# Responsibility of the Parent Corporation for the Acts of Its Subsidiary

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It is a familiar and ancient doctrine that the corporation as an entity, distinct from its shareholders, will be disregarded by the courts to prevent fraud, injustice, evasion of laws, or obstruction of public policy. The entity theory is a convenient one to be used only when legitimate ends are served and is in no way sacrosanct in the mind of the Court.

During the past thirty years, an outgrowth of this doctrine has been evolving, in some courts, to the effect that where one corporation *controls* another and *uses* it for its own purposes, the dominant corporation shall be responsible for the acts of the subservient one. This principle has its most frequent application in cases of a parent using subsidiary corporations. Other cases have arisen where there is a common ownership of the dominant and servient corporation.

This formula is now used not only as a reason for disregarding the entity of the controlled corporation in the familiar cases mentioned in the opening paragraph, but is also used to carry further the responsibility of the dominant corporation for the acts of the servient one. Thus the dominant corporation is held responsible for such unpremeditated torts of the servient corporation as the negligence of its employees and even, at times, for its debts and contracts.

The following are the type statements of this principle: "The legal fiction of distinct corporate existence will be disregarded when necessary to circumvent fraud. It may also be disregarded in cases where a corporation is so organized and controlled, and its affairs so conducted as to make it merely an

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instrumentality or adjunct of another corporation,"[1] and, "where such ownership of stock is resorted to, not for the purpose of participating in the affairs of the corporation in which it is held in a manner normal and usual with stockholders but for the purpose of making it a mere agent or instrumentality or department of another company, the courts will look through the forms to realities of the relation between the companies as if the corporate agency did not exist and will deal with them as the justice of the case may require."[2]

For the purpose of this paper it will be convenient to speak of the principle as the instrumentality rule. Where the servient corporation is used by the dominant one to perpetrate fraud, evade law, etc., there is no controversy. The value of the instrumentality rule as a separate rule is that it may make the dominant corporation liable for torts and possibly contract obligations of the instrumentality corporation. And, as would be expected, the rule is denied by some courts at these points. When courts make this advance, it illustrates once more the flexibility of existing principles and their applicability to new situations and inventions. In this case, the greatly increased practice on the part of corporations of carrying on parts or departments of their business through subsidiaries or other servient corporations constitutes the new situation or device to which the law is to be applied.

Practically, the cherished value of the corporate form of doing business is the preservation of the private estate of the individual shareholder, the part which he does not care to risk in the venture. This is socially valuable in that it facilitates the bringing together of capital from many sources. But in case of parent and subsidiary corporations, the individual shareholder in the parent corporation has already achieved immunity from the debts of the parent. Shall he achieve further immunity

[1] *In re Watertown Paper Co.*, 169 Fed. 252 (C.C.A. 2nd, 1909).

[2] *United States* v. *Reading Co.*, 253 U.S. 26, 40 S. Ct. 425, 64 L. Ed. 760 (1920).

through the immunity of the parent from the debts of its various departments? And in case of pyramided corporations, shall immunity be added to immunity? A possible answer to this question is in the language of the court at the conclusion of its opinion in the case of *Industrial Research Corporation* v. *General Motors Corporation*:[3] "It is against sound policy, when 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 the business to permit it to enjoy exclusively the fruits of such subsidiary activity and escape the concomitant responsibilities flowing therefrom."

It should be noted that the court, in this case, considered the parent responsible for a patent infringement by one of its subsidiaries. This should be distinguished from torts such as negligence committed by a subsidiary. The latter type of case presents a more severe test of the instrumentality rule. It is easier for the court to hold that the parent should not take advantage of patent infringements by its subsidiary as this fits into the established patterns of judicial thinking. It has the appearance of a fraud upon the law, and of a device to permit the parent to infringe a patent and escape responsibility therefor. Nevertheless the language is very general. There will be discussed, in this paper, cases involving the liability of the parent for the negligence of its subsidiary instrumentality.

