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Christopher W. Frost
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by

CHRISTOPHER W. FROST*

Introduction

The financial collapse of a corporation raises significant questions regarding its shareholders and creditors' ex ante allocation of the risk that such a collapse might occur. In bankruptcy, most of these risk allocation issues relate to the priority of particular creditors' claims against the assets of the failed business. But determining priority first requires some reasoned means of identifying the assets against which creditors may assert their claims. In many cases, this question is simply one of locating and distributing assets. However, when bankrupt firms have conducted their operations through a complex web of subsidiary corporations, each holding distinct assets and having separate liabilities, the question becomes much more complex.

As a general rule, bankruptcy law respects the separations between commonly owned corporations.1 Regardless of the ownership structure of corporate entities, assets and liabilities of related corporations are treated as distinct for the purpose of a reorganization or liquidation. In a growing number of cases, however, bankruptcy courts have invoked the doctrine of substantive consolidation to disregard the separations that

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* Assistant Professor of Law, Saint Louis University School of Law; B.A. 1983, University of Kentucky; J.D. 1986, University of Kentucky College of Law. I thank Barry Cushman, Thomas Greaney, Daniel Keating, Nancy Kaufman, Frank Kennedy, William Lash, Katherine Pratt, and Douglas Williams for their valuable comments on an earlier draft of this paper. I also thank Alexander Giftos and Stanley Rice for their able research assistance.

commonly owned corporate entities would have enjoyed under non-bankruptcy law.

Substantive consolidation is the combination of the assets and liabilities of two related bankruptcy estates into one entity for purposes of distribution in a liquidation or under a plan of reorganization. The result of a consolidation order is similar to a merger under state law. Creditors of the separately incorporated entities become creditors of the consolidated group, sharing in the combined assets with all of the group's creditors. Joint claims against two or more pre-consolidation entities become one claim against the consolidated entity. Substantive consolidation also eliminates intercompany obligations, and renders moot fraudulent transfer claims between the consolidated entities.

Because the effect of consolidation is a pooling of assets and liabilities, creditors may find that consolidation radically alters the ultimate distribution of assets or ownership interests in the reorganized entity. In

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3. This Article uses the term “consolidation” to refer to substantive consolidation as opposed to joint administration or “procedural consolidation.” The latter terms describe cases in which multiple bankruptcies are consolidated only for procedural convenience. Distributional questions in these cases are determined on an entity-by-entity basis. In re Parkway Calabasas Ltd., 89 B.R. 832, 836 (Bankr. C.D. Cal. 1988), aff'd, 949 F.2d 1058 (9th Cir. 1991); supra note 2, at § 1100.07. While procedural consolidation is not meant to interfere with the asset ownership and liability among related corporations, it may have very real practical effects on distributional outcomes. See In re Manville Forest Prods., Corp., 896 F.2d 1384, 1390-91 (2d Cir. 1990) (discussing the difficulties created by procedural consolidation).


5. In re Parkway Calabasas, 89 B.R. at 836-37.


8. In Drabkin v. Midland-Ross Co. (In re Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987), the court observed that “because every entity is likely to have a different debt-to-asset ratio, consolidation almost invariably redistributes wealth among the creditors of the various entities.” See also In re Snider Bros., 18 B.R. 230, 234 (Bankr. D. Mass. 1982) (noting the virtual certainty of disparate ratios of assets to liabilities).

For example, assume that a parent holding corporation (Holding) has two subsidiaries. One of the subsidiaries (Manufacturing Co.) has assets of $5,000,000 and unsecured obligations of $10,000,000. The other (Sales Co.) has assets of $10,000,000 and unsecured obligations of $35,000,000. If the estates are treated separately, the creditors of Manufacturing Co. will receive a distribution equal to 50% of their claims while the creditors of Sales Co. will receive a distribution equal to 29% of their claims. If consolidated, all the creditors will re-
fact, unless the consolidated group is solvent, some creditor group will necessarily find that consolidation results in a lower distribution than would otherwise be the case. If the corporate group remains solvent after consolidation, none of the creditors will be harmed. In this case, however, consolidation may result in a lower distribution to the shareholders and a higher distribution to the creditors of the group.\(^{10}\)

Unless the asset to liability ratio of each member of the corporate group is equal, substantive consolidation will necessarily reduce the bankruptcy distribution to some group of creditors or equity owners. Given the general presumption of limited liability, consolidation normally defeats contractual expectations by rewriting the contracts governing the allocation of business risk among participants in the enterprise.\(^{12}\)

Because substantive consolidation abrogates the general corporate rule of limited liability, it may dramatically affect the way corporate creditors and shareholders think about the allocation of business risk. In particular, creditors and shareholders negotiate the terms of loans and capital contributions against a backdrop of legal rules that provide a baseline risk allocation. Limited liability forms a fundamental part of this backdrop by isolating the assets of business entities for the purpose of capital formation. Because substantive consolidation subjects the assets of the business to all of the obligations of the consolidated entities, the creditors and shareholders' contractual expectations regarding this isolation will be unfulfilled.

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9. A corporation is "solvent" when the value of its assets exceeds the amount of its liabilities and is "insolvent" when its liabilities exceed the value of its assets. See 11 U.S.C. § 101(31) (1988).

10. See, e.g., In re Murray Indus., 119 B.R. 820, 830 (Bankr. M.D. Fla. 1990). Extending the example from note 8 supra, assume that Manufacturing Co. has assets of $10,000,000 and total liabilities of $5,000,000 and Sales Corp. has assets of $5,000,000 and total liabilities of $10,000,000. If limited liability between the subsidiary corporations is respected, Sales' creditors will receive a distribution equal to 50% of their claims and Holding will receive no distribution. In contrast, the creditors of Manufacturing Co. will be paid in full and, after that payment, Holding will receive a distribution equal to the remaining $5,000,000. If the two companies are consolidated, both the assets and the liabilities of the consolidated entity will total $15,000,000. Thus, the creditors of both Manufacturing and Sales will receive distributions equal to the full amount of their claims and Holding will receive nothing. This result will be obtained unless all of the members of the corporate group are solvent.


12. See infra text accompanying notes 84-103.
Of course, any consistently administered system could alleviate the problem of unmet contractual expectations. In fact, many of the problems resulting from consolidation may result more from its unpredictable application than from the particular limited liability rule adopted in bankruptcy. If the baseline rule in bankruptcy were consolidation, creditors and shareholders would have no claim that the doctrine interfered with their contractual expectations. Their expectations would have been developed against this baseline.

The choice of rule, however, is not entirely irrelevant. The substantive consolidation of corporate groups will result in the elimination of creditor and shareholder reliance on limited liability between constituent corporations which, in turn, will alter the structure of business organization and finance. Whether such an alteration would create a more desirable regime must be closely analyzed with reference to its effect on the total costs of both aggregating capital and operating the business.

Bankruptcy highlights the conflicting interests and controversies that arise in corporate and commercial law. Because the bankruptcy system is fast becoming a significant means of resolving such disputes in these areas, the substantive results in bankruptcy necessarily shape creditors and shareholders' views of the contracts into which they have entered. Substantive consolidation is no exception. A bankruptcy rule that limits liability within corporate groups will necessarily have an impact on the aggregation of capital and organization of business operations.

Of course, limited liability is a concern in cases outside of bankruptcy. In non-bankruptcy cases, parties often seek to “pierce the corporate veil.” Thus, the analysis presented in this Article is applicable outside of bankruptcy. This Article focuses on the bankruptcy rule of substantive consolidation not only because bankruptcy cases are increasingly important in resolving conflicts among corporate creditors and shareholders, but also because some bankruptcy courts seem to order consolidation on an unprincipled and unpredictable basis.

This Article examines the effect of substantive consolidation on voluntary creditors rather than tort and other involuntary claimants. Commentators have taken a renewed interest in the question of tort pri-

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14. Taxing entities, like tort claimants, may be characterized as involuntary claimants. See, e.g., Jonathan M. Landers, Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy, 43 U. CHI. L. REV. 527, 529 (1976) [hereinafter Landers, Another Word].
ory, and have established a convincing case for eliminating limited liability within corporate groups for the benefit of tort claimants. Limiting liability within corporate groups externalizes the risk to tort claimants because unlike voluntary creditors, tort claimants are unable to bargain for protection against, or compensation for, the increased risk limited liability imposes. Because voluntary creditors theoretically can bargain for protection against any increase in risk caused by limited liability, these creditors may have less of a need for the protection substantive consolidation provides.

Thus, the impact of substantive consolidation on voluntary and involuntary credit relationships may be analyzed separately. Notwithstanding notable exceptions, most bankruptcy cases do not involve large numbers of tort claims. Further, the consolidation rule adopted with respect to tort claimants need not affect the rule applied to voluntary claimants.

Thus limited, this Article looks to the economic principles underlying separate incorporation and limited liability in order to determine whether corporate groups should be consolidated in bankruptcy. Part I


17. See infra text accompanying notes 170-175 for a discussion of contractual controls on risk.


19. For example, claims of the Pension Benefit Guaranty Corporation (PBGC) for underfunding of pension plans extend to all members of the employer’s “controlled group.” 26 U.S.C. § 4971(e)(2)(A) (1988). Thus, the PBGC enjoys a claim against the entire corporate group without regard to corporate formalities. See generally PBGC v. Ouimet Corp., 630 F.2d 4 (1st Cir. 1980) (all members of the controlled group held jointly and severally liable for pension plan underfunding subject to a 30% net amount limitation), cert. denied, 450 U.S. 914 (1981).

While the size of pension liabilities has created difficulties in a few bankruptcy cases, see In re Chateaugay Corp., 130 B.R. 690 (Bankr. S.D.N.Y. 1991) (discussing the difficulties created by large underfunding liability), the joint and several nature of the liability has not been seriously challenged.
Part II examines the rationale for limited liability. This Part introduces a transaction cost analysis premised on the ability of parties to allocate the risks of corporate failure through contract. This analytical model focuses on the effect of the default rule governing risk allocation on the costs of the contracting process. Part II argues that corporate law rules governing risk allocation should comport with most investors’ and lenders’ preferences. This approach would reduce transaction costs by minimizing the parties’ need to contract around the corporate law rules.

Part III examines the organization of the production of goods and services in firms and across markets. It also discusses the importance of limited liability to various organizational structures. This analysis concludes that limited liability is fundamental to the efficiencies generated by horizontally related and conglomerate firms, but is less necessary to vertically integrated firms. Thus, those who invest in and lend to entities that operate as a component of a larger, vertically related production process are less likely to be satisfied with the baseline rule of limited liability.

Parts IV and V consider the impact of limited liability on particular risks faced by creditors. Part IV offers a model of risk analysis that divides risk into two components—enterprise risk and misappropriation risk. Misappropriation risk is defined as the risk that shareholders will force management to take actions that increase the risk of firm failure. This type of risk is distinguished from enterprise risk—the irreducible variability in the earnings of the business. Limited liability increases misappropriation risk by increasing opportunities for asset shifting after the rate of interest on debt is fixed. Parts IV and V also examine the existing controls on misappropriation risk. These Parts conclude that the misappropriation risk created by limited liability in vertically integrated corporate groups is not adequately restricted by existing constraints.

Finally, Part VI provides a model for substantive consolidation that looks primarily to the level of vertical integration between the entities sought to be consolidated. The Article proposes that courts should typically consolidate entities that constitute components of vertically integrated operations. Firms comprising parts of other types of organizations should be consolidated only in rare circumstances.

20. See infra note 155 and accompanying text.
I. Substantive Consolidation and the Effect of Creditor Expectations

One of the most fundamental principles underlying the Bankruptcy Code is its rule governing priority of distribution. Under Chapter 7 of the Code,21 proceeds of asset liquidations are generally paid in accordance with state law priorities.22 Reorganizations under Chapter 11 of the Code are governed by a default rule of absolute priority. The absolute priority rule provides that if a class of claims or interests does not accept a plan of reorganization,23 confirmation of the plan can occur only if that class has been paid in full or if no junior class of claims or interests receives any property under the plan.24 These provisions combine to make non-bankruptcy law priorities an important part of the bankruptcy system.

