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Feature

By Marshall S. Huebner[1]

A Dangerous Mix: Multiple Board Service and Insolvency

Marshall S. Huebner
Davis Polk & Wardwell LLP; New York

Marshall Huebner is global head of Davis Polk & Wardwell LLP's Restructuring Group in New York and represents financial institutions and companies in restructurings and bankruptcies.

Directors of U.S. companies in certain industries or with sponsor shareholders frequently serve on the boards of multiple entities within a single corporate family — often, the parent company and one or more subsidiaries. Under the law of Delaware (where many U.S. companies are incorporated), these directors are often called "dual fiduciaries" because they owe fiduciary duties to each entity that they serve.[2] Developments in the law regarding the duties owed — and the conflicts faced — by dual fiduciaries should heighten directors' awareness of certain risks if they serve on the board of a parent corporation and one or more subsidiaries that is (or might soon become) insolvent.

Holding multiple directorships in a corporate family where every entity is financially healthy poses relatively few problems. However, a troubled financial condition and a reasonably foreseeable insolvency changes the equation for dual fiduciaries due to potentially diverging interests among the corporate entities. The combination of this tension with the dearth of safe harbors — even recusal on the topic at both boards might be inadequate — elevates the risk of personal liability. Directors can lower this risk by, among other things, (1) resigning from one or more of the boards at an appropriately early moment; (2) organizing the corporate entities as limited liability corporations (LLCs) or limited partnerships (LPs) and disclaiming fiduciary duties; and (3) maintaining adequate insurance policies, including direct standalone coverage for directors and officers (D&Os).

Fiduciary Duty Framework Under Delaware Law

Directors must manage the affairs of the corporations they serve with care (the duty of care) and subordinate their personal interests to those of the corporation (the duty of loyalty). The duty of loyalty also encompasses the duty of good faith, which requires that directors act with the purpose of advancing the best interests of the corporation.

A dual fiduciary owes the same duties to each corporation on which he/she serves, and courts have long held that dual-fiduciary status does not diminish the extent or strength of these obligations.[3] Whether potential, actually divided or conflicting, loyalties appreciably increase litigation risk and turn largely on whether any of the entities — typically the subsidiary — is insolvent.

Financial distress and the risk of insolvency fundamentally alter the risk equation. A solvent wholly owned subsidiary normally exists solely for the benefit of its parent, and owes only contractual duties to other stakeholders such as creditors.[4] However, when a subsidiary becomes insolvent, the way it maximizes its value might diverge from what is best for its (now-out-of-the-money) parent. In such an event, the subsidiary's creditors replace its shareowner as the residual claimants on the firm's value and acquire derivative standing, ordinarily held only by shareholders, to sue derivatively for fiduciary breaches.[5]

Directors initially enjoy the broad protection of the business-judgment rule when they are sued

1 The author wishes to thank Eugene Park and Kenneth Hershey for their help in preparing this article.
2 *Weinberger v. UOP Inc.*, 457 A.2d 701, 710 (Del. 1983) ("Thus, individuals who act in a dual capacity as directors of two corporations, one of whom is a parent and the other subsidiary, owe the same duty of good management to both corporations[.]").
3 *Id.* ("There is no dilution of this [fiduciary] obligation where one holds dual or multiple directorships, as in a parent-subsidiary context.").
4 *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1998); *Trenwick Am. Litig. Trust v. Ernst & Young LLP*, 906 A.2d 168, 173 (Del. Ch. 2006), *aff'd sub nom.*, *Trenwick Am. Litig. Trust v. Billet*, 931 A.2d 438 (Del. 2007); *but see* J. Haskell Murray, "'Latchkey Corporations': Fiduciary Duties in Wholly Owned, Financially Troubled Subsidiaries," 36 *Del. J. Corp. L.* 577, 593-98 (2011) (noting that these holdings reflect practical reality rather than broad principles of corporate law).
5 *N. Am. Cath. Educ. Programming Found. Inc. v. Ghewalla*, 930 A.2d 92, 99-102 (Del. 2007).

for alleged breaches of their fiduciary duties. The business-judgment rule is a default presumption that corporate directors make decisions on an informed basis, in good faith and in the honest belief that their actions are in the best interests of the companies they serve.[6] It is intended to prevent courts from second-guessing good-faith business decisions and shield directors from frivolous litigation. When applicable, the rule broadly protects directors from fiduciary duty litigation, placing their business decisions beyond the reach of judicial scrutiny.[7]

However, if a complaint plausibly rebuts the business-judgment rule (*e.g.*, by claiming that the directors acted in bad faith by approving a transaction while they faced a conflict of interest), the burden of proof shifts to the defendants as courts apply the far more demanding "entire fairness" standard.[8] Entire fairness requires that the challenged transaction be both procedurally ("fair dealing") and substantively ("fair price") fair.[9] When the business-judgment rule has been rebutted, it opens the door to costly and risky litigation, as the defendant/directors fight an uphill battle to demonstrate that they did not violate their fiduciary duties in ratifying the suspect transaction. Because dual fiduciaries owe fiduciary duties to each entity separately, creditors have every incentive to try to rebut the business-judgment rule and implicate the entire fairness standard[10] by citing any and all potential conflicts. Therefore, it is paramount that directors avoid the conflicts of interest — and even the appearance of such conflicts - that give plaintiffs any grounds to strip directors of business-judgment rule protection.

