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Volume 12  
Issue 1 *Corporation Tort Problems (A  
Symposium)*

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Article

1963

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#### Recommended Citation

Richard H. Burgess, Liability of Parent Corporation for Tort of Subsidiary, 12 Clev.-Marshall L. Rev. 176 (1963)

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## *Liability of Parent Corporation for Tort of Subsidiary*

Richard H. Burgess\*

MUCH HAS BEEN WRITTEN about liability of parent corporations for acts of their subsidiaries, but much of the material principally concludes that there is no clear law on the subject. It has often been said that the legal concepts involved in this determination are mere verbiage or metaphors used to label the results of a purely equitable decision. Two of the classic statements to this effect are those of Cardozo, J., in *Berkey v. Third Ave. Ry. Co.*,<sup>1</sup>

The whole problem of the relation between parent and subsidiary corporation is one that is still involved in the mists of metaphor. Metaphors in law are to be carefully watched, for starting as devices to liberate thought, they often end by enslaving it.

and of Justice Roberts, in the "Deep-Rock" case,<sup>2</sup>

The so-called instrumentality rule is not, properly speaking, a rule, but a convenient way of designating the application, in particular circumstances, of the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice.

In an analysis of the cases up until that time, William O. Douglas, a Yale law professor who was to become a Supreme Court Justice, analyzed the more modern view.<sup>3</sup> He pointed out that, while there were no hard and fast rules in this field, several factors could be recognized which might be useful in the analysis of any given case to reduce diverse facts to a small number of "lower common denominators." Depending on the presence or absence of various legal and equitable factors, liability might or might not be found. The present article is an attempt to illustrate several of the more recent cases defining

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<sup>1</sup> 244 N. Y. 84, 94, 155 N. E. 58, 61, 50 A. L. R. 599, 604 (1926).

<sup>2</sup> *Taylor v. Standard Gas and Electric Co.*, 306 U. S. 307, 322 (1939).

<sup>3</sup> *Douglas & Shanks, Insulation from Liability Through Subsidiary Corporations*, 39 Yale L. J. 193 (1929). See also, 4 Oleck, *Modern Corporation Law*, c. 71 (1960).

various lower common denominators useful in analysing corporate entity problems related to parent and subsidiary corporations.

### General Principles

The ownership of stock in one corporation by another does not destroy the former corporation's separate legal entity. The stock owning corporation is generally not liable for the torts of its subsidiary unless the separate corporate existence is a mere sham or is an instrumentality for concealing the truth or perpetrating fraud.<sup>4</sup> The fact that parent and subsidiary have common or identical directors and officers does not make the parent liable for the acts of its subsidiary. There must be actual operating control by the parent or at least a fraudulent intent.

Douglas and Cataldo elaborate on four standards to be met in order to keep the business units from being treated as assimilated. These are:

1. A separate financial unit should be established for each corporation, sufficiently financed to meet normal strains.
2. Business transactions and records of the two units should be separately kept.
3. Formalities must be observed, so that it is always possible to tell for which corporation a common director or officer is acting.
4. To avoid estoppel, the two units should never be represented as one.<sup>5</sup>

Even though it is reasonably certain that when these four criteria are met there will be no imputed liability, there is no certainty as to corporate structures not meeting these standards. It is in this remaining gray area that several writers have felt that confusing and indefinite terminology was being used to explain results which actually depended solely on fraud.

Judge Soper of the 4th Circuit broadly outlined the problem in the case of *Certain-teeed Products Corp. v. Wallinger*.<sup>6</sup>

It is obvious that the extent of stock ownership and potential control possessed by the holding company is not the de-

<sup>4</sup> *Brown v. Standard Casket Manufacturing Company*, 234 Ala. 512, 175 So. 358 (1937).

<sup>5</sup> Douglas & Shanks, *supra*, n. 3; Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporation*, 18 Law & Contemp. Prob. 473 (1953). And see Oleck, *op. cit. supra*, n. 3.

<sup>6</sup> 89 F. 2d 427, 434 (4th Cir. 1937); see also references to Powell on Parent & Subsidiary Corporations, c. 1 (1931); Latty on Subsidiaries & Affiliated Corporations, 5, 41, 142, 143 (1936), and cases cited.

termining factor when its liability for the acts and obligations of the subsidiary are under consideration. Something more must be found—something of fraud, or illegality or wrong-doing, productive of loss or injury, to the complainant, to justify the Courts, as they are wont to say, in disregarding the corporate entity of the subsidiary body; and it is because of the vague boundaries of this added essential element that it is well nigh impossible in the present state of the law to enunciate a clear-cut rule.

