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David C. Bayne, S.J.

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THE DEEP ROCK DOCTRINE RECONSIDERED, II*

DAVID C. BAYNE, S.J.†

THE detailed factual delineation, the step-by-step progression through the Deep Rock litigation, and the analysis of the adjudication from the aspect of its intrinsic reasonableness have laid a broad foundation for a consideration in the remaining pages of the full implications of the opinion as a formulated doctrine to be applied by the courts as a precedent.

Any difficulty attendant on possible factual obscurity has been removed. The study of the adjudication has yielded an understanding of the duty of the Court as a court of equity: full justice to all parties. The question before the Court was clear: the claim, the counter-claim and the over-all equity. Analysis of the opinion has led to the conclusion that the Court proceeded from well-reasoned ultimate factual determinations, indicating an application in its full force of the Instrumentality Principle, to what, it has been submitted, is a repudiation of that principle, or at the least a failure to carry it through to its reasonable conclusion. This was the principal point of the early parts of this commentary.

These are the materials from which to produce an evaluation of the Deep Rock decision as a doctrine. Yet it should not be understood that all these materials are of equal importance. The central point of the Deep Rock adjudication must remain the allowance of the Standard claim in the face of the general indicia pointing to disallowance, and the misposition of that claim behind the publicly held preferred stock, but ahead of the publicly held common stock.

PART IV: DEEP ROCK AS A DOCTRINE

Logical procedure would demand at this point a definition of the doctrine. Since the very burden of this study will result in that definition, something tentative must suffice.

Of interest to this purpose is the definition of Professor Berle.¹⁴⁸ After enumerating the traditional requisites for breach of the corporate veil, Professor Berle instances Deep Rock as a case where courts will, in order to protect the public shareholders of a subsidiary, disregard the

† Member of the District of Columbia Bar.

* This is the second of two articles by Mr. Bayne on the *Deep Rock* case. The first article contained: PART I: ANTECEDENTS; PART II: LITIGATION and PART III: ANALYSIS OF THE ADJUDICATION. This article contains PART IV: DEEP ROCK AS A DOCTRINE and PART V: SUBSEQUENT HISTORY OF THE DOCTRINE, AND CONCLUSION.

148. BERLE AND WARREN, *CASES AND MATERIALS ON THE LAW OF BUSINESS ORGANIZATIONS (CORPORATIONS)* 155, 156 (1947).

corporate entity. In this definition, moreover, there is no mention of either allowance of the parent's claim nor its misposition ahead of the common stockholders, but simply subordination of a debt due the parent (the validity of the claim is presumed) to the claims of the preferred shareholders. It is quite obvious that Professor Berle regards, or would like to regard, the Deep Rock doctrine as an elaboration of the Instrumentality Doctrine.¹⁴⁹ It is grouped in that category in his book and defined as such above. Since Professor Berle is not alone in his desire to group Deep Rock with the traditional instrumentality cases, a short review of the instrumentality tradition may place the Deep Rock case in proper perspective.

Before Deep Rock—The Instrumentality Cases

Deep-rooted in the law of corporations is the theory of separate corporate entity. The corporation is a juridical person, possessed of its own individuating notes, character and personality. It is "a fictitious personality with independent entity."¹⁵⁰ In accordance with the classic statement, of which that contained in *Salomon v. A. Salomon & Co.*,¹⁵¹ is typical, the corporation has always been regarded as a "legal entity distinct from . . . the then members who composed it. . . . The company is *ex hypothesi* a distinct legal persona."¹⁵²

From the very fact that this distinct corporate entity is a legal fiction, it follows that there will be times when the continued use of that fiction must result in inequity. Many such occasions have manifested themselves. They have taken on different guises, but the courts have had the tendency to group their designation under the one, or a kindred, title: "disregard of the corporate entity".

What this concept comes down to is a generalization deduced from many particularizations, an attempt at a universal rule of equity. It has been called a fiction oddly employed to look through a fiction. This may be one good way of designating it. Actually the many variations of conditions under which equity demands that the corporate fiction be ignored render a generalization difficult, but at the same time such a general rule is altogether possible.

Thus there are certain conditions and results that are always present in these cases of "piercing the corporate veil."¹⁵³ Where the parent

149. Professor Berle is far more circumspect in his article, Berle, *The Theory of Enterprise Entity*, 47 COL. L. REV. 343 (1947). But the same stand on the Deep Rock doctrine is present.

150. BERLE AND WARREN, *op. cit. supra* note 148, at 156.

151. [1897] A. C. 22. See also *Broderip v. Salomon*, [1895] 2 Ch. 323.

152. *Salomon v. A. Salomon & Co.*, [1897] A. C. 22, 42.

153. WORMSER, *THE DISREGARD OF CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS* 42 (1927).

corporation has set up a subsidiary as a mere front, a dummy, the veil will be pierced and the parent will be held liable for its own actions performed under the guise of its instrumentality. The indicia detailed so elaborately by the Court in the Deep Rock case result in identity and hence generally in liability of the parent.¹⁵⁴ On this the textwriters are in accord. For instance "the parent corporation will be responsible for the obligations of its subsidiary";¹⁵⁵ "liability is imposed to reach an equitable result";¹⁵⁶ "the courts disregard the corporate entity at least to the extent of attaching the liabilities of the corporation to the person or corporation really furnishing the basic assets and operation."¹⁵⁷

The instance which is generally accepted as one of the first applications of this theory is *In re Watertown Paper Co.*¹⁵⁸ There the court expressed the rule to the effect that the corporate entity may be disregarded where a corporation is so organized and controlled, or its affairs so conducted as to make it merely an instrumentality or adjunct of another corporation. Since that day in 1909, the courts have followed with a continuous series of such adjudications reducible to the general rule already noted. In the well known *Chicago, M. & St. Paul Ry. v. Minnesota Civic Ass'n*¹⁵⁹ the Court stated that where stock ownership has been used for the purpose of controlling a subsidiary company as a mere agency or instrumentality, the courts will not permit themselves to be deceived by mere forms of law, but, regardless of fictions, will deal with the substance of the transaction involved as if the corporate agency did not exist and as justice may require.

Mention need be made of only a few other decisions to illustrate the principle.¹⁶⁰ In 1920 the Circuit Court disregarded the corporate entity

154. The important element in the word "liability" as used in this context is responsibility. That might have been a better word to have used throughout. Thus it is really responsibility for one's own acts regardless of whither or to whom the responsibility flows. The "whither and to whom" is determined after responsibility is first determined through identity. The responsibility in one case might flow to third party creditors, in another to tort claimants, and so on, whereas in Deep Rock the responsibility of Standard for acts done *nomine* Deep Rock would accrue to Deep Rock creditors, but also and more so to the public shareholders of Deep Rock's stock. The responsibility to third party creditors is not essentially different from the liability to third party minority public shareholders. Thus the order of progression in enunciating this doctrine would be this: first, identity of corporations; second, responsibility for acts and duties; third, determination of the nature and direction of such responsibilities.

155. POWELL, PARENT AND SUBSIDIARY CORPORATIONS 8 (1931).

156. LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 191 (1936).

157. BERLE AND WARREN, *op. cit. supra* note 148, at 155.

158. 169 Fed. 252, 256 (2d Cir. 1909).

159. 247 U. S. 490 (1918).

160. The more outstanding cases in the instrumentality tradition are: *Davis v. Alexander*, 269 U. S. 114 (1925); *United States v. Reading Co.*, 253 U. S. 26 (1920); *Hart Steel*

in *Luckenbach Steamship Co. v. W. R. Grace & Co.*¹⁶¹ Luckenbach owned 94% of the Luckenbach Steamship Company and 90% of the Luckenbach Company. Hence both were controlled by the same shareholders. What the court did was to hold the Luckenbach Company liable for a default of the Steamship Company on a contract for freight carriage. Actually there was no evidence of direct intervention, either in general or in the particular instance involved in the litigation. But the Luckenbach Company, with a capital of \$800,000, owned and leased eight or nine steamers, worth hundreds of thousands of dollars, to the Steamship Company which had a capital of only \$10,000. The rentals were far less than the actual rental value of the ships. The result? The courts held the companies "identical" concluding that for all practical purposes the two were one and that it would be unconscionable to allow the owner of a fleet of steamers worth millions of dollars to escape liability because it had turned them over a year before to a \$10,000 corporation, which was simply itself in another form. The similarity in expression, and the identity in concept, between the words of the Circuit Court and the words of Judge Bratton in the Circuit Court dissent in *Deep Rock* demand remark: ". . . the assertion of a claim in such circumstances amounts to the presentation of a claim against itself. . . ."¹⁶² The *Luckenbach* case presents a simple form of the usual procedure. Shorn of the complexities of *Deep Rock* it illustrates the principle and points clearly to the requisite equitable outcome.

