New Wine in an Old Bottle: How Minnesota's Receivership Statute Can Promote Both Efficiency and Equity

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Recommended Citation
Available at: http://digitalcommons.hamline.edu/hlr/vol36/iss3/4
NEW WINE IN AN OLD BOTTLE:
HOW MINNESOTA’S RECEIVERSHIP STATUTE CAN
PROMOTE BOTH EFFICIENCY AND EQUITY

Jenny Bourne∗

I. INTRODUCTION

Firms can be an efficient way to organize production, as Ronald Coase noted three-quarters of a century ago.1 When things go awry, however, society requires some way of resolving the troubles of distressed businesses.2 Bankruptcy offers one such means, but it can be cumbersome, costly, and over-attentive to the interests of certain parties, particularly when company management can choose between liquidation and reorganization;3 it is also a one-size-fits-all solution.4 Instead of going bankrupt, a distressed firm could simply struggle along, dissipating productive assets until it falls apart.

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2 Just over 5.7 million firms went out of business in the U.S. between 1999 and 2008, with over 95 percent of these being firms with fewer than 20 employees. See U.S. SMALL BUS. ASS’N, Employer Firm Births and Deaths by Employment Size of Firm, 1989-2008, available at http://www.sba.gov/sites/default/files/dyn_us_tot_1.pdf. Of course, not all firms that folded were distressed, but presumably many businesses closed their doors because they were not as economically successful as their owners had anticipated.
An attractive alternative for unwinding or turning around an enterprise is receivership, an ancient remedy rooted in English chancery law. I suggest that receivership can be the best way of preserving asset value and treating parties fairly when businesses encounter problems. A greater use of receivership can also create incentives for future parties to anticipate contingencies, leading to efficient private resolution of problems rather than costly legal proceedings. Yet receiverships have been underutilized, in part because existing law concerning receivership provides little guidance to either businesses or legal practitioners.

A Minnesota statute effective August 2012 offers a clear and comprehensive set of rules regarding receivership. This new law will educate the legal and business community about an appealing alternative to bankruptcy, promote an efficient and fair way of restructuring or liquidating troubled companies, and encourage firms to foresee and address potential problems in advance.

II. THE BANKRUPTCY ALTERNATIVE

When a business begins to have problems, its creditors naturally worry about the safety of their investments. In the presence of transaction costs and the absence of governing law, each individual creditor has an incentive to rush to secure its interests, even if waiting and working together would yield more overall. In a desperate race to get to assets ahead of rivals, stakeholders in a firm would spend productive resources simply to gain title to existing property. Bankruptcy law in theory provides a mechanism by which creditors can avoid this free-for-all and, instead, act cooperatively.

An effective bankruptcy regime would serve as a screening process, preserving efficient businesses and eliminating firms whose resources could be better used elsewhere. What is more, it would do these things in the least-cost fashion so as to economize on administrative costs.

Yet both theory and empirical evidence suggest that U.S. bankruptcy law falls short on allocative efficiency grounds. Most bankruptcies are

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6 Act of March 30, 2012, ch. 143, 2012 Minn. Laws 51 (codified as amended at Minn. Stat. § 576.21 (2012)). Article 1 of the statute concerns receiverships; article 2 addresses assignments for the benefit of creditors (ABCs). An ABC is a procedure in which a debtor voluntarily transfers all or substantially all of its property to a third party (the assignee) who is responsible for liquidating the property and distributing the proceeds to the debtor’s creditors. The assignee is functionally equivalent to a receiver.

7 See, e.g., Jeremy I. Bulow & John B. Shoven, The Bankruptcy Decision, 9 Bell J. of Econ. 437, 455 (1978); see also, e.g., Michelle J. White, Public Policy toward Bankruptcy: Me-First and Other Priority Rules, 11 Bell J. Econ. 550, 551 (1980).

