

## HARVARD LAW REVIEW

MEGASUBSIDIARIES:  
THE EFFECT OF CORPORATE STRUCTURE  
ON CORPORATE CONTROL †*Melvin Aron Eisenberg* \*

*Professor Eisenberg describes the recent growth of massive subsidiary corporations and the legal and economic reasons behind this development. He then points out the subversion of shareholder voting rights that can occur if some of the major transactions of these subsidiaries need be approved only by the board of directors of the parent. His conclusion is that the right to vote the subsidiary's stock in these transactions either inheres in the parent and is exercisable by the body of the parent's shareholders or passes through the parent directly to the parent's shareholders.*

IT has long been observed that most of this country's business assets are held by corporations, so that ultimate ownership is once removed from the assets themselves.<sup>1</sup> Within the last few years, however, the process has gone one step further. Due to a number of recent legal and economic developments, a significant portion of the country's business assets is now held, not only by corporations, but by massive subsidiary corporations — megasubsidiaries. As a result, ultimate ownership of business assets is often not only once but twice or more removed from the assets themselves. The purpose of this article is to explore this development and its implications for corporate law.

## I. GROWTH OF THE MEGASUBSIDIARY PHENOMENON

*A. Wholly Owned Megasubsidiaries*

In terms of a corporate law analysis, megasubsidiaries may

† Copyright 1971 by Melvin Aron Eisenberg. This is the third in a series of articles on the allocation of legal powers within the modern corporation. See Eisenberg, *The Legal Roles of Shareholder and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1 (1969); Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489 (1970).

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<sup>1</sup> See, e.g., A.A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* viii-ix, 13-16 (rev. ed. 1968).

be divided into two classes: those in which the parent owns all or virtually all of the stock (hereafter referred to as wholly owned subsidiaries), and those in which a significant minority interest is owned by persons other than the parent — in particular, by members of the public. Characteristically, the very largest of the megasubsidiaries fall into the former class. Indeed, many sectors of economic life are now dominated by such corporations. For example, the country's ten largest commercial banking institutions<sup>2</sup> — Bank of America, First National City, Chase Manhattan, Manufacturers Hanover, Morgan Guaranty, Western Bancorporation, Chemical, Bankers Trust New York Corporation, Continental Illinois, and First National Bank of Chicago — are all wholly owned megasubsidiaries or holding companies whose banking business is done through one or more such megasubsidiaries.<sup>3</sup> All told, fourteen of the fifteen largest commercial banking institutions, and thirty-three of the fifty largest, are in holding-company form.<sup>4</sup> Megasubsidiaries are also extremely important in the savings-bank sector. The three largest savings-and-loan associations<sup>5</sup> — Home Savings, American Savings & Loan, and Great Western — are all wholly owned megasubsidiaries,<sup>6</sup> and more than half the assets of federally insured investor-owned savings-and-loan associations are under holding-company control.<sup>7</sup>

In insurance too, the megasubsidiary has become a major force.<sup>8</sup> The six largest investor-owned life insurance companies<sup>9</sup> — Aetna Life, Connecticut General, Travelers, National Life & Accident, Occidental of California, and Continental Assurance —

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<sup>2</sup> Ranking is by assets. *The 50 Largest Commercial Banks*, FORTUNE, May 1970, at 204.

<sup>3</sup> See MOODY'S BANK & FINANCE MANUAL (1970) under the corporation names in text.

<sup>4</sup> See *The 50 Largest Commercial Banks*, *supra* note 2, at 205-06.

<sup>5</sup> Ranking is by assets. MOODY'S BANK & FINANCE MANUAL 245 (1970).

<sup>6</sup> See *id.* under corporation names in text, save for Home Savings, which is described in *Hearings on H.R. 1322, H.R. 8696, and H.R. 12025 Before the Subcomm. on Domestic Finance of the House Comm. on Banking and Currency*, 90th Cong., 1st Sess. 48 (1967).

<sup>7</sup> See *Hearings*, *supra* note 6, at 48; Brigham & Pettit, *Effects of Structure on Performance in the Savings and Loan Industry*, in 3 U.S. FEDERAL HOME LOAN BANK BOARD, STUDY OF THE SAVINGS AND LOAN INDUSTRY 971, 1102-03 (1969). Almost 80% of the assets of savings-and-loan associations are accounted for by mutual associations, but stock associations, including holding companies, are growing faster than mutuals. *Id.* at 981, 1102-05, 1167.

<sup>8</sup> See Brigham & Pettit, *supra* note 7, at 1120; Main, *Why Nobody Likes the Insurers*, FORTUNE, Dec. 1970, at 83, 87, 119; Rose, "The Future Largest Landlords in America," FORTUNE, July 1970, at 90, 133-3.

<sup>9</sup> Ranking is by assets. *The 50 Largest Life-Insurance Companies*, FORTUNE, May 1970, at 206.

and the six largest investor-owned property-liability insurers<sup>10</sup> — Allstate, Travelers, Continental Corporation, Aetna Life & Casualty, Hartford Fire, and INA — are either wholly owned megasubsidiaries or holding-company complexes doing their insurance business through wholly owned megasubsidiaries.<sup>11</sup> In transportation, many of the country's largest railroads are owned by wholly owned megasubsidiaries, including the Penn Central; Southern Pacific; Atchinson, Topeka & Santa Fe; Union Pacific; and Seaboard Coast Line.<sup>12</sup> So is the country's largest airline,<sup>13</sup> United.<sup>14</sup> And the four largest message-communications companies, comprising almost the entire sector<sup>15</sup> — AT&T, General Telephone, Continental Telephone, and Western Union — are all holding companies operating principally through wholly owned subsidiaries.<sup>16</sup>

This dominance of many business sectors by wholly owned megasubsidiaries is a recent development.<sup>17</sup> All but a handful of the sector-dominating megasubsidiaries were independent corporations as late as 1955, and many or most were independent as

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<sup>10</sup> Ranking is by property-liability premiums. MOODY'S BANK & FINANCE MANUAL 248 (1970).

<sup>11</sup> See *id.* under the corporation names in text, save for Hartford Fire, which is described in MOODY'S BANK & FINANCE NEW REPORTS, July 31, 1970, at 1607, col. 1. As in the case of savings-and-loan associations, many insurance companies are mutuals, rather than investor owned. See *The 50 Largest Life-Insurance Companies*, *supra* note 9, at 206.

<sup>12</sup> See MOODY'S TRANSPORTATION MANUAL (1970) under the corporation names in text.

<sup>13</sup> See *The 50 Largest Transportation Companies*, FORTUNE, May 1970, at 210.

<sup>14</sup> See MOODY'S TRANSPORTATION MANUAL 1375 (1970).

<sup>15</sup> See *The 50 Largest Utilities*, FORTUNE, May 1970, at 212.

<sup>16</sup> See MOODY'S PUBLIC UTILITY MANUAL (1970) under the corporation names in text.

<sup>17</sup> A similar but more limited phenomenon occurred during the Twenties and early Thirties when holding companies dominated the public utility sector and were common, although not dominant, among the industrials. Beginning in the mid-Thirties, however, this pattern was reversed. Public utility holding companies fell under the "death-sentence" clause of the Public Utility Holding Company Act of 1935, § 11(b), 15 U.S.C. § 79k(b) (1964). See 1 L. LOSS, SECURITIES REGULATION 131-41 (2d. ed. 1961); 4 *id.* at 2276 (Supp. 1969). Many of the industrial companies dropped the holding-company form in favor of a simplified corporate structure. Compare J. BONBRIGHT & G. MEANS, THE HOLDING COMPANY 76-79, 90-95 (1932), with 2 A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 985-87, 999-1006 (5th ed. 1953).

There were also important bank and railroad holding companies in the Twenties, but the form was not widespread in those areas, and many such corporations later dropped it in favor of corporate simplification. See J. BONBRIGHT & G. MEANS, *supra* at 223-24, 323-24; 2 A. DEWING, *supra* at 958-63, 986-87.

late as 1967. Even more striking than the suddenness of this development, however, is the way in which it has occurred. In most cases, theretofore independent corporations turned themselves into subsidiaries by reversing normal corporate biology and creating their own parents.<sup>18</sup>

The reasons for such a seemingly unusual procedure, and indeed for the megasubsidary phenomenon as a whole, are grounded in part on legal and economic considerations unique to each business sector. However, some considerations are common to virtually all of the sectors affected. Because the phenomenon is particularly pervasive and well documented in commercial banking, an account of the way it developed in that sector sheds light on the phenomenon as a whole.

1. *Megasubsidiaries in the Regulated Area; The Case of Commercial Banking.*—Commercial banking is a regulated business. As one aspect of this regulation, the types of activity in which a banking corporation may legally engage are normally quite limited. A national bank may carry on "the business of banking,"<sup>19</sup> and has "incidental powers . . . necessary to carry on the business of banking,"<sup>20</sup> but is not empowered to engage in any business activity which is neither banking nor incidental thereto. Nor can a national bank, or a state-bank member of the federal reserve system, carry on a nonbanking business through a subsidiary.<sup>21</sup> And the Bank Holding Company Act of 1956 made it illegal for any corporation controlling two or more banks to engage in any business other than banking, or to own voting shares of any corporation except one engaged in banking<sup>22</sup> or one "all the activities of which are of a financial, fiduciary, or insurance nature and which the [Federal Reserve] Board . . . has determined to be so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto."<sup>23</sup>

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<sup>18</sup> See MOODY'S MANUALS under the corporations named in text at pp. 1578-79 *supra*; pp. 1581, 1584 *infra*.

In the message-communications sector, however, only one of the four corporations named in the text—Western Union—falls into the pattern described.

<sup>19</sup> National Bank Act of 1864, § 5, 12 U.S.C. § 21 (1964).

<sup>20</sup> 12 U.S.C. § 24 (Supp. V, 1970), *amending* National Bank Act of 1864, § 8, ch. 106, § 8, 13 Stat. 101.

<sup>21</sup> See *id.*; 12 U.S.C. § 335, *amending* Federal Reserve Act of 1913, § 9, ch. 6, § 9, 38 Stat. 259; 12 C.F.R. § 7.10(a) (1970).

<sup>22</sup> Bank Holding Company Act of 1956, § 4(a), 12 U.S.C. § 1843(a) (1964), as *amended*, Pub. L. 91-607, 39 U.S.L.W. 115 (Dec. 31, 1970).

<sup>23</sup> Bank Holding Company Act of 1956, § 4(c)(6), 12 U.S.C. § 1843(c)(6) (1964), as *amended*, Pub. L. 91-607, 39 U.S.L.W. 115 (Dec. 31, 1970). (The present § 4(c)(8), the amended version of § 4(c)(6), quoted in text, is set out in note 37 *infra*.)

There was, however, a gap in the statutory restrictions on nonbanking activities. The Bank Holding Company Act (until amended in 1970<sup>24</sup>) was not applicable to parent corporations holding the stock of only *one* bank — one-bank holding companies.<sup>25</sup> This gap assumed great significance in the mid-1960's, when a number of major banks became eager to engage in various new activities which might or might not have been permissible or permitted by the regulatory authorities — electronic data processing, equipment leasing, the operation of commingled investment funds, factoring, customs brokerage, credit reporting, warehousing, selling insurance, and managing travel agencies.<sup>26</sup> Taking advantage of this gap in the regulatory net, these banks proceeded to turn themselves into wholly owned subsidiaries of parents which they themselves created. Since the parent did not itself engage in banking, it was not subject to restrictions applicable to banking corporations; and since the parent held only one banking subsidiary, it was not subject to the restrictions of the Bank Holding Company Act. The resulting corporate complex was free to go into any business, either directly through the parent, or indirectly through subsidiaries other than the bank, and therefore to deploy its capital in whatever way seemed most profitable. Several important collateral advantages also followed from the new corporate structure. For one thing, the parent could finance its activities and those of its nonbanking subsidiaries free of the legal restrictions applicable to the financing of banks.<sup>27</sup>

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There were a number of other relatively limited exceptions. For example, the Act permitted retention, for a limited period, of "shares acquired by a bank in satisfaction of a debt previously contracted in good faith." Bank Holding Company Act of 1956, § 4(c)(2), 12 U.S.C. § 1843(c)(2) (1964).

<sup>24</sup> See pp. 1582-83 *infra*.

<sup>25</sup> One supposed justification for this exception was that the Act was aimed primarily at the use of holding companies to achieve interstate branching or de facto branching in states where branching is prohibited, and that one-bank holding companies usually do not pose these particular problems. Note, *Diversification by National Banks*, 21 STAN. L. REV. 650, 670 (1969); Note, *Approaches to Regulation of One-Bank Holding Companies*, 55 VA. L. REV. 952, 954 (1969). Another was that most one-bank holding companies in existence in 1956 were relatively small. Rose, *The Case for the One-Bank Holding Company*, FORTUNE, May 15, 1969, at 163; Note, 55 VA. L. REV., *supra* at 954, 985-86 n.171. Undoubtedly the exception also reflected practical politics.

<sup>26</sup> See Beatty, *What Are the Legal Limits to the Expansion of National Bank Services?*, 86 BANKING L.J. 3, 3-14 (1969); Bunting, *One-Bank Holding Companies: A Banker's View*, HARV. BUS. REV., May-June 1969, at 99, 100-102.

<sup>27</sup> See Nadler, *The One-Bank Holding Company*, BANKING, December 1968, at 34-35; Shapiro, *The One-Bank Holding Company Movement: An Overview*, 86 BANKING L.J. 291, 297-99 (1969); Whitsel, *Economics of the One-Bank Holding Company*, THE BANKER'S MAGAZINE, Winter 1969, at 28, 30-31.

Many or most of the newly formed one-bank holding companies have restricted

For another, stock in the potentially diversified parent might command a higher multiple than stock in a regulated business.<sup>28</sup> Thus while bank stocks traditionally were traded over-the-counter,<sup>29</sup> many bank-holding companies have listed their stock: the holding companies of First National City, Manufacturers Hanover, Morgan Guaranty, Chemical, Bankers Trust, and Irving Trust were listed on the New York Stock Exchange within the space of eight months.<sup>30</sup>

Chiefly as a result of such considerations, over three hundred and fifty one-bank holding companies have been formed since 1965 — most of them, including many of those formed by very large banks, since mid-1968.<sup>31</sup> As of May 1970, one-bank holding companies held deposits of \$180 billion — up from \$15.1 billion in 1965 — and accounted for forty-one percent of total commercial bank deposits.<sup>32</sup> The five largest commercial banking institutions, ten of the fifteen largest, and nineteen of the fifty largest, are now one-bank holding companies.<sup>33</sup> Meanwhile, the number of multibank holding companies has also been growing rapidly, and more than doubled between 1965 and the end of 1970.<sup>34</sup> Indeed, many of the fifty largest commercial banking institutions which are not one-bank holding companies are multibank holding companies.<sup>35</sup> Such companies and their affiliates now account for fifteen percent of total bank deposits,<sup>36</sup> so that bank holding companies as a class account for more than half of such deposits.

