

Corporate and M&A Law

Fiduciary Duties

Duties in Insolvency & Bankruptcy

Navigating a Family Business Through the Zone of Insolvency



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The motivations of those involved in a family-run business are often complex and multifaceted, but become significantly more troublesome as that business begins to experience financial distress. While corporate law generally separates control and ownership between the directors and shareholders respectively,¹ the small business model often blurs the line between these two distinct roles. Indeed, an individual's occupation of various roles within a family-owned business may place increased demands on that individual to reconcile his or her views and goals with his or her fiduciary obligations, especially when that business entity encounters financial difficulty.²

The Impact of Insolvency or the Zone of Insolvency on Fiduciary Duties

The directors of solvent corporations owe fiduciary duties to the corporations and to their shareholders.³ Directors satisfy their fiduciary duties by “selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm’s value” for the benefit of shareholders.⁴ In the absence of financial distress, directors owe no fiduciary obligations to creditors, who are protected through, *inter alia*, contractual agreements and bankruptcy law.⁵

Yet, the fiduciary obligations of those involved transform when a business becomes insolvent. Though directors must continue to try to maximize the firm’s value for any potential residual benefit for shareholders, directors primarily owe fiduciary obligations to the firm for the *benefit of the creditors* upon insolvency.⁶ Directors, however, do not owe any *direct* fiduciary obligations to creditors upon insolvency.⁷

Additionally, “[a]t least where a corporation is operating in the [zone] of insolvency, a board of directors is not merely the agent of the [shareholders], but owes its duty to the corporate enterprise.”⁸ The zone of insolvency commences when a company faces financial distress and may possibly be insolvent.⁹ “When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its *shareholder* owners.”¹⁰

The duties owed by a corporation’s directors under Delaware law are purposefully straightforward.¹¹ However, applying these fiduciary obligations to a family-run business can be challenging.

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The Zone of Insolvency from Three Perspectives

Those involved in corporations generally occupy one of three different roles: (1) capital provider; (2) employee; or (3) entrepreneurial leader of the business. Yet, in a family business context, various family members often occupy more than one role. And the goals of individuals in these roles can differ vastly. Capital providers, such as shareholders, may desire profit maximization.¹² Employees and entrepreneurial leaders, however, may desire combinations of profit maximization, salary, and perquisites that yield them increased value.¹³ Employees and entrepreneurial leaders, on the other hand, may generally be more risk averse than shareholders because (1) their financial assets are typically concentrated in the firm, rather than diversified, and (2) they often have a significant investment in firm-specific human capital.¹⁴ As a result, entrepreneurial leaders will often focus less on profit maximization than capital providers would otherwise desire.¹⁵

For example, an individual who serves solely as a capital provider may see no benefit to a reorganization that eliminates the equity holders and, as such, may want to delay a bankruptcy filing with the hope that the firm's financial prospects will improve.¹⁶ On the other hand, those who serve as employees or entrepreneurial leaders of the business may be motivated to gain allegiance with the party that is least likely to fire them and may benefit from a reorganization, even if they lose any equity that they may have.¹⁷ The business itself, however, will most benefit from a quick reorganization and exit from bankruptcy, and may be harmed by costly and protracted bankruptcy proceedings that acutely focus on ensuring that a particular constituency of the firm walks away with the largest slice of the pie.¹⁸

– Agency Risk Arising from Management Conflicts of Interest

Yet, when a company is truly insolvent, agency risk may materialize with respect to a company's entrepreneurial management. Agency risk occurs when a firm's management no longer acts in the best interest of its shareholders, but instead works to benefit only itself. In a solvent company, the interests between management and shareholders generally align; however, upon insolvency, shareholders have little incentive to manage risk. Indeed, in the case where no true equity cushion exists (*i.e.*, the value of company stock approaches zero), shareholders can utilize their position to effectively shift risk to the employees and management, as shareholders now reap to gain all potential upside without the attendant downside risk.

The agency risk of shareholders in an insolvent family business described above may very well act to the detriment of management and employees. Illustrative of this theme is the increasing presence of so-called "vulture" funds in the past decade, with such funds purchasing, at deep discounts, increased holdings in companies on the brink of bankruptcy. Although the presence of these "vulture" funds is certainly not widespread amongst family-operated businesses, their behavior after purchasing large interests demonstrates the ever-divergent interests between

management of an insolvent company and shareholders who purchase shares at a deep discount and seek to reap extraordinary profits for pushing the company into profitability. Oftentimes in these situations, the shareholders' risk calculus changes due to the economics of their position, driving them to make drastic cuts in employees, replace management, and otherwise engage in risk-taking to others' detriment. It is precisely in these instances—*i.e.*, when shareholders of insolvent corporations have little to lose and much to gain—that managers in a family-owned business should be most wary of their shareholders.

