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CORPORATION STATUTES AS THE ANSWER TO PARENT-SUBSIDIARY LIABILITY*— The purpose of these few pages is to call attention to the view concerning the liability of a parent corporation for obligations of its subsidiaries set forth in a comment in a recent number of the REVIEW.[1] According to that view:

> "The only time when it may logically be said that stockholders have a liability beyond the amount of their investment in shares is when it is so provided by the legislature or when 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."[2]

And in conclusion it is said that, for the sake of certainty when a lawyer is advising his client, courts should approach the problem "from the basis of what the statute under which the corporation was formed permits, directs and demands. . . ."[3]

Now, if the present writer correctly understands the foregoing view, the contention seems to be this: that when faced with the problem of a parent's liability for its subsidiary, a court should merely look to the corporation statutes; thus, (a) if those statutes provide that a corporation is duly formed when steps *X*, *Y* and *Z* have been taken and those steps have been taken; and (b) if the statutes provide for the observance of certain formalities in operation and management (e.g. meetings, etc.) and those formalities have been observed; and (c) if those statutes, expressly or impliedly, relieve holders of fully-paid stock from liability[4] and the stock has been fully paid—then a court must decide that there is no liability upon the parent corporation (or other stockholder).

The present writer disagrees with the view (if that be the view) that it is merely a question of interpreting the statutes.

True, it would be a great help to certainty in the law if all one had to do was, say, to read section 47 of the corporation code in com-

* The editors are glad to afford Professor Elvin R. Latty of the University of Missouri Law School this opportunity to answer the views expressed in a comment which appeared in the January issue. Professor Latty is a former student editor of the REVIEW; B.S., Bowdoin; J.D., Michigan; J.Sc.D., Columbia; author of *Subsidiaries and Affiliated Corporations* and of various law review articles.—*Ed.*

[1] 35 MICH. L. REV. 467 (1937).

[2] Id at 472.

[3] Id. at 473.

[4] An example is the Maryland statute: "There shall be no individual liability upon any . . . holder of any stock of any corporation of this State, beyond his obligation . . . to comply with the terms of the contract of subscription. . . ." Md. Ann. Code (1924), art. 23, § 47.

bination with section 17 and 63 and follow the express or implied mandate of the language therein. But certainty is not the only end which the law seeks to attain. One does not have to agree with Jerome Frank[5] that certainty is a myth in order to point out that a just adjustment of conflicting interests is equally desirable. As Judge Mack has expressed it:

> "the just decision of causes requires a careful weighing of social and economic considerations not to be found in the strict body of the law itself."[6]

If, on behalf of certainty, one were to cling literally to the language of statutes, the corporation laws would lend themselves to anti-social manipulation. Aided by other legal devices such as leases, loans, and mortgages, they would permit the formation of creditor-proof corporations;[7] they would permit a single economic entity to subdivide itself endlessly into parts technically distinct as against all the world that the economic entity contacts, beyond the social justification of limited liability.[8] It would be a lamentable situation if judges were powerless to say that the statutory limitation of liability does not contemplate an abuse of the incorporation privilege. The present writer inclines to the view that in a "proper" situation (never mind what is such, for the moment) a court can and should take this position: the statutory limitation upon a stockholder's liability is not to be applied to *this* situation. Of course, this thought can be framed in such a way as to appear nothing more than a matter of interpreting the statute; that is, one could say that the question is whether or not certain unmentioned but implied limitations are to be read into the statute. In that event the view herein expressed would differ from that criticized on the question of interpretation.

It is not an unknown phenomenon in the law for courts to impose equitable limitations upon statutory language which seems absolute upon its face or to hold a statute inapplicable though on its face it seems to cover the facts involved in the case. Thus, corporation statutes often provide that a certain percentage in interest of the stockholders can sell the corporate assets or consolidate or merge with other corporations. For instance, in *Kavanaugh v. Kavanaugh Knitting Co.*,[9] the statute, so far as its mere language went, permitted dissolu-

[5] FRANK, LAW AND THE MODERN MIND 3-12, 243-252 (1930).

[6] FRANK, LAW AND THE MODERN MIND, introduction, p. x (1930).

[7] LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS, §§ 34, 35 (1936); Douglas and Shanks, "Insulation from Liability through Subsidiary Corporations," 39 YALE L. J. 193 (1929).

[8] LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS, c. 8 (1936).

[9] 226 N. Y. 185, 123 N. E. 148 (1919).

tion of a corporation upon the adoption by the directors of a resolution that it was in their opinion advisable to dissolve and the approval of the resolution by two-thirds in interest of the stockholders; yet, in spite of the fact that the prescribed "statutory" steps had been taken, dissolution was enjoined because it was to be used to freeze out the minority.[10] Again, corporation statutes often prescribe that the affairs of a corporation shall be managed by its board of directors; yet transactions carried out with the approval of all the stockholders have been held to be valid corporate action even though no formal action was taken by, or at a meeting of, the directors[11]—indeed, even though the corporation had no directors.[12] The same thing can be observed outside the corporation statutes: the Uniform Negotiable Instruments Law furnishes a number of illustrations; so does the statute of frauds. Under the Bankruptcy Act, a petition may be filed in any jurisdiction where the debtor has resided for sufficient time; yet a debtor cannot file a petition in a district to which he has moved his residence solely for the purpose of filing his petition in that district.[13] Decisions under scores of statutes could be collected to prove the point.[13a]

The view of the present writer, elsewhere set forth,[14] is that liability of a parent corporation can turn upon factors not even remotely touched upon in the corporation statutes. The writer is not alone in his views. They are apparently approved by a distinguished practitioner whose practise brings him in constant touch with corporation problems, including those of the parent and subsidiary relationship.[15]

[10] For further illustrations, see Lattin, "Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders," 30 MICH. L. REV. 645 (1930).

