The Case for Disregarding Entity Shielding

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ABSTRACT

One of the fundamental characteristics of a corporation is its legal personality. As a legal person, a corporation holds a pool of assets separated from those of its shareholders. This separation is referred to by scholars as "entity shielding." However, courts in the United States have created doctrines that restrict or even disregard entity shielding. These doctrines include successor liability, reverse piercing of the corporate veil, and substantive consolidation. Currently, the application of these doctrines remains uncertain and may evolve in different directions.

Building on the law and economics theory of asset partitioning, this article posits that entity shielding incurs both costs and benefits and should be restricted when its social costs outweigh its benefits. It further identifies four major factors that should be considered in determining whether to restrict or disregard entity shielding: (1) whether the debtor transfers substantially all its assets to a new corporation; (2) the financial independence of the corporation from its shareholders and other sibling corporations; (3) the number of investors in the new corporation; and (4) the identity of the creditors. These factors offer important implications for the development of the relevant doctrines.

DOI: https://doi.org/10.15779/Z38DB7VR16

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INTRODUCTION

In 2016, J.Crew was heavily buried in debts and needed to raise money. The company decided to invest the ownership interests of the J. Crew brand and other intellectual property rights in its newly established subsidiary corporation located in the Cayman Islands, beyond the reach of J.Crew's original creditors.[1] The subsidiary corporation then used these intellectual property rights to borrow money from Blackstone Group LP.[2] Following this, the subsidiary corporation licensed the intellectual property rights back to J.Crew to use but retained ownership interests. Despite objections from its creditors, J.Crew maintained that this move was perfectly legal – nothing in the loan agreement prevented it from doing so and the issue has not been litigated.[3]

J.Crew's aggressive financial arrangement took advantage of an essential function of corporate law—entity shielding.[4] Since the subsidiary corporation is a separate legal entity, its assets usually will not be considered part of J.Crew's bankruptcy estate and are protected from the claims of its shareholders' creditors.[5] Moreover, the creditors of the subsidiary corporation have priority over J.Crew and its creditors in the subsidiary's assets. Thus, the creditors of J.Crew, including its many employees, were significantly affected by the asset stripping transactions.

Scholars have recognized that entity shielding serves the important functions of reducing information costs and protecting the going concern value of a corporation.[6] Without entity shielding, a corporation's creditors would constantly be concerned about the financial status of the corporation's shareholders. Shareholders would also need to monitor each other, which may incur significant social costs. Despite these benefits, entity shielding may also lead to certain social costs, largely due to "debtor opportunism."[7] The interests

1. *See* Peter Coy, *In Finance, 'J. Crew' Is a Verb. It Means to Stick It to a Lender*, BLOOMBERG QUINT (June 17, 2019), https://www.bloombergquint.com/bq-blue-exclusive/in-finance-j-crew-is-a-verb-it-means-to-stick-it-to-a-lender; Reshmi Basu & Hema Oza, *Revlon Lenders Play Defense After J. Crew Asset Transfer Spooks Market*, FORBES (Dec. 5, 2017), https://www.forbes.com/sites/debtwire/2017/12/05/revlon-lenders-play-defense-after-j-crew-asset-transfer-spooks-market/#1e51fe36c4ea.

2. *Id.*

3. *Id.*

4. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387–440 (2000).

5. *Id. See also* Henry Hansmann & Richard Squire, *External and Internal Asset Partitioning: Corporations and Their Subsidiaries*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 251 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018).

6. *See* Hansmann & Squire, *supra* note 5.

7. This process is referred to by scholars as "asset substitution," which is a major source of the agency costs of debt. The social costs are sometimes referred to as "the agency costs of debt." William W. Bratton,

of a shareholder's creditors would be negatively affected when the shareholder invests substantially all of their assets into a new corporation. This is because the creditor's claims over the shareholder's assets would be subject to a set of constraints and would be inferior to the claims of the corporation's creditors.

The costs and benefits of entity shielding may vary in different circumstances, thus justifying restricting or disregarding entity shielding when the costs outweigh the benefits. Currently, courts in the United States have developed doctrines that allow them to restrict or disregard entity shielding. These doctrines include successor liability, reverse piercing of the corporate veil, and substantive consolidation.[8] Courts may also impose other restrictions on entity shielding in bankruptcy proceedings.[9] However, these doctrines remain controversial and the conditions for the application of these doctrines are largely unclear.[10]

This article argues that courts should disregard entity shielding under certain circumstances and identifies four major factors that should be considered when determining whether to restrict or disregard entity shielding: (1) whether the debtor transfers substantially all its assets into a new corporation; (2) the financial independence of the new corporation; (3) the number of investors in the subsidiary corporation; and (4) the identity of creditors. It further identifies two restrictions on the amount and scope of liabilities when courts disregard entity shielding to limit the potential social costs. First, the claims of the investors' creditors can be capped at the value of assets transferred to the new corporation. Second, the new corporation can be held responsible only for the liabilities that existed prior to the transfer.

The factors identified as important in this article and the relevant legal designs contribute to the literature on asset partitioning. Scholars have noted that compared with owner shielding, entity shielding plays a more essential role for modern business organizations.[11] However, current studies have paid more attention to owner shielding than entity shielding. In the academic literature,

Corporate Debt Relationships: Legal Theory in a Time of Restructuring, DUKE L.J. 92, 127 (1989). *See also* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118–19 (1979); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 6–7 (1996).

8. *See, e.g.*, Gregory S. Crespi, *The Reverse Pierce Doctrine: Applying Appropriate Standards*, 16 J. CORP. L. 33 (1990); George W. Kuney, *A Taxonomy and Evaluation of Successor Liability*, 6 FLA. ST. U. BUS. L. REV. 9 (2007); Timothy E. Graulich, *Substantive Consolidation-A Post-Modern Trend*, 14 AM. BANKR. INST. L. REV. 527, 529 (2006).

9. For a detailed discussion, see *infra* Section II.D.

10. *See, e.g.*, Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5, 22 (2005); Crespi, *supra* note 8; Kuney, *supra* note 8.

11. Hansmann & Kraakman, *supra* note 4.

scholars have discussed the costs and benefits of owner shielding (limited liability) at length.[12] Fewer efforts have been devoted to the study of entity shielding. Most of the limited number of studies on entity shielding have mainly focused on explanations of the historical evolution of different business forms.[13] While scholars have started to examine how courts can bring doctrines more in line with the economic theory,[14] there is still a lack of systematic analysis of the various factors that courts should consider in restricting entity shielding. In addition, there is a dearth of research concerning how to apply the doctrines on restricting entity shielding in the United States. This article intends to further consider the normative implications of the theory of entity shielding. Rather than examining the different business forms, it focuses on how the law should impose restrictions on entity shielding for corporations, the most typical form of business associations in modern times.

This article proceeds as follows. Part I analyzes, from a theoretical perspective, the factors important to courts in determining whether to restrict or disregard entity shielding arrangements and the limitations on the total amount and scope of liabilities that might reduce the information costs associated with doing so. Part II considers the implications of the theory of asset partitioning on the doctrines of successor liability, reverse piercing of the corporate veil,

12. *Id*. For general discussions on the efficiency of limited liability, see generally Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 612 (1986); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 102 (1991); Paul Halpern, Michael Trebilcock & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117 (1980); Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203 (2002). For a recent academic writing summarizing the costs and benefits of limited liability, see generally Hansmann & Squire, *supra* note 5. For the discussion in developing countries such as China, see generally Mark Wu, *Piercing China's Corporate Veil: Open Questions from the New Company Law*, 117 YALE L.J. 328 (2007); Bradley C. Reed, *Clearing Away the Mist: Suggestions for Developing a Principled Veil Piercing Doctrine in China*, 39 VAND. J. TRANSNAT'L L. 1643 (2006). This discussion extends beyond the United States. *See, e.g.*, Sandra K. Miller, *Piercing the Corporate Veil Among Affiliated Companies in the European Community and in the US.: A Comparative Analysis of US, German, and UK Veil-Piercing Approaches*, 36 AM. BUS. LAW J. 73 (1998). Many scholars have examined the law of piercing the corporate veil in both developed and developing countries, hoping to learn lessons from various jurisdictions and to test the theories with more empirical evidence. *See, e.g.*, Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1990); Hui Huang, *Piercing the Corporate Veil in China: Where is it now and where is it heading?* 60 AM. J. COMP. L. 743–74 (2012).