The hesitancy of some courts to carry the instrumentality rule to such advanced ground is sometimes based on a *reductio ad absurdum* argument. To deny the parent immunity from obligations and liabilities of subsidiaries because they are controlled as departments or instrumentalities is also to deny immunity to the individual shareholder who controls a corporation, or perhaps owns all its stock. The argument recognizes no distinction between the individual in control of a corporation and the corporation in control of another corporation. Such

[3] 29 Fed. (2d) 623 (D.C., Ohio, 1928).

courts would confine the application of the instrumentality rule to the familiar types of cases which are applicable to individuals as shareholders and corporations as shareholders alike, namely, cases where the corporation is used as an instrumentality by its shareholders to perpetrate frauds, evade laws, etc. But the reader will note that in both of the type forms of statement of the instrumentality rule, as above quoted, and which are quoted in one way or the other in the numerous cases recognizing the rule, no mention is made of the individual shareholder. Only the parent corporation or other form of dominating corporation is mentioned. The distinction is assumed without argument. There is an occasional remark, such as that quoted above from *Industrial Research Corporation* v. *General Motors Corporation.*[4] The silence as to argument indicates that to the courts citing the rule, it is axiomatic that we should have a special rule for a corporation which conducts its authorized business through incorporated departments or instrumentalities.

Another *ad absurdum* argument against the rule, and the one most difficult for a proponent of the rule in its extreme application to handle, is that it is impossible to distinguish between the case where a parent exercises the usual controls through majority stock ownership, election of directors and the like, and the case where the subsidiary is so dominated and controlled as to become a mere instrumentality or adjunct of the parent. The argument is that under the company lawyer's advice, all forms of separation between parent and subsidiary will be meticulously observed. Separate books, separate accounts, separate financing of the business of the subsidiary will be observed. No direct interference in the subsidiary's business by the parent will be discovered. But with the same directors and officers as the parent, the subsidiary is under the parent's control for all practical purposes. And (the argument proceeds), a court could not prohibit a parent from owning stock in a subsidiary and exercising the usual controls through stock ownership,

[4] See note 3, *supra.*

by election of such directors and officers as the parent desires, so long as statutory law permits one corporation to own voting control in another.

It would not seem so shocking if the court should admit the *ad absurdum* argument and should then go on to hold that when a corporation conducts its own business through corporate instrumentalities which it controls by stock ownership, the thing speaks for itself, and no further evidence of control is necessary to make the parent responsible for the acts of the subsidiary. However, an examination of the cases shows the courts making a sincere effort to weigh the evidence and determine the nice point whether the participation in the affairs of the subsidiary is in the manner normal and usual with stockholders or whether it is for the purpose of making it a mere agent, instrumentality, or department of the parent.

Sometimes the acts speak for themselves. Once it is shown that the parent organized a subsidiary to commit a fraud, or evade a law, or permitted such acts in its subsidiary, to the advantage of the parent, the instrumentality formula may be applied without further evidence of direction or control. No amount of legal care in keeping the corporations technically separate would avail. A discussion of such cases, which are numerous, is not necessary to this paper.

Nor will time permit an excursion into bankruptcy and receivership cases where the parent attempts to present its claim to the trustee or receiver of its insolvent subsidiary. If the claim of the parent is not allowed, it seems to be a recognition that the parent is liable for the debts of the subsidiary. Sometimes the parent's claim has been disallowed because the insolvent subsidiary was proved to be an instrumentality. But in these cases other equitable considerations were generally also assigned as reasons for the courts holding.

A reference to one of these cases is pertinent at this point as illustrating the proof usually adduced to demonstrate an instrumentality. In *In re Otsego Waxed Paper Co.*,[5] the federal dis-

[5] 14 Fed. Supp. 15 (D.C. Mich., 1935).

trict judge disallowed the parent's claim on the sole ground that the bankrupt subsidiary was an instrumentality of the parent. The court said that it was sufficient to prove that the bankrupt was a mere instrumentality of the parent and not necessary to prove that the subsidiary was used to perpetrate a fraud, in order to justify the trustee's refusal to allow the parent's claim. The parent's claim was about one-third of the total of unsecured claims and there was no suggestion made that the subsidiary was inadequately financed or fraudulently held out. It was noted that the parent manufactured paper board, the bankrupt manufactured waxed paper; the plants were adjacent; all books of the bankrupt were kept by the parent's employees; all matters of the bankrupt's business policies were directed by the parent's officers; all of the bankrupt's capital stock was owned by the parent. The directorates were interlocking. The bankrupt's principal office was in the parent's main office. All loans and purchases were made through the parent's office. Thus it was shown that the subsidiary was a mere instrumentality of the parent.

