Substantive Consolidation: A Critical Examination

Andrew Brasher
(abrasher@law.harvard.edu)

Modern businesses are composed of multi-tiered, overlapping layers of complex corporate entities.[1] Sometimes subsidiary limited liability companies, partnerships and special-purpose corporate entities operate independently of the corporate group. More often, however, they are only viable within the greater corporate enterprise. When one of these corporate behemoths files for bankruptcy, the court must address a fundamental question: Are these entities legally distinct or should they be collapsed? This Note seeks to provide a framework for answering that question through an examination of substantive consolidation.

Substantive consolidation is the pooling of the assets and liabilities of technically distinct corporate entities. For the purposes of confirming a Chapter 11 plan or for liquidating assets under Chapter 7, the creditors of the previously distinct subsidiaries are creditors of a single debtor. Although courts use language akin to "piercing the corporate veil," the doctrines are quite distinct—instead of pooling assets vertically (e.g. parent and subsidiary), substantive consolidation pools asserts horizontally (e.g. subsidiary and subsidiary).[2] Despite several attempts to craft a coherent doctrine at the appellate level, however, bankruptcy courts continue

[1] *See generally*, Steven L. Schwarcz*, Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. Cin. L. Rev. 1309 (2002). Enron was composed of around 2,000 entities. Joseph N. Distefano*, In Delaware, Enron Found Secrecy and Savings*, PHILA. INQUIRER, Jan. 31, 2002, at A1.

[2] A short hypothetical can tease out this difference. Corporation A wholly owns Corporations B and C. B is undercapitalized and cannot pay its creditors. Assume that a bankruptcy court could either pierce B's corporate veil or substantively consolidate B and C. If the bankruptcy court pierced B's veil, then B's creditors would take first from B's assets and then the remainder of their claims from A's distinct assets. C would remain a distinct subsidiary. Corporation A may pay off B's unpaid creditors by giving them its stock in C. C's creditors, however, would remain completely unaffected. If, however, B and C were substantively consolidated, the assets and liabilities of all three entities would be pooled and all cross stock ownership would be wiped out. B's creditors, C's creditors, and A's creditors would all have equal pro-rata claims against a single pool of assets.

to apply substantive consolidation without a coherent theoretical framework.[3] This lack of theoretical coherence makes courts hesitant to order substantive consolidation under the best of facts and leads to irregularity when they do.

The failure of courts and scholars to coherently rationalize substantive consolidation is particularly problematic. First, the bankruptcy court's power to substantively consolidate is built upon a shaky statutory and equitable foundation.[4] Second, unlike equitable subordination or other equitable remedies, substantive consolidation "almost invariably redistributes wealth among [all] creditors;"[5] creditors of a less solvent entity will gain at the expense of creditors of the more solvent entity and vise versa. By combining ALL the assets and liabilities of multiple debtors, substantive consolidation fundamentally alters the value of creditors' claims.

This Note provides a theoretical foundation for substantive consolidation by grounding the doctrine in recent academic literature. Part I describes what an order of substantive consolidation entails and the doctrine that governs when an order should be granted. It then distinguishes between three leading circuit level balancing tests, finding that each understands creditors' subjective reliance and objective indications of corporate unity in slightly different ways. Part II presents the costs and benefits of allowing certain assets to be partitioned into

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[3] *See* Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U.CHI. L.REV. 589, 652 (1975) ("Current decision making tends to be whimsical, and the hackneyed expression that 'each case must be decided on its own facts' serves the yeoman's task of substituting for reasoned analysis."); Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381, 384 (1998)("[I]t is virtually impossible to predict when related entities will be consolidated.").

[4] There is no direct statutory authority for substantive consolidation although it is somewhat contemplated when necessary to effectuate a plan of reorganization by 11 U.S.C. § 1123(a)(5)(C). Instead, substantive consolidation is an equitable remedy ordered pursuant to 11 U.S.C.§ 1105(a). However, particularly in light of *Grupo Mexicano de Desarrollo, S.A. v. Alliance Cond Fund, Inc.,* 527 U.S. 308 (1999), many judges and commentators have questioned whether substantive consolidation is a constitutional exercise of a bankruptcy court's equitable power. *See, e.g.*, In re Fas Mart Convenience Stores, Inc., 320 B.R. 587, 594 n.3 (Bankr.E.D.Va. 2004); J. Maxwell Tucker, *Development*: Grupo Mexicano *and the Death of Substantive Consolidatio*n, 8 AM. BANKR. INST. L.REV. 427 (2000); *but see* Ryan W. Johnson, *The Preservation of Substantive Consolidation*, AUG. 24 AM. BANKR. INST. J. 44 (2005) (arguing that bankruptcy courts have authority to order substantive consolidation). Needless to say, these constitutional and statutory interpretation questions are outside the scope of this Note.

separate subsidiaries; it further argues that these costs fall differently on three different types of unsecured creditors. Part III argues that substantive consolidation is acceptable insofar as it balances the costs of affirmative asset partitioning and provides an effective remedy for unsophisticated creditors; it both rationalizes and critiques current doctrine. Part IV argues that current doctrine inadequately accounts for the equitable interest of involuntary creditors. It argues that the use of asset partitioning to "judgment proof" is inequitable and proposes a new test applicable to bankruptcies caused by significant amounts of involuntary claims. Part V, of course, concludes.

Part I: Substantive Consolidation: The Doctrine

A. What is (and what is not) substantive consolidation?

Before delving into the doctrine that determines when substantive consolidation should be ordered, it is useful to identify precisely what an order of substantive consolidation entails. There are two preliminary issues: 1) if and how substantive consolidation differs from other forms of consolidation in bankruptcy, and 2) how the remedy of substantive consolidation differs from simply piercing the corporate veil of a bankrupt subsidiary to reach the assets of its parent.

Generally when a litigant moves for substantive consolidation, he motions for the court to consolidate the assets and liabilities of several fully owned subsidiaries into their parent and into each other. In a Chapter 7 case, multiple asset/liability pools are reduced to a single pool and payments are made pursuant to a claim's priority in that single pool. In a Chapter 11 case, class voting, classification of claims, and cramdown are all adjudicated on the basis of the combined entity and, when the corporate group emerges from Chapter 11, it does so as a single

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[5] In re Auto-Train Corp., 810 F.2d 270, 276 (D.C. Cir. 1987); *See also*, Christopher W. Frost, *Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups*, 44 HASTINGS L.J 449, 450-51, nn.7 & 10 (1993).

corporation.[6] This is the classic substantive consolidation. Nonetheless, bankruptcy courts also have other means at their disposal to combine formally distinct corporations in more limited ways.

First, although efficient administration is often an argument in favor of substantive consolidation, parties can take advantage of consolidated administration outside substantive consolidation through a more conservative motion for joint administration or "procedural consolidation." It is simply easier to make determinations about the feasibility of a reorganization plan, the fairness of claim classification, whether secured creditors can lift the automatic stay as to their collateral, etc., when the bankruptcies of a parent and its subsidiaries are jointly administered. However, a motion for joint administration seeks much less than a motion for substantive consolidation: the assets and liabilities of formally distinct entities are kept separate, inter-entity claims remain (fraudulent conveyance actions, for example), plan confirmation and cramdown issues are judged on the basis of each individual estate, and, as a general matter, the substantive rights of creditors are not altered.[7] Because procedural or administrative consolidation is such a narrow remedy to the problems associated with the large bankruptcies of corporate groups, [8] for the purposes of this Note, substantive consolidation will not include joint administration.[9]

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[6] *See generally* In re Continental Vending Machine Corp., 517 F.2d 997 (2d. Cir. 1975) (approving substantive consolidation pursuant to a reorganization plan).

[7] *See generally* Tatelbaum, *The Multi-Tiered Corporate Bankruptcy and Substantive Consolidation—Do Creditors Lose Rights and Protection*?, 89 COM. L.J. 285, 285 (1984) (comparing substantive and procedural consolidation).

[8] It is also worth noting that an order for joint administration is built on a much firmer foundation than an order for substantive consolidation. *See* BANKR. R. 1015(b) ("[T]he court may order a joint administration of [a debtor and an affiliate].").

[9] *See* Gilbert *supra* ___ at 212 – 213. *But see* Seligson & Mandell, *Multi-Debtor Petition—Consolidation of Debtors and Due Process of Law*, 73 COM. L.J. 341, 347 (1968) ("It is doubtful that there can be a consolidation of separate entities which affects only procedural rights. It would seem that every consolidation, however characterized, is likely to have an impact upon the substantive rights of at least some of the parties involved.").

However, there are two other related doctrines that are rightly encompassed by the doctrine of substantive consolidation: deemed consolidations and partial consolidations. "Deemed" consolidations occur in the context of Chapter 11 reorganization. For the purposes of voting, distribution and/or cramdown, claims are estimated as if the formally distinct entities were consolidated; however, the reorganized corporate group that emerges from bankruptcy is not consolidated and may retain its pre-bankruptcy structure.[10] Although courts have questioned whether deemed consolidations should be governed by the same rules as substantive consolidation, both doctrines achieve essentially the same result. Insofar as creditors' rights and the corporate group's pre-bankruptcy debts are concerned, there is usually no difference between a deemed consolidation and a normal substantive consolidation. The added benefit of a deemed consolidation is to maintain the separate legal personalities of various subsidiaries during and after reorganization for tax purposes, regulatory reasons, to secure post-petition financing or to more easily sell a group of assets pursuant to a plan.[11] These purposes are usually tangential to this Note's inquiry (which is concerned with what happens to pre-petition creditors, claims and assets in bankruptcy) and therefore, unless otherwise specified, deemed consolidations are encompassed by substantive consolidation.

Partial consolidations are substantive consolidation with a twist. Some courts have held that, even if the conditions are right for substantive consolidation, a creditor that can show that it actually and reasonably relied on an entity's separateness from the overall corporate group can have its claims settled solely from the assets of that entity. Thus, upon the distribution of assets in a liquidation or pursuant to a plan, the court sets aside the assets of the subsidiary to which the

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[10] *See* In re Genesis Health Ventures, Inc., 402 F.3d 416 (3d Cir. 2005) (describing deemed consolidaitons); *see also* In re Standard Brands Paint, 154 B.R. 563 (Bankr. C.D. Cal. 1993) (most likely the first "deemed" consolidation).

[11] *See, e.g.,* In re Standard Brands Paint, 154 B.R. at 565 (indicating that the "deemed" combined entities were to emerge separately from bankruptcy for tax reasons).

objecting creditor loaned and satisfies his claims from this pool within a pool.[12] Partial consolidation usually requires the court to estimate what the objecting creditor's recovery would have been had there not been consolidation. Because partial consolidation operates only in the context of a more general substantive consolidation and seems to rarely, if ever, occur, it will also be treated as substantive consolidation for the purposes of this Note.

Finally, it is important to distinguish substantive consolidation from the related doctrine of piercing the corporate veil.[13] In a suit against a corporation that ignored corporate formalities or was intentionally undercapitalized, a court may set aside the corporation's legal personality and allow a direct claim against its shareholders.[14] Piercing the corporate veil and substantive consolidation are related doctrines in that they both propose to mitigate the fraudulent use of the corporate form and because courts use similar language to describe their inquiry. Furthermore, outside of bankruptcy (assuming substantive consolidation were practical and/or advisable outside of bankruptcy), both piercing the corporate veil and substantive consolidation would often result in the same remedy. However, from the perspective of creditors of a bankrupt firm, they are completely different.