13. Scholars have employed the cost-benefit-analysis of entity shielding to explain the evolution of organizational forms in western countries. *See* Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335 (2005). *See generally* Hansmann & Kraakman, *supra* note 4; Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Entity Shielding and the Development of Business Forms: A Comparative Perspective*, 119 HARV. L. REV. F. 238 (2005). Few studies consider the implications of this theory on the application of legal doctrines. *See, e.g.*, Hansmann & Squire, *supra* note 5.

14. Hansmann & Squire, *supra* note 5, at 267.

substantive consolidation, and other relevant restrictions on entity shielding in the United States. These parts also rationalize the existing doctrines and rules to provide guidance for their future application. The final part concludes.

I. THE FUNCTIONS AND LIMITATIONS OF ENTITY SHIELDING

Legal personality is an essential characteristic of modern corporations, implying both "owner shielding" and "entity shielding."[15] Owner shielding offers protection for shareholders—they enjoy limited liability and their assets are protected from creditors of the corporation they invest in.[16] Entity shielding protects the assets of the corporation from the creditors of the shareholders.[17] Compared with owner shielding (i.e., limited liability), entity shielding is often regarded as a more important characteristic of modern corporations.[18] This part reviews the current discussion on the costs and benefits of entity shielding, argues that entity shielding should be restricted due to its potential problems in certain circumstances, and identifies the major factors that might affect the cost-benefit analysis.

A. The Meaning of Entity Shielding

Entity shielding consists of two components: priority and liquidity protection.[19] Under the arrangement of entity shielding, the creditors of a corporation have priority claims over the corporation's assets compared to its shareholders. Consider an example as illustrated in Figure 1. Suppose a corporation, J.Corp, invests its assets in a subsidiary corporation, J.Sub. The creditors of J.Sub can directly ask J.Sub to pay off the debts with the corresponding assets, while the creditors of J.Corp cannot directly recover from the subsidiary company. Thus, the creditors of J.Sub have priority claims over J.Sub's assets. Only after J.Sub pays off all of its debts will the remaining assets be distributed to J.Corp and then to J.Corp's creditors. In other words, by setting up a new corporation, J.Corp may change the priority of the claims of its existing creditors over its assets.

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15. These two terms are also referred to as "affirmative asset partitioning" (entity shielding) and "defensive asset partitioning" (owner shielding). *See* Hansmann & Kraakman, *supra* note 4, at 393.

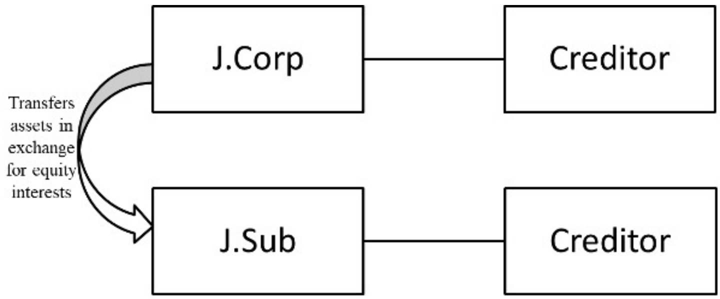
16. *See* Hansmann & Kraakman, *supra* note 4, at 393.

17. Hansmann & Kraakman, *supra* note 4, at 406.

18. Hansmann and Kraakman point out that limited liability is only a default arrangement and does not play a fundamental role in commercial transactions. There is reason to believe that commercial entities have difficulty arranging entity shielding in the absence of corporate law provisions. *See* Hansmann & Kraakman, *supra* note 4, at 406.

19. Hansmann & Kraakman, *supra* note 4, at 394.

Figure 1



Liquidation protection is another important component of entity shielding. After a new corporation has been set up, its shareholders need to go through specific procedures to trigger a corporate liquidation and recover their invested capital. Some scholars refer to this effect as "capital lock-in."[20] Even when a subsidiary's shareholder (in the above scenario, J.Corp) enters bankruptcy, its creditors may not demand the subsidiary corporation be liquidated without approval from a vote of the subsidiary's shareholders.

Different types of firms have different levels of entity shielding and can be divided into those with a "weak form of asset partitioning" (such as partnerships) and those with a "strong form of asset partitioning" (such as corporations).[21] Partnerships have a weak form of asset partitioning because while partnership creditors have priority in the liquidation of partnership assets, partnerships have no liquidation protection. This means that when a partner enters bankruptcy, its creditors may force the partnership to return the investment made by the partner. Apart from these two common types of firms, some nonprofit organizations are considered to be legal entities with a super strong form of asset partitioning.[22] The assets donated to a nonprofit organization cannot be withdrawn through distribution or liquidation. The creditors of a nonprofit organization thus have stronger claims over the organization's assets than the creditors of a corporation.

20. Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003).

21. Hansmann & Kraakman, *supra* note 4, at 395.

22. *Id*.

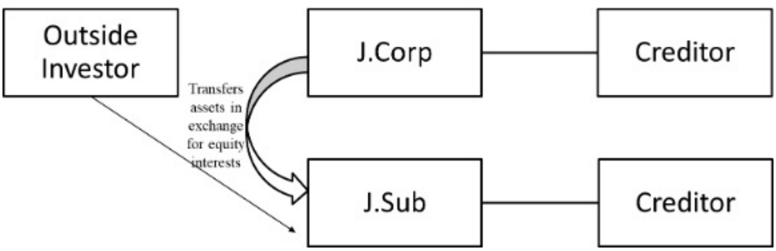
B. The Benefits and Costs of Entity Shielding

1. Efficiency

Entity shielding generates several important benefits. First, it protects the going-concern value of corporations since a shareholder cannot liquidate the corporation without going through the collective decision-making procedures. In practice, corporations often invest in specified assets that cannot be easily liquidated without significantly reducing their value. The value of an operating car manufacturer, for example, is likely to be much higher than the combined value of the assets of the manufacturer because many of the assets cannot be used for other purposes. Therefore, liquidation protection is socially beneficial for many corporations.

Second, entity shielding may substantially reduce information costs for shareholders. The conventional wisdom of entity shielding is that it alleviates information costs for a corporation's investors. To illustrate, suppose that a corporation, J.Corp, establishes a subsidiary, J.Sub, and transfers substantially all its assets to J.Sub to evade the debts owed to its creditor, as shown in Figure 2. If there are many other investors in J.Sub, holding J.Sub responsible for the debts of one of its shareholders may negatively affect the interest of the outside investors or at least generate a great deal of uncertainty. Given that there might be multiple shareholders in J.Sub, each would need to investigate the potential liabilities of other shareholders if the law does not offer entity shielding.

Figure 2



Similarly, if courts disregard entity shielding, creditors of J.Sub would also need to collect information on J.Corp before transacting with J.Sub since J.Corp's creditors may raise claims against J.Sub. Suppose a bank is considering lending to J.Sub, the bank would need to evaluate the financial risks of J.Sub and each of its shareholders before the transaction. With the protection of entity shielding, by contrast, the bank only needs to investigate the financial status of J.Sub since it is not affected by the liabilities of its shareholders. If J.Sub is a listed corporation with thousands of shareholders, disregarding entity shielding would incur enormous information costs if the creditors of each shareholder can directly seek payment from J.Sub for the liabilities of the shareholder. Thus, entity shielding also reduces information costs for creditors.

