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Note

Federalism in Bankruptcy: Relocating the Doctrine of Substantive Consolidation

R. Benjamin Hanna*

When revelations of accounting fraud drove WorldCom into Chapter 11 bankruptcy protection in 2002 and 2003, it was the largest bankruptcy the world had yet seen. The company’s assets exceeded $103 billion, a figure eventually surpassed only by the bankruptcies of Lehman Brothers and Washington Mutual during the 2008 financial crisis. Equally astounding was the complexity of WorldCom’s corporate structure: it was comprised of over 400 legal entities, of which 222 were debtors in the bankruptcy proceedings. In just a few years, millions of transactions with an aggregate value of approximately one trillion dollars took place between the entities’ subsidiary accounts. Irregularities in accounting meant that even WorldCom itself could not untangle its Gordian knot. Rather than face the protracted battle of sorting out each entity’s accounts, the Creditor’s Committee opted for—and the court approved—the alternative of substantive consolidation. This procedure allowed WorldCom’s creditors to combine the assets of

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1. The Largest U.S. Bankruptcies, BLOOMBERG BUSINESSWEEK (May 31, 2009, 10:00 PM), http://www.businessweek.com/bwdaily/dnflash/content/may2009/db20090531_413174.htm.
2. See id.
4. Id. at *11.
5. See id. at *10–16 (highlighting weaknesses in WorldCom’s accounting).
6. See id. at *16, *37.
the many debtor entities and treat their liabilities as if a single company owed them.\footnote{See id. at *35.}

Corporate bankruptcy law plays an important role in American economic life. When a corporation is unable to pay its debts or meet other current financial obligations, it must put its assets under new management either by liquidation or by rewriting its business plan and reorganizing.\footnote{See generally 11 U.S.C. §§ 701–84 (2006) (detailing the liquidation process); id. §§ 1101–74 (detailing the reorganization process). The chapters of Title 11 contain the primary federal bankruptcy provisions.} In either case, bankruptcy promotes the efficient use of society’s scarce resources by drawing a line in the sand at which to halt ineffective uses of productive assets.\footnote{Frank H. Easterbrook, \textit{Is Corporate Bankruptcy Efficient?}, 27 J. FIN. ECON. 411, 411 (1990) ("If [bankruptcy] works well, assets continue to be devoted to their most productive uses.").} It correspondingly safeguards the interests of the corporation’s unsecured creditors, in part by preventing a wasteful “race to the courthouse” to collect first.\footnote{See, e.g., Thomas H. Jackson, \textit{Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain}, 91 YALE L.J. 857, 862 (1982).} Substantive consolidation is one of an array of mechanisms that identify which assets in an enterprise ought to be subject to such treatment.\footnote{Substantive consolidation helps define who the debtor is; but more attention has been given to identifying what the debtor owns under the various provisions of 11 U.S.C. § 541. See, e.g., Thomas E. Plank, \textit{The Outer Boundaries of the Bankruptcy Estate}, 47 EMORY L.J. 1193, 1286–87 (1998) (arguing that property of the estate “should contain the interests, and only the interests, of the debtor in property as of the commencement of the case").} In substantive consolidation, related debtor entities merge, combining the assets and liabilities of those entities under the auspices of a single debtor corporation.\footnote{E.g., Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.), 402 F.3d 416, 423 (3d Cir. 2005) ("Substantive consolidation treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities . . .").}

Within the Bankruptcy Code, 11 U.S.C. § 105 authorizes substantive consolidation by giving the court power to issue any order necessary to carry out the provisions of Title 11.\footnote{11 U.S.C. § 105(a); see also id. § 1123(a)(5)(C) ("Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . . provide adequate means for the plan’s implementation, such as . . . merger or consolidation of the debtor with one or more persons . . .").} Recently, however, circuit courts have attempted to limit the application of substantive consolidation by narrowing the factual circumstances that may allow it,\footnote{E.g., In re Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005) (adopting
has theoretically narrowed the authority of bankruptcy courts to provide equitable relief to creditors.\textsuperscript{15} Separation of powers within the federal government is the primary rationale for denying the power of federal bankruptcy courts to grant substantive consolidation, because Congress has not explicitly authorized this remedy.\textsuperscript{16} Nonetheless, courts often apply the equitable remedy of substantive consolidation, despite the practice’s doubtful theoretical grounds.\textsuperscript{17} Its widespread applicability has important ramifications for the structures of both industrial corporations and syndicated financing arrangements.\textsuperscript{18} In both cases, debtor-creditor and inter-creditor bargaining “takes place in the shadow of . . . substantive consolidation,” as it would in the shadow of any relevant law.\textsuperscript{19}

This Note will argue that principles of federalism should limit the application of substantive consolidation. Part I of this Note examines the current law of substantive consolidation in the context of federal bankruptcy law and state corporate law. Part II analyzes the role and constitutionality of state law in bankruptcy remedies. Part III proposes to replace or supplement the federal doctrine of substantive consolidation with state laws, giving greater deference to state policy decisions regarding corporate structure. This solution would lead to greater transparency and predictability for creditors, higher shareholder value, and a long-awaited sound theoretical grounding for the doctrine of substantive consolidation.


\textsuperscript{17} See Douglas G. Baird & Robert K. Rasmussen, Antiflankruptcy, 119 YALE L.J. 648, 658 (2010) (“[W]e have an odd world in which substantive consolidation takes place in more than half of the largest cases, even though black letter law unequivocally states that the practice is to be imposed only in the rarest of circumstances.” (footnotes omitted)).

\textsuperscript{18} William H. Widen, Corporate Form and Substantive Consolidation, 75 GEO. WASH. L. REV. 237, 244–46 (2007).

\textsuperscript{19} Id. at 245. For a discussion of the impact of substantive consolidation on structured finance, see Comm. on Bankr. & Corp. Reorg., Ass’n of the Bar of the City of N.Y., Structured Financing Techniques, 50 BUS. LAW. 527, 558–65 (1995).
I. FEDERAL LAW DEFINEES BANKRUPTCY AND SUBSTANTIVE CONSOLIDATION, WHILE STATE LAW ESTABLISHES CORPORATIONS AND THEIR INTERESTS

This Part explores the legal framework around substantive consolidation and state law creditors’ remedies in federal bankruptcy for corporations. First, it provides a brief overview of the bankruptcy process and places substantive consolidation in its statutory context. Then it assesses the role of state law provisions in corporate bankruptcy. Finally, it highlights how states compete for corporate registrations.