This approach seems to be agreed to by Lattin & Jennings, Latty, and Oleck.<sup>7</sup>

The courts have often attempted to limit or define such terms as *alter ego*, agency, sham, instrumentality and adjunct. The following section presents some of the cases dealing with these terms.

### Metaphors

#### Agency

Douglas cast the question as being whether the subsidiary is an agent of the parent.<sup>8</sup> But Learned Hand states, to the contrary in the case of *Kingston Dry Dock Co. v. Lake Champlain Transp. Co.*,<sup>9</sup> that the question of actual agency seldom arises in a parent-subsidiary tort problem. This is because agency is a consensual relation, and is not usually found to exist so as to bind a parent for its subsidiary's torts.

Generally, the cases on parent-subsidiary agency require a close business relation between the two companies in addition to the elements of fraud that proximately caused harm to the plaintiff.<sup>10</sup> It is essential to a holding of agency that the subsidiary be performing acts for the parent if it is to be treated as the act of the parent, and that it be doing so under the parent's control.<sup>11</sup>

<sup>7</sup> Lattin & Jennings, *Cases & Materials on Corporations*, 115, 135-38 (3d ed. 1959); Latty, *op. cit. supra*, n. 6 at 162; Oleck, *op. cit. supra*, n. 3.

<sup>8</sup> Douglas, *supra*, n. 3, at 210.

<sup>9</sup> 31 F. 2d 265 at 267 (2d Cir. 1929); see also *Lowendahl v. Baltimore & O. RR Co.*, 247 App. Div. 144, 287 N. Y. S. 62 (1936), *aff'd* 272 N. Y. 360, 6 N. E. 2d 56.

<sup>10</sup> *Miller v. Bethlehem Steel Corp.*, 189 F. Supp. 916 (S. D. W. Va. 1960); *Owl Fumigating Co. v. California Cyanide Co.*, 30 F. 2d 812, *affg.* 24 F. 2d 718 (3d Cir. 1929).

<sup>11</sup> *Mueller v. Seaboard Commercial Corp.*, 5 N. J. 28, 73 A. 2d 905 (1950); *Mangan v. Terminal Transportation System, Inc.*, 157 Misc. 627, 284 N. Y. S. 183 (1935); *Ross v. Penna. Ry. Co.*, 106 N. J. L. 536, 148 Atl. 741 (1930); *Owl Fumigating Co. v. California Cyanide Co.*, *supra*, n. 10.

The Court in the case of *Owl Fumigating Co. v. California Cyanide Co.* stated:<sup>12</sup>

When . . . it is charged that a corporation is a mere agency or department of another corporation, and it is used as an instrumentality to perpetrate fraud, justify wrong, avoid litigation or make it more difficult, or generally escape liability for what are in substance its own acts, Courts will put aside the screen and determine the truth and place responsibility where it belongs.

Complicated fact situations are generally present in parent-subsidary tort situations, and the results depend on an integration of many significant facts. As an example of a relatively simple fact situation, in the case of *Miller v. Bethlehem Steel Corp.*,<sup>13</sup> a corporation owned all of the capital stock of a company and many of the same persons were officers and directors in both company and corporation. The corporation operated no physical property and the corporation and company did not share the same office space. Directors' meetings were not controlled by or subject to approval of the corporation. Under the facts the company was held not to be the agent of the corporation and the corporation was not liable for alleged negligence of the company. The Court emphasized an essential element in the finding of liability of the parent through agency as follows:

The clue to what is necessary to disregard corporate entity is . . . *the element of fraud*. That entity may be ignored, whether in law or in equity, when the latter corporation is organized to promote an unfair purpose.<sup>14</sup>

### Instrumentality

Instrumentality is a term which several Courts have attempted to define in this context. It seems to be in much greater favor than the agency concept of liability. The case of *Fisser v. International Bank*,<sup>15</sup> quoting from *Lowendahl v. The Baltimore & O. RR. Co.*,<sup>16</sup> set out three elements which must be proved in order to justify application of the instrumentality rule in the absence of express agency, estoppel, or direct tort by the parent. These elements are:

<sup>12</sup> *Owl Fumigating Co. v. California Cyanide Co.*, *supra*, n. 10 at 813.

<sup>13</sup> *Miller v. Bethlehem Steel Corp.*, *supra*, n. 10.

<sup>14</sup> *Ibid.*

<sup>15</sup> 282 F. 2d 231, 238 (2d Cir. 1960).

<sup>16</sup> *Supra*, n. 9.