Priority is only half of the picture. To fully understand the bankruptcy distributional scheme, the scope of assets to which creditor claims extend must be considered. When a multi-tiered corporate structure collapses, the scope of assets subject to particular claims can be difficult to determine. The records of the corporation may be insufficiently clear to distinguish between the assets and liabilities of each corporation. Even when the accounting records of the business are adequate to make these distinctions, creditors may claim either that they were unaware of the corporate separations between business operations, or that economically, the business is a single, unitary enterprise. In the face of these problems, substantive consolidation can be an attractive alternative.25

23. In order to accept a plan of reorganization, claimants holding at least two-thirds in amount and more than one-half in number of claims must assent. 11 U.S.C. § 1126(c) (1988). Acceptance by a class of equity interest requires only the assent of interest holders of at least two-thirds in amount of the total interests in the class. 11 U.S.C. § 1126(d) (1988).
25. The Bankruptcy Code does not specifically provide for substantive consolidation. Therefore, bankruptcy courts must rely on their general equity powers under section 105 of the Code. See Union Sav. Bank v. Auggie/Restivo Baking Co. (In re Auggie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988); Drabkin v. Midland-Ross Co. (In re Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987); In re Continental Vending Mach. Corp., 517 F.2d 997, 1000 (2d Cir. 1975), cert. denied, 424 U.S. 913 (1976); In re Murray Indus., 119 B.R. 820, 828 (Bankr. M.D. Fla. 1990). Section 105 of the Code authorizes bankruptcy courts to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code].” This broad grant of authority has been severely limited by Supreme Court pronouncements that “whatever equitable powers remain in the bankruptcy courts must and can only be
In many of the reported cases in which consolidation has been ordered, the assets of the corporate group cannot be segregated and identified with any particular entity within that group. Substantive consolidation in these cases may be attributed to the need for resolution in a situation in which the protection of contractual expectations is impracticable. When the cost of allocating the assets of a corporate group into the constituent corporations is so high that it will consume the estate, pragmatism requires that the assets and liabilities of the group be pooled. A second category of cases involves corporate management's affirmative misrepresentation of either the corporate structure or the asset ownership of the company. These misrepresentation cases seem relatively uncontroversial as well. In an increasing number of cases, however, courts have held that neither entanglement nor affirmative misrepresentation is necessary to warrant an order of substantive consolidation. These cases seek to balance the prejudice that may result from a failure to consolidate against the harm that consolidation may visit on particular creditors—readily admitting a liberal trend toward consolidating corporate groups.


28. See Richard A. Posner, The Rights of Creditors of Affiliated Corporations, 43 U. CHI. L. Rev. 499, 520-21 (1976) [hereinafter Posner, Affiliated Corporations] (“Misrepresentation is a way of increasing a creditor's information costs, and the added costs are wasted from a social standpoint to the extent that the misrepresentation could be prevented at lower cost by an appropriate sanction against it.”).


30. See, e.g., In re F.A. Potts & Co., 23 B.R. at 573 n.3; In re Richton Int'l, 12 B.R. at 558.

On the one hand, it may be argued that a bankruptcy court, acting as a court of equity, should have the ability to recognize that some multi-tiered corporate groups are single enterprises. On the other hand, consolidation clearly will result in harm to some creditor or shareholder group. These conflicting propositions have led to statements such as: "[T]he fact that . . . creditors may be adversely affected by . . . substantive consolidation [is] not controlling and the bankruptcy court must weigh the conflicting interests which should be balanced in such way as to reach a rough approximation to some rather than to deny justice to all." At best, "rough approximation" supplies a very loose guideline for the courts. If some equalization of return among the creditors of the constituent corporations is desired, one must remain mindful of Judge Friendly's admonition that "[e]quality among creditors who have lawfully bargained for different treatment is not equity but its opposite." 

At bottom, courts considering substantive consolidation seem primarily concerned with a search for contractual expectations. In many cases, consolidation is based on the creditors' past dealings with the separate entities as one business. In these cases, courts utilize consolidation ostensibly to fulfill the contractual expectations of the creditors. Reliance concerns cut both ways, however. Creditors may have entered into credit arrangements with an expectation that the borrower would not be liable for the debts of affiliated entities. Therefore, while consolidation may be necessary to protect the expectations of some creditors, it may destroy the expectations of others.


33. There are, of course, some cases in which a "rough approximation" may be the best any creditor or shareholder could hope for. This situation occurs when the books and records of the corporate group are so hopelessly obscured that any attempt to segregate the assets of the group would be hopeless. See supra text accompanying note 26.

34. Chemical Bank N.Y. Trust Co. v. Kheel (In re Seatrade Corp.), 369 F.2d 845, 848 (2d Cir. 1966) (Friendly, J., concurring).

35. See, e.g., Eastgroup Properties, 935 F.2d at 250; Soviero v. Franklin Nat'l Bank, 328 F.2d 446, 448 (2d Cir. 1964); see also PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: BANKRUPTCY LAW 420 (1985) ("Where a creditor reasonably thought that it was dealing with the enterprise as a group rather than with one of the affiliated corporations conducting the business, complete substantive consolidation, making available all assets of the enterprise for satisfaction of the claim, is obviously proper.").

36. See cases cited supra notes 30-32.

This aspect of consolidation has led to judicial statements such as: "The power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others." While many courts warn of the dangers of interference with contractual expectations, their levels of adherence to this principle differ radically.

In *In re Flora Mir Candy Corp.*, a classic case involving creditors’ reliance on the separation of the entities, the Second Circuit affirmed a district court order refusing to consolidate Flora Mir with its affiliate, Meadors. The consolidation request was opposed by a group of Meadors’ creditors who held bonds that were issued while Meadors was still an independent corporation. Because the claims of the Meadors creditors arose before Meadors was acquired by Flora Mir, the creditors had clearly relied on the separateness of the entities.

In *Flora Mir*, Judge Friendly stated that the district court “decision was so manifestly correct that we should hardly have written an opinion were it not to make it plain that referees should not order consolidation on so flimsy a basis as was done here.” The *Flora Mir* court emphasized creditor reliance on separateness: “[T]he inequity of consolidation could scarcely be clearer than in this case. The debentures had been issued when Meadors was an independent company, more than six years before its acquisition by Flora Mir.”

Courts have also sought to protect the reliance interest of lenders that have extended credit while the borrower was part of the corporate group sought to be consolidated. In *In re Crown Machine & Welding, Inc.*, the court refused consolidation, noting the disparity between the asset and liability ratios of the two entities. Unlike the situation in

40. 432 F.2d 1060 (2d Cir. 1970).
41. *Id.* at 1062-63.
42. *Id.* at 1062-63.
43. *Id.* at 1062-63.
44. *Id.* at 1062.
45. *Id.*
47. *Id.* at 28.
**Flora Mir,** however, the objecting creditors were not shown to have extended credit prior to the combination of the group.\(^{48}\)

Not all courts seem to be as concerned with creditor reliance. In *Eastgroup Properties v. Southern Motel Association,*\(^{49}\) the Eleventh Circuit affirmed an order consolidating two debtors that owned and operated motels. One of the companies was a limited partnership that acquired and held an interest in motel properties.\(^{50}\) The other debtor was a corporation that operated the properties.\(^{51}\) Creditors of the limited partnership appealed the order consolidating the entities. The court acknowledged that the objecting creditors would be harmed by the consolidation, but found that the creditors had not shown that they relied solely on the credit of the limited partnership.\(^{52}\) The fact that the entities held themselves out as separate was insufficient to show reliance.\(^{53}\)

Although courts often defer to creditor reliance interests, they do not generally defer to shareholder reliance interests. For instance, in *In re Murray Industries,*\(^{54}\) an equity security holder objected to the consolidation of a group of sixteen affiliated corporations.\(^{55}\) The court determined that, regardless of shareholder reliance on limited liability, claims by equity security holders are subordinate to all creditor claims against the group.\(^{56}\) Thus, when courts take reliance issues into consideration, it is for the benefit of creditors rather than shareholders.\(^{57}\)

The courts’ varying approaches to the problem of contractual expectations illustrates a fundamental misperception of the way in which such expectations are developed. In large part, expectations are a function of the underlying legal regime.\(^{58}\) By attempting to determine contractual

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\(^{48}\) The unsecured creditors’ committee of Crown Welding raised objections to consolidation, presumably on behalf of the majority of unsecured creditors. *Id.* at 26. There was no indication in the opinion that the entities sought to be consolidated had recently become affiliated.

\(^{49}\) 935 F.2d 245 (11th Cir. 1991).

\(^{50}\) *Id.* at 246.

\(^{51}\) *Id.* at 246-47.

\(^{52}\) *Id.* at 251.

\(^{53}\) *Id.*


\(^{55}\) *Id.* at 827.

\(^{56}\) “Thus, in the last analysis, the equity clearly favors the entire creditors’ constituency over the interest of the equity security interest holders.” *Id.* at 832.

\(^{57}\) This situation must be distinguished from cases in which parent company management plays a role in the downfall of a subsidiary. The reliance by these management creditors is disregarded because of their participation in the subsidiary’s demise, not because they are shareholders. *See In re I.R.C.C.,* 105 B.R. 237, 243 (Bankr. S.D.N.Y. 1989).

\(^{58}\) Of course, some courts recognize this fact and are much more cautious in their approach to creditor reliance questions. In *In re Augie/Restivo Baking Co.,* the court stated: [C]reditors who make loans on the basis of the financial status of a separate entity
expectations on an *ad hoc* basis, courts have developed a series of decisions that cannot be systematized into a coherent legal regime. Thus, the application of substantive consolidation presents an indeterminate risk to the "expectations" parties have when entering into contracts, because it is becoming increasingly difficult to determine the doctrine's applicability.

When deciding whether to apply substantive consolidation, some courts make extensive use of factor and balancing tests.\(^5^9\) Several courts, however, have recognized that the inquiry is not subject to analysis in such terms.\(^6^0\) These courts justify consolidation by showing that the prejudice to the parties seeking consolidation outweighs the prejudice to any particular creditor group.\(^6^1\) Alternatively, some courts seek an ap-

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59. The most widely used "factor" test was developed by the court in *In re Vecco Constr. Indus.,* 4 B.R. 407 (Bankr. E.D. Va. 1980). These factors are: (1) the presence or absence of consolidated balance sheets; (2) the unity of interests and ownership between the various entities; (3) the existence of parent and intercorporate guaranties on loans; (4) the degree of difficulty in segregating and ascertaining individual assets and liabilities; (5) the transfers of assets without formal observance of corporate formalities; (6) the commingling of assets and business functions; (7) the profitability of consolidation at a single physical location. *Id.* at 410.


61. In *In re Snider Bros.*, the court discussed the development of the *Vecco* factors and determined that the "only real criterion" in considering consolidation should be "the economic prejudice of continued debtor separateness versus the economic prejudice of consolidation." 18 B.R. at 234.

The court concluded that this criterion must be met prior to granting consolidation. The applicant must show that there is neither a necessity for consolidation or a harm to be avoided by use of the equitable remedy of consolidation, and that the benefits of consolidation outweigh the harm to be caused to the objector. *Id.* at 238. Various courts have adopted this analysis as determinative. See Drabkin v. Midland-Ross Co. (*In re Auto-Train,* 810 F.2d 270, 276 (D.C. Cir. 1987); Holywell Corp. v. Bank of New York, 59 B.R. 340, 348 (S.D. Fla. 1986); *In re Tureaud,* 45 B.R. 658, 663 (Bankr. N.D. Okla. 1985), aff'd, 59 B.R. 973 (N.D. Okla. 1986); *In re DRW Property Co.,* 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985); *In re F.A. Potts & Co.,* 23 B.R. 569, 572 (Bankr. E.D. Pa. 1982); *In re Manzey Land & Cattle Co.,* 17 B.R. 332, 338 (Bankr. D.S.D. 1982).

A few courts have further refined the test by including two additional factors: the "substantial identity" among the debtors and the creditors' reliance on the credit of a particular
proach that will "yield an equitable treatment of creditors without any undue prejudice to any particular group."\(^{62}\)

Courts appear to analyze substantive consolidation under a variety of tests and with an eye toward protecting various reliance interests. Yet these approaches are little more than legitimating devices for an *ad hoc* application of a doctrine that significantly affects corporate risk allocation. Beyond the few general observations made above, a doctrinal analysis of substantive consolidation can only provide an illustration of how difficult it is to predict instances in which it will be applicable.\(^{63}\) Barring the cases involving misrepresentation and hopelessly intermingled assets, the only guide to predicting case outcomes is a general impression that courts harbor some vague concerns about protecting creditor expectations.

II. A Transaction Cost Analysis of Limited Liability

The primary difficulty with the substantive consolidation doctrine is that its application is uncertain and unprincipled. As a result, limited liability, a fundamental baseline rule regarding the allocation of risk of business failure, is also rendered uncertain. Because this baseline is indeterminate, transaction costs are increased as capital contributors attempt to understand and protect themselves against the uncertainty. An obvious solution to the problem of indeterminacy is to provide clarity by always, or never, consolidating corporate groups. While this solution is superficially appealing, it ignores the complex relationships among corporate capital contributors. Fixed rules applicable to all situations will not provide the answer, because they will nearly always be under- or over-inclusive. Instead, the solution may lie in creating a limited number of legal rules tailored to broad categories of cases presenting consistent types of problems.

This Part looks at limited liability with reference to the transaction costs such a rule can be expected to generate. This model assumes that contracting parties are able to adjust their contractual expectations regardless of the rule followed by corporate law. For example, if corporate groups are normally consolidated in bankruptcy, creditors and shareholders will not rely on corporate separateness in making their financing subsidiary. *See, e.g.,* Eastgroup Properties v. Southern Motel Ass'n, 935 F.2d 245, 251 (11th Cir. 1991); *In re* Baker & Getty Fin. Serv., 78 B.R. 139, 142 (Bankr. N.D. Ohio 1987).


