CORPORATIONS - PARENT'S LIABILITY FOR SUBSIDIARY'S OBLIGATIONS

Michigan Law Review

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Corporations — Parent's Liability for Subsidiary's Obligations — A parent corporation owned all the stock of a subsidiary which it had organized to hold real estate, its own business being mercantile. The directors and officers of both corporations were identical. The subsidiary sublet premises for ninety-nine years, in turn leasing them to the parent for ten years. Improvements were made in accordance with the subsidiary's contract, and "leasehold trust certificates" were issued by an assignee of the underlying lease. The parent quit the premises before the expiration of its lease, but paid the rent for the whole period. The subsidiary then defaulted on the ninety-nine year lease, having no assets with which to pay the rent. Plaintiffs, holders of "leasehold trust certificates," then sued the parent for the rent. Upon these facts it was held in a recent case that since there was no showing of actual fraud, the fact that one corporation owns all the stock of another or even has created the other to avoid personal liability will not make the parent, which is a separate entity, responsible for the obligations of the subsidiary. Three judges dissented on the grounds that where a corporation is so closely tied up with another and so controlled by stock ownership that it may be said to be a "mere agent, arm, instrumentality, or department of the parent" (which is a question of fact), the court will ignore the

2 North v. Higbee Co., 131 Ohio St. 507 at 528, 3 N. E. (2d) 391 (1936).
3 The records in the principal case indicate the following facts: Complete stock ownership of all shares issued; officers and directors identical in both companies; books of both companies consolidated by a write-off from subsidiary's and corresponding entries on parent's with indication of whose assets and liabilities the entries represented, said to be for convenience; consolidated tax returns, stated therein to be such with indications of each company's income; payment of subsidiary's rent, taxes, and improvement costs by parent; change orders in contracts made by subsidiary by parent (president claiming parent's name was used erroneously); only part of authorized stock was issued, and this to the parent by action of the subsidiary's board of directors,
technically separate entities and hold the parent on the obligations of the subsidiary, without a showing of actual fraud.\(^4\)

Because of the continued expansion of corporations and their increasing power over private property, the question of the liability of one corporation for the obligations of another which it controls by means of stock ownership is becoming progressively more important.\(^5\)

Generally, a parent corporation is not liable on the obligations of its subsidiary.\(^6\) Some courts have applied a so-called agency theory\(^7\)


\(^7\) Cases holding agency (note the facts relied on by the court): Erickson v. Minnesota & Ont. Power Co., 134 Minn. 209, 158 N. W. 979 (1916), subsidiary built dam with parent's funds, mortgaged it to parent, parent maintained dam, had exclusive use of water by contract, subsidiary's only asset was the dam; Lehigh Valley R. R. Co. v. Dupont, (C. C. A. 2d, 1904) 128 F. 840, decedent bought ticket from parent, was injured on subsidiary's line, no mention on ticket of subsidiary, all lines part of large "system," so represented; Specht v. Missouri Pac. R. R., 154 Minn. 314, 191 N. W. 905 (1923), railroad car had defective coupler, car belonged to parent on subsidiary's line, statute made railroad liable for injuries due to hauling or using to haul cars with wrong type couplers; Oriental Investment Co. v. Barclay, 25 Tex. Civ. App. 543, 64 S. W. 80 (1901), subsidiary inadequately financed, reports to parent by manager of hotel for subsidiary, hotel rented to subsidiary at rental great enough to keep it assetless, plaintiff had no actual knowledge of subsidiary's existence; Chicago, M., St. P. R. R. v. Minneapolis Civic & Comm. Assn., 247 U. S. 490, 38 S. Ct. 553 (1918), not a parent-liability case, but parent held discriminating through contracts with subsidiary for rate rebates, subsidiary owning no stations or rolling stock, case being significant principally for its language and frequent citation; In re Kentucky Wagon Mfg. Co., (D. C. Ky. 1932) 3 F. Supp. 958, affd (C. C. A. 6th, 1934) 71 F. (2d) 802, 26 Am. B. R. (N. S.) 263, cert. den. 293 U. S. 612, 55 S. Ct. 142 (1934), representations of subsidiary's responsibility by parent, telling creditors subsidiary was "sound," decision in effect held parent liable for subsidiary's obligations by disallowing claims against the insolvent subsidiary by parent; Clere Clothing Co. v. Union Trust & Sav. Bank, (C. C. A. 9th, 1915) 224 F. 363, where there was a contract between parent and subsidiary and a denial of parent's claim against the insolvent subsidiary with strong language used; Spokane Merchant's Assn. v. Clere Clothing Co., 84 Wash. 616, 147 P. 414 (1915), arising out of same transactions
to hold the parent, using looser terms as well,\(^8\) said to be derived from control by the parent, as a basis for liability.\(^9\) Other courts have relied on general notions of justice and equity to hold the parent, as preceding case cited, where subsidiary was selling goods purchased by parent, and parent was held liable for debts contracted by president of subsidiary having at least apparent authority to do so.

