THE RIGHT OF A PARENT'S SHAREHOLDERS TO INSPECT THE BOOKS AND RECORDS OF SUBSIDIARIES: NONE OF THEIR BUSINESS?

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I. INTRODUCTION

The corporate scandals of the last five years have been the impetus for major changes in corporate governance. Legislatures and courts have invoked the names of Enron, WorldCom and Arthur Andersen in their crusades for tougher regulations and penalties. The results of this reform effort are visible in massive regulatory measures like Sarbanes-Oxley,[1] images of handcuffed CEOs,[2] and even reports of a domestic diva behind bars.[3]

While much has been made of the increased accountability of executives, directors, and their professional service-providers, the role of the shareholder in this new world of corporate governance may be evolving more quietly. Shareholders, of course, have always had a fair amount of power under this country's corporate framework. By virtue of their ownership share in the company, they are entitled, among other things, to elect the board of directors, vote on major issues, file derivative suits, and inspect the corporation's books and records. In an age where even simple corporations are likely to have one or more subsidiaries, this final power, the right to inspect books and records, raises an interesting question. What right, if any, do the shareholders of a parent corporation have to inspect the books and records of that corporation's subsidiaries? If such a right does exist, is it absolute or must the shareholder establish wrongdoing or control to justify the disregard of the subsidiary's separate corporate existence?

The Ohio Supreme Court recently had an opportunity to address these issues in *Danziger v. Luse*.[4] Jared, Nathan, and Samuel Danziger owned stock in Croghan Banchshares, Inc. (Croghan), a holding company

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1. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7243 (2000 & Supp. II 2002)).

2. Krysten Crawford, *Lay Surrenders to Authorities*, CNN Money, July 12, 2004, *available at* http://money.cnn.com/2004/07/08/news/newsmakers/lay.

3. Constance L. Hays, *Martha Stewart's Sentence: The Overview; 5 Months in Jail, and Stewart Vows, 'I'll Be Back'*, N.Y. TIMES, July 17, 2004, at A1.

4. 815 N.E.2d 658 (Ohio 2004).

whose only operating asset was Croghan-Colonial Bank (the Bank).[5] The Danzigers sent a letter to Croghan demanding to inspect both its corporate minutes and those of the Bank.[6] After Croghan failed to respond, the Danzigers filed suit asserting their right as shareholders to inspect the books and records of both the parent and subsidiary companies.[7] Croghan acceded to the demand to inspect its minutes but it refused the request to inspect the Bank's records.[8] It reasoned that the Danzigers had no right to these records because they were shareholders of the Bank's holding company, not the Bank itself.[9] The trial court agreed, applying the plain language of the Ohio inspection statutes and granting summary judgment for Croghan.[10] An appeals court affirmed this decision.[11]

On appeal, the Ohio Supreme Court ruled 4–3 that the Danzigers did have a right to inspect the Bank's records.[12] The court agreed with the lower courts' conclusion that no statutory basis existed for such inspection, but it held that shareholders of a parent corporation have a common law right to inspect the books and records of a wholly owned subsidiary.[13] As the shareholder's right to inspect has become an increasingly important tool to ensure corporate accountability, this Casenote breaks new ground in its attempt to resolve questions surrounding the scope of the right's application. Part II of this Casenote examines the approaches that other jurisdictions have taken in addressing the right of inspection's applicability to subsidiaries. Part III analyzes the *Danziger* decision, while Part IV considers whether the Ohio Supreme Court applied the appropriate standard for allowing inspection of subsidiary books and records. Finally, Part V concludes that Ohio, and other states, should adopt the new Delaware approach and explicitly provide a right to inspect a subsidiary's books and records in their corporate codes.

II. SPLIT OF AUTHORITY

Despite its status as a well-accepted tool of shareholder

5. *Id*. at 659.
6. *Id*.
7. *Id*.
8. *Id*.
9. *Id*.
10. *Id*.
11. *Id*.
12. *Id*. at 662.
13. *Id*. at 660.

empowerment, the right of inspection, as applied to subsidiaries, has received relatively little attention from the courts.[14] Courts addressing the scope of the right have come to various conclusions. Three general approaches have developed in determining when the parent shareholder's right should be extended to allow inspection of a subsidiary's books and records: (1) shareholders have no right to inspect the books and records of a subsidiary, absent a statutory basis for doing so; (2) shareholders may inspect the books and records of a subsidiary if the parent's domination of the subsidiary justifies disregarding the separate corporate existence of the entities; and (3) shareholders may inspect the books and records of a subsidiary upon a showing of fraud or that the subsidiary is merely an alter ego of the parent.

A. Strict Statutory Compliance

State corporate codes generally include provisions allowing shareholders to inspect certain books and records of a corporation in which they own stock.[15] Using fairly standard language, these statutes define "shareholder" and prescribe the scope of the right to inspect. However, only two states, Delaware and Oklahoma, statutorily extend the right of inspection to cover the books and records of a subsidiary.[16]

The simplest approach to determining whether shareholders have a right of inspection with regard to subsidiaries is a literal interpretation of the statutes. Under this approach, courts flatly deny shareholders access to a subsidiary's books and records because they are not shareholders of record in that subsidiary.[17] Although this approach seems to be common in the lower courts, it has not fared well on appeal. In *Danziger*, both the trial court and the intermediate appellate court based their decisions on the plain language of the statute, before the Ohio Supreme Court discounted the validity of that approach.[18]

Panitz v. F. Perlman & Co., Inc. presents another recent application of the plain language approach.[19] Shareholders of F. Perlman &

14. Philip I. Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities*, 28 CONN. L. REV. 295, 340 (1996).

15. *See, e.g.*, ARK. CODE ANN. § 4-27-1602 (West 2004); CONN. GEN. STAT. ANN. § 33-946 (West 2004); FLA. STAT. ANN. § 607.1602 (West 2004); 805 ILL. COMP. STAT. ANN. 5/7.75 (West 2004); KY. REV. STAT. ANN. § 271B.16-020 (West 2004); MICH. COMP. LAWS ANN. § 450.1487 (West 2004); OR. REV. STAT. ANN. § 60.774 (West 2003).

