SUBSTANTIVE CONSOLIDATION AND PARTIES' INCENTIVES IN CHAPTER 11 PROCEEDINGS

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Chapter 11 proceedings often involve large debtor companies consisting of multiple related corporate entities.[1] In a simple model, the debtor might consist of a corporate parent and a number of subsidiaries. Each of those entities typically has its own set of creditors who, in bankruptcy, seek distribution of that entity's assets. Each creditor attempts to maximize its return on its loan to the entity; creditors need not have any regard for the assets or creditors of related debtor entities. Additionally, any of those debtor entities may be solvent or insolvent. Accordingly, in the simple model, the creditors of a solvent subsidiary will recover fully, and the creditors of an insolvent subsidiary may not recover fully.

This model sets forth a straightforward distribution of assets in a reorganization. Underlying the model is the assumption that the debtor entities and creditors are neatly separated bundles of assets having distinct corporate forms. In other words, no two debtor entities have overlapping assets or corporate forms. This assumption simplifies the problem of reorganizing the entities: one must only match up a particular creditor's claim to a particular debtor's assets in order to determine how solvent an entity is. Yet the neat separation of assets and creditors by entity is not always the case. Sometimes there may be a reason for a bankruptcy court to disregard the corporate forms of debtor entities, particularly where strict adherence to corporate form would produce inequitable results. Substantive consolidation is one method of setting aside a debtor's corporate form in order to achieve equitable results in a reorganization.

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1. *See* William H. Widen, *Report to the American Bankruptcy Institute: Prevalence of Substantive Consolidation in Large Public Company Bankruptcies from 2000 to 2005*, 16 AM. BANKR. INST. L. REV. 1, 3–5 (2008) (finding hundreds of bankruptcies that involve multiple entities); Lynn LoPucki, The Myth of the Residual Owner: An Empirical Study 16 (UCLA Sch. of Law, Law & Econ Research Paper No. 3-11), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=401160.

Substantive consolidation is a common law remedy in bankruptcy proceedings[2] that "treats separate legal entities [of the debtor company] as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph into claims against the consolidated survivor."[3] Because the merged entities may be more or less solvent, as in the simple model above, substantive consolidation harms creditors of the more-solvent entities and benefits creditors of the less-solvent entities. By disregarding the debtor entities' corporate forms, this technique stands in tension with at least some creditors' ex ante expectations regarding the risk and value of their loans to those entities. It has the potential to change, and often does change, parties' state-law property rights in bankruptcy,[4] despite the absence of any Bankruptcy Code provision specifically authorizing such a remedy. The drastic effect this technique has on creditors' rights raises the following normative question: when, if ever, is substantive consolidation appropriate?

Three circuit courts of appeals have answered this question, each one differently.[5] In *In re Owens Corning*,[6] the Third Circuit proposed the latest test, attempting to settle the matter. Problematically, none of these tests adequately satisfies two uncontroversial bankruptcy policies. A proper substantive consolidation test ought to reflect parties' ex ante incentives and be practically administrable. By failing to meet these criteria, the two tests for substantive consolidation make large corporate reorganizations needlessly uncertain and inequitable.

This Note attempts to clarify the theoretical problems with the current models and proposes a test that satisfies the above three criteria. Part I explains the interests and incentives debtors and different kinds of creditors typically have in a Chapter 11 proceeding. Part II articulates the three leading substantive consolidation tests,

2. *See* Joy Flowers Conti, *An Analytical Model for Substantive Consolidation of Bankruptcy Cases*, 38 BUS. LAW. 855, 856 (1983) ("Substantive consolidation is a judicial doctrine which, with one exception [inapplicable to corporate bankruptcy], has not been codified by statute or embodied in any rule.").

3. *In re* Owens Corning, 419 F.3d 195, 205 (3d Cir. 2005) (quoting Genesis Health Ventures, Inc. v. Stapleton (*In re* Genesis Health Ventures, Inc.), 402 F.3d 416, 423 (3d Cir. 2005)).

4. *See* Widen, *supra* note 1, at 3–5.

5. *See* Owens Corning, 419 F.3d 195; Union Savings Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515 (2d Cir. 1988); Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270 (D.C. Cir. 1987).

6. 419 F.3d at 216.

examines the effects of those tests on the different kinds of creditors, and shows that the tests raise a number of important, problematic questions for the administration of a bankruptcy proceeding. Part III argues that none of the three tests is sufficiently grounded in parties' incentives and proposes a new test to solve this problem. Part IV applies this new test to three hypothetical scenarios and explains why the test represents better bankruptcy policy than any of the existing substantive consolidation frameworks. Part V concludes with a brief summary of the concepts discussed herein.

I.
DEBTOR AND CREDITOR INCENTIVES IN CHAPTER 11 PROCEEDINGS

A. Debtors

Companies use debt to finance their businesses and limit their own equity's exposure to risk.[7] In a simple loan model, the creditor gives cash to the debtor, and the debtor repays both principal and interest to the creditor over a period of time agreed upon by the parties.[8] The interest on the loan compensates the creditor for performing two services: renting out its cash for use by the debtor and assuming the risk that the debtor will fail to repay that cash.[9] The greater the cost of renting cash or the greater the risk that the debtor will default on the loan, the higher the rate of interest the debtor will pay for the loan.[10] Further, the profit-maximizing debtor will always seek to obtain credit as cheaply as possible.

In a Chapter 11 proceeding, however, the debtor's duty to reorganize[11] carries with it some conflicting incentives. First, the debtor seeks to settle its debts in accordance with a plan of reorganization either by obtaining the unanimous consent of all classes of creditors or by "cramming down"[12] the classes that dissent.[13] The

7. *See* Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 501, 502 (1976).

8. *See id.* at 501.

9. *See id.*

10. *See* ANDREW J.G. CAIRNS, INTEREST–RATE MODELS: AN INTRODUCTION 1 (2004) (discussing both components of interest rates).

11. *See* Michelle J. White, *The Corporate Bankruptcy Decision*, *in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 207, 217 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

12. *In re* Mattson, 210 B.R. 157 (Bankr. D. Minn. 1997), offers a definition of "Cramdown":

> Cramdown is the centerpiece of the reorganization chapters. Cramdown starts with § 506(a)[,] which basically provides that a creditor holding a security interest in property has a secured claim only to the extent that there is

profit-maximizing debtor will prefer whatever distribution of assets allows it to emerge from bankruptcy most quickly and cheaply. That is, the debtor will be relatively indifferent to who gets repaid and how much those parties receive, provided that such a distribution meets the statutory requirements of plan confirmation[14] and is acceptable to the bankruptcy court. Second, the debtor, like any other company, seeks to maximize the going-concern value of its business. The debtor wants to emerge from Chapter 11 in as strong an economic position as possible; therefore, it has an incentive to avoid either ruining its business relationships or driving up its future perceived default risk during the Chapter 11 process. These two reorganization incentives conflict to the extent that a debtor is unable to confirm a plan that does not impair at least some creditors.

This conflict underlies the decisions a large corporate debtor makes regarding whether to propose a plan involving substantive consolidation in a Chapter 11 reorganization. From the debtor's standpoint, "[s]ubstantive consolidation offers an inexpensive alternative to generating balance sheets for each individual company in a consolidated group of companies,"[15] thereby speeding the reorganization process and reducing transaction costs. Thus, the incentive to reorganize tends to favor substantive consolidation, whereas the incentive to maximize going-concern value (and minimize future perceived default risk), as described above, may tend to disfavor such a technique. The Chapter 11 debtor considering substantive consolidation must balance these two conflicting incentives in order to decide whether consolidation is appropriate.

B. Sophisticated Creditors

Sophisticated creditors[16] include banks, pension funds, institutional loan funds, and other financial institutions that typically ex-

> value in that property to provide actual security for its claim. . . . The basic rule of cramdown is that, under a plan, a debtor must make payments to a secured creditor [that] have a value equal to the debtor's allowed secured claim, which is not necessarily its entire claim.

Id. at 159.