In patent infringement cases, the federal courts have used the instrumentality rule in some instances. This was not so, however, in *Owl Fumigating Corporation* v. *California Cyanide Co., Inc.*,[6] where the court would require that the parent organized the subsidiary to infringe the patent or conspired with the subsidiary to infringe it. The parent not having done so was held not liable. In *Union Sulphur Co.* v. *Freeport Texas Co.*,[7] the parent was found to have known of the projected violation of plaintiff's rights and to have actively participated. Both cases state the rule that mere stock ownership, interlocking directorates and community of officers will not make the parent liable. But in *Industrial Research Corporation* v. *General Motors Corporation*,[8] and in *Detroit Motor Appliance Co.* v.

[6] 30 Fed. (2d) 812 (C.C.A. 3rd, 1929).
[7] 251 Fed. 634 (D.C. Del., 1918).
[8] 29 Fed. (2d) 623 (D.C. Ohio, 1928).

*General Motors Corporation*,[9] it was considered enough to prove that the subsidiary was controlled as a department by the parent.

In the *Industrial Research Corp.* case, it was enough to call attention to an admission in the pleadings that the policies and business of the subsidiary were wholly controlled and directed by the parent, to convert the subsidiary into a "mere agent or instrumentality." There was however more 'cogent proof,' "for," said the court, "exhibits are here, in the form of newspaper, sheet, and pamphlet advertising put on on behalf of the General Motors Corporation which imply most clearly that the alleged local agencies, though distinct corporations, are mere adjuncts to the General Motors Corporation. Aside from the other exhibit publications, the showing made in the annual reports of the General Motors Corporation setting forth for instance the Chevrolet Motor Company as a division of the General Motors Corporation, and a classification of the manufacturing and selling channels by which the overhead corporation has contacts with the public leave little room to doubt, not merely of the subsidiary character of the Chevrolet Motor Ohio Company and the General Motors Truck Company, but that these are mere conveniences employed by the principal movants in the transaction of their business. There is also in evidence the corporate articles of the General Motors Corporation which provide for the manufacturing and dealing 'in automobiles, trucks, cars, boats, flying machines, and other vehicles, their parts and accessories, and kindred articles, and to generally conduct an automobile business in all its branches.' "

Nor is it necessary under this rule that the parent conspired in or directed the infringement. A more diffused type of control is sufficient. In the *Detroit Motor Appliance Co.* case, the parent was found guilty of contempt of court in disobeying a previous order. The disobedience was by subsidiaries, The Cadillac Motor Car Co., and others. It was shown that the

[9] 5 Fed. Supp. 27 (E.D. Ill., 1933).

parent had ordered the subsidiaries to desist. This was taken as evidence that the subsidiaries were controlled as instrumentalities. There was of course other evidence to the same point. Agency was proven by (1) advertising the subsidiaries as divisions, (2) identical officers with the parent, and (3) orders given the subsidiaries to desist.[10]

In cases where the parent or dominant corporation is sued for damages resulting from the negligence of an employee of a subsidiary or servient corporation the cases are often made to turn on the instrumentality rule. The question of fact generally is whether the subsidiary or servient corporation is controlled in such a manner as to make it a mere instrumentality of the dominant corporation. Thus, in *Berkey* v. *Third Ave. Ry. Co.*,[11] the plaintiff sued the parent for the negligence of an employee of a subsidiary street railway corporation. The statement of the court was that the dominion of the parent may be so complete and interference so obtrusive that the subsidiary will be its agent. The evidence that it was not so operated by the defendant was that (1) it was not organized by the parent; (2) it paid its own employees who never went off its lines; (3) it paid all its own expenses and for its own repairs; (4) it was a large company and highly solvent; (5) advances by the parent for operating expenses were treated strictly as loans; (6) it leased its new cars from the parent. Opposed to this, the dissenting opinion noted that (1) the parent's pension system included the subsidiary; (2) paymasters operated for the entire system; (3) the parent paid for advertising for the subsidiary; (4) the parent set up a central school of instructions for employees for the entire system; (5) there was a central department for repairs and construction; (6) there was a common purchasing agent; (7) identity of officers and directors; (8) ownership through stock ownership by the parent. The

[10] See also a similar case in *Radio Craft Co.* v. *Westinghouse Electric Mfg. Co.*, 7 Fed. (2d) 432 (C.C.A. 3rd, 1925) for the same rule and the same results.

