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Directors and Officers Certainly Do Not Get Off *Scott*-Free, But Ought We Cut Them a Little Slack?

Holly D. Howes*

But 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? In what respects has he failed to discharge these obligations? And what are the consequences of his deviation from duty?¹

—Justice Frankfurter

I. INTRODUCTION

A corporation is defined as “[a]n entity having authority under law to act as a single person distinct from the shareholders who own it”² It has directors. It has officers. It has creditors. And it has shareholders or, minimally, one shareholder. Suppose a corporation has a single shareholder, and that shareholder is a corporation itself with its own directors, officers, creditors, and shareholders. Imagine a chain of corporations where each has a single, corporate shareholder. Now find a man and put him as an officer of this corporation that has another single, corporate shareholder. Tell this man he is a fiduciary.³ Tell him he is in charge of an entity “distinct from the shareholder[] who own[s] it.”⁴ But be sure to remind him the shareholders of the parent company control his fate. Be sure to inform this man that although he has authority under the law to control the corporation as a

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

2. BLACK’S LAW DICTIONARY 365 (8th ed. 2004).

3. A fiduciary is one “who is required to act for the benefit of another person on all matters within the scope of their relationship . . . [and] owes [that person] the duties of good faith, trust, confidence, and candor.” BLACK’S LAW DICTIONARY 658 (8th ed. 2004).

“Fiduciary” is a vague term, and it has been pressed into service for a number of ends My view is that the term ‘fiduciary’ is so vague that plaintiffs have been able to claim that fiduciary obligations have been breached when in fact the particular defendant was not a fiduciary . . . but simply had withheld property from the plaintiff in an unconscionable manner.

Id. (quoting D.W.M. WATERS, THE CONSTRUCTIVE TRUST 4 (1964)).

4. BLACK’S LAW DICTIONARY 365 (8th ed. 2004).

single entity, the parent corporation has several methods by which it could manipulate his decision.⁵

This man may have an understanding that he has a duty to act as a fiduciary, but as Justice Frankfurter noted, this is only the beginning.⁶ To whom does this man feel obligated? Should he begin to give a confident answer, ask him if his answer would change were the corporation to become insolvent. Should he ask for help, tell him the courts have given conflicting answers.⁷ This is the problem facing business men and women today. This Comment addresses to whom directors and officers of an insolvent, wholly-owned, Delaware subsidiary corporation owe fiduciary duties and the nature of those duties. Specifically, it focuses on whether or not duties are owed to the corporation itself by critiquing the result of *In re Scott Acquisition Corp.*⁸ in light of precedent, theories, and policy.

Part II of this Comment describes relevant case law preceding the *Scott* decision.⁹ It traces case law regarding both duties owed by directors and officers of a wholly-owned subsidiary and how duties owed by directors and officers of a corporation change once the corporation becomes insolvent.¹⁰ A summary of the *Scott* opinion and the aftermath thereof is also included in Part II.¹¹ A critique of the recent case law, including *In re Scott Acquisition Corp.*, is in Part III.¹² Furthermore, a solution based on theory and policy, as well as both statutory and case law, is given in Part III.¹³ Lastly, this Comment answers the question on a few readers' minds already: Why does it matter?¹⁴ This Comment concludes that directors and officers of an insolvent, wholly-owned, Delaware subsidiary corporation should owe fiduciary duties to the parent corporation and the creditors, but not to the debtor-subsidary corporation itself.¹⁵

5. For example, the shareholders often have the power to fire officers, reduce their pay, and change their benefits. See Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L.J. 287, 306 (1996).

6. *Chenery*, 318 U.S. at 85-86.

7. See *infra* Part II.

8. *Claybrook v. Morris (In re Scott Acquisition Corp.)*, 344 B.R. 283 (Bankr. D. Del. 2006).

9. See *infra* Part II.A-D.

10. *Id.*

11. See *infra* Part II.E-F.

12. See *infra* Part III.A-B.

13. See *infra* Part III.C.

14. See *infra* Part III.D.

15. See *infra* Part IV.

II. BACKGROUND & PERTINENT CASE LAW: DIRECTORS AND OFFICERS DO NOT GET OFF *SCOTT-FREE*

Just twenty years ago, the courts began to enunciate some principles that would make their way to the forefront of this debate in *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*¹⁶ The courts did not confront this issue head-on until late 2003 in *In re RSL Com Primecall*.¹⁷ This Part traces various precedents to their culmination in *In re Scott Acquisition Corp.*¹⁸ and concludes with the aftermath of that decision.¹⁹

A. *Anadarko: A Fiduciary Duty Is Only Owed to the Parent*

First, the Supreme Court of Delaware addressed fiduciary duties owed by directors of a wholly-owned subsidiary in *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*²⁰ In *Anadarko*, the subsidiary corporation, Anadarko Petroleum Corporation (“Anadarko”), brought suit against the parent company and former directors of the subsidiary for breach of fiduciary duty to prospective stockholders.²¹ Panhandle Eastern Corporation (“Panhandle”), the parent company, originally wholly-owned the subsidiary Anadarko.²² However, Panhandle voted to spin-off the subsidiary²³ and began to create a market in conjunction with the New York Stock Exchange for Anadarko’s new stock.²⁴ Panhandle then restructured contracts between itself and Anadarko in anticipation of their new relationship.²⁵ Anadarko sued once the spin-off was complete, claiming the defendants breached their fiduciary duty when they modified contracts to the disadvantage of the prospective shareholders.²⁶ Upon beginning its analysis as to whether a fiduciary duty was owed to prospective shareholders, the

16. *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171 (Del. 1988).

17. The Official Comm. of Unsecured Creditors of RSL Primecall, Inc. v. Beckoff (*In re RSL Com Primecall*), No. 01-11457, 2003 WL 22989669 (Bankr. S.D.N.Y. Dec. 11, 2003).

18. *Claybrook v. Morris (In re Scott Acquisition Corp.)*, 344 B.R. 283 (Bankr. D. Del. 2006).

19. See *infra* notes 20-129 and accompanying text.

20. *Anadarko*, 545 A.2d at 1171.

21. *Id.* at 1172.

22. *Id.*

23. As defined by the United States Securities and Exchange Commission, a spin-off is where “a parent company distributes shares of a subsidiary on a pro rata basis to the parent company’s shareholders.” U.S. Sec. & Exch. Comm’n, Spin-Offs, <http://www.sec.gov/answers/spinoffs.htm> (last visited January 15, 2008). Furthermore, a separate company results once the spin-off is complete. *Id.*

24. *Anadarko*, 545 A.2d at 1173.

25. *Id.*

26. *Id.* at 1172.

court set out some basic premises of Delaware corporation law.²⁷ One premise was that directors of a wholly-owned "subsidiary are obligated *only* to manage the affairs of the subsidiary in the best interests of the parent and its shareholders."²⁸ Ultimately, the court held no fiduciary duty was owed to prospective shareholders because duties were only owed to the parent corporation.²⁹ Therefore, the court affirmed the lower court's decision to grant Panhandle's motion for summary judgment.³⁰

B. *Geyer: Directors and Officers of Insolvent Corporations Owe a Fiduciary Duty to the Insolvent Corporation's Creditors*

Anadarko was the first glimpse at to whom directors and officers of wholly-owned subsidiaries owe a fiduciary duty. Generally, directors and officers of a wholly-owned subsidiary do not owe a fiduciary duty to the corporation's creditors.³¹ Creditors are entitled only to what they contract for in an arms-length transaction.³² If a corporation does not repay the money owed to creditors, the creditors can sue the corporation for breach of contract.³³ Of course, this assumes that the corporation has not dissolved and has money to pay the creditors. *Geyer v. Ingersoll Publications Co.* addressed the duty owed by directors and officers of an insolvent company to its creditors.³⁴

In *Geyer*, the Court of Chancery of Delaware addressed duties generally owed by directors of companies that have become insolvent.³⁵ Ingersoll and Geyer incorporated their former partnership in a newspaper company called Ingersoll Publications Company ("IPCO").³⁶ Ingersoll bought out Geyer's interest in the company and then failed to make the contracted payments to Geyer.³⁷ Geyer brought suit against Ingersoll.³⁸ He alleged IPCO was insolvent and, as the director of IPCO, Ingersoll owed Geyer, a creditor, a fiduciary duty.³⁹ Geyer

27. *Id.* at 1174.

