

In Search of a Higher Standard: Rethinking Fiduciary Duties of Directors of Wholly-Owned

Subsidiaries

By

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[T]o 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?

Justice Frankfurter¹

[O]ur corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs.

Unocal Corp. v. Mesa Petroleum Co.²

I. INTRODUCTION

Recent corporate scandals have made us aware of the abuses that can occur when corporate officers and directors succumb to greed in pursuit of the ever-increasing share price.³

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

² 493 A.2d 946, 957 (Del. 1985).

³ See Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 461—62 (2004) (attributing at least some of the recent corporate scandals to governance failures involving directors' lack of faithful management as fiduciaries); Kathleen Hale, *Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes*, 45 ARIZ. L. REV. 823, 856 n.122 (2003) ("Potentially, after the 2002 corporate debacles, people might be more inclined to question the primacy of shareholders' interests. [Professor] Gordon points out the ways in which the Enron bankruptcy challenged very basic assumptions about conducting business in America during an era of 'shareholders capitalism.'" (citing Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1234 (2002))).

Due to the power dynamics inherent in the parent/wholly-owned subsidiary context, the wholly-owned subsidiary is particularly vulnerable to manipulation.⁴ Imagine, for example, that you are a director of a wholly-owned subsidiary. You suspect that the parent company wants to loot the subsidiary or have the subsidiary engage in various sweetheart deals with the parent in order to improve the parent's bottom line.⁵ What should you do? You certainly have a fiduciary duty to the parent.⁶ But you also have a duty to the wholly-owned subsidiary as an entity.⁷ In addition,

⁴ Cf. *Pepper v. Litton*, 308 U.S. 295, 313 n.28 (1939) (“In all the experience of the law, there has never been a more prolific breeder of fraud than the one-man corporation. It is a favorite device for the escape of personal liability.” (quoting trial court opinion)); Geoffrey P. Miller, *Catastrophic Financial Failures: Enron and More*, 89 CORNELL L. REV. 423, 450-451 (2004) (pointing out that while “[i]n itself, a complex structure is not problematic,” with many good reasons existing “for a firm to operate with a family of parents, subsidiaries, and affiliates,” many of the firms involved in recent corporate scandals “appeared particularly prone to using complex structure”).

⁵ See Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L.J. 287, 338 n.9 (1996) (“A recent case in which a holding company ‘looted’ its subsidiary insurance company, allegedly to prop up the failing activities of its other subsidiaries illustrates the point.”); cf. *id.* at 290 (“[I]t is not unusual for subsidiaries to sell their products at reduced prices to their parents, to buy goods and services from their parents at inflated prices, to pay excessive management fees to their parents, to declare excessive dividends, or to otherwise to engage in transactions at the request of their parents that the subsidiaries never would have undertaken on their own.” (citing Kieran J. Fallon, Note, *Source of Strength or Source of Weakness?: A Critique of the ‘Source-of-Strength’ Doctrine in Banking Reform*, 66 N.Y.U. L. REV. 1344, 1383 (1991))); William W. Bratton, *Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law*, 61 GEO. WASH. L. REV. 1129 n.49 (“Section 5.11 [of the ALI's Principles of Corporate Governance] sweeps in most majority-to-minority fact patterns not involving transactions. It covers, among other things, the parent's (a) misusing a corporate position to obtain a tax benefit at a subsidiary's expense, (b) misusing dividend policy, (c) precluding a subsidiary from engaging in a business opportunity, (d) precluding a subsidiary from competing with a parent, and (e) obtaining profit from the sale of property to the exclusion of other shareholders.”).

⁶ *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1174 (Del. 1988) (“[I]n a parent and wholly owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders”). *But see, infra* note 7.

⁷ *First American Corp. v. Al-Nahyan*, 17 F. Supp. 2d 10, 26 (D.D.C. 1998) (“Even assuming the Virginia courts would follow *Anadarko*, they would understand it to apply only to the question of who are the shareholders to whom the directors of a wholly-owned subsidiary owe duties when the corporation is being spun off [T]he directors of a wholly-owned subsidiary owe the corporation fiduciary duties, just as they would any other corporation. As a result the subsidiary has standing to sue for breach of those duties.”). Cf. Gouvin, *supra* note 5, at 294-95:

Well-established law in Delaware and other jurisdictions holds that the directors of corporations owe fiduciary duties to both the corporation and its shareholders. The Delaware Supreme Court has recently stated that these two duties are ‘of equal and independent significance,’ but case law reveals that the directors’ duty to the corporation as an entity usually predominates over their duty to the shareholders. Only

you may (depending on the circumstances) have duties to the subsidiary's creditors,⁸ as well as certain government regulators.⁹ Finally, the interests of other constituencies may need to be considered.¹⁰

You are faced with a dilemma.¹¹ You can either: serve the parent and risk being sued by creditors, regulators and/or other constituencies;¹² serve the subsidiary and risk being sued and/or

in certain situations will the duty to the shareholders predominate over the duty to the corporation. If the law of parent and subsidiary follows corporate law generally, it would appear that in some situations the subsidiary board should make decision in the best interests of the parent corporation as shareholder, and at other times the directors should take action in the best interest of the subsidiary as a corporation. (quoting *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993)).

⁸ *Pepper*, 308 U.S. at 307 (1939) (stating that a director's fiduciary duty is "designed for the protection of the entire community of interests in the corporation – creditors as well as stockholders"); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 789 (Del. Ch. 1992) ("The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the directors [sic] only concern.").

⁹ See *Gouvin*, *supra* note 5, at 290:

The split between the parent's interests and the interests of the subsidiary can be especially pronounced when the subsidiary is a participant in a highly regulated industry. Often the directors of the regulated subsidiary will find themselves torn between a desire to make decisions in the best interest of the subsidiary as an independent corporation consistent with the larger regulatory scheme, and a countervailing desire to make decisions in accordance with the wishes of the parent corporation.

Id. at 318:

The concern over subsidiary director liability to nonshareholders is not a purely academic enterprise. For example, in many cases the directors of subsidiary banks have found themselves subject to liability to the FDIC. The chain of events leading to liability begins when a bank fails and the FDIC is appointed as receiver. As receiver, the FDIC must maximize the value of assets owned by the failed bank, including any causes of action the bank may have. Therefore, the FDIC may bring claims on behalf of the failed bank against the bank's directors for failure to take action in the best interest of the bank.

¹⁰ Forty-one states have enacted statutes that permit directors to consider the impact of various corporate actions on non-shareholder constituents as part of the directors' decision-making process. Kathleen Hale, *Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes*, 45 ARIZ. L. REV. 823, 833 (2003). Connecticut's statute is mandatory. CONN. GEN. STAT ANN. § 33-756. Case law also permits consideration of various stakeholders. See, e.g., *Paramount Communications Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1989).

¹¹ See *Gouvin*, *supra* note 5, at 293 (recognizing "fiduciary Catch-22" for directors who find themselves "torn between two duties").

¹² *Id.* at 291:

fired by the parent; or, you can quit.¹³ Where shall you look for guidance? This is obviously an important area of the law,¹⁴ but due in large part to the fact that, generally speaking, only the parent has standing to sue the board of its wholly-owned subsidiary (and it is much easier to just replace the directors), it is an area of the law that is far from well-developed.¹⁵ The Delaware Supreme Court has said that “in a parent and wholly owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders.”¹⁶ Meanwhile, the United States District Court for the District of Columbia has said that “the directors of a wholly-owned subsidiary owe the corporation fiduciary duties, just as they would any other corporation.”¹⁷ As for legal commentators, one has argued that a fundamental rights analysis should be applied to differentiate “legitimate” from “illegitimate” shareholder demands in the wholly-owned subsidiary context.¹⁸ Another commentator has suggested that due to the uniquely insulated nature of the relationship between

In the litigation that followed the wave of bank failures in the late 1980s and early 1990s, many directors faced personal liability for bank losses. Although they had made decisions in the best interest of their sole shareholder, the directors often found themselves the target of lawsuits instituted by nonshareholder constituents involved in the corporate enterprise, including the banking regulators, customers, and other parties.

¹³ *Id.* at 293.

¹⁴ *Al-Nahyan*, 17 F. Supp. 2d 10, 26 at n.17 (expressing hope that the “perplexing issue” of the duties of wholly-owned subsidiary directors will become the subject of “a more robust discourse”).

¹⁵ *Id.* at 26 (“[T]he duties of the directors of wholly owned subsidiaries have not been articulated in the law.”) (quoting Gouvin, *supra* note 5, at 324); *see* Gouvin, *supra* note 5, at 324 (“In part, this lack of clarity can be attributed to a lack of legal precedent, which, in turn, can be attributed to the fact that a parent corporation is unlikely to sue the board of its wholly owned subsidiary.”).

¹⁶ *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1174 (Del. 1988).

¹⁷ *Al-Nahyan*, 17 F. Supp. 2d at 26.

¹⁸ Emma D. Enriquez, Comment, *Honor Thy Shareholder At All Costs? Towards A Better Understanding of the Fiduciary Duties of Directors of Wholly-Owned Subsidiaries*, 32 SW. U.L. REV. 97, 114-15 (2003).

a parent company and its wholly-owned subsidiary, directors of wholly-owned subsidiaries should be held to a lesser standard than other directors—perhaps all we should expect of them is to act as mere agents of the parent.¹⁹ In this article, however, I will argue that precisely because the relationship between a parent company and its wholly-owned subsidiary is so insulated, directors of wholly-owned subsidiaries should be held to higher fiduciary standards than other directors. In the alternative, I argue that a derivative right to enforce the wholly-owned subsidiary director's duty to the corporation should be granted to stakeholders.

Following this Introduction, Part II of this article will examine the historical background and theories of the corporation generally. This examination of the historical background of the corporation will serve to remind us that the state's interest in bestowing limited liability upon shareholders and immortality upon the corporate entity is not merely to make shareholders wealthy, but rather to utilize shareholder wealth aggrandizement as a means to foster economic growth generally.²⁰ We shall see how both the so-called “race to the bottom” and the takeover boom of the 1980s laid the groundwork for the modern stakeholder empowerment movement in corporate law. We will furthermore be reminded that:

Companies sprang from the loins of the state. Even when they were set free in the mid-nineteenth century, they still had to secure what might be called “a franchise

¹⁹ Gouvin, *supra* note 5, at 304-05:

Since the parent entirely controls the subsidiary's management, it is unrealistic to expect the subsidiary directors to act solely in the best interests of the subsidiary corporation even though such action would ordinarily be required for corporate directors. Instead of requiring these directors to behave as if the subsidiary were an independent entity, the law should be more realistic and allow them to do the bidding of the parent or shareholder.

²⁰ Cf. William J. Rands, *Domination of a Subsidiary by a Parent*, 32 IND. L. REV. 421, 455 (1999) (asserting belief that “the granting of limited liability to a parent corporation encourages investment and economic development, producing a net benefit for society as a whole”).

from society.” . . . To keep doing business, the modern company still needs a franchise from society, and the terms of that franchise still matter enormously.²¹

Meanwhile, our examination of the theories of the corporation will demonstrate that supporting expansion of the fiduciary duties of wholly-owned subsidiary directors is in accord with both of the two main schools of corporate law theorists: communitarians and contractarians.

Part III will examine fiduciary duties of corporate directors generally, providing a framework within which to examine the fiduciary duties of directors of wholly-owned subsidiaries specifically. The conclusion of this section is that: (1) the law of fiduciary obligations of corporate directors is an evolving one; (2) the historical norm of shareholder primacy, which justified using shareholder interests as a proxy for other duties, has come under increasing scrutiny; and (3) the foundation for duties running to non-shareholder constituents is already in place.

After having discussed the history and theories of the corporation generally, as well as fiduciary duties of corporate directors generally, Part IV will move on to discuss some of the unique historical and legal aspects of the subsidiary entity specifically. This will help us to see that the law generally treats subsidiaries as separate entities, with all of the concomitant rights and responsibilities inherent therein. Therefore, if a parent corporation wishes to avail itself of the benefits of operating such a separate entity, it cannot simultaneously avoid having the directors of that entity fulfill their various statutorily-imposed duties.

In Part V, I will discuss why the unique position of directors of wholly-owned subsidiaries warrants subjecting them to expanded fiduciary duties. Specifically, I argue that

²¹ JOHN MICKLETHWAIT & ADRIAN WOOLRIDGE, *THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA* 182, 186 (Modern Library, 2003) (hereinafter, *THE COMPANY*). The use of the term “franchise” in the text should not be confused with a monopoly right. *See infra* note 22.

several of the factors justifying not extending fiduciary duties to other constituencies such as employees, customers, and members of the community generally are lacking in the wholly-owned subsidiary context. First of all, the power dynamics at work in the parent/wholly-owned subsidiary context are such as to seriously impugn the directoral independence that is so often viewed as a bar to serious challenge of directoral decisionmaking. Second, there are no large institutional investors at the level of the wholly-owned subsidiary to counteract the forces working upon the directors of the wholly-owned subsidiary to simply do the bidding of the parent. Third, there is no market for corporate control operating at the level of the wholly-owned subsidiary to provide an incentive for directors of that entity to maximize its performance. Finally, the parent is too removed from the stakeholders to allow us to assume that it will give sufficient, if any, consideration to their interests. All these factors create inefficiencies best addressed by the imposition of fiduciary duties to stakeholders upon the wholly-owned subsidiary's directors.