[11] 244 N.Y. 84, 155 N.E. 58, 50 A.L.R. 599 (1926).

majority held the parent not responsible for the tort of the subsidiary.

In *Mangan* v. *Terminal Transportation System*,[12] the plaintiff was injured by the operation of a cab belonging to one of four operating companies. The defendant, the Terminal Company, was related to these four companies in that defendant was a managing company and the four companies were operating companies, all owned by Yellow Truck and Coach Manufacturing Company, which system also included a manufacturing company, a sales company, and a financing company. The Terminal Company was held responsible for the tort, upon the finding that the four operating corporations were the agents and instrumentalities through which defendant carried on its business and that their operation was controlled by the defendant. The evidence was that (1) the defendant held the contract to furnish the cabs at the various terminals and used the operating companies to perform this contract, (2) provided starters and inspectors, (3) kept the books of the operating companies, (4) received the reports of daily receipts, (5) drew all payroll checks, (6) furnished a legal department and a claim department for the system, (7) examined and approved prospective employees of the operating companies, and (8) furnished rules as to the discharge of such employees.

In *Ross* v. *Penna. Railroad Co.*,[13] where the parent was held on the instrumentality rule for the negligence of the subsidiary, the evidence used was (1) the advertising time tables, (2) uniforms of train crew, and (3) letters written plaintiff by defendant's claim adjuster which seemed to concede responsibility for the tort of the subsidiary railroad company. The time tables and uniforms were of course an indication that the subsidiary was operated as a part of the Pennsylvania railroad system.

In the case of the *Willem van Driel, Sr.*,[14] we have a case

[12] 284 N.Y. Supp. 183, 157 Misc. 627 (1935), *aff'd*, 286 N.Y. Supp. 666 (App. Div. 1936).

[13] 106 N.J.L. 536, 148 Atl. 741 (1930).

[14] 252 Fed. 35 (C.C.A. 4th, 1918).

where the Pennsylvania Railroad Company was sued for damages growing out of the destruction of a ship which was being unloaded at the dock of an elevator company. An explosion and fire occurred as a result of the negligence of employees of the latter. The Pennsylvania through a lease contract was in complete control of the Elevator Company, having leased all the property of a railroad corporation which owned the stock in the Elevator Company. The following words from the court's opinion are worth quoting: "The Elevator Co. could accept no grain except that which came over the tracks of the controlling road. The general superintendent of the Pennsylvania Co. in Baltimore, as an incident of that office, is president of the Elevator Company. The treasurer, the assistant secretary, comptroller, subcomptroller and other accounting officers holding similar positions in the railroad company have charge of the accounts of the Elevator Company but are paid by the Railroad Company. An employee of the railroad company signs the vouchers of the Elevator Company as its auditor of disbursements. The railroad company, through various officers, issued orders, from time to time, as to the management of the Elevator Company. The salary of the superintendent of the Elevator Company was increased by order of the fourth vice president of the railroad company. The railroad company controls the funds of the Elevator Company. * * * It is true that the Elevator Company and its stockholders and directors held meetings, but in all essential particulars, their action was dictated and controlled by the railroad company. The whole course of dealing showed that the surplus of $200,000 it had in the bank at the time of the fire was absolutely under the control of the railroad company. The superintendent of the Elevator Company, who directed its mechanical operation and its subordinate employees, had no duty to perform with the railroad company but was evidently under its ultimate control. It would be impossible to imagine a relationship between corporations where the subsidiary corporation was more completely

under the control of the dominant corporation. The elevators were constructed and operated merely as a facility to the business of the railroad company. Applying the language of Judge Wallace, in *Lehigh Valley Railroad Co.* v. *DuPont*, 128 Fed. 840 (C.C.A. 2d, 1904) the potential and ultimate control of all the property and business affairs of the Elevator company was lodged in the railroad company, and this control was exercised as completely and directly as the machinery of corporate organism would permit. Such complete dominance made the elevator company its mere puppet."[15]

