Double Derivative Suits and Other Remedies With Regard to Damaged Subsidiaries

William H. Painter
Villanova University School of Law

Follow this and additional works at: http://www.repository.law.indiana.edu/ilj

Part of the Torts Commons

Recommended Citation
Available at: http://www.repository.law.indiana.edu/ilj/vol36/iss2/1

This Article is brought to you for free and open access by the Law School Journals at Digital Repository @ Maurer Law. It has been accepted for inclusion in Indiana Law Journal by an authorized editor of Digital Repository @ Maurer Law. For more information, please contact wattn@indiana.edu.
The subsidiary, as a means of doing business, seems to have become increasingly popular with the growth and sophistication of the modern corporate enterprise. The reasons for this are complex and varied. Subsidiaries may be useful for tax reasons, for achieving the advantages of limited liability, for centralizing control in a relatively small percentage of stock ownership, for qualifying to do business under the laws of the various states, for reasons related to financing, and doubtless for a number of other purposes. On the other hand, their existence in a particular situation may be due merely to simple inertia on the part of management in the perpetuation of a corporate entity which has been acquired by or come under the control of some larger organization.

The legal problems presented by doing business through subsidiaries are probably as diverse as the factors which motivate the use of this form of business organization. Thus the hope of limited liability may be frustrated where, under certain conditions, a parent company may be held liable for the obligations of its subsidiary, or a parent may have

† Associate Professor of Law, Villanova University School of Law.
3. For the sake of simplicity, the remainder of this discussion will refer to any corporation holding stock in another as a "parent" regardless of whether the extent of ownership would be enough to constitute the owner corporation a "parent" in the usually accepted sense of the term. Similarly, the owned corporation will be referred to as a "subsidiary." A derivative suit by a parent to enforce a cause of action belonging to a subsidiary will be referred to as a "simple derivative" action. (The term "single derivative" is an alternative but it has the disadvantage of ambiguously referring also to the number of possible actions which might be brought as opposed to the nature of the action.) A derivative suit by a stockholder of a parent to enforce a cause of action belonging to a subsidiary will be referred to as a "double derivative" action.
to qualify to do business and pay franchise taxes in a jurisdiction notwithstanding the fact that it has attempted to restrict its activities there solely to its subsidiary.

One particularly troublesome problem is whether a parent, through use of the subsidiary device, may effectively insulate one or more phases of its business from attack by minority stockholders. Suppose, for example, that a corporation is engaged in the manufacture of steel products of various types, including steel pipe and tubing, and that, for various reasons, it desires to create a business environment in which the management of its pipe and tubing division may operate free of liability or indirect control from certain stockholders of the steel company, although subject to the direct control of the steel company's management. An obvious and perhaps facile solution to the problem would be to create a second corporation to which the steel company would transfer the assets of its pipe and tubing division in exchange for all the outstanding stock of the transferee, which would then become a wholly-owned subsidiary. Since, in the absence of a so-called "spin-off," no stockholder of the parent would be a stockholder of the subsidiary, it would seem that the management of the latter would be responsible solely to the parent and hence could not be held liable in an action brought by one or more of the parent's stockholders, to whom they might have been liable, at least on a derivative basis, had the reorganization not taken place.

A fundamental problem which characterizes this entire area of liability is that of the circumstances under which courts are likely to ignore the form of a transaction and look to what they consider to be its substance or net effect. Thus, as far as form is concerned, stockholders of the parent obviously have no direct interest in a subsidiary since they own no stock in the latter, and arguably they should accordingly have no rights with respect to it in the event of mismanagement; yet common sense seems to say otherwise in view of the artificiality of the subsidiary device in many instances. A fortiori to the extent that subsidiaries should themselves be owned and operated by other subsidiaries, all created by or for the parent organization whose purposes they ultimately serve, although the problems may become more complex as the interests of the parent's stockholders appear more remote, the need for various forms of relief, equitable or otherwise, becomes, in certain instances, more pressing. As one court^ remarked:

DOUBLE DERIVATIVE SUITS

As corporate structures develop layers and layers of separate entities, pyramided in a form which centralizes control in the hands of a few and insulates the various enterprises from general liability or from taxation, a court of equity must become especially vigilant to protect the minority stockholder, whose money is in the control of those at the top but whose voice receives no attention through the maze.

The modern growth of the corporate form of business has been accompanied by ingenious and artificial legal devices designed to divorce the stockholder from any semblance of control over his investment. The more tenuous that vestige of control becomes, the more keen must be the eyes of equity to safeguard the investment in the hands of those who have the power to waste it.

In the following discussion, the various theories upon which liability has been based, and the consequent rights of the parent's stockholders with regard to wrongs to the subsidiary, will be considered and evaluated for their effectiveness.

I. The Double Derivative Stockholders' Suit

Of the few remedies available to the stockholder of the parent for mismanagement, waste and other wrongs with regard to the subsidiary, the most significant and effective is the so-called double derivative stockholders' suit. Since the subsidiary nearly always has a cause of action against those who have perpetrated the wrong, and since a stockholder of the subsidiary may under certain conditions bring a derivative suit to enforce the cause of action in favor of the subsidiary, it should follow that stockholders of the parent, which is of course a stockholder of the subsidiary, should, at least in some situations, have a right to enforce the parent's derivative cause of action. Hence the derivative stockholders' action once removed, as it were, or double derivative suit.

Although the above reasoning may seem convincing on first analysis, there are a number of uncertainties with regard to the conditions under which a double derivative action should be permitted. For example, although the argument for permitting such an action may be especially persuasive in the case of a subsidiary which is wholly-owned by a parent which itself has perpetrated the wrong, what result should follow with regard to a subsidiary which is not wholly-owned, or one in which the parent has a relatively small interest? Would a stockholder of an investment company or mutual fund have a right to sue on a double deriva-
tive basis for mismanagement of the affairs of one of the companies in which the fund or investment company has invested if those who manage such investments refuse to bring suit themselves? Should the double derivative action be restricted to wholly-owned, substantially owned or at least "controlled" subsidiaries? Where should the line be drawn?