28. *Id.* (emphasis added).

29. *Anadarko*, 545 A.2d at 1177.

30. *Id.*

31. WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 849 (2006).

32. *Id.*

33. *Id.*

34. *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784 (Del. Ch. 1992).

35. *Id.* *Geyer* did not address these duties in the parent and wholly-owned subsidiary context, but merely in the context of insolvent corporations generally. See generally *id.*

36. *Id.* at 786.

37. *Id.*

38. *Id.* at 785.

39. *Geyer*, 621 A.2d at 787.

further alleged Ingersoll breached his fiduciary duty when he gave up sizable assets for his own personal benefit.⁴⁰ Ingersoll moved to dismiss Geyer's complaint arguing it failed to state a cause of action upon which relief could be granted.⁴¹ However, the court denied Ingersoll's motion to dismiss, holding a fiduciary duty to creditors arises once a company becomes insolvent.⁴² Furthermore, the court reasoned precedent and the plain meaning of the word "insolvency" supported the conclusion that a fiduciary duty arises only once a corporation becomes insolvent in fact, rather than arising only once statutory proceedings are initiated.⁴³ Therefore, Ingersoll owed Geyer a fiduciary duty once the corporation became insolvent, and, as a result, the court denied Ingersoll's motion to dismiss.⁴⁴

C. *Interpreting Anadarko in the Insolvency Context: Does the Insolvency Exception⁴⁵ Extend to the Wholly-Owned Subsidiary Corporation?*

Within a year of each other, two different bankruptcy courts analyzed whether directors of a wholly-owned subsidiary owe a fiduciary duty to the subsidiary corporation itself when the subsidiary becomes insolvent.⁴⁶ Both courts may have given an answer for the specific parties in question, but, taken together, the opinions left interpretation of

40. *Id.* at 791 (The complaint alleged "Mr. Ingersoll caused IPCO to give up an asset worth approximately \$50 million for consideration primarily paid to Mr. Ingersoll . . . [and] Mr. Ingersoll caused IPCO to cancel valuable management agreements . . . in return for consideration paid to Mr. Ingersoll.").

41. *Id.* at 790.

42. *Id.* at 787.

43. *Id.* at 787-89. Scholars and courts have referred to the holding in *Geyer* as the insolvency exception. See, e.g., *Prod. Res. Group v. NCT Group*, 863 A.2d 772, 791 n.58 (Del. Ch. 2004); Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1482 (1993). Cases following the *Geyer* precedent extended the insolvency exception to corporations in the "zone of insolvency," also referred to as the "vicinity of insolvency." See, e.g., *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm'n Corp.*, Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991); *Weaver v. Kellogg*, 216 B.R. 563, 584 (S.D. Tex. 1997). The zone of insolvency line of cases is beyond the scope of this Comment. For a more detailed examination of the zone of insolvency, see Brian E. Greer, *Fiduciary Duties When the Corporation is in the Zone of Insolvency*, 25 AM. BANKR. INST. J. 26 (Nov. 2006).

44. *Geyer*, 621 A.2d at 790.

45. Generally, directors and officers only owe creditors the rights they have contracted for. *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 653 (Bankr. N.D. Ill. 1998). However, the insolvency exception is an exception to this general rule; it creates a fiduciary duty owed by directors and officers to creditors. *Id.* The rationale for this rule is economic in the sense that decisions made by the directors and officers while the corporation is insolvent directly affect the value of creditors' claims. *Id.*

46. See *The Official Comm. of Unsecured Creditors of RSL Primecall, Inc. v. Beckoff (In re RSL Com Primecall)*, No. 01-11457, 2003 WL 22989669 (Bankr. S.D.N.Y. Dec. 11, 2003); Collins

Delaware statutory law in a state of unrest. The Southern District of New York answered the question of whether a fiduciary duty is owed by the directors and officers to the Delaware subsidiary corporation itself in the affirmative,⁴⁷ while the District of Arizona answered it in the negative.⁴⁸

The Southern District of New York addressed whether a fiduciary duty was owed to the Delaware subsidiary corporation itself in *In re RSL Com Primecall*.⁴⁹ In *RSL*, litigation focused on one segment of a long line of parent and subsidiary companies.⁵⁰ RSL Com North America wholly-owned RSL Com U.S.A. who in turn owned a couple of other subsidiaries.⁵¹ RSL Com U.S.A., its subsidiaries, and their unsecured creditors sued RSL Com U.S.A.'s directors and officers.⁵² The plaintiffs alleged the defendants secured debts for RSL Com U.S.A.'s parent company "without any independent analysis or evaluation . . . [and] without giving due regard to the interests of RSL [Com] U.S.A."⁵³ Furthermore, the plaintiffs alleged the defendants guaranteed this debt when the subsidiary company already had more than six hundred million dollars in net losses and, therefore, "prolong[ed] the corporate existence . . . well past the point of insolvency."⁵⁴

The numerous arguments and claims presented by the plaintiffs included an allegation that the officers and directors of RSL Com U.S.A. breached their fiduciary duties when they wrongfully guaranteed the debt for the benefit of the parent corporation.⁵⁵ In response, defendants claimed they had no fiduciary duty to the subsidiary and cited to *Anadarko* for support of this claim.⁵⁶ The court characterized the defendants' position as "absurd,"⁵⁷ having "no basis,"⁵⁸ and advanced by "quoting out of context statements."⁵⁹ Specifically, the court reasoned all of the cases cited by the defendants described duties owed by directors and officers while the company was solvent.⁶⁰

v. Kohlberg & Co. (*In re Sw. Supermarkets*) (*Sw. Supermarkets I*), 315 B.R. 565 (Bankr. D. Ariz. 2004), *vacated in dictum*, 376 B.R. 281 (Bankr. D. Ariz. 2007).

47. *RSL*, 2003 WL 22989669, at *13.

48. *Sw. Supermarkets I*, 315 B.R. at 575.

49. *RSL*, 2003 WL 22989669.

50. *Id.* at *1.

51. *Id.*

52. *Id.* at *1, n.1.

53. *Id.* at *2.

54. *RSL*, 2003 WL 22989669, at *2.

55. *Id.* at *11.

56. *Id.* at *12.

57. *Id.* at *13.

58. *Id.*

59. *RSL*, 2003 WL 22989669, at *12.

60. *Id.*

The court held the insolvency exception, which created a special duty owed to creditors, also created special duties to the subsidiary itself.⁶¹ Therefore, the directors and officers owed duties to the parent-shareholder and creditors; the court expanded these special duties to the corporation.⁶² First, the court reasoned “directors who hold dual directorships in the parent-subsidary context may owe fiduciary duties to each corporation.”⁶³ Secondly, the court noted an absence of authority for the defendants’ position, again characterizing it as “permit[ting] [the subsidiary corporation] to be plundered for the benefit of its parent corporation.”⁶⁴

Among other things, *RSL* held that directors and officers of a subsidiary corporation owe fiduciary duties to the subsidiary corporation itself.⁶⁵ In reaching this holding, the court cited and reinforced the principles that fiduciary duties are always owed to the single shareholder⁶⁶ and become owed to the creditors upon insolvency of the subsidiary corporation.⁶⁷ The court interpreted Delaware statutory law and precedent as requiring fiduciary duties to also be owed to the subsidiary itself once the subsidiary became insolvent.⁶⁸

The next case to interpret *Anadarko* in the insolvency context was *In re Southwest Supermarkets*; Southwest Supermarkets was a wholly-owned Delaware subsidiary of Kohlberg & Co.⁶⁹ When Kohlberg & Co. acquired Southwest Supermarkets, Southwest Supermarkets paid a fee to Kohlberg & Co for acquisition efforts.⁷⁰ Southwest Supermarkets also agreed to pay a yearly management fee to its parent company, as well as pay Kohlberg & Co.’s tax liabilities.⁷¹ Six years after Kohlberg & Co. acquired Southwest Supermarkets, the wholly-owned subsidiary filed for bankruptcy.⁷² A bankruptcy trustee was appointed and the trustee sued Kohlberg & Co. for aiding and abetting breaches of fiduciary duty by directors of the subsidiary corporation.⁷³

61. *Id.* at *13.

62. *Id.*

63. *Id.* (citations omitted).

64. *RSL*, 2003 WL 22989669, at *13.