1. Control of the subsidiary by the parent,
2. That control is used by the parent to commit fraud or, worse, to perpetrate violation of statutory or other positive legal duties, or a dishonest and unjust act in contravention of legal rights, and
3. That the control and breach of duty proximately cause injury or the unjust loss complained of.<sup>17</sup>

Eleven factors have been enumerated in Powell on *Parent and Subsidiary Corporations*, Sections 5 and 6,<sup>18</sup> which, if present in a proper and sufficient combination, will call for application of the instrumentality rule. Powell states that this rule has been adopted in all jurisdictions and that the question is simply as to when it should be applied. His eleven criteria were adopted by the Court in *Taylor v. Standard Gas and Electric Company*,<sup>19</sup> and have been repeatedly relied on by the Courts. One recent case is that of *Garrett v. Southern Ry. Company*.<sup>20</sup> That case pointed out that there is an additional general requirement of elements of fraud or wrongdoing on the part of the parent corporation to the detriment of the subsidiary or third persons in their relations with the subsidiary. The eleven criteria are as follows:

1. The parent corporation owns all or most of the capital stock of the subsidiary.
2. The parent and subsidiary corporations have common directors or officers.
3. The parent corporation finances the subsidiary.
4. The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.
5. The subsidiary has grossly inadequate capital.
6. The parent corporation pays the salaries and other expenses or losses of the subsidiary.
7. The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.
8. In the papers of the parent corporation or in the statements of its officers the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own.

<sup>17</sup> Powell, *op. cit.*, *supra*, n. 6. at 4-6.

<sup>18</sup> *Ibid.*

<sup>19</sup> *Supra*, n. 2.

<sup>20</sup> 173 F. Supp. 915 (E. D. Tenn. 1959).

9. The parent corporation uses the property of the subsidiary as its own.

10. The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take their orders from the parent corporation in the latter's interest.

11. The formal legal requirements of the subsidiary are not observed.<sup>21</sup>

When a sufficient number of these factors are present in proper combination, and in the presence of some fraud or wrongdoing and consequent injury to the plaintiff, the parent will be held liable for the torts of the subsidiary.

Whether or not a parent uses its subsidiary as an instrumentality has been held to be a jury question.<sup>22</sup>

### **Alter-Ego**

The successor corporation in a merger has been held to be the *alter ego* of the former corporations<sup>23</sup> where the successor corporation expressly assumed all the liabilities of the first company as a condition of obtaining permission of the ICC to transfer a highway bus franchise to the successor.

### **Sham or Adjunct**

When a subsidiary is a mere sham or adjunct of its parent its existence will be disregarded.<sup>24</sup> These factors seem to apply when the subsidiary is simply a paper corporation and it is determined as fact that there was no good faith attempt to create a corporation. One case in which this rule was applied involved a subsidiary which leased all of its assets from the parent and whose stockholders gave only demand notes for their stock to the principal stockholder of the parent, on which notes payment was never demanded.<sup>25</sup>

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<sup>21</sup> Taylor v. Standard Gas and Electric Co., 96 F. 2d 693, 704-705 (1938); rev'd on other grounds, *supra*, n. 2.

<sup>22</sup> Johanssen v. Mid Continent Petroleum Corp., 232 Iowa 805, 5 N. W. 2d 20 (1942).

<sup>23</sup> Barnes v. Liebig, 146 Fla. 219, 1 So. 2d 247 (1941).

<sup>24</sup> Sheridan v. Pan-American Refining Corp., 123 F. Supp. 81 (S. D. N. Y. 1954).

<sup>25</sup> Wallace v. Tulsa Yellow Cab Taxi and Baggage Co., 178 Okla. 15, 61 P. 2d 645 (1936).

### Interpretations

All of the above theories have in common certain essential factors including elements of fraud and control.

### Control

Any majority stockholder, whether corporate or not, has some degree of control over his owned corporation; however, the degree of control required to establish the parent's liability for the acts of the subsidiary must be more than mere participation in the affairs of the subsidiary in a normal and usual manner.<sup>26</sup> A sufficient amount of control for liability has been held to include dispositive and proprietary power over or in the property of the subsidiary,<sup>27</sup> manipulation,<sup>28</sup> undue domination or influence resulting in an infringement upon the rights of the subservient corporation for the benefit of the dominant one,<sup>29</sup> and actual operation of the subsidiary's properties with utter disregard for its distinct corporate entity.<sup>30</sup>

In the case of *Garden City v. Burden*<sup>31</sup> the Court, in sustaining the jury finding that an irrigation company was the *alter ego* of its parent, said:

Where the relationship between the parent and subsidiary corporation is so intimate, parent's control over subsidiary is so dominating, and business and assets of the two are so commingled that recognition of distinct entity would result in injustice to third persons, courts should look through the legal fiction of separate entity and treat them as justice requires.

Thus, this case shows that when operating control of the subsidiary by its parent is so great as to result in injustice to third persons, the corporate veil is likely to be pierced.