Questions such as the above are best resolved by further inquiry into the theory behind the double derivative suit. Unfortunately, however, there seems to be not one theory but rather a number, several of which may overlap.

1. The fiduciary theory. Since the derivative cause of action is, after a manner of speaking, an "asset" of the parent, it like other assets is held by the parent as a "fiduciary" for its stockholders. If the parent wrongfully refuses to enforce the cause of action, this is both a waste of the parent's assets and a breach of its fiduciary duty to its stockholders. Accordingly, the latter should be permitted to enforce the cause of action on a double derivative basis.

This explanation of the double derivative suit seems unconvincing for a number of reasons. First of all, the derivative cause of action is hardly an "asset" of the parent in the usual sense of the term "asset" since its enforcement would not result in any monetary recovery or other direct benefit to the parent but would benefit it only indirectly by way of a possible increase in the value of its investment in the subsidiary. The distinction between the cause of action and the stock of the subsidiary held by the parent is of course crucial here. The stock is an "asset" in a very real sense, but the cases which adopt the fiduciary theory do not seem to emphasize that the reason for permitting the double derivative suit is to prevent diminution of the parent's investment (i.e. stock) in its subsidiary but stress rather the parent's refusal to enforce the derivative cause of action which it holds as a "fiduciary" for its stockholders.

5. Such diminution might give rise to a simple derivative cause of action in favor of the parent against those responsible for waste of its assets, rather than a double derivative suit with regard to the subsidiary. In this connection, see the discussion of General Rubber Co. v. Benedict, 215 N.Y. 18, 109 N.E. 96 (1915) in Section II, infra.

6. See, e.g., Goldstein v. Groesbeck, 142 F.2d 422, 425 (2d Cir. 1944), cert. denied, 323 U.S. 737 (1944); "A shareholder's suit in essence is nothing more than a suit by a beneficiary of a fiduciary to enforce a right running to the fiduciary as such; a double derivative suit is one in which the beneficiary is in his turn a fiduciary, and as such refuses to enforce the right which is his as beneficiary of the first fiduciary." Compare Goldstein v. Groesbeck, supra with the reasoning of the lower court opinion in Carter v. Producers & Refiners Oil Co., 164 Pa. 463, 30 Atl. 391, 394 (1894): "He [the stockholder] owns a part of the property of the [subsidiary] ... or is a cestui que trust with reference thereto by reason of the ownership of a part of the property of the [subsidiary] ... by the [parent company]. ..." Although the parent owns stock in the subsidiary, it is obviously inaccurate to refer to it as owning any of the property of the
DOUB"LE DERIVATIVE SUITS

Furthermore, aside from the somewhat doubtful analogy between a corporation and a trust, it does not follow that the beneficiary is permitted to sue in every instance where the trustee has wrongfully refused to do so. Finally, acceptance of the fiduciary theory would seem to imply that, wherever a derivative cause of action is held by the parent in a fiduciary capacity, the stockholders of the parent should be permitted to enforce the cause of action when the parent has been guilty of a breach of its fiduciary duty. If this is so, the rule would extend considerably beyond existing case law to permit recovery on a double derivative basis wherever a parent holds stock in another company, no matter how negligible its interest may be. Surely a breach of fiduciary duty, like a breach of moral duty, is not less so merely because its subject-matter is only "a small one."

2. Disregard of the corporate entity. Another possible rationale for the double derivative suit is to consider it as based upon disregard of the separate entities of the parent and subsidiary, treating the two as a single enterprise of which the plaintiff is a stockholder. The result is by hypothesis not a double derivative, but merely a simple derivative action brought on behalf of the combined enterprise. Although there is no compelling reason for doing so, it would seem more satisfactory from a technical standpoint to apply the same criteria to these cases as is applied in other situations where it becomes of importance to determine whether the court should disregard the corporate form, or "pierce the corporate veil" as the popular expression goes. Thus, in the absence of evidence that the affairs of the parent and subsidiary have been conducted as if they were a single enterprise, intermingling of bank accounts, identity of directors and officers, or, to use a test proposed in a leading decision by Judge Learned Hand, "the parent's direct intervention in the transaction, ignoring the subsidiary's paraphernalia of incorporation, directors and officers," the corporate subsidiary. A fortiori a stockholder of the parent owns no part of the property of either the subsidiary or the parent.

7. See Matthies v. Seymour Mfg. Co., 270 F.2d 365 (2d Cir. 1959), cert. denied, 361 U.S. 962 (1960), holding with regard to an active trust with several beneficiaries that one beneficiary could not sue derivatively on behalf of the trustee, who had refused to sue, without the joinder of all beneficiaries as indispensable parties. On this point there was one dissent and the case was criticized in 73 Harv. L. Rev. 1393 (1960). Generally speaking, however, the weight of authority appears to be that a beneficiary may sue derivatively if the trustee refuses to do so. BAllantine, Corporations 351 n.58 (rev. ed. 1946); 13 Fletcher, Private Corporations § 5985 (1943 repl. vol.).

8. Kingston Dry Dock Co. v. Lake Champlain Transp. Co., 31 F.2d 265, 267 (2d Cir. 1929). The opinion continues, "The test is therefore rather in the form than in the substance of the control; in whether it is exercised immediately, or by means of a board of directors and officers, left to their own initiative and responsibility in respect of each transaction as it arises. Some such line must obviously be drawn, if shareholding
entities should not be disregarded and, consequently, recovery on a double derivative basis should be denied, if this is to be the sole rationale of the action.