Moreover, entity shielding allows a corporation to put its different businesses in different legal entities so that creditors of each subsidiary can take advantage of their expertise in a particular business. When the same corporation holds multiple businesses and projects, its creditors may need to assess the risks of all projects. A corporation holding businesses in oil and real estate, for example, may separate these businesses into different corporation subsidiaries. As a result, creditors of a subsidiary holding the oil businesses only need to evaluate the commercial operation of the oil business rather than the overall management and operation of the corporate group. They can thus employ their professional knowledge of the oil industry to better evaluate the risks of the respective business and future cash flow more accurately.[23] Entity shielding thus promotes the division of labor and reduces the overall information cost to society.

Third, without entity shielding, debtors suffer from the problem of "debt overhang."[24] Suppose that a heavily indebted enterprise hopes to invest in a new promising project with a profitable outlook so that it can be released from its debts. However, given its financial status, the enterprise may have difficulty financing the project. Entity shielding allows the enterprise to have a fresh start by establishing a new corporation and investing in the project under the new corporation's name. The new corporation would have no difficulty borrowing money for the investment because entity shielding provides a separate legal personality.

Despite the great social benefits incurred by entity shielding, entity shielding may lead to a problem—debtor opportunism. In the above scenario, once the debtor, J.Corp, has transferred substantially all its assets to J.Sub, its main assets become the shares of J.Sub. J.Corp's creditors can seize these shares and step into the shoes of J.Corp as the shareholders of J.Sub if J.Corp fails to pay off the loan. However, the rights of J.Corp's creditors may be subject to various limitations, including priority and liquidity protection. The claims of J.Corp's creditor over the assets that initially belonged to J.Corp will also have become inferior to the claims held by creditors of J.Sub. Moreover, J.Corp's creditors, now shareholders of J.Sub, may not be successful in demanding that the subsidiary corporation be wound up and the investment be returned to its

23. *See* Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U.L.Q. 1061 (1996).

24. Hansmann & Squire, *supra* note 5, at 257.

shareholders if they do not control a majority of J.Sub's outstanding shares. Any such decision would generally need to be approved by the board of directors and shareholders at a general meeting. Accordingly, entity shielding would substantially harm the interests of J.Corp's creditors.[25]

Entity shielding may thus incur a type of social cost called the "agency costs of debt."[26] The interests of the debtor and creditor are often in conflict since the debtor has control over the use of assets and may engage in debtor misconduct that harms the creditor's interests. For this reason, debtor misconduct may lead to social costs. The creditor can try to address this problem by using contracts to limit the misconduct of the debtor. However, many creditors are so-called "non-adjusting" creditors who lack the opportunity to negotiate with the debtor.[27] As a result, enterprises may incur excessive debts owed to non-adjusting or unsophisticated creditors with the hope that they will not need to fully repay them afterward.

Furthermore, respecting entity shielding may also prevent the corporation from reaching a socially efficient reorganization plan in bankruptcy proceedings, thus heightening bankruptcy costs. Imagine a corporation investing its inventory, factories, and equipment in different subsidiary corporations to obtain financing. When the corporation enters bankruptcy, the subsidiaries hold these essential assets. Consequently, the parent company may not be reorganized using these assets without the approval of these subsidiary corporations. Each subsidiary corporation then has an incentive to hold out on the decision. When the investors in the subsidiary corporation miscalculate, they may hold out for too long and ask for too much, leading to the failure of the reorganization plan.

2. Income Redistribution

Entity shielding also generates concerns about distributive justice. Debtors can transfer wealth from non-adjusting creditors to adjusting ones by investing valuable assets in subsidiary corporations and giving creditors of the subsidiary corporations priority claims over the assets. By limiting or disregarding entity shielding, courts may offer stronger protection to the non-adjusting creditors in

25. In the United States, if a debtor intentionally delays the collection of debt by investing the assets in a new corporation as a kind of fraudulent conveyance. *See, e.g.*, United States v. Spencer, No. 10-CV-229-TCK-PJC, 2012 WL 4577927 (N.D. Okla. Oct. 2, 2012); *In re* Tronox Inc., 503 B.R. 239, 279 (S.D.N.Y. 2013).

26. *See* Bratton, *supra* note 7; Smith & Warner, *supra* note 7; Jensen & Meckling, *supra* note 7.

27. Thus, many scholars argue that bankruptcy law should grant more protection to involuntary creditors and prevent a corporation from transferring wealth from involuntary creditors to voluntary creditors by investing its assets into a subsidiary corporate entity. *See* Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz*, 52 STAN. L. REV. 55, 59 (1999).

the event of a bankruptcy by allowing them to seek payment from the subsidiary corporations.

Protecting the interests of non-adjusting creditors may achieve redistributive goals.[28] Many non-adjusting creditors, such as employees and tort victims, have lower income than financial creditors, who are more likely to be adjusting creditors. Disregarding entity shielding thus prevents the debtor from transferring wealth from the (potentially less wealthy) non-adjusting creditors to the (potentially more wealthy) adjusting creditors.

Scholars traditionally believe that courts should not consider income redistribution in the design of legal rules because taxation and other public redistributive programs may reduce inequality at lower costs.[29] Using legal rules to reduce inequality may lead to "double distortion" and hence is generally more costly.[30] For example, in a tort case, if the court forces the wealthier to pay a larger sum of awards, it will create two distortions: first, it discourages working, which is similar to the effects of income tax; second, it distorts the regulated behavior.[31] However, there is reason to believe that disregarding entity shielding may have certain advantages in reducing inequality compared with taxation. Recent studies show that the double distortion problem only arises when the court awards different damages based on the relative incomes of the parties.[32] If, however, that court devises a legal rule applicable to everyone which redistributes wealth from one group to another, and if the group membership is inelastic, the distortion of economic activities becomes much less severe.[33] By disregarding entity shielding, courts allocate more wealth to the employees and other non-adjusting creditors based on their identities as creditors rather than based on their income. As a result, doing so would not discourage working. Moreover, due to the inelastic group membership, there would be little behavior response since employees, tort victims, and other non-adjusting creditors normally would not change their behavior just because courts disregard entity shielding.

28. *See* Zachary Liscow, *Reducing Inequality on the Cheap: When Legal Rule Design Should Incorporate Equity as Well as Efficiency*, 123 YALE L.J. 2478 (2014). *See also* Lynn Lopucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1916 (1994).

29. *See* Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, n.1 (1994) (arguing that redistribution should not take place through "rules other than those that define the income tax and welfare system").

30. Liscow, *supra* note 28, 2488–89.

31. *Id*.

32. *Id*.

33. *Id*.

Another factor to consider in using legal rules to redistribute income is the economic incidence of distributing legal entitlements.[34] When a legal rule imposes additional costs on an actor to benefit other parties for distributional purposes, the actor may shift the costs to those other parties who the law seeks to protect. For example, a legal rule that prevents an employer from discriminating against employees with disabilities may, in fact, end up reducing the employment rate of workers with disabilities. However, when the court imposes restrictions on entity shielding to protect certain non-adjusting creditors, such cost shifting might not arise because the corporation and its shareholders may not easily shift the costs to the non-adjusting creditors. If the law did not provide entity shielding, it would be extremely costly for the parties to use contracts to achieve the same property arrangements.[35] Consequently, disregarding entity shielding may reduce inequality at a low cost and thus courts should consider it as a way to protect certain non-adjusting creditors.

It should be noted that whether disregarding entity shielding can actually achieve the goals of redistribution remains an empirical question that needs to be analyzed further. Some of the above assumptions may not always hold true. For example, one may reasonably question whether employees and tort victims really tend to have lower incomes compared with an individual shareholder of a corporation. However, the concern for redistribution may help understand the development of the relevant doctrines in the United States and should be considered by courts and policymakers.