63. "[S]ubstantive consolidation cases are to a great degree *sui generis.*" 5 KING ET AL., *supra* note 2, at § 1100.06[1].
decisions, especially given the ease with which a corporation may elect bankruptcy.\textsuperscript{64} The benefits of separately incorporating components of a corporate group will not include insulation of business assets from liabilities incurred by other business operations.\textsuperscript{65}

A. The Case for Limited Liability

Limited liability is perhaps the most well-recognized and important attribute of the corporation.\textsuperscript{66} Early analyses of the corporation justified limited liability as a logical extension of the view that corporations exist as entities separate from their investors.\textsuperscript{67} More recent models of the corporation see the rule as necessary to achieve the benefits of diversification and the aggregation of capital at low cost.\textsuperscript{68} While most of the scholarly analyses of limited liability have focused on its impact on capital market efficiency and diversification, an increasing body of scholar-

\begin{itemize}
\item \textsuperscript{64} Bankruptcy relief is widely available without regard to the financial condition of the business. See 11 U.S.C. § 109 (1988).
\item \textsuperscript{65} This will not necessarily mean the end of the corporate form of organization. Other benefits of incorporating include the shareholders' easy exchange of ownership rights, the corporation's perpetual life, and the separation of management from ownership. See Roger E. Meiners et al., \textit{Piercing the Veil of Limited Liability}, 4 \textit{Del. J. Corp. L.} 351, 364 (1979); see also \textit{ROBERT C. CLARK, CORPORATE LAW} 10-24 (1986) (discussing benefits of corporate organization).
\item \textsuperscript{66} \textit{See} Frank H. Easterbrook \& Daniel R. Fischel, \textit{The Economic Structure of Corporate Law} 40 (1991) ("Limited liability is a distinguishing feature of corporate law—perhaps the distinguishing feature."). \textit{But see} Meiners et al., \textit{supra} note 65, at 352 (questioning whether the baseline rule of limited liability has any significant impact on risk allocation).
\item \textsuperscript{67} This notion is reflected in the following excerpt:

Classically, a corporation was conceived as an artificial person, coming into existence through creation by a sovereign power.

Thence proceeded certain advantages, which led the corporate form to become the principal method of organization of commercial, and especially of industrial, activity. Its primary business advantage, of course, was insulation of individual stockholders composing the corporation from liability for the debts of the corporate enterprise.

Adolf A. Berle, Jr., \textit{The Theory of Enterprise Entity}, 47 \textit{Colum. L. Rev.} 343, 343 (1947). \textit{But see} William O. Douglas \& Carrol M. Shanks, \textit{Insulation from Liability Through Subsidiary Corporations}, 39 \textit{Yale L.J.} 193, 194 (1929) ("Little will be gained by seeking to ascertain what a corporation is. It is not a thing. It is a method. It defies definition when removed from the background of the purpose attempted to be accomplished and the manner of accomplishing it.").

\item \textsuperscript{68} \textit{See}, e.g., Easterbrook \& Fischel, \textit{supra} note 66, at 40-62; Paul Halpern et al., \textit{An Economic Analysis of Limited Liability in Corporation Law}, 30 \textit{U. Toronto L.J.} 117 (1980); Henry G. Manne, \textit{Our Two Corporation Systems: Law and Economics}, 53 \textit{Va. L. Rev.} 259 (1967); Meiners et al., \textit{supra} note 65, at 357-64.
\end{itemize}
ship has examined the need for limited liability within the corporate group.69

Perhaps the most compelling justification for limited liability is its beneficial effect on the processes by which capital is aggregated in the market. A rule of unlimited liability would reduce the benefits of diversification,70 because investing in a number of firms would entail a higher risk of losing all or a substantial portion of an individual's wealth.71

Limited liability also allows capital markets to work efficiently in setting a price for the securities of a particular company.72 Capital markets work efficiently when they set a uniform price for securities that impounds all relevant information about the value of firms.73 A rule of unlimited liability would result in a securities pricing system that would take into account not only the discounted cash flows of the business but also the wealth of the owners of the stock. Thus, a potential investor would need to expend more resources analyzing the prospects of a firm under consideration.74

Limited liability can also be justified through agency cost analysis. Easterbrook and Fischel see limited liability as necessary to facilitate the separation of management and risk bearing.75 Without a limitation on shareholder liability, each shareholder would place her entire wealth at


70. Portfolio theory provides that investors may reduce their potential loss by investing in many different companies. See John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, 85 MICH. L. REV. 1, 17-20 (1986); Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. POL. ECON. 288, 290 (1980); Eugene F. Fama & Michael C. Jensen, Agency Problems and Residual Claims, 26 J. LAW & ECON. 327, 329 (1983) ("Common Stock allows residual risk to be spread across many residual claimants who individually choose the extent to which they bear risk and who can diversify across organizations offering such claims.").

71. Manne, supra note 68, at 262; see also Easterbrook & Fischel, supra note 66, at 43 (noting efficient diversification under limited liability).

72. Manne, supra note 68, at 262-65; see also Halpern et al., supra note 68, at 129-31 (assessing unlimited liability in imperfect capital markets).


74. A few commentators have suggested that these market price distortions would be eliminated if liability were imposed on shareholders pro-rata on the basis of their percentage ownership of the firm's shares. See Hansmann & Kraakman, supra note 15, at 1903-04; Leebron, supra note 15, at 1608-10. Leebron asserts that under such a rule significant distortions in market prices would be unlikely because individuals without wealth do not buy shares. Leebron, supra note 15, at 1609. Under his pro rata rule he dismisses the effect of individual shareholder wealth on the value of shares as "highly unlikely in practice." Id.

75. Easterbrook & Fischel, supra note 66, at 41.
risk by investing in the corporation.\textsuperscript{76} This high level of risk would induce monitoring beyond that which is strictly necessary to prevent managerial shirking.\textsuperscript{77}

Unlimited liability would also increase agency costs by causing shareholders to monitor the wealth of one another,\textsuperscript{78} because their total exposure would be dependent on the financial position of the other shareholders as well as the corporation. Limited liability eliminates this monitoring because it makes the financial position of other shareholders irrelevant.\textsuperscript{79}

Although market efficiency and agency cost analyses provide compelling justifications for the limitation of liability in publicly held firms,\textsuperscript{80} these concepts are insufficient to explain the limitation of liability between members of corporate groups. Wholly owned subsidiary corporations do not access equity capital markets, and thus market efficiency is not a concern.\textsuperscript{81} Because risk bearing and management are not specialized and separated in privately held corporations, agency costs are minimized.\textsuperscript{82} The costs of shareholder monitoring are lower in private corporations because of the small number of shareholders. These observations have led many commentators to draw a sharp distinction between public and private corporations.\textsuperscript{83}

\textsuperscript{76} Id. at 40-41.

\textsuperscript{77} The problem with this analysis is that limited liability simply shifts some of the risk of business failure from the shareholders to the creditors. Thus even when shareholders have less of an incentive to monitor, creditors may have a higher incentive. If creditors are in a better position to monitor managers, the parties will most likely bargain for a rule limiting shareholder liability. \textsc{Easterbrook \& Fischel, supra} note 66, at 44-49. Therefore, such a limitation should be the off-the-rack rule provided by corporate statutes. \textit{Id.}

\textsuperscript{78} \textsc{Easterbrook \& Fischel, supra} note 66, at 42; \textsc{Halpern et al., supra} note 68, at 129-31.

\textsuperscript{79} Easterbrook and Fischel also argue that "limited liability facilitates optimal investment decisions" by insuring that managers do not refuse to undertake projects that are "too risky." \textsc{Easterbrook \& Fischel, supra} note 66, at 43-44.

\textsuperscript{80} Apparently the courts agree. In his empirical study of veil-piercing, Professor Thompson found that courts do not pierce the veil to benefit creditors of public corporations. Thompson, \textit{supra} note 16, at 1054-56.

\textsuperscript{81} See \textsc{Halpern et al., supra} note 68, at 147-48. While debt market efficiency may be a concern to members of corporate groups, few have seriously suggested that limited liability should not protect corporate creditors. See \textsc{Leebron, supra} note 15, at 1636-49 (considering and rejecting unlimited creditor liability to tort claimants, but proposing that tort claimants be granted priority over creditor claimants).

\textsuperscript{82} See \textsc{Easterbrook \& Fischel, supra} note 66, at 56.

\textsuperscript{83} See \textsc{Easterbrook \& Fischel, supra} note 66, at 55-57; \textsc{Halpern et al., supra} note 68, at 147-49; \textsc{Hansmann \& Kraakman, supra} note 15, at 1882-1909; Robert W. Hillman, \textit{Limited Liability and Externalization of Risk: A Comment on the Death of Partnership}, 70 \textsc{Wash. U. L.Q.} 477, 485. Cf. \textsc{Leebron, supra} note 15 at 1626-36 (stating that the benefits of limited liability in close corporations have been understated).
The justification for limited liability in privately held corporations, including corporate groups, is that it allocates the risk of the business venture in a way that creditors and shareholders usually prefer over any other alternatives. Thus, limited liability forms the backdrop against which creditors and shareholders develop contractual expectations regarding risk allocation.

All other things being equal, a baseline rule of limited liability allocates more of the risk of business failure to the creditors as a group. Limited liability provides a device for insulating shareholder assets from the claims of creditors. While this insulation normally protects the shareholders, the rule may also operate within corporate groups to allocate risk among various creditors. 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. Thus, the ability to limit the liability borne by a particular entity is an essential feature of corporate finance.

Perhaps the best approach to developing a justification for limited liability within corporate groups is to examine how capital contributors might adjust to an alternative rule. The risk allocation rule set by corporate or bankruptcy law may be largely irrelevant, because the fundamental risk of the business is unchanged by the limited liability rule. For fully informed capital contributors, expectations are a function of the baseline rule. When that rule does not fit the transaction, they may bargain around it. If courts reliably recognize limited liability, creditors may conduct their credit analyses and negotiate interest rates with reference to the assets, liabilities, and business operations of the borrowing entity alone. Conversely, if courts routinely disregard the separateness of related entities, creditors and managers may approach credit analysis and interest rate negotiation with reference to the entire corporate group.

The importance of the baseline rule may be further restricted by contracting parties' ability to opt out of the particular legal regime in existence. Under existing law, certain situations result in creditors contracting around the effects of limited liability. Institutional creditors

84. See Meiners et al., supra note 65, at 359 ("[T]he economic consequences of a rule of unlimited liability would probably have been little different from what we observe under the existing arrangement.").


86. See Posner, Affiliated Corporations, supra note 28, at 505-07.
often take guarantees from non-borrowing entities within a corporate group. These guarantees are a selective means of contracting around limited liability to reach the assets of the entire corporate group.

Under a baseline rule of unlimited liability, creditors and shareholders may also bargain to adopt a different risk allocation rule when they so desire. Shareholders may insist that certain creditor groups agree to limit the reach of their claims to particular assets. For example, general partnerships may borrow on a non-recourse basis when the partners are unwilling to subject all of their assets to the risk of the business venture.

Through secured credit, creditors can achieve the risk allocation results of limited liability in an unlimited liability regime. By ensuring priority through a security interest, lenders are less affected by the broader scope of assets and liabilities that an unlimited liability rule entails. Thus, in an unlimited liability regime, creditors may still order both their relative priorities and the scope of assets to which their claims are subject.

The foregoing analysis suggests that the particular rule is less important than its predictability. If contracting parties can ascertain the rule, they can adjust their contracts to account for its effects. Creditors and shareholders will either contract around the rule or adjust their demanded returns to account for the result of the applicable rule. Thus, Judge Richard Posner has observed that the general corporate rule of limited liability "should not be expected, in general, to have a profound impact on the credit system or to alter the balance of advantage between debtor and creditor."

C. Transaction Cost Analysis and the Landers-Posner Debate

Notwithstanding the foregoing discussion, the impact of the baseline chosen is not entirely neutral. The absence of any substantive impact

89. This observation holds even in substantive consolidation cases. Courts recognize the need to protect security interests when consolidating related entities. See In re Gulfco Inv. Corp., 593 F.2d 921, 926-27 (10th Cir. 1979).
90. "Predictability" is, of course, a relative term. One cannot expect absolute predictability from any system of law that must take complex and conflicting incentives into account. However, re-categorizing cases to which differing rules apply may still increase the system's predictability while at the same time resolving the difficulties created by conflicts among interested parties.
only changes the focus of the inquiry. Thus, rather than looking to the substantive effect of the rule, the true question is whether the particular rule reduces transaction costs.

The Coase Theorem suggests that in the absence of transaction costs parties will bargain to the most desirable property allocation regardless of the legal rule. Based on this view, the goal of the legal system should be to produce rules that reduce transaction costs. Because bargaining around a particular rule is costly, the rule should reflect the general desires of the parties.

This approach fueled a debate in the mid-1970s over whether limited liability should apply to multi-tiered corporations in bankruptcy. In the first volley of the debate, then-Professor Jonathan Landers asserted that managers operate separately incorporated units with an eye toward the overall profitability of the group and that creditors normally lend with an expectation that repayment will be tied to the overall earnings of the group. Landers was concerned that these factors shift the risk of promoting business from residual claimants to creditors and the public. According to Landers, the bankruptcy system should recognize the inherent “enterprise tendencies” in corporate groups and consolidate related entities in bankruptcy.