<sup>26</sup> *Chicago, M. & St. P. Ry. Co. v. Minneapolis Civic & Commerce Assoc.*, 247 U. S. 490 (1917).

<sup>27</sup> *Madison Pictures, Inc. v. Chesapeake Industries Inc.*, 147 N. Y. S. 2d 50 (1955).

<sup>28</sup> *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W. D. Ark. 1951).

<sup>29</sup> *Kentucky Electric Power Co. v. Norton Coal Mining Co.*, 93 F. 2d 923 (6th Cir. 1938).

<sup>30</sup> *Costan v. Manila Electric Co.*, 24 F. 2d 383 (2d Cir. 1928).

<sup>31</sup> 186 F. 2d 651 (10th Cir. 1951).



## Fraud

Fraud or intent to do wrong is generally an essential element for piercing the corporate veil.

It has been held that undue domination and control are insufficient to cause disregard of corporate entity unless the plaintiff was defrauded thereby.<sup>32</sup> The same case held that a plaintiff is estopped to claim that the parent corporation used the subsidiary as a mere instrumentality if, with knowledge of all the facts at the time of the transaction with the subsidiary, he accepted or approved the relation between the corporations.<sup>33</sup>

## Business Relations Between Parent and Subsidiary

The many varied reasons for organizing subsidiary corporations are outlined by Douglas<sup>34</sup> and elsewhere. One of the normal reasons is to enable the parent to effectively conduct a particular type of business in another state when it might not be able to do so directly. A parent corporation will generally not be liable for the torts of its subsidiary simply because it formed the subsidiary to do indirectly what it could not do directly.<sup>35</sup> The New York courts have gone so far as to say, in the case of a British parent and a New York subsidiary, that no matter how completely the parent might dominate the subsidiary, and even though the subsidiary is no more than an instrumentality for carrying out the parent's business, and although the dominant motive in organizing the subsidiary is avoidance of suits, without more, the parent would not be held liable.<sup>36</sup>

A subsidiary formed solely to distribute the products of its manufacturing company parent will be treated as a separate entity if it is operated independently and without dictation from the manufacturing company.<sup>37</sup> Also, one subsidiary which is a selling affiliate of the parent is not the agent of another subsidiary which is a manufacturing affiliate of the same parent.<sup>38</sup>

<sup>32</sup> *In re Kalamazoo Building Co.*, 21 F. Supp. 852 (W. D. Mich. 1937).

<sup>33</sup> *Ibid.*

<sup>34</sup> *Supra*, n. 3.

<sup>35</sup> *Segall v. Food Fair Store, Inc.*, 185 F. Supp. 81 (E. D. Pa. 1960).

<sup>36</sup> *Hazeltine Corp. v. General Electric Co.*, 19 F. Supp. 898 (D. Md. 1937); see also *McDermott v. Oil Burner Sales Corp.*, 266 Ill. App. 115 (1932).

<sup>37</sup> *Fergus Motors, Inc. v. Standard Triumph Motors, Inc.*, 130 F. Supp. 780 (S. D. N. Y. 1955).

<sup>38</sup> *Ledlow v. Goodyear Tire & Rubber Co. of Alabama*, 238 Ala. 35, 189 So. 78 (1939).

A theory of "enterprise entity" has been advanced by Berle.<sup>39</sup> This new theory has been used by the courts<sup>40</sup> and discussed by Lattin & Jennings.<sup>41</sup> According to Berle's analysis, the entity that should be treated in parent-subsidiary liability problems is the business or economic entity rather than the artificial corporate structure. He quotes from a case:

Rather we have a principle of law, namely, that below the corporate papers there is always an enterprise; that, *prima facie*, the corporate papers, minute books and books of account describe and indicate that enterprise; that it is always open to inquiry whether the enterprise-fact corresponds to the corporate-fact.<sup>42</sup>

### Conclusions

Although the metaphors of Cardozo do not constitute rigidly applicable rules, they do establish helpful guidelines. The later cases have considerably increased the usefulness of these concepts. The tests for holding a parent corporation liable for the torts of its subsidiaries, while not based solely on equity, do have distinct foundations in equitable case law.

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<sup>39</sup> Berle, *The Theory of Enterprise Entity*, 47 Col. L. Rev. 343 (1947).

<sup>40</sup> *Sisco-Hamilton Co. v. Lennon*, 240 F. 2d 68, (7th Cir. 1957).

<sup>41</sup> Lattin & Jennings, *supra*, n. 7, at 145.

<sup>42</sup> *Supra*, n. 37, at 353; *e.g.*: *Consolidated Rock Products Co. v. DuBois*, 312 U. S. 510 (1941); *Southern Pacific Ry. v. Bogert*, 250 U. S. 483 (1918).