No Safe Harbors

A landmark case avers that there are no "safe harbors" for directors who approve transactions in the face of divided loyalties.[11] For example, a dual fiduciary could not merely recuse himself/herself from an insolvent subsidiary board's decision with respect to a transaction (unduly) favoring the parent and vote for that transaction only in his/her capacity as a parent director. The director would still owe fiduciary duties to the subsidiary, and failing to act in the best interests of that subsidiary (by approving the transaction as a parent director) would violate the duties of good faith and loyalty owed to the subsidiary.[12]

Moreover, several courts have taken the view that even complete recusal on the topic from *both* boards (*i.e.*, abstaining from voting on a challenged transaction in any capacity) will not always restore business-judgment rule protection. Although directors cannot be held liable for decisions in which they had no involvement whatsoever,[13] a director can be held liable for his/her involvement in a challenged transaction — even if he/she did not personally vote on it.

For example, in *In re TOUSA Inc.*, a defendant director of an insolvent subsidiary abstained from voting on a transaction that allegedly favored the parent, yet the claims against him were permitted to go forward because the director was intimately familiar with the transaction and its substantial risks, and failed to warn the subsidiary's other directors against approving it.[14] So long as a director participates in a challenged transaction in some "legally significant way," recusal might not restore the business-judgment rule and immunize that director from liability.[15] This expansive approach to director liability, which comes close to imposing on directors an affirmative "duty to warn" against suspect transactions, was recently reaffirmed in a case holding that dual fiduciaries who are "involved with" a challenged transaction will be judged under the entire-fairness standard rather than the business-judgment rule — even if they do not vote on it.[16]

Dual fiduciaries who serve on the board of a parent company and on the board of a financially troubled subsidiary are thus placed in a perilous position. The subsidiary's financial distress and potential insolvency exposes them to derivative fiduciary duty litigation from creditors, and, for any transaction involving both the subsidiary and its parent, creditors can allege that the competing interests at stake warrant the application of the entire-fairness standard. Recusal on either side of the transaction might prove insufficient to re-establish business-judgment rule protection, and even recusal from all boards can still leave directors open to liability. In light of these risks, directors holding multiple board positions in a corporate family need to carefully consider the steps that they can take in order to protect themselves.

Solutions

Directors should first evaluate whether dual fiduciary status is worth maintaining when any of the relevant entities experiencing financial distress are (or may become) insolvent. Holding board positions at a parent entity and its subsidiaries is often sensible when every entity is financially healthy, but the risks posed by impending or actual insolvency might be too great to bear. Directors who may find themselves having to answer not only to a parent entity and its shareholders, but also to the creditors of an actually or potentially insolvent subsidiary should rethink whether they want to remain on multiple boards.

Directors should also attempt to manage risk through the choice of corporate form. While the creditors of an insolvent corporation have standing to pursue derivative fiduciary duty claims against its directors, creditors of an insolvent LLC or LP generally have a far more limited or no such right — *if* the corporate documents are properly drafted.[17]

Because Delaware LLCs and LPs can generally abrogate fiduciary duties other than the duty of good faith in their operating documents,[18] directors can lower their risks by

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6 *Off'l Comm. of Unsecured Creditors of Verestar Inc. v. Am. Tower Corp. (In re Verestar)*, 343 B.R. 444, 472 (Bankr. S.D.N.Y. 2006). These assumptions in effect amount to a default presumption that directors have abided by their fiduciary duties.

7 *Responsible Person of Musicland Holding Corp. v. Best Buy Co. Inc. (In re Musicland Holding Corp.)*, 398 B.R. 761, 788 (Bankr. S.D.N.Y. 2008).

8 *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 183 (Del. Ch. 2014).

9 *Cinerama Inc. v. Technicolor Inc.*, 663 A.2d 1156, 1162 (Del. 1995).

10 *See, e.g., In re Verestar Inc.*, 343 B.R. 444, 472-74 (Bankr. S.D.N.Y. 2006); *In re RSL Primecall Inc.*, Nos. 01-11457 (ALG) through 01-11469 (ALG), Adv. 03-2176 (ALG), 2003 WL 22989669, at *11-13 (Bankr. S.D.N.Y. Dec. 11, 2003).

11 *Weinberger v. UOP Inc.*, 457 A.2d 701, 710 (Del. 1983).

12 *Frederick Hsu Living Trust v. ODN Holding Corp.*, No. 12108-VCL, 2017 WL 1437308, at *27 (Del. Ch. April 14, 2017, corrected April 24, 2017).

13 *Id.* at 38.

