"LATCHKEY CORPORATIONS": FIDUCIARY DUTIES IN WHOLLY OWNED, FINANCIALLY TROUBLED SUBSIDIARIES

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ABSTRACT

The current state of the law fails to provide clear guidance to directors of wholly owned, financially troubled ("WOFT") subsidiaries regarding to whom their fiduciary duties run. Directors of solvent wholly owned subsidiaries can act in the best interests of their parent corporation with little fear of liability because the parent corporation is the only party that can sue derivatively on behalf of the subsidiary corporation and is also the subsidiary's only shareholder. However, when a subsidiary corporation becomes insolvent, or in some jurisdictions merely becomes financially troubled, most courts grant the creditors of the subsidiary corporation standing to sue derivatively on behalf of the subsidiary for breaches of fiduciary duty. This grant of standing to creditors traps directors of WOFT subsidiaries between the proverbial Scylla and Charybdis. If directors of a subsidiary favor their parent corporation, the directors will risk facing a fiduciary duty lawsuit from the creditors. On the other hand, favoring creditor interests could open directors of a subsidiary to fiduciary duty-based lawsuits from the parent corporation or lead to prompt removal of the directors by the parent corporation.

Outside of the wholly owned subsidiary context, this conflict between corporate stakeholders is of little practical importance, as directorial decisions are largely protected by the business judgment rule and exculpatory charter provisions. In the wholly owned subsidiary context, however, current law will often classify directors of WOFT subsidiaries as "interested directors" when dealing with their parent corporations. This classification strips directors of WOFT subsidiaries

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of their legal protections and leaves them vulnerable to creditor claims based on breaches of the fiduciary duty of loyalty. Accordingly, the current law encourages directors of WOFT subsidiaries to favor creditors. If directors of WOFT subsidiaries do begin to favor creditors and begin to challenge the instructions of their parent corporations, administrative costs will increase and wealth creation will decrease. Ultimately, owners of parent corporations may choose more flexible entity forms, such as limited liability companies, where the bounds of fiduciary duties can be better controlled. This Article argues that fiduciary duty law should not punish directors when they choose one of the subsidiary's legitimate constituencies, such as its parent corporation, over another constituency, such as its creditors. As a solution to theoretical and practical problems stemming from potential fiduciary duty lawsuits by creditors against directors of WOFT subsidiaries, this Article proposes extending business judgment rule or statutory protections to cover directors of WOFT subsidiaries who, in good faith, favor their parent corporations.

TABLE OF CONTENTS

I. INTRODUCTION 579
II. DUTIES OF CARE AND LOYALTY IN FINANCIALLY TROUBLED COMPANIES 583
A. *Duties of Care and Loyalty Generally* 583
B. *Fiduciary Duties to Creditors?* 584
C. *Timing of Creditor Rights under Fiduciary Duty Law* 588
D. *Extent of Creditor Rights under Fiduciary Duty Law* 591
III. FIDUCIARY DUTIES IN THE PARENT/WHOLLY OWNED SUBSIDIARY CONTEXT 593
A. *Fiduciary Duties of Directors of Wholly Owned Subsidiaries*.....593
1. Duties of the Directors of the Wholly Owned Subsidiary when the Subsidiary is Solvent 593
2. Duties of the Directors of the Wholly Owned Subsidiary when the Subsidiary is Insolvent....................................596
B. *Fiduciary Duties of the Parent to its Subsidiaries* 598
1. Duties of the Parent when the Subsidiary is Solvent but not Wholly Owned....................................598
2. Duties of the Parent when the Subsidiary is Solvent and Wholly Owned 599
3. Duties of the Parent when the Subsidiary is Insolvent and Wholly Owned 600
IV. REFINING THE FIDUCIARY DUTY FRAMEWORK FOR WHOLLY

OWNED, FINANCIALLY TROUBLED SUBSIDIARIES 601
A. *Current Problems in Fiduciary Duty Law* 601
1. "Much Ado about Something" 601
2. Smooth Sailing during Solvency 604
3. Directionless in Distress 606
4. Creating Administrative Difficulties and Undermining Wealth Maximization...609
5. Disfavor of the Corporate Form 612
B. *Case Study: In re* TOUSA, Inc. 613
C. *The Proposed Solution* 614
1. Business Judgment Rule Protection when Choosing between Legitimate Constituencies 615
2. Amending Exculpatory Charter Provision Statutes 617
3. No Business Judgment Rule or Statutory Protection for Purely Selfish Actions...618
V. IMPLICATIONS OF PROVIDING PROTECTION AGAINST DUTY OF LOYALTY CLAIMS IN THE PARENT/WHOLLY OWNED SUBSIDIARY CONTEXT 619
VI. CONCLUSION 623

I. INTRODUCTION

During the most recent recession, countless corporations—including household names such as Lehman Brothers, Bear Stearns, American International Group, Circuit City, and Blockbuster—battled some form of serious financial distress.[1] Many of these corporations are or were comprised of scores, if not hundreds, of subsidiaries.[2]

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[1]David Enrich & Damian Paletta, *The Financial Crisis: Walls Come Down, Reviving Fears of a Falling Titan*, WALL ST. J., Sept. 23, 2008, at A6 (describing the "collapse[]" of Bear Stearns and Lehman Brothers due, in large part, to the "evaporation of liquidity"); Liam Pleven, *Newly Bailed-Out AIG Reports Huge Loss*, WALL ST. J., Nov. 11, 2008, at C7 (detailing a piece of AIG's collapse and the subsequent bail-out saga by the United States government); Stephanie Rosenbloom, *Circuit City Going Out Of Business*, N.Y. TIMES, Jan. 17, 2009, at B1; Michael J. de la Merced, *Blockbuster, Hoping to Reinvent Itself, Files for Bankruptcy*, N.Y. TIMES, Sept. 24, 2010, at B3.

[2]PHILLIP I. BLUMBERG ET AL., 1 BLUMBERG ON CORPORATE GROUPS § 1.03, at 1-6–1-9 (2d ed. Supp. 2009) (noting that in 2002, the 100 largest American corporations had an average of 187 subsidiaries, of which, an average of 179 were at least 95% owned); *see also* Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L.J. 287, 287 (1996) ("In 1995, the ten largest companies on the Fortune 500 owned an average of 62 subsidiaries each."); *In re* Gen. Growth Props., Inc., 409 B.R. 43, 47 n.6 (Bankr. S.D.N.Y.

Commonly, subsidiary corporations have boards of directors that overlap with or are identical to their parent corporation's board of directors.[3] Fiduciary duty law generally directs each of these various boards of directors to act in the best interests of "the corporation and its shareholders."[4] For a director of a wholly owned subsidiary, this fiduciary mandate is clear when the subsidiary is solvent: act in the best interest of the parent corporation, which is both the only party that can sue derivatively on behalf of the subsidiary corporation and is also the subsidiary's only shareholder.

When a subsidiary corporation becomes insolvent, or in some jurisdictions merely becomes financially troubled, most courts grant creditors of the subsidiary corporation standing to sue on behalf of the subsidiary for breaches of fiduciary duty.[5] This grant of standing to creditors near or during insolvency traps directors of subsidiaries between the proverbial Scylla and Charybdis. If the directors of a subsidiary favor their parent corporation by, for example, forgiving a parental debt to the subsidiary or entering into a typical "sweetheart" deal with the parent, the directors will risk facing a fiduciary duty lawsuit from the creditors. On the other hand, favoring creditor interests could open directors of a subsidiary to fiduciary duty-based lawsuits from the subsidiary's only shareholder, the parent corporation, or lead to prompt removal of the directors by the parent corporation.

Outside of the wholly owned subsidiary context, this conflict between corporate stakeholders is of little practical importance, as directorial decisions are largely protected by the business judgment rule and exculpatory charter provisions.[6] In the wholly owned subsidiary

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2009) (noting that General Growth Properties had 388 entities as part of its corporate group that filed for Chapter 11 bankruptcy protection).

[3]*See infra* note 132.

[4]*See infra* note 19. Courts across the country recognize Delaware as a "pacesetter in the area of corporate law." *In re* Prudential Ins. Co. Deriv. Litig., 659 A.2d 961, 969 (N.J. Super. Ct. Ch. Div. 1995); *see also* 1 STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE 6-11 (6th ed. 2009) (compiling quotes from courts of various jurisdictions recognizing Delaware as the leading court system in the area of corporate law). Also, "[m]ore than 900,000 business entities have their legal home in Delaware including more than 50% of all U.S. publicly-traded companies and 63% of the Fortune 500." DELAWARE DIVISION OF CORPORATIONS, http://corp.delaware.gov/ (last updated Jun. 20, 2011). This means that the internal affairs of the majority of the largest corporations in the United States are governed by Delaware law. *See* 1 RADIN, THE BUSINESS JUDGMENT RULE 3-6. Given these facts, this Article focuses primarily on Delaware state law.

[5]*See infra* Part II.D.

[6]*See* DEL. CODE ANN tit. 8, § 102(b)(7) (2011) (allowing corporations to eliminate, in their certificates of incorporation, liability for monetary damages stemming from duty of care

context, however, current law generally classifies directors of wholly owned, financially troubled ("WOFT") corporations as "interested directors" when dealing with their parent corporation.[7] This classification strips directors of WOFT corporations of their legal protections and leaves them exposed to *creditor* claims based on breaches of the fiduciary duty of loyalty.[8] The business judgment rule and exculpatory charter provisions will, however, largely protect directors of WOFT corporations from fiduciary duty claims by the *parent* corporation based on allegations that the directors favored the creditors. These different levels of protection arise because directors of a subsidiary are much less likely to be "interested directors," in the eyes of the law, in transactions benefiting creditors than in transactions benefiting the parent corporation.[9] Thus, given the real possibility of viable duty of loyalty claims brought by creditors and the relative impotence of fiduciary duty claims brought by the parent corporation,

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claims); Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2002) (noting that the business judgment rule presumption greatly protects directorial decisions, but can be rebutted by facts that "establish that the *board* was either interested in the outcome of the transaction or lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders"); *see also* Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 368 (2007) (noting that the business judgment rule presumption will protect directorial decisions against the vast majority of fiduciary duty claims). Indemnification and insurance also often protect directors from potential personal liability stemming from breaches of their fiduciary duties. *See* Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 573-74 (1996).

[7]The phrase "financially troubled corporations" is used to encompass all corporations where a court would determine that creditors have rights under fiduciary duty law prior to that company filing for bankruptcy protection. As discussed in Part II, most courts, including Delaware courts, provide creditors with rights under fiduciary duty law only *upon* insolvency, while other courts grant creditors similar rights when the corporation enters into the poorly defined "zone" or "vicinity" of insolvency. *See infra* Part II.C.

[8]*See infra* Part IV.A.1.

[9]Directors of WOFT corporations will generally be detached and disinterested in dealings with creditors, but are much more likely to have material interests in the parent corporation. For example, many directors of subsidiaries also sit on the boards of directors of the parent corporation, may hold a substantial amount of the parent corporation's stock, and may be employed by the parent corporation. *See infra* Part IV.A.1.

> When the directors of a Delaware corporation appear on both sides of a transaction, the presumption in favor of the business judgment rule is rebutted and the directors are required to demonstrate their "utmost good faith and the most scrupulous inherent fairness of the bargain." Where a director holds dual directorships in the parent-subsidiary context, there is no dilution of this obligation to demonstrate the entire fairness of specific board actions.

In re Digex, Inc. S'holders Litig., 789 A.2d 1176, 1206 (Del. Ch. 2000) (citations omitted).

fiduciary duty law may propel directors of WOFT corporations towards one of two undesirable courses of action: (1) incur high administrative costs to regain legal protections against creditors; or (2) ignore the wishes of the parent corporation when facing any risky decision that may leave the subsidiary insolvent.[10]

This Article argues that current fiduciary duty law provides directors of WOFT corporations with no clear direction regarding to whom their fiduciary duties are owed, but encourages them to favor creditors. As directors of WOFT corporations challenge the instructions of their only shareholder and parent, administrative costs will increase and wealth creation will decrease. Ultimately, owners of parent corporations may choose more flexible entity forms, such as limited liability companies where fiduciary duties can be better controlled.[11] As a solution to theoretical and practical problems stemming from creditor fiduciary duty lawsuits against directors of WOFT corporations, this Article proposes extending business judgment rule or statutory protection to cover directors of WOFT corporations who, in good faith, favor their parent corporations. This Article suggests that because fiduciary duty law requires directors to act in the interests of "the corporation *and* its shareholders," it should not punish those directors when they choose one of those legitimate stakeholders over the other.

To set the stage, Part II of this Article discusses the evolving and muddled state of fiduciary duty law involving financially troubled companies. This part also unpacks the academic debate revolving around the following question: do directors of financially troubled companies owe fiduciary duties to the corporation, the shareholders, the creditors, or some combination thereof? Part III then examines multiple-entity corporate groups, which adds "the parent corporation" to the list of possible answers for the "to whom do the corporate directors' duties run" question.

Part IV asserts that in addition to the current law failing to provide clear guidance to directors of WOFT corporations regarding to whom their fiduciary duties run, the law also gives creditors an unnecessary weapon against even well-intentioned directors. To address these

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[10]The second route, disobedience in the face of parental orders, may not be a practical long-term option for directors of WOFT corporations because the parent corporation, as the subsidiary's only shareholder, has the power to remove the directors of the subsidiary from their directorial positions.

[11]*See infra* Part IV.A.5.

problems, this Article proposes that the law expand the business judgment rule or statutory protection to cover breach of duty of loyalty-based lawsuits, brought by creditors, against directors of WOFT corporations who acted, in good faith, on behalf of their parent corporation.

Finally, Part V addresses the implications of the proposed additional protections against fiduciary duty claims, by noting that additional legal rights—such as contract provisions, the implied covenant of good faith and fair dealing, fraudulent transfer law, rights to pierce the corporate veil and the ability to file an involuntary bankruptcy petition—protect creditors from most unseemly actions by directors of WOFT subsidiaries in favor of their parent corporation.[12] This Article concludes that these other bodies of law provide directors with better defined guidance than fiduciary duty law and also provide adequate protection to creditors without additional assistance needed from fiduciary duty law.

II. DUTIES OF CARE AND LOYALTY IN FINANCIALLY TROUBLED COMPANIES

In the mid-twentieth century, Justice Felix Frankfurter penned two of the most fundamental questions in all of corporate governance when he wrote these often quoted words: "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?"[13] As this part of the Article will show, these two elementary questions remain largely unanswered for a corporate director when her company encounters financial distress.

