Managing Foreign Parent-U.S. Subsidiary Clashes Under the Duty of Loyalty

By Paul Edelberg and Niloofar Zarei Henzaki

You represent a Chinese foreign company seeking to re-shore to Brazil its U.S. biotech subsidiary that it had acquired several years ago when the biotech was an emerging company in need of capital to further develop its technology. The subsidiary corporation was formed under Delaware law. Both for political reasons and for cost savings, the parent company has decided to exit the United States in favor of a more favorable country in which to conduct its business. The existing members of the Board of Directors of the subsidiary and the executive officers, most of whom were involved in the founding group of the subsidiary and were pre-acquisition carryovers, oppose this move. The board believes maintaining their U.S. operations is in the best interest of the subsidiary, and the executive officers create hurdles to hinder the parent company's efforts to re-shore the subsidiary. The executive officers demand that the parent company's representatives sign NDAs and indemnification agreements and refuse to cooperate in other ways. Your client seeks your advice as to how it can overcome these obstacles and expeditiously close down the U.S. operations, while at the same time minimizing the litigation risk of an attempt by the board of directors of the subsidiary to stop the re-shoring efforts of the parent company.

How do you advise your client?

Delaware corporate law provides a clear but nuanced framework for understanding the fiduciary obligations of directors serving on the boards of wholly owned and partially owned subsidiaries. The baseline principles (rooted in the duties of care and loyalty, and implemented through standards of review such as the business judgment rule, enhanced scrutiny, and entire fairness) apply with particular sensitivity where a parent company's interests intersect with, or diverge from, those of the subsidiary and its minority stockholders.

What Are the Core Fiduciary Duties?

Delaware law is a leader in defining the scope of fiduciary duties owed by a board of directors to a corporation and its parent entity, since Delaware has become the jurisdiction of choice for corporate formation and has a well-developed body of case law. Many foreign parent companies form their subsidiaries under Delaware law.

Delaware law recognizes two core duties for corporate directors: the duty of care and the duty of loyalty. The duty of care requires that directors make informed decisions with the diligence of ordinarily prudent persons under similar circumstances. The duty of loyalty requires directors to act in good faith and in the best interests of the corporation and its stockholders, and to refrain from self-dealing, usurpation of corporate opportunities, and other conflicted conduct. In general, a director's conduct is reviewed under the business judgment rule; however, where actual conflicts of interest are present (for example, in parent-subsidiary self-dealing), Delaware courts apply the exacting entire fairness standard, which evaluates both fair dealing and fair price. In change-of-control settings, enhanced scrutiny may also apply, but those principles are less central to the parent-subsidiary context than entire fairness.

Wholly Owned Subsidiaries

Where a subsidiary is wholly owned, Delaware courts have long recognized that the directors of the subsidiary manage the subsidiary in the interests of its sole stockholder, the parent.[1] In that posture, aligning the subsidiary's conduct with the parent's strategic, financial, tax, or structural objectives is not merely permissible but expected. The rationale is straightforward: fiduciary duties are owed to the corporation and its stockholders; a wholly owned subsidiary's stockholder is the parent; therefore, subsidiary directors properly consider what best serves the parent as stockholder when managing the subsidiary's business and affairs.

Delaware authority confirms this proposition in practical contexts. Decisions taken by a parent-appointed subsidiary board to advance the parent's interests typically receive the deference of the business judgment rule. Even where the outcome appears suboptimal for the subsidiary on a stand-alone basis, the analysis focuses on the interests of the subsidiary's sole equity owner at the time of the decision. Moreover, where the subsidiary is solvent, directors of the subsidiary do not assume a duty to protect the subsidiary as if it were independent from its parent's objectives; rather, they act for the enterprise consistent with the parent's interests as the residual claimant at the subsidiary level.

Delaware law recognizes an exception. Where the subsidiary is insolvent or will become insolvent as a result of the corporate action, the officers and directors of the subsidiary owe a separate and distinct fiduciary duty to the subsidiary and its creditors, in addition to its fiduciary duty to the parent company. The rationale being that the creditors have become the real stakeholders in the subsidiary. This is sometimes referred to as the "trust fund theory".[2] So the rendering of a foreign company's wholly owned subsidiary insolvent by plundering its assets and then relocating elsewhere conceivably could raise the ante for officers and directors of a wholly owned subsidiary. On the other hand, maintaining the solvency of the subsidiary and simply "re-shoring" it to another jurisdiction arguably avoids the trust fund theory.

Many other states subscribe to the same theory that the officers and directors of a wholly owned subsidiary owe fiduciary duties solely to the parent company.[3] However, not all states subscribe to the trust fund theory exception.[4] In *Abrams v. McGuire Woods LLP*, cited in the footnote below, the U.S. Bankruptcy Court for the Northern District of Indiana rejected that exception, stating that the officers and directors of a wholly owned subsidiary owe fiduciary duties only to the parent company under Indiana law.