**Cases holding no agency** (compare the facts of the cases preceding): Gillis v. Jenkins Petroleum Co., (C. C. A. 9th, 1936) 84 F. (2d) 74, subsidiary formed to avoid patent litigation, became insolvent, assets sold to receiver of both corporations, and parent was held liable on another ground; Harlan Public Service Co. v. Eastern Const. Co., 254 Ky. 135, 71 S. W. (2d) 24 (1934), machine loaned to affiliate, both companies adequately financed, both part of chain of utilities, separate officers and directors, little common beyond stock ownership; Bethlehem Steel Co. v. Raymond Concrete Pile Co., 143 Md. 67, 118 A. 279 (1922), railroad built by parent on its own land, leased to subsidiary formed by its agents to haul for parent, common cashier and disbursements, negligent injury caused by employee of subsidiary, beyond common officers and directors and stock ownership, separation was complete except for the foregoing; Berkey v. Third Ave. Ry., 244 N. Y. 84, 155 N. E. 58 (1926), parent made loans to subsidiary for construction and operation expenses, charging same to subsidiary, one manager of whole system and generally ran as a unit, directors of one were employees of another; First Nat. Bank v. Walton, 146 Wash. 367, 262 P. 984 (1928), receivers of parent intervened to have assets of both parent and subsidiary go for benefit of all creditors, which was refused, the court saying each corporation retained its identity, so giving a preference to subsidiary's creditors, it having been created for that purpose by the parent with no actual fraud on its own creditors; Martin v. Development Co. of America, (C. C. A. 9th, 1917) 240 F. 42, contract creditors could not reach assets of parent, the subsidiary having incurred debts on its own credit; General Discount Corp. v. First Nat. Bank—Detroit, (D. C. Mich. 1933) 5 F. Supp. 709, where receiver of an insolvent bank was allowed to set-off the bank's claims on parent corporation against its debt to parent, but not the bank's claims on subsidiaries; Owl Fumigating Corp. v. Calif. Cyanide Co., (D. C. Del. 1928) 24 F. (2d) 718, affd (C. C. A. 3d, 1929) 30 F. (2d) 812, parent a holding company without other assets except stock of subsidiary, and court pointed out there was no advantage to suit against it except to trouble holding company, it being a foreign corporation.

\(^8\) Ballantine, "Separate Entity of Parent and Subsidiary Corporations," 14 CAL. L. Rev. 12 (1925). Examples of such looser terms are "alter ego," "arm," "instrumentality," "department," "adjunct," "tool," "buffer," "dummy"; for such usage see North v. Higbee Co., 131 Ohio St. 507 at 528, 3 N. E. (2d) 391 (1936); Wheeling & L. E. R. R. v. Carpenter (The "Third Carpenter Case"), (C. C. A. 6th, 1914) 218 F. 273, subsidiary formed in reorganization, directors of which were employees of parent, subsidiary ratified certain agreements at direction of parent, but court did not find it to be a "mere instrumentality."