In the group of contract cases where the rule has been discussed, we find much opposition from the courts to the idea of holding the parent on contracts and debts of the subsidiary merely because the subsidiary is controlled as an instrumentality. Some of the cases supporting such a rule are of doubtful value as they could have been sustained on other grounds. Of this latter type of cases are *Platt* v. *Bradner*,[16] *John Church Co.* v. *Martinez*,[17] and *Dillard and Coffin Co.* v. *Richmond Cotton*

[15] Other negligence cases illustrating the rule, but which are inconclusive for the purpose of this paper because of peculiar facts involved are *Specht* v. *Mo. Pac. Ry.*, 154 Minn. 314, 191 N.W. 905 (1923), where the employees of the so-called instrumentality were in reality the employees of the parent and directly under the parent's control; *Luckenbach S.S. Co.* v. *W. R. Grace & Co.*, 267 Fed. 676 (C.C.A. 4th, 1920), where the servient corporation was so grossly undercapitalized, and intrusted with such large properties and business enterprises by the dominant corporation, without actual ownership, that the court found the arrangement to be "unconscionable"; and *The Santa Barbara*, 299 Fed. 147 (C.C.A. 4th, 1924), where the facts show direct operation of the property of the subsidiary by employees of the parent.

There are a number of tort cases in which the courts have stated the instrumentality rule in the form of the first type statement set out at the beginning of this paper but found that no instrumentality was shown by the evidence. *Harlan Public Service Co.* v. *Eastern Construction Co.*, 254 Ky. 135, 71 S.W. (2d) 24 (1934); *Stephenson* v. *List Laundry and Dry Cleaners*, 168 So. 317 (La. App., 1936); *McDermott* v. *A.B.C. Oil Burner Sales Corp.*, 266 Ill. App. 115 (1932); *Louisville Gas and Electric Co.* v. *Moore, et Ux.*, 215 Ky. 273, 284 S.W. 1082 (1926). But the case of *Nashville C. & S. L. Ry.* v. *Faris*, 166 Tenn. 238, 60 S.W. (2d) 425 (1933), seems, on the evidence, to give mere lip service to the rule.

[16] 131 Wash. 533, 230 Pac. 633 (1924).

[17] 204 S.W. 486 (Texas Civ. App., 1918).

*Oil Co.*[18] where the facts disclosed an estoppel. In these cases, the dominant corporation had either represented to the plaintiff that it owned, or was identical with, the contracting corporation and would see to the performance of the contract, or payment of the debt.

*Kimberley Coal Co.* v. *Douglas*,[19] found the parent liable for the contract of its instrumentality on the authority of the instrumentality rule alone, as did *Hunter* v. *Baker Motor Vehicle Co.*[20] The issue as raised was vital to the decision in these cases, though they were not cases of direct action against the parent on the debt.

*Old Ben Coal Co.* v. *Universal Coal Co.*,[21] sustained a declaration in an action against the Price Hill Colliery Co. for a debt contracted by the Universal Coal Co. on the allegation that the Universal Coal Co. was "in this transaction, and in its business and affairs merely the agent, adjunct and instrumentality of the Price Hill Colliery Company."

The case of *Kingston Dry Dock Co.* v. *Lake Champlain Transportation Co.*[22] was an action against the parent for debt for services rendered the subsidiary. The court found the companies to be separate on the evidence and said: "Control through ownership of shares does not fuse the corporations even when the directors are common to each. One corporation may, however, become an actor in a part of a business, or a whole business, and when it has, will be legally responsible. To become so, it must take immediate direction of the transaction through its officers by whom alone it can act at all. At times this is put as though the subsidiary became an agent of the parent. That may no doubt be true but only in quite other situations, that is, when both intend that relation to arise, for agency is consensual. This is seldom true, and liability normally, must

[18] 140 Tenn. 290, 204 S.W. 758 (1918).
[19] 45 Fed. (2d) 25 (C.C.A. 6th, 1930).
[20] 225 Fed. 1006 (D.C. N.Y. 1915).
[21] 248 Mich. 486, 227 N.W. 794 (1929).
[22] 31 Fed. (2d) 265 (C.C.A. 2nd, 1929).

depend upon the parent's direct intervention in the transaction ignoring the subsidiary's paraphernalia of incorporation directors and officers. The test is therefore rather in the form than in the substance of control, in whether it is exercised immediately or by means of a board of directors and officers, left to their own initiative and responsibility in respect of each transaction as it arises. Some such line must obviously be drawn if shareholding alone does not fuse the corporation in every case."

