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CORPORATIONS — PRIORITY BETWEEN PARENT CORPORATION AND PREFERRED STOCKHOLDERS OF BANKRUPT SUBSIDIARY — It is well settled that when an undercapitalized subsidiary corporation is bankrupt, the claims for money loaned by the parent corporation which has dominated the subsidiary will be subordinated to the claims of other creditors.[1] An analogous problem, which has seldom, if ever, been directly passed upon, is the priority between the claims of the non-voting preferred stockholders of the subsidiary and those of the dominating corporation which owns all the common voting stock of the subsidiary. In spite of the fact that intercorporate loans are a common and approved method of financing subsidiaries,[2] the question has

[1] Clere Clothing Co. v. Union Trust & Sav. Bank, (C. C. A. 9th, 1915) 224 F. 363; Hunter v. Baker Motor Vehicle Co., (D. C. N. Y. 1915) 225 F. 1006; 45 YALE L. J. 1471 (1936). For general discussions of the relationships between parent, subsidiary and creditors, see LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS (1936) and POWELL, PARENT AND SUBSIDIARY CORPORATIONS (1931).

[2] "the tie of stockholding is strengthened by the new relation of creditor and debtor." GERSTENBERG, FINANCIAL ORGANIZATION 594 (1926). Gerstenberg advo-

heretofore been relatively academic, since generally there will be little or nothing left for the stockholders to fight over after the outside creditors have been satisfied in full. But with the advent of Section 77B of the Bankruptcy Act[3] the problem would seem to become important, for now stockholders are allowed to participate in the reorganization even though they may actually have no equity in the debtor.[4] So far, this exact question has not been presented in reorganization proceedings, although a few cases approach it.[5] Of course, it cannot be predicted with certainty how the courts will hold when the case does come up. But, in spite of the relative paucity of authority in point, there is an extensive body of law on the general subject of intercorporate liability which will form a foundation for conjecture; and there is one case, that of *Fryer v. Wiedemann*,[6] which, although it involves natural persons as controlling stockholders, is otherwise directly

cates the financing of the subsidiary in this manner because of the difficulty of marketing the securities of the subsidiary. (See pages 593 ff.) Sometimes when the parent does not control all of the stock of the subsidiary, it will demand collateral for the advances made.

For a typical case of the financing of a subsidiary, see DEWING, FINANCIAL POLICY OF CORPORATIONS, 3d rev. ed., 876 (1934).

[3] 48 Stat. L. 912, 11 U. S. C. (Supp. 1936), § 207 (1934).

[4] In re New York Railways Corp., (C. C. A. 2d, 1936) 82 F. (2d) 739, cert. den. 298 U. S. 687, 56 S. Ct. 959 (1936); In re Celotex Co., (D. C. Del. 1935) 12 F. Supp. 1; In re McCrory Stores Corp., (D. C. N. Y. 1935) 12 F. Supp. 267; In re Burns Bros., (D. C. N. Y. 1936) 14 F. Supp. 910; In re Parker-Young Co., (D. C. N. H. 1936) 15 F. Supp. 965.

[5] The case of In re Davison Chemical Co., (D. C. Md. 1935) C. C. H. Bankruptcy Service No. 3656, contains a dictum to the effect that the claim of a parent corporation will not be subordinated to the interests of the preferred stockholders of a subsidiary, in reorganization of the latter under Section 77B. The case is not controlling on the point, however, since the court stated that under the circumstances of the particular case, even creditors of the subsidiary could not claim priority over the parent. If the creditors could not object to the proof of the claim by the parent, a fortiori the preferred stockholders could not object.