The following hypothetical makes the difference clear. Parent wholly owns Sub A and Sub B and has no assets but its shares in its subsidiaries. Creditor 1 loans money to Sub A while Creditor 2 loans money to Sub B. Both subsidiaries are underwater: Sub A owes Creditor 1 $500

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[12] The process is similar to settling a side-pot in "Texas Hold'em" poker. *See* Texas Hold'em: All-in, at http://www.noblepoker.com/gamerules.html ("At the showdown if the 'All-in' player has a winning hand, the main pot goes to the "All-in" player, and the side pot goes to the next best hand.")

[13] The difference between these two doctrines tripped up so many courts and commentators at first that now almost every article or case addressing substantive consolidation begins by explaining how and why one is not the other. *See* Kors, *supra* note ____ at 389-95.

[14] *See generally* Mobil Oil Corp. v. Linear Films, Inc., 718 F.Supp. 260 (D.Del 1989) (piercing the corporate veil); Mark A. Olthoff, Beyond the Form—Should the Corporate Veil Be Pierced?, 64 UMKC L. Rev. 311 (1995) (explaining when it is likely that a court would pierce the corporate veil).

but only has $200 in assets and Sub B owes Creditor 2 $500 but only has $400 in assets.[15] The entire corporate group enters bankruptcy and the facts exist for Creditor 1 to win both a motion to pierce the corporate veil between Sub A and Parent and a motion to substantively consolidate the corporate group. Which would Creditor 1 prefer?

If it pierces the corporate veil then it takes Sub A's $200 and $300 worth of Parent's equity in Sub B. However, since the absolute priority rule satisfies Creditor 2's claim against Sub B's assets first, Parent's equity is wiped out. Thus, Creditor 2 leaves with all of Sub B's assets and Creditor 1 leaves with all of Sub A's assets; the same result as if the corporate veil had not be pierced. But, if Creditor 1 wins his motion to substantively consolidate, the corporate group's assets will be combined and its liabilities will be satisfied from one pot. Creditor 1 and Creditor 2 will split the assets pro rata and Creditor 1's share will increase from $200 to $300.

One way of articulating the difference therefore is that piercing the corporate veil is "vertical consolidation" while substantive consolidation is "horizontal consolidation." Another way of approximating it is that piercing the corporate veil is a creditor's remedy against equity while substantive consolidation is a creditor's remedy against another creditor. Finally, we could also say that piercing the corporate veil ignores the default rule of limited liability while substantive consolidation ignores the default rule of entity shielding. However one chooses to articulate the difference, it is clear that the doctrines, despite being semantically and theoretically similar, are practically distinct.

B. The Evolving Doctrine

Substantive consolidation is an equitable remedy tailored to each case and, although it has given rise to certain limiting principles, it is still very much an *ultra vires* exercise of a bankruptcy court's power to shape the estate. Since the doctrinal intricacies of substantive

[15] Add four zeros to these numbers for a closer approximation to the real world.

consolidation have been thoroughly addressed elsewhere,[16] this section will focus on important cases and broad trends.

1. Checklist Approach—At the birth of the doctrine, bankruptcy courts developed factor tests or checklist approaches to substantive consolidation. Some bankruptcy courts considered seven factors,[17] others as many as ten.[18] These factors, in their most general and expansive derivation, include:

- The degree of difficulty in separating subsidiaries' assets and liabilities
- The administrative benefits of consolidation
- The commingling of assets and business functions
- Whether subsidiaries used consolidated financial statements
- Intercorporate loan guarantees or other intercorporate financing
- Transfer of assets without observing corporate formalities
- Unity of ownership between parent and subsidiaries
- Common officers and directors
- General failure to observe corporate formality[19]
- Whether creditors relied on the credit of a particular subentity or of the whole group

While most bankruptcy courts identified substantially the same factors as relevant to a substantive consolidation analysis, each case granted differing degrees of weight to each inquiry.

[16] For perhaps the best summary of substantive consolidation *see* J. Stephen Gilbert, Note*, Substantive Consolidation in Bankruptcy: A Primer*, 43 VAND. L. REV. 207 (1990). For a more recent treatment of the hundreds of consolidation cases *see generally* Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381 (1998).
[17] *See, e.g.*, Holywell Corp. v. Bank of New York, 59 Bankr. 340, 347 (Bankr. S.D. Fla. 1986); In re Vecco Contr. Indus., 4 Bankr. 407, 410 (Bankr. E.D. Va. 1980).
[18] *See* Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940).
[19] This factor includes: "directors or officers of subsidiary do not act independently in interest of subsidiary but take orders from parent, parent pays salaries or expenses or losses of subsidiary, and parent refers to subsidiary as a department or division." Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940).

Five, seven or ten factor tests did not provide a "formulaic resolution"[20] to the substantive consolidation question because, in part, no test held that specific factors were more important than others were.[21] Not only was the remedy tailored to the facts of each case but the inquiry was tailored as well. Therefore, consolidation determinations were held to be inconsistent at best and wholly unpredictable at worst; as one treatise admitted, "substantive consolidation cases are to a great degree *sui generis*."[22]

Despite, or perhaps because of, the inconsistency of the factor tests' application, courts began to work the factors into a theoretically more constraining doctrinal inquiry. As the Ninth Circuit noted,[23] the factors (as listed above) fall into two groups: 1) the first three focus the court on whether consolidation would lead to a more efficient administration of the estate and 2) the last seven focus the court on whether the parent and subsidiaries operated as a single enterprise leading up to bankruptcy. The federal courts of appeal have attempted to consolidate these factors into abstract balancing tests explicitly focused on these two separate lines of inquiry.

2. Balancing Tests in the Appellate Courts—The two most frequently cited circuit court tests were proposed by the D.C. Circuit and the Second Circuit.[24] The Eleventh and Eighth Circuits

[20] *In re Tureaud*, 59 Bankr. 973, 975 (Bankr. N.D. Olka. 1986) (adding that "courts . . . tend to list relevant factors without ranking their importance").
[21] *See e.g.,* In re Steury, 94 Bankr. 553, 554 (Bankr. N.D. Ind. 1988) (hold that the factors are "nothing more than sign posts along the road."); Holywell Corp. v. Bank of New York, 59 Bankr. 340, 347 (Bankr. S.D. Fla. 1986) (hold that "not all of [the factors] must be found to support consolidation" but not specifying which factors were unnecessary); In re DRW Property Co. 82 54 B.R. 489, 495 (Bkrtcy.N.D.Tex. 1985)("Yet these factors, considered alone, should not be dispositive of the issue of substantive consolidation."); In re Donut Queen, Ltd., 41 Bankr. 706, 709 (Bankr. E.D.N.Y. 1984) (noting that no one factor was more important than another).
[22] 5 Collier on Bankruptcy, 1100.06.
[23] The Ninth Circuit divides substantive consolidation decisions into similar groupings: whether there is a disregard of corporate formalities and commingling of assets by various entitles; and whether the benefits of substantive consolidation are greater than the harms that it would cause. *See* In re Bonham, 229 F.3d 750, 765 (9th Cir. 2000).
[24] In re Autotrain, 810 F.2d 270, 276 (D.C. Cir. 1987); In re Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir. 1988). There were, of course, circuit court decisions addressing substantive consolidation before *Autotrain* and *Augie/Restivo*, however, they did not propose any coherent method of analysis apart from factor tests. See, e.g., Stone v. Eacho, 127 F.2d 184 (4th Cir. 1942); In re Gulfco Investment Corp., 593 F.2d 921 (10th Cir. 1979).

were early adopters of the D.C. Circuit's standard[25] while the Ninth Circuit has adopted the Second Circuit's test.[26] Both tests, however, remain widely cited and applied in bankruptcy courts, especially within circuits that have not definitively adopted the one or the other.[27]

In *In re Autotrain Corp.*,[28] the D.C. Circuit created a doctrinal framework by combining the factor-based inquiries of lower court cases. *Autotrain* was not a substantive consolidation case per se but instead turned on the related issue of the validity of a bankruptcy court's *nunc pro tunc* order to consolidate. In order to determine whether the lower court was correct to make its order *nunc pro tunc*, the court necessarily addressed the validity of the underlying order of substantive consolidation. The court announced a three-part burden-shifting test for determining when to apply substantive consolidation.[29] First, the proponent of substantive consolidation must prove both a substantial identity between the entities to be consolidated and that the consolidation is necessary to avoid some harm or realize some benefit.[30] If the proponent satisfies its burden then an objecting creditor must show that it actually relied on the separate credit of an entity and that it will be prejudiced by the consolidation.[31] The objecting creditor's reliance may be overcome, however, if the court finds that the benefits of consolidation "heavily" outweigh the harm.[32] Although the D.C. Circuit presumed that the bankruptcy court's decision to consolidate was correct, it reversed the lower court's decision to give its substantive consolidation order retroactive effect.

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[25] *See* Eastgroup v. Southern Motel Ass'n, Ltd., 935 F.2d 245, 248-50 (11th Cir. 1991) (explicitly adopting the D.C. Circuit's enunciation of the law); In re Giller**,** 962 F.2d 796, 799 (8th Cir. 1992)(adopting at variant of the D.C. Circuit's test); *see also* In re Bonham, 229 F.3d at 766 & n. 11 (discussing *Eastgroup* and *Giller*).
[26] *See In re Bonham*, 229 F.3d at 765.
[27] *See, e.g.,* In re Brentwood Golf Club, LLC, 329 B.R. 802 (Bkrtcy. E.D.Mich. 2005) (applying both tests to hold that, under either test, the debtor entities should be consolidated).
[28] In re Autotrain, 810 F.2d 270, 276 (D.C. Cir. 1987).
[29] In re Autotrain, 810 F.2d 270, 276 (D.C. Cir. 1987).
[30] See id.
[31] See id.
[32] See id.

A year later, in *In re Augie/Restivo Baking Co.*, the Second Circuit adopted a two-prong test.[33] Two family-run bakeries, Augie and Restivo, effectively merged prior to bankruptcy through an exchange of common stock; however, while the newly constituted businesses were run as a single enterprise (as Augie/Restivo) the shell of Augie remained. Before the effective merger, the two entities had borrowed from separate banks; shortly after bankruptcy, Augie's bank, which was under-secured, moved for substantive consolidation. The Second Circuit proposed a two-prong test. The court held that the proponent of substantive consolidation must prove either that all creditors dealt with the separate legal entities as a single economic unit and did not rely on their separate identity or that the affairs of the debtor are so entangled that consolidation will benefit all creditors.[34] The court rejected consolidation on both grounds; it found that both banks had extended credit in the knowledge that they were dealing with separate entities and that, although the affairs of the debtors were entangled, they were not so entangled that all creditors would benefit from consolidation.