13. *See* 11 U.S.C. § 1129(a)–(b) (2006); White, *supra* note 11, at 217–19.

14. *See* 11 U.S.C. § 1129 (setting forth statutory requirements for plan confirmation).

15. William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 237, 280 (2007) [hereinafter Widen, *Corporate Form*].

16. These classifications generally follow those set forth in Andrew Brasher, Substantive Consolidation: A Critical Examination 16–17 (2006) (unpublished manuscript), *available at* http://law.harvard.edu/programs/olin_center/corpo-

tend "term loans, revolving credit loans, and letters of credit" to debtor companies.[17] These loans are "in many cases secured" by the debtor company's assets[18] or guaranteed by the parent debtor's subsidiaries—i.e., direct claims against related corporate entities in the event that the borrowing entity defaults. Ex ante, sophisticated creditors negotiate the terms, covenants, security interests, and interest rates of their credit agreements with the borrowing companies and structure their affairs with debtors so as to fix a predetermined level of risk and return.[19] These creditors profit from receiving interest payments on the loans they extend; they maximize profit by making as many loans as possible, setting interest rates as high as possible, and assuming as little risk as possible.[20]

When a debtor company is undergoing a Chapter 11 reorganization, creditors are motivated by their desire to maximize their own repayment from the debtor's limited pool of assets. Because their loans are typically secured, sophisticated creditors tend to recover ahead of other kinds of creditors.[21] Substantive consolidation affects these creditors' recoveries depending on the relative solvencies of the consolidated entities. Creditors of a more-solvent entity that is consolidated with a less-solvent one will, other things being equal, recover less than they would absent consolidation by virtue of the consolidated entities' asset-to-debt ratio being decreased. In another scenario, sophisticated creditors of a parent company whose loans are guaranteed by the parent's subsidiaries may find their loans undersecured after consolidation, leaving them to share part of the distribution equally with the subordinated, unsophisticated creditors of the parent. The possibility of substantive consolidation in bankruptcy therefore motivates sophisticated creditors to (1) assess the possibility that a borrowing entity will be substantively consolidated, (2) increase the default-risk component of that entity's interest rate to compensate for the risk of consolidation, and (3) monitor the borrowing entity as much as

rate_governance/papers/Brudney2006_Brasher.pdf. They differ in that there is no need to distinguish between Brasher's "unsophisticated" and "involuntary" creditors because, on the theory proposed herein, those two groups have identical incentive structures.

17. *See* Douglas R. Urquhart & Roshelle Nagar, *Dealing With Senior Lenders*, *in* WEIL, GOTSHAL & MANGES LLP, REORGANIZING FAILING BUSINESSES: A COMPREHENSIVE REVIEW AND ANALYSIS OF FINANCIAL RESTRUCTURING AND BUSINESS REORGANIZATION 2-1, 2-1 (2006).

18. *Id.*

19. *See* Posner, *supra* note 7, at 503–05.

20. *See* Brasher, *supra* note 16, at 17.

21. *See* 11 U.S.C. § 1129(b) (2006).

possible prepetition to ensure that it does not undertake activities during the course of the loan that would increase the risk of its consolidation.

C. Unsophisticated Creditors

Unsophisticated creditors include tort claimants, employees,[22] and trade creditors, all of whom extend credit to companies only as an incidental part of their business.[23] These groups typically do not have the benefit of ex ante negotiations with debtors such that they are fully compensated for their borrowed cash and assumed risk by restrictive covenants and interest rates.[24] "This means . . . that the provisions of corporation law," and, by extension, the test for substantive consolidation, "will have a greater impact on credit transactions with" these creditors than with sophisticated creditors.[25]

Both prepetition and postpetition, these creditors have the same two incentives: to recover as much of the money owed them as possible and to see the debtor become a viable company.[26] These incentives are somewhat aligned because unsophisticated creditors' rights in the debtor's assets are of a lower priority than sophisticated creditors' rights. If a debtor's asset value exceeds its going-concern value, secured creditors will seek to have the firm liquidated; conversely, if the debtor's going-concern value exceeds its asset value, secured creditors will want the firm to reorganize.[27] Because unsophisticated creditors hold unsecured claims and therefore do not recover at all until secured creditors recover in full, they maximize their chances of recovery by seeking to have the debtor reorganize rather than liquidate.[28] Unsophisticated creditors, like sophisticated creditors, will benefit from or be harmed by substantive consolidation depending on the solvency of their respective debtor entity relative to that of the entities with which it is consolidated.

22. This definition excludes issues relating to collective bargaining agreements, which are beyond the scope of this Note.

23. *See* Brasher, *supra* note 16, at 17 ("Typical unsophisticated creditors are trade creditors who provide services on credit but do not profit from financing; they have neither the skill nor resources to investigate the debtor's status as a legal entity.").

24. *See* Posner, *supra* note 7, at 505.

25. *See id.*

26. *See* Brasher, *supra* note 16, at 17.

27. *See* Todd J. Zywicki, *Bankruptcy*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS (2008), *available at* http://www.econlib.org/library/Enc/Bankruptcy.html.

28. *See id.* ("[U]nsecured creditors, who have no hope of recovering their investment if the company is killed, have an incentive to favor reorganization.").

Courts articulate the legal requirements for substantive consolidation against the backdrop of this economic incentive structure.[29] Three circuit courts of appeals have done so, with varying effects on the different kinds of actors in a Chapter 11 proceeding. Part II of this paper describes the three major tests for substantive consolidation these courts have set forth and examines how the applicable legal rules interact with the economic incentives described above.

II. THREE PROBLEMATIC TESTS FOR SUBSTANTIVE CONSOLIDATION

A. *The* Auto-Train *Analysis*

In 1987, the Court of Appeals for the District of Columbia Circuit proposed the first widely recognized test for substantive consolidation in *Drabkin v. Midland-Ross Corp.* (*In re Auto-Train Corp.*).[30] Under *Auto-Train*, a party moving for substantive consolidation establishes a prima facie case by showing both "a substantial identity between the entities to be consolidated"[31] and "that consolidation is necessary to avoid some harm or realize some benefit."[32] The prima facie case amounts to a showing that the debtor abused the corporate form to some unsecured creditors' detriment.[33] Like a veil-piercing analysis under state corporation law,[34] the *Auto-Train* test "recognize[es] that a parent company functions as a shareholder for its subsidiary, just as an individual may function as a shareholder for a single corporation."[35]

The burden then shifts to an objecting creditor to prove "that it relied on the separate credit of one of the entities and that it w[ould] be prejudiced" if the court ordered substantive consolida-

29. *Cf.* Posner, *supra* note 7, at 506 ("A corporation law that is out of step with [business] 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.").

30. 810 F.2d 270 (D.C. Cir. 1987).

31. *Id.* at 276.

32. *Id.*

33. Seth D. Amera & Alan Kolod, *Substantive Consolidation: Getting Back to Basics*, 14 AM. BANKR. INST. L. REV. 1, 23 (2006).

34. *See* Widen, *Corporate Form*, *supra* note 15, at 270 ("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."); Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381, 424–27 (1998).

35. Widen, *Corporate Form*, *supra* note 15, at 270.

tion of the debtor.[36] Finally, if an objecting creditor carries its burden, the court balances the harm and benefits to the parties. It may order substantive consolidation if the benefits "heavily outweigh the harm."[37]

The balancing aspect of this test lacks clarity. For example, what metric should the court use to ascertain the benefits and harm that substantive consolidation might cause? A court might measure the financial effects of consolidation in terms of either absolute dollar values of harm and benefits or the ratio of harm or benefits to the size of the respective creditor. The choice of metric may be outcome determinative of the consolidation motion. Secured creditors, of course, are larger, more sophisticated, and better able to bear default risk than unsecured creditors; if an *Auto-Train* analysis were to pit unsecured consolidation proponents against secured consolidation opponents, the same dollar value of loss would cause proportionally more harm to the unsecureds than it would to the secureds. Should the unsecureds therefore receive a handicap under a proportional analysis? Alternatively, if the court balances the benefits and harms of consolidation simply according to their absolute dollar values, what should be the threshold for the benefits "heavily" to outweigh the harm? No court construing the *Auto-Train* test has addressed these questions.[38]

Regardless of the metric, though, the *Auto-Train* test fails to conform to the ex ante incentives of the parties involved in a Chapter 11 proceeding, thereby systematically disadvantaging both sophisticated and unsophisticated creditors as well as debtors. First, the "avoid some harm or realize some benefit" language combined with the balancing prong frustrates sophisticated creditors insofar as it is not specific enough to allow them accurately to assess the risk that a debtor who enters Chapter 11 will be subject to a substantive consolidation. Risk-averse creditors thus will overestimate the prospect of consolidation, increase interest rates, and demand that more subsidiaries guarantee the loan than might otherwise be adequate to compensate them for the use of their money and allay the default risk they assume. This means more expensive credit and

36. *Auto-Train*, 810 F.2d at 276.