But the above seems to be too narrow a test, at least if the great weight of authority in this area is correct, since, with a few minor exceptions, none of the reported cases emphasize the necessity of using the criteria normally employed to determine whether the corporate entity should be disregarded as a means of deciding whether there is a right to sue on a double derivative basis. A lower New York court may have by dictum suggested this,9 but the remark was highly gratuitous under the circumstances of the case and is probably erroneous even if accepted at face value.10 An early federal district court opinion, Sabre v. United Traction & Electric Co.,11 suggesting a similar approach, appears to have been influenced to a considerable extent by the fact that counsel chose to argue the case on a theory of disregard of the corporate entity rather than a double derivative theory12 which may not at that time have attained full acceptance, at least in the federal courts.13 Other

10. See Note, Suits by a Shareholder in a Parent Corporation to Redress Injuries to the Subsidiary, 64 HARV. L. REV. 1313, 1315 (1951), suggesting that the dictum may have been inconsistent with prior and subsequent New York decisions. Even assuming the validity of the test, and applying it to the facts of the case, the court in Schneider v. Greater M. & S. Circuit, Inc., supra note 9, may have been in error in refusing to disregard the corporate entities in view of (1) the fact that the parent and subsidiaries had common officers and directors and (2) an express finding that there was "unity of ownership, operation, control and management." Schneider v. Greater M. & S. Circuit, Inc., supra note 9 at 535, 259 N.Y. Supp. at 321.
13. See DeVan v. United States, 50 F. Supp. 992 (D.N.J. 1943). The DeVan holding is of doubtful authority in view of the fact that one of the cases relied upon was subsequently reversed. Goldstein v. Groesbeck, 42 F. Supp. 419 (S.D.N.Y. 1941), rev'd, 142 F.2d 422 (2d Cir.), cert. denied, 323 U.S. 737 (1944). In addition, the only other authority relied upon, aside from Sabre v. United Traction & Elec. Co., supra note 11, was primarily concerned with a procedural point, the failure to join the parent corporation as an indispensable party. Busch v. Mary A. Riddle Co., 283 Fed. 443 (D.
DOUBLE DERIVATIVE SUITS

decisions which rely on the concept of disregard of the corporate entity do so as an alternative ground for the holding rather than an exclusive test of the right to bring a double derivative action. 14

3. Subsidiary as a "mere agent" or "instrumentality." A few cases give as a reason for permitting double derivative actions the fact that, in a particular situation, the subsidiary may be acting merely as an "agent" or "instrumentality" for the parent in carrying out the latter's instructions. 15 In a sense this is merely a legal conclusion or, more accurately, a description of one of the classic rationales for disregarding the corporate entity. 16 As such it scarcely qualifies as a separate test of the right to bring a double derivative suit and, to the extent that it states or describes merely a result rather than a reason, it is not a test at all. In any event, it is subject to the same criticism as the theory based on disregard of the corporate entity in that it is, if anything, too narrow and unsatisfactory an explanation of the majority of cases in this area.

4. "Holding" company and "operating" company. Occasionally a court states that one situation where a double derivative action is permitted is where the relationship between parent and subsidiary is that of a "holding" company to an "operating" company. 17 There appears

16. Weisser v. Mursam Shoe Corp., 127 F.2d 344, 346 n.3 (2d Cir. 1942), quoting a passage from United States v. Reading Co., 253 U.S. 26, 62-63 (1920) as "a classic statement applied generally in cases piercing the corporate veil." The test is said to be whether ownership of the subsidiary "is resorted to, not for the purpose of participating in the affairs of the corporation in which it is held in a manner normal and usual with stockholders, but for the purpose of making it a mere agent, or instrumentality or department of another company. . . ." United States v. Reading Co., supra. See Berle, The Theory of Enterprise Entity, 47 Colum. L. Rev. 343, 348 (1947). Douglas & Shanks, Insulation from Liability through Subsidiary Corporations, 39 Yale L.J. 193, 195 (1929).
however, to be no one recognized definition of the term "holding company." Since a distinction is drawn between that and an "operating" company, one would infer that the former is intended to designate a corporation formed primarily, if not exclusively, for the purpose of holding stock in one or more subsidiaries and which does not itself engage in operational activities. It is unclear whether this means that the "holding" company must own all of the stock of the subsidiary, as well as whether it may engage in operational activities of an incidental nature. In any event, such a rule, if it exists, seems arbitrary and artificial in character, since there seems to be no real reason for limiting the right to bring a double derivative suit to holding companies, and the cases indicate that the right has not been so restricted.

5. Common control. One of the most frequent situations where double derivative actions have been permitted is where "the original corporation that is said to have suffered wrong and its shareholder corporation which had the right to bring a derivative suit were in the control of those charged with inflicting the corporate injury," to quote what may have become the classic holding in this area. The reasons

18. Complete ownership does not seem to have been required. Kaufman v. Wolfson, 1 App. Div. 2d 555, 151 N.Y.S.2d 530 (1956). Essentially the same result was reached in a parallel federal case; Kaufman v. Wolfson, 132 F. Supp. 733 (S.D.N.Y. 1955). See Craftsman Fin. & Mortgage Co. v. Brown, 64 F. Supp. 168 (S.D.N.Y. 1945) (50% ownership); Hirshhorn v. Mine Safety Appliances Co., 54 F. Supp. 588 (W.D. Pa. 1944) (60% ownership); Birch v. McColgan, 39 F. Supp. 358 (S.D. Cal. 1941) (49% ownership); cf. Carter v. Producers & Refiners Oil Co., 164 Pa. 463, 30 Atl. 391 (1894) (68% ownership). In Saltzman v. Birrell, 78 F. Supp. 778, 783 (S.D.N.Y. 1948), the court expressly declined to specify a minimum stock ownership required for bringing a double derivative suit. The point is apparently still left open by the decisions, most of which have concerned subsidiaries in which the parent had approximately 50% or more by way of stock ownership. If the "control" test of United States Lines, Inc. v. United States Lines Co., 96 F.2d 148 (2d Cir. 1938) is adopted, then control as a practical matter (i.e. ability to determine the fundamental policies and, at least potentially, to direct the activities of the subsidiary through control of the requisite majority of its board of directors) would seem to be the determinant rather than mere percentage ownership.