C. Factors to Consider in Disregarding Entity Shielding

The above analysis shows that certain restrictions on entity shielding in some circumstances are thus necessary to curb the agency costs of debt in line with the law and economics analysis.[36] This article identifies four major factors for determining whether courts should restrict entity shielding, in cases where a debtor transfers its assets into a new corporation to evade existing liabilities, including (i) whether there is a transfer of substantially all assets; (ii) the financial independence of the subsidiary corporation; (iii) the number of investors in the corporation; and (iv) the identity of the creditor. It should be noted that all of these factors need to be considered together in specific contexts and no single factor is determinative.

First, whether the debtor has transferred substantially all its assets directly affects the social costs of entity shielding. If the debtor invests only part of its

34. *Id.* at 2497.
35. Hansmann & Kraakman, *supra* note 4, at 406.
36. Hansmann & Squire, *supra* note 5, at 267.

assets in a new corporation, then it still holds many other assets that can be seized by creditors. Thus, it is better to preserve entity shielding, given its social benefits. However, if the majority of the assets of a debtor have been transferred and mainly equity interests in other corporations remain, the creditor's claims would be subject to various restrictions and inferior to claims of the subsidiary corporation's creditors. In some cases, a corporation may put its liquid assets into a subsidiary and keep its illiquid assets. Such an arrangement may also harm the interests of its creditors. Once the corporation enters bankruptcy, creditors cannot effectively collect payment because the corporation's assets are illiquid, and their claims are inferior to claims of the subsidiary's creditors regarding assets held by the subsidiary. In this circumstance, courts should be inclined to disregard entity shielding to protect the interests of such creditors.

The second factor is the financial independence of the subsidiary corporation. One of the major benefits of entity shielding is that it allows creditors to take advantage of their expertise in a particular business and reduce information costs. For example, a corporation may operate businesses in the natural gas sector and the coal sector at the same time. It can put these two businesses in different subsidiary corporations to obtain finance at lower costs because creditors who specialize in one of these business types may lend money to the subsidiary that focuses entirely on that particular business. Those creditors may also offer to lend at a lower rate because they will not be exposed to other businesses' unfamiliar risks. However, if the financial risks are closely related between businesses, entity shielding does not generate a significant social benefit. For example, if members of a corporate group have made cross guarantees for each other's obligations, creditors of each corporation cannot focus solely on one particular business. Instead, they must consider the financial risks of the corporate group as a whole. The financial independence of the subsidiary corporation also depends on the nature of assets. Consider, for example, J.Crew's decision to put its trademark into a subsidiary corporation. The value of the subsidiary corporation still depends significantly on the operation of J.Crew. Thus, entity shielding does not allow creditors to take advantage of their expertise in a specific and independent business. Courts should then be more inclined to limit or even disregard entity shielding, given the lack of clear social benefits of respecting the subsidiary as a separate legal person.

Third, the number of investors in a corporation should be considered because it affects the social benefits of entity shielding, given its importance for evaluating the costs and benefits of asset partitioning. Hansmann and Squire distinguish "internal asset partitioning" from "external asset partitioning."[37]

37. *See generally id.*

Internal asset partitioning refers to the division of assets within a corporate group, usually between a parent corporation and its wholly owned subsidiaries. External asset partitioning, by contrast, refers to the division of assets between corporations with a dispersed shareholding structure and their shareholders. Hansmann and Squire argue that the former is usually less important than the latter, and it is more common for the law to disregard the legal personality of a corporation wholly owned by a sole shareholder (as opposed to a corporation with multiple shareholders). This phenomenon can be explained by the theory of asset partitioning. Although denying the legal personality of a subsidiary corporation inevitably brings information costs to outside investors, such costs are likely low if the number of shareholders is limited.[38] One of the highest information costs comes from the need for shareholders to investigate the debts of other shareholders. If shareholders transfer their shares frequently, the information costs can be enormous because each time a transfer occurs, the existing shareholders need to consider the financial status of the new shareholder. If no outside investor is involved, however, the information costs caused by disregarding entity shielding are much lower.

Fourth, the identity of creditors also affects the cost-benefit analysis of entity shielding. While entity shielding generally reduces information costs for creditors, the magnitude of these social costs depends on the identity of the creditors. Specifically, corporate creditors can be roughly divided into three categories. The first category comprises creditors who can assess risks and use contracts to protect themselves, including those with professional knowledge such as banks, other financial institutions, and corporate counterparties. They can generally be referred to as "adjusting creditors."[39] Financial institutions can employ contractual terms to protect their own interests or simply raise the interest rate to offset the risks of asset substitution. Since they are sophisticated adjusting creditors, entity shielding is unlikely to affect their interests.[40]

The second category includes certain involuntary creditors. These creditors generally do not have the opportunity to negotiate with the debtor and cannot protect their own interests through contracts and other means. Tort victims, for example, often do not have a chance to enter into a contract with tortfeasors. Tax

38. *See* Hansmann & Kraakman, *supra* note 4, at 402.

39. Reinier Kraakman, *Concluding Remarks on Creditor Protection*, 7 EUR. BUS. ORG. L. REV. 465–71 (2006).

40. In some cases, the original creditor has transferred the credit claims to another party. In such cases, I have recorded the identity of the original creditor. If the original creditor was a sophisticated financial institution, it should be able to protect itself with contract terms, such as a covenant or a higher interest rate. As a result, when the original creditor transferred the claim against the debtor to a third party, the third party also enjoyed the protection of the contract terms. Thus, the court should be less inclined to de-partition the assets between debtor and its subsidiary.

authorities are another type of non-adjusting creditor whose claims arise based on law rather than on contracts. The adverse effects caused by entity shielding are most obvious for this category of creditors because they cannot use covenants to protect themselves. The debtor can thus evade its liabilities by transferring substantially all assets into a new corporation.

The third category consists of creditors with a lack of knowledge and bargaining power, including employees and consumers. These creditors cannot protect themselves like banks and other financial institutions do because they often lack expertise and probably do not fully realize the risks of asset substitution. For these creditors, the benefits and costs of entity shielding fall between those of the first and second types of creditors. The second and third categories of creditors can be referred to as the "non-adjusting" creditors because they do not adjust their behavior in response to the debtor's misconduct.[41]

This article proposes two restrictions on the total amount and scope of liabilities when courts disregard entity shielding to limit social costs. First, while disregarding entity shielding may incur higher information costs, these costs can be limited to an extent if the liability of the subsidiary is capped in the amount. Courts could force the subsidiary to take partial responsibility for the debts of the shareholder, but only up to the value of the shareholder's investment. One reason for this arrangement is that courts should not allow a shareholder's creditors to claim more than what the shareholder has invested in the subsidiary corporation. Limiting the total amount of liability also protects other investors of the subsidiary corporation to some extent. If a court holds the subsidiary liable for the amount of the debtor's investment, the debtor's proportion of shares in the subsidiary corporation can be reduced to compensate other shareholders for the additional debts that the subsidiary has to assume.

For example, suppose that J.Corp invested $100,000 in a subsidiary, J.Sub, in exchange for 100 shares. Another corporation, B.Corp, also invested $100,000 in J.Sub in exchange for 100 shares. J.Corp took out a loan of $200,000 prior to the investment. The court may hold J.Sub responsible for the liabilities of J.Corp up to the value of the J. Corp's investment, which is $100,000. J.Sub could cancel the shares of J.Corp after paying $100,000 on its behalf. Such an approach would protect the interests of B.Corp since it now completely owns J.Sub and J.Sub is not responsible for any more of J.Corp's debts. By contrast, holding J.Sub fully responsible for the liabilities of J.Corp would harm the interests of B.Corp, which would incur substantial information costs and deter B.Corp from investing.

41. *See* Kraakman, *supra* note 39.