The movement to one-bank holding companies may be slowed

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themselves to business activities of a financial nature. See Bunting, *supra* note 26, at 102; Shapiro, *supra* at 298.

<sup>28</sup> See Nadler, *supra* note 27, at 35, 78.

<sup>29</sup> Cf. Metz, *Making Markets in Bank Stocks*, N.Y. Times, Sept. 10, 1968, at 60, col. 7.

<sup>30</sup> NEW YORK STOCK EXCHANGE, 1970 FACT BOOK 34-35; NEW YORK STOCK EXCHANGE, 1969 FACT BOOK 32-33.

<sup>31</sup> See Heinemann, *Bank Holding Battles Are Only Begun*, N.Y. Times, Jan. 10, 1971, § 3, at 1, col. 8. Compare STAFF OF HOUSE COMM. ON BANKING AND CURRENCY, 91ST CONG., 1ST SESS., THE GROWTH OF UNREGISTERED BANK HOLDING COMPANIES — PROBLEMS AND PROSPECTS 7 (Table 2) (Comm. Print 1969) with *Hearings on S. 1052, S. 1211, S. 1664, S. 3823, and H.R. 6778 [to amend the Bank Holding Company Act] Before the Senate Comm. on Banking and Currency*, 91st Cong., 2d Sess. 12 (1970).

<sup>32</sup> Compare THE GROWTH OF UNREGISTERED BANK HOLDING COMPANIES, *supra* note 31, at 5, with *Hearings*, *supra* note 31, at 12.

<sup>33</sup> Compare *The 50 Largest Commercial Banks*, *supra* note 2, at 205 (50 largest banks), with MOODY'S BANK & FINANCIAL MANUAL (1970) under the corporation names (their description).

<sup>34</sup> See *How Little Farmers Bank Went to the City And Discovered How to Swing — at a Profit*, Wall Street Journal, Jan. 27, 1971, at 32, col. 1.

<sup>35</sup> See *The 50 Largest Commercial Banks*, *supra* note 2, at 205.

<sup>36</sup> Wall Street Journal, *supra* note 34.

by the Bank Holding Company Act Amendments of 1970, which bring such companies under the provisions of the Bank Holding Company Act.<sup>37</sup> However, the amendments are unlikely to cause existing holding companies to readopt a simple corporate structure, since they do not appear to make a holding-company structure less advantageous than other corporate structures available to banking institutions.<sup>38</sup> The principal effect of the amendments on existing corporate structures is therefore likely to be that some one-bank holding companies will convert to multibank holding companies, since the comparative legal advantages of the one-bank form are no longer available.<sup>39</sup>

Commercial banking presents a particularly dramatic case of the increased use of wholly owned megasubsidiaries to conduct business. However, as has already been seen, a comparable pattern now prevails or is coming to prevail in most of the other major sectors of the regulated area — transportation, insurance, savings banks, and message communications.<sup>40</sup> By and large, the dominant themes of the one-bank holding company movement are echoed in these sectors. The manner of development has been comparable — operating companies have created holding companies to be their own parents. The chronology has been comparable — most of the activity has occurred since 1955.<sup>41</sup> And

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<sup>37</sup> Pub. L. No. 91-607, § 101(a), 39 U.S.L.W. 115 (Dec. 31, 1970). The 1970 amendments also make certain changes in the Bank Holding Company Act's substantive provisions. Among other things, § 4(c)(8) of the Act, the successor to § 4(c)(6), *see* p. 1580 *supra*, has been amended to permit bank holding companies to own "shares of any company the activities of which the [Federal Reserve] Board . . . has determined . . . to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." Pub. L. No. 91-607, § 103(4), 39 U.S.L.W. 116 (Dec. 31, 1970). It is not yet certain whether the new language will be read more liberally than the old. *See* Heinemann, *supra* note 31.

<sup>38</sup> Furthermore, a limited grandfather clause softens the impact of the 1970 amendments on existing one-bank holding companies. Pub. L. No. 91-607, § 103(4), 39 U.S.L.W. 116 (Dec. 31, 1970).

<sup>39</sup> *See Changes in New York Banking Structure Follow '70 Bank-Holding Act Amendments*, Wall Street Journal, Jan. 27, 1971, at 4, col. 2.

<sup>40</sup> One major regulated area not dominated by holding companies is public utilities, where holding companies were brought to heel by the death-sentence clause of the Public Utility Holding Company Act, *see* note 17 *supra*. Even in this area, however, holding companies never entirely disappeared and now appear to be staging a comeback. *See* 4 L. Loss, *supra* note 17, at 2276-77 (Supp. 1969).

<sup>41</sup> One index of the rapidity of the entire development is that while only one holding company was newly listed on the New York Stock Exchange in 1967, thirteen were newly listed in 1968, and in 1969 twelve were newly listed and another twelve already listed companies were converted into holding companies. NEW YORK STOCK EXCHANGE, 1968 FACT BOOK 30-31; NEW YORK STOCK EXCHANGE, 1969 FACT BOOK 32-33; NEW YORK STOCK EXCHANGE, 1970 FACT BOOK 34-35. Listing data also reflects the strong relationship between adoption of the holding-company form and the marketing of stock. For example, in 1968 and 1969, ten

the reasons have been comparable — a desire to diversify into nonregulated business; sometimes related to the regulated business, sometimes not; a desire to escape at least partially from capital-structure limitations characteristic of the regulated business; and a desire to upgrade the sex appeal of the corporation's stock.<sup>42</sup>

2. *Megasubsidiaries in the Nonregulated Area.* — While this pattern is predominantly to be found in the regulated sectors, it seems to be spreading to the nonregulated area. Of course, some corporations engaged in nonregulated businesses have traditionally operated in holding-company form.<sup>43</sup> Until recently, however, the trend in the nonregulated area had been away from holding-company structures toward corporate simplification.<sup>44</sup> But in the last year or two, the trend seems to have been abruptly reversed, as several important nonregulated companies have followed the pattern established in the regulated area. Among corporations listed on the New York Stock Exchange, Walter E. Heller & Company,<sup>45</sup> Marsh & McLennan, Incorporated,<sup>46</sup> General Acceptance Corporation,<sup>47</sup> and R. J. Reynolds<sup>48</sup> have created parents for themselves in the last four years. In their proxy statements, both General Acceptance and R. J. Reynolds stated as a major reason for adopting the holding-company form that it would permit some activities of the restructured corporate complex to be free from restrictions arising under debt instruments or preferred stock.<sup>49</sup> R. J. Reynolds also stated that the restructuring would permit "more appropriate reflection of managerial responsibilities in respect of [the] diversified activities" of the corporate complex,

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insurance holding companies, including many of the largest insurance companies in the country, listed on the New York Stock Exchange for the first time.

<sup>42</sup> See C. CLAWSON, F. BARSALOV, *et alia*, THE SAVINGS AND LOAN INDUSTRY IN CALIFORNIA VI-5 to -7, VI-10 to -13 (Stanford Research Institute Project No. I-3065, 1960); U.S. FEDERAL HOME LOAN BANK BOARD, REPORT ON SAVINGS AND LOAN HOLDING COMPANIES 4-5, 16 (1960); Brigham & Pettit, *supra* note 7, at 979, 1105-19; Main, *supra* note 8; Rose, *supra* note 8; Notice of Annual Meeting of Stockholders and Proxy Statement of United Air Lines, Inc., Mar. 12, 1969, at 4; Notice of Special Meeting of Shareholders and Proxy Statement of Aetna Life Insurance Co., Oct. 2, 1967, at 3-4.

<sup>43</sup> For example, Standard Oil of New Jersey has long conducted its operations principally through wholly owned subsidiaries, see MOODY'S INDUSTRIAL MANUAL 2271-73 (1970), while Western Electric has long been a subsidiary of AT&T, see MOODY'S PUBLIC UTILITY MANUAL 1238 (1970).

<sup>44</sup> See note 17 *supra*.

<sup>45</sup> See MOODY'S BANK & FINANCE MANUAL 1589-90 (1970).

<sup>46</sup> See *id.* at 2355-56.

<sup>47</sup> See *id.* at 1614, 1617.

<sup>48</sup> See MOODY'S INDUSTRIAL MANUAL 3321 (1970).

<sup>49</sup> See Notice of Annual Meeting and Proxy Statement of General Acceptance Corp., April 2, 1968, at 1-2; Notice of Annual Meeting and Proxy Statement of R.J. Reynolds Tobacco Co., March 16, 1970, at 6.



would substantially increase "flexibility in the assignment and deployment of personnel," and would "provide a more advantageous vehicle for future acquisitions and further diversification."<sup>50</sup>

### *B. Publicly Held Megasubsidiaries*

In most of the cases considered thus far, substantially all of the operating assets under the control of a corporate complex are owned by one or more megasubsidiaries, which in turn are one hundred percent or close to one hundred percent owned by the parent. A second type of megasubsidiary which has also become increasingly significant within recent years is that in which members of the public hold a significant stock interest — publicly held megasubsidiaries. Taken as a class, complexes involving publicly held megasubsidiaries tend to differ from complexes involving wholly owned megasubsidiaries in three major characteristics other than the percentage of the parent's ownership: (1) they are usually engaged in nonregulated businesses; (2) the parent is usually an operating, rather than a holding company, so that subsidiaries hold less than substantially all of the complex's operating assets; and (3) while the megasubsidiary is frequently large enough to be listed on a major stock exchange, it is usually not industry dominant.

Most of the publicly held megasubsidiaries have been generated by two corporate financial techniques which are relatively new in extent of application, if not in conception. The first of these is the takeover bid, which may be defined as a "technique of acquiring control of a corporation by making a public offer to purchase a part of the corporation's stock at a fixed price."<sup>51</sup> When, as is usually the case, the target corporation is publicly held, the bidder is itself a corporation, and the bid involves an amount of the target's stock sufficient to give the bidder effective control,<sup>52</sup> then the effect of a successful takeover bid is to convert a theretofore independent corporation into a publicly held subsidiary. Use of takeover bids on an important scale began in the early 1960's. While not unknown before then, they appear to have been rare;<sup>53</sup> as recently as in 1960 only eight takeover bids were made for corporations listed on the New York or American Stock Exchanges. By contrast, in 1965 there were forty-four

<sup>50</sup> Notice of Annual Meeting and Proxy Statement of R.J. Reynolds Tobacco Co., March 16, 1970, at 6.

<sup>51</sup> Fleischer & Mundheim, *Corporate Acquisition by Tender Offer*, 115 U. PA. L. REV. 317, 317 (1967).

<sup>52</sup> See *id.* at 318, 328.

<sup>53</sup> See Austin & Fishman, *The Tender Takeover*, MERGERS & ACQUISITIONS, May-June 1969, at 4, 12-13.

bids for corporations listed on one of those exchanges, and in 1966, over one hundred.<sup>54</sup>

The second important technique for creating publicly held subsidiaries is sometimes referred to as a partial spinoff. Under this technique, the parent of a theretofore wholly owned subsidiary distributes a minority interest in the subsidiary to the parent's shareholders, or, in a variant, sells or causes the subsidiary to sell a minority stock interest to the parent's shareholders or to the public directly. The result is to convert a wholly owned subsidiary into a subsidiary that is publicly held.<sup>55</sup>

The first prominent use of this technique occurred in 1964, when Ling-Temco-Vought, Incorporated placed most of its operating assets into three newly created subsidiaries, and then offered a minority stock interest in each of the subsidiaries to its shareholders in exchange for L-T-V stock and cash. Undoubtedly the most important reason for this transaction was its anticipated effect on L-T-V stock. Once a portion of the subsidiaries' stock became publicly held, it was actively traded, so that a market value was established for the stock of each subsidiary. The total market value of the subsidiaries' stock was substantially greater than either the total book value of the subsidiaries' assets, or the pre-spinoff total market value of L-T-V's stock. Since L-T-V had retained most of the subsidiaries' stock, the result was a dramatic appreciation in the price of L-T-V stock. Another reason which was stressed by L-T-V for partial spinoffs was that executives of

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<sup>54</sup> See S. REP. NO. 550, 90th Cong., 1st Sess. 2 (1967); Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, BUS. LAW., Nov. 1966, at 149.

The takeover-bid rate may have been slowed in 1968 by enactment of the Williams Bill, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (Supp. V, 1970), as amended, Pub. L. 91-567, §§ 1-5, 39 U.S.L.W. 113 (Dec. 22, 1970), which put several hurdles in bidders' paths. Even so, from August 1968, following passage of the bill, through the end of February 1970, eighty-eight publicly held corporations whose stock was registered under the Securities Exchange Act were targets of tender offers. *Hearings on S. 336 and S. 3431 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 91st Cong., 2d Sess. 91-93 (1970).

The number of corporations turned into subsidiaries as a result of takeover bids is, of course, less than the total number of bids. Not all bids are successful — although a high percentage are, see Austin & Fishman, *supra* note 53, at 13 (Table 17) — and many successful bids are followed by a merger between the bidding and the target corporation, thereby eliminating the parent-subsidiary relationship.

<sup>55</sup> A subsidiary in which persons other than the parent hold a significant interest may also result from the subsidiary having been originally organized by the parent and other persons. Usually this technique is confined to joint ventures, and normally in such cases the joint venturers enter into a preincorporation agreement delineating the rights of each party. This technique therefore normally does not pose the same problems, vis-à-vis the outside shareholders, as takeover bids and partial spinoffs, where the outside shareholders' rights are left to general corporate law. See pp. 1612-19 *infra*.

each subsidiary could be given stock options whose value depended on the performance of the subsidiary's business, rather than the performance of the corporate complex as a whole.<sup>56</sup>

There are other advantages in the use of this technique. Stock in a publicly held subsidiary corporation is probably more convenient security for prospective lenders to the parent than divisional assets. Subsidiaries are able to issue their own securities, which will apply to only a portion of the parent's assets. Also, a partial spinoff can be used to raise cash for either the parent or the subsidiary, or to conserve cash through distribution of stock in a subsidiary in lieu of a cash dividend.<sup>57</sup>

Over the years, L-T-V has created a number of publicly held megasubsidiaries.<sup>58</sup> Other major corporations, such as Armour and Gulf & Western, have followed L-T-V's lead.<sup>59</sup> A partial spinoff is, of course, particularly suitable for corporations composed of disparate businesses, since each business is presumably easily able to take on a separate identity. Given the growth of such corporations<sup>60</sup> and the advantages of a partial spinoff, use of this technique seems here to stay.