Having concluded that the unique dynamics of the wholly-owned subsidiary warrant imposition of additional fiduciary duties upon its directors, Part VI provides alternatives for implementing those duties. In Part VI, I also make an argument for granting a derivative right to stakeholders to enforce the wholly-owned subsidiary director's duty to the corporate entity. Finally, Part VII presents concluding remarks.

II. HISTORICAL BACKGROUND AND THEORIES OF THE CORPORATION: HOW THE CORPORATION WENT FROM STATE-DOMINATED, TO MANAGER-DOMINATED, TO MARKET-DOMINATED--AND THE GREAT DEBATE OVER WHO SHOULD CONTROL HOW MUCH

The corporate form is a powerful device. David M. Kennedy, professor of history at Stanford University, has described the limited-liability joint-stock company as nothing short of “a very marvel of the modern world economy, a historical force to rival religions, monarchies, and even states.”²² Precisely because the current form of the corporation is so dominant in our modern world, it is easy to lose sight of the myriad of legislative choices that have gone into its current form, as well as the evolution of the debate over its proper role in our society.²³

Therefore, this article will begin with a short recounting of both the history and theory of the corporation--reminding us that the corporate form and the rules that govern it were not handed down on stone tablets, but rather evolved over time and with much trial and error, and remain subject to continuing re-evaluation.²⁴

A. *Early History: A Creature of the State*

While the roots of the modern corporation can be traced all the way back to Roman times, and through the Middle Ages,²⁵ this article will begin its historical analysis of American

²² As quoted on the back jacket cover of *THE COMPANY*, *supra* note 21.

²³ *See, e.g.* *THE COMPANY*, *supra* note 21.

²⁴ *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *YALE L.J.* 663, 696 (1974) (stating that “one can fairly hope that the growth of the law in a civilized society should be evolutionary”).

²⁵ *See* *THE COMPANY*, *supra* note 21, at 4, 7 and 12:

William Blackstone, the great eighteenth-century jurist, claimed that the honor of inventing companies “belongs entirely to the Romans” Two sorts of medieval organization picked up where the Romans had left off: the merchant empires of Italy, and the state-chartered corporations and guilds of northern Europe. . . . In the early Middle Ages, jurists, elaborating

corporate law in pre-colonial England. There, the Crown granted corporate charters²⁶ on a case-by-case basis in order to facilitate the successful completion of various risky endeavors.²⁷ The Crown did this in part by leveraging the “subsidy of limited liability” because “[c]olonization was so risky that the only way to raise large sums of money from investors was to protect them.”²⁸

on Roman and canon law, slowly began to recognize the existence of “corporate persons”: loose associations of people who wished to be treated as collective entities. These “corporate persons” included towns, universities, and religious communities, as well as guilds of merchants and tradesmen.

Id. (footnote omitted).

²⁶ See LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 188 (2nd ed. 1985) (“A corporation, in the jargon of lawbooks, is an artificial person. . . . Its life begins with a charter;. . . The charter is a grant of authority from the sovereign. . . .”).

²⁷ See *THE COMPANY*, *supra* note 21, at 17 (“The sixteenth and seventeenth centuries saw the emergence of some of the most remarkable business organizations the world has seen: ‘chartered companies’. . . . Chartered companies represented a combined effort by governments and merchants to grab the riches of the new worlds opened up by Columbus (1471-1506), Magellan (1480-1521), and Vasco da Gama (1469-1524).”).

²⁸ *Id.* at 18. This “subsidy of limited liability” is not to be confused with a franchise. *Id.* at xviii. See FRIEDMAN, *supra* note 26, at 179 (“In the first half of the [19th] century, *franchise* was a key legal concept. The franchise was a grant to the private sector, out of the inexhaustible reservoir of state power.”). While the corporation is no longer tied to the state by means of a franchise, it is still very much dependent on the grant of limited liability. Cf. William J. Rands, *Domination of a Subsidiary by a Parent*, 32 *IND. L. REV.* 421, 423 (1999):

Limited liability has been a prevailing rule in the United States for more than a century. It is ‘fundamental to the law of every jurisdiction in the United States.’ The United States Supreme Court concluded that ‘limited liability is the rule not the exception; and on that assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted.’ Limited liability as a policy has been lavished with praise approaching hyperbole. The President of Columbia University once called it ‘the greatest single discovery of modern times. . . . Even steam and electricity are far less important.’

(quoting Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 *YALE L.J.* 1879, 1879 (1991); Cathy S. Krendl & James R. Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 *DENV. L.J.* 1, 2 (1978); *Anderson v. Abbott*, 321 U.S. 349, 362 (1944); 1 WILLIAM MEADE FLETCHER ET AL., *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 21 (perm. ed., rev. vol. 1990)). However, even if it is possible for a corporation to contract for limited liability directly with some parties, it certainly cannot do so with involuntary creditors such as tort claimants. See generally Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 *MD. L. REV.* 80 (1991).

Later, in the colonial United States, the responsibility for granting charters fell to the legislature.²⁹ These charters were initially granted primarily to further various public works projects³⁰ and, like in England, were handed out on a case-by-case basis.³¹ However, as a result of the United States' distaste for the selective bestowing of privileges generally associated with the Crown, and the clumsiness of the special charter system, the process moved from special charters to general corporate law.³²

As the focus of government shifted from granting franchises for the promotion of specific aspects of infrastructure to supporting growth generally,³³ the need grew “for an efficient,

²⁹ FRIEDMAN, *supra* note 26, at 188, n.34 (“In England, only the crown had the right to incorporate. In the colonies, royal governors, proprietors, and in some cases legislative bodies issued charters. . . . It was generally recognized after the Revolution that the legislature was the branch of government that made corporations.” (citing JOHN W. CADMAN, JR., *THE CORPORATION IN NEW JERSEY: BUSINESS AND POLITICS, 1791-1875* at 4 (1949))).

³⁰ *THE COMPANY*, *supra* note 21, at 43 (“The early American states used chartered corporations, endowed with special monopoly rights, to build some of the vital infrastructure of the new country – universities (like America’s oldest corporation, Harvard University, chartered in 1636), banks, churches, canals, municipalities, and roads.”); John S. Baker, Jr., *Reforming Corporations Through Threats of Federal Prosecution*, 89 *CORNELL L. REV.* 310, 339 (2004) (“At the time of our Founding and for several decades thereafter, corporations were quasi-public entities that ‘functioned very much like arms of government, usually serving some specific public end.’” (quoting JAMIL ZAINALDIN, *THE LAW IN ANTEBELLUM SOCIETY: LEGAL CHANGE AND ECONOMIC EXPANSION*, 43 (1983))).

³¹ FRIEDMAN, *supra* note 26, at 188 (“In the early 19th century . . . the legislature granted charters by statute, one by one. Every charter was in theory tailor-made to the case at hand.”).

³² FRIEDMAN, *supra* note 26, at 189:

The English tradition that corporate powers were to be granted only in rare instances, never deeply entrenched here, was opposed by a strong and growing prejudice in favor of equality – a prejudice which led almost at once to the enactment of general incorporation acts for ecclesiastical, educational, and literary corporations.

(quoting 2 JOSEPH S. DAVIS, *ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS*, *op. cit.*, 7-8 (1917)). See also Cary, *supra* note 24, at 663–64 (“In the early stages of the American economy there were grants of special franchises reminiscent of royal charters, but during the mid-nineteenth century there was a revulsion against them as anti-egalitarian, monopolistic, and scandalous.”) (footnote omitted).

³³ See FRIEDMAN, *supra* note 26, at 191:

Between 1800 and 1850, the essential nature of the corporation changed. No longer was the business corporation a unique, *ad hoc* creation, vesting exclusive control over a public asset or natural resource in one group of favorites or investors. Rather, it was becoming a general

trouble-free device to aggregate capital and manage it in business, with limited liability and transferable shares.”³⁴ The corporation—a separate legal entity³⁵ that divorced ownership from control—provided the answer.³⁶

It is important to note here (and should be obvious upon reflection) that the State did not grant limited liability to shareholders or immortality to the corporate entity merely out of a benevolent desire solely to increase the wealth of shareholders. Rather, the State saw that its interests as sovereign, whether building specific pieces of infrastructure or promoting economic growth generally, could be furthered via the corporate form.³⁷ As one commentator has noted:

In a perfect world, the three doctrines [of limited liability to encourage investment, fiduciary duty to address the agency problem, and the business judgment rule to encourage appropriate levels of risk taking on the part of

form for organizing a business, legally open to all, and with few realistic restrictions on entry, duration, and management.

³⁴ *Id.* at 201.

³⁵ *See* *Trustees of Dartmouth College v. Woodward*, 17 U.S. 518, 636 (1819) (“A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law”).

³⁶ *Cf.* Ribstein, *supra* note 28, at 89 & n.35 (identifying four corporate characteristics: “continuity of life [legal personality], centralized management, free transferability of interest and limited liability”). In addition to limited liability, the corporation is also indebted to the state for continuity of life. *See* THE COMPANY, *supra* note 21, at 11 (“[P]ermanence was the prerogative of the state. So it is unsurprising that the state played a big role in the creation of corporations.”). For a discussion of the “agency” problem created by the separation of ownership from control, *see generally* ADOLF BERLE AND GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); *see also* Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 584 (1992) (describing and expanding on the “essential goal of corporate law – to restrain managerial self-dealing”).

³⁷ *See* *Trustees of Dartmouth College*, 17 U.S. at 637-38 (“The objects for which a corporation is created are universally such as the government wishes to promote. They are deemed beneficial to the country; and this benefit constitutes the consideration . . . of the grant. . . . The benefit to the public is considered as an ample compensation for the faculty it confers, and the corporation is created.”). *Cf.* Mitchell, *supra* note 36, at 642 (“The suggestion, if not the requirement, that directors consider the interests of all corporate constituents does . . . reflect the desirability of a high level of altruism in business conduct that by its very nature is designed to increase the quality of life in our society.”); Baker, *supra* note 30, at 340 (“In return for limited grants of immunity, monopoly, and privilege to corporate bodies, the state retained the authority to structure individual charters *in the public’s interest*.” (quoting JAMIL ZAINALDIN, *THE LAW IN ANTEBELLUM SOCIETY: LEGAL CHANGE AND ECONOMIC EXPANSION*, 44-45 (1983))) (emphasis added).

management] allow aggregate investing, create a liquid stock market, and improve America's standard of living by allowing corporations to make riskier investments than is possible in other business forms. However, when the three doctrines are used to solely maximize personal shareholder and/or director wealth, then the economic policies underlying the doctrines are undermined.³⁸

Thus, along with the excitement over using the corporate form to facilitate economic growth, there was always a tension between promoting growth and maintaining control—often expressed as a fear of the perceived soulless nature of corporations and the lack of accountability on the part of those who ran them.³⁹

Legislative control of the corporate entity was attempted in a variety of ways, including direct state investment, limits on capitalization and regulation of specific industries.⁴⁰ The courts

³⁸ Enriquez, *supra* note 18, at 113.

³⁹ See FRIEDMAN, *supra* note 26, at 513:

The offices of the 'great corporations,' . . . were 'secret chambers in which trustees plotted the spoliation of their wards'. . . Modern society had 'created a class of artificial beings who bid fair soon to be the masters of their creator'; they were 'establishing despotisms which no spasmodic popular effort will be able to shake off. Everywhere . . . they illustrate the truth of the old maxim of the common law, that corporations have no souls.'

(quoting CHARLES FRANCIS ADAMS, *A Chapter on Erie*, in AN AUTOBIOGRAPHY (1916)). See also THE COMPANY, *supra* note 21, at 33 ("[T]hey cannot commit treason, nor be outlawed or excommunicated, for they have no souls." (quoting Sir Edward Coke (1552-1634))); *id.* ("Corporations have neither bodies to be punished, nor souls to be condemned, they therefore do as they like." (quoting Edward Thurlow (1731-1806))); *id.* at xiv ("This is a government of the people, by the people and for the people no longer. It is a government of corporations, by corporations and for corporations." (quoting President Rutherford B. Hayes));

Companies have proved enormously powerful not just because they improve production, but also because they possess most of the legal rights of a human being, without the attendant disadvantages of biology: they are not condemned to die of old age and they can create progeny pretty much at will. This privilege of immortality, not to mention the protection that the artificial corporate form has afforded various venal people down the ages has often infuriated the rest of society.

Id. at xv; FRIEDMAN, *supra* note 26, at 194 ("The corporation was an object of great controversy in the first half of the 19th century. . . . Corporations were creatures of state, endowed with breath for the sole purpose of holding franchise or privilege, that is, some power or right that no one else could lay claim to.").

⁴⁰ See generally FRIEDMAN, *supra* note 26, at 511-25.

tried to limit the power of corporations by construing charters strictly.⁴¹ However, corporate charters were soon “framed so broadly that nothing was beyond its power or its reach.”⁴² While restrictions on charters faded, the law to govern the relationships of officers, directors, shareholders, and creditors grew. “In this period, the courts wrestled with problems of control of corporate management To what standard of conduct should officers and directors be held? Case law looked to the concept of *fiduciary duty*.”⁴³

Obviously, this article will discuss fiduciary duties in much more detail in the coming pages, but first, it is important to cover another significant aspect of the history of corporate law in America—the “race to the bottom”⁴⁴ and “the market for corporate control.”⁴⁵ Understanding this race to the bottom and the market for corporate control is important because it provides an explanation for the current state of the fiduciary duties imposed upon corporate directors. It also provides a necessary background for better understanding both those theorists of corporate law who argue that state interference in corporate law matters should be kept to a minimum and those who argue that the state has a responsibility to exercise its power to protect non-shareholder constituents of the corporation. Once these theorists are understood, it becomes apparent that

⁴¹ See, e.g., *Charles River Bridge v. Warren Bridge*, 36 U.S. 420, 544 (1837).