*Wallace v. Tulsa Yellow Cab Taxi & Baggage Co.*¹⁶³ was an instance where the facts indicated instrumentality and consequent responsibility. The plaintiff sought and recovered a \$7,000 judgment in tort for a personal injury received from a cab operated under the name of the Yellow Cab Service Company. But the judgment was not collectible. The Yellow Cab Service Company had no realizable assets. In fact it had gone out of business, and the good-will, assets and business were now in the hands of the Tulsa Yellow Cab Taxi & Baggage Company. When the facts came out it appeared that the Yellow Cab Service Company had been incorporated with only \$1,000 in capital to remove the necessity of public liability insurance on the part of the already operating Tulsa Company. This kept the substantial assets of the Tulsa Company out of the way and left the depleted treasury of the Yellow Cab Service

Co. v. Railroad Sup. Co., 244 U. S. 294 (1917); *United States v. Delaware L. & W. R.R.*, 238 U. S. 516 (1915); *United States v. Lehigh Valley R.R.*, 220 U. S. 257 (1911); *McCaskill Co. v. United States*, 216 U. S. 504 (1910).

161. 267 Fed. 676 (4th Cir. 1920), *cert. denied*, 254 U. S. 644 (1920).

162. *Taylor v. Standard Gas & Electric Co.*, 96 F. 2d 693, 703 (10th Cir. 1938).

163. 178 Okla. 15, 61 P. 2d 645 (1936).

Company as the only source of satisfaction of tort losses. The court remarked upon the substantial assets in the one, the total lack of assets in the other, and outlined the obvious unity of the two. It declared that the absolute control of the new corporation remained in the old through its power to cancel the lease and take back the property necessary for operation. This was a question of fact, not law. Since the new corporation was a mere instrumentality of the old, the court stated its duty to look beyond the form to the substance of the transactions involved. The fiction of separate legal entity was disregarded and the two corporations were held to constitute but a single entity, with the liability on the parent. In *Telis v. Telis*¹⁶⁴ the defendant conveyed his property to a dummy corporation which he had set up for the purpose of defeating his wife's dower rights. The court refused to permit this and awarded the wife her statutory right of dower in the premises. Here the responsibility, once determined, flowed in a different manner, but nonetheless flowed.

In all of these decisions we find the same reasoning: first, identity of stockholder and corporation; second, responsibility for acts and duties; third, determination of the nature and direction of such responsibilities. This is the logical sequence in these cases. The clear holding of the Supreme Court of the United States in *Consolidated Rock Products Co. v. DuBois*¹⁶⁵ is noteworthy. In that case there had been a unified operation of the several properties of the parent, Consolidated, pursuant to an operating agreement, resulting in extensive commingling of assets. All management functions of the several companies were assumed by the parent. The subsidiaries abdicated their independent existence and Consolidated operated them as mere departments of its own business, without the formalities of separate corporate organizations, except in minor particulars such as the maintenance of certain separate accounts. In view of these facts, the Court held that Consolidated was in no position to claim that its assets were insulated from claims of creditors of the subsidiaries. The Court stated:

"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. . . . A holding company which assumes to treat the properties of its subsidiaries as its own cannot take the benefits of direct management without the burdens."¹⁶⁶

The tradition of the instrumentality cases would seem to indicate in

164. 132 N. J. Eq. 25, 26 A. 2d 249 (Ct. Err. & App. 1942).

165. 312 U. S. 510 (1941).

166. *Id.* at 524.

a case such as Deep Rock full liability of parent, disallowance of the parent's claim and allowance of the subsidiary's counterclaim, without the unintelligible misposition of the parent's claim and the exclusion of the minority common shareholders. Yet the conclusion in Deep Rock was surely otherwise. It is submitted that the Deep Rock decision impugns the instrumentality tradition, or at least fails to follow the tradition in its full logic. Merely to prove that Deep Rock is not an advance in the equitable instrumentality theory is alone insufficient to warrant its abandonment as a doctrine, although certainly this argument is suasive. Ultimately, the reason for rejection of the doctrine must be reducible to some form of illogicality. In a sentence, Deep Rock impugns the Instrumentality Principle because of its basic illogicality and it should be abandoned as a doctrine because this basic illogicality results in essential unpredictability.

Basic Illogicality

When a given process of reasoning is actually illogical, is a progression from known acknowledged premises to inconsequent conclusions, that reasoning process is unsound. When this particular instance of reasoning is subjected to a generalization and accepted as a universal principle for general application, that principle must perforce be also unsound. If the action of the Court in Deep Rock is intrinsically illogical the rule deduced from this instance will also be intrinsically illogical.

As illustration and corroboration of this thesis some hypothetical applications of the Deep Rock doctrine should be helpful as a prelude to a discussion of its actual application by the courts. Consider the instance where the parent is just crafty enough to eliminate all open account book claims, is foresighted enough to secure all claims with valuable assets and hence is never under the necessity to come into court with any unsecured claim. The force of the Deep Rock doctrine would be *nil*. Or, suppose that the parent had an extensive bona fide claim of say \$10,000,000 and had milked the subsidiary only to the small extent of a few thousand dollars, then would not an exact application of the Deep Rock doctrine be unjustly punitive of the parent? Further, picture something more similar to Deep Rock itself: no assets in the defunct subsidiary, and a counterclaim against the parent in the amount of \$100,000,000. With a claim of the parent of \$1,000,000 and outstanding preferred stock of \$101,000,000, the court subordinates the parent's claim to that of the preferred stock. Result: the parent loses the \$1,000,000 claim and the \$100,000,000 counterclaim is ignored.

Furthermore, all these examples ignore the plight of publicly held minority common stock. Consider only the one instance where the

common stock amounts to \$2,000,000 and the preferred stock to \$1,000,000 against \$2,000,000 in assets. Into this picture comes the parent with a claim of \$1,000,000 and a record of illicit and dominated activity resulting in a spoliation of the subsidiary in the amount of \$2,000,000. The Deep Rock decision would appear to allow the parent's claim, equal to the assets, ahead of the common stock. If the court, however, disallowed the parent's claim and ordered its assumption of responsibility for the \$2,000,000 in milkings, the common stock would be paid in full.

Uncertain Predictability

The unpredictability of the Deep Rock doctrine comes down to this, that the mind of man cannot logically reenact under different facts an illogical procedure. That is why there is uncertainty about the application of the so-called doctrine and that is why no one can predict what will come of the next attempt. In the end the best evidence of this unpredictability, and ultimately of the root illogicality of the doctrine, is the action of the courts in handling the concept embodied in the Deep Rock opinion. Complementary to this evidence derived from judicial decisions is the treatment accorded the doctrine by the writers and legal commentators. Moreover, analysis of what later courts did to the doctrine and what writers thought of it rounds out into an historical whole the treatment begun with the study of a few of the decisions antedating the Deep Rock.

PART V: SUBSEQUENT HISTORY OF THE DOCTRINE, AND CONCLUSION

The Courts and the Doctrine

In the eleven years since the Supreme Court brought forth the Deep Rock doctrine the higher federal courts have had resort to the Supreme Court's opinion approximately fifty times. Standing back from these later opinions a view of the Deep Rock doctrine in practical application can be held up next to the view of Deep Rock already outlined in theory, and the two views might well fit into the sides of a stereoscope. In retrospect what do these federal court opinions yield? Of the roughly fifty occasions on which mention was made of Deep Rock by the higher federal courts—The Supreme and Circuit Courts—about half of the references were confined to strictly collateral points. The opinions containing these references do not warrant detailed consideration. Of the remaining twenty-seven, categorization is indeed difficult. Roughly ten of these decisions prescind altogether from any niceties and simply called on Deep Rock for support for the old-line Instrumentality Principle. They grouped Deep Rock with such traditional authorities for

the Instrumentality Rule as *United States v. Lehigh Valley R.R.*,¹⁶⁷ *United States v. Reading Co.*,¹⁶⁸ the *Watertown*¹⁶⁹ and *Chicago Railroad*¹⁷⁰ cases. This is not difficult to understand, since a cursory reading, with no studied advertence to the conclusions reached, might conceivably leave the impression that the Deep Rock opinion does support the Instrumentality Principle. Moreover, the use in Deep Rock of the indicia of instrumentality and all of the preliminary instrumentality discussion might understandably be cited by an unwary court, in spite of the fact that later in the opinion the Supreme Court did not succeed in applying the principle at all.

The remaining seventeen opinions could well be called a hodge-podge. They represent the expressions of those judges who apparently had occasion to consider Deep Rock carefully and who appeared to take the decision for a variety of things, or adjudicated in a spirit clearly contrary to the doctrine. Of these, those *contra in spirit* predominate substantially. This predominance of cases *contra in spirit* is most important. The final box-score:¹⁷¹ Instrumentality Principle: ten; *contra in spirit*: eight; variation tantamount to straight equity: five; doubtful: four.