A. SUBSTANTIVE CONSOLIDATION OCCUPIES A USEFUL NICHE IN BANKRUPTCY LAW

As a general matter, bankruptcy law falls squarely within the federal domain. The United States Constitution authorizes Congress to “establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.” 20 Congress relied on this bankruptcy clause to create a comprehensive statutory scheme regulating American bankruptcies: the Bankruptcy Code. 21 Article III, § 1 of the Constitution authorizes jurisdictional grants for courts to hear bankruptcy cases. 22 Based on this Article III authority, 28 U.S.C. § 151 establishes bankruptcy courts as units of the district courts to carry out the Bankruptcy Code. 23 Section 157 further allows district courts to refer Title 11 matters to bankruptcy judges. 24

The Code establishes a complex set of rules governing the relationships of the debtor corporation, its creditors, and their representatives. 25 When a corporation is unable to meet its financial obligations, it may file a voluntary petition for either liquidation or reorganization with a bankruptcy court, 26 or three or more entities with claims against it may file an involuntary petition. 27 This filing automatically stays any other ac-

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22. See U.S. CONST. art. III, § 1 (“The judicial Power of the United States, shall be vested . . . in such inferior Courts as the Congress may from time to time ordain and establish.”).
24. Id. § 157(a).
25. For a brief overview of the typical bankruptcy proceeding, see, for example, MARK J. ROE, CORPORATE REORGANIZATION AND BANKRUPTCY ¶ 105 (2000).
27. Id. § 303.
tions attempting to collect from the debtor.\textsuperscript{28} The bankruptcy court may then appoint a trustee to manage the company’s bankruptcy estate on behalf of its creditors,\textsuperscript{29} or the current management may continue to operate the company as a debtor-in-possession.\textsuperscript{30} The creditors and equity security holders organize into committees representing the various types of claims against the debtor.\textsuperscript{31} These committees investigate the bankruptcy estate and negotiate a reorganization or liquidation plan.\textsuperscript{32} Meanwhile, the trustee or debtor-in-possession has the first opportunity to propose its own plan.\textsuperscript{33} If the creditor committees and debtor reach a settlement, that plan is enacted subject to court approval.\textsuperscript{34} If not, the court, resting on its powers in equity, may “cram down” a reorganization plan that it believes is fair and equitable to each class of claims.\textsuperscript{35} The provisions of such a plan may include the rejection of executory contracts, settlement of the debtor or estate’s legal claims, sale of assets, redistribution of interests in the corporation, and any other “appropriate” provision.\textsuperscript{36} Upon confirmation, the plan becomes binding on the debtor,\textsuperscript{37} and the court has authority to issue orders to implement it.\textsuperscript{38}

During the pendency of a bankruptcy, the trustee or debtor-in-possession may pursue legal claims that seek to enlarge the bankruptcy estate by pulling in property that ought to be subject to the creditors’ claims.\textsuperscript{39} These claims include the kinds of suits ordinarily brought by corporations, such as ac-

\textsuperscript{28} Id. § 362.
\textsuperscript{29} Id. § 1104 (allowing the appointment of a trustee); id. § 1106 (describing the duties of a trustee).
\textsuperscript{30} Id. § 1107(a) (“[A] debtor in possession shall have all the rights . . . and shall perform all the functions and duties . . . of a trustee . . . .”).
\textsuperscript{31} See id. § 1102.
\textsuperscript{32} Id. § 1103(c).
\textsuperscript{33} See id. § 1121(b).
\textsuperscript{34} See id. § 1128 (requiring the court to hold a confirmation hearing for the plan); id. § 1129(a) (listing the requirements of a confirmed plan).
\textsuperscript{35} See id. § 1129(b). In order to “cram down” a plan, the court must find that all of the requirements listed in 11 U.S.C. § 1129(a) are met, except 11 U.S.C. § 1129(a)(8), requiring each class to have accepted the plan, or at least not be impaired by it. Id. § 1129(b).
\textsuperscript{36} Id. § 1123(b).
\textsuperscript{37} Id. § 1141(a).
\textsuperscript{38} Id. § 1142.
\textsuperscript{39} See, e.g., Christopher Fong, Creditors and Rule 9019(A): Casting Doubt on the Trustee's Sole Authority to Settle Claims of the Estate, 82 AM. BANKR. L.J. 591, 610 (2008) (observing that “causes of action held by the debtor have been considered property of the estate” (footnote omitted)).
tions for breach of contract or fiduciary duty. Additionally, there are a number of actions or procedural options which are either specific to bankruptcy law or have special salience in this context. One such option is the motion for turnover of property, which gives the estate broad powers to collect from its debtors. For example, property seized by secured creditors prior to the commencement of the bankruptcy may be reclaimed by the estate.

The trustee has additional tools for collection when the debtors and creditors are related parties. Fraudulent conveyance or fraudulent transfer rules permit creditors to void recent transfers of property made for insufficient consideration, if such transfer was made with intent to “hinder, delay, or defraud” any creditor. Bankruptcy courts may subordinate to other creditors, or even refuse to recognize, the claims of shareholders on loans they made to the corporation.

State law also supplies actions that allow recovery to related parties by varying the attributes of corporate form. Alter ego or instrumentality rules make an owner’s or parent company’s assets available to creditors of the subsidiary where the parent has used the subsidiary as an extension of itself—where an identity between them is established. The closely related state law doctrine of piercing the corporate veil allows recovery from controlling shareholders where they have not respected the corporate form. Reverse piercing of the corporate veil—suit by or through an owner to reach assets of its

40. Under 11 U.S.C. § 1106(a)(1), in conjunction with § 704(a)(1), trustees have a duty to collect the property of the estate, which is defined by § 541(a). Such property includes any “causes of action belonging to the debtor at the time the case is commenced.” La. World Exposition v. Fed. Ins. Co., 858 F.2d 233, 245 (5th Cir. 1988); see also Smith v. Arthur Andersen LLP, 421 F.3d 989, 1002 (9th Cir. 2005) (“The property of the estate includes all legal or equitable interests of the debtor in property . . . including the debtor’s causes of action.” (internal quotation marks and citation omitted)).


43. 11 U.S.C. § 548(a)(1)(A); see also id. § 544.


45. This occurs most notably by suspending the corporate attribute of limited liability. E.g., Daniel R. Kahan, Shareholder Liability for Corporate Torts: A Historical Perspective, 97 GEO. L.J. 1085, 1095–96 (2009).

46. E.g., Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940) (enumerating ten circumstances determinative of instrumentality).

corporation—is available in many states, although a consistent theory has not yet emerged. New York has gone beyond reverse piercing by creating a horizontal piercing standard based on agency law for reaching the assets of related corporations that do not stand in a parent-subsidiary relationship. California is a leader in enterprise liability, which resembles alter ego theory but does not require a showing of fraud, whereas Texas courts made an early start but withdrew the state’s doctrine as contrary to legislative intent. Where one entity is an agent of another, or where multiple entities work together as a partnership, actions grounded in agency law may also have the effect of exposing related entities to each other’s liabilities.