Second, courts should also consider restricting the scope of liabilities. It is possible to hold the corporate subsidiary responsible only for the debts that shareholders incur before investing assets in the corporation. This restriction may alleviate the information costs incurred by disregarding entity shielding. To illustrate, suppose that J.Corp invested assets in a subsidiary, J.Sub, on June 1, 2020. If courts disregard entity shielding and hold J.Sub responsible for J.Corp's liabilities that were incurred after the date of investment, J.Sub's creditors would need to constantly monitor the liabilities of J.Corp to evaluate the risks associated with J.Sub. If, by contrast, courts hold J.Sub potentially liable only for the liabilities incurred by J.Corp prior to the date of the investment (i.e., June 1, 2020), J.Sub's creditors and shareholders only need to investigate J.Corp's liabilities that were incurred prior to June 1, 2020. This restriction on the scope of subsidiary liabilities may thus substantially reduce the information costs caused by disregarding entity shielding.

Lastly, the law on disregarding entity shielding should remain flexible. None of the factors mentioned above should be determinative. One major concern in establishing clear rules on entity shielding is whether investors and corporations can adjust their decisions based on the rules in order to evade their liabilities. It is thus necessary for courts to retain sufficient discretion to determine when to disregard entity shielding on a case-by-case basis. Courts may need to consider whether the investors involved are truly innocent outside investors and how much equity interest they hold in the subsidiary corporation. Although doing so may sometimes prove difficult, such discretion may discourage debtors from seeking to avoid liabilities simply by increasing the number of investors.

II. EXPLANATORY AND NORMATIVE IMPLICATIONS ON CURRENT DOCTRINES

While entity shielding is the general norm, courts in the United States have developed doctrines that sometimes disregard entity shielding under certain circumstances. There is a lack of understanding of the rationales behind these case laws, and there is still debate about whether courts have made the right decisions. This part applies the theory discussed above to provide guidance to courts in the future.

A. Successor Liability

In the United States, courts have developed the doctrine of successor liability, which allows them to disregard entity shielding to prevent the evasion of liabilities.[42] In the United States, when a corporation purchases assets from another enterprise, it does not normally become liable for the debts of the other enterprise. Courts, however, may require the enterprise receiving the assets to bear successor liability when certain conditions are met.[43]

Generally, there are six basic types of situations where courts have held the successor responsible for the seller's liabilities if certain requirements are met,[44] including: express or implied assumption, fraudulent schemes to escape liability, a de facto merger,[45] mere continuation, continuity of enterprise, and product line.[46] Among these sub-doctrines, the doctrine of the de facto merger may allow courts to disregard entity shielding. While the doctrine varies substantially across states, courts generally consider several major conditions in determining whether a de facto merger has occurred: (1) if the purchasing corporation continues to operate with similar "management, personnel, physical location, assets;" (2) continuation of ownership; (3) if the seller has ceased to operate and dissolves; and (4) if the purchasing corporation assumes "those liabilities and obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations."[47] Courts in many states require that all of these conditions be met before they apply the doctrine of de facto merger, although some courts in other states consider the conditions non-dispositive and may uphold the claims raised by creditors even when some of these conditions are missing.[48]

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42. It should be noted that the successor corporation may sometimes be responsible even if the transfer of assets does not constitute a fraudulent conveyance. *See* Hoggan v. Price River Irrigation Co., 55 Utah 170 (1919) ("The management of one corporation may organize another and transfer its property to the new corporation, but if it does so, even with the consent of all its stockholders, the new corporation is liable for the debts of the other to the extent of the value of the property received. Assuming that the conveyances . . . not void, nor fraudulent, nor made for the purpose of hindering or defrauding creditors . . . the [creditors] still ha[ve] a right to follow the property which had been transferred . . . .").

43. Scholars have summarized six types of successor liability. *See generally* George W. Kuney, *A Taxonomy and Evaluation of Successor Liability (Revisited)*, 18 TRANSACTIONS: TENN. J. BUS. L. 741, 742 (2013).

44. *Id*. at 744.

45. *Id*. at 766.

46. *See* Hall v. Armstrong Cork, Inc., 692 P.2d 787, 792 (1984) (refusing to apply product line test to successor that purchased but one of many asbestos product lines).

47. N.Y. v. Nat'l Serv. Indus., Inc., 460 F.3d 201, 209 (2d Cir. 2006); *see also* Payne v. Saberhagen Holdings, Inc., 190 P.3d 102, 107–08 (Wash. Ct. App. 2008); Chrysler Corp. v. Ford Motor Co., 972 F. Supp. 1097, 1099 (E.D. Mich. 1997); McKee v. Harris-Seybold Co., 264 A.2d 98, 103–105 (Law Div. 1970); Shannon v. Samuel Langston Co., 379 F. Supp. 797, 801 (W.D. Mich. 1974). *See generally* Kuney, *supra* note 8. For similar cases in the United Kingdom, see Creasey v. Breachwood Motors Ltd., [1993] B.C.L.C. 480 (Q.B. 1992).

48. In some states in the United States, it is not necessary for the selling company to cease all operation and dissolve. *See* Hamaker v. Kenwel-Jackson Mach., Inc., 387 N.W.2d 515, 518 (S.D. 1986) ("When the seller corporation retains its existence while parting with its assets, a 'de facto merger' may be found if the consideration given by the purchaser corporation is shares of its own stock."). *See also* Lumbard v. Maglia, Inc., 621 F. Supp. 1529, 1535 (S.D.N.Y. 1985); Luxliner P.L. Export, Co. v. RDI/Luxliner, Inc., 13 F.3d 69, 73 (3d Cir. 1993); Fizzano Bros. Concrete Prods. v. XLN, Inc., 42 A.3d

Currently, state laws lack coherence as to when courts should support claims under a de facto merger.[49] Recent studies have proposed some rationales to clarify this body of laws.[50] An important rationale is that courts should protect victims of product liability from inequitable results where they can no longer pursue their claim against the predecessor company because the predecessor has dissolved.[51] This reliance should not terminate because the predecessor company no longer exists.

This rationale, however, does not fully explain the successor liability doctrine for several reasons. First, courts often apply the doctrine of successor liability even when the predecessor corporation has not been dissolved.[52] Moreover, scholars have noted several early cases involving the debtors' attempts to evade their existing liabilities and harm the interests of creditors by "dummy incorporations."[53] In one early case that is considered to have evolved into the doctrine of successor liability,[54] *Hibernia Insurance Company v. St.*

951, 971 (2012); New Nello Operating Co., LLC v. CompressAir, 142 N.E.3d 508, 513 (Ind. Ct. App., 2020); Lehman Bros. Holdings v. Gateway Funding Diversified Mortg. Servs., L.P., 989 F. Supp. 2d 411, 412 (E.D. Pa. 2013), *aff'd*, 785 F.3d 96 (3d Cir. 2015).; Knapp v. N. Am. Rockwell Corp., 506 F.2d 361, 372 (3d Cir. 1974) (Rosenn, J., concurring: "On the basis of the foregoing, I am persuaded that the Pennsylvania courts would consider this transaction a merger within the intendment of section 803. This I believe they would do even though the transaction was structured as a sale and even though TMW had not fully wound up its affairs and dissolved until 18 months after the combination."); Kuney, *supra* note 8, at 28 (stating that courts in different states apply the doctrine of de facto merger differently. "On one end of the spectrum is the lengthy, mandatory checklist of required elements. On the other, the non-exclusive list of factors to be weighed in a totality of the circumstances fashion.").

49. *See* Kuney, *supra* note 8, at 28.

50. One common justification is that successor liability expands the product liability of manufacturers. It encourages them to produce better products by enhancing its costs when it sells the assets to the successor corporation. However, holding the successor corporation responsible for product defects does not necessarily enhance product safety as the successor does not directly control the manufacturing prior to the transfer of assets. *See* John H. Matheson, *Successor Liability*, 96 MINN. L. REV. 371, 407–410 (2011); Timothy J. Murphy, Comment, *A Policy Analysis of a Successor Corporation's Liability for Its Predecessor's Defective Products When the Successor Has Acquired the Predecessor's Assets for Cash*, 71 MARQ. L. REV. 815, 821–22 (1988).

