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Rationale and Framework Design for the Exercise of Parent Company Shareholders' Pass-through Rights

Miao Wang[1]

Abstract

The "shareholders' rights pass-through" in the context of a parent-subsidiary corporate framework refers to allowing shareholders of the parent company to bypass the legal entity barriers between the parent and subsidiary companies, thereby exercising the right to inspect the subsidiary's books. This system is also known as the "parent company shareholders' book inspection regime". In the face of global economic integration, the trend toward corporate group structures is inevitable. Traditional corporate law, centered around individual corporations, is ill-equipped to address the complexities of corporate groups. As a result, insiders of a corporation might exploit the parent-subsidiary structure to unjustly deprive parent company shareholders of their rightful information access, thereby illicitly consuming corporate assets. This paper examines the theories and practices of corporate law in the United States, Japan, and other countries, aiming to explore the potential adoption of the shareholders' rights pass-through system in China. We argue that in designing this system and the exercise of such rights in China, several issues should be considered: under what parent-subsidiary company structures should parent company shareholders be allowed to inspect subsidiary books; what grounds might subsidiaries have to deny such pass-through information rights; whether court permission is a prerequisite; and whether there should be specific shareholding requirements for the parent company's shareholders.

Keywords

shareholders' rights pass-through system; shareholder book inspection rights; legal applicability requirements.

Introduction

In modern corporate systems, the separation of ownership and management control necessitates that shareholders are granted the right to access pertinent company information, essentially endowing them with the right to be informed (Jiang, 2005). While shareholders can obtain necessary information through mandatory disclosure, not all information is suitable for public dissemination. Thus, shareholders must exercise their right to inspect the company's books to gain the needed insight. This right to inspect the company's financial records is crucial for internal governance. This article delves into shareholders' rights to information, focusing on their right to inspect financial records. This right entails accessing and copying the company's accounting books and financial statements (Pang, 2007). By exercising this right, shareholders can access original company data, enabling them to grasp the actual operational status of the company and avoid being misled by financial reports prepared by the board of directors. Moreover, by reviewing or copying the accounting records and related documents, shareholders can promptly detect any illegal acts within the board, facilitating legal actions against negligent directors. To safeguard this right, the Company Law of the People's Republic of China (hereinafter Company Law of PRC), explicitly stipulates shareholders' rights to inspect financial and accounting records. Depending on the type of company, Articles 34 and 98 of the Company Law of PRC provide specific provisions and criteria for the exercise of this right by shareholders in limited liability companies and joint-stock companies, respectively.

In traditional Company Law, shareholders' rights to inspect financial records are typically confined to the company where they have made investments, not extending to other entities with their own legal identities. With the rise of corporate groups, the internal monitoring structures face disruptions due to the parent-subsidiary architecture. The distinct legal personalities of subsidiaries can prevent parent company shareholders from accessing crucial information, leading to ineffective oversight. More specifically, corporate executives might leverage the legal barriers between parent and subsidiary entities to hinder shareholders from obtaining vital business and financial details of the subsidiaries, thus undermining the established shareholder inspection rights. In practice, when a corporate group's operational assets are concentrated within its subsidiaries, the financial wellbeing of parent company shareholders largely hinges on these subsidiaries. If these shareholders are barred from accessing information from the subsidiaries, monitoring and evaluating the subsidiaries' operational health becomes exceedingly difficult. Consequently, it is proposed that parent company shareholders should be allowed to navigate through these legal barriers within the parent-subsidiary construct to exercise their rights to inspect the subsidiaries' books. In academic and legal discussions, this is termed as the

[1] Chongqing University Law School

Corresponding author:
Miao Wang, Chongqing University Law School
Email: mwang1@gmail.com

"parent company shareholders" information rights pass-through system" or "parent company shareholders" pass-through book inspection regime."

Theoretical Disputes in American Case Law

In American case law, the question of whether parent company shareholders have the right to inspect the books of a subsidiary is not uniformly addressed across states, with many lacking explicit statutes initially. Courts in various states have expressed differing opinions on the applicability of such rights for parent company shareholders. Generally, these views can be categorized into two groups: those completely denying and those acknowledging the right of parent company shareholders to inspect subsidiary books.