16. OKLA. STAT. tit. 18, § 1065(B)(2) (2005); DEL. CODE ANN. tit. 8, § 220(b)(2) (2003).

17. Except, of course, in Delaware and Oklahoma where the statutes permit inspection of a subsidiary's books and records.

18. Danziger v. Luse, 815 N.E.2d 658, 663 (Ohio 2004).

19. 173 S.W.3d 421 (Tenn. Ct. App. 2004).

Company sought to inspect the records of the corporation and its subsidiaries, Southern Steel Supply and American Metal Supply.[20] In denying the shareholders' request, the court noted that the inspection statute referred only to the right of a corporation's shareholders to inspect that corporation's records.[21] It did not confer upon one corporation's shareholders the right to "inspect the records of a second corporation, even when the second corporation is wholly owned by the first."[22] The court held that the "intention of the legislative body must prevail," and that under the plain language of the statute the shareholders did not have "the right to inspect the records of two companies of which they are not shareholders."[23]

The plain language approach was again applied, albeit reluctantly, in *Feldman v. San Mateo Financial Corp*.[24] In that case, a shareholder of a bank holding company sought to inspect the records of the holding company and its wholly owned subsidiary bank.[25] The shareholder relied on California's general inspection statute even though, as was also the case in *Danziger*, a separate inspection statute existed for financial institutions.[26] The court, after finding that the shareholder was required to proceed under the inspection statute tailored for financial institutions, concluded that the plain language of the statute prevented the shareholder from inspecting the subsidiary's books and records.[27] However, the court also noted that the corporation had, through the use of a holding company, insulated the bank from "the ordinary opportunities afforded shareholders to gain information about their companies."[28] In the court's opinion, the statute "impeded the goal of promoting corporate responsibility" and warranted reexamination by the state legislature.[29]

B. Control or Domination

The second approach applied by courts allows shareholders to inspect the books and records of a subsidiary only where the parent corporation

20. *Id*. at 422. American Metal Supply was actually the wholly owned subsidiary of Southern Steel Supply, so this case involved two tiers of corporate ownership structure. *Id.*

21. *Id*. at 429.

22. *Id*.

23. *Id*.

24. 276 Cal. Rptr. 285, 288 (Cal. Ct. App. 1990).

25. *Id*. at 285.

26. *Id*. at 286

27. *Id*. at 288.

28. *Id*. at 287.

29. *Id*. at 288.

exercises enough control over the subsidiary to justify disregarding the entities' separate corporate existence. Courts using control or domination as the determinative factor liken the analysis to that applied in cases of piercing the corporate veil. In those cases, parent corporations exercising a great deal of control over the subsidiary, may be held liable for the torts of those subsidiaries.[30] Justice Cardozo explained, in oft-quoted language, that "[d]ominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent."[31] Extending this line of reasoning to shareholder inspection cases, courts have found that the same connection that imputes a subsidiary's liability to the parent corporation should also support a parent shareholder's right to inspect the books and records of a subsidiary.

In *State v. III Investments, Inc*, a Missouri appellate court expressed support for the control approach, holding that the trial court erred in denying inspection based on a literal interpretation of the statute.[32] In that case, the relator, a shareholder and former director of the parent corporation, as well as a former officer of the subsidiary, sought to inspect the corporate records of both corporations after a dispute regarding the valuation of his shares.[33] Although the court remanded the case on other grounds before reaching the issue of whether the shareholder was entitled to inspect the subsidiary's records, it chose to comment on the claim in the interest of judicial economy.[34] Relying on an earlier Missouri case, the court justified the adoption of the control standard from the parent-subsidiary liability context on grounds that "greater liberality should be indulged in determining whether the connections between a parent company and its subsidiary were sufficient to compel the examination of the subsidiary's corporate books."[35]

In addition to case law supporting control as the basis for permitting inspection of shareholder books and records, Delaware and Oklahoma have recently adopted this approach in their corporate codes. Prior to its amendment in 2003, the Delaware inspection statute, like the majority of other states' statutes, made no mention of the inspection of a subsidiary's books and records.[36] Under the pre-amendment version of the statute, Delaware courts allowed shareholders of a parent corporation

30. HENRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 148 (3d ed. 1983).

31. Berkey v. Third Ave. Ry. Co., 155 N.E. 58, 61 (N.Y. 1926).

32. 80 S.W.3d 855, 866 (Mo. Ct. App. 2002).

33. *Id*. at 857–58.

34. *Id*. at 865–66.

35. *Id.* (citing State v. Wright, 95 S.W.2d 804, 808 (Mo. 1936)).

