

Corporations - Parent and Subsidiary - Corporate Entity

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NOTES

CORPORATIONS—PARENT AND SUBSIDIARY—CORPORATE ENTITY.—A corporation is said to be legal entity.¹ The statement is comparatively correct, but subject to qualifications. A corporation is distinct from its stockholders; its acts are not their acts, nor its liabilities, so long as it remains solvent, their liabilities. However, there are instances when, for one reason or another, this “legal entity” theory is disregarded; the corporation is then considered as a collection of persons,² and the stockholders are not allowed to hide behind the theory that the corporation is distinct and complete in itself.³

The purpose of this article is not to discuss the theory of corporate entity in all of its various phases, but to inquire into the relationship of two or more closely united corporations. When will the court consider the parent and subsidiary corporations as two separate and distinct corporations, and when will it consider one as the adjunct or agent of the other, or further still, when will it consider the two as actually one? ⁴ For the purposes of the present consideration it matters little whether the court, as an abstract proposition, considers the subsidiary as an adjunct or agent of the parent, or whether the two are considered as one. The principle questions are: what are the rights of the person who deals with the combination, or of the creditor of one member of the insolvent unit, or of the person who has a contract with either, or of the individual who has been injured by the wrong of the controlling or controlled corporation?

There are generally two situations in which corporations may be found associated with the idea of “parent and subsidiary”; (1) where “A” company owns all or a majority of the stock of “B” company, either by reason of purchase, or by virtue of the organization of “B” company by “A” company, and in this case, “A” company is actually the stockholder; and (2) where the stockholders and directors of “A” company are the stockholders and directors of “B” company. As a general proposition, ownership alone of capital stock in one corporation by another does not create an identity of corporate interest between the two companies, or render the stockholding company the owner of the property of the other, or create the relationship of principal and agent, representative, or alter ego between the two.⁵ Nor do common officers,

¹ *Dartmouth College v. Woodward*, 4 Wheat. 518, 4 L.Ed. 629 (1819). Marshall, C. J. “A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law.”

² *Bank of United States v. Deveaux*, 5 Cranch 61, 3 L.Ed. 38 (1809).

³ *Booth v. Bunce*, 33 N.Y. 139 (1865); *Donovan v. Purtell*, 216 Ill. 629, 75 N.E. 334 (1905).

⁴ More common statements of the problem are: “When will the courts pierce the veil of corporate entity?”; “look through form to substance?” “When should the concept of corporate entity be adhered to, when should it be disregarded?” Wormser, *Piercing the Veil of Corporate Entity*, 12 Col. Law Rev. 496 (1912).

⁵ *Peterson v. Chicago, R. I. and Pacific Ry.*, 205 U.S. 364, 27 Sup. Ct. 513, 51 L. Ed. 841 (1907); *Erickson v. Minn. and Ont. Power Co.*, 134 Minn. 209, 158 N.W. 979 (1916); *United States v. Delaware, L. and W. R. Co.*, 238 U.S. 516, 35 Sup. Ct. 873, 59 L.Ed. 1439 (1914); *Owl Fumigating Corp. v. California Cyanide Co.*, 24 F. (2) 718, (D.C. Del., 1928), aff. 30 F. (2) 812, (C.C.A. 3d, 1929); *Cleveland Trust Co. v. Consolidated Gas, Elec. L. and Power Co.*, 55 F. (2) 211 (C.C.A. 4th, 1932).

directors and stockholders, and close affiliation establish identity of the corporations.⁶ But, when it appears that the parent has organized another corporation merely to facilitate the business of the former, and is actually controlling the business of the subsidiary, and the parent becomes insolvent, and the subsidiary has property free from all debts, so that upon liquidation the stockholders of the parent would receive the assets of the subsidiary, the court are quick to recognize the fact, that to sustain the corporate independence of the two would work an injustice upon the creditors.⁷

It seems to be the practice of corporations, as soon as they are "caught" in an illegal practice, to raise the cry of "corporate entity." If there is any instance in which the court will disregard the separate entity of the affiliated corporations, it is where one corporation has organized or assumed control of another in order to defeat the restrictions of a statute. A statute which has been enacted to remedy an existing unfair practice will not be defeated by the very practice which it is to prevent. The court will consider the two corporations as one, which in fact they really are. Thus, where one corporation organized a dummy in order to evade the "commodities clause" of the Hepburn Act,⁸ where one attempted to obtain rebates contrary to the provisions of the Interstate Commerce Act, and the Elkins Act,⁹ or where the

⁶ *Union Sulphur Co. v. Freeport Tex. Co.*, 251 Fed. 634 (D.C. Del. 1918); *Oil Fumigating Co. v. Cal. Cyanide Co.*, supra.