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Collins v. Kohlberg & Co. (In re Sw. Supermarkets) (Sw. Supermarkets I)*, 315 B.R. 565, 568 (Bankr. D. Ariz. 2004), *vacated in dictum*, 376 B.R. 281 (Bankr. D. Ariz. 2007).

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.* at 569.

Kohlberg & Co. moved to dismiss for failure to state a claim for which relief can be granted.⁷⁴

The court held directors and officers do not owe a fiduciary duty to the subsidiary corporation itself.⁷⁵ In its analysis, the court reasoned the trustee must show either that Kohlberg & Co. owed fiduciary duties to its wholly-owned subsidiary or that the directors and officers of the subsidiary owed a duty to the subsidiary corporation, which was breached with Kohlberg & Co.'s help.⁷⁶ The court began its analysis by stating a principle announced in *Anadarko*: officers and directors "owe their fiduciary duties *solely* to the single shareholder[.]"⁷⁷ The court interpreted *Anadarko* as holding duties are not owed to the subsidiary corporation.⁷⁸ Next, the court turned to the question of whether insolvency changed this result.⁷⁹ Kohlberg & Co. argued *RSL* held that it did.⁸⁰ The court, however, limited *RSL* to its facts; in other words, the insolvency exception applied only to creditor claims.⁸¹ The court reasoned this was correct because the business judgment rule does not apply once a corporation becomes insolvent,⁸² and, therefore, a higher standard is needed upon insolvency in the creditor context.⁸³ The court held this reasoning did not apply to debtor claims.⁸⁴ The District of Arizona briefly determined any creditor claims in the context of this case were barred by the statute of limitations.⁸⁵

Once the court expounded the holding of *RSL*, it further noted all the things *RSL* did not stand for.⁸⁶ *RSL* did not mandate "greater fiduciary duties become owed to the corporation" or that duties to the corporation become "owed upon insolvency."⁸⁷ Furthermore, other Delaware law did not suggest this result either according to the court.⁸⁸ Therefore, because no support existed for them in Delaware

74. *Sw. Supermarkets I*, 315 B.R. at 569.

75. *Id.* at 576.

76. *Id.* at 575.

77. *Id.* (emphasis added) (citing *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171 (Del. 1988)).

78. *Id.*

79. *Sw. Supermarkets I*, 315 B.R. at 575.

80. *Id.*

81. *Id.*

82. *Id.* See also EDWARD BRODSKY AND M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES § 2:10 (2007).

83. *Sw. Supermarkets I*, 315 B.R. at 575.

84. *Id.*

85. *Id.* at 576.

86. *Id.*

87. *Id.*

88. *Sw. Supermarkets I*, 315 B.R. at 576.

law, the court held fiduciary duties owed by the directors and officers of the subsidiary corporation to the corporation itself did not exist.⁸⁹

The *RSL* court interpreted *Anadarko* narrowly and *Geyer* broadly;⁹⁰ on the other hand, the *Southwest Supermarkets I* court interpreted *Anadarko* broadly and *Geyer* narrowly.⁹¹ Based on very different analyses, the courts came to vastly different conclusions. Before the federal bankruptcy court for the state of Delaware had an opportunity to address the issue of whether directors and officers of an insolvent subsidiary with a single shareholder owed a duty to the subsidiary corporation itself, the Chancery Court of Delaware took another look at the framework and nature of creditors' claims once a corporation becomes insolvent.

D. Production Resources Group: *A Second look at Creditors' Claims Against an Insolvent Corporation*

A month after the District of Arizona worked within the *Anadarko* and *Geyer* precedents to determine that fiduciary duties were not owed to the subsidiary corporation itself by the directors and officers, the Court of Chancery of Delaware unveiled the framework of the nature of creditors' claims against an insolvent corporation.⁹²

In *Production Resources Group, L.L.C. v. NCT Group, Inc.*, NCT Group, Inc., a public Delaware corporation, allegedly had been insolvent for a number of years.⁹³ NCT Group, Inc. had millions of dollars of debt owed almost exclusively to Salkind, a legal secretary and wife of a former director of the company.⁹⁴ Furthermore, paid consultants of NCT Group, Inc. included eight companies associated with Salkind's family.⁹⁵ As a lender, Salkind had obtained many shares of stock as well as liens on all of the company's assets.⁹⁶ Despite being unable to hold shareholder meetings because of the company's financial position, NCT Group, Inc. was alleged to pay "exorbitant salaries" to its directors and officers.⁹⁷ Production Resources Group, L.L.C., a creditor, brought suit alleging the directors and officers of NCT Group, Inc. breached their fiduciary duty by mismanaging the company's finances and by paying excessive salaries to certain of-

89. *Id.*

90. See *RSL*, 2003 WL 22989669.

91. See *Sw. Supermarkets I*, 315 B.R. at 565.

92. See generally *Prod. Res. Group v. NCT Group*, 863 A.2d 772 (Del. Ch. 2004).

93. *Id.* at 778.

94. *Id.* at 780.

95. *Id.*

96. *Id.* at 781.

97. *Prod. Res. Group*, 863 A.2d. at 779-780.

ficers.⁹⁸ The directors and officers of NCT Group, Inc. argued these facts do not give rise to a fiduciary duty; instead, they give rise to a duty of care, which “[wa]s exculpated by a provision . . . within NCT’s certificate of incorporation.”⁹⁹

The court initially determined the claims raised by Production Resources Group, Inc. were derivative in nature.¹⁰⁰ After a lengthy discussion of the zone of insolvency, the court concluded a cause of action in this case arose after the company became insolvent.¹⁰¹ The court cited to *Geyer* and did not dispute that fiduciary duties are owed to creditors by directors and officers of an insolvent corporation.¹⁰² Creditors, reasoned the court, are owed fiduciary duties because “by definition, the fact of insolvency places creditors in the shoes normally occupied by shareholder—that of residual risk-bearers.”¹⁰³ When creditors become residual risk-bearers, the nature of the claim for breach of fiduciary duty does not change from derivative to direct.¹⁰⁴ It does not change because the object of the director’s duties, the company itself, remains the same whether insolvent or solvent.¹⁰⁵ When directors and officers breach their fiduciary duties and the value of the firm diminishes, creditors have standing to sue, through the insolvency exception, even though the claim “is still one belonging to the corporation.”¹⁰⁶ By giving creditors standing, it allows them to “ensure . . . any valuable claims the corporation possesses against its directors are prosecuted.”¹⁰⁷

After establishing creditor claims for breach of a fiduciary duty are derivative, the court analyzed whether the claims here were exculpated due to language in the certificate of incorporation.¹⁰⁸ If found allegations of mismanagement were exculpated, however, claims of “conscious wrongdoing through [the company’s] transactions with Sal-kind” remained viable causes of action.¹⁰⁹ Therefore, NCT Group, Inc.’s motion to dismiss was granted in part and denied in part.¹¹⁰

98. *Id.* at 780.

99. *Id.* at 775.

100. *Id.* at 792-793.

101. *Id.* at 790-91.

102. *Prod. Res. Group*, 863 A.2d at 790-91.

103. *Id.* at 791.

104. *Id.* at 792.

105. *Id.*

106. *Id.*

107. *Prod. Res. Group*, 863 A.2d at 777.

108. *Id.*

109. *Id.*

110. *Id.* at 803.

E. *Squaring Production Resources Group with Anadarko: Whether a Fiduciary Duty is Owed by Directors and Officers of an Insolvent Wholly-Owned Subsidiary to the Subsidiary Corporation Itself?*

Mid-2006, the United States Bankruptcy Court of the District of Delaware addressed to whom directors and officers of an insolvent wholly-owned subsidiary owed duties in *In re Scott Acquisition Corp.*; in *Scott*, a trustee appointed in a bankruptcy proceeding sued the directors and officers of the wholly-owned subsidiary for breach of fiduciary duty on behalf of the parent corporation, the debtor-subsidiary corporation, and the creditors.¹¹¹ Scotty's Inc. was wholly-owned by Scott Acquisition Corporation.¹¹² Scotty's Inc. borrowed money from Congress Financial Corp. ("Congress") and, in turn, Congress took security interests in property owned by Scotty's Inc.¹¹³ When Scotty's Inc. failed to make payments on time, Congress directed them to sell the real estate.¹¹⁴ Scotty's Inc. sold the real property for less than fair market value, without soliciting third party offers, to the defendants¹¹⁵ on a sale-and-lease-back basis.¹¹⁶ To add insult to injury, the trustee further alleged the loans from Congress were "unnecessary . . . and were entered into at a time when the Debtors were insolvent."¹¹⁷ Before filing for bankruptcy, the directors and officers of Scotty's Inc. reduced their liability insurance limit by more than half.¹¹⁸ The directors and officers argued the court should dismiss the bankruptcy trustee's claims that were brought on behalf of the subsidiary corporation because the defendants did not owe a duty to the subsidiary.¹¹⁹

The court first addressed whether *Southwest Supermarkets I* supported the defendant's position that they did not owe a duty to the subsidiary itself.¹²⁰ The court disagreed with the *Southwest Supermarkets I* court's interpretation of Delaware law, especially its interpretation of the *Anadarko* precedent.¹²¹ *Anadarko* addressed a different issue—that of whether a fiduciary duty was owed to prospective stock-

111. Claybrook v. Morris (*In re Scott Acquisition Corp.*), 344 B.R. 283, 286 (Bankr. D. Del. 2006).

112. *Id.* at 284.