The Supreme Court

There have been eight Supreme Court opinions which have resorted to Deep Rock for one reason or another. These opinions began in 1939¹⁷² and extend to 1948.¹⁷³ Of these eight, four could be said to be implicitly and indirectly *contra* to Deep Rock.¹⁷⁴ Two used Deep Rock simply as an indication of the broad powers of the bankruptcy court,¹⁷⁵ and the other two merely mentioned the case.¹⁷⁶ None made use of the "doctrine." None made use of Deep Rock for the decision of the case at bar.

167. *United States v. Lehigh Valley R.R.*, 220 U. S. 257 (1911).

168. *United States v. Reading Co.*, 253 U. S. 26 (1920).

169. *In re Watertown Paper Co.*, 169 Fed. 252 (2d Cir. 1909).

170. *Chicago, M. & St. Paul Ry. v. Minn. Civic Ass'n*, 247 U. S. 490 (1918).

171. It should be unnecessary to say that such blanket summaries are hazardous at best, but this risk is offset by the deduced over-all impression. Further, when the more detailed analysis is mulled over, the conspectus above presented can be independently evaluated.

172. *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106 (1939).

173. *Comstock v. Group of Institutional Investors*, 335 U. S. 211 (1948).

174. *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106 (1939); *Pepper v. Litton*, 308 U. S. 295 (1939); *Consolidated Rock Products Co. v. DuBois*, 312 U. S. 510 (1941); and *Comstock v. Group of Institutional Investors*, 335 U. S. 211 (1948).

175. *American Ins. Co. v. Avon Park*, 311 U. S. 138 (1940); and *Sampsell v. Imperial Paper Corp.*, 313 U. S. 215 (1941).

176. *Prudence Corp. v. Geist*, 316 U. S. 89 (1942); and *Heiser v. Woodruff*, 327 U. S. 726 (1946).

The first Supreme Court decision citing Deep Rock was *Case v. Los Angeles Lumber Products Co.*¹⁷⁷ For the purposes of this study the *Case* opinion comes first felicitously. It inveighs militantly against subordination;¹⁷⁸ it restates the "fixed principle" of absolute priorities of interested parties in corporate reorganizations, and it links up well with *Consolidated Rock Products Co. v. DuBois*.¹⁷⁹ The spirit is *contra* to Deep Rock. Inasmuch as the general philosophy of the *Case* opinion was contrary to that of Deep Rock, it is understandable that any explicit reference to Deep Rock would have to be on a collateral point. The Court could not well cite Deep Rock as authority for the usual absolute priorities principle, or for denial of any subordination. For this reason the actual reference to Deep Rock is used to support the Court's action in rejecting a plan of reorganization, which had already been approved by the requisite number of interested parties, on the ground that the preferred stock of the debtor corporation was inequitably treated under the plan; merely because the vast majority of the security holders have approved the plan is not the test of whether the plan is a fair and equitable one. This was a valid citation and no one would deny that Deep Rock stands for that much. The point, however, in any long-range evaluation of Deep Rock, is that many other decisions stand for the same thing and it is far and away from judicious to let the questionable logic of Deep Rock persist merely to serve as such minor assistance to the courts.

This was the Court's direct reference to Deep Rock. The indirect references are more interesting. Citing *Louisville Trust Co. v. Louisville, A. & C. Ry.*,¹⁸⁰ the Court in the *Case* opinion affirmed the "familiar rule" that the stockholder's interest in corporate property is subordinate to the rights of creditors, first of secured and then of unsecured creditors, and that any arrangement of the parties by which the subordinate rights of stockholders are attempted to be secured at the expense of the prior rights of either class of creditors is untenable.

177. 308 U. S. 106 (1939).

178. The use of the term "subordination" can be confusing. When used to signify the hierarchical allocation of position pursuant to the traditional norms of priority in bankruptcy or reorganization the act described by the term is consistent with good law. When the term signifies the misposition of a security contrary to the traditional priorities, as is the case in Deep Rock, the practice is reprobated, as by the *Case* opinion. Furthermore the variety of human circumstances makes it impossible to preclude the possibility of an instance arising in which a certain form of subordination of one interest to another must be effected to do justice, but such a case is not here referred to. In short, whenever the term is used here it is referable to the specific type of subordination universalized as a result of the Deep Rock opinion.

179. 312 U. S. 510 (1941).

180. 174 U. S. 674 (1899).

It is interesting to reflect on the different result in Deep Rock had the misposition of the Standard claim never been made. Had the Court been forced to regard Standard as a real creditor perhaps the Court would have hesitated at leaving Standard not only unscathed by the counterclaim but collecting before the preferred stock. Had one illogicality—the denial of the millions in counterclaim—not been covered up by another—the misposition of the claim—the Court might have abandoned both for the rationality of allowance of the counterclaim. As little as the scrap of bread of subordination was, superficially it looked fairly decent, and it succeeded apparently in satisfying many who later read the Deep Rock opinion. In fine, the *Case* opinion decried such subordination and much of the principle of Deep Rock. It should be cited as the first in a series of opinions that are to condemn the principles of Deep Rock. The undermining of these principles may appear erosive in a fleet observation, but actually the courts have said as much against Deep Rock by simply contrary adjudication and rather bald implication as has the elucidation of the theory in these pages. That this, in general, is not entirely conscious or by advertence appears to be manifest, since it would seem that otherwise the courts would refrain from citing Deep Rock even for remotely collateral points.

Within the same year as Deep Rock, but in the following term, Mr. Justice Douglas, who was seated after Deep Rock, wrote the opinion in *Pepper v. Litton*.¹⁸¹ The first words of the opinion refer to the question of the power of the bankruptcy court to “. . . disallow either as a secured or as a general or unsecured claim a judgment obtained by the dominant controlling stockholder of the bankrupt corporation on *alleged salary* claims.”¹⁸² Even before the facts of the *Pepper* case are known, it will pay to consider these opening phrases, for in them lies the sole reason for the citation of Deep Rock. The Court desired support for the broad, equitable jurisdiction of the court of bankruptcy. It claimed the power and duty to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. The Court felt its duty was especially clear when the claim seeking allowance accrued to the benefit of an officer, director or stockholder. It referred directly to Deep Rock:

“In *Taylor v. Standard Gas & Electric Co.*, 306 U. S. 307, this Court held that the claim of Standard against its subsidiary (admittedly a claim due and owing) should be allowed to participate in the reorganization plan of the subsidiary only in subordination to the preferred stock of the subsidiary. This was based on the equities of the case. . . .”¹⁸³

181. 308 U. S. 295 (1939).

182. *Id.* at 296 (italics supplied).

183. *Id.* at 308.

The Court went on to list the other types of equitable action permissible to a court of bankruptcy. There has been mention of Deep Rock, but it has been only for the purpose of indicating the broad powers of the bankruptcy court as a court of equity. Hence, so far as it touches directly on Deep Rock, the opinion in the *Pepper* case, first, uses it only for collateral substantiation of equitable powers, and second, indicates where Deep Rock was deficient in not, itself, exercising full equitable powers—but this by implication only.

The words in the *Pepper* case opinion concern themselves only with disallowance of the claim. Actually that is all that was done. Litton was a one-man corporation, the Dixie Splint Coal Company. Pepper had money due him from this corporation for rentals and sought an accounting by suit in the state court of Virginia. Litton leaped in ahead of Pepper and had his corporation confess judgment in favor of himself in the amount of about \$33,000 allegedly due as salary over a five year period. If Litton's judgment were paid there would be no assets remaining at all for satisfaction of the Pepper rentals. There were other details whereby Litton safeguarded his \$33,000, but these were the essential facts. Such facts take the case essentially out of the pale of Deep Rock. Litton was a one-man corporation, hence once the rentals due Pepper were paid it really did not matter what happened to the corporation. The only creditor defrauded was the one claimant; so mere disallowance of Litton's claim would satisfy. There were no other claims which would demand a further definite contribution by Litton to make such claimants whole.

It is submitted that everything in the *Pepper* case points to a line of reasoning exactly opposite to Deep Rock. Had Pepper been owed a great sum which could only be satisfied by a contribution from the sole stockholder, all indications are that the Court would have ordered just such a contribution.

"He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. . . . Where there is a violation of these principles, equity will undo the wrong. . . ."184

Intrinsically the *Pepper* case belonged in the line of the traditional instrumentality cases. This was evident *passim* throughout the opinion, and in the basic result of the decision.

The third reference to Deep Rock came in 1940 in *American Insurance*

184. *Id.* at 311.