8 See Michelle J. White, The Corporate Bankruptcy Decision, 3 J. Econ. Persp. 129, 129-30 (Spring 1989) (discussing the history of U.S. bankruptcy law); David A. Skeel, Debt’s Dominion: A History of Bankruptcy Law in America (2001); Harvey Miller & Shai Waisman, Does Chapter 11 Reorganization Remain a Viable Option for Distressed
voluntary, meaning that the firm’s management remains in charge.\footnote{Involuntary bankruptcy is rare. See, e.g., Richard C. Friedman, \textit{Involuntary Bankruptcies – Part II - Ten Tips for Judges, Alleged Debtors, Assigness, Secured Creditors and Trustees}, 18(2) COM. L. BULL. 18 (2003); Edward M. Wolkowitz, \textit{Debtors Have New Weapons Against Involuntary Bankruptcy}, J. CORP. RENEWAL (Turnaround Management Association, Chicago, IL), Dec.1, 2007, available at http://www.turnaround.org/Publications/Articles.aspx?objectID=8503.} Management also has a choice of filing under either Chapter 7 (liquidation) or Chapter 11 (re-organization) and, presumably, will choose the alternative that serves its interests, which may not be the same as the interests of society.\footnote{The choice of Chapter 11 may simply delay the inevitable. Edward R. Morrison, \textit{Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small Business Bankruptcies}, 50 J. L. & ECON. 381, 392 tbl. 6 (2007) (showing that about 70 percent of Chapter 11 cases are eventually dismissed or converted to Chapter 7). But some firms choosing Chapter 7 may not be acting in a socially optimal fashion. Philippe Aghion, Oliver Hart & John Moore, \textit{The Economics of Bankruptcy Reform}, 8 J.L. ECON. & ORG. 523, 525 (1992) (noting that, if bad fortunes are due to bad luck rather than bad management, the best use of firm resources may be to continue operating).} Firms may thus opt for re-organization when society would benefit from their dissolution; less often, firms might choose to liquidate even though their assets are best deployed in the existing business.\footnote{White, \textit{supra} note 8, at 130; Michelle J. White, \textit{Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganizations and Out-of-Court Debt Restructurings}, 10 J.L. ECON. & ORG. 268, 291-93 (1994).} Michelle White goes so far as to suggest that the U.S. bankruptcy system actually delays the movement of resources to higher-value uses.\footnote{Douglas G. Baird, \textit{The Uneasy Case for Corporate Reorganizations}, 15 J. LEGAL STUD. 127, 128 (1986). \textit{See also} Thomas H. Jackson, \textit{Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain}, 91 YALE L.J. 857, 882 (1982). Baird’s critics} Prominent among the critics of Chapter 11 is Douglas Baird, who argues that, absent transaction costs, investors might well have agreed beforehand to accept a bankruptcy liquidation proceeding but would have been highly unlikely to agree to a re-organization.\footnote{White, \textit{supra} note 8, at 138.}
Administrative inefficiency is also a concern. Bankruptcy proceedings can involve substantial outlays of time and money.\textsuperscript{14} For small firms in particular, the costs of bankruptcy proceedings may seem daunting. And the detailed process required by bankruptcy statutes seems particularly ill-designed for winding down small enterprises.\textsuperscript{15}

Efficiency is not the only social issue that arises with troubled businesses, of course; the equitable treatment of stakeholders matters as well. However one might define “fairness,” the concept is not typically front and center in a bankruptcy proceeding. Under Chapter 11, for example, a court never has to determine whether a workout plan is “fair and equitable” unless an entire class of unsecured creditors has voted against it.\textsuperscript{16} According to one empirical study, the payoff to non-tax unsecured claims is zero in about 40 percent of Chapter 11 cases and less than 10 percent overall among filings by small businesses.\textsuperscript{17} Moreover, assets distributed or sold in a bankruptcy proceeding can carry with them liability concerns that a creditor or subsequent owner may not be well-equipped to handle. Although a bankruptcy trustee is authorized to sell assets free and clear of liens in some circumstances under 11 U.S.C. §363, a recent case heard in the Southern District of New York permits some successor liability claims even after a §363 sale.\textsuperscript{18}

**III. THE RECEIVERSHIP ALTERNATIVE**

A receivership occurs when a court orders a receiver to take involuntary possession of the property of someone else. Unlike a bankruptcy trustee, a receiver serves as an officer of the appointing court.\textsuperscript{19} Generally speaking, the receiver’s task is to preserve the value of the property and to


\textsuperscript{17} Douglas Baird, Arturo Bris & Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study* 22-23 (Yale Int’l Ctr. for Fin., Working Paper No. 05-29, 2005).

\textsuperscript{18} Morgan Olson LLC v. Frederico (*In re* Grumman Olson Indus., Inc.), 467 B.R. 694, 703 (S.D.N.Y. 2012) (holding that trustee may only sell where there is notice and a hearing, or trustee remains liable).