### *C. The Corporate Law Implications of the Megasubsidiary Phenomenon*

This dramatic proliferation of megasubsidiaries poses a difficult problem for corporate law. A major function of the corporate statutes is to allocate powers between shareholders and management. Characteristically, the statutes provide that certain corporate actions normally must be effected or approved by the body of shareholders<sup>61</sup> or by the holders of a designated percentage of outstanding shares.<sup>62</sup> Suppose that a *subsidiary* proposes to take

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<sup>56</sup> See Brown, *Jimmy Ling's Wonderful Growth Machine*, FORTUNE, January 1967, at 137, 172-73; McDonald, *Some Candid Answers From James J. Ling*, FORTUNE, Aug. 1, 1969, at 92, 95, 162-63; *LTV Keeps Expanding on Borrowed Money, Stock Price Increases*, Wall Street Journal, Aug. 18, 1967, at 1, col. 6.

<sup>57</sup> See Merjos, *Straw Into Gold?*, BARRON'S, Nov. 25, 1968, at 5.

<sup>58</sup> These include LTV Aerospace, LTV ElectroSystems, LTV Ling Altec, Wilson & Company, Wilson Sporting Goods Company, Wilson Pharmaceutical & Chemical Company, Okonite, Wilson Certified Foods, and Wilson-Sinclair Co. See MOODY'S INDUSTRIAL MANUAL (1970) under the names of these corporations.

<sup>59</sup> See *id.* at 2676-77, 2681 (Armour); *id.* at 2684 (Gulf & Western). For other examples, see Merjos, *supra* note 57.

<sup>60</sup> See Burck, *The Perils of the Multi-Market Corporation*, FORTUNE, Feb. 1967, at 130; O'Hanlon, *The Odd News about Conglomerates*, FORTUNE, June 15, 1967, at 130.

<sup>61</sup> For example, election of the board of directors. See, e.g., N.Y. BUS. CORP. LAW § 703(a) (McKinney 1963).

<sup>62</sup> For example, merger, sale of substantially all assets, amendment of the certificate of incorporation, and dissolution. See, e.g., N.Y. BUS. CORP. LAW §§

an action which comes within the statutory province of shareholders. Who are then "the shareholders" whose approval is statutorily required — the parent or the parent's shareholders? If the parent, which of its corporate organs has power to determine whether the approval will be forthcoming — its board or the body of its shareholders?<sup>63</sup>

It appears to have been commonly assumed that the power to vote a subsidiary's stock inheres in the parent's board.<sup>64</sup> This assumption may be adequate in the case of the usual subsidiary — one which is wholly owned by its parent, and which itself holds only an insubstantial share of the total assets within the parent's control. In such cases, a rule that the parent's board votes the parent's stock in the subsidiary would usually be unobjectionable. Since by hypothesis the subsidiary is wholly owned by the parent, no one except the parent's shareholders would normally have a recognizable interest in the identity of the persons who vote the subsidiary's stock; and since by hypothesis the subsidiary does not account for a significant portion of the assets within control of the corporate complex, the parent's shareholders would usually be indifferent even to major changes in the subsidiary's structure or enterprise.

However, in the case of subsidiaries which do account for a significant amount of the assets within the complex's control, or which are controlled but less than wholly owned by another corporation, a rule that the parent's board had power to vote the parent's stock in the subsidiary would have a real bite. If the subsidiary played a significant economic role in the corporate complex, the parent's shareholders might have a substantial interest in certain types of action which the subsidiary might undertake; while if the subsidiary were publicly held, the minority shareholders might have a substantial interest in the manner in which the parent exercised its control. It is the thesis of this article that in some such cases, at least, the right to vote the subsidiary's stock either inheres in the parent and is exercisable by the body of the parent's shareholders, or passes through the

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803(a), 903(a) (McKinney Supp. 1971); *id.* at §§ 909(a), 1001 (McKinney 1963). See generally Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1, 60-68 (1969).

<sup>63</sup> For a discussion of the significance of voting rights in publicly held corporations, see Eisenberg, *supra* note 62, at 21-60.

It should be observed that while this article is centered on the large publicly held corporation, essentially the same issues can arise in the context of much smaller corporations. See, e.g., *Baum v. Baum Holding Co.*, 158 Neb. 197, 62 N.W.2d 864 (1954).

<sup>64</sup> See, e.g., *Murphy, Corporate Divisions vs. Subsidiaries*, 34 HARV. BUS. REV., Nov.-Dec. 1956, at 83, 90.

parent directly to the parent's shareholders. Within this article, Part II will consider wholly owned subsidiaries which hold substantially all of the assets owned by the corporate complex ("economically dominant" subsidiaries); Part III will consider wholly owned subsidiaries which own less than substantially all such assets ("significant" and less-than-significant subsidiaries); and Part IV will consider subsidiaries in which persons other than the parent own a significant interest ("publicly held" subsidiaries).

The balance of this article is also organized on the principle that the allocation of corporate powers is most profitably discussed in the context of particular transactions. In particular, the focus will be on those transactions that normally require shareholder vote under the corporate statutes — sale of substantially all assets, merger, election of directors, certificate amendment, and dissolution. Most of the relevant principles will be developed in the context of an economically dominant subsidiary which proposes to engage in one of the first two types of transactions. The remainder of Part II will inquire whether the principles so developed are applicable to other transactions, and Parts III and IV will inquire whether those principles are applicable to other types of subsidiaries.

## II. WHOLLY OWNED SUBSIDIARIES WHICH HOLD SUBSTANTIALLY ALL OF THE ASSETS OWNED BY THE CORPORATE COMPLEX (ECONOMICALLY DOMINANT SUBSIDIARIES)

### *A. Sale of Substantially All Assets and Merger*

Under the corporate statutes, a sale of substantially all assets normally must be approved by the holders of a majority or two-thirds of the selling corporation's outstanding shares, and a merger normally must be approved by the holders of a majority or two-thirds of the outstanding shares of both corporate parties. Those requirements follow naturally from the economics of such transactions. If a corporation sells substantially all of its assets for cash, the result will generally be a significant restructuring of the corporation's enterprise, from the active operation of a going business to the passive ownership of cash. If two corporations engage in a merger involving an exchange of stock of one for assets of the other, the result will normally be a significant restructuring of the enterprise (and ownership) of each.<sup>65</sup>

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<sup>65</sup> See Eisenberg, *supra* note 62, at 61-66.

If the surviving party to a merger is substantially larger than the nonsurvivor, the merger will normally not result in a significant restructuring of the survivor.

Assume now that a wholly owned subsidiary which holds substantially all of the assets owned by a corporate complex proposes to sell those assets for cash, or to exchange its assets for the stock of a merger partner. Who has the right to vote the subsidiary's stock to approve or refuse to approve the transaction?

1. *Solution One.*—*The parent is entitled to vote the subsidiary's stock, and the parent's shareholders as a body to determine how the parent will vote.* Since in form, at least, the parent is the subsidiary's shareholder, one approach to the problem would be to accept this form as governing, and deem the parent entitled to vote the subsidiary's stock. Even under this approach, however, a question remains: which of the parent's corporate organs determines how the parent's shares will be voted?

Exactly why this question would remain requires some explanation. At common law, "the power of a corporation . . . [to] hold stock in other corporations . . . [was] involved in doubt."<sup>66</sup> Toward the end of the nineteenth century, New Jersey enacted a provision in its general corporation law expressly conferring such power.<sup>67</sup> Other states soon followed suit, so that today most corporate statutes specifically empower corporations to hold stock in other corporations and to vote that stock.<sup>68</sup> Normally, how-

Many corporate statutes therefore provide that in such cases a merger may not require approval of the survivor's shareholders. See *id.* at 69.

<sup>66</sup> *Robotham v. Prudential Ins. Co.*, 64 N.J. Eq. 673, 695, 53 A. 842, 851 (Ch. 1903). See J. BONBRIGHT & G. MEANS, *supra* note 17, at 55-57; 2 A. DEWING, *supra* note 17, at 861-62; Note, *Power of a Corporation to Acquire Stock of Another Corporation*, 31 COLUM. L. REV. 281 (1931). See generally W. NOYES, *A TREATISE ON THE LAW OF INTERCORPORATE RELATIONS* 472-509 (2d ed. 1909). This is not to say that the practice was unknown; a number of corporations had special charters empowering them to acquire and hold stock. See J. BONBRIGHT & G. MEANS, *supra* note 17, at 58-64; Compton, *Early History of Stock Ownership by Corporations*, 9 GEO. WASH. L. REV. 125 (1940).

<sup>67</sup> H. BALLANTINE, *CORPORATIONS* 236-237 (rev. ed. 1946).

<sup>68</sup> See, e.g., DEL. CODE ANN. tit. 8, § 123 (Supp. 1968); ILL. REV. STAT. ch. 32, § 157.5(g) (1969); N.J. STAT. ANN. § 14A:3-1(f) (1969); N.Y. BUS. CORP. LAW § 202(a)(6) (McKinney 1963); ABA MODEL BUS. CORP. ACT § 4(g) (rev. 1969). Some statutes specifically empower a corporation to own shares of other corporations, but do not explicitly empower a corporation to vote such shares. See, e.g., CAL. CORP. CODE § 802(d) (West 1955); OHIO REV. CODE ANN. § 1701.13(F)(3), (G) (Page 1964); PA. STAT. ANN. tit. 15, § 1302(6) (Supp. 1970). However, the effect is the same as if the power to vote were explicitly conferred, since the power to own shares carries with it an implied power to vote them. *Toledo Traction, Light & Power Co. v. Smith*, 205 F. 643, 653 (N.D. Ohio 1913); *Bouree v. Trust Francais des Actions de la Franco-Wyoming Oil Co.*, 14 Del. Ch. 332, 127 A. 56, 62 (Ch. 1924).

The seven jurisdictions and one model code which are referred to in this footnote (and elsewhere throughout the article) are fairly representative of corporate statutory law as a whole. See Eisenberg, *supra* note 62, at 60-61.

ever, the statutes do not designate which corporate organ can exercise that power.<sup>69</sup> A priori, any given corporate power might be exercisable either by the body of shareholders or by the board.<sup>70</sup> It is sometimes assumed, however, that the body of shareholders has only those powers specifically conferred upon it by statute, and that all other corporate powers vest in the board.<sup>71</sup> Under such a system, whenever the statute failed to specify how a corporate power was to be exercised — as in the case of the power to vote stock in another corporation — it would normally be exercisable by the board.

This assumption, however, is not solidly supported by either statutory or case law. Most corporate statutes do not in terms confer upon the board all corporate powers not specifically reserved to the shareholders. Instead, the only general power typically conferred upon the board by most statutes is the power "to manage the business of the corporation," or its "business and affairs."<sup>72</sup> The meaning of such terms in common usage, the common law background out of which the statutes arose,<sup>73</sup> and the general principles of corporate law recognized in the works of leading corporate commentators<sup>74</sup> all indicate that such provisions were not intended to vest the board with power to exercise all corporate powers not reserved to the shareholders, but only with power to make business decisions and set business policy, within the framework of the corporate structure at the time the decision is made. Power to make decisions which work a material change in that structure was reserved for the shareholders.

Thus in *Hodge v. Cuba Co.*<sup>75</sup> the directors of Cuba Company had formulated a plan under which debenture holders could exchange their existing debentures for new debentures and

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<sup>69</sup> See statutes cited in note 68 *supra*. But see p. 1594 & note 87 *infra*.

<sup>70</sup> In practice, many corporate powers are exercised by corporate officers. However, in theory at least, officers normally exercise such powers merely as delegates of the shareholders or the board.

<sup>71</sup> See, e.g., W. CARY, CASES AND MATERIALS ON CORPORATIONS 153 (4th ed. 1969).

<sup>72</sup> See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1968); ILL. REV. STAT. ch. 32, § 157.33 (1969); N.J. STAT. ANN. § 14A:6-1 (1969); N.Y. BUS. CORP. LAW § 701 (McKinney Supp. 1970); ABA MODEL BUS. CORP. ACT § 35 (rev. 1969).

<sup>73</sup> See I V. MORAWETZ, TREATISE ON THE LAW OF PRIVATE CORPORATIONS 447-48, 479 (2d ed. 1886). See also A.A. BERLE & G. MEANS, *supra* note 1, at 122-24; 5 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2097 (rev. vol. M. Wolf ed. 1967).

<sup>74</sup> See H. BALLANTINE, *supra* note 67, at 119-20; I G. HORNSTEIN, CORPORATION LAW AND PRACTICE 446-47 (1959); N. LATTIN, THE LAW OF CORPORATIONS 211 (1959).

<sup>75</sup> 142 N.J. Eq. 340, 60 A.2d 88 (Ch. 1948).

other consideration. The indenture under which the new debentures were to be issued provided that during a twelve-year period Cuba would not, over the objection of stated proportions of debenture holders, sell the stock of Compania Cubana, a subsidiary whose stock constituted Cuba's only substantial asset, or of Consolidated Railroads, a subsidiary of Compania; create a mortgage on the assets of either subsidiary; or recapitalize or reorganize either subsidiary. Cuba shareholders sued to enjoin consummation of the plan on the ground, *inter alia*, that it was beyond the powers of the board. The court granted injunctive relief:

While the power of directors to agree on the terms of payment of the Company's debt and to arrange for security cannot be doubted, yet when they plan so to exercise the power as to change substantially the capital structure of the Company and to control in important respects the discretion of their successors and of the stockholders for a long period, they should seek the approval of the stockholders before committing the Company.<sup>76</sup>

Many other cases have recognized that the body of shareholders has certain specific powers, even though such powers are not explicitly conferred upon the shareholders either by statute or the corporation's governing instruments. For example, the New York Court of Appeals in *Auer v. Dressel*,<sup>77</sup> and the Delaware Chancellor in *Campbell v. Loew's, Inc.*,<sup>78</sup> have both held that the body of shareholders has "inherent" power to remove a director for cause, notwithstanding that such a power was not conferred upon that body by statute, certificate of incorporation, or bylaw (and in *Auer*, notwithstanding a certificate provision which vested the board with such a power<sup>79</sup>).<sup>80</sup> Cases have also held that the body of shareholders has inherent power to fill newly created directorships between annual meetings, notwithstanding the absence of a statutory, certificate, or bylaw

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<sup>76</sup> *Id.* at 348, 60 A.2d at 93. See *Commercial Nat'l Bank v. Weinhard*, 192 U.S. 243 (1904); *Railway Co. v. Allerton*, 85 U.S. (18 Wall.) 233 (1873); *Aiple v. Twin City Barge & Towing Co.*, 274 Minn. 38, 143 N.W.2d 374 (1966); *Ostlind v. Ostlind Valve, Inc.*, 178 Ore. 161, 165 P.2d 779 (1946); *Baker's Appeal*, 109 Pa. 461, 472 (1885); *Eisenberg*, *supra* note 62, at 7-15, 53-60, 86-91; *cf.* *Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co.*, 41 F.2d 588 (7th Cir. 1930); *Kennerly v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 260 P.2d 823 (1953). But see *Hutchinson v. Green*, 91 Mo. 367, 1 S.W. 853 (1886); *Beveridge v. New York Elevated R.R.*, 112 N.Y. 1, 22-23, 19 N.E. 489, 494-95 (1889).