36. *See* Saito v. McKesson HBOC, Inc., 806 A.2d 113, 117 (Del. 2001).

to inspect the books and records of a subsidiary only where a showing of fraud was made or where the subsidiary was merely the alter ego of the parent.[37] The amended statute provides that a shareholder of the parent may inspect a subsidiary's books and records to the extent that the corporation has "actual possession and control of such records" or "the corporation could obtain such records through the exercise of control over such subsidiary."[38]

The Delaware Supreme Court recently addressed the amended inspection statute for the first time in *Weinstein Enterprises, Inc. v. Orloff*.[39] The plaintiff, a shareholder of Weinstein Enterprises, Inc. (Weinstein), sought to inspect the books and records of J.W. Mays, Inc. (Mays), a publicly traded New York corporation in which Weinstein had forty-five percent ownership.[40] A lower Delaware court found that although the amended inspection statute was "not perfectly drafted, it quite plainly contemplated situations in which a subsidiary at issue would be a less than wholly owned subsidiary and also a subsidiary that wouldn't be regarded in the law as merely an alter ego of the parent."[41] Although recognizing that Weinstein, despite its forty-five percent stake in Mays, was not in a position to compel the production of the documents for the plaintiff's inspection, the lower court employed its equitable powers to force production.[42] Mays opposed the inspection of its records, claiming that the "disclosure of proprietary, confidential information of Mays, that was not otherwise available to its public stockholders," would not be in its best interest.[43] The Delaware Supreme Court accepted an appeal to settle the dispute and lay the foundation for the proper application of the 2003 amendments to the inspection statute.[44]

According to the court, the inspection statute required a two-step inquiry.[45] The first step involved a determination of "whether Weinstein 'controlled the affairs' of Mays, for purposes of being a section 220(a)(3) 'subsidiary.'"[46] Noting that "the range of 'control' may start as low as 20% ownership," the court concluded that Mays met the

37. *Id*. at 118.
38. DEL. CODE ANN. tit. 8, § 220 (2003).
39. 870 A.2d 499 (Del. 2005).
40. *Id*. at 501.
41. *Id*. at 504.
42. *Id*. at 511.
43. *Id*. at 505.
44. *Id*.
45. *Id.* at 506.
46. *Id*. at 508.

statutory definition of a "subsidiary."[47] However, this determination was merely a condition precedent to allowing a parent shareholder to inspect the books of a subsidiary.[48] The second step required an inquiry into whether Weinstein could actually exercise its control to obtain the documents from Mays.[49] The lower court, having concluded that Weinstein could not exercise such control, resorted to its own equitable powers to compel production of the records.[50] The Delaware Supreme Court found that this remedy was "not contemplated by the statutory language . . . which requires the parent corporation to exercise its control, rather than to invoke the equitable power of a court, to compel production of the subsidiary corporation's records."[51] The court concluded, "Mays' separate corporate existence [was] entitled to respect."[52] Although Weinstein's ownership interest gave it "control" over Mays, it lacked the power to actually obtain the records in Mays's possession.[53]

C. Alter Ego

The third, and most common, approach to determining whether a parent corporation's shareholders should have access to a subsidiary's books and records also borrows from the area of parent-subsidiary liability. Courts employed alter ego analysis in cases interpreting the Delaware statute prior to its 2003 amendment, and the doctrine has long been used as grounds for piercing the corporate veil. Where a corporation is the "mere instrumentality or business conduit of another corporation . . . the corporate form may be disregarded," based on the rationale that "if the shareholders or the corporations themselves disregard the proper formalities of a corporation, then the law will do likewise."[54]

In *South Side Bank v. T.S.B Corp.*, the plaintiff, a shareholder of T.S.B. Corporation (T.S.B.), demanded to inspect the records of T.S.B. and its ninety percent owned subsidiary, Tri-State Bank.[55] The Illinois

47. *Id*. at 506.

48. *Id*.

49. *Id*. at 508.

50. *Id*. at 511.

51. *Id*. at 512.

52. *Id*.

53. *Id*.

54. 1 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 41.10 (perm. ed., rev. vol. 1999).

55. 419 N.E.2d 477, 479 (Ill. App. Ct. 1981).

appellate court denied the parent's shareholder the right to inspect the books of a subsidiary for failure to allege that the subsidiary was the mere alter ego of the parent or that some fraud had occurred.[56] The court began its analysis by noting that under the Illinois inspection statute, "the right to inspect a corporation's records extends only to those who are shareholders in the corporation."[57] Finding that the issue of whether a shareholder was entitled to inspect a subsidiary's records was an issue of first impression in the state, the court looked to other jurisdictions for guidance.[58] Following the lead of courts in California, Michigan and Texas, the court concluded that a showing of alter ego or fraud was required to justify the disregard of a subsidiary's separate corporate existence and allowing a shareholder of the parent company to inspect the subsidiary's records.[59] That T.S.B owned ninety-percent of Tri-State Bank did not establish that the subsidiary was a mere instrumentality of the parent:

> Ownership of capital stock in one corporation by another does not, itself, create an identity of corporate interest between the two companies, nor render the stockholding company the owner of the property of the other nor create the relation of principal and agent, representative, or alter ego between the two.[60]

A Delaware court applying the alter ego approach, prior to the amendment of the Delaware inspection statute, went even further than the court in *South Side Bank*.[61] It discounted the importance of common ownership between the parent and subsidiary and also held that "'[a]bsent a showing of a fraud or that a subsidiary is in fact the mere alter ego of the parent, a common central management alone is not a proper basis for disregarding separate corporate existence.'"[62]

III. THE *DANZIGER* DECISION

After two lower courts found for Croghan based on the plain language of the inspection statute, the Ohio Supreme Court accepted a

56. *Id*. at 480.