DOUBLE DERIVATIVE SUITS

for permitting such an action are obvious, since it would be naive to expect those on the board of directors of either corporation to vote in favor of either a direct or a simple derivative action under such circumstances. "If any other rule were adopted, the plaintiffs would be denied all relief, and the wrongs of which they complain would go unredressed."20

Perhaps more troublesome than the above case of so-called "common external control"21 is that presented where the wrongdoer or defendant controls only one of the corporations, or controls none at all. If he controls the parent corporation, and the latter controls the subsidiary, the reasons for permitting a double derivative suit are essentially the same as where the wrongdoer controls both corporations, for, by his control of the parent, he can effectively block any action against himself either by the parent or by its controlled subsidiary. But if the parent should not be in control of the subsidiary, there is less reason for permitting a double derivative action, particularly if there is an opportunity for a disinterested majority of the board of directors and/or stockholders of the subsidiary to vote on the desirability of maintaining an action. Similarly, if the wrongdoer should control the subsidiary but not control the parent, a disinterested vote of the board of directors and/or stockholders of the latter not to bring a derivative suit should be enough to prevent a stockholder from suing on a double derivative basis except in those exceptional instances where a majority may not ratify or consent to a transaction in such a way as to bind the minority.22 Essentially the same considerations would

a derivative suit and this recommendation was subsequently approved by a majority of stockholders, which, due to the defendants' control, was of course an interested majority. Although declining to say categorically that the defendants' stock could not be voted in favor of the recommendation, the court said that this should not be permitted unless there was a clear showing that it was advantageous to the corporation and its stockholders. Compare this aspect of the case with S. Solomont & Sons Trust v. New England Theatres Operating Corp., 326 Mass. 99, 93 N.E.2d 241 (1950), holding that a vote of a disinterested majority of the parent company's stockholders would prevent a double or triple derivative suit.

20. Ryan v. Leavenworth, A. & N.W. Ry., 21 Kan. 365, 404 (1879). The court went on to observe that, even if the management of the two corporations was willing to bring the action, it would be a "mockery" to permit it since the suit would be essentially against themselves.


22. See S. Solomont & Sons Trust v. New England Theatres Operating Corp., 326 Mass. 99, 93 N.E.2d 241 (1950) and United States Lines, Inc. v. United States Lines Co., 96 F.2d 148 (2d Cir. 1938). One of the classic situations in which the vote of a disinterested majority may not be effective to bind a minority is that of fraud. Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912). But even in instances of fraud, illegality, or other similar wrongs there is a diversity of opinion
prevail, a fortiori, where the wrongdoer is a complete stranger, or at least is not in control of either corporation.\textsuperscript{23}

The question of whether the parent must own a controlling interest in the subsidiary in order to permit recovery by a stockholder of the parent on a double derivative basis, or whether at least a minimum interest by way of stock ownership should be required, is still an open one. As stated above, the overwhelming majority of cases permit recovery in the absence of complete ownership, but, in most of the instances, if not all of them, the parent has been in control.\textsuperscript{24}

It has been suggested that neither control nor a minimum amount of stock ownership should be required since there is no such requirement with regard to the right of the parent corporation to bring a simple derivative suit.\textsuperscript{25} The suggestion may have a theoretical appeal perhaps, concerning the right of a minority of stockholders to insist on suing against the protest of a disinterested majority, some courts preferring to follow the strict English view established by Foss v. Harbottle, 2 Hare 461, 67 Eng. Rep. 189 (Ch. 1843) and thus prevent the minority from suing derivatively without the majority's consent. See Claman v. Robertson, 164 Ohio St. 61, 128 N.E. 2d 429 (1955); \textsc{Ballantine, Corporations} 346-47 (rev. ed. 1946). The federal cases, construing the language in Fed. R. Civ. P. 23(b) requiring application to the shareholders "if necessary," have been similarly split. See \textsc{Baker & Cary, Cases and Materials on Corporations} 654 (3d ed. 1958). In Gottesman v. General Motors Corp., 268 F.2d 194 (2d Cir. 1959), a derivative action by shareholders of General Motors to recover treble damages for activities of duPont, a substantial stockholder of General Motors, which previously, in United States v. E.I. duPont de Nemours & Co., 353 U.S. 586 (1957), had been found to be in violation of the antitrust laws, the court held that it was not necessary for the plaintiffs to make a demand on the General Motors stockholders before bringing the derivative suit. One of the reasons given was "the combination of duPont's sizable ownership of General Motors stock, the number and diffusion of the remaining stockholders, and the inability under relevant state law of the shareholders as a body to cause General Motors to prosecute [the] . . . action . . . ." In addition, the court pointed out, "At best a ratification by the body of shareholders merely compels the minority shareholder plaintiffs to shift slightly the legal theories on which they rely so as to raise charges of fraud, waste of corporate assets, or the like . . . . In the instant case even this slight effect on the litigation cannot occur, since the wrongful acts alleged—violation of the antitrust laws by duPont—can in no way be ratified or rectified by a vote of the shareholders of General Motors." \textit{Id.} at 197. For other valuable recent discussion on the federal level see Marco v. Dulles, 177 F. Supp. 533, 551 (S.D.N.Y. 1959).

23. Generally speaking, the plaintiff should give the board of directors of the parent and of each subsidiary involved an opportunity to exercise its discretion to refuse to bring the action. Note, 31 N.Y.U.L. Rev. 932, 941-42 (1956); Note, 64 \textsc{Harv. L. Rev.} 1313, 1318 (1951). In addition, perhaps a similar demand on the stockholders of the parent company should be required, at least in the federal courts or in a jurisdiction which continues to follow the doctrine of Foss v. Harbottle, \textit{supra} note 22. If the parent company should control the subsidiary a similar demand on the stockholders of the latter would be superfluous, unless the vote of a majority would be ineffective due to fraud, illegality, etc. See note 22 \textit{supra}.