‘This, like many other cases, is a bargain between a company of adventurers and the public, the terms of which are expressed in the statute; and the rule of construction in all such cases, is now fully established to be this; that any ambiguity in the terms of the contract, must operate against the adventurers, and in favour of the public, and the plaintiffs can claim nothing that is not clearly given them by the act.’

(quoting *Proprietors of the Stourbridge Canal v. Wheeley and others*, 2 B. & Ad. 793).

⁴² FRIEDMAN, *supra* note 26, at 519.

⁴³ FRIEDMAN, *supra* note 26, at 515.

⁴⁴ Cary, *supra* note 24, at 666.

⁴⁵ Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POLITICAL ECONOMY 110, 112 (1965).

one of the great divides that separate them is the extent to which they believe market forces can meet the needs of society. Then, by showing that those forces are absent to a great extent in the wholly-owned subsidiary context, we can see that state imposition of additional fiduciary duties is warranted in the wholly-owned subsidiary context regardless of the extent to which we believe those forces are effective otherwise. What follows is a brief summary of one way of understanding the interplay of the race to the bottom and the market for corporate control.

B. The Race to the Bottom and the Market for Corporate Control: Setting the Stage for the Modern Debate about the Role of the Corporation in Society

In deciding what types of fiduciary duties directors of wholly-owned subsidiaries should be subject to, it is important to recognize that the current makeup of fiduciary duties, imposed on directors generally, resulted at least in part from a competition among the states to lure businesses to incorporate in their jurisdiction. Obviously, the individuals most responsible for deciding where to incorporate are the business's managers, and many believe that therefore competition between the states for a piece of the "incorporation pie" resulted primarily in manager-friendly legislation.⁴⁶

The following is one summary of the process:

The fact that business on both sides of the Atlantic was still rooted in partnerships [in the late eighteenth century] did not make partnerships perfect. Unlimited liability restricted a firm's ability to raise capital. The untimely death of a key partner or even an heir often killed the firm with it Businesspeople stuck to them because they didn't like bringing the state into their private affairs. In the first half of the nineteenth century, the state began to step back. It did so first in America There were three prompts for change. The most important was the railroad [and their demands for large agglomerations of capital]. . . . The second was legal. In a ruling about the status of Dartmouth College in 1819, the Supreme Court found that corporations of all sorts possessed private rights, so states could

⁴⁶ See, e.g., Cary, *supra* note 24, at 730 (explaining that modern statutes covering corporations "are described as 'enabling' acts—enabling management to operate with minimum interference").

not rewrite their charters capriciously. The last prompt was political. Concerned that their states were losing potential business, legislatures, particularly in New England, slowly began to loosen their control over companies. In 1830, the Massachusetts state legislature decided that companies did not need to be engaged in public works to be awarded the privilege of limited liability. In 1837, Connecticut went further and allowed firms in most lines of business to become incorporated without special legislative enactment. This competition between the states was arguably the first instance of a phenomenon that would later be dubbed “a race to the bottom,” with local politicians offering greater freedom to companies to keep their business New Jersey . . . in 1889 had created the most liberal incorporation law in the country By 1901, two-thirds of all American firms with \$10 million or more of capital were incorporated in the state, allowing New Jersey to run a budget surplus of almost \$3 million by 1905 and paying for a rash of new public works. Inevitably, other states fought back. Virginia turned itself into what one legal treatise called a “snug harbour for roaming and piratical corporations.” . . . But the big winner of this particular “race to the bottom” would be Delaware.⁴⁷

Arguably, as a result of this race to the bottom and the manager-friendly corporate law it created, many corporations ended up being run inefficiently because their managers had more incentive to maintain the status quo (i.e. their jobs) than take the types of risks appropriate and necessary in business to maximize the output produced by a particular set of assets. Enter the market for corporate control, wherein corporate raiders using a variety of financing schemes targeted companies whose shares were trading below the liquidation value of the assets of the business. The emergence of this market for corporate control helped to refocus managers by making clear that those that did not get the assets under their care to produce a reasonable return would soon find themselves on the way out. In other words, the market for corporate control made it too risky to stay risk averse. But the takeover boom spurred by the market for corporate control also brought to light new concerns for the various non-shareholder constituents

⁴⁷ THE COMPANY, at 45-46, 68-69. See also Cary, *supra* note 24, at 664 (“The states, realizing that local restriction would be circumvented by foreign incorporation and eager for the revenue derived from the traffic in charters, joined in advertising their wares. In [Justice] Brandeis’ words, the race was not one of diligence but of laxity.”) (citing *Liggett Co. v. Lee*, 288 U.S. 517, 558-59 (1933)).

negatively affected by takeovers that often resulted in dramatic changes like plant closures.⁴⁸

The ensuing enactment of various antitakeover and stakeholder statutes (which will be discussed in more detail below)⁴⁹ set the stage for a great debate among corporate law theorists as to the nature of the corporation and its proper place in our society. The next section of this article will address this debate, and a general overview of this debate is important for our purposes here because I will argue that one does not need to choose between these theories to support the recommendations I make.

C. Communitarians and Contractarians: The Modern Debate

As alluded to above, many commentators believe the race to the bottom and its concomitant manager-friendly corporate law resulted in various stakeholders of the corporation

⁴⁸ See Hale, *supra* note 10:

Arguably, takeovers' deleterious effects were not immediately apparent. This is partly because the drawbacks of takeovers and mergers were counterintuitive to the fundamental assumptions of the time. Until this takeover phenomenon, profit maximization was believed to be a strategy that benefited everyone. As Millon puts it, 'larger pies imply larger servings for all.' It was not until the takeover boom that some people realized a larger pie does not always get divided up equitably.

Id. at 832 n. 69 (internal citations omitted) (quoting David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 241 (1991)); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993):

For much of this century, at least since the publication of Berle and Means' classic in 1932, the orthodox assumption has been that corporate law's objective is to develop legal structures that will maximize shareholder wealth. . . . [However, h]ostile takeovers, which seemed to promise so much for shareholders, ended up raising serious doubts about the shareholder primacy norm that was their strongest justification.

Id. at 1373-75 (internal footnote omitted) (citing ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932)); *id.* at 1389 ("For too many people, the traditional shareholder primacy model has outlived its utility and now threatens important values."); *id.* at 1390 ("Corporate law is currently in the midst of crisis, because of the exhaustion of the shareholder primacy model.").

⁴⁹ See Hale, *supra* note 10, at 829-30 ("The statutes are referred to by various names, including 'nonshareholder' statutes, 'constituency' statutes, and 'stakeholder' statutes. . . . Stakeholder groups include employees, consumers, creditors, suppliers, and communities, among others."); *id.* at n.21 ("The term 'stakeholder' was originally used at the Stanford Research Institute (now 'SRI International, Inc.') in 1963 and it meant 'those groups without whose support the organization would cease to exist.'") (quoting R. EDWARD FREEMAN, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* 31 (1984)).

being left on the outside looking in when it came to being accounted for in a corporation's decision-making process.⁵⁰ Employees, customers and members of the community in which the corporation is based are all in a type of symbiotic relationship with the corporate entity. Not only are they in many ways dependent upon the corporation, but the corporation is in many ways dependent upon them. And yet the corporation can make most of its significant decisions without having to consider the impact of those decisions upon these stakeholders.

To address these concerns, Communitarians (the legal theorists advocating greater consideration of various stakeholders) urge the state to impose additional requirements upon corporations, such as additional fiduciary duties, requiring them to consider these various stakeholders. Communitarians do this in part by relying on the entity theory of the corporation, which states that since the corporation is a separate entity owing its existence to the state, the state can demand that the corporation take on certain responsibilities in exchange for concessions granted by the state, such as limited liability and immortality.⁵¹

At the same time, there are many who believe that economic forces serve to mitigate any managerial bias of the so-called race to the bottom.⁵² These Contractarians believe that “the

⁵⁰ See Gouvin, *supra* note 5, at n.68 (“It has been argued that the U.S. system of state-level corporate law has a built-in dynamic that produces statutes catering to shareholder interests to the exclusion of nonshareholder interests.”). See generally David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1391 (1993) (providing a partial bibliography of communitarian scholarship in the corporate law field).

⁵¹ See Lyman Johnson, *The Eventual Clash Between Judicial and Legislative Notions of Target Management Conduct*, 14 J. CORP. LAW 35, 72 (1988) (“[W]hen business participants seek the many advantages of the corporate form . . . a state, the grantor of corporate status, may impose limitations of a kind not applicable to extracorporate business activity, thereby effectively requiring the participants to acknowledge the interests of others . . .”).

⁵² See Bratton, *supra* note 5, at 1102-03:

The introduction of a microeconomic model of the corporation in the early 1980s countered the antimanagerial case for intensified fiduciary controls. The economic model . . . assumes that individual self-interest motivates all relationships All corporate actors become rational figures who take contractual steps to protect themselves. Thus modeled, shareholders do not necessarily expect strict legal

corporation is a set of contracts among the participants in the business, including shareholders, managers, creditors, employees and others. . . . The policy implication is that private parties to the corporate contract should be free to order their affairs in whatever manner they find appropriate.”⁵³ They believe that the entity theory of the corporation is no longer valid,⁵⁴ and thus the state’s prerogative to mandate duties beyond those the contracting parties would have agreed to had they negotiated the matter is severely limited at best.⁵⁵

Even Contractarians should agree, however, that if we understand the current state of corporate director fiduciary duties to be based at least in part on an expectation that forces such as directoral independence, institutional investors, and the market for corporate control will

protection under the fiduciary rubric. Instead, they primarily rely on competition in the market for corporate control and the market for executive skills to assure protection of their interests.

(citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 310 (1976), as first articulating this economic model of the firm, and FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 171-74 (1991), as the leading legal application).

⁵³ Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 7-8 (1990).

⁵⁴ See Butler & Ribstein, *supra* note 63, at n.1:

The entity theory appears to support the approach that the “entity” is brought into being, and therefore subject to extensive regulation (either through direct administrative regulation or litigation) by the state. We will eschew language that lends itself to a priori treatment of corporations as different from other contractual relationships. The corporation is, indeed, a bundle of interrelated contractual relationships, but there is no conceptual justification for reifying this interrelationship.

See also William W. Bratton, Jr., *The “Nexus of Contract” Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 433-36 (1989) (arguing that the concession theory has lost its vitality); Gary M. Anderson & Robert D. Tollison, *The Myth of the Corporation as a Creation of the State*, 3 INT’L REV. L. & ECON. 107 (1983).

⁵⁵ See Butler & Ribstein, *supra* note 53, at 28 (“An important aspect of the contract theory of the corporation, and one that is hotly disputed by the anti-contractarians, is that fiduciary duties are a term of the corporate contract and therefore consensual in nature.”). (citing Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & Econ. 179 (1985). *But cf.* *Trustees of Dartmouth College*, 17 U.S. (4 Wheat.) at 643-44 (“This [charter] is plainly a contract to which the donors, the trustees *and the crown* . . . were the original parties.”) (emphasis added).

provide certain protections of the corporate entity from individual shareholder abuse, and we conclude that these protections are not fully available in the wholly-owned subsidiary context, then it is fair to suggest that the fiduciary duties that we otherwise rely upon should be expanded to compensate for the loss of that protection.⁵⁶ Before getting to that point, however, we should understand what exactly the current state of fiduciary duties of corporate directors is generally. This will demonstrate that the foundation for fiduciary duties running to stakeholders is already in place, and asking directors of wholly-owned subsidiaries to consider the needs of other constituents than the parent is something they are already asked to do in certain settings.

III. FIDUCIARY DUTIES OF CORPORATE DIRECTORS: MORE THAN MAKING SHAREHOLDERS RICH

The debate over whom corporate directors owe fiduciary duties to, and what the scope of those duties is, is a longstanding one.⁵⁷ At least some of the lack of unanimity on the issue of fiduciary duties stems from the unique status of fiduciary duties in our law generally:

⁵⁶ Cf. William J. Carney, *Defining The Corporate Constituency: Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 387 (1990):

Most of the groups considered constituencies of the firm are already in some form of contracting relationship with the corporation. I will ask whether there is evidence of overreaching by corporations in striking these bargains, fueled by market power, information asymmetries, or other barriers to reaching outcomes that can fairly be described as contractual. The only way we can conclude that constituency representation will make a difference is if the board, in considering all these interests, can conclude that prior contracting has allowed 'the corporation' to overreach one or more constituencies in striking its bargains. Even if we find that a board could conclude that the firm has exercised excessive power in a relationship, the question arises who will pay for the cure.

Id., at 388:

I begin with the assumption that both product and factor markets operate effectively to constrain both parties to the variety of bargains that form the firm. The evidence of the competitiveness of most of these markets is sufficiently strong, so that the burden is on those who claim markets are ineffective in protecting stakeholders to come forward with evidence.

