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Creditors beat shareholders when insolvency draws near

Mind your business

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When insolvency looms on the horizon, corporate officers, directors and shareholders had better not take liberties with funds earmarked for the company's creditors unless they are prepared to "pony up" when the company fails.

Recently, the very successful (and fictitious) Venice Co. underwent a restructuring. The board redeemed the shares of retiring shareholder Antonio — 100 shares for $1 million — giving a note payable at $10,000 per month. In turn, Antonio's son Bassanio purchased the same 100 shares for $1 million, making a note payable to Venice at $10,000 per month and secured by a deed of trust on Bassanio's home.

The 100 shares represented half of the issued and outstanding stock of the company. The other half of the outstanding shares were owned by the co-founder of the company, Lorenzo, who formed Venice Co. 20 years ago with Antonio.

Over the last year, Antonio and Lorenzo each took draws from the company of more than $300,000. Between that and the sagging economy, the assets of Venice barely equal the company's liabilities. The company's total debt (all unsecured) is $500,000, there is cash in the bank in the same amount, but there are no other assets to speak of. Moreover, Venice is losing approximately $100,000 a month.

Venice continues to pay on the note to Antonio, even though Bassanio is behind on his payments. Management believes that if Venice can weather the next six months, things will turn around and the company might be operated at least on a break-even basis.

Nevertheless, the trio must make a decision: Should the company liquidate for the benefit of its creditors today?

For Antonio, Bassanio and Lorenzo, the answer may depend in large part on the extent to which directors, officers and/or controlling shareholders may be held personally liable for corporate debts based on their conduct and operation of the corporation. Liability may be based on a breach of a fiduciary duty by the director or officer — a duty normally owed to shareholders, but which shifts to creditors when a corporation becomes insolvent or reaches a "vicinity" of insolvency.

As early as the 1930s, the U.S. Supreme Court recognized that the fiduciary obligations of controlling shareholders might extend beyond the corporation to include creditors. That's the case in fraudulent conveyances or in the context of transactions leading directly to the insolvency of the corporation. But it is also recognized that when a corporation becomes insolvent, its assets become a trust for the benefit of the corporation's credi-

tors. As trustees, corporate directors are then charged with a fiduciary duty to protect the assets for creditors.

For the past decade, in at least two jurisdictions (Delaware and Texas) the scope of this duty has continued to expand. Courts have held that a director/officer's fiduciary duty to the corporation's "community of interest" — including creditors — arises when the corporation is "operating in the vicinity of insolvency." This may be well before the corporation ceases to do business.

Under the circumstances, Bassanio and Lorenzo should think twice before they attempt to operate for the next six months on their creditors' ducats. And Antonio had better pay close attention. If they don't perceive a strong possibility that they will at least preserve the company's asset-to-liability relationship over that time, they ought to liquidate Venice for the benefit of its creditors. Otherwise, they may be paying the company's creditors out of their own pockets.

At a minimum, the company should seek insolvency counsel before making its next move.

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