⁷ *In re Muncie Pulp Co.*, 139 Fed. 546 (C.C.A. 2d, 1905); Coxe, Cir. J., at p. 548: "The Great Western Co. (which the pulp company had organized and to which it had transferred its gas and oil wells and lands) was undoubtedly a mere creature of the pulp company, having no independent business existence, and organized solely for the purpose of facilitating the business of the latter. The Great Western Co. has no shadow of claim to the property in controversy, and to permit it, or its president, or shareholders, to dispose of such property, is to sanction a fraud upon the creditors of the pulp company." This case is followed by, *In re Marcella Cotton Mills*, 8 F. (2) 522 (M.D. Ala. N.D., 1925), where by means of corporate entity, stockholders attempted to come in as creditors of an insolvent corporation. There it was said: "It is familiar that a court of equity will not allow corporate fiction to destroy the rights of creditors, where fraud either in fact or in law exists, and that the form or guise will be disregarded and the substance considered. * * * The evidence shows that, as trustees of the Marcella Cotton Manufacturing Co., Thomas Raby and Max Miller were mere subsidiaries or agents of Thomas Raby Inc., and as such can stand in no better position than Thomas Raby Inc.; for, if one corporation is wholly under the control of another, the fact that it is a separate entity does not relieve the latter from liability for its acts, and even when one corporation is the owner and proprietor of another, the latter will be regarded as a mere trade name, and the real beneficiary cannot resort to the fiction of claiming in the name of the latter to defeat bona fide creditors."

⁸ *United States v. Lehigh Valley R. R. Co.*, 220 U.S. 257, 31 Sup. Ct. 387, 55 L.Ed. 458 (1911). The railroad company had purchased all the stock in a coal company in order to evade the clause which prohibited the transportation, by a railroad from one state to another, any article manufactured, mined or produced by it. *Held*, that the coal company was merely the dummy of the railroad.

⁹ *United States v. Milwaukee Refrigerator Transit Co.*, 142 Fed. 247 (E.D. Wis., 1905). The Pabst Brewing Co. had formed the Transit Co. in order to obtain illegal rebates by an indirect method. An injunction was granted preventing the payment of such rebates, the court holding that the Transit Co. was merely a separate name for the Brewing Co., being in fact the same collection of persons and interests. Sanborn, J., stated at p. 255: "If any rule can be laid down, in the present state of authority, it is that a corporation will

Clayton Act prohibiting unfair competition was violated,¹⁰ or where the statute prohibiting usury was being evaded,¹¹ the courts were not hesitant to declare that such a practice could not be countenanced, and that they would "pierce the veil of corporate entity" and consider the two corporations actually as one. The same result is reached where a monopoly in restraint of trade is formed by means of a holding company.¹²

The courts are wont to disregard corporate entity when a corporation attempts to rid itself on an onerous contract by the formation of a successor, which is in fact the old corporation under a new name.¹³

The law seems to be more lenient with such affiliated corporations in matters of simple contract. Generally, the holding corporation is not liable on the contracts of its subsidiary.¹⁴ However, where the circumstances point to fraud, or to a transaction in which the holding company rather than the subsidiary reaped the benefit, liability will be imposed upon the parent company.¹⁵ It is well to note, that in many of the instances in which the parent was not held liable on the contract of the subsidiary, there were facts which showed that the other contracting parties had never looked to the parent company as their debtor, but had contracted upon the credit of the controlled company.¹⁶ It may be ventured that, had the creditors originally looked to the main corporation to carry out the contract, it would have been held liable.

The problem becomes increasingly difficult when one considers the case of a tort committed by the subsidiary company. In such a case there are no creditors to protect, the corporation has violated no statute, and no one has contracted upon the credit of the dominant corporation. The parent has certainly reaped no benefit by reason of the tort of its subsidiary. There are many cases in which the court has refused to hold the parent liable for the tort of its subsidiary on the

be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association of persons."

¹⁰ *Federal Trade Commission v. Thatcher Mfg. Co.*, 5 F. (2) 615 (C.C.A. 3d, 1925).

¹¹ *M. Lowenstein and Sons Inc. v. British American Mfg. Co.*, 300 Fed. 853 (D.C. Conn. 1924).

¹² *Northern Securities Co. v. United States*, 193 U.S. 197, 24 Sup. Ct. 436, 48 L.Ed. 679 (1903).

¹³ *Higgins v. California Petroleum Co.*, 147 Cal. 363, 81 Pac. 1070 (1905).