37. *Id.* (internal quotation marks omitted).

38. Often, courts state the *Auto-Train* test but do not perform the whole analysis. For example, in *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 723 (Bankr. S.D.N.Y. 1992), the bankruptcy court concluded that the consolidation proponents had established a prima facie case, *id.* at 766, and then ordered consolidation without explicitly mentioning whether any party had opposed consolidation and without explicitly balancing the benefits against any harm. *Id.* at 773.

less lending—in other words, the creation of deadweight loss—than would be the case if the *Auto-Train* analysis had a more predictable application.

Second, the requirement that the harm or benefit to proponents "heavily" outweigh the harm or benefits to opponents[39] disadvantages unsophisticated creditors because it places the heaviest burden on the creditors who are least able to control how much default risk they assume. Unsecured creditors are typically the proponents of consolidation.[40] They are also less able to negotiate and structure their loans to the debtor ex ante than secured creditors are.[41] By demanding a significantly stronger showing of the weaker creditors than of the stronger, the *Auto-Train* test further diminishes the economic position of the already weakest creditors, producing what is arguably an inequitable result.

Finally, the *Auto-Train* test fails to provide the possibility of partial substantive consolidation.[42] Partial consolidation may be a useful restructuring tool in some cases: "If the benefits of consolidation truly outweighed its harm"[43] for most but not all creditors, then consolidation might be optimal "if the objecting creditor were compensated for, or protected against, injury."[44] For all of these reasons, the *Auto-Train* test is an undesirable substantive consolidation analysis as a matter of bankruptcy policy.

39. *Auto-Train*, 810 F.2d at 276.

40. *See* Amera & Kolod, *supra* note 33, at 23 (noting that substantive consolidation is appropriate where movant shows that unsecured creditors would be harmed by abuse of corporate form).

41. *See supra* Part I.C.

42. As Andrew Brasher notes:

> Partial consolidations are substantive consolidation with a twist. Some courts have held that, even if the conditions are right for substantive consolidation, a creditor that can show that it actually and reasonably relied on an entity's separateness from the overall corporate group can have its claims settled solely from the assets of that entity. Thus, upon the distribution of assets in a liquidation or pursuant to a plan, the court sets aside the assets of the subsidiary to which the objecting creditor loaned and satisfies [its] claims from this pool within a pool. Partial consolidation usually requires the court to estimate what the objecting creditor's recovery would have been had there not been consolidation.

Brasher, *supra* note 16, at 5–6; *see also In re* Lionel L.L.C., No. 04–17324, 2008 WL 905928, at *11 (Bankr. S.D.N.Y. Mar. 31, 2008) (ordering partial consolidation as part of plan confirmation).

43. *See* Amera & Kolod, *supra* note 33, at 24.

44. *Id.*

B. *The* Augie/Restivo *and* Owens Corning *Analyses*

The Courts of Appeals for the Second and Third Circuits rejected the *Auto-Train* test and articulated their own tests in *Union Savings Bank v. Augie/Restivo Baking Co.* (*In re Augie/Restivo Baking Co.*)[45] and *In re Owens Corning*,[46] respectively. These courts' analyses have much in common with each other. Under *Augie/Restivo*, a consolidation proponent must prove either that prepetition "creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit"[47] or that postpetition the debtor entities' affairs "are so entangled that consolidation will benefit all creditors."[48] Likewise, under *Owens Corning*, a consolidation proponent must prove either that "prepetition [the debtor companies] disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity"[49] or that "postpetition [the debtors'] assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[50] These tests both contain a "reliance" prong and an "entanglement" or "efficiency" prong;[51] they are both disjunctive; and they both reject the balancing framework used in *Auto-Train*. Despite the substantial agreement between the Second and Third Circuits as to the appropriate substantive consolidation analysis,[52] the *Augie/Restivo* and *Owens Corning* tests contain a number of problems that can lead to inconsistent or theoretically problematic results.

i. The "Reliance" Prong

A reliance-based test systematically disadvantages unsophisticated creditors to the benefit of sophisticated creditors. As discussed *supra* in Part I.B, unsophisticated creditors either lack the means to understand the legal implications of the debtor's corporate form or, in some cases, lend money to the debtor involuntarily and against their own interests. Only sophisticated creditors have the

45. 860 F.2d 515 (2d Cir. 1988).

46. 419 F.3d 195 at 210.

47. *In re Augie/Restivo*, 860 F.2d at 518 (internal quotation marks omitted).

48. *Id.*

49. *In re* Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005).

50. *Id.*

51. *See* Widen, *Corporate Form*, *supra* note 15, at 268–69; J. Maxwell Tucker, *Substantive Consolidation: The Cacophony Continues*, 18 AM. BANKR. INST. L. REV. 89, 167–68 (2010).

52. *See* Tucker, *supra* note 51, at 168–69. As Tucker also points out, the Owens Corning test places a somewhat higher burden on proponents of consolidation. *Id.*

opportunity to rely on the corporate form of the debtor at all, regardless of whether that form appears to them to be unified or separate.[53] Since unsophisticated creditors do not have a meaningful "opportunity to transact around the provisions of corporation law, the provisions governing limited liability [and substantive consolidation] may alter the relative position of debtor and creditor,"[54] as well as the position of unsophisticated creditors relative to sophisticated creditors.[55]

As discussed above, unsophisticated creditors consist mainly of three groups, none of which are reasonably able to consider the debtor's corporate form before extending credit. Tort claimants cannot rely on the debtor's corporate form because they are involuntary creditors, discovering their status as such only after the debtor injures them and they obtain a right to compensation through settlement or a court-ordered award of damages.[56] Trade creditors do not rely on the debtor's corporate form because they "provide services on credit but do not profit from financing; they have neither the skill nor the resources to investigate the debtor's status as a legal entity."[57] And employees do not have a realistic option to rely because they typically cannot assess the corporation-law implications of working at one related corporate entity as opposed to another. Rather, employees either work at the entity that offers them employment or they do not; the corporate form of their employer simply is not part of their rational decisionmaking. And, in any event, the contingency of substantive consolidation generally does not enter into one's decision whether to accept employment at a particular firm.

Sophisticated creditors, by contrast, make it their business to take all potentially relevant factors into consideration before making loans to debtors.[58] Sophisticated creditors negotiate ex ante for an interest rate that compensates them for all the default risk they assume. They have an opportunity to assess the debtor's risk of defaulting on their loans, and debtors compensate them for bearing that risk by paying an appropriate interest rate. Unsophisticated creditors do not have these opportunities to conduct ex ante nego-

53. *Cf.* Kors, *supra* note 34, at 418 ("[A reliance] requirement eliminates tort and statutory claimants, who, as involuntary creditors, by definition did not rely on anything in becoming creditors.").

54. Posner, *supra* note 7, at 506.

55. *See supra* Part I.C.

56. *See id.*

57. Brasher, *supra* note 16, at 17.

58. *See id.* at 17.

tiations around default corporation-law principles.[59] They are thereby at a disadvantage in an *Augie/Restivo* or *Owens Corning* framework: reliance applies to sophisticated creditors but not to unsophisticated creditors, limiting unsophisticated creditors' ability to obtain the remedy of substantive consolidation.