24. See note 18 \textit{supra}.

25. Note, 64 \textsc{Harv. L. Rev.} 1313 (1951), citing United States Lines, Inc. v. United States Lines Co., 96 F.2d 148 (2d Cir. 1938) which, since it involved a parent and subsidiary both under the common control of the defendant, is of little value on the question of minimum stock ownership.
DOUBLE DERIVATIVE SUITS

and yet it need not necessarily follow that, in every instance where a parent may bring a simple derivative action, its rights may be enforced by one of its stockholders on a double derivative basis. In fact, there may be serious policy reasons for refusing double derivative recovery where the ownership interest of the parent is minimal, either with respect to the "control" factor as regards the subsidiary or with respect to the total assets of the parent itself, as in the case of mutual funds and other investment companies. To argue that double derivative recovery should be permitted because "wrongs should be redressed" is to beg the issue. There are numerous instances in the law of derivative stockholders' suits where, for one reason or another, the plaintiff may not be entitled to sue despite the existence of a "wrong" to the corporation. It is perhaps no coincidence that a case squarely presenting the question has yet to arise, in view of the likelihood that, where one company holds an interest in another which is not substantial enough to be controlling, a bona fide determination of the board of directors of the former not to sue derivatively would normally preclude recovery on a double derivative basis. In such a situation, there is certainly not the same probability of interlocking directorates, identity of officers and directors and other elements of community of interest between the two corporations which would, in the case of a controlled subsidiary, render the board of directors of the parent an interested board of

26. Note, 31 N.Y.U.L. Rev. 932, 941 (1956). The argument recalls some of the following language of the early opinion in Holmes v. Camp, 180 App. Div. 409, 412, 167 N.Y. Supp. 840, 842 (1917): "The part which a stockholder plays in such an action is merely that of an instigator. The cause of action is that of the corporation, and the recovery must run in its favor. Under these circumstances it is not easy to see why a stockholder in a holding company may not maintain such an action for the benefit of the subsidiary company, and thus indirectly for the advantage of the holding company. His stock interest in the latter company is sufficient to relieve him from the imputation of being a mere officious and impertinent intermeddler. The free use of holding companies which has grown up in recent years would prevent the righting of many wrongs if an action like the present might not be maintained by a stockholder of a holding company." In Holmes v. Camp, supra, however, there was 97 per cent ownership of the subsidiary by the parent and hence the case does not involve the question of minimum stock ownership, except, perhaps, with regard to the stockholder plaintiff, and that does not appear material to the right to sue derivatively. Given a sufficient interest of the parent in the subsidiary, if a minimum interest should be required in this respect, there seems to be no reason to require that the stockholder plaintiff hold a similar minimum interest in the parent's stock.

27. E.g., the inability of the so-called "subsequent shareholder" to sue derivatively in many jurisdictions and also in the federal courts, where Fed. R. Civ. P. 23(b) requires an allegation that the plaintiff "was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law." Also so-called "security-for-expenses" statutes in numerous jurisdictions, which appear to codify a policy against "strike suits" by those with only a minimum interest in a corporation. -E.g., N.Y. Gen. Corp. Law § 61-b; Pa. Stat. Ann. tit. 12, § 1322 (Supp. 1960).
directors and hence not qualified to prevent double derivative recovery by its refusal to sue.

Nevertheless, in a few relatively rare instances, double derivative recovery might be allowed despite the absence of "control." Generally speaking, this would seem appropriate where the management of the parent, by refusing to sue derivatively, is exceeding the bounds of ordinary business discretion and is guilty of a breach of trust amounting to waste of the parent's corporate assets.28 In view of the wide discretion given directors in refusing to enforce corporate causes of action even where enforcement might result in some direct or indirect corporate benefit, the area in which double derivative actions should be permitted in the absence of "control" is necessarily limited, and the mere existence of a derivative cause of action which might be enforced by the parent is, in itself, obviously insufficient. Thus, for example, investment companies and mutual funds should not normally be exposed to litigation of the double derivative variety despite the existence of simple derivative causes of action with regard to particular investments in their portfolios.29 On the other hand, where the parent's directors have been clearly arbitrary or guilty of a breach of trust in refusing to sue derivatively, a double derivative action should be permitted even in the absence of "control." Although this may be nothing more than a variant of the "fiduciary" theory discussed above, unlike the cases which follow the "fiduciary" theory, the crucial factor here is the presence of potential corporate waste with regard to the parent's investment in its subsidiary rather than waste of the derivative cause of action, considered as a corporate "asset." In this regard it may resemble

28. Cf. Notes, 49 Harv. L. Rev. 1004 (1936); 34 Mich. L. Rev. 680, 684 (1936); 45 Yale L.J. 649, 666 (1936). As these authorities indicate, the line between a breach of trust and ordinary business discretion with which the courts will not interfere is not a clear one. See particularly Notes, 34 Mich. L. Rev. 680, 684 (1936) and 45 Yale L.J. 649, 666 (1936). The question of breach of trust would ordinarily be one of law, but if certain facts need be established in order that the existence of a breach of trust be determined, the question could be submitted to the fact finding body under appropriate instructions that there should in no event be a finding for the plaintiff unless the parent's directors, in refusing to bring a derivative action, were guilty of a breach of trust.

29. The worry here may be an illusory one in view of the restrictions, self-imposed or otherwise, under which such concerns customarily operate, limiting the amount which may be invested in any one security. See, for example, restrictions set forth on page 8 of the Prospectus, dated October 15, 1969, of Scudder, Stevens & Clark Common Stock Fund, Inc.: "To insure adequate diversification, no more than 5% of the value of the Fund's gross assets may be invested in the securities of any one issuer except the United States Government. The Fund may not purchase the securities of any issuer if such purchase would cause more than 10% of any class of securities of such issuer to be held in the portfolio, and may not invest in the securities of companies which, including predecessors, have not a record of at least three years of continuous operation."
DOUBLE DERIVATIVE SUITS

superficially the cases discussed in the following section, which permit direct recovery by the parent for waste of its investment, and yet the suggestion here is to permit double derivative, rather than direct recovery, as is allowed by those cases.

If the above is an acceptable solution to the question of when double derivative suits should be permitted, there is no reason why it could not be made applicable to more complex derivative actions involving triple derivatives with sub-subsidiaries and more elaborate corporate structures.30 In most instances there will be a sufficient control relationship, either one of common control by the defendant or control of one corporation by another. In the rare situation where control does not exist, the test could be made applicable to each link in the chain. Thus the initial determination is whether there is a derivative cause of action in favor of the lowest subsidiary, then whether there is a double derivative cause of action in favor of the subsidiary next highest in the chain and similarly until the rights of the plaintiff are determined.