particularly in cases where the subsidiary is insolvent or was inadequately financed, the theory still being that the parent was identified with the subsidiary, the courts having pierced the "corporate veil." Courts also say that contracts of a wholly-owned subsidiary will be given careful scrutiny as to fairness and as to what light they throw on the relation of the parent and the subsidiary. However, many other courts have refused to ignore the corporate fiction on the grounds that the facts of the cases before them do not justify such action. What general basis there ought to be for a parent and subsid-

10 Industrial Research Corp. v. General Motors Corp. (D. C. Ohio, 1928) 29 F. (2d) 623 at 627, where Judge Killits said:

"It is against sound policy, where a corporation has grown so large, and it has entered into activities so various and so generally distributed that it finds itself compelled to operate through many subsidiaries, doing nothing directly itself in carrying on its business, to permit it to enjoy exclusively the fruits of such subsidiary activity and to escape the concomitant responsibilities flowing therefrom."

It appeared, however, that the parent actually had controlled the acts of the subsidiary without the discretion of the subsidiary's directors. The case was quoted and approved in Detroit Motor Appliance Co. v. General Motors Corp., (D. C. Ill. 1933) 5 F. Supp. 27, there being specific evidence that the parent had directly caused the subsidiary to act and had not observed the corporate form. See also Ballantine, "Separate Entity of Parent and Subsidiary Corporations," 14 Cal. L. Rev. 12 (1925), suggesting that liability may be predicated as usual where one person (human or corporate) directs the acts of another, and when this may not be done, the decision should rest on fairness and justice; Berkey v. Third Ave. Ry., 244 N. Y. 84, 155 N. E. 58 (1926).


13 The fact that directors and officers are the same or that one corporation owns all the stock of another said not to be enough: Berkey v. Third Ave. Ry., 244 N. Y. 84, 155 N. E. 58 (1926); American Cyanimid Co. v. Wilson & T. Fertilizer Co., (C. C. A. 5th, 1931) 51 F. (2d) 665; Texas Co. v. Roos, (C. C. A. 5th, 1930) 43 F. (2d) 1; Wm. Wrigley, Jr., Co. v. L. P. Larson, Jr., Co., (D. C. Ill. 1925) 5 F. (2d) 731. That it has not appeared that to recognize the corporate entities would "aid in the consummation of a wrong": Erkenbrecher v. Grant, 187 Cal. 7, 200 P. 641 (1921). That the evidence fails to show that there has been "complete domination": Lowendahl v. Baltimore & Ohio R. R., 247 App. Div. 144, 287 N. Y. S. 62 (1936); Hollywood Cleaning & Pressing Co. v. Hollywood Laundry Service, 217 Cal. 124, 17 P. (2d) 709 (1932), where parent did business through a subsidiary which it could not do itself. That it had not been demonstrated that there was a "consolidation of the entities": Linker Realty Corp. v. S. S. C. Realty Co., 117 N. J. Eq. 482, 176 A. 323 (1935), affg. 115 N. J. Eq. 427, 171 A. 160 (1934), where parent's mortgage of subsidiary's land was held prior to a second mortgagee's, who was not injured, having dealt with the subsidiary, and who would get a windfall if the two corporations were held to be one when the parent acquired the originally prior mortgage; Riley v. Pierce Oil Co., 245 N. Y. 152, 156 N. E. 647 (1927);
A corporation is a creature of the state, created in the manner prescribed by the laws of the state. A corporate franchise is a right given to a group of individuals by the state to organize in certain specified ways with concomitant power to exist and function as a legal person, thereby gaining a permanence of undertaking impossible to obtain as individuals.

Doing business in corporate form allows the persons interested to risk only the amount paid or owing for their interest in any enterprise permitted by the state, while, at the same time, these persons have a voice in the management of the business and a participation in the returns therefrom as proprietors, through stock ownership. Not only may individuals organize in corporate form with the assent of the state, but corporations may do so through


Ohio Ins. Co. v. Nunnemacher, 15 Ind. 294 (1860); Schuetzen Bund v. Agitations Verein, 44 Mich. 313, 6 N. W. 675 (1880); Blackrock Copper Min. & Mill Co. v. Tinge, 34 Utah 369, 98 P. 180 (1908); Hirney v. Oppold, 48 S. D. 70, 201 N. W. 721 (1925); Sneed v. Tippet, 114 Okla. 173, 245 P. 40 (1926).