The risk of inconsistent or theoretically problematic results is particularly high when courts must assess whether an unsophisticated creditor has satisfied the reliance prong of the *Augie/Restivo* test. To say, for example, that tort claimants "dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit"[60] is problematic for two reasons. First, the debtor's corporate form is irrelevant to the debtor's injury of tort claimants: accident victims neither deal with the debtor entities as a single economic unit nor deal with them as separate economic units.[61] Second, any attempt to determine what entity the tort claimant dealt with must involve after-the-fact assessments that the parties could not have made prior to the injury. Tort claimants seeking substantive consolidation will argue that they dealt with the debtor as a single entity, whereas opposing creditors will argue that the tort claimants dealt with the debtor's individual subsidiaries. But since the tort claimants likely made no such ex ante assessment because they extended credit only involuntarily,[62] neither side's argument should be successful. For these reasons, analyzing an unsophisticated creditor's ex ante understanding of the debtor's corporate form is likely to produce problematic or inconsistent results.

Despite the inequitable and inconsistent results reliance-based tests can produce, some arguments in support of reliance-based

59. Put differently, "[r]eliance concerns cut both ways . . . . Creditors may have entered into credit arrangements with an expectation that the borrower would not be liable for the debts of affiliated entities." Christopher W. Frost, *Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups*, 44 HASTINGS L.J. 449, 457 (1993). This may often be the case with unsophisticated creditors who are unaware of the legal implications of the borrower's corporate form.

60. Union Savings Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988) (internal quotation marks omitted).

61. *See* Brasher, *supra* note 16, at 34–35 (explaining that the "contractarian definition of equitable harm—reliance and expectation[—]makes little sense" when applied to unsophisticated and involuntary creditors). *Cf.* Tucker, *supra* note 51, at 163–64 (setting forth another scenario in which *Augie/Restivo* reliance analysis would produce problematic result).

62. *See* Brasher, *supra* note 16, at 34–35.

tests nevertheless conclude that it is unfair to deprive bank creditors of the "benefit of their bargain":[63]

> It is inherently unfair to stand on corporate formality, where the debtors failed to do so themselves, when to do so would deny some creditors claims to greater funds and give other creditors a windfall simply as a result of happenstance concerning which entity was holding which assets at the time of the bankruptcy filing. . . . The harm comes from treating a creditor that did rely on the financial health of a particular debtor as if that creditor had assumed the risk of doing business with related entities in much poorer financial health.[64]

These arguments ignore a fundamental principle of corporate finance: "[T]he interest rate on a loan is payment not only for renting capital *but also for the risk that the borrower will fail to return it.*"[65] Sophisticated creditors know that the increased availability of a substantive consolidation remedy in bankruptcy increases the risk that the debtor will fail to repay the loan.[66] Therefore, sophisticated creditors will consider this increased risk—just as they would consider the possibility of the debtor's entering bankruptcy—when determining an appropriate interest rate for the debtor's loan.

Yet the impact of the availability of substantive consolidation on a debtor's default risk may be impossible to measure ex ante. "At the time of lending, creditors [might] have difficulty assessing whether the difficulties of disentanglement or other bankruptcy concerns might lead a bankruptcy court a few years hence to consolidate 'their' debtor with related entities."[67] Even in this case, however, a creditor's ex ante knowledge that additional default risk exists allows it to structure its affairs with the debtor to a greater extent than can unsophisticated or involuntary creditors. Sophisticated creditors can at least estimate the additional default risk and demand appropriate compensation; unsophisticated and involuntary creditors must accept the default risk whatever its cost.

63. Brief of Amici Curiae in Support of Appellant, et al. at 25–28, *In re* Owens Corning, 419 F.3d 195 (3d Cir. 2005) (No. 04-4080); Kors, *supra* note 34, at 446; *see, e.g.*, Sabin Willett, *The Doctrine of Robin Hood: A Note on "Substantive Consolidation,"* 4 DEPAUL BUS. & COM. L.J. 87, 89 (2005) ("The zero-sum principle always holds true: when estates are substantively consolidated, the rich are taxed to benefit the poor.").

64. Amera & Kolod, *supra* note 33, at 36–37.

65. Posner, *supra* note 7, at 501 (emphasis added).

66. *See* Brasher, *supra* note 21, at 34 ("If the creditor was a sophisticated creditor, then it almost certainly accounted for the potential for substantive consolidation and corporate disregard in its loan agreement.").

67. Kors, *supra* note 34, at 446.

In sum, reliance-based tests ignore a fundamental disparity between the two classes of creditors: sophisticated creditors evaluate risk and extend credit as their business, whereas unsophisticated creditors do not.[68] Trade creditors are often parts or services suppliers to the debtor, and extending credit is merely incidental to their lines of work. Employees can be characterized as voluntary creditors only with difficulty, and tort claimants extend credit only involuntarily. Compared to these kinds of creditors, banks are specialists in extending credit and even have a meaningful opportunity to control the risks they assume. Thus, any test that accommodates bank creditors' reliance interests fails to hold sophisticated creditors to a standard commensurate with their specialized ability to mitigate their losses—especially vis-à-vis unsophisticated creditors.[69] Accordingly, the reliance-based tests in *Augie/Restivo* and *Owens Corning* systematically disadvantage unsophisticated creditors insofar as those creditors are simply unable to rely on a debtor's corporate form before extending credit.

ii. The "Entanglement" Prong

The entanglement prong is distinct from the reliance prong in that it "relates primarily to the [debtor's] failure to maintain business records that properly identify assets with particular corporate names . . . and not to the destruction of artificial personality . . . ."[70] The problem with the entanglement prong of the *Augie/Restivo* and *Owens Corning* tests is that it fails to identify just how much entanglement is necessary to warrant substantive consolidation of the debtor entities.[71] For example, where assets are commingled, substantive consolidation would be a desirable remedy if it benefited every creditor and harmed no one; it would be undesirable if it merely effected an arbitrary transfer of wealth.[72] But a considerable gray area exists between these two ends of the spectrum. What if, for example, consolidation would harm one creditor but benefit every

68. *Compare* Frost, *supra* note 59, at 465 ("Creditors develop their expectations of risk, and concomitantly their desired return, by reference to the liabilities as well as the assets of the borrowing entity."), *with* Brasher, *supra* note 16, at 17 (explaining that trade creditors "do not profit from financing").

69. *But see* Tucker, *supra* note 51, at 178–80 (explaining why use of special-purpose entities might justify consideration of sophisticated creditors' reliance interests).

70. Widen, *Corporate Form*, *supra* note 15, at 269.

71. *See* Tucker, *supra* note 51, at 164 (examining difficulty of interpreting *Augie/Restivo* entanglement analysis), 168 (same, regarding *Owens Corning* entanglement analysis).

72. *Id.* at 280–91.

other creditor? Whereas *Auto-Train* might balance these interests,[73] *Augie/Restivo* and *Owens Corning* appear to grant veto power over the whole consolidation to the one creditor who is harmed.[74] This is the case even if the aggregate benefits of consolidation "heavily outweigh"[75] the harms. Alternatively, how much money would have to be spent unscrambling the debtor's financial records before "separating them is prohibitive and hurts all creditors"?[76]

Professor William H. Widen has identified four different factual scenarios that are susceptible to entanglement analysis,[77] and courts have not been entirely correct on which of those ought to merit a substantive consolidation order. First, substantive consolidation might be necessary if the debtor's financial records are literally "incapable of reconstruction by forensic accountants."[78] Substantive consolidation makes obvious sense here: if the business recordkeeping is so poor[79] that unscrambling the records would consume 100% of the bankrupt estate, then substantive consolidation at least pays creditors something in return for their loans, however crudely distributed those payments might be. This is indeed what *Owens Corning* seems to imply: that "[w]ithout substantive consolidation all creditors will be worse off (as Humpty Dumpty cannot be reassembled or, even if so, [only the professionals will profit])."[80] *Augie/Restivo* is similarly restrictive, requiring "'hopeless[ ] obscur[ity]' of interrelationships."[81] A number of courts have subsequently interpreted the standard narrowly. In one case, the District of New Jersey affirmed the bankruptcy court's denial of substantive consolidation on entanglement grounds where "postpe-

73. *See* Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987).