Regarding the denying perspective, most courts adhere to a literal interpretation of statutes, strictly applying the law to deny parent company shareholders' rights to inspect subsidiary books. For instance, in the 2001 case of Noel Saito v. McKesson HBOC, Inc., Delaware's General Corporation Law did not specify this cross-inspection right ("Noel Saito v. McKesson HBOC,INC." 2001a). The Delaware courts, following the letter of the law, upheld that unless fraud is involved or the companies are proven to be essentially the same entity, parent and subsidiary companies should be treated as separate legal entities. Since the plaintiff, a parent company shareholder, was never a shareholder of the subsidiary HBOC, they were not granted rights under Delaware Corporation Law Section 220 to inspect HBOC's books, and the Delaware Supreme Court denied the request for access.

On the affirming side, opinions diverge into the "alter ego theory" and the "control or domination theory." The alter ego theory, or "fraud theory," is invoked by courts that reject literal interpretation to determine shareholder rights ("Danziger v. Luse", 2004). Before revisions to Delaware's General Corporation Law, courts in Delaware permitted parent company shareholders to inspect subsidiary books only if fraud was demonstrated or the companies were shown to be essentially the same entity, a principle often used to pierce the corporate veil ("Noel Saito v. McKesson HBOC,INC." 2001b).When a company acts merely as an instrument or conduit of another, and the independence of the corporation is disregarded by its shareholders or itself, its corporate form might be legally disregarded (Fletcher, 1999).The control or domination theory suggests that parent company shareholders may inspect subsidiary records only if the parent exercises sufficient control to justify treating the entities as not legally separate. This theory is applied by courts as a decisive factor akin to piercing the corporate veil. In situations where the parent extensively controls the subsidiary, the parent might bear liability for the subsidiary's wrongful acts (Henry G & John R, 1983). As Justice Cardozo once explained, when a parent company's domination and interference in a subsidiary are overwhelmingly complete, it might be reasonable under common agency principles to treat the parent as the principal and the subsidiary as the agent ("Berkey v. Third Ave. Ry. Co." 1926). If this rationale applies to book inspection cases, the logic that attributes the subsidiary's responsibilities to the parent could support the parent company shareholders' right to access the subsidiary's books and records (Matthew A, 2006).

Justification for Parent Company Shareholders to Inspect Subsidiary Books

When the law does not specify, the question of whether parent company shareholders can review subsidiary financial records becomes essential for defining the scope of their inspection rights. This issue was thoroughly examined in the 2004 Ohio case of Danziger v. Luse ("Danziger v. Luse", 2005; "REV. CODE ANN", 2005). In this case, Jared, Nathan, and Samuel Danziger, shareholders in Croghan Company, whose significant asset was its subsidiary Croghan-Colonial Bank, requested access to the financial records of both the parent and subsidiary. After receiving no response from Croghan, the Danzigers filed a lawsuit asserting their rights to inspect the books of both entities. Croghan acknowledged the shareholders' right to inspect its records but refused access to the subsidiary's records, arguing the plaintiffs were not shareholders of Croghan-Colonial Bank. The Ohio lower court strictly applied Ohio's shareholder inspection statutes, which did not articulate rights to inspect wholly-owned subsidiaries' records, and ruled against the Danzigers. Dissatisfied, they appealed to the Ohio Supreme Court. The Ohio Supreme Court, consisting of seven justices, concurred that the interpretation should not be confined to the statutory text alone but debated between adopting the alter ego/fraud theory and the control/domination theory. By a 4-3 decision, they chose the control theory, recognizing the plaintiffs' entitlement to inspect the subsidiary's records. Justices who favored the "same entity theory" observed that Delaware's General Corporation Law, prior to its amendment, did not specifically address the right to inspect the records of subsidiaries, a standard consistent across various state corporate laws. Traditionally, Delaware courts permitted shareholders of a parent company to review subsidiary records only under circumstances of proven fraud or when the parent and subsidiary effectively operated as the same entity. This approach has been a fundamental aspect of the doctrine for piercing the corporate veil. In the Danziger case, since no allegations of fraud were made, the critical question was whether the subsidiary and parent functioned as essentially the same entity. The court examined criteria for piercing the corporate veil and recognized the standards for considering an operation as the same entity, as identified by the Kansas Supreme Court, which includes overly close relationships, predominant control by the parent, and business and asset intermingling that would significantly harm third parties if the subsidiary were regarded as separate. Nonetheless, given the distinct financial records and independent governance meetings of Croghan Company and Croghan-Colonial Bank, the court concluded they did not operate as the same entity. Justices in favor of the "control theory" believed that Croghan Company's significant control over Croghan-Colonial Bank made it reasonable to extend shareholders' inspection rights, thereby increasing transparency and offering additional opportunities to deter wrongdoing. Since Croghan Company wholly owned Croghan-Colonial Bank, shared its board of directors, held

annual meetings simultaneously, and conducted these at the bank's premises, with all financial activities centered on the bank, the case supported negating the separate legal status of Croghan-Colonial Bank. As a result, the Danzigers, being shareholders of Croghan Company, should have the right to access the financial records of Croghan-Colonial Bank.