In re Celotex Co., (D. C. Del. 1935) 12 F. Supp. 1; In re McCrory Stores Corp., (D. C. N. Y. 1935) 12 F. Supp. 267; In re Burns Bros., (D. C. N. Y. 1936) 14 F. Supp. 910; In re New York Railways Corp., (C. C. A. 2d, 1936) 82 F. (2d) 739, cert. den. 298 U. S. 687, 56 S. Ct. 959 (1936). In the Celotex case and the Burns case, minority stockholders, sharing as such in the reorganization, were allowed to share also as creditors. In the McCrory Stores case, a stockholder elected a director who assisted the former in buying up a number of claims against the debtor. It was held that the stockholder could prove the claims at the purchase price only. In the Railway case, the parent corporation had purchased the bonds of the subsidiary on the open market at 10% of their face value. The parent was allowed priority for these bonds. The present problem would have been presented if the bonds had not been purchased on the open market, but had been issued directly to the parent for loans to the subsidiary.

[6] 148 Ky. 379, 146 S. W. 752 (1912).

in point. In that case, the stockholder-creditors held $47,000 of common stock out of a total capitalization of $81,000, including both preferred and common. In receivership, claims presented amounted to $134,000, of which $77,449 were for money loaned by the common stockholders. The assets sold for $77,450, leaving nothing for the preferred stockholders if the common were allowed to prove their claim. On demurrer, the court allowed the common stockholders to recover as creditors, holding that a majority stockholder could validly loan funds to the corporation and, in the absence of fraud, could collect as a creditor.

While consideration of the logic and validity of the various decisions involving parent and subsidiary corporations would doubtless be valuable, the primary purpose of this discussion is to forecast, if possible, the stand that the courts will probably take on this problem in the future. It is submitted that whether or not *Fryer v. Widemann* was properly decided, it will probably not be followed when a case arises involving a corporate stockholder. The technical rules of law laid down by the court are correct, but they do not necessarily lead to the result obtained. It is true that, in theory, the corporation and a stockholder are separate entities [7] and it has been held that a stockholder may contract with the corporation and loan money to it, in the same manner as any third person.[8] However, the courts have often been inclined to "ignore the corporate entity," or to "pierce the corporate veil," and to hold that in the particular case at bar the corporation and the stockholder were really one and the same.[9] After making that assumption, the court will hold against the common stockholder just as certainly as it held in his favor in *Fryer v. Wiedemann* where the contrary assumption was made. Of course, a man cannot prove a claim in his own bankruptcy.[10] But this form of epithetical jurisprudence, while it may be picturesque, will solve few of the problems of an attorney, and furthermore, it is not particularly appropriate in the mouth of another stockholder of the very corporation whose entity is to be ignored.[11] Instead, the status of the two groups of stockholders

[7] 1 FLETCHER, CYCLOPEDIA CORPORATIONS, perm ed., 84 (1931).

[8] 13 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 36, 50 (1932).

[9] LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 5 (1936).

[10] Clere Clothing Co. v. Union Trust & Savings Bank, (C. C. A. 9th, 1915) 224 F. 363; Centmont Corp. v. Marsch, (C. C. A. 1st, 1933) 68 F. (2d) 460, comment 82 UNIV. PA. L. REV. 868 (1934); Ballantine, "Separate Entity of Parent and Subsidiary Corporations," 14 CAL. L. REV. 12 at 16 (1925); 45 YALE L. J. 1471 (1936).

[11] Baille v. Columbia Gold Mining Co., 86 Ore. 1, 167 P. 1167 (1917), holding that a stockholder is in no position to contend that the corporate form is a fiction. For application of the same argument to bondholders, see New York Trust Co. v. Carpenter, (C. C. A. 6th, 1918) 250 F. 668.

must be examined to determine whether or not justice demands that legal forms be disregarded to prevent an inequitable result.[12] With this goal in mind, there are at least three aspects of the problem which may be considered and which have been separately passed upon by the courts. First is the relationship between the parent corporation and a creditor; second is a comparison of preferred stockholder and bondholder; and third is the relationship between the non-voting stockholder and the controlling parent corporation.

