

FIDUCIARY DUTIES IN TROUBLED TIMES

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I. INTRODUCTION

The recent economic tumult brings to the forefront the issue of fiduciary duties in the context of insolvency – an unfortunate circumstance faced by an increasing number of boards of directors and shareholders in these troubled times. The fact, or threat, of insolvency can dramatically alter the prism under which a director or controlling shareholder’s conduct will be scrutinized. Insolvency creates the circumstance where duties that are normally owed to shareholders may shift to creditors as residual owners of the corporation. Fiduciary duties can be owed to creditors by individual officers and directors, or by shareholders and parent companies, depending on the circumstances.

The purpose of this article is to briefly summarize the evolving law of fiduciary duties in the context of insolvency, and to highlight recent developments of which all business lawyers and litigators – and their clients – should be aware. Keep in mind, however, that the rules governing a particular director’s or shareholder’s duties must be analyzed under the appropriate governing state law and with respect to the documents memorializing the various relationships at issue. The discussion in this article primarily focuses on Delaware law, with some references to other jurisdictions, as well as their application in the federal courts.

II. FIDUCIARY DUTIES OF INDIVIDUAL DIRECTORS

A. Directors’ Duties *vis a vis* Solvent Companies

Before turning to the special circumstances facing directors in the context of insolvency, a review of the standards governing director duties¹ where the company remains solvent is in order. The starting point is the maxim that responsibility for the management of a corporation’s business and affairs is generally vested in the corporation’s board of directors. *See, e.g.*, DEL. CODE ANN. 8, § 141(a); NEB. REV. STAT. § 21-2035(1); OHIO REV. CODE § 1701.59(A). As the corporate managers, the directors owe fiduciary duties to the shareholders of the corporation, who own the corporation and on whose behalf the directors manage the company.

1. The Duties of Care, Loyalty, and to Act in Good Faith

According to the Delaware Supreme Court, directors of a Delaware corporation owe the corporation and its shareholders a “triad” of duties. *In re Fedders North America, Inc.*, 405 B.R.

¹ The Delaware Supreme Court recently clarified that corporate officers owe the very same duties as directors. *Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009) (“In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold.”). The Court noted, however, that the fact that officers owe the same duties as directors “does not mean . . . that the consequences of a fiduciary breach by directors or officers, respectively, would necessarily be the same. Under 8 Del. C. § 102(b)(7), a corporation may adopt a provision in its certificate of incorporation exculpating its directors from monetary liability for an adjudicated breach of their duty of care. Although legislatively possible, there currently is no statutory provision authorizing comparable exculpation of corporate officers.” *Id.* at 709 n. 37.

527, 540 (Bankr. D. Del. 2009) (citing *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998)). This triad is composed of the duty of care, the duty of loyalty, and the duty to act in good faith. *Id.* The “triparte fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided.” *Id.*

With regard to the duty of care, a plaintiff must generally make a showing of gross negligence in order to prove a breach of the duty. *In re Fedders*, 405 B.R. at 540; *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096, 1113 (Del. Ch. 2008) (noting “a corporate director is only considered to have breached his duty of care in instances of gross negligence”). What behavior constitutes gross negligence varies based on the particular facts of the case, but courts generally hold that it occurs when directors fail to inform themselves fully and in a deliberate manner. *See, e.g., Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368 (Del. 1993) (collecting cases); *see also Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 194 (Del. Ch. 2006), *aff’d*, 931 A.2d 438 (Del. 2007) (observing that gross negligence may be pleaded by alleging “that a board undertook a major acquisition without conducting due diligence, without retaining experienced advisors, and after holding a single meeting at which management made a cursory presentation”).

The duty of loyalty “mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.” *In re Fedders*, 405 B.R. at 540 (quoting *Cede & Co.*, 634 A.2d at 361). “To state a legally sufficient claim for breach of the duty of loyalty, plaintiffs must allege facts showing that a self-interested transaction occurred, and that the transaction was unfair to the plaintiffs.” *Id.* (quoting *Joyce v. Cuccia*, 1997 WL 257448, at *5 (Del. Ch. May 14, 1997)). The duty of loyalty generally prohibits conduct that qualifies as self-dealing, such as misappropriation of corporate opportunities, taking excessive compensation, and utilizing corporate assets or information for personal gain. *See generally* Ramesh K.S. Rao, David Simon Sokolow & Derek White, *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 53, 60-61 (1996) (collecting cases to illustrate specific violations of duty of loyalty).

The third duty – to act in good faith – has been described as a subsidiary element of the duty of loyalty. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). To qualify as violation of the duty of good faith, a plaintiff must show “conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (*i.e.*, gross negligence).” *Id.* at 369. The Delaware Supreme Court has identified three examples of conduct that may establish a failure to act in good faith. First, a violation of the duty occurs where a director “intentionally acts with a purpose other than that of advancing the best interests of the corporation.” *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 67 (Del. 2006). Second, a breach of the duty of good faith may be shown if a director “acts with the intent to violate applicable positive law.” *Id.* Finally, a violation may be alleged where a director “intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” *Id.* There “may be[, however,] other examples of bad faith yet to be proven or alleged, but these three are the most salient.” *Id.*

Note that Delaware and most other jurisdictions allow corporations to eliminate personal liability of directors to the corporation or its stockholders for failure to act with due care – but not liability for breach of the duty of loyalty or for intentional misconduct. *See, e.g.*, DEL. CODE. ANN. 8 § 102(b)(7).

2. Directors' Duties Run to the Corporate Enterprise.

The duties described above generally flow to the corporation and its shareholders. “It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders.” *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007) (hereinafter “*Gheewalla*”) (citing *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939) and *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998)).

Officers and directors of a corporation generally do not owe a fiduciary duty to the creditors of the corporation unless the corporation is insolvent. *See Simons v. Cogan*, 549 A.2d 300, 302-04 (Del. 1988); *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 790 (Del. Ch. 1992) (holding that “fiduciary duties to creditors arise when one is able to establish the fact of insolvency”); *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) (finding that officers and directors of a corporation owe fiduciary duties to creditors when the corporation is “operating in the vicinity of insolvency”); *see also Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1525 (S.D.N.Y. 1989); *Metropolitan Sec. v. Occidental Petroleum Corp.*, 705 F. Supp. 134, 141 (S.D.N.Y. 1989); *C-T of Virginia, Inc. v. Barrett*, 124 B.R. 689, 692-93 (W.D. Va. 1990). Although there are some limited exceptions to this general rule, unless the corporation is insolvent, creditors must rely on general creditors’ rights – such as contract, secured credit, fraudulent transfer and preference – in protecting their rights against the corporation. In the context of insolvency, however, creditors join the corporate constituency to which directors owe their duties.

B. The “Insolvency Exception”

Once a company becomes insolvent² the directors’ fiduciary duties shift to the entire community of interests, including the creditors. *In re Musicland Holding Corp.*, 398 B.R. 761, 786 (Bankr. S.D.N.Y. 2008); *Claybrook v. Morris (In re Scott Acquisition Corp.)*, 344 B.R. 283, 290 (Bankr. D. Del. 2006); *Official Comm. of Unsecured Creditors of Verestar, Inc. v. Am. Tower Corp. (In re Verestar, Inc.)*, 343 B.R. 444, 471-72 (Bankr. S.D.N.Y. 2006). This so-called “insolvency exception” to the general rule that directors do not owe any special duties to

² A corporation is insolvent under Delaware law when its liabilities exceed the reasonable market value of its assets, or when it is unable to pay its debts as they come due in the usual course of business. *Prod. Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 775-776 (Del. Ch. 2004); *Geyer v. Ingersoll Publ’ns Co.*, 621 A.2d 784, 791 (Del. Ch. 1992). The definition of insolvency in the Bankruptcy Code (11 U.S.C. § 101, *et seq.*) is more expansive, including, in addition to the balance sheet test, the inability of an entity to pay debts as they come due and the incurrence of debt that an entity cannot expect to repay. *See* 11 U.S.C. § 101(32).

creditors can be traced to the “trust fund doctrine” set forth 175 years ago by Justice Story in *Wood v. Dummer*, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944). See *In re Mortgageamerica Corp.*, 714 F.2d 1266, 1268-69 (5th Cir. 1983).

The insolvency exception has become increasingly relevant in these times, where many corporations are either insolvent, or in the zone of insolvency. Whether an entity is or is not actually insolvent is not often clear, and many courts have found that the fiduciary duty to creditors can be implicated when a company enters the so-called “zone of insolvency.” Moreover, whether and to what extent officers, directors or controlling shareholders must consider the interests of creditors in decision-making can be a complicated question with unclear answers. There have been some developments in recent years, however, that may help clarify.