14 *Off'l Comm. of Unsecured Creditors of TOUSA Inc. v. Tech. Olympic S.A. (In re TOUSA Inc.)*, 437 B.R. 447, 455 (Bankr. S.D. Fla. 2010).

15 *Id.*

16 *Frederick Hsu Living Trust*, 2017 WL 1437308, at *38.

17 *CML V LLC v. Bax*, 6 A.3d 238, 241 (Del. Ch. 2010); *see also* Russell C. Silberglied and Blake Rohrbacher, "*TOUSA*, *USACAFES* and the Fiduciary Duties of a Parent's Directors Upon a Subsidiary's Insolvency," *Norton's Ann. Surv. of Bankr. L.* 33, 55-56 (November 2011).

18 6 Del. C. § 17-1101(d) (2010) and § 18-1101(c) (2013); *see also* Russell C. Silberglied, "Litigating Fiduciary Duty Claims in Bankruptcy Court and Beyond: Theory and Practical Considerations in an Evolving Environment," 10 *J. Bus. & Tech. L.* 181, 205-06 (2015).

electing to organize as or convert corporate entities to LLCs or LPs. Dual fiduciaries must also ensure that the charters and bylaws (at both the parent and subsidiary levels) of the LLCs or LPs expressly and broadly free and exculpate them from fiduciary duty claims.

Lastly, directors should ensure that high-quality and properly drafted D&O insurance policies are in place. Particularly in the context of insolvency, when an employer might be unable or unwilling to indemnify its directors, a protective D&O policy (ideally, with a stand-alone "side A" policy) is a vital risk-management tool.[19]

Case Study: *Quadrant Structured Products*[20]

The Delaware Court of Chancery recently drew a line in *Quadrant Structured Products Co. Ltd. v. Vertin*[21] between dual fiduciary decisions that — in the context of insolvency — are subject to the entire-fairness standard, and those that retain business-judgment rule protection.

Background

Athilon Capital Corp. sold credit-default swaps on senior collateralized debt obligations, such as mortgage-backed securities. Its business model depended on a AAA credit rating, which partially rested on the company's compliance with certain risk-limiting operating guidelines. If Athilon violated these restrictions, the company would enter a "runoff," which mandated an eventual liquidation. Athilon issued several tranches of notes in three series: senior subordinated, subordinated and junior subordinated notes. Athilon's runoff provision was triggered in August 2010.

Later in 2010, EBF & Associates purchased all of Athilon's outstanding equity and junior subordinated notes and appointed four of the five board directors, two of whom were employed and compensated by EBF and thus owed fiduciary duties to both EBF (Athilon's shareowner) and Athilon (an insolvent subsidiary). In 2011, Quadrant Structured Products Co. Ltd. purchased Athilon's senior subordinated and subordinated notes.

The Challenged Board Decisions

After Quadrant became the senior creditor, the new board (1) continued to pay interest on the junior notes held by EBF instead of deferring the payments as the company had a right to do and (2) abandoned its low-risk business model in favor of a riskier investment strategy that might generate higher returns (creating a risk of loss borne chiefly by Quadrant). Quadrant brought a derivative suit against the directors, claiming a breach of the duty of loyalty on the basis that the board improperly transferred value away from it as the senior creditor to benefit EBF. Athilon responded with a motion to dismiss Quadrant's complaint.

The Decision

The court held that the Athilon board had the burden of proving that the decision to make interest payments on the junior notes was entirely fair.[22] The court determined that since Quadrant was the residual beneficiary of any increase in value, the board improperly transferred value away from Quadrant when they failed to defer the interest payments until the eventual liquidation. However, the court dismissed the claim challenging the adoption of a riskier investment strategy, holding that it enjoyed the protection of the business-judgment rule. Although the risk of this new approach was borne largely by Quadrant, the strategy decision would affect the value of the entity as a whole and not confer *specific* benefits on the directors themselves or EBF.[23] The court found it was reasonably in the interest of both entities, and by extension their respective residual beneficiaries, to adopt a strategy that might increase Athilon's value as a whole.

Takeaways from *Quadrant*

Quadrant should encourage dual fiduciaries to engage in business activities that do not create conflicts of interest between entities to which the fiduciaries owe equal duties, even if they increase the risk for all or only some of the insolvent entity's stakeholders. However, dual fiduciaries cannot rely on *Quadrant* to shield from judicial scrutiny decisions executed in the presence of conflicting interests. Measures must be taken to neutralize the conflicts of interest that arise under these circumstances. abi

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19 Marshall S. Huebner and Benjamin M. Schak, "D&O Insurance and Insolvency: Navigating the Intersection," 25 *Corp. Governance Advisor*, No. 3, May/June 2017, at 9.

20 Marshall S. Huebner and Darren S. Klein, "The Fiduciary Duties of Troubled Corporations," XXXIV *ABI Journal* 2, 18-19, 80-81, February 2015, *available at* abi.org/abi-journal.

21 102 A.3d 155, 187-91 (Del. Ch. 2014).

22 *Id.* at 185.

23 *Id.* at 187.