Most recently, in *In re Owens Corning*,[35] the Third Circuit reversed the district court's[36] application of the *Autotrain* test and adopted a modified version of the *Augie/Restivo* test—the terminology is similar but the test narrows the circumstances under which substantive consolidation should be ordered. Owens Corning was a complicated corporate group that manufactured fiberglass and other building materials.[37] In 1997, Owens Corning faced growing asbestos liability and suffered from a poor credit rating. Nonetheless, a consortium of large

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[33] In re Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir. 1988); In re Bonham, 229 F.3d 750, 767 (9th Cir. 2000).
[34] *Augie/Restivo*, 860 F.2d at 518.
[35] 419 F.3d 195 (3rd Cir. 2005).
[36] The order was from the district court because Judge Wolin, the bankruptcy judge to whom the case was originally assigned, recused himself. *Owens Corning*, 419 F.3d at 198.
[37] *Id*. It was composed of many subsidiaries including: an intellectual property holding company that, for tax reasons, licensed Owens Corning's intellectual property to members of the group; a holding company for profits from its overseas operations; a company to process asbestos claims; and Exterior System, Inc., which manufactured asbestos products. *Id*.

banks offered Owens Corning's asbestos unit $1.6 billion in financing provided that each subsidiary cross-guaranteed the banks' loan, the subsidiaries agreed to keep separate financial records and maintain other corporate formalities, and that the parent promise not to enter into transactions that would result in losses to its subsidiaries. The court held that a proponent of substantive consolidation bears the burden to prove either that: 1) pre-petition, the entities "disregarded separateness so significantly that creditors relied on the breakdown of entity borders and treated them as one legal entity or 2) post-petition, the debtors' assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[38] The court found that, although the entities somewhat disregarded formal separateness prior to bankruptcy, such disregard neither enticed creditors to treat the group as one legal entity nor excessively scrambled the groups financial records.

C. The Doctrine's Progression

There are several streams within the evolution of substantive consolidation doctrine worthy of note. First, appellate courts have been tightening the discretion of bankruptcy courts to determine when to order substantive consolidation. While the doctrine began as a functional inquiry with a checklist approach, the appellate courts have narrowed the focus of the inquiry to whether specific interests are served. This may be in direct response to predictability and rule of law concerns or it may represent more generic differences in judging on the bankruptcy court and appellate court levels. While the Second and Third Circuit "either/or" tests may at first appear to give greater leeway to lower courts, they are actually more constraining. Most importantly, they limit the nature of the "harm" that the bankruptcy court is allowed to minimize by its order of substantive consolidation. While Auto-train simply identified minimizing generic equitable harm as the point of substantive consolidation, *Augie/Restivo* and *Owens Corning*

[38] In re Owens Corning Inc. 2005 WL 1939796, *9-10 (3rd Cir. 2005).

make clear that the only cognizable pre-petition harm is a creditor's mistaken reliance on the corporate group's credit while the only harm that arises post-petition is an increase in bankruptcy costs due to the debtors' entanglement.

Secondly, the appellate level tests all balance an inquiry into objectively discernible disregard of corporate formalities (i.e. unity of interest) between the consolidated entities in a corporate group and the subjective reliance of creditors. *Auto-train* separates these inquiries; objective unity is a prerequisite to consolidation, whether individual creditors relied on separate credit or combined credit is secondary. Reliance is a secondary question both in the sense that a creditor's mistaken reliance on the credit of the corporate group as a whole is only one of the "harms" that substantive consolidation may be used to avoid and also because a creditor's reliance on the credit of one single entity can only be raised as a defense to an otherwise valid consolidation.[39] On the other hand, *Augie/Restivo* focuses almost solely on creditors' expectations; consolidation is possible under its first prong simply if all creditors relied on the common credit of the corporate group. Although an objective unity of interest between subsidiaries is likely in such a situation, it does not appear to be necessary for substantive consolidation. Unlike *Augie/Restivo*, *Owens Corning*, however, appears to require both objective disregard of corporate formalities and subjective creditor reliance in order to consolidate based on pre-petition concerns.

Lastly, a key feature of *Augie/Restivo* and *Owens Corning* is that their tests are written in the disjunctive. Both *Augie/Restivo and Owens Corning* announce explicitly different standards for substantive consolidation based on pre-petition facts and substantive consolidation based on post-petition facts. *Autotrain's* three-part framework, however, applies equally to pre-petition

[39] It is also unclear whether the objecting creditor can defeat the entire substantive consolidation or simply the consolidation as it relates to his or her claim. See the discussion of partial consolidation, *supra*.

and post-petition equitable concerns. Still, because "harm" and "benefit" are so amorphous under *Autotrain*, it is quite possible that, in application, courts actually distinguish between post-petition and pre-petition harms and benefits.

Part II: The Essential Function of the Corporate Form

A. Affirmative Asset Partitioning

As many scholars have noted in the context of veil piercing, the question of whether to recognize or ignore entity separateness strikes at the heart of corporate law. Answering it requires an answer to, or at least a discussion of, the more basic question: What does corporate law accomplish?

Until recently, scholars have answered this question by arguing that limited liability is the hallmark of organizational law[40]—corporate default rules are tailored to resolve conflict between creditors and shareholders. Under this theory, corporate law is simply default contract law; it allocates loss from business failure in an economically efficient way that, if it proved to be inefficient, could be changed contract by contract. As Judge (then Professor) Posner argues: "[T]he primary utility of corporation law lies in providing a set of standard, implied contract terms . . . so that business firms do not have to stipulate these terms anew every time they transact . . . The criterion of an efficient corporation law is therefore whether the terms do in fact reflect commercial realities."[41] The arguments in favor of certain modern corporate law default rules are varied;[42] nonetheless, each argument proffered in favor of distinct corporate law rules

[40] By "limited liability," I mean limited liability of shareholders—the fact that shareholders of a corporation can lose what they invest in the corporation in payment of a corporation's debts but no more. I do not mean for this term to include the associated limited liability of creditors.
[41] Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. Chi. L. Rev. 499, 506 (1976).
[42] *See generally* Frank H Easterbrook & Daniel R. Fischel, Limited Liability and the Corporation, 52 U. Chi. L. Rev. 89, 93 - 97 (1985) (arguing that, among other things, limited liability encourages widespread share ownership, separate management and ownership, and wealthy individuals to hold shares).

assumes that they are simply default loss-allocation rules designed to govern the creditor/shareholder relationship in the absence of greater specificity.

Recent scholarship however has shifted this paradigm. While the limited liability default rule shields the assets of the owners from creditors of the entity ("defensive asset partitioning" or "owner shielding"), Professors Hansmann and Kraakman argue that the key function of the corporation is to prioritize claims against the owner's assets. By recasting organizational law in light of the debtor-creditor relationship, they show that corporate law operates independently of contract law—in other words, corporate law provides something more than default contract rules. They argue that the essential function of organizational law is "the ability of the firm to own assets that are distinct from the property of other persons, such as the firm's investors, and . . . [to] pledge to creditors."[43]

Thus, corporate law requires a rule that sounds more deeply in property than contract: affirmative asset partitioning—"the shielding of assets of the entity from the claims of the creditors of the entity's owners."[44] Contract default rules cannot provide affirmative asset partitioning:

> [T]o assure his business creditors a prior claim on his business assets, the entrepreneur would need to promise them credibly that he would obtain from all his personal creditors, *both past and future*, agreements subordinating their claims on the entrepreneur's business assets to those of the entrepreneur's business creditors. [45]

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[43] Henry Hansmann & Reinier Kraakman, *What is Corporate Law?* at 7, THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (2004)

[44] Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 390 (2000) (hereinafter "Hansmann & Kraakman, *Essential Role*"); *see also* Henry Hansmann, Reinier Kraakman, & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1337 (2006) (hereinafter "Hansmann et al. Law and the Rise") (renaming affirmative asset partitioning "entity sheidling").

[45] Hansmann & Kraakman, *Essential Role*, *supra* note 44 at 407.

Because such contracts would require impossibly detailed agreements between temporally separated parties, creating separate asset pools even though the assets are held by the same person or group requires the entity shielding function of organizational law.[46]

The importance of affirmative asset partitioning is easy enough to see in the following hypothetical. Parent X owns Subsidiary A and Subsidiary B. Upon the bankruptcy of all three entities, creditors of Parent X take first the assets of Parent X, creditors of Subsidiary A take from the assets of Subsidiary A, etc. If entity separateness is recognized, a creditor of Parent X will take shares in A and B to satisfy its claim against X, however, it will only take the assets of A and B after creditors to each subsidiary are fully satisfied.[47] The corporate form prioritizes A and B's creditors' claims against their assets.

B. The Costs and Benefits of Affirmative Asset Partitioning

Affirmative asset partitioning (and its use to create subsidiary structures) carries with it both benefits and costs. At the highest level of generalization, the costs and benefits of a system of affirmative asset partitioning are two-fold. First, there are "social" costs and benefits—externalities. Secondly, there are "intrafirm" costs and benefits—voluntarily accepted by parties that contract with the firm.

It is also important to note that the costs and benefits of asset partitioning affect different kinds of creditors differently. Creditors come in three classes depending on their ex ante bargaining position: sophisticated voluntary creditors, unsophisticated voluntary creditors, and

[46] *See* Hansmann & Kraakman, *Essential Role*, *supra* note 44 at 407; Hansmann et al., Law and the Rise, supra note 44, at 1340-43. While sophisticated creditors can accomplish similar results through security interests, security interests are a "relatively awkward" means of asset partitioning. Hansmann & Kraakman, *Essential Role, supra* note 38 at 418; s*ee* Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 Harv. L. Rev. 625, 1 (1997) (reporting that large corporations infrequently use secured financing because " 'there is a lower cost in an unsecured situation'" (quoting William S.H. Stuart)).

[47] *See* Hansmann & Kraakman, *Essential Role*, *supra* note 44 at 394. The hypothetical drawing the difference between veil piercing and substantive consolidation in Part I.A explains how the creditors of Subsidiary A could still reach the assets of Subsidiary B through veil piercing.

involuntary creditors.[48] (From now on, I will refer to the two classes of voluntary creditors as simply "sophisticated" or "unsophisticated" creditors.) Sophisticated creditors have skill and resources to alter their loan terms based on a change in a debtor's legal or business status. Typical sophisticated creditors are banks and other institutions whose business is to loan money. Unsophisticated creditors can respond to a debtor's business status but not its legal status.[49] Typical unsophisticated creditors are trade creditors who provide services on credit but do not profit from financing; they have neither the skill nor resources to investigate the debtor's status as a legal entity. Involuntary creditors can respond to neither a debtor's business nor legal status. Typical involuntary creditors are tort claimants and taxpayers; they do not bargain at all ex ante.

1. Social Costs and Benefits—Affirmative asset partitioning benefits society by increasing investment and other economic activity. To the extent that subsidiary structures allow businesses to spread risk across distinct industrial groups, raise additional capital, more effectively manage business units, etc., subsidiary structures benefit society.[50] Nonetheless, there are two negative byproducts of the use of subsidiaries: activity costs and administrative costs.

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[48] *See* Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 Harv. L. Rev. 1197, 1214-16 (2005). This Note combines Warren and Westbrook's involuntary and quasi-involuntary categories (henceforth "involuntary") and its unsophisticated creditors and creditors-with-small-claims categories (henceforth "unsophisticated"). *See id.* at 1216; *see also* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 Va. L. Rev. 1887 (1994) (recognizing similar categories); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 Yale L.J. 857 (1996) (same).

[49] Relying on a corporation's business status as opposed to its legal status is, perhaps, not a straightforward distinction. As an example of business status reliance, consider the Massachusetts bankruptcy court's description of what this creditor considered before advancing value:

> In approximately May of 1984, the principals of S & G of America contacted Mr. Martinelli regarding the purchase of goods and the extension of credit for the company owned stores of S & G of America. As a result of their conversations, Transmission Parts, Inc. did supply and extend credit to the company owned stores and is presently owed approximately $21,000 in pre-petition debts. However, any decision to extend credit to S & G of America was not based upon any review of the debtor's financial statement but, rather, on S & G of America's proposed plans to go nationwide, and the supposed opportunity for Transmission Parts, Inc. to be the main supplier of such an enterprise.

In re Stop & Go of America, Inc. 49 B.R. 743, 749 (Bankr. Mass. 1985).