113. *Id.*

114. *Id.*

115. That is, the directors and officers of the wholly-owned Delaware subsidiary corporation.

116. *Scott*, 344 B.R. at 285.

117. *Id.*

118. *Id.*

119. *Id.* at 286.

120. *Id.*

121. *Scott*, 344 B.R. at 286-87.

holders—than the one presented here, held the court.¹²² The court supported its narrow interpretation of *Anadarko* by citing to other courts who interpreted *Anadarko* in the same manner.¹²³

Next, the court determined *RSL* could be distinguished from the facts presented in *Southwest Supermarkets* due to the debtor/creditor distinction.¹²⁴ However, the court was “hesitant” to distinguish the cases in that manner.¹²⁵ Furthermore, the court referred to the holding in *Southwest Supermarkets* as “awkward” because fiduciary duties owed to creditors by directors and officers of an insolvent corporation are derivative in nature.¹²⁶ Therefore, the court concluded 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.”¹²⁷

The court based much of its conclusion on the holding in *Production Resources* when it held officers and directors of an insolvent wholly-owned subsidiary owe duties to the subsidiary itself.¹²⁸ In fact, the court suggested the court in *Southwest Supermarkets* reached the result it did because it “did not have the benefit of *Production Resources*.”¹²⁹

F. *The Aftermath: Southwest Supermarkets Court Invites Reconsideration*

After, and possibly because of, the holding in *In re Scott Acquisition Corp.* by the United States Bankruptcy Court in the District of Delaware, the *Southwest Supermarkets* court “invited the parties to address whether the [c]ourt should reconsider” its decision.¹³⁰ Upon reconsideration, the court held directors and officers of a wholly-owned, insolvent Delaware subsidiary corporation do owe fiduciary duties to the

122. *Id.* at 287.

123. *Id.* at 287 (citing *First Am. Corp. v. Skeikh Al-Nahyan*, 17 F. Supp. 2d 10, 26 (D.D.C. 1998); *In re Mirant Corp.*, 326 B.R. 646, 651 (Bankr. N.D. Tex. 2005); The Official Comm. of Unsecured Creditors of RSL Primecall, Inc. v. Beckoff (*In re RSL Com Primecall*), No. 01-11457, 2003 WL 22989669, at *12-13 (Bankr. S.D.N.Y. Dec. 11, 2003)).

124. *Scott*, 344 B.R. at 288.

125. *Id.*

126. *Id.* at 288-9. (citing *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992); *Prod. Res. Group v. NCT Group*, 863 A.2d 772, 791-92 (Del. Ch. 2004); DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, *CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY* § 9-2[a] (2005)).

127. *Scott*, 344 B.R. at 290.

128. *Id.* (citing *Prod. Res. Group v. NCT Group*, 863 A.2d 772, 791-92 (Del. Ch. 2004)).

129. *Id.* at 289.

130. *Collins v. Kohlberg & Co. (In re Sw. Supermarkets)* (Sw. Supermarkets II), 376 B.R. 281, 283 (Bankr. D. Ariz. 2007).

corporation itself.¹³¹ The court noted three reasons for vacating its previous decision.¹³²

The first reason was that the principal espoused in *Anadarko*, upon which the *Southwest Supermarkets* court had previously based its reasoning on, was mere dictum, which, without more, could not “convince [the *Southwest Supermarkets* court] that Delaware ha[d] made such a dramatic change in long-settled law.”¹³³ Citing its previous reading of *Anadarko* as “overly broad,” the court noted “[the *Anadarko* opinion] should be ‘confined to its specific facts.’”¹³⁴

Once the court held the language in *Anadarko* was dictum, it examined persuasive authority, citing to several cases to support the holding that fiduciary duties are owed to the subsidiary corporation itself.¹³⁵ First, the court reasoned two federal cases—*In re Scott Acquisition*¹³⁶ and *VPB LLC v. Campbell Soup Co.*¹³⁷—sustained its holding and were “entitled to greater weight than” its previous opinion.¹³⁸ Likewise, a Delaware chancery court held fiduciary duties were owed to the subsidiary corporation, again supporting the court’s holding.¹³⁹

Lastly, the court held that “even if *Anadarko* did divest wholly owned subsidiaries of fiduciary duties, such a rule [did] not apply . . .

131. *Id.*

132. *Id.*

133. *Id.*

134. *Id.* (quoting *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1177 (Del. 1988)).

135. *Sw. Supermarkets II*, 376 B.R. at 283-84.

136. *Scott*, 344 B.R. at 287 (Bankr. D. Del. 2006) (citing *Am. Corp. v. Skeikh Al-Nahyan*, 17 F. Supp. 2d 10, 26 (D.D.C. 1998) and *In re Mirant Corp.*, 326 B.R. 646, 651 (Bankr. N.D. Tex. 2005)).

137. *VPB LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007). The facts in *Campbell* are as follows: Campbell Soup wholly-owned VFI. *Id.* at 627. Campbell created VFI for the sole purpose of disposing of underperforming subsidiaries. *Id.* at 626-27. Once created, Campbell took out a loan under an agreement providing that the rights and obligations under the agreement would be assumed by VFI upon transfer of the businesses. *Id.* at 627. After selling the subsidiaries, Campbell Soup issued dividends to its shareholders in the form of stock in VFI. *Id.* Three years after the spin-off, VFI went bankrupt. *Id.* at 627-28. During bankruptcy reorganization, VFI assigned all of its claims to VFB. *Id.* at 628. VFB sued Campbell Soup asserting, among other things, that Campbell Soup aided and abetted a breach of the VFI directors’ duty of loyalty to VFI. *Id.* at 634. Applying New Jersey law, the court held VFI’s directors did not breach their fiduciary duty to VFI because the subsidiary was wholly-owned and solvent at the time of the spin-off; therefore, its only duty was to act in the benefit of the parent corporation. *Id.* at 635. The court noted “it ma[d]e 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* A duty of loyalty against the parent should arise whenever the subsidiary represents some minority interest in addition to the parent.” *Id.* (emphasis in original).

138. *Sw. Supermarkets II*, 376 B.R. at 283.

139. *Id.* at 284 (citing *Cochran v. Stifel Fin. Corp.*, No. Civ.A. 17350, 2000 WL 286722 (Del. Ch. Mar. 8, 2000)).

[o]nce the subsidiary bec[a]me insolvent.”¹⁴⁰ In other words, if *Anadarko* was to be literally read, it did not apply once a corporation became insolvent because more than one shareholder would exist.¹⁴¹

III. ANALYSIS

This Part reflects back on the reasoning used in those cases, critiques the analysis in *Scott* and its building blocks, and provides a solution to the insolvent subsidiary officer and director dilemma based on law, theory, and policy.¹⁴² Ultimately, it concludes directors and officers of an insolvent, wholly-owned, Delaware subsidiary corporation should owe duties to the parent corporation and creditors, but not to the debtor-subsidary itself.¹⁴³

A. *A Second Look at the Building Blocks of the Scott Decision*

The *Scott* decision took a number of premises and attempted to fit them all together to form a conclusion. Unfortunately, because of the nature of these premises, the court rested its decision on a rejection of other options¹⁴⁴ and vague characterizations¹⁴⁵ rather than citing to sound legal principles. This portion of the Comment examines those premises to gain insight as to the building blocks the court used to make its holding.