57. *Id*. at 478.

58. *Id*.

59. *Id*. at 479 (citing Lisle v. Shipp, 273 P. 1103 (Cal. Ct. App. 1929); Woodworth v. Old Second Nat'l Bank, 118 N.W. 581 (Mich. 1908); and Williams v. Freeport Sulphur Co., 40 S.W.2d 817 (Tex. App. 1930)).

60. *Id*.

61. Carapico v. Phila. Stock Exch., Inc., 791 A.2d 787 (Del. Ch. 2000).

62. *Id*. at 793 (quoting Skouras v. Admiralty Enter., Inc., 386 A.2d 674 (Del. Ch. 1978)).

discretionary appeal to consider an issue of first impression in Ohio.[63] Although all seven justices agreed that looking beyond the statute was necessary, they were sharply divided over which alternative approach should prevail. In the end, by a four votes to three margin, the court reversed the lower court's ruling, adopted the control approach as law in Ohio, and decided that the Danzigers were entitled to inspect the subsidiary's records.[64]

A. Majority Approach

The majority began its analysis by reviewing the Ohio statutes conferring the shareholder's right of inspection.[65] In this case, because the corporation was a bank, the court examined both the bank inspection statute and the general corporate statute.[66] As neither statute addressed "whether shareholders have a right to inspect the records of a wholly owned subsidiary of the company in which they own stock," the court quickly concluded that the Danzigers did not have a statutory right to inspect the Bank's records.[67] However, it also found that the inspection statutes did not "abrogate the common-law right to inspection or specifically prohibit shareholders from having access to the corporate records of wholly owned subsidiaries."[68] A review of cases from the earlier half of the twentieth century, along with two law review articles, convinced the majority to "adopt the general view" that shareholders have a common-law right to inspect a subsidiary's books and records "where the separate corporate existence of the subsidiary corporation should be disregarded."[69]

This conclusion alone is not remarkable, as most courts and the *Danziger* dissent agree that the right of inspection should be extended to reach subsidiaries in some circumstances. However, the majority's

63. Danziger v. Luse, 815 N.E.2d 658 (Ohio 2004).

64. *Id*. at 663.

65. *Id*. at 660 (citing OHIO REV. CODE ANN. § 1103.16(C) (West 2005) (inspection statute specifically for banks); OHIO REV. CODE ANN. § 1701.37(C) (West 2005) (general inspection statute)).

66. *Id*.

67. *Id*. The Ohio inspection statute for financial institutions states that:

> Any shareholder of the bank, upon written demand stating the specific purpose of the demand, has the right to examine in person or by agent or attorney at any reasonable time and for any reasonable and proper purpose, the books and records of the bank, except books and record of deposit, agency or fiduciary accounts, loan records, and other records relating to customer services or transactions.

OHIO REV. CODE ANN. §1103.16(C) (West 2005).

68. *Danzinger*, 815 N.E.2d at 660.

69. *Id*. at 661.

justification for disregarding the subsidiary's separate corporate existence drew the ire of the dissenting justices.[70] It concluded that, in Ohio, shareholders should have the right to inspect the records of a subsidiary "when the parent corporation . . . controls and dominates the subsidiary."[71] The extension of the right, the majority rationalized, gives shareholders "additional opportunities to ferret out misdeeds and contributes to corporate transparency."[72] To further justify its position, the majority questioned "[w]hether inquisitive shareholders could have prevented the worst offenses of the Enron scandal."[73]

After establishing control or dominance as the standard for allowing shareholders to inspect the books and records of a subsidiary of the corporation in which they own stock, the majority applied it to the facts at hand.[74] Because Croghan wholly owned the Bank, shared a common board of directors, held its annual meeting at the same time and place as the Bank's, and derived all of its revenue from the dividends paid by the Bank, the majority concluded that "the company is the bank and that in this case, the bank's separate corporate existence should be disregarded."[75] The Danzigers, as shareholders of Croghan, were entitled to inspect the books and records of the Bank.[76]

B. Dissent

The dissent characterized the majority's approach as "an unprecedented departure from the traditional application of the alter-ego doctrine."[77] Fearing that the decision to disregard the separate corporate existence of companies in a "classic parent-subsidiary" relationship would "adversely affect the conduct of business in Ohio," the dissent proposed that the court adopt the standard utilized in most other jurisdictions.[78] Under this standard, the shareholders of a parent corporation have the right to inspect the books and records of a wholly owned subsidiary only where a "showing of fraud or that the subsidiary is the alter ego of the parent corporation" is present.[79] In support of this

70. *Id*. at 664 (O' Donnell, J., dissenting).
71. *Id*. at 662.
72. *Id*.
73. *Id*.
74. *Id*.
75. *Id*. at 662–63.
76. *Id*. at 663.
77. *Id*. (O' Donnell, J., dissenting).
78. *Id*.
79. *Id*.

position, the dissent relied on a brief review of the relevant common law decisions and a lengthy statutory analysis.[80]

Because the shareholders' right of inspection has been controlled by statute since 1955, the dissent summarily discussed several cases from other jurisdictions in which courts required fraud or domination.[81] Two of the cases cited were also cited by the majority as evidence of other courts' willingness to extend the right of inspection to reach subsidiaries.[82] With the common law analysis yielding little, the dissent proceeded to examine more recent cases construing the statutory right of inspection.[83]

