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CORPORATIONS -PARENT AND SUBSIDIARY-RIGHT OF PARENT OR SUBSIDIARY TO SHARE WITH OTHER CREDITORS IN ASSETS OF ASSOCIATED CORPORATION ON THE LATTER'S INSOLVENCY

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CORPORATIONS — PARENT AND SUBSIDIARY — RIGHT OF PARENT OR SUBSIDIARY TO SHARE WITH OTHER CREDITORS IN ASSETS OF ASSOCIATED CORPORATION ON THE LATTER'S INSOLVENCY — Increasingly in the past few years, courts throughout the country have seemed willing to disregard what Professor Ballantine has called the "basic theory of corporation law,"[1] the concept that a corporation is an entity entirely distinct and separate from its stockholders. It is not the purpose of this writer to take issue with this tendency; for the most part the decisions seem sound and the results just. It is believed, however, that the rules used by the courts in reaching those decisions are, in many instances, open to question. There is one situation in particular

[1] Ballantine, "Separate Entity of Parent and Subsidiary Corporations," 14 CAL. L. REV. 12 at 20 (1925).

in which the courts have "pierced the veil"[2] of corporate entity, that would seem to merit more cautious progress than some courts have seen fit to pursue. That is the case where parent and subsidiary corporations are closely interrelated and, on the insolvency of one, the other seeks to share in the assets of the insolvent, on the basis of advancements made prior to the insolvency.

I.

A case which fairly presents the problem to be considered is that of *Peckett v. Wood*,[3] decided by the Circuit Court of Appeals for the Third Circuit. Here a partnership[4] organized a corporation to manufacture goods for the partnership to sell. The firm acted as a selling, and occasionally as a buying, agent for the corporation, but the corporation did business in its own name and was given credit on its own name. The affairs of the two organizations, as well as their books and accounts, were kept separate and distinct. They had different creditors and each paid its own bills. The corporation became insolvent, and certain individuals, members of the firm, sought to prove claims against the bankrupt for advancements made. The other creditors objected, claiming that the corporation was merely an agency or department of the partnership and that the court should disregard the corporate entity and prevent the individuals from proving claims against themselves. The court refused to disregard the entity, laying down as the test whether or not the firm or its members would have been responsible for the debts of the corporation, were the corporate creditors to sue,[5] and deciding that the two organizations were not sufficiently assimilated here to warrant disregarding the entity.[6]

It would seem that the result reached in this case is eminently just. It has been held on several occasions[7] that mere sole ownership of

[2] This phrase was coined, it is believed, by Professor Wormser, "Piercing the Veil of Corporate Entity," 12 COL. L. REV. 496 (1912). The article contains an interesting discussion of the general problem of disregarding the corporate entity.

[3] (C. C. A. 3d, 1916) 234 F. 833.

[4] Although one of the organizations involved in this case was a partnership, the principles involved are equally applicable to the parent-subsidiary corporation question.

[5] Among the cases in which the parent has been held liable for the debts of its subsidiary are Interstate Tel. Co. v. Baltimore & Ohio Tel. Co., (C. C. Md. 1892) 51 F. 49; New York Trust Co. v. Carpenter, (C. C. A. 6th, 1918) 250 F. 668; The Wm. Van Driel, Sr., (C. C. A. 4th, 1918) 252 F. 35; Fourth National Bank of Montgomery v. Portsmouth Oil Refining Co., (C. C. A. 5th, 1922) 284 F. 718; Radio-Craft Co., Inc. v. Westinghouse Electric & Mfg. Co., (C. C. A. 3d, 1925) 7 F. (2d) 432; In re Marcella Cotton Mills, (D. C. Ala. 1925) 8 F. (2d) 522; In re Kentucky Wagon Co., (D. C. Ky. 1932) 3 F. Supp. 958.

[6] See also note in 15 MICH. L. REV. 172 (1916).

[7] See 1 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 43 (1931), and the following cases: Majestic Co. v. Orpheum Circuit, (C. C. A. 8th, 1927) 21 F. (2d)

stock plus identity of officers is not sufficient to warrant a disregard of the corporate entity. And where two organizations are careful to keep their functions separate so as to preserve in practice as well as in theory their respective entities, no reason is observed why one should not be entitled to share as a creditor in the assets of the insolvent. Limited liability is the chief advantage of the corporate form of organization,[8] and the practice of so limiting liability by incorporation is now well established in the law. To hold that mere identity of stockholders and officers, the separate entities being otherwise preserved, is sufficient to prevent the sharing of an associate corporation as a creditor is to thwart the very purpose of incorporation, and, it appears, without valid reason.

