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Corporate Form and Substantive Consolidation

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> *Legislators have frequently shown a disposition to promote equality, under the name of* equity, *a word to which greater latitude has been given than to* justice. *But, this idea of equity, vague and half developed, has rather appeared an affair of instinct than of calculation. It was only by much patience and method, that it was found possible to reduce to rigorous propositions, an incoherent multitude of confused sentiments.*[1]

Introduction

This Article introduces you to the equity doctrine of substantive consolidation. In substantive consolidation the assets of individual members of a corporate group are pooled and intragroup debts forgiven so that claims of third-party creditors may be satisfied from a single common source during a bankruptcy proceeding. I hope to convince you that it is the most important doctrine in corporate reorganization. Each year the allocation of billions of dollars among competing creditor groups turns on decisions by courts to approve or reject use of the doctrine. For this reason, I believe that courts and commentators should have clearly stated the parameters of substantive consolidation doctrine long ago. To date, however, no such clear formulation exists; the current state of substantive consolidation doc-

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1 Jeremy Bentham, Theory of Legislation 134 (Richard Hildreth trans., Boston, Weeks, Jordan, & Co. 1840).

trine is a mess, leaving courts and reorganization participants adrift. Though few would disagree that the doctrine is in disarray, I largely part company with accepted wisdom in an attempt to remedy the situation. The merits of this Article reside in its multiple deviations from the norm.

My overall argument for reformulation of substantive consolidation doctrine is structured as a series of observations in which I make the following general points. First, the recent *Owens Corning* decisions[2] are examined (1) to explain why the doctrine matters to modern commercial finance, (2) to illustrate how the doctrine works in a particular case, and (3) to provide the factual background necessary to understand why I believe a federal circuit court incorrectly decided the case—a mere $1 billion may have changed hands based on flawed judicial reasoning. Second, contrary to case law rhetoric suggesting that the doctrine of substantive consolidation should be rarely used, my empirical research shows that the doctrine is used in over half of our large public bankruptcy cases. This widespread usage highlights the importance of understanding the doctrine (beyond the possibility of a $1 billion judicial error). Third, basic economic theory explains why so many situations exist for application of the doctrine, despite judicial pronouncements that occasions for its use should be rare. Simply put, we are not surprised when managers pursue cost savings. I suggest that when managers of one corporation replace market transactions with internal production of goods and services by acquiring another corporation, in many cases we would expect managers to ignore corporate formalities for the acquired corporation following its acquisition as part of the cost-savings effort. Significantly, the failure to observe corporate formalities often sets the stage for the imposition of substantive consolidation. Empirical research finding widespread occasions for use of substantive consolidation might be explained by managers' pursuit of cost savings as predicted by economic theory.

Fourth, though I observe a muddle in the case law, I reason that substantive consolidation can be supported in three situations and suggest reformulating the doctrine based on this simple tripartite division: substantive consolidation may be granted (1) to achieve cost savings that a court believes will benefit at least one creditor without harming other creditors, (2) in cases justifying the application of traditional veil piercing doctrine upon a showing of the need to correct some harm, and (3) when intercompany guarantees are present. I ex-

2 *In re* Owens Corning, 316 B.R. 168 (Bankr. D. Del. 2004), *rev'd*, 419 F.3d 195 (3d Cir. 2005), *cert. denied*, 126 S. Ct. 1910 (2006).

plain how the cost-saving and veil-piercing rationales are firmly grounded in existing substantive consolidation case law, requiring only that courts recognize them as discrete and alternative grounds.

My explanation of why substantive consolidation is justified in cases of intercompany guarantees is new to substantive consolidation doctrine, however I ground my arguments in traditional equity-based concerns over intercreditor fairness. Though intercompany guarantees have long been considered a basis for substantive consolidation, the courts have never articulated a reason for this position (and it was firmly rejected by the circuit court in *Owens Corning*). I argue that substantive consolidation is appropriate in most guarantee cases to avoid claim dilution for those creditors without guarantees, because intercompany guarantees should be identified as a form of double proof (an evil that our insolvency laws often attempt to mitigate in other contexts). I label the form of double proof worked by intercompany guarantees the "squeeze down effect." I observe that reformulation of intercompany guarantees as a separate and independent ground for substantive consolidation does not in fact destroy the legitimate reliance interests of most creditors who obtain the benefit of guarantees. Rather, many guaranteed creditors use guarantees to create *by contract* the result achieved by substantive consolidation in a courtroom.

Lastly, I argue that use of substantive consolidation doctrine is on sound constitutional footing. To do so, I first find statutory support for the substantive consolidation procedure through close analysis of the bankruptcy claims filing process, rejecting the extant weak arguments that find support for the doctrine in § 105 and § 1123 of the Bankruptcy Code. Second (to supplement my statutory analysis), I debunk arguments that the doctrine is unconstitutional because the procedure did not exist at the time of the Judiciary Act of 1789. I find approval for a consolidation remedy in English Chancery practice in 1673 (a result directly contrary to the widely held belief that the consolidation procedure originated in the U.S. Supreme Court in 1941).

My observations and analysis yield a reformulated doctrine of substantive consolidation that is easy to understand, passes constitutional muster, and can comfortably coexist with both asset-backed financing and syndicated lending.

On a broader level, the prevalence of substantive consolidation in our largest bankruptcies teaches us something about corporate form as actually used in practice, supplementing recent corporate law scholarship. The signature book guiding current corporate law debates—

The Anatomy of Corporate Law[3]—explores neither the impact of insolvency law on corporate form nor the special problems raised by corporate groups.[4] Professors Hansmann and Kraakman, two of the seven authors of *The Anatomy of Corporate Law*, stress the idea that separate corporate personality holds the key to understanding corporate form, proposing that separate corporate personality be understood in terms of "asset partitioning."[5] Because substantive consolidation breaks down asset partitions within corporate groups under the stress of insolvency by ignoring corporate form, I argue that we must choose between a context-sensitive and a context-neutral rule for evaluating the role that corporate form plays in ordering financial relationships.

I suggest that the function of asset identification and the mechanisms of artificial personality are coequal in importance with asset partitioning in understanding the corporate form. The mechanisms of artificial personality are simply those features of certificates of incorporation and bylaws that allow corporations to make decisions through the actions of natural persons. A stand-alone company actively uses its mechanisms of artificial personality to conduct business.

When a parent company acquires subsidiaries, however, it acquires multiple mechanisms for the exercise of artificial personality, which the parent company does not need—the management mechanisms of the acquired companies are redundant. Accordingly, these acquired mechanisms of artificial personality hibernate. By distinguishing the asset partitioning function from the mechanisms of artificial personality we can see that hibernation of the mechanisms of artificial personality need not result in the breakdown of an asset partition (contrary to the reasoning of some courts).

Asset identification occurs when ceremonies are performed (and transaction costs incurred) to collect assets under a single corporate

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3 REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (2004).

4 *See id.*; *see also* David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 YALE L.J. 1519, 1522 (2004) (book review).

5 *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 394–95 (2000). Asset partitioning has two facets: affirmative and defensive. Affirmative asset partitioning provides a corporation's creditors a priority claim against the assets of the corporation, ahead of claims of the shareholders' creditors. Defensive asset partitioning limits the liability of shareholders for claims against the corporation. Recently, Professors Hansmann and Kraakman further developed the theory of asset partitioning, noting the potential of the "unsettled" doctrine of substantive consolidation as a possible cost-saving measure in reorganizations. *See* Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1401–02 (2006).

name through various contribution and acquisition transactions. Future transfers of assets previously collected under a single name may be accomplished without duplicating the prior ceremonies of collection by simply transferring the corporate name through a simple transfer of stock certificates. Transfers of stock certificates preserve the benefits of prior ceremonies used to collect assets under a single name, thus saving transaction costs because the cost of a stock transfer typically is less than the cost of the multiple transactions undertaken originally to collect assets under the corporate name.

By recognizing the asset identification function as separate from the asset partitioning function we can see that a parent corporation may acquire subsidiary corporations simply because a stock acquisition provides a means of transferring assets at the lowest direct cost. When this occurs, we find that asset partitions within corporate groups simply may be by-products of acquisition transactions undertaken with aims unrelated to matching creditors with asset pools (i.e., for reasons unrelated to affirmative or negative asset partitioning).

My three-part division[6] of aspects of the corporate form lurks in the background of my reformulation of the doctrine of substantive consolidation, suggesting when use of the doctrine is appropriate and when it is not.

Part I of this Article provides a general explanation of why substantive consolidation doctrine is of great importance to commercial finance. Part II shows how substantive consolidation doctrine profoundly affects America's largest insolvency cases by examining details of the Owens Corning bankruptcy. Part III then looks more broadly at recent large reorganizations, noting its widespread use and offering economic explanations for this phenomenon. Part IV of this Article goes behind the case law rhetoric, encumbered as it is by a plethora of factors and tests, to extract principles that might be used to reformulate the doctrine. Parts V, VI, and VII develop three independent rationales for the use of substantive consolidation: an economic rationale (Part V); an equitable rationale grounded in corporate law veil piercing (Part VI); and an equitable rationale

6 My recognition of the mechanisms of artificial personality and the asset identification function are not original. Indeed, Professors Hansmann and Kraakman note them as essential ingredients in creating an asset partition. *See* Hansmann & Kraakman, *supra* note 5, at 392–93. I differ in two respects. First, I emphasize the asset identification function as having independent value by facilitating future asset transfers at lower cost irrespective of the asset identification function's essential role in allowing the creation of an asset partition. Second, I note how use of the mechanisms of artificial personality are context-sensitive: active use being essential in a stand-alone company but potentially redundant within a corporate group.

grounded in historical considerations of fairness, originating with doctrines of marshaling (Part VII). In each case, the purpose is to explain how substantive consolidation doctrine should be formulated, and not to merely describe its current state of development.[7] Part VIII of this Article explains why reformulation of the doctrine of substantive consolidation passes constitutional muster under the Supreme Court's decision in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*[8] *Grupo Mexicano* taught us that equitable remedies must be grounded in equity as it existed in 1789,[9] absent a subsequent grant of statutory authority.[10] This Article shows how substantive consolidation may be justified on statutory grounds and also shows that, contrary to popular wisdom, equity had favorably considered a consolidation remedy prior to 1789.

I. Why Substantive Consolidation Matters to Commercial Finance

In the Owens Corning bankruptcy case,[11] the allocation of approximately $1 billion turned on the application of the arcane equity doctrine of substantive consolidation.[12] A district court judge had ordered the substantive consolidation of various Owens Corning subsidiaries to facilitate a plan of reorganization.[13] In substantive consolidation, the intercompany liabilities of the subject companies are eliminated, the assets of these subject companies are pooled, and the third-party liabilities of the subject companies are satisfied from this single pool of assets. This pooling of assets changes the percentage of recovery, for better or worse, that individual creditors would

7 Many articles collect and discuss substantive consolidation cases in an attempt to assist our understanding of this body of law. *See, e.g.*, Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381 (1998) (collecting cases and articles). To my mind, these efforts remain a valuable resource but none synthesize and rationalize the doctrine in a manner that helps courts systematically decide future cases on a basis that I find satisfactory. For example, I understand Professor Kors to suggest that substantive consolidation doctrine should evolve as an overall balancing test. *See id.* at 449–51. Though her thorough analysis allows for more sophisticated balancing (making many fine points with which I agree), without guidance as to how factors should be weighted in the test, I fear we return to the state of confusion currently found in the courts. In my view, the last thing we need is another balancing test.

8 Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308 (1999).

9 *Id.* at 318–19.

10 *See In re* Owens Corning, 419 F.3d 195, 208 n.14 (3d Cir. 2005) (discussing arguments against substantive consolidation after *Grupo Mexicano*).

11 *In re* Owens Corning, 316 B.R. 168 (Bankr. D. Del. 2004), *rev'd*, 419 F.3d 195 (3d Cir. 2005), *cert. denied*, 126 S. Ct. 1910 (2006).

12 *Id.* at 172.

13 *Id.*

receive in the absence of a consolidation.[14] In *Owens Corning*, the district court judge approved a special type of substantive consolidation known as a "deemed" consolidation, in which legal entities are not actually combined but distributions to creditors are made "as if" there had been a business combination.[15] A deemed consolidation may save transaction costs as compared with an actual business combination by eliminating the need to perform various procedures associated with an actual business combination (such as retitling assets and assigning contracts). The order benefited various unsecured bond holders and trade creditors to the detriment of a syndicated lending group by increasing the expected recoveries to the unsecured creditors and decreasing the expected recoveries to the syndicated lenders (a result that would have obtained whether or not a "deemed" consolidation had been chosen to effect the reorganization).[16] The Third Circuit reversed, siding with the syndicated lenders who argued that the facts did not support imposition of substantive consolidation because the lenders had relied on separate guarantees from various subsidiaries and the substantive consolidation destroyed certain benefits associated with the guarantees.[17]

Though any billion-dollar decision focuses the mind, the case has larger ramifications. For three principal reasons, the *Owens Corning* decisions hold highest significance for commercial financing practices. First, the trillion-dollar securitization industry must craft structured financing transactions that withstand attempted substantive consolidation of the special purpose companies ("SPCs") used in those financings.[18] Relaxation of the standards for imposition of substantive consolidation makes structuring these transactions more difficult and,

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14 For examples of the procedure, see *infra* Part II ("The Owens Corning Bankruptcy as an Illustration of the Technique") and Part V ("Reformulating an Efficiency Promotion Rationale for the Doctrine").

15 *Owens Corning*, 419 F.3d at 199, 202.

16 *Owens Corning*, 316 B.R. at 169, 172.

17 *Owens Corning*, 419 F.3d at 216.

18 In a typical structured financing, a parent company transfers assets to a wholly owned SPC. Though the financing can take many forms, in substance, the SPC borrows money using the transferred assets as collateral and returns the loan proceeds to the parent as compensation for the initial transfer of assets. The parent can use the SPC as the vehicle to obtain financing at a lower rate of interest so long as investors believe that the financing has been insulated from the harmful effects of a potential parent company bankruptcy. *See generally* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994) (describing the structure and purpose of asset-backed financing transactions including the isolation of assets in an SPC). For a detailed discussion of special purpose entities, see STANDARD & POOR'S, STRUCTURED FINANCE: LEGAL CRITERIA FOR U.S. STRUCTURED FINANCE TRANSACTIONS 43–57 (2004), http://www2.standardandpoors.com/spf/pdf/fixedincome/SF_legal_criteria_FINAL.pdf.

if relaxed too far, could destroy the utility of structured financing altogether.[19]

Second, the mere threat of substantive consolidation provides an impetus for creditors in nonstructured financings to reach agreement on reorganization plans for fear of the consequences of nonagreement. The recently confirmed reorganization plans for Worldcom, Inc., Enron Corp., and Conseco, Inc.—the three largest bankrupt companies ever reorganized in the United States[20]—all reflect this influence.[21] Bargaining over the structure of corporate reorganization plans takes place in the shadow of the doctrine of substantive consolidation just as bargaining takes place in other circumstances against the backdrop of laws relevant to those contexts.[22] Tightening the standards for imposition of substantive consolidation alters the balance of power in reorganization negotiations, generally making the position of certain institutional lenders stronger as compared with the interests of many classes of unsecured creditors, including trade creditors and involuntary claimants.

Third, the possibility of substantive consolidation may inform and shape the restructuring of a debtor with unsecured syndicated financing (i.e., a large loan facility arranged by an agent bank in which many other banks fund a portion of the loan commitment). In syndicated finance, one of the largest capital markets in the world, agent banks often structure transactions in which a parent company borrows funds supported by unsecured guarantees granted by its various subsidiary companies to the lender group. Before *Owens Corning*, the marketplace considered the presence of these guarantees as a reason to impose substantive consolidation[23] because case law had identified the presence of intercompany guarantees as a factor supporting use of

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19 *See* TRIBAR OPINION COMM., OPINIONS IN THE BANKRUPTCY CONTEXT: RATING AGENCY, STRUCTURED FINANCING, AND CHAPTER 11 TRANSACTIONS (1990), *reprinted in* 46 BUS. LAW. 718, 726 (1991) (noting that substantive consolidation would defeat one of the major premises of the rating in a structured finance transaction).

20 *See* William H. Widen, *Prevalence of Substantive Consolidation in Large Bankruptcies from 2000 to 2004: Preliminary Results*, 14 AM. BANKR. INST. L. REV. 47, 59 (2006) [hereinafter Widen, *Prevalence of Substantive Consolidation*] (listing large bankruptcies).

21 *Id.* at 60 (describing the role of substantive consolidation in selected bankruptcies).

22 *See, e.g.*, Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225, 225 (1982); Robert N. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979); Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 625 (2003).

23 *See* TRIBAR OPINION COMM., *supra* note 19, at 741, exh. A (including in factor "(x)" the absence of guarantees between parent and SPC as a basic assumption underlying a nonconsolidation opinion required by rating agencies in a structured finance transaction).

substantive consolidation.[24] In a complete reversal of marketplace expectations, *Owens Corning* transformed intercompany guarantees into a tool to oppose substantive consolidation because, in overturning the district court's order of substantive consolidation, the Third Circuit gave significant weight to the syndicated lenders' reliance on the intercompany guarantees as a factor against consolidation.[25] Existing substantive consolidation case law does not adequately theorize how to address the special problems presented by syndicated lending when unsecured intercompany guarantees are used to structure a loan.

The first two considerations pull in opposite directions. The securitization industry prefers significant limits on the scope of substantive consolidation primarily because the substantive consolidation of a bankrupt debtor with an affiliated SPC subjects the assets of the SPC to the automatic stay applicable to the debtor's assets.[26] This automatic stay prevents the timely application of the SPC's assets to make payments on the obligations issued by the SPC. The timeliness of payments figures prominently in the investment grade credit rating assigned to obligations issued by the SPC.[27] Because timeliness of payment forms a cornerstone for an investment grade credit rating (and substantive consolidation directly interferes with timely payment), the securitization industry hovers between panic and dread whenever a judge, like the district court judge in *Owens Corning*,[28] suggests that the doctrine applies to a wider range of cases. On the other hand, use of the doctrine can greatly simplify restructuring a bankrupt family of companies, potentially reducing costs associated with accounting for a multitude of separate entities. Many unsecured creditors recoil whenever a judicial decision, like that of the Third Circuit in *Owens Corning*,[29] proposes new limits on application of the

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24 *See, e.g., In re* Vecco Constr. Indus., Inc., 4 B.R. 407, 411 (Bankr. E.D. Va. 1980). The presence of intercompany guarantees continues to weigh in favor of substantive consolidation in some circuits. *See, e.g., In re* Verestar, Inc., 343 B.R. 444, 462 (Bankr. S.D.N.Y. 2006). Historically, the market did not give credence to a passing case law suggestion that the presence of guarantees might counsel against use of substantive consolidation in some cases because the existence of guarantees reflected knowledge of corporate separateness. *See In re* Snider Bros., Inc., 18 B.R. 230, 238 n.5 (Bankr. D. Mass. 1982) (noting that the presence of guarantees indicates awareness of separate corporate forms).

25 *In re* Owens Corning, 419 F.3d 195, 212 (3d Cir. 2005) (noting that to undo the bargain represented by guarantees is "a demanding task").

26 The automatic stay appears in § 362 of the Bankruptcy Code. *See* 11 U.S.C. § 362 (2000).

27 *See* TriBar Opinion Comm., *supra* note 19, at 720.

28 *In re* Owens Corning, 316 B.R. 168, 171 (Bankr. D. Del. 2004), *rev'd*, 419 F.3d 195 (3d Cir. 2005).

29 *Owens Corning*, 419 F.3d at 211–12.

doctrine because limits on the doctrine reduce their bargaining power to negotiate forms of restructuring using consolidation that may enhance their recoveries (both by lowering transaction costs and through simple hold-up value conferred by the mere threat of substantive consolidation).

If the practical threat of substantive consolidation disappears through the tightening of standards for its imposition, then so does a point of leverage to negotiate reorganization plans that use the technique. I believe this result would tend to disadvantage small creditors and tort claimants. Academics have considered how the institution of secured credit disadvantages these creditor classes,[30] but attention has not focused on how syndicated lenders' use of multiple guarantees may disadvantage this same group by systematically diluting recoveries on their claims. This Article explains the phenomenon of claim dilution and shows how substantive consolidation may reduce the disadvantage of claim dilution.[31]

The *Owens Corning* decisions reflect a general failure by courts to establish clearly the parameters of a doctrine vitally important to modern corporate finance. This Article will argue that while capital markets have evolved sophisticated securitization and syndication techniques, development of the doctrine of substantive consolidation has failed to keep pace. This Article offers a critique of the existing doctrine and offers a way forward for development of the doctrine that remains sensitive to concerns of the securitization and syndicated lending industries while also preserving some balance in reorganization negotiations.

I continue with a brief overview of the facts in the *Owens Corning* decisions and then proceed with an examination of how and why the doctrine of substantive consolidation figures prominently in the largest bankruptcy cases in our history.

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30 *See, e.g.*, Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) (arguing that the institution of secured credit may be inefficient); Symposium, *The Priority of Secured Debt*, 82 CORNELL L. REV. 1279 (1997) (discussing a proposal to "carve out" a specified percentage of asset value in companies for the repayment of unsecured creditors rather than secured creditors). Professor Elizabeth Warren at Harvard Law School originally suggested that a percentage carve-out of asset value of a debtor should be exempt from claims of secured creditors and reserved for the payment of unsecured claims in order to promote fairness to unsecured creditors. *See* Elizabeth Warren, *An Article 9 Set-Aside for Unsecured Creditors*, 51 CONSUMER FIN. L.Q. REP. 323, 323 (1997).

31 *See infra* Part VII ("A New Fairness Rationale for the Doctrine Based on Eliminating Double Proof in Cases of Intercompany Guarantees").

II. *The Owens Corning Bankruptcy as an Illustration of the Technique*

The table below illustrates, in a simplified format, what is at stake in the *Owens Corning* decisions. In the example, Owens Corning's ("OC's") seventeen bankrupt subsidiaries become SubOne, SubTwo, and SubThree, as direct wholly owned subsidiaries of OC Parent. Dollar figures are fictional for ease of illustration. Asset values do not include the value of any interests in subsidiaries.

Table 1: The Basic Arithmetic of *Owens Corning*

Entity	Asset Value	Noteholder Claims	Loan Amount	Lender Claims
OC Parent	$980 million	$4 billion	$2 billion	$2 billion
SubOne	$1 billion	-0-	-0-	$2 billion
SubTwo	$1 billion	-0-	-0-	$2 billion
SubThree	$20 million	-0-	-0-	-0-
Consolidated	$3 billion	$4 billion	$2 billion	N/A

Notice that, even though the lending syndicate's loan amount to OC Parent totals only $2 billion, the lenders hold a $2 billion claim against both SubOne and SubTwo. These two other claims exist because the lenders required that SubOne and SubTwo provide guarantees of the loan to OC Parent. The lenders do not have a direct claim against SubThree because, as part of the negotiation with OC Parent, the lenders agreed to limit guarantee claims to significant subsidiaries with an asset value of $30 million or more. This means that the equity value in SubThree benefits creditors of OC Parent.

These guarantees have two effects. First, they protect the lending syndicate against structural subordination. No future creditor of the consolidated group[32] may achieve structural priority over the lending syndicate in the assets of SubOne or SubTwo. Potential future creditors include voluntary contract claimants, involuntary tort claimants, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation. Second, the guarantees give the lending syndicate structural priority over the noteholders, who only have a single claim against OC

32 Readers must distinguish between (1) procedural consolidation, (2) substantive consolidation, and (3) a consolidated group. Procedural consolidation simply means that a single court has jurisdiction over multiple related cases; it results in administrative efficiencies when debtors are related by common ownership but does not result in the combination of legal entities. Substantive consolidation combines legal entities, either hypothetically (in a "deemed" consolidation) or actually, for the purposes of making distributions and voting on plans. A consolidated group is simply a family of companies related by common ownership that would prepare consolidated financial statements and tax returns; it does not imply any combination of legal entities.

Parent. This structural priority allows the lending syndicate to collect an aggregate of $2 billion out of SubOne and SubTwo before any noteholder sees a dime. This result follows from the general rule that a legal entity pays its creditors before its shareholders receive any distributions. The guarantee claims of the lending syndicate turn the lenders into direct creditors of SubOne and SubTwo. OC Parent only has an equity interest in SubOne and SubTwo.

The "Consolidated" row in the table illustrates the situation where substantive consolidation breaks down the asset partitions created by the separate subsidiaries, eliminating intercompany liabilities. The noteholders, with $4 billion in claims, compete with the lenders, holding $2 billion in claims, on a *pari passu* basis, for $3 billion in assets so that every creditor receives fifty cents on the dollar. The additional lender claims created by the guarantees disappear in the consolidation. For the loan syndicate, this represents the difference between getting paid the full $2 billion on their loan and receiving only $1 billion.

The Owens Corning debtors started the proceeding that requested substantive consolidation prior to formal consideration of a reorganization plan.[33] They hoped to learn whether substantive consolidation would be available so that, if they included it as part of a plan, they would not have to develop a new plan if the court disallowed consolidation at a later stage.[34] A district court judge heard this matter, rather than a bankruptcy court judge, because jurisdiction had been removed from the bankruptcy court judge for reasons not pertinent to this analysis.[35]

In deciding to approve substantive consolidation, the district judge focused first on the management of the Owens Corning consolidated group, stating: "[the court has] no difficulty in concluding that there is indeed substantial identity between the [OC Parent] and its wholly owned subsidiaries."[36] The presence of central headquarters control, management on a product line (rather than legal entity) basis, lack of separate business plans or budgets, dependence on the parent company for funding, centralized cash management, and establish-

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33 *Owens Corning*, 419 F.3d at 202.

34 *See id.* at 202 n.6.

35 *Id.* at 202 & n.8.

