New York Law Journal
Corporate Update
Thursday, October 26, 2006
ALM

Duties of Subsidiary Directors Run to Subsidiary, Not Parent

BY CORINNE BALL

A recent decision addressed the fiduciary duties of a subsidiary's directors and officers in the zone of insolvency. The case, *Scott Acquisition Corp.*,[1] involved a subsidiary's pre-bankruptcy real estate divestitures to certain of its insiders for what was later determined to be less than fair market value. Defending the transactions, the directors and officers argued that they could not be held liable for the divestitures because (i) directors and officers have no fiduciary duties to a subsidiary—rather, they argued that such directors and officers owe fiduciary duties only to the parent—and (ii) a trustee could not raise a claim on behalf of the subsidiary's creditors. The bankruptcy court rejected each argument. *Scott* confirms that in a distress setting, an officer or director of a subsidiary cannot approve a transaction which would benefit a parent to the detriment of either the subsidiary or its creditors.

Role of the Director in Zone of Insolvency

In general, the role of a director or officer of a corporation in the zone of insolvency is outlined in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*[2] and its progeny. Interestingly, in addition to addressing fiduciary duties in a financially distressed subsidiary, *Credit Lyonnais* also focused on the parent subsidiary paradigm. Generally, directors owe shareholders the fiduciary duties of care and loyalty. The duty of care mandates that a director exercises the degree of care that an ordinary prudent person would exercise under the same or similar circumstances. Under the duty of loyalty, a director may not self-deal or usurp corporate opportunities. In contrast, as a general matter, the relationship between the director of a corporation and its creditors is contractual, not fiduciary.

Corinne Ball *is a partner at Jones Day. Associates* **Joshua P. Weisser** *and* **Ross S. Barr** *assisted in the preparation of this article.*

DISTRESSED MERGERS AND ACQUISITIONS

In *Credit Lyonnais*, the Court of Chancery confirmed that once a company enters the zone of insolvency, directors owe fiduciary duties not just to the corporation and its shareholders, but, instead, to the corporation and to all of its interested constituencies, which includes both its creditors and its stockholders. The shift is justified because the creditors occupy "the position of residual owners."[3]

In the years following *Credit Lyonnais*, courts debated directors' obligations in the zone of insolvency. The debate centered on, among other things, whether insolvency changes the extent of the director's duties or just the beneficiary of such duties. Vice-Chancellor Strine's decision in *Production Resources Group, L.L.C. v. NCT Group*[4] should have settled the debate, as he took that decision as the opportunity to explain the intended rationale of *Credit Lyonnais* and further define the directors' role in the zone of insolvency. In *Production Resources*, Strine held that *Credit Lyonnais* did not change the scope of the directors' duties; indeed, he affirmed that directors of a distress corporation are still protected by the business judgment rule. He left no doubt that *Credit Lyonnais* changed the community of interests that must be taken into account in making a business decision.

Provided that directors comply with their contractual obligations to creditors, including the implied duties of good faith and fair dealing and laws governing creditors' rights, such as the prohibition against fraudulent conveyances, directors are "free to take risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value."[5] Nonetheless, once a company enters the zone of insolvency, directors should incorporate the corporation's financial condition and the likely impact of risk taking on the company's creditors in exercising their discretion "to temper the risk that they take on behalf of the equity holders."[6] In holding directors accountable to creditors, *Credit Lyonnais* also expanded the parties who have standing to bring suit against the directors. *Production Resources* clarifies that actions by creditors are derivative, and that creditors should be viewed as the residual owners of a distress corporation, and in essence have the rights usually accorded shareholders as well as the same limitations in terms of exoneration of directors.

Subsidiary Director's Role

In *Scott*, the bankruptcy court applied the rationale of *Production Resources* to the actions of a subsidiary's directors and officers, entering the debate of whether a director of a subsidiary in financial distress owes a fiduciary duty to that subsidiary and, by extension, to its creditors or instead, to the parent corporation. The debate began after a seemingly broad rule was announced in *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*,[7] where the Delaware Supreme Court addressed a corporate parent's and directors' duties to a prospective stockholder of a wholly-owned subsidiary after the parent announced its intention to spin-off the subsidiary. According to the plaintiffs in that case, after the announcement of the spin-off, the directors developed duties of loyalty and disinterestedness to the prospective shareholders, and promptly violated those duties by approving agreements which benefited the parent to the subsidiary's detriment. The court disagreed, granting summary judgment to the defendant subsidiary directors because "in a parent and wholly-owned subsidiary context, the directors of a subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders."[8] Importantly, the *Anadarko* court did not address the directors' and officers' duties to a financially distressed subsidiary.

Courts outside of Delaware have interpreted the *Anadarko* decision twice in the insolvency context, examining whether a subsidiary's officers and directors owe a duty to the parent corporation or the subsidiary and its creditors. Interestingly, each case came to a different conclusion. In *RSL Com. Primecall, Inc. v. Bechoff*,[9] the bankruptcy court rejected the claims of the subsidiary directors and officers that, under *Anadarko*, they owed a fiduciary duty to the parent and not to either the subsidiary or its creditors. The court reasoned that the defendants' reliance on *Anadarko* was erroneous because *Anadarko* did not address corporate duties in the zone of insolvency. As such, "[i]t 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."[10]