74. *See* Union Savings Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 519 (2d Cir. 1988) ("[S]ubstantive consolidation should be used only after it has been determined that *all* creditors will benefit . . . .") (emphasis added); *In re* Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005) (stating that substantive consolidation is appropriate where "assets and liabilities are so scrambled that separating them is prohibitive and hurts *all* creditors") (emphasis added). The Third Circuit has not decided whether such veto power is appropriate or whether partial consolidation except as to the harmed creditor would suffice. *See Owens Corning*, 419 F.3d at 212 n.22.

75. *Auto-Train*, 810 F.2d at 276.

76. *Owens Corning*, 419 F.3d at 211.

77. *See* Widen, *Corporate Form*, *supra* note 15, at 280–91.

78. *Id.* at 281.

79. *See id.* at 282–83.

80. *Owens Corning*, 419 F.3d at 211–12 n.20.

81. Union Savings Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 519 (2d Cir. 1988).

tition the assets of the entities were not so scrambled as to prohibit accountants from separating them."[82] Shortly thereafter, the Bankruptcy Court for the Northern District of New York denied substantive consolidation where "untangling the affairs of the [d]ebtor[ ], while it may [have] require[d] extensive legal and forensic accounting work, [wa]s not impossible."[83] But courts often "will be able to estimate ranges" of assets held by entities and assets in dispute, and may have the ability to order partial consolidation only with respect to the estimated assets in dispute.[84] So although consolidation on the basis of actual necessity would be justified, the stringent entanglement requirements and the availability of partial consolidation make an "actual necessity" scenario unlikely to arise.

Second, substantive consolidation would be Pareto efficient[85] if it benefitted at least one creditor and harmed no one.[86] This scenario would arise where "the transaction costs incurred to create separate balance sheets are factored into the analysis, [and] a substantive consolidation yields a preferred result for [some] creditors and a neutral result for [others]."[87] This standard is similar to actual necessity in that it requires that no creditor be harmed by consolidation; it is different in that it allows consolidation where unscrambling is possible but not practical. Pareto-efficient substantive consolidation is justified because, as it was with actual necessity, its benefits outweigh its costs. Yet Pareto-efficient consolidation presents its own difficulties. One problem is that the transaction-cost savings substantive consolidation would provide can only be measured if the assets are actually unscrambled, which they must not be if the court orders them to be consolidated.[88] But assuming the savings could be estimated, different parties may not agree on

82. *In re* Macrophage, Inc., Nos. Civ. 06 3793 JBS, Civ. 06 3794 JBS, 2007 WL 708926, at *6 (D.N.J. Mar. 2, 2007).

83. *In re* Reserve Capital Corp., Nos. 03-60071 to - 78, 2007 WL 880600, at *5 (Bankr. N.D.N.Y. Mar. 21, 2007) (interpreting both *Augie/Restivo* and *Owens Corning*).

84. *See* Widen, *Corporate Form*, *supra* note 15, at 283–84 (analogizing partial consolidation of disputed assets to Enron settlement, which involved consolidation of 30% of each relevant creditor's claim based on 30% likelihood that substantive consolidation, if sought, would be granted).

85. Pareto superiority is defined as follows: "S_1 is Pareto superior to S if and only if no one prefers S to S_1 and at least one person prefers S_1 to S." JEFFRIE G. MURPHY & JULES L. COLEMAN, PHILOSOPHY OF LAW: AN INTRODUCTION TO JURISPRUDENCE 182 (rev. ed. 1990).

86. *See* Widen, *Corporate Form*, *supra* note 15, at 285–86.

87. *Id.* at 286.

88. *See id.*

that estimate and whether it would in fact justify consolidation.[89] Despite these difficulties, courts have often granted substantive consolidation on grounds of Pareto efficiency,[90] even though the language of the *Augie/Restivo* and *Owens Corning* entanglement tests literally excludes Pareto efficiency as a ground for ordering substantive consolidation.[91] Further, there may be little difference to creditors between the actual necessity scenario and the Pareto efficiency scenario because, in both cases, consolidation harms no creditors and benefits at least some. For these reasons, the Pareto-efficient consolidation scenario demonstrates that the *Augie/Restivo* and *Owens Corning* tests are underinclusive.

Third, substantive consolidation would be Kaldor-Hicks efficient if consolidation harmed some creditors but those creditors were compensated and ultimately made better off through subsequent negotiations with the creditors who benefitted from consolidation.[92] In this case, "consolidation yields enough [transaction-]cost savings such that [creditors that benefit] could pay [creditors that are harmed] to accept the consolidation and, following the payment, all parties would benefit financially."[93] This scenario essentially collapses into one of Pareto efficiency: "[C]ourts do not expressly mention Kaldor-Hicks improvement as a rationale because they wait until the parties themselves have converted a

89. *See id.* at 286–87.

90. *See, e.g.*, ASARCO LLC v. Americas Mining Corp., 382 B.R. 49, 68 (S.D. Tex. 2007) (finding that *In re Owens Corning*, 419 F.3d 195 (3d. Cir. 2005), did not apply where lawsuit challenged as being tantamount to substantive consolidation did not harm any creditors); Widen, *Corporate Form*, *supra* note 15, at 287 & n.156; *cf.* Windels Marx Lane & Mittendorf, LLP v. Source Enters., Inc. (*In re* Source Enters., Inc.), 392 B.R. 541, 554 (S.D.N.Y. 2008) (affirming bankruptcy court's grant of substantive consolidation under *Union Savings Bank v. Augie/Restivo Baking Co.* (*In re Augie/Restivo Baking Co.*), 860 F.2d 515 (2d Cir. 1988), where "the substantive consolidation does not benefit one creditor at the expense of another").

91. *See In re Augie/Restivo Baking Co.*, 860 F.2d at 518 (2d Cir. 1988) (permitting substantive consolidation on entanglement grounds only where debtors' records are "so entangled that consolidation will benefit all creditors"); *Owens Corning*, 419 F.3d at 211 (permitting substantive consolidation on entanglement grounds only where "postpetition [the debtors'] assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors"). By contrast, Pareto-efficient substantive consolidation would permit consolidation where it benefits at least one creditor but does not harm any.

92. *See* Widen, *Corporate Form*, *supra* note 15, at 288. Kaldor-Hicks efficiency is defined as follows: "S_1 is Kaldor-Hicks efficient to S if and only if in going from S to S_1 the winners *could compensate* the losers so that no one would be worse off than he or she was in S and at least one person would be better off than he or she was in S." MURPHY & COLEMAN, *supra* note 85, at 186.

93. *See* Widen, *Corporate Form*, *supra* note 15, at 288 (emphasis omitted).

Kaldor-Hicks Scenario through negotiations"[94] into one that is Pareto efficient. Further, the "large number of consensual substantive consolidation reorganization plans suggests . . . that, in some cases, courts approve substantive consolidation in Kaldor-Hicks Scenarios that are not also Pareto improvements."[95] But since courts cannot order consolidation under *Augie/Restivo* or *Owens Corning* based on a Kaldor-Hicks improvement, this scenario shows that creditors that stand to be harmed may be able to withhold their consent to consolidation in order to extract rents from creditors who stand to benefit. The Kaldor-Hicks scenario demonstrates that the entanglement prongs are underinclusive to the extent they prohibit courts from ordering some consolidations that would ultimately lead to benefits for all creditors.