There is variation between states with respect to these intra-corporate actions. This variation is borne out by which liability standards are recognized, how they are articulated, and, most importantly, how they are applied.

Substantive consolidation provides yet another theory for trustees seeking a broader asset base in a federal bankruptcy proceeding. A bankruptcy court may combine related entities if doing so would avoid inequity in distributions among creditors. Short of actually combining entities, the court may also distribute the assets of all related entities as if such a combina-
tion had occurred ("deemed consolidation"). Two distinct strains of the substantive-consolidation doctrine have arisen. The Court of Appeals for the District of Columbia Circuit grants substantive consolidation if substantial identity exists between the entities and consolidation is necessary to avoid harm or realize a benefit that outweighs the harm from consolidation. However, if a creditor objects because it relied on the entities' separateness in extending credit, consolidation may occur only if the benefit greatly outweighs the harm. In contrast, the Second Circuit Court of Appeals allows consolidation when either of two factors is satisfied: (1) creditors did not rely on the separateness of the entities; or (2) the "affairs of the debtor are so entangled that consolidation will benefit all creditors." Other circuits use some hybrid of these inquiries. For example, the Third Circuit will consolidate related entities if creditors relied on the debtor's own disregard for the separateness of entities, or if the debtor's accounts are "so scrambled that separating them is prohibitive . . . ." Courts often cite substantive consolidation as a rare or limited remedy, but in practice it is used frequently, particularly in the bankruptcies of large, complex firms. This is presumably because the practice is a very useful one. Consolidation overcomes the need to determine ownership of assets as between a parent corporation and its subsidiaries, which can require a great expenditure of time and resources for forensic accounting and protracted litigation. Procedural consolidation of related-entity bankruptcies necessarily follows from substantive consolidation; therefore, some further savings may accrue from consolidation if the cases were not yet under

55. E.g., In re Owens Corning, 419 F.3d 195, 202 (3d Cir. 2005).
56. In re Auto-Train, 810 F.2d at 276.
57. Id.
59. E.g., In re Owens Corning, 419 F.3d at 211.
60. Id.
61. E.g., In re Bonham, 229 F.3d 750, 767 (9th Cir. 2000).
62. Widen, supra note 18, at 252–55 ("[O]ver fifty percent of large corporate reorganizations use substantive consolidation . . . .").
63. See In re WorldCom, Inc., No. 02-13533(AJG), 2003 WL 23861928, at *16 (Bankr. S.D.N.Y. Oct. 31, 2003) (noting the prohibitive cost of litigating intercompany claims); Baird & Rasmussen, supra note 17 (citing In re WorldCom, which involved nearly a trillion dollars in transfers between corporations with accompanying financial statements).
joint administration.\textsuperscript{64} Consolidation, both procedural and substantive, is entrenched in federal bankruptcy law. Nevertheless, there are some ways that state law can impact the outcome of corporate bankruptcy and substantive consolidation.

\textbf{B. STATES PLAY A CRITICAL ROLE IN SHAPING THE BANKRUPTCY PROCESS}

States lack the authority to explicitly regulate bankruptcy by dividing a debtor's property among its creditors because the Constitution places that remedy under the purview of Congress.\textsuperscript{65} The Supreme Court has held that Congress's desire for national uniformity in enacting the Bankruptcy Code necessarily excludes state regulation, to avoid inconsistencies and confusion with state law.\textsuperscript{66} Thus, “[s]tates may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations.”\textsuperscript{67} Nevertheless, state law can influence bankruptcy in at least three important ways.

1. Definition of Property and Claims

In \textit{Butner v. United States}, the U.S. Supreme Court opened the door to limited indirect state regulation over bankruptcy through the definition of property and security rights.\textsuperscript{68} Section 541 of the Bankruptcy Code identifies the property of the estate, and therefore incorporates state property law into the Code.\textsuperscript{69} The rule in \textit{Butner} upholds the application of such state laws in federal bankruptcy court to the extent that they do not conflict with the laws of Congress, and no federal interest requires a different result.\textsuperscript{70} \textit{Butner} and its progeny give states a

\begin{footnotesize}

\textsuperscript{65} See U.S. CONST. art. I, § 8, cl. 4 (granting Congress power to make laws on the subject of bankruptcies); id. art. VI, cl. 2 (holding laws of the United States supreme over state laws); Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 126–27, 129 (1819).

\textsuperscript{66} Int'l Shoe Co. v. Pinkus, 278 U.S. 261, 265 (1929).

\textsuperscript{67} Id.

\textsuperscript{68} 440 U.S. 48, 54–55 (1979) (“Congress has generally left the determination of property rights ... to state law.”).


\textsuperscript{70} \textit{Butner}, 440 U.S. at 54 n.9, 55.
\end{footnotesize}
limited gap-filling power to define claims and defenses. The Fifth Circuit pushes this logic further by presuming the validity of the application of state law. It contends that “[c]reditors’ entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor’s obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code.” However, courts often distinguish Butner as inapplicable for particular kinds of claims. For example, in In re Kenneth Allen Knight Trust, the Court of Appeals for the Sixth Circuit drew a distinction between substantive property rights defined by state law and questions of procedure which state law does not control.

2. Corporate Structure

Regardless of operational structure, a business often exists formally as a collection of entities in parent-subsidiary and partnership relationships, rather than as a unitary corporation. One function of this subdivision is to identify the assets belonging within a business unit of the firm. Where a business’s subdivision corresponds to its operations, it can serve as a basis for internal managerial accountability. Otherwise, it may simply reduce transaction costs associated with the acquisition or sale of groups of assets. Another, more substantive function of subdivision is asset partitioning: if state law so provides, the use of multiple entities can shield one entity from the debts of the others. Two corporate features, artificial pe-

