

CORPORATE FORM AND SUBSTANTIVE CONSOLIDATION

WILLIAM H. WIDEN^{*}

INTRODUCTION

Legislators have often shown a disposition to follow the counsels of equality under the name of *equity* to which greater latitude has been conceded than to *justice*: but, this idea of equity, vague and ill developed, has rather seemed a matter of instinct than of calculation. It is only by much patience and order that a multitude of incoherent and confused sentiments can be reduced into rigorous propositions—JEREMY BENTHAM.[◇]

In the Owens Corning bankruptcy case, the allocation of approximately US \$1 billion turns on the application of the arcane equity doctrine of substantive consolidation. A district court judge had ordered the substantive consolidation of various Owens Corning subsidiaries to facilitate a plan of reorganization.¹ In substantive consolidation, the inter-company 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 recovery, for better or worse, that individual creditors would receive in the absence of a consolidation.² The 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. The order benefited various unsecured bond holders and trade creditors to the detriment of a syndicated lending group. The Third Circuit reversed,³ siding with the syndicated lenders who argued that the facts did not support use of substantive consolidation doctrine.

^{*} Associate Professor, University of Miami School of Law; Professor Widen practiced corporate and commercial law at Cravath, Swaine & Moore in New York City from 1984 to 2001, where he was a partner from 1991. I am grateful for advice and database assistance from Professor Lynn M. LoPucki at the UCLA School of Law; without his bankruptcy database, it would not have been possible to start my exploration of the prevalence of substantive consolidation in bankruptcy. I am grateful for valuable discussions with Caroline Bradley, David Carlson, Michael Froomkin, Stephen Halpert, Fran Hill, Elliott Manning, George Mundstock, Patricia Redmond, Robert Rosen and Stephen Vladeck.

[◇] THEORY OF LEGISLATION, VOL. I 134 (1840).

¹ *In re Owens Corning*, 316 B.R. 168 (Bankr. D. Del. 2004).

² Examples of the procedure appear hereinafter in Part I. The Structure of the Owens Corning Dispute and Part IV. The Efficiency Promotion Rationale.

³ *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), *petitions for cert. filed* 74 USLW 3395 (Dec. 23, 2005) and 74 USLW 3443 (Jan. 26, 2006).

Though any billion dollar decision focuses the mind, the case has larger ramifications. For three principal reasons, *Owens Corning* holds highest significance for commercial finance. 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.⁴

Second, the mere threat of substantive consolidation provides an impetus for creditors in non-structured financings to reach agreement on reorganization plans for fear of the consequences of non-agreement. The recently confirmed reorganization plans for Worldcom, Inc., Enron Corp. and Conseco, Inc.—the three largest bankrupt companies ever reorganized in the United States—all reflect this influence. Bargaining over the structure of reorganization plans takes place in the shadow of the doctrine of substantive consolidation.⁵

Third, the possibility of substantive consolidation informs and shapes the restructuring of debtors with unsecured syndicated financing. Syndicated finance is one of the largest capital markets in the world, often using unsecured guarantees as part of a financing structure. Before *Owens Corning*, the marketplace considered the presence of these guarantees as a reason to impose substantive consolidation. In a complete reversal, *Owens Corning* transforms intercompany guarantees into a tool to oppose substantive consolidation. Substantive consolidation case law does not currently theorize how to address the special problems presented by syndicated lending.

The first two considerations pull in opposite directions. The securitization industry prefers significant limits on the scope of substantive consolidation. It hovers between panic and dread whenever a judge, like the district court judge in *Owens Corning*, 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*, proposes new limits on application of the

⁴ See, e.g., STANDARD & POOR'S CORPORATION, LEGAL CRITERIA FOR U.S. STRUCTURED FINANCE TRANSACTIONS, 43-53, (Apr. 1, 2004) (discussing special purpose entities) available at http://www2.standardpoors.com/spf/fixedincome/SF_legal_criteria_FINAL.pdf (last visited Mar. 16, 2006).

⁵ See, e.g., Robert N. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979); Robert Cooter & Stephen Marks (with Robert Mnookin), *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982); Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621 (2003).

doctrine.

If the practical threat of substantive consolidation disappears, then so does a leverage point to negotiate certain types of reorganization plans. 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,⁶ but attention has not focused on how syndicated lending practices may disadvantage this same group by other means. This Article shows how substantive consolidation may reduce this disadvantage.

The *Owens Corning* decisions collectively manifest a failure of courts to articulate clear parameters for 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 existing doctrine and offers a way forward for development of the doctrine that remains sensitive to the needs of these two important areas of finance while also preserving some balance in reorganization negotiations.

First, this Article shows how and why substantive consolidation doctrine profoundly affects America's largest insolvency cases. It begins by examining details of the Owens Corning bankruptcy and then looks more broadly at recent large reorganizations. Second, the Article goes behind the case law rhetoric, encumbered as it is by a plethora of factors and tests, to suggest three rationales for the use of substantive consolidation: an economic rationale, an equitable rationale grounded in corporate law veil piercing and an equitable rationale grounded in historical considerations of fairness, originating with doctrines of marshalling. In each case, the purpose is to explain how substantive consolidation doctrine should be formulated, and not merely describe its current state of development.⁷ Third, the 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

⁶ See, e.g., SYMPOSIUM, *The Priority of Secured Debt*, 82 CORNELL L. REV. 1279 (1997). Discussion of a carve-out to secured credit to address fairness concerns originated with Professor Elizabeth Warren at Harvard.

⁷ Many articles collect 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 synthesizes and rationalizes the doctrine in a manner that helps to systematically decide future cases.

⁸ 527 U.S. 308 (1999).

in equity practice as it existed in 1789, absent a subsequent grant of statutory authority. 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.

On a broader level, the prevalence of substantive consolidation in our largest bankruptcies teaches us something about corporate form in action, supplementing recent corporate law scholarship. The signature book guiding current corporate law debates—*The Anatomy of Corporate Law*⁹—does not explore either the impact of insolvency law on corporate form or the special problems raised by corporate groups.¹⁰ 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 “affirmative asset partitioning.”¹¹ Because affirmative asset partitioning breaks down within corporate groups under the stress of insolvency, I argue that we must choose between a context sensitive and a context neutral rule for evaluating the effectiveness of asset partitions created using the corporate form.

I start 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.

I. THE STRUCTURE OF THE OWENS CORNING DISPUTE

The chart below illustrates, in a simplified format, what is at stake in the *Owens Corning* decisions. In the example Owens Corning’s 17 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.

⁹ REINIER KRAAKMAN ET. AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* (2004).

¹⁰ See David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 *YALE L.J.* 1519, 1522 (2004) (book review of *THE ANATOMY OF CORPORATE LAW*).

¹¹ See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 *YALE L.J.* 387 (2000) [hereinafter “Hansmann & Kraakman”]. Asset partitioning has two facets: providing a barrier between claims of corporate creditors and investors and preventing liquidation of assets committed to a business by individual shareholders.

Legal Entities	Asset Values	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 each of SubOne and SubTwo. These two other claims exist because the lenders required that SubOne and SubTwo provide upstream guarantees of their 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 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 group¹² may achieve 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 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 chart illustrates the situation if substantive consolidation breaks down the asset partitions created by the separate subsidiaries, eliminating intercompany liabilities. The

¹² Readers must distinguish between (i) procedural consolidation, (ii) substantive consolidation and (iii) 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 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.

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 50 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 debtors started the proceeding that requested substantive consolidation prior to formal consideration of a reorganization plan. 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 start all over again if the court disallowed consolidation at a later stage. 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 that do not matter to this analysis.

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 substantial identity between the [OC Parent] and its wholly-owned subsidiaries.”¹³ 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 establishment of subsidiaries for the convenience of the parent (particularly for tax reasons),¹⁴ all supported this finding.

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

¹³ 316 B.R. at 171.

¹⁴ Several of the most valuable subsidiaries in the Owens Corning consolidated group that provided guarantees to the lending syndicate are tax shelters. As an example, Owens Corning Fiberglass Technologies, Inc. (“OCFT”), a common 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. The state tax benefits are twofold: consolidated group members get a state tax royalty deduction in their home states, while 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*, *Geoffrey v. South Carolina Tax Comm.*, 313 S.C. 15 (S.C. Supreme Ct. 1993), *cert. denied*, 510 U.S. 992 (1993); *Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505 (Mass. Supreme Ct. 2002); *A & F Trademark, Inc. v. Tolson*, 167 N.C. App. 150 (N.C. Ct. App. 2004); *Lanco, Inc. v. Division of Taxation*, 379 N.J. Super. 562 (N.J. Super. Ct. 2005).

payments¹⁵ and resolving outstanding assertions that the lending syndicate's guarantees should be voided as fraudulent conveyances.¹⁶ For the district judge, this made a prima facie case for substantive consolidation.

The lending syndicate did not rebut this prima facie case to the judge's satisfaction because he found that, though the syndicate had relied on guarantees to prevent others from achieving priority, in reality the syndicate relied on the overall credit of the consolidated group. For example, the lending syndicate received consolidated financial reporting only and did not monitor the separate debt level at the subsidiary guarantors.

The Third Circuit reversed. It suggested that the substantial identity between parent and subsidiaries created by centralized management are ordinarily found in consolidated groups. It deemed problems over calculation of interest and royalty payments relatively minor. Without minimizing fraudulent conveyance concerns over intercompany guarantees, it felt those issues should be handled separately, and not as part of a motion for substantive consolidation. 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 did rely on the guarantees for priority, and not merely to assure parity.¹⁷ 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.

¹⁵ Royalty payment calculations that caused accounting problems relate to the intellectual property holding company tax shelter described above. *See supra* note 14.

¹⁶ 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).

¹⁷ One of the petitions for certiorari makes much of the fact that the Third Circuit did not give proper deference to the fact finding of the District Court. *See* 74 USLW 3395 (Dec. 23, 2005). 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*, 286 B.R. 532, 541-43 (Bankr. D. Del. 2002).

II. THE PREVALENCE OF SUBSTANTIVE CONSOLIDATION

A. AN UNCOMMON REMEDY?

Courts and litigants who oppose imposition of substantive consolidation often claim that use of the doctrine is extraordinary.¹⁸ 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.¹⁹ 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. In fact, substantive consolidation appears frequently in negotiated plans for our largest Chapter 11 reorganizations. An empirical study of the 21 largest corporate bankruptcy filings from 2000 to 2004,²⁰ ranked by asset size,²¹ reveals that substantive consolidation was imposed, proposed or settled in 11 of those cases. Eight of the top 10 bankruptcies constituted “Substantive Consolidation Bankruptcies” as defined in the study.²²

The contrast between the constant caution against widespread use of the doctrine in reported decisions and its common use in negotiated plans of

¹⁸ There is almost unanimous judicial consensus that the remedy is to be used sparingly. *See In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005); *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, Ltd.*, 935 F.2d 245, 248 (11th Cir. 1991) (noting that substantive consolidation should be used “sparingly”).