36 *In re* Owens Corning, 316 B.R. 168, 171 (Bankr. D. Del. 2004), *rev'd*, 419 F.3d 195 (3d Cir. 2005).

ment of subsidiaries for the convenience of the parent (particularly for tax reasons)[37] all supported this finding.[38]

The district judge then found that substantive consolidation would greatly simplify the proceeding because questions still existed over the accuracy of audit results to separate the financial affairs of the Owens Corning companies, the key remaining problems being failures to pay interest on intercompany advances, calculation of intercompany royalty payments,[39] and resolving outstanding assertions that the lending syndicate's guarantees should be voided as fraudulent conveyances.[40] For the district judge, these first two issues made a prima facie case for substantive consolidation.[41]

The lending syndicate did not sufficiently rebut this prima facie case.[42] Though the syndicate had relied on guarantees to prevent others from achieving priority, the judge found that in reality the syndicate had also relied on the overall credit of the consolidated group.[43] For example, the lending syndicate only received consolidated financial reporting and did not monitor the separate debt level at the subsidiary guarantors.[44]

The Third Circuit reversed.[45] It suggested that the substantial identity between a parent and its subsidiaries, which is created by cen-

37 Several of the most valuable subsidiaries in the Owens Corning consolidated group that provided guarantees to the lending syndicate are tax shelters. For example, Owens Corning Fiberglass Technology, Inc. ("OCFT"), a common type of tax shelter known as an "intellectual property holding company," owns all intellectual property in the Owens Corning consolidated group, licensing it back to consolidated group members. *Owens Corning*, 419 F.3d at 200 n.3. The state tax benefits are twofold: consolidated group members get a state tax royalty deduction in their home states, and the royalty income received by OCFT is not subject to state tax because OCFT's state of incorporation has no state-level corporate tax. Some states have attacked similar shelters as sham transactions. *See* Syms Corp. v. Comm'r of Revenue, 765 N.E.2d 758 (Mass. 2002); Lanco, Inc. v. Dir., Div. of Taxation, 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005); A & F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App. 2004); Geoffrey, Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13 (S.C. 1993).

38 *Owens Corning*, 316 B.R. at 171.

39 Royalty payment calculations that caused accounting problems relate to the intellectual property holding company tax shelter described above. *See supra* note 37.

40 *Owens Corning*, 316 B.R. at 171–72. An intercompany guarantee might produce a fraudulent transfer if the guarantor does not receive reasonably equivalent value for providing the guarantee (for example, if SubOne and SubTwo provided guarantees without receiving loan proceeds). *See generally* Phillip I. Blumberg, *Intragroup (Upstream, Cross-Stream, and Downstream) Guaranties Under the Uniform Fraudulent Transfer Act*, 9 CARDOZO L. REV. 685, 689 n.14 (1987) (collecting citations to articles).

41 *Owens Corning*, 316 B.R. at 171.

42 *Id.* at 172.

43 *Id.*

44 *Id.*

45 *In re* Owens Corning, 419 F.3d 195, 216 (3d Cir. 2005).

tralized management, is ordinarily found in consolidated groups.[46] It deemed problems over calculation of interest and royalty payments relatively minor.[47] Without minimizing fraudulent conveyance concerns over intercompany guarantees, the Third Circuit felt those issues should be handled separately, and not as part of a motion for substantive consolidation.[48] Rather than finding that the lending syndicate had relied on the credit of the consolidated group as a whole, the Third Circuit pointed to the specific negotiation of the guarantees, including a $30 million guarantee threshold, and its belief that the syndicated loan agreement required Owens Corning to maintain the separate existence of its subsidiaries, as evidence that the lenders relied on the guarantees for priority, and not merely to assure parity.[49] The Third Circuit was unmoved by the fact that the offering memoranda used to market the parent company notes to noteholders did not disclose their structural subordination as a risk factor, suggesting that the proper way to handle such concerns would be in a fraud suit.[50]

III. The Widespread Use of Substantive Consolidation

In this Part, I argue that courts commonly use substantive consolidation despite their rhetoric that the occasions for its use should be few and far between. This usage occurs primarily in approval of consensual reorganization plans. I provide an economic explanation for why this result should not surprise us.

Though one might conclude that courts would treat consensual plans very differently than they might treat a contested case (e.g., in the consensual case simply rubber stamping the wishes of the parties), we find dicta in case law suggesting that courts must make an independent assessment of the appropriate use of the remedy. Reorganization plans themselves often cite principles developed in contested case law to support use of the doctrine. Though, on the margin, I suspect it is easier to obtain approval for use of the doctrine in a negotiated plan

46 *Id.* at 215.

47 *Id.*

48 *Id.*

49 *Id.* at 212–14. One of the petitions for certiorari made much of the fact that the Third Circuit did not give proper deference to the fact finding of the district court. *See* Petition for a Writ of Certiorari at 26–30, McMonagle v. Credit Suisse First Boston, 126 S. Ct. 1910 (2006) (No. 05-827), 2005 WL 3606450. These questions are not germane to the issues discussed in this Article. The procedure pursuant to which a bankruptcy court makes an early determination of plan issues, prior to a confirmation hearing, was approved in *In re Stone & Webster, Inc.*, 286 B.R. 532, 541–43 (Bankr. D. Del. 2002).

50 *Owens Corning*, 419 F.3d at 215 n.27.

context, the statements of both courts and reorganization parties attest to the importance and vitality of the case law doctrine in the negotiated plan context.

The widespread use of the doctrine of substantive consolidation raises the question of whether our corporate law default rule treating each legal entity separately, even when it is a member of a corporate group, should be replaced with a default rule consolidating entities in bankruptcy. If over fifty percent of large corporate reorganizations use substantive consolidation, one might argue that the more efficient default rule would mirror the contract that most parties would negotiate for themselves.

A. *Substantive Consolidation Is Not an Uncommon Remedy*

Courts and litigants who oppose imposition of substantive consolidation often claim that use of the doctrine is extraordinary.[51] They stress the mundane nature of the facts in their cases. The conclusion follows that, if substantive consolidation applies to the common case, then use of the doctrine will break out everywhere like a plague. Some academics predict that common use of the doctrine will wreak havoc on the orderly conduct of business affairs.[52] According to this view, the sanctity of the corporate form, shielding investors from personal liability for business debts, demands the quarantine of substantive consolidation to the truly rare situation. The accepted wisdom, however, springs from a false premise.

Substantive consolidation appears frequently in negotiated plans for our largest Chapter 11 reorganizations. My preliminary empirical study of the twenty-one largest corporate bankruptcy filings from 2000 to 2004, ranked by asset size,[53] reveals that substantive consolidation was imposed, proposed, or settled in eleven of those cases.[54] Eight of

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51 There is almost unanimous judicial consensus that the remedy is to be used sparingly. *See id.* at 208–09; *see also In re* Gandy, 299 F.3d 489, 499 (5th Cir. 2002) (stating that substantive consolidation is "an extreme and unusual remedy"); Eastgroup Props. v. S. Motel Ass'n, 935 F.2d 245, 248 (11th Cir. 1991) (noting that substantive consolidation should be used sparingly).

52 *See* Brief of Amici Curiae in Support of Appellant, *Owens Corning*, 419 F.3d 195 (No. 04-4080) [hereinafter Brief of Amici Curiae] (arguing against substantive consolidation).

53 The ranking of bankruptcy cases based on prefiling asset size comes from WebBRD, a database maintained by Professor Lynn M. LoPucki at the UCLA School of Law, which adjusts asset size to current dollars. *See* Lynn M. LoPucki, WebBRD: A Window on the World of Big-Case Bankruptcy, http://lopucki.law.ucla.edu/index.htm (last visited Jan. 3, 2007). The Owens Corning bankruptcy is the twenty-first largest bankruptcy filed during the 2000–2004 time period. *Id.* Professor LoPucki provided valuable insight into the advantages and disadvantages of various definitions that might be used to analyze data.

54 Widen, *Prevalence of Substantive Consolidation*, *supra* note 20, at 53. My ongoing em-

the top ten bankruptcies constituted "Substantive Consolidation Bankruptcies," as defined in the study.[55]

The contrast between the constant caution against widespread use of the doctrine in reported decisions and its common use in negotiated plans of reorganization stands out with particular force because the standard for imposition of substantive consolidation is purported to be the same in both contexts. In negotiated reorganizations, courts use substantive consolidation both (1) in consideration of settlement of actual or potential litigation involving substantive consolidation and (2) in approving liquidations and reorganizations that impose substantive consolidation in some form.

Settlement of substantive consolidation litigation takes place in the shadow of the substantive consolidation doctrine because, even if the parties consent, bankruptcy courts must still assess the propriety of the settlement. This independent assessment does not require the court to decide whether it would have imposed substantive consolidation. Rather, the court reviews the settlement to determine whether, in light of the doctrine, a reasonable basis exists for the settlement.[56]

> The fact that courts do not ordinarily scrutinize the merits of compromises involved in suits between individual litigants cannot affect the duty of a bankruptcy court to determine that a proposed compromise forming part of a reorganization plan is fair and equitable. There can be no informed and independent judgment as to whether a proposed compromise is fair and equitable until the bankruptcy judge has apprised himself of all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated.[57]

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pirical research finds that substantive consolidation was used in over half of the largest public company bankruptcy cases filed from 2000 to 2004.

55 *See id.* at 59, tbl. The study counts "deemed" consolidations as "substantive consolidations" because courts apply the same tests, factors, and justifications to order both actual consolidations and deemed consolidations. *Id.* at 50. Further, many creditors simply do not care about the structure of the company emerging from bankruptcy but focus instead on the size of the distribution received. *See id.* at 51.

56 *In re* W.T. Grant Co., 699 F.2d 599, 608 (2d Cir. 1983) (stating that a bankruptcy court may approve a fair and equitable settlement that is not "below the lowest point in the range of reasonableness" (citation omitted)). Rule 9019(a) of the Federal Rules of Bankruptcy Procedure provides in pertinent part that "[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement." FED. R. BANKR. P. 9019(a).

57 Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968) (citation omitted).

Many reported decisions reflect court approval of the settlement of substantive consolidation litigation.[58]

Courts consider the substantive consolidation doctrine in detail when confirming plans that provide for substantive consolidation.[59] This consideration often occurs in the context of some opposition to a plan.[60] In *In re Standard Brands Paint Co.*,[61] however, the court considered the propriety of a "deemed" consolidation in a reorganization plan even though no party opposed it.[62]

"Deemed consolidation" is a peculiar and awkward term of art with a recent vintage. In a "deemed" substantive consolidation, distinct legal entities are not combined. Instead, votes on a plan, plan distributions, or both, are computed "as if" legal entities had been combined.[63] Courts disagree over whether deemed consolidations

58 *See, e.g.*, *In re* Apex Oil Co., 118 B.R. 683, 688, 693 (Bankr. E.D. Mo. 1990); *In re* Resorts Int'l, Inc., 145 B.R. 412, 418, 459 (Bankr. D.N.J. 1990); *see also* Findings of Fact & Conclusions of Law Confirming Supplemental Modified Fifth Amended Joint Plan of Affiliated Debtors Pursuant to Chapter 11 of the United States Bankruptcy Code, and Related Relief, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. July 15, 2004) [hereinafter Findings of Fact]. In *In re Enron*, the court spent significant time and effort in concluding that the terms of the settlement of substantive consolidation issues were supported by an assessment of the likelihood of successful litigation in light of the doctrine. *Id.* at 39, 48–55, 113–14, 138.

59 *See, e.g.*, *In re* Lisanti Foods, Inc., 329 B.R. 491, 497–99 (D.N.J. 2005); *see also In re* Worldcom, Inc., No. 02-13533 (AJG), 2003 WL 23861928, at *6–16 (Bankr. S.D.N.Y. Oct. 31, 2003).

60 The plan proponent, typically the debtor or debtors in possession, must prove by a preponderance of the evidence that the plan meets the requirements of § 1129 of the Bankruptcy Code. *See, e.g.*, *In re* Cellular Info. Sys., Inc., 171 B.R. 926, 937 (Bankr. S.D.N.Y. 1994). These requirements include that the plan not "discriminate unfairly," and that it be "fair and equitable" to creditors impaired under the plan who have not voted to accept it. 11 U.S.C. § 1129(b)(1) (2000). Thus, in a plan subject to this so-called "cram down" provision, the court would need to consider the appropriateness of imposing substantive consolidation as part of considering the plan as a whole. In the absence of a plan cram down, the need for an express review of the appropriateness of substantive consolidation is less clear, though courts have considered the applicability of the doctrine even in the absence of objections. *See infra* text accompanying note 62. There may be individual creditor objections within an impaired class even if the class itself votes to accept a plan. This may provide a further reason for a court to separately consider the appropriateness of imposing substantive consolidation.

61 *In re* Standard Brands Paint Co., 154 B.R. 563 (Bankr. C.D. Cal. 1993).

62 *Id.* at 565.

63 For a description of a deemed consolidation, see *In re* Genesis Health Ventures, Inc., 402 F.3d 416, 420 n.6 (3d Cir. 2005). The earliest reported decision of which I am aware that considers and approves a deemed consolidation is *In re Standard Brands Paint Co. See In re Standard Brands Paint Co.*, 154 B.R. at 566–67 (indicating that a plan that made distributions as if the entities were combined, but without actually combining the legal entities, was "unusual, possibly unique"). As far as the parties and the court could determine, the plan proposed in *In re Standard Brands Paint Co.* was the first deemed consolidation, though the procedure was not then referred to as such. *Id.* at 573.

should be considered substantive consolidations at all.[64] I find no limitation in the Bankruptcy Code restricting a court's ability to craft a limited remedy custom tailored to particular facts by scaling back an already accepted remedy.[65] This custom tailoring occurs when a court orders something less than a full substantive consolidation to reach a fair, equitable, and cost-effective result.[66] Indeed, a deemed consolidation may save costs compared to a full consolidation, in part by eliminating the need to retitle property and obtain new business qualifications, leaving more value for creditors in a reorganized company.[67]

Empirical research shows that appropriate occasions for use of substantive consolidation are neither few nor far between. Why does the case law rhetoric of rarity differ from the commonplace reality in large reorganizations? Foundational work in economics and law provides an answer.

B. *Economic Theory Explains Why Many Cases Exist*

In his examination of the role of transaction costs in determining the size of firms, Ronald Coase posited a distinction between external transaction costs (those costs that a firm incurs when it bargains with third parties to acquire goods and services) and internal transaction costs (those costs that a firm incurs internally to provide those same goods and services to itself).[68] He theorized that the size of the firm expands so long as the firm determines that the external transaction costs exceed the internal transaction costs of providing those goods and services.[69]

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64 *Compare In re Standard Brands Paint Co.*, 154 B.R. 563 (approving a deemed consolidation), *with In re Genesis Health Ventures, Inc.*, 402 F.3d at 424 (finding that a deemed consolidation does not constitute a de facto substantive consolidation).

65 The possible constitutional limitations on the use of equity by courts exercising bankruptcy jurisdiction are discussed in Part VIII, *infra* ("Why Use of the Doctrine Does Not Present Constitutional Concerns").

66 As an equitable doctrine, some courts have expressly recognized that they may modify or adjust the effects of substantive consolidation to fit the circumstances of the case. *See In re Standard Brands Paint Co.*, 154 B.R. at 570; *In re* Parkway Calabasas, 89 B.R. 832, 837 (Bankr. C.D. Cal. 1988). Under such a flexible approach, a court need not actually combine entities in order to take advantage of the benefits that asset pooling or voting combinations might offer in a particular case.

67 In *In re Standard Brands Paint Co.*, for example, tax considerations strongly favored a deemed consolidation without the actual combination of legal entities. *See In re Standard Brands Paint Co.*, 154 B.R at 565. An actual combination would have triggered cancellation of indebtedness income for state tax purposes. *Id.*

68 *See* Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 392 (1937).

69 *Id.* at 394. Coase's view of the firm does not necessarily conflict with the conception of the firm as a nexus of contracts. Indeed, Coase appeared to view the two theories as comple-

When we examine the structure of corporate law, we find a variety of mechanisms designed to allow a corporation to function as an independent, artificial person. The corporation has managers to determine which products and services to sell, to set prices, and to bargain with others, together with procedures within which managers make these decisions (such as those found in certificates of incorporation and bylaws). These are the mechanisms of artificial personality. What should we expect to happen when another firm decides to provide itself with goods and services internally rather than continue to bargain with the third-party corporation?

Often, the firm simply acquires the third-party corporation, bringing the formerly external functions inside the firm. This technique has many advantages over internally developing the ability to provide those same goods and services, not the least of which is speed. The acquisition may occur either as an asset purchase or as a stock purchase.[70]

From the narrow perspective of closing the acquisition at the lowest cost, the stock purchase presents many advantages over the asset acquisition. The stock purchase does not require diligence to prepare asset schedules, transfers of title to particular assets (other than

mentary. *See* Saul Levmore, *Irreversibility and the Law: The Size of Firms and Other Organizations*, 18 J. CORP. L. 333, 334 n.2 (1993). The literature identifies limitations on Coase's insight that firms and markets present alternative forms of economic organization, selected based on relative transaction costs. *See, e.g.*, OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 3–4 (1985) ("Unless the factors responsible for transaction cost differences could be identified, the reasons for organizing some transactions one way and other transactions another would necessarily remain obscure."). Even critics who suggest these limitations see themselves as building upon Coase's insight. *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 783–84 (1972) ("We do not disagree with the proposition that, *ceteris paribus*, the higher the cost of transacting across markets the greater will be the comparative advantage of organizing resources within the firm; it is a difficult proposition to disagree with or refute."). For example, Coase's insight has been refined to develop an explanation for vertical integration. *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 194 (1975); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978). The perceived limitations of Coase's insight are not liabilities for the analysis herein presented because my goal is not to explain transaction cost differences. I rely only on the simple notions that firms have incentives to internalize the production of goods and services when transaction cost savings result and that one method to internalize is through acquisition.

70 The acquisition of shares often requires additional procedures such as preparation of disclosure materials, shareholder votes, director votes, and government approvals, such as antitrust clearance from the Department of Justice or the Federal Trade Commission. Even with such additional procedures, acquisition by share purchase may have timing and other cost-saving advantages over internal development of capacities. Similar procedures accompany an asset acquisition.

shares), assignment of existing contracts and licenses, rehiring of employees, and other similar administrative matters. Thus, in many cases, we find that the single-entity firm acquires a subsidiary when it internalizes the production of goods and services. Over time, the single-entity firm grows into a complex, consolidated corporate group, increasing in size until it no longer can identify cost savings that might be achieved through further growth because the internal monitoring and information costs of managing the larger entity would exceed the potential cost savings realizable through internalizing away from the market. (One might characterize such growth as the move from firm to economic institution, but in this Article I focus on corporate groups that function as single firms despite internal structure.)

After internalization of production, many of the target corporation's officers and directors are no longer needed to determine product, set prices, and negotiate with third parties. Further, the target's structure for management decision making duplicates similar structures already existing at the parent (e.g., the parent has its own officers, directors, and bylaws). Because the prospect of transaction cost savings motivated internalization in the first place, we should expect the redundancies to atrophy or hibernate, particularly if special circumstances do not motivate the acquiring firm to maintain them.[71]

Here it is important to focus on one of the central themes of substantive consolidation case law: when a subsidiary becomes the "alter ego" or "mere instrumentality" of the parent company, the environment is ripe for imposition of substantive consolidation. The celebrated case of *Fish v. East*[72] provides a representative list of factors for determining when a substantial identity exists between parent and

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71 The business combination between R.J. Reynolds Industries ("RJR") and Nabisco Brands, Inc. in 1985 provides an obvious example of special circumstances in which efforts to preserve corporate separateness following an acquisition could be important. Though I understand that the parties took some care to keep the asset partition created by the separate corporate forms in place so that potential tobacco litigation exposure in RJR did not spill over to Nabisco, the market did not consider these efforts entirely successful. *See* BRUCE WASSERSTEIN, BIG DEAL 679 (1998) (describing the failure of a targeted stock offering linked to the Nabisco food business because of fears that the food business might have become responsible for tobacco-related liabilities of RJR). The tobacco and food businesses eventually were separated in a spin-off transaction. *See* Nabisco Group Holdings Corp., Annual Report (Form 10-K), at F-11 (Mar. 21, 2000), *available at* http://www.sec.gov/Archives/edgar/data/847903/0000912057-00-012717.txt. Until recently, subsidiary corporations had an independent reason to keep up at least the charade of independence because a contract to cede control away from a corporation's board of directors was void. *See* McQuade v. Stoneham, 189 N.E. 234, 237 (N.Y. 1934). *See generally* ROBERT CHARLES CLARK, CORPORATE LAW 781–88 (1986) (outlining history of cases and examples of state law).

72 Fish v. East, 114 F.2d 177 (10th Cir. 1940).

subsidiary.[73] Significantly, the listed factors could double as a to-do list of cost-saving steps to implement as part of internalizing production. Consider how the *Fish v. East* factors discussed below translate into this to-do list.

The acquiring corporation owns all the stock of the target company when a stock acquisition is selected to implement the decision to internalize production. Typically, the acquiring company replaces the officers and directors of the target company with its own officers, making the subsidiary management mirror that of the parent.[74] To save costs, the acquiring company often centralizes capital-raising and cash-management activities.[75] In many acquisitions, particularly the acquisition of a public company, the acquiring company will have formed its new subsidiary—a factor mentioned in *Fish v. East* and one that particularly concerns companies who internally create SPCs for securitization transactions.[76] Though the acquiring company typically does not adopt as one of its goals the express strategy of leaving the target company with insufficient capital, the consolidated group has no incentive to monitor the level of capital within the newly acquired subsidiary because financing decisions are made at the parent level for the consolidated group as a whole. Because the acquiring company made the acquisition to produce goods and services internally, the target company may have little or no business aside from providing products to other members of the corporate group. The new subsidiary

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73 *Id.* at 191 (listing factors to consider because "[t]he determination as to whether a subsidiary is an instrumentality is primarily a question of fact and degree"). Factors cited include: (1) the parent owns all or a majority of the capital stock of the subsidiary, (2) there are common directors and officers, (3) the parent corporation finances the subsidiary, (4) the parent corporation is responsible for incorporation of the subsidiary, (5) the subsidiary has grossly inadequate capital, (6) the parent company pays the salaries or expenses or losses of the subsidiary, (7) the subsidiary has no independent business from the parent, (8) the subsidiary is commonly referred to as a subsidiary or as a department or a division of the parent, (9) directors and executive officers of the subsidiary do not act independently but take direction from the parent, and (10) the corporation and subsidiary are not following the legal requirements of separation. *Id.*

74 If the acquiring company is a public company, it typically does not place outside directors on the boards of its internal subsidiaries because, among other problems, such a move would increase the costs of internal decision making by, for example, incurring the cost of providing information to outside directors.

75 Localized efficiencies gained from centralized capital-raising activities are explored in William H. Widen, *Lord of the Liens: Towards Greater Efficiency in Secured Syndicated Lending*, 25 CARDOZO L. REV. 1577 (2004) [hereinafter Widen, *Lord of the Liens*].

76 This occurs when the acquiring company forms an acquisition subsidiary and makes a tender offer for the shares of the target company (assume a 91% tender condition). After the acquisition subsidiary acquires 91% of the shares of the target, it effects a short-form merger of the target into itself, squeezing out the minority shareholders of the target who did not tender their shares, with the acquisition company surviving the merger.

often may be thought of as a division or department (and, in any event, will be identified as a subsidiary of the parent). The directors and officers of the new subsidiary almost always take direction from the parent company, even when a complete overlap in personnel does not exist. Finally, the importance placed upon formalities associated with internal asset transfers and corporate meetings typically is dramatically less than it is in third-party transactions. Preparation of evidence of these internal transactions and meetings is prepared (if at all) after the fact, by junior lawyers in law firms or on a general counsel's staff. The preparation of such documentation provides good fodder for teaching young attorneys precisely because the internal transactions often do not really matter to the firm—it is not like third-party negotiations because mistakes can easily be fixed.

I do not mean to suggest that all acquiring companies purchase target companies, thus forming subsidiaries, for the transaction cost reduction reasons given in Coase's model. Subsidiaries may be formed internally for a variety of reasons[77] or acquired externally simply for investment. Nor do I mean to suggest that every acquiring company implements all the transaction cost reducing steps listed in *Fish v. East*. I do mean to suggest, however, that we should expect many acquiring companies to take steps that create a substantial identity between the target and the acquiring company.

The economic theory predicts that firms seeking to become more cost-efficient through growth will create the very environment that breeds substantive consolidation. My empirical survey of the use of substantive consolidation in large public bankruptcies supports this proposition because it finds that the corporate form is routinely ignored within corporate groups in bankruptcy.[78] I believe this substantial identity between a parent company and its subsidiaries exists in a wide variety of cases precisely because creation of that identity of in-

77 A firm might expand to achieve increased market power or monopoly status. Expansion also may occur for less rational reasons, such as the desire of a CEO to empire-build. I do not suggest that Coase developed a complete theory of firm expansion. My observation that the Coase insight provides only a partial explanation of firm structure merely reflects the consensus view in the literature, which contains additional theories compatible with Coase's insight. *See, e.g.*, OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE (1995) (developing a property rights theory of the firm); Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387 (1998) (developing a theory of the firm based on power over physical assets). To the extent the theory does provide a partial explanation, we should expect to see the reduction of various internal capacities within subsidiary corporations as part of the cost savings achieved when a firm moves from external to internal product sourcing by acquiring a subsidiary.

78 *See* Widen, *Prevalence of Substantive Consolidation*, *supra* note 20.

terest produces the very cost savings that motivated the creation of the consolidated corporate group in the first place. Though I focus my attention on asset partitions created within corporate groups through the process of acquisitions, subsidiaries may be created within a corporate group for a variety of other reasons (such as the desire for a tax advantage or the ease of qualification to do business in a foreign jurisdiction), for which the mechanisms of artificial personality in the newly formed company are also redundant. In these cases too, we would expect cost-saving concerns to result in the atrophy or hibernation of the additional mechanisms of artificial personality within the corporate group.

The above remarks reveal potential context-sensitivity to the corporate form because the same legal entity may function very differently in the context of being a member of a corporate group than it functioned prior to its acquisition in the context of being a stand-alone company. When a corporation acts as a stand-alone investment vehicle or as a parent company, it performs several functions. First, it creates a primary asset partition between its investors and creditors of the business it operates, providing a liability shield. Second, the corporate form contains within its legal structure management and other mechanisms by which it selects product, makes pricing decisions, and bargains with third parties—the features that make it an artificial person.