Another case, reaching a similar result, is *In re Watertown Paper Co.*[9] In that case, stockholders of a paper company caused the organization of a pulp company, and, since the paper company owed money to its stockholders, the latter had this advanced to the pulp company to pay for their stock. The paper company itself owned none of this stock in the pulp company, and while the two corporations mingled their affairs carelessly, separate entities were kept up, with separate books, separate creditors, separate assets, and separate names. When the paper company became insolvent, the pulp company sought to prove a claim against it as a creditor, over the objection of other creditors. The court refused to disregard the entities, and allowed the claim, saying:[10]

> "Undoubtedly the controlling stockholders regarded the two corporations as being, in a general way, different departments of their business. But the separate corporate organizations were apparently kept up. Each corporation had its own creditors, its own assets, and conducted its business in its own name. Books of

720; Cleveland Trust Co. v. Consolidated Gas, Electric Light & Power Co. of Baltimore, (C. C. A. 4th, 1932) 55 F. (2d) 211; Centmont Corp. v. Marsch, (C. C. A. 1st, 1933) 68 F. (2d) 460; Greenbaum v. Lehrenkrauss Corp., (C. C. A. 2d, 1934) 73 F. (2d) 285; Ayer & Lord Tire Co. v. Commonwealth, 208 Ky. 606, 271 S. W. 693 (1925).

[8] "The principle of limited liability is by far the most effective legal invention for business purposes made in the nineteenth century—not that corporations have not other advantages over partnerships, such as the advantageous holding of real estate, the easy transference of the stockholders' interest and convenience in suing and being sued; but the fundamental advantage of a corporation, the advantage which enables it to mass and direct capital, is the privilege of limited liability." Ex-President Eliot of Harvard, quoted in Cook, "Watered Stock—Commissions—Blue Sky Laws—Stock Without Par Value," 19 MICH. L. REV. 583, note 4 (1921).

[9] (C. C. A. 2d, 1909) 169 F. 252. Relied on by the court in Peckett v. Wood, (C. C. A. 3d, 1916) 234 F. 833, discussed supra in the text.

[10] 169 F. at 257.

> account were kept, showing their financial relations. The stockholders were not entirely the same. We cannot, upon these facts, hold that the corporations were identical, nor that the Pulp Company was merely an adjunct or instrumentality of the Paper Company. Instead of coming under the exceptions, this case seems clearly to come within the general rule that the distinct corporate existence of two separate, although associated, corporations will be regarded by the courts."

It is submitted that the caution exercised by these two courts might well be imitated by some courts today, who, on occasion seem perhaps overly ready to disregard the corporate entity.

Most decisions sufficiently in point since *Peckett v. Wood* have gone the other way,[11] and it would seem that, for the most part, they have been correctly decided. Few would deny the justice of refusing the associated corporation's claim when there is really no bona fide pretence of maintaining separate entities. But from the later decisions the feeling seems inescapable that courts have been very quick to find in the relationships sufficient factors to warrant the result reached, and a few seem to have disregarded the entities of the organizations concerned even without a clear case of assimilation on the facts found by the trial court.

There is, for example, the case of *In re Burntside Lodge*.[12] Here a family owned certain resort property which they conveyed to a corporation, formed by them for the purpose, in return for all, or nearly all, of the capital stock. A few others were brought in and made directors, serving, the court found, as mere dummies. The family conducted the resort business, controlled all the affairs of the corporation, received the benefits from the business, and incurred the liabilities. On the strength of these facts, the court refused the claim in bankruptcy of the individual stockholders for back salaries, holding that the corporation was the mere instrumentality of the claimants, and that to allow the claims would be to permit them to prove claims against their own estate. The only elements of assimilation here are ownership of stock and control of the corporation. While a few courts seem to intimate that sole stock ownership and control are sufficient to warrant a disregard of the legal entity, the weight of authority seems

[11] See however, Briggs v. Harper Clay Products Co., 150 Wash. 235, 272 P. 962 (1928); and Finley v. Union Joint Stock Land Bank, 281 Mich. 214, 274 N. W. 768 (1937), where it was held that even though assimilation seemed sufficient, the court would not disregard the entity in the absence of a showing that a third person, or, in the Michigan case, the plaintiff, had been injured or wronged thereby. The Michigan case was cited by the court in In re Kalamazoo Bldg. Co. (D. C. Mich. 1938) 21 F. Supp. 852.