<sup>77</sup> 306 N.Y. 427, 118 N.E.2d 590 (1954).

<sup>78</sup> 36 Del. Ch. 563, 572, 134 A.2d 852, 857-58 (Ch. 1957).

<sup>79</sup> 306 N.Y. at 430, 118 N.E.2d at 593.

<sup>80</sup> See also *In re Burkin*, 1 N.Y.2d 570, 572, 136 N.E.2d 862, 864 (1956); H. BALLANTINE, *supra* note 67, at 434.



provision to that effect,<sup>81</sup> and indeed even in the face of a bylaw<sup>82</sup> or statute<sup>83</sup> providing that the board of directors has power to fill such positions. Similarly, it appears settled that the body of shareholders has the inherent power to appoint an independent public auditor for the corporation, or to require the corporation to issue certain types of reports, such as postmeeting reports, although the statute, certificate, and bylaws are silent on the point.<sup>84</sup>

Granted that the power to vote the stock held by a parent in a subsidiary might a priori be exercisable either by the parent's board or the body of its shareholders, the question remains as to which organ may exercise that power in the case of a proposal by an economically dominant subsidiary to sell its assets — comprising, by hypothesis, substantially all of the assets owned by the corporate complex — or to merge with another corporation. Certainly such a transaction would transcend the power of the parent's board to "manage the business" of the parent. So much is indicated not only by the economic nature of the transaction, but also by the statutes themselves, which provide that such transactions must normally be approved by the shareholders. Furthermore, a major purpose of the statutory requirement of shareholder approval for a merger or a sale of substantially all assets is to prevent consummation of such transactions by management action alone, without approval by those who own the equity underlying the corporate enterprise. That purpose would be completely subverted if a parent-subsidiary complex, substantially all of whose assets were held by a wholly owned subsidiary, could sell those assets, or merge the entity in which they are enveloped, merely by the concurrent action of the parent's and subsidiary's boards — two bodies which may, indeed, have an identical composition. Thus the first possible solution to

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<sup>81</sup> See *Gold Bluff Mining & Lumber Corp. v. Whitlock*, 75 Conn. 669, 55 A. 175 (1903); *Campbell v. Loew's, Inc.*, 36 Del. Ch. 563, 134 A.2d 852 (Ch. 1957); *Automatic Steel Products, Inc. v. Johnston*, 31 Del. Ch. 469, 64 A.2d 416 (Sup. Ct. 1949); *Moon v. Moon Motor Car Co.*, 17 Del. Ch. 176, 151 A. 298 (Ch. 1930); *In re A.A. Griffing Iron Co.*, 63 N.J.L. 168, 41 A. 931 (Sup. Ct. 1898), *aff'd per curiam*, 63 N.J.L. 357, 46 A. 1097 (Ct. Err. & App. 1899).

<sup>82</sup> See *Automatic Steel Products, Inc. v. Johnston*, 31 Del. Ch. 469, 64 A.2d 416 (Sup. Ct. 1949).

<sup>83</sup> See *Campbell v. Loew's, Inc.*, 36 Del. Ch. 563, 571, 134 A.2d 852, 857 (Ch. 1957).

<sup>84</sup> See *SEC v. Transamerica Corp.*, 163 F.2d 511, 516-18 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948); Clusserath, *The Amended Stockholder Proposal Rule: A Decade Later*, 40 NOTRE DAME LAW. 13, 45-46 (1940); *cf.* *Respess v. Rex Spinning Co.*, 191 N.C. 809, 133 S.E. 391 (1926).

the problem at hand is that while the parent is entitled to vote the subsidiary's stock on such transactions, the body of the parent's shareholders is the corporate organ which determines how the parent will vote.

2. *Solution Two.*—*For purposes of the relevant statutory provisions, the parent's shareholders are entitled to vote the subsidiary's stock directly.* The first solution, while undoubtedly preferable to permitting the parent's board to vote the subsidiary's stock on such transactions, still has two significant drawbacks.

First, most statutes provide that a merger or a sale of substantially all assets requires approval by the holders of a majority or two-thirds of the corporation's total outstanding shares. That requirement would be negated under the first solution. If the parent is deemed entitled to vote the subsidiary's stock, the issue to be decided by the body of shareholders would be how the stock as a unit should be voted. The body of shareholders, however, acts by a simple majority of the votes cast or present at a duly constituted meeting—not by a percentage of total outstanding shares.<sup>85</sup> In most publicly held corporations, a quorum consists of a majority of outstanding shares, and often less.<sup>86</sup> Under the first solution, therefore, a sale of substantially all of the assets held by the corporate complex, or a merger of the entity in which those assets were enveloped, could be approved by just over twenty-five percent of the parent's total outstanding shares, and by even less than twenty-five percent where the parent's bylaws provided for a less-than-majority quorum.

Furthermore, the first solution is predicated on the assumption that the relevant statute confers upon the board only the power to manage the corporation's business, or its business and affairs, and that there is no relevant certificate or bylaw provision. Some statutes, however, confer upon the board all powers not specifically reserved to the shareholders.<sup>87</sup> Even where this is not so, the certificate may contain such a provision.<sup>88</sup> And bylaws

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<sup>85</sup> See 5 W. FLETCHER, *supra* note 73, at § 2020.

<sup>86</sup> See, e.g., By-Laws of American Express Co., art. II, § 2.4 (majority); By-Laws of American Machine & Foundry Co., Apr. 1, 1969, art. I, § 5 (majority); By-Laws of The Anaconda Co., as amended to Feb. 27, 1969, art. 2, § 5 (one-third); By-Laws of Avco Corp., as amended through Apr. 25, 1969, art. II, § 3 (majority); By-Laws of Eastman Kodak Co., as amended through Feb. 20, 1969, art. I, § 5 (majority); By-Laws of General Motors Corp. § 11 (thirty percent); By-Laws of Mobil Oil Corp., as amended to Sept. 27, 1963, art. II, § 4 (one-third).

<sup>87</sup> See, e.g., CAL. CORP. CODE § 800 (West 1955); OHIO REV. CODE ANN. tit. 17, § 1701.59(A) (Anderson Supp. 1970); PA. STAT. ANN. tit. 15, § 1302 (Supp. 1970).

<sup>88</sup> See, e.g., the Delaware certificate-of-incorporation forms in G. SEWARD, BASIC CORPORATE PRACTICE 131 (1966).

sometimes contain a boilerplate provision specifically conferring upon the board<sup>89</sup> or even upon a designated officer<sup>90</sup> the power to vote shares of stock which the corporation owns.

Both of these drawbacks stem from the fact that under the first approach the parent is deemed to be the subsidiary's shareholder. Accordingly, both would be eliminated by treating the parent's shareholders as entitled to vote the subsidiary's stock on an individual basis—that is, by passing the right to vote the subsidiary's stock on such transactions *through* the parent to the parent's shareholders. Each shareholder in the parent corporation would thus be entitled to vote that proportion of the subsidiary's stock which equalled his proportionate holding of the stock of the parent. Since the subsidiary's stock would be voted in parcels, rather than as a unit, the integrity of statutory requirements that a merger or sale of substantially all assets be approved by a majority or two-thirds of outstanding shares would be preserved. And since the right to vote the subsidiary's stock would inhere in the parent's shareholders rather than the parent as an entity, boilerplate provisions in the parent's certificate or bylaws concerning the voting of stock held by the parent would be irrelevant, as would generalized provisions (statutory or other-

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<sup>89</sup> See, e.g., W. CARY, *supra* note 71, app. C at A-100; G. SEWARD, BASIC CORPORATE PRACTICE 131 (Supp. 1969); By-Laws of General Motors Corp. § 68; cf. CAL. CORP. CODE § 2222 (West 1955); PA. STAT. ANN. tit. 15, § 1508 (1967); ABA MODEL BUS. CORP. ACT § 33 (rev. 1969).

<sup>90</sup> See, e.g., By-laws of American Express Co., art. VII, § 7.2.

Arguments could be made, however, that such provisions should not be read to authorize a parent's board to vote the stock of an economically dominant subsidiary in favor of a sale of substantially all assets or a merger. A statutory or certificate provision conferring upon the board all corporate powers not reserved to the shareholders could be read, in light of the common law background of the corporate statutes, to refer to those powers necessary to manage the business of the corporation—not to the power to make fundamental or structural changes in the corporation. See 2 W. FLETCHER, *supra* note 73, at § 540 (rev. vol. M. Wolf & E. Comiskey eds. 1969); cf. Automatic Steel Products, Inc. v. Johnston, 31 Del. Ch. 469, 64 A.2d 416 (Sup. Ct. 1949); Bruch v. National Guar. Credit Corp., 13 Del. Ch. 180, 185-90, 116 A. 738, 740-43 (Ch. 1922). A certificate or bylaw provision authorizing the board or officers to vote stock held by the corporation need not be construed to give the board power to restructure drastically the corporate complex. In corporate as in noncorporate law, language—including grants of power to corporate organs—is not always to be taken literally, but must be given a purposive interpretation. See, e.g., Hayes v. Canada, Atl. & Plant S.S. Co., 181 F. 289, 292-93 (1st Cir. 1910) (interpretation of bylaw); Bruch v. National Guar. Credit Corp., *supra* at 188-90, 116 A. at 742-43 (interpretation of statute); Maryland Trust Co. v. National Mechanics' Bank, 102 Md. 608, 634-35, 63 A. 70, 79-80 (1906) (interpretation of bylaw); Fensterer v. Pressure Lighting Co., 85 Misc. 621, 625-26, 149 N.Y.S. 49, 52-53 (City Ct. 1914), *appeal denied*, 167 App. Div. 904, 151 N.Y.S. 1115 (1915) (same).

wise) conferring on the board the right to exercise corporate powers.<sup>91</sup>

While a pass-through of rights adhering to a subsidiary's stock might appear at first glance to be a novel conception, in fact the pass-through technique is no stranger to the corporate institution. For example, it has long been settled that in certain situations a shareholder may bring a derivative action asserting a claim on behalf of his corporation. But it is now also established that in an appropriate case a shareholder in a parent corporation can bring a derivative action on behalf of a *subsidiary*, despite the fact that technically he is not a shareholder in the subsidiary.<sup>92</sup> Although there is some discord as to the precise theory justifying this result, the commentators are agreed that such an action may be brought even where the subsidiary's corporate entity would be respected for other purposes.<sup>93</sup> Thus in

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<sup>91</sup> In some cases, the pass-through has yet another advantage over the first solution. Certain types of transactions, such as merger and, under many statutes, sale of substantially all assets, commonly trigger a right in dissenting shareholders to have their stock purchased by the corporation at an appraised price. See, e.g., N.Y. BUS. CORP. LAW § 910 (McKinney Supp. 1970). Under the first solution, appraisal rights would be cut off, since the parent's stock would be voted as a unit, so that there would be no dissenting shareholders. Under a pass-through, however, each of the parent's shareholders votes individually, and the appraisal right provided by statute would be preserved.

<sup>92</sup> See, e.g., *Goldstein v. Groesbeck*, 142 F.2d 422, 425 (2d Cir.), cert. denied, 323 U.S. 737 (1944); *United States Lines, Inc. v. United States Lines Co.*, 96 F.2d 148 (2d Cir. 1938); *Birch v. McColgan*, 39 F. Supp. 358, 366 (S.D. Cal. 1941); *Holmes v. Camp*, 180 App. Div. 409, 167 N.Y.S. 840 (1917); Note, *Suits by a Shareholder in a Parent Corporation to Redress Injuries to the Subsidiary*, 64 HARV. L. REV. 1313, 1313-16 (1951).

There are also a number of cases in which the shareholder's right to inspect books and records has been extended to cover the books and records of a subsidiary. See *Woodworth v. Old Second Nat'l Bank*, 154 Mich. 459, 117 N.W. 893 (1908); *State ex rel. United Brick & Tile Co. v. Wright*, 339 Mo. 160, 95 S.W.2d 804 (1936); *Siravo v. Sirian Lamp Co.*, 124 N.J.L. 433, 12 A.2d 682 (Ct. Err. & App. 1940); *Bailey v. Boxboard Prod. Co.*, 314 Pa. 45, 170 A. 127 (1934); *Williams v. Freeport Sulphur Co.*, 40 S.W.2d 817 (Tex. Civ. App. 1930); cf. *Martin v. D.B. Martin Co.*, 10 Del. Ch. 211, 88 A. 612 (Ch. 1913). But cf. *Lisle v. Shipp*, 96 Cal. App. 264, 273 P. 1103 (1929); *State ex rel. Rogers v. Sherman Oil Co.*, 31 Del. 570, 117 A. 122 (Super. Ct. 1922).

As another example, in appropriate cases the right to recover damages awarded in a simple derivative action brought on a corporation's behalf may be passed through the corporation directly to its shareholders, so that those shareholders who are not barred on personal grounds can recover individually, on a pro rata basis according to their holdings. See *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955); Grenier, *Prorata Recovery by Shareholders on Corporate Causes of Action as a Means of Achieving Corporate Justice*, 19 WASH. & LEE L. REV. 165 (1962).