93. Posner, Affiliated Corporations, supra note 28, at 506 (“The criterion of an efficient corporation law is therefore whether the terms do in fact reflect commercial realities, so that transacting parties are generally content with them.”).  
94. See generally Landers, Unified Approach, supra note 69 (opposing limited liability of affiliated corporations); Posner, Affiliated Corporations, supra note 28 (supporting limited liability); Landers, Another Word, supra note 14 (rebutting Posner). Although this initial exchange took place over 15 years ago, these three articles have set the terms for further debate and the controversy remains unresolved. See Blumberg, supra note 35, at 448, 448-52 ( siding with Landers); Hansmann & Kraakman, supra note 15, at 1919-20 ( siding with Posner); Lelbron, supra note 15, at 1614 (same); see also Posner, Economic Analysis, supra note 85, at 406-09 (revisiting the debate).  
95. Landers, Unified Approach, supra note 69, at 641. Landers also provides another reason to consolidate: “Whether any one company has a significant amount of assets to satisfy claims is likely to be either fortuitous or the result of an attempt to favor certain creditors over others.” Id.  
96. Id. at 593.  
97. Landers was not the first to use the term “enterprise” to describe these tendencies. In The Theory of the Enterprise Entity, Berle noted a category of cases in which “courts disregar[d] the corporate fiction specifically because it has parted company with the enterprise-fact, for whose furtherance the corporation was created.” Berle, supra note 67, at 348; see also Elvin R. Latty, Subsidiaries and Affiliated Corporations 212-20 (1936) (discussing the single enterprise).  
98. Landers recognized that some creditors rely on the separate nature of corporations operating within a group, and he therefore created a limited exception to his principle when a
Judge (then-Professor) Richard Posner's response was characteristically well developed. What Landers failed to recognize, Posner asserted, is that the efficiency of corporate law depends entirely on whether parties find it necessary to change the terms of an off-the-rack contractual rule. Posner contended that the "primary utility of corporation law lies in providing a set of standard, implied contract terms . . . so that business firms do not have to stipulate these terms anew every time they transact, although they could do so if necessary." He argued that shifting the risk from shareholder to creditor may be desirable because creditors may be superior risk bearers, and that the additional risk imposed on creditors would be compensated through a higher interest rate. Posner went on to explain that corporate groups did not present any particular risk to corporate creditors because the management of the business could be expected to operate the constituent corporations as "profit centers."

The Landers-Posner debate illustrates the difficulty of applying the transaction cost analysis to the problem of limited liability in corporate groups. Both sides appear to be correct at some level. The organizational structure of some corporate groups is closely tied to the ability to shift risk freely among the various capital contributors. Market mechanisms designed to shift risk among capital contributors should normally produce the most efficient allocation of resources and organizational structures. On the other hand, limiting liability under certain circumstances produces separate corporate entities that do not have any relationship to the economic operations of the group. The separateness of these entities raises suspicions that they have been separated for some sinister purpose—to externalize risk from shareholders onto creditors. Mediating these competing ideas requires a close examination of the reasons that members of a corporate group are separately incorporated and the types of risk that various organizational forms can be expected to impose on creditors.

creditor could demonstrate reliance on the creditworthiness of a particular member of the group. Landers, Unified Approach, supra note 69, at 639-40. The problems with the courts' approaches to creditor and shareholder reliance issues are illustrated supra text accompanying notes 35-63.

100. Id. at 506.
101. Posner asserts that creditors may be superior risk bearers because they are generally less risk averse and are better able to assess the risk of business failure. Id. at 501-02; see also Posner, ECONOMIC ANALYSIS, supra note 85, at 394 (creditors are in a better position than shareholders to appraise risk and receive the added protection of limited liability by virtue of their corporate form).
103. Id. at 513-14; see Posner, ECONOMIC ANALYSIS, supra note 85, at 408.
III. Organizational Form and Limited Liability

A baseline rule of limited liability makes more sense when one understands the reasons for corporate affiliation. Professor Phillip Blumberg, who has commented extensively on the impact of economic integration on decisions involving corporate groups,104 asserts that courts generally support the “enterprise” theory of liability.105 In essence, Blumberg’s view holds that courts should ignore separate corporate lines when the affiliated entities are but a single integrated enterprise.106 Blumberg appears to see “integration” as going beyond the classical, vertically integrated firm and encompassing horizontal relationships as well as the ownership unification of components of a single production process.107

This Part examines the impact of limited liability on various forms of corporate organization by distinguishing three major categories of economic organization. Initially, economic relationships may be separated into two categories—integrated and conglomerate.108 While conglomerate relationships stand alone in an analysis of economic organization, the term integration itself comprises two forms of corporate affiliation—vertically integrated and horizontally related. The classical vertically integrated firm owns components of a single production and distribution process. Vertically integrated affiliates are characterized by large numbers of intercompany transfers of goods and services.109 Horizontally related entities produce complementary or competing products. This type

104. See generally BLUMBERG, supra note 35, at 36.
105. Id. at 451 (“There can be no question that the enterprise view expressed by Professor Landers is dramatically supported by the reported cases.”).
106. See id. at 8-12; Landers, Another Word, supra note 14, at 539-40.
107. For example, Blumberg describes In re Gulfo Investment Corp., 593 F.2d 921 (10th Cir. 1979), as a case involving an economically integrated group. See BLUMBERG, supra note 35, at 437. In In re Gulfo, however, the subsidiaries operated different realty developments and thus may have been more appropriately characterized as horizontally related. In re Gulfo, 593 F.2d at 929.

Landers appears to take a similar approach. See Landers, Unified Approach, supra note 69, at 590 (defining “enterprise” to mean any affiliated group of corporations without regard to the economic relationships between the entities).

108. A “conglomerate” firm is defined as: “[a] firm comprising a holding company and a diverse group of subsidiary companies which are generally unrelated in their activities and markets.” THE MIT DICTIONARY OF MODERN ECONOMICS 77 (David W. Pearce ed., 3d ed. 1986).

109. This characterization of vertically integrated firms is important to understanding the type of risks limited liability imposes on creditors of the group. To the extent that the economic relationship involves numerous transactions in goods and services, legal protections against misappropriation risk are less effective. See infra text accompanying notes 201-215.
of organizational relationship involves fewer transfers of goods and services between entities, but may involve regular transfers of cash.

Admittedly, the precise category into which particular groups fall may be difficult to discern in some cases. Many corporate groups may include both types of relationships. Assuming for the moment that the various forms of organization are distinct will lead to a clearer understanding of the need for a baseline rule of limited liability under various forms of corporate organization.110

The economic relationship between members of corporate groups directly impacts the need for limiting liability between the constituent members of the group. As more fully developed below, limited liability may be necessary to facilitate the effective functioning of horizontally related and conglomerate organizations. In these contexts, a baseline rule of limited liability may comport more closely with creditor and shareholder desires, resulting in fewer instances of contracting around the general rule. In contrast, vertically integrated corporations are less dependent on the need to limit liability. A baseline rule of limited liability in this context may actually increase transaction costs if more creditors desire to opt out of the rule through contract.

A. The Organization of Production

Why do firms make instead of buy inputs to production? What factors limit the size of firms? Why do some firms invest in diverse businesses rather than distribute excess capital to shareholders? The answers to these questions depend on how adequately product and capital markets adjust capital and other inputs to a firm's production needs in light of the costs of contracting. These costs may also give rise to managerial structures designed to coordinate production and capital allocation effectively.

Take first a firm's decision to integrate vertically.111 There are a number of reasons why producers may choose to unify component parts of production within a firm. Components may be technologically inseparable as in the integration of iron making with steel making. Both operations require heat; coordinating both stages of steel production within

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110. This assumption is relaxed at infra text accompanying notes 221-224.
one firm may help realize thermal economies.\textsuperscript{112} Transportation costs may also be saved by integrating operations.\textsuperscript{113} Producers may also choose to integrate into retailing to eliminate freeriding problems.\textsuperscript{114}

While many of these concerns are solvable by unifying ownership and control of the successive stages of production, they are also theoretically solvable through contract. Iron and steel manufacturers could operate "cheek-by-jowl\textsuperscript{115}" and divide any gains realized through thermal economies by contract. Transportation costs could be saved in a similar manner. Contractual vertical restraints could also solve freerider problems.\textsuperscript{116} Because contracting is theoretically available to reduce these costs, a more powerful explanation of vertical integration is necessary. One such explanation is that vertical integration reduces transaction costs. Because contracting across markets increases transaction costs,\textsuperscript{117} direct allocation of inputs through firms may be an attractive way to decrease these costs.\textsuperscript{118}

\textsuperscript{112} OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 83 (1975) [hereinafter WILLIAMSON, MARKETS AND HIERARCHIES]; see also Armen A. Alchian & Harold Demsetz, Production, Information Costs and Economic Organization, 62 AM. ECON. REV. 777 (1972) (presenting a similar explanation of integration focusing on the interdependence of labor).

\textsuperscript{113} OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 88 (1985) [hereinafter WILLIAMSON, ECONOMIC INSTITUTIONS].


\textsuperscript{115} WILLIAMSON, ECONOMIC INSTITUTIONS, supra note 113, at 88.

\textsuperscript{116} See generally Butler & Bairstinger, supra note 114, at 1023-28 (discussing freerider problem in context of synthesis of contract law, economics, and organization theory).

\textsuperscript{117} See WILLIAMSON, MARKETS AND HIERARCHIES, supra note 112, at 17. Williamson examines the source of transaction costs in depth. He notes that "bounded rationality" (a rationality assumption that recognizes limits on an economic actor's ability to act in accordance with perfect information) limits parties' abilities to enter into comprehensive long-term contracts. \textit{Id.} at 91. Less comprehensive long-term contracting, an alternative to integration, may lead to opportunism. \textit{Id.} at 91-93. Shorter term contracting may give rise to small numbers problems and opportunism. \textit{Id.} at 26-28. All of these problems create transaction costs, making vertical integration a more attractive alternative.

\textsuperscript{118} For a thorough explanation of this theory of the firm, see WILLIAMSON, ECONOMIC INSTITUTIONS, supra note 113, at 85-102, and WILLIAMSON, MARKETS AND HIERARCHIES, supra note 112, at 82-105. See also Benjamin Klein et al., Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J. L. & ECON. 297-98 (1978) (citing post-contractual opportunistic behavior as a cost of using the market system). Transaction costs increase the marginal cost (supply) curve resulting in reduced output. A profit maximizing firm will seek to reduce these costs often by unifying the operations under common ownership.
Although contracting across markets increases transaction costs, integration increases governance costs.\footnote{See generally \textit{Williamson, Economic Institutions}, supra note 113, at 131-62 (discussing the incentive and bureaucratic features of firms); \textit{Williamson, Markets and Hierarchies}, supra note 112, at 117-31 (discussing the limits of vertical integration and firm size).} In complex, vertically integrated organizations, management may find that necessary information is difficult to obtain and that subordinate managers refuse to cooperate.\footnote{\textit{Williamson, Markets and Hierarchies}, supra note 112, at 124-26.} An increase in firm size may decrease management's ability to operate the integrated organization effectively. Correspondingly, the marginal savings of integration decrease as the firm grows.\footnote{See \textit{id.}; see also \textit{Coase}, supra note 111, at 28 (noting that as a firm gets larger there may be decreasing returns).}

The increase in governance costs constrains not only the depth of integration but also the breadth of firm operations. Governance costs curtail the geographic and product line scope of firm operations. Management personnel that are skilled in running automobile manufacturing, for example, may realize managerial economies of scale by expanding the firm's operations horizontally through a merger or a start-up. But, at some point, the administrative costs of managing the production of an additional product may offset the benefits of an operationally skilled management.\footnote{\textit{Williamson, Markets and Hierarchies}, supra note 112, at 117-31 (discussing the limits of vertical integration and firm size).}

These costs can be reduced by selecting the appropriate managerial structure. Professor Oliver Williamson has developed an analytical model of firm organization that focuses on the way the management of production is divisionalized.\footnote{See generally \textit{Williamson, Economic Institutions}, supra note 113, at 279-85 (reviewing the development of the divisionalized corporate form); \textit{Williamson, Markets and Hierarchies}, supra note 112, at 132-54 (examining unitary, multidivisional, and holding enterprise forms).} The unitary form, or U-form, enterprise is divided into operating units along functional lines.\footnote{\textit{Williamson, Markets and Hierarchies}, supra note 112, at 133.} The vertically integrated firm with purchasing, manufacturing, sales, and finance unit managers reporting to a central executive staff exemplifies this form of enterprise.\footnote{\textit{Id.} at 133-34.} Increased governance costs limit the radial expansion of vertically integrated firms that are organized in such a manner.\footnote{See \textit{id.} at 134-35.} Expansion into new products and geographic operations attenuates the central staff's ability to direct the operational aspects of such firms. This lack of control by the central management creates autonomy in the func-
tional unit heads who may not have enterprise-wide profit pursuit in mind.127

In response to these problems, Williamson describes the rise of the multi-divisional structure, or M-form firm.128 Management authority within M-form organizations is divided by product, brand, or geographic lines rather than along functional lines.129 Such divisions may be horizontally related or unrelated (conglomerate) U-form organizations that are small enough to be managed efficiently.130