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72. In re Miller, 570 F.3d 633, 640 (5th Cir. 2009).
73. Id. (citation omitted).
74. See 303 F.3d 671, 678–79 (6th Cir. 2002) (“Whether an entity is eligible for relief under title 11 . . . is purely a matter of federal law.”).
75. See Baird & Rasmussen, supra note 17, at 657–58 (noting that large businesses often comprise a corporate group with distinct subsidiaries).
76. See Widen, supra note 18, at 260–61 (“[T]he corporation allows for easy identification of a group of assets under a single name.”).
77. WorldCom failed to take advantage of this opportunity. See In re WorldCom, Inc., No. 02-13533(AJG), 2003 WL 23861928, at *10 (Bankr. S.D.N.Y. Oct. 31, 2003) (recognizing WorldCom had far more company account codes than legal entities).
78. See Widen, supra note 18, at 260–61.
79. Id. at 260.
sonality and limited liability, produce this effect.\textsuperscript{81} Artificial personality identifies a debt as owed by the specific entity rather than the business as a whole.\textsuperscript{82} Limited liability prevents the parent from being held liable for the subsidiary’s debt beyond the extent of its investment (affirmative asset partitioning) or the subsidiary from being held liable for the parent’s debt, except to the extent that some of the subsidiary’s shares may be seized by the creditor.\textsuperscript{83} In bankruptcy, the result of this noninterference between parent and subsidiary assets is that “creditors of the parent company may recover from the assets of the subsidiary company only after the subsidiary has paid all of its obligations.”\textsuperscript{84} This is referred to as “structural subordination” or “structural seniority,” and it typically applies even with respect to senior secured lenders of the parent.\textsuperscript{85}

States modify the results of structural subordination through causes of action related to the operation and management of related entities, such as piercing the corporate veil, alter ego, enterprise liability, and reverse piercing of the corporate veil.\textsuperscript{86} Some of these state law claims remain valid through the bankruptcy process because they are held by related debtor entities and regarded as property inhering in the claimants—now the bankruptcy estate.\textsuperscript{87} However, outsiders seeking to assert claims against debtor entities are relegated to unsecured creditor status, if the claim is allowed at all.\textsuperscript{88} Even so, any

\textsuperscript{81} See Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819) (“Being the mere creature of law, [a corporation] possesses only those properties which the charter of its creation confers upon it . . . . Among the most important are immortality, and . . . individuality . . . .”).

\textsuperscript{82} Cf. Widen, supra note 18, at 261 (“[A]ssets in the subsidiary remain governed by the name of the subsidiary.”).

\textsuperscript{83} See Cole, supra note 80, at 1255–59.

\textsuperscript{84} Tucker, supra note 50, at 90.

\textsuperscript{85} Id. at 90 n.3.

\textsuperscript{86} Application of these liability theories moots structural subordination by permitting otherwise junior creditors to share pari passu with existing creditors. See id. at 160 n.307 (discussing the effect of reverse veil-piercing on structural subordination).

\textsuperscript{87} See, e.g., Smith v. Arthur Andersen LLP, 421 F.3d 989, 1002 (9th Cir. 2005) (“The property of the estate includes all legal or equitable interests of the debtor in property . . . including the debtor’s causes of action.” (internal quotation marks and citation omitted)).

claims allowed have the effect of diluting the interests of other unsecured creditors, varying the outcome of the bankruptcy.\footnote{ Cf. Daniel R. Fischel, The Economics of Lender Liability, 99 YALE L.J. 131, 134 (1989) (defining “claim dilution” in the more typical context of new debt issuance).}

3. Bankruptcy by Contract

Notwithstanding the variety of claims that may be mustered amongst debtor entities and against them by outside creditors, debtors and creditors may attempt to predetermine the outcome of credit events by contract.\footnote{ See Barry E. Adler, Bankruptcy and Risk Allocation, in CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 190, 190 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996) (“[T]he actual bargain among investors is not silent on how to allocate insolvency risk.”).} Similarly, businesses can contract away their entity distinctions by granting indemnification to creditors of a subsidiary entity, or among the debtor entities. Enforceability is the critical caveat to this principle. State law provides the first hurdle: ordinary state law contract defenses still apply.\footnote{ See Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 450 (2007) (citing the settled principle that “requires bankruptcy courts to consult state law in determining the validity of most claims”).} Enforceability at the federal level is a greater challenge, because creditors in bankruptcy hold only generic claims bereft of bargained-for contractual protections.\footnote{ Baird & Rasmussen, supra note 17, at 663–64.} Academics and judges are split over whether, which, and to what extent contracts regarding substantive or procedural rights in bankruptcy should be enforced.\footnote{ See Susan Block-Lieb, The Logic and Limits of Contract Bankruptcy, 2001 U. ILL. L. REV. 503, 512–18 (comparing arguments for and against contract bankruptcy proposals); Ted Janger, Crystals and Mud in Bankruptcy: Judicial Competence and Statutory Design, 43 ARIZ. L. REV. 559, 572–73 (2001) (noting a difference in judges’ attitudes toward ex-ante bankruptcy contracts); John McConnell & Henri Servaes, The Economics of Pre-Packaged Bankruptcy, in CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES, supra note 90, at 322, 322 (highlighting the benefits of pre-packaged bankruptcies); Robert K. Rasmussen, Debtor’s Choice: A Menu Approach to Corporate Bankruptcy, 71 TEX. L. REV. 51, 100–21 (1992) (arguing for a menu of contract options to replace mandatory Chapter 11 reorganization).} Bankruptcy courts have considerable discretion within their equitable powers to allow or disallow the contractual claim, or approve or disapprove of a reorganization plan that purports to settle the claim.\footnote{ See 11 U.S.C. § 1129(b) (2006).} Depending upon the leeway granted by bankruptcy judges, contract claims can be the most important way that state law influences federal bankruptcy results.
C. STATES COMPETE AS CORPORATE DOMICILES AND REGULATORS

Corporations are creatures of state law. Their charters are issued by states, and amount to contracts between states and corporations. Regardless of where business activities will take place, organizers can choose to incorporate in any of the fifty states, although in practice incorporators typically choose either Delaware or the state where the corporation is headquartered. Assuming rational value-maximizing behavior, corporate organizers will choose to incorporate in the state that best meets their needs, considering factors such as convenience, shareholder and related-corporation liability, antitakeover statutes, blue sky laws, taxation, franchise fees, structural flexibility, director and officer liability, judicial quality, the adoption of the Model Business Corporations Act, and contract enforcement. These factors can affect shareholder wealth directly through relative costs and benefits to the corporation, and also indirectly through their impact on the cost of capital.

There is considerable debate over whether state competition along these lines has been good or bad for shareholder value, states, and society—for example, whether it constitutes a “race to the top” or “race to the bottom.” The potential for incorporation or reincorporation in another state confers agency costs on the choice of state because management may seek states with laws more favorable to its job security than to

97. See, e.g., Letsou, supra note 95.
99. See id. at 1827, 1852 (finding that managers migrate to states with typical antitakeover statutes).
102. E.g., Subramanian, supra note 98, at 1797–98.
shareholder value. Nevertheless, there are some good reasons to think that allowing states discretion in governing corporate affairs is a generally positive thing. First, the agency costs of reincorporation are partially mitigated by the common requirement of shareholder approval. Second, this federalist arrangement gives states latitude to experiment, as the so-called laboratories of democracy. The penalty of declining charter revenues gives states incentive to improve their policies to meet changing economic conditions. States have the ability to be more agile than the federal government in doing so, and the result of a mistake impacts only one state rather than the whole nation. When one state does achieve a workable solution to a perceived problem, a majority of the remaining states follow suit.

