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The Deep Rock Doctrine Reconsidered I

David C. Bayne, S.J.
THE DEEP ROCK DOCTRINE RECONSIDERED I

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Eleven years ago, the Supreme Court of the United States in an opinion written by Justice Roberts, disdaining precedent, handed down its adjudication in *Taylor v. Standard Gas & Electric Company.*\(^1\) Out of this opinion was born the "Deep Rock doctrine." The Deep Rock is the Deep Rock Oil Corporation. It still exists. In the times of the litigation, and before, it was the subsidiary of the Standard Gas & Electric Company.

As for the "doctrine," it is the statement, more or less, of the holding in the *Taylor* case, now more commonly known as "the Deep Rock case." There should be some definition of the "doctrine," but its very nature renders this difficult. There will be stated, however, the attempts at definition of others,\(^2\) for a working beginning. A writer in a recent article\(^3\) phrases the "doctrine" in the words of another:

"Where a showing can be made that a subsidiary corporation having public preferred stockholders was inadequately capitalized from the outset, and was managed substantially in the interest of its parent, rather than its own interests, the parent will not, in a bankruptcy or reorganization proceeding affecting the subsidiary, be permitted to assert a claim as a creditor, except in subordination to the claims of preferred stockholders."

This statement represents in a general way the holding in the *Deep Rock* case, and serves only the limited purpose here of introducing the subject.

Once Justice Roberts expressed the Court's opinion in the *Deep Rock* case, it was snatched up. Every year thereafter found articles, comments and notes.\(^4\) Thus the "doctrine" grew. Each added thoughts on the matter, interpreted it and hailed its advantages. The courts took it up also, from the Supreme Court to the lowest court.

The holding in the *Deep Rock* case and the "Deep Rock doctrine" entwine themselves inextricably in the general field of the law of parent and subsidiary corporations and in the particular field surrounding the well known "instrumentality rule."\(^5\) Some have contended that "Deep

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\(^1\) Member of the District of Columbia Bar.
\(^3\) Note 47 Col. L. Rev. 800 (1947).
\(^4\) Citations of the commentaries, infra.
\(^5\) *Latty, Subsidiaries and Affiliated Corporations* 191 (1926). A fuller treatment of this problem will be given a *propos.*
Rock” was right in line with the instrumentality tradition, others have denied it; but almost all have condoned the holding and approved the “doctrine.”

It is frankly the hope that this commentary will be of some help in clarifying the thought that has somehow become uncertain in the matter of the “Deep Rock doctrine.”

The reason for this hope lies in the very thesis of this article: (1) That the “Deep Rock doctrine” essentially impugns the “instrumentality rule”; that it might be said to repudiate it, but at least it may be said to be a failure to carry through the instrumentality principle to its reasonable conclusion; (2) that because of questionable logic at the foundation of the reasoning, the formulation of any working principle is at best fraught with danger; (3) that this intrinsically questionable logicality renders prediction uncertain and confused; (4) that consequent on these points, the most prudent course would be, it is submitted, abandonment of the holding as a doctrine. This is the thesis of this article.

The proof of this thesis will be attempted in five parts. Part I: Antecedents; Part II: Litigation; Part III: Analysis of the Adjudication; Part IV: Deep Rock as a Doctrine; Part V: Subsequent History of the Doctrine, and Conclusion.

Part I: Antecedents

One of the predominant causes of misunderstanding in the analysis of Deep Rock as a doctrine appears to have been an insufficient knowledge of the facts. The likelihood of this necessitates a factual perusal beyond the ordinary.

History

The beginnings of the Deep Rock Oil Corporation were founded in H. M. Byllesby and Company, (hereafter referred to as “Byllesby”) a Chicago investment banking house and later top holding company of a billion dollar empire.6

Of chief interest to Deep Rock was its parent Standard Gas and Electric Company, a holding company in the utility field, controlled by Byllesby. As the years progressed, Byllesby erected affiliates and subsidiaries in all activity areas requisite to a full vertical structure in the organization, underwriting, refinancing, management, technical engineering and general supervision of public utility companies. Relative to Deep Rock the major supervision and management responsibility was in the

Byllesby Engineering and Management Company "...given to Standard gratis in order to help it and give it an earning statement."

The post-war recession led to the purchase by Byllesby of the Shaffer Oil and Refining Company, an operating company, renamed Deep Rock for $15,000,000. From the time of Shaffer's retirement in 1921 Standard was in complete control and owned substantially all of the common stock of Deep Rock.

Standard was now in "...the oil business, a wholly unrelated industry..." to its usual public utilities. From 1919 the structure developed to a state in 1928 when the bulk of the common, at $1 par value, was in Standard and the preferred, at $100 par value and $10,000,000 in notes were in the hands of 5,500 public holders across the country. There was no time when "...there was preferred stock outstanding in sufficient amount to outvote the common stock held at the time by Standard..."

The Byllesby Management Company, Standard and Byllesby had common directors. Deep Rock and Standard had common auditors, attorneys, and officers. The officers of Deep Rock, chosen for technical experience, were allowed some discretion in operation, but were always subject to the direction of Standard. All fiscal affairs were wholly controlled by Standard, which was banker and the only source of financial aid.

Intercompany Relations

The activities of Standard and Deep Rock spanned fourteen years—1919 to 1933. During that time the "open-account" indebtedness of Deep Rock to Standard grew and fluctuated over the years so that it reached the sum of $9,000,000 by 1933, chiefly through rentals, supervision fees, dividends, and interest charges.

The rental charges. In 1923 Byllesby had added the Deep Rock Oil and Refining Company to the system. "The Refining Company has its office with the Deep Rock... It didn't have any employees. All the

9. 96 F. 2d 693, 697 (10th Cir. 1938).
10. Id. at 696.
11. "At organization Deep Rock had a cash working capital of only about $6,600,000 and a mortgage indebtedness of $12,000,000, the interest and sinking fund requirements of which were nearly $2,000,000 a year. Its assets at that time were appraised at about $16,000,000." 306 U.S. 307, 315 (1939).
salaries of the Refining Company were paid by the Deep Rock. . . . The Refining Company had no bank account. 14 In short, it was "a purely inactive dummy corporation," 15 and all "the capital stock of said Deep Rock Oil & Refining Company, with the exception of qualifying shares, was issued to Deep Rock, thereby creating it the beneficial owner of all the properties of said corporation." 16 During the years prior to the Refining Company, Deep Rock had expanded. A cracking plant had been added at over a million and a half dollars, 17 new properties costing $2,000,000 were purchased. 18 At its organization in 1923 all these properties were placed in the hands of the Refining Company. Then,—"Later as the result of transactions reflected on the books of the three corporations, Standard became the owner of the entire capital stock of the Refining Company." 19

Standard then announced that Deep Rock " . . . will then lease the property of the Deep Rock Oil and Refining Company and . . . will pay rental of $600,000 per annum . . . " 20 "By this lease Deep Rock became the lessee of the very properties which it had purchased, paid for and operated as its own throughout the entire three year period since their acquisition." 21

After the Refining Company came into the rentals as income, it declared it as dividends to Standard. But, "no checks were drawn, it was just a bookkeeping transaction." 22 The "dividends on the Refining Company's stock were charged by Standard against Deep Rock in lieu of the Refining Company first collecting the $50,000 monthly rental under the lease and then paying it over to Standard as a monthly dividend." 23 The total for the period came to $4,500,000.