1. The Origins of the Insolvency Exception

Under the trust fund doctrine, “the directors [of an insolvent corporation] become trustees tasked with preserving capital for the benefit of creditors who are deemed to have an equity-like interest in the firm’s assets.” *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 791 (Del. Ch. 2004); see also *In re Mortgageamerica Corp.*, 714 F.2d 1266 at 1269; *Clarkson Co., Ltd. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1991), *cert. denied*, 455 U.S. 990 (1982).

Expanding on this doctrine, courts have held that when a company becomes insolvent, the directors’ duties expand to include, or shift to, the corporation’s creditors. *In re Hechinger Investment Co. of Delaware*, 274 B.R. 71, 89 (D. Del. 2002) (“At the moment a corporation becomes insolvent . . . the insolvency triggers fiduciary duties for directors for the benefit of creditors.”); see also *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982) (“[W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors.”); *Henderson v. Buchanan (In re Western World Funding, Inc.)*, 52 B.R. 743, 763 (Bankr. D. Nev. 1985) (holding that when a corporation is insolvent the fiduciary of directors run to creditors); see also *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); *Brundage v. New Jersey Zinc Co.*, 226 A.2d 585, 598-99 (N.J. 1967); *Geyer v. Ingersoll Pubs. Co.*, 621 A.2d 784, 787 (Del. Ch. 1992).³ “This is because when a corporation enters the zone of insolvency, the creditors – and not just the shareholders – are residual risk bearers whose recovery is dependent upon business decisions of the directors. In other words, in an insolvency situation, the directors can be said to be ‘playing with the creditors money.’” *In re Hechinger*, 274 B.R. at 89.

The seminal case for the proposition that a director’s fiduciary duties expand to include creditors when the corporation is insolvent or in the so-called “zone of insolvency” is *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991) (unpublished) (hereinafter “*Credit Lyonnais*”). In *Credit Lyonnais*, the Delaware

³ See also generally Robin E. Phelan, *If Their Business Judgment Was So Good How Come They’re In Bankruptcy and Other Perplexing Mysteries of the Business Judgment Rule: Corporate Governance Issues for the Financially Troubled Company*, 10 J. BANKR. L. & PRAC. 471, 475-76 (Sept./Oct. 2001).

Chancery Court held that directors would be protected by the business judgment rule if they pursued in good faith a less risky business strategy because they believed a more risky strategy might render the company unable to meet its obligations to its creditors. *Id.* at *34 n.55. Therefore, the case seemed to be about *protecting* directors in their management of the corporation, not expanding grounds for holding them liable for a breach of a duty.

Instead of merely applying this holding to determine whether a director was protected by the business judgment rule, courts applying *Credit Lyonnais* and its progeny have interpreted the case as expanding fiduciary duties to include creditors. The confusion stems from a single footnote in which the *Credit Lyonnais* court provided an example of a solvent corporation weighing the risks versus rewards of a particular business decision that could potentially impact creditors and shareholders differently. *Id.* The court noted that directors will reach the best decision if, instead of looking to shareholders and creditors separately, they “consider the *community of interests* that the corporation represents.” *Id.* (emphasis added). The court stated that the best result would “not be reached by a director who thinks he owes duties directly to shareholders *only*,” but rather “by directors who are capable of conceiving of the corporation as a legal and economic entity.” *Id.* (emphasis added). “[I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (*or the creditors*, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.” *Id.* (emphasis added). Whatever the Chancery Court’s intent, this example, nestled in a footnote, has given rise to a long line of cases holding that creditors may now assert fiduciary duty claims against directors in the context of insolvency.

In the subsequent *Production Resources* case, the Chancery Court argued that other courts have misinterpreted *Credit Lyonnais*’s “creative language,” and that the case was not intended to create extended or expanded duties to creditors. *Production Resources Group*, 863 A.2d at 789. Rather, it was intended to create an additional *shield* for directors against shareholders claiming the company should have taken increased risks for their benefit. *Id.* at 789-90. By perhaps unintentionally expanding creditor rights, *Credit Lyonnais* may have done as much to confuse this area of law as to clarify it.

As one bankruptcy court recently stated, “[c]ourts across the nation have looked to Delaware for further developments and clarification regarding the cause of action” for breach of fiduciary duty asserted by a creditor in the context of insolvency. *I.G. Services v. Wells Fargo Bank*, 2007 WL 2229650, at *2 (Bankr. W.D. Tex. July 31, 2007). “[I]t was not until [recently] that the Delaware Supreme Court finally helped to clear what have been for many years very muddy legal waters.” *Id.* at *2.

2. The Delaware Supreme Court Clarifies the Insolvency Exception in the *Gheewalla* case.

The recent development to which the bankruptcy court in *I.G. Services* was referring above is the *Gheewalla* case, in which the Delaware Supreme Court clarified the insolvency

exception and the nature of the duties owed by directors in the context of insolvency. The Court considered the following question: “[A]s a matter of Delaware law, can the creditor of a corporation that is operating within the *zone of insolvency* bring a *direct action* against its directors for an alleged *breach of fiduciary duty*?” *Gheewalla*, 930 A.2d at 99 (emphasis in original).

The *Gheewalla* opinion addressed the tension between creditor and shareholder rights, and noted that normally creditors are protected by existing contract, fraudulent transfer and other laws designed specifically to protect them:

While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. Delaware courts have traditionally been reluctant to expand existing fiduciary duties. Accordingly, the general rule is that directors do not owe creditors duties beyond the relevant contractual terms.

Id. at 99 and n.25 (internal quotes omitted, citing *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988), *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986), *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992), and *Production Res. Group v. NCT Group, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004)).

The Court compared the circumstance of solvency to insolvency, and stated that whether a claim is asserted by a shareholder or a creditor, it is really a derivative claim asserted on behalf of the corporate enterprise:

When a corporation is *solvent*, [fiduciary] duties may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation’s growth and increased value. When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

Id. at 101 (emphasis in original). The issue, as framed by the Delaware Supreme Court, is therefore not whether fiduciary duties are *owed* to creditors (they are not – creditors have adequate protection in contract, fraudulent transfer and other related law), but whether creditors have *standing* to pursue fraudulent transfer claims on behalf of the corporate enterprise. That standing is only conferred in the circumstance of insolvency. As the *Gheewalla* Court explained:

[T]he creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation’s insolvency “makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value.” Therefore, equitable considerations give creditors standing to pursue derivative

claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

Id. at 101-02 (emphasis in original, quoting *Production Resources Group*, 863 A.2d at 794 n. 67)).

Based on this analysis, the Court held that “[r]ecognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation.” *Id.* at 103. The Court’s ruling gives some comfort to directors attempting to navigate a corporation through troubled financial waters:

To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors’ duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. *Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.* Accordingly, we hold that individual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors.

Id. (emphasis added).⁴ Therefore, under *Gheewalla*, directors do not owe fiduciary duties directly to creditors – they continue to owe duties only to the corporate enterprise – creditors merely have standing to pursue fiduciary duty claims on behalf of the enterprise. *Id.*

In terms of standing, courts applying *Gheewalla* have permitted a derivative claim brought by a Chapter 7 trustee on behalf of the creditors of an insolvent corporation to proceed. *See In re VarTec Telecom, Inc.*, No. 06-3506, 2007 WL 2872283, at *3-4 (Bankr. N.D. Tex. Sept. 24, 2007); *see also In re MS55, Inc.*, No. 06-1233, 2008 WL 2358699, at *3 (D. Colo. Jun. 6, 2008) (holding that under *Gheewalla*, bankruptcy trustee could “stand in the creditor’s shoes” and bring derivative action for aiding and abetting breach of fiduciary duties against insolvent corporation’s officers and directors).

And in terms of recovery, whether a claim is brought by shareholders or creditors, the derivative suit is being brought on behalf of the corporation, and as a result any recovery must go to the corporation. *Torch Liquidating Trust ex rel. Bridge Associates L.L.C. v. Stockstill*, 561 F.3d 377, 385 (5th Cir. 2009); *see also Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004); *Prod. Res. Group*, 863 A.2d at 792 (noting that in derivative claims brought by creditor of insolvent company, “any recovery logically flows to the corporation and

⁴ *But see In re Allserve Sys. Corp.*, 379 B.R. 69, 79 (Bankr. D.N.J. 2007) (acknowledging *Gheewalla* but declining to hold, under New Jersey law, that creditors do not have a direct fiduciary duty claim against directors in the context of insolvency).

benefits the derivative plaintiffs indirectly to the extent of their claim on the firm's assets").