Co. v. Avon Park.¹⁸⁵ The reference was brief and on a collateral point. It served as a further reminder of the full equitable powers of the court and of the duty of full justice to all parties. The Court claimed power ample for the exigencies of varying situations, not dependent on express statutory provisions and inherent in the jurisdiction of a court of bankruptcy. This is a frequent use for Deep Rock. Clearly Deep Rock indicated the possession and presence of the power. Just as clearly did it indicate its abuse rather than proper use. Beyond this reference to the powers of the bankruptcy court, the *American Insurance Co.* case did not mention Deep Rock. Nor was there further that could be of interest to this study.

The *Consolidated* case¹⁸⁶ was next, and came in 1941. The principles of this decision weigh heavily against the Deep Rock doctrine. First, it rebutted, *in effect*, disallowance of the Deep Rock counterclaim by an admission of the feasibility of arriving at the amount of a claim of a subsidiary against the parent.¹⁸⁷ It saw no barriers to valuation and enforcement of the subsidiary's claim and declared that equity would not permit a holding company, which has dominated and controlled its subsidiaries, to escape or reduce its liability to those subsidiaries because of difficulty and expense in establishing the claim. Second, it also asserted the power of the bankruptcy court as a court of equity to adjudicate all of the issues pertinent to the claim. This was another implicit thrust at the truncated disposition of the Deep Rock issues. Third, it openly condemned subordination. Not only did it indicate the full ability of the court of equity to estimate and allow the claim of the subsidiary against the parent, but it specifically forbade misposition.¹⁸⁸ Fourth, it placed the decision in the line of cases following the traditional Instrumentality Principle and indirectly added another point against the Deep Rock doctrine. (This point was discussed when treating the *Consolidated* case in the instrumentality line.) The Court stressed the point that a holding company which assumes to treat the properties of its subsidiaries as its own cannot take the benefits of direct management without the burdens. Standard's burden was the amount of the counterclaim. And what of the actual mention of Deep Rock? Again, of necessity it had to be on a collateral and relatively unimportant point. There could be no direct citation of a decision so diametrically opposed

185. 311 U. S. 138 (1940).

186. *Consolidated Rock Products Co. v. DuBois*, 312 U. S. 510, 521, 522 (1941).

187. In the *Deep Rock* case the courts in effect disallowed Deep Rock's counterclaim against Standard by the simple process of ignoring it. Despite the fact that the counterclaim was urged upon the courts, no opportunity appears to have been afforded to prove it. No audit was ordered although the situation seemed to call for an investigation.

188. *Consolidated Rock Products Co. v. DuBois*, 312 U. S. 510, 527 (1941).

in spirit to the decision in hand. Mr. Justice Douglas cited Deep Rock for the very general proposition that a holding company had fiduciary duties to security holders. This was a point that hardly required Deep Rock for support.

In the *Consolidated* case, beyond the one, lone direct citation, all goes *contra* in tone to Deep Rock. It admits of the possibility of estimating and evaluating the claim against the parent; it stressed the equity power to do full justice, it condemned subordination; and it applied the Instrumentality Principle in achieving equities for all parties. All these factors lead to the conclusion that *Consolidated* is outstanding in this study for its off-set value as the antithesis of Deep Rock. It affords a fine example of what the Court might have done in Deep Rock.

There remain only two lesser instances of resort to Deep Rock in this treatment of the Supreme Court adjudications before we consider *Comstock v. Group of Institutional Investors*.¹⁸⁹ Both were on collateral matters, and both served their turn in eating away at the Deep Rock doctrine. The first of these last two cases—*Sampsel v. Imperial Paper Co.*¹⁹⁰—was the fifth instance of reference to Deep Rock by the Supreme Court. It stated that the powers of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors were complete. It added that the theme of the Bankruptcy Act is equality of distribution. Then it cited Deep Rock. The equality of distribution is a point in which Deep Rock suffered by comparison. The second of these two cases of lesser importance is *Prudence Corp. v. Geist*.¹⁹¹ It came in 1942. This time the Court adverted directly to the power of subordination. The Court did not condemn the practice, but merely stated that it was unnecessary for the Court to apply it; another instance where the Court quietly avoids the application of the "doctrine". There cannot be said to be any explicit repudiation in this avoidance, but in the light of the general treatment accorded Deep Rock by the Supreme Court it can be instanced as more of the erosive process by which the "doctrine" has been undermined. There was no further reference in the *Prudence Corp.* case to Deep Rock.

The Comstock Case

From most aspects *Comstock v. Group of Institutional Investors*¹⁹² is the leading commentary on the Deep Rock doctrine in both Supreme and Circuit Courts. The *Comstock* case can be said (1) to epitomize the

189. 335 U. S. 211 (1948).

190. 313 U. S. 215, 219 (1941).

191. 316 U. S. 89, 93 (1942).

192. 335 U. S. 211 (1948).

general uncertainty surrounding Deep Rock; (2) to attempt, albeit inadvertently, to change its original meaning; (3) to exemplify the questionable logic and uncertain predictability at the base of the Deep Rock opinion. The Court split five to four in the *Comstock* case and there is essential variance throughout between the majority and the dissent.

The Majority in Comstock. The majority of the Court refused to review the findings of fact made by the District Court¹⁹³ and affirmed by the Circuit Court of Appeals,¹⁹⁴ relying upon the settled rule that the Supreme Court will not review concurrent findings of two courts below in the absence of a very exceptional showing of error.¹⁹⁵ The facts were that since 1933 the Missouri Pacific Railroad Company (MOPAC) and its subsidiary, the New Orleans, Texas and Mexico Railway Company (NOTM), plus many affiliates, had been in reorganization under Section 77 of the then National Bankruptcy Act. A second plan of reorganization was approved by the Interstate Commerce Commission and in 1944 was before the District Court for the Eastern District of Missouri when Comstock objected to the allowance of a claim of about \$10,500,000 by MOPAC against NOTM.

At all times MOPAC controlled NOTM by majority ownership of the sole NOTM issue of capital stock and managed NOTM through common officers. Throughout an expansion program MOPAC made advances to NOTM and with the permission of the Interstate Commerce Commission NOTM issued to MOPAC notes in excess of \$10,000,000, which were in turn pledged by MOPAC to the Reconstruction Finance Corporation. This was the claim to which Comstock objected. Comstock was the holder of some of MOPAC's 5¼% Secured Serial Bonds, which aggregated \$13,000,000 and which were secured by the pledge of NOTM stock in equal face value. Thus Comstock had an interest in the stock of NOTM and its assets which MOPAC's claim, if allowed, would deplete. He objected to the plan on the ground of MOPAC's mismanagement and more specifically charged that MOPAC caused NOTM to pay dividends out of capital and improvidently to declare and pay dividends unjustified by NOTM's condition and business and that MOPAC made loans to NOTM in order to enable NOTM to pay dividends to MOPAC and caused a NOTM indebtedness growing out of the expansion. Comstock prayed that MOPAC's claim be either disallowed or subordinated to the NOTM stock interest.

In a broad consideration of the entire case the majority of the Supreme

193. *In re Missouri Pac. R.R.*, 64 F. Supp. 64 (1945).

194. *Comstock v. Group of Institutional Investors*, 163 F. 2d 350 (1947).

195. *United States v. Dickinson*, 331 U. S. 745 (1947); *Stuart v. Hayden*, 169 U. S. 1 (1898).

Court agreed with the District and Circuit Courts that, while MOPAC controlled NORM, MOPAC's claim "was the outgrowth of complicated but legitimate good faith business transactions, neither in design or effect producing injury to the petitioner or the interests for which he speaks."¹⁹⁶ In specific reference to the dividends paid to MOPAC, in the face of contemporary loans by MOPAC to NORM in substantially the same amounts, the majority referred to the findings of good faith and the fact that the dividends were paid out of earnings or surplus.

Concerning Deep Rock the majority said:

"In that case this Court reformulated for application to reorganization cases a wholesome equity doctrine to the effect that a claim against a debtor subsidiary be disallowed or at least subordinated when the claimant corporation has wholly dominated and controlled the subsidiary and in the transactions creating the debt has breached its fiduciary duty and acted both to its own benefit and to the detriment of the debtor. As we later said of the decision, 'This was based on the equities of the case—the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors.' *Pepper v. Litton*, 308 U. S. 295, 308."¹⁹⁷

The holding of the majority moves the *Comstock* case outside the pale of comparison with Deep Rock and hence any reference to Deep Rock must necessarily have been *obiter*. Set off against the history of spoliation in Deep Rock the facts as accepted by the majority in the *Comstock* case indicate complete good faith and actual benefit to the entire railroad system, including NORM. Added to the absence of such factual similarity the following points should be noted: (1) in Deep Rock the Standard claim was never adjudicated on the merits; in *Comstock* all three courts state that MOPAC's claim was valid; (2) in Deep Rock Standard's claim was actually allowed; in *Comstock* the main plea was for disallowance which could never follow under the Deep Rock holding in any event; (3) in Deep Rock there was the inexplicable position of the allowed Standard claim ahead of the common stock and behind the preferred; in *Comstock* there was only one type of stock and hence misposition could not be similarly effected. Subordination would actually be disallowance; (4) NORM had no counterclaim against MOPAC.