[1]E.g., Trenwick America Litigation Trust v.Ernst & Young, L.L.P., 906 A.2d 168 (Del. Chancery Ct 2006).
[2]*But see*, Wooley v. Lucksinger, 61 So.3d 507 (La. Sup. Ct. 2011), holding that under Texas, the officers and directors of a wholly owned subsidiary owe fiduciary duties if the subsidiary corporation will be rendered "unable to meet its legal obligations" as a result of the transaction.
[3]U.S. Small Business Administration v. Feinsod, 347 F. Supp.3d 147 (2018).
[4]Abrams v. McGuireWoods LLP, 518 B.R. 491 (U.S. N.D. Indiana 2014).

Partially Owned Subsidiaries

Where a foreign company acquires a majority interest in a U.S. company, allowing the founders to retain a minority stake, the fiduciary framework changes materially. Where a subsidiary has minority stockholders, the subsidiary board owes duties to the subsidiary and all of its stockholders, including the minority. In practice, that means:

- Parent–subsidiary transactions implicate the duty of loyalty and are frequently reviewed under entire fairness, particularly where the board is not majority-disinterested and independent concerning the transaction.
- The entire fairness standard examines both process and price. A fair process - robust negotiation, independence, absence of coercion, informed decision-making, and full disclosure - supports a finding of fairness and mitigates litigation risk. Process flaws can be outcome-determinative where price cannot independently carry the day.
- Protective measures - such as formation of a fully empowered, independent special committee, retaining independent legal and financial advisors, and conditioning the transaction on approval by an informed, uncoerced majority-of-the-minority vote - have long served as the principal means to mitigate the specter of conflict and restore business judgment deference under Delaware common law. In particular, when a controlling stockholder stands on both sides of a transaction or receives a non-ratable benefit, the combination of a fully functioning independent committee and majority-of-the-minority approval historically has allowed for business judgment review if implemented ab initio and satisfied in substance.

These concepts are widely accepted throughout the various state jurisdictions in the United States, with Delaware case law viewed as the standard bearer.

Delaware has now codified statutory "safe harbors" in DGCL Section 144 that provide pathways to avoid entire fairness review in conflicted settings if certain conditions are met. For interested director and officer transactions, and for controlling stockholder transactions, the statute recognizes alternative cleansing mechanisms, disinterested committee approval or disinterested stockholder approval (with more exacting conditions for going-private transactions). These amendments simplify, in some respects, the common-law apparatus and, in others, adjust thresholds and timing requirements. While their ultimate integration with existing case law will continue to evolve, the statutory safe harbors provide practical, concrete procedural routes for corporate actors to reduce litigation risk in parent–subsidiary transactions.

Limited Liability Companies

Limited liability companies have become a common form of business entity in the United States, driven in part by tax consequences and in part by the contractual freedom inherent in limited liability companies. Corporations in the United States are statutory creatures; their structures and procedures are governed, and in some cases mandated, by the statutes of the jurisdiction in which they are formed. On the other hand, limited liability companies are creatures of contracts. They are governed by a limited liability company agreement, or sometimes called an operating agreement, which is not mandated by statute. The owners, or members, of the limited liability company have much more flexibility in establishing the rights of the members and the procedures by

which limited liability companies are operated. In fact, in those states governed by the Uniform Limited Liability Company Act, the statutory prescriptions are merely default provisions, allowing the adoption of an operating agreement that can deviate, with limited exceptions, from the statutory prescriptions.

Limited liability companies are either member-managed or manager-managed. In the context of a foreign parent company, limited liability companies are for the most part manager-managed, typically by a board of managers akin to a corporate board of directors. Like a corporation, fiduciary duties are imposed on a board of managers. The case law varies from state to state on whether the board of managers owe a fiduciary duty to the limited liability company itself, or to its members (in the context of this article, the wholly owned foreign parent of the limited liability company). Delaware law recognizes a fiduciary duty of the board of managers both to the limited liability company and to its members.[5] Michigan, on the other hand, attributes the fiduciary duty of managers solely to the limited liability company and not to its individual members.[6] In most states, if not all states, the relevant statutory provisions of the State's limited liability company law permits the limited liability company agreement to alter or eliminate (with certain exceptions) its fiduciary duties and to define to whom fiduciary duties are owed. Therefore, an analysis on whether a board of managers of a subsidiary U.S. limited liability company owes a fiduciary duty to the limited liability company or its managers and what actions the board of managers can take vis-à-vis the parent company depends on the state jurisdiction as well as to the language of the limited liability company agreement and any exculpatory language regarding fiduciary duties.

Managing Parent–Subsidiary Conflicts in Practice

In real-world governance, the place where doctrine meets process is the boardroom. Several principles guide boards navigating conflicts between a foreign parent company and its U.S. subsidiary in the context of re-shoring.