[11] Gerard v. Empire Square Realty Co., 195 App. Div. 244, 187 N. Y. S. 306 (1921).

[12] STEVENS, CORPORATIONS 556 (1936).

[13] In re Garneau, (C. C. A. 7th, 1904) 127 F. 677.

[13a] One more illustration from the corporation field may not be inappropriate: A New York statute authorized the appointment of a receiver of a corporation "to preserve the assets of a corporation having no officer empowered to hold the same." Held, receiver should not be appointed under this statute where the officers resigned solely to have a receiver appointed thereunder. Zeltner v. Henry Zeltner Brewing Co., 174 N. Y. 247, 66 N. E. 810 (1903).

[14] LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS, c. 5, c. 8 (1936).

[15] Book review by Robert T. Swaine, of Messrs. Cravath, De Gersdorff, Swaine and Wood of New York City, in 23 VA. L. REV. 363 at 364 (1937), reviewing LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS (1936):

"The chapter entitled Effect of Inadequate Capital, while dealing with a comparatively limited number of adjudicated cases, points a trend with such clarity and conviction that it cannot but have a real influence upon future decisions. Many a house counsel of a great corporation has blithely set up a separate subsidiary, say for each city in which he desired to operate a theatre, has embroidered these various subsidiaries with leases or mortgages from or to the parent and then has sat back in smug self-satisfaction at these masterpieces of the draftsman's art and prided himself on having thus ingeniously rendered the parent and its other subsidiaries immune to the

True, it possibly has been assumed by many lawyers that once they have created a corporation in strict technical compliance with corporation statutes, they can "sit back in smug self-satisfaction of these masterpieces of the draftsman's art," as Mr. Swaine has so aptly put it.[16] Particularly is this likely to be true of the "elder practitioner" whose conservatism is referred to by Mr. Swaine. If so, the elder practitioner is likely to be fooled. The fact that hundreds of corporations (subsidiaries or otherwise) have been set up in serene assurance of insulability is not at all conclusive. One has but to remember, analogously, *Northern Pacific Ry. v. Boyd*.[17] Technical perfection may count for naught; courts will astutely perceive that it is precisely in those situations where the corporation is skating on thin ice that the organizing lawyer will exercise the highest technical abilities of the profession.

Furthermore, it is not merely a question of what the courts *ought* to do. What are the courts doing *in fact*? It is clear that, however thick be the "mists of metaphor"[18] with which courts envelop their gropings toward a just decision, courts *in fact* have, in a number of cases, imposed liability upon parent corporations (and upon non-corporate stockholders).[19] Yet, in each of those cases, if one were to look solely to the statutory language, no liability would be imposed. Even if the cases were wrongly decided (which is herein denied, as to many of them at least), one concerned with predictability (here is our "certainty" again) cannot realistically overlook that *there they are*; and very likely they will be followed in other similar cases. If this is so, then the important thing is to discover what are the real reasons (which may or may not—probably not—be the ones given in the opinions) which motivate such decisions. Once those are discovered one has a basis of predictability. The writer has elsewhere attempted to discover some of them;[20] future investigators of greater ability and knowledge will, it is hoped, discover other bases or replace those tentatively put forth by the writer by sounder ones.

risks of that particular segment of the business. He will do well to heed the warning of this particular chapter.

"In the final chapter, Limitations upon Limited Liability, the author reaches his ultimate conclusions upon the philosophy underlying the problem involved. His summary of the fundamentals of the problem may, to an elder practitioner, seem radical in that it is perhaps new, but it cannot seem radical in any other sense."

[16] Supra, note 15.

[17] 288 U. S. 482, 33 S. Ct. 554 (1913).

[18] Berkey v. Third Ave. Ry., 244 N. Y. 84 at 94, 155 N. E. 58 (1926).

[19] LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS, c. 5, c. 8 (1936); POWELL, PARENT AND SUBSIDIARY CORPORATIONS (1931); Douglas and Shanks, "Insulation from Liability through Subsidiary Corporations," 39 YALE L. J. 193 (1929).

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

Not only is mere statutory interpretation the wrong way to handle the problem, but it is not at all clear that the problem *should* be covered by statute. If it were covered by statute, what should that statute provide? Of course, if considerations of justice and of the function of the corporation as a social institution were to be overlooked, a statute could, by clear and explicit terms, expressly say that a parent corporation (or other stockholder) should have no liability, no matter how inadequate the capital, how creditor-proof the set-up or how minutely subdivided be the economic entity. If a statute did so provide, then one could truly decide a case without looking beyond the statute and one would come out at a point close to that which seems advocated by the author of the previous comment. Or on the other hand, the statute could provide generally that only incorporation *in good faith* can limit liability; or it could specifically exclude certain situations (e.g. creditor-proof set-up) from the privilege of limited liability. But perhaps it is just as well that courts, instead of concerning themselves with disputes over the meaning of a statutory term, should be free, for some time yet at least, to call proper halts to limited liability, guided by their own common sense. Gradually a line of demarcation will be delineated by successive decisions. This is a field of law which is growing; it is proper that its growth be natural and along lines that best adjust the conflicting interests. Let codes come in the adult, rather than in the adolescent, stage.

Elvin R. Latty *

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* See editorial note, supra p. 794.