While Standard was building up the open account, Deep Rock was losing $1,600,000 in the operations of the leased properties. Although Standard owned the properties, Deep Rock spent $2,000,000 in improving them. 24 Mr. Shinners, Vice President of Byllesby, thought the terms

18. Ibid., II, 34-6, 44-6, 128-9, 176-7, 194-5, 227.
19. 96 F.2d 693, 697 (10th Cir. 1933). But there is no evidence of consideration.
95. Also see: R. and B., II, 75.
24. Id. at II, 176-7, 17, I, 134-5.
of the lease "were excessive." Yet the lease was renewed for five more years in 1930. Mr. Riddle who signed for Deep Rock, stated he would not have been in a position to protest.

Beyond the straight rental charges Standard billed Deep Rock for the Federal taxes on the rental income, insurance premiums, depreciation losses, depletion and retirement accounts.

Supervision fees. In 1930 the Management Company billed Deep Rock $2,000,000 as supervision fees for the year ending December 31st, 1930. The total for the fourteen year period came to about $1,500,000. No one was able to reveal what services were performed. The work of making stock transfers and keeping stock registers would come to about $25,000 over the whole period.

J. J. O'Brien, president of the companies, declared: "We knew nothing about the oil business at that time." There was no contract for the services or the charges. Nor did the president have any knowledge as to "how the amount of the charges that were made for these managerial fees were arrived at." These supervision charges brought the open account to $6,052,682.83.

Dividends. In spite of the fact (as President O'Brien put it) that "Deep Rock was about two feet in front of the wolf," Standard ordered the declaration of dividends. Standard did not feel that the question as to the availability of that much cash in the accounts of Deep Rock had anything to do with this method of handling dividends rather than by actual payment. Nor was there any concern over the fact that Deep Rock "was, at the time, borrowing in large amounts from or through Standard." The total declared to Standard in dividends was over $4.5 million. This brought the open account to $10,638,695.83.

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25. Id. at II, 431.
26. Id. at II, 230.
27. Id. at II, 81–2.
28. Id. at II, 202–3.
29. Id. at II, 216.
30. Id. at III, 83, Exhibit 2 to Kerr's answer to 25th interrogatory; also, Ibid., I, 62.
31. Id. at II, 4–5, 7, 9–10, 14–16, 27, 29, 40, 41, 55–59, 27–8, 239.
32. Id. at II, 57–8.
33. Id. at II, 4.
34. Id. at II, 28, 244.
35. Id. at II, 7. Mr. Shinners, Standard's vice president testified that the management fees were excessive and should be eliminated since they did not represent services actually rendered and that the charges were fixed by the "same top men, who were top men in all these companies." R. and B., II, 433, 434.
36. Id. at II, 10, 11.
37. Id. at II, 88, 59; also I, 61.
38. 306 U.S. 307, 317 (1939). See R. and B., III, 90, 93 where it is shown that Deep Rock had neither surplus nor earnings with which to pay any dividends; see also II, 7, 16, 26, 35, 37, 88–9, 224.
Interest charges. On the substantial sums already owing Standard by Deep Rock interest was charged at the rate of seven percent, compounded monthly. There was no consideration of the questionable nature of the debts represented by the open account. The interest amounted to six million dollars during the fourteen years.39 The total now reached: $17,087,136.52.

General activity. While the foregoing major items were building up the Deep Rock debt, Standard and Byllesby were engaging in side activities that were substantially lucrative. Byllesby and Standard effected many stock and note issues.40 Byllesby was principal and agent in trading with the public in Deep Rock securities.41 There were instances that might be called market manipulation.42 At times the public valuations of Deep Rock,43 the prospectuses44 and the annual reports45 were declared questionable in their reliability.

The Court concluded by reference to the numerous transactions beneficial to Standard effected by Standard domination.46 The capitulation of all questionable charges of Standard against Deep Rock came to approximately $20,000,000.

PART II: LITIGATION

Such was the state of affairs in 1933 when Deep Rock was first brought into court. Gray and Riddle,47 Deep Rock officers, initiated receivership proceedings in the District Court of Tulsa County, Oklahoma, but Deep Rock had the cause removed immediately to the District Court for the Northern District of Oklahoma.

The Special Master

Once in the District Court receivers were appointed,48 Standard filed a petition of intervention49 and a claim for $9,342,642.37, which was the

40. Id. at II, 11, 114, 420. See also, 306 U.S. 307, 315-316 (1938).
42. R. and B., II, 421, 508-11, 642.
43. Id. at 254, 297, 593-605; III, 103-114. See also 306 U.S. 307, 319 (1939).
44. Id. at II, 258, 297.
45. Id. at II, 593-605; I, 103-114; see also III, 90-93. Thus the prospectus for the note sale listed the refinery as a Deep Rock asset while Standard claimed it in its annual report and collected rentals on it from 1925 to 1933. Report of the Securities and Exchange Commission on proposed Plans of Reorganization.
47. From 1924 to 1933 Deep Rock was under the management of Gray and Riddle. Each of them owned securities of Deep Rock and neither had any interest in Standard or Byllesby. 96 F.2d 693, 697 (10th Cir. 1938).
49. Id. at II, 245.
balance owing on the open account. (The $20,000,000, represented the alleged wrongful charges and would, if verified, absorb the nine million odd dollars claim of Standard and result in an eleven million dollar residue.) G. S. Ramsey was retained by the receivers, filed his answer to Standard and requested the appointment of a Special Master. The answer attacked the Refining Company leases, called all the Byllesby companies, "mere agents, instrumentalities and adjuncts" of Standard, utilized by Standard for the purpose of transacting the latter's business and demanded that the separate corporate entity of Deep Rock be judicially ignored and a proper and equitable judgment and decree entered adjudging Standard indebted to Deep Rock.\(^5^0\)

The Special Master was appointed and began hearings. Standard was present, not as proprietor or owner, but as simple creditor. Deep Rock countered with the $20,000,000 in allegedly wrongful charges. Shortly thereafter Deep Rock filed its petition in bankruptcy, under Section 77B of the Bankruptcy Act.\(^5^1\) Ramsey was retained by the trustee in bankruptcy and the hearings continued. All of the witnesses were officers, directors, or agents of Standard, or its affiliates, and officers of the Deep Rock and the documentary evidence came from the books and records of Standard and Deep Rock. The facts were essentially uncontroverted.

At this point Byllesby determined to form a reorganization committee and to submit a plan of reorganization. The Committee was headed by John J. Shinners, Standard's vice-president, and was composed of men not directly connected with the Byllesby system, but more or less remote associates.\(^5^2\) The court acquiesced in the representation and notices to creditors were ordered.\(^5^3\) "The committee recognized that the validity and extent of the Standard claim was an important element in the formulating of any plan of reorganization. . . . It proceeded at once with an independent and careful study of the relationship and transactions between Deep Rock, Standard, Byllesby, the Management Corporation, and the Refining Company."\(^5^4\) It was significant when in 1934 counsel for the committee advised its members that Standard would have to be considered in any reorganization plan, since in their opinion the instrumentality rule was not applicable and Standard could establish a claim in the approximate amount of $7,300,000.00.\(^5^5\)

\(^5^0\) Id. at II, 290.
\(^5^1\) Section 77(b) of the Bankruptcy Act was formerly 48 Stat. 912, 11 U.S.C. 207(b). The drastic amendments of the Chandler Act (52 Stat. 839, 11 U.S.C. 501 et seq.) have today superseded that section.
\(^5^2\) R. and B., I, 68.
\(^5^3\) Id. at I, 71, 78.
\(^5^4\) 96 F.2d 693, 699 (10th Cir. 1938).
\(^5^5\) Ibid.
With this advice from counsel, the committee advanced its plan of reorganization predicated upon the allowance of the Standard claim for at least $5,000,000.00, of which a substantial amount was to rank on a parity with the Deek Rock notes. The plan provided for the elimination of Deep Rock's preferred shareholders, and a new two and a half million dollar issue of preferred stock entirely in favor of Standard. Standard also was to receive three-fourths of the common stock of the reorganized company. Ten percent of the common was to go to the old preferred holders.