All of these considerations disclose the inapplicability of the Deep Rock decision. However, the *obiter* discussion of the majority indicates conflict with the Deep Rock doctrine. The first notable conflict is in the matter of the validity of the parent's claim. The Court takes pains

196. 335 U. S. 211, 229 (1948).

197. *Id.* at 228.

to point out that the claim was rightly adjudicated on the merits and that the duty of the court of bankruptcy encompasses just such matters. This is opposed in principle to the Deep Rock approach, especially where the domination and spoliation in the latter case were so marked. Secondly, the Court depicts a situation parallel to what actually would have happened in *In re Kansas City Journal-Post Co.*,¹⁹⁸ *infra*, and emphasizes the punitive effects of such subordination. It “. . . would unjustly enrich the holders of the Capital Stock of the New Orleans. . . .”¹⁹⁹ In other words, even granting *ex arguendo* similarity between the facts in the *Comstock* and *Deep Rock* cases, subordination as in *Deep Rock* would not be the answer because NOTM did not have such a substantial allowance coming to it as its due. Were the facts to indicate something due NOTM, it still was not so much as the subordination of a \$10,000,000 claim would give it. The dissent points this out. Thirdly, the majority of the Court in *Comstock* in summarizing what *Deep Rock* had held indicates uncertainty as to whether *Deep Rock* stood for disallowance or subordination. It quoted the decision in the *Pepper*²⁰⁰ case as explicative of the Court’s stand on *Deep Rock* repeating that the *Deep Rock* holding was “. . . based on the equities of the case. . . .”²⁰¹ Yet in *Deep Rock* the counterclaim was ignored, the claim allowed and no reasons were adduced for either. To determine what *Deep Rock* held we must go to *Deep Rock* itself rather than depend on what the Court later says of the decision. Finally, the majority in *Comstock* felt that *Deep Rock* deprived “. . . the wrongdoer of the fruits of his wrong.”²⁰² With *Deep Rock*’s \$20,000,000 counterclaim undetermined, this is a debatable estimation of the *Deep Rock* holding.

The Dissent in Comstock. The dissenting opinion refused to apply the rule that makes concurrent findings of two courts binding on the Court, because it found exceptional error. The dissent found that MOPAC made advances to NOTM, not for improvements, but for dividends and that MOPAC had made an inter-company adjustment at the height of the depression shortly before the initiation of the reorganization proceedings, which had the effect of shifting from a less financially responsible subsidiary of NOTM to NOTM itself an indebtedness due to MOPAC. Of the entire \$10,500,000 claim of MOPAC against NOTM the dissent found that the advances made for dividend purposes and the inter-company debt, saddled upon NOTM, amounted to approximately

198. 144 F. 2d 791 (8th Cir. 1944).

199. *Comstock v. Group of Institutional Investors*, 335 U. S. 211, 229 (1948).

200. *Pepper v. Litton*, 308 U. S. 295, 308 (1939).

201. *Comstock v. Group of Institutional Investors*, 335 U. S. 211, 228 (1948).

202. *Id.* at 229.

\$4,000,000 and held that this amount of the claim should be subordinated to the claims of the pledgees of the NORM stock. The dissent said:

"Indeed, the main thrust of Comstock's objection to this segment of the MOP claim is directed toward the entire history of MOP's management of NOTM. The thought is that the relationship of the parent and the subsidiary has been so complex and so saturated with mismanagement as to warrant subordination of the entire claim of the parent without bothering to differentiate between particular transactions. See *Taylor v. Standard Gas Co.*, *supra*, 323. But the record does not support such an approach to the MOP-NOTM relationship. There have been, as we have seen, two examples of mismanagement on MOP's part that warrant the application of the Deep Rock doctrine. But those situations are separable in nature from the other transactions between MOP and NOTM. And the Deep Rock doctrine is not one that operates to bar an entire parental claim if only a separable portion of it is inequitable. It is only where, as in the *Taylor* case, the parent-subsidiary relationship has been so complex that it is impossible to restore the subsidiary to the position it would have been in but for the parent's mismanagement that the entire claim may be subordinated without distinguishing the good transactions from the bad. Such is not the situation in this case."²⁰³

This offers an explanation neither of the misposition of Standard's claim nor of the failure to examine into Deep Rock's counterclaim.

The dissent in Comstock takes what is submitted to be an ill-advised course, but once on the way it approaches the Deep Rock doctrine in the only manner consonant with the intrinsic reasoning of that opinion. It is ill-advised in attempting to make anything of the doctrine. It acts as it must, once embarked, by avoiding any exact application of Deep Rock and by hacking away at the doctrine until there would seem to be little left of the original. In one sentence the dissent gives the approach it will take to Deep Rock: "And so the Deep Rock doctrine is as broad and as narrow as the equities in each case."²⁰⁴ In other words, to the dissent in Comstock Deep Rock is simply general equity acting within the context of any of a multitude of parent-subsidiary relations. The dissent makes it eminently clear that it is not going to entangle itself in any exact definition of the Deep Rock doctrine. Illustrative of this are the following. (1) The dissent would extend the doctrine to all public shareholders, without the distinction made in Deep Rock between common and preferred. This is implied and *obiter*. (2) Deep Rock would be extended beyond bad faith transactions. "The equities which form the Deep Rock doctrine relate not alone to matters of bad faith. They are also concerned with essential fairness and propriety of

203. *Id.* at 251.

204. *Id.* at 239.

transactions from an objective standpoint."²⁰⁵ This is somewhat difficult to understand, but it is even more difficult to find such principles in Deep Rock. Certainly the Court in Deep Rock never adduced so many and such reasons in support of its disregard of the Deep Rock counterclaim and the allowance of the Standard claim. (3) The dissent was ready to alter the Deep Rock doctrine to cover insolvent parents, apparently not recognizing that Standard was actually insolvent:

"And the Deep Rock doctrine is not one that operates to bar an entire parental claim if only a separable portion of it is inequitable. It is only where, as in the *Taylor* case, the parent-subsidiary relationship has been so complex that it is impossible to restore the subsidiary to the position it would have been in but for the parent's mismanagement that the entire claim may be subordinated without distinguishing the good transactions from the bad."²⁰⁶

The dissent in Comstock had a choice in regard to Deep Rock. It could say simply that the Deep Rock doctrine did not apply or it could state that the Deep Rock doctrine stood for the broadest type of equity and then apply it just as it pleased. The dissent did the latter. Had it done the former it would have lined up with the bulk of federal references to Deep Rock. In either case it would have acted exactly as the Deep Rock doctrine requires. The Deep Rock doctrine can be approached in three ways: (1) direct overruling; (2) sidestepping; or (3) liberal watering down. The Comstock dissent chose the latter in appealing to equity principles. This the dissent would accomplish by ignoring several elements of the Deep Rock doctrine and by converting it into a broad equitable principle ". . . as broad and as narrow as the equities in each case."²⁰⁷ But the point here is that the dissent was using an unfit instrument to accomplish its end. Deep Rock simply did not contain all the elements which the dissent would like it to have.

Comstock in overall substantiates admirably the thesis thus far and illustrates in majority and dissent the general uncertainty, the inability to apply the Deep Rock doctrine to a given fact situation, and the constant attempt either to change the doctrine to suit the case or to avoid it altogether.

This concludes the analysis of the opinions of the Supreme Court in which word of Deep Rock appeared. The important fact is that none of the opinions directly rejected Deep Rock, that none of them openly opposed it but in four of them were present principles *contra* to the Deep Rock adjudication. Were it not for the Circuit Court opinions,

205. *Id.* at 238.

206. *Id.* at 251.

207. *Id.* at 239.

and the writers, it might well be said that the courts needed no encouragement to abandon Deep Rock, that the Supreme Court had already deserted it, and had declared openly in the *Case, Pepper, Consolidated* and *Comstock* opinions principles and doctrine inherently opposed to the Deep Rock doctrine. But to get the complete picture of the status of the doctrine, the other federal court opinions must be considered.

The Circuit Courts

There have been roughly forty references to Deep Rock in the various Circuit Courts of Appeals. Of these, about half are immediately excluded from study. They used Deep Rock for the most collateral matters, or mentioned it altogether *obiter*. Of the remaining cases about half cited Deep Rock with the old-line instrumentality cases. The other half are more difficult to classify. It is this remaining group which give the fullest force to the suggestion "that some confusion exists as to the actual nature of the *Deep Rock* doctrine."²⁰⁸ In this group, for the most part, the opinions contain either implicit rejection of the doctrine or are based upon straight-line general equity principles, far from any peculiarly Deep Rock reasoning.