¹⁹ *See* Brief of Law Professors as Amicus Curiae in *Owens Corning* before the Third Circuit in opposition to imposition of substantive consolidation.

²⁰ *See* William H. Widen, *Prevalence of Substantive Consolidation in Large Bankruptcies from 2000-2004: Preliminary Results*, AM. BANKR. INST. L. REV. (forthcoming May 2006), available at SSRN: <http://ssrn.com/abstract=878388>. [hereinafter “*Prevalence of Substantive Consolidation*”]

²¹ The ranking of bankruptcy cases based on pre-filing asset size comes from WebBRD which adjusts asset size to current dollars. The Owens Corning bankruptcy is the twenty first largest bankruptcy filed during the 2000-2004 time period. WebBRD is a database maintained by Professor Lynn M. Lopucki at the UCLA School of Law. *See* Lynn M. LoPucki, WebBRD: Lynn M. LoPucki’s Bankruptcy Research Database, at <http://lopucki.law.ucla.edu/index.htm> (last visited Dec. 21, 2005). Professor LoPucki provided valuable insights into the advantages and disadvantages of various definitions that might be used to analyze data.

²² 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. 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 Prevalence of Substantive Consolidation*, *supra* note 20.

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 (a) in consideration of settlement of actual or potential litigation involving substantive consolidation and (b) in approving liquidations and reorganizations that impose substantive consolidation in some form.

Settlement of substantive consolidation litigation takes place in the shadow of 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.²³

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.²⁴

Many reported decisions reflect court approval of settlement of substantive consolidation litigation.²⁵

Courts consider substantive consolidation doctrine in detail when confirming plans that provide for substantive consolidation.²⁶ This

²³ Protective Comm. For Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 428 (1968) (holding that a bankruptcy court may approve a fair and equitable settlement that is not “below the lowest point in the range of reasonableness”). 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.”

²⁴ *Id.* at 444-45 (citation omitted).

²⁵ See, e.g., *In re Stoecker*, 125 B.R. 767, 774 (Bankr. N.D. Ill. 1991); *In re Resorts Int'l, Inc.*, 145 B.R. 412, 418, 459 (Bankr. D. N.J. 1990); *In re Apex Oil Co.*, 118 B.R. 683, 688 (Bankr. E.D. Mo. 1990); see also *In re Enron*, Findings of Fact and 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, Case No. 01-16034 (AJG), (Bankr. S.D.N.Y. July 15, 2004). 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.

²⁶ See, e.g., *In re Lisanti*, 329 B.R. 491, 497-99 (D. N.J. 2005); see also *In re Worldcom Inc.*, No. 02-13533, 2003 WL 23861928, at *6-16 (Bankr. S.D.N.Y. Oct. 31, 2003).

consideration often occurs in the context of some opposition to a plan.²⁷ However, in *In re Standard Brands Paint*,²⁸ the court considered the propriety of a “deemed” consolidation in a reorganization plan even though no party opposed it.

“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.²⁹ The procedure has become known as a “deemed” consolidation.³⁰ Courts disagree over whether deemed consolidations should be considered substantive consolidations at all.³¹ 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.³² This custom tailoring occurs when a court orders something less than a full substantive consolidation to reach a fair, equitable and cost effective result.³³ Indeed, a

²⁷ 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) (“[A] plan proponent must demonstrate that its plan satisfies section 1129(b) by a preponderance of evidence.”). These requirements include that the plan not “discriminate unfairly” and be “fair and equitable” to creditors impaired under the plan who have not voted to accept it. 11 U.S.C. § 1129(b). 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 28. 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.

²⁸ 154 B.R. 563 (Bankr. C.D. Cal. 1993).

²⁹ The earliest reported decision of which I am aware that considers and approves a deemed consolidation is *In re Standard Brands Paint*. *Id.* at 566-67 (indicating that a plan which made distributions as if the entities were combined, but without actually combining the legal entities, was “unusual, maybe unique”). As far as the parties and the court could determine, the plan proposed in *In re Standard Brands Paint* was the first deemed consolidation, though the procedure was not then referred to as a “deemed” consolidation. *Id.* at 573.

³⁰ See *In re Genesis Health Ventures, Inc.*, 402 F.3d 416 (3d Cir. 2005) (containing a description of a deemed consolidation by the author of the Third Circuit’s *Owens Corning* decision).

³¹ *Id.*

³² The possible Constitutional limitations on the use of equity by courts exercising bankruptcy jurisdiction are discussed hereinafter in Part VII. Constitutional Concerns Over Evolution of Equity Principles.

³³ As an equitable doctrine, some courts expressly have recognized that they may modify or adjust the effects of substantive consolidation to fit the circumstances of the case. See *In re*

deemed consolidation may save costs compared to a full consolidation, including eliminating the need to re-title property and obtain new business qualifications, leaving more value for creditors in a reorganized company.³⁴

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. AN ECONOMIC EXPLANATION

In his examination of the role of transaction costs in determining the size of firms,³⁵ 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). 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.³⁶

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 product, set prices and bargain with others, together with procedures within which managers make these decisions (such as those found in certificates of incorporation and by-laws). 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

Standard Brands Paints, 154 B.R. at 570; *In re Parkway Calabasas*, 89 B.R. 832 (Bankr. C.D. Cal. 1988). Under the 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.

³⁴ In *In re Standard Brands Paint*, for example, tax considerations strongly favored a deemed consolidation without the actual combination of legal entities. 154 B.R. at 565. An actual combination would have triggered cancellation of indebtedness income for state tax purposes. *Id.*

³⁵ Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMETRICA* 386 (1937).

³⁶ 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 complementary. See Saul Levmore, *Irreversibility and the Law: The Size of Firms and Other Organizations*, 18 *J. CORP. L.* 333, 334 n. 2 (1993).

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.³⁷

From the narrow perspective of closing the acquisition at 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 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. (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 by laws). Because the prospect of transaction cost savings motivated internalization in the first place, we should expect the redundancies to atrophy, particularly if special circumstances do not motivate the acquiring firm to maintain them.³⁸

Here it is important to focus upon 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

³⁷ The acquisition of shares often requires additional procedures such as preparation of disclosure materials, shareholder votes, director votes and government approvals, such as anti-trust 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.

³⁸ The business combination between RJR and Nabisco provides an obvious example. The parties went to great lengths 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. 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 and McGraw*, 189 N.E. 234 (N.Y. 1934); ROBERT CHARLES CLARK, *CORPORATE LAW*, 781-788 (1986, Little Brown & Co.); *accord* Expert Report of Jonathan R. Macey, *infra* note 170.

*Fish v. East*³⁹ provides a representative list of factors for determining when a substantial identity exists between parent and subsidiary. 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 translate into this 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 subsidiary management mirror that of the parent.⁴⁰ To save costs, the acquiring company often centralizes capital raising and cash management activities.⁴¹ 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* that particularly concerns companies who internally create SPCs for securitization transactions.⁴² 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

³⁹ 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”). Factors cited include (a) the parent owns all or a majority of the capital stock of the subsidiary; (b) there are common directors and officers; (c) the parent corporation finances the subsidiary; (d) the parent corporation is responsible for incorporation of the subsidiary; (e) the subsidiary has grossly inadequate capital; (f) the parent company pays the salaries or expenses or losses of the subsidiary; (g) the subsidiary has no independent business from the parent; (h) the subsidiary is commonly referred to as a subsidiary or as a department or a division of the parent; (i) directors and executive officers of the subsidiary do not act independently but take direction from the parent; and (j) the formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

⁴⁰ If the acquiring company is a public company, it typically does not insert outside directors onto the boards of its internal subsidiaries because, among other problems, such a move would increase the costs of internal decision making—the cost of providing information to outside directors being an example.

⁴¹ 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 CARD. L. REV. 1577 (2004).

⁴² 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 being the survivor in the merger.

products to other members of the corporate group. The new subsidiary 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. Lastly, formalities associated with internal asset transfers and corporate meetings typically suffer, with preparation of evidence of these transactions and meetings 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 because the internal transactions often do not really matter—it is not like third party negotiations because mistakes easily can 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 reasons⁴³ 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 at the level of theory we should expect acquiring companies to take steps that create a substantial identity between the target and the acquiring company.

The economic theory predicts that growing firms will create the very environment that breeds substantive consolidation. The empirical survey of use of substantive consolidation in large bankruptcies⁴⁴ supports what this theory predicts. The substantial identity between a parent company and its subsidiaries exists in a wide variety of cases precisely because creation of that identity of interest produces the very cost savings that motivated the construction of the consolidated corporate group in the first place.

The above remarks reveal potential context sensitivity to the corporate form in action. 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

⁴³ 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. However, to the extent the theory provides 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.

⁴⁴ See *Prevalence of Substantive Consolidation*, *supra* note 20.

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. With any corporation, a variety of prior performative acts imbued with legal meaning, such as capital contributions and asset acquisitions, identified, collected and segregated 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 to identify, collect and segregate those assets under a new name.

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 many transactions. 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.⁴⁵ 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.⁴⁶ Transactions *internal* to

⁴⁵ In practice, I have been involved in numerous transactions in which (i) the parent could not provide a list of all its subsidiaries without extensive due diligence, (ii) the parent could not provide an accurate list of the officers and directors of its subsidiaries, (iii) when a list of officers and directors of subsidiaries was provided, many of the named individuals had retired or died, (iv) no share certificates existed bearing the current names of the subsidiaries (often because the subsidiaries were acquired in a merger), (v) when minute books could be found, the most recent entries were many years old and (vi) 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.

⁴⁶ The problem is not simply 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

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.⁴⁷

In summary, we find three key functions performed by the corporate form: (i) asset partitioning, (ii) artificial personality, and (iii) asset identification. All three functions operate actively when the corporation is independent. When, however, the corporation becomes a subsidiary, 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.

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. However, 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. REVISITING AN OLD DEBATE OVER DEFAULT RULES

In the mid-1970's, 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; and, (then Professor) Richard Posner objected.⁴⁸ The Landers' proposal amounts to a reversal of

problems raised by the ongoing identification of assets to particular subsidiaries on a case by case basis only when confronted with an actual third party transaction.

⁴⁷ 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.