A. *Duties of Care and Loyalty Generally*

Directors of a corporation are often said to owe duties of care and loyalty to "the corporation and its shareholders."[14] Directors may violate their duty of care if they are grossly negligent in carrying out their

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[12]*See* Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 787 (Del. Ch. 2004) (listing various protections, outside of fiduciary duty law, available to creditors).

[13]SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

[14]*See, e.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) ("It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders.").

duties,[15] while the duty of loyalty requires the director to act in the best interest of the corporation, and comprises, among other things, an obligation to act in good faith.[16] Given that the business judgment rule and the exculpatory charter provisions, such as those authorized by the Delaware General Corporation Law section 102(b)(7), have taken most of the bite out of the duty of care, this Article will focus mainly on issues arising from alleged breaches of the duty of loyalty, which are not given the same level of protection by the law and may be measured by using the exacting "entire fairness" standard in conflict of interest situations.[17]

B. *Fiduciary Duties to Creditors?*

Generally, directors do not owe fiduciary duties directly to creditors.[18] Rather, common law has traditionally advised that directorial duties run to "the corporation and its shareholders."[19] The communitarian

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[15]*See, e.g.*, *In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 64 (Del. 2006) (describing the category of conduct that involves a "lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent").

[16]*In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 751 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("The rule that requires an undivided and unselfish loyalty to the corporation demands that there [shall] be no conflict between duty and self-interest." (quoting Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939))); Stone *ex rel.* AmSouth Bancorp. v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[T]he fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.").

[17]Through the business judgment rule "directors are entitled to a *presumption* that they were faithful to their fiduciary duties." Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004). Delaware General Corporation Law section 102(b)(7) authorizes corporations to include provisions in their certificates of incorporation that protect "directors from personal monetary liability for breaches of the duty of care." *In re* NYMEX S'holder Litig., 2009 WL 3206051, at *6 (Del. Ch. Sept. 30, 2009); *see also* Anne Tucker Nees, *Who's the Boss? Unmasking Oversight Liability Within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 215-22 (2010) (describing director oversight liability under duty of care claims as a "toothless tiger"). *See infra* note 129 (describing the "entire fairness" standard).

[18]Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992) ("[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms."). *Accord* Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 777 (Del. Ch. 2004); *In re* Netzel, 442 B.R. 896, 899 (Bankr. N.D. Ill. 2011) ("Officers and directors usually do not owe a fiduciary duty to creditors . . . .").

[19]*Gheewalla*, 930 A.2d at 99; *see also* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) (holding that under well-established Delaware law, "directors owe fiduciary duties of care and loyalty to the corporation and its shareholders" (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986))); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939); J.

model and the more recent team production theory focus on the "corporation" half of that judicial mandate, arguing that directors should consider various stakeholders—including creditors—while acting on behalf of the corporation as a whole.[20] On the other side of the judicial mandate, shareholder wealth maximization advocates have argued that during solvency, directors should focus their attention solely on shareholders and that allowing otherwise would permit directors to disguise self-interested decisions as actions done in the name of non-shareholder constituencies.[21]

Upon insolvency, however, it is clear that directors must shift at least some of their attention to the corporation's creditors.[22] Some commentators have argued that directors of a corporation should only consider the interests of the corporation as a whole.[23] Other commentators, under the "trust fund doctrine," have suggested that, upon

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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, 431 (2007) ("It is mantra that directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.").

[20]*See* Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. BUS. & TECH. L. 607, 609-10 (2007) ("Recent team production theory argues that directors are not and should not be directly accountable to shareholders or any other specific corporate stakeholder. Instead, in order to promote and protect firm-specific investment by diverse team members, directors owe fiduciary duties to 'the corporate coalition as a whole.'" (quoting Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 298 (1999))).

[21]Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1438 (1993) ("[M]anagement could freely pursue its own self-interest by playing shareholders off against nonshareholders. When management's interests coincide with those of shareholders, management could justify its decision by saying that shareholder interests prevailed in this instance, and vice-versa.").

[22]*See Geyer*, 621 A.2d at 787 (noting that no party to the case seriously disputed that "when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors"); *Prod. Res. Grp*., 863 A.2d at 790-91 ("When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm's directors are said to owe fiduciary duties to the company's creditors."); ASARCO LLC v. Ams. Mining Corp., 396 B.R. 278, 395 (Bankr. S.D. Tex. 2008) (noting that when insolvency places the creditors in the shoes of the shareholders as residual risk-bearers, "[t]he directors' focus is no longer solely on its shareholders' interests, but also on the creditors' interests"); *In re Netzel,* 442 B.R. at 899 ("Officers and directors usually do not owe a fiduciary duty to creditors but Illinois courts have long recognized an exception to this rule when a corporation is insolvent.").

[23]*See* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1496-97 (1993) (arguing that directors of financially distressed corporations should strive to maximize firm value rather than focusing solely on the interests of shareholders or creditors); James Gadsden, *Enforcement of Directors' Fiduciary Duties in the Vicinity of Insolvency*, AM. BANKR. INST. J., Feb. 2005, at 16 (arguing that "the duties of directors do not run to creditors, but instead always run to the corporation. . . . [T]hose fiduciary duties may be enforced by the shareholders of the corporation through a shareholders' derivative action").

insolvency, directors should no longer concentrate on the interests of the shareholders, but rather should focus on the creditors' well-being.[24] Yet others argue that directors should consider the interests of the corporation and its creditors;[25] or the interests of the corporation, its shareholders, and its creditors.[26] Some academics have argued that directors should owe

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[24]Fed. Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982). The court notes that:

> The law by the great weight of authority seems to be settled that when a corporation becomes insolvent, or in a failing condition, the officers and *directors no longer represent the stockholders*, but by the fact of insolvency, become trustees for the creditors, and that they cannot by transfer of its property or payment of cash, prefer themselves or other creditors.

Id. at 977 (emphasis added). The argument in favor of shifting fiduciary duties to creditors upon insolvency has been dubbed the "trust fund doctrine," as it describes "insolvent corporation[s] as becoming akin to a trust for the benefit of the creditors." *Prod. Res. Grp*., 863 A.2d at 791 n.61 (listing a number of cases that followed the "trust fund doctrine" and citing Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L.REV. 45, 64 (1998) for "describing the 'trust fund doctrine' as the 'seminal theory' justifying creditor fiduciary duties"). As the Delaware Court of Chancery noted in *Production Resources*, this line of thinking has been "by no means universally praised." *Prod. Res. Grp.*, 863 A.2d at 791. *See also In re* VarTec Telecom, Inc., 2007 WL 2872283, at *2 (Bankr. N.D. Tex. Sept. 24, 2007) ("Several courts have recognized that once a corporation is insolvent, the officers and directors owe fiduciary duties to the corporation's creditors, usually relying on the 'trust fund' theory."); *In re* Jacks, 266 B.R. 728, 736 (9th Cir. 2001) ("California courts have recognized that all of the assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of all of its creditors.") (internal quotation marks omitted); Dawson v. Withycombe, 163 P.3d 1034, 1057 (Ariz. Ct. App. 2007) ("Arizona recognizes the trust fund doctrine, under which all assets of a corporation are considered to exist for the benefit of all its creditors when a firm reaches insolvency.").

[25]*In re* USDigital, Inc., 443 B.R. 22, 45-46 (Bankr. D. Del. 2011) (holding that "when USDigital became insolvent, the Director Defendants owed fiduciary duties to USDigital and its creditors"); Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 196 n.75 (Del. Ch. 2006) ("[T]he fact of insolvency does not change the primary object of the directors' duties, which is the firm itself. . . . [T]he jurisprudence refers to the directors as owing fiduciary duties to the firm and its creditors [in insolvency].") (internal quotation marks omitted); *In re* Scott Acquisition Corp., 344 B.R. 283, 290 (Bankr. D. Del. 2006) (rejecting "the suggestion that upon insolvency a director of a wholly-owned subsidiary owes a duty to that corporation's creditors but not to the corporation itself," and noting that "[a] more natural reading of Delaware law is that upon insolvency directors of a wholly-owned subsidiary owe fiduciary duties to the subsidiary and its creditors"); Robert B. Millner, *What Does It Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?*, 9 J. BANKR. L. & PRAC. 201, 206 (2000) ("When a corporation becomes insolvent, the fiduciary duty of directors shifts from the stockholders to the creditors.") (internal quotation marks omitted).

[26]*In re* Berman, 629 F.3d 761, 766 (7th Cir. 2011) ("Under Illinois law, like the law of many states, a corporate officer or director assumes a fiduciary duty toward the corporation, its shareholders, and, upon the corporation's insolvency, *also* to its creditors.") (emphasis added); VFB LLC v. Campbell Soup Co., 482 F.3d 624, 635 (3d Cir. 2007) ("Directors normally owe

creditors no special fiduciary duties at all.[27] At least one court has stated that it would not force directors to consider creditors during insolvency,[28] and other courts have expressly stated that directors do not owe fiduciary duties to creditors in insolvency.[29] It understates the obvious to say that to whom directorial fiduciary duties run during insolvency is an issue subject to considerable debate and confusion.[30] Nonetheless, agreement is

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no duty to corporate creditors, but when the corporation becomes insolvent the creditors' investment is at risk, and the directors should manage the corporation in their interests *as well as that of the shareholders*.") (emphasis added); *Withycombe*, 163 P.3d at 1058 (noting that "when a firm is insolvent, creditors *are included* in the class of persons to whom a board of directors owes a fiduciary duty" (citing *Prod. Res. Grp*., 863 A.2d at 790-91)) (emphasis added); *In re* RSL COM PRIMECALL, Inc., 2003 WL 22989669, at *7 (Bankr. S.D.N.Y. Dec. 11, 2003) ("Insolvency, however, changes the scope of a director's duties, and upon insolvency directors owe fiduciary duties to creditors or, stated differently, to the corporation and to all of its interested constituencies, including creditors and shareholders.").

[27]Callison, *supra* note 19, at 434 (stating that "there should not be a 'creditor shift' even when a corporation or other business entity is insolvent"); Larry E. Ribstein & Kelli A. Alces, *Directors' Duties in Failing Firms*, 1 J. BUS. & TECH. L. 529, 550 (2007) (arguing that "[c]orporate directors do not have special duties to creditors, whether or not the corporation is in or near insolvency"); *see generally* Bainbridge, *supra* note 6.

[28]*In re* I.E. Liquidation, Inc., 2009 WL 2707223, at *5 (Bankr. N.D. Ohio Aug. 25, 2009) (applying Ohio law, the court held that it could not "conclude that the law imposes a mandatory obligation on a director to consider creditor interests, even when the entity is insolvent or operating in the zone of insolvency"). *See also In re* HydroGen, L.L.C., 431 B.R. 337, 348 n.6 (Bankr. S.D.N.Y. 2010) ("Ohio caselaw is split as to whether directors and officers of a corporation owe any fiduciary duty to its creditors upon the corporation's insolvency.").

[29]*In re* Eisaman, 387 B.R. 219, 224 (Bankr. N.D. Ind. 2008) ("Unlike some jurisdictions, when a corporation becomes insolvent, Indiana does not make corporate officers and directors fiduciaries for the corporation's creditors. Instead, their duties always run to the corporation and its shareholders, not to the corporation's creditors.") (citation omitted); *In re* Bostic Constr., Inc., 435 B.R. 46, 61 (Bankr. M.D.N.C. 2010) ("In North Carolina, directors of a corporation do not owe a fiduciary duty to the creditors of the corporation."); *see also* Torch Liquidating Trust *ex rel*. Bridge Assocs. L.L.C. v. Stockstill, 561 F.3d 377, 386 n.8 (5th Cir. 2009) (applying Delaware law and stating, "the fiduciaries never owe duties to the creditors") (citing N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007)); Berg & Berg Enters., LLC v. Boyle, 100 Cal. Rptr. 3d 875, 893-94 (Cal. Ct. App. 2009). The *Berg* court noted:

> [W]e conclude that under the current state of California law, there is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors solely because of a state of insolvency, whether derived from *Credit Lyonnais* or otherwise. And we decline to create any such duty, which would conflict with and dilute the statutory and common law duties that directors already owe to shareholders and the corporation.

Id.

[30]*In re Bostic*, 435 B.R. at 62 n.3 ("Commentators are divided on the issue of whether or not the duty of directors actually shifts from the corporation to creditors."); *see also* ASARCO LLC v. Ams. Mining Corp., 396 B.R. 278, 395 n.135 (Bankr. S.D. Tex. 2008),

nearly uniform that courts should provide creditors with *some* additional rights, beyond their contract, when a corporation is financially troubled or insolvent, even if it is merely the right to bring derivative actions on behalf of the corporation.[31] When those additional rights arise[32] and the extent of those rights,[33] however, remains unsettled.

C. *Timing of Creditor Rights under Fiduciary Duty Law*

Creditors may generally sue derivatively, on behalf of the corporation, for breaches of fiduciary duty when the corporation crosses into insolvency, rather than having to wait until a statutory bankruptcy filing.[34] Until 2007, however, extensive debates ensued regarding rights of creditors, if any, when a corporation was in the "zone" or "vicinity" of insolvency.[35] The debates appear to have sprung primarily from Chancellor Allen's pronouncement in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*[36] that "[a]t least where a corporation is operating in the *vicinity of insolvency*, a board of directors

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noting that:

> There appears to be some difference of opinion regarding whether, in the case of insolvency, directors still owe any fiduciary duties to the shareholders, or rather, if the creditors essentially take the place of the shareholders as residual beneficiaries. Some courts seem to take a 'community of interests' approach, while others recognize that the creditors and shareholders switch places.

Id. Additionally, see Brad B. Erens, Scott J. Friedman & Kelly M. Mayerfeld, *Bankrupt Subsidiaries: The Challenges to the Parent of Legal Separation*, 25 EMORY BANKR. DEV. J. 65, 118 (2008) (noting the confusion in the law and stating that the "[d]irectors and officers of a company may owe a fiduciary duty to its creditors when the company is in the vicinity of insolvency, or, at least, the duties owed by such parties to the corporation may be enforced by the corporation's creditors").

[31]*See Gheewalla*, 930 A.2d at 101 (noting that creditors may bring derivative claims for breach of fiduciary duty, on behalf of insolvent corporations). The vast majority of courts followed this aspect of *Gheewalla* and most academics have not seriously challenged—from a normative perspective—that creditors should have standing to bring derivative claims after insolvency. *See infra* Part II.C and Part II.D.

[32]*See infra* Part II.C.

[33]*See infra* Part II.D.

[34]Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992) (noting that "insolvency means insolvency in fact rather than insolvency due to a statutory filing").