Fourth, substantive consolidation might effect a "pure wealth transfer," and in this case it may or may not be efficient.[96] Here, "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 . . . ."[97] Wealth transfers fail the *Augie/Restivo* and *Owens Corning* entanglement analyses because some creditors are harmed by consolidation. Generally speaking, this is correct: courts should not allow arbitrary wealth transfers. But it may be the case that not all such consolidations are unprincipled. For example, when a substantive-consolidation fight pits sophisticated creditors against unsophisticated creditors, as in *Owens Corning*,[98] the entanglement and reliance analyses may become intertwined insofar as consolidation will frustrate one of the two groups' reliance interests.[99] Put differently, situations may arise in which the entanglement analysis weighs in favor of unsophisticated creditors seeking consolidation; but the reliance analysis weighs in favor of sophisticated creditors seeking to avoid consolidation. Such a case might, for instance, involve a group of related debtor entities having entangled books, one or more of those debtor entities having liabilities to unsecured credi-

94. *Id.* at 289.
95. *Id.*
96. *Id.* at 290–91.
97. *Id.*
98. *See In re* Owens Corning, 419 F.3d 195 (3d Cir. 2005).
99. *See* Widen, *Corporate Form*, *supra* note 15, at 291 ("The Third Circuit decision might be seen to foreclose a substantive consolidation that results in a pure wealth transfer . . . . The better view is instead that the Third Circuit decision simply rejects the district judge's finding of necessity.").

tors in excess of assets, and entities having secured obligations to sophisticated creditors. In this case, entanglement analysis ought to give way to reliance analysis in order to reflect the parties' incentive structures, i.e., that sophisticated creditors have the ability to structure their loans ex ante, whereas unsophisticated creditors do not.[100] This further demonstrates the underinclusiveness of the existing entanglement tests, which may be understood to block all wealth transfers.

As demonstrated above, the *Auto-Train*, *Augie/Restivo*, and *Owens Corning* tests for substantive consolidation raise a host of difficult and unanswered questions. No court has yet articulated a test that is at once practical to apply and grounded in the parties' preexisting incentives. It may be that the Courts of Appeals for the District of Columbia, Second, and Third Circuits have designed their substantive consolidation tests based on unsound policies of bankruptcy or corporation law. The next part of this Note examines what might be wrong with these courts' policy choices and proposes a new test for substantive consolidation that avoids the problems raised by the existing tests.

III. PROTECTING CREDITORS THAT CANNOT PROTECT THEMSELVES

A. Existing Substantive Consolidation Frameworks Are Not Grounded in Sound Policies

Each of the three courts of appeals stated policy considerations to guide application of its substantive consolidation test. Problematically, some of these policy choices are unsound, leaving the tests open to producing problematic results. In *Auto-Train*, the Court of Appeals for the District of Columbia Circuit attempted to balance two competing policies.[101] First, substantive consolidation is supposed to facilitate the debtor's reorganization and reduce transaction costs by "avoid[ing] the expense or difficulty of sorting out the debtor's records to determine the separate assets and liabilities of each affiliated entity."[102] Second, courts should not order substantive consolidation if it would cause unjustified windfalls or exaggerated losses to parties, bearing in mind that the remedy "almost invariably redistributes wealth among the creditors of the various

100. *See supra* Part I.
101. *See* Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987).
102. *Id.*

entities."[103] The court correctly determined that reducing transaction costs is good for all parties because it means that an additional portion of the debtor's assets will go to creditors rather than to professionals.[104] But the court also determined that because redistributing wealth harms some creditors, redistributing wealth is generally bad. By failing to explain when a windfall would be unjustified and when a loss would be exaggerated, the court needlessly foreclosed the possibility that consolidations with such ramifications may sometimes be justifiable.

As discussed previously,[105] substantive consolidations that defeats sophisticated creditors' purported reliance interests for the benefit of unsophisticated creditors is not inherently unfair, particularly where the opposite result would obtain absent consolidation.[106] In situations like these, courts cannot ignore the parties' different incentive structures: sophisticated creditors are always able to structure their loans to the debtor ex ante, but most unsophisticated creditors are not.[107] Courts must, in these situations, hold sophisticated creditors fully responsible for the default risk they chose to assume. Those creditors have already recovered for losses attributable to substantive consolidation by having charged the debtor an appropriate interest rate.[108] What the *Auto-Train* court should have said is that *arbitrary* wealth transfers are bad. Rather than requiring creditors opposed to consolidation to show "reli[ance] on . . . separate credit" to defeat consolidation, the *Auto-Train* test ought to require those creditors to show that substantive consolidation would effect an arbitrary transfer of wealth. Protecting the creditors that were unable ex ante to protect themselves would not be arbitrary; it would be justified by the difference in creditors' abilities to structure their loans to the debtor before extending credit. Thus, by using the broader term "unjustifiable" instead of the narrower term "arbitrary" to describe the kinds of wealth transfers that ought to be prohibited, the *Auto-Train* court grounded its substantive consolidation test on a bankruptcy policy that is unsound insofar as it is overinclusive.

103. *Id.*

104. *See In re* Owens Corning, 419 F.3d 195, 211–12 n.20 (3d Cir. 2005) ("With substantive consolidation the lot of all creditors will be improved, as consolidation advance[s] one of the primary goals of bankruptcy-enhancing the value of the assets available to creditors[—]often in a very material respect." (internal quotation marks omitted)).

105. *See supra* Part II.B.ii.

106. *See, e.g.*, *Owens Corning*, 419 F.3d at 202–03.

107. *See supra* Part I.C.

108. *See* Posner, *supra* note 7, at 501.

In *Augie/Restivo*, the Court of Appeals for the Second Circuit stated that "[t]he sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors."[109] With respect to the entanglement prong, the court expressed no specific policy statement other than that substantive consolidation should maximize all creditors' recoveries.[110] The problems resulting from this formulation are described above.[111] With respect to the reliance prong, however, the court explained that "lenders structure their loans according to their expectations regarding [the form and finances of a particular] borrower . . . . Such expectations create significant equities. Moreover . . . fulfilling those expectations is . . . important to the efficiency of the credit markets."[112] But again, this incorrectly appraises the relative ex ante positions of sophisticated versus unsophisticated creditors. Courts ought not protect sophisticated creditors at the expense of unsophisticated creditors because unsophisticated creditors typically do not have a meaningful chance to structure their loans ex ante the way sophisticated creditors do. Further, as mentioned above, sophisticated creditors protect themselves against default risk ex ante by charging the debtor an interest rate on their loans, whereas unsophisticated creditors do not.[113] Allowing those same creditors to assert their reliance interests in bankruptcy, particularly at the expense of unsophisticated creditors, amounts not to an efficient credit market but to a windfall for the banks: they recover prospectively through an appropriate interest rate, and they also recover retrospectively by defeating substantive consolidation. To prevent such a windfall, sophisticated creditors' reliance interests must be subordinated to unsophisticated creditors' competing reliance interests or lack thereof.

Two hypothetical situations, however, seem to suggest that sophisticated creditors' reliance interests should be given more weight. In one case, a debtor might decide to obtain loans by affirmatively misleading sophisticated creditors about its finances and corporate form. In another case, a debtor might decide to obtain loans through honest representations to sophisticated creditors and then shuffle around its assets among subsidiaries so as to undersecure the loan to the original borrowing entity. These two situa-

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

110. *See id.* at 519 ("In such circumstances, all creditors are better off with substantive consolidation.").

111. *See supra* Part II.B.ii.

112. *In re* Augie/Restivo Baking Co., 860 F.2d at 518–19.

113. *See* Posner, *supra* note 7, at 501, 505.

tions involve the apparent intersection between fraudulent conveyance law and substantive consolidation law.

In the second, easier case, "[f]raudulent transfer law serves as a more appropriate remedy for misappropriation because it allows this simple recovery of the misappropriated assets or elimination of unfairly incurred liabilities."[114] It even "provides a clear and precise statutory formula to redress misappropriation," thereby making the remedy administratively easier to accomplish than a substantive consolidation remedy.[115]

The first case, although admittedly more difficult, calls not for the application of substantive consolidation doctrine but rather for the modification of turnover or fraudulent conveyance law.[116] Substantive consolidation in cases of ex ante fraud by the debtor is appropriate, under the principles discussed above, only when its resulting wealth transfer would be non-arbitrary. Consolidation should be limited here because it "is the most dramatic and far-reaching exception to corporate separateness."[117] In other words, substantive consolidation would be justified only when the debtor has fraudulently obtained so many loans that there would be no principled basis for maintaining the corporate form during bankruptcy. Another, more tailored alternative is partial consolidation of the assets in dispute.[118] In sum, the policy choice underlying the *Augie/Restivo* test's reliance prong is unsound because, in accounting for the reliance interests of sophisticated creditors but not of unsophisticated creditors, it allows banks to gain windfall recoveries at the expense of unsophisticated creditors.