It is clear from these proceedings that courts are shifting from the same entity or fraud theory to the control or domination theory when addressing cases where parent company shareholders seek access to subsidiary records. Additionally, there are identified drawbacks to using the same entity or fraud theory: it entails complex considerations and multiple factors, which can lead to inconsistent outcomes and consume considerable time. Particularly in corporate groups where subsidiaries possess critical assets, the mere formal legal separation between a parent and its subsidiary should not preclude parent shareholders' rights. For instance, in the Danziger case, even though the parent and subsidiary had separate records and boards, the shareholders' genuine interests were with the subsidiary, not the parent, suggesting their rights should be maintained. Also, excluding parent shareholders' rights could result in inefficient capital distribution within the corporate group. Moreover, when parent shareholders exercise inspection rights, the objective is not to attribute liability to them by piercing the corporate veil. Hence, courts favoring the same entity theory typically apply a less stringent standard, raising concerns about this leniency extending to other veil-piercing cases. Courts must exercise caution to ensure that adopting a standard in one context does not adversely affect its application in another. Furthermore, it's important to note that the control theory was explicitly embraced in the 2003 amendment of Section 220 of the Delaware General Corporation Law. This revision clarified that parent company shareholders are entitled to inspect the subsidiary's books when the parent has actual control and possession of the subsidiary's financial records or can access these records through its control over the subsidiary ("Del. Code Ann. tit." 2003).

Prerequisites for Parent Company Shareholders to Inspect Subsidiary Books

Upon establishing the legitimacy for parent company shareholders to access subsidiary records, the next step involves identifying specific conditions under which these rights are applicable. The United States and Japan have legislative provisions outlining scenarios where parent company shareholders may exercise inspection rights over subsidiary books. The discussion here focuses on the application of these statutes in American and Japanese law.

Application of Section 220 of the Delaware General Corporation Law

The 2003 amendment to the Delaware General Corporation Law expanded the inspection rights of controlling company shareholders to encompass subsidiaries. Initially, the law clarifies the definition and scope of a subsidiary (W. Xu, 2010). Under Section 220(a)(3), a subsidiary is defined as any entity, whether directly or indirectly, wholly or partially owned by the company, whose shareholders are also the company's shareholders, and where the company controls the entity's affairs, including corporations, partnerships, and other entities. Section 220(b)(2) delineates conditions under which parent company shareholders can inspect subsidiary books and records. Shareholders may inspect if (1) the company factually holds and controls the subsidiary's records; (2) the company can access these records by exercising control, assuming the inspection does not contravene any agreements with third parties; and (3) the subsidiary has no legal basis to deny access to these records. This indicates that inspection rights are void if they breach legal or contractual obligations. Moreover, after meeting these conditions, parent company shareholders must present a written request to the parent company to examine the subsidiary's records.

Analysis of the Current Japanese Company Law

In 2005, Japan overhauled its Commercial Code, introducing the new Company Law that consolidated shareholder inspection rights from the previous code into Article 433, maintaining the rights for parent company shareholders to review subsidiary books ("Companies Act (Part I, Part II, Part III and Part IV)", 2005). Here's how these rights are structured:

a. Exercise Requirements: Article 433(3) of the Japanese Company Law states that parent company shareholders, when necessary for exercising their rights, may request court permission to access accounting books or related materials, clearly stating their reasons. Article 433(1) allows shareholders with at least 3% voting rights (or a lower percentage if the articles of incorporation permit) to make such requests, detailing their rationale for either inspecting or copying the materials, whether in written or electronic form.
b. Grounds for Refusal: Moreover, Article 433(4) outlines conditions under which a court may deny such permission, thus allowing the company to refuse the inspection request. These include scenarios where the request is for non-investigative purposes, aims to disrupt the company's operations, competes with the company's business, seeks to profit from disclosing information to third parties, or involves a requester who has previously benefited from such disclosures.