[35]Prominent corporate legal scholars addressed this confusion in the University of Maryland School of Law "Twilight in the Zone of Insolvency" Conference and their accompanying articles. *See generally* Bainbridge, *supra* note 6; Callison, *supra* note 19; Ribstein & Alces, *supra* note 27; Tung, *supra* note 20. As discussed *infra* notes 41-45 and accompanying text, much of the confusion regarding the "vicinity of insolvency" was remedied, at least in Delaware law, by *Gheewalla*.

[36]1991 WL 277613 (Del. Ch. Dec. 30, 1991).

is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[37] After the *Credit Lyonnais* case, confusion ensued regarding how to determine when a company was in the "zone" or "vicinity" of insolvency, and once determined, to whom exactly the directors' fiduciary duties ran.[38] Thirteen years after *Credit Lyonnais*, Chancellor Strine explained, in *Production Resources Group, L.L.C. v. NCT Group, Inc.*,[39] the odd fact that practitioners, academics, and even some courts took language from *Credit Lyonnais* as "creating a new body of creditor's rights law," rather than recognizing the more limited apparent attempt by Chancellor Allen to "emphasize that directors have discretion to temper the risk that they take on behalf of the equity holders when the firm is in the 'zone of insolvency.'"[40]

Citing much of Chancellor Strine's *dicta* from *Production Resources*, the Delaware Supreme Court, in the 2007 case of *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,[41] provided a substantial amount of clarity regarding the timing of creditor rights under fiduciary duty law.[42] In *Gheewalla*, the

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[37]*Id.* at *34 (emphasis added). In the famous footnote 55 of the *Credit Lyonnais* opinion, Chancellor Allen set out a hypothetical where the shareholders and creditors would, like the directors, make different decisions, and noted:

> [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. at *34 n.55.

[38]*See* Bainbridge, *supra* note 6, at 348-55 (explaining the *Credit Lyonnais* case and the confusion it has caused); Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 787-93 (Del. Ch. 2004) (explaining the history following *Credit Lyonnais* and exploring some of the difficulties associated with fiduciary duties in and around insolvency).

> [I]t appears that under both Delaware law and Texas law, corporate insiders . . . *may have* a fiduciary duty to the corporation's creditors even when the corporation was not insolvent. The Court holds that Plaintiff may therefore prevail on his breach of corporate duty claims if he shows, for each allegedly wrongful transaction, that [the corporation] was, at the time, in "the vicinity of insolvency"; that the transaction led to [the corporation's] insolvency; or that the transaction was a fraudulent conveyance, as defined by the federal and state statutes.

Weaver v. Kellogg, 216 B.R. 563, 583-84 (S.D.Tex. 1997) (emphasis added) (citation omitted).

[39]863 A.2d 772 (Del. Ch. 2004).

[40]*Id.* at 788.

[41]930 A.2d 92 (Del. 2007).

[42]*See id.* at 98-103.

court made clear 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."[43] The court also explained that, in the zone of insolvency, the directors' fiduciary duties still run to "the corporation and its shareholders."[44] The vast majority of jurisdictions outside of Delaware to consider the issue after 2007 have followed *Gheewalla*'s pronouncement that directors' fiduciary duties continue to run to the corporation and its shareholders through the "zone" or "vicinity" of insolvency.[45] At least one jurisdiction, however, has explicitly recognized the creditors' right to bring an action in the "zone of insolvency," post-*Gheewalla*.[46] Some jurisdictions still recognize as

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[43]*Id*. at 101; *see also In re* Netzel, 442 B.R. 896, 901 (Bankr. N.D. Ill. 2011) ("The Illinois Supreme Court is likely to agree with *Gheewalla* and conclude that an individual creditor may not directly sue a director of an insolvent corporation for breach of fiduciary duty."); Vichi v. Koninklijke Philips Electronics N.V., 2009 WL 4345724, at *20 (Del. Ch. Dec. 1, 2009) (extending *Gheewalla*'s denial of direct claims by creditors to the LLC context); *Cf.* CML V, LLC v. Bax, 6 A.3d 238, 249-50 (Del. Ch. 2010) (noting that creditors lack standing to sue derivatively in the LLC context).

[44]*Gheewalla*, 930 A.2d at 101.

> [T]he 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.

Id. *See also* E. Norman Veasey, *Counseling the Board of Directors of a Delaware Corporation in Distress*, 27 AM. BANKR. INST. J., Jun. 2008, at 63 (noting that the court did *not* hold whether creditors of a solvent corporation could bring a *derivative* action in the "zone of insolvency," but concludes that "[w]hether creditors may bring derivative claims against directors of a corporation that is solvent but in the zone of insolvency is unclear, but doubtful as a practical matter").

[45]*See* RSL Commc'ns PLC v. Bildirici, 649 F. Supp. 2d 184, 203 (S.D.N.Y. 2009) ("Specifically, New York State's corporate directors do not owe a duty of care to a corporation's creditors when the corporation is arguably operating within the 'zone of insolvency' . . . [i]n light of the other legal protections afforded to creditors."); *accord* Master-Halco, Inc. v. Scillia, Dowling & Natarelli, LLC, 739 F. Supp. 2d 100, 103-04 (D. Conn. 2010) (applying Connecticut law).

[46]*See In re* VarTec Telecom, Inc., 2007 WL 2872283, at *3 (Bankr. N.D. Tex. Sept. 24, 2007) (denying the defendant's motion dismiss and stating that, "[b]oth Texas and Delaware law recognize a cause of action for breach of fiduciary duty against the directors or officers of a corporation may be brought by the creditors of a corporation when the corporation is *either* insolvent or in the 'zone' or 'vicinity of insolvency.'")

good case law pre-*Gheewalla* cases that allow creditors to bring fiduciary duty claims in the "zone" or "vicinity" of insolvency.[47]

D. *Extent of Creditor Rights under Fiduciary Duty Law*

Gheewalla also addressed the extent of creditor rights under fiduciary law, concluding that creditors could not bring direct claims, but rather were limited to bringing derivative claims on behalf of the corporation.[48] The Delaware Supreme Court reasoned that allowing direct creditor claims for breaches of fiduciary duties would undermine directors' need to negotiate in good faith with creditors, and "would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation."[49] Again, most courts have followed Delaware's lead in *Gheewalla*, and agreed that creditors may not maintain direct claims for breaches of fiduciary duties.[50]

Even though *Gheewalla* certainly quieted the "vicinity of insolvency" debate, it did not crystalize core issues such as: (1) when *exactly* do creditor rights under fiduciary duty law arise? and (2) to whom do directors' fiduciary duties run during insolvency? As to the first issue, though *Gheewalla* may appear to have answered the timing

[47] Carrieri v. Jobs.com Inc., 393 F.3d 508, 534 n.24 (5th Cir. 2004) (applying Texas law, the court held that "[o]fficers and directors that are aware that the corporation is insolvent, or within the 'zone of insolvency' as in this case, have expanded fiduciary duties to include the creditors of the corporation") (citing Weaver v. Kellogg 216 B.R. 563, 583-84 (S.D. Tex. 1997) (applying Delaware and Texas law)); *In re* James River Coal Co., 360 B.R. 139, 170 (Bankr. E.D. Va. 2007) (applying Virginia law in a case decided approximately three months before *Gheewalla*, the court stated that "[o]nce a corporation enters the zone of insolvency, the fiduciary duties owed by the Directors extend also to the corporation's creditors").

[48] *Gheewalla*, 930 A.2d at 101. *But see In re* MS55, Inc., 2008 WL 2358699, at *2 (D. Colo. June 6, 2008) (noting that while Delaware law limits creditor fiduciary duty claims to derivative actions, creditors can bring direct actions under Colorado law).

[49] *Gheewalla*, 930 A.2d at 103.

[50] Torch Liquidating Trust *ex rel*. Bridge Assocs. L.L.C. v. Stockstill, 561 F.3d 377, 385-86 (5th Cir. 2009) (applying Delaware law and following *Gheewalla* in prohibiting creditor standing for direct claims for breaches of fiduciary duty). *Accord In re* TOUSA, Inc., 437 B.R. 447, 456 (Bankr. S.D. Fla. 2010) (applying Delaware law); *Master-Halco, Inc.*, 739 F. Supp. 2d at 102-03 (applying Connecticut law); *In re* Netzel, 442 B.R. 896, 899 (Bankr. N.D. Ill. 2011) (applying Illinois law); Sanford v. Waugh & Co., 328 S.W.3d 836, 839 (Tenn. 2010) (applying Tennessee law); *In re* TOCFHBI, Inc., 413 B.R. 523, 539 (Bankr. N.D. Tex. 2009) (applying Texas law). *But see* JetPay Merchant Services, LLC v. Miller, 2007 WL 2701636, at *7-8 (N.D. Tex. 2007) (denying a motion to dismiss based in part to the uncertainty in Colorado law regarding creditor standing to bring fiduciary duty claims).

question with the clear reply of "upon insolvency," the moment at which a corporation becomes insolvent is generally debatable, requires fact intensive inquires, and is judged by several different legal tests.[51] As to the second issue, *Gheewalla* merely shifted the debate from "which constituent or constituents are entitled to directorial fiduciary duties in the 'vicinity of insolvency'?" to "which constituent or constituents are entitled to directorial fiduciary duties upon the occurrence of insolvency?"[52]

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[51]*See infra* note 141 (citing cases that rejected solvency opinions by financial advisors); Interim Healthcare, Inc. v. Spherion Corp., 884 A.2d 513, 550 (Del. Super. Ct. 2005) (noting that measuring a firm's value is by no means an "exact science"). Insolvency can be shown by "1) 'a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof,' or 2) 'an inability to meet maturing obligations as they fall due in the ordinary course of business.'" Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 782 (Del. Ch. 2004) (quoting Siple v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at *2 (Del. Ch. Apr. 13, 1982)); *see also* 11 U.S.C. § 101(32)(A) (2006) (defining insolvency as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property"). For obvious reasons, this is often referred to as the "bankruptcy test." *See* Zipora Cohen, *Directors' Negligence Liability to Creditors: A Comparative and Critical View*, 26 J. CORP. L. 351, 377 (2001) (discussing both the "bankruptcy test" and the "equitable insolvency test," "according to which the corporation is deemed to be insolvent when it is unable to pay its debts as they become due in the usual course of business").

> [T]he mere incantation of the word insolvency does not open the key to discovery. If a plaintiff seeks to state a claim premised on the notion that a corporation was insolvent and that the directors of the corporation were therefore obligated to consider the corporation's creditors, as an object of their fiduciary beneficence, the plaintiff must plead facts supporting an inference that the corporation was in fact insolvent at the relevant time.

Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 195 (Del. Ch. 2006). *See also* Francotyp-Postalia AG & Co. v. On Target Tech., Inc., 1998 WL 928382, at *5 (Del. Ch. Dec. 24, 1998), *reprinted in* 24 DEL. J. CORP. L. 649, 659 (1999). In *Francotyp-Postalia*, the Delaware Court of Chancery noted:

> Defining insolvency to be when a company's liabilities exceed its assets ignores the realities of the business world in which corporations incur significant debt in order to seize business opportunities. I cannot accept that definition as a "bright line" rule as it could lead to a flood of litigation arising from alleged insolvencies and to premature appointments of custodians and potential corporate liquidations.

Id. The court also cited Delaware precedent for the proposition that the liabilities in excess of assets test would require "the additional element that there be no reasonable prospect that the business can be continued in the face of that condition." *Id.*

[52]*See supra* Part II.B. Even if one argues that directors should simply seek to maximize wealth for the corporation upon insolvency, in a zero sum game, where, by definition, the result to the corporation is the same, the current state of the law offers little guidance to directors regarding upon whose behalf they should act. *See* Bainbridge, *supra* note 6, at 350-51.

III. FIDUCIARY DUTIES IN THE PARENT/WHOLLY OWNED SUBSIDIARY CONTEXT

A. *Fiduciary Duties of Directors of Wholly Owned Subsidiaries*

Over a decade ago, the United States District Court for the District of Columbia noted:

> [T]he duties of the directors of wholly owned subsidiaries have not been articulated in the law. Indeed, case law leaves subsidiary directors wondering whether their duty runs primarily to the parent corporation as shareholder, to the subsidiary corporation itself as an entity, or even to other constituencies such as creditors, regulators, employees, and communities.[53]

While some subsequent cases have addressed this issue, the current jurisprudence regarding the duties owed by directors of wholly owned subsidiaries, particularly by directors of *insolvent* wholly owned subsidiaries, remains muddled.[54]

1. Duties of the Directors of the Wholly Owned Subsidiary when the Subsidiary is Solvent

The Delaware Supreme Court case of *Anadarko Petroleum Corp. v. Panhandle Eastern Corp*.[55] has been heavily cited over the years for issues involving fiduciary duties between parent corporations and their wholly owned subsidiaries.[56] In *Anadarko*, a former wholly owned subsidiary alleged that its former parent corporation and certain directors breached their fiduciary duties to the subsidiary by modifying contracts between the companies prior to spinning-off the subsidiary.[57] In holding

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[53]First Am. Corp. v. Al-Nahyan, 17 F. Supp. 2d 10, 26 (D.D.C. 1998) (quoting Gouvin, *supra* note 2, at 324, 289 (internal quotation marks omitted)).

[54]*See*, *e.g.*, Hamilton Partners, L.P. v. Englard, 11 A.3d 1180, 1199-1201 (Del. Ch. 2010) (wrestling with fiduciary duty law in the parent/wholly owned subsidiary context).

[55]545 A.2d 1171 (Del. 1988).

[56]*See* 2 RADIN, *supra* note 4, at 2172 (noting that many decisions, beginning with the Delaware Supreme Court decision in *Anadarko*, state that wholly owned corporations should be managed in the best interest of the parent corporation).

[57]*Anadarko*, 545 A.2d at 1172.

that the parent corporation owed no duty to prospective stockholders of the subsidiary, the Delaware Supreme Court wrote, in *dicta*, that "in 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" (the "*Anadarko* language").[58]

The *Anadarko* language has generated much controversy.[59] A few courts appear to follow the plain reading of the *Anadarko* language, and have restated that subsidiary directors owe fiduciary duties only to the parent corporation and not to the subsidiary or any other constituencies.[60] Many courts, however, have limited *Anadarko* to its facts and/or suggested that the parent/wholly owned subsidiary relationship does not change the structure of corporate law; meaning, that like any other directors, directors of a wholly owned subsidiary owe fiduciary duties to both the corporation and its shareholders.[61]

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[58]*Id.* at 1174 (emphasis added).