It should be noted that although the *Gheewalla* opinion restricts creditor claims to derivative suits, it nonetheless reaffirms the "insolvency exception" concept, *i.e.*, that a director's duties shift and creditors join the corporate constituency to which directors owe duties. *See, e.g., Schoon v. Smith*, 953 A.2d 196, 208 n.46 (Del. 2008) ("*Gheewalla* confers standing upon creditors to bring a derivative action where the corporation is insolvent, but only because the shareholders of an insolvent corporation no longer have an economic interest in the corporate entity—only its creditors have that interest. Only for that reason and in that context does *Gheewalla* permit creditors to stand in the shoes of the shareholders."). This holding is not without controversy. Despite the Delaware Supreme Court's continuing confidence in the doctrine, the insolvency exception has come under heavy criticism in recent years, and some commentators have called for its abolition.⁵

3. The "Zone of Insolvency"

The second significant (albeit not entirely clear) holding of the *Gheewalla* case concerns what has become known as the "zone of insolvency." Delaware courts have held that directors owe a fiduciary duty to creditors where the corporation is not technically insolvent, but is operating in the "zone of insolvency." *Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'ns Corp.*, 1991 WL 277613 (Del. Ch. 1991); *see also Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004); *Trenwick America Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006); *Big Lots Stores, Inc. v. Bain Capital Fund VI, LLC*, 922 A.2d 1169 (Del. Ch. 2006); *Geyer v. Ingersoll Pubs. Co.*, 621 A.2d 784, 791 (Del. Ch. 1992). This malleable area of law caused much consternation among directors, and academics, who were frequently faced with trying to ascertain when, and to what extent, they owed duties to creditors in addition to – or to the exclusion of – shareholders.⁶

⁵ *See* Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L. J. 809, 809, 864 (2008) (arguing that the current insolvency exception "suffer[s] fatal theoretical infirmities" and that it "should be eliminated"); Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1324 (Oct. 2007) (arguing for the abolition of the insolvency exception, and stating that "[r]egardless of financial condition, a corporation and its directors should never owe a duty to creditors, apart from constraints arising in contract or tort"); J. William Callison, *Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice*, 1 J BUS. & TECH. L. 431, 434, 444-53 (2007) (arguing that the insolvency exception is not supported by classical theories of fiduciary duty and it creates unacceptable ambiguity and uncertainty, and therefore it should be reversed).

⁶ Rutheford B. Campbell, Jr. & Christopher W. Frost, *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. Corp. L. 491 (2007); Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent or In the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COM. L.J. 295, 301-02 (2004); Patrick M. Jones & Katherine Heid Harris, *Chicken Little Was Wrong (Again): Perceived Trends in the Delaware Corporate Law of Fiduciary Duties and Standing in the Zone of Insolvency*, 16 J. BANKR. L. & PRAC. 2 (2007); Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1487 (1993); Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003); Ramesh K.S. Rao, et al., *Fiduciary Duty A La Lyonnais: An Economic*

The Delaware Supreme Court has not yet defined what “zone of insolvency” precisely means. *Gheewalla*, 930 A.2d at 98 n.20. In *Gheewalla*, however, upon considering a motion to dismiss, the court found that the complaint alleged that the debtor operated in the zone of insolvency where, among other things, the debtor could not raise sufficient funds to pay its debts, that it was unable to borrow money from any source other than from one investor, and that it had a specific specific amount of cash on hand that was being spent at a certain rate each month. *Id.* at 97-98. Needless to say, whether a corporation falls within the zone of insolvency (as opposed to actual insolvency) could prove quite worrisome for officers and directors seeking guidance on how to appropriately serve their corporate constituents.

Taking up the zone-of-insolvency issue in *Gheewalla*, the Delaware Chancery Court noted that it had previously expressed some concern about the doctrine, which inherently involves

using the law of fiduciary duty to fill gaps that do not exist. Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections. The implied covenant of good faith and fair dealing also protects creditors. So does the law of fraudulent conveyance. With these protections, when creditors are unable to prove that a corporation or its directors breached any of the specific legal duties owed to them, one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, if extant. Having complied with all legal obligations owed to the firm’s creditors, the board would, in that scenario, ordinarily be free to take economic risk for the benefit of the firm’s equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm’s value.

Gheewalla, 930 A.2d at 100 (quoting *Production Resources Group*, 863 A.2d at 790). Appearing to address these concerns, the Delaware Supreme Court in *Gheewalla* held that the plaintiff-creditor had failed to state a claim for direct breach of fiduciary duty against a corporation’s directors:

Perspective on Corporate Governance in a Financially-Distressed Firm, 22 J. CORP. L. 53 (1996); Myron M. Sheinfeld & Harris Pippitt, *Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case*, 60 BUS. LAW. 79 (2004); Robert K. Sahyan, Note, *The Myth of the Zone of Insolvency: Production Resources Group v. NCG Group*, 3 HASTINGS BUS. L.J. 181 (2006); Vladimir Jelisavcic, *Corporate Law-A Safe Harbor Proposal to Define the Limits of Directors’ Fiduciary Duty to Creditors in the “Vicinity of Insolvency:” Credit Lyonnais Bank Nederland N.V. v. Pathe Commc’ns Corp.*, 18 J. CORP. L. 145 (Fall 1993); see also Selected Papers from the University of Maryland’s “Twilight in the Zone of Insolvency” Conference: Stephen M. Bainbridge, *Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335 (2007); J. William Callison, *Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities Is Incorrect as a Matter of Theory and Practice*, J. BUS. & TECH. L. 431 (2007); Larry E. Ribstein & Kelli A. Alces, *Directors’ Duties in Failing Firms*, 1 J. BUS. & TECH. L. 529 (2007); Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. BUS. & TECH. L. 607 (2007).

In this case, the need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. *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.

Gheewalla, 930 A.2d at 100 (emphasis added). Nonetheless, the Court did not clearly hold that a fiduciary duty claim could not be brought by creditors – derivatively or otherwise – in the zone of insolvency.

Moreover, at least two courts have interpreted *Gheewalla* as holding that, under Delaware law, a creditor may bring a derivative action for breach of fiduciary duty against the directors or officers of a corporation when the corporation is in the “zone of insolvency.” *In re MS55, Inc.*, 2008 WL 2358699, at *3 (D. Colo. June 6, 2008) (“[C]reditors have standing to . . . bring a derivative claim against directors on behalf of the debtor corporation in the zone of insolvency to remedy the injuries the creditor suffered as a result of the injuries to the debtor.”); *Mims v. Fail*, 2007 WL 2872283, at *3-4 (Bankr. N.D. Tex. Sept. 18, 2007) (explaining that *Gheewalla* clarified that, under Delaware law, creditors of a corporation that is either insolvent or in the “zone of insolvency” can maintain derivative suits for breach of fiduciary duty against corporate directors).

Although some courts continue to find that creditors may pursue fiduciary duty claims in the context of the zone of insolvency, some question whether *Gheewalla* did away with this doctrine. See, e.g., Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1324 (noting that the *Gheewalla* court rejected *Credit Lyonnais*’s “zone of insolvency” trigger “in favor of the more precise (and stringent) trigger of ‘insolvency’”). Whether and to what extent the zone of insolvency will continue to be a viable liability theory for creditors in the context of insolvency remains to be seen, but in the meantime directors should assume that such liability still exists.

C. The Business Judgment Rule

Looking back to the origins of the insolvency exception – the *Credit Lyonnais* case – one must consider the business judgment rule to put directors’ fiduciary duties into procedural context. Assuming insolvency occurs, and the director’s fiduciary duties have shifted to include creditors of the corporation, that shift is only the beginning of the inquiry. The parties and the court must still consider the application of the business judgment rule, which often decides whether the directors will be held liable for breach of their fiduciary duties (and whether other defendants will be liable for aiding and abetting).

1. The Protections of the Business Judgment Rule

The business judgment rule protects a board of directors from being questioned or second-guessed on conduct of corporate affairs.⁷ See, e.g., *In re PSE & G S'holder Litig.*, 173 N.J. 258, 801 A.2d 295, 306 (2002). The rule creates a rebuttable presumption that “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); see also *Gantler v. Stephens*, 965 A.2d 695, 705-06 (Del. 2009); *In re Healthco Int'l, Inc.*, 208 B.R. 288, 306 (Bankr. D. Mass. 1997); *In re PSE & G*, 801 A.2d at 306. The deferential business judgment rule is “primarily a process inquiry. Courts give deference to directors’ decisions reached by a proper process, and do not apply an objective reasonableness test in such a case to examine the wisdom of the decision itself.” *Brazen v. Bell Atl. Corp.* 695 A.2d 43, 49 (Del. 1997).