[50] *See* Hansmann et al., *Law and the Rise, supra* note 44 (explaining how asset partitioning contributed to economic development).

First, although asset partitioning has enabled economic success, it is important to note that, while economic activity obviously has its benefits, economic activity also comes with costs.[51] Either the costs lie where they fall or they are dissipated throughout society—to the taxpayer through assistance programs or to the consumer through higher prices. Thus, to the extent that affirmative asset partitioning increases economic activity, *activity costs* increase as well. Second, the complexity of subsidiary structures imposes administrative costs. These ex post administrative costs are either paid by the creditors in a bankruptcy case (which would lead to higher average interest rates) or are paid for by taxpayers.[52]

2. Intra-firm Costs and Benefits—Inside the firm, a decision to incorporate a group of assets—thereby employing affirmative asset partitioning—requires balancing certain costs and benefits. Asset partitioning implicates voluntary creditors' valuation costs (the costs of forming an accurate picture of risk)[53] and monitoring costs (the costs of coping with the risk once assumed).[54] Furthermore, it can affect the going concern value of an enterprise—neither shareholders nor their creditors have the right to withdraw assets from an entity before the

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[51] The evolution of negligence and strict liability through the 19th and 20th centuries are often explained as an attempt to balance the benefits of economic activity with its costs. *See* GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 69-75 (1970); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 139, 145 (2nd ed. 1977).

[52] Although society sustains the cost of a bankruptcy system as a whole, creditors also bear individual costs whenever a debtor goes bankrupt. So, to a certain extent these costs are both societal and intra-firm. Asset partitioning may make it easier to divide up a bankrupt's estate—by matching claims with groups of assets and valuing those assets more quickly—or it may make it more difficult—by obfuscating the operational structure of the firm and leading to fraudulent conveyance claims between subsidiaries, etc. *See* Hansmann et al., *Law and the Rise*, *supra* note 38 at 1346-48 & 1352-53.

[53] "Valuation costs" are the costs incurred by a creditor to value the assets of a debtor in order to determine the market interest rate. Obviously, to the extent that a debtor entity specializes, the risks associated with lending to that debtor are specialized as well and, therefore, generally, asset partitioning results in lower valuation costs. Posner refers to these costs as "the problem of information." Posner, supra note __ at 508.

[54] Once a creditor gains a priority interest in the assets of a subentity, it need not monitor new loans to the parent or the parent's other subsidiaries—only the status of the subentity to which it loaned. Hansmann et al., *Law and the Rise*, *supra* note 38 at 1344. However, subentities can also be used to commit or facilitate fraud, so the extent to which monitoring costs decline or increase pursuant to asset partitioning is case sensitive. *See id.* at 1351-52 ("When the means of delineating and enforcing the distinction between [subsidiary] and [parent] assets are weak, giving [subsidiary] creditors priority in [subsidiary] assets may be less efficient than creating no priorities at all.);

creditors of that entity for their liquidation value.[55] Asset partitioning also un-diversifies a creditor's risk by narrowing the asset pool against which he or she lends; to the extent this effect isn't accounted for by the creditor's interest rate, asset partitioning imposes a <u>diversification cost</u>.[56] Sophisticated creditors will either capture the benefits of asset partitioning to the extent that they exceed the costs of asset partitioning (in an imperfect credit market) or pass these benefits on to owners through lower interest rates (in a competitive market for credit). Thus, when deciding to incorporate a subsidiary, firm owners must weigh any increased <u>formality costs</u>[57] of asset partitioning against the lower cost of capital.

The following hypothetical explains how a rational parent corporation weighs the costs and benefits of incorporating a subsidiary.[58] Imagine a group of entrepreneurs that wants to start two distinct businesses: renting cars and renting office space. There are two ways to organize such a business: 1) as a single corporation with one division renting cars and another division renting office space or 2) as two corporations, one renting cars and the other renting office space, that are both wholly owned by a single parent corporation or partnership.

Banks may find it costly to set their interest rates when loaning to a commercial landlord that is also renting cars. While they have data on the likelihood of failure of a commercial landlord and a car rental company separately, they have no experience lending, at one rate of interest, to a company in both lines of business. Therefore, failure to partition the two businesses increases <u>valuation costs</u>. However, if the entrepreneurs use a subsidiary structure, they may

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see also Posner, *supra* note ___ at 508 ("The second source of risk to the creditor is the possibility that the corporation will take steps to increase the riskiness of the loan after the terms have been set.").

[55] *See* Hansmann et al., *Law and the Rise*, *supra* note 38 at 1348. Instead, to tap into the going concern value of a firm, the shareholders sell their shares at some premium over liquidation value.

[56] *See* Hansmann et al., *Law and the Rise*, *supra* note ___ at 1348.

[57] Formality costs are the costs of maintaining separate corporate structures—additional accounting and legal fees, separate corporation fees, distinct income tax liability, etc.

[58] This hypothetical is based on the much more eloquent and thorough hypothetical provided in Hansmann & Kraakman, *Essential Role*, *supra* note 44 at 399-401.

shuttle assets out of the car company by renting the cars to the office building's tenants for no charge or by simply paying for renovations at the office building with their car company's profits. Therefore, asset partitioning may increase or decrease the banks' *ex ante* monitoring costs or lead to fraud and misappropriation. Nonetheless, in order to form legally cognizable subsidiaries, the entrepreneurs will have to maintain the formalities that separate corporate structures require—open two checking accounts, keep two sets of records, etc. Thus, the entrepreneurs' decision will weigh the lower interest rate they can expect from their bank with the formality costs of maintaining separate corporate structures.

The decision to sub-incorporate will also depend on the parties' assessment of the risk of diversification versus the risk of non-diversification. Some creditors may be happy to lend to a corporation operating many businesses; others may want to limit exposure to one of the entrepreneur's operations. A problem arises only when a creditor, such as a maintenance company operating at the office building, is not aware that the corporation renting the office building also runs the car rental business. If the car company fails, the maintenance company may find that it unintentionally diversified to its detriment; it will have to compete with the car company's creditors for the same assets. If the office building fails, the maintenance company may find that it luckily, albeit unintentionally, diversified; it will have a claim against the car company's assets that it never knowingly bargained for.

The upshot of this hypothetical is that, all things being equal, the more economically independent two lines of business are the greater the net benefits of partitioning their assets in separate subsidiaries. This is, in part, because "the two lines of business are likely to depend . . . on two different classes of creditors;"[59] specialized creditors, particularly unsophisticated

[59] Hansmann & Kraakman, *Essential Role*, *supra* 44 at 399; see also id. at 400 ("It follows that both sets of suppliers are likely to extend more favorable terms if the hotel and oil operations are separately incorporated.")

creditors, can more efficiently value and monitor separate entities. More importantly, it is also true because the formality costs of running functionally distinct businesses through separate legal entities are roughly the same as running them under one parent. It is unlikely that the entrepreneurs would ever need to transfer the assets of the hotel business to the car business or, more fundamentally, run the businesses as a single profit making enterprise.[60] Instead, each business will be run for its own profitability—not the profitability of the corporate group as a whole. This situation is in stark contrast to some modern subsidiaries that could never operate profitably outside of the corporate group.[61]

Part III: Substantive Consolidation: The Doctrine Applied

Asset partitioning allows an unsecured creditor to prioritize its claim in a group of assets; substantive consolidation destroys this priority. This part will argue that substantive consolidation is best viewed as a reaction to the costs of affirmative asset partitioning. Sometimes, the parties themselves recognize these costs agree to limit them. However, there is still a role for courts to order substantive consolidation over objecting parties. Coercive substantive consolidation is necessary 1) to prevent holdouts from gaining an upper hand in negotiations and 2) to rectify equitable wrongs between sophisticated and unsophisticated creditors.

A. Substantive Consolidation to Minimize Administrative Costs

Although courts faced with the question of whether to impose substantive consolidation frequently claim that it is a rare and extraordinary remedy,[62] it is actually a common component

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[60] Posner, supra ___ at 513 ("Normally the profits of the group will be maximized by maximizing the profits of each constituent corporation. Indeed, if the corporations are engaged in truly unrelated lines of business, the profits of each will be completely independent.")

[61] *See generally*, Landers, *supra* note ___ at 623-25 (describing the "incentive to operate the subsidiary with a view toward obtaining the maximum profitability of the entire enterprise").

[62] *See, e.g.,* In re Gandy, 229 F.3d 489, 499 (5th Cir. 2002) (calling substantive consolidation "an extreme and unusual remedy"); In re Bonham, 229 F.3d 750, 767 (9th Cir. 2000) ("[A]lmost every other court has noted [that

of negotiated plans. Furthermore, it appears that the larger and more complicated the bankruptcy, the more likely it is for the parties to propose substantive consolidation. A recent empirical study of the largest corporate bankruptcies between 2000 and 2004 shows that, far from being an infrequent remedy, 50 percent of all confirmed reorganization plans substantively consolidated some subsidiaries.[63] In smaller reorganizations, the rate of substantive consolidation is closer to 10 percent.[64]

This disparity between what courts say (infrequent consolidation) and what the parties do (frequent consolidation) raises an intriguing question:[65] what do the parties stand to gain from substantive consolidation that the courts do not see? Because "one of the principal functions of bankruptcy law is to enhance the value of a failing firm,"[66] the least controversial consolidation decisions should be where bankruptcy courts consolidate corporate estates to decrease creditors' post-petition formality and valuation costs and society's administrative costs. Since, typically, all creditors bear these post-petition costs equally (or at least pro rata), substantive consolidation should be ordered under *Augie/Restivo's* and *Owens Corning's* second prong.[67] In slightly more academic language, substantive consolidation is often pareto optimal—no creditor's expected recovery is reduced and at least one creditor's expected recovery is increased. This scenario presents itself in two theoretically similar but factually distinct situations.

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substantive consolidation] should be used 'sparingly.'" (citation omitted)); Eastgroup Props. v. S. Motel Ass'n, Ltd. 935 F.2d 245, 248 (11th Cir. 1991) (also noting that substantive consolidation should be used "sparingly").

[63] *See* William H. Widen, *Prevalence of Substantive Consolidation in Large bankruptcies from 2000-2004: Preliminary Results* 12 (January 20, 2006), available at SSRN: http://ssrn.com/abstact=878388).

[64] *Id*. at 8.

[65] It is also worth noting that a bankruptcy judge must sign off on a plan whether it was negotiated or not and that, at least doctrinally, the inquiry is the same whether a plan is voluntary or contested. *See* In re Richton International Corp., 12 B.R. 555, 556 (Bankr. S.D.N.Y 1981).

[66] Elisabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 344 (1993).

[67] These decisions or plan confirmations are typically unopposed because, even if creditors did rely on the credit of the separate entities, these creditors also gain by consolidating the estates.

First, some cases recognize that the cost of disentangling the assets of subsidiaries is so much that little value would be left to distribute to creditors. This is the *Bleak House* situation where preference avoidance, equitable subordination, and fraudulent conveyance claims are so numerous and/or the debtors' affairs are so confused that, without consolidation, only the lawyers would be paid. If the court recognized the corporate form in such situations, no creditor would be better off. In *In re Seatrade Corp.*,[68] for example, the Second Circuit, faced with a group of bankrupt subsidiaries that frequently transferred assets between themselves with little or no documentation, upheld an order of consolidation instead of requiring the parties and bankruptcy court to expend the resources to sort out entangled (actually, non-existent) records.