To discuss each of the instrumentality applications of Deep Rock would be profitless. What is needed is a prototype, since all of the opinions cited Deep Rock and the traditional cases together as support for the Instrumentality Principle. And the prototype chosen adds a bit of irony to the study, since it was handed down by the same three judges who sat on the Circuit bench when Deep Rock was adjudicated. *Fish v. East*,²⁰⁹ without a dissent, was handed down by Phillips, Bratton and Williams, Circuit Judges. The opinion was by Williams, J., who had formerly sided with Phillips, J., in agreeing that the Standard claim should be allowed. The court began by stating that the corporate entity may be disregarded where not to do so would defeat public convenience, justify wrong or protect fraud. It was here that Deep Rock was first cited. The court then declared that the determination as to whether a subsidiary is an instrumentality is primarily a question of fact and

208. Note, *The Deep Rock Doctrine: Inexorable Command or Equitable Remedy*, 47 Col. L. Rev. 800 (1947).

209. 114 F. 2d 177, 191 (10th Cir. 1940). The other decisions citing Deep Rock for the Instrumentality Principle are: *In re Clark Supply Co.*, 172 F. 2d 248, 254 (7th Cir. 1949); *Godfrey v. Powell*, 150 F. 2d 486, 489 (5th Cir. 1945); *Great Northern Co-op. Ass'n v. Bowles*, 146 F. 2d 269, 271 (Emergency Court of Appeals, Wis. 1944); *Nichols & Co. v. Secretary of Agriculture*, 131 F. 2d 651, 656 (1st Cir. 1942); *Page v. Haverty*, 129 F. 2d 512, 514 (5th Cir. 1942); *Weisser v. Mursam Shoe Corp.*, 127 F. 2d 344, 345 (2d Cir. 1942); *Inland Development Co. v. Commissioner*, 120 F. 2d 986, 988, 989 (10th Cir. 1941); *Continental Oil Co. v. Jones*, 113 F. 2d 557, 562 (10th Cir. 1940).

degree. Very interestingly there followed ten indicia of instrumentality with only the very slightest variance from the indicia used previously in Deep Rock. The court here again cited Deep Rock and concluded that the Instrumentality Principle had application in the instant case. These cases, represented by *Fish v. East*, might be said to illustrate the first-glance estimate of Deep Rock, namely that all the preliminary reasoning and indicia of instrumentality in Deep Rock meant the actual application of the principle.

The remaining opinions are difficult to classify. The one thing that might be said is that all indicate the same uncertainty. In *St. Louis Southwestern Ry. v. Herrwood*,²¹⁰ the court showed perspicacity in apparently realizing the arbitrary character of the Deep Rock subordination. When subordination was sought the court replied that, with recovery and the amount of recovery both uncertain, there was no proper basis for subordinating the claims to the interests of the stockholders. It was clear that subordination could result in a punitive blow or an overbountiful largess, depending on the real equities involved. So the court simply remarked that subordination was out of order under the conditions.

Some courts did not appear to see through to the core of Deep Rock. One²¹¹ cited it for disallowance of a claim asserted as part of a scheme by a dominating stockholder to defeat the lawful prior claims of creditors. Of course, this could be classed with the general type that used Deep Rock as support of the Instrumentality Principle. Other courts were able without difficulty to distinguish Deep Rock from the facts at hand, which is the more likely procedure due to the intrinsic difficulty of applying the Deep Rock doctrine. One of these was the Circuit Court in the *Comstock* case,²¹² which, as already indicated, stated that the Court in Deep Rock had to deal with a situation entirely different, and as the trial court had said, entirely contrary. Another court²¹³ cited Deep Rock for the obvious statement that if preferred

210. 157 F. 2d 337, 389, 390 (8th Cir. 1946).

211. *Columbia Gas & Electric Corp. v. United States*, 151 F. 2d 461, 467 (6th Cir. 1946).

212. *Comstock v. Group of Institutional Investors*, 163 F. 2d 350 (8th Cir. 1947). Similar to this were the words of the dissent in *Geist v. Prudence Corp.*, 122 F. 2d 503 (1941). The Supreme Court reversed, hence the dissent in the lower court carries some weight: "This is not at all a case . . . as in *Taylor v. Standard Gas & Electric Co.*, 306 U. S. 307 . . . and related cases." *Id.* at 508. Note 3 of the dissenting opinion reads: "Were the facts of this case such as to bring it within the general outlines of the rule of the *Taylor* case, *supra*, we would be obliged to consider the significance of the cautionary comments in *Consolidated Rock Products Co. v. DuBois*, March 3, 1941, 61 S. Ct. 675, 85 L. Ed. 982." *Id.* at 508.

213. *In re Consolidated Rock Products Co.*, 114 F. 2d 102, 108 (9th Cir. 1940).

stockholders have an equity after satisfaction of creditors they should be considered in the plan of reorganization. Still another court,²¹⁴ cited Deep Rock as substantiation for proper priorities in reorganization. Perhaps the court misunderstood the misposition of the Standard claim and the disallowance of the Deep Rock counterclaim.

In three federal court opinions the resort to Deep Rock was in support of a straight application of general equity principles, but the results accomplished were altogether different from the doctrine of subordination. In the first two of the cases the assets of the parent and subsidiary were commingled. (How different Deep Rock would have been had the assets of Standard and Deep Rock been commingled.) In such cases as these are found the more marked variances from what would seem to be the actual Deep Rock doctrine. In the first of these cases,²¹⁵ the very logical result of the illogical subordination would have taken place had the court applied Deep Rock. Had the parent's claim been subordinated the creditors of the subsidiary would have been paid almost in full, yet there would have been only about 30% for the creditors of the parent. Both parent and subsidiary were insolvent. The subsidiary had been inadequately capitalized. Hence, to meet the manifest equities, and aided by the application of the Instrumentality Principle, the court pierced the corporate veil, disregarded the entities and commingled the assets. The second²¹⁶ of these cases was about the same in principle as the first. The facts were very complicated but the result was substantially the same. The assets were mingled again with the same divergence from the Deep Rock doctrine. In the third and more recent decision²¹⁷ the court cites Deep Rock for the broad principle that a court of bankruptcy under its equity powers in distributing assets may subordinate a claim of one creditor to the claims of other creditors where the subordinated creditor has been guilty of inequitable conduct justifying subordination. The facts in the case render the citation of Deep Rock as altogether inappropriate inasmuch as the governing rule concerned the requirements for tracing and identifying a trust *res*. There was insufficient factual evidence to permit the conclusion that the court had anything in mind concerning Deep Rock beyond the most general equity powers.

The case of *In re Commonwealth Light & Power Co.*,²¹⁸ has been

214. *Petition of Portland Electric Power Co.*, 162 F. 2d 618, 622 (9th Cir. 1947).

215. *Stone v. Eacho*, 127 F. 2d 284 (4th Cir. 1942).

216. *In re Associated Gas & Electric Co.*, 149 F. 2d 996 (2d Cir. 1945).

217. *Johnson v. Morris*, 175 F. 2d 65 (10th Cir. 1949).

218. 141 F. 2d 734 (7th Cir. 1944). See also Note, *The Deep Rock Doctrine: Inexorable Command or Equitable Remedy*, 47 COL. L. REV. 800, 814 (1947).

referred to as an application of the Deep Rock doctrine. Again it comes down to a simple application of equity in an instance of mismanagement by a completely dominating parent. There was no real subordination but a simple disallowance of a claim. Nothing was done that was without the pale of straight equitable remedies.

In re *Kansas City Journal-Post Co.*,²¹⁹ is a case wherein the illogicality of subordination was clearly repudiated. This is the denouement to the study of the opinions of the federal courts and of their approval of the Deep Rock doctrine. The facts of the case show the fraudulent withdrawal from the bankrupt corporation's almost-defunct treasury of \$24,000 by a certain individual who had just bought the capital stock of the bankrupt. This stockholder was also a lienholder in the amount of \$500,000. He was clearly guilty of inequity in his withdrawal of the \$24,000. The referee in bankruptcy subordinated his claim of \$500,000. The District Court reversed and was affirmed by the Circuit Court which said:

"The referee, however, in refusing to recognize Schapiro's title under the foreclosure sale and in subordinating his lien rights, did not, as we have pointed out, do so for any purpose of equalizing the position of general creditors in relation to the loss of the \$24,000 to the estate. . . . the only purpose for which it was in fact made, was to forfeit the lien property to the general creditors in punishment of the inequity which the evidence justified the referee in finding that Schapiro had actually committed. . . ."²²⁰

Had the subordination of the \$500,000 of the lienholder's equity been allowed, the result would have been the loss of \$500,000 by a man who had been guilty of an inequity to the extent of \$24,000 and an award to the general creditors who had had at no time any expectation of the property covered by the general mortgage lien. The Circuit Court did require the return of the \$24,000 fraudulently withdrawn and refused to allow the arbitrary subordination.