A third function of the corporate form lurks in the background: in both internal and external roles, the corporation allows for easy identification of a group of assets under a single name. It functions like the folder on your computer desktop that holds many individual files. With any corporation, a variety of prior performative acts imbued with legal meaning (such as capital contributions and asset acquisitions) operate to identify, collect, and segregate property under the single, convenient label of the corporate name. When an acquiring company proceeds by stock acquisition, transaction cost savings accrue (which the parties presumably share in the process of negotiation) because the acquiring company buys a collection of assets simply by acquiring a name that represents the cumulative effect of prior transactions. The asset acquisition, in contrast, requires a reenactment of all the prior ceremonies of transfer and acquisition in order to identify, collect, and segregate those assets under a new name. By analogy to the computer desktop, an asset acquisition requires the transfer of individual files rather than the transfer of a single folder.

The convenience of asset identification in the initial stock acquisition, however, comes at a price. When the consolidated group desires to transact business with *external* third parties involving property identified under a previously acquired subsidiary's name, the convenience experienced in acquiring the assets becomes an inconvenient transaction cost. The parent must then revive the artificial personality of the subsidiary to complete any transaction. For example, if a third party wants to purchase an asset from a subsidiary or a bank wants a direct claim against the assets of the subsidiary through a guarantee or security interest, the parent must use the management functions of the subsidiary to authorize the sale, the guaranty, or the grant of security. This is particularly important in large transactions in which legal opinions must confirm the proper authority and enforceability of the transaction.[79] This burden remains because, to the world outside the consolidated group, as a matter of property law, the assets in the subsidiary remain governed by the name of the subsidiary.[80] Transactions *internal* to the corporate group do not suffer from this liability; managers often neglect these formalities when the discipline of *external* third-party involvement does not exert pressure for more costly, formal procedures over less costly, informal ones.[81]

In summary, we find three key functions performed by the corporate form: (1) asset partitioning, (2) artificial personality, and (3) asset identification. All three functions operate actively when the corporation is independent. When, however, the corporation becomes a sub-

79 In practice, I have been involved in numerous transactions in which (1) the parent could not provide a list of all its subsidiaries without extensive due diligence, (2) the parent could not provide an accurate list of the officers and directors of its subsidiaries, (3) when a list of officers and directors of subsidiaries was provided, many of the named individuals had retired or died, (4) no share certificates existed bearing the current names of the subsidiaries (often because the subsidiaries were acquired in a merger), (5) when minute books could be found, the most recent entries were many years old, and (6) other similar lapses were present. These issues all came up in the context of preparing opinions for transactions with third parties or preparing due diligence rooms for acquisitions. Many of these transactions involved large, well-known, investment-grade companies that otherwise appeared to be well run.

80 The problem is not overcome by merging the subsidiary into the parent because the merger itself may present many of the same transition-related transaction cost issues raised by an acquisition through an asset sale. Rather than incur certain transaction costs today (to facilitate a future transaction that may never come), parent companies often deal with the problems raised by the ongoing identification of assets to particular subsidiaries on a case-by-case basis when confronted with an actual third-party transaction.

81 The presence of external auditors does not exert significant pressure because auditors typically certify only consolidated financial statements. The consolidated financial statements may be materially correct even if the consolidating statements incorrectly locate particular assets within the consolidated group.

sidiary, active use of the artificial personality structures may largely cease. Further, the asset identification function may suffer if internal transactions do not receive proper documentation. A substantial identity between a parent and a subsidiary may exist because the artificial personality of the subsidiary is shut down or because systems of asset identification break down. Thus, in many cases we find a haphazard structure of asset partitions within a corporate group. A structure of asset partitions may arise for reasons of convenience and expediency rather than for the specific purpose of partitioning assets in a particular manner—in these cases, the asset partition is merely a by-product of procedures (such as stock acquisitions) selected for other reasons. I suggest that parties may more easily ignore the "incidental" asset partition in bankruptcy proceedings than the asset partition expressly established to segregate assets and liabilities.

The above analysis poses a key question for our default rules governing the effect of use of the corporate form: should the legal effect of the corporate form be treated differently when a corporation exists as a subsidiary than when it exists as either a stand-alone company or a parent company? In particular, should hibernation of the artificial personality structures or breakdown in the asset identification function adversely impact the asset partitioning function? This, in essence, is the question posed by the doctrine of substantive consolidation, though the doctrine asks the question indirectly. To see why this is so, we need to return to an old debate over whether treatment of the corporate form should be context-sensitive or context-neutral.

C. *Should We Change Default Rules for Corporate Groups in Light of the Facts?*

In the mid-1970s, Professor Jonathan Landers proposed that the assets of each entity in a corporate group should be available to satisfy the creditors of any member of the corporate group;[82] (then Professor) Richard Posner objected.[83] The Landers proposal amounts to a reversal of the current, context-neutral default rule in which the assets of each entity are available to satisfy that entity's creditors but not the creditors of other entities in the corporate group. In effect, Landers

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82 *See* Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975).

83 Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 500 (1976) ("Landers writes persuasively and his legal scholarship is meticulous. But his neglect of economic principles vital to an understanding of credit transactions, limited liability, and corporate affiliation undermines both his general approach and his specific conclusions.").

proposed a change in law providing for the mandatory substantive consolidation of members of a corporate group in a bankruptcy proceeding. The Landers rule is context-sensitive, altering the legal effect of the corporate form depending upon the environment in which it appears.

Judge Posner took strong issue with the proposal because it was not grounded in sound economic analysis of debtor-creditor relationships.[84] He concluded that, except in cases of misrepresentation, there was no good reason to adopt a default rule that collapsed separate legal entities into a single asset pool to satisfy creditors.[85] Moreover, he gave reasons to believe the opposite by suggesting why rational debtors and creditors should prefer the existing default rules.[86] Landers responded that Posner's economic analysis diverted him from the reality of actual cases in which benefits flow from having the law's result mirror the reality of a single economic enterprise.[87]

Judge Posner correctly framed the default rule issue presented by Professor Landers's proposal to shift the presumption in consolidated groups to favor a substantive consolidation creating a form of enterprise liability. He stated:

> The criterion of an efficient corporation law is therefore whether the terms do in fact reflect commercial realities, so that the transacting parties are generally content with them. A corporation law that is out of step with those realities, and so induces contracting parties to draft waivers of the contract terms supplied by the law, is inefficient because it imposes unnecessary transaction costs.[88]

My empirical results finding use of substantive consolidation in over fifty percent of large public company bankruptcies would appear to lend support to Professor Landers's proposal (at least in large cases), because we find parties contracting around the default rule in

84 *Id.*

85 *Id.* at 507, 520–21, 526.

86 *Id.* at 516–19.

87 Jonathan M. Landers, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, 43 U. CHI. L. REV. 527, 540 (1976). Landers's proposal to make substantive consolidation of wholly owned companies the norm, rather than the exception, formed part of his comprehensive suggestion to restructure debtor-creditor relationships in the context of affiliated groups. *Id.* at 528. It included a proposal to subordinate the debt claims of affiliated companies to the debt claims of independent third parties. *Id.* at 528, 536.

88 Posner, *supra* note 83, at 506. I assume in this analysis that the structure of corporate law default rules matters, and I do not address considerations to the contrary. For an opposing view, see Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990).

the majority of cases. At a surface level, Judge Posner's efficiency criterion would seem to suggest that a change in the default rule was in order. However, the details of particular consolidations reflect a level of customization in plans that would not be captured by a simple universal consolidation rule.[89] On the basic question of whether Professor Landers's proposal should be adopted, I must side with Judge Posner in spite of my empirical results, but for a limited reason. I am unable to say whether adopting Landers's change in the default rule would save costs in any global or macro sense. How many parties would need to contract around his new default rule, and how those increased costs of contracting would compare to the costs of contracting around the existing default rule, are empirical questions for which Judge Posner fails to provide evidence in support of his conclusions. I am unable to make a guess, much less a calculation.[90] I can, however, identify a context in which a strong case can be made that Landers's proposed default rule would save costs, the signature example being unsecured syndicated lending. Ironically, Professor Landers identified professional financiers[91] as one class of creditors that did not need help from his enterprise liability theory, precisely because they created a form of substantive consolidation by contract using guarantees.[92] Yet, in *Owens Corning*, we find a lending syndicate that, having contracted around the existing default rule to create a substantive consolidation for the syndicate's benefit, insists that substantive

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89 For example, in *Enron*, the court approved a settlement that gave a thirty-percent weight to consolidation. In other cases, we find that some subsidiaries are excluded from the scope of the consolidation, the Adelphia bankruptcy providing a recent example.

90 Judge Posner argued for the existing default rule respecting the asset partition of the corporate form by providing arguments explaining what rational debtors and creditors should prefer in order to reduce transaction costs. *See* Posner, *supra* note 83, at 505–09. I am unprepared to argue for the efficiency of the existing scheme on this basis. I simply do not believe that arguments for or against Professor Landers's proposal can be based on global considerations of efficiency in the absence of empirical research. For a discussion of epistemological problems with certain broad efficiency-based arguments, see William H. Widen, *Spectres of Law & Economics*, 102 MICH. L. REV. 1423 (2004).

91 I say "professional financier" here, rather than the more modern "syndicated lender," because modern syndicated lending did not begin until November 12, 1987, with Chemical Bank's syndication of a $2,414,500,000 credit facility for HM Anglo-American Ltd. and Imperial Investments (Grosvenor) Limited to acquire Kidde, Inc.—a transaction in which I represented the lead lender and for which I prepared the commitment papers and loan documentation. This transaction was the first of its kind, and was managed by James B. Lee, who is widely recognized as the father of modern syndicated finance. *See, e.g.*, Phillip L. Zweig, *The New Stars of Finance*, BUS. WK., Oct. 27, 1997, at 122, 125 ("Few institutions have come further faster than Chase Manhattan Corp., thanks largely to its powerful head of investment banking, James B. Lee, 44, who dominates the huge syndicated-loan business.").

92 *See* Landers, *supra* note 87, at 531 n.11.

consolidation is inappropriate because of reliance on the very guarantees that broke down the asset partition.

In fact, benefits might well accrue to lending syndicates and borrowers (who generally pay the lending syndicate's legal fees) under the Landers regime. When a lending syndicate makes a loan to a consolidated group of companies, it often requires guarantees from each member of the consolidated group so that the syndicate's loan will not be structurally subordinated to the claims of the creditors of individual subsidiaries. Such a lending syndicate could dispense with guarantees from the dozens, sometimes hundreds, of subsidiaries in a consolidated group. The costs of (1) due diligence to identify the subsidiaries, (2) corporate authorization to approve the guarantees, (3) the documentation to evidence the guarantees, (4) the legal opinions to confirm the effectiveness of the guarantees, and (5) ongoing monitoring to make sure that required additional guarantees are provided as new subsidiaries are added to the corporate group should make the Landers proposal attractive in some syndicated lending circles. Also, the Landers regime would simplify negotiation of covenants restricting the extent to which a borrower might modify its internal structure (for example, by transferring assets to newly created subsidiaries or merging subsidiaries out of existence). Finally, with the Landers proposal, the lending syndicate need not fear structural subordination if the borrower formed new subsidiaries and incurred debt that was structurally senior to the syndicate's loans without providing additional guarantees.

Though syndicated lenders might prefer the Landers proposal, this is not the key insight provided by the debate over default rules. The key idea for my analysis is Professor Landers's recognition that intercompany loan guarantees are nothing more than an attempt to contract around the existing default rule for corporate groups and replace that regime with his model of enterprise liability. In sum, intercompany guarantees create a type of substantive consolidation by contract.

The contractual solution achieved by the intercompany guarantees is, however, an approximation of Landers's model, rather than a precise replication.[93] Were Landers's default rule adopted, other creditor groups who might prefer the existing default rule would be forced

93 A main difference between the status quo and the enterprise liability scheme is the treatment of involuntary creditors, such as tort claimants, who do not have a chance to negotiate around a particular default rule. Recoveries for such creditors necessarily differ under the two schemes.

to contract around the mandatory consolidation.[94] One group that certainly would object to a broad form of the proposed default rule is the securitization industry. Securitization depends on the notion that the assets of a subsidiary, particularly of an SPC, remain separate from the assets of the parent and other consolidated group members. Financiers to the SPC do not intend that the SPC's assets remain available to creditors of other consolidated group members. Just how an SPC might be confident that its affiliates had successfully contracted around Landers's proposed default rule is unclear.[95] Certain borrowers who structure their affairs around "internal capital markets" similarly might wish to contract around the proposed default rule.[96]

Though no legislative proposal is pending to enact Landers's context-sensitive default rule into corporate law,[97] observe how the structure of the doctrine of substantive consolidation could, in effect, substantially implement the Landers proposal through the back door. To imagine this scenario you need only assume two things: *first*, that imposition of substantive consolidation is proper upon a simple showing that a substantial identity exists between a parent company and its subsidiary; and *second*, that this substantial identity is widespread because the pursuit of transaction cost savings motivates consolidated

94 Under the Landers regime, a debtor in a consolidated group would need to insist upon a liability waiver from each of its creditors to absolve the other group members of liability and vice versa. This procedure would not be available for limitation of the scope of liability for tort claimants. Further, the Landers proposal potentially creates federal income tax problems for consolidated groups with foreign subsidiaries because, under current law, if a foreign subsidiary guarantees the debt of its U.S. parent, the guarantee creates a deemed dividend. *See* I.R.C. § 956 (2000).

95 Professor Landers does contemplate that demonstration of reliance might provide an exception to his general scheme of enterprise liability. Perhaps an SPC would demonstrate this reliance or the default rule might specifically provide an exception for SPCs used in structured financing transactions. At the time of his debate with Posner, the securitization industry did not exist.

96 *See* George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102 (2004) (describing how entities might be structured to create internal capital markets—a technique more difficult to use in a Landers regime).

97 In contexts other than corporation law, legislatures already have enacted a version of the Landers proposal, imposing a form of enterprise liability on corporate groups to pay federal income taxes and pension liabilities. For example, several liability is imposed on "affiliated" group members if an election is made to file consolidated federal income tax returns. *See* I.R.C. §§ 1501, 1502, 1504 (2000 & Supp. 2006). Similarly, certain federal pension funding obligations apply jointly and severally to all "controlled group" members. *See* 29 U.S.C.A. § 1082 (West Supp. 2006); *see also* I.R.C. § 414. The Supreme Court has resisted imposing enterprise liability in the context of environmental laws, absent a showing that factors justifying traditional corporate law veil piercing are present. *See* United States v. Bestfoods, 524 U.S. 51 (1998).

groups to produce this substantial identity. If I have made the case that significant numbers of large American corporate groups carry the substantive consolidation "virus" because they predictably ignore the mechanisms of artificial personality in pursuit of cost savings, then the contours of substantive consolidation doctrine become extremely important.

To be clear, my first assumption above is largely a myth. For the most part, courts do not hold that imposition of substantive consolidation doctrine is proper *simply* because the subsidiary is the alter ego or mere instrumentality of the parent, but some courts come close to this standard. Nevertheless, the securitization market behaves as if this simple test might apply; judicial rhetoric certainly does not discourage this fear. I will use the simple test of substantial identity as the benchmark against which to gauge the actual tests that courts use. The closer a test comes to this benchmark, the closer we find ourselves to a de facto judicial enactment of the Landers proposal.

The currently recognized justifications for imposition of substantive consolidation divide into two camps. The first justification rationalizes use of the doctrine on considerations of efficiency and necessity. The second justification rationalizes use of the doctrine on grounds based in corporate law veil piercing, so long as its use does not destroy some reliance interest. Both approaches may appear in a single case. Courts often state tests as a combination of these two justifications, creating needless confusion in the process.

IV. Extracting Two Tests for Substantive Consolidation from Case Law

In this Part, I first examine market perceptions of substantive consolidation and then consider the basis for these perceptions in case law in an attempt to distill a few simple tests that might be applied by courts. I explain how the courts have mixed standards and tests, creating confusion. Lastly, I conduct a close examination of reliance interests, using *Owens Corning* as an example. Reliance interests figure prominently in the case law tests, yet I believe reliance interests in commercial financing settings have been seriously misunderstood. This analysis sets the stage for my reformulation of substantive consolidation into three distinct tests in Parts V, VI, and VII of this Article.

A. *How the Financial Markets View Substantive Consolidation*

Substantive consolidation opinions issued by law firms,[98] going back to the 1980s, acknowledge and discuss two traditionally recognized and distinct rationales for use of substantive consolidation. These opinions present a good starting point for analysis because they reveal how the securitization market views the doctrine. These views represent a tremendous investment in research on the doctrine of substantive consolidation, undertaken by numerous law firms, investment banks, and rating agencies. The securitization industry has structured and sold trillions of dollars of financing on the hope that its understanding of the doctrine allows the creation of bankruptcy-remote SPCs not subject to the risk of substantive consolidation. My account of these market views derives from practice experience during which I was one of the principal drafters and reviewers of nonconsolidation legal opinions at my firm.[99]

1. *The Efficiency Rationale for Substantive Consolidation*

What I consider to be the modern rationale for substantive consolidation surfaces in Second Circuit cases.[100] These cases stress that substantive consolidation is proper in cases of hopeless entanglement of financial affairs of the subject companies. Given hopeless entanglement, all creditors might benefit from substantive consolidation rather than spending funds to disentangle the mess. Indeed, in some cases, it may be impossible to separate the financial affairs of members of a corporate group, and spending funds to attempt the impossible makes little sense. In other cases, the disentanglement might be possible, but so expensive that it dramatically reduces, or eliminates altogether, the return to creditors. Whether based on necessity or simply cost sav-

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98 Law firms typically render substantive consolidation legal opinions to a rating agency (such as Moody's or Standard & Poor's) to support the award of a high investment grade credit rating to a financing structure. The rating agency wants to know whether a special purpose subsidiary corporation will remain separate from its parent company should the parent company find itself in bankruptcy proceedings. Transaction participants often refer to the opinion as a "nonconsolidation letter." *See* TriBar Opinion Comm., *supra* note 19.

99 To avoid misunderstanding, though my views derive from practice experience, they represent solely my own interpretation and not the views of any law firm or company.

100 *See* Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518–20 (2d Cir. 1988); Flora Mir Candy Corp. v. R.S. Dickson & Co., 432 F.2d 1060, 1062–63 (2d Cir. 1970); Chem. Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966); *In re* Commercial Envelope Mfg. Co., No. 76 B2354, 1977 Bankr. LEXIS, at *15 (Bankr. S.D.N.Y. Aug. 22, 1977); *accord* Reider v. FDIC (*In re* Reider), 31 F.3d 1102, 1105–06 (11th Cir. 1994). The Second Circuit introduced the term "substantive consolidation." *See* James Talcott, Inc. v. Wharton (*In re* Cont'l Vending Mach. Corp.), 517 F.2d 997, 1004 n.3 (2d Cir. 1975).

ings, this justification relies on economic efficiency to support use of substantive consolidation.

The former Bankruptcy Act and the current Bankruptcy Code both reflect this important goal of cost reduction.[101] The rhetoric of "hopeless entanglement" links directly to the idea of substantial identity. The entanglement metaphor, however, relates primarily to the failure to maintain business records that properly identify assets with particular corporate names (a breakdown in the asset identification function), and not to the destruction of artificial personality (ignoring the mechanisms of artificial personality).

2. *The Veil Piercing Rationale for Substantive Consolidation*

The second rationale for substantive consolidation traces its origins to the veil piercing doctrine[102] and dicta in the Supreme Court case of *Sampsell v. Imperial Paper & Color Corp.*[103] In a corporate

101 The general goal of the Bankruptcy Act was to enhance recoveries for creditors both by increasing the assets available to the estate (by, for example, recovering preferential transfers and fraudulent conveyances) and by minimizing costs incurred by the estate. *See* Otte v. United States, 419 U.S. 43, 53 (1974) (noting "an overriding concern in the Act with keeping fees and administrative expenses at a minimum so as to preserve as much of the estate as possible for the creditors"); Katchen v. Landy, 382 U.S. 323, 328 (1966) (observing that legislative history indicates that Congress gave special consideration to making the bankruptcy laws inexpensive in their administration). Historically, the cost-reduction concern was a paramount factor affecting the debates over the structure of our bankruptcy laws. *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 40 (2001) (discussing concern over costs in the debates on the 1898 Act). Concerns over cost minimization continue under the Bankruptcy Code. *See, e.g.*, NLRB v. Bildisco & Bildisco, 465 U.S. 513, 517 n.1 (1984) (noting that Congress enacted the Bankruptcy Code "with the intention that business reorganizations should be quicker and more efficient"); 9 COLLIER ON BANKRUPTCY 1001 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2006). The Federal Rules of Bankruptcy Procedure also reflect the policy of cost minimization. *See* FED. R. BANKR. P. 1001 ("These rules shall be construed to secure the just, speedy, and inexpensive determination of every case and proceeding.").

102 *See* Stone v. Eacho (*In re* Tip Top Tailors, Inc.), 127 F.2d 284, 288–89 (4th Cir. 1942) (employing reasoning analogous to that employed in veil piercing cases without explicitly mentioning "veil piercing"); Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940) (same). The veil piercing rationale continued into the 1960s, *see* Soviero v. Franklin Nat'l Bank of Long Island, 328 F.2d 446, 448 (2d Cir. 1964), and the 1970s, *see In re Cont'l Vending Mach. Corp.*, 517 F.2d at 1000, while the modern economic efficiency rationale was developing. By borrowing from state-law veil piercing doctrine to formulate substantive consolidation, bankruptcy law, in essence, developed a federal version of corporate law to use in insolvency cases. Today, the economic efficiency rationale and the veil piercing rationale for substantive consolidation coexist. One study measures the significance of the doctrine of "piercing the corporate veil" outside the substantive consolidation context. *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

103 Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 218 (1941) ("Mere legal paraphernalia will not suffice to transform into a substantial adverse claimant a corporation whose affairs are so closely assimilated to the affairs of the dominant stockholder that in substance it is

veil piercing action, creditors of a corporation assert liability against the shareholders of the corporation. The creditors seek to break down the wall of limited liability that exists between a corporation and its creditors, on the one hand, and the shareholders, on the other hand. One of the primary functions of the corporate form is to insulate the shareholders from the creditors of the corporation by forming an asset partition, shielding personal assets from business activity risks.[104] In the classic case of asset partitioning by corporate form, we conceive of individual natural persons as the protected shareholder class. Investment in the corporation presents the extent and limit of an individual's exposure to risk of particular business activity.

In a veil piercing action, plaintiffs allege that the corporation is either the "alter ego" or a "mere instrumentality" of the shareholders, as evidenced by a failure to observe corporate formalities. If shareholders did not respect the corporate form, then that form should not act as a liability shield for shareholders against the corporation's creditors.[105] Significantly, classic veil piercing doctrine requires a showing of some connection between the failure to respect corporate form and harm suffered by the veil piercing proponent.[106] Substantive consolidation doctrine applies this theory of respect for corporate form, recognizing that a parent company functions as a shareholder for its subsidiary, just as an individual may function as a shareholder for a single corporation. On my analysis, if factors exist to support veil piercing outside of bankruptcy, then they also support substantive consolidation in bankruptcy.

Typically, veil piercing involves "upstream" claims by corporate creditors against shareholders.[107] In a substantive consolidation, direction does not matter: through a request for substantive consolidation, creditors of a parent may seek a direct claim against assets of a

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little more than his corporate pocket."). The Court described the technique used by the bankruptcy referee as "an order consolidating the estates." *Id.* at 219.

104 *See* Hansmann & Kraakman, *supra* note 5, at 390.

105 I note those aspects of veil piercing that apply most directly to substantive consolidation doctrine. Comprehensive attempts to understand the justification for veil piercing exist that emphasize multiple factors and considerations, including undercapitalization of corporations and fraudulent transfers to shareholders. *See, e.g.*, Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 542–43 (1977).

106 *See, e.g.*, 1 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 43 (perm. ed., rev. vol. 1999).

107 Though the upstream move provides the general pattern for veil piercing cases, examples of reverse veil piercing, in which creditors of a shareholder attempt to reach assets of the corporation, do exist. *See, e.g.*, Goldberg v. Engelberg, 92 P.2d 935, 935 (Cal. Dist. Ct. App. 1939); C.F. Trust, Inc. v. First Flight L.P., 580 S.E.2d 806, 810 (Va. 2003).

subsidiary (a downstream move), creditors of a subsidiary may seek a direct claim against assets of a parent (an upstream move), or creditors of one subsidiary may seek a direct claim against assets of another sister subsidiary (a lateral move). Disappointed creditors simply follow the assets in an attempt to enhance their recoveries, with simultaneous moves in all directions permitted.

In a veil piercing action, disappointed creditors of the corporation seek the assets of a shareholder, although existing creditors of the shareholder are unable to share in the assets of the corporation. The corporate creditors typically exhaust company assets and, remaining unsatisfied in the process, thereafter seek recovery from the shareholder, competing with existing creditors of the shareholder. In contrast, a substantive consolidation provides that creditors of the various companies share pooled assets on a *pari passu* basis, absent court-imposed subordination.[108]

In a consolidated group, the parent company forms the primary asset partition between individual shareholders and creditors of group members. My sense is that courts tend to respect this primary separation between individual investors and corporate group creditors in large public bankruptcies, even if they ignore the various asset partitions created by subsidiaries within the consolidated group, because of practical difficulties associated with pursuing assets from a large, diverse shareholder group (and one likely to include the proverbial widows and orphans, or their trusts). This is why I believe that, in the large public bankruptcy cases, we do not find that a substantive consolidation within the corporate group leads to a veil piercing action against shareholders.

In addition to this practical reason, I believe that important decision makers in our society generally subscribe to the notion that limited liability for investors (particularly for individual natural persons) is the foundation on which our successful capital markets are built. Ignoring limited liability among the legal entities in a consolidated group does not threaten the perceived beneficial precondition for a successful capital market structure so long as use of the doctrine does not spill over to create liability for individual investors. Application of substantive consolidation doctrine stops at the border of the parent company more because the alternative is unthinkable in our frame of reference than for reasons of doctrinal coherence (though at the level

108 For classic presentations of equitable subordination, see Pepper v. Litton, 308 U.S. 295 (1939), and Taylor v. Standard Gas & Elec. Co. (Deep Rock), 306 U.S. 307 (1939).

of doctrine it might be harder to show an identity between a company and a large group of investors than between a company and a small group of investors). Neither the practical concerns of tracing nor concerns over capital market disruptions apply to limit application of the doctrine to privately held businesses.