Second, sometimes disregard of the corporate form is justified solely to preserve going concern value—especially in the bankruptcy of subsidiaries that cannot function as independent businesses. Oftentimes, the weighty formality and monitoring costs of asset partitioning were the very reason that the corporate group entered bankruptcy. In *In Re Worldcom*, the bankruptcy court confirmed a substantive consolidation plan for precisely these reasons.[69] Worldcom's bankruptcy included over 220 debtor corporations but, nonetheless, "WorldCom's business [was] organized along operational and functional lines rather than by legal entities."[70] The court found that generating accurate historical accounting data for each subsidiary would be impossible for the very reason that Worldcom filed bankruptcy—managerial misappropriation and widespread accounting fraud—and all parties agreed that a consolidated, streamlined business would lead to a more competitive business emerging from bankruptcy.[71] The absence of substantive

[68] 369 F.2d 845 (2nd Cir. 1966).
[69] 2003 WL 23861928 (Bankr. S.D.N.Y., 2003) (unreported).
[70] *Id*. at *7-11.
[71] *Id*. at *16.

consolidation "would have a material adverse effect on . . . the chances of a successful reorganization."[72]

Although these cases are doctrinally similar in that both types advance the interests of all creditors, it is useful to recognize that substantive consolidation can be used to mitigate different asset-partitioning costs. First, when substantive consolidation is warranted to mitigate administrative, formality or valuation costs, it is quite likely that deemed consolidation would be a less drastic alternative—only the claims and not the debtor may need to be consolidated in order to address these costs. A certain subsidiary structure may still yield economic benefits coming out of bankruptcy even though it increases costs inside bankruptcy.[73] Conversely, when consolidation is necessary to preserve a business's going concern value, deemed consolidation is ineffective. However, by focusing on asset partitioning's effect on going concern value, the court may still be able to craft less drastic solutions than substantive consolidation. For example, *In Re Babcock & Wilcox Co.*,[74] the court allowed new post-petition financers a security interest in the assets of an entire corporate group instead of limiting their supra-priority to the formally distinct entities receiving their funds. Thus, the court consolidated the debtor entities going forward without affecting post-petition claims against the debtors—essentially the inverse of a deemed consolidation. The court maintained the going concern value of the corporate group—in other words, it forestalled conversion to Chapter 7—without mitigating administrative, valuation or monitoring costs.

The obvious utility of substantive consolidation under this scenario explains why it is so often a component of negotiated plans; when consolidation is pareto optimal, all creditors have

[72] *Id.*

[73] This was, for example, the situation in the deemed consolidation of *In re Standard Brands*, 154 B.R. 563 (Bankr. C.D.Cal. 1993). The costs of recognizing entity separateness in bankruptcy were high but entity separateness had a special value to the corporate group at its emergence from bankruptcy.

an incentive to negotiate a voluntary consolidation. There seem to be only two reasons a creditor would oppose such a consolidation: 1) because the costs saved are actually not equal to or greater than that party's losses (or, rather, the creditor does not *believe* the consolidation to be pareto optimal)[75] or 2) because the creditor wants to hold out to gain a negotiation advantage elsewhere. Clearly, in either case, a creditor's reliance on entity separateness should not be allowed to defeat the consolidation. To allow reliance to defeat a mutually beneficial consolidation would give creditors that can demonstrate reliance on entity separateness an extra bargaining chip in negotiations with counterparties.[76] At the very least, the court should order a partial consolidation and satisfy the reliant party's claims from a separate hypothetically unconsolidated pool. This strategy would force the party seeking a negotiation advantage into the consolidation—stripped of his veto power he would seek the benefits of consolidation—while allowing a party that truly believed consolidation to be against his interests a distinct claim commiserate with his reasonable reliance.

B. Formality, Valuation and Monitoring Costs: Expectation and Reliance

While the cases discussed above resolve the post-petition costs caused by asset partitioning, substantive consolidation is also useful in shaping pre-petition costs. Because the costs remedied by substantive consolidation under the above rationale (i.e. administrative, valuation, and formality costs) only arise post-petition, courts do not need to differentiate

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[74] 250 F.3d 955 (5th Cir. 2001).

[75] *Autotrain*'s rule that "the benefits of consolidation outweigh the harms" may nonetheless require consolidation even in a non-pareto optimal situation. In other words, despite the individual creditor's net loss, if there is a greater benefit shared by other creditors—a "Kaldor-Hicks" improvement whereby the winning creditors could compensate the losing creditors and still have a net gain from consolidation—the court should nonetheless order a consolidation. See ____. Whether such an efficiency-motivated transfer would be "fair" is outside the scope of this paper.

[76] Nonetheless, in the earlier cases, courts frequently allowed one party to trump a mutually beneficial consolidation with demonstrated reliance. *See, e.g.,* In re Flora Mir Candy Corp., 432 F.2d 1060 (2d Cir. 1970) (disallowing consolidation in spite of the fact that it was practically impossible to disentangle numerous intercompany transfers.) These cases appear to be driven by some inexplicable notion that the party who relied on corporate formality deserves a stronger bargaining position than parties that where unaware of corporate formality. *See* Chemical Bank of New York Trust Co. v. Kheel, 369 F.2d 845, 848 (2nd Cir. 1966) (Friendly, J., concurring).

between the three classes of unsecured creditors in their substantive consolidation analysis.[77] This section, however, argues that substantive consolidation is also useful to shape the ex ante behavior of creditors. For that reason, it must differentiate between sophisticated and unsophisticated creditors. This section argues that substantive consolidation based on pre-petition facts can alter the ex ante behavior of sophisticated creditors in beneficial ways and remedy unsophisticated creditors' otherwise misplaced reliance.

1. Substantive Consolidation: An Inequitable Remedy for the Misplaced Reliance of Sophisticated Creditors—Before and after the circuit courts' balancing tests, bankruptcy courts have held that, when a corporate group holds itself out as a single entity, unknowing creditors of its disparate parts have the right to substantive consolidation in bankruptcy.[78] Sophisticated creditors expect to be satisfied from the asset pool against which they are lending, expend resources to value that asset pool, and set an interest rate based on the risks of that asset pool. Banks, for example, will understand a corporation's legal and operational structure before approving a loan to a parent or a subsidiary. Therefore, a corporate group must take an affirmative act in order to confuse sophisticated creditors about its legal personality. If sophisticated creditors are misled into lending against a more risky asset pool (a subsidiary on the brink of insolvency instead of a healthy corporate group), then the interest rate charged is too low; this results in a wealth transfer between the sophisticated creditor and the shareholders.

[77] *See supra* note 48 and accompanying text.
[78] *See* Christopher W. Frost, *Organizational Form, Misappropriation Risk, and the Substantive Consolidation of corporate Groups*, 44 HASTINGS L.J. 449, 456-57 (1993) ("A second category of cases involves corporate management's affirmative misrepresentation of either the corporate structure of the asset ownership of the company. . . . In these cases, courts utilize consolidation ostensibly to fulfill the contractual expectations of the creditors." (citations omitted)).

Therefore, when a sophisticated creditor mistakenly relies on the credit of a corporate group although its loan was technically to a sub-entity, courts call it fraud and intervene.[79]

Professor Kors agrees with courts that "[c]reditors' actual and reasonable reliance on the legal unity among legally distinct entities in extending credit may justify substantive consolidation."[80] However, why substantive consolidation should be a remedy in such a case is not clear. First, the sophisticated creditor can protect itself by increasing its valuation costs prior to the loan and monitoring costs during the loan. Therefore, at a minimum, sophisticated creditors' should be required to prove that their reliance was genuine and reasonable under the circumstances. Otherwise, sophisticated creditors would be able to both save valuation and monitoring costs and command an interest rate commiserate with a high-risk pool of assets without suffering the consequences of these cost savings once an entity goes bankrupt.[81] Second, substantive consolidation is almost always a remedy against other creditors and not shareholders. Why should the creditors of a more solvent sub-entity be required to forego their good fortune to correct a wealth transfer between another creditor and the shareholders?

Consider the following hypothetical. Bank 1 loans to Sub A but is duped into believing that it is loaning to both Sub A and Sub B. Bank 2 loans to Sub B but is similarly duped and, importantly, did not rely on Sub B's credit. Assume both sub-entities are underwater but Sub B

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[79] *See, e.g.*, In re Leslie Fay Cos., Inc., 207 B.R. 764, 779 (Bankr. S.D.N.Y. 1997) (ordering consolidation because of fraud); In re Murray Indus., Inc. 119 B.R. 820, 831 (Bankr. M.D. Fla. 1990) (same); In re Mortgage Inv. Co., 111 B.R. 604, 610 (Bankr. W.D. Tex. 1990) (ording consolidation because "the creditors[relied] on the assets of both entities."). *Cf.* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study,* 76 Cornell L. Rev. 1036, 1039 (1991) ([Most cases] arise in situations where the court is concerned with possible misrepresentation . . . ."). The lack of misplaced reliance is also cited as a reason not to consolidate. *See, e.g.*, In re 599 Consumer Elec., Inc., 195 B.R. 224, 247 (S.D.N.Y 1996) (denying consolidation because creditor failed to prove that it relied on the credit of the corporate group as a whole).

[80] Kors *supra* note ____ at 419.

[81] In the context of piercing the corporate veil, courts are understandably reluctant to find that sophisticated creditors actually relied on the credit of entities with which they were not negotiating. *See, e.g.*, CM Corp. v. Oberer Dev. Co., 631 F.2d 536, 540 (7th Cir. 1980) (denying a piercing remedy where the creditors "were experienced businessmen who fully understood the nature of related corporate structures [and] the separate identities [of the subsidiaries]").

is more solvent. While piercing the corporate veil would give Bank 1 a remedy against the shareholders for defrauding it, substantive consolidation simply reduces the windfall of Bank 2—a similarly defrauded party. Thus, the only case where substantive consolidation is warranted on a finding of fraud alone is when no other creditor is harmed—in other words, Bank 1 should be able to take the shareholders' equity in Sub B but not diminish Bank 1's claim.[82] Because Bank 1 should only be able to take from Sub B only insofar as Sub B has some equity interest left,[83] substantive consolidation is the same as simply piercing the corporate veil, which is a much more direct and less far-reaching remedy for simple fraud.

Instead, a sophisticated creditor's reliance is protected by the exception to substantive consolidation recognized in *Augie/Restivo* and *Owens Corning*—the claim of a creditor that can prove that it actually relied on the separateness of a sub-entity should not be consolidated.[84] When courts speak this language of "reliance," they are speaking about pre-petition valuation, formality and monitoring costs. A clear rule that recognizes the separate formal identity of a sub-entity decreases the sophisticated creditor's valuation costs and monitoring costs and therefore decreases the rate of interest that he needs to charge. After all, streamlining the valuation and monitoring of a group of assets is the primary net benefit of affirmative asset partitioning.[85] Thus, this default rule sounds both in efficiency[86]—it decreases transaction costs

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[82] Thus, the doctrine is similar to marshalling. Marshalling is an equitable doctrine whereby a bankruptcy court requires a crosscollateralized secured lender to look first to the debtor's equity in all of its collateral before eating into the claim of lower priority secured creditors.

[83] These facts are not common—most of the time all the related subsidiaries of a corporate group in bankruptcy will be underwater and the only remedy against equity will be piercing the corporate veil. For a rare case where substantive consolidation was used to redistribute the equity of shareholders, however, *see* In re Gainesville P-H Properties, Inc. 106 B.R. 304, 306 (Bankr. M.D. Fla. 1989) ("[A]bsent substantive consolidation, the majority of creditors will receive only a small portion of their claims, while the equity interest holders may receive a substantial distribution.").

