

Insolvency and crisis

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A. Setting the Scene

- The primary challenge addressed in this presentation is that while we know a lot about insolvency and bankruptcy, we still haven't formed a clear perspective on bankruptcy of steward ownership organisations.
- Perhaps this is the reason why the literature on this issue is still significantly more limited compared to that available on other matters concerning these companies.
- Notably, the legal taxonomy of social enterprises is unsettled, lacking uniform recognition across jurisdictions.
- As *Fleischer and Pendl* (2024) aptly mention: “The social Enterprise Zoo [comprises] six broadly conceived types of animals (or cross-breeds between them): commercial nonprofits, social cooperatives, social business, public-private partnerships, and public sector social enterprises”.

A. Setting the Scene

- Additionally, the diverse organizational structures of stewardship organizations, along with varying national frameworks—such as specialized company forms (e.g., benefit corporations in the US, CICs in the UK) versus private certification—further obscure the discussion.
- Considering that these companies share the common characteristic of pursuing a social purpose alongside profitability, functioning simultaneously as commercial companies, this presentation aims to explore the factors that may distinguish their insolvency focus and processes.

B. Legal instruments and structural design

- *Reiser and Dean (2018)*, argue that a social enterprise's capacity to maintain its mission during financial distress often hinges on pre-existing deal structures and governance frameworks.
- In some cases, a social enterprise's financial success may be closely tied to its social mission, prompting even profit-driven buyers to uphold the enterprise's social focus as it aligns with their financial interests.
- While not all social enterprises will reach this ideal scenario, those with valuable assets can negotiate from a stronger position, structuring deals to enforce mission-related commitments, particularly if they are willing to trade off some financial returns.
- Entrepreneurs and investors can also proactively design governance frameworks and contract rights that prioritize mission preservation, even during exits.
- However, external market forces may precipitate insolvency, challenging these protective tools.

B. Legal instruments and structural design

- While the law can facilitate the growth and stabilization of social enterprises, it can also help mitigate the impact of such drastic transitions on the enterprise's mission. Despite the limitations imposed by insolvency laws, a venture's social mission does not necessarily need to be completely abandoned.
- During dissolution, a phased process unfolds where assets are liquidated to pay creditors, and any remaining assets are distributed to owners. If a social enterprise enters dissolution with assets still available after settling debts, owners can negotiate to transfer mission-critical assets – such as intellectual property or inventory – to entities capable of sustaining the enterprise's social impact.
- As assets deplete, the ability to protect mission-related assets diminishes, requiring prompt, decisive action to implement mission-preserving strategies before creditors' claims dominate.

C. Critical questions

- In typical insolvency proceedings, control of a company shifts from its owners and fiduciaries to its creditors—who may not share the company's social mission. This transition raises a fundamental question when a social enterprise faces bankruptcy: **Should the primary goal be maximizing asset value for creditor repayment, or preserving the organization's social purpose?**
- In some cases, socially-minded lenders may be open to accepting reduced repayments if it enables the continuation of mission-critical activities or allows assets to be transferred to similarly aligned organizations.
- This scenario prompts further inquiry: **Should legal frameworks include provisions that protect social objectives in insolvency?**
- While there are specialized financial instruments designed to safeguard mission integrity, access to these tools isn't universal. Nonetheless, **innovative deal structures and governance mechanisms can offer pathways to preserve the mission**—whether by restructuring ownership or guiding the enterprise through a values-aligned dissolution process.

D. The different approaches

- One perspective holds that the existing bankruptcy framework—especially in the context of liquidation—is poorly suited to the goals of social enterprises.
- Typically, bankruptcy proceedings do not take into account efforts to preserve a social mission.
- In fact, if mission-driven actions diminish the potential returns for creditors, such actions are usually not permitted under bankruptcy law.
- Even in reorganization scenarios, the formal procedures and priorities embedded in bankruptcy systems offer little assistance to founders and investors seeking to safeguard a social enterprise's mission during financial distress.
- After all, social enterprises differ from charitable organizations—their aim is to produce both financial and social returns through a business framework, rather than rely on purely philanthropic activity.

D. The different approaches

- *Hampson (2022)* argues that in the case of benefit corporations, their statutes are designed not only to allow—but to mandate—boards to take into account both general and specific public benefits. But what happens to this legal obligation when a benefit corporation faces financial hardship?
- This question strikes at the heart of the benefit corporation's viability and credibility. It is precisely under financial strain—such as insolvency or during a sale process—that the distinctive mission of a benefit corporation is supposed to come to the forefront.
- If, in such moments, a benefit corporation acts no differently from a conventional for-profit corporation, its unique principles and social commitments risk becoming meaningless.

D. The different approaches

- But what if, during financial distress, the board of a benefit corporation decides to abandon its public benefit mission? Can shareholders or creditors intervene legally to enforce that commitment?
- Although courts have not yet ruled on this issue, the answer should be yes. Not only is this outcome desirable from a policy standpoint but it also aligns with established legal principles. Once a benefit corporation becomes insolvent, creditors may gain derivative standing—similar to shareholders in conventional corporations—enabling them to bring a benefit enforcement proceeding.
- That said, benefit enforcement actions may not necessarily redirect the path of a bankrupt company. These actions typically seek forward-looking, injunctive relief rather than monetary compensation, making them distinct from most bankruptcy-related derivative suits. As a result, key decisions—such as asset sales or plan confirmation—will still be evaluated using the flexible, case-specific standards of bankruptcy law.
- Nevertheless, the duty to consider public benefit could still shape outcomes in bankruptcy.

E. Assessment

Discussion Questions

1. To what extent should insolvency regimes accommodate the dual purpose of social enterprises?
2. How might existing fiduciary duties be interpreted or reformed to protect public benefit obligations during insolvency?
3. Should creditor rights in social enterprises be subordinate to mission-preserving mechanisms? Why or why not?
4. What role does channelling theory play in justifying legal distinctions for benefit corporations in insolvency?

E. Assessment

Necessary steps

1. **Critically assess** whether current insolvency laws are fit for purpose in the context of steward ownership enterprises.
2. **Discuss the legal feasibility and normative desirability** of introducing mandatory mission-preservation clauses in insolvency procedures involving steward ownership enterprises.
3. **Examine the role of fiduciary duties** under steward ownership enterprises statutes and their impact on social mission preservation during financial distress.