The burden is on the plaintiffs to rebut the business judgment rule. *Aronson v. Lewis*, 473 A.2d at 811. If the plaintiff fails to satisfy that burden, “a court will not substitute its judgment for that of the board if the . . . decision can be ‘attributed to any rational business purpose.’” *Gantler*, 965 A.2d at 706 (quoting *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (in turn quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971))); see also *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (in applying the business judgment rule, the court will not measure, weigh, or quantify directors’ judgments unless they are found to be wholly irrational). The burden of rebutting the business judgment rule is high. *Parnes v. Bally Ent'mt Corp.*, 722 A.2d 1243, 1246 (Del. 1999) (“The presumptive validity of a business judgment is rebutted in those rare cases where the decision under attack is ‘so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.’”) (quoting *In re J.P. Stevens & Co., Inc.*, 542 A.2d 770, 780-81 (Del. 1988)).⁸

The business judgment rule is comprised of four elements: (1) a business decision; (2) disinterestedness and independence; (3) due care; and (4) good faith. *Roselink Investors, L.L.C. v. Shenkman*, 386 F. Supp. 2d 209, 217-21 (S.D.N.Y. 2004) (applying Delaware law). The presumption and protections of the business judgment rule can be rebutted by demonstrating that one of these elements is not present. *Id.* If a party successfully rebuts the presumption, the

⁷ It should be noted that there is some academic debate over whether the business judgment rule applies equally to officers and directors. Compare *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995) (indicating, in *dicta*, that the business judgment rule applies to officers qua officers to the same extent as directors) with *Rafool v. Goldfarb Corp. (In re Fleming Packaging Corp.)*, 351 B.R. 626, 635 (Bankr. N.D. Ill. 2006) (“Although the Delaware Supreme Court routinely states that the business judgment rule covers officers as well as directors when it recites the rule in actions involving only directors, the court has never held that the rule applies to officers acting in that capacity.”) (citing Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005) (arguing, generally, that the business judgment rule should be applied more narrowly to officers than to directors)).

⁸ See also *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“The rule posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be attributed to any rational business purpose.”).

burden of proof shifts to the defendant to show the entire fairness of the transaction. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989).

If the business judgment rule is rebutted, the director must prove the entire fairness of the challenged transaction. *See, e.g., ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 407 (S.D. Tex. 2008). “There are two aspects of the entire fairness inquiry: fair dealing and fair price.” *Id.* (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983)). “Fair dealing” focuses on the actual conduct of the corporate fiduciaries in effecting the transaction. *Id.* (citing *Mills Acquisition Co. v. Macmillan*, 559 A.2d 1261, 1280 (Del. 1989)). “This includes how the transaction was initiated, structured and negotiated and the timing of the transaction.” *Id.* “Fair price” relates to the economic and financial considerations of the transaction.” *Id.* Proving fair price requires a showing that “the price offered was the highest value reasonably available under all the circumstances.” *Id.* (quoting *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993)). In this respect, at least one court has distinguished between fair price and “reasonably equivalent value.” *See generally id.* (finding that reasonably equivalent value was paid for asset, but that “fair price” was not shown).

2. Business Judgment Rule Protection in the Context of Insolvency

The full scope of the business judgment rule’s application is beyond the scope of this article, but a few summary examples are useful. Most importantly, the decision whether to file for bankruptcy protection or not is generally a matter of the directors’ business judgment. *Torch Liquidating Trust ex rel. Bridge Associates L.L.C. v. Stockstill*, 561 F.3d 377 (5th Cir. 2009); *In re Fedders North America, Inc.*, 405 B.R. 527, 542 (Bankr. D. Del. 2009); *see also Odyssey Partners, L.P. v. Fleming Companies, Inc.*, 735 A.2d 386, 416-20 (Del. Ch. 1999).⁹

Similarly, there is no cause of action against a director for breach of fiduciary duty based on the concept of “deepening insolvency.”¹⁰ The mere fact that a strategy turned out poorly is

⁹ *See, e.g., Kittay v. Atlantic Bank of N.Y. (In re Global Servs.)*, 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004) (“The fiduciaries of an insolvent business might well conclude that the company should continue to operate in order to maximize its ‘long-term wealth creating capacity,’ or more generally, its enterprise value. In fact, chapter 11 is based on the accepted notion that a business is worth more to everyone alive than dead.”); *see also NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984) (“The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.”); *In re RSL COM PRIMECALL, Inc.*, 2003 WL 22989669, at *8 (Bankr. S.D.N.Y. Dec. 11, 2003) (“It has never been the law in the United States that directors are not afforded significant discretion as to whether an insolvent company can ‘work out’ its problems or should file a bankruptcy petition.”); *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998) (noting there is no duty “to liquidate and pay creditors when the corporation is near insolvency, provided that in the directors’ informed, good faith judgment there is an alternative”), *aff’d in part & rev’d on other grounds*, 2000 WL 28266 (N.D. Ill. 2000); H.R.Rep. No. 95-595, at 220 (1977), as reprinted in 95th Cong., 1st Sess. 1978 U.S. Code Cong. & Admin. News, pp. 5963, 6179 (“The premise of a business reorganization is that assets that are used for production in the industry for which they are designed are more valuable than those same assets sold for scrap It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.”).

¹⁰ *See, e.g., Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.)*, 448 F.3d 672, 678 (3d Cir. 2006) (“The deepening of a firm’s insolvency is not an independent form of corporate damage. Where an independent

insufficient to create an inference that the directors who oversaw the strategy breached their fiduciaries duties. *Trenwick*, 906 A.2d at 193. “Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm.” *Id.* at 204. In other words, “the mere fact that a business in the red gets redder when a business decision goes wrong and a business in the black gets paler does not explain why the law should recognize an independent cause of action based on the decline in enterprise value in the crimson setting and not in the darker one.” *Id.* at 205.

Therefore, even when a company is insolvent, its directors and officers may “take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red.” *Id.* at 174. The fact that a firm is insolvent does not mean that the company’s officers and 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.” *Id.* In the court’s view, attempting to save the firm does not transform a director into a “guarantor of success.” *Id.*

In addition, the fact that officers and directors continue to be employed and compensated during the company’s financial troubles, standing alone, is not sufficient to support a claim for breach of fiduciary duty. *See, e.g., Grobow v. Perot*, 539 A.2d 180, 188 (Del.1 988) (“The only averment permitting such an inference [of financial interest on the part of the directors] is the allegation that all GM’s directors are paid for their services as directors. However, such allegations, without more, do not establish any financial interest.”), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000).

III. FIDUCIARY DUTIES OF CORPORATIONS

Whether a corporation owes a fiduciary duty to a subsidiary or another entity is a different question from whether individual directors owe fiduciary duties to creditors or shareholders. *See, e.g., Arnold v. Society for Sav. Bancorp, Inc.*, No. 12883, 1995 WL 376919, at *8 (Del. Ch. 1995) (“Respondeat superior . . . does not provide a basis for imputing the fiduciary duties of the directors to the corporation. . . . The directors and officers of a corporation independently owe fiduciary duties directly to the stockholders. Because Bancorp owed no fiduciary duty to its stockholders, either directly or vicariously, it cannot be held liable for its directors’ failure to act as fiduciaries.”). Therefore, in the circumstance where wrongdoing is alleged against a corporate entity by an affiliate or a subsidiary, creditors or fellow shareholders, the basis for the entity’s liability and the nature of entity’s alleged conduct

cause of action gives a firm a remedy for the increase in its liabilities, the decrease in fair asset value, or its lost profits, then the firm may recover, without reference to the incidental impact upon the solvency calculation.”) (citing Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549, 552-57 (2005)); *Joseph v. Frank, et al. (In re Troll Comm., LLC)*, 385 B.R. 110, 122 (Bankr. D. Del. 2008) (deepening insolvency is not a valid cause of action or theory of damages under Delaware law); *Coroles v. Sabey*, 79 P.3d 974, 983 (Utah Ct. App. 2003) (declining to recognize deepening insolvency as sufficient damages); *Christians v. Grant Thornton, LLP*, 733 N.W.2d 803, 812 (Minn. Ct. App. 2007) (deepening insolvency is not a recognized form of corporate damage in Minnesota); *Comm. Fin. Servs., Inc. v. J.P. Morgan Securities, Inc.*, 152 P.3d 897, 900 (Okla. Civ. App.2006) (deepening insolvency is not a recognized measure of damages in Oklahoma).

must be analyzed separately from the duties and conduct of any directors.