Six years after *Anadarko*, a federal district court in Arizona, in *Southwest Holdings, L.L.C. v. Kohlberg & Co*,[11] also interpreted *Anadarko* and came to the opposite conclusion regarding director and officer liability. The case involved the buyout of Southwest Supermarkets ("Southwest") by Kohlberg & Co. ("Kohlberg"). After Southwest subsequently filed for bankruptcy, the chapter 11 trustee filed a complaint alleging that, under the terms of the buyout, Kohlberg breached its fiduciary duty to Southwest. The court, however, did not find Kohlberg liable. Relying principally on *Anadarko*, it held that, under Delaware law, "when a subsidiary is wholly owned, its officers and directors owe their fiduciary duties solely to a single shareholder, and not to the subsidiary corporation itself."[12] Moreover, according to the court: "[T]here is nothing to suggest this law changes when the corporation becomes insolvent."[13]

In *Scott*, Judge Walsh joined Judge Gropper in his *RSL* decision in deciding not to apply *Anadarko* to a subsidiary's officers and directors in the zone of insolvency. The *Scott* case focused on certain real estate divestitures completed by a debtor while allegedly within the zone of insolvency. Prior to the divestitures, the parent of the operating debtor, a retailer of building materials and home improvements, obtained a loan that was secured by a lien on substantially all of the subsidiary debtor's property. As financial troubles mounted, the operating subsidiary began selling real estate to reduce its debt, using sale-leaseback transactions. The debtor sold some properties to independent third parties for fair value, while others were sold for less than fair value to entities controlled by insiders.

In its complaint, the trustee asserted three claims: (1) a breach of fiduciary duty claim against the defendants, the subsidiary's directors and officers, (2) that the defendants aided and abetted one another's fiduciary duty breach, and (3) that the defendants breached the terms of their employment agreements with the subsidiary. The trustee asserted its claims on behalf of the parent, the subsidiary, and the subsidiary's creditors. Relying on *Anadarko*, the defendants argued, among other things, that (1) the trustee could not raise a claim on behalf of the subsidiary because the subsidiary's officers and directors owed a fiduciary duty only to the parent and not to the subsidiary; and (2) the trustee had no standing to sue in a direct action on behalf of the subsidiary's creditors. According to the defendants, while the directors did owe a contractual duty to the subsidiary's creditors, they did not owe it a derivative duty, and, consequently, the trustee could not bring a direct action on behalf of the creditors.

Judge Walsh ruled that corporate duties under *Production Resources* applied not only to the distress parent's directors, but also to the distress subsidiary's directors, limiting *Anadarko* to a narrow set of facts: "*Anadarko* did not address the situation here…[n]or did *Anadarko* radically alter a director's fiduciary obligations to the corporation…."[14] Under Delaware law, the court concluded, in the zone of insolvency, a wholly-owned subsidiary's directors owe fiduciary duties directly to the subsidiary and, derivatively, to its creditors.

Significantly, Vice-Chancellor Strine, the author of the *Production Resources* decision, analyzed whether the *Scott* court's holding was consistent with his previous ruling in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*[15] Strine acknowledged 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 it obligations."[16] Moreover, in reviewing Judge Walsh's rationale, he confirmed that *Credit Lyonnais* and traditional legal thought mandates that in the context of insolvency, a subsidiary's directors and officers owe fiduciary duties to the subsidiary's creditors, stating that the residual owners of an insolvent company are its creditors, and "it is for their benefit that the directors must manage the firm."[17]

Conclusion

The Delaware court's decision in *Scott* should not be a surprise, in light of *Production Resources*' categorical affirmation of *Credit Lyonnais*. The decision, nonetheless, may have ramifications in both federal and state courts. Commonly, parents and subsidiaries jointly file for chapter 11 relief, at which time intertwined boards must make decisions for each company that are in that company's separate best interests, and not just in the best interests of the parent. A subsidiary's officers and directors may be appointed by the parent company to run the subsidiary for the parent's benefit. Nonetheless, in the zone of insolvency, directors and officers develop a fiduciary duty to the subsidiary's creditors, its residual owners.

Under *Scott*, if the officers and directors of a financially distressed subsidiary approve any transaction which would benefit the parent to the detriment of the subsidiary or its creditors, they may be liable to both. Officers and directors of a subsidiary have fiduciary duties to that subsidiary, and a transaction that harms the subsidiary—especially one that would benefit an insider or affiliate—would constitute a breach of that duty. The director's duty to the distress subsidiary's creditors derives from his duty to the corporation itself.[18]

The *Scott* court's ruling could have a profound impact on the sale of distress subsidiaries at a discount, because while the parent may want to liquidate its holdings in the subsidiary and recover some sort of return on its capital, the parent cannot force the directors and officers of the subsidiary to agree to the sale to the detriment of the subsidiary's creditors. Furthermore, Vice-Chancellor Strine's later ruling in *Trenwick* implies that the *Scott* ruling is consistent with his own ruling in *Production Resources* and that Delaware state courts will likely follow the Scott court's lead and hold that, in the insolvency context, officers and directors have fiduciary duties to the subsidiary and its creditors.

1. 344 B.R. 283 (Bankr. D. Del. 2006).
2. 1991 WL 277613 (Del. Ch. Dec. 30, 1991).
3. See, e.g., *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784 (Del. Ch. 1992).
4. 863 A.2d 772 (Del. Ch. 2004).
5. Id. at 790.
6. Id. at 788.
7. 545 A.2d 1171 (Del. 1998).
8. Id.
9. 2003 WL 22989669 (Bankr. S.D.N.Y. Dec. 11, 2003).
10. Id. at 13.
11. 315 B.R. 565 (Bankr. D. Ariz. 2004).
12. Id. at 575.
13. Id. at 576.
14. Id. at 287.
15. 906 A.2d 168.
16. Id. at 203.
17. Id.
18. *In re Global Marine, Inc.*, 108 B.R. 998, 1002 (Bankr. S.D. Tex. 1987). In *Global Marine*, the court held that while representation of multiple debtors or affiliates could potentially cause a conflict, it does not inherently necessitate disqualification.