With the end of 1934 the hearings before the Special Master were closed by both sides. Standard had steadfastly asserted its claim. Ramsey for the trustee opposed it. In over four hundred and twenty-five pages of brief he had excoriated the Refining Company deal, branded the lease "unconscionable" and "fraudulent," cited the dividends, the interest charges, and the supervision fees. He alleged a clear case of domination of Deep Rock by Standard. At this point the record is not too explicit in details, and the fact alone is noted that Mr. Shinners, of Standard, paid a call on Mr. Ramsey, counsel for the trustee. Henceforward the change of attitude of the counsel for the trustee is notable.

It was also about this time that the Taylor brothers who had "bought this security entirely upon the recommendation of Byllesby & Company, . . ." entered upon the scene. They had invested about $50,000 in preferred stock of Deep Rock and now feared for their interests. The Taylors retained their own counsel and henceforward the full prosecution of Deep Rock interests was in their hands. On February 21, 1935—exactly eight days after the closing of the hearings before the Special Master—they intervened in the bankruptcy proceedings, filed their objections to Standard's claim, strongly denied that the trustee could protect their interest, and adopted as their own the arguments of Ramsey.

Shortly after Shinners had suggested compromise of the Standard claim the trustee filed a petition reporting the offer to the Court and requesting authority to accept it. This was in the face of statements made previously—and subsequently—that were in considerable derogation of such a stand.

57. Id. at II, 218, 241.
58. Brief of Trustee, passim, Vol. 92, Briefs.
59. 96 F.2d 693, 699 (10th Cir. 1938).
62. 96 F.2d 693, 700 (10th Cir. 1938).
63. Among others: "I don't know of any reason why there should not be a claim in this case made against Standard, not only that the claim that they make should not be
This proposed compromise called for substantially the same terms outlined in the plan. Standard was ready to accept $5,000,000 for the outstanding charges of over $9,000,000. The Special Master expressed his fears that the trustee might lose all if the compromise were rejected and thereupon approved it. The Taylors reiterated the arguments of Ramsey and concluded that Standard should be adjudged liable to Deep Rock in an amount in excess of $20,000,000. The Special Master awarded Standard $5,000,000.

The District Court

The hearings before the District Judge followed. Seemingly midway in the hearing the District Judge interrupted:

"Now there is no need to go any further with this argument. I am thoroughly convinced. I have been studying this case, and that is the reason I had it set down for further argument, my conscience wouldn't let me approve this compromise from just hearing the arguments. Here is $5,000,000.00 worth of stock outstanding; somebody got that money from the public. Now under this settlement if I was to approve it, and in approving the plan of reorganization I would just as well say to the [preferred] stockholders, you are wiped out; you get a little piece of paper called common stock that I wouldn't give one cent for."

The District Judge had apparently reached a conclusion contrary to that of the Special Master. He summed up his reasoning as falling under the category of the instrumentality rule:

"The evidence is overwhelming that Standard ran this company; they officered it; they capitalized it; it is just a child in their hands, and if there ever was a case the law is clear on, it is nothing in the world but an instrumentality, according to the admissions."

Had it not been for the Taylors the matter would have long ago been disposed of, since everyone else seemed to be satisfied.

At this stage all the issues had been looked into with the exception of the Deep Rock counter charge of $20,000,000. The Master had said: "I have, however, studiously endeavored to avoid a fixed and definite conclusion upon the primary questions of law and fact."
The District Judge suggested a second compromise.  

"Suppose I let the matter stand without a date. If you cannot compromise we want to get together and finally dispose of the claim on its merits."

**The Second Compromise**

Some months later the reorganization committee presented an amended plan, which contemplated the compromise of Standard's claim at $5,000,000 as before, and the organization of a new company which should issue $10,000,000.00 par value of debentures and 520,000 shares of common stock. The noteholders received an equivalent ten million in notes of the new company. The preferred shareholders were again eliminated from their preferred position. For their seven million dollar interest they were allotted one hundred thousand shares of the new common stock. The upshot: "... to Standard approximately seventy-three percent, to the old preferred stockholders nineteen percent, and to the noteholders eight percent of the common stock." Reduced to intelligible terms there was equally nothing left for the preferred shareholders with the claim compromised at five million as if left at nine million, since Deep Rock was evaluated at seventeen million and twelve of that went to the noteholders for principal and interest.

At the end of the District Court hearings the District Judge did not hand down an opinion. He had made some comments on the way, but his final order merely approved the offered compromise of Standard's claim.

**The Circuit Court**

The Taylors, as an Independent Committee representing the preferred stockholders, appealed. "Counsel for the independent committee devoted 275 pages of their inordinate brief to the proposition that the Standard claim should be disallowed on the merits." The Circuit Court replied however, that that was "... not the issue here... Whether a proposed compromise of a claim against a debtor shall be approved rests in the sound discretion of the trial court." The validity of the claim to be compromised was not considered by the Circuit Court.

The Taylors continued to stress the instrumentality rule. The Cir-

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72. See also: R. and B., I, 296; II, 731, 734; I, 33, 34.
75. 96 F. 2d 693, 703 (10th Cir. 1938).
76. Ibid.
77. Ibid.
cuit Court then proceeded to consider the rule and indicated a realization of its importance in the instance of Standard, Deep Rock and the Byllesby system:

"... the parent corporation will be responsible for the obligations of its subsidiary when its control has been exercised to such a degree that the subsidiary has become its mere instrumentality."78

There was no doubt of the Court's full preoccupation with the question of instrumentality.79 It regarded the rule with Justice Cardozo as "still enveloped in the mists of metaphor,"80 but proceeded to spend many pages in discussing it.81

Point by point the elements of the instrumentality rule were considered and dismissed. The court listed eleven elements:

(a) The parent corporation owns all or most of the capital stock of the subsidiary.
(b) The parent and subsidiary corporations have common directors or officers.
(c) The parent corporation finances the subsidiary.
(d) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.

These four, the Court found to be present. It found the presence of the following fairly debatable:

(e) The subsidiary has grossly inadequate capital.
(h) In the papers of the parent corporation the subsidiary is described as a department... of the parent corporation, or its business... is referred to as the parent corporation's own.

The remaining five were held to be absent:

(f) The parent corporation pays the expenses or losses of the subsidiary.
(g) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.
(i) The parent corporation uses the property of the subsidiary as its own.
(j) The directors or executives of the subsidiary do not act independently but take their orders from the parent corporation in the latter's interest.

78. 96 F.2d 693, 704 (10th Cir. 1938).
79. Id. at 706.
81. 96 F.2d 693, 704 et seq. (10th Cir. 1938).
(k) The formal legal requirements of the subsidiary are not observed. The Circuit Court found strong support for the District Court's action in approving the compromise.

The Circuit Court, however, did not treat the matters with silence as had the District Court. With the exception of the claim on the merits, it discussed each point in order. It referred to the dividends, and stated that "A sufficient answer is that the evidence shows actual earnings..." It noted the financial situation as wholly controlled by Standard, but concluded that since the parent corporation was the natural source of the subsidiary's credit, the fact that the parent financed the subsidiary would not render the subsidiary a mere instrumentality of the parent. The Circuit Court remarked upon the stock ownership, the complete identity of directors and officers, but concluded that such, without more, would not justify the application of the instrumentality rule.

The Circuit Court concluded by referring to the "eminent counsel" and to the Special Master as learned and of worthy judgment, and stated: "... we cannot say the result of the contest over the claim was not so doubtful or the claim itself so devoid of merit as to form no reasonable justification for the compromise." The court had, however, already regarded the counterclaim as "... not the issue here...