As a general rule, corporations do not owe fiduciary duties – the officers and directors who manage the company do. Corporations may, nonetheless, find themselves on the receiving end of a fiduciary duty lawsuit. This section summarizes two such scenarios: a corporation that is the majority shareholder of another corporation, and the circumstance of a wholly-owned subsidiary, where the parent is the sole shareholder. This section also addresses the conundrum faced by directors of wholly-owned subsidiaries in the context of insolvency, and aiding and abetting claims against parents of wholly-owned subsidiaries.

A. The General Rule – Corporate Entities Don’t Owe Fiduciary Duties

Unlike corporate directors, corporate entities generally do not owe fiduciary duties to shareholders. *Arnold v. Society for Sav. Bancorp, Inc.*, 678 A.2d 533, 539 (Del. 1996) (“Plaintiff has not cited a single case in which Delaware courts have held a corporation directly liable for breach of the fiduciary duty of disclosure. Fiduciary duties are owed by the directors and officers to the corporation and its stockholders.”); *Alessi v. Beracha*, 849 A.2d 939, 950 (Del. Ch. 2004) (“[T]he only cognizable claim pled in the complaint is for breach of fiduciary duty, but [plaintiff] concedes, as she must, that fiduciary duties are owed by the directors and officers to the corporation and its stockholders. In other words, Earthgrains owes no fiduciary duty to [plaintiff].”) (internal quotations and citation omitted); *Burcham v. Unison Bancorp, Inc.*, 77 P.3d 130, 146-47 (Kan. 2003) (liability for breach of corporate officers’ and directors’ fiduciary obligation does not run against the corporation itself); *Gaffin v. Teledyne, Inc.*, No. CIV.A. 5786, 1987 WL 18430, at *2 (Del. Ch. Oct. 9, 1987) (“[B]reach of a director’s fiduciary obligation cannot run against the corporation itself.”).

As the Sixth Circuit has explained:

Liability for breach of the directors’ fiduciary obligation could not possibly run against the corporation itself, for this would create the absurdity of satisfying the shareholders’ claims against the directors from the corporation, which is owned by the shareholders. There is not, and could not conceptually be any authority that a corporation as an entity has a fiduciary duty to its shareholders.

Radol v. Thomas, 772 F.2d 244, 258 (6th Cir. 1985) (holding that a corporation cannot be held vicariously liable for breach of the fiduciary obligations owed by its directors). This general rule has not, however, prevented lawsuits from being pursued directly against corporate entities.

B. Controlling Shareholders

The most likely scenario in which a corporate entity will face fiduciary duty claims is when it is a controlling shareholder of another corporation. A majority shareholder, or a group of shareholders who combine to form a majority, owes a fiduciary duty to the corporation and to its minority shareholders if the majority shareholder dominates the board of directors and controls the corporation. *In re MAXXAM, Inc.*, 659 A.2d 760, 771 (Del. Ch. 1995) (“A

shareholder that owns a majority interest in a corporation, or exercises actual control over its business affairs, occupies the status of a fiduciary to the corporation and its minority shareholders.”); *see also Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989); *Singer v. Magnavox Co.*, 380 A.2d 969, 976-77 (Del. 1977); *Trenwick*, 906 A.2d at 192 n.66; *Weinberger v. UOP, Inc.*, 409 A.2d 1262, 1265 (Del. Ch. 1979); *Kaplan v. Centex Corp.*, 284 A.2d 119, 122-23 (Del. Ch. 1971); 18A AM. JUR. 2d *Corporations* § 644 (“Majority, dominant, or controlling shareholders owe a fiduciary duty to the minority shareholders.”) (listing cases).

“Part of the rationale for this [rule] is that when minority shareholders are involved, the subsidiary does not exist solely for the parent’s benefit. Recognition of a fiduciary duty in the dominant shareholder is designed to protect the entire community.” *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 414 (S.D. Tex. 2008) (citing *Pepper v. Litton*, 308 U.S. 295, 307 (1939)). The rule “also prevents the ‘corporate machinery’ from being ‘manipulated so as to injure minority shareholders....’” *Id.* (quoting *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769, 775 (Del. Ch. 1967)).

It is not always clear if an entity qualifies as a majority or a controlling shareholder. Under Delaware law, “[a] stockholder is not deemed controlling unless it owns a majority of the stock or has exercised actual domination and control in directing the corporation’s business affairs.” *In re Sea-Land Corp. S’holders Litigation*, 1987 WL 11283, at *4 (Del. Ch. 1987 (internal citations omitted); *Lewis v. Leaseway Transp. Corp.*, 1990 WL 67383, at *2 n.1 (Del. Ch. May 16, 1990). The plaintiff must show that the defendant exercised day-to-day control over the corporation’s conduct, or over the decisions with respect to the specific transactions at issue. *See, e.g., In re Western Nat’l Corp. S’holders Litig.*, 2000 WL 710192, *6 (Del. Ch. May 22, 2000). Merely showing that a shareholder had the potential to exercise domination and control is insufficient to satisfy this standard, *In re Sea-Land*, 1987 WL 11283 at *5, just as the fact that the shareholders had leverage by virtue of certain contractual rights is insufficient to establish control. *Gradient OC Master Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 130-31 (Del. Ch. 2007). Thus, threatening to place a company into bankruptcy, or refusing to lend necessary funds will not demonstrate the requisite control. *In re Marketxt Holdings Corp.*, 361 B.R. 369, 391-93 (Bankr. S.D.N.Y. 2007) (applying Delaware law).

The fact that a shareholder does not actually own more than 50% of the stock will not preclude a finding that it is a controlling shareholder. *Hollis v. Hill*, 232 F.3d 460, 466 and n. 16 (5th Cir. 2000) (“[O]ther jurisdictions have agreed that the question of minority versus majority should not focus on mechanical mathematical calculations, but instead, [t]he question is whether they have the power to work their will on others-and whether they have done so improperly.”) (internal quotes and citation omitted). Instead, the scope and extent of a controlling shareholder’s fiduciary duty depends on the circumstances of the challenged action or inaction. *See Matter of Reading Co.*, 711 F.2d 509, 517 (3d Cir. 1983) (citing *Gabelli & Co. v. Liggett Group*, 444 A.2d 261, 265 (Del. Ch. 1982)); *see also Mukamal v. Bakes*, 383 B.R. 798, 822-23 (S.D. Fla. 2007). Therefore, the analysis of whether a shareholder qualifies as “controlling,” and thus owes fiduciary duties to minority shareholders, will be a fact intensive analysis where control or domination is not conceded.

Assuming such a duty is found to exist, that duty will extend to creditors in the context of insolvency (at least derivatively), just as it would if the controlling shareholder were a director. See, e.g., *In re Total Containment, Inc.*, 335 B.R. 589, 604 (Bankr. E.D. Pa. 2005); *In re Hechinger Inv. Co. of Delaware*, 280 B.R. 90, 92 (D. Del. 2002); *In re High Strength Steel, Inc.*, 269 B.R. 560, 569 (Bankr. D. Del. 2001). What, then, of the circumstance where the controlling shareholder is the *only* shareholder, and thus, there are no minority shareholders to protect?

C. Parent Companies of Wholly-Owned Subsidiaries

1. Sole Shareholders Do Not Owe Fiduciary Duties to Their Wholly-Owned Subsidiaries.

There is an important distinction between majority shareholders and sole shareholders: “whether a corporate parent owes fiduciary duties to a *wholly-owned* subsidiary (it doesn’t) is entirely different from whether it owes duties to a corporate subsidiary of which it is merely the majority shareholder (it does).” *MC Asset Recovery, LLC v. Southern Co.*, 2006 WL 5112612, at *10 (N.D. Ga. Dec. 11, 2006) (applying Delaware law) (emphasis in original). Court’s refusal to apply fiduciary duties to wholly-owned subsidiaries is logical. “[P]arents and their wholly owned subsidiaries have the same interests because all of the duties owed to the subsidiaries flow back up to the parent. . . . If the subsidiary is not wholly owned, however, in the interest of protecting minority shareholders we revert to requiring that whoever controls the subsidiary seek to maximize its economic value with requisite care and loyalty.” *In re Teleglobe*, 493 F.3d at 266-67.