⁵⁷ Compare A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) (arguing that corporate powers are held in trust for only the shareholders) with E. Merrick Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932) (arguing that corporate managers are trustees for employees,

Fiduciary relationships present a problem of legal classification. They lie in a gray area between the more clearly defined worlds of government regulation and private ordering through contract. They plausibly can be characterized as a species of either. Because the fiduciary acts on another's behalf, the relationship implies a beneficiary needing protective regulation. But fiduciary relationships also are volitional and inevitably entail a measure of private ordering, in many cases a large measure. As a result, the same fiduciary relationship may be the subject of two sharply contrasting descriptions with contrasting normative implications. Depending on the factors emphasized, either legally mandated self-sacrifice or unconstrained pursuit of self-interest in an environment of free contract may be implied.⁵⁸

It has been suggested that, “[r]ecognition that the law of fiduciary obligation is situation-specific should be the starting point for any further analysis.”⁵⁹ What follows is an examination of the current state of corporate director fiduciary duties generally. This examination focuses on whom duties are owed to, as opposed to what form those duties take. The parties covered are: shareholders, the corporate entity, creditors and other constituencies. Then, later, we shall examine the situation at the level of the wholly-owned subsidiary.

A. *Duty to Shareholders: A Foundation Showing Some Cracks*

It is a well-settled and long-standing rule of corporate law that directors owe fiduciary duties to shareholders.⁶⁰ The primary economic justification for this is that absent such a duty, the cost of capital would be prohibitively high as investors would be reluctant to turn their

consumers, and the general public). *But see* Hale, *supra* note 57, at n.119 (“Berle’s perspective prevailed as the dominant conception of the corporation. However, after his view became accepted, Berle actually conceded that Dodd’s view was a better model. In other words, Berle conceded that corporations should act in the entire community’s interest rather than just in the shareholders’ interest.”) (citing Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. Rev. 1189, 1208-09 (2002)).

⁵⁸ William W. Bratton, *Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law*, 61 GEO. WASH. L. REV. 1084, 1100 (1993).

⁵⁹ Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 879 (1988).

⁶⁰ *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed to that end.”).

money over to managers in light of the agency problem.⁶¹ In other words, it is one thing for individuals to accept personal liability for a business they are personally overseeing, but quite another to do so when others are making the daily decisions. While the recent increase in institutional investor power, along with increasing awareness of the impact of market forces such as the market for corporate control, has weakened this economic justification somewhat,⁶² the director's fiduciary duty to shareholders remains a mainstay of corporate law.

⁶¹ See Mitchell, *supra* note 36, at 595:

[T]he singular problem engendered by the separation of ownership and control in the large, publicly held corporation is to restrain management from acting in its own self-interest to the detriment of the corporation...the general instrument designed to address this problem is the broad principle of fiduciary duty
. . . .

Cf. id. at 603 (“The significance of analyzing the problem in this way is that it clarifies that the current legal identification of the beneficiary as the stockholder—to the exclusion of other constituent groups—is not a function of this duty, but of the means by which this duty can be enforced.”).

⁶² See Bratton, *supra* note 68, at 1105:

Shareholders . . . appear less and less well-suited to the victim's role. It no longer seems safe to assume that mandatory self-abnegation among managers promotes investor confidence and lowers the cost of capital. The idea of investor protection, which formerly served as the justification for introducing traditional values of fiduciary law into corporate governance discussions, now carries little weight as a policy imperative. The economic critique also increased sensitivity to the costs of enforcing fiduciary duties.

A further justification for this “shareholder primacy”⁶³ has been the belief that what was good for the shareholder was good for all.⁶⁴ Thus, in the ordinary situation, the interests of the shareholders and the interests of the corporation are aligned. This allows the interest of shareholders to serve as “proxy” for the interests of the corporation.⁶⁵ However, the takeover boom of the 1980s, which often created much shareholder value at the expense of the corporations themselves and their non-shareholder constituencies, caused many to question this assumption.⁶⁶ Arguably, in recognition of this failure of shareholder primacy, a series of celebrated cases explicitly recognized that there are times when a directors’ duty to the

⁶³ See Hale, *supra* note 3, at 837:

By giving corporate leaders permission to consider stakeholders, stakeholder statutes represent a radical change in corporate law. Prior to stakeholder statutes, corporate leaders could not be sure if they were permitted to consider stakeholders’ interests. Corporate leaders could only be certain that they were “legally required to manage a corporation for the exclusive benefit of its shareholders.” This legal requirement, known within corporate law as the ‘shareholder primacy norm,’ refers to ‘this conception of management’s responsibility and also to corporate law’s commitment to shareholder welfare as the primary objective of corporate activity.’ The shareholder primacy norm dictates that when corporate leaders make decisions affecting the organization, their decisions must aim to maximize shareholders’ wealth.

(quoting Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 23 (1991); David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 277, n.2 (1991)).

⁶⁴ See *id.* at 829-30 and 838-39.

⁶⁵ See, e.g., Mitchell, *supra* note 36, at 586 (“[T]he basic approach has been to equate the interests of the stockholders and the interests of the corporation. . .”).

⁶⁶ See Hale, *supra* note 56, at n.69:

Arguably, takeovers’ deleterious effects were not immediately apparent. This is partly because the drawbacks of takeovers and mergers were counterintuitive to the fundamental assumptions of the time. Until this takeover phenomenon, profit maximization was believed to be a strategy that benefited everyone. As [Professor] Millon puts it, ‘larger pies imply larger servings for all.’ It was not until the takeover boom that some people realized a larger pie does not always get divided up equitably.’ (quoting David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 241 (1991)).

corporation as an entity may in fact warrant action that is contrary to the wishes of shareholders.⁶⁷ We move on now to examine this duty to the corporate entity.

B. Duty to the Corporate Entity: Defending the Corporate Bastion

A good understanding of the director's duty to the corporation can be gained from examining a series of cases from Delaware arising, in one form or another, out of the takeover boom of the 1980s. These cases make clear that: (1) the directors of a corporation are primarily responsible for running that corporation's business;⁶⁸ (2) the directors are protected in running the business by the "business judgment rule [which] is a 'presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company'";⁶⁹ (3) the business judgment rule may be modified when the directorial decisions being challenged involve the imposition of takeover defenses—due to the inherent conflicts of interest;⁷⁰ and (4) when a business is put up for sale, the primary duty of the directors becomes maximizing the value the shareholders receive from that sale.⁷¹ What is most important about these cases for our purposes is that, when viewed as a whole, they leave little doubt that in running the business directors

⁶⁷ See *Paramount Communications Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

⁶⁸ See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1991 & Supp. 1992) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors. . . ."); Report of the Committee on Corporate Laws, *Corporate Director's Guidebook Third Edition*, 56 BUS. LAW. 1571, 1579 (2001) ("All corporate powers shall be exercised by or under authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors. . . .") (quoting the Model Business Corporation Act).

⁶⁹ *Unocal*, 493 A.2d at 954 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

⁷⁰ See *id.* at 955.

⁷¹ See *id.*

have “a supervening duty to protect the corporate enterprise”⁷² that includes consideration of non-shareholder constituencies.

In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court upheld a selective self-tender offer implemented by the board of directors of Unocal for the purposes of thwarting what the board saw as a coercive tender offer by one of Unocal’s shareholders, T. Boone Pickens, Jr.—“a corporate raider with a national reputation as a ‘greenmailer.’”⁷³ In doing so, the court affirmed that “[t]he board has a large reservoir of authority upon which to draw . . . [which] derives from its fundamental duty and obligation to protect the corporate enterprise.”⁷⁴ Exercise of that power would be protected by the business judgment rule, the court explained, under which “a court will not substitute its judgment for that of a board if the latter’s decision can be ‘attributed to any rational business purpose.’”⁷⁵ However, the court did note that in order for the business judgment rule to apply to a board’s decision involving takeover defenses, which may obviously be designed primarily to keep the board in power and thus present the “omnipresent spectre that a board may be acting primarily in its own interests,”⁷⁶ the directors “must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed,”⁷⁷ and that the defensive measure adopted was “reasonable in relation to

⁷² *Id.* at 958.

⁷³ *Id.* at 956.

⁷⁴ *Id.* at 953-54.

⁷⁵ *Id.* at 954 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

⁷⁶ *Id.*

⁷⁷ *Id.* at 955.

the threat posed.”⁷⁸ Finding both of these elements present, the *Unocal* Court upheld the selective self-tender, even though it essentially pitted the board against one of its own shareholders.

Unocal is important to us here for two primary reasons. First, it highlights the role of the board of directors as managers of the business as opposed to mere shareholder pawns. In fact, the case has been read to stand for the proposition that “a board can make decisions in the best interests of the corporation even if the shareholders would have preferred other courses of action,” and that this “necessarily implies that the corporation is more than just the sum of its shareholders.”⁷⁹ Second, in discussing how a determination is made of whether a defensive measure is reasonably related to the threat presented, the court included “the impact on ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)” in its exposition of factors that may be considered by a board in assessing the impact of a takeover bid on the corporate enterprise.⁸⁰ The explicit mention of non-shareholder constituencies by the court is important because it has been suggested that the ultimate reason the *Unocal* Court gave directors a role in such a clear conflict-of-interest situation, and stepped away from the court’s usual formalistic mode of analysis in order to do so, was because “more was at stake than simply stockholder interests.”⁸¹

⁷⁸ *Id.*

⁷⁹ Gouvin, *supra* note 5, at 298.

⁸⁰ *Unocal*, 493 A.2d at 955. *Cf.* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (“A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders.”).

⁸¹ Mitchell, *supra* note 36, at 613.

The director's duty to the corporation was further developed in *Paramount Communications Inc. v. Time Inc.*⁸² In that case, the board of directors of Time, Inc., decided it would be in the best interests of Time to pursue a merger with Warner Communication, Inc.⁸³ However, shareholder approval of such a merger fell into serious doubt after Paramount Communications, Inc., made a very attractive "all-cash offer to purchase all outstanding shares of Time for \$175 per share," which was \$49 per share above the then-current trading price.⁸⁴ Thus, Time restructured its business combination with Warner as a tender offer, in order to avoid a shareholder vote.⁸⁵ The Delaware Supreme Court upheld the decision to change the structure of the transaction, along with the adoption of various measures designed to impede Paramount's pursuit of Time.⁸⁶

⁸² 571 A.2d 1140 (Del. 1989). *Cf. Gouvin, supra* note 5, at 299 ("The *Time* opinion rests firmly on the premise that the corporation is an entity in its own right whose interests are not always identical with the interests of its shareholders."); *Mitchell, supra* note 36, at 611:

Ironically, the occasion for pronouncing directorial hegemony is a case dealing with the permissible defenses against a tender offer. That directors have a role in this type of transaction at all suggests the independence of their function on behalf of the corporation. After all, a tender offer is nothing more than an offer by a bidder to take up and pay for the shares of a corporation held by each of its stockholders. As such, it is a private transaction between a selling stockholder and a buyer, with no corporate involvement. When an offer to buy stock is addressed to all of the stockholders as a group, the corporation, acting through its board, theoretically has no greater role than when an offer is addressed to an individual stockholder.

⁸³ *Id.* at 1146.

⁸⁴ *Id.* at 1147; *see id.* at 1149 ("Paramount [later] raised its all-cash offer to buy Time's outstanding stock to \$200 per share.").

⁸⁵ *Id.* at 1148.

⁸⁶ *Id.* at 1142; *see id.* at 1146-47:

Time's board adopted several defensive tactics. Time entered an automatic share exchange agreement with Warner. . . . Time sought out and paid for "confidence" letters from various banks with which it did business. In these letters, the banks promised not to finance any third-party attempt to acquire Time. . . . Time also agreed to a "no-shop" clause, preventing Time from considering any other consolidation proposal, thus relinquishing its power to consider other proposals, regardless of their merits.

The *Time* Court began, like the court in *Unocal*, by asserting the “broad mandate” of directors “to manage the business and affairs of the corporation.”⁸⁷ Then, following application of the two-part *Unocal* test, the court applied the business judgment rule and approved the board’s actions. Specifically, the court noted that the plaintiffs’ claims that the directors violated their fiduciary duties failed at least in part due to:

[A] fundamental misunderstanding of where the power of corporate governance lies. Delaware law confers the management of the corporate enterprise to the stockholders’ duly elected board representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders. Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.⁸⁸

As one commentator has pointed out, “[w]hat is especially noteworthy is that this result was permitted despite the fact that Time’s board and management remained largely intact under the Warner deal, whereas under the Paramount deal, they undoubtedly would have been removed. . . . [a] classic conflict-of-interest transaction.”⁸⁹ If such directoral prerogative can withstand challenge in the public company setting, where the perception is that the risk of abuse

See also id. at n.5:

Time [already] had in place a panoply of defensive devices, including a staggered board, a ‘poison pill’ preferred stock rights plan triggered by an acquisition of 15% of the company, a fifty-day notice period for shareholder motions, and restrictions on shareholders’ ability to call a meeting or act by consent.

Cf. id. at n.11, (“Time encouraged local cable franchises to sue Paramount to prevent it from easily obtaining the [necessary] franchises.”).

⁸⁷ *Id.* at 1150.

⁸⁸ *Id.* at 1154 (internal citations omitted); *see* *Paramount Communications Inc. v. Time Inc.*, 1989 WL 79880, *30 (Del. Ch. 1989) (unpublished) (“The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of [the] shares. In fact, directors, not shareholders, are charged with the duty to manage the firm.”).