A most recent citation of Deep Rock and the last of the opinions demanding study is In re *V. Loewer's Gambrinus Brewery Co.*²²¹ handed down by the Second Circuit in 1948. The facts in the *Gambrinus* case were not complex. The stockholders, officers and directors of a realty company and a brewery company were identical and held stock in both firms in approximately the same proportions. Acting as the realty company the stockholders loaned money to the brewery company. In the bankruptcy of the brewery company the realty company came in with

219. 144 F. 2d 791 (8th Cir. 1944).

220. *Id.* at 806.

221. 167 F. 2d 318 (2d Cir. 1948).

claims and asked for parity with the general creditors of the brewery company. The debt was bona fide.

Judges Frank and Learned Hand wrote separate opinions and Judge Swan merely concurred in the result. Judge Frank remarked the identity of stockholders and stockholder interest and stated that the situation should be regarded as if the brewery company were indebted directly to its stockholders. He posed the question: ". . . If stockholders, acting in concert, make loans to their corporation in amounts directly proportionate to their stockholdings, may they assert unsubordinated claims, for such loans, against their corporation when it becomes bankrupt?"²²² Judge Frank's reply was in the negative. The claim was not allowed on a parity with the creditors. It is the reason behind the reply that is of interest here.

Judge Frank cited Deep Rock along with the decisions in the *Pepper*²²³ and *Imperial Paper Corp.*²²⁴ cases as authority for this denial of parity to the claimant shareholder-owners, stating: "The test does 'not turn on the existence or non-existence of the debt' nor on the existence of an 'instrumentality' or the like; the test is whether failure to subordinate will 'work injustice'. . . ."²²⁵ Judge Frank stated that since no creditors of the realty corporation had intervened it was unnecessary to consider whether they would be adversely affected.

The concurring opinion by Judge Hand adds to the understanding of just how the court regarded the Deep Rock opinion and what it stood for in relation to the *Gambrinus* case. Judge Hand recalled that courts generally have held it unjust to allow a corporation to claim in insolvency upon a parity with other creditors against another corporation, when the shareholders of both are the same citing the *Watertown Paper* case. This, he said, was based on the instrumentality principle, ". . . but Taylor v. Standard Gas Co. repudiated this as a test, and said that the question was one of 'fraud or injustice,' which left the matter wholly at large."²²⁶ The italics here have been added since they indicate in a phrase the practical result of the Deep Rock adjudication. Judge Hand went on to say that "Pepper v. Litton perhaps re-established the earlier statement by confining the doctrine to cases where the creditor corporation was 'a part of the stockholder's own enterprise.'"²²⁷ Judge Hand then expatiates very appropriately and very clearly on the relative posi-

222. *Id.* at 319.

223. *Pepper v. Litton*, 308 U. S. 295 (1939).

224. *Sampsell v. Imperial Paper Corp.*, 313 U. S. 215 (1941).

225. *In re V. Loewer's Gambrinus Brewery Co.*, 167 F. 2d 318, 319 (2d Cir. 1948).

226. *Id.* at 320 (italics supplied).

227. *Ibid.*

tions of shareholders and creditors in any corporate venture. "The shareholders stand to lose first, but in return they have all the winnings above the creditor's interest, if the venture is successful; on the other hand the creditors have only their interest, but they come first in distribution of the assets."²²⁸ There follows a stressing of the proper priorities and the injustice of allowing one person to act as both shareholder and creditor at the same time.

In the light of the clear facts and the equally clear adjudication any dilation on the *Gambrinus* case would be unwarranted. So much has already been said in commentary on similar situations that only the barest summary will satisfy. The case and the words of the members of the court speak for themselves. (1) There was no factual parity with Deep Rock. (2) The "subordination" was not Deep Rock subordination. In *Gambrinus* it was disallowance, since as shareholders the realty company received the residuum in any event. (3) There was no misposition. The fact situation in this particular resembled the *Pepper* case. (4) There was no counterclaim, no public minority stockholders, no questionable debt, no evidence of milkings. (5) The correct relation of owner and creditor was stressed. (6) The proper priorities were endorsed. (7) Other authority than Deep Rock, more relevant, would have sufficed. The point remains that the *Gambrinus* case indicates that the most recent use of Deep Rock has brought no change, that the uncertainty and vagueness remain, that the last application of the doctrine is no different than the first.

The total impression of the forty odd references to Deep Rock in the Circuit Courts of Appeals is not substantially different from that received from the conspectus of Supreme Court opinions. Roughly half dealt with wholly collateral matters of such insignificance as not to warrant consideration. Of the remaining half, a half again put Deep Rock down as another instance of the Instrumentality Principle and the balance, just analyzed in detail, were apparent misconceptions in one form or other of the Deep Rock Doctrine as originally announced in the *Deep Rock* case.

The general conclusion that can be drawn from all the opinions of the higher federal courts—Supreme and Circuit Courts—is patent. The references to Deep Rock have in no instance achieved any purpose of importance. In the insignificantly collateral points, the same object could have been as well effected by other authority. In the instrumentality cases, the same could be said *a fortiori*. In the remaining instances where the doctrine, as originally announced, was apparently

228. *Ibid.*

misunderstood or misapplied, only confusion has resulted from the continued use and application of the so-called doctrine.

The very fact that no court in the eleven years and fifty instances could use the Deep Rock as really governing is notable. The courts, then, appear to bear out the burden of this study. It remains to consider the opinions of the commentators.

The Commentators and the Doctrine

There have been roughly a dozen commentaries of one type or another on the Deep Rock doctrine in the eleven years since the adjudication. A perusal of these writings serves an excellent purpose in concluding this study.

There are four outstanding points to be noted in this perusal. First, it would seem warranted to say that no one of the dozen commentaries presented an analysis that could be said to be generally consonant with the thesis presented in these pages. Second, in substantially every commentary one point or another, isolated albeit in relation to the writer's whole treatment, could be excerpted, brought forward and adduced in some support of the analysis here outlined, thus forming, by a strange congeries, a totality in confirmation of a stand impugning the Deep Rock doctrine. Third, the analyses, explanations and comments of the writers reflect exactly the opinions and comments of the courts, as both in turn, as it were perforce, reflect the inherently questionable logic of the Deep Rock opinion itself. Fourth, no commentary has had occasion to impugn the Deep Rock opinion or question its general logic or equity. *E contra* the consensus has been clearly approbation and praise.

In 1939, immediately on handing down of the adjudication, the journals came forward with notes and recent decisions. In many respects it would appear that the conclusions reached by these early writers formed the basis and set the theme both in terminology and conclusion for all of the later studies.

In an early Recent Decision,²²⁹ the writer, seeming to attribute to Deep Rock an endorsement of absolute priorities in bankruptcy, began with: "The decision seems to be an application of the rule of the *Boyd* case. . . ."²³⁰ This sentence summarizes the writer's conclusions. The discussion, moreover, was based on the assumption that the Standard claim was actually disallowed. This brief commentary closed with the

229. 38 MICH. L. REV. 88 (1939).

230. *Ibid.* The *Boyd* case referred to is *Northern Pacific Ry. v. Boyd*, 228 U. S. 482 (1913).

statement that “. . . the result reached in the principal case is eminently proper.”²³¹

About the same time a Recent Decision in the *Virginia Law Review*²³² showed the same inclination to regard the Deep Rock adjudication as consonant with the rule in the *Boyd* case. It should be noted, however, that this writer did show concern for the manner in which the *Boyd* rule was treated. “The Supreme Court did not deny the status of creditor. . . .”²³³ The writer then adds: “But *ordinarily* a parent’s valid claim as creditor is barred only by showing that the two corporations are in fact one.”²³⁴ Here, although the validity of the claim is assumed, the recognition of the unusual approach in Deep Rock showed an insight into the doctrine which the unqualified assertion of application of the *Boyd* rule, above, did not indicate. In general, however, this note manifested the same uncertainty as to the exact nature of the Deep Rock doctrine. The writer remarked the fact that the court cited “. . . neither precedent nor principle”²³⁵ and this realization, especially that no *principle* had been cited, is most important. In the end, however, the broader issues of misposition and disregard of counterclaim were not noted. The writer decided that the case “. . . *apparently* extends the application of estoppel properly to prevent the return of control to those whose mismanagement caused the insolvency, and to protect the previously impotent stockholders.”²³⁶

In the same year, 1939, a Note in the *Illinois Law Review* felt the *Deep Rock* case was decided on

“. . . the ‘equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice.’”²³⁷

It is not to be expected that writers would proceed in any wise differently from the courts in their interpretation. Hence this conclusion that Deep Rock was based on the Instrumentality Principle is not unusual. After this rather clear statement, the Note added a distinction without an apparent difference: “The Court rejected the instrumentality doctrine as a ‘rule’ but accepted it as a principle for making equitable adjustments in reorganizations.”²³⁸ In view of the inherent difficulty

231. *Ibid.*

232. 25 VA. L. REV. 849 (1939).