The veil piercing justification for substantive consolidation is particularly important to understanding the current state of the doctrine. Veil piercing cases supply the seemingly endless list of factors that courts recite to justify substantive consolidation. These factors often appear as simple laundry lists, without separation of the important from the relatively minor,[109] creating a justified impression of undertheorized chaos.[110] When importing these factors into the substantive consolidation context, courts often forget the traditional veil piercing requirement that misuse of the corporate form must contribute to a harm. The veil piercing rationale for substantive consolidation thus finds itself distanced from its origins, creating the risk that a simple finding of substantial identity may trigger a substantive consolidation. To make matters worse, courts often combine the economic rationale with the (often scaled-down) veil piercing rationale.

B. *How the Courts Have Mixed Two Different Standards*

Consideration of the two most celebrated articulations of the substantive consolidation doctrine illustrates the case law confusion between the economic rationale and the veil piercing rationale. In *Union Savings Bank v. Augie/Restivo Baking Co.*,[111] the court states the test as follows: "[first] whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . or [second] whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[112] The court clearly contemplates a disjunctive test. The first "veil piercing" branch of the test (i.e., the "single economic unit" finding) allows substantive consolidation without a prior finding that the remedy is needed to correct an identified "wrong," though it adds to the "single

109 *See supra* note 73 (listing factors).

110 In this respect I am in complete agreement with the academic brief filed with the Third Circuit in *Owens Corning*. *See* Brief of Amici Curiae, *supra* note 52, at 11 ("There is danger here. Differing tests with a myriad of factors run the risk that courts will miss the forest for the trees. Running down factors as a check list can lead a court to lose sight of why we have substantive consolidation in the first instance.").

111 Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515 (2d Cir. 1988).

112 *Id.* at 518 (quotation omitted) (citation omitted).

economic unit" factor the additional requirement that a reliance interest not be destroyed. In applying elements of the *Augie/Restivo* test, the Third Circuit's *Owens Corning* analysis suffers from this defect by applying a veil piercing rationale without a prior finding of harm.[113] The second "economic" rationale in *Augie/Restivo* retains a link to the requirement of substantial identity with its metaphor of entanglement, and grafts onto that notion the requirement of an economic benefit to all creditors. Substantial identity figures in both branches of the test.

In contrast, the test in *In re Auto-Train Corp.*[114] requires the substantive consolidation proponent to make two showings: first, that "a substantial identity [exists] between the entities to be consolidated," and second, "that consolidation is necessary to avoid some harm or to realize some benefit."[115] If the proponent makes these showings, the court may order substantive consolidation if it finds that the "demonstrated benefits of consolidation heavily outweigh the harm."[116] The *Auto-Train* test mixes the economic rationale with the veil piercing rationale and, in the process, sanctions a pure wealth transfer from one creditor class to another on mere economic grounds. Further, the balancing of benefit against harm is inconsistent with *Augie/Restivo*'s notion of "benefit [to] all creditors."[117]

To understand fully my reformulation of substantive consolidation doctrine, you must distinguish between two types of creditor "harm." The first type occurs whenever a creditor experiences a "decreased distribution" in consolidation—a basic economic harm. The second type occurs whenever a creditor is "wronged." Under my analysis, a wrong of the second type results when a court defeats a creditor's reasonable reliance on the separate existence of a particular legal entity—typically a harm resulting from interfering with a contract-based right. This happens when a court eliminates benefits from a specific contract right that a creditor enjoys which protects the separate legal status of the entity relied upon. In my view, such a right does not exist merely because a creditor has contracted with a particu-

113 *See In re* Owens Corning, 419 F.3d 195, 210 (3d Cir. 2005).

114 Drabkin v. Midland Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270 (D.C. Cir. 1987).

115 *Id.* at 276.

116 *Id.* (quotation omitted). In an alternate version of this test used by the lower court in *Owens Corning*, the question does not become whether the benefits heavily outweigh the harm but, rather, whether an objecting creditor "relied on the separate credit of one of the entities to be consolidated," and whether that creditor "will be prejudiced by substantive consolidation." *In re* Owens Corning, 316 B.R. 168, 171 (Bankr. D. Del. 2004), *rev'd*, 419 F.3d 195 (3d Cir. 2005). If reliance and prejudice are shown, then the consolidation is not proper. *See id.*

117 *In re Augie/Restivo Baking Co.*, 860 F.2d at 518.

lar debtor, because a creditor does not, in the usual case, have a right to prevent a debtor from entering into business combinations.[118] Instead, specific contractual protection of separateness must exist for reliance in this sense. An example of such a contract-based right would be a covenant in a loan agreement in which a lender required an entity (either borrower or guarantor) to maintain its separate corporate existence.

Under my analysis, substantive consolidation does not produce a "wrong" simply because the consolidation produces a wealth transfer. The two types of "harm" are distinct. The facts underlying the Third Circuit's *Owens Corning* decision strongly support this proposition. In *Owens Corning*, if the presence of a wealth transfer were sufficient to defeat substantive consolidation, the estimated $1 billion wealth transfer from the syndicated lenders to the unsecured noteholders and other parent creditors would have created a simple bar to use of the doctrine. Rather than relying on the mere fact of a wealth transfer to support its decision, the Third Circuit instead believed it needed to find separate creditor reliance on the individual guarantors.[119] Without this reliance, apparently the Third Circuit would have viewed the lower court's imposition of substantive consolidation proper despite the wealth transfer.

C. *How the* Owens Corning *Circuit Court Misunderstood the Role of Reliance on Guarantees in Syndicated Finance*

My analysis of the difference between a wealth transfer and a wrong suggests that the Third Circuit made an error in *Owens Corning* when it found loan syndicate reliance on intercompany guarantees (despite the amicus support from the Loan Syndications and Trading Association).[120] A lending syndicate typically employs a web of intercompany guarantees defensively, rather than offensively. A defensive use of intercompany guarantees ensures that no subsidiary creditor has structural seniority over the syndicate's loans.[121] This protection allows the syndicate to rely confidently upon consolidated financial statements and consolidated financial tests to monitor the corporate group as a single economic unit. Testimony from lending

118 *See infra* note 123.

119 *In re* Owens Corning, 419 F.3d 195, 212–14 (3d Cir. 2005).

120 *See id.* The Loan Syndications and Trading Association is the industry association that advances the interests of lenders participating in the syndicated lending market.

121 The structure of syndicated lending and its use of guarantees are explained in Widen, *Lord of the Liens*, *supra* note 75.

syndicate representatives suggests the defensive use of guarantees in the Owens Corning credit agreement, though the Third Circuit drew the opposite conclusion from its understanding of what it called "Lending 101."[122]

A lending syndicate uses corporate form to ensure a priority position—an offensive posture—only when it takes affirmative steps to ensure that the asset partitions created by the separate corporate forms within the consolidated group remain in place for the life of their loans. Offensive use requires extra steps because the general corporate law rule holds that a creditor may not oppose a consolidation or merger.[123] If lenders do not want their borrower engaging in business combinations, they must contractually prohibit them. For example, if lenders make loans to a stand-alone company but do not want the loans to continue if their borrower becomes a subsidiary of another company, they include a "change in control" default in their loan agreement. This accelerates the maturity of the loan upon acquisition of the borrower. Similarly, from extensive personal experience, I know that if lenders make loans to a particular subsidiary within a corporate group and they want that loan to function as a stand-alone credit, the lenders prohibit the merger, consolidation, or dissolution of that subsidiary. A lender might require a pledge of shares of a subsidiary to further ensure the integrity of the asset partition.[124] The most extensive affirmative steps to ensure integrity of an asset partition occur in securitization transactions because the asset partition between

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122 For a debate on the issue of reliance, compare *Owens Corning*, 419 F.3d at 212, with Post-Hearing Brief in Support of Substantive Consolidation at 52–73, *Owens Corning*, 419 F.3d 195 (Nos. 00-03837 to -03854 (JKF)) [hereinafter Post-Hearing Brief] (excerpting lender testimony). For example, a lead credit officer supervising the loan agreement testified that she could think of no purpose for the guarantees other than to avoid structural subordination. Post-Hearing Brief, *supra*, at 57.

123 *See, e.g.*, Cole v. Nat'l Cash Credit Ass'n, 156 A. 183, 185 (Del. Ch. 1931) ("[I]t is not permitted to a creditor of a corporation to prevent its merger or consolidation with another if the statutory law of its creation authorizes it."). In *Cole*, the financial condition of the combined company was less sound than the prior stand-alone company against which the complaining creditor had a claim. *Id.* at 186. The court rejected this as a justification for enjoining the consolidation. *Id.* The court reasoned that the consolidated company would provide the creditor with a larger pool of net assets from which it could seek payment. *Id.* The creditor could now bring the claim against the combined entity, which included a claim against the assets of the former company as well as a claim against additional assets of its merger partner. *Id.*

124 Courts have found substantive consolidation improper if consolidation destroys the benefits of a pledge of subsidiary shares unless a priority is given to the holder of the pledge. *See, e.g.*, FDIC v. Hogan (*In re* Gulfco Inv. Corp.), 593 F.2d 921, 926–27 (10th Cir. 1979).

the SPC and other consolidated group members must survive to an investment grade level of certainty.[125]

The Third Circuit found that the lending syndicate in *Owens Corning* intended an offensive web of guarantees to afford it a priority (rather than merely to assure it a defensive parity).[126] On my analysis of reliance, the court could only have done so if it believed that the credit agreement protected the integrity of the individual subsidiaries. The lower court did not provide a specific interpretation of the merger covenant in its opinion, though it found an absence of creditor reliance.[127] My reading of the loan agreement leads me to believe that the Owens Corning subsidiaries could merge with both themselves and the parent, though in fairness to the Third Circuit, the drafting could have been clearer.[128]

Regardless of the presence or absence of a merger prohibition, the loan agreement does not prohibit either the liquidation or the dissolution of the subsidiary companies into the parent, nor would it have prohibited all the subsidiaries from forming a general partnership with the parent—a move equally devastating to a corporate asset partition.[129] In fact, so long as no material adverse effect resulted to the consolidated group, the only entity that had to maintain its corpo-

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125 *See* TriBar Opinion Comm., *supra* note 19, at 720.

126 *Owens Corning*, 419 F.3d at 213–14.

127 *In re* Owens Corning, 316 B.R. 168, 172 (Bankr. D. Del. 2004), *rev'd*, 419 F.3d 195 (3d Cir. 2005). At the hearing, Judge Wolin remarked that he found Section 8.09 "potentially ambiguous," though he was later replaced by Judge Fullam who authored the lower court opinion. *See* Post-Hearing Brief, *supra* note 122, at 59 (quotation omitted).

128 The prohibition on mergers appears in Section 8.09 of the credit agreement and provides:

> [Article 8] B. Negative Covenants. The Company shall not, and shall not permit any Subsidiary to, directly or indirectly:
>
> . . . .
>
> Section 8.09 Mergers, Consolidations and Acquisitions. (a) Merge or consolidate with any Person, except for, if after giving effect thereto no Default would exist, (i) the Merger, (ii) any merger or consolidation of the Company or any Subsidiary with any other Person; provided that (A) the Company or such Subsidiary, as the case may be, shall be the continuing Person, and (B) in the case of a merger or consolidation with any Subsidiary, the other Person shall not be a Subsidiary, (iii) any merger or consolidation of any Subsidiary that is not a Loan Party with and into any one or more other Subsidiaries, and (iv) any merger or consolidation of any Subsidiary that is a Loan Party with any one or more other Subsidiaries that are Loan Parties . . . .

Owens Corning, Quarterly Report (Form 10-Q), at 45, 50 (July 24, 1997), *available at* http://www.sec.gov/Archives/edgar/data/75234/0000075234-97-000012-index.html.

129 By forming a general partnership, the various entities in the consolidated group would have become collectively liable for debts of the general partnership.

rate existence to avoid default was the parent company.[130] I suspect the court did not consider these alternate structural possibilities because substantive consolidation so often is compared simply to a merger (though the procedure bears equal analogy to dissolutions and consolidations). Yet, because of these alternatives, the syndicate could not properly have relied on the continued separate existence of the subsidiaries to provide advantage. I find the lending syndicate's claim of reliance on fragile and unprotected asset partitions inside bankruptcy implausible when those very partitions might have been eliminated without penalty outside bankruptcy.

Under the Owens Corning loan agreement, only subsidiaries with assets of $30 million or more provided guarantees.[131] The Third Circuit apparently viewed this threshold as further evidence of affirmative lender reliance,[132] similar to specifying collateral coverage for a loan. The specification of a $30 million limit, in this context, does nothing of the sort. In the case of collateral amounts, the lender typically seeks a particular loan to collateral value ratio for which the dollar values of particular assets are crucial. A casual review of the financial covenants in the Owens Corning credit agreement reveals that the lenders structured a cash flow deal, not an asset coverage deal—no specific dollar amount of guaranteed value supports outstanding loan amounts.[133]

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130 Owens Corning, Quarterly Report (Form 10-Q), *supra* note 128, at 44. My interpretation of the merger prohibition is strengthened by the covenant requiring the Company and its Subsidiaries to maintain corporate existence. The Company (i.e., Owens Corning) must maintain its corporate existence but no default occurs if any subsidiary fails to do so provided that the failure does not result in a materially adverse effect on the consolidated group. *Id.* The provision provides in relevant part:

> [Article 8] A. Affirmative Covenants. The Company shall and shall cause each Subsidiary to:
>
> Section 8.01 Preservation of Existence and Properties, Scope of Business, Compliance With Law, Payment of Taxes and Claims. (a) Preserve and maintain its corporate existence and all of its other franchises, licenses, rights and privileges, . . . except that this Section 8.01 (other than clause (a), in so far as it requires the Company to preserve its corporate existence . . .) shall not apply in any circumstance where noncompliance, either singly or together with all other incidents of non-compliance, would not have a Materially Adverse Effect on the Company and the Consolidated Subsidiaries taken as a whole.

Id.

131 *Owens Corning*, 419 F.3d at 201.

132 *Id.* at 213 (noting that each subsidiary guarantor had assets with a book value equal to at least $30 million).

133 Though I am critical of the Third Circuit's understanding of syndicated lending, I have great sympathy for their predicament. The Third Circuit is not the first court, nor will it be the last, that fails to understand a complex financial transaction and the context in which it was

The $30 million limit likely arose as a compromise between protection for the lending syndicate and limitation of internal monitoring costs for Owens Corning. Often corporate groups form subsidiaries for minor purposes, such as reserving corporate names in a particular jurisdiction. Any top-level manager who monitors a credit agreement typically would be unaware of such small matters. Further, the person forming the subsidiary would not be aware of the terms of a loan agreement that required guarantees from "all" subsidiaries. Yet, top managers must periodically certify to the lending syndicate that the borrower is in compliance with the terms of its loan agreement.[134] A $30 million guarantee threshold is low enough to give the lending syndicate practical comfort that it has a direct claim on most of the assets of the consolidated group, yet it is high enough to comfort top managers that they will not be forced to make false certifications about loan agreement compliance. Far from the $30 million number functioning as a surrogate for collateral, it simply represents a compromise between competing concerns in the context of breaking down an asset partition.

Another way of looking at the situation is to recognize that, if the provision of subsidiary guarantees had no cost, the lending syndicate would have required them from all entities in the consolidated group. Such a scheme would have provided a complete match between the assets on the consolidated balance sheet (which the lending syndicate uses to monitor the credit) and the assets against which the lending syndicate might assert a *pari passu* claim.[135]

Many debtors will enter bankruptcy with unsecured intercompany guarantees in place. *Owens Corning* effectively gives lending syndicates holding such guarantees a veto right over any plan of reorganization that proposes the use of substantive consolidation. The Third Circuit's decision changes the structure of negotiations in cases

made. Counsel for the lending syndicate did a masterful job of eliciting, and then working with, testimony in which syndicate managers acknowledged that a natural consequence of using guarantees was to create possible priorities for the lending syndicate.

134 Kenneth Lay, formerly of Enron, was convicted of ten counts in an indictment, four of which asserted that he made false statements to banks from whom he had made margin borrowings. Alexei Barrionuevo, *The Enron Verdict: The Overview; 2 Enron Chiefs Are Convicted in Fraud and Conspiracy Trial*, N.Y. TIMES, May 26, 2006, at A1. His criminal indictment and subsequent conviction highlight why members of management take care to avoid making false statements to lending syndicates.

135 A significant exception to this general principle is the provision of guarantees by foreign subsidiaries. For federal income tax reasons, lenders typically do not require guarantees from foreign subsidiaries when they exist in a consolidated group because the guarantee results in a deemed dividend. *See* I.R.C. § 956(a), (d) (2000).

where intercompany guarantees are present, giving a veto right to powerful economic players who did not rely on the guarantee to provide priority. When a priority based on corporate form is intended to be relied upon, lending syndicates do not rely on naked guarantees. Professional financiers require more. Significantly, creditworthy borrowers resist providing security interests and limiting their ability to manage internal corporate structure, believing that a good credit rating entitles them to access the credit markets with limited restrictions. Whenever a borrower grants a security interest or agrees to overly restrictive covenants, it sends the market a message of financial weakness.

Before the Third Circuit's decision in *Owens Corning*, I can confidently say that no sophisticated lending syndicate ever relied on a mere covenant prohibiting merger, consolidation, or dissolution to create priority when the syndicate itself employed a web of guarantees. The reason for nonreliance on such covenants is simple: the market believed that the presence of intercompany guarantees virtually assured that imposition of substantive consolidation would be proper for any companies forming part of an intercompany guarantee web (and no competent counsel would have opined otherwise).[136] In *Owens Corning*, rather than a bona fide case of reliance on asset partitions, we have a case of simple good fortune for the lenders: the asset partitions and guarantees happened to remain in place until the bankruptcy filing, and the continued presence of the guarantee structure afforded them a priority.

My critique of the Third Circuit's approach in *Owens Corning* does not follow simply from the court's imperfect understanding of lending practices, but from my own analysis of how substantive consolidation doctrine should be reformulated. I turn now to that reformulation, focusing first on economic justifications for substantive consolidation (Part V) and then on the veil piercing rationale (Part VI). Lastly, I formulate a new rationale for substantive consolidation based on traditional fairness considerations (Part VII).

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136 *See, e.g.*, Eastgroup Props. v. S. Motel Ass'n, 935 F.2d 245, 248–49 (11th Cir. 1991); *In re* Amereco Envtl. Servs., Inc., 125 B.R. 566, 568 (Bankr. W.D. Mo. 1991); Bruce Energy Ctr. Ltd. v. Orfa Corp. of Am. (*In re* Orfa Corp. of Phila.), 129 B.R. 404, 415 (Bankr. E.D. Pa. 1991); *In re* Snider Bros. Inc., 18 B.R. 230, 238 n.5 (Bankr. D. Mass. 1982); *In re* Manzey Land & Cattle Co., 17 B.R. 332, 337 (Bankr. D.S.D. 1982); *In re* Commercial Envelope Mfg. Co., No. 76 B2354, 1977 Bankr. LEXIS, at *15 (Bankr. S.D.N.Y. Aug. 22, 1977); *see also* TriBar Opinion Comm., *supra* note 19, at 741 (listing absence of guarantees as a factor supporting issuance of a legal opinion).

V. Reformulating an Efficiency Promotion Rationale for the Doctrine

In a classic substantive consolidation, multiple related companies appear in a procedurally consolidated bankruptcy proceeding. Typically, a parent company owns one or more subsidiary companies. A simple arithmetic example illustrates the different economic results with and without a consolidation.

Table 2: Separate Entities Versus Consolidation

Entity	Asset Value	Big Bank	Factor Co.	Local Bank
A	$750	$1000	-0-	-0-
B	$500	-0-	$1000	-0-
C	$250	-0-	-0-	$1000
Consol.	$1500	$1000	$1000	$1000

Suppose company *A* owes Big Bank $1000 and owns assets worth $750, company *B* owes Factor Co. $1000 and owns assets worth $500, and company *C* owes Local Bank $1000 and owns assets worth $250. In the absence of a substantive consolidation, Big Bank would receive 75% of its claim, Factor Co. would receive 50% of its claim, and Local Bank would receive 25% of its claim. Upon the substantive consolidation of the three companies, the aggregate of $3000 in claims would be satisfied from the common pool of $1500 in assets, with each creditor receiving 50% of its claim. Whereas Factor Co. is indifferent to substantive consolidation, Big Bank is harmed and Local Bank is benefited. Substantive consolidation almost always takes money from one creditor to pay another creditor in a world without transaction costs. In the simple model, substantive consolidation is a zero-sum game. This situation potentially changes when the transaction costs of gathering information are factored into the model.

The question of substantive consolidation typically arises when a court and the parties are unsure about the allocation of assets and liabilities among the subject companies. Substantive consolidation offers an inexpensive alternative to generating balance sheets for each individual company in a consolidated group of companies. Dispensing with the accounting and other procedures to generate separate balance sheets potentially saves transaction costs, leaving more assets available for distribution to creditors.

I identify below four different scenarios that emerge from this discussion and label them: Necessity, Pareto, Kaldor-Hicks, and Wealth Transfer.

A. *The Necessity Scenario*

Courts often employ the rhetoric of "necessity" to justify the use of substantive consolidation.[137] When the facts of a case reflect extremely poor recordkeeping, a failure to observe corporate formalities, and similar deficiencies, this rhetoric actually may match a situation where separate accounting is truly impossible (i.e., incapable of reconstruction by forensic accountants). If the asset identification function within the consolidated group has broken down, the only practical alternative appears to be a pooling of the assets of the subject companies and the pro rata satisfaction of third-party creditors from a common fund.[138] I consider such a situation a proper one for use of the "necessity" rhetoric. In true cases of necessity, poor recordkeeping and failure to observe corporate formalities may explain the breakdown in the asset identification function. Such shortcomings should not, however, be seen in themselves as reasons for imposition of substantive consolidation.[139]

Though I use the inability to reconstruct financial records as my paradigm case of necessity, courts might be confronted with other forms of necessity presented by a complex business form. In the ongoing Adelphia bankruptcy case, for example, one party requested that each individual debtor in the procedurally consolidated cases be represented by an independent fiduciary and an independent coun-

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137 *See infra* note 149 and accompanying text.

138 I term a pro rata distribution as the "only" practical alternative based on my assumption of what distributional schemes will satisfy collective notions of fairness. In cases of shortage, the allocation of available resources based, pro rata, on the amount of the claim has broad appeal. I trace the notion at least back to Jeremy Bentham:

> The loss of a portion of wealth will produce, in the total happiness of the loser, a defalcation greater or less, according to the proportion of the part lost to the part which remains.
>
> Take away from a man the fourth part of his fortune, and you take away the fourth part of his happiness, and so on.

BENTHAM, *supra* note 1, at 106.

This notion is grounded in the principle of average utility, which directs society to maximize the average utility per capita rather than total utility. *See* JOHN RAWLS, A THEORY OF JUSTICE 162 (1971). Other schemes might be advanced, such as a lottery with the winner being paid first, in full, with those holding higher numbers paid in order until funds are exhausted. In lieu of a lottery to determine order of payment, one might adopt a temporal priority by paying either the oldest or the most recent claims first.

139 Some cases suggest that poor recordkeeping and failure to observe corporate formalities may constitute separate and independent grounds for imposition of substantive consolidation as a form of penalty for poor corporate housekeeping. *See* Kors, *supra* note 7, at 433 & n.272. In my formulation, such failures do not justify ignoring the separate entity form unless one of my three rationales for substantive consolidation is met. *Accord id.*

sel.[140] As consolidated group members in large bankruptcies often number in the hundreds or the thousands, the sheer complexity of consolidated group structure may overtax the professional resources available to manage procedurally consolidated cases on an entity-by-entity basis. Indeed, one suspects that the creditor in *Adelphia* requested separate entity representation to create negotiation leverage equal to the increased costs and disruption that granting such a request would create.

Though I do not find case law disagreement over use of substantive consolidation in situations of strong necessity, two practical problems lurk behind the analysis: (1) the poor quality of corporate recordkeeping and (2) the magnitude of particular recordkeeping problems in relation to the actual effect on creditors caused by imposition of substantive consolidation.

In practice, I have found that business recordkeeping is often quite poor,[141] even in well-run businesses. Many courts considering substantive consolidation will be able to conclude that it is, in some sense, "impossible" to identify accurately the assets and liabilities of consolidated group members. To effect a separation, a court may need to draw arbitrary lines to establish the levels of intercompany payables and receivables—to decide which asset transfer was a loan, which asset transfer was a capital contribution, and which asset transfer was a dividend. Unless courts require something short of perfection for entity separation, almost any business situation might support imposition of substantive consolidation on necessity grounds.[142]

Unfortunately, the case law does not give much guidance on the extent to which a court should allow parties and their accountants to fill gaps in order to create the separate books and records needed to

140 *In re* Adelphia Commc'ns Corp., 333 B.R. 649, 655 (S.D.N.Y. 2005). The party later dropped the request for such relief. *Id.* at 665 & n.102.

141 *See* David Wessel, *Wall Street Is Cleaning Derivatives Mess*, WALL ST. J., Feb. 16, 2006, at A2 (describing 18,000 undocumented credit derivatives trades). Moreover, it would not surprise me to find that insolvent companies, on average, have less comprehensive and accurate recordkeeping than solvent companies and that poor recordkeeping might contribute to the poor financial condition by providing management with less information. I do not, however, know that to be the case and, accordingly, I am not suggesting an independent penalty for failure to keep a clean corporate house. Certainly, as Coase's model suggests, some recordkeeping might be inefficient.

142 I do not mean to suggest that such matters need to be proven "beyond a reasonable doubt" or some other standard in excess of that typically required for proof in a civil matter. I do mean that, in some cases, there simply will not be any evidence (or, at least, evidence appropriate for civil proof) to decide the allocation question.

administer separate bankruptcy estates. Though pure creative writing should not suffice, what type of evidence should pass muster?[143]

The recordkeeping problem looms large in any case in which the range of the uncertainty related to settling intercompany accounts is small in relation to the estimated distributional effect on third-party creditors caused by a substantive consolidation. A simple arithmetic example illustrates this point. Suppose that company *A* owns $100 of tangible assets and owes Local Bank $1000, while company *B* owns $500 of tangible assets and owes Big Bank $1000. If we analyze this situation before consideration of intercompany balances, we find that imposition of substantive consolidation is a boon to Local Bank and a disaster for Big Bank.