Unsurprisingly then, every state recognizes some form of veil-piercing theory, and many allow additional actions. Although states may not directly regulate bankruptcy, these entity-disregarding claims are often valid in bankruptcy, but do not operate to the extent of substantive consolidation of debtors. Part II of this Note will assert that states may extend their creditor remedies to the point of allowing substantive consolidation of debtors.


105. See New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (encouraging “experimentation in the fields of social and economic science” among the states).


107. Cf. id. at 235–36 (noting that national policies are likely to replicate only an average state’s regime, at best).

108. Id. at 216.

II. THERE IS CONSTITUTIONAL AND STATUTORY SCOPE FOR STATES TO INFLUENCE SUBSTANTIVE CONSOLIDATION

Exercising their traditional authority in matters relating to corporate law, states may intervene in corporate bankruptcies to alter the outcomes related to substantive consolidation of debtor entities by establishing property interests and causes of action that demarcate the boundaries of corporate form. This Part asserts that federal substantive consolidation doctrine adversely impacts states' ability to define their own corporate law. This Part demonstrates that state actions for substantive consolidation are permissible under the U.S. Constitution and Bankruptcy Code with respect to both direct limits on state bankruptcy laws and bankruptcy court jurisdictional defects. Part III will then contend that states should adopt such substantive consolidation policies.

A. SUBSTANTIVE CONSOLIDATION DIMINISHES THE ROLE OF STATES AND BUSINESSES IN DEFINING CORPORATE BOUNDARIES

In the absence of substantive consolidation, states have significant discretion in defining the property rights and corresponding liability standards that will carry through to bankruptcy.110 States can adopt standards that respect or disregard business entities to the extent they deem appropriate, though this power is muted by the equitable powers of bankruptcy courts, for example, through equitable subordination of interests.111 To the extent state laws differ, businesses may select which legal standards will apply to them by exercising their ability to choose their state of incorporation.112

The federal bankruptcy doctrine of substantive consolidation arrests states' capacity to define the boundaries of corporate form by mandating an enterprise theory of related-entity

112. Where it applies, the internal affairs doctrine makes an organizer’s choice of where to incorporate meaningful by applying the law of the state of incorporation to disputes among or between the corporation and its current officers, directors, or shareholders, even if the action is brought in another jurisdiction. E.g., Hollis v. Hill, 232 F.3d 460, 464–65 (5th Cir. 2000); see also Edgar v. MITE Corp., 457 U.S. 624, 645 (1982).
liability regardless of state law. Reckless consolidation rearranges the priority of claims by rendering structural subordination inapposite. Subsidiary entities merge into the parent, or all of them into a new entity, so that there is no longer any distinction of which groups of assets are subject to which claims. This override of structural subordination forces creditors of one debtor to share pari passu with creditors of a less solvent debtor. Merger doctrine extinguishes any intra-company claims. The rhetorical (albeit not actual) reluctance of courts to grant substantive consolidation rests substantially on the fact of the doctrine’s significant impact on creditors’ rights. Indeed, substantive consolidation is most likely at precisely the point it has the greatest impact: in the case of large, sophisticated companies that have ordered their affairs in reliance on the legal distinctness of subsidiary entities under state corporate law.

There are both costs and benefits to this federal override of claim priority. Substantive consolidation undoubtedly frustrates the reasonable state-law-based expectations of some parties, though in many cases consolidation is an element of a reorganization plan agreed on by the creditors’ committees. In an extremely complex case, like WorldCom, the application of substantive consolidation seems unobjectionable because some of the justifications for strict separation of entities were unmet. Asset partitioning (dividing a business’s assets among multiple entities) may have reduced the cost of creditor monitoring, but these savings were offset by the cost of moral hazard as

113. See Tucker, supra note 50, at 187 (describing substantive consolidation as a “federalization of state corporate law” in favor of enterprise theory).
114. Id. at 163.
115. See In re Augie/Restivo Baking Co., 860 F.2d 515, 519 (2d Cir. 1988).
116. Id. at 518.
117. See id. at 519.
118. See id. at 518 (“[S]ubstantive consolidation is no mere instrument of procedural convenience . . . but a measure vitally affecting substantive rights, . . . to be used sparingly.” (quoting Flora Mir Candy Corp. v. R.S. Dickson & Co., 432 F.2d 1060, 1062 (2d Cir. 1970))).
120. See Baird & Rasmussen, supra note 17 (noting the process by which judges often approve such plans).
121. See Cole, supra note 80, at 1256–57.
structural complexity allowed for the concealment of fraud.\textsuperscript{122} Rather than enhance internal controls, the subdivision of the business into subsidiary entities generated related-party transactions which the accountants were unable to reconcile.\textsuperscript{123} The principal benefit of substantive consolidation in such cases is that it regards the corporation as the corporation regarded itself, and avoids the impracticable task of properly identifying assets with entities.\textsuperscript{124}

The primary cost of federal substantive consolidation comes in the form of uncertainty for creditors, which translates into higher borrowing costs for debtors. As the Second Circuit recognized in In re Augie/Restivo, “lenders’ expectations are central to the calculation of interest rates and other terms of loans, and fulfilling those expectations is therefore important to the efficiency of credit markets. Such efficiency will be undermined by imposing substantive consolidation in circumstances in which creditors believed they were dealing with separate entities.”\textsuperscript{125} Uncertain outcomes increase the cost of capital for businesses, decreasing shareholder value. If creditors are unsure which law will apply in bankruptcy, substantive consolidation or state corporate law, and are unable to contract around it, they will demand higher interest rates in compensation for bearing that risk.\textsuperscript{126} The Augie/Restivo court sought to mitigate the uncertainty created by substantive consolidation by applying the doctrine only when justified by the course of dealing and expectations.\textsuperscript{127} Given the difficulty of accurately assessing expectations ex post, having a clear, definitive, black-letter law of substantive consolidation, or no law at all, would be more helpful in avoiding the cost of uncertainty.

B. THE BANKRUPTCY CLAUSE AND BANKRUPTCY CODE DO NOT PREEMPT STATE SUBSTANTIVE CONSOLIDATION LAWS.

Preemption is a plausible objection to state laws implementing substantive consolidation. According to the preemp-


\textsuperscript{124} Id. at *16.