\textsuperscript{19} Clark, *supra* note 5, at 17.
treat all interested parties fairly.\textsuperscript{20} Requests for the appointment of a receiver can come from a creditor to a struggling company, from a shareholder, or from within the company itself.\textsuperscript{21}

Receivership proceedings arose in English chancery courts at least as early as the 16\textsuperscript{th} century; most U.S. states have crafted some legislation regarding receivership.\textsuperscript{22} The heyday of receiverships occurred in the U.S. during the latter half of the nineteenth century when railroad companies began to encounter financial distress and to search for viable reorganization schemes.\textsuperscript{23} With the codification of federal bankruptcy legislation, however, receiverships became much less prominent,\textsuperscript{24} although they have remained in use for collecting debts, liquidating companies, overcoming shareholder deadlock, and coping with mismanagement or fraud.\textsuperscript{25}

\textsuperscript{20} Clark, \textit{supra} note 5, at 6, explains that receivership arose out of the practice of granting injunctions to preserve property and avoid waste. Courts began to appoint receivers in cases where doubt arose as to whether the person in possession of the property would comply with the injunction. Examples include situations with remaindermen and infant owners. Equitable remedies generally have their origins in courts of chancery; the principles upon which chancellors were to base their decisions were “honesty, equity, and good conscience.” Clark, \textit{supra} note 5, at 5. A receiver is required to represent all parties with an interest in the litigation. \textit{Weeks v. Cornwell}, 106 N.Y. 626, 631 (1887); \textit{People v. Security Life Ins. Co.}, 79 N.Y. 267, 270 (1879); \textit{Bull v. International Power Company}, 86 N.J. Eq. 275, 278 (N.J. Ch. 1916).

\textsuperscript{21} The party seeking a receiver must have at least a colorable claim to the property in question. \textit{Red River Potato v. Bernardy}, 148 N.W. 449, 450 (Minn. 1914).


\textsuperscript{24} In Delaware, for example, business bankruptcy filings from 2000 to 2009 totaled 8,760, whereas an “unscientific search on Westlaw for receivership decisions” counted 108 for the same period. Honorable J. Travis Laster, \textit{The Chancery Receivership: Alive and Well}, 28 \textsc{Del. Law.} 12, 15 (Fall 2010) (stating statistics on receiverships); see \textsc{also} \textsc{American Bankruptcy Inst.}, \textit{Annual U.S. Filings}, http://www.abiworld.org/AM/Template.cfm?Section=Annual_U_S_Filings1&Template=/TaggedPage/TaggedPageDisplay.cfm&TPLID=62&ContentID=36294 (last visited Sept. 5, 2012) (collecting bankruptcy statistics for several different time periods).

By their very nature, then, receiverships are focused on allocative efficiency (via their emphasis on asset preservation by a disinterested party) and equity (due to the charge given receivers to represent all stakeholders). Receiverships thus can avoid the filtering and principal/agent problems that arise in bankruptcy when debtors remain in charge of assets and have the choice to dissolve or to reorganize.

What is more, receivers may be much more well-suited than bankruptcy trustees at maintaining enterprise value. Bankruptcy trustees must be experts in the complexity of bankruptcy law, but receivers are often persons who understand a particular industry and can operate a business in that industry, or persons who can successfully evaluate and market the assets of a firm. A property manager might be a typical choice for a receiver when a single piece of real estate is involved, for example, whereas a CPA might act as a receiver in a liquidation case.26

Despite the merits of receivership, one might question how well it can work in large, complex, or multistate cases. And the flexibility and stripped-down nature of administering a receivership via a unique court order is potentially a double-edged sword: its simplicity is appealing but may lead to duplication of effort. One attractive quality of detailed legislation is that parties are well aware of the rules and do not have to re-invent the wheel each time a new case arises. In addition, bankruptcy cases go through specific courts staffed by judges trained in bankruptcy law, whereas any judge can issue an order to establish a receivership.

Yet these are not insurmountable issues. Receiverships can be federal, and state receivers can seek supplemental orders from judges in other states. The exhaustive rules and processes laid out in bankruptcy legislation may be irrelevant for many troubled businesses, particularly as most firm “deaths” occur among small firms.27 Statutory guidance can make receivership rules as clear as (though less cumbersome than) those governing bankruptcy. And receivership orders are public; the more of them that are issued, the more that businesses, judges, and lawyers will have templates to consult.


27 U.S. SMALL BUS. ASS’N, supra note 2.
Perhaps most compelling, a greater use of receiverships could encourage people to anticipate more contingencies in advance, thus economizing on legal costs later on in the life of the business. Because the request for receivership can come from any interested party, businesses will have an incentive to plan ahead – more so than under a strict bankruptcy regime which gives entrenched management considerable leeway over decision-making during troubled times. If something does go amiss, receivership can be a valuable tool for encouraging voluntary agreements rather than drawn-out, court-involved remedies. \(^{28}\) As one commentator has stated, “Even the filing of a motion for a receiver can often spur serious settlement discussions and the resolution of disputes.” \(^{29}\)

This last point raises an important issue: for administrative efficiency’s sake, society wants parties to resolve potential problems in advance when doing so is cheaper than relying upon the legal system afterward. Having any legal mechanism in place to unwind a business could encourage careless behavior and lack of planning, because private parties do not bear the full cost of administering the legal system. I suggest, however, that a better understanding and use of receiverships as an alternative to bankruptcy could lead to lower administrative costs than our current system generates.