The Circuit Court Dissent

The Circuit Court had split two to one with Bratton, J., writing a brief dissent. Chief reliance was on the instrumentality rule. "... the fiction of corporate entity should be disregarded when it is necessary to circumvent fraud or uproot a harbor for wrong." In the mind of the dissenting judge, the long list of indicia all pointed to the fact that Deep Rock was an agency, department, or instrumentality of Standard. Bratton, J., concluded that advancements made in such circumstances could not constitute an indebtedness recognizable as a claim in bankruptcy:

"... allowance of the claim in any sum amounts to Standard asserting a claim against itself in legal fraud of others... it follows as the night the day that the approval of this plan with the untenable claim included as a liability of the corporation constituted a grave prejudice to the rights of others in interest. It is respectfully submitted that the claim should have been disallowed in toto; that the proposed plan of reorganization with the claim included should

82. Id. at 706.
83. Ibid.
84. Id. at 703.
85. Id. at 707.
have been disapproved; and that for these reasons the orders should be reversed.\textsuperscript{886}

\textit{The Supreme Court}

The Supreme Court granted the petition for \textit{certiorari} and on February 27, 1939 a unanimous court\textsuperscript{87} handed down its decision and the "Deep Rock doctrine" was born. Justice Roberts wrote the opinion of the court. With scattered exceptions, his whole opinion came in the last three pages. He understood that "[p]etitioners had invoked the so-called instrumentality rule. It is not, properly speaking, a rule, but a convenient way of designating the application in particular circumstances of the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice."\textsuperscript{888} He also noted that the Taylors were basing their attack on the decree below on the instrumentality rule. He discussed this rule briefly, delineated exactly the equitable duties of the bankruptcy court, sitting as a court of equity, and stated specifically the court's duty to recognize the rights of the preferred stockholders. He referred to the "abuses in management," "the interlocking directors," "the paramount interest" of the officers "in the preservation of Standard's position," the forced dividends, the dominated management.\textsuperscript{89} Justice Roberts did, however, feel it was impossible to recast Deep Rock's history so as even to approximate what would be its financial condition had it been adequately capitalized and independently managed with an eye single to its own interests. There was not, however, any mention of the Deep Rock counterclaim.

The essence of the opinion came in the last paragraph and was condensed to the point of being cryptic:

"If a reorganization is effected the amount at which Standard's claim is allowed is not important if it is to be represented by stock in the new company, provided the stock to be awarded it is subordinated to that awarded preferred stockholders. No plan ought to be approved which does not accord the preferred stockholders a right of participation in the equity in the Company's assets prior to that of Standard, and at least equal voice with Standard in the management. Anything less would be to remand them to precisely the status which has inflicted serious detriment on them in the past."\textsuperscript{900}

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86. \textit{Id.} at 710.
87. The Court was composed of Chief Justice Hughes and Justices McReynolds, Brandeis, Stone, Reed, Black, Butler and Roberts. Justice Douglas had not yet been seated and Justice Frankfurter did not take part in the decision.
89. \textit{Id. passim}, 308 to 323–
90. \textit{Id.} at 324.
\end{flushright}
The Decision in Dollars and Cents

The implementation of the decision fell in course to the District Court for the Northern District of Oklahoma. Reorganization plans were received from both Standard and the Taylors. The Securities and Exchange Commission entered at this point under its powers over corporate reorganizations under Chapter X of the Bankruptcy Act and both plans were submitted to it for examination. The Court placed great weight on the work of the Commission embodied in its twenty-two page report. This report, as revised by the figures finally used in the opinion of the Circuit Court of Appeals, shows a full conspectus of the picture presented to the reorganization court. General creditors and reorganization expenses were listed at $560,000. Deep Rock's 6% convertible gold notes, plus accrued interest, amounted to $14,350,000 and the preferred stock, plus accrued dividends, to $8,272,500; a total of senior claims amounting to $23,182,500. The common stock consisted of 599,475 shares, 20,830 of which were held by the public.

The report disagreed with the trustee's valuation of assets and regarded the District Court's finding of $17,000,000 as a maximum which could be considerably lowered. The report, upon a 10% capitalization of the total work of Deep Rock, estimated the value of the assets at slightly over $7,000,000. Accordingly, the Securities and Exchange Commission recommended rejection of both plans.

The District Court acted in general accordance with the Securities and Exchange Commission report, rejected both plans and approved a modified plan. The plan as finally approved gave to the holders of gold notes $5,500,000 of new debentures, 300,000 shares of stock and $2,900,000 of cash (including interim distributions). The preferred stockholders received 100,000 shares of stock. If we accept the valu-

91. Standard Gas & Electric Company v. Deep Rock Oil Corporation et al., 117 F. 2d 615 (10th Cir. 1941), cert. denied, 313 U. S. 564 (1941).
92. These contentions of the Securities and Exchange Commission are useful as background for the finally approved plan. They serve as an indication of the deep influence of appraisal downward by the SEC on the action of the Federal District Court. In the plan proposed by the Shinners Committee the capitalization would have taken the form of $5,500,000 in 6% Sinking Fund Debentures, dated 1 January 1940 and maturing 31 December 1951. There were also to be 500,000 shares of common stock. All of the new debentures and 400,00 shares of the common were to go to the presently outstanding gold notes in full settlement. The remainder of the common was to go to the 50,000 shares of preferred stock. The common stock was to receive nothing. Under the plan of the Independent Preferred Stockholders' Committee the gold notes were to receive 5% Debentures in the amount of $7,000,000 and half of the 500,000 shares of new common stock with the preferred stockholders receiving the balance and the common stockholders eliminated.
93. The modified plan approved was contested by Standard without success. In re Deep Rock Oil Corp., 113 F. 2d 266 (10th Cir. 1940), cert. denied, 311 U. S. 699 (1940).
ation of the Securities and Exchange Commission, the noteholders received $2,900,000 cash and debentures backed by assets worth approximately $3,700,000. The common stock they and the preferred stockholders received was apparently worthless.

The common stock held by the public which had been subordinated to the preferred stock, was not considered by the court. With Deep Rock's $20,000,000 counterclaim against Standard ignored, the position of the publicly-held common stock was academic.

PART III: ANALYSIS OF THE ADJUDICATION

At the outset of any analysis of Deep Rock one very important point should be remarked. The facts as narrated were substantially uncontested. Beyond this factual agreement there was accord on the duty of the court. The action was a bankruptcy proceeding, and bankruptcy always means equity. The court, therefore, had uncontested facts, all the parties before it, and the duty of an equity court.

The Question Before the Court

The Court stated early in its opinion that "The question presented is whether the District Court abused its discretion in approving the compromise of a claim...." Some attention should be given to this formulation of the question by the Court. The first step towards the basic question is seemingly from consideration of discretion to that of the compromise. The compromise, it is submitted, is prior in consideration to the question of the exercise of discretion. This is because it is, inevitably, an abuse of discretion if the compromise was in fact invalid. The question, therefore, before the court is the validity of the compromise.

But that still would apparently not be the ultimate question. It is difficult to speak of the validity of the compromise of a claim when the intrinsic validity of that very claim has not yet been at least considered. It would not be judicious to pay an invalid claim. It would be, at best, only half judicious to compromise a claim of questionable validity. Judge Bratton in the Circuit Court dissent seemed to understand this.