The M-form firm is characterized by senior management that is insulated from the operational decisions taking place within the firm.131 By freeing senior managers from the day-to-day operational decisions, the M-form structure allows them to function as specialized owners, making many of the decisions ordinarily made by the capital markets.132 The executive office functions more effectively than the capital market by monitoring the performance of operational managers and setting incentives through salaries and status.133 Because of the managerial authority afforded by the ownership of all of the equity in the operating companies, these miniature capital markets may enjoy monitoring efficiencies not available to the broader capital market.134

127. Id. at 135.
128. Id. at 136.
129. Id.
130. Id. at 136-37.
131. Id. at 137-38.
132. See generally id. at 143-48. Williamson's goal in analyzing these types of organizational forms is to prescribe an efficient method of organizing, rather than to state the way corporations actually do organize. Thus, he argues that the M-form firm is the most efficient means of organizing behavior: "The organization and operation of the large enterprise along the lines of the M-form favors goal pursuit and least-cost behavior more nearly associated with the neoclassical profit maximization hypothesis than does the U-form organizational alternative." Id. at 150.
133. Id. at 145-46. The M-Form structure may alleviate many of the problems created by the separation of ownership from control in large corporations. Commentators have spent a substantial amount of intellectual energy analyzing the agency costs that such a separation generates. See, e.g., Coffee, supra note 70, at 25-26; Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395, 401-03 (1983); Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288 (1980); Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301, 304 (1983).
134. Williamson has argued that "the M-Form structure and its conglomerate variant have served to attenuate aspects of the managerial discretion problem." Oliver E. Williamson, Organization Form, Residual Claimants, and Corporate Control, 26 J.L. & Econ. 351, 366 (1983).
134. Williamson elaborates as follows:

The advantages of the general office over the capital market in auditing respects are of two kinds. First, division managers are subordinates; as such, both their accounting records and backup files are appropriate subjects for review. Stockholders, by contrast, are much more limited in what they can demand in the way of disclosure.
More fundamentally, Williamson asserts that the M-form firm also replaces the capital market in assigning excess cash flows to their best (highest yield) uses. This method of capital allocation is seen as more efficient than allocation through the general capital market because it reduces the costs of information dissemination, thus allowing a “sequential decision process (in which additional financing is conditional on prior stage results and developing contingencies) . . .” In essence, Williamson argues that the unification of diverse businesses within the M-form structure allows a faster and better informed allocation of capital than can be accomplished through capital markets.

In addition to being an effective method of organizing broad, horizontally related manufacturing processes, the M-form structure may help to explain the rise of the conglomerate. The M-form’s superior monitoring capabilities coupled with the relative ease of replacing its operational managers can reduce agency costs at the operating company level. Williamson further contends that the M-form’s superior information gathering ability makes the miniature capital market a more efficient structure within which to allocate capital.

While Williamson’s organizational theory may be descriptively powerful, several commentators have pointed to difficulties that may render the theory normatively weak when applied to the “true” conglomerate. The monitoring efficiencies of the M-form firm may not be as great as Williamson asserts. Also, even if monitoring efficiencies are present at the executive office level, the ultimate shareholders still need to

Second, the general office can expect knowledgeable parties to be much more cooperative than can an outsider. Thus, whereas disclosure of sensitive internal information to an outsider is apt to be interpreted as an act of treachery, internal disclosure is unlikely to be regarded opprobriously.

Williamson, Markets and Hierarchies, supra note 112, at 146-47.

135. Id. at 147.
136. Id. at 148.
137. The rise of the conglomerate raises the following question: Why do firms choose to invest earnings in non-integrated business operations rather than distribute the earnings to shareholders for re-deployment and diversification? Because shareholders themselves can diversify away non-systematic risk, there is really no additional benefit to be gained by further diversification at the firm level. Leebron, supra note 15, at 1617.

138. See supra note 133.
140. The true conglomerate is a corporate group with operational subsidiaries sharing no obvious operational or managerial synergies.

141. Coffee, supra note 70, at 33 (“[S]ome evidence has shown that diversification at the shareholder level has outperformed conglomerate firms. This is hardly the result one would expect if the modern conglomerate had superior monitoring ability.”).
monitor the central management.\(^{142}\) Finally, several commentators have suggested that the M-form's superior capital allocation properties may be overstated.\(^{143}\) While the M-form innovation makes the growth of firms possible, it does not place the necessary constraints on over-diversification at the corporate level.\(^{144}\)

Still, the M-form structure does lead to managerial efficiencies in many corporations. Even though the monitoring efficiencies created by the structure may lead to excessive and inefficient growth, there may be many cases in which the form provides net benefits. A closely related issue is the problem of definition: What one person may see as over-diversification, another may see as appropriate horizontal expansion.

B. The Effects of Limited Liability on Organizational Form

Williamson's analytical model of firm organization does not address the risk allocation structures necessary to M-Form and U-Form structures. Still, his model suggests an approach to the problem of limited liability in corporate groups that focuses on the economic relationships between various components of the group. Vertically integrated, U-form organizations do not require separate incorporation of components within the production process to realize their efficiencies. There is no indication that the savings in transaction costs associated with unifying ownership of inputs is dependent on the ability to separate the operations of vertically integrated firms into distinct subsidiaries.

\(^{142}\) As Coffee states:

One possibility is, of course, that the managerialists could be more right than Professor Williamson. That is, the growth of the conglomerate could owe more to the growth-maximizing preferences of managers, who are seeking to build a diversified portfolio within a single firm, than to its greater efficiency as Professor Williamson postulates. A more balanced interpretation might be that the advent of the M-Form Firm facilitated corporate growth, including inefficient growth . . . .

Coffee, supra note 70, at 32.

\(^{143}\) See, e.g., Louis Lowenstein, Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation, 83 COLUM. L. REV. 249, 312 n.250 (1983) ("The M-form may have encouraged too much emphasis on short-term financial management at the expense of longer term product and market development.").

\(^{144}\) The M-form organizational structure may allow managers to expand a corporation's operations beyond the point at which the operations can be effectively monitored. To the extent that M-form conglomerates have grown to such a size that managerial efficiencies are lost, investors would likely prefer a distribution of earnings that they could invest in a diversified portfolio. See Coffee, supra note 70, at 31-35.

Williamson recognizes that abuses of the form have occurred and will continue: "Lest I be misunderstood, I do not mean to suggest that opportunities to express managerial preferences in ways that conflict with the preferences of the stockholders have been extinguished as a result of the conglomerate form." WILLIAMSON, ECONOMIC INSTITUTIONS, supra note 113, at 289.
In fact, separating components of a vertically integrated operation into subsidiaries may increase transaction costs because creditors may insist on guarantees from the subsidiaries holding other components. Williamson and others have illustrated that one of the primary determinants of vertical integration is asset specificity. When assets necessary to a particular production process have limited usefulness outside of that process, ownership integration is more likely to occur because of the difficulty of contracting between multiple owners of various specialized inputs. This condition can be expected to impact creditors as well, causing at least sophisticated creditors to seek guarantees that ensure that their claims extend to the entire production process.

The efficiency of firms with horizontally related production processes, particularly those operating under an M-form structure, may require that courts give more deference to separate incorporation and limited liability. Firms must be able to separate and insulate productive assets along product, market, or geographic lines in order to realize fully the efficiencies associated with the operation of the businesses within a miniature capital market.

Further, when there is no physical asset specificity between subsidiaries operating in a corporate group, lenders may be able to extend credit on the basis of the assets and operations of a single member of the corporate group. Therefore, the economic justifications for the limitation of liability are strongest in situations of horizontal or conglomerate organization.

IV. Corporate Risk Relationships—A Model Of Risk Analysis

In determining whether limited or unlimited liability is appropriate as a baseline rule, it is not enough simply to point to the managerial efficiencies associated with various organizational forms. An inquiry into the effects of the rules on the relationships among the firm’s capital contributors is also required. This Part examines the effect of limited liabil-

145. WILLIAMSON, ECONOMIC INSTITUTIONS, supra note 113, at 90-96.
146. Asset specificity creates a quasi-rent that is subject to the risk of appropriation by opportunistic contracting partners. Klein et al., supra note 118, at 298.
147. Other commentators have approached similar conclusions. Blumberg discussed the impact of economic integration of corporate groups on consolidation but did not distinguish between horizontal and vertical integration. BLUMBERG, supra note 35, at 416-20. He concluded that “[a] demonstration that the related companies have conducted an economically integrated unitary business, while in and of itself important, is not always decisive.” Id. at 420.

In analyzing the effect of limited liability on tort claimants, Leebron also pointed to the effect of integration (though not necessarily vertical integration) on the justifications for limited liability. Leebron, supra note 15, at 1616-17.
ity on the risks creditors face. It divides risk into two components—enterprise risk and misappropriation risk. While both types of risk are present in any debtor-creditor relationship, limited liability within corporate groups increases misappropriation risk by providing increased opportunities for wealth transfers from shareholders to creditors. Thus, while limited liability may reduce transaction costs associated with market based risk allocations, it may increase the cost of controlling misappropriation risk.

A. Enterprise and Misappropriation Risk

The debate between Landers and Posner illustrates the essential tension between the desire to protect creditors against risk through legal rules and the concerns regarding the interference of such rules with market resolutions of risk allocation problems. The first step in the resolution of this tension, however, must be to clarify what the term “risk” means. There are at least two types of risks with which a system of corporate law must be concerned.

First there is enterprise risk—the expected variability of the earnings of a business at any point in time. Obviously, even if all of the corporate participants are pure of heart and acting in good faith, creditors face the risk that companies may ultimately fail and be unable to pay their debts. At some level, the risk of failure cannot be eliminated—changes in consumer preferences, natural disasters, limitations on managerial prowess, and the like present risks that the enterprise will fail notwithstanding the good faith efforts of all of the participants.

Enterprise risk does not, however, fully explain the tensions arising in the creditor-shareholder relationship. This relationship also gives rise to misappropriation risk—a risk that the corporation’s management will attempt to shift corporate wealth to the shareholders at the expense of the creditors. The most obvious example of misappropriation is the misrepresentation of the financial status of the business to potential creditors. By misrepresenting the nature and extent of enterprise risk, the business may obtain credit when it otherwise would not have attracted financing or a lower interest rate than it otherwise would have paid.

148. See infra text accompanying notes 149-155 for definitions of “enterprise risk” and “misappropriation risk.”

149. Landers characterized the distinction between him and Posner in the following way: “Professor Posner perceives the ‘consortium of banks’ as the paradigm group of creditors . . . . I find in the bankruptcy cases large numbers of involuntary, high-information-cost, and trade creditors who simply are not obtaining adequate protection under the present system.” Landers, Another Word, supra note 14, at 540.

150. Even Posner would abrogate limited liability when the corporate group has affirma-
Of more interest in an examination of limited liability are potential misappropriations occurring after credit is extended. Creditors that operate under a regime of limited liability are always subject to risks of misappropriation after the interest rate of debt is fixed.151 Increasing this risk after fixing the interest rate allows the shareholders to benefit because the value of their shares depends on the variability of the income stream to which they look for payment.152 Creditors control this risk through contract. Contractual covenants may shift ownership of the assets to the creditors153 when events increase risk beyond that contemplated by the parties in setting the interest rate.

Misappropriation risk may not appear to differ radically from enterprise risk. Both may be the subject of creditor contracting. Moreover, the process by which creditors bargain with management over the appropriate levels of both of these types of risk may converge. In credit relationships, however, the concepts are separate. The essential distinction between the two kinds of risk is that while misappropriation risk is subject to contractual control, enterprise risk is subject only to contractual allocation.

Enterprise risk, the expected variability of the earnings of the business at any point in time, affects all of the owners of inputs to the production process.154 It may be reduced through a variety of means, but because it is an estimated value at a given point in time, it cannot be controlled.155 Misappropriation risk, an uncompensated change in enterprise risk, looks to future actions designed to benefit shareholders at the


152. See Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, J. Pol. Econ. 637, 649-53 (1972); see also Posner, Economic Analysis, supra note 85, at 395-96 (providing a numerical example of this point).


154. This Article focuses on contributors of capital, as opposed to contributors of labor or physical supplies.

155. Consider the negotiations leading to an extension of credit. Even though a lender may make suggestions intended to reduce enterprise risk and may require covenants designed to inform it of events that increase enterprise risk, there will always be some variability in the earnings of the business. This variability (risk) cannot be reduced any further and thus must be allocated through the interest rate.
expense of creditors. Therefore, it is subject to contractual or legal control.

The control-allocation distinction is critical to an understanding of the interplay between legal rules and contractual mechanisms in corporate risk relationships. Allocations of enterprise risk necessarily occur in all corporate debt relationships. Creditors expect some variability in earnings at the time they extend credit. Therefore, the risk that variability represents must be allocated among the shareholders and creditors. The relative allocation of this risk through off-the-rack rules is only a starting point and the parties may reallocate or adjust compensation for risk bearing. In fact, off-the-rack rules, if well understood by the parties, may not be particularly relevant to actual allocations. As the following discussion illustrates, however, control of misappropriation risk presents a greater role for legal rules.

The differences between the two types of risk is illustrated by the Landers-Posner debate.156 Landers was primarily concerned with the increase in misappropriation risk.157 By contrast, while Posner considered misappropriation risk,158 he seemed more concerned with the allocation of enterprise risk.159 Their approaches conflict because the desirability of enterprise risk allocation through the baseline limited liability rule may substantially increase misappropriation risk.