[12] (D. C. Minn. 1934) 7 F. Supp. 785.

clearly contra.[13] Other and additional factors are ordinarily required. Would the court have been willing in this case, for instance, to allow the creditors to recover from the individual stockholders the amount of their claims? And if so, what happens to the whole theory behind the corporate structure? It is difficult to see why, because certain individuals have taken advantage of a policy sanctioned by the law, and have attempted to protect and control their investment through legal channels of stock ownership, they should be denied the right to claim at least partial compensation for their labor and services, unsuccessful though their efforts may have been.[14] The principle of this case seems directly to conflict with that laid down in the leading case of *Broderip v. Salomon.*[15]

Another case in which it is difficult to understand the theory of the court in disregarding the corporate entity is *Clere Clothing Co. v. Union Trust & Savings Bank.*[16] There, *P* Corporation was subjected to involuntary bankruptcy proceedings, and *C* Corporation, one of its creditors, effected a compromise with other creditors, by virtue of which *C* Corporation was to advance a sum of money in exchange for the stock of goods owned by *P* Company. *C* borrowed the money from a bank, and placed the goods with a sales agent, the proceeds to go toward retirement of the loan. Later, the sales agency was changed and given to *P* Company with a similar arrangement as to the proceeds. *P* Company then reorganized, with the president of *C* purchasing four hundred ninety-eight out of a total of five hundred shares of its stock. The reorganized *P* Company then purchased the remaining goods from *C* Company, giving in exchange therefor its note. *P* Company again became insolvent, and *C* sought to assert the amount of the note as a claim, along with other creditors. It appeared that the corporations were rather closely associated, and that the *P* Corporation, after reorganization, was permitted to write checks on the *C* Corporation. The court held that the corporations were sufficiently interrelated to warrant disregarding the corporate entity, and refused to allow *C's* claim. The decision appears questionable to this writer in view of the fact that, though the president of *C* Corporation did own all but two shares of the stock of *P* Company, the *C* Corporation had no stock whatever in the *P* Company, and nothing appears from the report which would seem to warrant looking through the legal separation between *C* Company and its president. But were that warranted, the report of the case shows no actual symptoms of control by the *C*

[13] See cases cited in note 7, supra.

[14] For a case involving facts similar to those of In re Burntside Lodge, see Wheeler v. Smith, (C. C. A. 9th, 1929) 30 F. (2d) 59.

[15] [1895] 2 Ch. D. 323.

[16] (C. C. A. 9th, 1915) 224 F. 363.

Corporation other than the policy of allowing *P* to write checks on *C's* account. There is no showing that the formal legal requirements were not scrupulously adhered to, no showing that the policies of the "subsidiary" were directed by, and in the sole interest of, the "parent." And even if it were admitted for present purposes that there was reason to disregard the legal barrier between the president of *C* Corporation and *P* Corporation, there still remains the necessity for explaining the disregard of the entity of *C* as a corporation distinct from its president as an individual. The case would appear to represent an inclination on the part of the court to be rather too hasty in its discarding, for the purposes of the instant case at least, of a principle so fundamental in the field of corporate law.[17]

2.

The intention is not, however, to criticize all decisions on this point. While there are not many presenting the precise problem under discussion, it is safe to say that a majority are clearly sound on the facts determined by the trial court. Whenever a parent seeks to assert a claim in bankruptcy against an insolvent subsidiary, or a subsidiary against an insolvent parent, the claim should, it is believed, be subjected to close scrutiny. It has been so held by some courts.[18] But it is believed also that this scrutiny should be a considered one, with the court keeping in mind the fact that the law sanctions limited liability through corporate channels, and sets up the formal requisites to be complied with in order to enable the individuals involved to take advantage of this feature of the corporate form of business organization. Where, with this in mind, the court finds a clear case of assimilation, one where the subsidiary is really only an instrumentality or adjunct of the parent, the disallowance of the claim seems the only fair result.

A number of recent cases have served to illustrate this point of view. There is, for example, the case of *Centmont Corporation v. Marsch*,[19] where the parent railroad corporation wished to construct

[17] While it is freely admitted that the trial court was in a much better position to interpret the facts which were brought out at the trial than the writer is from the report, still another court, in seeking precedent, must also be guided by the facts which appear in the report, and from this point of view, the criticism seems justifiable.