"Whether a proposed plan of reorganization shall be approved rests in large measure in the sound judicial discretion of the trial court. But assuming that the claim of Standard should not have been allowed in any sum, it follows as the night the day that the approval of this plan with the untenable claim in-

cluded as a liability of the corporation constituted a grave prejudice to the rights of others in interest. 97

This question of the validity of the claim of Standard was in truth a bifurcated one. Suppose that the claim in itself and without further consideration of surrounding circumstances were valid, but that actually Standard was in no position to be presenting any claim at all, valid or no. That would pose another question beyond the question of the mere validity of the claim. It could be said that this is nothing other than saying that the claim is in itself invalid. Perhaps that is true. There is a point for consideration, however. Another way to put that question would be: Can Standard come in as a creditor? It is suggested that the determination of whether Standard can come in with any claim is a question that is best answered before the validity of the claim Standard comes in with is passed upon. Now the question might be: Can Standard present any claim? There are many ways of putting this. Can Standard be considered a creditor at all? If Deep Rock is Standard, and Standard Deep Rock, can Standard claim anything from Deep Rock? If Deep Rock is a part of Standard, can a whole claim against its part? 98

Strictly this bifurcated question of the validity of the claim is answered jointly. While the Court is determining if Standard can come in at all, it must perforce consider each of the elements in the claim that would render the claim bona fide. This is precisely what the Court does do. It considers each item of the claim, and of necessity, decides the general position of Standard while considering the several items of the claim in globo.

The Supreme Court was cognizant of this. It adverts to the fact that neither of the lower courts, or the Special Master ever passed on the question of the claim on its merits. 99 It is difficult to understand how the Court maintained such steadfast silence on the matter of Deep Rock’s alleged counterclaim.

It is finally proposed, therefore, that the ultimate question of the Court was a viewing of the equities of the parties. It could be otherwise expressed as a concurrent determination of the validity of Standard’s claim on the one hand and of Deep Rock’s counterclaim on the other. With this over-all view, the proper order of questions would not be first discretion, nor allowance, nor compromise, nor even claim alone. Ultimately the question would then be: Has Standard a claim, or had Deep

97. 96 F. 2d 693, 710 (10th Cir. 1938).
98. See Bratton, J., expressed the same concept in his dissent: “... the allowance of the claim in any sum amounts to Standard asserting a claim against itself ..." 96 F. 2d 693, 710 (10th Cir. 1938).
DEEP ROCK DOCTRINE CONSIDERED

Rock a counterclaim? or: What are the substantial equities of all the parties?

The Ultimate Factual Determinations

The Court proceeded slowly to answer the question before it. In so doing, it handed down adjudications. They were not, any one of them, the final conclusions of the case, but they were essential pronouncements that would finally, in mass, form the basis for the ultimate conclusions of law. These determinations formed a pattern that was later to stand out in the decision of the case. This pattern is the "instrumentality principle", with the several elements of it forming the inner design, and the totality of the elements forming the pattern as a whole.

This pattern that the Court followed can be described in many terms, but it expresses an elemental concept under any guise. To the Circuit Court it was a case of "... looking through the fiction of distinct entity...." Perhaps the most fortuitous expression of the essence of the concept came from Bratton, J.:

"A parent corporation may not assume the position of creditor and assert a claim in bankruptcy against its subsidiary which has been dominated and controlled as a mere adjunct, department, or instrumentality, since the assertion of a claim in such circumstances amounts to the presentation of a claim against itself in fraud of bona fide creditors. (Cases cited)."

The Supreme Court put the same concept in its own way but refused to designate the instrumentality principle as a rule, referring to it rather as "a convenient way of designating the application ... of the broader equitable principle that the doctrine of corporate entity ... will not be regarded when to do so would work fraud or injustice."

Although the Supreme Court did not devote many words beyond those already noted to the intricacies of the rule, it stated that it had carefully read the opinion below. Phillips, J., for the majority had detailed the various elements of the rule elaborately. Just prior to this enumeration he had quoted Powell on Parent and Subsidiary and had proceeded to list the eleven general elements that could comprise the "so-called instrumentality rule". These general categories have been stated already, and since they are a good workable break-down of the concept, and the Supreme Court followed them in fact, though perhaps not in enunciated formality, they will form the pattern on which the Supreme Court's

100. 96 F. 2d 693, 706 (10th Cir. 1938).
101. Id. at 708.
103. '96 F. 2d 693, 704 (10th Cir. 1938). See Powell, Parent and Subsidiary Corporations 8 (1931).
reasoning will be laid. The relevant factual determinations which comprise these elements occupied the bulk of the highest Court's opinion.

The Indicia of Instrumentality

The Capital Stock Ownership. The Circuit Court had described the first element as: "The parent corporation owns all or most of the capital stock of the subsidiary." The Supreme Court makes occasional references throughout the opinion to the total ownership of Deep Rock stock by Standard, and adequately treated the matter of complete ownership of capital stock by Standard.

Common Directors and Officers. Throughout the opinion the fact of the interlocking directorate was recurred to. The Court finally grouped all the factual information concerning the common directors and officers in one conclusive phrase: "... the paramount interest of interlocking officers and directors in the preservation of Standard's position..." This element was the second of the four elements admittedly present in the enumeration of the Circuit Court.

The Parent Corporation Finances the Subsidiary. The Supreme Court spent little time in elaborating this point. It summarized its stand in one sentence: Standard "... was its banker and its only source of financial aid."

The Parent Incorporates the Subsidiary. The whole story of the Deep Rock was open to the Court in the records and briefs including the testimony of Standard's president: "So we got into the oil business that way." The Court speaks of the organization in 1919 and then concludes the matter:--"... Byllesby, an investment banking corporation which controlled Standard, entered into a contract with Shaffer whereby he was to organize. ..." Deep Rock. "... Standard then had investments in various utility properties but had never been interested in oil."

Inadequate Capitalisation. Of all the indicia of corporate identity in the law of parent and subsidiary, the fact of inadequate initial and continued capitalization is generally regarded as one of the most cogent. Such inadequacy sets the legal mind to thinking that here is rather a

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104. Ibid.
106. Id. at 323.
107. Id. at 311.
joint enterprise than separate entities; that rather the financing is con-
ing, and should as a consequence be continued to its logical conclusion. Such thoughts might well have been at the base of the Court's mind when it said: "So inadequate was Deep Rock's capitalization that, in the period from organization to 1926, the balance due on open account to Standard grew to more than $14,800,000." This risk-nothing and gain-all attitude of Standard's was prominent in the Court's thinking: "From its organization Deep Rock was, most of the time, 'two jumps ahead of the wolf,' as one of Standard's officers testified." At another point: "As before, Deep Rock's resources were wholly insufficient for its business and the open account began to build up. . . ." It is interesting to note that the Circuit Court majority had concluded that the presence of this element of undercapitalization "... may be said to be fairly debatable." The Supreme Court, on the other hand, had concluded: "From the outset Deep Rock was insufficiently capitalized, was top-heavy with debt and was in parlous financial condition."

**Parent's Use of Subsidiary's Property.** A favorite term with the Court when referring to Standard is "proprietor". It refers to Standard "... as at once proprietor and creditor of Deep Rock." This proprietorship manifested itself, in the mind of the Court, in connection with the dependence upon Standard of Deep Rock officers.