[59]*See* 2 RADIN, *supra* note 4, at 2172-82 (describing cases following *Anadarko*, and cases limiting or rejecting *Anadarko*).

[60]*See, e.g.*, *In re* Teleglobe Commc'ns Corp., 493 F.3d 345, 366 (3d Cir. 2007) (recognizing, in *dicta*, that under Delaware law, "all of the duties owed to the subsidiaries flow back up to the parent"); Aviall, Inc. v. Ryder Sys., Inc., 913 F. Supp. 826, 832 (S.D.N.Y. 1996), *aff'd on other grounds*, 110 F.3d 892 (2d Cir. 1997) ("When one company wholly owns another, the directors of the parent and the subsidiary are obligated to manage the affairs of the subsidiary in the best interests only of the parent and its shareholders.").

[61]*See* First Am. Corp. v. Al-Nahyan, 17 F. Supp. 2d 10, 26 (D.D.C. 1998) (noting that the wholly owned subsidiary had standing to sue its directors for breach of fiduciary duties because "the directors of a wholly-owned subsidiary owe the corporation fiduciary duties, just as they would any other corporation."); *see also In re* Mirant Corp., 326 B.R. 646, 651 (Bankr. N.D. Tex. 2005) (stating that the defendant engaged in an "overly-broad reading of *Anadarko*," and noting that *Anadarko* "held that directors of a parent owed no fiduciary duty to prospective shareholders of the subsidiary prior to a spinoff, not that the subsidiary's directors owed no duty to the subsidiary"); *In re* Scott Acquisition Corp., 344 B.R. 283, 286-87 (Bankr. D. Del. 2006) ("The *Southwest* court relied on the Delaware Supreme Court's decision in [*Anadarko*] for the proposition that the directors of a wholly-owned insolvent subsidiary owe fiduciary duties to the parent but not the subsidiary corporation. I do not believe that *Anadarko* advances this position."); *In re* Touch Am. Holdings, Inc., 401 B.R. 107, 129 (Bankr. D. Del. 2009) (declining to extend *Anadarko* and holding that "directors of a wholly-owned subsidiary owe fiduciary duties to *both* the subsidiary and to the sole shareholder, the parent corporation") (emphasis added); *In re* RSL COM PRIMECALL, Inc., 2003 WL 22989669, at *14 (Bankr. S.D.N.Y. Dec. 11, 2003) (noting that the *Anadarko* "line of authority cannot be applied blindly to immunize an insolvent subsidiary's Board from liability for action in disregard of its own interests and those of its creditors"). Even before *Anadarko*, Delaware law recognized that "individuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations . . . ." Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (stating that "the long-existing

If the subsidiary is solvent, the *Anadarko* language is of little practical consequence. While it is theoretically dangerous to state that directors should be able to neglect the corporation on whose board they sit, as a practical matter, the parent is the only stakeholder likely able to bring a derivative fiduciary duty lawsuit during solvency.[62] When the subsidiary becomes insolvent, however, the *Anadarko* language becomes more problematic because the parent is no longer the only constituency that the directors must worry about.[63]

Chancellor Strine, in the Delaware Court of Chancery decision of *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,[64] anticipated the need for an insolvency exception to the *Anadarko* language and inserted an important solvency-qualifier in that case, stating that "[t]o the extent that [the subsidiary] was a wholly-owned *solvent* subsidiary of [the parent], the fiduciary duties owed by the [subsidiary's] board ran to [the parent]."[65] The *Anadarko* language might, as a practical matter, correctly instruct directors of *solvent* wholly owned subsidiaries to act only on behalf of their parents.[66] *Trenwick* and subsequent cases realized, however, that subsidiary directors *always* have a duty to the corporation.[67] When a wholly owned subsidiary is solvent,

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principle of Delaware law that [parent] designated directors on [a subsidiary's] board still owed [the subsidiary] and its shareholders an uncompromising duty of loyalty," and noting that "[t]here is no dilution of this obligation where one holds dual or multiple directorships, as in a parent-subsidiary context").

[62]When the wholly owned subsidiary is solvent, the parent is both the only shareholder of the subsidiary, and is also the only party with standing to bring a derivative lawsuit on behalf of the corporation. *See* VFB LLC v. Campbell Soup Co., 482 F.3d 624, 635 (3d Cir. 2007) ("Directors must act in the best interests of a corporation's shareholders, but a wholly-owned subsidiary has only one shareholder: the parent."); Stefan J. Padfield, *In Search of a Higher Standard: Rethinking Fiduciary Duties of Directors of Wholly-Owned Subsidiaries*, 10 FORDHAM J. CORP. & FIN. L. 79, 82 (2004).

[63]*In re* Magnesium Corp. of Am., 399 B.R. 722, 773 (Bankr. S.D.N.Y. 2009) ("[W]hile officers and directors of subsidiaries may legitimately advance the interests of the corporate parent when the subsidiaries are not insolvent, they may no longer do so when the subsidiaries are insolvent, or would be rendered insolvent by the contemplated action.").

[64]906 A.2d 168 (Del. Ch. 2006).

[65]*Id.* at 200 (emphasis added).

[66]*In re* RSL COM PRIMECALL, Inc., 2003 WL 22989669, at *12 (Bankr. S.D.N.Y. Dec. 11, 2003) (recognizing that solvent corporations are to be managed in the interest of the shareholders, which, in the case of a wholly owned subsidiary, is the parent corporation).

[67]*See* VFB LLC v. Campbell Soup Co., 482 F.3d 624, 635 (3d Cir. 2007).

> A duty of loyalty against the parent should arise whenever the subsidiary represents some minority interest in addition to the parent. . . . It could also happen if the subsidiary were insolvent. Directors normally owe no duty to corporate creditors, but when the corporation becomes insolvent the creditors' investment is at risk, and the directors should manage the corporation in their

the director's duty to the subsidiary is simply latent because the parent corporation is the only entity that can enforce a breach of fiduciary duty.[68]

2. Duties of the Directors of the Wholly Owned Subsidiary when the Subsidiary is Insolvent

The *Anadarko* line of cases broadly states that directors of wholly owned subsidiaries only owe duties to the parent corporation. As discussed above, however, the *Anadarko* language is better understood as stating a practical reality rather than changing the duties of directors to the corporation and its shareholders.[69] Again, as a practical reality, when a wholly owned subsidiary is solvent, only the parent has standing to bring a typical fiduciary duty claim; however, upon insolvency, creditors of the subsidiary are given standing to sue for breaches of duties to the corporation.[70]

> interests as well as that of the shareholders.

Id. *See also In re* Teleglobe Commc'ns Corp., 493 F.3d 345, 366-67 (3d Cir. 2007). The court noted that:

> [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 interest of the parent and its shareholders[]. While we normally assume that 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. 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. Similarly, if the subsidiary is insolvent, we require the same in the interest of protecting the subsidiary's creditors.

Id. (internal quotation marks and citations omitted).

[68] *See supra* note 67.

[69] *See supra* Part III.A.1.

[70] *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007). The Delaware Supreme Court noted:

> It is well settled that directors owe fiduciary duties to the corporation. When a corporation is *solvent*, those 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. Consequently, the creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.

Id. (citations omitted).

In a 2004 opinion, *In re Southwest Supermarkets, L.L.C.*,[71] the United States Bankruptcy Court for the District of Arizona opted for a broad reading of the *Anadarko* language. The court stated that "Delaware law appears to hold that when a subsidiary is wholly owned, its officers and directors owe their fiduciary duties solely to the single shareholder, and not to the subsidiary corporation itself," and that "there is nothing to suggest this law changes when the corporation becomes insolvent."[72] Two New York cases, decided around the same time, disagreed with this interpretation.[73] In 2006, the United States Bankruptcy Court for the District of Delaware rejected the broad reading of *Anadarko* put forward by the Arizona Bankruptcy Court, agreed with the two New York courts, and opined that "Delaware law would recognize that the directors and officers of an insolvent wholly-owned subsidiary owe fiduciary duties to the subsidiary and its creditors," rather than only to the parent corporation.[74] Then, in 2007, the Arizona Bankruptcy Court vacated, in part, its 2004 *Southwest Supermarkets* opinion, recognizing that its interpretation of *Anadarko* was overly broad and holding that "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."[75] In the 2007 *Southwest Supermarkets* opinion, the Arizona Bankruptcy court continued to retreat from its 2004 opinion, stating "[i]t 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."[76] Furthermore, the 2007 *Southwest* opinion observed that the

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[71]315 B.R. 565, 575 (Bankr. D. Ariz. 2004).

[72]*Id.* at 575-76.

[73]*See In re* RSL COM PRIMECALL, Inc., 2003 WL 22989669, at *13 (Bankr. S.D.N.Y. Dec. 11, 2003), noting that:

> 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.

Id. *See also* Roselink Investors, L.L.C. v. Shenkman, 386 F. Supp. 2d 209, 215 (S.D.N.Y. 2004) ("[D]irectors of a wholly-owned subsidiary, who otherwise would owe fiduciary duties only to the parent, also owe fiduciary duties to creditors of the subsidiary when the subsidiary enters 'the zone of insolvency.'").

[74]*In re* Scott Acquisition Corp., 344 B.R. 283, 286 (Bankr. D. Del. 2006).

[75]*In re* Sw. Supermarkets, LLC, 376 B.R. 281, 283 (Bankr. D. Ariz. 2007) (emphasis added).

[76]*Id.*

Anadarko language was merely *dicta*, and stated that the "[d]efendants do not cite any case decided since *Anadarko* in which a defalcating director obtained dismissal of a suit brought by the corporation he served on the ground that the corporation was a wholly owned subsidiary so no fiduciary duty was owed to it."[77]

Therefore, while defendants continue to cite *Anadarko* and *Trenwick* for the proposition that wholly owned subsidiaries only owe fiduciary duties to its parent,[78] the current state of the law appears fairly well settled that directors of wholly owned subsidiaries owe fiduciary duties not only to its shareholder/parent, but also to the subsidiary as a whole.[79]

B. *Fiduciary Duties of the Parent to its Subsidiaries*

Not only do directors of a subsidiary owe fiduciary duties to the subsidiary, but the parent corporation, as controlling shareholder, may also owe fiduciary duties to the subsidiary. This subsection discusses the possibility that the parent corporation may be sued by creditors who sue derivatively on behalf of the subsidiary. The creditors may choose to sue the parent corporation in place of, or in addition to the subsidiary's directors, when the parent corporation uses its power as controlling shareholder to dominate its wholly owned subsidiary.

1. Duties of the Parent when the Subsidiary is Solvent but not Wholly Owned

Controlling shareholders generally owe fiduciary duties of care and loyalty to minority shareholders.[80] Thus, a parent corporation may

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[77]*Id.*

[78]*See, e.g.*, Seidel v. Byron, 405 B.R. 277, 285 (N.D. Ill. 2009); *In re* Musicland Holding Corp., 398 B.R. 761, 786 (Bankr. S.D.N.Y. 2008).

[79]*See In re* Touch Am. Holdings, Inc., 401 B.R. 107, 129 (Bankr. D. Del. 2009) ("[T[he directors of a wholly-owned subsidiary owe fiduciary duties to both the subsidiary and to the sole shareholder, the parent corporation."); First Am. Corp. v. Al-Nahyan, 17 F. Supp. 2d 10, 26 (D.D.C. 1998) ("[D]irectors of a wholly-owned subsidiary owe the corporation fiduciary duties, just as they would any other corporation.").

[80]*See, e.g.*, Gentile v. Rossette, 906 A.2d 91, 103 (Del. 2006); Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994); Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988). *See also* Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1681-82 (1990) (arguing for application of more strict fiduciary duties in the close corporation context).

owe fiduciary duties to minority shareholders in its subsidiary.[81] While a parent may act in its own economic interest, the parent owes duties to the subsidiary when it is exerting board-like control on the subsidiary.[82] Moreover, the famous *Sinclair Oil* case stated that a parent corporation is *not* protected by the business judgment rule when "the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary."[83]

2. Duties of the Parent when the Subsidiary is Solvent and Wholly Owned

The Delaware Supreme Court, in *Anadarko*, stated that "a parent [corporation] does not owe a fiduciary duty to its wholly owned subsidiary."[84] Similar to the discussion regarding fiduciary duties of directors of wholly owned subsidiaries, this rule makes sense, as a practical matter, while the subsidiary is solvent.[85] Controlling shareholders, such as many parent corporations, owe fiduciary duties to

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[81]*See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (noting that "[a] parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings," but that the entire fairness standard will only apply "when the fiduciary duty is accompanied by self-dealing—the situation when a parent is on both sides of a transaction with its subsidiary.").

[82]*See* Abraham v. Emerson Radio Corp., 901 A.2d 751, 759 (Del. Ch. 2006) (noting that "the premise for contending that the controlling stockholder owes fiduciary duties in its capacity as a stockholder is that the controller exerts its will over the enterprise in the manner of the board itself"); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 888 (Del. 1970) (noting that although "the parent owes a fiduciary duty to its subsidiary, the duty does not require self-sacrifice from the parent. The parent corporation, too, has shareholders which it is bound to consider, and the parent's directors owe that corporation a fiduciary duty").

[83]*Levien*, 280 A.2d at 720.

[84]Anadarko Petro. Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988). *See also In re* HydroGen, L.L.C., 431 B.R. 337, 347 (Bankr. S.D.N.Y. 2010) (noting that "the weight of authority around the country holds that the directors of a parent corporation owe *no* fiduciary duties to a wholly-owned subsidiary"); VFB LLC v. Campbell Soup Co., 482 F.3d 624, 635 (3d. Cir. 2007) (applying New Jersey law and noting 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*").

[85]*VFB LLC*, 482 F.3d at 635 ("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.").

minority shareholders in a subsidiary, but if the subsidiary is wholly owned by the parent corporation, then there are no minority shareholders to whom a duty can be owed.[86] When the parent itself is the 100 percent shareholder, it is free to use a solvent subsidiary almost entirely as it wishes with little fear of a fiduciary duty lawsuit because while the subsidiary is solvent the parent corporation itself is the only entity likely to have standing to bring such a lawsuit.