This situation may not change much if we set reliable upper and lower bounds on the amount of net intercompany payables and receivables. For example, suppose that, as a historical matter, *A* and *B* actively exchanged assets, with *A* sometimes owing *B* up to $50 in net payments and *B* sometimes owing *A* up to $50 in net payments. Suppose that, other than a justified belief in this range, no reliable information allows the level of intercompany receivables to be set as of the bankruptcy filing date. A substantive consolidation still works a significant disadvantage for Big Bank even if we use the range of net intercompany payables least favorable to *B* (i.e., *B* owing *A* $50 net). Indeed, this type of situation may reflect the true facts in *Owens Corning*. In such a case, we are confident that substantive consolidation results in a wealth transfer from Big Bank to Local Bank even though we are unable to place a precise dollar figure on the amount of the wealth transfer.[144]

If no basis exists to set an upper or lower bound on the net intercompany payables and receivables, then substantive consolidation is proper on grounds of necessity. In many cases, however, the court will be able to estimate ranges.[145] What should a court do if the only determinable facts allow the setting of an upper and a lower bound, but not fixing any details in between? Again, the existing case law

143 Some courts have attempted to answer the issue of what constitutes a permissible degree of accounting inaccuracy. *See, e.g.*, R 2 Invs., LDC v. World Access, Inc. (*In re* World Access, Inc.), 301 B.R. 217, 276–79 (Bankr. N.D. Ill. 2003).

144 The Third Circuit perceived this to be the situation in *Owens Corning*. *See In re* Owens Corning, 419 F.3d 195, 215 n.26 (3d Cir. 2005).

145 At least the parties may think they can set ranges. Some research suggests that bankruptcy participants may not be particularly good at making these kinds of judgments. *See* Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341, 1345–46 (2004).

provides little guidance to answer this type of question.[146] My recommendation in such cases is that courts impose a partial substantive consolidation,[147] but I am not aware of any court that has taken the precise step in contested cases needed to solve this kind of estimation or range problem. The settlement in *Enron* provides one example of a form of partial substantive consolidation that might be adapted for this purpose. In a negotiated settlement context, the Enron parties allowed claims on the basis that litigation to force a substantive consolidation had a 30% chance of success. Thus, 30% of each claim's amount was paid as if substantive consolidation had been ordered and the balance of each claim was paid as if substantive consolidation had not been ordered.[148] The compromise appeared to result from an assessment of the relative strengths and weaknesses of the substantive consolidation claims, rather than limits on the ability to conduct fact finding. In the *Owens Corning* case, however, the problem focused on by the district judge appeared to be the cost and ability to conduct fact finding on issues related to intercompany payables, with the amount in dispute being a far lower dollar amount than the amount of the wealth transfer that would result from a complete substantive consolidation. If the *Owens Corning* court found uncertainty over the allocation of $100 million in receivables among various entities, I suggest that a different sort of partial consolidation might have been ordered (i.e., rather than one predicated on the probabilities of success). The court might have distributed $100 million in assets as if the estates had been consolidated, with the balance distributed as if no consolidation had taken place. Such a compromise would allow cost savings associated with foregoing accounting procedures (while avoiding the "all or nothing" quality of the actual $1 billion dispute that confronted the court in *Owens Corning*) because the partial consolidation would have

146 Case law suggests that courts have flexibility to craft partial substantive consolidations of some sort, though the particular case law examples amount to simply preferring one creditor or collateral claim against the claims of other creditors. *See, e.g.*, First Nat'l Bank of El Dorado v. Giller (*In re* Giller), 962 F.2d 796, 799 (8th Cir. 1992); FDIC v. Hogan (*In re* Gulfco Inv. Corp.), 593 F.2d 921, 927 (10th Cir. 1979); Talcott v. Wharton (*In re* Cont'l Vending Mach. Corp.), 517 F.2d 997, 1001–02 (2d Cir. 1975); *In re* Pittsburgh Rys., 155 F.2d 477, 484–85 (3d Cir. 1946); Gill v. Sierra Pac. Const., Inc. (*In re* Parkway Calabasas Ltd.), 89 B.R. 832, 837 (Bankr. C.D. Cal. 1988). Even the "deemed" consolidation might be seen as a form of partial consolidation because legal entities are not actually combined. Though courts and commentators have noted general court authority to custom tailor partial consolidations, *see* Kors, *supra* note 7, at 450–51 & n.337, I am not aware of cases or commentators advocating the form of partial consolidation that I suggest to solve problems of proof.

147 *See* Kors, *supra* note 7, at 450–51 & n.337.

148 *See* Findings of Fact, *supra* note 58, at 47–48.

been crafted as a solution tailored to the size of the accounting problem. All creditors in *Owens Corning* might have benefited from the administrative cost savings if a partial consolidation had been used whereas a total consolidation created a large wealth transfer.

Courts also employ necessity rhetoric to justify imposition of substantive consolidation when no literal impossibility exists, but the costs associated with providing a separate accounting are prohibitively high.[149] This second use of "necessity" reflects a judicial determination that the accounting and related costs of preparing separate financial records for individual companies is so significant that it jeopardizes a meaningful return to creditors. In these cases, substantive consolidation preserves a return to creditors by reducing the accounting costs—consolidation is "necessary" to maximize each creditor's recovery. Courts often supplement necessity rhetoric by finding that a substantive consolidation "benefits all creditors."[150] This second type of case forms the "Pareto Scenario."

B. *The Pareto Scenario*

I borrow the label "Pareto" from welfare economics.[151] I intend my use of the label as simply descriptive of a particular class of financial circumstances. Substantive consolidation may distribute the savings achieved by dispensing with procedures to separately account for each member in a consolidated group in a manner that improves each creditor's position. The situation feels like the familiar Pareto improvement from economics. A substantive consolidation fits my Pareto Scenario if no creditor's expected recovery is reduced and at

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149 For a case that displays concerns over both actual necessity and practical necessity associated with high administrative accounting costs, see Chemical Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966).

150 Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988).

151 *See* Howard F. Chang, *A Liberal Theory of Social Welfare: Fairness, Utility, and the Pareto Principle*, 110 YALE L.J. 173, 175 (2000) (describing the Pareto principle as a measure of improvement in social welfare). *See generally* Talcott Parsons, *Pareto's Central Analytical Scheme*, *in* PARETO & MOSCA 71, 81–83 (James H. Meisel ed., 1965). I do not use the term to describe a rule of decision that might be used for a particular society as a whole, but simply use the same arithmetic to describe procedures for deciding allocations among creditors in a particular bankruptcy proceeding. In this narrow setting, the welfare of creditors is determined by the size of their recoveries. Further, I do not wish to take sides in the debate over whether the Pareto principle is compatible with notions of fairness. *Compare* Louis Kaplow & Steven Shavell, *Notions of Fairness Versus the Pareto Principle: On the Role of Logical Consistency*, 110 YALE L.J. 237 (2000), *with* Howard F. Chang, *The Possibility of a Fair Paretian*, 110 YALE L.J. 251 (2000). I use the arithmetic of the Pareto principle to sharpen case law notions that use of substantive consolidation doctrine should benefit all creditors.

least one creditor's expected recovery is increased by the consolidation.[152] Return to our base example, but now with the introduction of a column to illustrate the impact of transaction costs.

Table 3: Transaction Cost Effects in Parento Scenario

Entity	Value	Costs	Big Bank	Factor Co.	Local Bank
A	$750	($250)	$1000/500	-0-	-0-
B	$500	($250)	-0-	$1000/250	-0-
C	$250	($250)	-0-	-0-	$1000/-0-
Consol.	$1500	N/A	$1000/500	$1000/500	$1000/500

Introducing transaction costs, Big Bank would receive $500 in either the consolidation or in the separately administered case (and is thus indifferent). Factor Co. would receive $500 in the consolidation but only $250 in the separately administered case, and Local Bank would receive $500 in the consolidation and $0 in the separately administered case. Thus, when the transaction costs[153] incurred to create separate balance sheets are factored into the analysis, a substantive consolidation yields a preferred result for two creditors and a neutral result for one creditor. In the real world, however, neither the parties nor the court have any assurance that a substantive consolidation will yield such a value-enhancing result because the transaction costs to be incurred must be incurred in order to perform the very calculation at issue. Only with hindsight, after incurring the transaction costs, might we determine whether a substantive consolidation actually put more money in the creditors' pockets than separately administered estates.

Despite this chicken-and-egg problem caused by lack of knowledge, parties and courts might make educated guesses about the relative costs and benefits of imposing substantive consolidation. In cases in which all parties make the same assessment, a substantive consolidation might be agreed upon as part of a reorganization plan and no controversy will result.[154] A controversy will, however, arise in two cases. First, different parties might make honest, but different, estimates concerning the relative costs and benefits of a substantive con-

152 These criteria are analogous to the strong Pareto criteria. The analog to the weak Pareto criteria would require that the consolidation benefit all creditors.

153 I use the costs associated with preparing balance sheets as an example. In fact, these costs are merely one type of cost that might be saved. Cost savings include reduced litigation costs over fraudulent transfers, the benefits of emerging from bankruptcy sooner, and the simplification in, and reduction in number of, plans of reorganization that must be prepared and distributed to creditors for votes.

154 Nevertheless, case law tells us that a court must make a separate and independent finding that substantive consolidation is justified. *See supra* text accompanying notes 56–62.

solidation compared to the costs and benefits of separately administered estates. Second, one or more parties might elect to engage in strategic behavior. For example, Big Bank might object to a substantive consolidation hoping to extract some value from Local Bank because, in the absence of the consolidation, the parties expect Local Bank to receive little or nothing and estimate that Big Bank will receive a substantially equivalent recovery. Big Bank might "sell" its consent to the substantive consolidation by initially objecting to a proposed consolidation. For an enhanced recovery percentage, Big Bank might later drop its objection to a plan that included substantive consolidation. The enhanced recovery to Big Bank would be justified as part of a settlement of litigation over substantive consolidation.

Such hold-out behavior might arise based solely on facts and circumstances related to that case. But it may also be the product of a differing perspective between a court and creditors. In theory, the court administers a bankruptcy case in the best interests of the particular group of creditors in the case before it. Individual creditors, however, may have rational incentives outside the particular case to take positions that do not maximize returns within the case.[155] Beyond possible different vantage points between judges and creditors, the possibility of court action further allows a judicial override if the personalities and testosterone levels in a particular case come to overshadow the exercise of sound judgment—a not uncommon phenomenon in my observation of workout negotiations.

However rationalized, courts routinely approve substantive consolidation under the rubric of "benefiting all creditors"—a justification grounded in the promotion of efficiency.[156] The promotion of efficiency has a firm grounding in the history of the Bankruptcy Code and its predecessors.[157] I turn now to another scenario in which appeals to efficiency might justify imposition of substantive consolidation, but one which courts have not explicitly adopted.

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155 This situation might exist for creditors who participate in numerous bankruptcy cases. Positions taken in one case may influence results in other cases. In effect, any particular bankruptcy case functions as merely one stage in a multistage, multiplayer game for these creditors. For example, a bank might take a tough position in one case, even at the expense of its recovery in that case, hoping its reputation for tough negotiating will provide advantage in another case.

156 *See* Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988).

157 *See supra* note 101.

C. *The Kaldor-Hicks Scenario*

If a court embraced the "Kaldor-Hicks Scenario" as justifying substantive consolidation, the court would use the remedy when: (1) those creditors benefiting from the consolidation could afford to pay those creditors harmed by the consolidation and still be better off financially, and (2) those creditors harmed by the consolidation could not afford to bribe those benefiting from the consolidation to forego the consolidation. Though I again borrow a label from welfare economics, my use of "Kaldor-Hicks" is intended simply as a description of financial circumstances affecting a clearly identified group of creditors in a bankruptcy proceeding, and is not intended to be suggestive of a decision procedure applicable to improve a larger segment of society.

An arithmetic example illustrates the point by simply changing the relative transaction costs needed to separately account for each entity.

Table 4: Transaction Costs in Kaldor-Hicks Scenario

Entity	Value	Costs	Big Bank	Factor Co.	Local Bank
A	$750	($150)	$1000/600	-0-	-0-
B	$500	($350)	-0-	$1000/150	-0-
C	$250	($250)	-0-	-0-	$1000/-0-
Consol.	$1500	N/A	$1000/500	$1000/500	$1000/500

Administration through a substantive consolidation would hurt Big Bank (by lowering its recovery from $600 to $500), though it would help both Factor Co. (by increasing its recovery from $150 to $500) and Local Bank (by increasing its recovery from $0 to $500). Though this simple consolidation would not satisfy the narrow Pareto improvement criteria (because Big Bank is hurt by the consolidation), substantive consolidation yields enough cost savings such that Factor Co. and Local Bank *could* pay Big Bank to accept the consolidation and, following the payment, all parties would benefit financially. Such a simple renegotiation would find Factor Co. and Local Bank agreeing to pay Big Bank an aggregate of $101 or more to consent to the substantive consolidation.

Unlike the Necessity Scenario and the Pareto Scenario in which case law rhetoric matches the scenario, I do not find reported cases which embrace the rhetoric of the Kaldor-Hicks Scenario to justify imposition of substantive consolidation. Outside the case law, however, I find a large number of negotiated reorganizations in which substantive consolidation is imposed as part of implementing a plan, or in which settlement of threatened substantive consolidation litigation is used, as the rationale to adjust claim amounts and/or percentage recoveries.[158] The large number of consensual substantive consolidation reorganization plans suggests to me that, in some cases, courts approve substantive consolidation in Kaldor-Hicks Scenarios that are not also Pareto improvements.[159] I suspect parties often negotiate reorganization plans to share cost savings to improve the positions of all parties even though mere imposition of substantive consolidation, absent the negotiation, would not have improved everyone's position. If this supposition is correct, the possibility of a Kaldor-Hicks improvement functions as a silent efficiency rationale for imposition of substantive consolidation or use of the doctrine by a court in justifying approval of a reorganization plan or a settlement. The important point is this: courts do not expressly mention Kaldor-Hicks improvement as a rationale because they wait until the parties themselves have converted a Kaldor-Hicks Scenario into a Pareto Scenario through negotiations.

Another possibility does exist, given that the parties are functioning under the umbrella of uncertainty. Creditors who believe (1) that they are operating in a Kaldor-Hicks Scenario and (2) that they would be harmed by use of substantive consolidation (such as Big Bank in the example) simply may fear that, despite their beliefs, the facts would allow a court to support a finding of a Necessity Scenario or a Pareto Scenario and that this finding would not constitute reversible error, even if erroneous. In such a case, the threat of substantive consolidation looms over the negotiation of the reorganization plan, leading creditors to agree to settle claim amounts and distribution percentages at levels they believe fairly allocate savings associated with the use of substantive consolidation in a Kaldor-Hicks Scenario. For example, Big Bank may accept an aggregate payment of $75 to approve a consolidation for fear that, even though on the actual facts Big Bank should receive $101 or more, the court will order consolidation and Big Bank will receive only $500, rather than the $600 it believes it is entitled to outside of consolidation.

As with the Pareto Scenario, creditors have incentives to agree to a substantive consolidation reorganization plan in a Kaldor-Hicks Sce-

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158 *See generally* Widen, *Prevalence of Substantive Consolidation*, *supra* note 20.

159 To think otherwise, one would have to assume that all these consensual substantive consolidation plans either are cases of strict necessity or cases of a Pareto improvement. This is a restrictive assumption that seems unlikely to me and, therefore, one that I do not make.

nario because negotiations allow each creditor to improve its position. Again, one might question the need for the remedy to apply in such a scenario because the parties should agree to the efficient outcome without court intervention. Again, the motive of limiting strategic behavior applies in the Kaldor-Hicks Scenario as in the Pareto Scenario. Through the threat of substantive consolidation, the court can influence the parties to produce an efficient result even if they would fail to reach that result in the absence of the threat.

Why does case law rhetoric fail to embrace forced imposition of substantive consolidation in the Kaldor-Hicks Scenario? Perhaps courts fear that the precedent of causing certain creditors economic harm to create economic gain for other creditors cannot be contained. Once harm to a particular creditor is allowed because it enhances overall creditor recoveries, the rationale may expand beyond the narrow situation in which we might criticize the harmed creditor for failure to reach a bargain sharing benefits that flow from consolidation. The same problem does not apply to a reorganization plan *negotiated* in a Kaldor-Hicks Scenario, because the negotiation produces a Pareto-like result. A consolidation *imposed* by the court in a Kaldor-Hicks Scenario, without negotiation, produces a wealth transfer as a penalty for failure to agree (unless the court attempts to mirror a negotiated result by, for example, ordering consolidation with respect to a portion of the estate). Yet there is no assurance that the penalty will fall on those who might be said to have unreasonably failed to reach agreement. Rather than imposing a random penalty for negotiation failure, the court approves a plan in a Kaldor-Hicks Scenario only after the negotiation results in reallocations benefiting all creditors. Allowing courts to order partial consolidations tailored to the size of identified accounting problems would give the courts a tool to achieve a result benefiting all creditors in the absence of negotiations converting a Kaldor-Hicks Scenario into a Pareto Scenario.

Even though imposing substantive consolidation might produce cost savings that boost the total payments to creditors, we would not criticize a creditor for opposing consolidation if the harm to the creditor exceeded any possible compensating payment from other creditors. In such a case, the substantive consolidation creates a wealth transfer—my fourth scenario.

D. The Wealth Transfer Scenario

In a Wealth Transfer Scenario, the aggregate amount of losses suffered as a result of substantive consolidation by creditors harmed in the consolidation exceeds the aggregate amount of transaction cost savings realized by imposing substantive consolidation. The losses suffered by the disadvantaged creditors show up as gains for the creditors who benefit from the consolidation. Because the substantive consolidation saves transaction costs, the aggregate payout to creditors *with* consolidation exceeds the aggregate payout to creditors *without* consolidation (even though some individual creditors are worse off). As seen in the Necessity Scenario, some cases of necessity may result in wealth transfers.[160] This will be the case when the magnitude of accounting questions that are not determinable (e.g., does company *B* own a $50 receivable or owe a $50 payable?) is small in relation to the estimated wealth transfer effected by the substantive consolidation (e.g., the expected $500 loss suffered by Big Bank as a result of consolidation).

The Third Circuit clearly identified the *Owens Corning* case as a Wealth Transfer Scenario,[161] while the district judge found substantive consolidation "a virtual necessity" to effect the reorganization.[162] Both courts might be correct. Indeed, we have seen how a case of necessity can overlap with a case of pure wealth transfer. The existing articulation of the substantive consolidation doctrine did not give the district judge the option of imposing partial substantive consolidation to save costs without creating a wealth transfer.[163]

The Third Circuit decision might be seen to foreclose a substantive consolidation that results in a pure wealth transfer (particularly a significant wealth transfer). The better view is instead that the Third Circuit decision simply rejects the district judge's finding of necessity. The latter reading is strongly preferred because, in the face of a wealth transfer, the court went on to consider whether substantive consolidation conflicted with the lending syndicate's reliance interest.

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160 *See supra* Part V.A ("The Necessity Scenario").

161 *In re* Owens Corning, 419 F.3d 195, 214 (3d Cir. 2005).

162 *In re* Owens Corning, 316 B.R. 168, 172 (Bankr. D. Del. 2004), *rev'd*, 419 F.3d 195 (3d Cir. 2005).

163 The Third Circuit identified the possibility of a partial consolidation as an open question in *Owens Corning*. *See Owens Corning*, 419 F.3d at 210 n.16. Case law supports a partial approach in similar contexts. *See supra* text accompanying note 146. Generally, a partial consolidation would involve a court-imposed accommodation, similar to the negotiated settlement in *Enron*, in which a portion of the estate is distributed as if consolidation had been ordered, with the balance being distributed on a separate entity basis. *See supra* text accompanying note 146.

E. Reformulation of the Economic Rationale

In summary, case law should be reinterpreted to justify the imposition of substantive consolidation on economic grounds in the Necessity Scenario and the Pareto Scenario. In addition, courts might properly justify approval of substantive consolidation in the Kaldor-Hicks Scenario when the parties have conducted their own negotiations as reflected in a plan of reorganization or a settlement, so that, by the time the plan or settlement is approved, benefits flow to all creditors. The approval of the plan then rises or falls with the voting procedures of Chapter 11. In no case, however, does the economic rationale support the imposition of substantive consolidation *on economic grounds alone* when the consolidation creates a pure wealth transfer. Case law to the contrary should thus be rejected.[164] A court might use dicta in a variety of cases to support crafting a "partial" consolidation to break an impasse between creditors when a case of "minor" necessity arises.[165] General acceptance of "partial" consolidation as a method to save costs in cases of factual uncertainty (as a supplement to the "deemed" consolidation procedure) is a development that I would strongly endorse.[166]

The valuation/timing problem for application of the substantive consolidation doctrine is analogous to the valuation/timing problem with identifying the "residual owner" of a bankruptcy estate. Professor LoPucki succinctly states the problem with identifying the residual owner:

> To identify the residual owner presumably would require valuation of the firm. That valuation would have to occur at the outset of the bankruptcy reorganization case. Yet, valuation is notoriously expensive and difficult. Indeed, valuation is the essence of the bankruptcy reorganization process. If the court could value the firm at the outset of the proceeding, the proceeding would no longer be necessary.[167]

Similar to the problem of identifying a "residual owner," a court often will not be sure that its imposition of substantive consolidation will benefit all creditors. In some cases, for a court to make this finding confidently, the parties would need to have already spent the time, effort, and expense to prepare separate balance sheets. Yet, avoiding

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164 An example of the rhetoric courts should ignore is the balancing test in *Auto-Train*. *See supra* text accompanying notes 114–16.

165 *See supra* note 146.

166 *See supra* note 146.

167 LoPucki, *supra* note 145, at 1345–46 (citation omitted).

this expenditure provides the very benefit that imposition of substantive consolidation is expected to produce. The circular process of determining the facts needed to justify application of the rule destroys the benefit achieved by application of the rule. At a minimum, a significant tension exists between the need to find facts and the anticipated benefits. The more fact finding required, the less savings creditors might realize. Uncertainty is present in all scenarios. There is, however, no uncertainty in the application of the rule. The rule of decision is not open textured, though the application of the doctrine is uncertain for epistemological reasons. Use of a laundry list of factors detailing a failure to observe corporate formalities relating to a breakdown in the internal asset identification function of the consolidated group serves as a heuristic device to justify the finding of cost savings that benefit all creditors. This use of factors differs, however, from use of factors in a balancing test.

One might rationally decide that proper analysis of substantive consolidation should begin and end with the economic account given above. The rhetoric of case law instead reveals a separate and distinct justification for substantive consolidation grounded in the rationale originally evolved for corporate law "veil piercing" and related doctrines. Lawyers involved in securitization transactions recognize this dual strand of justification for substantive consolidation. Veil piercing cases still receive mention in substantive consolidation legal opinions rendered in structured financings, attesting to the doctrine's continued vitality.

VI. Veil Piercing as a Stand-Alone Rationale for the Doctrine

In contrast to substantive consolidation grounded in economics, where the stated rule is clear but the facts are uncertain, the rule justifying substantive consolidation on veil piercing grounds is open textured, though the facts are not often disputed. The law provides a list of factors without suggesting the particular weights assigned to those factors or how those factors might combine to produce an outcome. The judicial discretion to assign different weights to particular factors (or combinations of factors) contributes to the open texture of the doctrine and to the indeterminacy of outcome.[168] Factors such as common directors, officers, and shared bank accounts present little room for factual disagreement. The debate revolves around the legal effect

168 *See generally* John Zeleznikow, *The Split-Up Project: Induction, Context and Knowledge Discovery in Law*, 3 LAW, PROBABILITY & RISK 147 (2004) (describing various sources of open texture in law).

given to such facts.[169] The problems facing substantive consolidation justified on veil piercing grounds mirror the problems facing substantive consolidation justified on economic efficiency grounds.

My reflection on the cases produces the following principle: a court may order substantive consolidation to correct a "wrong" if, in so doing, the court does not commit a "wrong." For this purpose, producing a simple wealth transfer does not constitute a "wrong." The classic wrong committed by a company in a substantive consolidation case is some form of misrepresentation in which the company misleads a class of creditors into thinking that more assets support their loans than in fact exist.[170] (This is true whether the deficiency existed at the time of the loan or resulted from subsequent transfers.) This explains why, in many early cases, courts employ the substantive consolidation remedy in circumstances that also support the use of fraudulent conveyance law to protect creditors.[171] In these latter cases, the debtor typically has transferred assets to a related company to prevent payment to a creditor. Breach of a covenant also might constitute a "wrong" correctable by substantive consolidation.[172] I am not suggesting that a court is limited to correcting only actionable "wrongs" such as fraud.

The various factors listed to support the veil piercing rationale for substantive consolidation should not be examined solely for the purpose of generating an identity among the various companies as might be done in a traditional "alter ego" or "instrumentality" analysis. Instead, I suggest that the court should consider these factors as part of its determination of whether a wrong was committed, such as misleading a creditor. One can easily see how, in some cases, a combination of the veil piercing factors might produce a creditor misperception. The misperception might be caused either from a breakdown in the internal asset identification function of the consolidated group or from

169 *See, e.g.*, Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940) (listing factors to consider because "[t]he determination as to whether a subsidiary is an instrumentality is primarily a question of fact and degree").

170 *Cf.* Posner, *supra* note 83, at 520–22 (discussing veil piercing).

171 For example, *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941), is essentially a fraudulent transfer case. *See also* Kors, *supra* note 7, at 392.

172 It is common for a syndicated loan agreement to provide that the borrower must cause any new subsidiary formed by it to execute a guarantee of the loan. If the borrower forms subsidiary companies but does not cause the guarantees to be executed, then the syndicate will be structurally subordinated to credit incurred by the new subsidiaries. The existence of a default for failure to procure the guarantees does not change this result. In such a case, a substantive consolidation of the new subsidiaries with the borrower would correct the harm caused by the breach, benefiting, rather than harming, the loan syndicate.

a breakdown in the artificial personality of the consolidated group members. In the absence of such a misperception or other wrong, we should not worry about silly things such as whether an SPC has a separate phone line and letterhead. Substantive consolidation does not exist simply as a remedy to promote good corporate housekeeping.