\textsuperscript{125} In re Augie/Restivo Baking Co., 860 F.2d 515, 519 (2d Cir. 1988).

\textsuperscript{126} Cf. id. (noting the importance of lender expectations for interest rates).

\textsuperscript{127} Id.
tion argument, Congress alone has specific authority under the Bankruptcy Clause of the Constitution to establish uniform laws for bankruptcy.\(^{128}\) In enacting the Bankruptcy Code, Congress showed clear intent to occupy the entire field, preempting any state bankruptcy laws that might be passed.\(^{129}\) A state substantive consolidation law would be a state bankruptcy law, and therefore would be unconstitutional due to federal preemption.

A state substantive consolidation law must be rejected if it purports to establish a system for the discharge of insolvent debtors.\(^{130}\) This prohibition is implied from the Bankruptcy Clause itself, even in the absence of a federal bankruptcy code.\(^{131}\) However, a state law of substantive consolidation need not go to this length to be effective. Where Congress has acted by creating a federal bankruptcy code, Butner v. United States provides the formula for determining whether a state law has been preempted where the "constitutional authority of Congress . . . would . . . encompass a federal statute defining" the disputed interest.\(^{132}\) Inclusion of the property interest within the constitutional limits of Congress’s bankruptcy power is the threshold inquiry for Butner analysis.\(^{133}\) The Bankruptcy Clause would clearly authorize Congress to enact a substantive consolidation rule; however, Congress has failed to do so. Thus, a state substantive consolidation law is not necessarily preempted, and Butner analysis should apply.

A state law does not need to define an interest in property per se to invoke Butner.\(^{134}\) State law granting a private cause of action would create a substantive property interest in the claim sufficient to raise Butner analysis.\(^{135}\) For example, giving senior creditors of a parent corporation the right to force a merger between parent and subsidiary would therefore be sufficient to

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128. U.S. CONST. art. I, § 8, cl. 4 (giving Congress the power "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States").
129. Int'l Shoe Co. v. Pinkus, 278 U.S. 261, 265 (1929) ("States may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations.").
133. Id.
134. Id. at 55 ("The justifications for application of state law are not limited to ownership interests . . . ").
invoke Butner. *Kenneth Allen Knight Trust* distinguished between substantive state laws and procedural laws that determine access to federal bankruptcy courts and eligibility for relief. Substantive laws would be subject to Butner analysis while procedural laws would be evaluated under federal law. A state substantive consolidation law would not fall into the proscribed procedural category because it has no bearing on whether a claimant under the law would have standing to file a bankruptcy case. Properly drafted, it would merely state an interest to be vindicated, either in state or bankruptcy court. Therefore Butner analysis applies.

Under Butner, state laws are “suspended only to the extent of actual conflict with the . . . Bankruptcy Act.” Furthermore, state law property interests should not be “analyzed differently” due to the bankruptcy context, “[u]nless some federal interest requires a different result” than that provided by state law. State substantive consolidation laws would meet this test. They would not be in actual conflict with the Bankruptcy Act because there is little explicit statutory support for federal substantive consolidation. The doctrine’s one-line mention in 11 U.S.C. § 1123(a)(5)(C) is part of a list of examples of how a court might implement a reorganization plan. Most, if not all, of the items listed in this statute relate to other things governed primarily or exclusively by state law, even within the bankruptcy context. Statutory analysis suggests that Congress intended to let state law apply.

No federal interest requires a different result from that provided under state law. When a property interest is at stake, the federal interest in uniformity does not act as a bar to state laws. It is simply expected that property interests will differ by state. The federal interest in national uniformity is not compelling here because Congress failed to provide any mech-

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137. *Cf. id.* (holding that the character of a business trust was properly addressed by federal law because the question pertained to whether the trust had standing to file a bankruptcy case).
139. *Id.* at 55.
141. *See id.* § 1123(a)(5).
143. *See id.* at 53.
anism to ensure uniformity in application among federal courts. Instead, substantive consolidation is relegated to the general equitable administration of the court’s business. Thus, federal interests in equitable and efficient administration of the bankruptcy laws support allowing the states to define substantive consolidation.

While state substantive consolidation laws could lead to bankruptcy outcomes that vary state to state (horizontal non-uniformity), they would have the advantage of making results consistent between state and federal courts within the same state (vertical uniformity). The Butner and International Shoe courts recognized an interest in “[u]niform treatment of property interests by both state and federal courts within a State.” The courts fear that non-uniformity within a state would promote uncertainty and confusion of legal standards, forum shopping, offer a choice of between relief under the Bankruptcy Act or state insolvency laws, and potentially give one party a windfall merely due to the debtor’s bankruptcy. Yet, the current state of substantive consolidation law has these very effects.

State law creditors’ remedies and inter-corporate liability theories do not go as far as substantive consolidation in putting all of the bankrupt enterprise’s assets into one pot. This difference means that as much as a billion dollars of recovery can ride on the distinction between litigating in state court and consolidating in bankruptcy court. State substantive consolidation rules could prevent this non-uniform application of state law by providing a single rule of decision for both state courts and bankruptcy courts sitting in the state.

State substantive consolidation laws would not offend the Bankruptcy Clause of the Constitution and would not be preempted by the Bankruptcy Code. They are a logical extension of the more expansive enterprise theory causes of action, which are allowed under the Code so long as they are valid un-

144. See, e.g., id. at 54.
146. Butner, 440 U.S. at 55; see also Int’l Shoe Co. v. Pinkus, 278 U.S. 261, 265 (1929).
147. See Butner, 440 U.S. at 55; Int’l Shoe Co., 278 U.S. at 265.
148. Cf. Levitin, supra note 16, at 16 (“Allowing courts... to go farther afield than the statutory language undercuts the point of codification.”).
149. Cf. Tucker, supra note 15, at 427 (describing substantive consolidation as an “extraordinary remedy” that “may have the effect of overriding the bedrock principle of limited liability”).
150. See, e.g., Widen, supra note 18, at 243.
der state law. Allowing those claims in bankruptcy is little different from allowing substantive consolidation. However, simply avoiding preemption is not sufficient to bring an action to court. The bankruptcy court must also have jurisdiction to hear the claim.

C. BANKRUPTCY COURTS MAY LACK AUTHORITY TO ORDER SUBSTANTIVE CONSOLIDATION YET HAVE JURISDICTION TO DECIDE A STATE ACTION FOR SUBSTANTIVE CONSOLIDATION

Substantive consolidation is a popular remedy today, but its time may be coming to an end. Some scholars argue that bankruptcy courts lack authority to implement substantive consolidation because it was unavailable in English Chancery Courts when the Constitution was drafted. If this argument gained traction in the courts, it could threaten the basis of federal substantive consolidation doctrine, but open the door for state causes of action.