In *Owens Corning*, the Third Circuit articulated five policy considerations underlying its substantive consolidation test: (1) "[l]imiting the cross-creep of liability by respecting entity separateness . . . absent compelling circumstances calling equity . . . into play";[119] (2) "[t]he harms substantive consolidation addresses are nearly always those caused by *debtors* . . . who disregard separateness";[120] (3) case-administration benefits do not justify substantive

114. Kors, *supra* note 34, at 421–22.

115. *Id.* at 422.

116. *See generally* Timothy E. Graulich, *Substantive Consolidation–A Post-modern Trend*, 14 AM. BANKR. INST. L. REV. 527, 537 (2006) (describing mechanisms of turnover and fraudulent conveyance law).

117. *Id.* at 538.

118. *Cf.* Widen, *Corporate Form*, *supra* note 15, at 283–84 (proposing method of partial consolidation in entanglement context).

119. *In re* Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005).

120. *Id.*

consolidation;[121] (4) substantive consolidation is "extreme . . . and imprecise," and ought to be a remedy of last resort;[122] and (5) substantive consolidation may not be used "to disadvantage tactically a group of creditors in the plan process or to alter creditor rights."[123] Most of these are uncontroversial, but the first policy consideration—which also seems to have the most substance of the five—gives short shrift to unsophisticated creditors' reliance interests in precisely the same way the policy underlying the *Augie/Restivo* test does. Significantly, the *Owens Corning* court held that sophisticated creditors' reliance interests defeated substantive consolidation, without ever considering the ex ante position of the unsophisticated creditors who supported the motion.[124] To the extent a bankruptcy court's application of the *Owens Corning* test is guided by the first stated policy consideration, it also rests on unsound footing for the same reasons as *Augie/Restivo*.

Of the three existing tests, *Auto-Train* comes closest to sound bankruptcy policy because its balancing aspect allows a court to order consolidation in some cases where unsophisticated creditors would otherwise be harmed for the benefit of sophisticated creditors; *Augie/Restivo* and *Owens Corning* appear to foreclose this possibility.[125] Nevertheless, all three substantive consolidation tests are grounded in unsound policy choices that have the effect of system-

121. *Id.*

122. *Id.* Indeed, the United States District Court for the District of Delaware reversed, with express reference to this policy consideration, the Bankruptcy Court's confirmation of plan that involved a technique similar to classic substantive consolidation. The Court set forth the following analysis:

> The question raised on appeal is whether the plan, by aggregating multiple debtors into debtor groups to resolve claims, effects a substantive consolidation. As the bankruptcy court points out, the plan here does not call for the typical case of substantive consolidation where multiple separate entities are merged into a single entity and inter-entity liabilities are erased; instead of many-into-one, the plan calls for many-into-three, and the inter-entity liabilities are not erased. [Yet this] framework still presents the same potential inequities for creditors[:] namely that creditors face increased competition for a consolidated pool of assets and a re-valued claim that is less precise than if the creditors were dealing with debtors individually. This is the "rough justice" against which *Owens Corning* warns and, because it is effected by aggregating multiple debtors into one or more debtor groups, it falls within the definition of substantive consolidation.

In re New Century TRS Holdings, Inc., 407 B.R. 576, 591 (D. Del. 2009).

123. *In re Owens Corning*, 419 F.3d at 211.

124. *See id.* at 212–14.

125. *Cf.* Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5, 8 (2005) ("Someone wanting to argue in favor of substantive consolidation for [a hypothetical debtor] might begin by invoking [*Auto-Train*].").

atically disadvantaging unsophisticated creditors. This is particularly true where sophisticated creditors' loans are guaranteed by one or more of the debtor entities. As Professor Widen wrote, however, "[S]ubstantive consolidation doctrine can be used to balance the equities when we find that intercompany guarantees divide creditors into various camps of single-source creditors competing with a multiple-source creditor that benefits from the web of intercompany guarantees. Substantive consolidation in this context removes the unfairness" to the unsophisticated creditors by eliminating the intercompany guarantees.[126] Bearing in mind this suggestion, Part III.B describes what a correct test might look like based on a correct understanding of creditors' reliance interests.

B. A Better Test for Substantive Consolidation

A proper substantive consolidation test ought to reflect what the parties' incentives actually are, so as not to "alter the relative position" of any party.[127] The three existing tests fail to accomplish these goals because they allow sophisticated creditors' reliance interests to trump the ex ante interests of unsophisticated creditors, thereby systematically disadvantaging the creditors who are least able to protect themselves. In this regard, the legal framework of substantive consolidation is itself a windfall of sorts for sophisticated creditors. Under all three major tests for substantive consolidation, the court-devised reliance analyses allow sophisticated creditors to benefit both ex ante by raising loan interest rates to compensate them for the risk that a default—necessarily including a substantive consolidation—will take place and ex post by asserting their reliance interests in bankruptcy court to defeat substantive consolidation.[128] A legal regime that allows this to happen does not take default risk seriously: it allows banks to obtain compensation for a certain measure of risk that they do not actually assume.

A proper test should also allow entanglement-based consolidation when it would benefit every creditor through either a Pareto improvement or a Kaldor-Hicks improvement combined with negotiation among creditors, regardless of whether substantive consoli-

126. Widen, *Corporate Form*, *supra* note 15, at 307–10. *But see* Tucker, *supra* note 51, at 171–72 (setting forth counterarguments to Widen's proposed "fairness" rationale for employing substantive consolidation).

127. *See* Posner, *supra* note 7, at 506.

128. This is the case even if sophisticated creditors actually determine that the probability of substantive consolidation is zero and, therefore, do not increase the cost of their loans accordingly. Sophisticated creditors benefit ex ante merely by having the opportunity to increase the cost of borrowing.

dation would be "rare and . . . of last resort."[129] If substantive consolidation can bring about an increased recovery for every creditor, it makes no difference whether such a remedy is rare or commonplace.[130] Yet by granting veto power over substantive consolidation to any creditors who are harmed, without regard to how much benefit all other creditors may gain, the Courts of Appeals for the Second and Third Circuits have foreclosed the use of substantive consolidation to achieve Kaldor-Hicks efficiency.[131] Notably, *Auto-Train* may avoid this result by allowing a court to balance benefits against harms. But its "heavy-outweighing" requirement might preclude Kaldor-Hicks-improving consolidations where the benefits outweigh the harm only narrowly but enough such that negotiations could make all creditors ultimately better off.

Finally, a proper test should allow consolidation where the borrowing entities received credit on the basis of fraudulent representations *and* there would be no principled way to sort out which entities should hold which assets for reorganization purposes. In these situations, when neither fraudulent conveyance law nor turnover law can achieve an equitable solution, substantive consolidation is indeed a last resort. In other words, a court's insistence on separate accountings in these situations would amount to arbitrary distributions of wealth.

On the basis of the critiques and policy discussions set forth above, a bankruptcy court ought to be able to order substantive consolidation if any one of the following conditions is met:

(1) separate accountings of entangled entities would result in lower recoveries for unsophisticated creditors than substantive consolidation would;

(2) substantive consolidation would achieve a Pareto improvement or facilitate a Kaldor-Hicks improvement with respect to the creditors of the consolidated entities;[132] or

(3) insisting on separate accountings of the relevant entities would produce an arbitrary transfer of wealth.

This test avoids the unsound policies that underlie the reliance prongs of the three existing tests. It clarifies when consolidation

129. *Owens Corning*, 419 F.3d at 211.