B. Misappropriation Risk in the Corporate Group

Misappropriation risk in the context of corporate groups not only pits shareholders against creditors but also raises conflicts among creditors of related entities. While inevitable in any credit relationship, the failure of a corporate group spotlights these creditor-shareholder and creditor-creditor conflicts, because financial failure normally engenders a complete breakdown in the contractual framework of the business. In large part, the conflicts are regulated by the explicit contracts of the various participants in the corporate enterprise, but these contracts are negotiated with an eye toward the "standardized contracts" provided by corporate and bankruptcy law.

Misappropriation risk can take several forms. After fixing the interest rate of debt, shareholders may increase enterprise risk by withdraw-
ing assets from the corporation, substituting riskier assets for existing assets, purchasing risky assets through new debt issuance, and by foregoing valuable investment opportunities.\textsuperscript{160} While these varied forms of misappropriation risk are inevitable in any credit relationship, limited liability within corporate groups creates an opportunity to engage in transactions designed to withdraw corporate assets in ways that existing constraints may not adequately control.\textsuperscript{161} In these situations, the imposition of a different baseline rule may be the only answer.\textsuperscript{162}

Creditor-shareholder conflicts are inevitable in any lending relationship. Credit relationships imply differing claims on the cash flow and asset structure of the business.\textsuperscript{163} Both creditors and shareholders demand a return based partly on the risk of the business operations. Because the priority of credit claims reduces the risk of non-payment, creditors can demand a lower rate of return than that demanded by shareholders. Once the interest rate on debt is fixed, creditors are subject to the risk that shareholders will take actions to increase the risk of the enterprise beyond that taken into account by the interest rate. In this manner, shareholders may transfer wealth from the creditors to themselves.

Take the most obvious example: a dividend payment from a subsidiary corporation to its parent. All other things being unchanged, such a dividend payment can be expected to increase the enterprise risk faced by the subsidiary's creditors because it reduces the assets subject to their claims without increasing the value relevant to them.\textsuperscript{164} The ultimate shareholders of the parent corporation may seek the payment in order to increase the subsidiary's enterprise risk and to correspondingly reduce the parent corporation's enterprise risk. In the absence of any constraints, shareholders can be expected to insist on some level of dividend payments, because such payments reduce the total value of assets subject to prior claims.\textsuperscript{165}

Creditor-creditor conflicts are perhaps less obvious but are nonetheless present in the multi-tiered corporate structure. However, they are

\textsuperscript{160} Picker, \textit{supra} note 151, at 653.
\textsuperscript{161} See \textit{infra} text accompanying notes 167-201.
\textsuperscript{162} See \textit{infra} notes 182-215 and accompanying text.
\textsuperscript{163} Frost, \textit{supra} note 151, at 108-09.
\textsuperscript{164} Black & Scholes, \textit{supra} note 152, at 651 ("Even for dividends of modest size, a higher dividend always favors the stockholders at the expense of the bond holders.").
\textsuperscript{165} Of course, in many situations, shareholders will attempt to completely isolate the assets by requiring a further distribution from the parent to themselves. However, the transfer from the subsidiary to the parent may constitute a misappropriation even without a further distribution.
likely to be derivative of the creditor-shareholder conflicts described above. In the dividend example, the motivation for the dividend payment may have been to benefit the ultimate shareholders of the group, but this transfer also altered the enterprise risk allocation between the creditors of the subsidiary and the creditors of the parent by shifting assets between the entities.

Dividend payments present the most obvious example of misappropriation risk and are perhaps the easiest type of transaction to control. They also illustrate a type of transaction that is not unique to corporate groups. Any creditor lending to a business or individual is subject to the risk that its borrower will dissipate assets and thereby increase enterprise risk.

Misappropriation risk in corporate groups may be much more subtle than the particular form of misappropriation risk discussed in the foregoing example. When there are numerous intercompany transfers of goods and services between affiliated entities, the common managers of the group may price the transfers in order to benefit one of the two entities. For example, consider a vertically integrated corporate group consisting of separately incorporated manufacturing and sales components. Assume further that the shareholders of the group’s parent seek to increase the assets of the sales component (Sales) at the expense of the manufacturing component (Manufacturing). In order to shift assets between the components, the common management might price transfers from Manufacturing to Sales at a low enough level to ensure that Manufacturing incurs continuing losses while Sales earns abnormally high profits. The economic effect of such a scheme is no different from that yielded in the previous dividend example. Through transfer pricing, the management of the group may shift assets from Manufacturing to Sales in order to avoid the claims of Manufacturing’s creditors.

Both dividend payments and subsidized transfer pricing reduce the assets available to pay the debts of one of the members of the group and increase the assets of another. Because total liabilities remain unchanged, shifting assets through dividends or intercompany transactions necessarily shifts risk between the various entities within the corporate group. Whether these transactions ultimately benefit the shareholders or the creditors of a particular entity is beside the point. For all creditors,

166. Even if Manufacturing and Sales are not in a parent-subsidiary relationship, a shift in assets may benefit the shareholders of the parent corporation. If one of the corporations has incurred significantly more debt than the other, a shift in assets from the leveraged member of the group to the unleveraged insulates those assets and benefits the ultimate shareholders.
the limitation of liability results in a potentially uncompensated shift in the asset base to which they may look for payment.

But this is not to condemn either intragroup transactions or dividend payments. Obviously, both are normal, expected practices in many corporations. These illustrations simply show that limited liability creates a situation in which a transfer of assets becomes relevant to creditors. The desirability of restricting these types of transfers does not follow directly from the observation that such transfers may create a potential for misappropriation. Much of the risk of misappropriation may be limited by contractual, reputational, and governance constraints. There remain, however, practical limitations on the effectiveness of these control devices. In the absence of legal constraints, these limitations would allow corporations to externalize some of the risk of their operations through misappropriation.

C. Constraints Against Misappropriation Risk

Limiting liability within corporate groups increases misappropriation risk by enabling management to shift assets among the entities of the group. One answer to this problem is to eliminate limited liability as a baseline rule. Alternatively, the increase in misappropriation risk may not be significant given the many constraints on such behavior.

While any lending relationship presents opportunities for misappropriation, there are several constraints on such behavior. For example, the reputational damage caused by misappropriations is likely to impair the ability of the business to survive as a going concern. Therefore, shareholders may be unlikely to insist on such wealth transfers. Contractual covenants may further restrict dividend payments and intercompany transactions. Creditors may also obtain guaranties and security interests to reduce misappropriation risk. In large corporations, the shareholders' lack of control over the management of the corporate group may diminish misappropriation risk. While each of these constraints reduces misappropriation risk, all provide incomplete protection. Legal remedies, the subject of the following Part, are necessary to supplement the foregoing constraints.

(1) Reputational Constraints

Reputational concerns may provide a powerful constraint against misappropriation in the context of the financially healthy business. Shareholders that are interested in maintaining their investment in a going concern are unlikely to cause management to substantially increase the risk to creditors, because to do so would increase the cost of ob-
taining future credit. Assuming self-interested actors, however, this control on misappropriation risk applies only when the present value of maintaining a going concern is greater than the present value of the benefits derived from the misappropriation. In addition, the benefits of maintaining a going concern must be discounted by the probability of firm failure in the future. Therefore, shareholders of firms with substantial financial problems may rationally choose to forego the benefits of continuing to maintain the business in favor of transfers of wealth to themselves.

(2) Contractual Constraints

Explicit contracting works relatively well to reduce misappropriation risk facing institutional creditors. Institutional creditors are likely to have better information regarding this risk and may more easily set an appropriate interest rate. They may bargain for contractual provisions that limit dividends and intercompany transactions. Even if such provisions are ineffective or the costs of negotiating them too high, both lenders of substantial funds and management will have incentives to contract around the limited liability rule by obtaining either the guaranty of other members of the group or a security interest in particular assets.

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167. See Easterbrook & Fischel, supra note 66, at 51.

168. Id. ("There is no 'externality' except in the last period—that is, the time after which the firm no longer contemplates raising new money in capital markets.").

169. As a firm encounters financial difficulties, the expected value of the firm as a going concern will decrease. If the benefit to shareholders from a particular asset shift remains constant, the likelihood that the value of that shift will exceed the loss caused by a damaged reputation will increase. Thus, misappropriation is more likely to occur in times of financial distress. See Frost, supra note 151, at 109.

170. A reduction in misappropriation risk ex ante benefits all of the participants in the corporate group. To the extent that the management of the group is able to provide such contractual protection to the creditors, the shareholders will be benefitted by a reduction in the interest rate the creditors will charge. These contractual constraints carry their own costs, however, by reducing managerial flexibility. Thus capital contributors will most likely bargain for a level of contractual protection that is consistent with their cost-benefit criterion.

171. See Landers, Another Word, supra note 14, at 540 ("I hardly doubt the ability of the banks to protect themselves.").

172. See Smith & Warner, supra note 153, at 130-35 (dividend restrictions). Restrictions on intercompany transactions have not been fully analyzed by commentators, but these restrictions could be useful in reducing the misappropriation risk facing lenders of separately incorporated components of vertically integrated production processes.

173. If misappropriation risk stems from the limitation of liability, a guaranty, which abrogates the limitation, may reduce that risk.

174. See Picker, supra note 151, at 654 ("[S]ecured credit itself can be understood as [an] attempt to reduce debtor misbehavior . . .").
Smaller voluntary creditors may have more difficulty protecting themselves by contract. Small suppliers and employees may not fully appreciate the misappropriation risk they face when dealing with a member of a corporate group. The absolute level of indebtedness owed to any particular supplier may be inadequate to support the transaction costs involved in understanding the risk and providing contractual protection. This factor may be particularly problematic when a supplier is dealing with a separately incorporated but vertically integrated operation. The supplier may not fully appreciate the misappropriation risk that is created by the fact that the entity with which it is doing business does not include all of the assets of the entire integrated business.\(^\text{175}\) Finally, obtaining better information entails transaction costs that might be avoided by abrogating limited liability in the corporate group.\(^\text{176}\)

(3) Governance Constraints

Misappropriation risk is significantly controlled by the corporate governance structure of the borrowing entity. This model of risk analysis has thus far assumed that shareholders can cause management to engage in behavior that results in a misappropriation. In many circumstances, however, shareholders may lack effective control over the management of the corporate group. In this case, managers may have less of an incentive to shift assets among the members of the group.

Lack of shareholder control over management has been the subject of extensive commentary and analysis. In large corporations, shareholder voting and other control devices have been shown to be less than effective means of aligning the incentives of managers with those of the shareholders.\(^\text{177}\) Diversification\(^\text{178}\) has resulted in widespread holdings of small numbers of shares. The small stake held by individual shareholders limits their incentive to control managerial actions.

This separation of ownership from control redounds to the benefit of creditors. Because managers are heavily invested in the firm and are un-

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\(^{175}\) See Posner, Economic Analysis, supra note 85, at 408-09 (noting the potential for misrepresentation in separately incorporated but vertically integrated corporations).

\(^{176}\) See Landers, Another Word, supra note 14, at 530-32 (citing high information costs as prohibiting small creditors from protecting themselves through contract). Even institutional creditors may not adequately protect themselves with contractual covenants. See McDaniel, supra note 151, at 236-38 (noting studies indicating a lack of contractual protection).


\(^{178}\) See supra note 70.
able to diversify their firm-specific skills, they are likely to be risk-averse. Thus, while shareholders may desire to increase enterprise risk after the interest rate of debt is fixed, managers may be reluctant to do so. The shareholders' inability to have complete control over the management of the corporate group reduces their opportunity to engage in misappropriations.

Governance structures do not, however, eliminate the problem of misappropriation risk. First, many corporations are not controlled by an autonomous management. In many small, closely held corporations, managers hold a significant percentage of the equity interests and may, therefore, have an incentive to engage in asset shifting. Second, if the corporation is in financial difficulty, managers may choose to move assets from the weakest entities to those entities that have the best chance of survival.

The inadequacy of the constraints against misappropriation risk affects all credit relationships. If all lenders could rely on these constraints, there would be no reason for the law to provide further protection. Creditors would simply choose the level of protection at which they were willing to lend and demand an interest rate sufficient to compensate them for any remaining enterprise and misappropriation risk. While they would choose incorrectly some of the time, they could not complain that the system somehow treated them unfairly.

Transaction costs weaken these controls on misappropriation risk by limiting the ability of many lenders to understand the reputational and governance constraints and to tailor their contractual constraints to particular deals. Many lenders, such as wage claimants and suppliers, are simply unable to incur the transaction costs necessary to both gaining an understanding of and dealing with the misappropriation risk presented by a particular situation. In any event, the costs of negotiating appropriate constraints can be eliminated by structuring a protective off-the-rack rule.