[84] Fraudulent conveyance law also protects sophisticated creditors' reliance. If an entity trades its assets for less than fair value such that the sophisticated creditor would get less recovery than it bargained for, the creditor can force those assets to be returned.

[85] *See* Hansmann et al., *Rise of the Firm*, *supra* note _____ at 1344.

and leads to a better perception of risk—and equity[87]—it fulfills the expectation of the sophisticated creditor.

Nonetheless, courts should be just as skeptical about a sophisticated creditor's claim that it relied on the separate credit of a subsidiary as a creditor's claim that it relied on the corporate group's combined credit. Sophisticated creditors will negotiate against the backdrop of applicable law; if there is some risk of their claim being diluted by substantive consolidation, they will factor that risk into their interest rate and loan terms.[88] As discussed in the previous section, raising claims of reliance may simply be a way for a creditor to negotiate for a better position post-petition.

2. Alter Ego: A Remedy for Unsophisticated Creditors—Although proof of misplaced reliance or fraud is not sufficient to justify substantive consolidation on the behalf of sophisticated creditors, these fraud cases can be justified by reference to the conjoined inquiry into "unity of interest" or "disregard of the corporate form" under the *Autotrain* and *Owens Corning* tests. Professor Kors asks why courts routinely hold that "the failure to maintain corporate formalities, the operation of multiple legal entities as one economic enterprise, the use of the entities to intentionally evade legal obligation and the undercapitalization of an entity" all militate toward substantive consolidation.[89] Without differentiating between sophisticated and unsophisticated creditors, she concludes that a finding "that one entity is the 'alter ego' of another does not justify consolidation."[90] However, a finding of alter ego or corporate disregard

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[86] See Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 501-07 (1976).

[87] *See* Landers, *supra* note ___ at 633 ("Because they are unable to protect themselves and may not even realize that they need protection, creditors who can demonstrate reliance on one constituent company must be accorded different treatment.").

[88] Therefore, especially considering the second prong of *Owens Corning* and *Augie/Restivo*, one would expect that corporate groups like Enron and Worldcom whose assets are partitioned into very many intricate subsidiaries pay a larger interest premium to sophisticated creditors.

does justify substantive consolidation;[91] substantive consolidation on these facts protects the interests of unsophisticated creditors.

Unsophisticated creditors can neither rely on corporate separateness nor rely on corporate disregard. Because they do not bargain differentially based on corporate form and do not vary loan terms based on an individualized risk assessment, they do not set an interest rate expecting a priority claim in a specific group of assets. Instead, these creditors "rely" on economic and business realities; they expect a certain rate of default depending on the business they and their debtors are in. Because unsophisticated creditors cannot show that they relied on the combined credit of a corporate group, they will not be able to instigate substantive consolidation on grounds of "fraud" alone. Because unsophisticated creditors cannot show that they relied on the separate credit of a subsidiary, they will also not be able to prevent consolidation of their claims on grounds of reliance alone. However, granting a substantive consolidation order based on a finding of "alter ego" protects unsophisticated creditors. It requires that, if firms or sophisticated creditors desire the valuation and monitoring benefits of asset partitioning, they must also assume the necessary formality costs of asset partitioning.

The sophisticated creditor's goal to lower its risk coincides with the goal of the shareholders and managers of a firm to decrease its capital costs. The easiest route to these ends is often to invoke affirmative asset partitioning and set aside assets within a corporate shell as the "collateral" for an unsecured loan. If a manufacturing business divides itself into two wholly owned subsidiaries, an operational subsidiary that purchases materials on credit and a holding company that owns the business's factory and intellectual property, it can use affirmative asset

[89] Kors, *supra* note ____ at 386.
[90] Kors, *supra* ____ at 445.
[91] *See, e.g.*, Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. Chi. L. Rev. 589, 639 (1975) ("A rule rejecting consolidation in the absence of extraordinary circumstances,

partitioning to create a highly stable pool of assets against which a sophisticated credit will loan money at a low rate. The borrowing entity then disregards the corporate veil and transfers the loaned money from the high asset subsidiary to pay for the operational subsidiary.[92] Suppliers, ignorant of the manufacturer's subsidiary structure, will calculate their risk based on prevailing market conditions in the manufacturer's industry. Thus, the shareholders benefit from a wealth transfer from the unsophisticated creditors; they pay a lower rate to the sophisticated creditors (who are compensated by a better pool of assets) and to the unsophisticated creditors (who charge less interest than their risk merits).

Substantive consolidation on these facts re-transfers wealth from the sophisticated creditor (who has bargained for a more solvent asset pool) to the unsophisticated creditor (who is ignorant of the legal entity of the debtor). This wealth transfer is equitable because it places the costs of affirmative asset partitioning on the party most capable of mitigating them—the sophisticated creditor. To avoid consolidation of its own claims, the sophisticated creditor will demand that a business seeking to separate asset ownership and operations incur the increased formality costs commiserate with additional asset partitioning. (An unsophisticated creditor, because it was never conscious of the legal structure of the business, could not make these demands.) After factoring in these increased formality costs,[93] the corporate group may find that affirmative asset partitioning is not worthwhile after all. Or, after making these demands, the sophisticated creditor will raise its interest rate to account for any risk that the debtor corporate

aimed at protecting creditors who 'dealt with' the enterprise in ignorance of its corporate structure, protects too large and amorphous a group and conflicts with the basic realities of multi-corporate enterprises.")

[92] Note that fraudulent conveyance law does not remedy this misappropriation and, in fact, enables it. Fraudulent conveyance law requires the operational entity to return the value it received from the asset ownership entity; in bankruptcy, this amounts to the unsophisticated creditors paying the sophisticated creditors for the misappropriation between the two entities.

[93] For example, the corporate group would not be able to shift money or other assets from one subsidiary to another, run the enterprise through centralized management, keep common accounting books, etc.

group would violate its loan agreement and to account for its increased monitoring costs to make sure that the loan agreement is followed.

Requiring sophisticated creditors and/or shareholders to balance formality and monitoring costs decreases the use of affirmative asset partitioning closer to its optimal level. To the extent that affirmative asset partitioning is efficient once all intra-firm costs are accounted for, it will be the norm throughout a competitive industry. Because asset partitioning affects loan default rates and the percentage of a creditor's recovery in bankruptcy, unsophisticated creditors' credit terms will reflect industry practice. Unsophisticated creditors get a closer approximation to what they "bargained" for and sophisticated creditors will protect themselves from a substantive consolidation wealth transfer by ex ante bargaining.

Furthermore, alter ego analysis prevents mistaken substantive consolidation on the basis of a "fraud" theory. Bankruptcy is designed, at least in part, to internalize the costs of business failure onto parties that deal with the business.[94] As noted in Part III.B.2, the more that two lines of business are economically independent the greater the benefits of partitioning each line of business. If Sub A and Sub B both seek to maximize individual profits, then it makes no sense for Sub A's creditors to pay the costs of Sub B's business failure. However, if Sub A and Sub B are not independent businesses—then Sub A's creditors should bear some of the cost of Sub B's failure. Even a cursory alter ego analysis is useful in determining whether these two businesses were run to maximize their profits independently of one another or to maximize the profits of the corporate group. Off-balance-sheet transfers, disregard of the corporate form, unity of officers and directors, etc. all indicate that the joint subsidiaries were really in the same line of business and that, but for opportunistic behavior by sophisticated creditors and shareholders, the business would have been organized as a single corporation. The fact that shareholders defrauded

sophisticated creditors into relying on the group's credit adds nothing to this analysis. In fact, a court relying solely on a fraud theory might inadvertently lay the costs of one businesses' failure on the creditors of another business.

C. A Brief Return to the Doctrine

This section will briefly apply the preceding discussion to the competing doctrinal tests for substantive consolidation. First, it appears that the *Owens Corning* and *Augie/Restivo* dichotomy between pre-petition and post-petition reasons to consolidate is helpful; Autotrain's "one-size-fits-all" test is probably over- and under-inclusive and gives too little guidance to lower courts. Second, *Owens Corning*'s tightening of the postpetition prong of *Augie/Restivo*—"separating [the debtors' asset and liabilities] is prohibitive and hurts all creditors"—may prevent otherwise pareto optimal consolidations. Third, courts should be more willing to explore more narrowly tailored remedies than full consolidation; partial consolidation and deemed consolidation may, under the right circumstance, be more efficient than either substantive consolidation or no consolidation. Fourth, it appears that all three circuit court tests put too much weight on the expectation interest of sophisticated creditors. To the extent that the *Augie/Restivo* test purports to authorize substantive consolidation simply because of creditors' expectation or reliance,[95] it is aimed at equitable disparities better addressed by merely piercing the corporate veil.

Finally, courts applying any of the dominant doctrinal standards should more explicitly examine whether the creditors calling for substantive consolidation or objecting to substantive consolidation were, ex ante, sophisticated or unsophisticated creditors. This is a useful inquiry for two reasons. First, it prevents bankruptcy courts from jamming square peg unsophisticated

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[94] Warren, *Bankruptcy Policy*, *supra* note ___ at 361-68.
[95] *See* discussion *supra*.

creditors into round sophisticated holes. There should be no need for a bankruptcy court to manufacture signs of reliance on a corporate group's combined credit or shareholder fraud to order a consolidation.[96] Bankruptcy courts should order consolidation based upon an appreciation of the ex ante risks to which each type of creditor agreed. Second, it should help bankruptcy courts judge claims of reliance when proffered to defeat substantive consolidation. A creditor that claims that it relied on the separate credit of a subsidiary in the face of a unity of interest between the parent and its subsidiaries and widespread disregard of the corporate form is almost certainly making an opportunistic after-the-fact argument. If the creditor was a sophisticated creditor, then it almost certainly accounted for the potential for substantive consolidation and corporate disregard in its loan agreement. If the creditor was an unsophisticated creditor, it almost certainly did not predicate its loan or the loan's terms on the separate subsidiary's capital structure.

IV. Substantive Consolidation to Mitigate the Societal Costs of Profligate Asset Partitioning

While *Autotrain*, *Augie/Restivo* and *Owens Corning* protect, to a certain extent, the reliance interests of sophisticated and unsophisticated creditors, no test accounts for the interests of involuntary creditors. This is, in part, because substantive consolidation doctrine has evolved to become firmly rooted in traditional entity law; under the prevailing tests, courts presume that the parties bargained based on the assumption that sub-entities are legally distinct.[97] Thus, courts adopt a contractarian definition of equitable harm—reliance and expectation. As noted above, this presumption makes little sense when applied to unsophisticated creditors and it

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[96] *See, e.g.*, In re Munford, Inc., 115 B.R. 390, *395 (Bankr. N.D.Ga. 1990) (holding that "public representations in recruitment brochures, press releases and interviews, and even business stationery" defrauded trade creditors into relying on a corporate group's combined credit).

[97] For what it's worth, this presumption stems from state law, not federal law. *See, e.g.*, Cal. Corp. Code § 409 (West 1992); Del. Code Ann. Tit. 8 § 162 (1991); N.Y. Bus. Corp. Law. § 628 (McKinney 1992). Because it is a state law default rule, it can be set aside by the same bankruptcy policies that require the alteration of state law contract rights and cap tort damages.

makes even less sense when applied to involuntary creditors: "tort and statutory claimants, . . . as involuntary creditors, by definition d[o] not rely on anything."[98]

Unfortunately, shareholders and sophisticated creditors have begun to use asset partitioning to avoid bearing the negative externalities of their economic activity by shifting these costs onto involuntary creditors through "judgment proofing." This inequitable risk shifting leads to greater than optimal activity costs. This part will argue that substantive consolidation can prevent judgment proofing in many cases and mitigate the deleterious effects of judgment proofing in most cases. It expands the definition of *Autotrain*'s "harm" and "benefit" beyond the protection of reliance interests and suggests a third prong for the *Augie/Restivo* and *Owens Corning* formulations of the doctrine.