130. *See* William C. Blasses, Comment, *Redefining Into Reality: Substantive Consolidation of Parent Corporations and Subsidiaries*, 24 EMORY BANKR. DEV. J. 469, 505 (2008) (describing *Auto-Train*, *Augie/Restivo*, and *Owens Corning* tests as "overly restrictive" because they "prevented substantive consolidation, many times at the cost of equity").

131. *See* Amera & Kolod, *supra* note 33, at 38.

132. *See* Tucker, *supra* note 51, at 177–78.

should be ordered under an entanglement analysis. And its third prong avoids arbitrary transfers of wealth, including those that would otherwise result from fraudulent representations made to obtain credit. It is primarily useful when considering substantive consolidation of debtor entities whose sophisticated creditors' loans are guaranteed by one or more debtor entities. Ultimately, this test provides for a more desirable application of bankruptcy policy than the three existing tests because it avoids the problematic questions the other tests raise. Moreover, because of its simpler language, this test may also be easier to apply in practice than the existing tests. The next part addresses how the proposed test could be put into practice.

IV. COULD COURTS EVER ADOPT THE PROPOSED TEST?

The *Owens Corning* case itself would undoubtedly have turned out differently under this proposed substantive consolidation test because *Owens Corning* pitted unsophisticated creditors seeking consolidation against sophisticated creditors opposing it.[133] The Court of Appeals for the Third Circuit could have affirmed the district court's order granting substantive consolidation under the first prong above. Practically speaking, the Courts of Appeals for the District of Columbia, Second, and Third Circuits would not be able to adopt this proposed test without overruling their own tests to some extent.[134] But the following three hypothetical scenarios present appropriate situations for adopting at least parts of this test.

In all three scenarios, Debtor D is a large public company with a complex corporate structure involving hundreds of subsidiaries. Debtor D has raised cash primarily by obtaining secured loans from Bank A and Bank B. These loans are guaranteed by Debtor D's subsidiaries, which hold significant assets but against which there are no unsecured claims. The loans took weeks to negotiate and involved numerous lawyers, bankers and accountants. To obtain these loans, Debtor D had to provide the Banks and professionals with corporate diagrams and the respective financial statements of all of its corporate entities. Banks A and B have been extending credit to Debtor D for years and are very familiar with D's complex

133. *See Owens Corning*, 419 F.3d at 202; *see also* Widen, *Corporate Form*, *supra* note 15, at 291.

134. *See* Tucker, *supra* note 51, at 181–88 (contending that proper test for substantive consolidation might be more appropriately defined by Congress than by courts).

corporate structure. Debtor D has also received unsecured credit in a number of ways: by withholding payment for forty-five days to small companies that supply parts to it; by paying its employees at the end of every second week rather than at the end of every day; and by structuring its settlements over a period of twenty years with a number of tort plaintiffs. D records its trade credit in the financial statements of whatever subsidiary a supplier dealt with, but D has always represented itself as one unified company to its suppliers. D and all of its subsidiaries enter into a jointly administered Chapter 11 proceeding.

In the first scenario, a substantive consolidation of D with some of D's subsidiaries would benefit the unsecured creditors at the expense of the secured creditors, while separate accountings of the subsidiaries would give the banks a full recovery but leave the unsecured creditors much worse off than they had expected to be. (This is essentially the wealth-transfer scenario described above.) Here, a bankruptcy court could appropriately grant unsophisticated creditors a substantive consolidation remedy because the banks have already been compensated for assuming default risk on their loans but the unsecured creditors have not been. Banks A and B are not deprived of the benefits of their bargains; rather, they are held to their bargains by suffering the event of default. Denying consolidation would instead deprive the unsecured creditors of the benefits of their bargains because those creditors never voluntarily assumed the debtor's default risk in any meaningful sense. In contrast, neither *Owens Corning* nor *Augie/Restivo* would allow this consolidation, and *Auto-Train* would allow it only if the unsecureds' benefits "heavily outweigh"[135] the secureds' harm.

In the second scenario, Banks A and B have not monitored Debtor D's assets carefully. D and its subsidiaries have in the past few months performed a flurry of inter-entity transactions, all of which are undocumented. The assets of D's corporate family have become entangled, but not hopelessly so. Unscrambling the assets would cost more for highly active subsidiaries—i.e., those that have made the most accounting transactions—and less for relatively inactive subsidiaries.[136] For some subsidiaries, unscrambling would consume all the assets; for others, it would consume only a very small proportion. Substantive consolidation of the entire corporate family, it turns out, would benefit all creditors except Bank A, but Bank A would suffer only a negligible loss. Separate accountings

135. Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987).

136. *See, e.g.*, Widen, *Corporate Form*, *supra* note 15, at 288.

would harm all other creditors, but Bank A would recover fully. Here, substantive consolidation would again be appropriate. Bank A should not be able to exercise de facto veto power over substantive consolidation when such a remedy would benefit every other creditor. Bank A would have the incentive to "'sell' its consent to the substantive consolidation—and thereby extract rents from the other creditors—by initially objecting to a proposed consolidation. For [a rent-extracting] recovery[,] Bank [A] might later drop its objection to a plan that included substantive consolidation."[137] Ex ante incentives cannot be forgotten even under an entanglement analysis, and Bank A, having previously charged Debtor D an interest rate that compensated it for assuming the risk of D's default, would not be treated unjustly if it suffers a loss in this situation. Again, *Owens Corning* and *Augie/Restivo* would block this consolidation, granting veto power to Bank A; *Auto-Train* would require balancing of the equities at issue.

In the third scenario, Banks A and B find that Debtor D has affirmatively misled them into extending credit. D, in fact, has just a few assets, all of which are scattered throughout its various subsidiaries. If separate accountings were performed, which they could easily be, some creditors would recover significantly more than others; however, there was so much fraud on D's part that those creditors would gain their enhanced recoveries by sheer luck. No creditor had a more reasonable basis for relying on D's misrepresentations than any other; all are equally surprised upon discovering the fraud. Substantive consolidation is appropriate here because there is no principled basis for performing separate accountings. A reorganization based on separate accountings would be tantamount to an arbitrary distribution of wealth. *Owens Corning* and *Augie/Restivo* would almost certainly block this consolidation because those tests grant veto power to a single creditor's reliance interest. How a bankruptcy court would apply *Auto-Train*, on the other hand, is inconclusive: it would require balancing the harms against the benefits of consolidation.

These hypothetical examples demonstrate that the prevailing frameworks for substantive consolidation are at best underinclusive. At worst, those frameworks systematically disadvantage unsophisticated creditors and work to the benefit of sophisticated creditors. The test proposed herein attempts to solve these problems by realigning the legal framework for substantive consolidation law with the parties' ex ante incentive structures.

137. *Id.* at 287 (discussing incentive in Pareto-improvement context).

V. CONCLUSION

When grounded in sound principles of bankruptcy law and creditors' ex ante incentive structures, substantive consolidation can be a valuable tool to facilitate debtors' reorganizations in Chapter 11.[138] Yet the Courts of Appeals for the District of Columbia Circuit, Second Circuit, and Third Circuit have derived their substantive consolidation tests from principles that neither account for creditors' ex ante incentives nor provide practical guidance around which creditors may structure their future affairs. With these principles in mind, this Note analyzes the shortcomings of the substantive consolidation tests in *Auto-Train*, *Augie/Restivo*, and *Owens Corning*, and fashions a test that is better aligned with all parties' incentives. The proposed test attempts to achieve greater equity in consolidation proceedings, not by focusing on the debtor's end of its bargains with sophisticated creditors, but by holding sophisticated creditors fully to the risks they assume when they loan money to debtors. Treating banks as specialists in the field of risk assessment is equitable because, when compared to the unsophisticated creditors with whom they often compete for recovery in bankruptcy, they are indeed specialists. Through adoption of this proposed test and the principles on which it rests, future courts may at once correct and clarify the standards for substantive consolidation and make it a more practical reorganization remedy.

138. *See, e.g.*, *id.* at 280.