<sup>93</sup> See Painter, *Double Derivative Suits and Other Remedies With Regard to Damaged Subsidiaries*, 36 IND. L.J. 143, 147-49 (1961); Note, *supra* note 92, at

permitting such actions, the law in effect permits the parent's right to bring an action on the subsidiary's behalf to be passed through the parent to the parent's shareholders. At least one policy reason for a double-derivative action is similar to the reason for permitting a pass-through of voting rights. Absent such a pass-through, a vital shareholder right (the right to a loyal and careful management) could be subverted merely by the insertion of an extra layer of entity between ownership and management. "The free use of holding companies . . . would prevent the righting of many wrongs, if an action [on a subsidiary's behalf] might not be maintained by a stockholder of a holding company." <sup>94</sup>

Other existing pass-throughs involve the voting right itself. Many large corporations have created employee-pension trust funds whose investment policies are under the sole or joint control of the corporation's management, acting through the pension fund's trustees. Often such funds invest in stock of the employer corporation. To prevent management from voting such stock to perpetuate itself in office, many pension funds provide that the right to vote such stock is passed through the trustees to the employee beneficiaries.<sup>95</sup> One commentator listed 101 corporations which had adopted such pass-throughs, including many of the country's largest corporations, such as Chrysler, Ford, du Pont, Mobil, U.S. Steel, Alcoa, A & P, Standard Oil of New Jersey, and Sears, Roebuck.<sup>96</sup> Some pension-fund pass-throughs have been adopted voluntarily. Many others have been adopted to comply with the practices of the New York Stock Exchange; if a corporation which seeks an original or supplementary listing has a pension fund holding a material amount (approximately one percent or more) of its own voting stock, the Exchange requires, as a condition to listing, assurance that

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1313; Note, *Corporations — An Examination of the Multiple Derivative Suit and Some Problems Involved Therein in Light of the Theory of the Single Derivative Suit*, 31 N.Y.U.L. Rev. 932, 937-38 (1956).

In contrast, the cases permitting inspection of books and records of subsidiaries, note 92 *supra*, have a piercing-the-veil flavor.

<sup>94</sup> *Holmes v. Camp*, 180 App. Div. 409, 412, 167 N.Y.S. 840, 842 (1917). See also *Kaufman v. Wolfson*, 1 App. Div. 2d 555, 151 N.Y.S.2d 530 (1956); Note, *supra* note 93, at 940; 2 How. L.J. 263, 265 (1956). By virtue of this policy, one case in which a double-derivative action should clearly lie is when defendants control both the parent and the subsidiary. See *United States Lines, Inc. v. United States Lines Co.*, 96 F.2d 148, 151 (2d Cir. 1938); Painter, *supra* note 93, at 150-51.

<sup>95</sup> Hone, *Pass Through Voting: An Analysis*, 17 PROFIT SHARING, October 1969, at 22. See, e.g., Prospectus of DeSoto Employees Savings and Profit Sharing Pension Fund, May 27, 1970, at 6, 8; Prospectus of The Savings and Profit Sharing Pension Fund of Sears, Roebuck and Co. Employees, May 25, 1970, at 5-6, 8.

<sup>96</sup> Hone, *supra* note 95, at 26-27 n.1.

the corporation will provide for a pass-through of the voting rights on that stock.<sup>97</sup> Perhaps more in point for present purposes is another, somewhat less formalized, Exchange policy. If more than ten percent of the stock of a corporation which applies for listing is controlled by a closely held corporation, the Exchange normally requires, as a condition to listing, that the right to vote the listed stock be passed through the closely held corporation to its shareholders.<sup>98</sup> Indeed, where a significant part of the closely held corporation's stock is held in trust, the Exchange normally requires a second pass-through to the ultimate beneficiaries of the trust.<sup>99</sup>

A pass-through has also been explicitly required by at least one legislature. Since 1966 the Pennsylvania Business Corporation Law has required a pass-through of voting rights in the case of a sale of substantially all assets by a subsidiary corporation, where the assets to be sold by the subsidiary constituted substantially all of the assets within the control of the parent-sub-sidiary complex.<sup>100</sup>

This widespread use of voting pass-throughs<sup>101</sup> testifies,

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<sup>97</sup> *Id.* at 22. The same applies to retirement, stock-purchase, and other employee plans.

<sup>98</sup> Letter to the author from Merle S. Wick, Vice President, New York Stock Exchange, January 23, 1970.

<sup>99</sup> *Id.* In a similar vein, after the Supreme Court held that du Pont's holding of 23% of General Motors' stock was an antitrust violation, *United States v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586 (1957), du Pont proposed a decree allowing du Pont to retain the GM stock but requiring a multiple pass-through of voting rights in the stock. *United States v. E.I. du Pont de Nemours & Co.*, 177 F. Supp. 1, 8 (N.D. Ill. 1959). The district court adopted a modified version of the company's proposal. *Id.* at 39-46. On appeal, however, the Supreme Court held that complete divestiture was required. *United States v. E.I. du Pont de Nemours & Co.*, 366 U.S. 316 (1961).

<sup>100</sup> See PA. STAT. ANN. tit. 15, § 1311(B) (1967), which provides that "[t]he sale . . . of property or assets by a direct or indirect subsidiary corporation which is controlled by a parent corporation shall also be deemed a sale . . . of property or assets of the parent corporation" for the purposes of the voting provisions applicable to a sale of substantially all assets.

<sup>101</sup> Other expressions of support for the pass-through concept can be summoned. In *Ex parte Holmes*, 5 Cow. 426 (N.Y. Sup. Ct. 1826), a corporation's stock was held in trust for the corporation. The issue was whether the trustee could vote the stock. The court concluded that it could not, but stated in dicta that "if there could be a vote at all upon such stock, one would suppose that it must be by each stockholder of the company, in proportion to his interest in it." *Id.* at 434. See also *O'Connor v. International Silver Co.*, 68 N.J. Eq. 67, 70, 59 A. 321, 323 (Ch. 1904), *aff'd on other grounds*, 68 N.J. Eq. 680, 62 A. 408 (Ct. Err. & App. 1905) (*Ex Parte Holmes* dictum quoted with approval).

Pass-throughs have also been advocated for situations in which a subsidiary holds stock in its parent. The normal rule is that the subsidiary cannot vote such stock. See pp. 1601-02 and note 114 *infra*. It has been argued, however, that the right to vote that portion of the subsidiary's shares in the parent which is attrib-

among other things, to the feasibility of the device. Indeed, as used in the pension fund area, a pass-through results in the extension of the voting right to hundreds or thousands of otherwise nonenfranchised employees, while as applied to the shareholders of a parent with an economically dominant subsidiary, a pass-through would only result in a shareholder vote which would have been required in any event had a parent-subsidiary structure not been employed.

3. *Legal Principles Supporting Pass-through.* — Two related principles of existing law suggest that a pass-through is required when an economically dominant subsidiary proposes to sell its assets or merge with another corporation.

The first principle recognizes that statutes not only regulate activities within their literal scope, but often serve as an expression of legislative policies of wider application. That being so, legislative rules, like judicial rules, may be extended, by elaboration of the underlying principle and by analogy, to situations not precisely covered by the rule as originally formulated — and should be so extended if necessary to prevent subversion of the legislative policy.<sup>102</sup>

This principle has found frequent reflection in corporate law, often in situations very similar to that under consideration. For example, in *Aiple v. Twin City Barge & Towing Co.*,<sup>103</sup> the management of Twin City, a Minnesota corporation, wanted to increase its equity capital. Accordingly, management sought to amend Twin City's certificate of incorporation to authorize additional shares of common stock which could then be sold. Under the Minnesota statute, a certificate amendment normally had to be approved by the holders of two-thirds of a corporation's stock. Aiple, the owner of more than one-third of Twin City's outstanding stock, objected to the proposed amendment,<sup>104</sup> and it thus could not pass. Management then adopted an alternative plan, under which it organized a new subsidiary with authorized stock of fifty thousand shares, and transferred to the subsidiary the assets of a Twin City division and cash, in ex-

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utable to the outside shareholders of the subsidiary should be passed through to them. Note, *The Voting of Stock Held in Cross Ownership*, 76 HARV. L. REV. 1642, 1651-55 (1963); Comment, 28 U. CHI. L. REV. 151, 152 (1960).

<sup>102</sup> See Gellhorn, *Contracts and Public Policy*, 35 COLUM. L. REV. 679, 690-91 (1935); Landis, *Statutes and the Sources of Law*, in HARVARD LEGAL ESSAYS 213 (R. Pound ed. 1934); Pound, *Sources and Forms of Law* (pt. 3), 22 NOTRE DAME LAW. 1, 36-45 (1946).

<sup>103</sup> 274 Minn. 38, 143 N.W.2d 374 (1966).

<sup>104</sup> The court observed that "[t]he effect of the defendant's plan is to diminish the interest of [Aiple], or force him to buy stock in a new corporation to protect his proportionate interest or investment." *Id.* at 45, 143 N.W.2d at 379.

change for four thousand shares of the subsidiary's stock and the subsidiary's assumption of the division's liabilities. It was apparently contemplated that the subsidiary would thereafter sell a portion of its remaining forty-six thousand authorized but unissued shares, thereby indirectly increasing Twin City's capital. On Aiple's motion the court set aside the transaction, on the ground that:

If this can be done, the [statutory provisions governing certificate amendment] may be circumvented to the point where a corporation might fragment itself into any number of divisions, thus leaving minority stockholders without the protection that the statute was designed to give them.<sup>105</sup>

If a wholly owned subsidiary which owns substantially all of the assets under the control of a parent-subsidiary complex could sell those assets, or merge with another corporation, without the approval of the parent's shareholders, or with the approval of only twenty-five percent or less of those shareholders, the sale-of-substantially-all-assets and merger provisions would be similarly "circumvented . . . , thus leaving . . . stockholders without the protection that the statute was designed to give them."

The second principle supporting a pass-through — perhaps more accurately, a special case of the first principle — is that in applying statutory rules a corporate entity will be disregarded if regard for the entity would frustrate a statutory purpose. "[A] corporation will 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 . . . the law will regard the corporation as an association of persons."<sup>106</sup>

Several of the cases applying this principle are particularly instructive for present purposes. One such case is *Anderson v. Abbott*.<sup>107</sup> While corporate statutes normally permit a shareholder's risk to be limited to the amount of his investment,<sup>108</sup> a

<sup>105</sup> *Id.* at 45, 143 N.W.2d at 379; *cf.* *Applestein v. United Board & Carton Corp.*, 60 N.J. Super. 333, 159 A.2d 146 (Ch. 1960), *aff'd per curiam*, 33 N.J. 72, 161 A.2d 474 (1960); *Small v. Sullivan*, 245 N.Y. 343, 157 N.E. 261 (1927). *See also* *Klopot v. Northrup*, 131 Conn. 14, 37 A.2d 700 (1944); *Schwab v. E.G. Potter Co.*, 194 N.Y. 409, 87 N.E. 670 (1909); *Moore v. Los Lugos Gold Mines*, 172 Wash. 570, 21 P.2d 253 (1933).

<sup>106</sup> *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, 255 (E.D. Wis. 1905); *accord*, *W. CARY*, *supra* note 71, at 148. *See also* *E. LATTY*, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* 41-42, 54-57, 67-68, 74-76 (1936); *Note, Efficacy of the Corporate Entity in Evasion of Statutes*, 26 *IOWA L. REV.* 350 (1941).

<sup>107</sup> 321 U.S. 349 (1944).

<sup>108</sup> *See, e.g.*, *DEL. CODE ANN.* tit. 8, § 102(b)(6) (Supp. 1968).



shareholder in a national bank corporation was at one time subject to so-called "double liability," under a statutory provision which made such a shareholder liable for the debts of the bank "to the amount of his stock therein, at the par value thereof in addition to the amount invested in such stock."<sup>109</sup> The question in *Anderson v. Abbott* was how to apply this statute when a national bank was a subsidiary corporation. The Supreme Court held that in such cases the parent's shareholders, rather than the parent, would be deemed shareholders of the bank subsidiary for purposes of the statutory double-liability provisions, on the ground that to hold otherwise would permit the purpose of those provisions to be undercut:

It has often been held that the interposition of a corporation will not be allowed to defeat a legislative policy, whether that was the aim or only the result of the arrangement. . . .

. . . .  
To allow this holding company device to succeed would be to put the policy of double liability at the mercy of corporation finance.<sup>110</sup>

The Court stressed that its conclusion was not based on a finding of intent to evade the statute.<sup>111</sup>

Even more in point are several cases dealing directly with the effect of subsidiaries on the allocation of control over a corporate complex. It is well established that treasury stock — stock of a corporation owned by the corporation itself — cannot be voted.<sup>112</sup> This rule is reflected in many corporate statutes by provisions such as, "Shares of its own stock belonging to a corporation shall not be voted, directly or indirectly. . . ." <sup>113</sup> Suppose, however, that a subsidiary holds shares of stocks in its parent. In that case the statute would not be literally applicable, since, at least in form, neither the parent nor the subsidiary would hold "shares of its own stock." Nevertheless, the cases hold that

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<sup>109</sup> Federal Reserve Act § 23, ch. 6, § 23, 38 Stat. 273 (1913). This provision paralleled the National Bank Act § 12, ch. 106, § 12, 13 Stat. 102-03 (1864). The liability imposed by these provisions was severely qualified, and then effectively eliminated, by Act of June 16, 1933, ch. 89, § 22, 48 Stat. 189, *as amended*, Act of Aug. 23, 1935, ch. 614, § 304, 49 Stat. 708, *as amended*, Act of May 18, 1953, ch. 59, § 2, 67 Stat. 27. Both provisions were finally repealed by Act of Sept. 8, 1959, Pub. L. 86-230, § 7, 73 Stat. 457.

<sup>110</sup> 321 U.S. at 362-63. *See also* *Kavanaugh v. Ford Motor Co.*, 353 F.2d 710, 716-17 (7th Cir. 1965); *Note, supra* note 106, at 353-56.

<sup>111</sup> 321 U.S. at 357-58. *See also* *Kavanaugh v. Ford Motor Co.*, 353 F.2d 710, 717 (7th Cir. 1965).

<sup>112</sup> *See* H. BALLANTINE, *supra* note 67, at 402-03.

<sup>113</sup> ILL. REV. STAT. ch. 32, § 157.28 (1969). *See also* *Note, The Corporate Fiduciary's Power to Vote its Own Stock*, 68 COLUM. L. REV. 116, 117-19 (1968).

the voting of such shares by the subsidiary is prohibited in a jurisdiction where such a statute is in effect:

That the shares of corporation A owned by it through its ownership of all the shares in corporation B are within the equity of this statute as well as within the mischief which it was intended to prevent, is too plain for argument.<sup>114</sup>

Applying the principle reflected in these cases to the problem at hand, the fact that there are two layers of corporate entity between shareholders and enterprise, rather than one, should not be allowed to defeat important shareholder rights established by statute. To preserve the integrity of statutory provisions requiring the approval of a designated percentage of outstanding shares for a sale of substantially all assets or a merger, the shareholders of the parent of an economically dominant subsidiary should be treated as shareholders of the subsidiary for purposes of the statute, so that the right to vote the subsidiary's stock on such transactions is passed through the parent to the parent's shareholders.