⁴⁸ See Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975); Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976); Jonathan M. Landers, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, 43 U. CHI. L. REV. 527 (1976). Landers' 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. It included a proposal to

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 proposed a law change 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 for its not being grounded in sound economic analysis of debtor-creditor relationships, concluding 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; further, he gave reasons to believe the opposite. 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.

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

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.⁴⁹

On the narrow issue, I must side with Judge Posner, but for a limited reason. I am unable to say whether or not adopting Landers' 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 would those increased contracting costs compare to the costs of contracting around the existing default rule? I am unable to make a guess, let alone a calculation.⁵⁰ However, I can identify a context in which a strong case can be made that Landers' proposed default rule would save costs—the

subordinate the debt claims of affiliated companies to the debt claims of independent third parties.

⁴⁹ See Posner, *supra* note 48, at 506.

⁵⁰ Judge Posner believed that the existing default rule respecting the asset partition of the corporate form could be shown more efficient by arguments explaining what rational debtors and creditors should prefer. I am unprepared to argue for the efficiency of the existing scheme. I simply do not believe that argument for a change can be based on global efficiency. For a discussion of epistemological problems with broad efficiency based arguments see William H. Widen, *Spectres of Law & Economics*, 102 MICH. L. REV. 1423 (2004).

signature example being unsecured syndicated lending. Ironically, Professor Landers identified professional financiers⁵¹ as one class of creditor that did not need help from his enterprise liability theory precisely because they created substantive consolidation by contract using guarantees.⁵² 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 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 (i) due diligence to identify the subsidiaries, (ii) corporate authorization to approve the guarantees, (iii) the documentation to evidence the guarantees, (iv) the legal opinions to confirm the effectiveness of the guarantees and (v) ongoing monitoring to make sure that required additional guarantees are provided, 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. Lastly, 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.

Professor Landers recognized 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. The contractual solution achieved by the guarantees is, however,

⁵¹ 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 H M Anglo-American, Ltd. and Imperial Investments (Grosvenor) Limited to acquire Kidde, Inc. This transaction was the first of its kind, 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*, BUSINESSWEEK, Oct. 27, 1997, at ___ (Noting that "[f]ew 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.").

⁵² See Landers, *supra* note 48, 43 U. CHI. L. REV. at 531 n. 11.

an approximation of Landers' model, rather than a precise replication.⁵³ Were Landers' default rule adopted, then other creditor groups who might prefer the existing default rule would be forced to contract around the mandatory consolidation.⁵⁴ One group that certainly would object to the new 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 Lander's proposed default rule is unclear.⁵⁵ Certain borrowers who structure their affairs around "internal capital markets" similarly might wish to contract around the proposed default rule.⁵⁶

Though no legislative proposal is pending to enact Lander's context sensitive default rule into corporate law,⁵⁷ 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 groups to produce this substantial

⁵³ 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.

⁵⁴ 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 (Code year).

⁵⁵ 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. At the time of his debate with Posner, the securitization industry did not exist.

⁵⁶ 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).

⁵⁷ 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. 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 *U.S. v. Bestfoods*, 524 U.S. 51 (1998).

identity. If I have made the case that significant numbers of large American corporate groups carry the substantive consolidation “virus,” 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.

III. DUELING STANDARDS FOR SUBSTANTIVE CONSOLIDATION

A. THE VIEW FROM THE MARKET

Substantive consolidation opinions issued by law firms,⁵⁸ going back to the 1980’s, 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

⁵⁸ 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 “non-consolidation letter.”

practice experience during which I was one of the principal drafters and reviewers of non-consolidation legal opinions at my firm.⁵⁹

What I consider the modern rationale for substantive consolidation surfaces in Second Circuit cases.⁶⁰ 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. In some cases, it may be impossible to separate the financial affairs of members of a corporate group. 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 savings, this justification relies on economic efficiency to support use of substantive consolidation.

The former Bankruptcy Act and the current Bankruptcy Code both reflect the important goal of cost reduction.⁶¹ 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 to particular corporate names, and not to destruction of artificial personality.

⁵⁹ 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.

⁶⁰ See *Union Savings Bank v. Augie/Restivo Baking Co.*, 860 F.2d 515 (2d Cir. 1988); *Flora Mir Corp. v. Dickson & Co.*, 432 F.2d 1060 (2d Cir. 1970); *Chemical Bank v. Kheel*, 369 F.2d 845 (2d Cir. 1966); see also *Commercial Envelope Mfg.*, 3 B.C.D. 647 (Bankr. S.D.N.Y. 1977); *accord Reider v. Fed. Deposit Ins. Corp. (In re Reider)*, 31 F.3d 1102, 1105-06 (11th Cir. 1994). The Second Circuit introduced the term “substantive consolidation.” See *In re Cont’l Vending Mach. Corp.*, 517 F.2d 997 (2d Cir. 1975).

⁶¹ 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. U.S.*, 419 U.S. 43, 53 (1974) (noting “an overriding concern in the Act with keeping the 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 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., *N.L.R.B. v. Bildisco & Bildisco*, 465 US 513, 517 n.1 (1984) (noting that Congress enacted the Bankruptcy Code “with the intention that business reorganizations should be quicker and more efficient ...”) (citing HR Rep. No. 595, 5 (1977)); 9 *COLLIER ON BANKRUPTCY* 1001 (Lawrence P. King et al. eds., 15th ed., rev. 2005). The Bankruptcy Rules 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”).

The second rationale for substantive consolidation traces its origins to veil piercing doctrine⁶² and *dicta* in a Supreme Court case.⁶³ In a corporate 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. The corporate form has, as one of its primary functions, the role of insulating the shareholders from the creditors of the corporation by forming an asset partition, shielding personal assets from business activity risks.⁶⁴ 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 the veil piercing action, plaintiffs allege that the corporation is either the "alter ego" or a "mere instrumentality" of the shareholders, as evidenced by 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.⁶⁵ 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.⁶⁶ Substantive consolidation doctrine applies this theory of respect for corporate form within the corporate group, recognizing that a parent company functions as shareholder for its subsidiary, just as an individual may function as shareholder for a single corporation. If factors exist to support veil piercing outside of bankruptcy, then they also support

⁶² See *Stone v. Eacho (In re Tip Top Tailors, Inc.)*, 127 F.2d 284, 288 (4th Cir. 1942); *Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940). The veil piercing rationale continued into the 1960s, see *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446, 448 (2d Cir. 1964), and the 1970s, see *In re Conti'l Vending Mach. Corp.*, 517 F.2d at 997, while the modern economic efficiency rationale was being developed. By borrowing from state 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 co-exist. 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).

⁶³ See *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941).

⁶⁴ See *Hansmann & Kraakman supra* note 11.

⁶⁵ 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 C. Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505 (1977).

⁶⁶ See, e.g., 1 FLETCHER CYCLOPEDIA OF PRIVATE CORP. § 43 (2005).

substantive consolidation in bankruptcy.

Typically, veil piercing involves “upstream” claims by corporate creditors against shareholders.⁶⁷ 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 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 assets of a shareholder, while existing creditors of the shareholder are unable to share in the assets of the corporation. The corporate creditors typically have exhausted 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.⁶⁸

In a consolidated group, the parent company forms the primary asset partition between individual shareholders and creditors of group members. Courts tend to respect this primary separation between individual investors and corporate group creditors even if they ignore the various asset partitions created by subsidiaries within the consolidated group. Thus, substantive consolidation within the corporate group typically does not also lead to a veil piercing action against shareholders. This pattern appears, not surprisingly, with particular force when the parent company has a large, widely dispersed investor base.

The veil piercing justification for substantive consolidation is particularly important for 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, creating a justified impression of under-theorized chaos.⁶⁹ When

⁶⁷ 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. Engleberg*, 92 P. 2d 935 (1939).

⁶⁸ For classic presentations of equitable subordination, see *Taylor v. Standard Gas & Elec. Co. (Deep Rock)*, 306 U.S. 307 (1939); *Pepper v. Litton*, 308 U.S. 295 (1939).

⁶⁹ In this respect I am in complete agreement with the academic brief filed with the Third Circuit in *Owens Corning*. *See supra* note 19.

importing these factors into the substantive consolidation context, courts often forget the traditional veil piercing requirement that misuse of the corporate form contribute to a harm. The veil piercing rationale for substantive consolidation finds itself distanced from its origins, creating the risk that a simple finding of substantial identity might trigger a substantive consolidation. To make matters worse, courts often combine the economic rationale with the (often scaled down) veil piercing rationale.

B. THE MUDDLE IN THE COURTS

Consideration of the two most celebrated articulations of 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.*,⁷⁰ 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.”⁷¹ Though the court clearly contemplates a disjunctive test, the first “veil piercing” branch allows substantive consolidation without a prior finding that the remedy is needed to correct an identified “wrong,” though it adds to the “single economic unit” requirement that a reliance interest not be destroyed. In approving the *Augie/Restivo* test,⁷² the Third Circuit’s *Owens Corning* test suffers from this defect. The second “economic” rationale in *Augie/Restivo* retains a link to the requirement of substantial identity with its metaphor of entanglement, but it 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.*⁷³ 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 realize some benefit. 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.⁷⁴ The *Auto-Train* test mixes the economic

⁷⁰ 860 F.2d 515 (2d Cir. 1988).

⁷¹ *Id.* at 518.

⁷² 419 F.3d at 210.

⁷³ 810 F.2d 270, 276 (C.A.D.C. 1987).

⁷⁴ 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 the consolidation. If reliance and prejudice are shown, then the consolidation is not proper. *See* 316 B.R. at 171.

rationale with the veil piercing rationale, and, in the process, sanctions a pure wealth transfer from one creditor class to another creditor class on mere economic grounds. Further, the balancing of benefit against harm is inconsistent with *Augie/Restivo*'s notion of "benefit to all creditors."

Understanding fully the two justifications for use of substantive consolidation requires a distinction between two types of creditor "harm." The first type occurs whenever a creditor experiences a "decreased distribution" in consolidation. The second type occurs whenever a creditor is "wronged." A wrong results when a court defeats a creditor's reasonable reliance on the separate existence of a particular legal entity. This happens when a court interferes with a specific contract right that a creditor enjoys that protects the separate legal status of the entity relied upon. Such a right does not exist merely because a creditor has contracted with a particular debtor because a creditor does not, in the usual case, have a right to prevent a debtor from entering into business combinations.⁷⁵ Specific contract protection of separateness must exist for reliance in this sense.

