THEORIES OF LIABILITY AGAINST PRINCIPALS OF DEBTOR

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All too often, businesses cease operating, leaving creditors with little or no ability to collect on their debts. Fortunate creditors may have collateral or personal guaranties signed by a person or entity that is not judgment-proof. For the vast majority of creditors, however, their recourse is limited to collecting from the failed business. Especially where the amount owed is significant, creditors will want to consider ways that they might collect from—or credibly threaten collection from—the debtor's principals.

These materials will explore eight theories under which principals of a debtor may be held liable on trade debt, absent an express contractual undertaking on their part to pay the debt. They are: failure to designate representative capacity, piercing the corporate veil, breach of fiduciary duty, deepening insolvency, fraudulent transfers, excessive salaries, illegal dividends and insider preferences.

Under certain forms of business the owners are liable anyway for all of the business's debts. These will be explored first, followed by the eight theories of liability noted above.

Business Forms

The principal forms of business and the nature and extent of the liability of their owners are as follows:

Sole Proprietorship. A business owned by an individual. The individual owns or leases the business's assets and is liable for all of its debts.

General Partnership. A business owned by two or more persons or other entities not as a corporation or other limited liability entity. The partnership owns or leases the assets and is liable for the debts. The partners do not own the assets but are liable for all of the debts, absent an agreement with the creditor to the contrary. Partnership law is governed in most states by the Uniform Partnership Act.

Limited Partnership. This is the same as a general partnership except that all except one of the partners can be limited partners. Limited partners are passive owners in a limited partnership and are not liable for the partnership debt absent an agreement with the creditor to the contrary. General partners manage the partnership business and are liable for the partnership debts.[1] Limited partners can be treated as general partners if they take an active role in the partnership's management or if they permit their name to be used in the partnership name. Where the limited partner's name appears in the partnership name the limited partner is liable to the creditor unless the creditor has actual knowledge that the partner is a limited partner. Where liability is sought against a limited partner because the limited partner plays an active role in management the limited partner can be held liable if the creditor reasonably believed that the limited partner was a general partner.[2]

Limited Liability Partnership (LLP) and Limited Liability Company (LLC). Both the LLP and the LLC are like partnerships except that the owners are not liable for the partnership debts absent an agreement with the creditor to the contrary. LLPs and LLCs must be registered with the state. There is no uniform law dealing with LLPs and LLCs, although there are many similarities among the states' laws.

Corporations. Corporations are business entities created by statute that exist separate and apart from their owners. A corporation is owned by its shareholders, but the shareholders neither own the assets nor are they generally liable on the debts, absent an agreement with the creditor to the contrary. A corporation is managed by its board of directors and its officers, who may or may not also be shareholders. Each state's laws differ slightly on the formation and governance of corporations.

Failure to Designate Corporate Capacity

As a general rule, unless it is clear from a contract that the person signing the contract is signing in a representative capacity—i.e., on behalf of a business entity and not individually—the person signing the contract is personally liable under it. Persons signing on behalf of a corporation should insert their title next to their name in order to signify that they are signing as a representative of the corporation and not in an individual capacity. A typical situation arises where a business is named in an agreement but the agreement is not clear whether the business is a sole proprietorship, corporation or some other legal entity. Without more, one might rightly assume that the business is a sole proprietorship and that the business name is merely a trade name used by the individual signing the contract. Persons who sign contracts without designating their titles may be exposing themselves to personal liability.

[1] A corporation can be a general partner. These corporations often do not have sufficient assets to pay their debts, which frequently makes it difficult for creditors to collect from corporate general partners.

[2] Limited partnership law is governed in most states by the Uniform Limited Partnership Act.

Piercing the Corporate Veil

Piercing the corporate veil, otherwise known as disregarding the corporate entity, imposes liability on shareholders for the debts of a corporation when they have abused the corporate form. There are many reasons to operate under a corporate form. The biggest attraction for the small, closely-held corporation is that the shareholders are not liable for the debts of the corporation. This follows the underlying theory of corporate law that corporations are distinct, separate entities from their shareholders. Thus, in order to maintain insulation from liability shareholders must provide the corporation with financial substance and must maintain its separateness from their personal affairs. Where the shareholders do not follow these rules they may be held liable for all of the debts of the corporation.