Therefore, “[a]lthough it is said in general terms that a parent corporation owes a fiduciary obligation to its subsidiaries, *this obligation does not arise as such unless the subsidiary has minority stockholders.*” *Trenwick*, 906 A.2d at 192 n.66 (emphasis added, citing David A. Drexler, Lewis S. Black, Jr., & A. Gilchrist Sparks, III, *DELAWARE CORP. LAW AND PRACTICE* § 15.11, at 15-72 (2002)); see also *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174-77 (Del. 1988) (hereinafter “*Anadarko*”) (“[I]n a parent and wholly-owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders.”). Numerous other courts and jurisdiction have affirmed this rule.¹¹

¹¹ See also *Westlake Vinyls, Inc. v. Goodrich Corp.*, 518 F. Supp. 2d 918, 939 (W.D. Ky. 2007) (“The weight of authority holds that a parent corporation owes no fiduciary duties to its wholly-owned subsidiary”); *Mc Asset Recovery, LLC v. Southern Co.*, No. CIV.A. 1:06-CV-0417B, 2006 WL 5112612, at *10 (N.D. Ga. Dec. 11, 2006) (applying Delaware law); *Shaev*, 1998 WL 13858 at *2 (*supra*); *Aviall, Inc. v. Ryder System, Inc.*, 913 F. Supp. 826, 832 (S.D.N.Y. 1996), *aff’d*, 110 F.3d 892 (2d Cir. 1997) (“Because the officers and directors of a parent company owe allegiance only to that company and not to a wholly owned subsidiary, it is reasonable to conclude that a parent corporation itself is under no obligation to provide the subsidiary with independent representation during the spin-off process.”); *Abex Inc. v. Koll Real Estate Group, Inc.*, No. CIV. A. 13462, 1994 WL 728827, at *16 (Del. Ch. Dec. 22, 1994) (“[T]he duties owed by management did not give rise to a fiduciary duty running from one entity . . . to the other.”) (relying on *Anadarko*); *Resolution Trust Corp. v. Bonner*, No. 92 Civ. 430, 1993 WL 414679, at *3 (S.D. Tex. June 3, 1993) (dismissing derivative suit against corporation because “a parent corporation owes no duties to its wholly-owned subsidiary”); *Household Reinsurance Co., Ltd. v. Travelers Ins. Co.*, No. 91 C 1308,

In *Anadarko*, one of the most oft-cited cases, the Delaware Supreme Court held that a corporate parent owes no fiduciary duty to a wholly-owned subsidiary in preparing contracts between the parent and the subsidiary in anticipation of a spin-off. *Anadarko Petroleum Corp.*, 545 A.2d at 1174-77. The plaintiff subsidiary sued both the parent corporation and the parent's individual directors for breach of fiduciary duties following a spin-off transaction. The court first noted the general principle that "a parent does not owe a fiduciary duty to its wholly owned subsidiary." *Id.* at 1174; *see also Shaev v. Wyly*, No. 15559-NC, 1998 WL 13858, at *2 (Del. Ch. 1998), *aff'd*, 719 A.2d 490 (Del. 1998) (it is a "settled rule[] of law" that "'a parent does not owe a fiduciary duty to its wholly[-]owned subsidiary'" (quoting *Anadarko*). The subsidiary nonetheless argued that the parent "assumed" fiduciary duties to prospective shareholders of the subsidiary by setting a record date for the dividend distribution that would constitute the spinoff. *Anadarko*, 545 A.2d at 1174-1175. Rejecting this argument, the Court held that prior to the dividend, the prospective subsidiary shareholders were simply shareholders of the parent, and the directors of the parent owed no fiduciary duty to prospective shareholders of the subsidiary prior to the spinoff. *Id.* at 1175. Therefore the subsidiary did "not provide a valid basis to impose fiduciary duties" on the parent. *Id.*

The rule that sole shareholders do not owe fiduciary duties to their subsidiaries makes practical sense because, as "Delaware courts have recognized, [] parents and their wholly owned subsidiaries have the same interests because all of the duties owed to the subsidiaries flow back up to the parent." *In re Teleglobe Communications Corp.*, 493 F.3d 345, 366 (3d Cir. 2007). Therefore, while "normally . . . a corporation's primary interest is in maximizing its economic value, the only interest of a wholly owned subsidiary is in serving its parent. . . . That doing so may not always involve maximizing the subsidiary's economic value is of little concern." *Id.* (citing *Anadarko*, 545 A.2d at 1174).

As the *Trenwick* case noted, there is nothing wrong (or even unusual) about a parent company causing its solvent wholly-owned subsidiary to act in a way that benefits the corporate family but harms the individual subsidiary:

Assume for a moment that *Trenwick* itself never went bankrupt. Imagine further that it had bought another insurer and pledged a key asset of *Trenwick America* as security for the purchase price. The purchase goes wrong and causes *Trenwick* to become less profitable, but not insolvent. To satisfy its creditors, *Trenwick* causes *Trenwick America* to sell the key pledged asset and uses the proceeds to pay off the acquisition debt. As a result, *Trenwick America* is less profitable and less valuable. In this scenario, even though the course of events posed no prospect of benefit for *Trenwick America* when it is conceived solely as an entity, there would be nothing troubling about it from a fiduciary perspective. Rather, the scenario would involve a garden-variety situation when a parent corporation

1992 WL 22220, at *3-4 (N.D. Ill. Jan. 31, 1992) ("Under Minnesota law, a 100% shareholder does not owe a fiduciary duty to the wholly owned corporation").

used the asset value of one of its wholly-owned subsidiaries to help it finance and absorb the down-side of the parent's larger business strategy.

Trenwick, 906 A.2d at 192. What, then, is the rule where a wholly-owned subsidiary finds itself insolvent – does the parent company now owe fiduciary duties to the subsidiary's creditors? As discussed in the next section, most likely not.

2. Sole Shareholders Do Not Owe Fiduciary Duties to the Creditors of Their Wholly-Owned Subsidiaries in Insolvency.

The reasons for imposing fiduciary duties upon majority or controlling¹² shareholders do not apply to the relationship between a sole shareholder and its subsidiary's creditors.¹³ While it is logical that a creditor would look to the subsidiary's directors for stewardship of the estate upon the occurrence of insolvency, a creditor should have no such expectation from the parent company. A subsidiary's creditor usually has no relationship, contractual or otherwise, with the parent company (to the extent contract rights exist, they can be pursued), and the insolvency of the subsidiary, with whom the creditor has contracted, should not, as a matter of policy, create a right to traverse the corporate barriers to impose liability on the parent.

“Where there are shareholders in addition to the parent company, both the directors of the subsidiary and the parent company, as controlling shareholder, have a duty to consider the interests of the minority shareholders. . . . However, where the subsidiary is wholly-owned by the parent, the directors of the subsidiary owe the parent a fiduciary duty to manage the subsidiary in the best interests of the parent.” *Roselink Investors, L.L.C. v. Shenkman*, 386 F. Supp. 2d 209, 218 n.3 (S.D.N.Y. 2004) (applying Delaware law) (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) and *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1174 (Del. 1988)). While it is logical that a majority shareholder might owe fiduciary duties to minority shareholders in certain circumstances, because a minority shareholder is particularly vulnerable when dissension arises,¹⁴ that logic has little relevance where the subsidiary is owned by only one shareholder.

Therefore, as a general principle, a parent of a wholly-owned subsidiary is not required to act in the subsidiary's best interest – because it is the *parent's* best interest, or the interest of the corporate enterprise, that is paramount.

¹² The term “controlling” should not be confused with a *sole* owner. Rather, a controlling shareholder, “although lacking a clear majority, [has] such formidable voting and managerial power that they, as a practical matter, are no differently situated than if they had majority voting control.” *In re PNB Holding Co. Shareholders Litig.*, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006)

¹³ See, e.g., *In re Teleglobe Commc'ns Corp.*, 493 F.3d 345, 266-67 (3d Cir. 2007) (“Delaware courts have recognized that parents and their wholly owned subsidiaries have the same interests because all of the duties owed to the subsidiaries flow back up to the parent. . . . If the subsidiary is not wholly owned, however, in the interest of protecting minority shareholders we revert to requiring that whoever controls the subsidiary seek to maximize its economic value with requisite care and loyalty.”); see also *Radol*, 772 F.2d at 258 n.9.

¹⁴ See, e.g., *Muellenberg v. Bikon Corp.*, 669 A.2d 1382, 1386 (N.J. 1996).