As noted, the direct intervention of the parent and direction of the transaction involved seems here to be the test. Generally in the cases where the instrumentality rule is recognized the court has been satisfied with a more diffused control. A domination of the policies and an ultimate control is sufficient. A direct interposition in each transaction or an immediate direction of the employees of the subsidiary has not been essential. As a generalization, the language of this case is an admission that, even in the case of contracts, the parent is liable if the control is sufficiently obtrusive.

In *Pagel Horton & Co.* v. *Harmon Paper Co.*,[23] an effort was made to collect the insolvent subsidiary's debt from the parent. The opinion was devoted to showing that all the business of parent and subsidiary was kept strictly separate and that the subsidiary was not an instrumentality. Each kept separate books, maintained and operated its own plant, had separate customers, manufactured a different kind of paper, paid its own debts out of its own treasury, made its own contracts in its own name, and kept strict account of loans made one to the other. The opinion, however, noted two exceptions to the observance of the legal entity of a corporation. The first was the usual one as to its being a cloak for fraud or illegality and the second was where the subservient corporation "is so organized, related to or controlled by the other as to be its mere agent, instrumentality or *alter ego*."[24]

[23] 258 N.Y. Supp. 168, 263 App. Div. 47 (1932).

[24] The cases of *United Smelting Refining & Mining Exporation Co.* v. *Wallapai Mining & Development Co.*, 27 Ariz. 126, 230 Pac. 1109 (1924),

In a number of important contract cases, where the decision was in favor of the parent though the subsidiary was conceded to be an instrumentality the court has stated that it must be shown that the domination of the parent over the subsidiary was carried out in such a manner as to *defraud* or *wrong* the complainant. But it is usually emphasized that the plaintiff was not wronged since he selected the subsidiary to be his debtor.[25] In *North* v. *The Higbee Co.*,[26] the contract involved was a long term lease signed with a subsidiary of a department store company. In *Gledhill* v. *Fisher*,[27] the matter was similar, being a land contract which the parent employed a subsidiary to take. In the *Carpenter case*[28] the subject matter consisted of bonds signed by a coal company owned and operated by a railroad company as an instrumentality.

In the last mentioned case, the Federal Circuit Court speaking of the frequently quoted statement of the instrumentality rule said, "We do not think these decisions establish a hard and fast rule from which there is no escape, whatever the circumstances under consideration, and without regard to the reasons upon which an exception could be properly founded. But in every case in which a corporation has been held liable for the debt of another because of dominance or control through stock ownership or otherwise, and not depending on principles of agency or estoppel, the reason was, that to hold otherwise would result in a wrong for which the law must find a remedy." And later in the discussion there is this: "From the examination of many decisions, we venture to say that no corporation, acting within its powers, has been held liable for the debts of another

and *Martin* v. *Development Co. of America*, 240 Fed. 42 (C.C.A. 9th, 1917), while recognizing the rule in contract cases, handle the facts in such a way as to practically refute it.

[25] *North* v. *The Higbee Company*, 131 Ohio St. 507, 3 N.E. (2d) 391 (1936); *Gledhill* v. *Fisher*, 272 Mich. 353, 262 N.W. 371 (1935); *New York Trust Company* v. *Carpenter*, 250 Fed. 668 (C.C.A. 6th, 1919).

[26] See note 25, *supra*.

[27] See note 25, *supra*.

[28] See note 25, *supra*.

corporation legally organized, because it controlled such corporation by reason of ownership or otherwise, except by reason of contract, or on ground of agency or estoppel, or because the controlled corporation has been used in such a way that the maintenance of its character as a separate and distinct entity would work injustice."

But in *Kimberley Coal Co.* v. *Douglas*,[29] the circuit court in the same circuit later used the instrumentality rule in a contract case. The Jewett Bigelow and Brooks Coal Company of Detroit, Michigan, had a subsidiary company, the J. B. Stores Co. An action was brought against the parent alone on a claim growing out of the abandonment of a mining lease from plaintiff to the parent and the subsidiary. A judgment was had, a certain part of the claim being dropped. Later the J. B. Stores Co., the subsidiary, was in receivership and the dropped part of the claim was presented to the receiver. However, the claim was rejected. It was held to have been already adjudicated in the Michigan trial although the Stores Company was not a party. The court said: "This contention as to the independent liability of the J. B. Stores Company cannot be maintained. If, as is conceded, the J. B. Stores Company was a mere instrumentality, used by the Jewett Bigelow and Brooks Coal Company in the conduct of its business, the property of the Stores Company must, in equity, be considered the property of the Jewett Bigelow and Brooks Coal Company and the debts of the subsidiary as the debts of the parent company. The independent entity of the two companies is so far disregarded that each is considered as but a part of the indivisible whole."