### *B. Election of Directors*

Legally as well as practically, the board of directors is an independent power center within the corporation.<sup>115</sup> Under most statutes, it has the general power to make all business decisions within the framework of the corporation's enterprise, and a variety of specific powers, such as the power to declare dividends<sup>116</sup>

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<sup>114</sup> *O'Connor v. International Silver Co.*, 68 N.J. Eq. 67, 71, 59 A. 321, 323 (Ch. 1904), *aff'd on other grounds*, 68 N.J. Eq. 680, 62 A. 408 (Ct. Err. & App. 1905); *accord*, *Italo Petroleum Corp. v. Producers Oil Corp.*, 20 Del. Ch. 283, 290-91, 174 A. 276, 279 (Ch. 1934). *See* *Continental-Midwest Corp. v. Hotel Sherman, Inc.*, 13 Ill. App. 2d 188, 141 N.E.2d 400 (1957); *Thomas v. International Silver Co.*, 72 N.J. Eq. 224, 73 A. 833 (Ch. 1907); H. BALLANTINE, *supra* note 67, at 403; 5 W. FLETCHER, *supra* note 73, at § 2040; *cf.* *Lawrence v. I.N. Parlier Estate Co.*, 15 Cal. 2d 220, 100 P.2d 765 (1940); *American Ry.-Frog Co. v. Haven*, 101 Mass. 398 (1869); *Ex Parte Holmes*, 5 Cow. 426 (N.Y. Sup. Ct. 1826). *But cf.* *Vanderlip v. Los Molinos Land Co.*, 56 Cal. App. 2d 747, 133 P.2d 467 (1943). *See generally* Note, *supra* note 101.

The statutes of Delaware, New Jersey, and several other states, now explicitly provide that a subsidiary cannot vote shares of its parent if the parent owns a majority or plurality of the shares entitled to vote in the election of the subsidiary's directors. *See, e.g.*, DEL. CODE ANN. tit. 8, § 160 (Supp. 1968); N.J. STAT. ANN. § 14A:5-13 (1969); N.Y. BUS. CORP. LAW § 612(b) (McKinney 1963); WISC. STAT. ANN. § 180.25(2) (Supp. 1971).

<sup>115</sup> *See* Eisenberg, *supra* note 62, at 5-6.

<sup>116</sup> *See, e.g.*, CAL. CORP. CODE §§ 800, 1500 (West 1955); DEL. CODE ANN. tit. 8, § 170(a) (Supp. 1968); ILL. REV. STAT. ch. 32, § 157.41 (1969); N.J. STAT. ANN. § 14A:7-14(1) (1969); OHIO REV. CODE ANN. § 1701.33 (Anderson Supp. 1970); PA. STAT. ANN. tit. 15, § 1702 (1967); ABA MODEL BUS. CORP. ACT § 45 (rev. 1969).

and to appoint officers.<sup>117</sup> In addition, the statutes often require board as well as shareholder approval for certain structural changes such as merger, sale of substantially all assets, certificate amendment, and dissolution.<sup>118</sup> Nevertheless, the shareholders own the corporation; accordingly, the corporate statutes uniformly require that the corporate organ with the right to exercise these crucial powers be elected by the shareholders.<sup>119</sup>

Who has the power to elect the board of an economically dominant subsidiary? In a corporate complex involving such a subsidiary, the parent's board will have only the most limited functions to perform. Since the operating assets are located in the subsidiary, it is the subsidiary's board, rather than the parent's, which will have the legal power to set business policy and make significant business decisions for the enterprise, appoint the enterprise's operating officers, determine what portion of enterprise earnings will be retained for use in the enterprise and what portion paid out as dividends, and give or withhold concurrent approval of structural changes in the enterprise and the corporate entity in which it is enveloped. That being so, effectuation of the statutory provisions vesting in shareholders the right to elect the persons who can exercise these crucial corporate powers requires that the right to elect the board of such a subsidiary be passed through the parent to the parent's shareholders.<sup>120</sup>

It might be argued that such a pass-through is unnecessary, on the ground that the right to elect those who elect the subsidiary's board is tantamount to the right to elect the subsidiary's board itself. This argument, however, would fly in the face of experience; in few situations is the right to elect those who elect others the functional equivalent of the right to elect those others directly.<sup>121</sup> Alternatively, it might be argued that election of the

<sup>117</sup> See, e.g., CAL. CORP. CODE § 821 (West 1955); ILL. REV. STAT. ch. 32, § 157.43 (1969); N.J. STAT. ANN. § 14A:6-15(1) (1969); N.Y. BUS. CORP. LAW § 715(a) (McKinney 1963); OHIO REV. CODE ANN. § 1701:64 (Anderson Supp. 1970); PA. STAT. ANN. tit. 15, § 1406 (Supp. 1970); ABA MODEL BUS. CORP. ACT § 50 (rev. 1969).

<sup>118</sup> See Eisenberg, *supra* note 62, at 60-68.

<sup>119</sup> See, e.g., CAL. CORP. CODE §§ 2200-01 (West 1955); DEL. CODE ANN. tit. 8, § 211(b) (Supp. 1968); ILL. REV. STAT. ch. 32, § 157.34 (1969); N.J. STAT. ANN. § 14A:6-3 (1969); N.Y. BUS. CORP. LAW § 703(a) (McKinney 1963); OHIO REV. CODE ANN. § 1701.39 (Page 1964); PA. STAT. ANN. tit. 15, § 1401 (Supp. 1971); ABA MODEL BUS. CORP. ACT § 36 (rev. 1969).

<sup>120</sup> Cf. *Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co.*, 41 F.2d 588 (7th Cir. 1930); *Kennerson v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 260 P.2d 823 (1953); *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 297 N.Y. 174, 77 N.E.2d 633 (1948).

<sup>121</sup> See, e.g., *Gray v. Sanders*, 372 U.S. 368, 378 (1963). Compare U.S. CONST. art. I, § 3, with U.S. CONST. amend. XVII.

subsidiary's board by the parent's shareholders would serve no real purpose, since the subsidiary's board will necessarily be under the control of the parent's board. This argument, however, seems quite circular, since it assumes that the parent's board has the right to elect the board of the subsidiary. If that right is vested in the parent's shareholders, the subsidiary's board would have a power base of its own, through its access to the subsidiary's proxy machinery. In any event, even where a subsidiary's board is elected by the parent's, it is not necessarily under the latter's thumb — for example, it was recently reported that the presidents of three subsidiaries of Universal Container Corporation have combined with a minority faction on Universal's board to launch a proxy fight aimed at unseating the present board majority.<sup>122</sup>

Furthermore, both arguments ignore the fact that the statutes do not simply require that the board be elected by the shareholders; they also limit a director's permissible term of office.<sup>123</sup> If the parent's directors had the right to elect the subsidiary's board, they could elect themselves as directors of the subsidiary for terms ending after the expiration of their terms as directors of the parent. The parent's directors could thereby perpetuate their control over the complex's enterprise beyond the statutorily permissible term and beyond the term for which they were elected by the complex's ownership.<sup>124</sup>

Another problem would be presented in states where cumulative voting is mandatory,<sup>125</sup> thereby enabling a sufficiently large block of minority shareholders to acquire board representation. If the parent's stock in the subsidiary were voted by the parent,

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<sup>122</sup> *Fight to Get Reins of Universal Container Being Led by 2 Directors, Heads of 3 Units*, Wall Street Journal, Mar. 12, 1971, at 28, col. 2. See also Cordtz, *They're Holding Feet to the Fire at Jersey Standard*, FORTUNE, July 1970, at 78, 79-80; J. BONBRIGHT & G. MEANS, *supra* note 17, at 39.

<sup>123</sup> See, e.g., CAL. CORP. CODE §§ 805, 2200-01 (West 1955) (one year); DEL. CODE ANN. tit. 8, § 141(d) (Supp. 1968) (three); N.J. STAT. ANN. § 14A:6-4 (1969) (five); N.Y. BUS. CORP. LAW § 704 (McKinney 1963) (four); OHIO REV. CODE ANN. § 1701.57 (Page 1964) (three); PA. STAT. ANN. tit. 15, § 1403 (Supp. 1970) (four); ABA MODEL BUS. CORP. ACT § 37 (rev. 1969) (three).

<sup>124</sup> Not incidentally, such a technique might discourage outsiders from launching a bid to take over the parent, since the fruits of a victory could be long delayed. Cf. Gower, *Corporate Control: The Battle for the Berkeley*, 68 HARV. L. REV. 1176 (1955).

<sup>125</sup> See, e.g., CAL. CORP. CODE § 2235 (West 1955); ILL. REV. STAT. ch. 32, § 157.28 (1969); OHIO REV. CODE ANN. § 1701.55(C)-(D) (Page 1964). Many statutes that do not require cumulative voting permit its use. See, e.g., DEL. CODE ANN. tit. 8, § 214 (Supp. 1968); N.J. STAT. ANN. § 14A:5-24(2) (1969); N.Y. BUS. CORP. LAW § 618 (McKinney 1963); PA. STAT. ANN. § 1505 (Supp. 1970); ABA MODEL BUS. CORP. ACT § 313 (rev. 1969).

it would be voted as a unit; therefore, a bare majority of the parent's board (or, under solution one, of the parent's shareholders) would be able to elect all the members of the subsidiary's board. Minority directors of the parent, and the minority shareholders they represent, could thus be frozen out of membership on the only board with power to control the corporation's enterprise, and mandatory cumulative voting would be completely undercut. Pass-through solves this problem, since it enables the parent's shareholders to vote the subsidiary's stock directly, and therefore to cumulate their votes.

### C. Certificate Amendment

Unlike a merger or a sale of substantially all assets, an amendment of a corporation's certificate of incorporation does not in itself materially change the structure of the corporation's enterprise. An amendment may, however, significantly change the relative position of management and shareholders in the control structure enveloping that enterprise, as by increasing authorized stock which could then be issued by the board without further shareholder approval, or by authorizing a new type of business which the board could enter without further shareholder approval. Accordingly, to preserve the rights of the owners of the corporate enterprise, the corporate statutes normally require that amendments of the corporation's certificate be approved by the holders of a majority or two-thirds of the corporation's outstanding shares.<sup>126</sup>

If an amendment of the certificate of an economically dominant subsidiary would significantly augment the powers of the management of the corporate complex (taken as a class to include the boards of both the parent and the subsidiary) vis-à-vis the owners of the complex, the right to vote on it should be passed through to the parent's shareholders, lest a primary purpose of the statutory provisions governing certificate amendment be undercut. So, for example, an amendment increasing the authorized stock of such a subsidiary should require the approval of the parent's shareholders, since otherwise management could confer upon itself the power to restructure ultimate ownership of the complex's enterprise without any approval by the complex's owners. Indeed,

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<sup>126</sup> See, e.g., CAL. CORP. CODE § 3632 (West 1955) (majority); DEL. CODE ANN. tit. 8, § 242(d) (Supp. 1968) (majority); ILL. REV. STAT. ch. 32, § 157.53(c) (1969) (two-thirds); N.Y. BUS. CORP. LAW § 803(a) (McKinney Supp. 1970) (majority); OHIO REV. CODE ANN. § 1701.71 (Page 1964) (majority); PA. STAT. ANN. tit. 15, § 1805(A) (Supp. 1971) (majority); ABA MODEL BUS. CORP. ACT § 59(c) (rev. 1969) (majority). *Contra*, N.J. STAT. ANN. § 14A:9-2(4) (rev. 1969) (majority of votes cast).

*Aiple v. Twin City Barge & Towing Co.*<sup>127</sup> is directly in point, since it held that by virtue of the statutory provisions requiring shareholder approval for certificate amendment, the board could not create a subsidiary with authorized but unissued stock. There is no meaningful distinction in this regard between creation of a subsidiary with authorized but unissued stock, and amendment of a subsidiary's certificate to increase authorized but unissued stock.

Similarly, an amendment authorizing an economically dominant subsidiary to engage in a business previously unauthorized for either the parent or the subsidiary should require the approval of the parent's shareholders; otherwise management could confer upon itself the power to restructure the complex's enterprise without any approval by the complex's owners.<sup>128</sup> On the other hand, an amendment authorizing the subsidiary to engage in a type of business already authorized for the parent should not normally require approval by the parent's shareholders, since it would not significantly augment management's powers over the complex's enterprise.<sup>129</sup>

#### D. Dissolution

Corporate dissolution is usually associated with termination of the corporation's enterprise. Even where the enterprise is left intact by dissolution, it is taken out of corporate solution and placed directly into the hands of the shareholders. Thus it is a highly significant economic event, and the statutes normally require that "dissolution" (a term apparently intended to cover both dissolution of the corporate entity and liquidation of the enterprise<sup>130</sup>) be approved by the holders of a majority or two-thirds of the corporation's outstanding shares.<sup>131</sup>

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<sup>127</sup> 274 Minn. 38, 143 N.W.2d 374 (1966). See pp. 1599-1600 *supra*.

<sup>128</sup> However, many states now permit the filing of certificates which do not limit the corporation to particular businesses. See, e.g., DEL. CODE ANN. tit. 8, § 102(a)(3) (Supp. 1968); N.J. STAT. ANN. § 14A:2-7(1)(b) (1969); OHIO REV. CODE ANN. § 1701.04(A)(3) (Page Supp. 1970).

<sup>129</sup> The certificate amendments discussed in the text are of course merely illustrative. As noted, the basic question is whether a given amendment would significantly change the relative position of management and shareholders in the control structure enveloping the enterprise. If it would, approval by the parent's shareholders should be required.

<sup>130</sup> See Eisenberg, *supra* note 62, at 176-77.

<sup>131</sup> See, e.g., DEL. CODE ANN. tit. 8, § 275(b) (Supp. 1968) (two-thirds); ILL. REV. STAT. ch. 32, § 157.76(c) (1969) (two-thirds); N.Y. BUS. CORP. LAW § 1001 (McKinney 1963) (two-thirds); OHIO REV. CODE ANN. § 1701.86(E) (Page 1964) (majority); PA. STAT. ANN. tit. 15, § 2102 (1967) (majority); ABA MODEL BUS. CORP. ACT § 84 (rev. 1969) (majority). *Contra*, CAL. CORP. CODE § 4600

Should dissolution of an economically dominant subsidiary require the approval of the parent's shareholders? Normally, no, because in this case a pass-through is not necessary to prevent subversion of the statute. Dissolution of a subsidiary neither alters the complex's enterprise nor brings the enterprise out of corporate solution. Indeed, its effect is to extract a layer of corporate entity lying between the complex's enterprise and the complex's owners, thereby bringing the enterprise one step closer to the owners' control.