One court has questioned this conclusion. *ASARCO LLC v. Americas Min. Corp.*, 382 B.R. 49 (S.D. Tex. Oct. 12, 2007), *on reconsideration in part*, 396 B.R. 278 (S.D. Tex. Aug 30, 2008). In the *ASARCO* case, the debtor in possession (ASARCO, a wholly-owned subsidiary) asserted fiduciary duty claims (in addition to others) against its parent company and sole shareholder, AMC, related to an alleged fraudulent transfer. ASARCO claimed that AMC both owed and breached fiduciary duties to ASARCO and its creditors because ASARCO was insolvent at the time of the transfer. On AMC’s motion to dismiss, the court refused to dismiss the fiduciary duty claim, stating that New Jersey and Delaware law “would not preclude a claim for breach of fiduciary duty brought on behalf of the creditors of an insolvent [wholly-owned] subsidiary against the subsidiary’s directors *and/or the parent corporation.*” *ASARCO*, 382 B.R. at 71. In reaching this conclusion, the court relied largely on the Third Circuit’s recent holding in *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624, 635 (3rd Cir. 2007). *Id.* at 69.

However, the *VFB* case did not hold a parent corporation liable for breach of fiduciary duty. In *VFB* the wholly-owned subsidiary was asserting that its parent “*aided and abetted* a breach of the [subsidiary’s] duty of loyalty to [the subsidiary].” *Id.* (emphasis added). In order to pursue the aiding and abetting claim against the parent, the subsidiary was required to show “that the [subsidiary’s] directors did in fact breach a duty of loyalty to [the subsidiary].” *Id.* The district court had rejected this claim, “holding that [the subsidiary’s directors] breached no fiduciary duty because [the subsidiary] was solvent at the time of the spinoff.” *Id.* The Third Circuit affirmed, relying on case law concerning the fiduciary duties owed by corporate directors – not parent companies.¹⁵ Neither the district court nor the Third Circuit in *VFB* held that the *parent* corporation owed any fiduciary obligations to the subsidiary or its creditors, rather the decision hinged on whether the *subsidiary’s own directors* would owe the subsidiary a fiduciary duty in the context of insolvency.

The *ASARCO* court nonetheless apparently relied on the following language in support of its position that *VFB* stood for the proposition that a parent company owes fiduciary duties to a wholly owned insolvent subsidiary: “A duty of loyalty *against the parent* should arise whenever a subsidiary represents some minority interest in addition to the parent. That could happen . . . if the subsidiary were insolvent.” *VFB.*, 482 F.3d at 635 (emphasis added). But this language did not address a parent’s fiduciary duties – rather, when read in the actual context of the opinion, it was discussing the subsidiary’s *directors’* fiduciary duties, and whether they flowed *to the parent* or the subsidiary and its directors. *Id.*

¹⁵ *Id.* at 634–635 (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994) (addressing dissenting shareholder’s breach of duty of loyalty claims against board of directors); *AYR Composition, Inc. v. Rosenberg*, 619 A.2d 592, 595 (N.J. App. Div. 1993) (addressing duties owed by sole officers and directors); *In re PSE & G Shareholder Litigation*, 801 A.2d 295, 307-308 (N.J. 2002) (addressing shareholders’ derivative action against officers and directors of corporation and its subsidiary, alleging reckless mismanagement of nuclear power facilities); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (discussing directors’ fiduciary obligations when they sit on boards of both a parent and a subsidiary); *Brundage v. New Jersey Zinc Co.*, 226 A.2d 585, 598-99 (N.J. 1967) (discussing directors’ duties vis a vis the companies they serve)).

The district court in *ASARCO* subsequently held after a bench trial that the parent was liable for aiding and abetting the breach of fiduciary duty by the subsidiary's directors – not that it owed fiduciary duties to its subsidiaries. *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278 (S.D. Tex. Aug 30, 2008). Reversing course on the fiduciary duty issue, the court noted that “ASARCO asks the Court to recognize that a parent corporation owes a fiduciary duty to its wholly owned subsidiary and the subsidiary's creditors if the subsidiary is insolvent.” *Id.* at 415. The court considered this request, and stated that it had “reconsidered its prior decision acknowledging this duty and determine[d] that the high court in New Jersey would not recognize the proposed exception.” *Id.*

The court explained its reversal on the issue as follows:

[T]he Court notes that in order to recognize the urged exception, the Court would have to find that a new duty is *created* by the subsidiary's insolvency. Directors always owe fiduciary duties to the corporation. When the corporation is solvent, the beneficiaries of the duty are the shareholders of the corporation; however, if the corporation becomes insolvent, the creditors become beneficiaries of these same duties. In other words, insolvency does not create a new duty, it merely changes the beneficiaries of that duty to include creditors. In contrast, a parent corporation does not owe a fiduciary duty to its wholly owned subsidiary (if it did, it would essentially owe a fiduciary duty to itself). To recognize the existence of such a duty to the subsidiary and its creditors only if the subsidiary is insolvent would mean that insolvency would create a duty where one did not previously exist, instead of merely adding beneficiaries to a pre-existing duty. The Court finds this to be a significant distinction.

Id. at 415 (emphasis in original). The court further noted that the subsidiary's proposed new rule was unnecessary because creditors could look to aiding and abetting liability. *Id.* (citing Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Director's Duty to Creditors*, 46 VAND. L. REV. 1485, 1516-17 (1993)). “The aiding and abetting claim can serve [a] gap-filling purpose; thus, there is no need to impose a duty directly on the parent corporation.” *Id.* Finally, the court noted that it had found the parent liable for aiding and abetting a breach of fiduciary duty – and that such a claim can only be asserted against a non-fiduciary. *Id.* at 416. Therefore, the wholly-owned subsidiary's fiduciary duty claim against its parent failed as a matter of law.

D. The Special Problem of Directors of Wholly-Owned Subsidiaries and Aiding and Abetting Claims

Just because the parent of a wholly-owned subsidiary does not owe fiduciary duties directly to the subsidiary or its creditors does not mean it is out of the woods. As illustrated by the *ASARCO* case, it is not uncommon for wholly-owned subsidiaries and their parent corporations to share directors. This shared interest can create problems for the director in the

context of insolvency, where the subsidiary's creditors join the mix of interests to be protected.¹⁶ The question of to whom director duties are owed is also critical because the parent could be subject to aiding and abetting liability. *See, e.g., ASARCO LLC*, 396 B.R. at 394-414.

In the context of a wholly-owned subsidiary, there is a question concerning whether the presence of a director who sits on both the parent's board and the subsidiary's board constitutes the type of "interestedness" that warrants a rebuttal of the business judgment rule. The protection of the business rule "can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Aronson*, 473 A.2d at 812.

"Interest," as defined by the Delaware Supreme Court in this context, means "that directors can neither appear on both sides of a transaction nor expect to derive personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Roselink Investors, L.L.C. v. Shenkman*, 386 F. Supp. 2d 209, 217 (S.D.N.Y. 2004) (quoting *Aronson*, 473 A.2d at 812). The alleged interest of the director must be material, meaning "that it must be 'significant enough, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties to the shareholders without being influenced by her overriding personal interest.'" *Id.* (quoting *Orman v. Cullman*, 794 A.2d 5, 23 (Del. Ch. 2002) (emphasis in original). "Independence" under the business judgment rule analysis means "that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Aronson*, 473 A.2d at 816. "In assessing director independence, Delaware courts apply a subjective 'actual person' standard to determine whether a 'given' director was likely to be affected in the same or similar circumstances." *McMullin v. Beran*, 765 A.2d 910, 923 (Del. 2000). "To be disqualifying, the nature of the director interest must be substantial" and not merely "incidental." *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1169 (Del. Ch. 1994), *aff'd* 663 A.2d 1156 (Del. 1995).