On this analysis, substantive consolidation does not produce a "wrong" simply because the consolidation produces a wealth transfer. The two types of "harm" are distinct. The Third Circuit's *Owens Corning* decision strongly supports 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. Instead of relying on this wealth transfer, the Third Circuit believed it needed to find separate creditor reliance on the individual guarantors. Without this reliance, the lower court's imposition of substantive consolidation would have been proper despite the wealth transfer.

C. AN EXAMPLE OF MISPLACED RELIANCE

I am confident that the Third Circuit made an error in *Owens Corning* by finding loan syndicate reliance on inter-company guarantees (despite the amicus support from the Loan Syndications and Trading Association).⁷⁶ A lending syndicate typically employs a web of inter-company guarantees defensively, rather than offensively. A defensive use of inter-company guarantees insures that no subsidiary creditor has structural seniority over the syndicate's loans.⁷⁷ This protection allows the syndicate confidently to

⁷⁵ See *infra* note 79.

⁷⁶ The Loan Syndications and Trading Association is the industry association that advances the interests of lenders participating in the syndicated lending market.

⁷⁷ The structure of syndicated lending and its use of guarantees is explained in William H.

rely upon consolidated financial statements and consolidated financial tests to monitor the corporate group as a single economic unit. Testimony from lending syndicate representatives suggest this defensive use in the Owens Corning credit agreement, though the Third Circuit drew the opposite conclusion from its understanding of what it called “Lending 101.”⁷⁸

A lending syndicate uses corporate form to insure a priority position—an offensive posture—only when it takes affirmative steps to insure that the asset partitions created by the separate corporate forms within the consolidate 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.⁷⁹ 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, 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 insure the integrity of the asset partition.⁸⁰ The most extensive affirmative steps to insure integrity of an asset partition occur in securitization transactions because the asset partition between the SPC and

Widen, *Lord of the Liens: Towards Greater Efficiency in Secured Syndicated Lending*, 25 CARD. L. REV. 1577 (2004).

⁷⁸ Compare 419 F.3d at 212 with *In re Owens Corning*, Case Nos 00-03837 to 3854 (JKF), Post-Hearing Brief in Support of Substantive Consolidation, 52-73 (Aug. 6, 2004) (excerpting lender testimony). For example, a lead credit officer supervising the loan agreement testified that the only purpose of the guarantees was to avoid structural subordination. *Id.* at 57.

⁷⁹ See, e.g., *Cole v. Nat’l Cash Credit Ass’n*, 18 Del. Ch. 47, 156 A. 183 (1931) (stating “it 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”). Significantly, in the merger in *Cole*, the financial condition of the combined company was less sound, as evidenced by its quick ratio, than the prior stand alone company against which the complaining creditor had a claim.

The fact that the quick asset condition of the consolidated company will, in relation to its liabilities, render it less desirable as a debtor from the viewpoint of current financial soundness than the constituent debtor, if true as alleged, cannot serve to justify an enjoining of the consolidation on the creditor's complaint.

Id. at 186. The court's reasoning depended, in part, on the notion that the creditor retained a 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.

⁸⁰ 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 (10th Cir. 1979).

other consolidated group members must survive to an investment grade level of certainty.

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) because it interpreted the loan agreement to prohibit the merger of subsidiaries with the parent. The lower court did not provide a specific interpretation of the merger covenant in its opinion, though it found an absence of creditor reliance.⁸¹ My reading of the loan agreement leads me to believe that the Owens Corning subsidiaries could merge with both themselves and with the parent, though in fairness to the Third Circuit, the drafting could have been clearer.⁸²

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. In fact, so long as no material adverse effect resulted to the consolidated group, the only entity that had to maintain its corporate existence to avoid default is the parent company.⁸³ I suspect the court did not consider these alternate structural

⁸¹ At the hearing, Judge Wollin remarked that he found Section 8.09 “potentially ambiguous,” though Judge Fullam authored the lower court opinion. See Brief in Support, *supra* note 78.

⁸² The prohibition on mergers appears in Section 8.09 of the credit agreement and provides:

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.

See Owens Corning Form 10Q—Quarterly report (accepted July 24, 1997), available at <http://www.sec.gov/Archives/edgar/data/75234/0000075234-97-000012-index.html>.

⁸³ 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 material adverse effect on the consolidated group. The provision provides in relevant part:

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, . . .

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 provided 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. The Third Circuit apparently viewed this threshold as further evidence of affirmative lender reliance, 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 guarantee value supports outstanding loan amounts.⁸⁴

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 periodically must certify to the lending syndicate that the borrower is in compliance with the terms of its loan agreement.⁸⁵ A \$30 million guarantee threshold is low

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.*

⁸⁴ 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 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.

⁸⁵ Kenneth Lay, formerly of Enron, faces 11 counts in an indictment, 4 of which assert that he made false statements to banks from whom he had made margin borrowings. This criminal indictment merely highlights why members of management take care to avoid making false statements to lending syndicates.

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 because such a scheme would provide 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.⁸⁶

Many debtors will enter bankruptcy with unsecured inter-company guarantees in place. *Owens Corning* gives lending syndicates holding guarantees a veto right over any plan of reorganization that proposes use of substantive consolidation to implement the plan. The Third Circuit's decision changes the structure of negotiations in cases where inter-company 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 a good credit rating entitles them access to 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 non-reliance on such covenants is simple. The market believed that the presence of inter-company guarantees virtually assured that imposition of substantive consolidation would be proper for any companies forming part of an inter-company guarantee web (and no competent counsel would have opined

⁸⁶ 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 (Code year).

otherwise).⁸⁷ In *Owens Corning*, rather than being presented with a *bona fide* case of reliance on asset partitions, we have a case of musical chairs in which the lending syndicate found a seat when the music stopped.

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 and then to the veil piercing rationale. Lastly, I formulate a new rationale for substantive consolidation based on traditional fairness considerations.

IV. THE EFFICIENCY PROMOTION RATIONALE

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.

Legal Entities	Asset Values	Big Bank	Factor Co.	Local Bank
A	\$750	\$1000	-0-	-0-
B	\$500	-0-	\$1000	-0-
C	\$250	-0-	-0-	\$1000
Consolidated	\$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. Only 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.

⁸⁷ See, e.g., *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991); *Bruce Energy Ctr. Ltd. v. Orfa Corp. of Am. (In re Orfa Corp. of Philadelphia)*, 129 B.R. 404 (Bankr. E.D. Pa. 1991); *In re Amereco Envtl. Servs., Inc.*, 125 B.R. 566 (Bankr. W.D. Mo. 1991); *In re Manzey Land & Cattle Co.*, 17 B.R. 332 (Bankr. D. S.D. 1982); *In re Snider Bros. Inc.*, 18 B.R. 230 (Bankr. D. Mass. 1982); *In re Commercial Envelope Mfg. Co.*, No 76 B2354, 1977 Bankr. LEXIS 15, at *15 (Bankr. S.D.N.Y. Aug. 22, 1977).

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 rhetoric of “necessity” to justify use of substantive consolidation. When the facts of a case reflect extremely poor record keeping, a failure to observe company formalities, and similar deficiencies, this rhetoric actually may match a situation of true impossibility that forensic accountants are unable to reconstruct. 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.⁸⁸ I consider such a situation a proper one for use of the “necessity” rhetoric. In true cases of necessity, poor record keeping and failure to observe corporate formalities may explain the break down in the asset identification function. However, such shortcomings should not be seen, in themselves, as reasons for imposition of substantive consolidation *on the grounds of necessity*.⁸⁹

⁸⁸ I term a *pro rata* distribution the “only” practical alternative based on my assumption of what distributional schemes will satisfy collective notions of fairness. In cases of shortage, allocation of available resources, *pro rata* based 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 a loss of happiness to each individual, more or less great, according to the proportion between the portion he loses and the portion he retains. Take away the fourth part of his fortune, and you take away the fourth part of his happiness; and so of the rest.”

JEREMY BENTHAM, PRINCIPLES OF THE CIVIL CODE, PART 1, OBJECTS OF THE CIVIL LAW, CHAPTER 6.

This notion has grounding 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 were 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.

⁸⁹ Some fear that poor record keeping and failure to observe corporate formalities may constitute separate and independent grounds for imposition of substantive consolidation. I

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,⁹⁰ one party requested that each individual debtor in the procedurally consolidated cases be represented by an independent fiduciary and an independent counsel.⁹¹ 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: (i) the poor quality of corporate recordkeeping⁹² and (ii) 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 business recordkeeping often quite poor,⁹³ even in well run businesses. Many courts considering substantive consolidation will be able to conclude that it is, in some sense, “impossible” to accurately identify 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 inter-company 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.⁹⁴

argue that such failures do not justify ignoring the separate entity form unless one of my three rationales for substantive consolidation is met.

⁹⁰ *In re Adelphia Communications Corp.*, 333 B.R. 649 (S.D.N.Y. 2005).

⁹¹ *Id.* at 665.

⁹² It would not surprise me to find that insolvent companies, on average, have less comprehensive and accurate record keeping than solvent companies and that poor recordkeeping might contribute to the poor financial condition by providing management with less information. However, I do not know that to be the case and, accordingly, I am not suggesting an independent penalty for failure to keep a clean corporate house. Certainly, some recordkeeping might be inefficient as Coase’s model suggests.

⁹³ *Accord* David Wessel, *Wall Street Is Cleaning Derivatives Mess*, WALL ST. J., Feb. 16, 2006, at A2 (describing 18,000 undocumented credit derivatives trades).

⁹⁴ I do not mean to suggest that such matters need to be proven “beyond a reasonable doubt”

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 administer separate bankruptcy estates. Though pure creative writing should not suffice, what type of evidence should pass muster?⁹⁵

The recordkeeping problem looms large in any case in which the range of the uncertainty related to settling inter-company 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 A Co. owns \$100 of tangible assets and owes Local Bank \$1000, while B Co. owns \$500 of tangible assets and owes Big Bank \$1000. If we analyze this situation before consideration of inter-company 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 inter-company payables and receivables. For example, suppose that, as an historical matter, A Co. and B Co. actively exchanged assets, with A Co. sometimes owing B Co. up to \$50 in net payments and B Co. sometimes owing A Co. up to \$50 in net payments. Suppose that, other than a justified belief in this range, no reliable information allows the level of inter-company 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 inter-company payables least favorable to B Co. (i.e. B Co. owing A Co. \$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.⁹⁶

If no basis exists to set an upper or lower bound on the net inter-company payables and receivables, then substantive consolidation is proper on grounds of necessity. However, in many cases, the court will be able to estimate ranges.⁹⁷ What should a court do if the only determinable facts

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.