In piercing the corporate veil, courts often observe that the corporation is nothing more than the alter ego of its shareholders. In order to find shareholder liability, courts have expressed the notion that two elements must exist:

- There must be such a unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist; and

- The observance of the corporate form would sanction a fraud, promote injustice, or an inequitable result would occur.

Sometimes courts will find that a complete disregard of the corporate separateness, in itself, satisfies the second requirement.

In making the determination as to whether the corporate separateness should be disregarded courts typically consider the following factors: (1) pervasive control; (2) confused intermingling of business activity, assets or management; (3) thin capitalization; (4) nonobservance of corporate formalities; (5) absence of corporate records; (6) no payment of dividends; (7) insolvency at the time of the litigated transaction; (8) siphoning away of corporate assets by dominant shareholders; (9) non-functioning of officers and directors; (10) use of the corporation for transactions of the dominant shareholder; and (11) the use of the corporation in promoting fraud.

Breach of Fiduciary Duty

As a general matter, the officers and directors of a corporation are protected by the so-called business judgment rule, which insulates them from liability for decisions made in accordance with their reasonable business judgment. More specifically, they are not liable unless they have acted in bad faith,[3] were uninformed or were grossly negligent in their decision-making.

A fertile area for holding officers and directors liable is when they have breached their fiduciary duty. Officers and directors generally have a fiduciary duty only to the corporation's shareholders. But, when a corporation becomes insolvent that duty shifts ***to include*** the creditors.

Note that the fiduciary duty is not solely to the creditors. In other words, the officers and directors do not have to operate the business with a view towards the creditors' interests alone. The shift in focus is to include creditors within the scope of those to whom the officers and directors owe a fiduciary duty. Thus, once a corporation becomes insolvent or approaches insolvency, its duty must not only include what is best for the shareholders but what is best for the creditors as well.

Where officers and directors of an insolvent corporation are deemed to have breached their fiduciary duty, creditors may only be able to sue in a derivative capacity, not directly.[4] This means that, while the creditor might bring suit, its suit would be on behalf of the corporation, with all recoveries being paid by the officers or directors to the corporation, not to the creditor itself. The end result is that the fruits of the creditor's lawsuit would likely be shared among all creditors. Even so, the possibility of a derivative lawsuit should not be ruled out. Depending on the amount of debt the debtor owes and the amount of money recoverable in such litigation, it still may be worth the creditor's efforts to bring a derivative suit. Moreover, the threat of the lawsuit may be sufficient. Oofficers and directors of a debtor corporation may decide that it is worth their while to pay the creditor threatening the lawsuit rather than to litigate the issue, with the attendant litigation costs and risks of losing.

Deepening Insolvency

A trend in the cases is for creditors to assert a theory of liability known as "deepening insolvency." This theory argues that officers and directors should be held liable if through either fraudulent or negligent decisions they prolong the life of a corporation and in the process increase the corporation's debt.

The courts are divided on whether a cause of action for deepening insolvency exists and what the parameters are of the cause of action. One court recently held that a cause of action exists only if the conduct of the officers and directors was fraudulent. That

[3] "Bad faith" means a transaction that is authorized for some purpose other than a genuine attempt to advance corporate welfare or is known to constitute a violation of applicable positive law.