233. *Id.* at 850.

234. *Ibid.* (italics supplied).

235. *Ibid.*

236. *Ibid.* (italics supplied).

237. Note, *Disposition of Parent's Claim in Reorganization of the Subsidiary*, 34 ILL. L. REV. 94 (1939).

238. *Id.* at 95.

in understanding the Deep Rock adjudication, this remark would seem to reflect the holding itself. The writer concluded that ". . . the result is acceptable . . ." ²³⁹

Of the four early commentaries, Cornell's Earle B. Henley, Jr. came the closest to the full appreciation of the situation.²⁴⁰ He recognized that the Court did not apply the Instrumentality Doctrine. He further appreciated the fact that there was no real reason given for the subordination:

"The court refused either to apply the instrumentality rule or to disregard the corporate fiction, but held that under the bankruptcy act, as a court of equity, it was 'required to recognize the rights and status of the preferred stockholders arising out of Standard's wrongful and injurious conduct in the mismanagement of Deep Rock's affairs.' "²⁴¹

Although this writer appreciated some of the limitations of the opinion he nevertheless failed to discuss the basic deficiencies and indicated no dissatisfaction with the manner in which the Court had acted as a court of equity. He felt that the Court attained the same result as if it had used the Instrumentality Doctrine.²⁴² Probably the most incisive and enlightened reflection in Henley's commentary was his remark on the predictability of future application:

"The difficulty with the court's decision in the instant case is the lack of any definite, certain rule by which to predict the outcome of any similar case. The court makes no attempt to point out what factual basis will justify the exercise of this power of subordination."²⁴³

In this Henley put his finger on the basic illogicality which must inevitably offer difficulty in application.

One of the most interesting works that treated Deep Rock was written by one not a lawyer.²⁴⁴ Speaking more properly in his own field the writer expresses the need, noted throughout these pages, of a full accounting and investigation of the history of the various intercompany transactions:

"In these days only an item by item analysis and adjustment can balance equities. . . . Corporate histories can be reconstructed with sufficient accuracy to meet the needs. . . ." ²⁴⁵

239. *Id.* at 96.

240. 24 CORNELL L. Q. 587 (1939).

241. *Id.* at 588.

242. *Id.* at 589.

243. *Ibid.*

244. Field, *The Instrumentality Doctrine in Reorganizations of Subsidiary Corporations*, 9 AM. L. SCHOOL REV. 728 (1940).

245. *Id.* at 733.

Yet this writer was indignant at the decision, not because of the illogic of allowance, nor of subordination, but because Standard was not given its full \$9,000,000 ahead of everyone:

"Subordination of claims in these cases is arbitrary and capricious. It is punitive rather than compensatory. It smacks more of bills of attainder and of Hitler's levy on the Jews than it does of calm weighing of equities."²⁴⁶

The last article in 1939 came from the hand of Charles Rembar of New York.²⁴⁷ There is much valuable collateral matter here, but the treatment of Deep Rock is wholly consonant with all that has already been considered, and reflects the same difficulties encountered by the courts and writers. The author does, however, note the counterclaim, but in the matter of the foundation of the Court's conclusion, he too is seemingly misled by the Court's redenomination of the concept of instrumentality. He states: "The Supreme Court noted the rule and dismissed it."²⁴⁸ The article did point out the novelty of analysis in Deep Rock. "The opinion, disdaining precedent, took an approach altogether different from that of previous claims cases. . . ."²⁴⁹ But the writer took no exception to this approach, since he concluded that: "In dealing with this problem, the court shows common sense remarkable against the background of the entity-instrumentality doctrine."²⁵⁰ Nor did Rembar fail to note the unusual nature of the misposition: "On the contrary, well-known principles of priority in reorganization would require that Standard's claim be taken care of before stockholders received anything."²⁵¹ The writer analyzed the Court's use of the word "equity" in these words:

"What the Court meant was that it found the instrumentality, adjunct, *alter ego*, talk not at all helpful, and that the dominant consideration in dealing with a parent's claim was fairness."²⁵²

The writer's conclusion was that "the result was salutary."²⁵³

Once these initial commentaries had appeared the pattern of what was henceforward to be said on the matter of Deep Rock was settled. There are few deviations from this pattern, either by notes, comments or articles. It would be wastefully repetitious to consider them in detail.

246. *Id.* at 732.

247. Rembar, *Claims Against Affiliated Companies in Reorganization*, 39 COL. L. REV. 907 (1939).

248. *Id.* at 924.

249. *Ibid.*

250. *Id.* at 930.

251. *Id.* at 925.

252. *Ibid.*

253. *Id.* at 931.

In 1941 a *Harvard Law Review* Note²⁵⁴ concurred in the general analysis. It contemned "the unilluminating practice" of the Instrumentality Rule, and attributed such attitude of contempt to the Court. Its most helpful contribution was the general conclusion that: "The exact nature of this subordination was doubtful after the *Deep Rock* case."²⁵⁵ An article in the *Columbia Law Review* in 1942²⁵⁶ by Myron Krotinger anticipated excellent results from the *Deep Rock* opinion and is otherwise consistent with the set pattern. In that same year, Carlos Israels remarks in another *Deep Rock* article: "On present indications, the future of the doctrine is wholly speculative."²⁵⁷ In fact Israels did stress the questionable predictability of the doctrine, although his analysis is essentially the same as the others. On another point Israels showed penetration to the basic issues:

"The important fact is that in the *Deep Rock* Case there was no judgment and no precise determination of the amount of any claim which *Deep Rock* might have had against Standard. No one examining the record could doubt that a reasonable basis for a substantial claim existed."²⁵⁸

This was the most forthright reference to the counterclaim found in any of the *Deep Rock* commentaries.

A Note²⁵⁹ in the *Columbia Law Review* in 1947 reiterated much that had been said before and generally approved of the holding.

The latest commentary on *Deep Rock* was somewhat *obiter* to the present study since it concerned itself in the main with the *Comstock* opinion. The Note appeared in 1949 as "Limiting the *Deep Rock* Doctrine,"²⁶⁰ and treated *Comstock* in relation to the *Deep Rock* doctrine. Implicit throughout were many of the same concepts expressed by the previous writers and there was nothing to characterize this discussion as a marked departure from the past. This can be seen *passim* throughout. Thus the author refers to disallowance of the claim as apparently an expression of the *Deep Rock* holding and would seem to indicate that all the public investors were protected in *Deep Rock*, thus ignoring the plight of the publicly-held common stock. The Note refers

254. Note, 54 HARV. L. REV. 1045 (1941).

255. *Id.* at 1049.

256. Krotinger, *The "Deep Rock" Doctrine: A Realistic Approach to Parent-Subsidiary Law*, 42 COL. L. REV. 1124 (1942).

257. Israels, *The Implications and Limitations of the "Deep Rock" Doctrine*, 42 COL. L. REV. 376, 391 (1942).

258. *Id.* at 390.

259. Note, *The Deep Rock Doctrine: Inexorable Command or Equitable Remedy*, 47 COL. L. REV. 800 (1947).

260. Note, *Limiting the Deep Rock Doctrine*, 58 YALE L. J. 773 (1949).

to the Deep Rock doctrine and states that the *Comstock* case “. . . may in fact represent its first significant limitation.”²⁶¹ The Note further remarks that “. . . *Deep Rock* sets up a system of equitable priorities in bankruptcy to supplement the system of absolute priorities.”²⁶² And in another place: “Flexibly applied to require responsible management for the subsidiary, the *Deep Rock* doctrine can equitably resolve the conflict of interests in the holding company structure.”²⁶³ Here and at other points the author indicates that he feels the doctrine is basically sound.

Conclusion

It is finally submitted that this study substantiates the original thesis that: (1) the Deep Rock doctrine essentially impugns, or even repudiates, the Instrumentality Principle or at the least fails to carry it through to its reasonable conclusion; (2) that, because of questionable logic at the foundation of the Deep Rock opinion, the formulation of any working principle as an expression of the Deep Rock holding is at best fraught with danger; (3) that this intrinsically questionable logicity renders prediction by the use of any formulation uncertain and confused; (4) that consequent on these points, the most prudent and guarded course would be, it is submitted, abandonment of the holding as a doctrine capable of accurate and intelligent application to facts and circumstances in litigation.

261. *Id.* at 774.

262. *Id.* at 774 n. 5.

263. *Id.* at 781.