### III. WHOLLY OWNED SUBSIDIARIES WHICH HOLD LESS THAN SUBSTANTIALLY ALL OF THE COMPLEX'S ASSETS

To what extent are the principles formulated in connection with wholly owned, economically dominant subsidiaries applicable to wholly owned subsidiaries which hold less than substantially all of the complex's assets? In answering this question, two factors must be taken into account. The first of these is that for intracorporate purposes there is little practical difference between such a subsidiary and a corporate division:

[A] "true" division might be defined as an organizational unit that acts in all respects like a subsidiary whose stock is held by the parent or holding company, differing primarily in the fact that it has no legal existence apart from the parent company.

Such a quasi-subsidiary division has a full complement of officers and sales, production, and other functional departments. Also, it often has some form of supervisory or advisory board, which corresponds roughly to the board of directors of a subsidiary company. . . . In extreme cases the division may even be permitted to use "divisional seals" and to go through the motions of declaring dividends.<sup>132</sup>

That being so, significant rights of the parent's shareholders should not be made to turn on whether a corporate enterprise is held through a division or through a wholly owned subsidiary. This suggests the following working rule: in the case of a wholly owned (but not economically dominant) subsidiary, the right to vote should normally be passed through to the parent's shareholders if, but only if, the transaction in question would have required the approval of the parent's shareholders had the subsidiary's assets been held by the parent through a division.

The second factor, which runs against the first, is that the

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(West 1955) (50% of shareholders); N.J. STAT. ANN. § 14A:12-4(H) (1969) (majority of votes cast).

<sup>132</sup> Murphy, *supra* note 64, at 84-85.

category of wholly owned nondominant subsidiaries includes, by hypothesis, subsidiaries which are not economically significant members of the corporate complex of which they are a part. In the case of such subsidiaries, a pass-through may not be necessary to prevent subversion of the relevant statutory provision; correspondingly, in such cases the benefits resulting from a pass-through may not justify the expense involved. This analysis suggests a second working rule: in the absence of special circumstances, a pass-through should normally be required only in the case of a subsidiary which is an economically significant member of its corporate complex.

What constitutes economic significance in this context is, of course, a question of judgment, but objective and well-known guidelines are available. Thus SEC Regulation S-X, which governs the form and content of financial statements under the Securities Acts, provides that:

The term "significant subsidiary" means a subsidiary meeting any one of the following conditions:

(1) The assets of the subsidiary . . . exceed 15 percent of the assets of the parent and its subsidiaries on a consolidated basis.

(2) The sales and operating revenues of the subsidiary exceed 15 percent of the sales and operating revenues of its parent and the parent's subsidiaries on a consolidated basis. . . .<sup>133</sup>

A fifteen or twenty percent boundary line for determining economic significance has also been employed in other corporate contexts, such as provisions of various corporate statutes as to when a merger requires shareholder approval or gives rise to appraisal rights;<sup>134</sup> New York and American Stock Exchange rules requiring shareholder approval for acquisitions of assets;<sup>135</sup> and the definition of what constitutes a significant amount of assets for purposes of SEC Form 8-K, requiring the reporting of material corporate events.<sup>136</sup> While these provisions are not determinative in the present context, taken together they provide fairly persuasive support for regarding a wholly owned subsidiary as "economically significant" when its assets or revenues comprise at least fifteen percent, although less than substantially all, of the assets or revenues of the corporate complex.

<sup>133</sup> Reg. S-X, Rule 1.02(k), 17 C.F.R. § 210.1-02(k) (1970).

<sup>134</sup> See, e.g., DEL. CODE ANN. tit. 8, §§ 251(f), 262(k) (Supp. 1968) (15%); N.J. STAT. ANN. §§ 14A:10-3(4), 14A:11-1(1)(a)(ii) (1969) (15%); OHIO REV. CODE ANN. § 1701.78(D)(3) (Anderson Supp. 1970) (16⅔%).

<sup>135</sup> NEW YORK STOCK EXCHANGE, COMPANY MANUAL A-283-84 (1970) (20%); CCH AMER. STOCK EXCH. GUIDE ¶ 10,032 (1969) (20%).

<sup>136</sup> SEC Form 8-K, Information to be Included in Report Item 2, Instruction 4, 2 CCH FED. SEC. LAW REP. ¶ 31,003 (1971) (15%).



Let us now examine the operation of these two working rules on the transactions discussed in Part II.

*A. Sale of Substantially All Assets and Merger*

Suppose a significant subsidiary proposes to sell its assets. By hypothesis, such assets would comprise less than substantially all of the assets held by the corporate complex. However, it is only a sale of substantially all assets which requires shareholder approval under the statutes. Therefore, if the subsidiary's assets had been held by the parent through a division, the statutes would have permitted them to be sold without the approval of the parent's shareholders. No reason is apparent why the presence of a subsidiary should give those shareholders greater rights than they would have if the same assets had been held through a division. Accordingly, the sale of substantially all the assets of a significant subsidiary should not require approval of the parent's shareholders under the sale-of-substantially-all-assets provisions.

Mergers present a more complicated problem. Functionally, a merger is a corporate combination achieved through the issuance of stock by one corporation (the "survivor") in exchange for the assets of another (the "transferor"), resulting in a fusion of the two corporations.<sup>137</sup> A merger involving a significant subsidiary in which the subsidiary is the transferor is therefore comparable to a disposition by the parent of a significant amount, but less than substantially all, of its assets in exchange for stock in another corporation. Such a disposition would not require the approval of the parent's shareholders under the sale-of-substantially-all-assets provisions, since it would involve less than substantially all of the parent's assets. Nor would it require shareholder approval under the merger provisions, since it would not involve a fusion of the parent and the survivor corporation. Therefore, the merger of a significant subsidiary should not require approval of the parent's shareholders under those provisions if the subsidiary is the transferor.

Suppose the subsidiary is the survivor? In that case the merger would be usually comparable to an acquisition by the parent of the assets of another corporation in exchange for a significant amount, but less than substantially all, of the parent's stock. The latter transaction might constitute a merger within the meaning of the statutory merger provisions, since from the perspective of the parent corporation it would involve an economically significant fusion of two corporations (the parent and

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<sup>137</sup> See Eisenberg, *supra* note 62, at 61-62, 102-04.

the transferor) through the issuance of stock by one (the parent) in exchange for the assets of another (the transferor).<sup>138</sup> On that basis, it is arguable that a comparable transaction by a significant subsidiary should also require approval by the parent's shareholders. On the other hand, if the subsidiary rather than the parent were the merging corporation, there would be no fusion involving the parent. Therefore, on balance such a transaction probably should not require approval by the parent's shareholders under the merger provisions, except where it is a step in a plan which contemplates fusion of the subsidiary into the parent through a second merger or through liquidation of the subsidiary.<sup>139</sup>

### *B. Election of Directors*

If an enterprise is owned directly through a division, the board cannot delegate to a group of individuals its legal powers as a board vis-à-vis that enterprise.<sup>140</sup> Furthermore, if the subsidiary is significant, to permit the parent's board to elect the subsidiary's board would be to permit subversion of the statutory requirement that the persons holding those legal powers over an enterprise which are statutorily vested in the board must be elected by the shareholders; of the statutory limits on the length of a director's term of office; and of mandatory provisions for cumulative voting.<sup>141</sup> Thus at least in the case of a significant subsidiary, the right to elect the board should be passed through to the parent's shareholders.

On the other hand, where the subsidiary is not significant, in most cases it would be at least arguable that direct election of the subsidiary's board by that of the parent would not subvert

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<sup>138</sup> See *id.* at 118-21.

<sup>139</sup> See *id.* at 138-41.

The analysis in this section is restricted to the rights of the parent's shareholders under the statutory provisions referred to. As I have shown elsewhere, the shareholders may have the right to vote on certain sales or corporate combinations even in the absence of a specific statute, under common law principles. For example, a sale of a significant amount, although less than substantially all, of a corporation's assets might require shareholder approval under such principles. See Eisenberg, *supra* note 62, at 86, 91, 150-57. If that is so, then the parent's shareholders should also have the right to determine whether a significant subsidiary shall sell its assets. Similar reasoning would be applicable to a disposition of a significant amount of assets in exchange for stock rather than cash.

<sup>140</sup> Cf. *Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co.*, 41 F.2d 588 (7th Cir. 1930); *Kennerson v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 260 P.2d 823 (1953); *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 297 N.Y. 174, 77 N.E.2d 633 (1948).

<sup>141</sup> See pp. 1602-05 *supra*.

the relevant statutory provisions. By hypothesis, the subsidiary's board would not have a significant role to play in the corporate complex; correspondingly, the benefits to be achieved by pass-through would not justify the costs in most such cases.<sup>142</sup>

### *C. Certificate Amendment*

If an enterprise is owned directly through a division, management cannot alter its powers or duties in relation to the enterprise in a manner requiring certificate amendment without obtaining approval of the corporation's shareholders. For example, management can not modify its fiduciary duties toward one of a corporation's divisions by unilaterally amending the corporation's certificate to permit interested-director transactions involving that division. No reason is apparent why management should be able to accomplish the same result simply because the enterprise is segregated into a wholly owned subsidiary rather than a (functionally equivalent) division. Furthermore, it may be that in this case the approval of the parent's shareholders should be required even if the subsidiary is not economically significant. Otherwise, management could escape the confines of the parent's certificate of incorporation simply by causing the amendment of a subsidiary's certificate. For example, if the parent is not authorized to engage in a given business, management should not be able to engage in that business through a subsidiary, without approval of the parent's shareholders, even if the subsidiary holds only, say, five percent of the complex's assets.

### *D. Dissolution*

It has already been seen that dissolution of an economically dominant subsidiary should not require approval of the parent's shareholders, since its effect is to bring those shareholders one step closer to the underlying assets.<sup>143</sup> If the dissolution of a subsidiary which holds substantially all of a complex's assets should not require approval of the parent's shareholders, it follows that neither should the dissolution of a subsidiary which holds less than substantially all assets.

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<sup>142</sup> One situation in which a pass-through of the right to elect the board should perhaps be required, even in the case of a subsidiary which is not significant, is where a substantial amount of the parent's assets are held through such subsidiaries, since the parent's shareholders would otherwise have no direct voice in the election of those directors who have effective control over a substantial amount of the parent's assets.

<sup>143</sup> See pp. 1606-07 *supra*.

#### IV. SUBSIDIARIES IN WHICH PERSONS OTHER THAN THE PARENT OWN A SIGNIFICANT INTEREST (PUBLICLY HELD SUBSIDIARIES)

In Parts II and III it was assumed that the parent owned substantially all of the subsidiary's stock. In this part we will consider the case of the publicly held subsidiary — that is, the case in which a significant interest in the subsidiary is owned by persons other than the parent. As in the case of wholly owned subsidiaries, it will be useful to begin with those subsidiaries in which the parent's equity constitutes substantially all of its assets.

##### *A. Where the Equity in the Subsidiary Constitutes Substantially All of the Parent's Assets*

1. *The interests of the parent's shareholders.* — If the parent's equity in a subsidiary constitutes substantially all of the parent's assets, the reasons for passing through the right to vote on a sale of the subsidiary's assets, a merger of the subsidiary, an election of its board, or an amendment of its certificate, would not seem to be made any less compelling by the fact that persons other than the parent also own a significant interest in the subsidiary. Nevertheless, the presence of such an outside interest does introduce certain complexities into the analysis. One complexity is relatively mechanical — the economic focus is shifted slightly, from the importance of the subsidiary's assets to the importance of the parent's equity in the subsidiary. A second complexity goes somewhat deeper. It will be recalled that disregard of the corporate entity is one of the concepts which pass-through draws upon for support. It might be thought that this concept is more apposite when the subsidiary is wholly owned than when it is not, since in the former case the subsidiary is functionally similar to a division, while in the latter case the subsidiary's entity is likely to be clearly delineated. Under this view, the parent would have the power to vote the stock of a publicly held subsidiary, although in particular types of transactions the parent's shareholders as a body might be the corporate organ with the right to determine how the parent would exercise that power.<sup>144</sup>

However, such a view, while plausible, is unsound. On a conceptual level, it is the entity of the *parent* which pass-through

<sup>144</sup> See *Baum v. Baum Holding Co.*, 158 Neb. 197, 62 N.W.2d 864 (1954); *cf.* *Adams v. Clearance Corp.*, 35 Del. Ch. 459, 121 A.2d 302 (Sup. Ct. 1956); *Dal-Tran Serv. Co. v. Fifth Ave. Coach Lines, Inc.*, 14 App. Div. 2d 349, 220 N.Y.S.2d 549 (1961). *But cf.* *Robotham v. Prudential Ins. Co.*, 64 N.J. Eq. 673, 53 A. 842 (Ch. 1903).

disregards by treating the parent's shareholders as shareholders of the subsidiary. Therefore, whether regard should be had for the subsidiary's entity is not strictly in point. Moreover, while pass-through does derive support from the concept of disregard of corporate entity, it is ultimately grounded on application of the principles expressed by the statutory provisions governing the transactions to which the pass-through relates.<sup>145</sup> So, for example, in a related case, the fact that a subsidiary is less than wholly owned, and stands free from its parent as an independent entity, has not been viewed as a barrier to the maintenance of a double-derivative action brought in the subsidiary's behalf by a shareholder of the parent.<sup>146</sup>

2. *The Interests of the Subsidiary's Outside Shareholders.* — Indeed, if the argument is shifted from concept to policy, the reasons supporting pass-through are reinforced rather than diminished by the presence of outside shareholders. In a wholly owned subsidiary, a pass-through preserves only the voting rights of the parent's shareholders. In a publicly held subsidiary, however, a pass-through may also serve to ameliorate three problems faced by the outside shareholders.

(a) *Unfair Intercompany Transactions.* — The first of these problems is that such shareholders are likely to be subjected to unfair intercompany transactions between their corporation and the parent. To be sure, unfair transactions between a corporation and its controlling shareholders are possible even when a corporation is controlled by individuals. However, they are much more likely to occur where control is held by another corporation. While controlling individuals may or may not be engaged in business themselves, a controlling corporation almost invariably is. Therefore, at the least the parent corporation is likely to provide the subsidiary with headquarters services — management, legal, accounting, and the like — on a fee basis. If the parent's business is related to the subsidiary's, as will frequently be the case, there will probably be substantive business transactions between the two corporations as well.<sup>147</sup> Chief Justice

<sup>145</sup> See pp. 1599-1602 *supra*.