One must keep in mind that, as discussed *supra*, the directors of a wholly-owned subsidiary generally owe fiduciary duties only to the parent and sole shareholder. *See, e.g., Richardson v. Reliance Nat'l Indem. Co.*, 2000 WL 284211, at *12 (N.D. Cal. Mar. 14, 2000)

¹⁶ "It would be absurd to hold that the doctrine that directors owe special duties after insolvency is inapplicable when the insolvent company is a subsidiary of another corporation. That is precisely when a director must be most acutely sensitive to the needs of a corporation's separate community of interests, including both the parent shareholder and the corporation's creditors. The Delaware courts have recognized that directors who hold dual directorships in the parent-subsidary context may owe fiduciary duties to each corporation. . . . There is no basis for the principle . . . that the directors of an insolvent subsidiary can, with impunity, permit it to be plundered for the benefit of its parent corporation." *Claybrook v. Morris (In re Scott Acquisition Corp.)*, 344 B.R. 283, 289 (Bankr. D. Del. 2006); *see also Collins v. Kohlberg & Co. (In re Southwest Supermarkets, LLC)*, 376 B.R. 281, 282-283 (Bankr. D. Ariz. 2007) ("Delaware law does impose fiduciary duties on the officers and directors of a wholly owned subsidiary that run directly to the subsidiary itself, and not only to its sole shareholder It would be a startling and dramatic departure from settled law to conclude that officers and directors do not owe any fiduciary duty to the corporation they serve.").

(under California law, directors of subsidiary corporation owe duty to parent corporation and its shareholders, not subsidiary). Thus, there is typically no divided loyalty even when a director sits on the boards of both the parent and wholly-owned subsidiary – because each director owes fiduciary duties to the parent, whether or not they are actually also sitting on the parent’s board. As the Third Circuit explained in the *VFB* case:

[S]crutiny is unnecessary when the two companies are a parent and its wholly-owned, solvent corporate subsidiary. . . . Directors must act in the best interests of a corporation’s shareholders, but a wholly-owned subsidiary has only one shareholder: the parent. There is only one substantive interest to be protected, and hence “no divided loyalty” of the subsidiary’s directors and no need for special scrutiny of their actions.

VFB LLC v. Campbell Soup Co., 482 F.3d 624, 634-35 (3d Cir. 2007). The court further noted that “[c]orporate duties should be as broad as their purpose requires, but it makes no sense to impose a duty on the director of a solvent, wholly-owned subsidiary to be loyal to the subsidiary *as against the parent company.*” *Id.* at 635 (emphasis in original).

In the context of insolvency, however, some courts have held that the duties that directors of the wholly-owned subsidiary normally owe to the parent and sole shareholder shift to include creditors. *Id.* (A duty of loyalty against the parent should arise whenever the subsidiary represents some minority interest in addition to the parent. That could happen if the subsidiary were not wholly-owned, [or] . . . if the subsidiary were insolvent.”); *see also ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 395 (S.D. Tex. 2008) (“If the wholly owned subsidiary is insolvent, the director’s fiduciary duties to the corporation run to the benefit of the creditors.”) (citing *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 790-91, 863 A.2d 772, 791 (Del. Ch. 2004) (“The fact of insolvency places the creditors in the shoes normally occupied by the shareholders-that of residual risk-bearers.”)); *In re Scott Acquisition Corp.*, 344 B.R. 283-290 (Bankr. D. Del. 2006) (“[U]pon insolvency directors of a wholly-owned subsidiary owe fiduciary duties to the subsidiary and its creditors.”).

Of course, as discussed above, a finding that a duty exists does not end the inquiry – directors enjoy the protections of the business judgment rule, unless it has been rebutted. *See supra* at II(C). The Southern District of New York, applying Delaware law, considered this very issue. *Roselink Investors LLC v. Shenkman*, 386 F. Supp. 2d 209, 218 (S.D.N.Y. 2004). In *Roselink*, CB.com, the wholly-owned subsidiary of Crown Books, made a significant loan to Crown Books despite the fact that CB.com was insolvent at the time. *Id.* at 213-15. The creditors of CB.com challenged the transaction as a breach of fiduciary duty, and sought to rebut the business judgment rule due to allegedly interested directors. Specifically, the loan was approved by two CB.com director-defendants who served on the boards of both CB.com and Crown Books. *Id.* at 218. Moreover, one of the CB.com directors owned the common stock of Crown Books, and the other served as the President and CEO of Crown Books and collected a salary in connection with those positions. *Id.*

The court first held that “presence [of the subsidiary’s directors] on both sides of the

transaction does not automatically rebut the business judgment rule presumption.” *Id.* (citing *Cullman*, 794 A.2d at 20 n.6). The Court then granted the defendants’ summary judgment motion, holding that the business judgment rule was not rebutted, and would be applied to protect the directors’ approval of the loan to the parent, “because of one *essential fact* overlooked by Creditors: Crown Books [the parent] was the sole shareholder of CB.com [the subsidiary].” *Id.* (emphasis added). Because the subsidiary was wholly-owned, the subsidiary’s directors owed fiduciary duties to the parent company (the only shareholder), which “means that defendants were obligated to consider the interests of [the parent] in any business decision they made.” *Id.* “Indeed, given that Delaware law required defendants, as directors of a wholly-owned subsidiary, to consider the interests of the parent company, defendants would have been in breach of their fiduciary duties had they not considered the best interests of [the parent] in deciding whether to make the Loan.” *Id.*

Most importantly, the court reached this ruling under Delaware law in the context of the subsidiary’s insolvency, and despite the fact that the interested directors also owed duties to the subsidiary’s creditors. *Id.* at 218 n.2. Because the creditor plaintiffs did not assert “any personal interests on the part of defendants relating specifically” to the transaction over and above their dual interests in the parent and subsidiary, the business judgment rule was not rebutted. *Id.* at 218-19.

The significance of the *Roselink* holding is that in the context of wholly-owned subsidiaries, directors would be protected by the business judgment rule when they made decisions for the subsidiary, even in the context of insolvency, *even if* they also sat on the board of the subsidiary’s parent company (as often is the case). The rationale is that each of the subsidiary directors owed duties to the parent anyway, in and out of insolvency. Therefore, absent some independent interest that is personal to the director or some other ground for rebutting the business judgment rule, the decision-making process should be protected by the business judgment rule’s presumptions.

This issue is also of substantial importance to parent companies with wholly-owned subsidiaries, which often find themselves defending against aiding and abetting claims based on a dual director’s breach. For example, in holding the parent liable for aiding and abetting the breach of fiduciary duty by subsidiary directors, the district court in *ASARCO* disagreed with this aspect of the *Roselink* case, arguing that “it ignores the fact that the directors of an insolvent wholly owned subsidiary have divided loyalties (between the parent, their corporation (the subsidiary), and the subsidiary’s creditors), and ‘[w]hen faced with such divided loyalties, directors have the burden of establishing the entire fairness of the transaction to survive careful scrutiny by the courts.’” *ASARCO LLC*, 396 B.R. at 405 n. 149 (quoting *Mills Acquisition Co. v. Macmillan*, 559 A.2d 1261, 1280 (Del. 1989)¹⁷). Therefore, the business judgment rule was

¹⁷ Unlike the *Roselink* case, *Mills Acquisition* did not involve a wholly-owned subsidiary, a fairly important distinction. *Mills Acquisition* addressed a circumstance where certain officers and directors were swayed by a personal financial interest to favor an entity to which they did not owe fiduciary duties. 559 A.2d at 1264-65, 1273-78 (in an auction for sale of corporate control, certain officers and directors of the auctioning company had substantial financial incentive to approve first bidder (a non-related entity), and took action to undermine second bidder (also a non-related entity)). Therefore, the alleged interest was one that benefited the directors personally,

rebutted and the parent company was forced to prove the entire fairness of the transaction – even though it owed no fiduciary duties to the subsidiary or its creditors. Whether this *de facto* fiduciary duty will prevail on appeal remains to be seen, but it is certain this is not the last the courts have seen on this complicated, and timely, issue.

VI. CONCLUSION

There is consensus as to one (and perhaps only one) basic point regarding fiduciary duty of directors of distressed corporations – that at or about the point of insolvency, a duty to creditors is triggered. While recent case law has clarified the issue of the duty of officers and directors generally *vis a vis* creditors in the single corporate entity context, the law is still unsettled and evolving in the parent/subsidiary context. The rationale that, in an insolvency situation, creditors are residual risk bearers whose recovery depends on business decisions of the directors may ultimately encompass duties of care and loyalty normally owed to shareholders in the multi-level corporate family context. Directors of insolvent or near insolvent entities are clearly well advised to take steps (such as obtaining expert professional advice) to assure that their decisions – particularly decisions that could be characterized as risky turnaround efforts – will be (and appear to be) amply justified if scrutinized for their reasonableness and fairness. Likewise, directors who sit on parent and subsidiary boards should insure that transactions are not only fair to the parent as well, or at least meet the business judgment test for both entities, or they may bear the risk of breach of fiduciary duty or aiding and abetting litigation in the event of the subsidiary's ultimate insolvency.

but not the shareholders or the corporation.