– Divergent Goals of Management and Employees

Despite the above example, management and employees do not always share the same goals, and such differences are exacerbated when the company is experiencing extreme financial distress. During times of normal operations, management and employees generally share similar goals: stable employment and increased productivity. When the company undergoes financial difficulties, however, oftentimes management is incentivized to deal a blow to the company's employees through layoffs, furloughs, and salary reductions. Indeed, these differences can often be magnified in small companies because those companies may not be subject to the same stringent employment laws that larger corporations face. It is likely that one of the first cost-cutting measures of a struggling company would be to cut employees. Sometimes, however, the terminated employees are related to management and are asked to leave because either they are less productive than other employees or their salaries or wages are higher.

– Competing Incentives Created by Dual Roles

These issues become increasingly complex when a director of a family business occupies more than one of these roles. Under this scenario, there may be internal tensions that can create competing incentives, which may render the fulfillment of one's fiduciary obligations to the firm more difficult. Such a situation can become even more troublesome when the company begins to encounter financial hardship and begins to contemplate reorganization under [Chapter 11](#) of the federal bankruptcy laws. As was aptly noted by the Delaware Chancery Court in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation*, "[t]he possibility of insolvency can do curious things to incentives, exposing . . . opportunistic behavior and creating complexities for directors."¹⁹ The reorganization decision affects not only firm value, but the distribution of value across parties involved in the firm.²⁰

– Different Incentives to Pursue Risky Ventures

Another situation in which the incentives of various constituencies of the firm may conflict occurs when officers or directors decide whether to pursue a risky business venture.²¹ Though a risky investment is generally a matter of unreviewable business judgment, it may be viewed from a different perspective when a company's ability to pay its financial obligations is uncertain.²²

In these instances, shareholders of a nearly insolvent corporation are already in a position where they may possibly lose their investment.²³ They will thus generally benefit from the risky venture because they carry little downside risk and, as equity holders, stand to profit if the risky venture succeeds.²⁴ Creditors may be harmed because the risky investment may increase the likelihood that the corporation will default on the owed obligation.²⁵ Employees and entrepreneurial leaders will also likely be harmed by a decision to take on a sub-optimal amount of risk because it may result in the (1) demise of a family institution, (2) loss of employment, and (3) loss of firm-specific human capital.

– Potential Conflicts Between Shareholders and the Corporation Itself

Not only may the interests of shareholders and the corporation conflict with that of creditors, but there may also be tension between maximizing value to the shareholders and maximizing value to the corporation itself.²⁶ This point is significant because it helps to illuminate the internally conflicting incentives that may exist for individuals that are involved in family businesses. In such cases, a decision to take on an undue amount of risk or engage in protracted bankruptcy proceedings is probably not “in the best interests of the corporation,” as required under Delaware law, but may be in the best interests of a diversified shareholder.²⁷ The tension between maximizing the value of the firm and maximizing the value for shareholders is problematic for directors and can result in uncertainty about their fiduciary obligations. This conflict, however, may have less practical importance in a family business context in which capital providers often have a vested interest in the perpetuation of the firm.

– The Competing Interests of Creditors

The above examples emphasize that “when a corporation is in financial distress, the interests of the shareholders and the corporation itself may inherently collide with those of the creditors, making any respective duties owed by directors to each constituency potentially in conflict and making the scope of each respective duty elusive and difficult to ascertain.”²⁸ To be sure, it is exceedingly difficult to simplify the motivations and goals of any category within a family-owned business and generalize broadly. In any of the situations outlined above, one could probably envision a set of scenarios where the behaviors of that group are different than, or even opposite from, those generalized in this article. Yet, despite the inherent difficulties in such generalizations, the scenarios discussed above can provide useful guidance in determining the motivating behaviors of any individual within a family-owned business enterprise.

Conclusion

Understanding an individual’s conflicting incentives can help one to reconcile those competing interests, fulfill fiduciary obligations, and avoid liability. Directors are vulnerable to lawsuits from

creditors, shareholders, and the corporation itself when the corporation operates in the zone of insolvency.²⁹ Because the financial future of the corporation may be at stake, interested parties may challenge every significant decision in the future using 20-20 hindsight.³⁰ Directors should thus exercise the utmost caution when the corporation enters the zone of insolvency.³¹ In order to avoid liability, directors should thoroughly discuss and, if possible, disinterested directors should control any major decisions involving the firm.³²

Most importantly, individuals involved in a family-run business must remember their respective roles and responsibilities—especially when the corporation operates in the zone of insolvency.³³ This seemingly simple task may be challenging for individuals who have multiple roles with varying degrees of fiduciary obligations. The task may be simplified if individuals make clear distinctions between their various roles and remember the fiduciary obligations that attach when pursuing a particular course of action or acting pursuant to authority provided for by one of their roles. Thus, these individuals should adhere to one simple rule: “remember what hat you are wearing” at any given time.