⁹⁵ Some courts have attempted to deal with the degree of accounting inaccuracy that will be tolerated. See *R 2 Invs., LDC v. World Access, Inc. (In re World Access, Inc.)*, 301 B.R. 217 (Bankr. N.D. Ill. 2003).

⁹⁶ The Third Circuit perceived this to be the situation in *Owens Corning*. See 419 F.3d 195, 215 n. 26 (3d Cir. 2005).

⁹⁷ At least the parties may think they can set ranges. Some research suggests that bankruptcy

allow the setting of an upper and a lower bound but not fixing any details in between? Again, the existing case law provides little guidance to answer this type of question.⁹⁸

Courts also employ necessity rhetoric to justify imposition of substantive consolidation when no literal impossibility exists. 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.” These second type of cases form the “Pareto Scenario.”

B. THE PARETO SCENARIO

I borrow the label “Pareto” from welfare economics. However, I intend my use 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 least one creditor’s expected recovery is increased by the consolidation. Return to our base example, but now with the introduction of a column to illustrate the impact of transaction costs.

Entities	Values	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 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

participants may not be particularly good at making these kinds of judgments. See LoPucki, *infra* note 107.

⁹⁸ My recommendation in such cases is that courts impose a partial substantive consolidation, but I am not aware of any court that has taken this step. The settlement in Enron provides an example of a partial substantive consolidation in a negotiated settlement context, though the compromise resulted from an assessment of the relative strengths and weaknesses of the substantive consolidation claims, rather than limits on the ability to conduct fact finding.

transaction costs⁹⁹ 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.¹⁰⁰ A controversy will arise in two cases. First, different parties might make honest, but different, estimates concerning the relative costs and benefits of a substantive consolidation 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.

Hold out behavior might arise based solely on facts and circumstances related to that case. But it also may 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

⁹⁹ I use the costs associated with preparing balance sheets as an example. In fact, these costs are merely one type 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.

¹⁰⁰ Nevertheless, case law tells us that a court must make a separate and independent finding that substantive consolidation is justified. *See supra* text accompanying note 28.

within the case.¹⁰¹ Beyond possible different vantage points between judge and creditor, 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 workouts.

However rationalized, courts routinely approve substantive consolidation under the rubric of “benefiting all creditors”—a justification grounded in the promotion of efficiency. The promotion of efficiency has a firm grounding in the history of the Bankruptcy Code and its predecessors.¹⁰² 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.

C. THE KALDOR-HICKS SCENARIO

If a court embraced the “Kaldor-Hicks Improvement Scenario” as justifying substantive consolidation, the court would use the remedy when: (i) those creditors benefiting from the consolidation could afford to pay those creditors harmed by the consolidation and still be better off financially and (ii) those creditors harmed by the consolidation could not afford to bribe those benefiting from the consolidation to forgo the consolidation. Though I again borrow a label from welfare economics, my use of “Kaldor-Hicks” is intended simply as descriptive of financial circumstances affecting a clearly identified group of creditors. An arithmetic example illustrates the point by simply changing the relative transaction costs needed to separately account for each entity.

Entities	Values	Costs	Big Bank	Fator 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

¹⁰¹ 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 multi-stage, multi-player 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.

¹⁰² See *supra* note 61.

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 be better off 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 Kaldor-Hicks improvement 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. 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.¹⁰³ 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 exists, given that the parties are functioning under the umbrella of uncertainty. Creditors who believe (i) they are operating in a Kaldor-Hicks Scenario and (ii) 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 hangs 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 use of substantive consolidation in a Kaldor-Hicks Scenario. For example, Big Bank may accept an aggregate payment of \$75 to approve a consolidation

¹⁰³ 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.

for fear that, even though on the true facts Big Bank should receive \$101 or more, the risk exists that 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-Hick Scenario because negotiations allow each creditor to improve its position. Again, one might question the need for the remedy to apply in this 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 doesn't case law rhetoric 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. 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.

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. 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, while the district judge found substantive consolidation “necessary” to effect the reorganization. Both courts might be correct. We have seen how a case of necessity can overlap with a case of pure wealth transfer. Existing articulation of substantive consolidation doctrine did not allow the district judge the option of imposing partial substantive consolidation to save costs without creating a wealth transfer.¹⁰⁴

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 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.

E. REFORMULATION OF THE ECONOMIC RATIONALE

In summary, case law justifies imposition of substantive consolidation on economic grounds in the Necessity Scenario and the Pareto Scenario. Additionally, courts may 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,

¹⁰⁴ The Third Circuit identified the possibility of a partial consolidation as an open question in *Owens Corning*. See 419 F.3d 195, 210 n.16 (3d Cir. 2005). Case law supports a partial approach in similar contexts. Cf. *Talcott v. Wharton (In re Continental Vending Machine Corp.)*, 517 F.2d 997 (2d Cir. 1975), *cert. denied* 424 U.S. 913 (1976) (noting that a court may qualify substantive consolidation to protect unsecured creditors, while not consolidating secured claims); *In re Pittsburgh Rys. Co.*, 155 F.2d 477 (3 Cir. 1946), *cert. denied*, 329 U.S. 731 (1946) (noting that a court may order consolidation with respect to unsecured claims and leave cases unconsolidated with respect to secured claims). In my mind, 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.

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 rationale support imposition of substantive consolidation *on economic grounds alone* when the consolidation creates a pure wealth transfer. On this reformulation, case law to the contrary should be rejected.¹⁰⁵ 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. However, such a step would be an innovation (though one that I would endorse).¹⁰⁶

The valuation/timing problem for application of 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.¹⁰⁷

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 confidently to make this finding, the parties would need to have already spent the time, effort and expense to prepare separate balance sheets. Yet, avoiding 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 that 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

¹⁰⁵An example of rhetoric to be ignored is the balancing test in *AutoTrain*. See *supra* text accompanying note 74.

¹⁰⁶ See *supra* note 104.

¹⁰⁷ Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L. Q 1341, 1345-46 (2004).

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.

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, however, reveals a separate and distinct justification for substantive consolidation grounded in the rationale originally evolved for corporate law “veil piercing.” Lawyers doing securitization transactions recognize this dual strand of justification for substantive consolidation. Veil piercing cases still merit mention in substantive consolidation legal opinions rendered in structured financings today, attesting to its continued vitality.

V. THE VEIL PIERCING RATIONALE

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 often are not disputed. Nevertheless, 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 indeterminacy of outcome.¹⁰⁸ Factors such as common directors, officers and shared bank accounts present little room for factual disagreement. The argument revolves around the legal effect given to such facts.¹⁰⁹ The problems facing substantive consolidation justified on veil piercing grounds mirrors the problems facing substantive consolidation justified on economic efficiency grounds.

Reflection on the cases, however, 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, it is to be understood that 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

¹⁰⁸ See generally John Zeleznikow, *The Split-Up Project: Induction, Context and Knowledge*, 3 LAW, PROBABILITY & RISK 147 (2004) (describing various sources of open texture in law).

¹⁰⁹ 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”).

loans than in fact exist.¹¹⁰ (This is true whether the deficiency existed at the time of the loan or if it resulted from subsequent transfers.) This explains why, in many early cases, courts employ the substantive consolidation remedy in circumstances that also support use of fraudulent conveyance law to protect creditors. 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.¹¹¹ 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 for the simple purpose of generating an identity among the various companies. Instead, 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 a breakdown in the artificial personality of the consolidated group members. However, in the absence of such a misperception or other wrong, we should not worry about silly things such as whether a special purpose company has a separate phone 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*,¹¹² 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.

¹¹⁰ *Accord* Posner *supra* note 48.

¹¹¹ 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.

¹¹² 318 NLRB 732 (1995).

For the Board, mere failure to observe corporate formalities did not suffice for veil piercing. Disrespecting the corporate form must create, in some sense, a “wrong” which veil piercing corrects. This view conforms to that expressed by federal courts when using veil piercing to further some federal policy.¹¹³ What I am advocating is that the veil piercing rationale for substantive consolidation remember its roots, and require a prior finding of a harm to correct.¹¹⁴

The analytical problems with the rationale for veil piercing were discussed in the 1920’s¹¹⁵ and apply with equal force when used as a rationale for substantive consolidation. At a surface level, veil piercing is justified by a litany of metaphors:¹¹⁶ 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. 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, 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. 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.

¹¹³ See *Bd. of Trs. of Mill Cabinet Pension Trust Fund for N. Cal. v. Valley Cabinet & Mfg. Co.*, 877 F.2d 769 (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 U.S. v. Bestfoods*, 524 U.S. 51 (1998); *Bangor Punta Operations v. Bangor & Aroostook R.R. Co.*, 417 U.S. 703, 713 (1974) (disregarding corporate form where form was used “to defeat an overriding public policy. . . .”); *Anderson v. Abbott*, 321 U.S. 349 (1944) (finding good faith and adequate capitalization not necessary to pierce the corporate veil when pursuing federal policy required liability).

¹¹⁴ This suggestion might seem to go against many courts’ perception of substantive consolidation as distinct from state law veil piercing. See, e.g., *In re Stone & Webster, Inc.* 286 B.R. at 538-39. I too believe there is a difference. However, I base the difference 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.

¹¹⁵ William O. Douglas & Carol 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).

¹¹⁶ Judge Cardozo aptly described veil piercing doctrines as “enveloped in the mists of metaphor.” *Berkey v. Third Ave. Ry. Co.*, 155 N.E. 58, 61 (N.Y. 1926), *reh’g denied*, 155 N.E. 914 (1927).

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 . . . of the broader equitable principle that the doctrine of corporate entity . . . will not be regarded when to do so would work fraud or injustice."¹¹⁷ 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 substantive consolidation. This approach coheres with my approach to the economic rationale in which misuse of the corporate form explains the break down in the asset identification function but does not independently justify use of substantive consolidation.

On 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 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. 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 parent company assets support the loan. For this, 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 leading to the confusion. 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 value in subsidiary companies reflected on a consolidated balance sheet would be available to repay their notes because 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 first should have found a "wrong" to correct—ideally either a misrepresentation or a covenant breach relating to 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 might 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

¹¹⁷ Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322 (1939).

creditors of subsidiaries, such as the lending syndicate.¹¹⁸ An offering memorandum typically discloses the risk of structural subordination when the corporate structure presents that risk.¹¹⁹

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 decide whether failure to mention the risk of structural subordination amounted to a material omission, justifying use of substantive consolidation.

Assume that the disclosure failure amounted to a material omission. Only then would the court turn to the question of whether 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.¹²⁰

My reformulation of the existing economic and veil piercing rationales for substantive consolidation do not exhaust my view of the proper reach of the doctrine. Though I believe it would be appropriate for a court to use the fairness rationale advanced below, such a use would launch the doctrine into uncharted territory as far as direct case law support is concerned.