<sup>146</sup> See *Goldstein v. Groesbeck*, 142 F.2d 422, 425 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944); *Saltzman v. Birrell*, 78 F. Supp. 778, 783 (S.D.N.Y. 1948); *Craftsman Fin. & Mortgage Co. v. Brown*, 64 F. Supp. 168, 176 (S.D.N.Y. 1945); pp. 1596-97 & notes 92-94 *supra*; cf. *Continental-Midwest Corp. v. Hotel Sherman, Inc.*, 13 Ill. App. 2d 188, 141 N.E. 2d 400 (1957).

<sup>147</sup> See, e.g., *Ewen v. Peoria & E. Ry.*, 78 F. Supp. 312, 315-17 (S.D.N.Y. 1948) (L. Hand, J.), *cert. denied*, 336 U.S. 919 (1949); *Alliegro v. Pan Am. Bank*, 136 So. 2d 656 (Fla. Dist. Ct. App. 1962), *cert. denied*, 149 So. 2d 45 (Fla. 1963); *Ripley v. International Rys.*, 8 N.Y.2d 430, 171 N.E.2d 443, 209 N.Y.S.2d 289 (1960).

Traynor has pointed out the dangers to the subsidiary that may flow from these transactions:

If . . . a controlling interest [in one corporation is acquired by another] the [acquired] company . . . will become a subsidiary of the acquiring company . . . and cease, in fact though not in law, to be an independent entity. . . .

[T]he parent company will wish to operate the subsidiary for the benefit of the group as a whole and not necessarily for the benefit of that particular subsidiary.<sup>148</sup>

The self-interest of those who control the parent will lead them to favor the parent in such transactions. The lower the parent's percentage of ownership, the greater will be the temptation to favor the parent unduly.

The checks on such self-dealing are few. In theory, of course, the fairness of such transactions is reviewable by the courts; but in practice such review would be difficult even if the courts had the will to engage in it,<sup>149</sup> and they have often lacked the will.<sup>150</sup> A different kind of check may exist where the parent's controlling interest is significantly less than a majority. In such cases, gross exploitation of the subsidiary might be eschewed simply because it could goad the outsiders into a proxy fight, or, alternatively, drive down the price of the subsidiary's stock and make it worthwhile for an outsider to acquire an overmatching control block.

Suppose, however, that the parent owns the majority block in the subsidiary. In that case, even this possible check would fail if the parent's shares were voted as a unit. But if the right to vote the subsidiary's stock were passed through to the parent's shareholders, the efficacy of this check on unfair dealings might be reinstated. In at least some cases, the subsidiary's outside shareholders could gain control of the subsidiary by purchasing shares of the parent, and adding the pass-through votes adhering to those shares to the votes on their stock in the subsidiary. Even if the outside shareholders do not actually buy shares in the parent, the fact that they could do so may keep the parent honest.

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<sup>148</sup> *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 112, 460 P.2d 464, 474, 81 Cal. Rptr. 592, 602 (1969) (Traynor, C.J.) (quoting from GOWER, *THE PRINCIPLES OF MODERN COMPANY LAW* 561 (2d ed. 1957)).

<sup>149</sup> See *Ewen v. Peoria & E. Ry.*, 78 F. Supp. 312, 315-17 (S.D.N.Y. 1948) (L. Hand, J.), *cert. denied*, 336 U.S. 919 (1949).

<sup>150</sup> See, e.g., *Western Pac. R.R. v. Western Pac. R.R.*, 206 F.2d 495 (9th Cir.), *cert. denied*, 346 U.S. 910 (1953); *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967); *Case v. New York Cent. R.R.*, 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965); cf. *Everett v. Phillips*, 288 N.Y. 227, 43 N.E.2d 18 (1942). But see *Alliegro v. Pan Am. Bank*, 136 So. 2d 656 (Fla. Dist. Ct. App. 1962), *cert. denied*, 149 So. 2d 45 (Fla. 1963); *Ripley v. International Rys.*, 8 N.Y.2d 430, 171 N.E.2d 443, 209 N.Y.S.2d 289 (1960).

(b) *Loss of Control Value of Stock*.—A related problem which arises if a parent's majority block of shares is voted as a unit, is that the stock held by the minority shareholders becomes de facto nonvoting stock; except for transactions which require approval by two-thirds of outstanding shares, voting by the minority is an all but meaningless gesture. This in turn is likely to find reflection in the value of the minority's shares. Where a corporation is controlled by individuals, an element of control value normally attaches even to those voting shares which are not presently members of the control block. Since such a block faces dismemberment by death and taxes, voting shares which are not members of today's control block may become members of tomorrow's, and that fact should be reflected in their price.<sup>151</sup> A parent corporation, on the other hand, has perpetual life. If, therefore, a parent's majority block could be voted as a unit, the minority stock would be permanently condemned to de facto nonvoting status, and the element of control value that normally attaches to the voting right would be lost.

At least in some cases, pass-through could restore voting rights and control value to the minority shares. On any given issue, a combination of the subsidiary's outside shareholders and some, although less than a majority, of the parent's shareholders could prevail. Comparably, persons seeking control of the subsidiary might now be willing to buy shares of the minority shareholders, since control of the subsidiary could be obtained by combining these shares with shares of the parent.

(c) *Pyramiding*.—The two problems already described may be compounded by pyramiding.

This involves the owning of a majority of the stock of one corporation which in turn holds a majority of the stock of another—a process which can be repeated a number of times. An interest equal to slightly more than a quarter or an eighth or a sixteenth or an even smaller proportion of the ultimate property to be controlled is by this method legally entrenched. By issuing bonds and nonvoting preferred stock of the intermediate companies the process can be accelerated. . . . The owner of a majority of the stock of the company at the apex of a pyramid can have almost as complete control of the entire property as a sole owner even though his ownership interest is less than one percent of the whole.<sup>152</sup>

<sup>151</sup> See *Honigman v. Green Giant Co.*, 208 F. Supp. 754 (D. Minn. 1961), *aff'd*, 309 F.2d 667 (8th Cir. 1962), *cert. denied*, 372 U.S. 941 (1963); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Repr. 592 (1969); *Allen v. Chase Nat'l Bank*, 180 Misc. 259, 40 N.Y.S.2d 245 (Sup. Ct. 1943); Eisenberg, *supra* note 62, at 57-59.

<sup>152</sup> A.A. BERLE & G. MEANS, *supra* note 1, at 69. See also J. BONBRIGHT & G. MEANS, *supra* note 17, at 18-20.

In the 1920's, fantastic corporate pyramids were constructed, particularly, although not exclusively, in the public utility sector.<sup>153</sup> Pyramiding in that sector came under legal control by virtue of the Public Utility Holding Company Act of 1935.<sup>154</sup> However, there is little direct legal control over pyramiding in other sectors,<sup>155</sup> and while pyramiding has apparently subsided, it has by no means disappeared.<sup>156</sup>

A major vice of pyramiding is that it tends to magnify the problems of the outside shareholders. The risk of unfair inter-corporate transactions is increased, because ultimate voting power is so enormously disproportionate to ultimate investment stake. And because pyramiding is usually associated with high-ratio debt leverage, corporations closer to the apex may draw excessive funds out of corporations closer to the base in order to service their own debt obligations.<sup>157</sup> For the same reason, corporate pyramids tend to be financially unstable, since failure at any one level may resonate throughout the entire system.<sup>158</sup>

The problem of pyramiding faced by outside shareholders in publicly held subsidiaries would be significantly ameliorated by the pass-through. A major foundation of pyramiding is the supposed legal rule that the parent's stock in a subsidiary is voted as a unit. If the right to vote the subsidiary's stock is passed through the parent to its shareholders, however, pyramiding loses much of its appeal to the promoter. To illustrate, suppose that Corporation *A* owns fifty-one percent of the stock of Corporation *B*. If *A* can vote its stock in *B* as a unit, then a fifty-one percent interest in *A* can be pyramided into absolute control of *B*, although it represents only about a twenty-six percent equity interest in *B*. If, however, the right to vote the *B* stock is passed through *A* to *A*'s shareholders, it becomes possible

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<sup>153</sup> See A.A. BERLE & G. MEANS, *supra* note 1, at 69; J BONBRIGHT & G. MEANS, *supra* note 17, at 18-20, 108-23, 253-62; Brigham & Pettit, *supra* note 7, at 1131.

<sup>154</sup> 15 U.S.C. § 79k (b) (1964). See note 17 *supra*.

<sup>155</sup> There is at least one indirect control. The New York Stock Exchange generally refuses to list common stock of a corporation in which 30% or more of the common stock is held by another publicly held corporation, or which is otherwise controlled through a voting pyramid, principally on the ground that stock should carry voting rights, and that voting rights should be related to investment. Letter from Merle S. Wick, *supra* note 98.

<sup>156</sup> See, e.g., *Adams v. Clearance Corp.*, 35 Del. Ch. 459, 121 A.2d 302 (Sup. Ct. 1956); *Baum v. Baum Holding Co.*, 158 Neb. 197, 62 N.W.2d 864 (1954); cf. *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

<sup>157</sup> See 2 A. DEWING, *supra* note 17, at 1011-14.

<sup>158</sup> See J. BONBRIGHT & G. MEANS, *supra* note 17, at 19-20, 46-47; 2 A. DEWING, *supra* note 17, at 1013-14.



to acquire control of *B* by combining an *A* and a *B* shareholding, and no firm pyramid could be constructed.<sup>159</sup>

Needless to say, the pass-through is not a panacea for the problems of the outside shareholder. For one thing, its usefulness to the outside shareholders decreases as the parent's holding in the subsidiary approaches one hundred percent. On the other hand, as the parent's holding in the subsidiary approaches one hundred percent, the temptation to unduly favor the parent in intercorporate transactions is proportionately diminished, and the problem of pyramiding avoided. Furthermore, other remedies, such as the mandatory buy-out of minority shareholders, may then become possible.<sup>160</sup>

*B. Where the Equity in the Subsidiary  
Constitutes Less than Substantially  
All of the Parent's Assets*

A further complexity is introduced when the parent's equity in the subsidiary constitutes a significant amount, rather than substantially all, of the parent's assets. Generally speaking, the advantages of pass-through to the parent's shareholders do not seem any more diminished by the presence of outside shareholders in this case than they do when the equity constitutes substantially all of the parent's assets. However, the economic interests of the parent's shareholders in the subsidiary's decisions is not as strong in the former case as in the latter. With this in mind, it might be argued that the parent's shareholders would regard the disadvantages to the subsidiary's outside shareholders that pass-through ameliorates as benefits to the parent's share-

<sup>159</sup> Cf. *Robotham v. Prudential Ins. Co.*, 64 N.J. Eq. 673, 704-05, 53 A. 842, 854-55 (Ch. 1903), where the court said, in dicta:

In an ingenious and able brief, presented on behalf of these defendants, the following statement is made of a situation claimed now to be legally possible and unassailable under the laws of New Jersey:

"One man controls a company of \$10,000,000 capital. He may form a new company with a capital of \$5,100,000 to hold a majority of the stock. He may then sell all but \$2,600,000 of the stock to company No. 2 and transfer his remaining stock to a new company with a capital of \$2,600,000. He may then sell to company No. 3 all but \$1,400,000 and transfer that to a new company. This process may go on until the power of the whole chain of corporations is vested in the holder of a few thousand dollars of stock in the ultimate company, and the same chain can be used for an unlimited number of companies."

The brief concludes that "the check on the process is not in the law, but in the difficulty of unloading the minority shares of each company."

. . . This startling proposition suggests a variety of interesting questions . . . such as . . . [w]hether the actual, beneficial owners of the \$5,100,000 of stock could not break through the chain of corporate fictions which separated them from their property and dictate how its voting power should be exercised.

<sup>160</sup> See Eisenberg, *supra* note 62, at 131-38; cf. Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation*, 1969 ILL. L.F. 1, 22.

holders, outweighing the advantages of pass-through to themselves. Similarly, the parent's shareholders might believe that without pass-through the effect of the parent's stock in the subsidiary's voting process would be maximized. That is, a shareholder of the parent might believe that it is to his overall advantage to forego his ability to vote stock in the subsidiary against a proposed action where he disagrees with the majority of the parent's shareholders, since in return he would be assured that whenever his voting wishes coincide with a majority of such shareholders, the full strength of the parent's block in the subsidiary would be placed behind his position.

However, the advantages to the outside shareholders that may flow from pass-through are not necessarily disadvantages to the parent's shareholders. That the minority's shares retain an element of control value does not decrease the subsidiary's earnings, which are normally the parent's principal concern, nor does it necessarily decrease the value of the shares held by the parent. Undermining the foundation of a potential pyramid may be disadvantageous for some of the parent's shareholders but advantageous for others, since the parent might be as vulnerable to pyramiding as the subsidiary. As to intercorporate transactions, it is true that dollars which the subsidiary's outside shareholders may save because of constraints on unfair intercorporate dealings are dollars that would otherwise have gone into the pockets of the parent's shareholders. On the other hand, an interest in the power to deal unfairly does not present a very attractive case for legal protection. Nor is it clear that the parent's shareholders themselves would regard such an interest as a legitimate one. As for the second possible drawback of pass-through, the fact that the parent's shareholders might not welcome the diminishment in the voting power of the parent's block that pass-through entails must be balanced against the undeniable possibility of damage to the same shareholders that could occur if major corporate decisions, such as director election<sup>161</sup> and certificate amendment,<sup>162</sup> were to occur without pass-through. On balance, therefore, the rules applicable to wholly owned significant subsidiaries should also be applicable to publicly held subsidiaries in which the parent's equity is economically significant.

Suppose, finally, that the parent's equity in a publicly held subsidiary is less than a significant amount of the parent's assets. Generally speaking, the interests of the parent's shareholders do not require pass-through in such cases.<sup>163</sup> The major interests

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<sup>161</sup> See pp. 1602-05, 1610-11 *supra*.

<sup>162</sup> See pp. 1605-06, 1611 *supra*.

<sup>163</sup> See p. 1608 *supra*.

to be served by a pass-through, therefore, would be those of the subsidiary's outside shareholders. While these interests seem worth taking into account when they generally coincide with the interests of the parent's shareholders, it is doubtful whether in themselves they are sufficient to justify a pass-through on the basis of existing statutory provisions. To be sure, the fact that the parent's equity in the subsidiary is not significant does not diminish the desirability of pass-through from the perspective of the subsidiary's outside shareholders, since it does not diminish the dangers of unfair intercorporate transactions and loss of stock value. Solution to these problems, in that context, must, however, await statutory reform since the primary thrust of existing statutory provisions goes to the interests of the parent's shareholders.