It is not without significance that in negligence cases the instrumentality rule is so often approved and that in contract cases it is often denied, for in the contract cases, there enters the possibility of a selection by the third person. In the contract cases the court frequently finds there was no fraud upon the plaintiff because with his eyes open he selected the instrumen-

[29] 45 Fed. (2d) 25 (C.C.A. 6th, 1930).

tality. It is then stated that the instrumentality must be used to wrong or defraud plaintiff if it is to be disregarded as a separate entity. It would be logically possible for the court to adhere to the instrumentality rule and still hold in such cases that the complainant cannot recover from the dominant corporation since he has made an election, a familiar analogy from the law of principal and agent.

It would seem that such a solution would be logical and salutary as tending to simplicity and greater certainty in prediction of the law. It would likewise be a salutary advance if, in contract cases, the courts might adopt by analogy a further principle from the law of principal and agent, namely, that where the third person has before him the principal and the agent and enters into a contract, in terms with the agent, it is presumed that he does not, by so doing, intend to release the principal and confine his recovery to the agent; but rather that he intends recourse against both. This presumption may be overcome by showing either from the language of the contract, or other evidence that this act was intended as a selection of the agent alone.[30] This need not involve any confusion with other parts of the law of principal and agent. Agency as a consensual relationship is quite a different thing from the instrumentality situation arising where one corporation dominates and uses another for the carrying out of the purposes of the dominant corporation.

It has been argued that in cases using the instrumentality rule, the court has, in each case, decided the case either against or for the parent upon some equitable ground and, after that, has proceeded to rationalize its decision by holding that the subsidiary was or was not dominated as an instrumentality; and this though the equitable reasons may not have been mentioned in the opinion. This line of reasoning grows from the *ad absurdum* argument already mentioned, that there is no practical difference between control growing out of mere ownership of stock and election of the directors and the obtrusive controls

[30] Restatement of the Law of Agency, Sec. 149.

discussed in this paper.[31] But after all, lawyers, in practice, are dealing with judicial precedents and the cases may not be ignored. And, conceding the argument, these courts are moving toward a desired objective by the easiest gradient. And there is a real difference between the case of a corporation holding stock in another corporation merely as an investment, and that of a corporation using another controlled corporation to perform some part of the business of the dominant corporation or some function essential to its business.

Another argument that has been used is that in no case will the instrumentality rule be effective unless the dominant corporation is using the servient one in such a way that some one of the familiar rules for disregarding the corporate entity comes into play. A classification of such cases includes cases of fraud, obstruction of justice, evasion of law, estoppel, stripping the subsidiary of its assets, fraudulent undercapitalization of the subsidiary, etc. This method of handling the cases denies responsibility of the parent in many cases where, under the instrumentality rule as discussed in this paper, the parent would be liable.[32]

Space will not permit an examination of the cases which support the argument in the foregoing paragraph. For Ohio, in a contract case, the conclusion in the foregoing paragraph is followed in *North* v. *The Higbee Company*.[33] That case grew out of a situation where a department store company used a wholly owned realty company to take a long term lease on the department store site. In turn the department store took but a ten-year lease. This arrangement gave the department store a practical option on as many renewals of its lease as it might desire without absolute liability on the long lease. The department store abandoned the premises and failed to renew the ten-year lease. The realty company could not pay the rentals and

[31] See Latty, Subsidiaries and Affiliated Corporations (1936).
[32] See Powell, Parent and Subsidiary Corporations (1931).
[33] *Supra*, note 25. Three judges dissented.