**Domination and Control.** Were any one of the several elements of the concept of corporate identity of would-be entities to be called the most important it would be that of domination and control. If one corporation, exercises such thorough domination over another it is apparent that the subsidiary has no life of its own, that it can be called nothing but a "department" or "adjunct" or "instrumentality". Essentially what faced the Court in determining whether Standard could present a claim against Deep Rock was the question: to what extent did Standard lead and direct Deep Rock's life for it so that it could be said that not Deep Rock but Standard lived, that Deep Rock had no body or life except as a part of Standard's life and body. This explains why the Court devoted so much of its time to considerations surrounding domination. More ample treatment was required to picture the "stranglehold", as the

112. Id. at 310.
113. Id. at 316. It is interesting to note that the Circuit Court majority had concluded that the presence of this element of undercapitalization "... may be said to be fairly debatable." 96 F. 2d 693, 705 (10th Cir. 1938). The Supreme Court on the other hand, had concluded: "From the outset Deep Rock was insufficiently capitalized, was top-heavy with debt and was in parlous financial condition." 306 U. S. 307, 315 (1939).
115. Id. at 315.
Court called it, which Standard had on Deep Rock. The Court gives a summary of its stand on the question of domination:

"It is impossible within the compass of this opinion to detail the numerous other transactions evidenced by the books of the two companies many of which were to the benefit of Standard and to the detriment of Deep Rock. All of them were accomplished through the complete control and domination of Standard and without the participation of the preferred stockholders who had no voice or vote in the management of Deep Rock's affairs. . . . n. 4. At no time did Standard have less than a majority of the voting stock outstanding."\[110\]

**Internal Domination — Properties.** The Court indicated fully the control of Standard over Deep Rock Properties,\[117\] reciting how in 1922 Standard decided that, in view of the unsatisfactory progress of Deep Rock, earnings must be increased by the acquisition of additional oil properties and by the erection of a modern gasoline cracking plant; how part or all of the sums expended for the acquisition of the oil properties were advanced by Standard to Deep Rock and charged against the latter. The Court traced all the maneuverings in and around Standard, Deep Rock and the Refining Company, including the formation in 1922 of the Deep Rock Oil and Refining Company by Standard, with the intention that it should take title to the oil properties and the cracking plant. The Court then detailed the abrupt shift of ownership from Deep Rock to the new Refining Company, the equally sudden transfer of the Refining Company, with the ownership of the properties, to Standard. The Court summed up the domination of Standard over the properties of Deep Rock:

"Thus, on the face of things, Standard, through ownership of the capital stock of Refining Company, owned and controlled the Bradstreet properties and the cracking plant and put itself in such a position that, without its continued cooperation, Deep Rock could not function."\[118\]

**Internal Domination — Leases.** Full attention is called to the lease of these properties back to Deep Rock\[119\] at the dictation of Standard's officials and the immediate declaration of the rentals by the Refining Company as a dividend to Standard, and the debiting to Deep Rock of such as was not paid by Standard in the open account. Under this lease Deep Rock paid, or became obligated to Standard, in the total of $3,075,000. The Court adds: "During the term of the lease the operations of the leased properties showed a net loss of $30,401.40."\[120\] The

\[116\] Id. at 320.
\[117\] Id. at 317.
\[118\] Id. at 318.
\[119\] Id. at 319.
\[120\] Ibid.
Court concluded the matter of the leases in a remark that typified its attitude towards all the lease arrangements:

"In spite of the losses entailed upon Deep Rock by the lease arrangement, Standard dictated its renewal for another term of five years commencing October 1, 1930, and from that date to the receivership Deep Rock paid, or was debited by Standard with, $1,450,000, as rental and suffered, in the operation of the properties leased, a total loss of $1,584,458.05."\textsuperscript{121}

Internal Domination—Interest and Fees. There was no dilation on the matter of interest and fees:

"During the whole period from 1919 to the receivership, Standard charged Deep Rock interest at the rate of seven per cent. per annum compounded monthly on the balance shown by the open account. During the entire period the Management Corporation charged Deep Rock with round annual sums for management and supervision of Deep Rock's affairs which totaled $1,219,034.83, all of which Standard assumed and charged into the open account."\textsuperscript{122}

Dividends. Throughout its opinion the Court reverts from time to time to the payment of dividends declared in the face of the fact that Deep Rock had not the cash available to pay them and was, at the time, borrowing in large amounts from or through Standard. The Court emphasized the inability to pay these dividends:

"Whatever may be the fact as to the legality of such dividends judged by the balance sheets and earnings statements of Deep Rock, it is evident that they would not have been paid over a long course of years by a company on the precipice of bankruptcy and in dire need of cash working capital."\textsuperscript{123}

With Standard owning 98\% of the common, and the dividends going to the common, this single factor was perhaps the most flagrant act of domination in the fourteen year history. Yet the Court felt:

"This is only one of the aspects in which Standard's management and control has operated to the detriment of Deep Rock's financial condition and ability to function. Others are apparent from what has been said and from a study of the record."\textsuperscript{124}

Scattered throughout the opinion the Court makes other general conclusions, albeit on the proximate level, which dispose of the several elements of the instrumentality theory in a mass. For example:

"Deep Rock finds itself bankrupt not only because of the enormous sums it owes Standard but because of the abuses in management due to the para-

\textsuperscript{121}. \textit{Ibid.}
\textsuperscript{122}. \textit{Id. at 320.}
\textsuperscript{123}. \textit{Id. at 323.}
\textsuperscript{124}. \textit{Ibid.}
mount interest of interlocking officers and directors in the preservation of Standard’s position, as at once proprietor and creditor of Deep Rock.”  

The Court did not omit comment on the false annual statements, the market manipulations, the domination by Byllesby of the Reorganization Committee.

In short the Court expressed its conclusions as to every salient point in the long history of the enterprises. At this point the Court has presented the results of its study, has reviewed in the form of ultimate factual determinations every operation up to the date of the argument, and had gone far towards the ultimate conclusion. The Court had announced at the very outset: “Without going into the minutiae of the transactions between the two companies, enough may be stated to expose the reasons for our decision.” Thus far, then, we have seen the reasons of the Court. There remains to consider the decision itself in the light of these reasons.

The Ultimate Conclusions of Law

To find, analyze, and try to fit together a nexus between the reasons and conclusions of the case is in effect the nub of the discussion. There is no possible substitution for sound reasoning. Reasons either support conclusions, or they do not. Any amount of persiflage, or e contra evasion of the point, cannot answer for logical progression from cause to effect, from reasons to conclusions. The Court had presented its relevant factual evaluations. What of the nexus between these and the ultimate conclusions springing from them? The Court had presented its first premise and had done so thoroughly, step by step and in detail. This first premise contained every constitutive element generally attributed to the basic concept variously denoted the “instrumentality doctrine” a “broad equitable principle”, a “rule”, or simply a principle, doctrine or concept. To have such a first premise so clearly defined and delineated is an appreciable step along the way to the conclusion.

As a matter of fact what the Court had so laboriously laid down was its minor premise. It had said: Deep Rock has all these elements. Knowledge and an understanding of the major premise should, without more, lead to the conclusion. The law of the United States supplies the major premise. The joining of the major and the minor results in a conclusion.

What are the precedents? What is the major premise to the Court’s minor premise which the norms of stare decisis have supplied? The major has always been: Where the elements of the instrumentality concept are

125. Ibid.
126. Id. at 315.
present there is identity of the parent with the subsidiary. This fills out the syllogism: Elements of concept equal identity of parent and subsidiary. But Deep Rock presents elements of concept. Therefore, Deep Rock results in identity with parent.

The Writers

Probably one of the most thorough treatments of the question of identity of parent and subsidiary has been presented by Latty. Latty takes the pains to point out what has been well discussed here, that by whatever name, handle or description the concept is given, the essence is the same, and the result is the same: identity of parent and subsidiary. Identity results ipso facto from the disregard of the entity. Latty stresses this point. He is concerned lest one accuse him of a mechanical and rigid rule. He emphasized the rule's pliable nature, and reiterates the result:

"What the formula comes down to, once shorn of verbiage about control, instrumentality, and corporate entity, is that liability is imposed to reach an equitable result."

