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CONSOLIDATION OF BANKRUPTCY PROCEEDINGS AGAINST PARENT AND SUBSIDIARY CORPORATIONS

Stone, et al., v. Eacho (In re Tip Top Tailors, Inc.)[1]

Tip Top Tailors, Inc., a Delaware corporation, owned and operated eight retail stores for the purpose of conducting its made-to-measure clothing business in Georgia, New York, Ohio, Michigan, and the District of Columbia. The business was carried on in the following manner: Customers would order from samples kept in the local stores and the orders would be sent to the main office of the corporation which was located in Newark, New Jersey. The garment would be made up according to specification, sent to the store from which the order came and delivered to the customer.

[1] 127 F. (2d) 284 (C. C. A. 4th, 1942), petition for rehearing denied, 128 F. (2d) 16 (C. C. A. 4th, 1942).

In 1939 the Delaware company incorporated a subsidiary in Virginia, known as the Tip Top Tailors (Virginia), Inc. The subsidiary opened a store in Richmond and this store was operated in exactly the same manner as the other retail outlets of the parent corporation, none of which were incorporated. Only three shares of stock in the subsidiary were issued and these had a par value of one dollar and were held by nominees of the parent. Both corporations had the same officers and the subsidiary was, in effect, merely a department of the parent.

The parent company furnished the new store in Richmond and supplied it with the piece goods which were to serve as samples. All of the furnishings and fixtures were charged at cost to the subsidiary's account which was kept on the books of the parent and $900.00 was also contributed by the parent for current petty cash expenditures. Except for very small items the expenses of the Richmond store were paid by the Delaware corporation by its own check and debited on its books to the Richmond store.

On November 20, 1940, the parent corporation was adjudicated bankrupt in New Jersey. Several days later creditors of the subsidiary levied attachments on the assets in the hands of the Virginia corporation. When the receiver of the parent learned of this he immediately filed an involuntary petition in bankruptcy against the Virginia corporation seeking, as a creditor of the subsidiary, to have the latter separately adjudicated bankrupt, although the affairs of the other retail stores were being administered in the New Jersey proceedings. The District Court for the Eastern District of Virginia adjudged the subsidiary bankrupt and a trustee was appointed, whereupon the parent trustee, on behalf of the creditors of the parent company, filed a claim in the sum of $39,069.67, which figure was the debit balance of the subsidiary's account with the parent.

The amount and the factual validity of this claim were never seriously challenged but the trustee of the subsidiary argued that the corporate entity of the subsidiary should be ignored and because of the affiliation of the corporations the claim asserted by the trustee of the parent should be postponed to the claims of the local creditors. To meet this objection the parent trustee, with the permission of the New Jersey Court, filed an application for a consolidation of the subsidiary and parent proceedings, contending that if the corporate entity should be disregarded it should be disregarded for all purposes. This move for consolidation was actively seconded by intervening creditors of the parent. The dispute was referred to a special master who reported that the claim of the parent trustee should be subordinated to the claims of the Richmond creditors. The order of the District Court adopted the master's report and at the same time dismissed the application for consolidation. On appeal, the order of the District Court was reversed and the case remanded so that the Virginia proceedings could be consolidated with the New Jersey proceedings against the parent company.

The keystone of the master's report was the accepted rule that where a subsidiary corporation that is merely an instrumentality of the parent becomes insolvent, the parent will not be allowed to share *pari passu* with the other creditors of the insolvent subsidiary.[2] The master recognized the distinguishing fact that in the instant case both corporations were insolvent and the conflict was between two sets of creditors. However, the master coupled with the rule stated above the minor premise that the creditors of the parent had no greater rights than the trustee and the latter stands in the shoes of the bankrupt. From these premises flowed the conclusion that the claim filed by the parent trustee was not entitled to participation on a *pari passu* basis.