⁸⁹ Mitchell, *supra* note 36, at 619-20.

resides in the self-interest of unchecked management, then how much more should that prerogative be protected in the wholly-owned subsidiary context, where the greatest risk of abuse arguably comes from the parent?⁹⁰

But we are not finished with our examination of the director's general duty to the corporation. There is a situation in which the directors' primary duty is to maximize shareholder value in the short term over all else, and that is when the corporation is being put up for auction. These so-called "*Revlon* duties", as set forth in the case of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,⁹¹ are imposed when the decision to sell the business has already been made.⁹² What is interesting about *Revlon* duties for our purposes here is that, by making the maximization of shareholder value the sole goal of directoral decisionmaking in the auction setting, they further affirm the director's duty to the corporation as an entity in the ordinary case. For instance, the *Revlon* Court explicitly stated that only after the corporation was put up for sale had "[t]he duty of the board . . . changed from the preservation of *Revlon* as a corporate entity to

⁹⁰ Ultimately, I will argue that the solution to the problem of the insulated nature of the wholly-owned subsidiary is to either create a duty running to non-shareholder constituents or grant them a right to enforce the directors' duty to the corporate entity.

⁹¹ 506 A.2d 173 (Del. 1986).

⁹² See *Time*, 571 A.2d at 1150:

Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction . . . involving the breakup of the company.

(Internal citation omitted).

the maximization of the company's value at a sale for the stockholders' benefit."⁹³ Only then were the directors allowed to turn away from their role as "defenders of the corporate bastion."⁹⁴

One of the things these cases teach us is that, as highlighted at the beginning of this Part III, "the law of fiduciary obligation is situation-specific."⁹⁵ In the normal circumstance, the doctrine of shareholder primacy is a satisfactory norm to guide directors in their decision-making. There are situations, however, where horizontal conflicts⁹⁶ emerge between shareholders and other constituents of the corporation (as well as the corporate entity itself) and the directors are at the very least permitted to consider the impact of their decisions upon these stakeholders and act contrary to the short-term goals of shareholders in order to protect the corporate entity. Nevertheless, once the decision has been made to sell the business, the directors' duties are adjusted once again to facilitate maximizing the value received by the shareholders. As we shall see in the next section, the situation-specific nature of the corporate director's fiduciary duties does not end here. Coming within "the vicinity of insolvency"⁹⁷ brings creditors into the scope of those duties. All this, of course, supports the argument that the wholly-owned subsidiary context presents its own unique situation—one that requires an extension of fiduciary duties to include stakeholders.

⁹³ *Revlon*, 506 A.2d at 182.

⁹⁴ *Id.*; see also *Paramount Communications Inc. v. QVC Networks Inc.*, 637 A.2d 34, 46 (Del. 1994).

⁹⁵ DeMott, *supra* note 69.

⁹⁶ See generally Mitchell, *supra* note 36, at 592 (arguing that fiduciary duties work well for what he calls "vertical conflicts" between the directors and shareholders, but—due to a reliance on the shareholder norm—are inefficient in addressing "horizontal conflicts" between shareholders and other constituents of the corporation).

⁹⁷ *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, Civ. 12150, 1991 WL 277613, at *34 (Del. Ch.1991).

C. Duty to Creditors: Protecting the Community of Interests in the Corporation--Not “If”, but “When”

In 1939, Justice Douglas stated that a director’s fiduciary duty is “designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.”⁹⁸ While the current status of fiduciary duties to creditors is not universally consistent,⁹⁹ the majority rule appears to be that where a corporation finds itself “in the vicinity of insolvency” a duty arises to maintain corporate assets for creditors.¹⁰⁰ This is at least in part due to the fact that “[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors.”¹⁰¹ Thus, “the general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent ‘special circumstances . . . e.g., fraud, insolvency, or a violation of a statute. . . .’”¹⁰²

Another interesting aspect of the cases imposing a fiduciary duty on corporate directors to maintain corporate assets on behalf of creditors is the justification that, since creditors make up part of “the community of interest that sustained the corporation,”¹⁰³ the creditors’ interests

⁹⁸ *Pepper v. Litton*, 308 U.S. 295, 307 (1939).

⁹⁹ *Compare Allied Indus. Int’l, Inc. v. AGFA-Gevaert, Inc.*, 688 F. Supp. 1516, 1521 (S.D. Fla. 1988) (“As president, director, and sole shareholder of Allied, Michael Rubin owed a fiduciary duty to the corporation and its creditors.”), *with* Bratton, *supra* note 5, at n.46:

The [ALI’s] Principles’ [of Corporate Governance’s] treatment of the creditors’ interest in the corporation makes a notable point of contrast. The drafters take no position” on the matter of corporate dut[y] to creditors. They acknowledge that some observers favor a duty to creditors, but note that Part V “does not treat” the matter as such, leaving creditor protection to contract and bankruptcy law.

¹⁰⁰ *Credit Lyonnais*, 1991 WL 277613, at *34.

¹⁰¹ *Id.* at *34 n.55.

¹⁰² *Geyer v. Ingersoll Publ’n Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (quoting *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), *rev’d* in part on other grounds, 347 A.2d 133 (Del. 1975)).

¹⁰³ *Credit Lyonnais*, 1991 WL 277613, at *34.

can not be ignored when certain difficult decisions concerning the future of the corporation have to be made. As the Delaware Court of Chancery has noted:

[I]f we consider the community of interests that the corporation represents ... directors who are capable of conceiving of the corporation as a legal and economic entity ... will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.¹⁰⁴

Thus, as we saw in the cases discussing the director's duty to the corporation above, there is more to running the business than following the whims of the shareholders.¹⁰⁵ We turn next to a closer examination of the specific duties running to the "other constituencies" that make up the community of interests supporting the corporation.

D. Duty to Other Constituencies: A Work in Progress

In general, U.S. corporate law has left non-shareholder constituents of the corporation (other than creditors) to fend for themselves under tort and/or contract law. Even then, their remedy is held in check by principles of limited liability, except where they can pierce the corporate veil.¹⁰⁶ However, as has been pointed out, the takeover boom of the 1980s raised

¹⁰⁴ *Id.* at *34 n.55.

¹⁰⁵ The distinctions between a duty to creditors, a duty to the community of interests that support the corporation and a duty to the corporate entity are not always clear. See *In re RSL Com Primecall, Inc. v. Beckoff*, 2003 WL 22989669, at *7-8 (Bankr. S.D.N.Y. Dec. 11, 2003) ("[U]pon insolvency directors owe fiduciary duties to creditors or, stated differently, to the corporation and to all of its interested constituencies, including creditors and shareholders. [D]irectors must consider the best interests of the corporation, and not just the interests of either creditors or shareholders alone."). The fine lines of these distinctions are not as important, for our purposes here, as the recognition that duties exist beyond maximizing shareholder value.

¹⁰⁶ See Carsten Alting, *Piercing the Corporate Veil in American and German Law - Liability of Individuals and Entities: A Comparative View*, 2 TULSA J. COMP. & INT'L L. 187, 191 (1995) ("rules of piercing the veil . . . can be applied only in exceptional cases. German corporate law, in the context of affiliated entities, has a rather different approach to the issue of disregarding an entity's veil of limited liability. In contrast, the American law extends the equitable rules of piercing the veil to situations involving affiliated entities") (footnote omitted); Rands, *supra* note 20, at 444 (noting "the frequently expressed judicial reluctance to pierce the corporate veil."). Agency principles

awareness of the limitation of shareholder primacy as a means of best achieving the desired ends of corporate law. In response to this realization, both the courts and legislatures sought to improve the extent to which stakeholder interests were protected, or at least considered, during times of dramatic corporate change.¹⁰⁷

As far as case law goes, we have already seen that, in deciding what corporate actions are in the best interest of the business, directors may consider non-shareholder constituencies. However, as far as any independent duty running to non-shareholder constituents, the best that one can say under that case law is that since the *Revlon* court found consideration of non-shareholder constituencies “inappropriate [in the auction setting because] the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder”¹⁰⁸, those constituencies must otherwise make up part of the corporate enterprise to be protected.¹⁰⁹ Thus, like creditors who at certain times are beneficiaries of independent duties running to them as members of the community of interest that has sustained the corporation, so too should non-

and enterprise liability are other ways in which a parent can be held liable for the actions of its subsidiary. *Cf.* NLRB v. Deena Artware, Inc., 361 U.S. 398, 402-03 (1960) (pointing out that even though “[t]he insulation of a stockholder from the debts and obligations of his corporation is the norm, not the exception. ‘Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent.’” (quoting Justice Cardozo in *Berkey v. Third Avenue R. Co.*, 155 N.E. 58, 61 (N.Y. 1926))) (citations omitted).

¹⁰⁷ See James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 103 (1991).

¹⁰⁸ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173, 182 (Del. 1986).

¹⁰⁹ *Cf.* Gouvin, *supra* note 5, at 311:

In the language of the *Revlon* court, concern for nonshareholder constituencies in the change-of-control context is ‘inappropriate’ because the ‘object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.’ This language supports the idea that the concept of the ‘corporation’ includes the interests of nonshareholders. This language implies a difference between maintaining the ‘corporate enterprise’ (in which context concern for nonshareholders is appropriate) and maximizing shareholder value (i.e., selling the shareholder interests to the highest bidder).

(footnote omitted) (quoting *Revlon*, 506 A.2d at 182.)

shareholder constituencies like employees, customers, and members of the local community¹¹⁰ be beneficiaries of at least some type of similar duty, at least under certain circumstances.

However, there is little, if any, case law available to provide either a means or a method for any type of independent fiduciary duty to stakeholders to be exercised.¹¹¹ Statutory law, however, does provide slightly more guidance. Connecticut, for example, has a stakeholder statute that:

requires the board to take into consideration the “long-term” interests of the corporation and its shareholders, the interests of employees, customers, creditors, and suppliers and “community and societal considerations” when making decisions in connection with the merger or the sale of substantially all the assets of a publicly traded Connecticut corporation.¹¹²

Meanwhile, forty other states permit consideration of other constituencies by statute.¹¹³ In addition, the ALI Principles of Corporate Governance specifically allow consideration of non-shareholder constituency interests.¹¹⁴

¹¹⁰ See Carney, *supra* note 66, at 414-15:

Communities, including individuals, other businesses, school districts, and state and local governments, make investments in specific assets in reliance on a firm’s location of a plant or facility in that community. Those investments frequently will be dissipated if the firm later closes the plant and relocates, and no new employer occupies the plant. All the road, water, and sewer improvements built to serve the plant will become worthless, schools will become vacant as workers leave, and the value of homes built in anticipation of continued employment will decline.

¹¹¹ Cf. Enriquez, *supra* note 18, at 105:

[N]o decisions specifically provide directors guidelines for determining what constituency interests should be considered. More importantly, no decisions provide methods by which non-shareholder constituents can enforce their interests. Therefore, since non-shareholder constituents lack standing to bring suit, directors have very little incentive to consider them other than to justify their decisions made in the hostile takeover setting.

¹¹² Gouvin, *supra* note 5, at 312 n.119 (quoting CONN. GEN. STAT. ANN. § 33-313 (West Supp. (1995))).

¹¹³ Hale, *supra* note 10, at 833.

¹¹⁴ Gouvin, *supra* note 5, at 314 (“The Principles also permit the corporation to use a ‘reasonable amount’ of its resources for ‘public welfare, humanitarian, educational, and philanthropic purposes.’”).

While these “statutes have been . . . criticized by [some] legal commentators,”¹¹⁵ their adoption by a majority of states demonstrates a belief that the fiduciary duties of corporate directors extend beyond merely maximizing shareholder short-term return.¹¹⁶ In fact, they may well constitute an approval of a concept of the firm that is lacking in case law.¹¹⁷ At the same time, “[t]hese statutes raise many questions, such as whether they give nonshareholders standing to sue. . . .”¹¹⁸

What this brief overview of the current state of the law concerning the responsibilities of corporate directors to stakeholders tells us is that the foundation is clearly in place for an independent duty running to stakeholders. Not only is the foundation in place, but directors

¹¹⁵ *Id.* at 313 (citing Carney, *supra* note 66; Hanks, Jr., *supra* note 117; and Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 36 (1991) (“arguing that the ‘gap-filling’ function of the fiduciary duty should apply only to the director-shareholder relationship because of the difficulties of providing explicit contractual mechanisms to cover all aspects of that dynamic, while on the other hand, nonshareholder constituents do possess adequate contractual protections”)).

¹¹⁶ *Id.* Compare Steven M. H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 163 (1991) (counting twenty-nine states with such statutes), with Hale, *supra* note 10, at 833 (counting forty states with such statutes in 2003).

¹¹⁷ See Gouvin, *supra* note 5, at 313 (“[T]he real function of the statutes [may be] to help the directors achieve their primary goal of discharging their duty to the corporation, with the understanding that ‘corporation’ is broadly defined to include all constituents that contribute to the corporate enterprise.”). Cf. Mitchell, *supra* note 36, at 629-30 (“The Delaware Supreme Court’s intermittent references to constituencies, combined with the chancery court’s explicit questioning of traditional corporate theory, suggests that the case law of the nation’s most important corporate law court is moving, although tentatively, in the direction attained by constituency statutes.”).