V. Legal Constraints Against Misappropriation Risk

As illustrated above, the transaction cost analysis of limited liability within corporate groups creates a paradox. If transaction costs are to be

179. See Coffee, supra note 70, at 19.
180. See Frost, supra note 151, at 109.
181. As a firm encounters financial difficulties, managers may be willing to raid weaker elements of the business in order to obtain operating capital to bolster stronger elements. Again, while this approach may be beneficial to the entity as a whole, it may increase the likelihood of the failure of a weaker subsidiary in a way that was not contemplated by that subsidiary's creditors.
minimized, the rule allocating enterprise risk should approximate what parties would bargain for in the absence of such a rule. If this allocational rule is limited liability, misappropriation risk may increase. This tension can be partially resolved by expanding the analysis to include off-the-rack rules designed to counter the ill effects of the limited liability regime.

Controlling misappropriation risk may involve increased transaction costs so great that many creditors will forego contractual protections. This Part incorporates the protection provided by the fraudulent transfer laws into the transaction cost analysis.\textsuperscript{182} While limited liability within the corporate group may exacerbate misappropriation risk, creditors’ legal protections, such as those furnished by fraudulent transfer laws, provide a remedy for misappropriation. To the extent that this remedy adequately controls misappropriation risk, it is consistent with a transaction cost approach.\textsuperscript{183} As illustrated below, however, fraudulent transfer laws may provide inadequate protection against misappropriation risk occurring in separately incorporated but vertically integrated members of corporate groups. This failure may allow a corporation to externalize some of its enterprise risk.

A. Fraudulent Transfer Law

Aside from any contractual protection creditors have negotiated, creditors are assured that corporate transactions that drastically impair the financial condition of the business may be remedied. Section 548 of the Bankruptcy Code\textsuperscript{184} and its state law counterparts, the Uniform Fraudulent Conveyance Act (UFCA)\textsuperscript{185} and the Uniform Fraudulent Transfer Act (UFTA),\textsuperscript{186} are designed as recovery mechanisms for particular transfers that increase creditors’ risk beyond that incorporated

\textsuperscript{182} By and large, the entity-enterprise debate seems to have disregarded the role of off-the-rack protective rules; however, the transaction cost analysis is incomplete without further consideration of the effect of such protections on the credit contract. Cf. Landers, Unified Approach, supra note 69, at 592-95 (dismissing fraudulent transfer laws and dividend restriction statutes as “rather narrow”).

\textsuperscript{183} Fiduciary duties to minority shareholders exemplify off-the-rack protective rules. Minority shareholders are positioned similarly to creditors of corporate groups. Managers may have an incentive to engage in transactions designed to benefit the majority shareholders at the expense of the minority—a species of misappropriation risk. See generally J.A.C. Hetherington, Defining the Scope of Controlling Shareholders’ Fiduciary Responsibilities, 22 WAKE FOREST L. REV. 9 (1987) (analyzing conflicts between the interests of the controlling and minority shareholders).


\textsuperscript{185} UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 430 (1918) [hereinafter UFCA].

\textsuperscript{186} UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 643 (1984) [hereinafter UFTA].
into the interest rate. In addition to voiding transfers made with the intent to “hinder, delay, or defraud” creditors, section 548 also voids constructively fraudulent transfers—transfers made for “less than [a] reasonably equivalent value” during periods in which the present or contemplated financial condition of the business falls below particular benchmarks.188

The dividend transfer problem189 provides the most obvious application of the constructive fraudulent transfer laws: The dividend transfer between the parent and subsidiary is made for “less than [a] reasonably equivalent value,” because it results in a reduction in capital without a corresponding increase in the value of the assets to which creditors may look for payment.190 If the subsidiary is “insolvent,” the transfer is recoverable from the parent.191 If, on the other hand, the subsidiary is solvent and the financial standard for creditor protection has not otherwise been met, the creditors of the subsidiary are not protected.192

Dividend payments present one of the simplest examples of the application of the constructive fraudulent transfer laws to these sorts of conflicts. Reasonably equivalent value is clearly lacking, and thus the question is simply whether the financial performance benchmarks have

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187. 11 U.S.C. § 548(a)(1) (1988). This provision, as well as UFCA § 7 and UFTA § 4(a)(1), protects creditors against actual fraud without regard to the financial condition of the transferor corporation. While these sections provide substantial protection against misappropriation risk, they may be inadequate to combat misappropriations occurring in the ordinary course of the corporate group’s business because of the difficulty in proving intent to defraud.

188. 11 U.S.C. § 548(a)(2) (1988). Under section 548, the UFTA and UFCA apply only when the transferor corporation is in, or anticipates being in, dire financial straits, unless the transfer was made with actual intent to hinder, delay, or defraud creditors. The “constructive” fraudulent transfer provisions of section 548 provide a remedy only when the transferor is insolvent or has unreasonably small capital, or when the transferor anticipates incurring indebtedness beyond its ability to repay. See generally Bruce A. Markell, Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital, 21 IND. L. REV. 469 (1988) (reviewing the origins and development of the unreasonably small capital branch of fraudulent transfer law).

189. See supra text accompanying note 166.

190. Dividends are also subject to specific corporate law restrictions. See, e.g., CAL. CORP. CODE § 500 (West 1992); DEL. CODE ANN. tit. 8, § 170 (1991); N.Y. BUS. CORP. LAW § 510 (McKinney 1992); MODEL BUSINESS CORP. ACT. § 45 (1979). These statutes approach the dividend problem in the same way as fraudulent transfer laws. See CLARK, supra note 65, at 86-90.


192. If the parent corporation pays a further dividend to the ultimate shareholders, a similar analysis applies to resolve the shareholder/creditor risk allocation. If the financial condition of the subsidiary is below the threshold set by the fraudulent transfer laws, the creditor of the subsidiary may seek return of the funds from the shareholders of the parent. See 11 U.S.C. § 550(a)(2) (1988).
been met. The concept of a transfer under the fraudulent transfer rules extends beyond the scope of the obvious transfer found in dividend payments, however, and can be used to resolve more subtle conflicts.

Constructive fraudulent transfer laws might be applied to remedy the misappropriation risk raised by the transfer pricing hypothetical. The definition of transfer, under the Code, is broad enough to include even intercompany sales transactions undertaken in the ordinary course of business. Under section 548, the UFCA, and the UFTA, a court examines each transaction to determine whether the property exchanged was of a reasonably equivalent value. If the exchange fails this test, the court further inquires whether the subsidiary that received less than reasonable equivalent value was in poor enough financial condition to implicate the protection provided by the fraudulent transfer laws. There are, however, several factors that limit the practical effectiveness of this method of creditor protection.

B. The Conceptual Limitations on Fraudulent Transfer Laws

The transaction costs justification for fraudulent transfer laws requires that these off-the-rack creditor protections be closely circumscribed to resemble the bargain that creditors and shareholders would reach in the absence of transaction costs. Failure to adhere closely to the bargain model may result in a loss of managerial flexibility and may provide creditors with protections they would have been willing to relinquish by contract. Remedies provided by section 548, the UFCA, and

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193. See supra text accompanying note 166.
194. "'Transfer' means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property . . ." 11 U.S.C. § 101(54) (Supp. II 1990).
198. Baird & Jackson, supra note 197, at 834. Addressing fiduciary duties to minority shareholders, Professor Hetherington observed:
When the courts import substantive obligations into private contracts, those obligations are certain to differ to some extent from those the parties themselves would have made. The degree of divergence will, of course, vary. When this divergence is small, the parties have little to gain by negotiating to modify or avoid the impact of the law-created term; the greater the divergence, the greater the incentive. Bargaining is costly, and the parties may be expected to engage in it only when the prospective benefits exceed the costs. In resolving disputes ex post, the efficiency and productivity of exchange transactions would be enhanced if the courts sought the allocation which the parties would have made ex ante had they then considered that the gains of bargaining exceeded the costs.
the UFTA are limited to transactions that fail a threshold level of "fairness." In addition, they are restricted in their application to transactions occurring when the firm is in dire straits or transactions undertaken with actual intent to defraud.

These limits on the fraudulent transfer remedy highlight concerns that its application might interfere with explicit contractual expectations of parties other than the corporation and the protected creditors. A protective rule allowing creditors to challenge transactions because they were not good deals for the corporation would inhibit transacting. Third parties would not be able to rely on their explicit contracts with the corporation. Reassurance given to third parties would require that all creditors agree to the transaction at issue.199 By limiting the application of these remedies to transactions occurring during insolvency or transfers undertaken with intent to defraud, the fraudulent transfer laws provide third parties with some means of determining the risk that their contractual expectations will be upset.200

Using fraudulent transfer laws to reallocate assets misappropriated through transfer pricing directly implicates these concerns. Creditors of the subsidiary receiving the allegedly fraudulent transfer may have relied on their borrower's business relationship with its affiliate. If, for example, a sales subsidiary enjoys a particularly favorable pricing relationship with its manufacturing affiliate, the sales subsidiary's creditors may come to rely on that relationship in setting the terms of the credit relationship. Creditors of the subsidiary harmed by the relationship may, however, complain that the arrangement constituted a misappropriation. Despite these complaints, the potential reliance of sales' creditors requires limitations on the fraudulent transfer remedy. Unless the remedy is limited in some way, neither group of creditors will have any baseline against which to develop their expectations.

It is necessary to determine when fraudulent transfer laws should be applied to the myriad conflicts between parties dealing with an insolvent corporation. But unlike the application of fraudulent transfer laws to single transactions, such as dividend payments, the restrictions on the remedy renders it ineffective to protect against misappropriation resulting from a series of transactions that are part of the normal course of vertically integrated production processes. The application of the fraudulent transfer laws to these intercompany arrangements presents compli-

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199. Baird & Jackson, supra note 197, at 839. Thus unlike allocational rules, protective rules are generally not subject to ex ante contractual abrogation. See id. at 835.
200. See id. at 839.
cations that are not present in more general applications. In the dividend example, the court is presented with a discrete transaction that is clearly of no value to the subsidiary corporation. The only inquiry is whether the subsidiary met the financial standard of the fraudulent transfer laws on the date of the transfer. The intragroup sale of goods problem requires more than a mere inquiry into the fairness of the intercompany arrangement. Because of the regular nature of the transfers, the court must also determine precisely when the subsidiary moved from a state of solvency to insolvency. Since there is unlikely to be any one event that created the condition of insolvency, the line drawing may be relatively arbitrary.

C. The Transfer Pricing Problem

The difficulty of determining the point of insolvency may be dwarfed by the difficulties posed by the requirement that the transfers be unfair for one or the other subsidiary. Such an inquiry is likely to be as complex as it is critical. Transfer pricing analysis requires cost and revenue allocations that may be beyond the competency of the judicial process. Thus, fraudulent transfer laws may be inadequate protection against misappropriation risk in transfer pricing situations.

Posner asserts that, while managers may take steps to distort the profitability of the various members of the corporate group, they are unlikely to do so because of their need for undistorted information about the relative profitability of the various components of the group. He concludes that this managerial need will cause most vertically integrated units of the group to be operated as "profit centers." Thus, Posner would likely conclude that intragroup transactions would not normally implicate the constructive fraudulent transfer laws because the transactions would be priced at a fair or reasonably equivalent value.

One response to this assertion is that, like reputational limits on misappropriation risk, the profit center notion provides meaningful protection only in the context of a going concern. The protection is effective only insofar as the management of the business finds that the informational distortions resulting from a pattern of misappropriation cost more than the expected value of the misappropriations themselves. If the fi-

201. Transactions occurring prior to insolvency would not implicate the constructive fraudulent transfer laws, but those occurring after insolvency would.
204. See supra text accompanying notes 168-169.
nancial condition of the business is such that managers believe that the group will not survive, managers’ desire to avoid distortions in information may be outweighed by the potential profitability of the misappropriation.

A more fundamental problem with relying on the profit center concept as a limitation on misappropriation risk arises from the conceptual difficulties raised by transfer pricing. Transfer pricing for managerial purposes may differ radically from the pricing structure in truly independent corporations. The term “profit center” suggests corporate entities that, apart from the fact that they are affiliated in the ownership sense, operate as independent autonomous entities. Such is not the case. In fact, transfer pricing practices often diverge from market-based pricing.

Effective transfer pricing mechanisms fulfill several goals. According to commentators, there are three criteria in effective transfer pricing: efficiency, monitoring, and fairness. In order for a business to set its price and output at the most efficient level, the input prices must be valued correctly. This may require setting the transfer price at marginal cost rather than market price, unless the input is sold in a perfectly competitive market. Monitoring and managerial fairness must also be considered when determining the transfer price. Satisfying all of these goals may require that transfer prices differ from the market prices.

Thus, corporations may only rarely be expected to price intragroup transfers by reference to the market. While this is clearly justifiable from a managerial perspective, the allocation of enterprise risk among the subsidiaries is necessarily distorted. While operating as “profit centers” in a managerial sense, individual subsidiaries may, from the creditors’ perspective, have artificial revenues and costs.

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205. See ROBERT G. ECCLES, THE TRANSFER PRICING PROBLEM: A THEORY FOR PRACTICE 1 (1985) (“The transfer pricing problem is a difficult and frustrating one. Although there has been substantial interest in this problem among academics, many managers regard it as unsolved or unsolvable.”).

206. In a study of the transfer pricing practices of 13 companies, Robert Eccles discovered that only 30% of these companies utilized a market price policy. Id. at 110. See also RALPH L. BENKE, JR. & JAMES DON EDWARDS, TRANSFER PRICING: TECHNIQUES AND USES 43-47 (1980) (noting that market based pricing could result in a “profit buildup”—a condition resulting from transfers through several divisions—that could distort cost information).