II. SIMPLE DERIVATIVE ACTIONS ON BEHALF OF THE PARENT

As opposed to the remedy discussed in the foregoing section, which concerns a cause of action existing in favor of the subsidiary, which the stockholder of the parent may enforce on a double derivative basis, there is another theory of recovery involving a cause of action in favor of the parent, enforceable either directly by it or on a simple derivative basis by one or more of its stockholders. This is suggested by the somewhat controversial case of General Rubber Co. v. Benedict.31 There a parent corporation which owned all but eighteen shares of a Brazilian subsidiary sued one of the parent’s directors alleging that he, together with the general manager of the subsidiary, had caused funds to be wrongfully transferred from the latter to another company in which the defendant owned a twenty-five per cent interest and of which he was also vice-president. The theory of recovery was not derivative, although it was recognized that there may have been a derivative cause of action as well, but was rather that the director, by conspiring with the manager of the subsidiary to deprive it of assets, or by negligently permitting the manager to do so, had violated his fiduciary duty to

the parent to conserve its assets and to prevent a depreciation in value of the parent's investment which he might have foreseen and which, by taking appropriate measures, he could have prevented. With two justices dissenting, the New York Court of Appeals sustained the complaint on demurrer, holding, in effect, that the duty of the defendant to the parent to conserve its assets was distinct from any duty he may have had to its subsidiary and that it gave rise to a cause of action even though the subsidiary may also have been entitled to recover for the same wrong. The Court recognized the possibility of double recovery but said that this was merely a matter of estimating the damages to be recovered by the parent. Any subsequent recovery by the subsidiary would inure to the parent's benefit indirectly and consequently the existence of the subsidiary's cause of action could be taken into account in assessing the amount by which the parent's investment had depreciated in value. The extent of reduction in value was held to be a question for the jury. How the jury was to make an intelligent appraisal on such a basis was not indicated, and the court, somewhat casually it seems, disposed of the problem with the doubtfully reassuring statement that, "Whatever difficulty there is in determining the measure of the loss is inherent in the very nature of these problems of appraisal. To determine the value of the shares, every asset of the subsidiary company must be reckoned, and the defendant's liability to that company, if it exists, must be included like any other." An important part of the appraisal process then would be a jury determination of the present value of a hypothetical cause of action in favor of the subsidiary, necessitating an instruction to the jury on the law with respect to that cause of action in the same manner as would be required if the subsidiary rather than the parent had been the plaintiff. The possibilities of confusion here are obvious, since the jury is required to consider two theories of liability which, although technically distinct to a lawyer, are likely to be one and the same to laymen who have not had the good

32. Id. at 24-26, 109 N.E. at 98-99.
33. Id. at 25, 109 N.E. at 98.
34. Id. at 26, 109 N.E. at 99. The injury to the subsidiary resulted in a decrease in value of its assets. But, since the subsidiary's cause of action to recover for the injury is, in a sense, an asset, the damage sustained by the parent (i.e. the decrease in value of its shares) will obviously depend on the difference in worth of the subsidiary's cause of action and its lost assets. See Note, 64 HARV. L. REV. 1313, 1317 n.32 (1951).
35. The court by way of dictum stated that the defendant would not be liable to the subsidiary for "mere neglect" and implied that such liability would have to be based upon proof of conspiracy with the manager of the subsidiary to plunder it. Id. at 23-24, 109 N.E. at 98. See Note, 2 U. CHI. L. REV. 317, 320 n.18 (1935).
fortune to become acquainted with the subtleties of the legal mind.36

Furthermore, the reasons for permitting the plaintiff to recover directly for damage to its subsidiary are not clear. To argue that the damage referred to in the complaint is not the damage suffered by the subsidiary but rather that which has been sustained by the parent in the depreciation in value of its shares is unconvincing, for by this hypothesis any stockholder could recover directly for a corporate wrong.37 The fact that in the General Rubber case, the defendant was also a director of the plaintiff, and hence owed it a fiduciary duty, should not in itself justify direct recovery for a wrong which in reality is one against the subsidiary. The theory of the complaint evidently was that, if the defendant had informed the plaintiff of what he knew concerning the damage being done to the subsidiary, "the plaintiff could and would have taken such action as would have caused the funds and moneys . . . theretofore so misapplied to have been recovered and as would have prevented the further misapplication of said funds and moneys."38 However, as the dissenting opinion pointed out, even if this were so, the parent company would still be in a position to cause the funds to be

36. In this connection see the recent concurring opinion of Mr. Justice Bok in Fisher v. Strader, 399 Pa. 222, 225-26, 160 A.2d 203, 204-05 (1960), remarking with some distress on the "twelve-year-old mentality we ascribe in one breath to the average juror . . . [while in] another breath we expect of him prodigious feats of memory and absorption . . . and . . . douse him with a kettleful of law that would make a third-year law student blanch."

37. The instances in which direct recovery has been allowed are somewhat exceptional in nature and frequently involve situations where there is a so-called "separate duty" owed by the defendant to the plaintiff (separate from the duty owed to him as a stockholder), or where the wronged corporation is in the process of liquidation or is no longer in existence and it would be futile to permit recovery in its favor. For cases involving the "separate duty" theory, see Note, Remedies of Stockholder of Parent Corporation for Injuries to Subsidiaries, 50 Harv. L. Rev. 963, 964 n.8 (1937). For discussion of these and other situations in which direct recovery has been permitted see Ballantine, Corporations § 143 (rev. ed. 1946). Occasionally such recovery has been permitted where a derivative suit would unjustly enrich or confer some indirect benefit upon the defendant due to his being a stockholder in the corporation. See, e.g., Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955). But none of the above seem applicable to General Rubber Co. v. Benedict, 215 N.Y. 18, 109 N.E. 96 (1915) except, possibly, the "separate duty" theory. The "separate duty" involved could only arise from the fact that the defendant happened to be a director of the plaintiff corporation, since it seems clear that, absent such a relationship, he would not have been liable to it directly, even if he had been motivated by a malicious intent to injure it, unless he had intentionally caused the value of its shares to be depressed with the hope of buying them himself. See Baker & Cary, Cases and Materials on Corporations 636-37 (3d ed. 1958) and Note, 28 Harv. L. Rev. 409, 410 n.7 (1915). But, in view of the disadvantages of permitting direct rather than derivative recovery, and the evident feasibility of the latter, it is highly arguable that the "separate duty" theory should not be stretched to cover this situation, although this is precisely what the court in General Rubber Co. v. Benedict, supra seems to have done.