1. *Anadarko*: The Beginning of the End

The *Anadarko* court made a broad statement when it held “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 interest of the parent and its shareholders.”¹⁴⁶ The court in *Anadarko* used this proposition to support its holding that fiduciary duties were not owed by the directors and officer of the wholly-owned subsidiary to prospective stockholders.¹⁴⁷ Read in the context of the case, the premise appears sound; however, when applied to other fact patterns and issues, it loses its viability. Some courts have limited the

140. *Id.* at 285.

141. *Id.*

142. *See supra* Part II.

143. *See infra* Part III.C.4.

144. *Claybrook v. Morris (In re Scott Acquisition Corp.)*, 344 B.R. 283, 288 (Bankr. D. Del. 2006) (rejecting the holding in *Southwest* because it was awkward).

145. *Id.* (using words such as “hesitant,” “awkward,” and “typical” in explaining its reasoning).

146. *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988).

147. *Id.*

Anadarko holding to its facts;¹⁴⁸ other courts take *Anadarko* for its face value and apply it as generally as it was written.¹⁴⁹

Interestingly, the court in *Scott* does not distinguish *Anadarko* based on the solvency/insolvency context.¹⁵⁰ Instead, the court interpreted Delaware law as requiring directors and officers to owe a fiduciary duty to the subsidiary *and* its creditors in an insolvency context¹⁵¹ and noted other courts agree,¹⁵² but cited to no authority to uphold either premise. Although parenthetically, the *Scott* court ultimately found the proper reading of *Anadarko* was a narrow one.¹⁵³ Working within this framework, the *Scott* court moved to the next key precedential cases: *RSL* and *Southwest Supermarkets*.

2. Reconciling *RSL* and *Southwest Supermarkets*

The *Scott* court determined the *Anadarko* holding should be read as “confined.”¹⁵⁴ While this tipped the scales as to which on-point precedent—*RSL* or *Southwest Supermarkets*—the court would follow, it did fully answer whether fiduciary duties are owed to the debtor-subsidiary corporation itself. The *Scott* opinion never expressly adopted either precedent, but one can infer the court believed *RSL* to be the better reasoned precedent because the language in *RSL*,¹⁵⁵ was extensively quoted, while *Southwest Supermarkets*¹⁵⁶ was criticized.

Turning to its analysis of the *RSL* precedent, the *Scott* court cited the *RSL* decision as “rejecting the precise argument that the defendant’s advance here”¹⁵⁷ and quoted a lengthy portion of the *RSL* opinion.¹⁵⁸ The court then turned its attention to the *Southwest Supermarkets* decision, and, thereafter, only mentioned *RSL* indirectly when analyzing the reasoning and holding of *Southwest Supermarkets*.¹⁵⁹

148. See *Scott*, 344 B.R. 283 at 286; *First Am. Corp. v. Sheikh Al-Nahyan*, 17 F. Supp. 2d 10, 26 (D.D.C. 1998); *In re Mirant Corp.*, 326 B.R. 646, 651 (Bankr. N.D. Tex. 2005); The Official Comm. of Unsecured Creditors of *RSL Primecall, Inc. v. Beckoff* (*In re RSL Com Primecall*), 2003 WL 22989669 (Bankr. S.D.N.Y. 2003).

149. See *Collins v. Kohlberg & Co.* (*In re Sw. Supermarkets*) (*Sw. Supermarkets I*), 315 B.R. 565 (Bankr. D. Ariz. 2004), *vacated in dictum*, 376 B.R. 281 (Bankr. D. Ariz. 2007).

150. See *Scott*, 344 B.R. 283 at 286-87.

151. *Id.* at 286.

152. *Id.*

153. *Id.* at 287 (“(describing the holding [in *Anadarko*] as ‘narrow’)”).

154. *Id.* at 283.

155. *Scott*, 344 B.R. at 287-88.

156. *Id.* at 286-89.

157. *Id.* at 287.

158. *Id.* at 287-88.

159. *Id.* at 283.

The *Scott* court was “hesitant” to adopt the *Southwest* decision,¹⁶⁰ noting it would lead to an “awkward” result.¹⁶¹ Furthermore, the *Scott* court claimed the *Southwest Supermarkets I* court did not understand that creditor claims are derivative.¹⁶² Implying the *Southwest* court in some way failed, the *Scott* court remarked the *Southwest* “decision did not have the benefit of *Production Resources*.”¹⁶³ The *Scott* court concluded its analysis by citing a lengthy portion of the *Production Resources* opinion, followed by its conclusion that fiduciary duties are owed to both the subsidiary and creditors.¹⁶⁴

RSL, the decision that the *Scott* court appears to favor, has problems similar to those presented in *Scott*.¹⁶⁵ *RSL* also strayed to blunt characterizations of the alternatives, such as “quoting out of context statements”¹⁶⁶ and “absurd”¹⁶⁷ with “no basis,”¹⁶⁸ without giving the reader the benefit of sound legal reasoning. With regard to the precedent the *RSL* court does cite to, the court fails to describe how the principles in those cases apply to the facts at hand.¹⁶⁹

The *RSL* court concluded that the position advanced by the defendants had no basis,¹⁷⁰ but failed to realize it may be due to the fact that the issue had not been litigated before in this factual context. The lack of analysis is disheartening considering the absence of authority¹⁷¹ in this area of the law. Unfortunately, it occurred not just in these cases, but continued as the court analyzed the next precedent relevant to this issue.¹⁷²

3. *Production Resources*

While the *Scott* decision may be devoid of analysis on this point of law, the precedent the court cited to is certainly not.¹⁷³ In fact, the *Production Resources* court goes into an extensive analysis of the na-

160. *Scott*, 344 B.R. at 288.

161. *Id.*

162. *Id.* at 288-89.

163. *Id.* at 289.

164. *Id.* at 289-90.

165. The Official Comm. of Unsecured Creditors of RSL Primecall, Inc. v. Beckoff (*In re RSL Com Primecall*), No. 01-11457, 2003 WL 22989669 (Bankr. S.D.N.Y. Dec. 11, 2003).

166. *Id.* at *12.

167. *Id.* at *13.

168. *Id.*

169. *Id.*

170. *RSL*, 2003 WL 22989669, at *13.

171. See Corrine Ball, *Distressed Mergers and Acquisitions: Duties of Subsidiary Directors Run to Subsidiary, Not Parent*, N.Y.L.J., Oct. 26, 2006, at 5 (noting *RSL* is only one of the two cases that addressed this matter before *Scott*).

172. See *supra* notes 157-165 and accompanying text.

173. See *Prod. Res. Group v. NCT Group*, 863 A.2d 772 (Del. Ch. 2004).

ture of duties owed to creditors by officers and directors of an insolvent company.¹⁷⁴ However, when explaining the nature of fiduciary duties, the court fails to cite to any authority supporting its most important premise: a fiduciary duty is owed to the corporation itself.¹⁷⁵ Unfortunately, in order to get to the conclusion that duties are owed to creditors and those duties are derivative in nature, it is imperative to establish fiduciary duties are owed to the corporation itself.¹⁷⁶ *Production Resources* cites this premise many times,¹⁷⁷ but each time fails to support this statement with any statutory or case law.

The *Scott* court quotes extensively from this reasoned, unsupported analysis.¹⁷⁸ However, it fails to detail how the reasoning in *Production Resources* applied to the facts in *Scott*.¹⁷⁹ As stated earlier, the court in *Scott* noted the *Production Resources* opinion was not available for other precedents, quoted a lengthy portion of the *Production Resources* opinion, and then gave its conclusion,¹⁸⁰ leaving the reader to assume the connection of the analysis there to the facts presented in *Scott*.

4. Summation: A Lack of Reasoning

Scott concluded a “more natural reading of Delaware law” is that duties are owed to creditors and the subsidiary company upon a wholly-owned subsidiary becoming insolvent.¹⁸¹ Unfortunately, the court did not cite to which Delaware law it was interpreting.¹⁸² Nor did the court say why this was a more natural reading.¹⁸³ Instead, the court drew its holding in the same manner it had built up its entire argument thus far: by merely citing precedent and then directly reaching a conclusion.¹⁸⁴

B. *The Aftermath of Scott: A Viable Answer?*

Having the benefit of *Production Resources* and the enlightenment of a federal court opinion from the Bankruptcy Court of the District

174. *Id.*

175. *Id.* at 792.

176. *See generally id.* at 772.