[18] Among the cases are Ohio Valley Bank Co. v. Mack, (C. C. A. 6th, 1906) 163 F. 155; and Consolidated American Royalty Corp. v. Taliaferro, (C. C. A. 10th, 1935) 78 F. (2d) 802. The principle is related to that involved when a director or officer of a corporation contracts with the corporation.

[19] (D. C. Mass. 1932) 1 F. Supp. 1004, affirmed (C. C. A. 1st, 1933) 68 F. (2d) 460, certiorari denied, 291 U. S. 680, 54 S. Ct. 530 (1933). See also 82 UNIV. PA. L. REV. 868 (1934).

a line in the state of Massachusetts, and because of a Massachusetts requirement that a railroad must be constructed in that state, if at all, by a local corporation, it incorporated a subsidiary in Massachusetts for the purpose of building and running that line. All of the stock of the subsidiary, at least at the time of suit, was owned by the parent; the executive officers were the same, as were a majority of the board of directors. All capital was furnished by the parent, and the engineers to supervise the construction were hired by the parent. The officers of the subsidiary received their salaries from the parent, and the accounts of both were kept in the parent's offices by the parent's accountants. On the insolvency of the subsidiary, the parent sought to assert a claim for advancements and to share in the assets on a par with other creditors, one of whom objected. The federal District Court refused to allow the claim, holding the subsidiary to be a mere adjunct or instrumentality of the parent. The Circuit Court of Appeals affirmed the opinion of the District Court, saying:

> "The rule is often laid down that mere stock ownership or identity of executive officers will not alone be sufficient to establish one corporation as the agent or instrumentality of another. But it is equally well settled where, in addition, it appears that the business carried on by the subsidiary is a part of the business of the holding company, and the holding company dominates the affairs of the subsidiary through its stock ownership and common officers, and actually directs the affairs of the subsidiary as a part of its own business, for which purpose the subsidiary was organized, that the courts will look through the corporate form and hold that in such cases a subsidiary is a mere adjunct to or instrumentality for carrying on the business of the holding company."[20]

The decision can hardly be criticized from the standpoint of precedent for there is ample and good authority to support it.[21] And there are other decisions,[22] equally sound, which do not merit special consideration here.

[20] 68 F. (2d) 460 at 463. It is interesting to note that in the original suit by Marsch against the parent, the Massachusetts court refused to disregard the entities and to hold the parent liable for the debt of the subsidiary. Marsch v. Southern New England R. R., 230 Mass. 483, 120 N. E. 120 (1918). The case was appealed on demurrer, however, and the federal courts in the later case distinguished the two cases on the facts.

[21] There might, however, be grounds for criticism on the theory of the argument in part 3 of this comment.

[22] Hunter v. Baker Motor Vehicle Co., (D. C. N. Y. 1915) 225 F. 1006, and other cases adjudicating the same general controversy reported in (D. C. N. Y. 1911) 190 F. 665, and (C. C. A. 2d, 1916) 238 F. 894; In re Mill Run Lumber Co., (D. C. Pa. 1933) 4 F. Supp. 807; S. G. V. Co. of Delaware v. S. G. V. Co. of Penn-

3.

From a rather close scrutiny of the cases and the facts as reported therein, the conclusion seems justified that a majority of the courts have reached what appear to be fair results. But it is believed, in view of the decisions in the ever-increasing number of cases involving parent and subsidiary corporations generally, that courts are becoming more prone to look through the corporate form than is necessary to accomplish justice and are thereby unnecessarily eating into the theory underlying that form. The rules which have been used by the judiciary are at best broad, vague, and elusive. The corporate entity has been disregarded in many different situations,[23] and the tests used by courts have been nearly as varied as are the situations themselves. Two authorities on corporation law have suggested tests for the solution of the problem under discussion which seem to this writer in essence to be very similar, and worthy of consideration in evaluating such cases. Mr. Powell puts his concept as follows:

> "[The subsidiary's corporate entity] will be disregarded if its formal statutory requirements are ignored or if it is conducted for the benefit of the parent corporation, not in the latter's capacity as a stockholder of the subsidiary, but for the benefit of the parent corporation in other capacities or in other directions."[24]

Professor Ballantine, in discussing the problem,[25] has this to say:

> "One corporation may be the agent of another, just as one individual may act for another. The difficult question is what facts of ownership, control, and management in a common enterprise should require that the acts and obligations and property of the subsidiary should be treated as if they were those of the parent. It is submitted that no mechanical rule based on objective facts of control or connection which will furnish a certain test is possible of formulation. Identity of stockholders, identity of officers,

sylvania, 264 Pa. 265, 107 A. 721 (1919); In re Kentucky Wagon Co., (D. C. Ky. 1932) 3 F. Supp. 958. See also Page v. Arkansas Natural Gas Corp., (C. C. A. 8th, 1931) 53 F. (2d) 27, where the "entities" of business trusts were pierced on analogy to corporation law.