VI. THE FAIRNESS RATIONALE

Commentators often identify the promotion of equity between a debtor and its creditors as a significant goal of bankruptcy law.¹²¹ What may get lost in a general account of bankruptcy's goals is the related objective of promoting equity among various creditors. When the goal of promoting equity among creditors is discussed, conversation tends to focus on provisions of the Bankruptcy Code such as the automatic stay,¹²² which prevents a race among creditors to the courthouse, the recovery of

¹¹⁸ The Third Circuit alludes to this disclosure failure when it suggests that those pursuing substantive consolidation should separately pursue securities fraud claims. *In re Owens Corning*, 419 F.3d 195, 212 n.22, 215 n. 27 (3d Cir. 2005).

¹¹⁹ See *In re Worldcom, Inc.*, 2003 WL 21498904 (S.D.N.Y. 2003) (noting that before 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.")

¹²⁰ See *supra* Part III. Dueling Standards for Substantive Consolidation, C. An Example of Misplaced Reliance.

¹²¹ SKEEL, *supra* note 61, at 45.

¹²² 11 U.S.C. § 362 (Code year).

preferential payments,¹²³ which defeats a debtor's attempt to prefer payment of one creditor over another, the recovery of fraudulent conveyances,¹²⁴ and the absolute priority rule, which prevents payments to lower ranking creditors or interest holders if higher ranking creditors have not been paid in full.¹²⁵ Another, less noticed, principle of equity among creditors lurks in the background; it 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, whereas others exist indirectly as equitable principles developed originally in England and incorporated into current law, arguably by § 105 of the Bankruptcy Code.¹²⁶

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 (i) a "shared source" and (ii) 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 also is balance sheet insolvent. In the absence of scarcity, the question of fair allocation does not arise.¹²⁷

The law provides a partial answer to the allocation question in various

¹²³ *Id.* § 547(Code year).

¹²⁴ *Id.* § 548 (Code year). State fraudulent conveyance law also may be employed using § 544 of the Bankruptcy Code.

¹²⁵ The absolute priority rule derives from Supreme Court precedent. *See* *N. Pac. v. Boyd*, 228 U.S. 482 (1913). William Douglas used this case to support the Bankruptcy Act's first version of the absolute priority rule. *See* SKEEL, *supra* note 61 at 67. The current version of the absolute priority rule appears in 11 U.S.C. § 1129(b)(2)(B)(ii). Prior to *Nothorn 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.

¹²⁶ The actual grounds for use of equitable principles by a federal court exercising bankruptcy jurisdiction are discussed hereinafter in Part VII. Constitutional Concerns Over Equity Principles.

¹²⁷ "[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." JOHN RAWLS, *A THEORY OF JUSTICE* 128 (1971).

related doctrines collected under the general heading of “marshalling.”¹²⁸ Again, at a most general level, the law says fairness requires that the multiple source creditor first seek payment from the alternate source rather than deplete the shared source of payment. Using up the shared source may harm the single source creditor without benefitting 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.¹²⁹ The principle of fairness that emerges from this general fact pattern is sometimes identified as the solution to the “two funds” problem.

In the above, I deliberately have been 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.”¹³⁰ 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 marshalling to compel the senior creditor to satisfy its claim first from Blackacre, the alternate payment source.¹³¹

¹²⁸ As a general matter, a court of equity does not consider the question of marshalling of assets unless both sources of payment are under the jurisdiction and control of the court. *See Lewis v. U.S.*, 92 U.S. 618, 623 (1875). In procedurally consolidated bankruptcies, all the 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 non-debtor were sought.

¹²⁹ 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. *See* JOSEPH STORY, EQ. JUR. § 633 (13th ed.)

¹³⁰ 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,” 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 its junior position in Greenacre was, in some sense, less at risk because of the additional security for A’s claim. C can not 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 marshalling.

¹³¹ In some jurisdictions, marshalling has developed so that the senior creditor A may proceed

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 also is 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 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."

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 answered 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.¹³² This result makes the second fairness question moot. In

against Greenacre even though it is the shared payment source. The junior creditor B invokes the doctrine of marshalling to obtain subrogation to A's mortgage on Blackacre. Professor Langdell reminds us that the marshalling 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. See C. C. Langdell, *A Brief Survey of Equity Jurisdiction*, 1 HARV. L. REV. 69-70 (1887).

¹³² This rule of subordination is part of the so-called "jingle rule" pursuant to which partnership creditors proved claims first against partnership assets and creditors of single

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. However, if the senior creditor had first satisfied a portion of its claim against the partnership assets before proceeding against the partner (as the “two funds” solution classically required), the possibility exists that the senior creditor be allowed only to prove the smaller, residual amount of its claim. Current bankruptcy law relating to partnerships changed prior law and allows a claim to be made for the full amount against the individual partner's estate once a deficiency in partnership assets is shown. Though the Bankruptcy Code now allows this specific form of double proof in partnership insolvencies, it takes care to eliminate other forms of double proof in the partnership context—revealing a mixed and theoretically inconsistent approach.¹³³

In contrast, Bankruptcy Code Section 506(a) directly addresses the problem of double proof when handling claims of partially secured creditors. The partially secured creditor is a multiple source creditor because he proves his claim against two sources: (i) the collateral or alternate source and (ii) the debtor's general estate available to unsecured

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, with partnership creditors taking the crumbs left by the creditors of the individual partner and creditors of the individual partner only accessing the value associated with the partner's residual interest in the partnership. Justice Holmes refers to this subordination rule in *Mitchell v. Hampel*, 276 U.S. 299 (1928). See also *Francis v. McNeal*, 228 U.S. 695 (1913) (Justice Holmes recounting “the old rule as to the prior claim of partnership debts on partnership assets, and that of individual debts upon the individual estate”). By the time of *Mitchell v. Hampel*, the Supreme Court clearly identified the subordination rule with Section 5f of the old Bankruptcy Act of 1898, see *Schall v. Camors*, 251 U.S. 239 (1920), without acknowledging its much older English origins. See *Craven v. Knight*, 2 Chancery Rep. 226 [21 E.R. 664] (1682), *Ex parte Crowder*, 2 Vern 706 [23 E.R. 1064] (1715), *Ex parte Cooke*, 2 Peere Williams 500 [24 E.R. 834] (1728); *Ex parte Elton*, 3 Vesey Junior 238 [30 E.R. 988] (1796). I rely on work by Dr. McNair and Dr. Getzler. See *infra* note 172. 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. To supplement liability imposed by the partnership business form, the creditor required that partners execute separate guarantees to provide additional security. The guaranty contract provided a separate basis for claims against the partners—claims not subject to subordination preventing double proof. See also *Myers v. Int. Trust. Co.*, 273 U.S. 380 (1927) (holding that a partnership composition agreement did not absolve partners of liability for endorsement of partnership notes). The “jingle rule” has been replaced by § 723 of the Bankruptcy Code. The Bankruptcy Code does not expressly repeal the jingle rule in Chapter 11 cases, accord *Kennedy, Partnership and Partners' Estates Under the Bankruptcy Code*, 1983 ARIZ. ST. L.J. 219, 274, 277, though courts have so held. See *In re Safren*, 65 Bankr. 566 (Bankr. C.D. Cal. 1986).

¹³³ See *Kennedy, supra*, note 132.

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.¹³⁴ However, in the case of these “secured” creditors, 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,¹³⁵ A holds two claims: a secured claim for \$70 and an unsecured deficiency claim for \$30. Suppose that B holds an unsecured claim against D, for \$100, and that D owns unencumbered assets worth \$60. The result is that A files a secured claim for \$70 and an unsecured claim for \$30; B files an unsecured claim for \$100. 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 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. The bankruptcy rule operates to prevent the squeeze down effect by preventing double proof. The United States Supreme Court determined, in a 5-4 decision,¹³⁶ that the bankruptcy rule derived from the express language of the former Bankruptcy Act¹³⁷ and, thus, did not apply in a context to which that act did not apply. In an insolvency proceeding for a national bank not subject to the former Bankruptcy Act, the Supreme Court applied the “chancery” rule and allowed the multiple source creditor to file a claim in the full amount of its

¹³⁴ See *Owens Corning Fiberglass Corp. v. Center Wholesale, Inc.* (*In re Center Wholesale, Inc.*), 759 F.2d 1440 (9th Cir. 1985). 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 marshalling collateral for secured claims.

¹³⁵ See 11 U.S.C. § 506(a) (Code year).

¹³⁶ *Merrill v. Nat. Bank of Jacksonville*, 173 U.S. 131 (1899) (Fuller, C.J.).

¹³⁷ *Id.* at 146-47.

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 further argued on statutory construction grounds why the bankruptcy rule should not be limited to the application given it in the Bankruptcy Act.¹³⁸

Properly understood, the so-called “bankruptcy rule,” though not expressly identified with the doctrine of marshalling, addresses the same problem outlined generically at the start of this section: how do we fairly deal with circumstances in which the interests of a multiple source creditor conflicts with the interests of a single source creditor? In each of the three cases—marshalling collateral, marshalling 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 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. Anytime 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. However, unlike the three cases discussed above, courts have failed expressly to articulate a modern doctrine of marshalling that might apply in the context of corporate groups using intercompany guarantees to obtain financing.¹³⁹

¹³⁸ The historical connection between bankruptcy laws in the United States and England is strong. The first United States bankruptcy law, enacted in 1800, derived almost entirely from English bankruptcy legislation. See SKEEL, *supra* note 61, at 2. The Supreme Court held early on that the United States 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*, 4 Wheaton 122 (1819).

¹³⁹ Combining the evolving notion of deemed consolidation with fairness considerations derived from principles of marshalling might produce a workable structure for reorganizing corporate groups. The process bears a family resemblance to the development of the equity

Creation of a web of guarantees by a consolidated group of companies is a business technique that breaks down the asset partitioning that results when a parent company owns one or more subsidiaries. Typically, the asset partitioning that results from the division of assets among multiple legal entities predates the planning for the syndicated financing. Thus, the guarantee web divides creditors between multiple source creditors and single source creditors, though it does not create the asset partitions.

The pre-existing asset partition created by the parent/subsidiary structure may have been created for the express purpose of matching different creditors with different assets.¹⁴⁰ 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 pre-existing 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 co-authored article.¹⁴¹

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 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

receivership out of traditional foreclosure law used initially to reorganize railroads. *See generally* SKEEL, *supra* note 61, at 57 (discussing development of equity receivership device). In an equity receivership, a court could order the sale of all the assets of a railroad in a single parcel at auction. This procedure produced a different result than might have 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.