¹⁴ *East St. Louis Connecting R.R. Co. v. Jarvis*, 92 Fed. 735 (C.C.A. 7th, 1899); *C. Crane and Co. v. Fry*, 126 Fed. 278 (C.C.A. 4th, 1903); *Pittsburg and B. Co. v. Duncan*, 232 Fed. 584 (C.C.A. 6th, 1916); *Martin v. Development Co. of Am.*, 240 Fed. 42 (C.C.A. 9th, 1917); *Allen v. Philadelphia Co.*, 265 Fed. 817 (C.C.A. 3d, 1920); *Haskell v. McClintic-Marshall Co.*, 289 Fed. 405 (C.C.A. 9th, 1923); *Stone v. Cleveland, C., C., and St. L. R. R. Co.*, 202 N.Y. 352, 95 N.E. 816, 35 L.R.A. (N.S.) 77 (1911); *Ambridge v. Philadelphia Co.*, 283 Pa. St. 5, 129 A. 67, 39 A.L.R. 1064 (1925).

¹⁵ *Interstate Telegraph Co. v. Baltimore and O. Teleg. Co.*, 51 Fed. 49, (D.C. Md., 1892), aff. 54 Fed. 50 (C.C.A. 4th, 1893); *Am. National Bank v. Nat. H'paper Co.*, 77 Fed. 85 (C.C.A. 8th, 1896); *Dillard and C. Co. v. Richmond Cotton Oil Co.*, 140 Tenn. 290, 204 S.W. 758 (1918).

¹⁶ *Pittsburg and B. Co. v. Duncan*, supra; *Martin v. Development Co. of Am.*, supra.

ground that control was not sufficient to establish such liability.¹⁷ However, the federal courts seem to disregard the corporate entity and place the liability upon the parent, upon the ground of agency,¹⁸ instrumentality,¹⁹ or identity.²⁰

It cannot be determined upon what ground a court will hold the parent, if at all; that depends upon the jurisdiction, and the degree of identity of the corporations, or of the stockholders and directors in both corporations. But, it can be said, with some degree of certainty, that a court will not allow the creditors of the insolvent member of the unit to be defrauded, nor allow the corporation to evade laws which have been dictated by public policy, nor to escape existing or future obligations, nor even to escape legal liability for tort, by adhering to the doctrine of "corporate entity". The "legal entity" theory will be upheld as long as is possible, but whenever any of the above elements become present, the court will look through to substance, rather than to form.

FRANK J. ANTOINE.

RECENT TENDENCIES IN THE REGULATION OF PUBLIC UTILITY HOLDING COMPANIES.—Seldom in American history has the close relationship between law and economics been as strikingly revealed as in the past three years. With the collapse of a business structure based upon legal principles developed in a laissez-faire agrarian society, there has come to most lawyers the disconcerting realization that law is not

¹⁷ *Berkey v. Third Ave Ry.*, 244 N.Y. 84, 155 N.E. 58 (1926); Plaintiff was injured while leaving a street car. The franchise to operate a street railway along that line belonged to the Forty-Second St. Co. and no one else. However, substantially all the stock of the company was owned by the Third Ave. Ry. Co., which had its own franchise along other streets. The parent company was not held liable; but the court seemed to be protecting the creditors of the controlling company and the interest of the public in cheap and efficient operation of public utilities. *Owl Fumigating Corp. v. California Cyanide Co.*, supra; *Bergenthal v. Boynton Automobile Livery Co. and Green Cab Co.*, 179 Wis. 42, 190 N.W. 901 (1922), where the parent company was not estopped from denying that the subsidiary was its agent or that the two were in fact one; *Atchison, T., and S. F. R. R. v. Cochran*, 43 Kans. 225, 23 Pac. 151 (1890); *Stone v. Cleveland, etc. Ry.*, supra; *Friedman v. Vandalia R. R. Co.*, 254 Fed. 292 (C.C.A. 8th, 1918).

¹⁸ *Lehigh Valley R. R. Co. v. Delachesa*, 145 Fed. 617 (C.C.A. 2d, 1906).

¹⁹ *Joseph Foard Co. v. Maryland*, 219 Fed. 827 (C.C.A. 4th, 1914).

²⁰ *Davis v. Alexander*, 269 U.S. 114, 46 Sup. Ct. 34, 70 L.Ed. 186 (1925); "Where one railroad company actually controls another and operates both as a single system, the dominant company will be liable for injuries due to the negligence of the subsidiary company"; *Ross v. Pennsylvania R. R. Co.*, 148 A. 741 (N.J. 1930); "Where a corporation holds stock of another, not for the purpose of participating in the affairs of the other corporation in the normal and usual manner, but for the purpose of control, so that the subsidiary company may be used as a mere agency or instrumentality for the stockholding company, such company will be liable for injuries due to the negligence of the subsidiary, and the mere fact that an accident is caused by the negligence of persons in the employ of the subsidiary will not relieve the dominant company of responsibility." The question of liability was not determined in this case, the court holding that the evidence should have been submitted to the jury to determine if such control was present.