¹¹⁸ Gouvin, *supra* note 5, at 313. See also Enriquez, *supra* note 18, at 105-06:

[W]hile these statutes are generally supportive of other constituents, they fail to provide non-shareholder constituents with a method for preserving their interests. This is due to the fact that the statutes permit, but do not mandate, that directors consider other constituencies. Thus, they appear to be nothing more than additional tools for directors to use when justifying the use of defensive maneuvers in a *Unocal* situation.

(citations omitted). Cf. Mitchell, *supra* note 36, at 604 (“Given that the rights to be asserted and duties to be enforced in the derivative action are corporate rights and duties, it might seem that any constituent with a legitimate interest in the corporation—for example bondholders—would be able to bring such a suit.”) (citations omitted).

already cope with the reality of such additional duties in particular settings. As one commentator has pointed out:

The concern over subsidiary director liability to nonshareholders is not a purely academic enterprise. For example, in many cases the directors of subsidiary banks have found themselves subject to liability to the FDIC. The chain of events leading to liability begins when a bank fails and the FDIC is appointed as receiver. As receiver, the FDIC must maximize the value of assets owned by the failed bank, including any causes of action the bank may have. Therefore, the FDIC may bring claims on behalf of the failed bank against the bank's directors for failure to take action in the best interest of the bank. In addition, bank directors are personally liable under federal banking laws.¹¹⁹

Thus, the foundation is in place and the reality is that at least some wholly-owned subsidiary directors already do more than simply serve the parent. Let us now look more closely at the subsidiary in particular--its historical background and relevant case law.

IV. SUBSIDIARIES: SEPARATE ENTITIES WITH THEIR OWN BOARD OF DIRECTORS—THAT SHOULD MEAN SOMETHING

In this article, we are focusing specifically on the unique position of directors of wholly-owned subsidiary corporations. The law in this area is less than clear.¹²⁰ “In part, this lack of clarity can be attributed to a lack of legal precedent, which, in turn, can be attributed to the fact

¹¹⁹ Gouvin, *supra* note 5, at 318 (footnote omitted).

¹²⁰ *See id.* at 288-89.

Like all corporate directors, the directors of subsidiaries are bound by fiduciary duties. However, as Justice Frankfurter observed more than fifty years ago, “to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry.” In the context of the parent- subsidiary relationship, a necessary inquiry is: To whom does the subsidiary director owe the fiduciary duty? That simple question defies a simple answer; it is not always clear to whom subsidiary directors owe their fiduciary duty. Case law leaves subsidiary directors wondering whether their duty runs primarily to the parent corporation as shareholder, to the subsidiary corporation itself as an entity, or even to other constituencies such as creditors, regulators, employees, and communities.

(citations omitted) (quoting *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943)). *See id.* at 289 n.8 (citing *Berkey v. Third Avenue Ry.*, 155 N.E. 58, 61 (1926) (Cardozo, J.) (“the whole problem of the relation between parent and subsidiary corporations is one that is still enveloped in the mists of metaphor.”)).

that a parent corporation is unlikely to sue the board of its wholly owned subsidiary.”¹²¹ For this reason, it is important to review the history of the subsidiary as corporate entity and closely examine the few cases that do directly touch on the area.

A. Historical Background: From Illegal to Dominant

In the early 1800s, corporations were prohibited from owning stock in other corporations.¹²² In 1888, New Jersey became first state to allow corporations to own stock in other companies.¹²³ Some would argue that this was just another part of the race to bottom:

For the robber barons, [trusts] were a way of getting around primitive antitrust laws prohibiting companies from owning shares in each other. . . . [I]n 1892, the Ohio Supreme Court . . . renounc[ed] the trust agreement [of Rockefeller’s Standard Oil Trust] saying that the trust had created a monopoly. . . . Standard’s bold response—that the only effect “will be to inconvenience us a little”—was partly true. Rockefeller now had an excuse to begin moving his empire to New Jersey, which in 1889 had created the most liberal incorporation law in the country, with politicians even setting up a company to handle the paperwork. The New Jersey law allowed for holding companies—umbrella companies that own a controlling proportion of the voting shares of subsidiary companies.¹²⁴

Since that time, subsidiaries have become a prevalent force in our society:

Holding companies dominate our economy. In 1995, the ten largest companies on the Fortune 500 owned an average of 62 subsidiaries each. Many subsidiary corporations, though owned entirely by another corporation, are themselves gigantic corporate enterprises. For example, Philip Morris, the tenth largest U.S.

¹²¹ *Id.* at 324.

¹²² See FRIEDMAN, *supra* note 26, at 520.

¹²³ See Gouvin, *supra* note 5, at n.21.

¹²⁴ Micklethwait & Woolridge, *supra* note 21, at 67-68. See also Cary, *supra* note 24, at 664:

“In 1896 New Jersey adopted what is regarded as the first of the modern liberal corporation statutes. As Mr. Justice Brandeis pointed out in *Liggett Co. v. Lee*, 288 U.S. 517, 562-63 (1933), this act is commonly credited with attracting the incorporation of the New Jersey trusts, such as the old Standard Oil Company, which were not trusts at all but corporations operating as consolidated or holding companies.”

(Internal citations omitted).

corporation, owns such major businesses as the Miller Brewing Company, Kraft Foods, and the Philip Morris tobacco manufacturing operating unit.¹²⁵

Meanwhile, the law has for the most part treated parent companies and their subsidiaries as separate legal entities¹²⁶ and, while there are a variety of reasons why subsidiaries are formed, this “idea of parent and subsidiary as independent entities is central to the primary reason for forming subsidiaries -- limitation of the parent’s liability.”¹²⁷ It is this confluence of factors—the important role of wholly-owned subsidiaries in our society, the rights bestowed upon them as separate corporate entities, their domination by a single parent, and the insulation provided that parent—which create the “special circumstances” warranting the extension of rights to the stakeholders of the wholly-owned subsidiary.

B. Relevant Cases: Wholly-Owned Subsidiary Directors—Not Just Pawns

Our analysis of relevant cases focuses on two cases that, when taken together, stand for the proposition that “[t]he directors of a wholly-owned subsidiary owe the

¹²⁵ Gouvin, *supra* note 5, at 287.

¹²⁶ See Enriquez, *supra* note 18, at 98 (“Legally, subsidiary corporations are generally treated as entities that are separate and distinct from their parent companies.”).

¹²⁷ See Gouvin, *supra* note 5, at 321; William J. Rands, *Domination of a Subsidiary by a Parent*, 32 IND. L. REV. 421, 451 (1999) (stating that a traditional strategy frequently used by corporate lawyers is to “tell the parent that it could significantly limit the impact of environmental risks merely by establishing a subsidiary corporation to conduct hazardous waste activities”). *But see* Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 772 (1984). (“[A] corporation may adopt the subsidiary form of organization for valid management and related purposes. Separate incorporation may improve management, avoid special tax problems arising from multistate operations, or serve other legitimate interests.”) Because lawyers also have fiduciary duties to their clients, they should be wary of advocating strategies that may operate as a sham. *See, e.g.*, Irma S. Russell, *Keeping the Wheels on the Wagon: Observations on Issues of Legal Ethics for Lawyers Representing Business Organizations*, 3 WYO. L. REV. 513, 514 (2003) (exploring the obligation of the lawyer to corporate clients and to society, including the duty to provide the client with independent professional judgment).

corporation fiduciary duties, just as they would any other corporation. As a result the subsidiary has standing to sue for breach of those duties.”¹²⁸

1. *Anadarko*

In the 1988 case of *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171 (Del. 1988), the Supreme Court of Delaware stated that “in a parent and wholly-owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders.”¹²⁹ In that case, a parent corporation had decided to spin off its wholly-owned subsidiary via issuance of a stock dividend.¹³⁰ Before the distribution of the stock dividend was completed (but after its declaration) the board of directors of the wholly-owned subsidiary approved a series of agreements between the parent and the wholly-owned subsidiary which favored the then-parent company.¹³¹ When the distribution was completed, the new shareholders brought suit alleging

¹²⁸ *First American Corp. v. Al-Nahyan*, 17 F. Supp. 2d 10, 26 (D.D.C. 1998); see Gouvin, *supra* note 5, at 294 (“Two recent efforts to clarify the underlying precepts of corporate governance, the A.B.A.’s Corporate Director’s Guidebook, and the A.L.I.’s Principles of Corporate Governance, make no special mention of the role of directors of subsidiaries. Perhaps this silence indicates that the duties of subsidiary directors are the same as those for corporate directors generally.”).

¹²⁹ *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1174 (Del. 1988) (citing *Sinclair Oil Corporation v. Levien*, 280 A.2d 717, 720 (Del. 1971); *Goodman v. Futrovsky*, 213 A.2d 899, 902 (Del. 1965)). This is a very interesting conclusion to draw from the portions of the two opinions cited. *Sinclair* stands primarily for the proposition that when a parent enters into a transaction with one of its subsidiaries, that transaction must meet the test of intrinsic fairness where “the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary.” *Sinclair*, 280 A.2d at 720. If the minority is not deprived of anything as a result of the parent’s transaction with its subsidiary, then any challenges of that transaction are subject to the business judgment rule. *Id.* at 722. It seems somewhat of a stretch to equate these statements of the law with a pronouncement that subsidiary directors are absolved of all duties other than doing the bidding of the parent when there are no minority shareholders involved. As for the *Goodman* opinion, the best that can be said for it as far as supporting the *Anadarko* Court’s conclusion is that it states flatly in the portion of the text cited, that “the Cohens and Lehrmans were the sole owners of Giant and could do with it as they wished.” *Goodman*, 213 A.2d at 902. It should not be too much to ask for more “analysis” than that in order to justify turning corporate directors with statutorily conferred obligations to manage an enterprise into mere shareholder pawns.

¹³⁰ See *Anadarko*, 545 A.2d. at 1172.

¹³¹ *Id.* at 1174.

that at the time of the agreements the subsidiary's directors owed a fiduciary duty to the prospective shareholders, which they violated by entering into the agreements.¹³² The court declined to find such a duty.¹³³

The holding in *Anadarko* raises a number of questions. First, if it is true that in some circumstances corporate directors owe duties to the corporate entity as separate from its shareholders, then where does such a duty fit in with *Anadarko's* affirmation of the Court of Chancery's ruling that "as a matter of law the former directors of *Anadarko* owed a fiduciary duty only to the parent corporation, Panhandle, at the time the disputed agreements were approved."¹³⁴ According to the *Anadarko* Court, the parent has no such fiduciary duty to the subsidiary corporate entity.¹³⁵ Also, how does the *Anadarko* ruling leave room for corporate directors of wholly-owned subsidiaries to carry out their state conferred prerogative to consider other constituencies?¹³⁶

If *Anadarko* is read to preclude the directors of the wholly owned subsidiary from considering any other interests than those of the parent,¹³⁷ then:

There are at least two possibilities to explain the fate of the subsidiary directors' duty to the corporation and other constituencies. The first possibility is

¹³² *See id.*

¹³³ *See id.* at 1177.

¹³⁴ *Id.* at 1172.

¹³⁵ *See Id.* at 1174 ("[A] parent does not owe a fiduciary duty to its wholly owned subsidiary.").

¹³⁶ *See* Gouvin, *supra* note 5, at 315 ("If directors of subsidiaries, like those of other corporations, must or may take into account the interests of nonshareholders, how does that consideration fit with the *Anadarko* assertion that the subsidiary directors owe a duty only to the parent corporation?").

¹³⁷ *See* Altig, *supra* note 116, at 221 (citing *Anadarko* for proposition that "if there is no minority shareholder, fiduciary duties do not exist"). Gouvin, *supra* note 5, at n.218 ("This is the position taken by the Delaware Supreme Court in [*Anadarko*] and adopted as black-letter law in 3 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS 852 n.4.50 (Supp. 1994), citing only *Anadarko* for support.").

that duties to nonshareholders do not exist in the wholly owned subsidiary context. This conclusion must be wrong, or else shareholders could cut off any fiduciary duty to third parties merely by placing all their operating companies in the ownership of a holding company. The second possibility is that the board of directors of the holding company bears a duty to the “corporation” it directs, and that corporation is defined to include the wholly owned subsidiaries. This approach seems workable, but case law supporting it is hard to find. In this view, the duties of the subsidiary directors would be imposed on the parent.¹³⁸

Fortunately, while *Anadarko* could have been read to broadly state the rule of law in this area, a later decision severely narrowed the interpretation of that holding.

2. *Al-Nahyan*

In a classic case of how wholly-owned subsidiary directors can end up answering to someone other than the sole shareholder, *First American Corp. v. Al-Nahyan*, 17 F. Supp. 2d 10 (D. D.C. 1998), dealt with the highly publicized scandal involving Bank of Credit and Commerce International.¹³⁹ As a result of “complex and massive fraud,”¹⁴⁰ *Al-Nahyan* Corporation was placed into the hands of a court-appointed Trustee.¹⁴¹ The Trustee, as part of his duty to maximize the assets of First American, pursued claims against the former directors of First American for breach of fiduciary duties for, among other things, entering into transactions unfavorable to First American solely for the purposes of benefiting the parent.¹⁴² The former

¹³⁸ Gouvin, *supra* note 5, at 316.

¹³⁹ See Miller, *supra* note 4, at 424, 451 (referring to the BCCI scandal as “[o]ne of the most notorious [financial] failures of all time” and noting specifically BCCI’s “arcane and byzantine” corporate structure, through which it “operated in seventy-two countries through an array of subsidiaries, divisions, joint ventures, and other corporate vehicles”).