My approach to this branch of substantive consolidation doctrine resembles the approach to veil piercing taken by the National Labor Relations Board when deciding the extent of shareholder liability for employment claims. In *White Oak Coal Co.*,[173] the Board stated:

> We conclude that the corporate veil may be pierced when: (1) the shareholder and corporation have failed to maintain separate identities, and (2) adherence to the corporate structure would sanction a fraud, promote injustice, or lead to an evasion of legal obligations.[174]

Mere failure to observe corporate formalities did not suffice for veil piercing in *White Oak Coal Co.*[175] Disrespecting the corporate form must create, in some sense, a "wrong" which veil piercing corrects.[176] This view conforms to that expressed by federal courts when using veil piercing to further some federal policy.[177] What I am advocating is that the veil piercing rationale for substantive consolidation remember its roots, and require a prior finding of a harm in need of correction.[178]

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173 White Oak Coal Co., 318 N.L.R.B. 732 (1995).

174 *Id.* at 732.

175 *Id.* at 735.

176 *Id.*

177 *See* Bd. of Trs. v. Valley Cabinet & Mfg. Co., 877 F.2d 769, 773 (9th Cir. 1989) (discussing veil piercing to recover pension contributions made pursuant to ERISA); Seymour v. Hull & Moreland Eng'g, 605 F.2d 1105, 1112 (9th Cir. 1979); *accord* United States v. Bestfoods, 524 U.S. 51 (1998); Bangor Punta Operations v. Bangor & Aroostook R.R., 417 U.S. 703, 713 (1974) (disregarding corporate form where form was used "to defeat an overriding public policy"); *cf.* Anderson v. Abbott, 321 U.S. 349, 357–58 (1944) (piercing the corporate veil despite a finding of good faith and adequate capitalization because liability was required by federal statute).

178 This suggestion might seem to go against many courts' perceptions of substantive consolidation as distinct from state-law veil piercing. *See, e.g.*, *In re* Stone & Webster, Inc., 286 B.R. 532, 538–39 (Bankr. D. Del. 2002); *see also* Kors, *supra* note 7, at 393 (noting situation in which court distinguished veil piercing from consolidation). I too believe there is a difference, which I base in the fact that three separate grounds exist for substantive consolidation. Only when using the veil piercing rationale do I require a finding of prior harm. Though I divide my analysis of substantive consolidation doctrine into an economic rationale and a veil piercing rationale, an economic justification can be given for the veil piercing rationale as well. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 58 (1991). Unlike a tort creditor, a typical contract creditor is compensated ex ante for increased risk ex post. This distinction between tort and contract creditors does not, however, exist when the debtor commits a "wrong" such as fraud or misrepresentation (i.e., the debtor firm may engage

The analytical problems with the rationale for veil piercing were discussed in the 1920s and apply with equal force when used as a rationale for substantive consolidation.[179] At the surface, veil piercing is justified by a litany of metaphors: a subsidiary is found to be the "alter ego" or "mere instrumentality" of the parent company, suggesting an identity of the subsidiary with the parent; this identity justifies a decision to ignore the asset partition created by the corporate business form.[180] Though the litany of factors requires resort to metaphor for their use, many courts appear unmoved by the mere presence or absence of these factors. Rather, my supposition is that courts use the factors to justify substantive consolidation when imposition of substantive consolidation avoids a perceived inequitable result; similarly, courts deny substantive consolidation when the perceived result is inequitable.[181] The prerequisite that there exist a "wrong" to correct lends structure to the examination of factors borrowed from veil piercing to justify substantive consolidation. Further structure comes from the notion that abuse of the corporate form must have contributed to the wrong. Thus, the factors do not simply appear as part of a balancing test.

My suggested approach to substantive consolidation is consistent with the Supreme Court's view that veil piercing doctrine "is not, properly speaking, a rule, but a convenient way of designating the application in particular circumstances of the broader equitable principle that the doctrine of corporate entity . . . will not be regarded when so to do would work fraud or injustice."[182] The core inquiry in this branch of substantive consolidation must be to find a "wrong" to correct, rather than merely to find a substantial identity between companies. The alter ego factors help explain why or how the "wrong" was committed, but do not serve as an independent reason to impose sub-

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in excessive risk taking, and therefore shift costs to creditors). Courts might respond to this "wrong" by allowing creditors to pierce the corporate veil. *Id.* at 58–59. Though the normative point can be made to justify the veil piercing rationale, a persuasive empirical study demonstrates that courts do not, in fact, currently decide veil piercing cases on this basis. *See* Thompson, *supra* note 102.

179 *See, e.g.*, William O. Douglas & Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193 (1929); *see also* Henry W. Ballantine, *Separate Entity of Parent and Subsidiary Corporations*, 14 CAL. L. REV. 12, 18–20 (1926) (considering notions of agency and alter ego, and metaphors of alias and dummy, to describe the relationship between parent and subsidiary).

180 Judge Cardozo aptly described veil piercing doctrines as "enveloped in the mists of metaphor." Berkey v. Third Ave. Ry., 155 N.E. 58, 61 (N.Y. 1926).

181 *See* Kors, *supra* note 7, at 397–409 (discussing current case law factors).

182 Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322 (1939).

stantive consolidation. This approach coheres with my approach to the economic rationale in which misuse of the corporate form explains the breakdown in the asset identification function but does not independently justify use of substantive consolidation.

Under this reformulation, the *Owens Corning* notion that a proponent of substantive consolidation must show actual reliance on an identity among the entities to be consolidated[183] is too strong. Indeed, if taken seriously, this requirement could operate in practice to prohibit many applications of substantive consolidation that my analysis suggests otherwise would be proper. Take, for example, a situation where a creditor may be misled into believing that assets support a loan made to a subsidiary without believing that it made a loan to the parent company. The creditor need only think that the parent company's assets support the loan. For this situation, we do not require a fraudulent transfer. The assets may have been parent company assets all along, with the creditor simply being misled by a breakdown in separate corporate personality or asset identification. This can happen even though the creditor is well aware that the subsidiary is a member of a consolidated group made up of different legal entities. In *Owens Corning*, the noteholders may have thought that the value in subsidiary companies reflected on a consolidated balance sheet would be available to repay their notes if they were unaware of the significant structural subordination caused by the lending syndicates' guarantees. This belief does not require that the noteholders also believed that Owens Corning had no subsidiaries.

Under my reformulation, the Third Circuit should have first found a "wrong" to correct—ideally either a misrepresentation or a covenant breach relating to the consolidated group structure. Then it should have proceeded to consider whether use of the remedy created a further "wrong" (which would have rendered use of the doctrine improper). A misrepresentation wrong may well have existed in the *Owens Corning* case; Owens Corning sold unsecured notes using an offering memorandum that did not disclose the risk that the note investors would be subject to structural subordination to creditors of subsidiaries, such as the lending syndicate.[184] An offering memorandum typically discloses the risk of structural subordination when the corporate structure presents such a risk.[185]

183 *In re* Owens Corning, 419 F.3d 195, 212–14 (3d Cir. 2005).

184 The Third Circuit alluded to this disclosure failure when it suggested that those pursuing substantive consolidation should separately pursue securities fraud claims. *Id.* at 215 n.27.

185 *See In re* Worldcom, Inc., No. M-47 HB, 2003 WL 21498904, at *1 (S.D.N.Y. June 30,

Notwithstanding this omission, the case for misrepresentation does not automatically follow. Owens Corning, the parent company, was not a mere shell entity with assets consisting solely of subsidiary stock. Rather, its other assets might have sufficed at one time to repay note investors notwithstanding structural subordination. Fact finding would determine whether failure to mention the risk of structural subordination amounted to a material omission, justifying the use of substantive consolidation. Only if the failure to disclose amounted to a material omission would the court examine whether the use of substantive consolidation creates a second wrong by harming a legitimate reliance interest of the syndicated lenders. As discussed above, however, the Third Circuit likely erred when it made its finding of creditor reliance on intercompany guarantees.[186]

My reformulation of the existing economic and veil piercing rationales for substantive consolidation does not exhaust my view of the proper reach of the doctrine. Though a court could appropriately use the fairness rationale advanced below, current case law does not extend into such uncharted territory.

VII. A New Fairness Rationale for the Doctrine Based on Eliminating Double Proof in Cases of Intercompany Guarantees

Commentators often identify the promotion of equity between a debtor and its creditors as a significant goal of bankruptcy law.[187] The related objective of promoting equity among different creditor classes receives less attention. Various provisions of the Bankruptcy Code promote equity among creditors: the automatic stay[188] prevents a race among creditors to the courthouse; the recovery of preferential payments[189] defeats a debtor's attempt to prefer payment of one creditor over another; fraudulent conveyance provisions allow for recovery of assets from third parties for distribution to creditors;[190] and the abso-

2003) ("Before WorldCom entered Chapter 11 bankruptcy, WorldCom issued more than $27 billion of debt. In the prospectus distributed by WorldCom, it informed buyers that their debt would be 'structurally subordinate' to the debt owed to creditors of subsidiaries, such as Wireless.").

186 *See supra* Part IV.C ("How the *Owens Corning* Circuit Court Misunderstood the Role of Reliance on Guarantees in Syndicated Finance").

187 *See* SKEEL, *supra* note 101, at 45.

188 11 U.S.C. § 362 (2000).

189 *Id.* § 547.

190 *Id.* § 548. State fraudulent conveyance law also may be employed using § 544 of the Bankruptcy Code.

lute priority rule prevents payments to lower-ranking creditors or interest holders if higher-ranking creditors have not been paid in full.[191]

Another, less-noticed principle of equity among creditors is based upon consideration of the sources of payment available to various creditors to satisfy their claims. Some of these provisions are reflected in express provisions of the Bankruptcy Code dealing with treatment of partnership bankruptcies, whereas others exist indirectly as equitable principles developed originally in England under the general rubric of "marshaling" and incorporated into current law, arguably by § 105 of the Bankruptcy Code.[192]

At a most general level, we have a simple question of fairness when one creditor (a "multiple-source creditor") has resort to two or more sources of payment (at least (1) a "shared source" and (2) one additional "alternate source" which is not shared), and another creditor (a "single-source creditor") has resort to a single shared source of payment also available to the multiple-source creditor. Should the law direct how the multiple-source creditor goes about satisfying his claims, or should the multiple-source creditor remain free to pursue remedies as he sees fit in accord with the contracts he has negotiated? The question arises in cases of balance sheet insolvency of the shared source. The problem increases in complexity when the alternate source is also balance sheet insolvent. In the absence of scarcity, the question of fair allocation does not arise.[193]

The law provides a partial answer to the allocation question in various related doctrines collected under the general heading of "marshaling."[194] Again, at a most general level, the law says fairness requires that the multiple-source creditor first seek payment from the

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191 *Id.* § 1129(b)(2)(B)(ii). The absolute priority rule derives from Supreme Court precedent. *See* N. Pac. Ry. v. Boyd, 228 U.S. 482, 508 (1913). William Douglas used this case to support the Bankruptcy Act's first version of the absolute priority rule. *See* SKEEL, *supra* note 101, at 67. Prior to *Northern Pacific*, railroad reorganizers often squeezed out unsecured creditors by allowing mortgage bondholders and existing equity security holders to participate in the reorganized company. Unsecured creditors complained that it was unfair to allow participation by equity security holders while they, as more senior members of the capital structure, had been excluded from participation. *Id.*

192 *See infra* Part VIII ("Why Use of the Doctrine Does Not Present Constitutional Concerns") (discussing actual grounds for the use of equitable principles by a federal court exercising bankruptcy jurisdiction).

193 *See* RAWLS, *supra* note 138, at 128 ("[T]he circumstances of justice obtain whenever mutually disinterested persons put forward conflicting claims to the division of social advantages under conditions of moderate scarcity.").

194 As a general matter, a court of equity does not consider the question of marshaling of assets unless both sources of payment are under the jurisdiction and control of the court. Lewis v. United States, 92 U.S. 618, 623 (1875). In procedurally consolidated bankruptcies, all the

alternate source rather than deplete the shared source of payment.[195] Using up the shared source may harm the single-source creditor without benefiting the multiple-source creditor. In some sense, a multiple-source creditor who first pursues a shared source for payment gratuitously harms the single-source creditor. Equity may intervene to stop this result.[196] The principle of fairness that emerges from this general fact pattern is sometimes identified as the solution to the "two funds" problem.[197]

I have been deliberately vague about the nature of the sources of payment. Sources of payment might be various items of collateral security pledged to creditors by a single debtor (with each payment source being an asset or pool of assets subject to a separate lien). The classic multiple-asset fact pattern involves a debtor, *D*, who grants a first mortgage on Blackacre to *A* and also grants a first mortgage on Greenacre to *A*. Later, *D* grants a second mortgage on Greenacre to *B*. Consider this circumstance to be a classic "multiple-asset scenario."[198] The payment sources are individuated in a multiple-asset scenario by a combination of asset identification through description, coupled with imposition of liens on the assets identified. The junior creditor invokes the doctrine of marshaling to compel the senior cred-

debtors, and all the assets subject to consolidation, are under the jurisdiction of a single court. This would not be the case, however, if consolidation of a debtor with a nondebtor were sought.

195 *See* 53 AM. JUR. 2D *Marshaling Assets and Inverse Order of Alienation* §§ 3, 4 (2006).

196 *See* JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE 637 (Melville M. Bigelow ed., Boston, Little, Brown & Co., 13th ed. 1886). Though equity might direct the senior creditor to exhaust a separate fund prior to accessing a shared fund, this directive typically would not be made if it resulted in harm to the senior creditor. *Id.* (stating that the general principle operates "whenever it will *not* trench upon the rights or operate to the prejudice of the party entitled to the double fund" (emphasis added)); *accord* 53 AM. JUR. 2D *Marshaling Assets and Inverse Order of Alienation* § 14.

197 *See* 53 AM. JUR. 2D *Marshaling Assets and Inverse Order of Alienation* § 25.

198 In a variation on the multiple-asset scenario, *D* later grants a second mortgage on Blackacre to *C*. With two junior interests to consider, the law must tell *A* which mortgage to foreclose first. Under the "inverse alienation doctrine," *see id.* §§ 33, 34, *A* is told to foreclose on Blackacre. The theory seems to be that, all the mortgages being public, *B* might have known that only *A* had a claim to Blackacre and taken comfort from the fact that its junior position in Greenacre was, in some sense, less at risk because of the additional security for *A*'s claim. *C* cannot take such comfort were *C* to have examined the record. *C* would have known that, on the facts available to *B* at the time of the second mortgage, *A* would have been required to look to Blackacre first. Thus, *D*'s alienation in the form of the second mortgage on Blackacre to *C* is least preferred. Properties are selected for foreclosure in the inverse order of alienation when multiple junior interests might be protected in support of the two funds doctrine, which is seen as the primary purpose of marshaling.

itor to satisfy its claim first from Blackacre, the alternate payment source.[199]

Sources of payment might consist of distinct legal persons who are jointly and severally liable on a debt. The classic multiple-legal-person fact pattern involves a general partnership and its individual general partners. If *A* is a creditor of the general partnership *D* (formed by partners *P* and *Q*), *A* is also a creditor of the general partners *P* and *Q* and, thus, is a multiple-source creditor. Multiple-source-creditor status results because, by operation of law, general partners are liable for their partnership's debts. Another creditor, *B*, may be a single-source creditor with a claim solely against *P* because *B* has no claim against the general partnership *D* or the other partner, *Q*. Consider this circumstance to be a classic "multiple-entity scenario." The payment sources in a multiple-entity scenario are individuated by the boundaries of the legal entities involved, coupled with rules and procedures that identify assets as owned by the legal entities. The assets identified as owned by the legal entities comprise the real payment sources, though these assets are described indirectly by reference to a legal entity. In both these scenarios we might think of *A* as the senior creditor and *B* as the junior creditor.

A significant structural difference exists between the multiple-asset and the multiple-entity scenarios; the difference relates to the priority of claims. In the classic multiple-asset scenario, the senior creditor holds a senior claim both on the assets in the alternate payment source and on the assets in the shared payment source. In the classic multiple-entity scenario, the senior creditor holds a senior claim on the alternate payment source (by virtue of structural seniority to investors and their creditors) but holds a claim ranked *pari passu* with the junior creditor on the assets in the shared payment source. The competition among *pari passu* claims for entitlement to the shared payment source raises the problem known as "double proof." The general rule is that a creditor may prove but a single claim with respect to a particular debt. A double proof results when multiple claims are made with respect to a single debt. The effect of double proof is to dilute the recoveries of other creditors with respect

199 In some jurisdictions, marshaling has developed so that the senior creditor, *A*, may proceed against Greenacre even though it is the shared payment source. *See id.* § 32. The junior creditor, *B*, invokes the doctrine of marshaling to obtain subrogation to *A*'s mortgage on Blackacre. Professor Langdell reminds us that the marshaling doctrine can be invoked to harm unsecured creditors and that, in such a situation, he finds use of the doctrine works the opposite of equity. C.C. Langdell, *A Brief Survey of Equity Jurisdiction*, 1 HARV. L. REV. 55, 69–70 (1887).

to their debts by multiplying claims with respect to the particular debt that is double proved.[200]

Double proof presents two related fairness questions for consideration. The first considers the priority of the senior creditor's claim against the same source. The second relates to the size of the claim that the senior creditor is permitted to make against the shared payment source.

In the case of partnership insolvencies, the law sometimes provides that the senior creditor's claim against the shared payment source should be subordinated to the claims of the junior creditor against the shared payment source.[201] This result makes the second fairness question moot. In circumstances in which partnership creditors' claims against a partner are not subordinated, the question of the size of the claim allowed against the partner remains. If not subordinated, the senior creditor could, in theory, make a full claim against the shared payment source—a form of double proof. If, however, the senior creditor had first satisfied a portion of its claim against the part-

200 *See* BLACK'S LAW DICTIONARY 1251 (8th ed. 2004) (defining "double proof").

201 Justice Holmes refers to this subordination rule in *Mitchell v. Hampel*, 276 U.S. 299, 302 (1928). *See also* Francis v. McNeal, 228 U.S. 695, 700 (1913) (Holmes, J.) (recounting "the old rule as to the prior claim of partnership debts on partnership assets, and that of individual debts upon the individual estate"). This rule of subordination is part of the so-called "jingle rule" pursuant to which (1) partnership creditors proved claims first against partnership assets, and (2) creditors of single partners proved claims first against the assets of the individual partners. Only after creditors had exhausted their respective sources of payment might claims be pursued against the other source. Partnership creditors could then take the crumbs left by the creditors of the individual partner, but creditors of the individual partner could only access the value associated with the partner's residual interest in the partnership. By the time of *Mitchell v. Hampel*, the Supreme Court had clearly identified the subordination rule with § 5f of the old Bankruptcy Act of 1898, *see* Schall v. Camors, 251 U.S. 239, 248 (1920), without acknowledging its much older English origins, *see* Craven v. Knight, (1682) 21 Eng. Rep. 664, 664 (Ch.). *See also Ex parte* Elton, (1796) 30 Eng. Rep. 988, 989 (Ch.); *Ex parte* Cooke, (1728) 24 Eng. Rep. 834, 834–35 (Ch.); *Ex parte* Crowder, (1715) 23 Eng. Rep. 1064, 1064 (Ch.). I rely on work by Dr. Macnair and Dr. Getzler. *See infra* note 244. On the facts of *Mitchell v. Hampel*, despite the subordination rule, a full double proof without subordination was allowed because the partnership creditor at issue had not relied simply on the liability of the partners under partnership law. *Mitchell*, 276 U.S. at 301–02. To supplement liability imposed by the partnership business form, the creditor required that partners execute separate guarantees to provide additional security. *Id.* The guaranty contract provided a separate basis for claims against the partners—claims not subject to subordination preventing double proof. *Id.*; *see also* Myers v. Int'l Trust Co., 273 U.S. 380, 384–85 (1927) (holding that a partnership composition agreement did not absolve partners of liability for endorsement of partnership notes). The "jingle rule" has been repealed by § 723 of the Bankruptcy Code for Chapter 7 liquidation cases. The Bankruptcy Code does not expressly repeal the jingle rule in Chapter 11 reorganization cases, *see* Frank R. Kennedy, *Partnership and Partners' Estates Under the Bankruptcy Code*, 1983 ARIZ. ST. L.J. 219, 235–36, 245, though courts have so held, *see In re* Safren, 65 B.R. 566, 575 (Bankr. C.D. Cal. 1986).

nership assets before proceeding against the partner (as the "two funds" solution classically required), the possibility exists that the senior creditor would be allowed to prove the smaller, residual amount of its claim. Current bankruptcy law relating to partnerships changed the prior law and § 723 of the Bankruptcy Code now allows a claim to be made for the full amount against the individual partner's estate once a deficiency in partnership assets is shown.[202] Though the Bankruptcy Code now allows this specific form of double proof in partnership insolvencies, it takes care to eliminate or mitigate the effect of other forms of double proof, creating a mixed and theoretically inconsistent approach.[203]

In contrast, § 506 of the Bankruptcy Code directly addresses the problem of double proof when handling claims of partially secured creditors because it bifurcates an undersecured creditor's claim into a secured claim equal to the value of the collateral and an unsecured claim equal to the amount of the deficiency. The creditor is not allowed to prove the full amount of its claim as an unsecured claim competing with other unsecured creditors.[204] The partially secured creditor is a multiple-source creditor because he proves his claim against two sources: (1) the collateral or alternate source and (2) the debtor's general estate available to unsecured creditors (i.e., the "shared source"). You might frame this problem as one of competing "secured" creditors claiming against the shared source because the bankruptcy trustee has the status of a hypothetical lien creditor.[205] In the case of these "secured" creditors, however, the multiple-source creditor does not enjoy a priority claim against the shared asset source. An example makes the situation clear.

Suppose that *A* holds a $100 claim against *D* that is secured by a lien on an asset worth $70. Under current bankruptcy law,[206] *A* holds two claims: a secured claim for $70 and an unsecured deficiency claim

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202 *See* 11 U.S.C. § 723 (2000).

203 *See* Frank R. Kennedy, *Partnerships and Partners Under the Bankruptcy Code: Claims and Distribution*, 40 WASH. & LEE L. REV. 55, 77 n.92 (1983) (noting that the Bankruptcy Code provisions relating to co-debtors should not apply to partners). *See generally* Larry E. Ribstein, *The Illogic and Limits of Partners' Liability in Bankruptcy*, 32 WAKE FOREST L. REV. 31, 65–67 (1997).

204 11 U.S.C. § 506(a)(1) (Supp. 2006).

205 *See* Owens-Corning Fiberglass Corp. v. Ctr. Wholesale, Inc. (*In re* Ctr. Wholesale, Inc.), 759 F.2d 1440, 1446–47 (9th Cir. 1985) (providing an example of such a situation). I do not believe that characterization of the problem as one of competing secured creditors has particular value except to the extent that it enables one to more closely tie the problem of double proof to the doctrine of marshaling collateral for secured claims.

206 *See* 11 U.S.C. § 506(a) (2000 & Supp. 2006).

for $30. Suppose that *B* holds an unsecured claim against D for $100, and that *D* owns unencumbered assets worth $60. *A* files a secured claim for $70 and an unsecured claim for $30; *B* files an unsecured claim for $100. The result is that *A* receives a bankruptcy dividend of $70 from the collateral proceeds and $13.85 from the unencumbered assets; *B* receives a bankruptcy dividend of $46.15 out of the unencumbered assets. If, however, *A* had been allowed to prove a full $100 unsecured claim, *A* would have been given $30 and *B* would have been given $30 out of the unencumbered assets. If *A* were permitted to prove its entire claim against the shared asset source, *A* would squeeze down the recovery obtained by *B*. The larger the numerator allowed to *A*, the more it reduces *B*'s recovery. There is a double-proof situation because $70 gets "proved" against two sources. Even in cases in which double proof has been permitted, the senior creditor is not allowed a double recovery; the bankruptcy dividend is capped at $100.

Historically, the principle of fairness that limited the senior creditor to filing a proof for the unsecured deficiency, rather than the entire amount of the debt, was known as the "bankruptcy" rule.[207] The bankruptcy rule operates to prevent the squeeze-down effect by preventing double proof. The U.S. Supreme Court determined, in a 5-4 decision, that the bankruptcy rule derived from the express language of the former Bankruptcy Act and, thus, did not apply in a context to which that Act did not apply.[208] An insolvency proceeding for a national bank was not subject to the former Bankruptcy Act. Accordingly, the Supreme Court instead applied the "chancery" rule and allowed the multiple-source creditor to file a claim in the full amount of its debt against the shared asset source. In two strongly worded dissents, Justices White and Gray explained the historical origins of the bankruptcy rule, tracing it back to England, and argued on statutory construction grounds why the bankrutpcy rule should not be limited to the application given it in the Bankruptcy Act.[209]

207 *See* Merrill v. Nat'l Bank of Jacksonville, 173 U.S. 131, 138 (1899) (discussing the bankruptcy rule).

208 *Id.* at 138, 146–47.

209 *See id.* at 153–61 (White, J., dissenting); *id.* at 172–76 (Gray, J., dissenting). The historical connection between bankruptcy laws in the United States and England is strong. The first U.S. bankruptcy law, enacted in 1800, derived almost entirely from English bankruptcy legislation. Skeel, *supra* note 101, at 2. The Supreme Court held early on that the U.S. Constitution's use of the term "bankruptcy" referred generally to laws governing financial distress and did not make a distinction between "bankruptcy" and "insolvency" as existed in English legislation. Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 143, 194–95 (1819).

Properly understood, the so-called "bankruptcy rule," though not expressly identified with the doctrine of marshaling, addresses the same problem outlined generically at the start of this Part: how do we fairly deal with circumstances in which the interests of a multiple-source creditor conflict with the interests of a single-source creditor? In each of three situations—marshaling collateral, marshaling partnership claims, and allowing claims of undersecured creditors—the law has developed doctrines in which considerations of fairness override the results that would obtain if the parties were free to exercise the rights given to them under contract.

In each case, the law recognizes that use of a particular, accepted business technique can result in unfairness even though there is nothing wrong per se with use of the business technique. In a context that creates unfairness, equitable considerations operate to modify the result that contract law produces by straightforward application of the business technique. In each case, use of the business technique both produces asset partitioning and divides creditors between multiple-source creditors and single-source creditors.