¹⁴⁰ Professors Hannsman and Kraakman contemplated such a scenario in their initial presentation of their theory of asset partitioning. *See* Hannsman & Kraakman, *supra* note 11. Professor Triantis contemplates a similar regime in his analysis of internal capital markets. *See* Triantis, *supra* note 56. 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.

¹⁴¹ William O. Douglas & Carol M. Shanks, *Insulation From Liability Through Subsidiary Corporations*, 39 YALE L.J. 193 (1929). Justice Douglas' 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 61, at 18.

factors. And at times it has appeared to recede.¹⁴²

Though use of the same business technique—application of the corporate form—appears in any corporate group, Douglas reminds 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 between 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 6 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. A Co. distributes proceeds from the syndicated loan throughout the consolidated group, as needed. 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 chart below illustrates the situation for the consolidated group and its debt investors.

Entity	Values	Third Party Creditors	Syndicate Loans	Syndicate Claim Amount	Syn. Dist.	3rd-P Dist.
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	\$41.55

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.¹⁴³ In the first,

¹⁴² Douglas & Shanks, *id.*, at 193.

¹⁴³ 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.

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 \$51.67, while the independent third party lender to receives a distribution of \$8.33 (in the absence of substantive consolidation).

The reason for the vast difference in outcome 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 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 “non-adjusting” 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 20% of collateral value for payment of non-adjusting and other unsecured creditors.¹⁴⁴

¹⁴⁴ See *supra* note 6. The concerns raised by the guarantee squeeze down relate directly to analysis performed by Professor LoPucki. See Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996); see also Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147 (1998). 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

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 Co. 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 non-adjusting creditors and may be of little help to small voluntary creditors. Nevertheless, the presence or absence of notice often figures prominently in our assessment of overall fairness of a structure. I mean to suggest here 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 who benefits from the web of intercompany guarantees. Substantive consolidation in this context removes the unfairness of the squeeze down effect. This notion of fairness, though articulated by courts for the structure of business enterprises in past times, has not found a voice with modern courts.¹⁴⁵

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, enhancing its recovery. Though it is beyond the scope of this Article, my analysis may have relevance to the treatment of consolidated group liability for tort claims—a much debated issue. *See, e.g.,* 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).

¹⁴⁵ On 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 inter-company guarantees. Indeed, this is the significance of the fact, given little credence by the Third Circuit, that no competent lawyer would have given a non-consolidation opinion in the face of a web of inter-company guarantees.

My remarks on the fairness rationale are intended to be descriptive as much as 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. 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.¹⁴⁶ Historically, 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 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.

VII. CONSTITUTIONAL CONCERNS OVER EVOLUTION OF EQUITY PRINCIPLES

In proposing my third rationale for substantive consolidation, I am mindful of the Supreme Court's decision in *Grupo Mexicano de Desarrollo S.A. v. Alliance Bond Fund, Inc.*¹⁴⁷ In that decision, authored by Justice Scalia, the Supreme Court held, in a 5-4 decision, 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 of 1789.¹⁴⁸ The idea is flexibility within limits.¹⁴⁹

¹⁴⁶ 11 U.S.C. 1129(b)(1) (Code year).

¹⁴⁷ 527 U.S. 308 (1999).

¹⁴⁸ The Judiciary Act of 1789 gave federal courts jurisdiction over "all suits . . . in equity." § 11, 1 Stat. 78. In fixing the scope of this jurisdiction to the time of separation of the United States from England, the Supreme Court relied on *Atlas Life Ins. Co. v. W.I.S., 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."); *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").

¹⁴⁹ The Supreme Court clearly 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

As a general matter, the Constitution provides that federal courts acquire power only through legislative grant;¹⁵⁰ thus, for a bankruptcy court properly to assert power to impose substantive consolidation, particular legislation must give the court power to use this remedy.¹⁵¹ The Court found that the equity powers Congress conferred pursuant to the Judiciary Act were limited to those exercised by the High Court of Chancery in 1789. Thus, if the remedy of substantive consolidation did not exist at that time, another act of Congress must be found that did confer such power. 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.¹⁵²

The *Grupo Mexicano* decision generated a flurry of speculation¹⁵³ that the Court had deprived bankruptcy courts of the ability to order substantive consolidation. First, accepted wisdom holds that the Supreme Court tacitly approved substantive consolidation doctrine in 1941, in *Sampsell v. Imperial Paper & Color Corp.*¹⁵⁴—far too recent if *Grupo Mexicano* requires a much older equitable practice to sustain its use. The evolution of

jurisdiction given it by the Bankruptcy Code and Title 28 of the United States Code. See *Pepper v. Litton*, 308 U.S. 295, 304 (1939). Bankruptcy courts use principles of equity to counteract fraud, to insure that form does not triumph over substance and to stop technical considerations from preventing substantial justice. *Id.* Bankruptcy courts have considerable latitude to modify debtor/creditor relationships. *United States v. Energy Res. Co.*, 495 U.S. 549 (1990).

¹⁵⁰ In addition to the equity jurisdiction conferred by the Judiciary Act of 1789, Congress has specifically granted federal courts jurisdiction in bankruptcy cases. 28 U.S.C. § 1334 (Code year). A separate clause of the Constitution provides Congress with the power to establish uniform bankruptcy laws. U.S. Const. art. I, § 8, cl. 4 (stating that Congress may “establish ... uniform Laws on the subject of Bankruptcies throughout the United States.”).

¹⁵¹ 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 Akhil Reed Amar, *A Neo-Federalist View of Article III: Separating the Two Tiers of Federal Jurisdiction*, 65 B.U. L. REV. 205 (1985); *Martin v. Hunter’s Lessee*, 14 U.S. 304 (1816). I do not see provision of certain equitable remedies as mandated by the structure of the Constitution and thus search for authority in grants of power by Congress to the courts.

¹⁵² See *Nw. Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) (stating that “whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code”).

¹⁵³ See, e.g., Sabin Willett, *The Doctrine of Robin Hood: A Note on “Substantive Consolidation”*, 4 DEPAUL BUS. & COM. L.J. 87 (2005); Daniel B. Bogart, *Resisting the Expansion of Bankruptcy Court Power Under Section 105 of the Bankruptcy Code: The All Writs Act and an Admonition from Chief Justice Marshall*, 35 ARIZ. ST. L.J. 793, 810 (2003); J. Maxwell Tucker, *Grupo Mexicano and the Death of Substantive Consolidation*, 8 AM. BANKR. INST. L. REV. 427 (2000).

¹⁵⁴ 313 U.S. 215 (1941).

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.¹⁵⁵ 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.¹⁵⁶ The Bankruptcy Code itself, in § 1123(a)(5)(C), provides the option of merger or consolidation¹⁵⁷ as available to implement a reorganization plan, but that section has been termed a slender reed upon which approval for substantive consolidation might rest.¹⁵⁸

A. A STATUTORY FOUNDATION

The lack of an extant general grant of equitable powers to federal courts exercising bankruptcy jurisdiction is both surprising and troubling. Section 105 of the Bankruptcy Code,¹⁵⁹ 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. Accepting this limitation, for

¹⁵⁵ See, e.g., *In re Owens Corning*, 419 F.3d 195, 209 n. 14 (3d Cir. 2005) (stating that “[w]hat the Court has given as an equitable remedy remains until it alone removes it or Congress declares it removed as an option”).

¹⁵⁶ The Bankruptcy Act of 1898, the Chandler Act of 1938 and the Bankruptcy Code of 1978 all contained a grant of general equitable jurisdiction. This grant was dropped, likely by mistake, when Congress “fixed” problems with the 1978 Code identified by the Supreme Court in *N. Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

¹⁵⁷ Cf. 11 U.S.C. § 302 (Code year) (providing for consolidation of the estates of a husband and wife in joint administration).

¹⁵⁸ See Douglas Baird, *Substantive Consolidation Today* (2005) available at http://www.iiiiglobal.org/country/usa/Substantive_Consolidation_5.pdf (last visited Mar. 6, 2006). 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) (Code year). 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.

¹⁵⁹ 11 U.S.C. § 105 (Code year).

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 Section 101, which has two parts.

(5) The term “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, secured, or unsecured.¹⁶⁰

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 to, its assertion of the claim (regardless of whether the claim itself is equitable in nature).¹⁶¹ Under Bankruptcy Code § 502,¹⁶² a claim is deemed allowed unless a party in interest objects. Following an objection, the court, after notice and hearing, determines the amount of the claim and whether to allow it.

This definition of “claim” arrived on the scene in 1978¹⁶³ as a significant change in law—well after the doctrine of substantive consolidation was recognized in the federal courts—and so one might

¹⁶⁰ 11 U.S.C. § 101 (Code year).

¹⁶¹ The Bankruptcy Code provides that, as a principle of interpretation, “or” is to be interpreted as inclusive, rather than exclusive. 11 U.S.C. § 102 (5) (Code year).

¹⁶² 11 U.S.C. § 502 (Code year).

¹⁶³ The definition of the term “claim” introduced in 1978 created a significant departure from the previous law. See S. REP. NO. 95-989, at 21-22 (1978), reprinted in LEGISLATIVE HISTORY OF THE BANKRUPTCY REFORM ACT OF 1978 (1979); accord H.R. Rep. No. 95-595, at 309 (1977), reprinted in LEGISLATIVE HISTORY OF THE BANKRUPTCY REFORM ACT OF 1978 (1979). The definition permits the broadest possible relief in the bankruptcy court to include equitable as well as legal rights to payment. *Id.*; see also *Ohio v. Kovaks*, 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 (Bankr. S.D.N.Y. 1999), *aff’d*, 266 B.R. 575 (S.D.N.Y. 2001) (noting that the drafters of §101 (5) of the Bankruptcy Code gave the term “claim” a broad definition in order to ensure that all those with potential calls on a debtor’s assets, provided that the call in at least some circumstances could give rise to suit for payment, came before the court so that their demands could be allowed or disallowed and their priority and dischargeability determined).

conclude 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 to measure the extent of “equity.”

The impediment to such an analysis is the question whether a creditor actually can request substantive consolidation as part of its assertion of an equitable claim or its entitlement to an equitable remedy.¹⁶⁴ Certainly, creditors do not assert a right to substantive consolidation outside of bankruptcy. However, the issue of substantive consolidation might 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 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 outside of bankruptcy. Veil piercing is considered an equitable remedy.¹⁶⁵

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 break down in the asset partition occasioned by C’s equitable claim.¹⁶⁶ If C’s equitable claim

¹⁶⁴ *In re Antonino*, 241 B.R. 883 (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.”).