Comparison, Lessons, and Considerations

In today's increasingly refined corporate frameworks, the parent-subsidiary structure has become commonplace. While this structure brings various benefits to corporate operations, it also presents challenges for the exercise of parent company shareholders' rights(L. Xu & Wu, 2005). Absence of a pass-through inspection system in legislation could leave parent company shareholders uninformed about subsidiary operations, complicating the exercise of their rights. Thus, to restore parent shareholders' rights within this structure, it's advocated that China's corporate law should introduce a pass-through inspection system. Drawing from American and Japanese legal theories and practices, this paper suggests

the following considerations for China in designing such a system and enabling shareholder rights:

1. Under what parent-subsidiary configurations can parent company shareholders request to inspect subsidiary books? Since the concept of "parent-subsidiary" is not explicitly defined in the Company Law of PRC, it's crucial to determine applicable configurations for a pass-through inspection regime. The Delaware General Corporation Law in the U.S. specifies two conditions for such an inspection: a control and subordination relationship, and the parent company's possession or control-derived access to the subsidiary's books. The first condition, involving recognizing the parent-subsidiary relationship, requires discussion. The second condition, concerning "control," may not be straightforward in practice and needs clearer definition. This paper suggests that instead of adopting the U.S. standards of "control and subordination" and "control," consideration should be given to the practical control exerted by parent company directors and executives over the subsidiary, balanced with the subsidiary's autonomy. The right to inspect the subsidiary's books should be granted when the parent company owns more than half of the subsidiary's voting shares.
2. On what grounds can a subsidiary deny a parent company shareholder's request to inspect records? Currently, the Company Law of PRC specifies reasons for denying a shareholder's request to inspect financial records only in the context of limited liability companies. It states that if a company reasonably believes a shareholder's request to inspect the accounting books has improper motives that could harm the company's legitimate interests, the company may deny access and must provide written reasons within fifteen days of receiving the request(Ye, 1997). In situations involving parent and subsidiary companies, where the subsidiary's accounting records hold critical operational information, if a parent company shareholder's request is essentially aimed at acquiring confidential information under the guise of inspecting records, it poses a potential harm to the subsidiary. Therefore, when considering the incorporation of a pass-through inspection regime, the Chinese legislation should clearly define the circumstances under which a subsidiary can refuse such a request. The Delaware General Corporation Law, for instance, outlines "contract violation" and "law infringement" as grounds for refusal. Meanwhile, the Japanese Company Law Article 433 provides five specific grounds, including requests made for purposes other than investigation, intentions to harm the company or shareholders' mutual interests, competitive business relations, or the desire to disclose information for personal gain. The U.S. approach of "contract violation" might be overly narrow, and "law infringement" too broad, whereas the Japanese approach directly addresses potential damages to the company. Thus, this paper suggests blending "legitimate purpose" and "no harm to the company's interests" as criteria, allowing subsidiaries to deny requests if they can prove the shareholder's inspection motives are not for investigation or could potentially harm the company, with a requirement to explain their reasons in writing within fifteen days of the request.
3. Should court permission be a prerequisite? Unlike the Company Law of PRC, which doesn't require court approval for book inspections, Japan mandates judicial permission for such requests. Given that shareholder inspection pertains to internal governance and courts lack commercial expertise, mandating judicial approval could contradict business autonomy. The U.S. law does not require court permission as a prerequisite but allows shareholders to seek a court order for enforcement as a remedial action. Similarly, Article 34 of the Chinese Company Law stipulates that if a company refuses to provide access, shareholders may petition the court to compel disclosure. As a safeguard for shareholder inspection rights, Chinese law already includes judicial intervention as a remedial measure. Therefore, this paper suggests following the spirit of China's existing legal framework and drawing on U.S. practice, designing a remedy where if a subsidiary unjustifiably refuses access or fails to respond within 15 working days after a request, shareholders should be entitled to seek court intervention to obtain the necessary records.
4. Should there be shareholding requirements for parent company shareholders? China's current law doesn't specify shareholding thresholds for exercising inspection rights. Similarly, neither the Delaware General Corporation Law in the U.S. nor the Japanese Company Law specifies shareholding prerequisites for parent company shareholders to exercise pass-through inspection rights, indicating that any parent company shareholder, upon meeting other stipulated conditions, is entitled to request these rights. Notably, in the recent discourse on amending Japanese Company Law, some viewpoints argue that if there's a "3% voting right" threshold for parent company shareholders to inspect the parent's books, applying a lower threshold for inspecting subsidiary books might be deemed inconsistent. They advocate that the requirement for parent company shareholders to inspect subsidiary books should be at least as stringent as the "3% voting right" criterion ("Organizing Association of Law: Opinions on the revision of the company law – centered on the parent company law", n.d.). Nevertheless, this paper posits that exercising book inspection rights is intrinsic to shareholder entitlements. Imposing additional shareholding stipulations could detract from the legal framework's purpose of safeguarding shareholder rights; thus, imposing such restrictions on parent company shareholders would be inappropriate.

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