177. *Id.* at 792-93.

178. *See Claybrook v. Morris (In re Scott Acquisition Corp.)*, 344 B.R. 283, 289-90 (Bankr. D. Del. 2006).

179. *Id.* at 290.

180. *Id.*

181. *Id.*

182. *Id.* at 283.

183. *Scott*, 344 B.R. at 283.

184. *See generally id.*

of Delaware, the *Southwest Supermarkets* court “invited the parties to address whether the [c]ourt should reconsider” its holding.¹⁸⁵ Although the entire opinion is dicta due to the parties’ prior settlement,¹⁸⁶ it is important to examine as a possible answer to the subsidiary directors’ dilemma.

First, *Southwest Supermarkets II* interpreted the principal in *Anadarko* as dictum, so much so that it is “beyond dispute.”¹⁸⁷ Ironically, the very principle the court had previously relied on as the foundation of its analysis in *Southwest Supermarkets I*¹⁸⁸ was now considered to be indisputable dictum. Although the principal announced in *Anadarko*¹⁸⁹ was not used to determine whether fiduciary duties were owed the subsidiary corporation itself, it was crucial to determining the central issue in the case: whether fiduciary duties were owed to prospective shareholders. If the principle is to be read as dictum, the word “only” must be read to mean “not to prospective shareholders,” rather than “not to other constituencies.” Therefore, the holding in *Anadarko* would beg the question: fiduciary duties are not owed to prospective shareholders because they are only owed to current shareholders. Dictum or not, it is still a statement by the Supreme Court of Delaware and, as such, should be considered authoritative.¹⁹⁰

Southwest Supermarkets II also cited persuasive precedents:¹⁹¹ *Scott*,¹⁹² *VFB LLC v. Campbell Soup Co.*,¹⁹³ and *Cochran v. Stifel*.¹⁹⁴ Part II.A already examined the reasoning used in *Scott*. The court’s reasoning in *Campbell Soup* was used by the *Southwest Supermarkets II* court as a third reason for vacating its previous opinion,¹⁹⁵ because

185. *Collins v. Kohlberg & Co. (In re Sw. Supermarkets)* (Sw. Supermarkets II), 376 B.R. 281, 282 (Bankr. D. Ariz. 2007).

186. *Id.* at 283 (“Because the parties have settled this litigation, this opinion has no effect except to correct an erroneous published analysis.”).

187. *Id.* at 281.

188. *Collins v. Kohlberg & Co. (In re Sw. Supermarkets)* (Sw. Supermarkets I), 315 B.R. 565 (Bankr. D. Ariz. 2004), *vacated in dictum*, 376 B.R. 281 (Bankr. D. Ariz. 2007).

189. *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988) (noting directors of a wholly-owned “subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders”).

190. See BLACK’S LAW DICTIONARY 485 (8th ed. 2004) (defining “dictum” as “[a] statement of opinion or belief considered authoritative because of the dignity of the person making it”).

191. *Collins v. Kohlberg & Co. (In re Sw. Supermarkets)* (Sw. Supermarkets II), 376 B.R. 281, 283 (Bankr. D. Ariz. 2007).

192. *Claybrook v. Morris (In re Scott Acquisition Corp.)*, 344 B.R. 283 (Bankr. D. Del. 2006).

193. *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007).

194. *Cochran v. Stifel Fin. Corp.*, No. Civ.A. 17350, 2000 WL 286722 (Del. Ch. Mar. 8, 2000), *aff’d in part and rev’d in part on other grounds*, 809 A.2d 555 (Del. 2002).

195. *Compare Campbell*, 482 F.3d 624 with *Southwest Supermarkets II*, 376 B.R. 281.

of this fact, this Section will first discuss *Stifel*, and then address *Campbell Soup Co.*, in conjunction with the third reason noted in *Southwest Supermarkets II*.

The Chancery Court of Delaware interpreted Section 145 of the Delaware Code¹⁹⁶ in *Cochran v. Stifel*.¹⁹⁷ Stifel Financial wholly-owned Stifel Nicolaus; Cochran was a director, officer, and employee of Stifel Nicolaus.¹⁹⁸ Cochran filed a complaint seeking contractual and statutory indemnification from the parent, alleging he was an agent of the parent.¹⁹⁹ Whether Stifel Financial was statutorily obligated to indemnify Cochran depended on the interpretation of the language “by or in the right of” used in the code.²⁰⁰ Stifel Financial alleged that “the Arbitration brought by Stifel Nicolaus against Cochran was, as a matter of law, also an action ‘by or in the right’ of Stifel Financial itself.”²⁰¹ In interpreting the statute, the court described the statute’s effect on traditional corporate law, noting “the separate existences of a parent corporation and its wholly-owned subsidiary”²⁰² and the “presumptive independence of the subsidiary board.”²⁰³ The court concluded that though it may be a “foolish consistency”²⁰⁴ and “formalistic,”²⁰⁵ “a suit brought by a wholly-owned subsidiary is not brought ‘by or in the right of’ its parent.”²⁰⁶

The *Southwest Supermarkets II* court noted had there been “no fiduciary duties owed to the subsidiary,” this result could not have been possible.²⁰⁷ The court’s analysis is sound; however, two things are important to note: the chancery court’s reluctance²⁰⁸ and the supreme court’s avoidance of the issue.²⁰⁹

The final reason the court gave in *Southwest Supermarkets II* for vacating its prior opinion is should *Anadarko* be read to require directors and officers of wholly-owned subsidiaries to owe fiduciary duties

196. DEL. CODE ANN. tit. 8, § 145 (2006).

197. *Cochran*, 2000 WL 286722.

198. *Id.* at *1.

199. *Id.* at *2.

200. *Id.* at *11.

201. *Id.*

202. *Cochran*, 2000 WL 286722, at *13.

203. *Id.*

204. *Id.* at *14.

205. *Id.*

206. *Id.* at *1.

207. *Collins v. Kohlberg & Co. (In re Sw. Supermarkets) (Sw. Supermarkets II)*, 376 B.R. 281, 283 (Bankr. D. Ariz. 2007).

208. *Cochran*, 2000 WL 286722, at *14 (using words “foolish consistency” and “formalistic” to describe the legislature’s approach).

209. *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 559 (Del. 2002) (determining the issue to be moot).

to the parent, but not the subsidiary corporation itself, insolvency changes that result.²¹⁰ The court reasoned *Anadarko* “does not apply when there is more than one” beneficiary of the fiduciary duties.²¹¹ An insolvent wholly-owned subsidiary is analogous to a solvent corporation with many shareholders; therefore, because the insolvent subsidiary owes fiduciary duties to the creditors, they must also owe duties to the debtor-corporation itself.²¹² However, this approach fails to take into account the practical purpose of most insolvency proceedings. The creditors want as much of their money back as possible; the shareholders want anything that is left over. The corporation is dissolving at worst or starting over from nothing at best. After all, if the corporation had enough money to pay the creditors and shareholders and have some money left over, it seems unlikely they would want to or be eligible for insolvency proceedings. And should one read *Anadarko* to mean directors and officers of a wholly-owned subsidiary do not owe fiduciary duties to the subsidiary corporation itself during solvency, during the time when the subsidiary can turn a profit, no purpose would be served by requiring directors and officers to owe that same subsidiary fiduciary duties when it is insolvent and the fate of the debtor-corporation is sealed.

C. *Finding the solution: Are Fiduciary Duties . . .*

Potentially, directors and officers of an insolvent wholly-owned subsidiary could owe a fiduciary duty to the parent corporation, creditors, the subsidiary corporation, or some combination of the three.²¹³ This Comment addresses whether fiduciary duties should be owed to each constituency in turn.²¹⁴

1. . . . Owed to the Parent Company?

Not only does the law support a fiduciary duty owed to the parent company,²¹⁵ but it also makes sense. *Anadarko* supports the proposition that fiduciary duties are owed to the parent corporation.²¹⁶ Although the decision is confined to its facts,²¹⁷ many cases still cite to

210. *Sw. Supermarkets II*, 376 B.R. at 284.

211. *Id.*

212. *Id.*

213. See Gouvin, *supra* note 5, at 294-309. There are also possible duties owed to customers, the community, bondholders, suppliers, and so forth, but that material is beyond the scope of this Comment. See *id.* at 309-10.