As the issue of a parent shareholder's right to inspect subsidiaries had not been addressed under the Ohio inspection statute, the dissent looked to decisions in other jurisdictions for support.[84] Noting the similar wording of the Ohio and Delaware inspection statutes, the dissent cited three instances in which Delaware courts had applied the two-part standard requiring fraud or alter ego status to deny a parent shareholder's demand to inspect the books of a subsidiary.[85] In *Saito v. McKesson HBOC, Inc.*,[86] *Skouras v. Admiralty Enterprises, Inc.*,[87] and *Carapico v. Philadelphia Stock Exchange, Inc.*,[88] Delaware courts found that the state's inspection statute required more than common ownership or control to justify the disregard of a subsidiary's separate corporate existence. As the Delaware rule had been adopted in Illinois, the dissent went on to cite two cases from that state further supporting its position.[89] What it did not point out, however, was that the decisions on which it relied were all decided prior to the Delaware statute's 2003 amendment. Notably, the amended Delaware inspection statute is different than the Ohio statute in that it specifically addresses the rights of a parent's shareholders to inspect a subsidiary's books and records.[90]

80. *Id*. at 664–68.

81. *Id*. at 665.

82. *Id*. The majority cited *Woodworth v. Old Second National. Bank*, 117 N.W. 893 (Mich. 1908) and *Bailey v. Boxboard Products Co.*, 170 A. 127 (Pa. 1934). *Danzinger*, 815 N.E.2d at 661 (majority opinion).

83. *Danzinger*, 815 N.E.2d at 664 (O' Donnell, J., dissenting).

84. *Id*. at 665–68.

85. *Id*. at 665.

86. 806 A.2d 113 (Del. 2002).

87. 386 A.2d 674 (Del. Ch. 1978).

88. 791 A.2d 787 (Del. Ch. 2000).

89. *Danziger*, 815 N.E.2d at 665 (O' Donnell, J., dissenting) (citing South Side Bank v. T.S.B. Corp., 419 N.E.2d 477 (Ill. App. Ct. 1981); Logal v. Inland Steel Indus., Inc., 568 N.E.2d 152 (Ill. App. Ct. 1991)).

90. DEL. CODE ANN., tit. 8, § 220(b)(2) (West 2003) ("Any stockholder, in person or by attorney or other agent, shall upon written demand under oath stating the purpose thereof, have the right during

After concluding that the inspection of a subsidiary's books or records required fraud or an alter ego relationship, the dissent applied its standard to the facts of the case.[91] As the Danzigers did not allege fraud in their complaint, the dissent found that the dispositive issue "should be limited to a determination of whether the bank is or is not the mere alter ego of Croghan."[92] The dissent then cited other courts that had applied alter ego analysis to develop a list of criteria useful in piercing the corporate veil.[93] Characteristics suggesting an alter ego relationship between parent and subsidiary and justifying the disregard of the subsidiary's separate corporate existence included the absence of corporate formalities, commingling of personal and corporate assets, a dominant stockholder's siphoning of corporate funds, and "the fact that the corporation is merely a facade for the personal operations of the dominant stockholder."[94] The dissent, in addition to those criteria, found the alter ego test employed by the Supreme Court of Kansas useful in its analysis:

> [T]he "ultimate test for imposing alter ego status is whether, from all of the facts and circumstances, it is apparent that the relationship between the parent and subsidiary is so intimate, the parent's control over the subsidiary is so dominating, and the business and assets of the two are so mingled that recognition of the subsidiary as a distinct entity would result in an injustice to third parties."[95]

After reviewing several more cases in which other courts had elucidated criteria for establishing the existence of an alter ego relationship, the dissent concluded that the court "should consider a broad and inclusive list of factors in deciding whether Croghan so dominates and controls the bank."[96]

The facts of this case did not convince the dissent that Croghan's ownership of all the Bank's shares, its reliance on the Bank for all of its income, and the commonality of directors and officers taken together was sufficient to establish that the Bank was the mere alter ego of its

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the usual hours for business to inspect for any proper purpose, and to make copies and extracts from: . . . (2) A subsidiary's books and records, to the extent that: (a) The corporation has actual possession and control of such records of such subsidiary; and (b) The corporation could obtain such books and records through the exercise of control over such subsidiary . . . .").

91. *Danziger*, 815 N.E.2d at 668 (O' Donnell, J., dissenting).

92. *Id*. at 666.

93. *Id*.

94. *Id*.

95. *Id*. at 667 (quoting Doughty v. CSX Transp., Inc., 905 P.2d 106, 108 (Kan. 1995)).

96. *Id* at 668.

parent.[97] That the two companies maintained separate records and conducted separate board and shareholder meetings supported the conclusion that their independent corporate existences should not be ignored.[98] The dissent then addressed each of the three bases on which the majority supported its finding of an alter ego relationship.[99]

First, the dissent dismissed the notion that a subsidiary is the alter ego of its parent simply because the parent is the sole owner of that subsidiary.[100] Citing Texas and Illinois precedent, it concluded that the majority failed to make "the distinction between corporate control incident to stock ownership and control of day-to-day operations of a subsidiary's business."[101] While Croghan, as the sole shareholder, was in a position to influence the Bank, the Danzigers failed to demonstrate that "Croghan control[led] the day-to-day operations of the bank's business."[102] Therefore, the majority was not justified in disregarding the Bank's separate corporate existence.[103]

Second, the dissent took issue with the majority's reliance on the common membership of the boards of directors at Croghan and the Bank.[104] Relying on *Carapico* and *Skouras*, it found that "longstanding precedent recognizes two separate corporations despite the fact the same individuals occupy positions as members of the board of directors of each corporation."[105] The dissent found that any inference of alter ego raised by the boards' makeup was mitigated by their practice of holding separate meetings and recording the minutes of their proceedings independently.[106]

Finally, the dissent confronted the majority's conclusion that the Bank, by providing all of Croghan's income in the form of dividends, had become the alter ego of its parent.[107] It found that the differences between the passive dividend income derived by Croghan and the Bank's income derived in the "normal course of conducting banking operations" precluded a finding that the two corporations were, in

97. *Id*.