Ohio Ins. Co. v. Nunnemacher, 15 Ind. 294 (1860); State ex rel v. Men's Club, 178 Mo. App. 548 at 562, 163 S. W. 901 (1914): "The corporate franchise is the right to exist as an entity for the purpose of doing things which are permitted under the law authorizing the incorporation. The things which the corporation is authorized to do are its powers as distinguishable from its franchise, that is, its right to exist as a corporation. . . ."

FLETCHER, CYCLOPEDIA CORPORATIONS, § 6 (1931); COOK, CORPORATIONS, § 2 (1923); THOMPSON, CORPORATIONS, §§ 2-4 (1927).

Thompson-Houston Electric Co. v. Murray, 60 N. J. L. 20, 37 A. 443 (1897); Stone v. Cleveland, C. C. & St. L. Ry., 202 N. Y. 352, 95 N. E. 816, 35 L. R. A. (N. S.) 770 (1911); COOK, CORPORATIONS, § 1, p. 7 (1923): "It is a principle of law, coeval with the existence of corporations having a capital stock, that, unless the corporate charter of a constitutional statute provides otherwise, a stockholder, the full par value of whose stock has been paid in, is not liable for and cannot be made to pay any sums in addition thereto"; Bicknell v. Altman, 81 Kan. 436, 105 P. 694 (1909).

their agents, 20 providing the organization is not in restraint of trade and
tending to monopoly so as to be against public policy, 21 or providing
the organization is not fraudulent as to creditors 22 or violative directly
or indirectly of some law. 23 The only time when it may logically be
said that stockholders have a liability beyond the amount of their in­
vestment in shares is when it is so provided by the legislature 24 or
where there has been a fraud on the law through failure to comply
with the provisions of the statute as to organization and management
of the corporation. 25 Where the organization has failed to comply
with the statute, the stockholders still may have no liability to per-


22 First Nat. Bank of Chicago v. F. C. Trebein Co., 59 Ohio St. 316, 52 N. E. 834 (1898); 1 Fletcher, Cyclopedia Corporations, § 43 (1931); Hurd v. New York, etc., Steam Laundry Co., 167 N. Y. 89, 60 N. E. 327 (1901); Cook, The Corporation Problem 85 et seq. (1891).


25 Berkey v. Third Ave. Ry., 244 N. Y. 84 at 95, 155 N. E. 58 (1926), where Judge Cardozo said that at certain times, "unity is ascribed to parts which, at least for many purposes, retain an independent life, for the reason that only thus can we overcome a perversion of the privilege to do business in corporate form. We find in the case at hand neither agency on the one hand, nor on the other abuse to be corrected by the implication of a merger. On the contrary, merger might beget more abuses than it stifled. Statutes carefully framed for the protection, not merely of creditors, but of all who travel upon railroads, forbid the confusion of liabilities by extending operation over one route to operation on another. In such circumstances, we thwart the public policy of the State instead of defending or upholding it, when we ignore the separation between subsidiary and parent and treat the two as one." (Italics added.)

Gledhill v. Fisher & Co., 272 Mich. 353 at 369-370, 262 N. W. 371 (1935), where dissenting Justice Sharpe said: "Corporations are creatures of the law. Under them, individuals may engage in business and avoid the danger of dissolution incident to a partnership on the death of a copartner. Their immunity from corporate obligations is a basic element of the corporate concept, and will be abrogated only when there is an abuse of the privilege granted to do business in corporate form—in other words, a fraud upon the law." (Italics added.)
sons who dealt with the corporation as such; or even where there were no contractual dealings upon which this sort of non-technical estoppel might be built, there may still be limited liability under the doctrine of de facto incorporation.