¹⁴⁰ *Al-Nahyan*, 17 F. Supp. 2d at 17 (quoting E. Gerald Corrigan, J. Virgil Mattingly, Jr. & William Taylor, *The Federal Reserve’s Views on BCCI*, 26 INT’L LAW 963, 970-71 (1992)).

¹⁴¹ *Id.* at 18.

¹⁴² *Id.* at 14-16.

directors of First American responded by citing *Anadarko* for the proposition that the only fiduciary duties they owed were to the parent.¹⁴³

The *Al-Nahyan* Court, however, responded by explaining that *Anadarko* applies “only to the question of who are the shareholders to whom the directors of a wholly-owned subsidiary owe duties when the corporation is being spun off—the parent or the prospective purchasers.”¹⁴⁴ As to the general duties of wholly-owned subsidiary directors, the *Al-Nahyan* Court cited *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 43 (Del. 1993), for the proposition that “[d]irectors owe fiduciary duties to the corporation and to the shareholders, taken as a whole.”¹⁴⁵ Thus, “the directors of a wholly-owned subsidiary owe the corporation fiduciary duties, just as they would any other corporation[,]” and “[a]s a result the subsidiary has standing to sue for breach of those duties.”¹⁴⁶

The Court in *Al-Nahyan* also went on to say, however, “[t]he far more perplexing issue is to define the scope of the duties. . . . Those questions will await future cases and further commentary for answers.”¹⁴⁷ Thus, what we can take from *Al-Nahyan* is that the fiduciary duties of the wholly-owned subsidiary director extend beyond merely serving the whims of the parent,

¹⁴³ *Id.* at 26.

¹⁴⁴ *Id.*; cf. *RSL Com Primecall, Inc. v. Beckoff (In re RSL Com Primecall, Inc.)*, 2003 WL 22989669, at *13 (Bkrcty. S.D.N.Y., 2003) Responding to argument that *Anadarko* stands for the proposition that directors of a wholly-owned subsidiary owed duties only to their parent in the case of insolvency by stating that:

It would be absurd to hold that the doctrine that directors owe special duties after insolvency is inapplicable when the insolvent company is a subsidiary of another corporation. That is precisely when a director must be most acutely sensitive to the needs of a corporation’s separate community of interests, including both the parent shareholder and the corporation’s creditors.

¹⁴⁵ *Al-Nahyan*, 17 F. Supp. 2d at 26.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* (footnote omitted) (citing Gouvin, *supra* note 5, at 290).

but that a need exists to define the exact nature of those duties. The following section explains why the duties of wholly-owned subsidiary directors should be expanded beyond those of other corporate directors to include some form of duty running to non-shareholder constituents.

V. WHY THE DIRECTORS OF WHOLLY-OWNED SUBSIDIARIES SHOULD BE SUBJECT TO MORE STRINGENT FIDUCIARY DUTIES

It has been argued that in the wholly-owned subsidiary context, the power of a parent entity is so great as to make it unrealistic to expect wholly-owned subsidiary directors to consider any other interests:

[Corporate directors] understand that ultimate control of the corporation rests with the shareholders, who can either sell their shares to other investors or vote different directors into office. The directors also understand that the shareholders are the only group that can sue the board on behalf of the corporation. This centralization of power in the shareholders focuses director attention on shareholder interests to the exclusion of other interests.

. . . [These problems] are especially severe in the context of the wholly owned subsidiary. If subsidiary directors owe the same duties as directors of corporations generally, the subsidiary directors may often encounter horizontal conflicts [between the interests of the parent, the corporate entity and other constituents] on a regular basis. Additionally, unlike the directors of a publicly traded corporation whose shareholders may be widely scattered, poorly organized, and more likely to sell their stock than to bring a derivative suit, the directors of the wholly owned subsidiary have their one and only shareholder looking over their shoulders on a regular basis. Since the parent entirely controls the subsidiary's management, it is unrealistic to expect the subsidiary directors to act solely in the best interests of the subsidiary corporation even though such action would ordinarily be required for corporate directors.¹⁴⁸

However, as we have seen, the argument that wholly-owned subsidiary directors should be mere agents of the parent has already been rejected.¹⁴⁹ This is proper in light of the statutorily

¹⁴⁸ Gouvin, *supra* note 5, at 304 (citations omitted).

¹⁴⁹ See Gouvin, *supra* note 5, at 305 (“[T]he law has treated a parent corporation and its subsidiaries as independent entities.”).

mandated role of directors and the legal precedent, which defines that role to include consideration of interests other than solely those of the parent.¹⁵⁰ Even if this were not the case, we might still want the wholly-owned subsidiary's directors to be empowered to do more than act as mere agents of the parent because they are closer to the entity itself and its constituents.¹⁵¹ What is important to note is that while the pressures upon wholly-owned subsidiary directors do not excuse them from carrying out their duties, they do call into question their independence in cases involving horizontal conflicts.¹⁵² Generally, directors can shield their decisions from much scrutiny by successfully claiming independent decision-making.¹⁵³ Where independence is lacking, the result often is that the directors do not get the benefit of the business judgment rule. But without a stakeholder right to challenge directoral decision-making, that "correction" becomes meaningless. Rather, an additional mechanism is needed to keep wholly-owned

¹⁵⁰ See, e.g., *supra* note 144.

¹⁵¹ Cf. Hale, *supra* note 10, at 843:

Decision-making power was once vested within local communities where corporate leaders were able to see the connection between their decisions and the well-being of stakeholders. Now, however, most corporations are massive bureaucracies in which key decision-makers might have little meaningful interaction with employees, vendors, suppliers, consumer advocates, charities, or local communities.

See also Armond W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 360, 368 (2004) (stating that "[w]ell informed and objective monitors—the board or shareholders—provide the most effective supervision and monitoring," and arguing that "effective monitoring of corporate management cannot exist unless the monitors possess the characteristics of either proximity or objectivity" (emphasis added)); Charles M. Elson, *Enron and the Necessity of the Objective Proximate Monitor*, 89 CORNELL L. REV. 496, 497 (2004) (arguing that "while active, nonproximate monitors may be helpful, the real key to the prevention of Enron-type scandals centers on the proximate monitors, namely, the company's directors").

¹⁵² See The Committee on Corporate Laws, Report, *Corporate Director's Guidebook Third Edition*, 56 BUS. LAW. 1571, 1590 (2001) (stating that "[t]o encourage an environment likely to nurture independence in fact . . . most corporate governance commentators recommend that at least a majority of the members of the board of a publicly held corporation be independent of management and the controlling shareholders"); Elson, *supra* note 161, at 498, (stating that board independence is "a critical component of modern governance theory").

¹⁵³ See *Revlon*, 506 A.2d at n.3 (citing "presumptions that generally attach to the decisions of a board whose majority consists of truly outside independent directors").

subsidiary directors from doing the bidding of the parent regardless of the costs. Effective stakeholder statutes could provide such a mechanism.

This need for heightened directoral duties in the wholly-owned subsidiary setting is particularly pronounced because market forces generally available to keep directors' interests aligned with maintaining the corporate entity they are overseeing and maximizing its performance are lacking in the wholly-owned subsidiary setting.¹⁵⁴ There is neither the presence of a large institutional investor nor an effective market for corporate control.¹⁵⁵

Normally, the interests of a large institutional investor would often be in conflict with other stakeholders. But in a situation, for example, where a parent wanted to "loot" its majority-owned subsidiary for its own gain, a large institutional minority investor in the subsidiary would have both the interest and standing to protect the entity.¹⁵⁶ Such protection is lacking in the wholly-owned subsidiary context. Furthermore, while the market for corporate control normally serves to focus director interest upon maximizing the performance of the corporation, in the wholly-owned subsidiary setting, that market is only operating at the level of the parent.¹⁵⁷ Thus,

¹⁵⁴ See John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 303 (2004) (listing "takeovers, control contests, institutional activism, and more aggressive boards" as the modern "mechanisms of corporate accountability").

¹⁵⁵ Cf. Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 406-07 (2004) ("The market for corporate control is an extremely powerful corporate governance device, and, in my view, the cornerstone of U.S. corporate governance.").

¹⁵⁶ Cf. Bratton, *supra* note 5, at 1105 n.99:

Corporate governance commentators have given up on the prospect of effective market controls of management to grapple anew with the old problem of management accountability. Ten or fifteen years ago, commentaries dealing with accountability problems often recommended revised fiduciary rules as a solution. . . . Today, the governance debate focuses on self-help by institutional investors rather than direct legal control under the fiduciary rubric.

¹⁵⁷ Cf. Report, *Managing Closely Held Corporations: A Legal Guidebook*, 58 BUS. LAW. 1073, 1084 (2003) ("Public company directors and officers are disciplined by a market that reacts almost instantaneously to news. In

should any conflict arise between the interests of the wholly-owned subsidiary and the parent, the directors of the wholly-owned subsidiary will be incentivized to focus on the parent's interests.¹⁵⁸ All this leads to inefficiencies:

Currently, enterprises operated as corporate families enjoy too much limited liability from the duties owed to nonshareholder constituents. Consequently, the enterprise as a whole does not bear the full cost of its activities. As a result, these enterprises seem more profitable. These artificially profitable companies cause inefficient resource allocation by attracting more investment capital than they should.¹⁵⁹

This is important because even Contractarians acknowledge that such inefficiencies may justify imposing fiduciary duties. As one set of commentators has noted in a different context:

Professor Coffee asserts that firms cannot distinguish themselves regarding expected agency costs, which permits defalcating managers to impose costs on better firms, resulting 'in an unnecessary and socially inefficient increase in the average cost of capital experienced by all firms. In short, there is an externality.'¹⁶⁰ As a result, according to Coffee, investors will overinvest in

contrast, closely held corporations are not subject to SEC audit, reporting or proxy rules and have no disclosure requirements imposed by market forces.'").

¹⁵⁸ For example, in a situation where a parent company's interests diverge from those of its subsidiary, a subsidiary director's commitment to the well-being of employees may be overridden by a desire to serve the parent, absent generally operating market forces. *Cf. Carney, supra* note 66, at 407:

Absent explicit contract terms or competitive markets to ensure contract performance, many employees get their principal protection from managers' realization that employees' goodwill is critical to the success of the business. To the extent that managers are long-term repeat players, developing a reputation for fair dealing with employees has payoffs for both managers and stockholders. . . . In these settings, market forces or relational considerations provide the principal protection for employees.

See also id. at 413 ("Where the expectation of repeated dealings is the motive for good behavior, contracting frequently fails in the last period of dealings between the parties. In these cases it is possible that constituency representation would make a difference.") (internal citation omitted); *Id.* at 422:

These problems are not particularly bothersome as long as the firm is subject to normal market pressures. Farsighted managers and directors will in fact consider the preferences of all stakeholders to the extent that doing so promotes corporate profits. The marketplace will constrain directors when they try to engage in non-profit-maximizing activity.

¹⁵⁹ Gouvin, *supra* note 5, at 337.

¹⁶⁰ One commentator has defined externalities as follows:

poorly managed firms, and the quality of management and of corporate contracts will regress to the mean, as in any “lemons” market. This is a significant point because, if correct and the costs are large enough to be relevant, it justifies imposing fiduciary duties and derivative remedies even on firms that have reasonably concluded that, for them, the burden of such remedies outweighs their benefit.¹⁶¹

Thus, just like fiduciary duties are extended to creditors when the corporation is in the vicinity of insolvency, so should duties be extended to other constituencies when horizontal conflicts are exacerbated by corporate structure. Enforceable constituency statutes allow such an extension.¹⁶²

VI. THE ALTERNATIVES: MAKE STAKEHOLDER STATUTES ENFORCEABLE OR GRANT NON-SHAREHOLDER CONSTITUENTS A DERIVATIVE RIGHT TO ENFORCE THE DUTY TO PROTECT THE CORPORATE ENTITY

One major problem with any theoretical expansion of corporate directors’ fiduciary duties to encompass non-shareholders is that “only shareholders have standing to derivatively sue directors for breaches of duty to the corporation [and they] are unlikely to bring a derivative action for the protection of ‘corporate’ interests unless their own interests are sufficiently

Externalities are economic side effects, arising when contracting parties’ actions affect third parties, who cannot be charged or compensated for the benefits or costs they receive. Pollution is a classic example of an externality: Smoke generated by a factory may impose health costs and cleanup costs on nearby residents who receive no compensation for bearing such costs. Polluters benefit from externalities if their production costs are lower than if polluters had to bear the total cost of their activities, including those incurred by third parties.

Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 411-12 (2004).

¹⁶¹ Butler and Ribstein, *supra* note 63, at 36-37.

¹⁶² See Mitchell, *supra* note 36, at 584-85 (“[C]onstituency statutes permit directors to allocate the externalized costs of rules restraining self-interest among the parties who benefit from those rules by internalizing those costs.”); *id.* at 607 (“[C]onstituency statutes permit the board to reallocate the cost of restraining managerial self-dealing among the corporation’s various constituents, while protecting the board from incurring additional risks of litigation by stockholders who are unhappy with that reallocation.”).

affected.”¹⁶³ This is a reality that can turn stakeholder statutes into a mere means for managers to further entrench themselves.¹⁶⁴ Therefore, if it is correct that the unique aspects of the wholly-owned subsidiary warrant extending fiduciary duties to stakeholders in that setting, then states will have to provide a means for those stakeholders to enforce those duties or else explain why they have not.