3. Duties of the Parent when the Subsidiary is Insolvent and Wholly Owned

In *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,[87] the Delaware Court of Chancery made a broad pronouncement, similar to that in Anadarko, that "[p]arent corporations do not owe [wholly owned] subsidiaries fiduciary duties. That is established Delaware law."[88] The court first noted, however, that the plaintiff had failed to show that the subsidiary was insolvent at the time of the challenged conduct.[89] It was only after noting the inadequacy of the pleadings on the point of insolvency that the court found the parent owed no duties to the subsidiary or its creditors.[90] The fact that the court first noted the inadequacy of the pleadings as to the insolvency of the wholly owned subsidiary left the door open for the potential imposition of fiduciary duties on a parent company when such a subsidiary was insolvent at the time of the challenged conduct. Courts have focused on alleged breaches of fiduciary duties by the directors of the subsidiary more often than alleged breaches by the parent corporation.[91] Case law suggests, however, that a subsidiary's creditors could bring a viable breach of fiduciary duty claim against the parent corporation or at least a claim for aiding and abetting the conduct of the subsidiary's directors.[92]

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[86]Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 192 n.66 (Del. Ch. 2006) (noting that "[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").

[87]906 A.2d 168 (Del. Ch. 2006).

[88]*Id*. at 173 (emphasis added).

[89]*Id.*

[90]*Id.*

[91]*Compare supra* Part III.A, *with* Part III.B.

[92]*See* Weaver v. Kellogg, 216 B.R. 563, 583 (S.D. Tex. 1997) (applying Texas and Delaware law, and noting that a "fiduciary obligation on a dominant or controlling stockholder or stockholders is not just for the protection of the corporation or its other stockholders, but

IV. REFINING THE FIDUCIARY DUTY FRAMEWORK FOR WHOLLY OWNED, FINANCIALLY TROUBLED SUBSIDIARIES

A. *Current Problems in Fiduciary Duty Law*

1. "Much Ado about Something"

In his insightful article entitled *Much Ado about Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, Professor Stephen Bainbridge discussed whether creditors should be able to bring fiduciary duty claims in the "vicinity of insolvency."[93] In the article, Bainbridge noted that the entire "vicinity of insolvency" debate was really "much ado about little" because "[i]n the vast majority of cases, the business judgment rule will preclude judicial review regardless of whether suit is brought by shareholders or creditors."[94] Similarly, one might argue that whether creditors of WOFT subsidiaries ought to be able to bring fiduciary duty claims is "much ado about little," but as discussed in this part, potential duty of loyalty claims, in the WOFT subsidiaries context, can actually have real bite.

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extends to corporate creditors as well" (quoting *In re* Jackson, 141 B.R. 909, 915 (Bankr. N.D. Tex. 1992))); *see also* Brad B. Erens, Scott J. Friedman & Kelly M. Mayerfeld, *Bankrupt Subsidiaries: The Challenges to the Parent of Legal Separation*, 25 EMORY BANKR. DEV. J. 65, 119 (2008), noting that:

> The parent itself, in addition to individuals serving on the subsidiary's board of directors, may owe similar fiduciary duties to the subsidiary or its creditors. The extent, if any, of such fiduciary duties is unclear, with some courts stating that controlling shareholders also owe a fiduciary duty to the company's creditors when it is in the vicinity of insolvency, at least under some circumstances.

Id. (footnotes omitted). For further illustration, see Allied Indus. Int'l, Inc. v. AGFA-Gevaert, Inc., 688 F. Supp. 1516, 1521 (S.D. Fla. 1988) (applying Florida law and noting that "[a]s president, director, and sole shareholder of Allied, [the defendant] owed a fiduciary duty to the corporation and its creditors"); *Cf. In re* RSL COM PRIMECALL, Inc., 2003 WL 22989669, at *14 (Bankr. S.D.N.Y. Dec. 11, 2003) ("[D]irectors of the parent cannot be compelled at such time to attend only to the interests of the subsidiary, especially where (as here) *both* were insolvent."). *But see* ASARCO LLC v. Ams. Mining Corp., 396 B.R. 278, 415-16 (Bankr. S.D. Tex. 2008) (applying New Jersey and Delaware law and denying a claim against the parent corporation for a breach of fiduciary duty by its wholly owned subsidiary, but allowing, on the same facts, a claim against the parent for aiding and abetting a breach of fiduciary duty).

[93] *See generally* Bainbridge *supra* note 6. Professor Bainbridge's article addressed the "vicinity of insolvency" debate before the Delaware Supreme Court issued its decision in *Gheewalla*, which provided some guidance on the "vicinity" or "zone" of insolvency debate.

[94] *Id*. at 368.

Corporate law is largely structured to encourage directors to take "risky, but potentially value-maximizing, business strategies," even in or near insolvency.[95] As a result, the business judgment rule and exculpatory charter provisions, such as those enabled by Delaware General Corporation Law section 102(b)(7), continue to provide directors with significant protection against duty of care claims, even when the corporation becomes insolvent.[96] Section 102(b)(7) does not allow corporations to protect their directors against *all* fiduciary duty claims, and notably excludes breaches of "the director's duty of loyalty to the corporation or its stockholders."[97] Likewise, the business judgment rule

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[95]Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 777 (Del. Ch. 2004) (referring to DEL. CODE ANN. tit. 8, § 102(b)(7), which limits corporate directors' liability for breaches of the duty of care).

[96]*See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2011). *See also Prod. Res. Grp.*, 863 A.2d at 777, 794-95. Chancellor Strine stated:

> The reality that creditors become the residual claimants of a corporation when the equity of the corporation has no value does not justify expanding the types of claims that the corporation itself has against its directors [to include claims typically barred by 102(b)(7)]. It simply justifies enabling creditors to exercise standing to ensure that any valuable claims the corporation possesses against its directors are prosecuted. . . . Moreover, by the statute's own terms, an exculpatory charter provision does not insulate directors from liability for various acts of disloyalty towards the firm. Thus, to the extent that directors have engaged in conscious wrongdoing or in unfair self-dealing, the exculpatory charter provision does not insulate them from fiduciary duty claims asserted on the firm's behalf by creditors.

Id. For further illustration, see Angelo, Gordon & Co. v. Allied Riser Commc'ns. Corp., 805 A.2d 221, 229 (Del. Ch. 2002) (stating that "even where the law recognizes that the duties of directors encompass the interests of creditors, there is room for application of the business judgment rule"). *But see* the following Texas cases: *In re* Performance Nutrition, Inc., 239 B.R. 93, 111 (Bankr. N.D. Tex. 1999) (noting, in *dicta*, that "the business judgment rule may be wholly inapplicable in a case where the corporation is insolvent"); *In re* Gen. Homes Corp., 199 B.R. 148, 151-52 (S.D. Tex. 1996) ("[W]hile the business judgment rule may apply to the decisions of solvent corporations, it has no consequence in the context of a conservatorship."); Floyd v. Hefner, 2006 WL 2844245, at *15 (S.D. Tex. Sept. 29, 2006) (stating that "the *General Homes* opinion does not apply to corporations that are insolvent *in fact*, or within the zone of insolvency. It applies only to corporations that are already the subject of a bankruptcy proceeding even though a court may not have entered a formal finding of insolvency").

[97]DEL. CODE ANN. tit. 8, § 102(b)(7)(i) (2011); *see also Prod. Res. Grp.*, 863 A.2d at 781. In denying the defendant's motion to dismiss, the Delaware Court of Chancery largely emphasized that certain directors "have received and continue to receive substantial salaries and bonuses during a period when [the defendant corporation's] financial performance and health have been dismal and when [the defendant corporation] has dishonored its debt to [the plaintiff]." *Id.* The court concluded that "[s]uch alleged behavior raises the possibility that, along with the payments to [the de facto controlling stockholder's] family companies, there is a pattern of improper self-enrichment by those in control." *Id.* Therefore, the motion to dismiss,

presumption does not protect directors if they were "interested" in the outcome of the challenged transaction.[98]

Under the current corporate law of most states, creditors can bring derivative actions on behalf of an insolvent corporation for injuries to the entity caused by its directors or its controlling shareholder.[99] Creditors of WOFT subsidiaries can and have sued the parent corporation, its board, and the board of the subsidiary corporation for breaches of the fiduciary duty of loyalty.[100] In those cases, the creditors successfully argued that the defendants were "interested" parties because the defendants were on both sides of the challenged transaction or received some material benefit from the transaction.[101] Duty of loyalty claims by

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relating to that alleged self-dealing behavior, was denied. *Id*. at 799-800; *see also In re* RSL COM PRIMECALL, Inc., 2003 WL 22989669, at *12 (Bankr. S.D.N.Y. Dec. 11, 2003) (noting that duty of loyalty claims were not covered by the exculpatory clause in the corporation's certificate of incorporation).

[98]*See* Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2002). The Delaware Court of Chancery noted that:

> [T]he business judgment rule presumption that a board acted loyally can be rebutted by alleging facts which, if accepted as true, establish that the *board* was either interested in the outcome of the transaction or lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders.

Id. Accord REVISED MODEL BUS. CORP. ACT § 8.31 (2010).

[99]*See Prod. Res. Grp.*, 863 A.2d at 800 ("[A]s pled, the unusual pattern of conduct is suggestive of injury to NCT as a firm, in the sense that there is the potential that the economic value of NCT otherwise available to all creditors has been diminished by improper transfer to insiders and to the de facto controlling stockholder."); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (noting that "the creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties").

[100]*See, e.g.*, *In re* The Brown Sch., 386 B.R. 37, 47 (Bankr. D. Del. 2008) (denying a motion to dismiss for duty of loyalty claims brought by a subsidiary against the subsidiary's controlling shareholder and certain directors of the subsidiary). In *In re The Brown Schools*, the Bankruptcy Court for the District of Delaware noted that duty of loyalty claims were much less likely to be disguised as deepening insolvency claims than duty of care claims. *Id.* Delaware explicitly denied claims for deepening insolvency. *See* Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 205 (Del. Ch. 2006); *see also In re* TOUSA, Inc., 437 B.R. 447, 456 (Bankr. S.D. Fla. 2010) (denying defendant's motion to dismiss for duty of loyalty claims brought against the subsidiary's directors); *In re RSL COM PRIMECALL, Inc.*, 2003 WL 22989669, at *11 (noting that a duty of loyalty claim, regarding a guarantee of 1.6 billion dollars of the parent corporation's debt by the subsidiary, should survive a motion to dismiss as a potentially self-dealing transaction on the part of the subsidiary's directors and the group that controlled ownership of the subsidiary).

[101]*See* cases cited *supra* notes 97-98; *In re* Greater Se. Cmty. Hosp. Corp., 353 B.R. 324, 347-48 (Bankr. D.D.C. 2006) (denying a motion to dismiss a duty of loyalty claim in the wholly owned subsidiary context due to directors being on both sides of the transaction, and thus self-interested); *In re* Healthco Int'l, Inc., 208 B.R. 288, 302-03 (Bankr. D. Mass. 1997); Fed. Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982) (noting that the

creditors who challenge transactions with the parent corporation are "much ado about something" for directors of WOFT subsidiaries because the directors are typically employed by and have ownership interests in the parent corporation, as well as the wholly owned subsidiary, and therefore may be considered "interested directors" under the law.[102] As "interested directors," who are on both sides of the transaction, current law will not afford directors of WOFT subsidiaries business judgment rule or section 102(b)(7) protection, thus leaving them completely exposed to toothy duty of loyalty claims brought derivatively by creditors.[103]

2. Smooth Sailing during Solvency

At least when the entities are solvent, the law rightly encourages efficiency and allows directors of wholly owned subsidiary corporations to simply follow the wishes of the parent.[104] The WOFT subsidiaries are merely "latchkey corporations" that may, in large part, be used by the parent corporation like any other wholly owned asset while the subsidiary is solvent.[105] The law does not require directors of wholly

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board of directors of the insolvent corporation was using the insolvent corporation's assets for the benefit of the parent and not the subsidiary, and stating that "[t]he parent, through the interlocking boards of directors, manipulated the assets, property and liabilities of the subsidiary. The directors violated the fiduciary duty owed to the creditors of the insolvent [subsidiary]. These two transactions clearly indicate fundamental unfairness and injustice").

[102]*Sea Pines Co.*, 692 F.2d at 977 (noting that "the common directors were violating their duty by securing the debts of their only viable master, the parent, to the detriment of the creditor"). *Cf.* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993) (noting that "a director who receives a substantial benefit from supporting a transaction cannot be objectively viewed as disinterested or independent").

[103]*See supra* notes 97-102 and accompanying text; *see also* Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984). The Delaware Supreme Court noted:

> The requirement of director independence [inheres] in the conception and rationale of the business judgment rule. The presumption of propriety that flows from an exercise of business judgment is based in part on this unyielding precept. Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.

Id. For further illustration, see McGowan v. Ferro, 859 A.2d 1012, 1029 (Del. Ch. 2004) (noting that "[i]n order to rebut the presumption of director disinterestedness and independence, a stockholder must show that the directors' self-interest *materially* affected their independence") (emphasis added).

[104]*See Trenwick*, 906 A.2d at 201 (noting that there is no basis to fault the directors of the subsidiary company for acceding to their parent's wishes, even if the subsidiary company took actions that made that entity less valuable).

[105]The subsidiary does need to maintain sufficient separateness from the parent to

owned solvent corporations to engage in their own "separate process of deliberation in order to consider whether a parent's acquisition strategy is sound, even if that strategy requires financial support or other aid from the subsidiary."[106] In *Trenwick*, the court noted the inefficiencies that would arise if every subsidiary were required to re-deliberate every decision the parent corporation made, writing that:

> There is no sound basis to hold that the boards of wholly-owned subsidiaries must engage in their own parallel . . . consideration processes, thereby setting in motion an inefficient intergenerational *Van Gorkom*-machine spreading the powerful procedural mandate of *Van Gorkom* and its progeny to every level of the corporate family.[107]

Directors of wholly owned subsidiaries regularly approve "sweetheart" deals with their parent corporation, and are protected if they do so and the subsidiary remains solvent.[108] If the directors approve a sweetheart deal that leads to the insolvency of the subsidiary, or if directors approve the deal when the subsidiary is already insolvent, then most current courts would unwisely strip the directors of their protective armor and expose directors of WOFT subsidiaries to claims brought by creditors for the breach of the fiduciary duty of loyalty.[109]

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avoid a piercing the corporate veil claim based on an "alter ego" theory, but is generally allowed to follow most of the parent's wishes and demands. *See* J. P. Golbert & David J. Habib, Jr., *Some Comments on the Law of Separate Corporate Identity*, 1 DEL. J. CORP. L. 23, 23-24 (1976).

[106] *Trenwick*, 906 A.2d at 203 n.95.

[107] *Id.* at 201.