1. Federal Courts Lack Authority to Grant Substantive Consolidation as a Federal Equitable Remedy

Although the doctrine of substantive consolidation in federal bankruptcy law arguably has ancient antecedents at equity, its explicit application in American bankruptcy courts is a relatively recent phenomenon. The Supreme Court first recognized the doctrine, albeit not yet by name, in its 1941 Sampsell v. Imperial Paper & Color Corp. decision. The Court upheld the absorption of corporate assets into the debtor's estate of the controlling individual shareholder, which resembled a reverse piercing of the corporate veil. Sampsell reached its conclusion by analogy to state law theories of fraudulent conveyance, alter ego, and piercing the corporate veil.

Two sections of the Bankruptcy Code are typically cited as the statutory basis for a bankruptcy court's authority to grant a request for substantive consolidation. 11 U.S.C. § 105(a) gives
courts the power to “issue any order . . . that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].”157 11 U.S.C. § 1123(a)(5)(C), declares that Chapter 11 reorganization plans shall “provide adequate means for . . . implementation, such as . . . merger or consolidation of the debtor with one or more persons . . . .”158 Read together, § 105(a) and § 1123(a) may allow a court to consolidate entities pursuant to the reorganization plan it approves.159 Section 105(a) grants bankruptcy courts sweeping equitable powers to enforce the Code, although there is substantial debate over how to define its outer limits.160 One theoretically clear limit on courts’ use of § 105(a) is that a court may only issue orders that fall within its grant of jurisdiction.161 It is less clear in marginal cases whether both Congress and the Constitution have granted jurisdiction that covers a particular order.

The import of this jurisdictional issue is that bankruptcy courts arguably lack power to issue orders granting substantive consolidation. The jurisdiction exercised by bankruptcy courts stems from § 105 of the Code,162 which in turn refers to Title 28, where 28 U.S.C. § 151 establishes bankruptcy courts as a division of the district courts.163 The district courts exercise subject matter jurisdiction under the Judiciary Act of 1789,164 which is limited by the constitutional heads of jurisdiction: “The judicial Power shall extend to all Cases, in Law and Equity, arising under . . . the Laws of the United States . . . .”165 Based on this constitutional limitation, the Supreme Court held in Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, 157. 11 U.S.C. § 105(a) (2006).
158. Id. § 1123(a)(5)(C).
159. Provisions of these statutes must reinforce each other to obtain this result, however. See Douglas G. Baird, Substantive Consolidation Today, 47 B.C. L. REV. 5, 19 (2005) (admitting that § 1123(a) “provides a thin reed for justifying substantive consolidation”); id. (“Courts have stated again and again that substantive powers cannot be derived from Section 105 . . . .”)
164. See Judiciary Act of 1789, § 11, 1 Stat. 73, 78–79.
Inc. that federal courts sitting in equity may only grant relief “traditionally accorded by courts of equity.”\(^{166}\) Thus bankruptcy courts exercising equitable powers are subject to the restrictions imposed by Grupo Mexicano: they have only the powers exercised by the Chancery Courts in England in 1789.\(^{167}\)

The jurisdictional basis for substantive consolidation has come under fire from academia over the past decade based on Grupo Mexicano,\(^{168}\) though courts have generally continued with bankruptcy as usual.\(^{169}\) Some scholars argue that substantive consolidation is a newer equitable remedy provided by a bankruptcy court sitting in equity under the auspices of the Judiciary Act, and therefore bankruptcy courts lack jurisdiction under Grupo Mexicano to impose consolidation.\(^{170}\) Alternatively, bankruptcy courts approving substantive consolidation could be regarded as doing so pursuant to a federal common law rule.\(^{171}\) Then analogy to the Erie doctrine would suggest that bankruptcy courts lack authority to create a federal common law of substantive consolidation.\(^{172}\) Courts have not yet affirmatively decided these issues, leaving substantive consolidation doctrine in a “peculiar nether-world” of uncertain legitimacy in the eyes of legal scholars.\(^{173}\) There is a risk that courts may eventually be persuaded they do not have jurisdiction over substantive consolidation.

2. Bankruptcy Courts May Nevertheless Order Substantive Consolidation Premised on State Causes of Action

The Constitutional limit on the jurisdiction of a bankruptcy court imposed by Grupo Mexicano would not be breached by hearing a case for the application of state substantive consolidation law, because it would take the form of an adjudication of a claim against the estate or a property interest owned by it. If

\(^{166}\) 527 U.S. 308, 319 (1999).

\(^{167}\) Id. at 318.

\(^{168}\) See, e.g., Tucker, supra note 15, at 437–45.

\(^{169}\) For a summary of judicial reactions to Grupo Mexicano in the context of substantive consolidation, see Amera & Kolod, supra note 155, at 39–43.


\(^{171}\) See In re Lisanti Foods Inc., 241 F. App’x 1, 2 (3d Cir. 2007).

\(^{172}\) See Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78 (1938). But see Baird, supra note 159, at 15–16 (2005) (suggesting that substantive consolidation is a matter of interstitial federal common law permissible under Erie).

\(^{173}\) Baird, supra note 159, at 21.
the state substantive consolidation law meets the Butner test, which identifies the law as creating a property interest, the court would not have to rely on its general equitable powers under § 105(a) of the Code. Instead, the court would exercise a specific statutory grant of authority under 28 U.S.C. § 157(c) to hear state law claims related to a case under Title 11. A bankruptcy court could hear the case, but a district court would render final judgment, unless the parties agreed otherwise. Enforcing a state law claim through federal code under a distinct grant of jurisdiction is not the sort of nontraditional equitable remedy that raises eyebrows under Grupo Mexicano. It stands alongside every other action explicitly authorized in the Code by Congress under authority of the Bankruptcy Clause, and every other exercise of a bankruptcy court’s 28 U.S.C. § 157 jurisdiction. Use of a state substantive consolidation action also avoids the Erie doctrine as long as the Butner test is satisfied. No federal common law, interstitial or otherwise, is applied when state law provides the rule of decision for substantive consolidation, so the issue is not raised.