The logical conclusion is that there is no point in designating a subsidiary corporation as a "mere agent, arm, instrumentality, or department" of the parent, as a basis upon which to predicate liability of the parent for obligations of the subsidiary, for these broad and general terms do not necessarily mean that there has been a breakdown of the corporate formalities and a consequent fraud on the law.

It is submitted that if the courts were to approach the problem from the basis of what the statute under which the corporation was formed permits, directs, and demands, with a consideration of the evidence before the court in this light, that there would be a sound basis for the practicing attorney to advise his corporate client on a future course of conduct relating to a subsidiary, instead of compell- ing guess-work and groping in the "mists of metaphor" for a firm footing. It would also seem that if attorneys (to whom the removal of this uncertainty appears vital) would emphasize individual or corporate stockholder's liability individually for debts or obligations of a corporation in which the stock is held, as an ordinary question of statutory interpretation, the courts would be compelled to lay a logical and predictable foundation for their approach.

The facts of the principal case indicate a preservation of the corporate forms in compliance with the statutory requirements under which both parent and subsidiary were formed. The result from the

26 Magnolia Shingle Co. v. J. Zimmern's Co., 3 Ala. App. 578, 58 So. 90 (1912); Bond & Braswell v. Scott Lumber Co., 128 La. 818, 55 So. 468 (1911) (note the comment on the statute); 8 FLETCHER, CYCLOPEDIA CORPORATIONS, § 3910 (1931) and cases there cited.

27 Kardo Co. v. Adams, (C. A. 6th, 1916) 231 F. 950; 8 FLETCHER, CYCLOPEDIA CORPORATIONS, § 3771 (1931): "With certain minor exceptions . . . [§ 3855 re eminent domain proceedings and stock subscription suits] the only difference between a de jure and a de facto corporation is that the former can successfully resist a suit by the state brought for the purpose of testing the rightfulness of its existence, while the latter cannot so sustain its right to exist"; Marsh v. Mathias, 19 Utah 350, 56 P. 1074 (1899); Chicago & W. I. R. R. v. Heidenreich, 254 Ill. 231, 98 N. E. 567 (1912).


30 Supra, note 3.

31 The subsidiary in the principal case was organized in Delaware in 1919,
suggested mode of attack, therefore, would be in accord with that reached by the majority, but it would seem that practical, clear, logical, and foreseeable reasons for the conclusions would no longer be lacking.

pertinent provisions of the statutes under which it was formed herewith being set forth. Del. Laws (1917), c. 113, p. 1915, § 1: "Any number of persons, not less than three, may associate to establish a corporation. . . ." Rev. Code (1915), p. 1991, § 77: "Any corporation organized under the laws of this state . . . may guarantee, purchase, hold, sell, assign, transfer, mortgage, pledge, or otherwise dispose of, the shares of the capital stock of, or any bonds, securities or evidence of indebtedness created by any other corporation or corporations of this State or any other State, country, nation, or government, and while owner of said stock may exercise all the rights, powers and privileges of ownership including the right to vote thereon." Laws (1917), c. 113, p. 1923, § 9: "The business of every corporation . . . shall be managed by a Board of not less than three directors. . . ." Rev. Code (1915), p. 1924, § 10: "Every corporation . . . shall have a President, Secretary and Treasurer, who shall be chosen by the Directors or stockholders, as the by-laws may direct; and shall hold their offices until their successors are chosen and qualified; the President shall be chosen from among the Directors; the Secretary shall be sworn to the faithful discharge of his duty, and shall record all the proceedings of the corporation and directors in a book to be kept for that purpose. . . ." Laws (1917), c. 113, p. 1934, § 20: "When the whole capital stock of a corporation shall not have been paid in, and the assets shall be insufficient to satisfy the claims of its creditors, each stockholder shall be bound to pay on each share held by him the sum necessary to complete the amount of the par value of such share as fixed by the charter of the company or its certificate of incorporation, or such proportion of that sum as shall be required to satisfy the debts of the company. . . ."