98. *Id*.

99. *Id*.

100. *Id*. at 669.

101. *Id*. (citing Gentry v. Credit Plan Corp. of Houston, 528 S.W.2d 571, 573 (Tex. 1975); Main Bank v. Baker, 427 N.E.2d 94, 101 (Ill. 1981)).

102. *Id*.

103. *Id*.

104. *Id*.

105. *Id*.

106. *Id*. at 670.

107. *Id*.

reality, the same entity.[108]

In concluding, the dissent implied that it was more concerned with the broader application of the majority's approach than with the expansion of the shareholders' right to inspect books and records.[109] Most notably, it was concerned that the majority's standard would migrate into cases involving piercing the corporate veil, because the first prong of the three-pronged test used by the court in determining whether to hold shareholders liable for a corporation's wrong-doing also depends on alter ego analysis.[110] By lowering the standard for establishing alter ego, the dissent feared that the majority approach would expose shareholders to additional liability and further discourage the growth of business in Ohio.[111]

IV. THE APPROPRIATE STANDARD

A. Other Shareholder Rights With Regard to Subsidiaries

Although the issue of a parent shareholder's right to inspect the books and records of a subsidiary presented the Ohio Supreme Court with an issue of first impression, concern over the proliferation of subsidiaries' effect on shareholder rights is nothing new. In a 1971 *Harvard Law Review* article, Professor Melvin Eisenberg identified the emergence of what he termed the "megasubsidiary" and advocated for pass-through rights for the protection of shareholders.[112] At the time of Eisenberg's article, the dominance of subsidiaries was a relatively new development in corporate structure.[113] He observed that many previously independent corporations had recently "turned themselves into subsidiaries by reversing normal corporate biology and creating their own parents."[114] This phenomenon was most noticeable in the heavily regulated banking and insurance industries. In the case of commercial banking, regulations prohibited banks from engaging in many potentially lucrative non-banking activities.[115] Because these restrictions did not apply to one-bank holding companies, many banks turned themselves into wholly

108. *Id*.

109. *Id*. at 672.

110. *Id*.

111. *Id*.

112. Melvin Aron Eisenberg, *Megasubsidiaries: The Effect of Corporate Structure on Corporate Control*, 84 HARV. L. REV. 1577 (1971).

113. *Id*. at 1579.

114. *Id*. at 1580.

115. *Id*.

owned subsidiaries of newly created parents, in order to pursue opportunities in the investment brokerage, data processing, and travel industries.[116]

After describing the megasubsidiary's emergence as an important corporate form, Eisenberg identified a related and troubling problem:

> A major function of the corporate statutes is to allocate powers between shareholders and management. Characteristically, the statutes provide that certain corporate actions normally must be effected or approved by the body of the shareholders or by the holders of a designated percentage of outstanding shares. Suppose that a subsidiary proposes to take an action which comes within the statutory province of shareholders. Who are then "the shareholders" whose approval is statutorily required—the parent or the parent's shareholders?[117]

Although the U.S. corporate structure had generally granted the parent corporation the statutory powers of a shareholder with respect to its subsidiaries, this model of governance was problematic when applied to megasubsidiaries. If the economic substance of an organization rests with the subsidiary, and not the parent, the parent corporation's shareholders are stripped of important rights. In response to this problem, Eisenberg proposed that in some cases, "the right to vote the subsidiary's stock either inheres in the parent and is exercisable by the body of the parent's shareholders, or passes through the parent directly to the parent's shareholders."[118] However, this concept of pass-through rights for a parent company's shareholders was "no stranger to the corporate institution."[119] The double-derivative action and the sale of substantially all of a subsidiary's assets presented two circumstances in which courts were already willing to allow a parent's shareholders to exercise some level of control over the affairs of a subsidiary.

1. Double-Derivative Actions

One of the most powerful tools employed by shareholders is the derivative lawsuit. Shareholders may bring a derivative suit "when the people ordinarily entrusted with the responsibility for vindicating the corporation's rights—typically the management—have refused to do so."[120] In these cases, shareholders sue on behalf of the corporation to

116. *Id*. at 1581.

117. *Id*. at 1587.

118. *Id*. at 1588–89.

119. *Id*. at 1596.

120. JACK H. FRIEDENTHAL, MARY KAY KANE & ARTHUR R. MILLER, CIVIL PROCEDURE § 16.9 (3d ed. 1999).

redress the wrong, instead of suing as individuals.[121] Because the derivative lawsuit is intended to benefit the corporation, Federal Rule of Civil Procedure 23.1 and its state law counterparts require that the shareholders present the claim to the corporation's directors before filing it.[122] Only after the directors refuse to take action may the shareholders proceed with a derivative suit.