[23] 1 FLETCHER, CYCLOPEDIA OF CORPORATIONS, perm. ed., 45 (1931); Majestic Co. v. Orpheum Circuit, Inc., (C. C. A. 8th, 1927) 21 F. (2d) 720 at 724, where it is said: "The corporation will be regarded as a legal entity as a general rule, and the courts acting cautiously and only when the circumstances justify it, will ignore the fiction of corporate entity, where it is used as a blind or instrumentality to defeat public convenience, justify wrong, or perpetrate a fraud, and will regard the corporation as an association of persons." (Citing practically all the cases in point.)

[24] POWELL, PARENT AND SUBSIDIARY CORPORATIONS 4 (1931).

[25] Ballantine, "Separate Entity of Parent and Subsidiary Corporations," 14 CAL. L. REV. 12 at 18-20 (1925).

> the manner of keeping books and records, the methods of conducting the corporate business as a separate concern or as a mere department of the other concern may be evidential facts to be considered as bearing on the question of juggling of separate capacities and whether the subsidiary is being managed in such a way as to make the controlling corporation justly responsible. But after all it comes down to a question of good faith and honesty in the use of the corporate privilege for legitimate ends. . . . Before the acts and obligations of a corporation can be legally recognized as those of particular individuals, and vice versa, it must appear that the circumstances are such that there is an agency [26] of the one for the other or that the privilege is being abused so that adherence to the distinction or separate capacity would sanction a fraud or promote injustice."

There is no pretense, in either of these suggestions, of laying down any definite or clear-cut rule for the courts to follow. It is generally conceded that such a rule is impossible of formulation.[27] But it does seem to this writer that both point out a common ground from which to start, they require a deference to the policy and theory of the corporate form of business organization, and they are flexible enough to meet any case which might arise.

It is submitted that an attempt to fit the particular case in any given instance into one of the innumerable categories which have been set apart by the courts is to focus the attention on individual factors rather than to approach the problem from the broader point of view of whether or not what the concerns have been trying to do, and have done, is really contrary to the policy of the law as it relates to the corporate theory. If a corporation has followed the prescribed formal requirements as laid down by statute,[28] and is pursuing a course not antagonistic to the policy of the law, why should a close association between them as to matters of stock ownership, control, and financing deprive them of the limited liability feature, the chief advantage of the corporate form of organization? A perusal of the financial statements of either or both corporations would disclose their financial

[26] Professor Ballantine argues that the corporate entity should be disregarded only when corporate privileges are abused, and that other cases may be decided "by the application of the usual principles of liability for the acts of other persons or for collusion with them." 14 CAL. L. REV. 12 at 20.

[27] See portion of Ballantine's article quoted above, and Wormser, "Piercing the Veil of Corporate Entity," 12 COL. L. REV. 496 (1912).

[28] Two cases in which the entity was disregarded, the failure to meet formal statutory requirements being an important factor, are In re Kentucky Wagon Co., (D. C. Ky. 1932) 3 F. Supp. 958; and In re Mill Run Lumber Co., (D. C. Pa. 1933) 4 F. Supp. 807.

relations, and other public records, such as the articles or certificates of incorporation, furnish data concerning the organizations themselves, for the protection of creditors. Close scrutiny of the relationship, as has been pointed out, is obviously desirable, in order to assure an adherence to the basic policy of this field of law. But once it is determined that the corporations have adhered strictly to the formal requirements, and are, or have been, in good faith and honesty, pursuing a course within the reasonable confines of corporate policy and privilege, the claim of either on the insolvency of the other, should, it is believed, be allowed.

It is submitted that a close scrutiny of the factors involved in the interrelation of the two corporations from a broad policy point of view, rather than an attempt to fit each case into one or more of the many categories evolved from other and different fact situations, would reach a result far more in consonance with social and economic expedience and policy.

Collins E. Brooks