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¹ See, e.g., *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

² In a family-run business, the fiduciary obligations of those involved are the same as those applicable to individuals involved in large corporations, but whether these obligations have been satisfied is subject to enhanced judicial scrutiny due to the inherent conflicts of interest present in a family-run business. *Don’t Get Caught with Your Hand in the Cookie Jar*, GPS (Feb. 22, 2011), <http://www.gps-business.net/dont-get-caught-with-your-hand-in-the-cookie-jar/>.

³ Zack A. Clement & Travis Torrence, *Directors’ Duties In and Around the Zone of Insolvency*, Journal of Corporate Renewal (Apr. 13, 2010), <http://www.turnaround.org/Publications/Articles.aspx?objectId=12725>.

⁴ *Production Resources Group L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 790 (Del. Ch. 2004).

⁵ *Gheewalla*, 930 A.2d at 99.

⁶ Clement & Torrence, *supra* note 3.

⁷ *Gheewalla*, 930 A.2d at 103. Because directors do not owe any direct fiduciary obligations to creditors, creditors of corporations that are insolvent or operating in the zone of insolvency do not have standing to assert direct claims for a director’s breach of fiduciary duties. *Id.* Under Delaware law, such creditors may assert only derivative claims on behalf of the corporation. *Id.*

Furthermore, according to a recent Delaware decision, creditors of limited liability companies (“LLCs”) lack the standing required to bring both derivative and direct claims. *CML V, LLC v. Bax*, No. 5373-VCL, 6 A.3d 238 (Del. Ch. Nov. 3, 2010). While *Gheewalla* held that “equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation,” the *CML* court held that the same analysis could not be extended to creditors of LLCs because the plain language of the Delaware Limited Liability Company Act withholds derivative standing to

such creditors. Tony M. Davis & Dustin Appel, *No Derivative Standing for Creditors of Insolvent LLCs*, Law360 (Dec. 10, 2010), <http://www.law360.com/articles/212550/no-derivative-standing-for-creditors-of-insolvent-llc>.

The Delaware Limited Partnership Act similarly contains a provision limiting the classes of persons who have derivative standing. Robert L. Eisenbach III, *New Ruling Finds Important Protection for Managers of Insolvent Delaware LLCs*, In the (Red): The Business Bankruptcy Blog (Nov. 16, 2010 7:25 AM), <http://bankruptcy.cooley.com/2010/11/articles/recent-developments/new-ruling-finds-important-protection-for-managers-of-insolvent-delaware-llcs/>. The Delaware Chancery Court noted this fact in *CML*. *Id.*

⁸ *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 BL 23, at *83 (Del Ch. Dec. 30, 1991).

⁹ *Zone of Insolvency – How to Conduct Business When Bankruptcy is Looming*, LawInfo (June 2010), <http://resources.lawinfo.com/en/Articles/Business-Law/Federal/zone-of-insolvency-how-to-conduct-business-wh.html>.

¹⁰ *Id.*

¹¹ *Gheewalla*, 930 A.2d at 103.

¹² Ronald J. Gilson & Bernard S. Black, (Some of) the Essentials of Finance and Investment 250 (1993).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Gilson & Black, *supra* note 12, at 248.

¹⁷ Lawrence A. Weiss & Karen H. Wruck, *Information Problems, Conflicts of Interests, and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines*, 48 J. Fin. Econ. 55, 58 (1998), available at <http://www.bankruptcylitigationblog.com/uploads/file/eastern%20airlines%20failure.pdf>.

¹⁸ Gilson & Black, *supra* note 12, at 248.

¹⁹ No. 12150, 1991 BL 23, at *90, n.55 (Del Ch. Dec. 30, 1991).

²⁰ Weiss & Wruck, *supra* note 17.

²¹ See *Credit Lyonnais Bank Nederland, N.V.*, 1991 BL 23 at *90, n.55 (describing shareholders' financial incentives that may lead them to induce directors to take on too much risk, which may unduly harm creditors).

²² Gilson & Black, *supra* note 12, at 248.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ Gilson & Black, *supra* note 12.

²⁷ *Credit Lyonnais Bank Nederland, N.V.*, 1991 BL 23 at *90, n.55.

²⁸ *Berg & Berg Enterprises, LLC v. Boyle*, 100 Cal. Rptr. 3d 875, 891 (Cal. Ct. App. 2010).

²⁹ Richard M. Cieri & Jeffrey B. Ellman, *As Directors Approach the 'Zone of Insolvency'*, Directors & Boards, Sept. 22, 2000, available at <http://www.thefreelibrary.com/As+directors+approach+the+%27zone+of+insolvency%27.-a068658079>.

³⁰ *Id.*

³¹ *Id.*

³² Marty B. Lorenzo, *Landmark Decisions Clarify Duties of Officers and Directors to their Stockholders*, DLA Piper (Feb. 24, 2009), <http://www.dlapiper.com/landmark-decisions-clarify-duties-of-corporate-officers-to-their-stockholders/>.

³³ Cieri & Ellman, *supra* note 29.