This result was reached by adopting an unduly narrow view of the parent-creditor's rights in a case such as this. If the parent had remained solvent it would be inequitable to allow it to recover its investment to the detriment of the subsidiary's creditors; and the courts have refused such recovery even where the parent company has made a capital investment in the guise of a loan. But where the parent is also insolvent there is no inequity in allowing its creditors equal participation in the assets of the subsidiary; the fact that creditors of the subsidiary may have been misled in extending credit, while operative against the one who misled them, should not be operative against the creditors of the latter. Although the report of the master was correct from the technical point of view it would have been less subject to challenge if both sets of creditors had been allowed to share on a proportionately equal basis.

The prevalence of the corporate form in general and the break-down of the economic process into its component parts with each function being performed by different

[2] 4 REMINGTON, BANKRUPTCY (4th Ed.) 344.

corporations all subject to a unified control, have resulted in a substantial body of case law dealing with the problems affected by the intercorporate relationship. One of the most common questions of this type is the "turnover" situation. Where a corporation becomes insolvent and bankruptcy or receivership proceedings are instituted, should the assets of a subsidiary be "turned over" to the trustee or receiver of the insolvent corporation? The Courts have made this question depend on whether the subsidiary is a distinct entity or merely an instrumentality of the parent. In cases where the subsidiary has no creditors, disregard of its corporate entity is largely governed by considerations of economy and facility of administration. Where the rights of subsidiary creditors are involved these considerations may still lead to a "turnover", but there is then presented the question of the proper disposition of the subsidiary's assets after they have been turned over. It is only where the parent and subsidiary are allowed to share *pari passu* in the consolidated assets that the problem involves what Professor Latty euphemistically terms "intercorporate vicarious liability".[3]

The instant case is closely related to the typical "turnover" case but it is further complicated by the diacritical element that here the parent and subsidiary were in bankruptcy *in different jurisdictions.* Where separate proceedings are instituted in the same jurisdiction against affiliated corporations the cases may be consolidated.[4] The power to consolidate in such cases is not derived from a specific section of the Bankruptcy Act; it is a general power of an equity court and is exercised mainly for the sake of expediency.

Section 32 of the Bankruptcy Act,[5] as amplified by General Order 6, gives to the court first acquiring jurisdiction power to transfer and consolidate proceedings instituted against the "same person" in different courts where the transfer will best serve the convenience of the parties in interest. These provisions are an exception to the rule that where two courts are of equal rank and exercise concurrent jurisdiction, the court first acquiring jurisdiction over the *res* shall retain exclusive jurisdiction.[6] This pro-

[3] LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS, 42-54, 142-145.

[4] In re Alaska American Fish Co., 162 F. 498 (D. C. W. D. Washington, 1908); In re Southwestern Bridge and Iron Co., 133 F. 568 (D. C. D. Kan., 1904). Cf. in re Foley, 1 F. (2d) 568 (D. C. S. D. Cal., 1924); affirmed 4 F. (2d) 154 (C. C. A. 10th, 1924).

[5] 11 U. S. C. (1934) 55.

[6] Hamilton Gas Co. v. Watters, 75 F. (2d) 176 (C. C. A. 4th, 1935).

vision of the Act has apparently been construed to authorize a transfer of proceedings to the court where the petition is first filed, although there has been no request by that court for the transfer.[7]

The Court in the instant case was impressed by the fact that the subsidiary was a mere shell, possessing a charter but having no real separate existence. Since this was so, no effect should be given to the purely formal compliance with the Virginia incorporation statutes. Consequently, the Court was faced with the situation of separate bankruptcy proceedings in different jurisdictions against the "same person". Consolidation of the Virginia proceedings with the proceedings in New Jersey (where the first petition was filed) was practically inevitable.[8]

There was a suggestion in the Court's opinion that the action of the parent trustee in filing the petition against the subsidiary was inopportune, and that it would have been preferable to petition the District Court in Virginia for the appointment of an ancillary receiver. It was stated that this might have been done even after the lower Court had assumed bankruptcy jurisdiction over the subsidiary; that, since the parent trustee was acting as an officer of the court, his action in filing the bankruptcy petition would not have worked an estoppel against him.[9]

The proceedings having been consolidated, the question of priority of claims must be determined by the New Jersey Court.[10] However, the Circuit Court of Appeals felt that the equitable result would be to let all creditors share *pari passu* in the consolidated assets.