51. *See* Matheson, *supra* note 50, at 410; David P. Dyer, *Successor Liability in Corporate Acquisitions – An Examination of Attempts to Limit the Use of the De Facto Merger Doctrine*, 46 J. AIR L. & COM. 483, 504 (1981).

52. *See, e.g.*, Knapp v. N. Am. Rockwell Corp., 506 F.2d 361, 372 (3d Cir. 1974); Arnold Graphics Indus. v. Indep. Agent Ctr., Inc., 775 F.2d 38, 42–43 (2d Cir. 1985); Hoche Prods., S.A. v. Jayark Films Corp., 256 F. Supp. 291 (S.D.N.Y. 1966); Fizzano Bros. Concrete Prods. v. XLN, Inc., 42 A.3d 951 (2012); Lehman Bros. Holdings v. Gateway Funding Diversified Mortg. Servs., L.P., 989 F. Supp. 2d 411 (E.D. Pa. 2013), *aff'd*, 785 F.3d 96 (3d Cir. 2015).

53. *See* I. MAURICE WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 47 (2000).

54. *See* Rachel P. Corcoran, *Why Successor Liability Claims Are Not "Interests in Property" Under Section 363(f)*, 18 AM. BANKR. INST. L. REV. 697, 711 (2010) ("One of the earliest formulations of the state law doctrine of successor liability was presented by the Circuit Court for the Eastern District of Missouri in *Hibernia Insurance Co. v. St. Louis and New Orleans Transportation Co.*"); *Rights of Creditors Against a Successor Corporation*, 44 HARV. L. REV. 260, 261 (1930).

Louis & New Orleans Trans. Co.,[55] stockholders in a corporation organized another corporation and transferred all of the corporate property to the new corporation in exchange for its stocks.[56] The court held that, while the debtor received shares in the new corporation in return for the assets, the creditors had rights to tangible property: "[e]quity will not compel the creditor of a corporation to waive his right to enforce his claim against the visible and tangible property of the corporation, and to run the chances of following and recovering the value of shares of stock after they are placed upon the market."[57]

The court held that the new corporation was responsible for the obligations of the original corporation "to the full extent of the assets received."[58] It should be noted that the court was concerned because the tangible property became shares of stock. Thus, even though creditors can still enforce their claims by seizing the stocks, the court felt the need to grant additional protection to creditors.

Second, once the predecessor has been dissolved, courts may still use alternative means, such as piercing the corporate veil, to protect creditors.[59] The current rationale does not fully explain the similarities and differences between piercing the corporate veil and successor liability. To illustrate, consider an example as demonstrated in Figure 3. Suppose a corporation, J.Corp, invests substantially all of its assets into a subsidiary corporation, J.Sub, in exchange for shares of stock. J.Corp then distributes all of the shares to its owners and dissolves, leaving no assets for its creditors. The creditors of J.Corp may be harmed because they now cannot resort to J.Corp for payment of debts. As one scholar noted, a logical way to protect creditors would be to allow them to seek damages from J.Corp's owners rather than holding J.Sub responsible.[60] What, then, is the difference between allowing creditors to enforce their claims against the equity interest in the successor corporation and holding the successor corporation responsible?

55. Hibernia Ins. Co. v. St. Louis & New Orleans Transp. Co., 13 F. 516, 517 (C.C.E.D. Mo. 1882).

56. *Id.* ("The Babbage Transportation Company sold all its property to the St. Louis & New Orleans Transportation Company in consideration of 500 shares of full-paid stock in the latter company, and the payment of the debts of the former company to an amount not exceeding $42,000. This consideration was paid by the delivery of the stock and the payment of the debts, amounting to something more than $42,000, but not including the claim of complainant.") For a discussion of this case, see Corcoran, *supra* note 54, at 711.

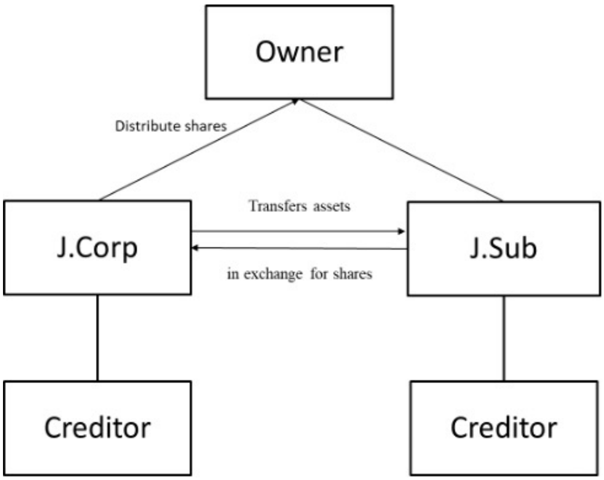
57. Hibernia Ins. Co. v. St. Louis & New Orleans Transp. Co., 13 F. 516, 518–19 (C.C.E.D. Mo. 1882).

58. *See* WORMSER, *supra* note 53, at 51.

59. Matheson, *supra* note 50, at 410.

60. *Id.* ("If the aim of successor liability law is to use the successor as a conduit to transfer injuries from plaintiffs to predecessors, it would be theoretically more effective to create legislative rules permitting plaintiffs to seek damages from the predecessor's stockholders directly.").

Figure 3



While current studies have recognized that "[s]uccessor liability, at bottom, is a judicial construction that has developed in response to perceived inadequacies of the corporate form and limited liability generally,"[61] it is surprising that current studies have not considered using the theory of asset partitioning to analyze the doctrine of successor liability. This article suggests that the successor liability doctrine essentially disregards entity shielding and allows the creditors of the predecessor corporation to directly enforce their claims against the subsidiary corporation in a way similar to the "reverse piercing of the corporate veil."[62] Disregarding entity shielding allows the creditors of J.Corp to enjoy equal rights against the assets of J.Sub as J.Sub's creditors, which more strongly protects their interests and prevents debtor opportunism compared with the piercing of the corporate veil. By contrast, merely allowing creditors to enforce their claims by taking the shares of stocks from J.Corp or J.Corp's owners would not offer them this protection. In the above scenario, successor liability grants J.Corp's creditors stronger protection when it allows them to directly request payment from J.Sub, while allowing them to pierce J.Corp's corporate veil to reach the stock of J.Sub held by J.Corp's owners would only put them in the shoes of J.Sub's shareholders.

61. *Id*. at 412.
62. *See infra* Section II.B. for a detailed discussion.

It should be noted that, as successor liability grants additional protection to creditors, it also more significantly disrupts asset partitioning. Courts thus should consider several factors to decide whether the benefits of doing so outweigh the costs. First, one of the most crucial factors is that the consideration is in the form of shares.[63] Such situations can be explained by the theory of asset partitioning. The investment of most assets in a new corporation may substantially affect the interests of the creditors since the creditors may lose their direct and prior claims regarding the tangible assets. By contrast, if the debtor transfers the assets to a new corporation in exchange for cash, the question then becomes a matter of determining whether the consideration is fair. While courts may still find the successor corporation liable, the theoretical basis becomes different, as do the factors that courts need to consider.

A related factor is the continuance of ownership, which may also be explained with the theory of asset partitioning.[64] If the successor corporation has the same ownership as the original debtor, this suggests that no outside investors are involved and, therefore, disregarding entity shielding would not incur high information costs for shareholders. In this scenario, holding the successor corporation responsible would not significantly affect the interests of outside shareholders, and courts can thus be more inclined to disregard entity shielding.

Whether the purchasing corporation continues to operate with similar management and personnel, however, should not be an important factor in disregarding entity shielding. Even if the new corporation has changed its management, transferring its valuable assets into a new corporate subsidiary may still negatively affect the interest of the investor's creditors. According to the theory of asset partitioning, the focus of courts should be on ownership rather than management and personnel.