It should be eminently clear that Latty is not concerned a whit at this point with the elements that go into the "instrumentality notion", as he calls it, but only with the consequences of the presence of these elements. In other words, he is concerned now only with the major premise: the elements of the notion equal identity.

Other writers speak the same result. The treatment is substantially the same in most of the authorities.

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127. Latty, Subsidiaries and Affiliated Corporations 157 (1936).
128. Id. at 191.
129. There is a very important dialectical point that should be discussed here. The tendency is to conclude, not simply identity of parent and subsidiary, but, more important, liability of parent for the debts of the subsidiary. Latty has certainly yielded to the tendency. The reason for this inclination to impose liability and not merely identity is that in the majority of cases in practice the next step and result from identity is liability of parent for the debts of the subsidiary. The instrumentality rule will, first, identify the two, and because of the identity, declare the parent liable for the debts of the subsidiary. But this is not the inevitable outcome of the rule in all cases. The declaration of identity is always the result, but after that, should the facts conceivably so occur, the identity might result, among other things in a general commingling of assets, or in the liability, in effect of the subsidiary for the debts of the parent. In short, the instrumentality rule effects identity, and the logical consequences of identity result in any number of possible outcomes, all portraying the reality behind the fiction, the most usual of which is liability of parent for the debts of the subsidiary. Here, therefore, the tendency to refer to liability as comitant with identity must be resisted until an analysis will indicate whether that is the next step in the Deep Rock case after identity has been effected. This point, moreover, should be recalled in all the instances and comparisons adduced passim.
130. Thus Powell was quoted extensively in the opinion of Phillips, J. in the Circuit Court (96 F. 2d 693 (10th Cir. 1938)).
The Courts

Since the courts and the writers have been in accord on this matter of liability, the word on the courts can be brief. Possibly the first expression of the concept came in 1909 in the Watertown Paper Case.131

The most well-known of the instrumentality cases has always been the Chicago Railway Case.132 There is nothing novel in the case, but the language of the opinion133 is frequently quoted to substantiate the point that, once the elements are posited, only one conclusion can follow.

But it should be understood that the result is identity of parent and subsidiary not because the courts and the writers have repeatedly so pronounced it when the elements of instrumentality have been found. The result is identity because of the intrinsic necessity of the reasoning involved in the entire concept. This inherent reasonableness must be stressed. It eliminates any thought of a mechanical rule.

These fundamental considerations lead to the next important question: —what did the Court do in the light of these principles?

The Decision Itself

In the ultimate factual determinations the Court had systematically spelt out its minor premise: Standard has the elements which commonly constitute the instrumentality doctrine. It is submitted that there could be only one conclusion: Identity, and identity here means Standard is liable.134 What, however, is the Court’s conclusion? Exactly the opposite. It allows the Standard claim of $5,000,000 and disallows the Deep Rock counterclaim of $20,000,000. That is not all the Court does, but for an immediate summary that is the essential point. There are lesser considerations that serve to highlight this one central core, but the allowance of the Standard claim in the face of the reasoning preceding it is the decision of the Court in a word. It further is a summary of the burden of this commentary and should be borne in mind throughout the subsequent analysis.

133. "... where stock ownership has been resorted to, not for the purpose of participating in the affairs of a corporation in the normal and usual manner, but for the purpose ... of controlling a subsidiary company so that it may be used as a mere agency or instrumentality of the owning company.... In such a case the courts will not permit themselves to be blinded or deceived by mere forms or law but, regardless of fictions will deal with the substance of the transaction involved as if the corporate agency did not exist and as the justice of the case may require." Id. at 501.
134. As the analysis of the opinion proceeds it will be seen that here is one of the many instances where the presence of the elements of instrumentality does actually equal liability, since the circumstances render "identity" in effect "liability". See footnote 128 supra.
The Supreme Court and Judge Bratton's Dissent

The Supreme Court said:

"A majority of the Circuit Court of Appeals ... concluded that the District Court had not exceeded the bounds of reasonable discretion in granting its approval. One judge thought that the instrumentality rule was applicable; that, under the rule, Standard had no provable claim; and that it was an abuse of discretion to approve the compromise and the reorganization plan. We agree with the conclusion of the dissenting judge, but for different reasons."

A tendency on the part of the Court was apparent to avoid a solid stand or openly enunciate a reason for the final disposition. But here are two unconditional statements. First, what was Judge Bratton's conclusion? It was that the Standard claim should have been disallowed in toto. Yet the Supreme Court concluded that the Standard claim be allowed. Perhaps the Supreme Court meant that both itself and Judge Bratton held for reversal. That, however, is not reaching the same conclusion from reasoned premises. Judge Bratton developed the elements of the instrumentality rule, just as the Supreme Court did, but the respective final conclusions from these premises differed as the night from the day. In fact, from same premises there resulted diametrically opposite conclusions.

Second, what were Judge Bratton's reasons? While he recognized that mere predominant stock ownership would not warrant the disregard of separate juridical entities, Judge Bratton took cognizance of the established rule that stock ownership, when utilized in an abnormal manner for the purpose of domination, called for treatment of the subsidiary as the parent's agent and instrumentality. The logical conclusion followed that such a parent corporation could not assume the position of a creditor and successfully assert a claim in bankruptcy against its instrumentality, i.e. against itself in fraud of bona fide creditors. Both Judge Bratton and the Supreme Court went through the same detailed process of reasoning. One concluded with a logical application of the instrumentality concept, the other with an anomalous application—or rather a total failure of application—of the principle.

The Supreme Court and the Instrumentality Rule

After adverting to the preferred stockholders' reliance upon the instrumentality rule and its extensive discussion in the court below, the Supreme Court said of the rule:

"It is not properly speaking, a rule, but a convenient way of designating

136. 96 F. 2d 693, 710 (10th Cir. 1938).
the application, in particular circumstances, of the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice. This principle has been applied in appropriate circumstances, to give minority stockholders redress against wrongful injury to their interests by a majority stockholder. It must be apparent that the preferred stockholders of Deep Rock assert such injury by Standard as the basis of their attack on the decree below.187

These are among the most significant words in the opinion of the Supreme Court. They have tended to confuse somewhat the greater number of writers who have attempted a study of the case and have led to difficulty for the courts. They come so parfluence close to a definite stand that some commentators have confusedly assumed that the stand was taken. Yet, in spite of the painstaking use of the constitutive elements of the rule throughout the opinion, the Supreme Court only comes to mention the rule itself at this very late stage. What has the Court said? First, that the instrumentality doctrine is not strictly a rule. Second, that as an "equitable principle" the doctrine accomplishes what is generally attributed to the same concept as a "rule". It prefers not to use the word "rule", but to call it an "equitable principle". Disregarding semantics, there is no essential change in the heart of the doctrine. The corporate entity is still disregarded when injustice would result. The parent, once its entity is disregarded, is still liable for the just debts of the subsidiary.

But there is far more important cause for notice in the first quoted sentence than the fact that the Supreme Court simply designates a new name for the old concept. The Court takes no definite stand on the matter. It has said the rule was much discussed below, but has not said whether it, the Supreme Court, agrees or disagrees with the discussion. It opines that properly speaking it is not a rule, but does not say whether it espouses or repudiates the improperly-called rule as applied to the facts of the case before it. It says that it is "a broader equitable principle", but again, whether as rule or equitable principle, there is no word as to where the Court stands in regard to it in the "particular circumstances" of the Deep Rock case. Thus far the treatment is academic.

And the next sentence? It would seem to be much the same. This principle—the Court continues to call it a "principle"—has been appropriately applied to redress the wrongs of minority stockholders against wrongful injuries by the majority. Would not the Court feel that that is a pari the situation in the Deep Rock case; that the preferred stockholders are those very minority stockholders; that there are public minority common stockholders; and that the Court itself has seemingly enumerated the wrongful injuries?