214. See *supra* notes 172-228 and accompanying text.

215. See *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171 (Del. 1988).

216. *Id.*

217. *Id.* at 1178 (“Our ruling is specifically confined to *Anadarko*’s claim . . .”).

it²¹⁸ suggesting the holding has more viability than the court realized at the time. While there is disagreement as to exactly how to interpret *Anadarko*,²¹⁹ two holdings of the case remain clear: a fiduciary duty is owed to the parent corporation²²⁰ and a duty is *not* owed to any prospective shareholders.²²¹

Directors and officers of a wholly-owned subsidiary owing a fiduciary duty to the parent company is also a logical proposition. As one scholar phrased it, "it is unrealistic to expect the directors of wholly owned subsidiaries to do anything but serve the interests of the parent."²²² Furthermore, the idea that directors and officers owe fiduciary duties to the parent corporation is so entrenched that it is rarely litigated,²²³ although this could merely be due to "other methods [the parent corporation has available to keep] subsidiary directors in line."²²⁴

2. . . . Owed to the Creditors?

Turning to a slightly more difficult question, upon insolvency, do directors and officers of a wholly-owned subsidiary owe fiduciary duties to creditors? Case law appears to answer this question in the affirmative.²²⁵ *Geyer* held, generally, officers and directors of an insolvent corporation owe fiduciary duties to creditors.²²⁶ Furthermore, the *Production Resources* court held this duty applied even for directors and officers of a wholly-owned subsidiary.²²⁷

A number of theories underlie why such a duty arises.²²⁸ The court in *Geyer* explained a duty arose because there is an "insolvency excep-

218. See, e.g., *In re Mirant Corp.*, 326 B.R. 646 (Bankr. N.D. Tex. 2005); *Shaev v. Wyly*, No. 15559-NC, 1998 WL 13858 (Del. Ch. Jan. 6, 1998); *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom* *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

219. Compare The Official Comm. of Unsecured Creditors of RSL Primecall, Inc. v. Beckoff (*In re RSL Com Primecall*), 2003 WL 22989669 (Bankr. S.D.N.Y. Dec. 11, 2003) with *Collins v. Kohlberg & Co. (In re Sw. Supermarkets) (Sw. Supermarkets I)*, 315 B.R. 565 (Bankr. D. Ariz. 2004), *vacated in dictum*, 376 B.R. 281 (Bankr. D. Ariz. 2007).

220. *Anadarko*, 545 A.2d at 1171; see also *Trenwick*, 906 A.2d at 200.

221. *Anadarko*, 545 A.2d at 1171.

222. Gouvin, *supra* note 5, at 306.

223. *Id.* at 306 ("[T]he reported cases dealing with this relationship are scarce."); *id.* at 324 (stating the parent corporation is unlikely to sue the board of its wholly-owned subsidiary).

224. *Id.* at 306.

225. See *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784 (Del. Ch. 1992); *Prod. Res. Group v. NCT Group*, 863 A.2d 772 (Del. Ch. 2004).

226. *Geyer*, 621 A.2d at 784.

227. *Prod. Res. Group v. NCT Group*, 863 A.2d 772 (Del. Ch. 2004).

228. See *infra* notes 211-229 and accompanying text.

tion” to the general contractual duties owed to creditors.²²⁹ The holding in *Production Resources* rests on the notion that fiduciary duties become owed to creditors because they step into the shareholder’s shoes and become the residual risk-bearers of a corporation that is insolvent.²³⁰ Still another theory known as the “trust fund doctrine” holds that when a corporation becomes insolvent, the directors and officers become trustees of the corporation with the creditors as beneficiaries.²³¹

Regardless of the approach taken, all theories conclude duties are owed to creditors of an insolvent wholly-owned subsidiary.²³² Precisely why these duties arise can better be answered after determining whether fiduciary duties are owed to the wholly-owned subsidiary itself.

3. . . .Owed to the Subsidiary Corporation?

Courts are split as to whether directors and officers of an insolvent wholly-owned subsidiary owe duties to the subsidiary itself.²³³ Even before these most recent cases that directly addressed the issue were decided, Delaware case law “seesawed back and forth.”²³⁴

This Comment argues upon insolvency, directors and officers of a wholly-owned subsidiary should *not* owe fiduciary duties to the corporation itself. A number of cases support this proposition.²³⁵ For example, in *Revlon, Inc. v. MacAndrews & Forbes Holdings*, the court held that when “it became apparent to all that the break-up of the company was inevitable,” as often is the case in the insolvency context, “[t]he duty of the board . . . changed from the preservation of [the company] as a corporate entity to the maximization of the company’s

229. *Geyer*, 621 A.2d at 787 (citing *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974)); see also Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors*, 46 VAND. L.REV. 1485, 1523 (1993) (citing *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm’n Corp.*, Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991)).

230. *Prod. Res. Group v. NCT Group*, 863 A.2d 772 (Del. Ch. 2004).

231. *Pepper v. Litton*, 308 U.S. 295, 307 (1939).

232. See Stephen M. Bainbridge, *Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency*, J. BUS. & TECH. L. (forthcoming), available at <http://ssrn.com/abstract=832504>.

233. See The Official Comm. of Unsecured Creditors of RSL Primecall, Inc. v. Beckoff (*In re RSL Com Primecall*), No. 01-11457, 2003 WL 22989669 (Bankr. S.D.N.Y. Dec. 11, 2003); Collins v. Kohlberg & Co. (*In re Sw. Supermarkets*) (Sw. Supermarkets I), 315 B.R. 565 (Bankr. D. Ariz. 2004), vacated in dictum, 376 B.R. 281 (Bankr. D. Ariz. 2007); Claybrook v. Morris (*In re Scott Acquisition Corp.*), 344 B.R. 283 (Bankr. D. Del. 2006).

234. Gouvin, *supra* note 5, at 310.

235. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986); *Sw. Supermarkets I*, 315 B.R. at 565.

value at a sale *for the stockholders' benefit*.”²³⁶ The court held this was so because:

[The board of directors] no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.²³⁷

While the holding in *Revlon, Inc.* was based on a buy-out context, its reasoning can be applied to insolvent corporations, especially those facing dissolution. Delaware law does recognize that directors and officers “in the parent-subsidary context may owe fiduciary duties to each corporation.”²³⁸ Therefore, although the law holds the parent and subsidiary out to be separate entities,²³⁹ were it to “became apparent to all that the break-up of the company was inevitable,”²⁴⁰ defensive measures for the benefit of the subsidiary would become moot.²⁴¹

Professor Bainbridge provides an illustrative hypothetical in *Much Ado about Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*.²⁴² To demonstrate his position, Bainbridge said as follows:

Suppose the board of directors faces a true zero sum decision, in which the sole issue is how to divide a static sum between two or more corporate constituencies. . . . [In this case,] the value of the corporate entity by definition will be unaffected by the decision. As such, [it is] the directors' duties running to specific constituencies, rather than to the entity, which are implicated in this setting.²⁴³

In other words, if the decision of the directors and officers will only affect the creditors and shareholders,²⁴⁴ but not the subsidiary company itself,²⁴⁵ it is not necessary to have a fiduciary duty owed to the company. Furthermore, even if a duty were owed to the company, it

236. *Revlon*, 506 A.2d at 182 (emphasis added).

237. *Id.*

238. The Official Comm. of Unsecured Creditors of RSL Primecall, Inc. v. Beckoff (*In re RSL Com Primecall*), No. 01-11457, 2003 WL 22989669, at*13 (Bankr. S.D.N.Y. Dec. 11, 2003) (citing *Weinberger v. UOP*, 457 A.2d 701, 710 (Del. 1983); *In re Digex Inc. Shareholders Litig.*, 789 A.2d 1176, 1205-06 (Del. Ch. 2000)).

239. See Gouvin, *supra* note 5, at 323 (“[T]he traditional view of parent and subsidiary corporations [is that they are] independent corporate entities.”).

240. *Revlon*, 506 A.2d at 182.

241. *Id.*

242. Bainbridge, *supra* note 232.

243. *Id.* at 19.

244. Such as how to distribute assets of a bankrupt corporation.

245. Because the subsidiary company will neither profit nor lose from the decision.

would not be possible to breach if the *company* is neither better nor worse off from the decision.