38. General Rubber Co. v. Benedict, supra note 37, at 29, 109 N.E. at 100 (extract from complaint quoted in dissenting opinion).
recovered through an action brought by the subsidiary or by bringing a derivative action itself.9 If such a suit would have been unsuccessful because of some defect in the cause of action of the subsidiary, there would then be no danger of double recovery, and a direct action by the parent could be allowed,40 but it certainly was not clear in the General Rubber case that the subsidiary would have been unable to recover, and it seems unwise to require a jury to prophesy the future in such a situation.41 In addition, it is of course irrelevant whether the defendant is solvent or is unable to satisfy a judgment, despite some speculation in this regard by both the majority and dissenting opinions.42 The ability of the defendant to pay should not determine the existence of a cause of action against him. If he were insolvent, there would of course be little point to the action; if he were solvent, the parent, alleged in the complaint to be in control of the subsidiary, could either cause the latter to sue or could bring a derivative suit itself. The crucial point is that the defendant should not be exposed to the possibility of double recovery and it is scarcely comforting that, in a direct action by the parent, the jury may technically be required to assess the worth of a hypothetical cause of action belonging to the subsidiary. Added to this is the risk that rights of creditors and shareholders of the subsidiary may be prejudiced by permitting the parent to recover for the impairment of its interest without direct recovery being permitted all others similarly affected. To draw a distinction between the latter and the parent on the ground that, in the General Rubber type situation, the defendant owes a fiduciary duty directly to the parent and only indirectly to the shareholders of the subsidiary (through his direct obligation to the subsidiary) seems artificial and an undue preference to the parent merely because one of its directors happened to have caused the damage. On the other hand to permit each stockholder of the subsidiary

39. Id. at 29-30, 109 N.E. at 100.
40. See Note, 2 U. CHI. L. Rev. 317, 320 n.18 (1935) and note 35 supra. If the director were found merely negligent, the subsidiary might have no cause of action against him and, accordingly, direct recovery by the parent on a theory of "separate duty" would seem unobjectionable.
41. It is assumed that, absent a "separate duty" relationship, stockholders of the subsidiary other than the parent would not be permitted to recover directly. See note 37, supra. Similarly, it is generally agreed that the rights of creditors of the subsidiary may be prejudiced in these situations. See Note, 50 Harv. L. Rev. 963, 966 (1937), raising the further possibility of a multiplicity of suits with potentially differing results, since the determination in the parent's suit of damages to the subsidiary would not be res judicata in a subsequent action by the subsidiary, nor in any action brought by one of its stockholders other than the parent.
DOUBLE DERIVATIVE SUITS

direct recovery involves all the disadvantages of a multiplicity of suits which it is the function of a derivative action to avoid.

If problems such as the above may be involved in a direct, rather than derivative, action by the parent, such a theory a fortiori should not be used to justify a derivative suit on behalf of the parent by one of its stockholders, as opposed to a double derivative action. However, if it were established that the subsidiary has no cause of action, direct recovery by the parent and, theoretically at least, a simple derivative action by a stockholder of the parent, might be appropriate. In all other cases, the parent and its stockholders should be required to bring the action on behalf of the subsidiary, which would result in a judgment in its favor, thereby eliminating the risk of double recovery and prejudice to the rights of its creditors and other shareholders.

In summary, then, although direct recovery by the parent, or simple derivative recovery on behalf of the parent by one of its stockholders, remains a distinct possibility in jurisdictions which accept the "separate duty" concept of the General Rubber case, the better remedy by far is the double derivative suit. If the subsidiary has not been harmed, or if for some reason it has no cause of action, there are by hypothesis no grounds for double derivative recovery, and consequently a suit by or on behalf of the parent would be the proper if not the only remedy.

III. INSPECTION OF BOOKS AND RECORDS OF THE SUBSIDIARY

Assuming the existence of a right to bring a double derivative action under certain conditions, of almost equal importance is the right of access to the subsidiary's books and records to ferret out wrongdoing and determine the basis for recovery. Although, if the subsidiary were a party to the action, the requisite information could be made available

43. See notes 35 and 40 supra.
44. See Notes, 50 Harv. L. Rev. 963, 966-67 (1937); 28 Harv. L. Rev. 409, 411 (1915); 2 U. Chi. L. Rev. 317, 319-20 (1935). The latter two discussions suggest an alternative solution of granting a stay with respect to the direct action by the parent, or one of its shareholders suing derivatively on its behalf, pending the determination of the subsidiary's cause of action. The same effect would be achieved by making the subsidiary a party to the action by or on behalf of the parent. See Note, 28 Harv. L. Rev. 409, 411 (1915).
45. Piccard v. Sperry Corp., 30 F. Supp. 171 (S.D.N.Y. 1939) indicates that the doctrine is still very much alive. There the court suggested that direct recovery might be available on an alternative basis in addition to a cause of action on a double derivative basis.
46. In any double derivative action, the subsidiary, as well as the parent, would normally be considered an indispensable party. See Note, 31 N.Y.U.L. Rev. 932, 940-45 (1956), discussing numerous procedural aspects of double derivative suits, including necessity of demand upon parent and subsidiary, the "contemporaneous ownership" rule, and security for costs.
by discovery proceedings, for obvious reasons it may be desirable to have access to the records in advance of bringing an action or for some purpose unrelated to a lawsuit, such as to enable a stockholder to vote his stock intelligently or to assist him in preparing a tax return.\footnote{47}

Generally speaking, what few decisions there are in this area follow the pattern established by the cases involving the right to bring a double derivative action. Thus there are a few holdings based on disregard of the corporate entity\footnote{48} as well as the concept of the subsidiary as the mere "agent" or "instrumentality" of the parent.\footnote{49} Similarly, where the latter is exclusively a holding company all of whose operational activities are carried out by one or more subsidiaries, inspection has been permitted.\footnote{50} There is no reason why a similar result should not be reached in the case of common control by the wrongdoer of both the parent and subsidiary, since this is one of the classic instances in which double derivative recovery has been allowed. Accordingly, inspection of the records of all the affiliated companies should be permitted.