First, identify the ownership structure and beneficiary. In a wholly owned corporate subsidiary, the board's touchstone is the parent's interest as stockholder, subject to baseline obligations to obey the law, avoid bad faith, and maintain oversight. In a partially owned subsidiary, the board's obligations run to the subsidiary and all of its stockholders. In a limited liability company, the board of managers' obligations run to the limited liability company itself and, depending upon its governing jurisdiction and the terms of the limited liability company agreement, may also run to the parent company. The decision whether to re-shore the subsidiary will need to be approved in most instances by the board of directors or board of managers, as applicable, of the subsidiary. In those situations, in which the board's fiduciary duties run in whole or in part to the subsidiary, the board must act in the best interests of the subsidiary.

Even in the context of a wholly owned corporate subsidiary, the rules may change if the corporate subsidiary is insolvent or may become insolvent as a result of the re-shoring transaction. If the subsidiary is insolvent, creditors become the primary beneficiaries of fiduciary duties enforced derivatively. Transfers of value to the parent or other affiliates may be scrutinized under entire fairness and fraudulent transfer law. Directors should avoid preferential or non-ratable value extractions favoring a controlling parent and ensure any intercompany arrangements reflect fair value and fair dealing. Oversight obligations remain active; knowing violations of law or abdication of core compliance oversight can give rise to non-exculpable loyalty claims. Care must be taken to structure the re-shoring wherever possible so as not to result in creating an insolvent subsidiary. For

[5] Kelly v. Blum, Del. Ch. No. 4516-VCP (2010); In Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451 (Del.Ch.2009).
[6] Frank v. Linkner, 310 Mich. App. 169, 871 N.W.2d 363 (2015), citing Section. 450.4404 of the Michigan Limited Liability Company Act, which explicitly states that managers must act in good faith, with the care of an ordinarily prudent person, and in a manner reasonably believed to be the best interests of the limited liability company.

instance, rather than assigning without consideration all the subsidiary's assets to the parent company, thereby rendering the subsidiary insolvent, and then establishing operations in another country, it should consider a control transaction, such as a merger or redomicile of the subsidiary entity in the new jurisdiction, in which the entity stays intact or becomes part of another entity and continuously maintains its business operations and substantially all of its assets.

It is wise to build a record of independence and informed decision-making where minority holders exist, establish a special committee of directors whom the board has reasonably determined are disinterested with respect to the transaction, delegate real authority - including the power to say "no" - retain independent advisors, and ensure the committee engages in a genuine negotiation process. Minority stockholder approval, if pursued, must be fully informed and uncoerced, with disclosures that satisfy Delaware's materiality standard. Even in wholly owned subsidiaries, maintaining a robust record of deliberation, legal compliance, and reasoned judgment supports business judgment protection and reduces the risk of loyalty-based claims that are non-exculpable.

Deploy statutory and contractual tools appropriately. For example, Section 102(b)(7) of the DGCL allows exculpation of directors for monetary liability for care-based claims but not for loyalty, bad faith, or knowing violations of law. Indemnification and advancement under Section 145, and D&O insurance, remain critical protections. In conflicted transactions, Section 144's safe harbors offer procedural shields if carefully implemented. Special committee mandates should be specific and sufficiently broad; stockholder approval conditions should be clear, and disclosure packages should be comprehensive and accurate.

Many of these measures are not necessary if the subsidiary is a corporation, is wholly owned and is solvent. In those situations, fiduciary duties run solely to the parent company, and the foreign parent generally is free to dictate the terms of the re-shoring.

Conclusion

The question at the outset of this article was how to advise your parent company client when the governing board of the subsidiary resists or imposes roadblocks on a decision by the parent company to re-shore its operations to another country, including a refusal to authorize a re-shoring where authorization is necessary. Your advice will depend upon the type of legal entity of the subsidiary, whether the subsidiary is wholly owned or partially owned and whether the entity is insolvent or will be rendered insolvent as a result of the re-shoring. You will need to advise your client to carefully plan how to effectuate the re-shoring. If carefully planned, the parent company can minimize legal exposure and/or litigation brought by the officers and directors of the subsidiary, as well as by creditors of an insolvent subsidiary.

One other word of caution: When acquiring the entire interest in a U.S. company that is a limited liability company, the foreign parent company should consider either converting its charter to corporate form to eliminate or minimize claims by the subsidiary's board of directors of a fiduciary duty to the subsidiary, rather than the parent, or, alternatively, clarifying in the limited liability company agreement that the board of managers of the subsidiary has no fiduciary duty to the limited liability company.

Paul Edelberg is a partner in the New York office of Fox Rothschild, a national law firm, and Niloofar Zarei Henzaki is an associate in the firm's Los Angeles office.

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