Modern financial practice presents the same conflict between the interests of multiple-source creditors and single-source creditors. The conflict arises with great frequency in syndicated lending. Any time a consolidated family of companies obtains a syndicated loan supported by intercompany guarantees, the syndicated lenders become multiple-source creditors. These multiple-source creditors compete with creditors of the individual group companies, typically single-source creditors. Unlike the three cases discussed above, courts have failed to articulate expressly a modern doctrine of marshaling that might apply in the context of corporate groups using intercompany guarantees to obtain financing.[210]

Creation of a web of guarantees by a consolidated group of companies is a business technique that breaks down the asset partitioning, which results when a parent company owns one or more subsidiaries. Typically, the asset partitioning resulting from the division of assets

210 Combining the evolving notion of deemed consolidation with fairness considerations derived from principles of marshaling might produce a workable structure for reorganizing corporate groups. The process bears a family resemblance to the development of the equity receivership out of traditional foreclosure law used initially to reorganize railroads. *See generally* SKEEL, *supra* note 101, at 56–60 (discussing the development of the equity receivership device). In an equity receivership, a court may order the sale of all the assets of a railroad in a single parcel at auction. This procedure produces a different result than might have been obtained if mortgages or judgments liens filed in individual counties and held by separate creditor groups were subject to separate foreclosure proceedings in a fragmented liquidation.

among multiple legal entities predates the planning for the syndicated financing. Thus, the guarantee web divides creditors into multiple-source creditors and single-source creditors, though it does not create the asset partitions.

The preexisting asset partition created by the parent/subsidiary structure may have been created for the express purpose of matching different creditors with different assets.[211] In such a case, a substantive consolidation might defeat expectations of creditors who had advanced funds to the separate legal entities. However, too often we forget that the preexisting asset partition might have resulted from other factors. Prior to his appointment to the Supreme Court, (then Professor) William O. Douglas made this very point in a coauthored article:

> The factor of limited liability has not been unimportant. It merely has not been paramount. The same can be said for the evolution that has taken place within the business units using the corporate form. Recent years especially have seen an increasing use of the subsidiary-parent structure. . . . The reasons for the use of this structure are manifold. The increased facility in financing; the desire to escape the difficulty . . . of qualifying the parent company as a foreign corporation in a particular state; the avoidance of complications involved in the purchase of physical assets: the retention of the good will of an established business unit; the avoidance of taxation; the avoidance of cumbersome management structures; the desire for limited liability, are among the primary motives. The desire for limited liability has been merely one among many factors. And at times it has appeared to recede.[212]

Though use of the same business technique, here application of the corporate form, appears in any corporate group, Douglas reminds

211 Professors Hansmann and Kraakman contemplated such a scenario in their initial presentation of their theory of asset partitioning. *See* Hansmann & Kraakman, *supra* note 5, at 399 (using as an example of possible segregation of creditors and assets a parent company that owned a hotel business and an oil business). Professor Triantis uses a similar fact pattern in his analysis of internal capital markets. *See* Triantis, *supra* note 96, at 1131–32. I examine a different sector of consolidated corporate groups, the world in which the internal asset partitions no longer serve the purpose of the group, yet the partition remains because it is cheaper to leave it in place than to dismantle it. In my experience, this is a common situation.

212 Douglas & Shanks, *supra* note 179, at 193 (citation omitted). Justice Douglas's views on corporate form have particular interest in the context of corporate reorganization because he and his cohorts at the Securities and Exchange Commission reflected anti–Wall Street, populist philosophy in the Chandler Act reforms of 1938. *See* SKEEL, *supra* note 101, at 18.

us of a basic reality. The presence of the business technique does not mean the same thing in all contexts. Context-sensitivity should guide equitable considerations.

The squeeze-down effect caused by intercompany guarantees becomes clear with a simple example. Suppose you are an investor with $100 allocated to purchase an outstanding corporate debt as an investment. You have a choice of purchasing a $100 note from two different borrowers with very different corporate structures. The first borrower, a single corporation with no subsidiaries, owns assets worth $2000 and owes third-party creditors claims totaling $1000. The second borrower is a member of a corporate group composed of six corporations; your investment might consist of a loan to any of these corporations. The corporate group owns assets in various entities with a consolidated value of $2000 and group members owe third-party creditors claims totaling $1000, of which $500 is owed to various third-party lenders and $500 is owed to a lending syndicate with intercompany guarantees. Company *A* distributes proceeds from the syndicated loan throughout the consolidated group, as needed.

Based on this example, in general, which investment should you prefer? You might answer this question by considering what happens if the stand-alone company and the consolidated group each lose $1700, leaving only $300 in realizable asset value. The table below illustrates the situation for the consolidated group and its debt investors.

Table 5: The Squeeze-Down Effect of Multiple Guarantees

Entity	Value	3rd-P. Creditors	Syndicate Loans	Syn. Claim	Syn. Distrib.	3rd-P. Distrib.
A	$50	$-0-	5 x $100	$500	$50	-0-
B	$50	$100	-0-	$500	$41.67	$8.33
C	$50	$100	-0-	$500	$41.67	$8.33
D	$50	$100	-0-	$500	$41.67	$8.33
E	$50	$100	-0-	$500	$41.67	$8.33
F	$50	$100	-0-	$500	$41.67	$8.33
Total	$300	$500	$500	N/A	$258.35	$41.65

There is a significant structural reason to prefer holding a $100 syndicated loan in the second company over holding either a $100 claim against the first company or an independent third-party claim against a member of a consolidated group in the second company.[213]

213 This structural reason supplements any preference for a claim against a larger asset pool rather than a smaller asset pool based on notions of risk diversification.

In the first, stand-alone corporation, the $100 debt investment receives a distribution of $30 because a total of $1000 in claims compete *pari passu* for $300 in assets. This would be true even if $500 of these claims were made by syndicated lenders because, in the absence of subsidiaries and guarantees, the syndicated lender claims simply compete on a *pari passu* basis with other third-party claims. In the consolidated group, however, the syndicated lender holding a $100 claim receives a distribution of $41.67, while the independent third-party lender receives a distribution of $8.33 (in the absence of substantive consolidation).

The reason for the vast difference in outcomes relates to the phenomenon of double proof. The syndicated lenders to the consolidated group file proofs of claim for $500 against each member in the group because each member in the group provided a full, complete, and unconditional guarantee of payment, not simply collection, to support the syndicated loan. This $500 thus squeezes down the recoveries of independent creditors of the individual group members. This would not have occurred if the individual group members had each arranged for their own separate financing, rather than having one member in the group, typically the parent company, arrange for centralized financing.

The squeeze-down effect in the context of intercompany guarantees magnifies the problem of double proof. In the example, we have not merely a simple problem of double proof but the problem of a sixfold proof. In general, the squeeze-down effect is enhanced as the number of guarantees from separate legal entities increases.

In the above example, the small independent creditors are squeezed down, while the organized syndicated lenders receive an enhanced recovery. A variety of fairness considerations may lead one to question the appropriateness of this result. First, the small independent creditors may be "nonadjusting" creditors (such as tort claimants) or they may be voluntary creditors with little or no bargaining power. We might have a simple case in which the transaction costs needed to provide guarantees to the voluntary little guys are perceived to be too high. These concerns echo those raised during the secured lending "carve-out" debate in which it was proposed that secured lenders and borrowers set aside twenty percent of collateral value for payment of nonadjusting and other unsecured creditors.[214]

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214 *See supra* note 30. The concerns raised by the guarantee squeeze-down relate directly to analysis performed by Professor LoPucki, who noted how multiplying legal entities can reduce liabilities. *See* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 20, 61–62 (1996);

An additional fairness consideration presents itself. The squeeze-down effect operates much like a security interest in two ways. In the above example, the asset partition provided by *A* gave the syndicated lenders complete priority in $50 of assets. In the case of the five group members in which independent lenders competed with the syndicate, the repetition of the large $500 proofs of claim by the syndicate created a distinct advantage, though not a complete priority. Unlike the priority created by secured credit, which requires some form of public notice for perfection, syndicated guarantees squeeze without systematic notice. In the case of public companies, it would be unusual to find any useful information on the extent of guarantee webs either in financial statements or SEC filings. In practice, of course, even the presence of notice is of no help to nonadjusting creditors and may be of little help to small voluntary creditors. Nevertheless, the presence or absence of notice often figures prominently in our assessement of overall fairness of a structure. I mean to suggest only that if secured lending presents fairness problems, the unsecured syndicated guarantee may be the 800-pound gorilla in the corner that goes unnoticed.

I propose a third justification to use substantive consolidation, also grounded in equity, but based on equitable considerations that sound in fairness rather than notions of responding to affirmative wrongs (such as misrepresentation, fraud, and the like). Simply put, substantive consolidation doctrine can be used to balance the equities when we find that intercompany guarantees divide creditors into various camps of single-source creditors competing with a multiple-source creditor that benefits from the web of intercompany guarantees. Substantive consolidation in this context removes the unfairness of the

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see also Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147, 148–52 (1998) (responding to critics of the analysis presented in *The Death of Liability*). My example shows how multiplying legal entities can enhance recoveries for a preferred creditor while reducing recoveries for all other creditors. With the example of a single economic firm dividing itself into multiple subsidiary entities, we see how easily one may squeeze down, theoretically to almost nothing, the claims of small voluntary creditors who deal with the entity only through one of its subsidiary nodes, as well as the claims of tort claimants who may be directly injured through contact with a subsidiary node. In contrast, if the firm had not organized itself into multiple subsidiary entities, the same economic activity, organized as a single legal entity, would provide a greater payout to the small contract creditor and the tort claimant. In the consolidated group structure, using a web of guarantees, the sophisticated financier reduces its exposure to these types of claims, thus enhancing its recovery. Though it is beyond the scope of this Article, my analysis may have relevance for the treatment of consolidated group liability for tort claims, a much debated issue. *See generally* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991); Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1 (1986).

squeeze-down effect. This notion of fairness, though stressed by courts critiquing the structure of business enterprises in past times, has not found a voice with modern courts.[215] Contrary to the circuit court's notion that substantive consolidation trampled upon the contract rights of the lenders, from the debate between Landers and Posner, we see that substantive consolidation may actually effectuate the purpose behind use of the guarantees because the guarantees are used to contract around the existing default rules that do not recognize enterprise liability.

My remarks on the fairness rationale are intended to be as much descriptive as they are normative. I expect many would cringe at the idea of advocating for a legal regime based on fuzzy notions such as fairness when notions of economic efficiency present a seemingly analytical bright line. I do not engage that debate here. The current bankruptcy law expressly includes doctrines of equity in the bankruptcy judge's toolbox. For example, in cases of disagreement over approval of reorganization plans in a cram-down context, the statute expressly instructs judges to consider both the *fairness* and the *equity* of the plan.[216]

Furthermore, historically speaking, considerations of fairness and equity have been raised in situations in which multiple-source creditors compete with single-source creditors. At the time these fairness issues were developed, the general partnership form dominated business, while the corporate form did not permit organization of corporate groups. Nevertheless, a long pedigree should not disqualify current use. The foregoing analysis would be all for naught, however, if the Supreme Court did not permit the evolution of equitable principles in the manner that I suggest.

VIII. Why Use of the Doctrine Does Not Present Constitutional Concerns

In proposing my reformulation of substantive consolidation doctrine, I am mindful of the Supreme Court's decision in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*[217] There is little

215 Analyzed under this third rationale for substantive consolidation, the lower court properly ordered substantive consolidation in *Owens Corning*. Far from surprising, this is the result that industry professionals would have expected in the case of unsecured intercompany guarantees. Indeed, this is the significance of the fact, given little credence by the Third Circuit, *see In re* Owens Corning, 419 F.3d 195, 213–14 (3d Cir. 2005), that no competent lawyer would have given a nonconsolidation opinion in the face of a web of intercompany guarantees.

216 11 U.S.C. § 1129(b)(1) (2000 & Supp. 2006).

217 Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308 (1999).

point in reformulating a doctrine if that doctrine is in danger of being thrown out as unconstitutional. In *Grupo Mexicano*, the Supreme Court held, in a 5-4 decision authored by Justice Scalia, that a federal court's equity jurisdiction is limited to the "jurisdiction in equity exercised by the High Court of Chancery in England at the time of the adoption of the Constitution and the enactment of the Judiciary Act, 1789."[218] The idea of such a rule is flexibility within limits—the courts have the power to craft a broad range of equitable remedies so long as they do not stray from the types of equitable remedies known at the time of the grant of authority to fashion them.[219]

As a general matter, the Constitution provides that federal courts acquire power only through legislative grant;[220] thus, for a bankruptcy court to impose substantive consolidation properly, particular legislation must give the court power to use that remedy.[221] Because the Court in *Grupo Mexicano* limited equity powers to those exercised by

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218 *Id.* at 318 (quotation omitted). The Judiciary Act of 1789 gave federal courts jurisdiction over "all suits . . . in equity." Judiciary Act of 1789 § 11, 1 Stat. 73, 78. In fixing the scope of this jurisdiction to the time of separation of the United States from England, the Supreme Court relied on its earlier such pronouncement in *Atlas Life Insurance Co. v. W.I. Southern, Inc.*, 306 U.S. 563, 568 (1939). *Accord* Vieth v. Jubelirer, 541 U.S. 267, 278 (2004) ("'The judicial power' created by Art. III, § 1, of the Constitution is not *whatever* judges choose to do . . . or even *whatever* Congress chooses to assign them . . . . It is the power to act in the manner traditional for English and American courts." (citation omitted)); *cf. In re* Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004) (noting that § 105 of the Bankruptcy Code does not justify vendor relief because the power given by the section implements, rather than overrides, provisions of the Code); Jamo v. Katahdin Fed. Credit Union (*In re* Jamo), 283 F.3d 392, 403 (1st Cir. 2002) (noting that the equitable power conferred by § 105 may be used only if "the equitable remedy dispensed by the court is necessary to preserve an identifiable right conferred elsewhere in the Bankruptcy Code").

219 The Supreme Court stated that bankruptcy courts "are essentially courts of equity, and their proceedings inherently proceedings in equity." Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934). A bankruptcy court employs principles and rules of equity within the jurisdiction given it by the Bankruptcy Code and title 28 of the U.S. Code. *Cf.* Pepper v. Litton, 308 U.S. 295, 304 (1939) (describing how bankruptcy courts use equitable principles). Bankruptcy courts use principles of equity to counteract fraud, to ensure that form does not triumph over substance, and to stop technical considerations from preventing substantial justice. *See id.* at 304–05. Bankruptcy courts have considerable latitude to modify debtor/creditor relationships. United States v. Energy Res. Co., 495 U.S. 545, 549 (1990).

220 U.S. CONST. art. III, § 1. In addition to the equity jurisdiction conferred by the Judiciary Act of 1789, Congress has specifically granted federal courts jurisdiction in bankruptcy cases. *See* 28 U.S.C. § 1334(a) (2000). A separate clause of the Constitution provides Congress with the power to establish uniform bankruptcy laws. U.S. CONST. art. I, § 8, cl. 4.

221 One might ask whether courts have certain mandatory powers under Article III of the Constitution, without the requirement of an act of Congress, thus focusing on the Constitution rather than the Judiciary Act of 1789. *See* Martin v. Hunter's Lessee, 14 U.S. (1 Wheat.) 304, 328–29 (1816); Akhil Reed Amar, *A Neo-Federalist View of Article III: Separating the Two Tiers of Federal Jurisdiction*, 65 B.U. L. REV. 205, 215, 272 (1985). I do not see a provision of certain

the High Court of Chancery in 1789, if the remedy of substantive consolidation did not exist at that time, another act of Congress must confer such power for it to be constitutional. Given *Grupo Mexicano*, the question remains whether Congress has chosen to confer the power to order substantive consolidation on the federal courts in any particular piece of legislation.[222]

The *Grupo Mexicano* decision generated a flurry of speculation that the Court had deprived bankruptcy courts of the ability to order substantive consolidation.[223] Accepted wisdom holds that the Supreme Court tacitly approved substantive consolidation doctrine in 1941, in *Sampsell v. Imperial Paper & Color Corp.*,[224] far too recent a decision if *Grupo Mexicano* requires a much older equitable remedy to sustain its use. The evolution of business forms presents a further complication; in 1789, corporations could not own subsidiaries, so the High Court of Chancery had no opportunity to order the remedy of substantive consolidation between a parent and a subsidiary corporation.

Since *Grupo Mexicano*, however, no federal court has found that substantive consolidation is unavailable, and several courts have specifically approved the use of substantive consolidation.[225] One might distinguish *Grupo Mexicano* on the grounds that bankruptcy jurisdiction derives from 28 U.S.C. § 1334, and not the Judiciary Act of 1789; but significantly absent from the current jurisdictional grant to federal courts exercising bankruptcy jurisdiction is an express grant of general equitable powers—a grant formerly present (including at the time of *Sampsell*) but no longer in effect.[226] The Bankruptcy Code itself pro-

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equitable remedies as mandated by the structure of the Constitution and thus search for authority in grants of power by Congress to the courts.

222 *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) ("[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.").

223 *See, e.g.*, J. Maxwell Tucker, Grupo Mexicano *and the Death of Substantive Consolidation*, 8 AM. BANKR. INST. L. REV. 427, 428 (2000); Sabin Willett, *The Doctrine of Robin Hood: A Note on "Substantive Consolidation,"* 4 DEPAUL BUS. & COM. L.J. 87, 99–101 (2005).

224 Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 221 (1941).

225 *See, e.g.*, *In re* Owens Corning, 419 F.3d 195, 209 n.14 (3d Cir. 2005) ("What the Court has given as an equitable remedy remains until it alone removes it or Congress declares it removed as an option.").

226 The Bankruptcy Act of 1898, the Chandler Act of 1938, and the Bankruptcy Code of 1978 all contained a grant of general equitable jurisdiction. *See* Tucker, *supra* note 223, at 435–38. This grant was dropped, likely by mistake, when Congress "fixed" problems with the 1978 Code identified by the Supreme Court in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 87 (1982) (rejecting, on constitutional grounds, the broad jurisdiction of the bankruptcy courts under the 1978 Code).

vides the options of merger or consolidation[227] to implement a reorganization plan, but that section has been termed a "thin reed" upon which approval for substantive consolidation might rest.[228]

A. *A Proposed New Statutory Foundation in the Bankruptcy Code to Support Use of the Doctrine*

The lack of an extant general statutory grant of equitable powers to federal courts exercising bankruptcy jurisdiction is both surprising and troubling. Section 105 of the Bankruptcy Code, often cited as a possible supplemental source of equity powers, appears limited to the use of equity to carry out express provisions of the Bankruptcy Code.[229] Accepting this limitation, for the sake of argument, if I had to locate in the Bankruptcy Code the power of a bankruptcy court to act generally as a court of equity or to order an equitable remedy in furtherance of substantive consolidation, I would turn to the definition of "claim" in § 101, which has two parts:

> "claim" means—
> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.[230]

It appears from the definition that rights to payment can be equitable in nature. Further, holders of some claims may be entitled to an equitable remedy. The language of the definition allows a creditor to assert its entitlement to an equitable remedy as part of, or in addition

227 11 U.S.C. § 1123(a)(5)(C) (2000); *cf. id.* § 302 (providing for consolidation of the estates of a husband and wife in joint administration).

228 *See* Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5, 19 (2005). Section 1123(a) of the Bankruptcy Code contemplates that a debtor may merge or consolidate with another person as part of implementing a plan of reorganization, though no specific authorization for substantive consolidation or deemed consolidation expressly appears in the Code. 11 U.S.C. § 1123(a)(5)(C). The references to merger and consolidation likely refer to state-law corporate procedures implemented by filing with the applicable secretary of state. Substantive consolidation might involve combining estates of a natural person with a corporation, as in *Sampsell*—a special bankruptcy procedure clearly not involving a state-law business combination.

229 *See* 11 U.S.C. § 105 (2000 & Supp. 2006).

230 *Id.* § 101 (2000).

to, its assertion of the claim (regardless of whether the claim itself is equitable in nature).[231] Under § 502 of the Bankruptcy Code, a claim is deemed allowed unless a party in interest objects.[232] Following an objection, the court, after notice and hearing, determines the amount of the claim and whether to allow it.[233]

This definition of "claim" arrived on the scene in 1978 as a significant change in law[234]—well after the doctrine of substantive consolidation was recognized in the federal courts. One might conclude, therefore, that when Congress decided that claims for payment may be equitable in nature and that entitlement to an equitable remedy might form part of a claim, it also intended to include substantive consolidation within the ambit of an equitable claim to payment, or within the scope of the term "equitable remedy," or both. This follows simply from the fact that, by 1978, federal courts had developed substantive consolidation as an equitable remedy and creditors often implored courts to use their equity powers of substantive consolidation to expand the universe of assets available to pay their debts. Thus, the year 1978, rather than the year 1789, becomes the date by which to measure the extent of "equity."

The impediment to such an analysis is the question of whether a creditor can actually request substantive consolidation as part of its assertion of an equitable claim or as part of its entitlement to an equitable remedy.[235] Certainly, creditors do not assert a right to substantive consolidation outside of bankruptcy. The issue of substantive consolidation might, however, arise in the following setting. Company *A* is a parent and company *B* is its subsidiary. Creditor *C* loaned money to *B*. Both *A* and *B* file for bankruptcy and the cases are

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231 The Bankruptcy Code provides that, as a principle of interpretation, "or" is to be interpreted as inclusive, rather than exclusive. *See id.* § 102(5).

232 *Id.* § 502(a).

233 *Id.* § 502(b) (2000 & Supp. 2006).

234 *See* S. Rep. No. 95-989, at 21–22 (1978); H.R. Rep. No. 95-595, at 309 (1977). The definition permits the broadest possible relief in the bankruptcy court, including equitable as well as legal rights to payment. S. Rep. No. 95-989, at 22; *see also* Ohio v. Kovacs, 469 U.S. 274, 279 (1985) (recognizing that Congress desired a broad definition of a "claim" in bankruptcy); *In re* Caldor, Inc.-N.Y., 240 B.R. 180, 190–91 (Bankr. S.D.N.Y. 1999) (noting that the drafters of § 101(5) of the Bankruptcy Code gave the term "claim" a broad definition to ensure that all parties with potential calls on a debtor's assets, provided that the call in at least some circumstances could give rise to suit for payment, would come before the court so that the permissibility, priority, and dischargeability of their demands could be determined), *aff'd sub nom.* Pearl-Phil GMT (Far E.) Ltd. v. Caldor Corp., 266 B.R. 575 (S.D.N.Y. 2001).

235 *See In re* Antonino, 241 B.R. 883, 888 (Bankr. N.D. Ill. 1999) ("A 'claim' exists for bankruptcy purposes only if the relationship between debtor and creditor contains all of the elements necessary to give rise to a legal obligation under relevant non-bankruptcy law.").

procedurally consolidated. *C* files a proof of a "legal" claim against *B* based on *B*'s prior execution of a note evidencing *C*'s loan to *B*. *C* also files a proof of an equitable claim against *A*, asserting that, under principles of veil piercing, *C* is entitled to be paid from *A*'s assets as well as from *B*'s assets. Assume *C* would be entitled to assert a state-law veil piercing claim, an equitable remedy,[236] outside of bankruptcy.

In determining whether to allow *C*'s claim against *A*, the court must decide, in effect, whether to substantively consolidate *A* with *B*. The court might conclude that, in respecting *C*'s claim against *A*, it should consolidate *A* with *B* so that all creditors of *B* benefit from the breakdown in the asset partition occasioned by *C*'s equitable claim.[237] If *C*'s equitable claim against *A* is justified, then the court would have found, in effect, that *A* was the alter ego of *B*, that *B* was a mere instrumentality of *A*, or some similar identity pursuant to which the asset partition between *A* and *B* should not be respected. Though a court might ignore the asset partition for *C*'s benefit (in effect consolidating for *C* alone in a form of "deemed consolidation") but respect the asset partition for the other creditors of *B*, it need not do so.[238] Often, a bankruptcy court asserts claims for the benefit of the entire estate that, outside of bankruptcy, would have been asserted by a single creditor for its own benefit.[239]

Further, if the court were to allow *C*'s equitable claim to stand against *A* without ordering a substantive consolidation, the court

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236 It is widely acknowledged that corporate veil piercing has evolved into an equitable doctrine. *See* Phillip I. Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities*, 28 CONN. L. REV. 295, 330 (1996) (describing the doctrine of corporate veil piercing as "a creation of nineteenth century equity jurisprudence under which equity courts disregard corporate forms where required to prevent fraud"); *see also* I. MAURICE WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 44 (1927) ("It has been oftentimes stated that courts of law invariably adhere to the entity theory even though gross miscarriages of justice result. It is quite true that equity, less abashed by forms or fictions than a court of law, is more willing to draw aside the veil and look at the real parties in interest.")

237 In the case of a fraudulent conveyance claim, a bankruptcy court will not allow a creditor in *C*'s position to assert a fraudulent conveyance claim against *A*. Instead, the trustee asserts the claim against *A* for the benefit of all creditors of *B*. This is true even though, outside of bankruptcy, *C*'s fraudulent conveyance claim against *A* would benefit only *C*. *See, e.g.*, Am. Nat'l Bank of Austin v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1275 (5th Cir. 1983).

238 The Third Circuit speculated that such a split treatment might be available to a court. *In re* Owens Corning, 419 F.3d 195, 210 n.16 (3d Cir. 2005). In light of the Third Circuit's apparent hostility to "deemed" consolidations, it is not clear how the Third Circuit would support the use of split treatment unless it did so under the simple principles of claim evaluation advocated herein.

239 *See Am. Nat'l Bank of Austin*, 714 F.2d at 1275.

would create the problem of a double proof benefiting *C*. In other contexts, we have seen that courts strive to limit double proof. In employing substantive consolidation to avoid the dilemma (both of double proof and of inconsistent treatment of the asset partition), the court merely employs substantive consolidation as part of evaluating and allowing proof of an equitable claim. The court must evaluate claims as part of its responsibilities under § 502.[240] Thus, in imposing substantive consolidation, the court is using the equity powers given it under § 105 to carry out its responsibility under another specific provision of the Bankruptcy Code.[241]

By the foregoing analysis, I do not mean to suggest that, in cases of substantive consolidation, the issue of the consolidation remedy actually arises *because* creditors have filed multiple proofs of equitable claims. I have never in fact seen such a case.[242] Analytically, however, a creditor's request for substantive consolidation amounts to the filing of a proof of an equitable claim against every member of a consolidated group for which that creditor does not have a legal claim (such as the legal claim the creditor would have through a note or a guarantee). Objection to the use of substantive consolidation by a party in interest amounts to objection to allowance of the equitable claim. Indeed, if courts found that substantive consolidation must pass through the eye of a proof of equitable claim under § 502, I would expect to see the filing of such proofs proliferate.