¹⁶⁵ 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.”)

¹⁶⁶ 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

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.¹⁶⁷ 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.¹⁶⁸

Further, if the court were to allow C's equitable claim to stand against A without ordering a substantive consolidation, the court 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 § 502.¹⁶⁹ 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.

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 seen such a case.¹⁷⁰ Analytically, however, a creditor's request

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 v. Mortgage Am. Corp. (In re Mortgage Am. Corp.)*, 714 F.2d 1266 (5th Cir. 1983).

¹⁶⁷ The Third Circuit speculates that such a split treatment might be available to a court. 419 F.3d at 210, n.16.. However, in light of the Third Circuit's apparent hostility to "deemed" consolidations, it is not apparent how the Third Circuit would support use of split treatment unless it did so under the simple principles of claim evaluation advocated here.

¹⁶⁸ *See In re Mortgage Am. Corp.*, 714 F.2d at 1266.

¹⁶⁹ 11 U.S.C. § 502 (Code year).

¹⁷⁰ 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 In re Enron Corp.*, 419 F.3d 115 (2005). An example of an equitable proof of claim based on veil piercing appears in Expert Report of Jonathan R. Macey, *In re Stone & Webster*, No. 00 2142, 2005 WL 3263064 (Bankr. D. Del. Apr. 22, 2005) (finding that "[u]nder traditional corporate law rules regarding piercing the corporate veil, BVG&E was the alter ego of Stone & Webster [and] should, therefore, be responsible for BVG&E's debts").

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 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 use of substantive consolidation despite the apparent gap in general bankruptcy equity jurisdiction created when 28 U.S.C. § 1481 was repealed in response to *Northern Pipeline*.¹⁷¹ Though I believe a court might fairly accept my statutory analysis to justify use of substantive consolidation, the reasons for its acceptance go much deeper and, I believe, are much older, tracing back to England in 1673.

B. AN OLD CASE

The prior analysis of marshalling, 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*.¹⁷² The case arose from a bill of review brought to reverse the 1673 decree in *Naylor v. Brown*.¹⁷³

In *Naylor v. Brown*, Naylor loaned 500£ to the Company of Woodmongers. The Company also owed debts to thirteen of its members totaling 620£. The Company owned a bond of 1000£ due from the King. The Company assigned the bond to Sir William Wild, who declared a trust

¹⁷¹ See *supra* note 156.

¹⁷² 73 Selden Society (1954), No. 557 at 419. I learned of the case through work on the early history of asset partitioning by Dr. McNair and Dr. Getzler. See Joshua Getzler & Michael McNair, *The firm as an entity before the Companies Acts*, in ADVENTURES OF THE LAW: PROCEEDINGS OF THE SIXTEENTH BRITISH LEGAL HISTORY CONFERENCE, DUBLIN 2003 267-88 (Dublin: Four Courts Press, Paul Brand, Kevin Costello & W.N. Osborough eds. 2005).

¹⁷³ Rep Temp Finch 83, 23 E.R. 44, *sub nom.* Naylor & Godfrey (1674), 73 Selden Society, No. 97 at 55-6.

for 620£ of the bond in favor of the thirteen member creditors, and as to the residue, in favor of the Company. 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). This state of affairs remained until a *quo warranto* was brought against the Company, resulting in its dissolution. Following the dissolution, the various member creditors claimed the bond except for a 135£ residue for the unrelated creditors, including Naylor. 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. 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.

Three key points emerge from a close reading of these cases: first, I suggest the parties conceived of the two declared trusts as an analog to modern corporate subsidiaries¹⁷⁴ 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; and, third, 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. 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.

The dog that did not bark in *Brown v. Naylor* 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).¹⁷⁵ Why did not Naylor argue that the initial assignment of the bond to Sir William Wild resulted in a violation of the Statute of Elizabeth? I suggest that a transaction form consisting of (i) an absolute assignment of the bond to Sir William, coupled with (ii) 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

¹⁷⁴ In three essays, Maitland provides authority for the early connection between the trust and the corporation. See Maitland, *The Unincorporate Body, Trust and Corporation and Moral Personality and Legal Personality*, H. D. HAZELTINE, ET. AL., MAITLAND, SELECTED ESSAYS (1936).

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. *Id.* at 214.

¹⁷⁵ See Introduction cii, 73 Selden Society (1954) (noting Lord Nottingham as a promoter of the Statute of Frauds).

bond outside the estate of the Company. Rather, 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 (i) had not joined in the authorization to create the trust, (ii) had not authorized Sir William to create the trust under Company seal, or (iii) had not authorized Sir William to declare the trust by any corporate act. 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.¹⁷⁶ 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. 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. The 1676 court rejected this argument.

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 properly formed, did not contain any language reciting a residual interest in favor of the Company. 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

¹⁷⁶ 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.

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.¹⁷⁷

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. However, the multiple signatures created 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 are owed 1200£. The first thirteen insider creditors are owed 650£ by the time of the appeal and the second group of twenty five creditors are owed 250£. Thus, we have a ratio of 3 insider claims to 4 outsider claims. With a total fund of approximately 1000£ from the King’s bond, 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 inside creditors from the second trust, and, we are told,¹⁷⁸ a residual of 135£ to the third party creditors from the second trust.

¹⁷⁷ I do not place great emphasis on this timing point because, from the version of the case in Seldon’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. This, however, makes the absence of a fraudulent conveyance claim all the more unusual.

¹⁷⁸ The amount of the claims reported is slightly inconsistent among the various reports and, in any event, the precise amounts available for distribution can not be reconciled without assuming interest on the King’s bond.

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—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. 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 *Naylor & Brown* 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 being 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.¹⁷⁹ Unlike the facts in *Grupo Mexicano* in which historically a creditor’s bill was not requested and given prior to judgment—the fatal flaw identified by Justice Scalia—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 belief in 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 & Brown* reminded me of

¹⁷⁹ Dr. McNair and Dr. Getzler note the early respect given to asset partitioning as a liability 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. 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. 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 question in modern English law. Dr. McNair and Dr. Getzler should not be understood to agree or disagree with my analysis of *Naylor & Brown*.

Associated Gas.¹⁸⁰

Associated Gas presented the question 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. 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. 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.

Harkening back to *Naylor & 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.

VIII. CONCLUSION

Theoretical work on the corporate form as it exists inside corporate groups, particularly in bankruptcy, lags behind scholarship focusing on more general aspects of the corporate form. To close this gap, this Article has argued for a framework that organizes this particular undertheorized milieu in terms of (i) asset partitioning, (ii) artificial personality and (iii) 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 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 substantive consolidation doctrine uncertain.

Some courts might feel more comfortable operating by direct appeal to unbounded notions of equity and fairness to reach what they consider the just result in particular cases. This general approach, however, leads to uncertainty, promoting a feeling that no real standards exist—to modify a phrase, justice is measured by the length of a particular judge's foot.¹⁸¹ A

¹⁸⁰ *In re Associated Gas & Elec. Co.*, 61 F. Supp. 11, 29-31 (S.D.N.Y. 1944), *aff'd*, 149 F.2d 996, 1004 (2d Cir. 1945), *cert. denied*, 326 U.S. 736 (1945).

¹⁸¹ I refer to Lord Seldon's celebrated remark that the measure of equity is the length of the

concern over unbounded rules fueling an expansionist tendency of courts 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 bankruptcy as a somewhat lawless contest—a form of legal roller derby—in which negotiations might take place.

This Article argued for an expanded rationale for use of substantive consolidation based on fairness concerns and gave 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 classes against more powerful creditor classes—the project actually amounts to an inherently conservative one. I am not inclined to believe that bankruptcy courts should be able to do whatever they like in the name of fairness and equity. Rather, the better approach finds bankruptcy courts exercising their powers on a bounded playing field. This only can be done, 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 non-bankruptcy law.¹⁸² 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 non-bankruptcy regime and those who favor the adjustments in rights made by bankruptcy law.¹⁸³ While harmful forum shopping *between* bankruptcy courts certainly occurs in some settings,¹⁸⁴ there seems to me only modest opportunity to forum shop between a bankruptcy and a non-bankruptcy alternative. Nevertheless, basic fairness and market predictability seem to recommend that differences between bankruptcy and non-bankruptcy 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, we can understand the different contexts in which the corporate form appears. In subsidiary corporations,

Chancellor's foot.

¹⁸² See Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931 (2004).

¹⁸³ This position has been forcefully argued by leading bankruptcy scholars. See generally THOMAS JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY* (1986).

¹⁸⁴ See LYNN M. LOPUCKI, *COURTING FAILURE* (2005).

economic theory predicts that both artificial personality and asset identification will suffer. 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.

Asset securitization practices reflect a competition between a bankruptcy regime and a non-bankruptcy regime. We might ask why many companies who establish SPCs engage in seemingly pointless activities, such as subleasing office space to the SPC, printing separate SPC letterhead and procuring a separate phone line for the SPC. All these activities are done in order 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 collateral might be substituted. To avoid the bankruptcy regime, financiers engage in wasteful activities to maintain the fiction of the artificial person.

On the analysis given here, such wasteful activities might be eliminated. Within corporate groups, we should expect managers to minimize costs. This often involves promoting identities between parent and subsidiaries that destroy artificial personality. It is little answer to claim that wasteful steps for SPCs, such as subleasing, stationary and telephones, are not really wasteful when we consider the overall cost savings realized from a securitized financing. Though the decision to securitize is motivated by cost savings, waste is simply waste. One thing that you can be sure of in a properly structured securitization is that the asset identification function will 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 over 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, not a reason to postpone implementation of reformulation of the doctrine 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.¹⁸⁵ However, 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 under this rationale. 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 versus 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 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—pre-bankruptcy 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

¹⁸⁵ Cf. *Walgreen Co. v. Sara Creek Property Co.*, 966 F.2d 273 (7th Cir. 1992) (Judge Posner describing calculation of damages and suggesting that prices and costs are more accurately determined by parties in the market than by government.). While, in general, markets may set prices better 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.

breach? The limit on court use of this power to correct also is clear. The power may not be used under the veil piercing rationale to cause another wrong—typically destruction of a reliance interest. However, this reliance interest should not 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—in effect, 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.

Lastly, 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*). Prior to that decision, nobody thought that the presence of inter-company 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 non-consolidation 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. 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 guarantees and their impact on substantive consolidation doctrine might derive, in some sense, from collective memories of fairness considerations that operated in past times.¹⁸⁶

¹⁸⁶ 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.