Fortunately, a model for the enforcement of stakeholder statutes is already available. Professor Mitchell has proposed a balancing test to determine if directors have violated their duties to stakeholders that continues to respect the basic premise that “directors are to act in the interests of maximizing stockholder wealth.”¹⁶⁵ However, rather than merely permitting boards to consider the impact of various actions upon stakeholders, “boards would further be required to take into account the extent to which such actions harm a range of statutorily identified constituents.”¹⁶⁶ Those stakeholders would then have a right to challenge corporate actions that harmed them, but the burden would be on them not only to prove that they were in fact injured, but also that the injury violated some “express or implied contracts with the corporation,

¹⁶³ Gouvin, *supra* note 5, at 303.

¹⁶⁴ *Cf.* Enriquez, *supra* note 18, at 105 (“[S]ince non-shareholder constituents lack standing to bring suit, directors have very little incentive to consider them other than to justify their decisions made in the hostile takeover setting.”); *id.* at 105-06 (“[W]hile these statutes are generally supportive of other constituents, they fail to provide non-shareholder constituents with a method for preserving their interests. . . . Thus, they appear to be nothing more than additional tools for directors to use when justifying the use of defensive maneuvers in a *Unocal* situation.”); Gouvin, *supra* note 5, at 304 (“[T]he mismatch between the duty owed to all the constituents of the corporation and an enforcement mechanism that allows only shareholders to bring derivative actions causes nonshareholder constituents to bear more than their share of the risk of detrimental director action.”).

¹⁶⁵ Mitchell, *supra* note 36, at 635; *cf. id.* at 637-38:

[T]he test need not be limited to jurisdictions with constituency statutes. Delaware, for example, lacks a constituency statute, but is the leading jurisdiction developing case law to permit broader directorial considerations. It would be a relatively easy matter to extend this case law to develop a common-law duty not to harm similar to that implicit in the constituency statutes.

¹⁶⁶ *Id.* (emphasis added).

legitimate expectations, [or] the like.”¹⁶⁷ Only then will the board carry a burden, and that will be “to prove that its actions were undertaken in pursuit of a legitimate corporate purpose rather than in the interests of the board itself. For example, the board would have to show that it was acting to promote the interests of stockholders . . . or of the corporation as a whole.”¹⁶⁸

Professor Mitchell has also addressed what is most likely the loudest question coming from critics of making stakeholder statutes enforceable: “How can the board fulfill its fiduciary obligation to act in the best interests of the stockholders, when it also is obligated to consider the conflicting interests of a variety of other groups?”¹⁶⁹ Professor Mitchell responds that:

As even the critics of constituency statutes recognize, directors have long been permitted to consider factors other than the immediate interests of stockholders, at least so long as a reasonably related benefit to stockholders, however attenuated, results. Given the ease with which such a reasonable relationship can be demonstrated, together with the protections afforded directors by the business judgment rule, it seems fair to say that substantial dilution of the stockholder primacy model has already been tolerated.

More importantly, the historical purpose of corporate fiduciary duties has not been to exclude the interests of every group but the stockholders. Rather, it has been to exclude the directors’ self-interest in performing their jobs in order to prevent harm to those with legitimate economic interests in the corporation. . . . The significance of analyzing the problem in this way is that it clarifies that the current legal identification of the beneficiary as the stockholder—to the exclusion of other constituent groups—is not a function of this duty, but of the means by which this duty can be enforced.¹⁷⁰

¹⁶⁷ *Id.* at 636.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 631; *cf.* Hale, *supra* note 3, at 848 n.213 (noting that constituency statutes “do not help corporate leaders determine ‘how much weight should . . . be given to the interests of one constituency versus other possible claims of the same constituency.’ The statutes also lack standards for determining what it means to ‘consider’ these interests or how one should go about such consideration.”) (quoting James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 113-14 (1991)).

¹⁷⁰ Mitchell, *supra* note 36, at 632, 603.

Another commentator has proposed that a test based upon a fundamental rights analysis may help guide directors:

How do we eliminate the conflict directors will face in meeting shareholder expectations and society's long-term expectations? This can be done by distinguishing legitimate shareholder expectations from illegitimate shareholder expectations.

. . . .Legitimate shareholder expectations of public companies can be inferred from the quasi-fundamental and fundamental rights established earlier. Specifically, shareholders have quasi-fundamental rights to have their shares of stock managed in a manner that is free from self-dealing and gross negligence. Shareholders have fundamental rights to obtain the highest price for their shares of stock when it is obvious that the sale of the corporation is inevitable. Illegitimate expectations are those that fall outside of identified expectations and harm the corporate entity.¹⁷¹

Finally, “to suggest that the test is imperfect is no answer in the face of a recognized need to redress some of the dislocations created by the parochial and outmoded focus of corporate law on stockholder wealth maximization.”¹⁷²

Another possible solution is to give a defined set of non-shareholder constituents of the corporation a derivative right to enforce the wholly-owned director's duty to the wholly-owned subsidiary.¹⁷³ This may make sense for a number of reasons.

¹⁷¹ See Enriquez, *supra* note 18, at 114-15.

¹⁷² Mitchell, *supra* note 36, at 640.

¹⁷³ See David Millon, *Redefining Corporate Law*, 24 INDIANA L. REV. 223, 271 (1991) (“Perhaps, however, it is preferable to think about management’s fiduciary obligation as a duty to the corporation as such, rather than to any particular constituency.”); *cf.* Pepper v. Litton 308 U.S. 295, 307 (stating “[w]hile normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder’s derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation--creditors as well as stockholders.”); see also Yaniv Grinstein, *Complementary Perspectives on “Efficient Capital Markets, Corporate Disclosure, and Enron”*, 89 CORNELL L. REV. 503, 504-06 (2004) (noting that “[l]ike other monitors, the board of directors should have the knowledge and incentives to execute its duties properly. In general, the sources of board incentives may be divided into three groups—ethical, legal, and monetary The second source of incentives comes from fear of legal punishment. Shareholders, employees, and other stakeholders can sue board members who violate their duties.”).

First, the goal here should be corporate entity utility maximization. As we saw in our examination of the history of the corporation, “[t]he objects for which a corporation is created are . . . deemed beneficial to the country.”¹⁷⁴ Of course, it can be argued that a corporation is of most benefit to the country when it maximizes shareholder value and thus serving shareholder interests should be the director’s only duty. But, as we have also seen, shareholder primacy has been shown to be flawed.¹⁷⁵ The realization of this fact is what has spurred the evolution of constituency statutes in the first place.¹⁷⁶ While in the “market-owned” corporation the biggest obstacle to optimum corporate performance is directoral self-interest—a problem addressed at least in part by fiduciary duties to shareholders and fiduciary duties to the corporation enforceable by shareholders—in the wholly-owned corporation the biggest obstacle to maximizing the efficiency of the wholly-owned subsidiary is arguably parental self-interest. This can be seen, by way of analogy, in the majority-owned corporation setting where we see duties running to the minority precisely because of the potential for abuse on the part of the majority.¹⁷⁷ Similarly, a check on parental power is needed in the wholly-owned subsidiary

¹⁷⁴ Trustees of Dartmouth College v. Woodward, 17 U.S. 518, 637 (1918).

¹⁷⁵ See discussion *supra*, Part III (A).

¹⁷⁶ See discussion *supra*, Part III (A) & (B).

¹⁷⁷ See Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (noting “the long-existing principle of Delaware law that [parent-]designated directors on [a subsidiary]’s board still owed [the subsidiary] and its shareholders an uncompromising duty of loyalty,” and that “[t]here is no dilution of this obligation where one holds dual or multiple directorships, as in a parent-subsidiary context”); see also Jones v. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969):

[T]he [California] Courts of Appeal have often recognized that majority shareholders, either singly or acting in concert to accomplish a joint purpose, have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just, and equitable manner. . . . Any use to which they put the corporation . . . must not conflict with the proper conduct of the corporation’s business.

Cf. Closely Held Guidebook, *supra* note 175, at 1108:

context if the wholly-owned subsidiary director's duty to the corporation is to have any meaning at all.¹⁷⁸ Granting non-shareholder constituents rights to enforce that duty can serve that purpose.

A second reason why granting non-shareholder constituents rights to enforce the wholly-owned subsidiary director's duty to the corporation may be a viable solution is that such a right can be tailored to respect the legitimate power of the parent as sole shareholder more than a duty running directly to non-shareholder constituents. To begin with, there is the "impediment" of derivative action, which requires claimants to make a demand upon the board of the entity.¹⁷⁹ Furthermore, the directors of the subsidiary could be granted the protection of a modified business judgment rule that would allow them to make decisions to benefit the parent at the expense of the subsidiary so long as the benefit to the parent outweighed the cost to the subsidiary. Only where the loss incurred by the subsidiary clearly was greater than the advantage gained by the parent would a claim be viable. This is also not unlike what has been done in the majority/minority context.¹⁸⁰

[C]ourts have generally imposed a duty of fairness on controlling shareholders in their dealings with the controlled corporation and its noncontrolling shareholders. Some courts have referred to this duty as one of 'entire' or 'intrinsic' fairness, encompassing both a duty of substantive fairness (i.e., fair price) and procedural fairness (i.e., fair dealing and full disclosure).

¹⁷⁸ See discussion *supra*, Part V.

¹⁷⁹ See *Grobow v. Perot*, 539 A.2d 180, 192 (Del. 1988) (affirming dismissal of derivative action for failure of plaintiffs to make prelitigation demand upon board of directors).

¹⁸⁰ Cf. Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1709 (describing the rule from *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976), as shifting "the burden from the fiduciary who has demonstrated a legitimate business purpose to the beneficiary who, to prevail, must then demonstrate that the majority could have achieved its business goal through methods less harmful to the beneficiary").

The third reason that granting non-shareholder constituents a derivative right would make sense is that it would avoid directoral conflicts arising from having duties flowing to various stakeholders. The directors would be left with the same fiduciary duties they have today—their duty to the parent and their duty to the entity—except that, their duty to the corporation would now actually have teeth.

Finally, there is one last alternative that warrants brief mention. Parent corporations could be given the ability to opt out of the limited liability that protects them from the liabilities of their wholly-owned subsidiary in exchange for the right to control that subsidiary as they deem fit. My expectation would be that there would not be a rush to accept this bargain, but it would be interesting to find out since much of my argument here is based upon the premise that it is the grant of limited liability that gives the state the prerogative to impose the additional duties we have been discussing. As one commentator has noted:

Adherence to the Landers model of proper behavior for a corporate group should be a prerequisite for sustaining the parent's limited liability. In a nutshell, the model requires that the parent structure the subsidiary so that it has a realistic potential for profitability. More particularly, the parent should adequately capitalize its subsidiary, avoid treating it as a department or a division, and avoid commingling or stripping its assets. Though the standard of conduct may not comport with the group's dominant motivation, which is to maximize a return for the enterprise as a whole, this author is willing to take the normative stance that adherence to this informal code of good conduct is the price that a parent corporation should be required to pay to preserve its limited liability. The law can say, "Treat your subsidiary like an independent, profit-making enterprise, and we will give you limited liability. That is what we ask of other corporations, and we ask it of you, too."¹⁸¹

¹⁸¹ Rands, *supra* note 20, at 456; *cf.* *Perma Life Mufflers, Inc. v. Int'l Parts Corp.*, 392 U.S. 134, 141-42 (1968) (“[S]ince respondents Midas and International availed themselves of the privilege of doing business through separate corporations, the fact of common ownership could not save them from any of the obligations that the law imposes on separate entities.”). It may also be necessary to grant stakeholders the right to sue the parent in cases where the parent removes directors, or otherwise retaliates against directors, solely for the purposes of thwarting the goals of these new rules.

These are all obviously just suggestions that will hopefully lead to further dialogue. The point is that there is a problem at the wholly-owned subsidiary level. While today's wholly-owned subsidiary can be as large as any independent corporation and have just as much impact on non-shareholder constituents, the forces that we rely on in other contexts to justify not extending additional duties or rights to those constituents are lacking.¹⁸² Thus, some type of mechanism is needed to correct the resulting inefficiency.

VIII. CONCLUSION

In conclusion, what this paper proposes is ultimately quite straightforward. First, I argue that the current state of the law imposes upon corporate directors a fiduciary duty to act not only in the best interests of the shareholders but also the corporate entity—and that acting in the best interests of the corporate entity includes taking into consideration the effect of corporate action on non-shareholder constituents.¹⁸³ Second, I argue that the current state of the law makes no concession as to this duty to the corporate entity in the case of the wholly-owned subsidiary director.¹⁸⁴ Third, I argue that the current state of general corporate fiduciary law represents a bargain between the state and the private sector that assumes certain market forces will focus director interests on fulfilling their fiduciary duties.¹⁸⁵ Finally, I argue that since at least some of those market forces are absent in the wholly-owned subsidiary context, the scope of fiduciary duties imposed on corporate directors acting in that setting should be expanded.¹⁸⁶

¹⁸² See discussion *supra*, Part V.

¹⁸³ See discussion *supra*, Part III (D).

¹⁸⁴ See discussion *supra*, Part IV (B).

¹⁸⁵ See discussion *supra*, Part V.

¹⁸⁶ See discussion *supra*, Part VI.