One court noted Professor Bainbridge “relie[d] heavily on the idea of the corporation as a nexus of contracts” in coming to such a conclusion.²⁴⁶ Indeed, there are numerous theoretical frameworks on which to base decisions on.²⁴⁷ Perhaps part of the reason courts come down on both sides of this issue is due to the failure of the courts to adopt one particular framework.²⁴⁸ A brief look at the various frameworks reveals a solution, for the most part, to the subsidiary director’s dilemma.²⁴⁹ Two of the theoretical frameworks would not require a fiduciary duty to be owed to the subsidiary corporation when the subsidiary was insolvent.²⁵⁰ Another reveals a fiduciary duty is owed despite the unrealistic standard it holds directors and officers to.²⁵¹ Finally, the last framework fails to answer the question altogether.²⁵²

a. Ad Hoc

In the ad hoc approach, “the facts and circumstances of the transaction in question determine the nature and extent of the duty owed.”²⁵³ In other words, there are no set rules or guiding principles because there is no way “specific rules . . . [could] cover every situation.”²⁵⁴ While this may or may not be the state of law today,²⁵⁵ it by no means is a sound approach because it fails to give guidance to directors, officers, and courts.²⁵⁶

b. Contract

Another approach is the contract theory of corporate law. In this theory, the law fills in the gaps of the contract between the parties with terms they would have contracted for.²⁵⁷ Under this theory, the corporation is not a “person” whom duties can be owed to, but rather

246. *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 n.75 (Del. Ch. 2006), *aff’d sub nom* *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

247. *See* Gouvin, *supra* note 5, at 324-337.

248. *Id.*

249. *Id.* at 324.

250. *See infra* notes 257-262, 268-271 and accompanying text.

251. *See infra* notes 263-267 and accompanying text.

252. *See infra* notes 253-256 and accompanying text.

253. Gouvin, *supra* note 5, at 325.

254. *Id.* at 324-25.

255. *Id.* at 325.

256. *Id.* at 326 (arguing the ad hoc approach is problematic because it treats similarly situated persons differently, it is not simple, it is not efficient, and it prevents planning).

257. *See id.* at 326.

a nexus of contracts.²⁵⁸ Professor Bainbridge's illustration fits within this framework²⁵⁹ because the corporation is seen as an "intersection of vast interconnecting . . . contracts between various constituencies;"²⁶⁰ therefore, it merely represents duties owed to the creditors and stockholders.²⁶¹ As detailed above, this approach to corporation law would find that a duty is not owed to the corporation itself.²⁶²

c. Horizontal Conflict

The horizontal conflict approach recognizes conflicting duties arise in many areas of corporate law, such as duties owed to holders of different classes of stock.²⁶³ The solution to determining whether there is a breach of fiduciary duty, according to scholars that take this view, is a two prong test: (1) whether the harmful action was undertaken for a legitimate business purpose and (2) whether it could have been achieved by less injurious means.²⁶⁴ In essence, the horizontal conflict approach gives all constituencies standing to sue and imposes a burden-shifting analysis on the parties.²⁶⁵

Under this approach, directors and officers would have a duty to the subsidiary corporation because duties are owed to all constituencies. There are two main problems with this theoretical framework. First, every decision could invariably be made in a way that is less injurious to one of the constituencies, but in turn more injurious to another.²⁶⁶ When a corporation becomes insolvent, inevitably, somebody is going to lose out. Secondly, expecting directors and officers to weigh concerns of each of the constituencies, including the corporation, is unrealistic because the parent company has more power, influence, and control over directors and officers than does any other constituency.²⁶⁷ For example, the parent company, unlike the other constituency, controls whether or not a specific director or officer re-

258. *See id.* at 327-28.

259. *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 n.75 (Del. Ch. 2006), *aff'd sub nom* *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

260. Gouvin, *supra* note 5, at 327-28.

261. And, perhaps, other constituencies.

262. *See supra* notes 242-246 and accompanying text.

263. Gouvin, *supra* note 5, at 330-31.

264. *Id.* at 331.

265. *Id.*

266. *See id.* at 332 ("[T]he board's actions will always be subject to review for a less harmful alternative.").

267. *See id.* at 332 ("The directors are subject to the control of the shareholder. Attenuated constituent interests that may or may not be sufficiently demonstrated at trial pale by comparison to the dominant interest of the shareholder. The subsidiary directors are not free agents but must do the bidding of the parent . . ." (citations omitted)).

tains employment. To have this model work in practice would require giving the other constituencies such powers. Therefore, fixing this unclear and uncertain area of law would disrupt well-settled corporation law, which would in turn create much bigger problems than the one presented.

d. Agency

Finally, the last approach scholars take to analyzing corporate law is the view that directors and officers, despite the fiction the law imposes of two separate entities in the parent-subsidiary context, are really simply agents of the parent corporation.²⁶⁸ Under this approach, not only do the directors and officers not owe a duty to the subsidiary corporation, but also they do not owe a duty to creditors.²⁶⁹ This view relies on the idea that the wholly-owned subsidiary does not truly exist apart from the parent company, even though the law may impose such a legal fiction at times. Directors and officers are seen as agents "who merely do the bidding of the parent," and as such, the parent "is obligated to pick up any other duty that the subsidiary directors would have owed."²⁷⁰ Most importantly, turning to the context at hand, this framework would not impose a fiduciary duty owed by the directors and officers of the subsidiary to the subsidiary corporation itself. Were such a duty to exist, it would be owed by the parent company.²⁷¹

4. The Solution

Duties clearly are owed to the parent company in a wholly-owned subsidiary context.²⁷² Insolvency of the subsidiary causes directors and officers to also owe fiduciary duties to creditors.²⁷³ Because of the nature of insolvency and the parent-subsidiary relationship, directors and officers need not also owe fiduciary duties to the subsidiary corporation itself. Not only would it be redundant,²⁷⁴ but also it would provide no guidance to directors,²⁷⁵ it is inconsistent with certain theo-

268. Gouvin, *supra* note 5, at 332.

269. *Id.* at 334-35 ("[I]n the context of wholly owned subsidiaries, . . . all duties of the subsidiaries' directors [are imposed] on the parent, whether these duties run to . . . creditors, stakeholders or regulators.").

270. *Id.* at 337.

271. *Id.*

272. *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988).

273. *See Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992); Bainbridge, *supra* note 232.

274. On a balance sheet, the corporation is made up of stockholders and creditors. *See Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 653 n.13 (Bankr. N.D. Ill. 1998).

275. *See Bainbridge, supra* note 232.

retical frameworks,²⁷⁶ and other theories fail as viable frameworks within which to address directors and officers fiduciary duties owed to an insolvent wholly-owned subsidiary.²⁷⁷

D. *Why does it matter?*

Professor Bainbridge argues this is all “much ado about nothing,” or at most, “much ado about very little.”²⁷⁸ On the other hand, Gouvin argues that because there is very little litigation on the subject, “academic commentary [becomes] all the more pressing.”²⁷⁹ While in most cases it may make little difference, there are key considerations that are greatly affected by whether or not duties are owed to the corporation itself. The fate of the business judgment rule,²⁸⁰ deepening insolvency claims,²⁸¹ the effect of exculpatory clauses,²⁸² and sales of distressed subsidiaries²⁸³ hang on the court’s solution to this question. As with many areas of law, if you vary directors and officers duties in the subsidiary context, these other areas of law will be affected. It is important to play out the full ripple effects before making a decision.

IV. CONCLUSION

Directors and officers of an insolvent wholly-owned Delaware-incorporated subsidiary ought to only owe duties to the shareholders and creditors of the corporation. They should not have to owe duties to the debtor-subsidiary corporation itself. The reasoning and case law in *Scott* leaves legal scholars and subsidiary directors and officers with much to be desired. By taking a second look at Delaware law, policy, theory, and common sense and piecing them together from scratch, a more appropriate, logical conclusion to the subsidiary director’s dilemma is that he or she does not owe a fiduciary duty to the corporation itself.

276. See *supra* notes 257-262, 268-271 and accompanying text.

277. See *supra* notes 253-256 and accompanying text.

278. Bainbridge, *supra* note 232.

279. Gouvin, *supra* note 5, at 324.

280. See Luis Salazar, *Fiduciary Duties Are Clarified. Delaware Court Play Up Business Judgment, Drop ‘Deepening Insolvency,’* NAT’L L.J., Oct. 30, 2006, at 16.

281. See *id.*

282. See *Prod. Res. Group v. NCT Group*, 863 A.2d 772 (Del. Ch. 2004).

283. Ball, *supra* note 171.