A. The Problem: Judgment Proofing

If shareholders want to insulate the value of their firm from tort liability, they have, essentially, four options: 1) cease activities that generate tort liability or, conversely, use a higher standard of care in those activities, 2) distribute the corporation's assets in a form of a dividend, 3) spin-off business lines that generate tort liability; or 4) restructure such that valuable assets are held separately from the operational line of a risky business.[99] Only the second and fourth options are judgment proofing—strategically externalizing the costs of economic activity onto involuntary creditors—because the other methods leave some assets for involuntary creditors to reach.

The fourth option is the most appealing to shareholders; the first may greatly increase costs or shut down the business, the second shuts down the business and opens up the possibility

[98] Kors, supra note ____ at 418. *See also* Zubik v. Zubik, 384 F.2d 267, 273 (3rd Cir. 1967) ("the injured tort claimant stands on a different footing [than voluntary creditors]")

[99] *See* Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 Va. L. Rev. 39 (1986). Prof. LoPucki identifies several other modern methods of judgment proofing, such as shifting value into exempt assets or creating a foreign

of piercing, and the third option requires either a willing buyer that has some superior strategy to insulate itself from tort liability or accepting a low price for the assets. Furthermore, the increased formality and monitoring costs of the additional affirmative asset partitioning will likely fall well below the benefit to the shareholder of avoiding tort liability.[100] This is most likely true even if a firm incurs enough formality costs to eliminate the prospect of veil piercing or substantive consolidation based on an "alter ego" test. Sophisticated creditors also respond well to option four. At a system-wide level, a large corporate group's liquidation or bankruptcy (caused by the costs of safety compliance) results in less demand for credit. In each particular case, the sophisticated creditor can use inter-company loan agreements and other relatively straightforward contractual terms to achieve the practical effect of loaning against the assets of the entire corporate group. Thus, unlike the other options, judgment proofing through affirmative asset partitioning is in the interests of both shareholders and sophisticated creditors.

Asset partitioning as a means of judgment proofing has several harmful effects. Some are unique to asset partitioning (like administrative costs) while others are common to all types of judgment proofing. The remainder of this section addresses three of the most general harms.

1. Sub-optimal levels of risk and safety because tort policy is not enforced—Insofar as the object of tort law is to arrive at the optimal level of risk for any activity and to efficiently allocate the costs of that activity when the risk manifests itself,[101] judgment proofing through affirmative asset partitioning frustrates tort policy.[102] Judgment proofing exacerbates the problems of

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trust, but these are more applicable to individuals than corporate groups. Lynn M. Lopucki, *The Death of Liability*, 106 Yale L.J. 1, 30-38 (1996).

[100] *See* Roe, *supra* note ____ at 48.

[101] *See* Guido Calabresi, The Costs of Accidents: A Legal and Economic Analysis 69-75 (1970); Richard A. Posner, Economic Analysis of Law 139, 145 (2nd ed. 1977). *But see* John A. Siliciano, *Corporate Behavior and the Social Efficiency of Tort Law*, 85 Mich. L. Rev. 1820 (1987) (arguing that tort law does not actually deter inefficient levels of safety).

[102] *See, e.g.*, Steven Shavell, *The Judgment Proof Problem*, 6 Int'l Rev. L & Econ. 45, 45 (1986).

limited liability more generally.[103] However, while limited liability makes shareholders more willing to invest in risky enterprises, it may, in fact, be necessary to achieve the benefits of widespread share ownership.[104] Judgment proofing, on the other hand, has a net negative effect. Limited liability prevents tort claimants from being made whole but the risky activity itself stops and shareholders lose their investment (which is a disincentive to invest in a risky enterprise). Judgment proofing, however, allows a firm that creates more economic costs than economic benefits to continue to operate. By financing risky activity through a subsidiary and securing loan guarantees from other members of the corporate group, a sophisticated creditor can finance high-risk activity and still ensure that it will not lose its investment.

2. Societal administrative costs—Judgment proofing increases the rate of asset partitioning without any countervailing benefit thereby resulting in a net loss to society. Avoiding tort liability is clearly a valuable intra-firm benefit of asset partitioning. It is no coincidence that wholly owned subsidiaries appeared around the same time when tort law moved away from business-friendly doctrines (like assumption of risk and contributory negligence).[105] In fact, there seems to be a ratchet effect between tort liability and affirmative asset partitioning; as tort law becomes more plaintiff friendly, corporate groups have more incentive to partition assets for judgment proofing purposes.[106] Thanks to recent legal and technological innovations,

[103] *See generally* Henry Hansmann & Renier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L. J. 1879 (1991).

[104] *See* Easterbrook & Fischel *supra* note ____ at 95.

[105] *See* Roe, *supra* note ____ at 46-48 including footnotes. For a thorough discussion of the proliferation of subsidiary structures during the latter part of the 20th century *see* PHILIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: SUBSTANTIVE LAW Ch. 1 (1987).

[106] Thus, the final solution to judgment proofing may include rolling back American's infamous litigiousness or outrageously high, compared to other industrialized nations, jury verdicts. *See, e.g.*, GEORGE EADS & PETER REUTER, DESIGNING SAFER PRODUCTS: CORPORATE RESPONSES TO PRODUCT LIABILITY LAW AND REGULATION VII (1983) (arguing that American product liability law is deeply flawed).

it is also getting less costly for corporate groups to use asset partitioning[107]—thus, sub-entities have been proliferating.[108]

However, the societal costs of asset partitioning are not declining at a similar rate. While high valuation and monitoring benefits made affirmative asset partitioning highly efficient in the example of the commercial office business and rental car business in Part II.B.2, asset partitioning as a means of judgment proofing results in no societal benefit. Judgment proofing increases the government's costs—administrative costs in bankruptcy and enforcement and monitor costs outside of bankruptcy—and shifts activity costs onto third parties. Therefore, when asset partitioning is used as a means of judgement proofing, it results in a net loss to society.

3. Non-diversification of the involuntary creditor's claim—Affirmative asset partitioning works to un-diversify a creditor's risk—loaning to two businesses is less risky than loaning to one. Insofar as a creditor expects this effect, he or she can diversify in other ways—for example, by loaning money to several narrow subsidiaries. Therefore, bankruptcy law should, as a default rule, impose diversification costs on the party most likely to mitigate them (by diversifying in other ways) or account for them (by adjusting the interest rate). Instead, the use of asset partitioning to judgment proof imposes diversification costs on involuntary creditors—the party least capable of diversifying its risk ex ante.[109] Thus, asset partitioning allows "negotiating creditors [to] push losses and the resulting inefficiencies off onto other parties who cannot

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[107] Novel vehicles such as limited liability companies and limited liability partnerships create separate asset pools without incurring disparate tax treatment. Furthermore, "the introduction of computer technology has dramatically altered the equation by reducing the costs of recordkeeping. Judgment-proofing strategies have become cheaper and easier to execute." Lopucki, *supra* note ____ at 5; *see also* Edward J. Kane, *Interaction of Financial and Regulatory Innovation*, 78 Am. Econ. Rev. 328, 331 (1988)

[108] *See* TAN *supra* notes 1 & 2.

[109] While involuntary creditors can purchase various kinds of health and disability insurance to mitigate this cost, truly involuntary creditors will not be able to predict with any accuracy their risk. But, to a certain extent, the law

adjust."[110] Perhaps because of the growing use of asset partitioning and other judgment proofing devices, the proportion of involuntary creditors in business bankruptcies doubled between 1994 and 2002.[111]

B. A Solution: Substantive Consolidation

Although some scholars are pessimistic about the judgment-proofing problem,[112] substantive consolidation is nonetheless a useful tool to remedy the specific costs of judgment proofing through asset partitioning.[113] Imagine a rule that allowed a bankruptcy court to order substantive consolidation whenever asset partitioning was used to judgment proof. In other words, the rule would refuse to recognize separate corporate structures in bankruptcy unless they were erected for some reason other than judgment proofing.[114] This section briefly explains how such a rule would mitigate the diversification cost and administrative costs of asset partitioning.

1. Ex Post Effects: Mitigating diversification costs—As the discussion in Section A makes clear, the benefits of judgment proofing do not inure solely to the shareholders; instead, judgment proofing through asset partitioning is to the benefit of sophisticated creditors as well. In this respect, sophisticated unsecured creditors act like secured creditors—they can only afford to lend against a group of assets only insofar as they can "victimize involuntary creditors."[115] These were the facts in *Owens Corning*; a consortia of banks made loans at a below market interest rate by spreading their risk across the corporate group. When *Owens Corning* went

should expect mal-adjusting contractual debtors, like employees, to mitigate diversification costs by purchasing insurance—both for unemployment/loss of wages and to remedy injuries on the job.

[110] Warren & Westbrook *supra* note ____ at 1239.

[111] Warren & Westbrook *supra* note ____ at 1237.

[112] LoPucki, *supra* note ____ at 4 (arguing that proposals to prevent judgment proofing amount to a "grand debate [. . .] over the arrangement of the deck chairs on the Titanic.")

[113] In fact, Part III.B shows how traditional alter ego analysis as a component of substantive consolidation analysis remedies a weak form of judgment proofing.

[114] Obviously, the difficult question is whether such a rule is possible. The next section presents a preliminary rule.

[115] *See* Lopucki*, Unsecured Bargain*, *supra* note ____ at 1897. Professor LoPucki argues that this is the central calculus of secured creditors.

bankrupt, the banks cashed in their advantage at a cost to the asbestos tort claimants—resulting in a wealth transfer from involuntary creditors to sophisticated creditors. By placing sophisticated and involuntary claims on equal footing, substantive consolidation operates as an *ex post* remedy to this wealth transfer.

2. Internalizing Activity Costs—Substantive consolidation also internalizes activity costs. Sophisticated creditors will not be able to avoid the risk of business failure; thus, they will either raise interest rates which places these costs on shareholders, maintain lower interest rates and accept an inefficient level of risk, or refuse to loan on an unsecured basis all together. Some firms will decrease the risk of tort liability to efficient levels in order to obtain better financing while other firms will simply pay higher capital costs. Of course, some highly inefficient firms will no longer have access to the capital markets at viable interest rates; these firms will become insolvent before generating activity costs in excess of activity benefits. The key, however, is that activity costs will be borne by the parties most capable of mitigating them *ex ante*.

3. Administrative Costs—Since substantive consolidation renders judgment proofing through asset partitioning ineffective, it should be a countervailing force to the modern phenomena of entity proliferation. Although the intra-firm costs of affirmative asset partitioning will continue to fall through the use of new technology and innovative corporate forms, these falling intra-firm costs will not be accompanied by an increasing intra-firm benefit in the form of avoided liability. Instead, affirmative asset partitioning will only be viable when it actually lowers valuation and monitoring costs. Since substantive consolidation eliminates the judgment proofing benefits of affirmative asset partitioning, fewer wholly owned subsidiaries will be incorporated. This should decrease administrative costs in bankruptcy and monitoring costs outside of bankruptcy.