That brings up the last sentence of the quotation, which serves to draw severe and sharp the lines of opposition and demark the opposing contentions clearly. But there is still no disclosure of which side is the Court's. It has refused to take either side, in spite of its expressed consonance with Judge Bratton's conclusion.

The Court adds an explanation of the powers of an equity court under the provisions of the National Bankruptcy Act, which permits realignment of the rights of stockholders or general modifications, and continues to permit full exercise of equity powers. To this point there have been occasional references to equity and fairness, and considerable academic treatment of the instrumentality rule, but yet no discernible stand on the rule itself.

It might be expected that the nexus between all the factual determinations and the ultimate disposition is at last at hand. The Court approaches closer:

"In the present case there remains an equity after satisfaction of the creditors in which only the preferred stockholders and Standard can have an interest. Equity requires the award to preferred stockholders of a superior position in the reorganized company."

Here there must be a stop. The first sentence, in the light of all that has transpired, in the light of the simple facts of the case, is very difficult to understand. Why no mention of the public minority common stockholders? Why should Standard "have an interest"? The language would seem to exclude Standard from the group of creditors. Yet later the Court seems to do just the opposite. And the second sentence. Just when it was thought that the Court might come out clearly and say that, since all the elements of the instrumentality principle were present, Standard should be held liable for the debts of Deep Rock, the opposite occurs. The last quoted words are the final conclusion. And the conclusion is apparently given without benefit of nexus with the ultimate factual determinations, or of the precedents demanding identity and consequent liability of Standard.

**The Misposition of the Allowed Claim**

In its adjudication, the Court did *two* things. It *first* allowed the Standard's claim, and disallowed Deep Rock's counterclaim. That was implicit in the statement of the decision. If the claim is to come after the preferred holders, it is obvious it has been allowed. But *second*


139. It is illuminating to read the words of the Circuit Court of Appeals (in the later implementation of the Supreme Court's decision) commenting on this allowance: "If, before the final consummation of any plan of reorganization, the assets of Deep Rock..."
the Court transplanted this allowed claim, moved it out of its proper order and placed it behind the preferred stockholders. Properly as a holder of an allowed claim, as an unsecured creditor, Standard would have its usual place after the secured creditors and before all stockholders. In bankruptcy it is axiomatic that the entrepreneur who furnishes the risk capital should be the last to be paid off—unless he is at the same time also a creditor. Did the Supreme Court determine that Standard was a creditor? It might seem not. Else why was Standard's claim subordinated to that of the preferred stockholders? And yet the claim of the proprietor-entrepreneur, Standard, was actually allowed, placed, it is true, out of a creditor position but ahead of the common stock, a minority of which was held by the public. The only explanation offered is the one word "equity".

Finally, the Court asserted that the same considerations which justified the District Court in rejecting the first offer of compromise required a rejection of the second. But the only reason which compelled the first rejection was the finding that Deep Rock was Standard's mere instrumentality.

One sentence appearing at the end of the opinion adds somewhat to its understanding:

should so increase in value that there would be a substantial equity to be applied to the satisfaction of Standard's claim, the court under its broad equitable powers would have power to procure a modification of the plan to make available this equity to Standard. The present status of Deep Rock sustains the finding of the court that there is no equity to be applied to the satisfaction of Standard's claim. . . . We think the trial court correctly interpreted the mandate of the Supreme Court to require that the claim of the note holders be first satisfied; that the claim of the preferred stockholders be next satisfied; and that any balance remaining belonged to Standard." In re Deep Rock Oil Corporation. Standard Gas & Electric Co. v. Taylor et al., 113 F. 2d 266, 269 (10th Cir. 1940).


141. The inclusion of a class of security holders in a plan or reorganization depends upon the existence of an equity for that class. A plan is not "fair and equitable" unless it provides participation for claims and interests in recognition of their priorities, and the value of the debtor's properties supports the extent of the participation accorded to each participating class. The allocation of any participation to stockholders, except on the basis of a contribution, is unfair to the creditors and, therefore, illegal. Case v. Los Angeles Lumber Products Co., Ltd., 308 U. S. 106 (1939). The same principal has been applied as between senior and junior creditors, (In re 620 Church Street Bldg. Corp., 299 U. S. 24 (1936)), between creditors and stockholders of a solvent corporation, (In re Chicago Great Western Ry., 29 F. Supp. 149 (N. D. Ill. 1939)) ; Cf. Tellier v. Franks Laundry Co., 101 F. 2d 561 (8th Cir. 1939), and between classes of stockholders (In re Utilities Power and Light Co., 29 F. Supp. 763 (N. D. III. 1939)) ; In re National Food Products Corp., 23 F. Supp. 979 (D. Md. 1938). Rembar, Claims Against Affiliated Companies in Reorganization, 39 Col. L. Rev. 907 (1939). See also 25 Va. L. Rev. 849 (1939).

"If a reorganization is effected the amount at which Standard's claim is allowed is not important, if it is to be represented by stock in the new company, provided the stock to be awarded it is subordinated to that awarded preferred stockholders." 4 No attention is paid to the publicly held common stock. This either bodes completely ill for the success of the envisaged corporation or the Supreme Court was rather free with its disposition of the stock. On the whole it is difficult to explain. The common stock in the reorganized corporation was asset-less only because Deep Rock's counterclaim was disallowed.

The Deep Rock Counterclaim

Had Deep Rock's counterclaim against Standard been allowed, Deep Rock would have been restored to solvency and a going concern. The noteholders would not find only $3,700,000 to satisfy their $5,500,000 in new notes and their 300,000 shares of common stock. The preferred stockholders would have something behind their share of the new common stock and even the public minority common stockholders, who were altogether ignored throughout, would be protected. "Equity, called for an audit. Though repeatedly requested, no unpartial audit had ever been given. 5 The reorganization court had appropriate jurisdiction not only to allow the $20,000,000 counterclaim as an offset against Standard's claim 6 but to permit, in the proceedings themselves, a recovery by Deep Rock against Standard on the counterclaim. 7 But in the end there was no word of the counterclaim.

The Conclusions of the Analysis

The Court was faced with an uncontroverted set of facts. Its duty was the duty of the court of equity. There was no obstacle to substantial justice. The question was clear: the claim, the counterclaim, the over-all equities of the parties. From the facts the Court came forward with a long series of ultimate factual determinations. Into the pattern of the instrumentality principle the Court wove the capital stock ownership, the interlocking directorates, the undercapitalization, the complete domination, leases, fees, interest, dividends,—all the indicia of instrumentality. To this minor premise was added the major,—the clear precedents of the courts: elements of instrumentality equal identity and consequent liability.

143. 306 U. S. 307, 324 (1939) (italics supplied).
As a conclusion to this line of reasoning, the court allowed the Standard claim in the amount of $5,000,000, but moved it out of priority to a place behind the preferred stock but in front of the common stock. The preferred stock is to get something, the common stock nothing. The Deep Rock counterclaim is disallowed and hence Deep Rock is insolvent.

It is submitted that these conclusions of the legal analysis substantially support the declaration, recalling the words of the initial statement of the thesis of this article, that basically the Deep Rock 'doctrine' essentially impugns the instrumentality rule and tradition, that it might even be said to repudiate it, but at the least it may be said to be a failure to carry through the instrumentality principle to its reasonable conclusion.147

147. This is the first of two articles by Mr. Bayne on the celebrated Deep Rock case. The second article, containing Part IV: Deep Rock as a Doctrine and Part V: Subsequent History of the Doctrine and Conclusion, will appear in the June issue of the Fordham Law Review.