosphere Clubs, Inc., 113 B.R. 164, 167 (Bankr. S.D.N.Y. 1990).

259. *See* Kassner & Cohen, *supra* note 100.

receivers are not automatically authorized to act as debtors-in-possession.[260] To take advantage of *Bayou*, a receivership order must vest the receiver with broad managerial power.[261] Once a receivership order is authorized by a federal court, it cannot be set aside by the bankruptcy court.[262] While courts recognize initial receivership orders can vest receivers with the power to act as debtor in possession, they are less likely to extend *Bayou* if managerial authority is derived from a petition filed after the initial receivership order.[263] If the receiver is initially classified as a custodian or if the receiver requested managerial authority after determining the debtor's assets should be liquidated, courts are less likely to extend *Bayou*.[264] Courts will consider other factors such as: expense to the bankruptcy estate, performance of the receiver, and whether creditors support the receiver's continuation when deciding whether to extend *Bayou*.[265]

Bayou is less likely to be extended in state receivership cases.[266] Receivership is an independent cause of action in state court and by itself

260. *See, e.g.*, *In re* Petters Co., Inc., 401 B.R. 391, 408 n.32 (Bankr. D. Minn. 2009), *aff'd sub nom.* Ritchie Special Credit Invs., Ltd. v. U.S. Tr., 415 B.R. 391 (D. Minn. 2009), *aff'd* 620 F.3d 847 (8th Cir. 2010); S.E.C. v. Byers, 609 F.3d 87, 92 (2d Cir. 2010); JY Creative Holdings, Inc. v. McHale, No. 8:14–CV–2899–JSM, 2015 WL 541692 , at *3–4 (M.D. Fla. Feb. 10, 2015).

261. *Cf.* S.E.C. v. Byers, 592 F. Supp. 2d 532, 539 (S.D.N.Y. 2008), *aff'd* 609 F.3d 87 (2d Cir. 2010) (explaining a situation where his role of receiver terminated following their bankruptcy petition, but the role of manager continued, and managers in Chapter 11 cases are automatically authorized to act as debtor-in-possession, which under the Bankruptcy Code simply means "debtor").

262. *See JY Creative Holdings, Inc.*, 2015 WL 541692, at *2 (citing *In re* Stratesec, Inc., 324 B.R. 156, 157 (Bankr. D.D.C. 2004)).

263. *Cf. In re* Ute Lake Ranch, Inc., No. 16-17054-EEB, 2016 WL 6472043, at *1–4 (Bankr. D. Colo. Sept. 14, 2016) (explaining how there is no state law that independently would have given the state court authority to make a court-appointed receiver a manager, and thus such an appointment as manager could not have been made without the person's role as receiver and custodian of the debtor; on the other hand, "the *Bayou* court relied on its inherent authority or equitable powers under federal securities law to . . . appoint[] independent of the federal receivership statute").

264. *See id.* at *5.

265. *See In re Petters Co. Inc*., 401 B.R. at 391; *see also Byers*, 609 F.3d at 93 (elaborating on how a decision to retain a receiver as debtor-in-possession is authorized by the appointment order, and acknowledging that a receiver becomes debtor-in-possession automatically by operation of law, but that the receiver's status could be challenged by creditors via statute or motion for trustee appointment).

266. *See In re* Roxwell Performance Drilling, LLC, No. 13-50301-RLJ-11, 2013 WL 6799118, at *4 (Bankr. N.D. Tex. Dec. 20, 2013); *In re* Ute Lake Ranch, Inc., No. 16-17054-EEB, 2016 WL 6472043, at *3 (Bankr. D. Colo. Sept. 14, 2016).

law and their own inherent equitable authority to vest receivers with managerial powers.[267] While state courts have distinguished *Bayou* for involving federal receivers, *Bayou* may be extended in certain state receivership cases. If a receiver is appointed in a state securities fraud case and empowered with managerial authority under the initial receivership order, courts may extend *Bayou* and allow the receiver to act as debtor in possession. Additionally, if the United States Trustee selects a state receiver to be appointed as trustee during a bankruptcy, courts may extend *Bayou*, provided that the receiver turns over assets for administration by the court prior to retaking possession as a trustee.

VI. CONCLUSION

Bayou is an important tool for bankruptcies involving Ponzi schemes and securities fraud. In securities fraud cases, bankruptcy represents a loss of control that can be detrimental to the bankruptcy estate and affect recovery for victims. By allowing receivers to retain possession through bankruptcy as debtors-in-possession, *Bayou* allows creditors to retain a known quantity to help administer the bankruptcy estate. *Bayou* will likely be extended in federal receivership cases where the receivership order grants broad managerial power. While *Bayou* is less likely to be extended in state receivership cases, courts may extend *Bayou* in situations involving state securities law violations where a receiver is given broad managerial power or in situations where the United States Trustee wants to appoint a state receiver as trustee.

267. *See* Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541, 548 (2d Cir. 2009).