[108] *See* Gouvin, *supra* note 2, at 290; *see also Trenwick*, 906 A.2d at 192 (explaining that a parent could cause a solvent, wholly owned subsidiary to sell one of its key assets to satisfy the debt of the parent, without triggering any fiduciary obligations, even though there was no benefit to the subsidiary). In *Trenwick*, the Court of Chancery referred to that scenario as containing "*nothing troubling . . . from a fiduciary perspective*," and as "a garden-variety situation when a parent 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." *Id.* (emphasis added). Chancellor Strine, in *Trenwick*, also noted that no duty of care claim could be brought against the directors of a solvent, wholly owned subsidiary's directors when those directors were simply following the wishes of the parent and entering such a sweetheart deal. *Id.* at 202. If it were otherwise, "a subsidiary board could not follow parental direction without risk that the failure of the parent's business strategy, and thus the subsidiary, would later expose the subsidiary board to negligence-based liability for its loyalty to the parent. A care-based claim premised on an act of fiduciary loyalty!" *Id.* at 202-03.

[109] *See In re* RSL COM PRIMECALL, Inc., 2003 WL 22989669, at *13 (Bankr. S.D.N.Y. Dec. 11, 2003); *In re* TOUSA, Inc., 437 B.R. 447, 459 (Bankr. S.D. Fla. 2010). The

3. Directionless in Distress

While the law guides directors of WOFT subsidiaries to honor their parent corporations' wishes during solvency, Chancellor Strine recognized in *Trenwick* that the boards were not obligated to follow "instructions [from the parent that] required the [subsidiary's] board to violate the legal rights of others," and speculated that "one might conceive that the directors of a wholly-owned subsidiary owe a duty to the subsidiary not to take action benefiting a parent corporation that they know will render the subsidiary unable to meet its legal obligations."[110] The Chancellor's musings were merely *dicta* and he noted that "[a]ny lesser standard would undercut the utility of the business judgment rule by permitting creditors to second-guess good faith action simply because the subsidiary ultimately became insolvent," and that "[e]ven the recognition of a cause of action along stringent lines requires careful consideration."[111]

Current law does not truly provide the directors of WOFT subsidiaries full discretion to act solely on behalf of the parent corporation because virtually any action could leave the subsidiary insolvent.[112] Similarly, during insolvency, but prior to bankruptcy, directors do not have full discretion to act solely on behalf of the creditors. For one, it may be impossible to act on behalf of "creditors," as "creditors" are a diverse lot, who may have different and conflicting interests.[113] Secured creditors, for example, may have much less of an appetite for risk than certain unsecured creditors, whose interests may be aligned with shareholders if the payout from asset liquidation would not

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Bankruptcy Court for the Southern District of New York noted:

> The rule that in the case of an insolvent subsidiary, fiduciary duties are owed to the *subsidiary and its creditors* (and not simply to the subsidiary's parent) is consistent with Delaware law that "directors of an insolvent corporation [must] consider . . . the interests of the corporation's creditors who, by definition, are owed more than the corporation has the wallet to repay."

Id. (emphasis added). *Accord In re* The Brown Sch., 386 B.R. 37, 46 (Bankr. D. Del. 2008); *Trenwick*, 906 A.2d at 205.

[110] *Trenwick*, 906 A.2d at 202-03.

[111] *Id.* at 203.

[112] *See supra* Part III.A.2 (describing the requirement imposed by fiduciary duty law that directors consider creditors during insolvency, or in decisions that could lead to insolvency).

[113] Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 790 n.57 (Del. Ch. 2004) ("[C]reditors are not monolithic and . . . different classes of creditors might have risk preferences that are greatly disparate, with some having interests more like stockholders.").

reach them in a bankruptcy proceeding.[114] Also, the law does not require a complete shift of directorial attention to creditors upon insolvency.[115] If directors were required to act exclusively for the benefit of creditors upon insolvency, then, after the creditors gained standing due to the insolvency, the creditors could immediately force the directors to file bankruptcy and reorganize or liquidate the corporation. The law, however, does not impose such a strict duty to file bankruptcy and reorganize or liquidate.[116] Rather, the law allows directors of corporations to take risks that benefit shareholders because upon insolvency—but prior to bankruptcy—the creditors do not become the sole residual claimants, but instead share that position with the shareholders.[117] Moreover, reaching insolvency does not mean that directors are precluded from taking good faith risks on behalf of its shareholders or from engaging in good faith but vigorous negotiations with its creditors.[118] In short, directors of WOFT subsidiaries are tasked, confusingly, with acting in the best interest of the corporation, which could include the interests of the shareholder (the parent), the interests of the creditors, or something in between.[119]

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[114] *Id.*

[115] *See supra* Part II.B (explaining that many courts require directors to consider various stakeholders within the corporation upon insolvency).

[116] Mukamal v. Bakes, 378 F. App'x 890, 901 (11th Cir. 2010) (applying Delaware law and stating that Delaware law "does not recognize a duty to liquidate"); RSL Commc'ns PLC v. Bildirici, 649 F. Supp. 2d 184, 213 (S.D.N.Y. 2009) (noting that "'there is no absolute duty under American law to shut down and liquidate an insolvent corporation.'" (quoting *In re* Global Serv. Grp., LLC, 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004))). Likewise, directors are under no absolute duty to extend the life of an insolvent corporation. *See In re* Drinks Unique, Inc., 2010 WL 3491184, at *13 (Bankr. E.D. Tex. Aug. 27, 2010) (noting that the defendant "officers and directors had no obligation to continue to operate an insolvent company or take out additional loans").

[117] *Prod. Res. Grp*., 863 A.2d at 790 n.57. The Delaware Court of Chancery noted:

> Of course, when a firm is insolvent, creditors do not become residual claimants with interests entirely identical to stockholders, they simply become the class of constituents with the key claim to the firm's remaining assets. As an academic commentator aptly put it, "creditors [of an insolvent corporation] do not enjoy the entire gain of making good decisions, but bear the entire risk loss of making bad ones."

Id. (quoting Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1492 (1993)).

[118] *See Prod. Res. Grp*., 863 A.2d at 788 n.52, 800.

[119] Confusion such as this has recently led to some well-regarded academics advocating for a movement away from the fiduciary model in corporate governance law altogether. *See generally* Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239 (2009); Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV.

Despite Delaware's clear abandonment of fiduciary duties to creditors prior to insolvency,[120] some states still give creditors of wholly owned subsidiaries standing to sue for breaches of fiduciary duties when the company enters the "zone" or "vicinity" of insolvency.[121] Delaware and many states following Delaware's lead, however, now only give creditors standing to sue *derivatively* on the corporation's behalf and only do so when the corporation is insolvent or was rendered insolvent by the challenged action.[122] Even so, directors of WOFT subsidiaries could find themselves trapped between a rock and a hard place when facing a decision that may render the subsidiary insolvent or when making a decision while the subsidiary is potentially already insolvent. If the directors act in favor of the parent, they risk violating their fiduciary duties to the subsidiary and its creditors.[123] If the directors act in favor of the subsidiary and its creditors, they risk violating their fiduciary duties to their only shareholder, the parent.[124] Most actions taken in favor of the subsidiary would be protected by the business judgment rule, as disinterested transactions taken in good faith, and most actions taken in favor of the parent would be interested transactions and would not be so protected.[125] Thus, fiduciary duty law currently encourages directors of WOFT subsidiaries to question the judgment of their subsidiary's parent corporation and incur costly transaction costs in its dealings with the parent in an effort to avoid liability. [126]

1309 (2008).

[120]*See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (noting creditors' inability to bring fiduciary duty claims when the corporation is solvent).

[121]*See supra* note 47 and accompanying text; *see also* Roselink Investors, L.L.C. v. Shenkman, 386 F. Supp. 2d 209, 215 (S.D.N.Y. 2004) (noting that "directors of a wholly-owned subsidiary, who otherwise would owe fiduciary duties only to the parent, also owe fiduciary duties to creditors of the subsidiary when the subsidiary enters 'the zone of insolvency'").

[122]*See Gheewalla*, 930 A.2d at 101-03.

[123]*See supra* Part II.B.

[124]*See supra* Part II.B.

[125]*See supra* Part IV.A.1.

[126]While fiduciary duty law encourages directors of WOFT subsidiaries to favor the subsidiary's creditors, the fact that the parent corporation can remove the directors from their positions, encourages the directors to act in favor of the parent. As such, directors of WOFT corporations find themselves pulled in opposite directions.

4. Creating Administrative Difficulties and Undermining Wealth Maximization

Directors of WOFT subsidiaries face an exacting "entire fairness" analysis when defending against a duty of loyalty claim brought by creditors who argue that the directors "self-dealt" by favoring their parent corporation.[127] To avoid or defeat such claims, companies may impose one or more of the following safeguards *ex ante*: (1) appoint independent directors to each WOFT subsidiary who can approve transactions and reclaim business judgment rule protections for the directors,[128] (2) ensure

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[127]*In re* Healthco Int'l, Inc., 208 B.R. 288, 302 (Bankr. D. Mass. 1997). In applying Delaware law, the Bankruptcy Court noted that:

> [A] dispute over violation of [the duty of loyalty] often arises when a director has a personal interest in a corporate transaction. Because of his self-interest, the director has the burden of proving the fairness of the transaction, and is not protected by the business judgment rule . . . absent approval of the transaction by a majority of disinterested directors.

Id. *See also In re* Musicland Holding Corp., 398 B.R. 761, 788-89 (Bankr. S.D.N.Y. 2008) (denying a motion to dismiss as to certain defendants due to alleged dependence on the parent corporation for "continued employment and compensation"); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (analyzing the duty of loyalty); *In re* Buckhead Am. Corp., 178 B.R. 956, 968 (D. Del. 1994) (denying the defendant's argument that "[t]o the extent the DIA Directors took actions for the benefit of DIC, its sole stockholder, and Reliance Capital, DIC's sole stockholder, such conduct is completely consistent with their duty of loyalty" (quoting the defendant's brief)); Bank of Am. v. Musselman, 222 F. Supp. 2d 792, 800-01 (E.D. Va. 2002) (compiling cases and stating that "the law of other jurisdictions is that directors and officers owe a limited fiduciary duty to creditors during insolvency; this duty extends only to refraining from self-dealing acts"). *But see In re* BH S & B Holdings LLC, 420 B.R. 112, 153-54 (Bankr. S.D.N.Y. 2009) (dismissing a breach of fiduciary duty claim, but upholding a piercing of the corporate veil claim). In *In re BH S & B Holdings LLC*, the court noted that Delaware law required the defendants, "as directors of a wholly-owned subsidiary, to consider the interests of the parent company, [and that] defendants would have been in breach of their fiduciary duties had they *not* considered the best interests of [the parent] in deciding whether to [take action]." *Id.* at 153 (quoting Roselink Investors, L.L.C. v. Shenkman, 386 F. Supp. 2d 209, 219 n.3 (S.D.N.Y. 2004). The court also stated that "[w]hile [the defendants] were officers of [the subsidiary] and not directors of its parent, they too cannot be faulted for following the directions of [the subsidiary's] managing member, *at least so long as no self-dealing or violation of law was involved.*" *Id.* (emphasis added).

[128]*See* Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors under section [DEL. CODE ANN. tit. 8, §] 144(a)(1) . . . permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."); Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 173 (Del. Ch. 2005) (noting that "if the requirements of § 144(a)(1) have been met, [the defendant's] 'interest' in the Transaction would not vitiate the presumptions of the business judgment rule"). *See also* DEL. CODE ANN. tit. 8, § 144(a)(1) (2011) (promulgating that no transaction or contract shall be void solely due to its interested

that each interaction between the parent and the WOFT subsidiary is "entirely fair,"[129] or (3) require a solvency opinion when making significant decisions involving a WOFT subsidiary.[130] Each of these *ex ante* safeguards is costly to the corporation as a whole, carries significant transaction costs, and is likely to reduce corporate wealth creation. Among the top 100 United States-based corporations, the average corporate group contains 187 subsidiaries.[131] Within these large corporate groups, the boards of directors often overlap or are even identical.[132] This only makes sense. Think about the costs involved if the law strongly encouraged companies like General Growth Properties, Bank of America, or HCA, with 750,[133] 716,[134] and 1,876[135] entities in

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nature if it is approved by a majority of fully-informed, disinterested directors).

[129]"If the interested director transaction falls outside [DEL. CODE ANN. tit. 8, § 144] 'safe harbor,' the courts generally will bypass the business judgment rule and conduct an entire fairness analysis on the challenged transaction." Kahn v. Roberts, 1995 WL 745056, at *5 (Del. Ch. Dec. 6, 1995). The directors would have the burden of proving "entire fairness," which the courts have described as having two basic elements: "fair dealing and fair price." Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). However, the court's inquiry into whether a transaction was entirely fair is a "holistic one. Thus, if the price is very fair, an unfair process may not render the whole transaction entirely unfair." 1 R. FRANKLIN BALOTTI & JESSE A. FINKLESTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.16[A] (3d ed. Supp. 2010). If directors of WOFT corporations ensured, *ex ante*, that all transactions with the parent corporation were "entirely fair," they would succeed in defending against creditor duty of loyalty claims. However, with this option, directors of WOFT corporations may still be required to prove "entire fairness" through an expensive and fact-intensive litigation process. *See* Clark W. Furlow, *Back to Basics: Harmonizing Delaware's Law Governing Going Private Transactions*, 40 AKRON L. REV. 85, 86 (2007) (stating that "[e]ven a frivolous claim brought under the entire fairness standard cannot be disposed of without a trial, and the trial of such claims is invariably complex and expensive").

[130]Under Delaware law, creditors do not have standing to sue for breach of fiduciary duty while the corporation is solvent. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007). Therefore, an accurate and unbiased solvency opinion could possibly give directors of WOFT corporations comfort that creditors could not bring a duty of loyalty claim based on the directors actions on behalf of the parent corporation.

[131]1 BLUMBERG, *supra* note 2, at § 1.03, 1-7.

[132]*See, e.g.*, United States v. Bestfoods, 524 U.S. 51, 69 (1998) ("[I]t is entirely appropriate for directors of a parent corporation to serve as directors of its subsidiary, and that fact alone may not serve to expose the parent corporation to liability for its subsidiary's acts. . . . [I]t is normal for a parent and subsidiary to have identical directors and officers.") (citations and internal quotation marks omitted); 1 BALOTTI, *supra* note 129, at § 4.16 [E][1] ("Delaware case law has confronted the dual-director problem most frequently in the context of relationships between parents and non-wholly-owned subsidiaries. In such cases, it is not unusual for the memberships of the boards of directors of the parent and the subsidiary to overlap.").

[133]*In re* Gen. Growth Props., Inc., 409 B.R. 43, 47 (Bankr. S.D.N.Y. 2009).

[134]1 BLUMBERG, *supra* note 2, at § 1.03, 1-7.