4. Other Ex Ante Effects—Because the root causes of judgment proofing—tort liability and incentives to avoid tort liability—will not disappear, one can expect that eliminating some judgment proofing by imposing a stronger substantive consolidation standard will push parties to other judgment proofing strategies. However, to the extent that the costs of other judgment proofing strategies are higher than judgment proofing through asset partitioning, a stronger substantive consolidation standard will result in less judgment-proofing overall. For example, Professor Ronald Mann argues that secured lending is significantly more costly than unsecured lending—especially for large public companies.[116] Security interests are also ineffective in prioritizing claims against some types of collateral—such as cash. Therefore, it is unlikely that judgment proofing through asset partitioning will ever be fully replaced by judgment proofing through secured lending. Even to the extent that asset partitioning is replaced by secured lending, secured lending may be a more equitable system for unsophisticated creditors (although not for involuntary creditors). First, the secured credit recording system is more transparent than a corporate group's internal structure; this may allow even unsophisticated creditors to make more accurate risk assessments. Second, unsophisticated trade creditors may be able to take countervailing and higher priority security interests themselves—for example, in the goods that they supply to the debtor.

C. A Proposal for an Additional Test for Substantive Consolidation

Most proposals to remedy judgment proofing require drastic changes to our entity-based system of settling judgments and, for this reason, are generally unworkable within the current

[116] *See* Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 658-59 (1997) (identifying increased "information costs" and "administration costs due to the lender's power to prevent the borrower from using its assets in the most profitable way).

system.[117] Prof. Blumberg's classic argument for attributing liability on a functionalist instead of formalistic definition of the firm—enterprise liability—is one such proposal.[118] Although allocating liability through an inquiry into "the degree of economic integration of the [corporate] group" sounds in theory,[119] Blumberg's broad categories of functional inquiry are not easy to apply.[120] If the assets of an "enterprise" are vague and uncertain, then the valuation and monitoring benefits to sophisticated creditors of affirmative asset partitioning fall by the wayside. Thus, the real difficulty of using substantive consolidation to implement tort policy is crafting a doctrine that mitigates the costs of judgment proofing without negating the benefits of affirmative asset partitioning. A plea that courts should root out judgment proofing like they would discriminatory animus is probably misguided.[121] Instead, this section outlines a burden-shifting substantive consolidation analysis that, because it is more conservative and limited in scope than a rule of generally applicable enterprise liability, effectively balances the costs and benefits of affirmative asset partitioning.

1. Presumption of Consolidation—When a substantial percentage of unsecured claims are held by involuntary creditors, there should be a presumption to substantively consolidate the assets and liabilities of all a corporate parent's wholly-owned subsidiaries.

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[117] Prof. LoPucki describes proposals for unlimited shareholder liability, pass through liability and trading partner liability as "de-entification." LoPucki, *supra* note ____ at 66. While de-entification may be a good thing, it requires completely restructuring major areas of the law.

[118] *See* PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: BANKRUPTCY LAW 699-704 (1985).

[119] PHILIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 431 (1983).

[120] Several scholars have leveled this criticism at Blumberg's approach. *See, e.g*, Kors, supra note ___ at 437 ("While enterprise liability may offer some appeal, measuring the extent of an "economic unit" introduces an intolerable level of uncertainty into the question of liability."); LoPucki, *Liability*, *supra* note ____ at 67 ("such a standard would produce intolerable uncertainty . . .").

[121] This was probably the lower court's intuition in Owens Corning and explains why it covered its ruling in a fairly standard doctrinal analysis. *See* In Re Owens Corning, 316 B.R. 168 (Bankr. D. Del. 2004). The Third Circuit understood, however, that the lower court had approved a purely redistributive consolidation but did not understand why. *See* In Re Owens Corning, 419 F.3d 195, 200 (3d Cir. 2005) ("[T]he proponents of substantive consolidation request it . . as a ploy to deprive one group of creditors of their rights while providing a windfall to other creditors.").

The nature of this presumption makes the proposed rule very conservative. First, this rule will affect a very small percentage of corporate bankruptcies. It appears that involuntary creditors hold claims in approximately ten percent of corporate bankruptcies.[122] Corporate bankruptcies in which a substantial number of unsecured claims are held by involuntary creditors are most likely very infrequent. Second, this rule only consolidates wholly-owned subsidiaries; it expects that minority shareholder protections will prevent the use of a majority-owned subsidiary solely as a judgment-proofing vehicle. Third, this rule only applies once some constituent part of a corporate group goes bankrupt with outstanding involuntary claims; debtors and creditors can avoid enterprise liability by paying involuntary creditors up front.[123] Thus, since this rule only imposes enterprise liability in bankruptcy, it only applies to mitigate demonstrable diversification costs.

Despite being conservative and under-inclusive, this rule puts lenders to industries that have the capacity to generate substantial tort liability on notice that one consequence of their debtor's insolvency may be substantive consolidation. Since these industries are the only industries likely to employ widespread judgment proofing, the rule makes judgment proofing through affirmative asset partitioning substantially less certain. However, it should not make affirmative asset partitioning any less certain in other industries. Google's creditors, for example, will not be affected by this presumption. In the future, sophisticated creditors in industries with large tort potential will simply not rely on corporate formality to keep their pool of assets separate if their debtor's corporate group commits or continues a mass tort.

[122] *See* Warren & Westbrook, *supra* note ____ at 1227-30. I choose this ten percent figure because it falls in the middle of Warren and Westbrook's 1% to 25.5% estimated range.

[123] Thus, this rule will have affects similar to involuntary creditor priority except involuntary creditor priority will only apply when tort liability causes the bankruptcy and only as to unsecured creditors. Therefore, it is more conservative than straightforward tort claimant priority. *See* LoPucki, *Bargain*, *supra* note ____ at 1907-16. However, because this rule prevents the sheltering of assets in separate entities while involuntary creditor priority only applies to the assets within an entity, it more effectively addresses asset partitioning judgment proofing.

Nonetheless, to mitigate its potential over-inclusive application, the rule should also allow certain caveats to vindicate the interests of sophisticated and unsophisticated creditors.

2. Defeating consolidation as to one claim—A claim should not be consolidated if a creditor can show that it objectively relied on the separate credit of its debtor subsidiary.

This exception allows a sophisticated creditor to unequivocally rely on two entities' separateness despite the presumption of consolidation and maintains valuation and monitoring benefits. The exception also engenders a higher degree of certainty; if a sophisticated creditor actually expects a loan to be paid from the assets of a single entity, there is no reason not to exempt its claim from consolidation. However, reliance must be objective and reasonable. If a bank requires loan guarantees from multiple corporate subsidiaries then it is relying on the credit of the subsidiaries as a group.

This exception also addresses what Prof. Roe refers to as the "foreseeability" problem of judgment proofing.[124] Strict liability in tort law holds parties liable for accidents or product failures even if they are not foreseeable, but effective judgment proofing requires that shareholders and creditors foresee a risk of tort liability. I do not mean to question the wisdom of tort policy; I raise this point only to show that consolidating a corporate group on the basis of tort liability that neither the shareholders nor creditors foresaw would have no effect on ex ante bargaining and, therefore, would not decrease judgment proofing. So, if neither the shareholders nor the creditors foresaw potential for tort liability in any remote sense at the time of the sophisticated creditor's loan, then the subsidiary structure was almost certainly developed for some reason besides judgment proofing.

3. Defeating consolidation as to all claims—A creditor will be able to prevent substantive consolidation upon proving that the entities were functionally separate businesses.

This exception imports enterprise liability principles to protect the "reliance" interest of unsophisticated creditors. Because the presumption of consolidation is already conservative, the indeterminacy of Blumberg's enterprise liability inquiry is not as harmful. Narrow line-drawing will almost certainly not be necessary. Furthermore, because any sophisticated creditor can forestall consolidation of its claim through demonstrated reliance, only unsophisticated creditors will invoke this exception. Therefore, to the extent that the standard remains vague, it will not create ex ante disturbances; business realities and not the standard of substantive consolidation will continue to govern unsophisticated creditors' bargaining.

Still, a court applying principles of enterprise liability under this substantive consolidation analysis has three advantages over a generally applicable test of enterprise liability. First, if two wholly owned subsidiaries are in bankruptcy, it is highly likely that they were economically integrated; one could not turn a profit without the other. Second, separate subsidiaries in horizontally integrated corporate groups will be easy to distinguish; the component parts of General Electric are clearly independent business lines.[125] Third, the nature of the unsophisticated trade creditors themselves can be used to distinguish one enterprise from another. If the corporate group's trade creditors are competitors or are otherwise in the same industry, more likely than not the debtors should be treated as a single enterprise. However, in a close case of vertically integrated subsidiaries, courts will still have Blumberg's factors to guide them: whether subsidiaries share a common public persona, whether employment and management structures are integrated, and whether the firm produces a unified end product or service.[126]

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[124] *See* Roe, *supra* ___ at 42-46.
[125] *See* Frost, *supra* note ____ at 492-95 (arguing that substantive consolidation is efficient for vertically integrated groups but not for horizontally integrated groups).
[126] PHILIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: GENERAL STATUTORY Law 835 (1988).

Part V: Conclusion

Responding to a perceived lack of uniformity of substantive consolidation at the doctrinal level and in application, this Note has examined substantive consolidation as a reaction to the costs of affirmative asset partitioning. In variously critiquing and justifying the current state of the law, it has suggested several changes to the way substantive consolidation should be considered and ordered. Essentially, it has found substantive consolidation to be justified in three situations.

First, substantive consolidation based on post-petition costs should be imposed over the objection of dissenting creditors when such consolidation would be pareto optimal. A creditor's reliance on the credit of a separate subsidiary should not forestall consolidation, but, depending on facts of the case, should militate in favor of granting the creditor's claim an exception from consolidation.

Second, substantive consolidation should be allowed based on evidence of disregard of the corporate form or "alter ego" leading up to bankruptcy sufficient to satisfy the court that formality costs were never actually observed. Creditors should not be required to show that they mistakenly relied on the credit of the corporate group as a whole or that the shareholders or managers of the firm effectively defrauded them. In particular, courts should use substantive consolidation to remedy inequities created when sophisticated creditors loan to one subsidiary and those assets are used to fund the activities of other subsidiaries at less than arm's-length. Reliance on the separate credit of a subsidiary should not defeat substantive consolidation; instead, a remedy should be provided against the misappropriating manager or shareholder.

Finally, this Note has argued that substantive consolidation should be ordered to counter a specific judgment proofing strategy. Courts should not allow sophisticated creditors and

shareholders to offload the costs of economic activity onto involuntary creditors. To this end, this Note proposed a conservative type of enterprise liability. A critical mass of involuntary creditors should cause courts to presumptive consolidate wholly owned subsidiaries on a motion from a party. To vindicate a sophisticated creditors expectation interest, the court should excise a creditor's claim from consolidation if it actually relied on the separate credit of the subsidiary. In order to prevent placing the costs of one business's failure on the creditors of another business, the court should refuse to consolidate the assets and liabilities of an entity at all upon a showing that the separate entities were functionally distinct.

Instead of obliquely classifying all creditors together, this Note suggests that courts recognize that creditors have neither the same interests in bankruptcy nor the same position ex ante. It is hoped that judges in the future will develop a greater appreciation for the costs and benefits of the corporate form and those harms that substantive consolidation avoids. Such an appreciation should lead courts to invoke substantive consolidation less hesitantly and more consistently to remedy the costs of asset partitioning in a world of multiplying entities.