Delaware Court of Chancery Decision Signals Greater Protection for Business Judgment and Reaffirms Duties between a Parent and its Subsidiary

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It is becoming increasingly common for bankruptcy trustees, creditors' committees and post-bankruptcy litigation trusts, in the aftermath of a business failure, to pursue "deep pocket" defendants, claiming that a company's directors and officers—and outside professionals—were responsible for the company's demise and the creditors' losses. A recent decision of the Delaware Chancery Court in the case of *Trenwick America Litigation Trust v. Ernst & Young, L.L.P., et. al*, Case No. 1571-N (Del. Ch. Aug. 10, 2006), written by Vice Chancellor Strine, may provide substantial protection to defendants in such litigation, broadly clarifying that directors and officers of insolvent companies are entitled to traditional "business judgment rule" protection in their exercise of their fiduciary duties. While creditors are certainly owed a fiduciary duty when a company is in the zone of insolvency, one cannot rely solely on the fact of the company's ultimate financial failure as evidence that those duties were breached. And while Delaware law (like federal law) provides a "fraudulent conveyance" remedy when an insolvent company transfers value outside the reach of its creditors without obtaining fair value in return, "[w]hat Delaware law does not do is impose retroactive fiduciary obligations on directors simply because their chosen business strategy did not pan out."

The *Trenwick* case arose out of the bankruptcies of an insurance holding company and its subsidiary. The subsidiary's plan of reorganization, as such plans commonly do, assigned the subsidiary's causes of action against third parties to a post-bankruptcy litigation trust. That trust brought claims against the members of the parent's and the subsidiary's boards of directors, and various former advisors, on theories of breach of fiduciary duty, gross negligence, fraud and "deepening insolvency." The court dismissed the complaint, holding that it did not state a cause of action under Delaware law. In doing so, the court articulated several principles that provide significant protection to directors and officers who seek to rehabilitate a troubled company, appreciating that well-intentioned efforts to rehabilitate a troubled business may ultimately prove unsuccessful:

(1) Relationship between parent and wholly owned subsidiary.

(a) *A solvent subsidiary's board of directors may act in the best interest of its parent*. The court reaffirmed the principle of Delaware law that a solvent wholly owned subsidiary's board of directors is entitled to serve the interests of the parent: "Wholly owned subsidiary corporations are expected to operate for the benefit of their parent corporations; that is why they are created."

(b) *A parent company's board of directors does not owe a fiduciary duty to the subsidiary, which cannot claim against parent's board* without *veil piercing*. The court also reaffirmed the principle of Delaware law that a parent company's board of directors does not owe a fiduciary duty to its wholly owned subsidiary. Rather, such an obligation arises only when the subsidiary has a minority stockholder. It is commonplace for a parent corporation to use the "asset value of one of its wholly owned subsidiaries to help it finance and absorb the downside of the parent's larger business strategy." And even if the facts suggested gross negligence, the subsidiary's claim would be against the parent company itself. The subsidiary could not claim against the parent's directors or officers without a basis for piercing the corporate veil to hold the individuals responsible for the corporate liability.

(2) There is no cause of action for "deepening insolvency" under Delaware law. Despite suggestions in previous federal court decisions that Delaware law would recognize a cause of action for deepening insolvency—a tort claim arising out of actions that "prolong" the existence and losses of an insolvent company, thus leading to smaller recoveries for creditors—the court held to the contrary: "Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate. Even when a company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm." Instead, creditor remedies are the traditional causes of action of breach of fiduciary duty and fraud. Thus, a business decision made in good faith with due care, even one that results in "deeper insolvency," is protected by the business judgment rule. "If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation become more insolvent as a result of the failed strategy."

(3) Litigation trust may not assert direct claims of creditors. While the litigation trust may pursue the *corporation*'s causes of action for the benefit of creditors, the court made clear that the trust lacked standing to assert whatever *direct* actions creditors might hold against the directors, officers or advisors. Indeed, even if a plan of reorganization might purport to assign such rights to the trust—which the plan here did not—"federal bankruptcy law is clear that litigation trusts do not have standing to pursue the direct claims of creditors."

(4) The *in* pari *delicto* doctrine does not protect insiders and advisors that defraud the corporation. While the court dismissed the trust's claims against each of the defendants, the court expressly declined to rely on one defense they advanced—the argument that where it was alleged that the company itself engaged in fraud, claims asserted by a bankruptcy trust (standing in the shoes of the prior corporation) are subject to an *in pari delicto* defense. In a footnote, the court effectively observed that an action brought by a bankruptcy trust for the benefit of injured creditors is analogous to a derivative action brought for the benefit of injured shareholders. Because the "doctrine of *in pari delicto* has never operated in Delaware as a bar to providing relief to the innocent by way of a derivative suit" in a context in which insiders or advisors are alleged to have defrauded the corporation, it does not bar a similar action brought by a litigation trust for the benefit of creditors.

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