> "But in a case such as this, where both corporations are insolvent, where the business has been transacted by and credit extended to the parent corporation, and where the subsidiary has no real separate existence whatever, there is no reason why the courts should not face the realities of the situation and ignore the subsidiary for all purposes, allowing the creditors of both corporations to share equally in the pooled assets".[11]

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[7] In re American Bond and Mortgage Co., 58 F. (2d) 379 (D. C. D. Me., 1932).

[8] Cf. Trustees System Co. v. Payne, 65 F. (2d) 103 (C. C. A. 3rd, 1933) where it was necessary for the Court to disregard the corporate entity in order to *sustain* jurisdiction.

[9] See Jackson v. Lynch, 111 F. (2d) 1003 (C. C. A. 9th, 1940), affirming In re Woodruff, 30 F. Supp. 17, cert. den. 311 U. S. 674 (1940).

[10] In this connection the Court pointed out that the Virginia creditors were free to assert their claims to priority in the New Jersey Court.

[11] *Supra*, n. 1.

The existence of subsidiary creditors affects the question of turning over the assets of the subsidiary for administration in the bankruptcy proceedings of the parent; and where the parent corporation is claiming in the bankruptcy proceedings of the subsidiary, the fact that the parent is also insolvent is an influential factor. As stated in the master's report, the general rule is that the parents claim will be subordinated to the claims of the creditors of the bankrupt if the latter is merely an instrumentality of the parent. In the celebrated *"Deep Rock"* case the test used was "fairness" instead of whether the subsidiary was a separate entity or a mere sham corporation.[12] If fairness is to be the test, the equities of the parent creditors should bar subordination of the parent's claim where the latter is insolvent.[13] Dictum by Mr. Justice Douglas in *Consolidated Rock Products Co. v. Dubois* seems to support this view.

> "To the contrary, it is well settled that where a holding company directly intervenes in the management of its subsidiaries so as to treat them as mere departments of its own enterprise, it is responsible for the obligations of those subsidiaries incurred or arising during its management. . . . We are not dealing here with a situation where other creditors of a parent company are competing with creditors of its subsidiaries."[14]

In the instant case the order of consolidation was clearly sound and it is submitted that it would be ultimately desirable to allow all creditors to share equally in the pooled assets. But the Court's preference for this result is apparently based on the supposition that the Richmond creditors had not been misled; and that there had been no reliance on the fact that the Richmond store had been separately incorporated under the laws of Virginia. There was no direct evidence on the question of reliance of local creditors.[15] The Court stressed the fact that all bills were paid by the parent. On the other hand, the corporate name of the subsidiary might well have led creditors to believe that

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[12] Taylor v. Standard Gas and Electric Co., 306 U. S. 307 (1939), noted (1941) 54 Harv. L. Rev. 1045.

[13] Rembar, *Claims Against Affiliated Companies in Reorganization* (1939) 39 Col. L. Rev. 907, 919.

[14] 312 U. S. 510, 524 (1941). This language is referred to in this connection by U. S. Circuit Judge Frank in the dissenting opinion in Geist v. Prudence Realization Corp., 122 F. (2d) 503, 508 (C. C. A. 2nd, 1941).

[15] Cf. New York Trust Co. v. Island Oil and Transport Co., 56 F. (2d) 580 (C. C. A. 2nd, 1932), where it was clear that the subsidiary creditors had relied on the credit of the parent.

it was an independent Virginia corporation. However, the Court's preference may be supported by a different principle. The fact that one group of creditors was misled should not afford them priority over another group, equally innocent.