taxes. Unfortunately, two years after the original lease transactions above mentioned, the lessor had assigned its underlying leasehold to a Trust Co. and leasehold trust certificates were sold. When the department store company abandoned the premises and the realty company defaulted, one of these certificate holders sued the department store company on his own behalf and on behalf of all certificate holders. His case was won and a judgment was obtained in a sum in excess of $769,000. This was sustained in the court of appeals but reversed in the Supreme Court. There was found to be no fraud in the original lease transactions as the lessor understood the situation and elected to give the long lease to the subsidiary. It was further found that the certificate holders were not wronged because (1) they should have known the circumstances, and (2) their losses in reality grew out of a vast deflation in realty values due to the depression. The syllabus, by the court, reads: "The separate entities of a parent and subsidiary corporation will not be disregarded and the parent corporation will not be held liable for the acts and obligations of its subsidiary corporation, notwithstanding the facts that the latter was controlled by the parent through its stock ownership, and that the officers and directors of the parent corporation were likewise officers and directors of the subsidiary in the absence of proof that the subsidiary was formed for the purpose of perpetrating a fraud and that domination of the parent over its subsidiary was exercised in such manner as to defraud complainant."[34]

[34] In addition to quotations from Powell, Parent & Subsidiary Corporations (1931) the court also quoted the following from *Gledhill* v. *Fisher*, 272 Mich. 353, 262 N.W. 391 (1935).

"3. To justify treating sole stockholder or holding company liable as responsible for a subsidiary corporation, it is not enough that the subsidiary is so organized and controlled as to make it merely an instrumentality, conduit, or adjunct of its stockholders, but it must further appear that to recognize their separate entities would aid in the consummation of a wrong.

"4. Relief against a parent corporation should be granted only if a refusal to do so would result in an unjust loss or injury to the complainant since refusal to recognize the ordinary immunity of stockholders not only overturns a basic provision of statutory or common law but is also contrary to a vital

It is to be noted that this was a contract case, one in which an election to hold the subsidiary was clear and one in which no fraud or wrong upon plaintiff was found to exist by the majority. Nevertheless three judges dissented, two of them holding that no other element is essential to hold the parent but to show that the subsidiary is a mere agent, arm, or instrumentality of the parent. Williams, J., in his dissent, said: "If the subsidiary is a mere agent, arm, instrumentality or department of the parent in the transaction in which the debt is incurred, such debt is that of the parent regardless of the existence of fraud." And Zimmerman, J., dissenting, quoted the language which found its inception in *In re Watertown Paper Co.*[35]

The writer has endeavored to present the views of those courts which have made use of the instrumentality formula for parent responsibility and particularly in tort and contract cases. It proves to be a very convenient yardstick of liability. It is obviously just in the tort cases. Referring again to the language of the Court in *Industrial Research Corporation* v. *General Motors Corporation, supra,* and applying the spirit of the language to other types of corporations, it is against public policy to permit a corporation to carry on its authorized business through incorporated departments and to perform its vital functions through incorporated instrumentalities, as that term is defined in this paper, and at the same time escape the concomitant responsibility for their acts. Practically this is important to the injured person as it gives him a direct route, for compensation, to the prime mover as well as to the instrumentality. It may be vital to him when the subsidiary is a small corporation or an insolvent one.

economic policy of the whole corporate concept." And from Wormser's *Disregard of the Corporate Fiction and Allied Corporate Problems,* p. 18, the following is quoted: "It follows that no fraud is committed in incorporating for the precise purpose of avoiding and escaping personal responsibility. Indeed, that is why most people incorporate, and those dealing with corporations know, or are at least presumed to know the law in this regard."

[35] See p. 1, this article, for the quotation.

The same statements may apply to cases of contract made with the subsidiary and debts contracted by the subsidiary. Here, however, enters the element of choice. The third person may choose between the parent and subsidiary. Those courts which apply the instrumentality rule to contract cases and ordinary debts of the subsidiary should admit the possibility of an election on the part of the third person to look to the subsidiary alone, and doubtless would in a proper case. Because of the fact that the business of parent and subsidiary is so often intermeshed in such fashion as to cause inevitable confusion in the minds of those dealing with the corporations it would be proper to throw upon the parent the burden of proving that the third person elected to deal with the subsidiary alone. And if the court is willing to trace the analogy between the case of parent corporation and instrumentality and the ordinary case of principal and agent, there is ample precedent for such a rule regarding election. With these provisions the instrumentality rule is a proper one in the contract and debt cases. It is significant that so many courts have applied the instrumentality rule in such cases.