The federal bankruptcy doctrine of substantive consolidation frustrates the objectives of state corporate law by failing to respect entity distinctions that would be upheld by the state, resulting in inconsistent and inequitable administration of the law between state and federal courts. Worse, bankruptcy courts may lack jurisdiction to administer substantive consolidation, but regularly do so anyway. States have latitude under both the Constitution and the Bankruptcy Code to enact their own actions for substantive consolidation, which can be enforced consistently in state, federal, and bankruptcy courts. Use of a

175. 11 U.S.C. § 105(a).
176. 28 U.S.C. § 157(c); see also Wood v. Wood (In re Wood), 825 F.2d 90, 96–97 (5th Cir. 1987) (explaining the differences between “arising under,” “arising in,” and “related to” jurisdiction under § 157).
180. See Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78 (1938).
state action instead of a federal equitable remedy avoids the jurisdictional trap of Grupo Mexicano, allowing a theoretically sound doctrine to develop in and be perfected by the states.

III. SUBSTANTIVE CONSOLIDATION SHOULD BE LIMITED TO THE PROVISIONS OF STATE LAW

The interests of shareholders and creditors would be best served if the federal bankruptcy remedy of substantive consolidation were abrogated and replaced by state law actions for substantive consolidation. States should adopt statutes that create a property or equitable interest in related-party assets triggered by the insolvency of one or more entities. Any of several possible variants could avoid inconsistent application of the law within a jurisdiction, reduce uncertainty in default and bankruptcy, and maintain the discretion of states to define their corporate law policies. However, to take the place of federal substantive consolidation in a bankruptcy court, a state law must meet several criteria. It must be narrowly tailored to avoid raising preemption concerns under the Bankruptcy Clause. As such, it cannot go beyond establishing a claim or property interest by discharging an entity’s debts, establishing procedural rules, or conflicting with the Bankruptcy Code in any way.181

A variety of substantive consolidation provisions are possible within these bounds. Attention to the details of substantive consolidation law is important, since small differences can have large impacts on payouts because of their effects on lien priority, structural subordination, and claim dilution.182 States may choose to establish claims that actually force debtor entities to merge, or they may grant a property interest in the assets of a related debtor entity. The latter would result in something like deemed consolidation or an extension of enterprise liability.

Claims may be held by either debtors or creditors, and held with respect to any number of related corporations. Claims owned by the primary debtor come closest to replicating the flexibility and efficiency of federal substantive consolidation. They would be property of the bankruptcy estate, under immediate control of the trustee or debtor-in-possession, but ulti-

182. Cf., e.g., Tucker, supra note 50, at 163–69 (discussing the interaction between structural subordination and substantive consolidation in federal bankruptcy courts).
mately under direction of the creditors’ committees. This arrangement preserves flexibility in deciding whether to exercise the debtor’s substantive consolidation rights by making the decision subject to the trustee’s fiduciary duty to maximize the estate’s value, or to a collective decision of the largest creditors. Claims owned by creditors would have two disadvantages. First, they would rank as the most junior unsecured creditor. Second, it would often be advantageous for some minority of creditors to consolidate entities; leaving the decision to individual creditors ensures the issue will have to be disputed when consolidation is not in the best interest of a majority.

The legal standards that trigger liability for substantive or deemed consolidation are critical to an effective policy. States should borrow from the precedent of federal circuit courts to formulate their basic standards. Drafters must delineate what credit events allow a claim to lie. Specifying bankruptcy per se as the trigger risks federal preemption by implementing regulations that complement or are auxiliary to the Bankruptcy Code. To be safe, states should specify that default and insolvency of two or more related entities give rise to a claim for consolidation. States must also decide what degree of relation must exist between related entities to subject them to consolidation rules.

Reducing the risk creditors face with regard to federal courts’ inconsistent application of substantive consolidation is one of the primary objectives of this proposal. Having black-letter law available and ensuring consistency between state and federal courts reduces uncertainty. Rather than making consolidation provisions mandatory, states could choose to preserve for businesses the right to contract around them or to modify their rights in the articles of incorporation or bylaws of subsidiaries. The advantage of establishing robust contractual rights related to substantive consolidation is that they allow

183. For example, states could use the District of Columbia Circuit rule exemplified by *Drabkin v. Midland-Ross Corp.* (In re *Auto-Train Corp*.), 810 F.2d 270, 276–77 (D.C. Cir. 1987), or the Second Circuit rule of *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518–19 (2d Cir. 1988).
185. See, e.g., Levitin, *supra* note 16, at 16 (asserting that adjudicating bankruptcy in equity “has been particularly problematic” because it fails to “provide clear ex ante rules that will result in uniform decisions”).
sophisticated creditors to reach a bargain in advance to minimize and efficiently allocate legal and operational risk.\textsuperscript{186}

Substantive consolidation is not likely to be implemented by every state, and is sure to be somewhat inconsistent among those that do adopt it, at least initially. The doctrine of substantive consolidation is still in its infancy, and competition and experimentation among the states is the best way to work toward its optimal form.\textsuperscript{187} As states gain experience in this form of regulation, their methods will tend to converge toward the most effective solutions, perhaps even culminating in a uniform code. To the extent variation remains, businesses will retain their ability to choose the state with regulations most appropriate for their corporate structures.\textsuperscript{188}

\textbf{CONCLUSION}

Substantive consolidation is an important component of the machinery of bankruptcy. It serves as a release valve in cases where the presence of multiple debtors in the same enterprise makes it impracticable to determine the true obligations of the debtors to each other and their creditors. As long the merger and acquisition mill persists in assembling increasingly complex collections of legal entities, the demand for substantive consolidation will continue to grow. But the more popular substantive consolidation becomes, the more today’s drawbacks will become apparent. Important creditors will push for bankruptcy, or work less hard to avoid it, to get this lucrative remedy unavailable in state court. Moreover, the mechanism is vulnerable to jurisdictional attack on federal substantive consolidation.

A state action for substantive consolidation should be created to fill the gap. Merely defining a property interest, it is neither preempted by federal law, nor does it suffer the same jurisdictional defect as the federal version. The state action achieves uniformity of law in the state by providing the same standard in both state and federal courts. In competition for in-

\begin{footnotesize}
\textsuperscript{186} See, e.g., Adler, \textit{supra} note 90, at 205–06 (‘‘Contract, not mandatory, rules can most effectively provide any conceivable benefit that bankruptcy reallocation now provides.’’).

\textsuperscript{187} Cf.\textbf{ ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW,} 48–51 (1993) (explaining the advantages of state corporate regulation in the areas of fiduciary duty and takeover statutes).

\textsuperscript{188} For a discussion of the welfare-enhancing effects of state competition in corporate law, see Romano, \textit{supra} note 106, at 214–45.
\end{footnotesize}
corporation fee revenues, states will hone their substantive consolidation laws to maximize shareholder value. Federalism could rescue one of the most staunchly federal laws around.