The double derivative action is probably the most common and well-settled example of pass-through shareholder rights. In a double derivative action, shareholders of a parent corporation may sue on behalf of a subsidiary of the parent, despite their lack of direct ownership in the subsidiary. Like a regular derivative action, the corporation's refusal to act on the claim itself is a prerequisite. The requirement for a double derivative differs however in that both the subsidiary and the parent must refuse to act before the shareholders can maintain an action.[123] In the case of double derivative actions, disregard for the subsidiary's separate corporate existence is justified because "[a]bsent such a pass-through, a vital shareholder right (the right to a loyal and careful management) could be subverted merely by the insertion of an extra layer of entity between ownership and management."[124]

2. Sale of Subsidiary Assets

The sale of a subsidiary's assets presents another situation in which a parent corporation's shareholders may be accorded some pass-through rights. Although shareholders are not included in decisions regarding the disposal of assets in the ordinary course of business, state corporate codes typically require shareholder approval of major dispositions. Under the relevant provision of the Ohio corporate code, directors must seek shareholder approval when disposing of "all, or substantially all, of the assets . . . of a corporation."[125] In some situations, these provisions allow shareholders to intervene in the affairs of a subsidiary in which they do not own stock. For example, the Danzigers would have been able to exercise their rights as shareholders if the Bank had attempted to sell all, or substantially all, of its assets, even though they were not its shareholders. As the Bank was Croghan's only asset, and the Danzigers were shareholders of Croghan, a court could recognize their right to intervene.

121. HENRY WITHROP BALLANTINE, BALLANTINE ON CORPORATIONS § 143 (rev. ed. 1946).

122. FED. R. CIV. P. 23.1.

123. BALLANTINE, *supra* note 121, § 148.

124. Eisenberg, *supra* note 112, at 1597.

125. OHIO REV. CODE. ANN. § 1701.76(A)(1) (West 2005).

In *Story v. Kennecott Copper Corp.*,[126] plaintiff-shareholders sought to compel the corporation to distribute the proceeds from the sale of a subsidiary.[127] Relying on a New York statute requiring shareholder approval for sales of all or substantially all of the corporation's assets, the plaintiffs argued that their authorization was necessary for the sale of Kennecott's subsidiary, Peabody.[128] As the court found that Peabody did not constitute "all or substantially all" of the corporation's assets, the plaintiffs did not prevail. However, had the subsidiary been a more substantial component of Kennecott's business, the sale of its assets would have required approval of the parent's shareholders.[129] The justification for allowing shareholders of the parent to intervene in the sale of a subsidiary's assets is similar to that supporting the double-derivative action. Allowing a corporation to strip the majority of its assets, through the sale of a economically dominant subsidiary, without the approval of its own shareholders would be unjust.

B. Existing Standards Compared

The justification for the extension of the rights of a parent company's shareholders in the case of derivative actions and the sale of a subsidiary's assets also supports the extension of the right to inspect books and records. If a corporation can block the shareholder's right to inspect the books and records by inserting an additional layer in the corporate structure, an important control measure is circumvented. This is especially true in cases such as *Danziger*, where the subsidiary is wholly owned and economically dominant. Shareholders purchasing stock in a one-bank holding company almost certainly consider themselves to be interested parties in the bank itself. As the holding company is merely a product of the banking regulatory scheme, the shareholders' investment decision was most likely informed by the operating results and prospects of the Bank, and not the bank holding company. Clearly, shareholders of a parent corporation should have the right to inspect a subsidiary's books and records.

However, reaching the conclusion that such a right should be recognized does not end the inquiry. It is still necessary to determine the circumstances under which shareholders should be permitted to exercise such a right.

126. 394 N.Y.S.2d 353 (N.Y. Sup. Ct. 1977).

127. *Id*.

128. *Id*. at 354.

129. *Id.* at 354–55.

1. Plain Language of Current Statute

Of the three commonly applied approaches to the inspection of a subsidiary's books and records, the plain language approach is the least acceptable. Although an overwhelming majority of jurisdictions maintain statutes that do not provide for the inspection of a subsidiary's books and records, courts are increasingly unwilling to end their inquiry on the face of the statute. In both *Danziger* and *State v. III Investments, Inc*, appellate courts expressly rejected the plain language approach applied by lower courts to prevent inspection.[130] Even courts willing to apply the statute literally have expressed concern that the legislative purpose of inspection statutes is being undermined by corporate structure.[131]

As long as states continue to exclude the right to inspect a subsidiary's books and records from their corporate codes, courts should avoid applying the plain language approach. The right of inspection is intended to ensure corporate accountability, and courts should further this purpose by looking beyond the plain language of the statute.

2. Alter Ego or Fraud

Courts rejecting the plain language approach have predominantly relied on alter ego analysis or allegations of fraud when determining whether shareholders of a parent corporation may inspect the books and records of a subsidiary. Delaware's endorsement of this approach certainly led to its adoption as the majority rule. The dissent in *Danziger* advocated for the alter ego approach and supported its position by referring to it as the "Delaware rule."[132] Of course, it failed to mention that alter ego analysis was actually Delaware's old rule. After the 2003 amendment of the inspection statute, Delaware shifted to a control or domination approach.[133]

Requiring that a subsidiary be the alter ego of its parent or that the plaintiff-shareholders establish fraud is problematic for at least two reasons. First, alter ego analysis often involves complicated balancing and consideration of many factors. Courts applying this approach are likely to reach inconsistent results and spend more time than necessary to resolve the issue. At least in the case of wholly owned, economically

130. Danziger v. Luse, 815 N.E.2d 658, 660 (Ohio 2004); State v. III Investments, Inc, 80 S.W.3d 855, 866 (Mo. Ct. App. 2002).