While it is not absolutely clear in every case on what basis the claim of the parent corporation is subordinated to that of the creditor, nevertheless, the courts appear to apply one or both of two tests. One is the "instrumentality rule"[13] that the corporate fiction will be ignored when ownership of stock is resorted to not for the purpose of participation in the affairs of the corporation in the manner normal to a stockholder, but for the purpose of making the corporation a mere agent or instrumentality.[14] However, it would seem that little injustice would arise merely from a failure to conform strictly to formal corporate procedure, and probably the second test, the adequacy of the capitalization of the subsidiary, is the deciding point in most cases.[15] There is a feeling apparent throughout these cases that the privilege of limited liability afforded by the incorporation statute should not be "abused" by an attempt to set up a creditor-proof business.[16] And though this feeling may not be warranted by strict construction of the incorporation statute,[17] nevertheless the privilege of limited lia-

[12] Jones Co. v. Home Oil & Development Co., 124 La. 148, 49 So. 1009 (1909); Texas Co. of Mexico S. A. v. Roos, (C. C. A. 5th, 1930) 43 F. (2d) 1; Wabash Ry. v. American Refrigerator Transit Co., (C. C. A. 8th, 1925) 7 F. (2d) 335; Briggs & Co. v. Harper Clay Products Co., 150 Wash. 235, 272 P. 962 (1928); Pittsburgh Reflector Co. v. Dwyer & Rhodes Co., 173 Wash. 552, 23 P. (2d) 1114 (1933); Douglas and Shanks, "Insulation From Liability Through Subsidiary Corporations," 39 YALE L. J. 193 at 218 (1929); 82 UNIV. PA. L. REV. 868 (1934); 35 MICH. L. REV. 794 (1937).

[13] The leading exponent of the Instrumentality Rule appears to be POWELL, PARENT AND SUBSIDIARY CORPORATIONS (1931). For a critical analysis of the rule see, LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 156 ff. (1936).

[14] Centmont Corp. v. Marsch, (C. C. A. 1st, 1933) 68 F. (2d) 460, comment 82 UNIV. PA. L. REV. 868 (1934); S. G. V. Co. of Delaware v. S. G. V. Co. of Pennsylvania, 264 Pa. 265, 107 A. 721 (1919); Forbush Co. v. Bartley, (C. C. A. 10th, 1935) 78 F. (2d) 805.

[15] Wilkinson v. Walker, (D. C. Tex. 1923) 294 F. 939; LATTY, SUBSIDIARY AND AFFILIATED CORPORATIONS 110 ff. (1936); Douglas and Shanks, "Insulation from Liability Through Subsidiary Corporations," 39 YALE L. J. 193 at 218 (1929); 45 YALE L. J. 1471 (1936).

[16] 35 MICH. L. REV. 794 (1937).

[17] Saloman v. Saloman and Co., [1897] A. C. 22. See 35 MICH. L. REV. 467 (1937).

bility of the parent will be restricted unless its capital contribution, as a stockholder, with perhaps the aid of third party lenders, is sufficient to support the normal credit demands of the business of the subsidiary.[18] Indeed, some of the decisions term the conduct of the parent "fraudulent"[19] and appear to imply, in spite of the general rule that a stockholder may make a valid loan to the corporation,[20] that all advances by a parent to the subsidiary shall be deemed capital contributions and not loans.[21] If this rule is intended to be absolute, and is applied irrespective of the person complaining, then merely by force of his contract,[22] the preferred stockholder will be given priority over the claims of the parent corporation. However, before taking this somewhat harsh means of forcing the proprietor of a business to have the courage of his convictions, it would be well to look first at the position of the party complaining. While it might validly be said that one who expects to gain the profits of a successful business should also bear the primary burdens of its failure, nevertheless, it must be remembered that the preferred stockholder is also a proprietor of the business and bound to bear some of the risk.

In legal theory, at least, the preferred stockholder is quite different from the creditor who has a right to demand that the ultimate risk of the failure of the subsidiary be borne by the parent corporation.[23] But since the solution of this problem depends upon the equities of the parties and obviously not on strict legal form, it is highly proper to question whether, as a matter of fact, there really is such a great difference between creditor and preferred stockholder. While the courts

[18] LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 153 (1936).