I intend the above discussion to strengthen the statutory basis for the use of substantive consolidation, despite the apparent gap in general bankruptcy equity jurisdiction created when 28 U.S.C. § 1471 was repealed in response to *Northern Pipeline*.[243] Although I believe a court might fairly accept my statutory analysis to justify the use of substantive consolidation, the reasons for its acceptance go much

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240 11 U.S.C. § 502 (2000 & Supp. 2006).

241 *Id.* § 105.

242 In an interesting twist on filing proofs of claim, one creditor in the Enron bankruptcy failed to file proofs of claim against all relevant entities, arguing that it did not do so because it expected a substantive consolidation in which its single proof of claim would have sufficed. *See* Midland Cogeneration Venture Ltd. v. Enron Corp. (*In re* Enron Corp.), 419 F.3d 115, 126 (2d Cir. 2005). An example of an equitable proof of claim based on veil piercing appears in Expert Report of Jonathan R. Macey ¶ 34, *In re* Stone & Webster, Inc., 286 B.R. 532 (Bankr. D. Del. 2002) (No. 00-2142), 2005 WL 3263064 ("Under traditional corporate law rules regarding piercing the corporate veil, BVG&E was the alter ego of Stone & Webster [and] Stone & Webster should, therefore, be responsible for BVG&E's debts.").

243 N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 87 (1982); *see also supra* note 226.

deeper and, I believe, are much older, tracing back to England in 1673.

B. *The Existence of the Remedy in Chancery Prior to the Judiciary Act of 1789*

The prior analysis of marshaling, double proof, and the so-called "bankruptcy rule" for undersecured creditors suggests that courts of equity have long balanced the general question of fairness between multiple-source creditors and single-source creditors. The label "substantive consolidation" is simply the name for a procedure pursuant to which, among other things, traditional questions of fairness might be addressed if members of a corporate group execute intercompany guarantees and later file for bankruptcy. Contrary to the accepted wisdom that pre-1789 chancery practice did not sanction a consolidation remedy, I find approval for a consolidation remedy in the 1676 chancery case of *Brown & Naylor*.[244] The case arose from a bill of review brought to reverse a 1673 decree in *Naylor v. Brown*.[245]

In *Naylor v. Brown*, Naylor loaned £500 to the Company of Woodmongers.[246] The company also owed debts to thirteen of its members totaling £620.[247] The company owned a bond of £1000 due from the King.[248] The company assigned the bond to Sir William Wild, who declared a trust for £620 of the bond in favor of the thirteen member-creditors, and as to the residue, in favor of the company.[249] Then the company declared a second trust on the company's residual interest to twenty-five other persons claiming debts (who also appear to be members).[250] This state of affairs remained until a *quo warranto* was brought against the company, resulting in its dissolution.[251] Following the dissolution, the various member-creditors claimed the bond except for a £135 residue for the unrelated creditors, including

244 Brown & Naylor (1676), *reprinted in* 73 SELDEN SOCIETY 419 (1954). I learned of the case through work on the early history of asset partitioning by Drs. Macnair and Getzler. *See* Joshua Getzler & Mike Macnair, *The Firm as an Entity Before the Companies Acts*, *in* ADVENTURES OF THE LAW: PROCEEDINGS OF THE SIXTEENTH BRITISH LEGAL HISTORY CONFERENCE, DUBLIN 2003, at 267 (Paul Brand et al. eds., 2005).

245 Naylor v. Brown, (1673) 23 Eng. Rep. 44 (Ch.), *sub nom.* Naylor & Godfrey (1674), *reprinted in* 73 SELDEN SOCIETY 55 (1954).

246 *Id.*

247 *Id.*

248 *Id.*

249 *Id.*

250 *Id.*

251 *Id.*

Naylor.[252] Naylor and the other third-party creditors sued Brown, the master of the Woodmongers, and the thirteen members of the company who benefited from the Wild declaration of trust.[253] Lord Nottingham held for Naylor and the other third-party creditors, directing an accounting for the £620 and granting priority to Naylor and the other third-party creditors over the thirteen insider-creditors.[254]

Three key points emerge from a close reading of these cases. I suggest first that the parties conceived of the two declared trusts as what we would today conceive of as corporate subsidiaries,[255] because each trust was seen as a separate corpus *within* the company. Second, the court ignored one trust based upon a failure to observe proper formalities in its formation, despite a later ratification. Finally, on appeal, the court considered a defendant-proposed alternate remedy: combine the two trusts with the company in a "kind of average" and satisfy all creditors from the common pool.[256] Lord Nottingham remarked that such an alternate consolidated solution was "fair" (without excepting the properly formed second trust), but he declined to adopt it because of the taint of fraud and the failure of the Woodmongers to raise the possibility of consolidation earlier.[257]

The dog that did not bark in *Naylor v. Brown* is the absence of any mention of the fraudulent conveyance remedy (particularly odd because Lord Nottingham was one of the promoters of the Statute of Frauds).[258] Why did Naylor not argue that the initial assignment of the bond to Sir William Wild resulted in a violation of the Statute of Elizabeth because it amounted to a fraudulent conveyance? I suggest that a transaction form consisting of (1) an absolute assignment of the bond to Sir William, coupled with (2) the grant back to the company of a residual interest in the trust created by Sir William was not seen as a transfer of the bond outside the estate of the company. Rather,

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252 Brown & Naylor (1676), *reprinted in* 73 SELDEN SOCIETY 419, 419 (1954).

253 *Naylor v. Brown*, 23 Eng. Rep. at 44.

254 *Id.* at 45.

255 In three essays, Maitland provides authority for the early connection between the trust and the corporation. *See* MAITLAND, *The Unincorporate Body*, *in* SELECTED ESSAYS 128 (H.D. Hazeltine et al. eds., 1936); MAITLAND, *Trust and Corporation*, *in* SELECTED ESSAYS, *supra*, at 141; MAITLAND, *Moral Personality and Legal Personality*, *in* SELECTED ESSAYS, *supra*, at 223. Maitland stated: "And now let me once more repeat that the connection between Trust and Corporation is very ancient. It is at least four centuries old. Henry VIII saw it." MAITLAND, *Trust and Corporation*, *supra*, at 214.

256 *Brown & Naylor*, 73 SELDEN SOCIETY at 419.

257 *Id.*

258 *See Introduction* to 73 SELDEN SOCIETY ciii (1954) (noting Lord Nottingham as a promoter of the Statute of Frauds).

this business structure was seen at the time as analogous to dropping an asset into a subsidiary company in today's corporate world. This account explains both why a fraudulent conveyance action was not brought and why the criticism of the transaction advanced in 1673 had any currency.

In 1673, the *Naylor v. Brown* court reasoned that the first trust failed because the company either (1) had not joined in the authorization to create the trust, (2) had not authorized Sir William to create the trust under company seal, or (3) had not authorized Sir William to declare the trust by any corporate act.[259] This reasoning only makes sense if the initial assignment of the bond to Sir William, coupled with the grant of a residual interest in the trust back to the company, failed to remove the bond from the estate of the company. Significantly, the 1673 court does not remark that the initial assignment to Sir William was defective; rather, it stated that the "*Declaration of the Trust*" was void.[260] If the assignment of the bond to Sir William had resulted in an absolute assignment outside the estate of the company, then Sir William needed no approval from the company or its seal to create a trust for the thirteen creditors or the company. With an absolute assignment of the bond, he could have created the first trust under his own signature. On appeal in 1676, the defendants did not argue this point.[261] Instead, they argued that the company had ratified the first trust when it approved the second trust because the recitals for the second trust mentioned the creation of the first trust and its residual interest.[262] The 1676 court rejected this argument.[263]

From the above, I conclude that the first trust transaction structure—an absolute assignment of property, followed by the creation of a trust, with the residual of the trust remaining in the company—was a technique designed to keep the bond within the estate of the company for the express purpose of preventing a fraudulent conveyance challenge based on the Statute of Elizabeth. Several additional factors support the conclusion that the trusts remained within the estate of the company. The first trust included an express assignment of a residual interest back to the company. The second trust, apparently

259 *Naylor v. Brown*, 23 Eng. Rep. at 44–45.

260 *Id.* at 45. Given the reporting standards of the day, any argument based on silence can only be a probable argument. Arguments stated in court simply might not have been recorded. In a case such as this, however, in which we have multiple reports and an appeal, the argument from silence appears much stronger.

261 *See Brown & Naylor*, 73 SELDEN SOCIETY at 419.

262 *Id.*

263 *Id.*

properly formed, did not contain any language reciting a residual interest in favor of the company.[264] Yet, the residual interest in the second trust did return to the company. Why this difference and result? I suggest that the creation of the second trust by the company grant was understood as not effecting an absolute transfer of the residual interest in the first trust outside the company's estate. No mention was made of the treatment of the residual interest in the second trust because of this understanding. Thus, the two trusts in this case, formed by different procedures, were intended to create asset partitions within the company itself. If the parties conceived of the two trusts as existing within the estate of the company, it further explains why the members of the company waited until dissolution to extract proceeds from the bond.[265]

A second critical question remains. Why did Lord Nottingham consider the proposal to consolidate both trusts with the company to be a "fair" proposal? Certainly, the consolidation of the first trust with the company might be considered fair given that the proper formalities were not observed in its formation. But what could have made consolidation of the second trust fair? I suggest that the multiple signatures of company members on Naylor's debt would have sustained this result. The court takes care to point out that none of these member signatures on the debt bound any of the members personally.[266] The multiple signatures did, however, create the impression that the company members nevertheless supported payment of Naylor's debt. Use of a trust, even the properly formed second trust, to prefer claims of members ran counter to the impression created by the company.

We might further ask: why did the Woodmongers suggest the consolidation remedy and why did Lord Nottingham decline to impose it, even though it was a "fair" solution? My tentative answer lies in the sketchy recitals of the relative amounts of the claims that we are given in the various reports. We are told that Naylor and the other third-party creditors were owed £1200.[267] The first thirteen insider-creditors were owed £650 by the time of the appeal and the second group of

264 *See Naylor v. Brown*, 23 Eng. Rep. at 44.

265 I do not place great emphasis on this timing point because, from the version of the case in Selden's Reports, it appears that the trusts may have been formed just prior to the liquidation and, indeed, as a device in anticipation of the liquidation. *See Brown & Naylor*, 73 SELDEN SOCIETY at 419. This, however, makes the absence of a fraudulent conveyance claim all the more unusual.

266 *Naylor v. Brown*, 23 Eng. Rep. at 45.

267 *See Brown & Naylor*, 73 SELDEN SOCIETY at 419.

twenty-five creditors were owed £250.[268] Thus, we have a ratio of three insider claims to four outsider claims. With a total fund of approximately £1000 from the King's bond,[269] a pro rata distribution to all creditors resulting from a consolidation would yield approximately £429 to the insider-creditors and £516 to the third-party creditors. Leaving the original decree in place (which did not attack the second trust) apportioned £650 to the third-party creditors from the first trust, £250 to the insider-creditors from the second trust, and, we are told,[270] a residual of £135 to the third-party creditors from the second trust.

Based on the distribution percentages, we can see why, as a collective, the Woodmongers suggested the consolidation remedy: consolidation enhanced their recovery. Also, we can see why, based on suspicion of fraud, including, perhaps, inflated debt claims by the insiders, the court simply affirmed the 1673 ruling, which was the only matter really before the court. The court might have liked the idea of consolidating both trusts with the company (and then subordinating the insiders), but that issue did not present itself on appeal because the 1673 case addressed only the first trust.[271] Thus, Lord Nottingham approved the concept of consolidating multiple artificial entities as a fair remedy, though he declined to impose it in this particular case.

What I take away from the foregoing analysis and the dicta in *Brown & Naylor* is that, if consolidation of two internal trusts with a company had been requested of Lord Nottingham in 1677, the Chancellor would have considered the request as one for an appropriate equitable remedy. I am not aware of counterexamples to his approval of consolidation as a remedy. Though the case does not present the consolidation of two "bankrupts," the facts are tantalizingly close to a modern substantive consolidation. Importantly, it is the feature of consolidation itself, more than the nature of trusts, that resonates here. One might disagree that the trusts were conceived of as separate entities. One might further disagree that the trusts were seen as existing within the company. Nevertheless, the trusts did form a primitive asset partition, however one otherwise conceives of them. The court remarked favorably upon the proposal to consolidate the asset partitions, though it declined to do so.[272] Unlike the facts in *Grupo*

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268 *Id.*

269 *Naylor v. Brown*, 23 Eng. Rep. at 44.

270 The amount of the claims reported is slightly inconsistent among the various reports and, in any event, the precise amounts available for distribution cannot be reconciled without assuming interest on the King's bond.

271 *See Naylor v. Brown*, 23 Eng. Rep. at 44–45.

272 Drs. Macnair and Getzler note the early respect given to asset partitioning as a liability

Mexicano, in which historically a creditor's bill was not requested and given prior to judgment (the fatal flaw identified by Justice Scalia),[273] consolidation of asset partitions, if not distinct legal entities, was considered appropriate prior to 1789.

Beyond finding a prototype of substantive consolidation approved prior to the Judiciary Act of 1789, my support for substantive consolidation as an appropriate remedy also stems from my belief that business fraud simply assumes new forms based on the existing legal technology available to miscreants. The same might be said of patterns of business advantage that do not rise to the level of fraud. Reading *Naylor v. Brown* and *Brown & Naylor* reminded me of *Associated Gas*,[274] with respect to business fraud in the form of a classic shell game.[275]

Associated Gas presented the question of whether the transfer of assets to a newly formed corporate subsidiary, followed by the incurrence of indebtedness by the new subsidiary, violates a negative pledge covenant that bound the parent/transferor to not create liens on its assets.[276] To circumvent the negative pledge clause, the miscreant simply created a series of structural priorities for new lenders, using the asset partition created by a new subsidiary, to give the new lender priority.[277] The structure was clever because one could argue that technically the procedure did not involve the creation of any lien, mortgage, or security interest, thus complying with the negative pledge covenant. The court was unwilling to confirm that this technical approach avoided a covenant violation.[278]

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shield between investors and business activity in the reluctance of the court in *Naylor v. Brown* to hold the members of the Woodmongers personally liable for company debts. Getzler & Macnair, *supra* note 244, at 286. Interestingly, in a note to the Finch Reports on *Naylor v. Brown* (not reproduced in Elizabeth's Reports), the idea of the company as a liability shield is traced to civil law. Naylor v. Brown, (1673) Rep. Temp. Finch 83 (Ch.). I understand from Dr. Getzler that "whether a fund held together by fiduciary law is separate from the entity it serves and those individuals who contributed to the fund or who have claims against it is a hard-fought over question in modern English law." E-mail from Joshua Getzler, CUF Univ. Lecturer in Law, Reader in Legal History, St. Hugh's Coll., Univ. of Oxford, to William Widen, Assoc. Professor, Univ. of Miami School of Law (Feb. 27, 2006) (on file with author). Dr. Macnair and Dr. Getzler should not be understood to agree or disagree with my analysis of *Brown & Naylor*.

273 Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308, 319, 330–31 (1999).

274 *In re* Associated Gas & Elec. Co., 61 F. Supp. 11 (S.D.N.Y. 1944), *aff'd*, 149 F.2d 996, 1004 (2d Cir. 1945).

275 *Id.* at 28–31.

276 *Id.* at 28–29.

277 *Id.*

278 *Id.* at 31.

Harkening back to *Naylor v. Brown*, with the precedent of *Associated Gas* in mind, I imagine counsel to the Woodmongers suggesting two internal trusts to create priority without violating the Statute of Elizabeth, just as the miscreant in *Associated Gas* sought to avoid the negative pledge covenant.

Conclusion

Theoretical work focusing on the corporate form as it exists inside corporate groups, particularly in the context of bankruptcy, lags behind scholarship surveying more general aspects of the corporate form. To close this gap, this Article argues for a framework that organizes this particular undertheorized milieu in terms of (1) asset partitioning, (2) artificial personality, and (3) asset identification. Using these tools, we better understand the doctrine of substantive consolidation—a doctrine used to destroy the very asset partitioning function of the corporate form, which is so important to our general understanding of that form outside consolidated group and insolvency contexts. This analytical framework fills a desperate need because courts have settled for articulation of a number of tests, sometimes inconsistent, and a listing of factors that leaves the scope of the substantive consolidation doctrine uncertain—we are left with vague balancing tests.

Some courts might feel more comfortable directly appealing to unbounded notions of equity and fairness to reach what they consider the just result in certain cases. This general approach, however, leads to uncertainty, reinforcing an impression that no real standards exist. To modify a phrase, justice is measured by the length of a particular judge's foot.[279] Concern over unbounded rules fueling courts' expansionist tendencies may explain the Supreme Court's decision in *Grupo Mexicano* as an attempt to reign in the discretion afforded lower courts generally. Further, uncertainty serves the interests of those creditors who view bankrutpcy as a somewhat lawless contest—a form of legal roller derby—in which negotiations might occur.

This Article argues for an expanded rationale for the use of substantive consolidation based on fairness concerns and gives reasons to deny a lending syndicate the benefit of a structural priority. Though some might consider this project a liberal one—expanding both debtor rights against creditors and rights of less powerful creditor clas-

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279 I refer to Lord Selden's celebrated remark that the measure of equity is the length of the Chancellor's foot. *Introduction* to 73 SELDEN SOCIETY xlii (1954).

ses against more powerful creditor classes—the project actually amounts to an inherently conservative one. Bankruptcy courts should not be able to invoke absolute discretion in the name of fairness and equity. Rather, they should exercise their powers on a bounded playing field. This can only happen, however, if the rules of the game are relatively clear.

Existing scholarship identifies principled reasons to believe that bankruptcy law should not significantly alter the balance of rights between debtors and creditors established under nonbankruptcy law.[280] Some have argued that a more expansive bankruptcy law that alters these rights might lead to expensive and inefficient contests reflecting the competition between those who favor the nonbankruptcy regime and those who favor the adjustments in rights made by bankruptcy law.[281] While harmful forum shopping *between* bankruptcy courts certainly occurs in some settings,[282] there seems to mė only a modest opportunity to forum shop between a bankrutpcy and a nonbankruptcy alternative. Nevertheless, basic fairness and market predictability seem to recommend that differences between bankruptcy and nonbankruptcy regimes be minimized. The proposals outlined in this Article are conservative in the sense that these differences are minimized.

By dividing the corporate form's function into asset partitioning, artificial personality, and asset identification, it is easier to understand the different contexts in which the corporate form appears. In subsidiary corporations, economic theory predicts that both artificial personality and asset identification will deteriorate. The asset identification function remains a crucial part of creating asset partitions inside a subsidiary, while the artificial personality function serves no similar role. Thus, it makes little sense to destroy an asset partition simply because a subsidiary has ceased to function as an artificial person in a consolidated group. The economic rationale for substantive consolidation addresses breakdowns in the asset identification function on its own terms. This analysis has particular relevance to the asset securitization business.

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280 *See generally* Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931 (2004) (arguing that bankruptcy law is a branch of civil procedure and should not create substantive rules that are equally applicable outside bankruptcy).

281 This position has been forcefully argued by leading bankruptcy scholars. *See* THOMAS JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 20–24 (1986).

282 *See* LYNN M. LOPUCKI, COURTING FAILURE 123–35 (2005) (discussing forum shopping).

Asset securitization practices reflect a competition between bankruptcy and nonbankruptcy regimes. We might ask why many companies that establish SPCs engage in seemingly pointless activities, such as subleasing office space to the SPC, printing separate SPC letterhead, and procuring a separate SPC telephone line. All these activities are done to shield against the risk of substantive consolidation because the law as presently articulated (one might say "muddled") creates the risk that a simple breakdown in artificial personality may influence a consolidation decision. Outside bankruptcy, the creditors can make current collections on securitized assets, such as receivables. Inside bankruptcy, the automatic stay prevents current collections and may permit collateral to be substituted. To avoid the bankrutpcy regime, financiers engage in wasteful activities to maintain the fiction of the artificial person.

Under this Article's analysis, such wasteful activities might be eliminated. Within corporate groups, we should expect managers to minimize costs. This often involves promoting identities between parents and subsidiaries that destroy artificial personality. Even though the expenses of maintaining SPCs—such as subleasing office space, separate stationary, and extra telephone numbers—are outweighed by the overall cost savings realized from a securitized financing, waste is simply waste. Notwithstanding the degree of artificial personality in a properly structured securitization, the asset identification function will almost always be operating smoothly. Further, such a financing typically involves public filings to perfect asset transfers and security interests, alleviating traditional veil piercing concerns over misrepresentation and fraud. When this is the case, the SPC and its investors should have no fears of substantive consolidation due to lack of robust artificial personality at the SPC.

Though the reformulated economic rationale goes hand in glove with evidentiary concerns, the four scenarios of Necessity, Pareto, Kaldor-Hicks, and Wealth Transfer provide reference points to frame any inquiry. My suggestion that future courts develop a doctrine allowing recognition of partial consolidation resolves an overlap between situations of Necessity and Wealth Transfer, but the suggestion merely amounts to a welcome refinement, rather than a reason to postpone reformulation of the doctrine as is more generally outlined in this Article. A fear that creditors may not always make decisions in their narrow best interests, as limited to the context of a single bankruptcy proceeding, suggests that courts should decide valuation disputes. This conclusion follows reluctantly because, as a general matter, government may be less suited to valuation tasks than private parties.[283] If a court orders substantive consolidation purely for reasons of cost savings on the reasonable belief that the remedy benefits all creditors, we do not create a pernicious divide between incentives inside and outside bankruptcy. As a general rule, parties pursue cost savings and enhanced returns both inside and outside bankruptcy.

Reformulation of the veil piercing rationale directs the doctrine of substantive consolidation in a similarly conservative manner back towards its origins by reintroducing the prerequisite of identifying a wrong to be corrected prior to use of the remedy. The traditional veil piercing remedy exists both inside and outside of bankruptcy court, so again the reformulation eliminates a potentially undesirable distinction. By clearly recognizing two types of harm (i.e., the economic harm of decreased distributions and the wrong that results from trouncing a reliance interest), we see how use of the veil piercing branch of substantive consolidation may remain effective. A general creditor may not protest against use of the remedy on veil piercing grounds simply because its use results in a wealth transfer. The court has the power to correct a wrong despite a purely economic-based complaint arising from a diminished bankruptcy dividend. In using substantive consolidation grounded in veil piercing, we require both that a substantial identity of parent and subsidiary must exist and that this identity must contribute to the original "wrong" that triggered the remedy. Breakdowns in either the management function or the asset identification function may contribute to causing a wrong suitable for correction in this context. When a court makes the causal connection between substantial identity and wrong, it may order substantive consolidation, subject only to respect for legitimate reliance interests.

This approach coheres with the corporate law notion that a creditor typically has no right to object to a consolidation, merger, or dissolution—prebankruptcy analogues to substantive consolidation. Why should a creditor's rights expand in bankruptcy, creating a hurdle for courts addressing particular harms, such as fraud, misrepresentation, or covenant breach? The limit on a court's use of this power to correct is also clear. The power may not be used under the veil piercing rationale to cause another wrong, typically destruction of a reliance

283 *Cf.* Walgreen Co. v. Sara Creek Prop. Co., 966 F.2d 273, 275–76 (7th Cir. 1992) (Posner, J.) (describing calculation of damages and suggesting that prices and costs are more accurately determined by parties in the market than by government). While markets may generally set prices more accurately than instruments of government, government determination, such as by a court, may be preferred when we have reason to believe that a market imperfection may exist.

interest. This reliance interest should not, however, be understood to exist simply because a creditor dealt with a particular subsidiary. It will always be the case that a creditor dealt with a particular member of a consolidated group. If the creditor did not have a particular contractual expectation of separateness, i.e., an ability to stop a merger, consolidation, dissolution, or similar event outside of bankruptcy, then it makes little sense to expand that right within bankruptcy to sustain an objection to a consolidation procedure.

Finally, the proposed fairness rationale for substantive consolidation is conservative for two reasons: it is grounded in historical practices and it coheres with accepted marketplace wisdom (at least, accepted prior to the Third Circuit's decision in *Owens Corning*).[284] Prior to that decision, nobody thought that the presence of intercompany guarantees provided a reason not to consolidate companies. Indeed, the market believed exactly the opposite. The presence of guarantees provided an affirmative reason to consolidate—a reason so strong that no reputable law firm would give a nonconsolidation opinion in the face of such guarantees.

Recall that Professor Landers criticized Judge Posner for allowing an economic analysis to divert attention from the reality of actual cases in which he believed benefits flowed from the law mirroring the reality of a single economic enterprise. The reformulation of substantive consolidation doctrine presented here does not overturn established default rules on difficult-to-prove efficiency grounds. Rather, a substantive consolidation is proper under the fairness rationale when the entities themselves, by their very action of executing intercompany guarantees (or otherwise designating themselves as multiple-source creditors within a consolidated group), signal the reality of a single economic enterprise.[285] The step to consolidate under this rationale thus rests on specific and historical fairness considerations, grounded in accommodations between multiple-source creditors and single-source creditors. I like to think that the market's perception of

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284 Further consideration might be given to the reception that my proposed tests would receive from regulators of financial institutions. Although in particular cases use of my reformulated tests might result in a lower recovery for bank lenders, I do not believe that bank lenders will systematically be disadvantaged. Indeed, in many cases, the option of substantive consolidation may save costs and benefit all lenders, including banks. The only circumstance in which bank recoveries will be systematically reduced is in the case of syndicated guarantees. As I have pointed out, prior to the Third Circuit's decision in *Owens Corning*, banks viewed the existence of such guaranties as a reason to consolidate and did not rely on the expectation of enhanced recoveries in such cases. *See supra* note 214 and accompanying text.

285 *See supra* notes 68 and 73 and accompanying text.

guarantees and their impact on substantive consolidation doctrine might derive, in some sense, from collective memories of fairness considerations that operated in past times.[286]

286 Future consideration should be given to the effect that veil piercing statutes, such as the joint and several liability of consolidated group members for federal income taxes, should have on the analysis. Further work remains to be done on the arithmetic of the squeeze-down effect, including analysis of its operation at varying degrees of insolvency. Computation of the subrogation effects when a guarantee squeeze-down results in full payment to certain creditors might not be easily computed under current 11 U.S.C. § 509.