[135]*Id*. at § 1.03, 1-9.

their respective corporate groups, to hire independent directors for each of their subsidiary corporations.[136] While the first safeguard, appointing independent directors to each WOFT subsidiary, would shift the burden of proof in a duty of loyalty case, appointing independent directors to each of one hundred, or more, of a corporate group's subsidiaries would be simply impractical.[137] The time spent finding and vetting potential independent directors alone would be prohibitively long, not to mention the expense involved in paying each separate set of directors.[138]

The second safeguard, ensuring entirely fair transactions within the corporate family, would allow the corporation to ultimately defeat the duty of loyalty claims brought, but would require tremendous expense in the form of paying experts to opine that each given transaction was fair.[139] For many of these transactions it may be difficult to determine the market value, especially if the good or service is not regularly traded on the open market. Also, an outside independent expert, rather than a current employee might be required to prevent bias, but even if a current employee could be used, a significant expenditure of human capital would be required to analyze and determine the fairness of each intercompany transaction. This process would entail using valuable corporate resources to determine whether a deal is entirely fair, rather than focusing on wealth creation.

Finally, the third available safeguard—a solvency opinion—may help the directors of WOFT corporations determine when they must start considering creditor interests. However, solvency opinions are costly and would have to be done before each major decision.[140] Also, solvency opinions are by no means a foolproof solution, and have been effectively

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[136]Obviously, these numbers include entity types other than just corporations. The data does not detail how many of the entities within each corporate group are corporations, as opposed to partnerships, limited liability companies, and other alternative entities.

[137]*See* Peter Lattman, *Directors May Be Underpaid, Wachtell Lipton Tells Its Clients*, N.Y. TIMES: DEAL BOOK (Jan. 19, 2011, 10:10 AM), http://dealbook.nytimes.com/2011/01/19/directors-underpaid-says-wachtell-lipton/ (noting that median compensation for outside directors of Fortune 500 companies rose above $200,000 per director for the first time in 2009).

[138]*Id.*

[139]Christopher M. Forrester & Celeste S. Ferber, *Fiduciary Duties and Other Responsibilities of Corporate Directors and Officers*, MORRISON & FOERSTER LLP (2008), http://www.rrdonnelley.com/financial/Downloads/PDF/Fiduciary_Duties_and_Other_Responsibilities_of_Corporate_Directors_and_Offiers.pdf.

[140]*See, e.g.*, *In re* TOUSA, Inc., 422 B.R. 783, 839-40 (Bankr. S.D. Fla. 2009) (noting that the debtor agreed to pay approximately $1 million to $2 million dollars for a solvency opinion, depending on the outcome of the opinion).

challenged in court.[141] Due to the current lack of any cost-efficient and effective options to combat potential duty of loyalty claims by creditors *ex ante*, directors of WOFT corporations may simply favor creditors over the parent corporation in their actions. Recognizing the likelihood of disobedience by directors of their WOFT corporations, owners of the parent corporation may increasingly disfavor the corporate form as an entity choice.[142]

5. Disfavor of the Corporate Form

Besides confusing directors regarding to whom their fiduciary duties run and requiring significant administrative costs to combat potential liability, allowing creditors to bring derivative actions against directors of WOFT corporations may result in corporate groups shying away from the corporate form. Vice Chancellor Laster's opinion in *CML V, LLC v. Bax*[143] emphasized that while creditors of insolvent *corporations* have standing to sue for breaches of fiduciary duties, creditors of insolvent *limited liability companies* do not.[144] Additionally, the law gives owners of limited liability companies wide latitude in restricting or eliminating fiduciary duty liability in their operating agreements.[145] Thus, if corporation law does not protect directors of

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[141]*See id.* at 839-43 (disregarding the solvency opinion as biased and influenced by an incentive fee structure); AT & T Corp. v. Walker, 2006 WL 2585026, at *5 (W.D. Wash. Sept. 7, 2006) (disregarding a solvency opinion as biased because it was not prepared by a disinterested expert and it was based on an erroneous assumption).

[142]*See* Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy,* 2009 U. ILL. L. REV. 131, 165 (2009) (positing that problems of "indeterminacy and instability," in corporation or Delaware law "may be instrumental in driving firms increasingly toward uncorporate forms of governance").

[143]6 A.3d 238 (Del. Ch. 2010). In the late stages of the editing of this Article, the Delaware Supreme Court affirmed the Delaware Court of Chancery decision. *See CML V, LLC v. Bax*, 2011 WL 3863132 (Del. Sept. 2, 2011).

[144]*Id.* at 240-41. *But see In re* Mervyn's Holdings, LLC, 426 B.R. 488, 501 (Bankr. D. Del. 2010) (noting that, under California law, the Supreme Court of California is likely to recognize that fiduciary duties are owed by the parent of an insolvent LLC subsidiary to both the LLC and its creditors). *See also* JPMorgan Chase Bank, N.A. v. KB Home, 632 F. Supp. 2d 1013, 1027 (D. Nev. 2009) ("Because the justifications for the corporate insolvency exception are equally applicable to limited liability companies, the Court concludes the Nevada Supreme Court would extend the insolvency exception to limited liability companies."); *In re* McCook Metals, L.L.C., 319 B.R. 570, 595 (Bankr. N.D. Ill. 2005) (noting that, under Illinois law, directors' fiduciary duties to creditors during insolvency, under corporation law, extend to managers of limited liability companies).

[145]DEL. CODE ANN. tit. 6, § 18-1101(c) (2011) (providing that fiduciary duties may be

WOFT corporations from duty of loyalty claims by creditors, parent companies may increase their use of limited liability companies, rather than corporations, as the entity of choice for subsidiaries in their corporate groups to exploit this difference between the entity forms.[146]

B. *Case Study: In re* TOUSA, Inc.

The recent *TOUSA* cases in the Southern District of Florida, applying Delaware law, exhibit the complexity of the problems addressed in this Article.[147] TOUSA Inc., the parent corporation, and a number of its subsidiaries borrowed $500 million, secured by assets of the subsidiaries, to settle third party litigation against the parent and one of its subsidiaries.[148] Six months later, both TOUSA and its subsidiaries filed for bankruptcy.[149] The Official Committee of Unsecured Creditors of the subsidiaries claimed that the granting of the liens was both a fraudulent transfer and a breach of fiduciary duties by directors of the subsidiary.[150] In separate judicial decisions, Bankruptcy Judge John Olson avoided the transaction as a fraudulent conveyance[151] and denied motions to dismiss the fiduciary duty claims.[152] The fraudulent conveyance decision was later quashed by the district court,[153] but it is the fiduciary duty decision that is important for the purposes of this Article.

In the fiduciary duty opinion, the *TOUSA* court emphasized that "'[o]ne who controls property of another may not, without implied or express agreement, intentionally use that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owner.'"[154] While the court claimed that "[o]nce the subsidiary becomes

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eliminated in a limited liability company agreement, but that the agreement "may not eliminate the implied contractual covenant of good faith and fair dealing"); Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451, at *8 (Del. Ch. Apr. 20, 2009) ("The Delaware LLC Act gives members of an LLC wide latitude to order their relationships, including the flexibility to limit or eliminate fiduciary duties.").

[146] *See supra* note 142 and accompanying text.

[147] *See generally In re* TOUSA, Inc., (*TOUSA I*), 422 B.R. 783 (Bankr. S.D. Fla. 2009); *In re* TOUSA, Inc., (*TOUSA II*), 437 B.R. 447 (Bankr. S.D. Fla. 2010); *In re* TOUSA, Inc., (*TOUSA III*), 444 B.R. 613, (Bankr. S.D. Fla. 2011).

[148] *TOUSA I*, 422 B.R. at 786-87.

[149] *Id.* at 786.

[150] *TOUSA II*, 437 B.R. at 452.

[151] *See TOUSA I*, 422 B.R. at 886-87.

[152] *See TOUSA II*, 437 B.R. at 464-65.

[153] *See TOUSA III*, 444 B.R. at 680 (quashing the order issued by *TOUSA I*).

[154] *TOUSA II*, 437 B.R. at 460 (quoting *In re* USACafes, L.P. Litig., 600 A.2d 43, 48-49 (Del. Ch. 1991)).

insolvent, Delaware law recognizes that the fiduciary duties shift to the creditors," it admitted that once the shift occurs the "effect is that there is more than one equitable beneficiary of those duties."[155] The *TOUSA* court did not address who would be the additional beneficiary or beneficiaries, other than the creditors.

The bankruptcy court in *TOUSA* concluded that the creditors committee's allegation that "the defendants used insolvent subsidiary debtors' assets to expand the parents' pie at the expense of the subsidiaries non-parent stakeholders" formed part of a legally sufficient complaint.[156] The court failed, however, to explicitly recognize that the defendants' conduct would have been unquestionably valid if TOUSA's subsidiaries were solvent, and, in any event, the parent was and continued to be a major stakeholder in the subsidiary. Additionally, TOUSA even received a formal solvency opinion prior to its decision to borrow the $500 million,[157] but the bankruptcy court disregarded the solvency opinion as biased for multiple reasons,[158] including the alignment of incentives in the fee structure.[159]

C. *The Proposed Solution*

In situations like *TOUSA*, what are well-intentioned directors of WOFT corporations to do? While Delaware law has long said that directors' fiduciary duties run to "the corporation *and* its shareholders," directors of WOFT corporations are often forced to choose either "the corporation" *or* "its shareholder." This Article proposes that the law provide directors of WOFT subsidiaries business judgment rule or statutory protection whether they choose, in good faith, to favor the corporation (and thus their creditors) or their shareholder (their parent). Fiduciary duty law should not punish directors for making decisions that

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[155]*Id*. at 457 n.32 (quoting *In re* Sw. Supermarkets, LLC, 376 B.R. 281, 285 (Bankr. D. Ariz. 2007)).

[156]*Id.* at 464.

[157]*TOUSA I*, 422 B.R. 783, 798 (Bankr. S.D. Fla. 2009).

[158]*Id*. at 839-43.

[159]*Id.* at 839-40 (reasoning that the solvency opinion was unpersuasive, in part, because TOUSA's fee agreement with an outside financial advisor firm made $2 million contingent if, and only if, the firm concluded that TOUSA and its subsidiaries were solvent on a consolidated basis rather than individually; but if the firm concluded that the corporate group was insolvent, then it would only be paid roughly half that amount in the form of reimbursements for its time charges and costs).

benefit the subsidiary's only shareholder (its parent) for four main reasons: (1) punishment would increase the administrative burden on large corporations; (2) punishment leaves fiduciary duty law overly complex and fails to provide directors with clear guidance on how to deal with the complexity; (3) punishment would result in a further favoring of the LLC form over the corporate form; and (4) creditors potentially harmed by those directorial decisions favoring the parent corporation have significant protections outside of fiduciary duty law. If, however, directors of a WOFT subsidiary make decisions that favor *neither* the subsidiary corporation nor the parent-shareholder, but only benefit the directors personally, then the creditors *should* be able to sue derivatively on behalf of the corporation for that breach of the duty of loyalty.

1. Business Judgment Rule Protection when Choosing between Legitimate Constituencies

The proposed solution falls in line with the legal principles underlying both the business judgment rule and fiduciary duties.[160] The business judgment rule is "a presumption that [directors] were faithful to their fiduciary duties,"[161] and is "[a]t the core of Delaware corporate law."[162] The business judgment rule presumes 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,"[163] and "prevent[s] a factfinder, in hindsight, from second-guessing the decisions of directors."[164] Also, allegations that merely claim that directors made a bad decision, unaccompanied by allegations of "bad faith, a conflict of interest or personal bias," are insufficient to state a cause of action.[165] Courts employ the business judgment rule because: (1) it encourages board service;[166] (2) it

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[160] *See infra* notes 185-186 and accompanying text for a discussion regarding the principles underlying the imposition of fiduciary duties.

[161] Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004); *see also* 1 RADIN, *supra* note 4, at 11-12.

[162] *In re* CompuCom Sys., Inc. S'holders Litig., 2005 WL 2481325, at *5 (Del. Ch. Sept. 29, 2005).

[163] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[164] Fed. Deposit. Ins. Corp. v. Stahl, 89 F.3d 1510, 1517 (11th Cir. 1996).

[165] Stuart Silver Assocs., Inc. v. Baco Dev. Corp., 665 N.Y.S.2d 415, 418 (N.Y. App. Div. 1997); *see also* Ash v. McCall, 2000 WL 1370341, at *10 (Del. Ch. Sept. 15, 2000).

[166] *See, e.g.*, Teachers' Retirement Sys. of La. v. Aidinoff, 900 A.2d 654, 668 (Del. Ch. 2006); Air Line Pilots Ass'n, Int'l. v. UAL Corp., 717 F. Supp. 575, 582 (N.D. Ill. 1989) ("The

encourages risk taking;[167] (3) courts recognize that directors are generally better situated to make business decisions than judges;[168] (4) courts recognize that the statutory regime provides responsibility for managing the corporation to directors, not shareholders;[169] and (5) courts recognize that "unhappy shareholders can always vote the directors out of office."[170]

Under this Article's proposal, creditors of a wholly owned subsidiary should be rebuffed by the business judgment rule when bringing duty of loyalty claims stemming from actions benefiting the parent corporation. When the party controlling the subsidiary's actions makes a decision that benefits the only shareholder of the wholly owned subsidiary—its parent—the decision maker should be protected for the same reason courts typically impose the business judgment rule.

The Delaware Court of Chancery has recognized that:

> [B]usiness failure is an ever-present risk. The business judgment rule exists precisely to ensure that directors and managers acting in good faith may pursue risky strategies that seem to promise great profit. If the mere fact that a strategy turned out poorly is in itself sufficient to create an inference that the directors who approved it breached their

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business judgment rule encourages competent individuals to become directors who otherwise might decline for fear of personal liability.").

[167]Gagliardi v. TriFoods Int'l., Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996). The Delaware Court of Chancery noted that:

> Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests, across the full range of diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.

Id.

[168]Int'l Ins. Co. v. Johns, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989) (noting that "[t]he business judgment rule is a policy of judicial restraint born of the recognition that directors are, in most cases, more qualified to make business decisions than are judges"); *see also* Postorivo v. AG Paintball Holdings, Inc., 2008 WL 553205, at *4 (Del. Ch. Feb. 29, 2008) ("The Delaware courts generally will not substitute the judgment of a judge for that of the board.").

[169]*See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (noting that the business judgment rule "is an acknowledgment of the managerial prerogatives of Delaware directors under [DEL. CODE ANN. tit. 8, § 141(a) (2011)]"); *see also* Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1735 (2006) (arguing that the director primacy model, as opposed to the shareholder primacy model, "accurately describes how corporations work").