[4] North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007)

same court also held that the cause of action can only be brought by the debtor and its bankruptcy estate, not by individual creditors.[5] Other courts have refused to recognize the cause of action altogether. A recent bankruptcy court decision took a middle ground, stating that deepening insolvency could be a basis for damages where an independent tort exists.[6] Under that theory it must be shown that "the defendant prolonged the company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt."[7]

In a 2006 decision, the Delaware Chancery Court rejected the theory of deepening insolvency.[8] The court's rationale is worth repeating:

> Equally important, however, is that Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept. Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, the directors do not become a guarantor of success. Put simply, under Delaware law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations.[9]

The Delaware Supreme Court finally ruled on the issue in a 2007 decision, holding in that case that officers and directors of Delaware corporations that are in the zone of

[5] Official Comm. of Unsecured Creditors ex rel. Estate of Lemington Home for the Aged v. Baldwin (In re Lemington Home for the Aged), 659 F.3d 282 (3d Cir. 2011), *quoting*, In re Citx Corp., 448 F.3d 672 (3d Cir. 2006).

[6] Fannie Mae v. Olympia Mortg. Corp., 2014 U.S. Dist. LEXIS 79479 (E.D.N.Y. June 6, 2014).

[7] Fannie Mae v. Olympia Mortg. Corp., *supra* at *28, *quoting*, Kittay v. Atl. Bank (In re Global Serv. Group LLC), 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004).

[8] Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom.*, Trenwick America Litigation Trust v. Billett, 931 A.2d 438 (Del. 2007).

[9] Trenwick America Litigation Trust v. Ernst & Young, LLP, *supra* at 174.

insolvency do not owe a fiduciary duty to its creditors.[10] Because a disproportionate number of corporations are incorporated in Delaware, this decision has wide-ranging significance.

Whether the cause of action for deepening insolvency exists is dependent entirely on the state in which the corporation was established. More time is needed to see how this emerging cause of action develops and which states recognize it.

Fraudulent Transfers

Payments and other transfers of property can be set aside if the payments were made with actual intent to defraud creditors or if the payment or transfer was made under the following circumstances:

- The debtor was insolvent at the time of the payment or transfer or was made insolvent thereby; and
- The payment or transfer was made for less than fair consideration.

Thus, principals of a business can be held liable for money that they siphon out of a business or property transferred to their new business if the transfer occurs when the business is insolvent or if it can be shown that the principal actually intended to defraud creditors by making the transfer.

Excessive Salaries

In 2005, Congress amended the Bankruptcy Code to make it clear that payments of excess salaries, including severance payments,[11] to insiders are subject to attack in bankruptcy cases as fraudulent transfers. The only limitations are that the payment must be made pursuant to an employment contract and the payment must have been made within two years prior to the bankruptcy filing. While there is no similar provision under the Uniform Fraudulent Transfer Act there is no reason why an excessive salary cannot be treated as a fraudulent transfer under state law, even without the express language in the statute including it.

[10] North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, *supra*.

[11] Stanley v. US Bank Nat'l Ass'n (In re TransTexas Gas Corp.), 597 F.3d 298 (5th Cir. 2010).

Illegal Dividends

Under most state's laws, dividends can be paid to shareholders only when the corporation is solvent. Distributions to persons who are shareholders should be examined carefully both to see if they can be characterized as illegal dividends or as fraudulent transfers.

Insider Preferences

Under the Uniform Fraudulent Transfer Act, which has been adopted in most states, the principals of a debtor are liable for amounts paid to them in repayment of debt if the payment was made at a time that the insider had reasonable cause to believe that the debtor was insolvent. This insider preference provision is similar to that existing under the Bankruptcy Code. There are two principal differences in the laws. The first is that suit can be brought by a creditor directly against the insider under the Uniform Fraudulent Transfer Act, while under the Bankruptcy Code such suits are reserved to the bankruptcy trustee or an entity acting on behalf of the trustee. Second, under the Uniform Fraudulent Transfer Act, it is necessary to show that the insider had reason to believe that the debtor was insolvent, whereas under the Bankruptcy Code the fact of insolvency itself is sufficient. In most instances it should not be too difficult to prove that an insider had reason to believe that the debtor business was insolvent at the time of the payments. While the Uniform Fraudulent Transfer Act imposes a greater burden on the creditor to prove that the insider had reason to believe that the debtor business was insolvent at the time of payments in most cases this should be a simple matter to prove.

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