[19] Clere Clothing Co. v. Union Trust & Sav. Bank, (C. C. A. 9th, 1915) 224 F. 363 at 366, "deliberate attempt on the part of the latter company [the stockholder] to prove debts against itself in fraud of legitimate creditors." See also Forbush Co. v. Bartley, (C. C. A. 10th, 1935) 78 F. (2d) 805.

[20] Supra, note 8.

[21] S. G. V. Co. of Delaware v. S. G. V. Co. of Pennsylvania, 264 Pa. 265 at 269, 107 A. 721 (1919): "one who invests money in his own business cannot in case of failure shift the loss to innocent parties because of the name under which the business was done or the manner of doing it." See also, Clere Clothing Co. v. Union Trust & Sav. Bank, (C. C. A. 9th, 1915) 224 F. 363; Ballantine, "Separate Entity of Parent and Subsidiary Corporations," 14 CAL. L. REV. 12 at 16 (1925); LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 151 (1936).

[22] "In the event of the liquidation, dissolution, or winding up of the Corporation, whether voluntary or involuntary, the holders of the Preferred Stock shall be entitled to be paid One Hundred Five Dollars ($105) per share . . . before any amount shall be paid to the holders of Common Stock. . . ." [Taken from the form for preference stock in BALLANTINE, MANUAL OF CORPORATION LAW AND PRACTICE 974 (1930).]

[23] Hamlin v. Toledo, St. L. & K. C. R. R., (C. C. A. 6th, 1897) 78 F. 664; Miller v. Ratterman, 47 Ohio St. 141, 24 N. E. 496 (1890); 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 708 (1932); 29 A. L. R. 254 (1924).

have been consistent in giving the creditor priority over the stockholder,[24] it would not be inconsistent to hold that, as against the common stockholder, the preferred stockholder should have the standing and equities of a creditor of the corporation.[25] In spite of the theoretical difference between creditor and stockholder, it is often difficult to distinguish between contracts of bondholders and those of preferred stockholders. Merely compare non-voting, non-participating, redeemable preferred stock with income bonds.[26] How much of an entrepreneur is one who is to take no part in the management of a business, and whose income and capital interest is definitely limited without regard to the total amount of profits? And how much of the risk of a business should such an investor bear? By force of his contract, the preferred stockholder expects to secure a fixed rate of yield and the ultimate return of his principal,[27] the latter often by redemption before the final winding up of the business. His interest is not the permanent, ultimate interest of the ordinary stockholder, but more like that of the creditor who expects to be paid off while the business is still going.[28] The risk that the preferred stockholder must bear should be commensurate with his interest in the subsidiary, and since, as far as the common stockholder is concerned, the interest of the preferred stockholder is much like that of a creditor, it can be argued that the common should be no more able to shift the risk to the preferred than to the creditor. If the parent corporation's claim is subordinated to those of creditors, it would seem that it should be subordinated to those of preferred stockholders as well. True, it can be said with some force that a preferred stockholder could be presumed to know the capital set-up of the corporation,[29] to know that additional capital in some form will be necessary, and that therefore he has in no way been misled.[30] However,

[24] Supra, note 21.

[25] Westerfield-Bonte Co. v. Burnett, 176 Ky. 188, 195 S. W. 477 (1917). But see the dictum in In re Davison Chemical Co., (D. C. Md. 1935) C. C. H. Bankruptcy Service No. 3656.

[26] For a discussion of the status of preferred stocks and hybrid securities in general, see Hansen, "Hybrid Securities," 13 N. Y. UNIV. L. Q. REV. 407 (1936); 28 COL. L. REV. 65 (1928); 45 YALE L. J. 907 (1936); and the comment on the same topic in this issue of the Review at page 96.

[27] BERLE, STUDIES IN THE LAW OF CORPORATE FINANCE 45 (1928).