[170]1 RADIN, *supra* note 4, at 40.

> fiduciary duties, the business judgment rule will have been denuded of much of its utility.[171]

The court was speaking about the duty of care in that instance.[172] But much of the same logic applies in the context of wholly owned subsidiaries and potential duty of loyalty claims by creditors. When solvent, wholly owned subsidiaries may generally be used like any other asset of the parent corporation, for the benefit of the parent.[173] However, as the *Trenwick* court noted, almost any business decision could ultimately lead to failure.[174] If subsidiary boards begin to question most interactions with its parent, the utility of the wholly owned corporation will decline.[175] Additionally, as the business judgment rule recognizes, courts are not well positioned to examine, *ex post*, decisions made by directors, in good faith, to favor one legitimate constituency over another.

2. Amending Exculpatory Charter Provision Statutes

An alternative to modifying the business judgment rule to recognize parent/wholly owned subsidiary transactions as uninterested transactions is to have the various state legislatures modify statutes such as Delaware General Corporation Law section 102(b)(7) ("section 102(b)(7)"). These statutes currently allow corporations to eliminate personal, monetary liability for their directors for breaches of the duty of care in the corporation's certificate of incorporation.[176] These statutes, however, expressly deny corporations the right to eliminate liability under breach of duty of loyalty claims.[177] Amending section 102(b)(7) and similar statutes to allow corporations to eliminate directorial liability for breaches of the duty of loyalty, when the director acts in favor of the

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[171] Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 193 (Del. Ch. 2006).

[172] *Id.*

[173] While a third party is unlikely to bring a derivative suit while the subsidiary is solvent, in preparation for potential insolvency, the parent corporation should keep enough separateness between the operations of the parent and the operations of the subsidiary to defend against potential alter-ego based claims to pierce the corporate veil.

[174] *Trenwick*, 906 A.2d at 193 (noting that “business failure is an ever-present risk”).

[175] *See supra* Part IV.A.4.

[176] *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2011).

[177] *Id*. at § 102(b)(7)(i).

corporation's parent, would solve the lack of guidance and protection issues discussed in this Article. Such an amendment would also allow the corporate form to better compete with the LLC entity form, which, under Delaware law, allows for a more complete elimination of the duty of loyalty and does not allow derivative creditor claims for breaches of fiduciary duties.[178]

The proposed business judgment rule modification would protect directors of *all* corporations, while an amendment to statutes such as section 102(b)(7) would only protect those corporations that chose to opt-out of fiduciary duty liability through an amendment to their certificate of incorporation.[179] Expansion of the business judgment rule has the advantage of eliminating one transaction cost for corporations, as they would not have to amend their charter. Statutory modification, on the other hand, would allow private ordering and gives corporations more flexibility in choosing whether to eliminate conflict of interest based duty of loyalty liability when directors choose to favor the parent corporation. Either a modification to the business judgment rule, or an amendment to statutes like section 102(b)(7), would, however, allow corporations to provide substantial protection to directors of WOFT subsidiairies.

3. No Business Judgment Rule or Statutory Protection for Purely Selfish Actions

Of course, the business judgment rule is merely a presumption, and section 102(b)(7) contains important exceptions.[180] The party controlling the subsidiary's decisions should not be protected from liability when she makes a decision that benefits *neither* the only shareholder of the wholly owned subsidiary (its parent), nor the subsidiary corporation as a whole. In other words, creditors should still

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[178]*See supra* Part IV.A.5 (explaining the current differences between corporate and limited liability company law in the area of fiduciary duties). Note that this Article does not argue for the *complete* elimination of the duty of loyalty in the corporate form, but rather, would protect the ability of creditors to bring duty of loyalty claims if the directors acted solely in their personal interests, rather than in the interest of a legitimate object of their fiduciary duties, such as the parent corporation.

[179]*See* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 4-5 (1990) (arguing for greater ability to opt out of fiduciary duties from a contractarian view of the corporation).

[180]*See supra* notes 97-98 and accompanying text.

have standing to bring duty of loyalty claims, derivatively on behalf of the subsidiary corporation, if the director was acting in her own personal interest, and not to benefit any of the subsidiary's legitimate constituents. The creditors of an insolvent wholly owned subsidiary should be able to sue, for example, when a director takes a corporate opportunity solely for herself. In that case, the director is no longer acting in the interest of a legitimate object of her fiduciary duties, and because the shareholder's economic interest has mostly evaporated they may no longer care to protect the corporate entity.[181]

V. IMPLICATIONS OF PROVIDING PROTECTION AGAINST DUTY OF LOYALTY CLAIMS IN THE PARENT/WHOLLY OWNED SUBSIDIARY CONTEXT

Critics may argue that business judgment rule or statutory protection will provide undue insulation to self-interested directors and leave creditors, especially involuntary creditors, without adequate protection.[182] First, while directors of WOFT subsidiaries may have ownership interests in the parent corporation, and even be employed by the parent corporation, the fact remains that the parent corporation is a legitimate constituency of the subsidiary until bankruptcy, and the directors' business judgment should therefore be given great deference. As discussed above, purely selfish actions, ones that do not benefit any legitimate constituency, but rather only the director personally, should be exempted from the business judgment rule and statutory protections.[183]

Second, voluntary creditors, such as banks, are well positioned to address these risks through contractual provisions, without the assistance of fiduciary duty law.[184] Courts created fiduciary duties to fill contractual

[181] *See* Schoon v. Smith, 953 A.2d 196, 208 n.46 (Del. 2008). The Delaware Supreme Court noted that:

> *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.

Id.

[182] *Cf.* Bainbridge, *supra* note 21, at 1427-28 (explaining that directors who are free to choose between multiple constituencies may use that freedom to pursue their own self-interest).

[183] *See supra* Part IV.C.3.

[184] *See* Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC, 922 A.2d 1169, 1180 (Del.

and statutory gaps,[185] and to align director interests with the interests of corporate constituents—who stand to gain from increased value to the corporation.[186] Most large voluntary creditors painstakingly negotiate their lending documents with the corporation and, in any event, it is likely that any gaps that exist in creditor contracts were intentional or stemming from oversight by the parties.[187] As such, the gap-filling rationale is a poor one in situations where the creditors have voluntary contractual arrangements with the subsidiary. If the voluntary creditors were unable to negotiate for protections from parental looting of the subsidiary, the law should not engage in *ex post* sweetening of the creditor's end of the bargain.[188] As to the alignment of interest rationale behind fiduciary duties, even during insolvency, but prior to bankruptcy, the shareholders and creditors *share* the potential upside of directorial decisions.[189] Therefore, acting on behalf of either the shareholders *or* the creditors should be allowed.

Involuntary creditors, such as tort claimants, have a stronger argument.[190] These creditors are not well positioned to negotiate for

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Ch. 2006) (noting that "creditors are usually better able to protect themselves than dispersed shareholders").

[185]Unisuper Ltd. v. News Corp., 2005 WL 3529317, at *8 (Del. Ch. Dec. 20, 2005), *reprinted in* 31 DEL. J. CORP. L. 1186, 1199 (2006) ("Fiduciary duties exist in order to fill the gaps in the contractual relationship between the shareholders and directors of the corporation.").

[186]N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (explaining that fiduciary duties are enforced by "the ultimate beneficiaries of the corporation's growth and increased value").

[187]Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 789-90 (Del. Ch. 2004) (suggesting that allowing creditors to utilize fiduciary duty law may result in an attempt to "fill gaps that do not exist," even though "[c]reditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections"); *see also* Jonathan C. Lipson, *The Expressive Function of Directors' Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. 224, 276 (2006) (noting that Chancellor Strine rejected the use of the priority-duty model because creditors do not necessarily have the same risk preferences, but rather, "might have risk preferences that are greatly disparate, with some having interests more like stockholders") (quoting *Prod. Res. Grp*., 863 A.2d at 790 n.57)).

[188]*Prod. Res. Grp*., 863 A.2d at 790 (noting that with the contractual protections, as well as the implied covenant of good faith and fair dealing, and the law of fraudulent conveyance protections, "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"); *Cf.* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 92-93 (1998) (stating that "[b]ecause the fiduciary principle is a rule for completing incomplete bargains in a contractual structure, it makes little sense to say that 'fiduciary duties' trump *actual* contracts").

[189]*See* Lin, *supra* note 23, at 1497.

[190]Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1193 (2003) (arguing that

protections against parental domination, nor can they typically demand some kind of parental guarantee. Involuntary creditors, by definition, have little power in determining the contours of their rights. However, involuntary creditors may indirectly benefit from the contractual provisions of voluntary creditors that limit sweetheart deals with the parent. In addition, both involuntary and voluntary creditors receive protection from fraudulent transfer law and rights to pierce the corporate veil.[191] Furthermore, under certain circumstances, creditors may petition for involuntary bankruptcy of the subsidiary.[192] Moreover, the implied covenant of good faith and fair dealing protects every creditor who entered into a contract with the subsidiary.[193]

Each of these areas of law provides protections to creditors against the parent company using its influence to extract value from its wholly owned subsidiaries. Each of these areas of law is also preferable over fiduciary duty law, as each area is better defined than fiduciary duty law, or is only used in extraordinary situations. The implied covenant of good faith and fair dealing "is a limited and extraordinary legal remedy," which "requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain."[194] Under the Uniform Fraudulent Transfer Act, as adopted by Delaware, the plaintiff must prove that:

> [T]he debtor made the transfer or incurred the obligation:
> (1) With actual intent to hinder, delay or defraud any creditor of the debtor; or
> (2) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
> a. Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

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"directorial duties should not be governed exclusively by priority in right of payment," but that "duties to creditors should be informed by the concerns that ordinarily animate duty in the corporate context—imbalances of volition, cognition, and exit.").

[191] *Prod. Res. Grp.*, 863 A.2d at 787.

[192] 11 U.S.C. § 302(b) (2010).

[193] *See* Lipson, *supra* note 190, at 1193 (noting that the claims by tort claimants or taxing authorities would be difficult to characterize as contractual in nature).

[194] Nemec v. Shrader, 991 A.2d 1120, 1128 (Del. 2010) (citations and internal quotation marks omitted).

> b. Intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.[195]

When determining whether to allow a piercing of the corporate veil, courts will often look at whether the plaintiff shows fraud or similar injustice and whether the parent and subsidiary "operated as a single economic entity."[196] Arguments for corporate veil piercing and breach of fiduciary duties have been characterized as very similar within the WOFT corporation context,[197] although piercing the corporate veil claims generally require more egregious facts for the plaintiff to succeed and are generally easier for defendants to protect against *ex ante* by following corporate formalities and avoiding fraud.[198]

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[195] DEL. CODE ANN. tit. 6, § 1304(a) (2011).

[196] *In re* Foxmeyer Corp., 290 B.R. 229, 235 (Bankr. D. Del. 2003) (citations and quotation marks omitted); *see also* Harper v. Del. Valley Broad., Inc., 743 F. Supp. 1076, 1085 (D. Del. 1990) ("Absent a showing of a fraud *or* that a subsidiary is in fact the mere alter ego of the parent, a common central management alone is not a proper basis for disregarding separate corporate existence." (quoting Skouras v. Admiralty Enters., Inc., 386 A.2d 674, 681 (Del. Ch. 1978))). This Article recognizes that corporate veil piercing has its own doctrinal problems. *See generally,* Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 480 (2001) (discussing problems with veil piercing doctrine, including, that the doctrine is "vague, leaving judges great discretion," and results in "uncertainty and lack of predictability, increasing transaction costs"). Veil piercing, however, is not likely to be of as great concern to directors as fiduciary duty claims, as veil piercing is only performed in extraordinary situations and courts do "not lightly disregard the separate legal existence of corporations." MicroStrategy Inc. v. Acacia Research Corp., 2010 WL 5550455, at *11 (Del. Ch. Dec. 30, 2010); *see also* Jeff Lipsaw, *Is "Intellectually Vacuous" the Right Expression for Veil-Piercing Doctrine?*, PRAWFSBLAWG (Feb. 22, 2011, 1:33 PM), http://prawfsblawg.blogs.com/prawfsblawg/2011/02/is-intellectually-vacuous-the-right-expression.html ("[P]iercing cases are rare, idiosyncratic, and usually marked by some outrageous conduct that makes the decision, in retrospect, not particularly surprising.").

[197] *See, e.g.*, Judson Atkinson Candies, Inc. v. Latini-Hohberger Dhimantec, 529 F.3d 371, 384 (7th Cir. 2008) ("[Plaintiff's] breach of fiduciary duty argument is mainly a rehashing of its veil-piercing argument.").

[198] *See* William J. Rands, *Domination of a Subsidiary by a Parent*, 32 IND. L. REV. 421, 456 (1999). Rands notes that:

> Adherence to the Landers model of proper behavior for a corporate group should be a prerequisite for sustaining the parent's limited liability. In a nutshell, the model requires that the parent structure the subsidiary so that it has a realistic potential for profitability. More particularly, the parent should adequately capitalize its subsidiary, avoid treating it as a department or a division, and avoid commingling or stripping its assets. Though the standard of conduct may not comport with the group's dominant motivation, which is to maximize a return for the enterprise as a whole, this author is willing to take the normative stance that adherence to this informal code of good conduct is

By contrast, current fiduciary duty law does not require as egregious facts, nor does current fiduciary duty law provide clear guidance to directors, as it currently requires consideration of multiple constituencies during insolvency of the corporation, but prior to bankruptcy.[199] Finally, given that fiduciary duty law requires directors to favor "the corporation *and* its shareholders," it should not punish those directors when they are forced to choose one of these legitimate stakeholders over the other.[200]

VI. CONCLUSION

The harm in leaving directors of WOFT corporations unprotected against fiduciary duty claims, for decisions that benefit the parent corporation, is great.[201] In contrast, the harm of not allowing such claims is relatively small.[202] Current law is unclear regarding the question of to whom directors of WOFT corporations owe their duties and this uncertainty can lead to significant administrative costs and a decline in corporate wealth creations. On the other hand, a panoply of other laws, outside of the fiduciary duty framework, protect creditor rights adequately, and also provide more definite and less conflicted guidance for directors. As such, courts and legislators should consider expanding business judgment rule or statutory protections to cover directors of WOFT subsidiaries who, in good faith, favor their parent corporations over their creditors prior to bankruptcy.

> the price that a parent corporation should be required to pay to preserve its limited liability.

Id.

[199] *See supra* Part II.
[200] *See supra* Part IV.C.
[201] *See supra* Part IV.
[202] *See supra* Part V.