In at least one respect, however, the conditions governing the right to bring an action for inspection of a subsidiary's books and records may differ from those which justify a derivative suit. As regards inspection, the parent company should obviously not be compelled to produce books and records of a subsidiary unless it is in a sufficient control relationship to insure compliance with a court order. With regard to permitting double derivative actions, the need for a criterion of "control" is not so apparent. If the two corporate entities are not disregarded, the fact that they happen to share the same offices should not determine the outcome, although this feature of the situation has occasionally been given some weight by the courts.\footnote{51} Essentially the

\footnote{47. See State ex rel. Rogers v. Sherman Oil Co., 31 Del. (1 Harr.) 570, 117 Atl. 122 (1922).}


\footnote{49. Martin v. D.B. Martin Co., supra note 48; Woodworth v. Old Second Nat'l Bank, 154 Mich. 459, 117 N.W. 893 (1908); Bailey v. Boxboard Prod. Co., 314 Pa. 45, 170 Atl. 127 (1934). See Lisle v. Shipp, supra note 48. As pointed out in the foregoing, the two theories of disregard of the corporate entity and of a subsidiary as a mere "agent" or "instrumentality" of the parent are not distinct from one another and, if anything, the latter theory is but a frequently used expression or rationalization for the former. See text accompanying note 16 supra.}

\footnote{50. State ex rel. United Brick & Tile Co. v. Wright, 339 Mo. 160, 95 S.W.2d 804 (1936).}

\footnote{51. See Martin v. D.B. Martin Co., 10 Del. Ch. 211, 88 Atl. 612 (Ch. 1913); 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 Atl. 127 (1934). Similarly, the fact that the books of the subsidiary are kept in a state different from that in which the principal
problem is one of control rather than propinquity. And here, although percentage ownership of the equity should be an important factor, it is not necessarily conclusive on the issue. Thus, in *State ex. rel. Rogers v. Sherman Oil Co.*, where X owned 94 per cent of Y, it was held that X did not have sufficient control over the affairs of its subsidiary to insure compliance with a decree for inspection. The factual situation was admittedly somewhat peculiar due to the short period of time during which X had held Y's stock, the latter having been purchased only a few months prior to the date on which the petition for inspection was filed. Since the annual meeting of stockholders to elect directors of Y had not yet been held, the court found that X had not yet attained sufficient representation on the board of directors to make its wishes felt and complied with. The holding may be somewhat unrealistic, since it seems likely that, as a practical matter, X could have exerted considerable influence over Y's directors and officers, despite the technical obstacles to a special stockholders' meeting or immediate replacement of individual directors who refused to comply, but this if anything illustrates how courts are inclined to decide each case on its own facts rather than impose a flat rule based exclusively upon the extent of the parent's interest in the subsidiary.

A possible alternative to the approach taken by the cases considered above, which involve the obligation of a parent company to make books and records of its subsidiary available for inspection, is based on the subsidiary's obligation to permit inspection by a stockholder of the parent. This could be justified in several ways. If the parent company is obligated under state or federal law to file annual or other periodic reports with some regulatory authority, or make such reports available to stockholders, and if these reports are prepared on a consolidated
basis, it is arguable that a stockholder of the parent should be permitted to inspect financial records of the consolidated enterprise since the parent and its affiliates have been treated as one economic unit, to which the stockholder must be given access in order that he may understand intelligently any part.\textsuperscript{54} The most powerful argument, however, is that if a stockholder may under certain conditions have a right to sue on a double derivative basis to enforce a subsidiary's cause of action, he should have a similar right to inspect the subsidiary's books and records.\textsuperscript{55} Although it might be a misnomer to call such a right double derivative, since, if anything it is no more than a simple derivative attempt to enforce the parent's right of inspection, it should exist under essentially the same conditions as those which determine the existence of the double derivative cause of action.\textsuperscript{56} Whether or not, in a particular situation, the two remedies are used in conjunction with one another, they should be considered as complementary and available under the same circumstances.

\textbf{IV. Conclusion}

Of the remedies available to a stockholder of a parent corporation for injuries to one or more of its subsidiaries, the most effective is the double derivative suit. Such an action should be permitted whenever the parent or wrongdoer is in control of the subsidiary or when the parent's board of directors, by refusing to sue derivatively, would be committing a breach of trust. Simple derivative suits by a stockholder of the parent on its behalf for injuries to its subsidiary should be permitted only where the subsidiary has no cause of action which can be enforced on a derivative basis. In any event, inspection of books and records of the subsidiary should be permitted a stockholder of the parent under essentially the same conditions as those which determine his right to bring a double derivative suit.

\begin{footnotes}
\item[54] This argument may be ineffective in jurisdictions where the right of inspection is restricted by statute to stockholders of record. See, \textit{e.g.}, D.C. \textsc{Code} \textsc{Ann.} § 29-920 (Supp. 1960); \textsc{Mich. Stat. Ann.} § 21.45 (1937).
\item[55] Notes, 64 \textsc{Harv. L. Rev.} 1313, 1326 (1951) and 50 \textsc{Harv. L. Rev.} 963, 968 (1937), the only sources which have been found suggesting this theory. No cases have taken this approach.
\item[56] \textit{Ibid.}
\end{footnotes}