208. A firm maximizes profits at the level of output at which marginal cost is equal to marginal revenue. See, e.g., ARMEN A. ALCHIAN & WILLIAM R. ALLEN, EXCHANGE AND PRODUCTION: COMPETITION COORDINATION AND CONTROL 208 (3d ed. 1983).


210. ECCLES, supra note 205, at 35-40.
Transfer pricing issues have presented an intractable problem under the Internal Revenue Code. The Internal Revenue Code authorizes the Internal Revenue Service to adjust the taxable income of commonly controlled taxpayers in order to place these taxpayers on a tax parity with the uncontrolled taxpayers that deal at arm’s length.211 These adjustments often involve an inquiry into the pricing of intragroup transfers. These transfer pricing cases have been described as “monsters”—involving extensive motions related to discovery and burden of proof issues, and taking years to resolve.212 Transfer pricing cases are so complex that the Tax Court now imposes an arbitration procedure in transfer pricing cases,213 and the House Ways and Means Committee is considering a proposal to partially abandon the arm’s length method of determining the taxable income of U.S. and foreign corporations.214

Complexity in transfer pricing makes it nearly impossible to determine the “fairness” of the intragroup exchange. Deciding that a transaction or series of transactions was for less than “reasonably equivalent value” or “fair consideration” would require the court to understand the transfer pricing structure and to determine whether the transactions at issue comported with the creditors’ expectations when they determined the level of enterprise risk their loans entailed.215 In addition, the court would have to value any cost efficiencies generated by the organizational structure and derive some reasoned method of allocating cost savings. These difficulties render fraudulent transfer laws ineffective as a creditor protection against misappropriation risk arising from a vertically integrated corporate relationship.

VI. A Model for Substantive Consolidation

Given the difficulties noted above, misappropriation risk may remain an impediment to the full internalization of enterprise risk in some corporate groups. The baseline rule of limited liability within corporate groups allows management to shift assets among members of the group, and thereby to increase the risk of particular members after credit exten-

213. Id.
215. If the transfer pricing scheme is fixed, the effects of the organizational structure on enterprise risk will be reflected in the financial statements of the various subsidiaries. Thus a corporate group’s employment of a non-market based transfer mechanism does not necessarily imply that the business is able to externalize risk.
sion. Thus, limited liability is an important factor in the increase of misappropriation risk.

This analysis does not suggest, however, the automatic substantive consolidation of all corporate groups. While the elimination of limited liability may substantially reduce the misappropriation risk faced by small creditors, this remedy may be a bit heavy-handed. Abrogating limited liability carries increased transaction costs of its own. One of the primary benefits of limited liability is that it enables businesses to segregate assets for long-term financing. By assuring that assets will not be subject to the claims of the creditors of other parts of the corporate group, potential lenders to one business operation may analyze the creditworthiness of that operation without regard to the remaining business operations. If corporate groups are consolidated on a regular basis, potential lenders will be forced to evaluate the credit of a broader group of businesses. At worst, such a situation will cause multi-product businesses to pay an interest rate that is based on the lowest common denominator in terms of creditworthiness. At best, regular consolidation will result in more creditors securing their loans to isolate their claims against the income streams generated by particular asset bundles.

At a minimum, the legal regime under which creditors and shareholders bargain over risk allocation and protection against misappropriation risk should be as determinate as possible. This goal, in turn, requires commitment to some indicia of the classes of cases to which a particular rule, such as limited liability, should apply. Recognizing that a cost of determinacy is that any particular rule will be under- or over-inclusive in some instances, an analysis of organizational form, coupled with the model of risk analysis set forth above, suggests an approach to the problem of limited liability that focuses on the organizational relationship between the members of the corporate group. Vertically integrated organizations should routinely be consolidated in bankruptcy, while horizontally related and conglomerate organizations should be consolidated only in rare circumstances.

A. Consolidation of Vertically Integrated Organizations

The benefits of limited liability are attenuated in the context of vertically integrated corporate groups. If the goal of vertical integration is to reduce transaction costs associated with contracting across markets, there are few benefits associated with integrating equity ownership while keeping the contingent ownership associated with creditors' claims sepa-

rate. Any savings in transaction costs achieved by unifying control over assets would be lost if the corporations were to act as unrelated market participants from the creditors’ perspectives.

In fact, vertically integrated but separately incorporated members of corporate groups do not act as unrelated entities from their creditors’ perspective. Profits from the production process must be allocated among the various entities comprising the group. Because such profits are allocated through managerial direction rather than through market transactions, the level of misappropriation risk is increased. Because contractual, reputational, and governance constraints are insufficient to control misappropriation risk, creditors may be forced to rely on legal constraints. But these legal protections are less effective when a vertically integrated production process is split into separate subsidiaries because it is difficult to determine whether intercompany transfers between members of the group have been priced fairly. Inasmuch as fraudulent transfer proceedings fail to detect misappropriations in this context, there are compelling reasons for the consolidation of these groups.

Further, a baseline rule of unlimited liability between vertically integrated components of a single production process will likely comport with most creditors and shareholders’ desires regarding the allocation of enterprise risk in such contexts. Production is integrated because asset specificity problems increase the costs of contracting across markets. The risks of incomplete contracting affect creditors as well as shareholders. Therefore, consolidating vertically integrated subsidiaries should not be expected to result in increased transaction costs overall.

B. Consolidation in Horizontally Related and Conglomerate Organizations

Horizontally related and conglomerate organizations may benefit more from a baseline rule of limited liability than do vertically integrated organizations. Limiting liability by segregating operations in separate subsidiaries may create managerial efficiencies by allowing the corporate group to be operated as a miniature capital market. Thus, a baseline rule of limited liability in this context is more likely to provide an allocation of enterprise risk that is consistent with the parties’ desires.

The legal controls on misappropriation risk are also more likely to be effective in these organizations. Regardless of the economic relationships between members of a corporate group, managers may have an incentive to engage in misappropriations by shifting assets among the group’s members. In horizontally related and conglomerate groups, however, business separations between subsidiaries increase the likelihood that any such asset shift will take the form of a dividend or in-
tercompany loan rather than of a transfer pricing scheme. Fraudulent transfer laws provide a much more realistic level of protection to creditors when managers shift assets through cash transfers rather than through transfers of goods and services.

C. Caveats and Limitations

It cannot be overemphasized that the model for substantive consolidation presented in this Article provides only an off-the-rack rule that is intended to reduce transaction costs by reducing the necessity of revising the baseline risk allocation. Regardless of the rule chosen, there will continue to be situations in which the results provided by the rule are contrary to the contracting parties' desires. Thus, the model should apply only in the absence of ex ante or ex post contractual risk allocations and control devices.

First, consider ex ante contractual risk allocations. In some instances, the enterprise risk of a particular component of a production process may be so substantial that, without the benefits of limited liability, that component would not be integrated. In these situations, unlimited liability may result in less integration even when integration provides the ownership structure that minimizes transaction costs. If management can convince creditors that adequate non-legal controls against misappropriation risk exist, the creditors may be induced to contractually limit their claims to the assets of the risky entity. In this manner, enterprise risk could be allocated in a way that would make integration attractive. The model for substantive consolidation simply requires that the parties confront these issues in their contract negotiations. It does not provide results that cannot be altered through contract.217

A second and perhaps more subtle point is that the parties must retain the ability to alter the legal regime ex post through the negotiation structure provided by Chapter 11 of the Bankruptcy Code. In deciding to consolidate affiliated corporations, a few courts have noted that the consolidation was necessary to the development of a plan of reorganization.218 Consolidation may be beneficial in reorganizations because it eliminates concerns over the priority of intercompany claims, problems stemming from fraudulent transfer, and claims of creditors against two or more members of the group. Consolidation may also reduce litigation over which entity owns particular assets and may substantially simplify

217. The same is true for the reallocation of risk through guaranties and security interests.
The classification and treatment of creditors. In these bankruptcy situations, some mechanism must exist to consolidate even horizontally related and conglomerate entities in order to preserve the possibility of an effective reorganization.

The mechanism should not, however, be a judicial determination that consolidation is in the interest of all of the creditor groups. Chapter 11 of the Code is premised on negotiations leading to a consensual plan of reorganization under which consolidation could be a feature. Creditors are permitted to express their individual approval of a plan rather than rely on a judicial finding that a particular outcome is in their interest. Chapter 11's negotiation and voting process avoids the representational problems that may be expected in a judicial process. The outcomes provided by the substantive consolidation model, like the effects of the general system of priority, should not be permitted to interfere with the Code's structure for ex post negotiations.

D. Problematic Fact Patterns

A model of substantive consolidation that focuses on the vertical or horizontal relatedness of separate subsidiaries may not provide courts with an absolutely clear indicator of the need for consolidation in all cases. The existence of misappropriation risk renders any neat system of corporate law, including substantive consolidation, subject to exceptions in extreme circumstances.

In many bankruptcy cases, the parties will face managerial actions that do not fit neatly within the confines of the model presented here. Managers will continue to transfer assets among entities without adequate record keeping and will misrepresent the corporate structure of the business. In these situations, substantive consolidation may be required even in the bankruptcies of horizontally related and conglomerate organizations.

Another possible problem is that many organizational forms may not fit neatly within the confines of a vertical-horizontal dichotomy. Some members of a corporate group may operate as cost centers, supplying a needed product or service to several horizontally related affiliates. In re Murray Industries presented an example of this type of problem. In Murray, several horizontally related manufacturing entities shared common names and two of the subsidiaries provided transportation and

219. See Frost, supra note 151, at 94-97.
220. See supra text accompanying notes 26-28.
research and development services to the other entities. The cost center subsidiaries and parent corporation could have been viewed as vertically integrated with several subsidiaries. The court's response, however, was to consolidate the entire corporate group, rather than deal with the more difficult question of the economic organization of the business.

The problems such a situation creates are solvable within the confines of the model presented here. If the corporations are to be liquidated, some of the assets and liabilities could be allocated among the various entities by analyzing the relative use of the services or assets of the subsidiaries. If creditors and shareholders agree on a reorganization of the entities, the plan negotiations could resolve these issues.

Conclusion

Bankruptcy is perhaps the best arena in which to examine the impact and effectiveness of the corporate law structure. In the midst of a complete business or financial collapse, the effect of contracts allocating the risk of that very event can be seen with clarity. Much of the conflict in bankruptcy revolves around the priority of distribution and control over the liquidation or reorganization. Yet the failure of a corporate group casts a spotlight on the equally important issue of allocating assets and liabilities among the various entities comprising the group.

Corporate shareholders and creditors allocate risk against the backdrop of existing laws and their contracts reflect expectations created by these general rules. If the parties are satisfied with the risk allocation corporate law provides, their contracts can be expected to be silent on this subject. It is only when parties are dissatisfied with the risk allocation resulting from the general rule that their contracts will address the problem. Of course, this assumes that the existing rules are reasonably predictable.

Some courts facing consolidation questions have failed to provide a principled basis for the application of the doctrine. Tests that seek to balance the benefits and burdens of a consolidation order and analyses that are based on creditor reliance do no more than legitimize a post hoc

222. Id. at 824.
223. Id. at 832.
224. It might be possible to provide the cost center subsidiary with a pro-rata claim against each of the other subsidiaries it serves. The claims would, in the aggregate, equal the amount by which the cost center's liabilities exceed its assets, and the total amount would be pro-rated based on some guideline such as level of usage.
225. See supra text accompanying note 219.
reshuffling of expectations. The problem of determining creditor expectations is exacerbated by the fact that each attempt renders the baseline rules uncertain. What is left is a mess that can only be sorted out by clarifying the baseline rules themselves.

Any desire for a clear baseline rule must be balanced against the fact that diverse corporate organizations create differing risk relationships among capital contributors. Some corporate structures rely to a greater extent on the limitation of liability than do others. Moreover, limiting liability in some organizations presents a greater risk that shareholders will successfully misappropriate corporate wealth. Thus, one baseline rule regarding the scope of liability may not be the most effective in all circumstances.

An approach to substantive consolidation that focuses on the level of vertical integration between the various entities comprising the corporate group strikes a middle ground between a regime of pristine clarity and a system of ad hoc rules individually tailored to specific corporate relationships. Vertically integrated firms are more likely to create the highest level of uncontrolled misappropriation risk because it is difficult to apply fraudulent transfer laws to the transfers taking place between such entities. Not only would consolidation eliminate a significant source of this type of risk, but it is also the baseline rule that normally comports with parties' risk allocation preferences.

There is less of a risk that shareholder misappropriations in horizontally related and conglomerate firms will remain unremedied. Because of the business separations between the members of these types of organizations, fraudulent transfer laws provide more realistic creditor protection against the risk that asset shifting will increase the enterprise risk in a particular entity. In addition, these forms of productive organization are more likely to require a limitation of liability between constituents in order to fully realize the efficiencies they generate. Only by both focusing on the economic reasons for separate incorporation and providing baselines that correspond to the parties' preferred risk allocations and needed protections, can courts provide a workable corporate limited liability framework.