Finally, whether the transferring corporation ceases to operate and dissolves should be a determining factor according to the theory of entity shielding.[65] If a corporation ceases to operate and dissolves, that usually implies that the corporation has few tangible assets to be seized by the creditors and that substantially all its assets have been transferred to the new corporation. The costs of entity shielding thus are higher in this scenario compared with the case where the debtor only transfers part of its assets.

63. *See* FRANKLIN GEVURTZ, CORPORATION LAW, 667–68 (2000).

64. *See* United States v. Sterling Centrecorp Inc., 960 F. Supp. 2d 1025, 1042 (E.D. Cal. 2013) ("Those courts that have assigned weight to individual factors in evaluating whether a *de facto* merger has occurred typically view continuity of shareholders (not continuation of the seller's enterprise) as the most important of the factors supporting a *de facto* merger.").

65. *See* Matheson, *supra* note 50, at 410.

While imposing greater restrictions on entity shielding may generate certain social costs, there are reasons to believe that such costs are limited. First and foremost, courts often impose a cap on the liabilities potentially borne by the subsidiary corporation.[66] Doing so may substantially reduce the information cost incurred by outside investors of the subsidiary corporation, since they may be protected from the liabilities as the subsidiary corporation can reduce the shares held by the debtor after paying off the creditors on its behalf.

In addition, the successor corporation is responsible only for the liabilities that arose prior to the transfer of assets, which is one of the major characteristics distinguishing successor liability from the reverse piercing of the corporate veil. The theory of asset partitioning suggests that holding the subsidiary corporation responsible only for the liabilities existing prior to the transfer of assets substantially reduces the information costs, thus explaining why courts are more willing to disregard entity shielding when there is evidence that a debtor is evading its liabilities by transferring its assets to a new corporation.

A widely accepted theoretical basis of de facto merger doctrine is fraudulent conveyance.[67] De facto merger helps rectify liability evasion through the fraudulent conveyance of assets where fraud cannot be proven.[68] Successor liability can be attached by proving the elements that establish circumstantial evidence of liability evasion.[69] When a debtor transfers substantially all of its assets and businesses to a new corporation, it is sometimes difficult for courts to determine whether the consideration is fair, given the lack of comparable transactions. As a result, the doctrine of successor liability may allow courts to curb the evasion of liabilities.

While this article acknowledges that the prevention of fraudulent conveyance could be a theoretical basis for successor liability, it should be noted that fraudulent conveyance and disregarding entity shielding are two independent theoretical grounds for successor liability that should be distinguished. Whether a transfer is unfair is neither a sufficient nor a necessary condition for disregarding entity shielding. Theoretically, a transaction should be voided if it is unfair and undertaken merely to evade liabilities. Thus, a transfer of assets can

66. *See* Hibernia Ins. Co. v. St. Louis & New Orleans Transp. Co., 13 F. 516, 518–19 (C.C.E.D. Mo. 1882).

67. Marie T. Reilly, *Making Sense of Successor Liability*, 31 HOFSTRA L. REV. 745, 748–49 (2002) ("The principal treatise on corporate successor liability feebly notes that the fraud basis 'is merely an application of the law of fraudulent conveyances.'… All three bases of successor liability serve the same purpose as fraudulent transfer law-protecting the transferor's creditors from the effect of a transfer that defrauds them.").

68. Frank Fagan, *From Policy Confusion to Doctrinal Clarity: Successor Liability from the Perspective of Big Data*, 9 VA. L. & BUS. REV. 391, 431 (2015).

69. *Id.* at 433.

be a fraudulent conveyance even when the consideration is not in the form of equity interests. If the debtor invests assets into a new corporation, it is possible that the consideration is unfair. For example, suppose that a debtor invests $1 million worth of assets into a new corporation in exchange for 50% of the shares, while another related party invests $500,000 worth of assets in exchange for 50% of the shares. The investment transaction is unfair to the debtor and thus should be voided to protect the interests of the creditors. However, this situation has nothing to do with disregarding entity shielding. Even if courts respect entity shielding, they may still void the transfer.

Meanwhile, even if an investment is not unfair, courts may consider disregarding entity shielding. Not all investments are unfair per se. For instance, if the debtor invests $1 million worth of assets in exchange for 100% of the new corporation's shares, the transaction would probably be fair, as the shares offered to the debtor are being undervalued.[70] However, this article suggests that courts may still consider disregarding entity shielding in this scenario given that the investment itself affects the priority of the claims regarding the assets of the debtor and constitutes debtor misconduct. Courts should still consider various factors to determine whether the debtor should be prevented from evading its existing liabilities by investing in the new corporation.[71] Distinguishing these two theoretical bases may deepen our understanding of the doctrine of successor liability and provide guidance to courts in future cases.

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70. Under this circumstance, the subsidiary corporation may borrow from a related party at an interest rate that is above the market, which would be unfair to the debtor.

71. The above difference between fraudulent conveyance and disregarding entity shielding can best be illustrated by the recent case in which Dynegy Holdings, Inc. (DHI) issued a large amount of public debt. It collected dividends from lower-level subsidiaries, Roseton and Danskammer, to pay bondholders. Faced with significant financial difficulties in 2010, DHI established two new entities, Dynegy Midwest Generation Corp. and Dynegy Power Corp. The valuable assets of Roseton and Danskammer, which were several gas and coal facilities, would be moved into these new corporations and used as collateral for the issuance of new debt. PSEG, which was a creditor of Roseton and Danskammer, challenged the decisions. The court held that the assets remained indirectly owned by DHI. Moreover, DHI did not receive less than the equivalent value, given that DHI held 100% of the ownership of the assets indirectly. Plaintiff also could not establish that DHI was or would be rendered insolvent by the transfer. In the Dynegy case, in considering fraudulent conveyance, the court mainly focused on whether the transaction was unfair to the debtor and ignored many other factors identified in this article, including the identity of creditors and the number of investors in the new corporation. *See* REPORT OF SUSHEEL KIRPALANI, EXAMINER (2012), https://www.sec.gov/Archives/edgar/data/1105055/000110465912018950/a12-6988_1ex99d1.htm; Rosetón OL, LLC v. Dynegy Holdings Inc., No. 6689-VCP, 2011 WL 3275965, 14–17 (Del. Ch. July 29, 2011).

B. Reverse Piercing of the Corporate Veil

In the United States, a similar concept that enables courts to disregard entity shielding is the doctrine of "outside reverse piercing of the corporate veil."[72] Courts in the United States have developed sophisticated case laws on piercing the corporate veil. Creditors usually need to prove that the corporation is serving as the "alter ego" of the shareholder and that holding the shareholder liable is necessary to avoid injustice.[73] The factors that courts consider in determining whether a corporation is merely an "alter ego" includes whether the corporation follows the corporate procedures, such as holding board meetings, maintaining records, and keeping separate bank accounts.[74] Courts also place substantial emphasis on whether the debtor misled the creditor through misrepresentation.[75]

Reverse piercing of the corporate veil is the opposite of piercing the corporate veil. Under certain circumstances, instead of holding shareholders liable for the debts of their subsidiaries, subsidiaries may be held liable for the debts of their shareholders.[76] In *Kingston Dry Dock Co. v. Lake Champlain Transportation Co.* (hereinafter referred to as *Kingston*),[77] the plaintiff repaired a ship owned by Champlain's subsidiary. The repairment contract was signed between the plaintiff and Champlain. After Champlain defaulted, the plaintiff requested the attachment of the subsidiary's assets to collect on Champlain's debts. Judge Learned Hand held that the reverse piercing of the corporate veil could be sustained only under extremely rare circumstances. Unlike in cases of piercing the corporate veil, in which the subsidiary corporation often becomes the "agent" of the shareholder, it is very rare for a shareholder to be dominated by the subsidiary corporation and become its "agent."[78]

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72. One of the major differences between successor liability and outside reverse piercing of the corporate veil is that the selling enterprise is usually dissolved in cases involving successor liability. If the seller enterprise did not dissolve and liquidate, courts in some jurisdictions may hold the purchasing enterprise liable on the grounds of reverse piercing of the corporate veil. *See* Dan D. Prentice, *Veil Piercing and Successor Liability in the United Kingdom*, 10 FLA. J. INT'L L. 469, 481 (1995); Kuney, *supra* note 8, at 12 ("It may be better to characterize it [successor liability] as a part of that body of law, much like the 'alter ego' or 'piercing the corporate veil' doctrines, rather than as a simple creature of tort law, despite it being used as a tool by plaintiffs who are involuntary tort claimants.").