[28] Ibid. at 157: "In the last analysis, the interest of stockholder and bondholder in the use of a subsidiary corporation is much the same."

[29] Behrman v. Zelman, 130 Misc. 846, 225 N. Y. S. 385 (1927); Memphis & L. R. R. v. Dow, (C. C. N. Y. 1884) 19 F. 388. In the latter case, bondholders of a corporation foreclosed their mortgage, purchased the property and turned it over to a new corporation, taking both stock and bonds. When plaintiff subsequently acquired stock and attempted to have the mortgage set aside, it was held that he took with notice of the bonds and had no right to complain.

[30] Several cases seem to rely on some notion of estoppel as a basis for subordination

the presumption of knowledge of capital set-up is usually quite fictitious and merely a mechanical method of justifying a result already decided upon.

The very weakness of the preferred non-voting[31] stockholder is an argument in his favor. He is peculiarly at the mercy of the controlling stockholder, and consequently the latter may not run the subsidiary in its own interest to the injury of the former.[32] Clearly any deliberate attempt by the voting stockholder to freeze out the non-voting group or to appropriate the assets of the corporation for its own benefit may be avoided by the non-voters. Building contracts with the corporation,[33] mortgages,[34] leases,[35] and plans for dissolution, merger, consolidation, reorganization, or sale of assets[36] must be fair and entered into in good faith or they may be avoided by the minority or non-voting stockholders. Likewise, any deliberate attempt to loan money to the subsidiary for the purpose of later freezing out the non-voters by foreclosure will be prevented.[37] And it might further be argued that any attempt to shift the risks of the subsidiary to the non-voting stockholders by means of loans to the subsidiary is a breach of duty.

of the stockholder's claims as creditor. See Hock & Co. v. Strohm, 166 Md. 253, 170 A. 738 (1934); Gledhill v. Fisher & Co., 272 Mich. 353, 262 N. W. 371 (1935); Marsch v. Southern New England R. R., 230 Mass. 483, 120 N. E. 120 (1918).

[31] The use of non-voting stock is apparently on the wane, due to the attitude of the New York Stock Exchange. See MEAD, CORPORATION FINANCE 44 (1933). However, in a study of 1,048 preferred stock issues between 1925 and 1930, 5.3% of the industrials were non-voting, while 66.5% became voting only an a default in dividends; of public utility issues, 9.6% were non-voting and 61.2% were non-voting until default. DEWING, CORPORATION SECURITIES 193 (1934).

[32] BERLE, STUDIES IN THE LAW OF CORPORATE FINANCE 169 (1928); 1 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 174 (1931); 28 MICH. L. REV. 181 (1929).

[33] Bell v. Fred T. Ley & Co., 278 Mass. 60, 179 N. E. 294 (1932).

[34] Heffern Co-op. Consol. Gold Min. & Mill. Co. v. Gauthier, 22 Ariz. 67, 193 P. 1021 (1920).

[35] Fleming v. Black Warrior Copper Co., 15 Ariz. 1, 136 P. 273 (1913); Rogers v. Nashville, C. & St. L. Ry., (C. C. A. 6th, 1898) 91 F. 299; Meeker v. Winthrop Iron Co., (C. C. Mich. 1883) 17 F. 48; Glengary Consol. Min. Co. v. Boehmer, 28 Colo. 1, 62 P. 839 (1900).

[36] Rothschild v. Memphis & C. R. R., (C. C. A. 6th, 1902) 113 F. 476; Ervin v. Oregon Ry. & Nav. Co., (C. C. N. Y. 1886) 27 F. 625; Boyd v. N. Y. & H. R. R., (D. C. N. Y. 1915) 220 F. 174; Southern Pac. Co. v. Bogert, 250 U. S. 483, 39 S. Ct. 533 (1919); Mumford v. Ecuador Development Co., (C. C. N. Y. 1901) 111 F. 639; Kavanaugh v. Kavanaugh Knitting Co., 226 N. Y. 185, 123 N. E. 148 (1919).