**IV. A NEW RECEIVERSHIP STATUTE FOR MINNESOTA**

Although receivership is potentially a valuable means of coping with troubled firms, it has been underutilized. What is more, receivership practice has been confined to a narrow set of lawyers, and many judges have little knowledge about how receiverships might work. This is partly because the law governing receivership has been scattered and less than comprehensive. In existing Minnesota statutes, for example, nearly 300 references to receivership appear. \(^{30}\)

Minnesota’s new Chapter 576 addresses both procedural and substantive issues regarding receiverships so as to clarify and simplify the law. It sets out detailed qualifications for receivers and requires the court to verify in writing that the proposed receiver is qualified and independent. \(^{31}\) Receivers must give notice to all known interested parties, maintain records and file reports with the court, and post a bond in an amount set by the

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\(^{29}\) Id.


Professionals retained by the receiver must file a notice with the court but then may receive payment without prior court approval, although the court may specify a process by which interested parties can object. The court will also establish processes regarding claims and distributions. This procedural streamlining will go a long way toward making receivership a viable alternative to bankruptcy – or to floundering along and wasting resources – when business enterprises run into problems.

Many of the substantive provisions of the new act will help conserve asset value and enable markets to function more smoothly. Parties in possession or control of receivership property will have to surrender it upon the receiver’s demand and could be held in contempt of court if they fail to do so, for instance. A receiver also succeeds to all of the rights and duties of the respondent – that is, the person over whose property the receiver is appointed – under any executory contract unless the court orders otherwise. In addition, the receiver can obtain unsecured credit and incur unsecured debt without a court order. In contrast to bankruptcy proceedings, then, assets and firm activity will be in the hands of a disinterested party charged with maintaining value rather than under the control of entrenched management, which may have its own agenda. In certain circumstances the court also will be able to order that a receiver’s sale of property is free and clear of all liens, including redemption rights of the respondent. Productive resources thus will more quickly re-enter the market than when possibly encumbered property is distributed or sold by a bankruptcy trustee.

Under the new statute, unsecured stakeholders in a troubled business have a better opportunity to recover than they would under a bankruptcy proceeding. Although secured claimants have priority, distribution of

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35 Act of March 30, 2012, ch. 143, 2012 Minn. Laws 64 (codified as amended at MINN. STAT. § 576.40 (2012)). The receiver may also compel turnover by motion. Id.
38 The new law also improves upon existing receivership law in maintaining value. A receiver for property in foreclosure will have discretion to pay expenses out of property income in any order that will best preserve property value, for instance, rather than following the strict order of priority specified in current law. Act of March 30, 2012, ch. 143, 2012 Minn. Laws 54 (codified as amended at MINN. STAT. § 576.25 (2012)).
39 Act of March 30, 2012, ch. 143, 2012 Minn. Laws 67-68 (codified as amended at MINN. STAT. § 576.46 (2012)). The receiver must demonstrate that the amount likely to be realized by any person objecting to the receiver’s sale is equal to or greater than the objecting person would realize within a reasonable time absent the sale. Id.
remaining company assets will be made on a pro rata basis. This provision, coupled with the general charge to receivers to treat all interested parties fairly, suggests that equity as well as efficiency will be a greater concern in receivership cases than it has been in bankruptcy proceedings.

V. CONCLUSION

Healthy businesses are the lifeblood of the marketplace; keeping the arteries of commerce clear requires an effective means of coping with sickly or failing firms. Although society would like for businesses to anticipate and prepare for contingencies, sometimes problems – a macroeconomic shock, for example – are hard to foresee, or parties may have incomplete or asymmetric information. We therefore need a body of law to help resolve issues arising in troubled firms in an efficient and timely manner and to give incentives to parties to anticipate these issues when doing so is cheap. Equitable treatment of stakeholders in a distressed firm is likewise a social concern.

Bankruptcy law offers one way of coping with ailing enterprises. Yet, because it leaves many decisions in the hands of firm management, current U.S. bankruptcy law sometimes resuscitates firms that are better left to die and sometimes kills off enterprises that are only temporarily under the weather. What is more, bankruptcies have often left many company stakeholders with little or nothing to show for their investment.

Receivership provides an appealing alternative to bankruptcy. At its heart, receivership can be both an efficient and an equitable remedy. Because existing law governing receiverships is scattered and unfamiliar to many practitioners and businesspersons, however, receiverships have been underutilized as a means of working out troubled enterprises. The new Minnesota statute offers a timely solution: its provisions will help promote efficiency and fair treatment when firms encounter trouble, and its existence will encourage businesses to anticipate potential problems and handle existing ones promptly, leading to additional savings of social resources.