131. Feldman v. San Mateo Fin. Corp., 276 Cal. Rptr. 285, 288 (Cal. Ct. App. 1990).

132. *Danziger*, 815 N.E.2d at 665.

133. *See, e.g.*, Weinstein Enter., Inc. v. Orloff, 870 A.2d 499 (Del. 2005).

dominant subsidiaries, such as the Bank in *Danziger*, parent corporations should not be allowed to circumvent shareholders' rights by merely complying with the corporate formalities and maintaining the subsidiary's separate corporate existence. Even when the parent and subsidiary maintain independent records and have separate boards of directors, the fact remains that the shareholders' real interest is in the subsidiary, not in the parent.

Second, courts applying the alter ego approach may be inclined to lower the standard in cases where shareholders are seeking to inspect the books and records of a subsidiary. After all, in most instances, the results of a shareholder inspection will not have the impact of piercing the corporate veil to establish parent-shareholder liability. The problem is that a lower alter ego standard in this area could very easily migrate to cases involving piercing the corporate veil. When a standard is applied in several areas of the law, courts should be careful to avoid making changes in one area that could adversely affect another application.

3. Domination or Control

The third and most sensible approach requires that a parent corporation dominate or control the subsidiary before shareholders of the parent will have the right to inspect the books and records of the subsidiary. The majority in *Danziger* found that Croghan's level of control over the Bank justified an extension of the shareholders' right to inspect.[134] However, the manner in which the majority applied the approach made it difficult to differentiate it from the alter ego analysis. Relying on the same facts as the dissent, the majority determined that Croghan did control the Bank, while the dissent found that the Bank was not Croghan's alter ego. To avoid the previously discussed problems with alter ego analysis and the pitfalls of a highly subjective test, courts should adopt the new Delaware approach to domination or control.

By explicitly conferring a right to inspect the books of a subsidiary, the Delaware corporate code dispenses with the difficulties of finding the right in the common law. Although the statute relies on control or domination as the deciding factor, as described by the Delaware Supreme Court in *Weinstein*, the test is much more objective than the test applied by the majority in *Danziger*. The court, instead of alter ego analysis, examined control by looking at the parent's percentage of ownership in the subsidiary and its actual power to effect change at the

134. *Danziger*, 815 N.E.2d at 662–63.

subsidiary by exercising its own rights as a shareholder.[135] It stressed the importance of determining whether the parent company had enough voting power to elect directors that could, in turn, control the subsidiary. Importantly, the court also drew a sharp distinction between the parent's ability to control as a shareholder (i.e., vote to elect certain directors) and its ability to control the day-to-day operations of the subsidiary.[136] While a parent corporation with 51 percent ownership in a subsidiary will be able to control shareholder voting, it may not be able to force the subsidiary to produce documents for inspection.[137]

V. CONCLUSION

Although the *Danziger* majority's suggestion that an extended right of shareholder inspection may have prevented the "worst offenses of the Enron scandal" may be an exaggeration, the right does remain an important component of shareholder protection and corporate governance.[138] The shareholders' ability to effect change through the voting process and other rights may be insufficient in times of crisis, because of the long, drawn-out disputes that often ensue. The right to inspect books and records, on the other hand, provides shareholders with an immediate check on the corporation's accountability. The *Danziger* court recognized the importance of the right of inspection and clearly furthered its purpose by allowing the inspection of the subsidiary's books and records. However, neither the majority nor the dissent succeeded in developing an approach that should be followed going forward. The approach adopted by the majority unnecessarily complicates the issue and threatens to dilute the alter ego analysis employed in other areas of corporate law, while the dissent's approach does not do enough to prevent the circumvention of shareholders' rights.

Ohio, and other states, would be best served by following Delaware's lead and amending its inspection statute to allow the shareholders of a corporation to inspect the books and records of that corporation's subsidiaries. Applying the two-part inquiry laid out by the Delaware

135. *Weinstein Enter., Inc.*, 870 A.2d at 507–08.

136. *Id*.

137. *Id*. at 508.

138. *Danziger*, 815 N.E.2d at 662. Some commentators have recognized the usefulness of inspection statutes as tools in discovery. *See* Randall S. Thomas & Kenneth J. Martin, *Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions*, 77 B.U. L. REV. 69 (1997) and Jonathan D. Horton, *Oklahoma Shareholder and Director Inspection Rights: Useful Discovery Tools?*, 56 OKLA. L. REV. 105 (2003).

Supreme Court in *Weinstein*,[139] the *Danziger* case is much simpler. It obviates both the reliance on centuries-old cases for a common law right to inspect and the sometimes convoluted alter ego analysis. A court applying this test need only ask (1) whether the company, whose books and records the plaintiff seeks to inspect, is a subsidiary of the parent and (2) whether the parent has the actual control necessary to force its subsidiary to produce the books and records. In *Danziger* both of these questions would clearly be answered in the affirmative. This new Delaware approach produces fair results by allowing inspection in cases where the subsidiary, as the economically dominant corporate unit, is the shareholder's true interest. Flatly denying a parent shareholder's right of inspection or laboring through alter ego analysis to reach the right places form over substance and should therefore be replaced by a new statutory approach.

139. *Weinstein Enter., Inc*., 870 A.2d at 506.