[37] Jacobus v. Diamond Soda Water Mfg. Co., 94 App. Div. 366, 88 N. Y. S. 302 (1904); Male v. Atchison, T. & S. F. R. R., 179 App. Div. 87, 166 N. Y. S. 593 (1917). A notorious example of such practice is found in Farmers' Loan & Trust Co. v. New York & N. Ry., 150 N. Y. 410, 44 N. E. 1043 (1896). The New York Central purchased a controlling interest in the New York & Northern and also had

In the case of *Westchester Fire Ins. Co. v. Syracuse, B. & N. Y. Ry.*,[38] the controlling corporation, the Delaware, Lackawanna and Western, had leased a railroad from the subsidiary, the Syracuse Company, the lease providing that the subsidiary should issue bonds when demanded by the lessee. The court, in avoiding the lease on complaint of the minority stockholders, said,

> "The Lackawanna Company is thus given power to embark upon the most ambitious projects of extensions and new construction it may desire at no risk to itself, but wholly at the risk of the Syracuse Company."[39]

Similar language may be found in other cases,[40] but none of them actually hold that the stockholder may not collect a loan made while the subsidiary was solvent, and it was expressly held in *Fryer v. Wiedemann*[41] that it was not a breach of duty for the controlling stockholders to create claims in favor of themselves superior to those of the preferred stockholders. Still, there is some weight to the argument that the placing of risk on the non-voting stockholders is unfair, and it is an equity in their favor.

Adding everything together, the picture discloses a controlling parent corporation (unsavory in itself) attempting to achieve profit substantially without risk, at the expense of one who is actually like a creditor. If the attempt is frustrated, violence will be done to several

Drexel, Morgan & Co., purchase about $1,700,000 of the mortgage bonds of the N. Y. & N. The N. Y. C. then deliberately proceeded to mismanage the N. Y. & N., causing a default on the bonds. Drexel, Morgan thereupon directed the trustee to foreclose. On the objection of the minority stockholders of the N. Y. & N., the decree of foreclosure granted by the lower court was reversed by the Court of Appeals.

[38] 97 Misc. 471, 161 N. Y. S. 759 (1916).

[39] 97 Misc. 471 at 480.

[40] In Heim v. Jobes, (C. C. A. 8th, 1926) 14 F. (2d) 29, it was held that it was an improper preference and a breach of duty to the minority for the controlling stockholder to take a mortgage from the corporation while it was insolvent. A plan of reorganization under Section 77B of the Bankruptcy Act was held unfair because voting power was taken away from the preferred stock and the debtor was to be allowed to mortgage its property to any amount. In re Parker-Young Co., (D. C. N. H. 1936) 15 F. Supp. 965.

[41] 148 Ky. 379, 146 S. W. 752 (1912). The case is especially strong on this point because the preferred stock contract provided that no liens were to be placed on the property prior to the interest of the preferred. The court held that the claim of a general creditor was not a lien. See also, Southern Pacific Co. v. Bogert, 250 U. S. 483, 39 S. Ct. 533 (1919); Jacobus v. Diamond Soda Water Mfg. Co., 94 App. Div. 366, 88 N. Y. S. 302 (1904); and Heffern Co-op. Consol. Gold Min. & Mill. Co. v. Gauthier, 22 Ariz. 67, 193 P. 1021 (1920), where the courts held that although the controlling stockholders could not enforce their mortgages, they were still creditors for the amount they had advanced.

technical legal doctrines, including the entity concept of the corporation and the theoretically proprietary nature of the preferred stockholder's interest. But it must be remembered that the whole approach that the courts have taken to this general subject is one of blithe disregard of legal forms.[42] Dry logic, based on theoretical concepts, will not convince a court emotionally bent on placing the risk of a business where it believes it belongs. Perhaps it would not be too bold to prophesy that whenever the parent corporation's claim is subordinated to the claims of creditors, the preferred stockholder can also obtain priority.

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[42] 35 MICH. L. REV. 794 at 797 (1937).