73. Hansmann & Squire, *supra* note 5, at 269.

74. *Id.*

75. *See* Jonathan Macey & Joshua Mitts, *Finding Order in the Morass: The Three Real Justifications for Piercing the Corporate Veil*, 100 CORNELL L. REV. 99 (2014).

76. There are two types of reverse piercing of the corporate veil. Inside reverse piercing occurs when a shareholder seeks to disregard the corporate shell of a company it holds. Outside reverse piercing occurs when a creditor seeks to pierce the corporate shell so that the corporation can take responsibility for the debts of its shareholders. This article is mainly about outside reverse piercing of the corporate veil. *See* Crespi, *supra* note 8, at 55; Nicholas B. Allen, *Reverse Piercing of the Corporate Veil: A Straightforward Path to Justice*, 85 ST. JOHN'S L. REV. 1148 (2011).

77. Kingston Dry Dock Co. v. Lake Champlain Transp. Co., 31 F.2d 265 (2d Cir. 1929).

78. *Id.* at 267.

Most states do not sustain claims of reverse piercing except under the most extreme circumstances,[79] although some scholars have suggested that outside reverse piercing should be adopted to protect creditors when alternative remedies are insufficient to prevent injustice.[80] In *C.F. Trust, Inc. v. First Flight LP*, the court held that reverse piercing should be granted based on the principles of fairness and equity, and that not permitting it may allow judgment debtors to avoid paying for their outstanding liabilities in certain situations.[81] Courts that have refused the application of reverse piercing have recognized the many problems associated with it.[82] The doctrine of reverse piercing allows the creditor to take an interest in the corporation's assets rather than holding and selling the shareholder's interest in the corporation, thus bypassing the ordinary judgment-collection procedures.[83] This may adversely affect (1) the rights of innocent shareholders by undermining the financial stability of the corporation,[84] (2) the rights of existing creditors due to the possibility of losing their collateral,[85] and (3) a corporation's ability to raise capital, since creditors may request a premium for the increased risk of default associated with reverse piercing.[86]

In recent years, however, courts reverse pierced the veil in several cases involving LLCs. For example, in *Curci Investments, LLC v. Baldwin* (hereinafter referred to as "*Curci*"), Respondent Baldwin, a prominent businessman, held a limited liability company JPB Investment LLC (JPBI) for the exclusive purpose of "hold[ing] and invest[ing] [Baldwin and his wife's] cash balances."[87] Baldwin

79. *See, e.g.*, *id.*; Boeing Co. v. KB Yuzhnoye, No. CV 13–00730–AB (AJWx), 2016 WL 2851297, at 29 (C.D. Cal. May 13, 2016) ("Reverse veil piercing is a highly controversial and intensely debated corporate law doctrine. . . ."); *In re* ALT Hotel, LLC, 479 B.R. 781, 801 (N.D. Ill. 2012) (noting that courts are "deeply split on the theory"); *In re* Glick, 568 B.R. 634, 659 (N.D. Ill. 2017) ("Reverse piercing is controversial. Not all states endorse it."); *In re* Howland, 579 B.R. 411, 416 (E.D. Ky. 2016) ("Reverse veil piercing is by no means a widely accepted legal principle."), *aff'd*, 674 Fed. Appx. 482 (6th Cir. 2017). Even in states where reverse piercing is permitted, courts only allow its application in the most egregious circumstances. *See, e.g.*, C.F. Tr., Inc. v. First Flight L.P., 580 S.E.2d 806, 811 (Va. 2003) ("In Virginia, unlike in some states, the standards for veil piercing are very stringent, and piercing is an extraordinary measure that is permitted only in the most egregious circumstances, such as under the facts before this Court."). *See also* William Meade Fletcher, *Fletcher Cyclopedia of the Law of Corporations*, § 41.70 at 322–25 (2015 rev.) (stating that "not all" jurisdictions recognize reverse piercing, and some that do recognize it "only under very limited circumstances").

80. *See generally* Allen, *supra* note 76.

81. *See* C.F. Trust, Inc. v. First Flight LP, 140 F. Supp. 2d 628, 642 (E.D. Va. 2001).

82. Elham Youabian, *Reverse Piercing of the Corporate Veil: The Implications of Bypassing Ownership Interest*, 33 SW. U.L. REV. 573, 596 (2004).

83. *See* Floyd v. IRS, 151 F.3d 1295, 1299 (10th Cir. 1998); Youabian, *supra* note 82.

84. *See* Kathryn Hespe, *Preserving Entity Shielding: How Corporations Should Respond to Reverse Piercing of the Corporate Veil*, 14 J. BUS. & SEC. L. 69, 77 (2013); Youabian, *supra* note 82, at 593.

85. *See* Youabian, *supra* note 82, at 593.

86. *See* Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557 (10th Cir. 1990); Youabian, *supra* note 82, at 593–94.

87. Curci Invs., LLC v. Baldwin, 14 Cal. App. 5th 214, 217 (Ct. App. 2017).

had 99 percent member interest and his wife had 1 percent member interest in JPBI. Two years after forming JPBI, Balwin borrowed $5.5 million from Curci, the Applicant, and failed to repay the loan.[88] As a result, Curci filed a motion to add JPBI as a judgment debtor based on the outside reverse veil piercing doctrine.[89] The court held that legal separation might be disregarded to prevent fraud, circumvention of a statute, or other wrongful or inequitable purposes.

According to the court, two conditions need to be met before reverse piercing a corporation's veil. First, "there must be such a unity of interest and ownership between the corporation and its equitable owner that the separate personalities of the corporation and the shareholder do not in reality exist."[90] Second, "there must be an inequitable result if the acts in question are treated as those of the corporation alone."[91] The court also made it clear that reverse veil piercing is a means of reaching the LLC's assets, not the debtor's transferable interest in the LLC.[92]

It should be noted that recent cases on reverse piercing involve LLCs rather than corporations. In *Curci*, the court hinted that it would be more inclined to reverse pierce the veil of LLCs compared with corporations because if the debtor is a shareholder of a corporation, the creditor can step into the shoes of the debtor and obtain the shares and it can then "have whatever rights the shareholder had in the corporation."[93] By contrast, if the creditor steps in the shoes of a member of an LLC, the creditor can only obtain a charging order that requires the LLC to make distributions to the member according to the California Corporate Code.[94] In *Curci*, the creditor did not receive payment since the LLCs did not make any distributions. While it remains unclear whether the court would have ruled in the same way if the debtor was a shareholder of a corporation, the court's reasoning shows that it is willing to offer additional support for creditors when the normal judgment collection procedures fail to adequately protect their interests.

Similarly, in *Sky Cable, LLC v. DIRECTV, Inc.* (hereinafter referred to as "*Sky Cable*"), the court also supported reverse piercing of the corporate veil. In 2013, Randy Coley (Mr. Coley) was held liable for conducting a fraudulent scheme against DIRECTV, LLC (DIRECTV) and a judgment was entered against Mr. Coley in the amount of over $2.3 million. DIRECTV failed to collect

88. *Id.* at 218.
89. *Id.* at 219.
90. *Id.* at 221.
91. *Id.*
92. *Id.* at 223.
93. *Id.* at 221. *See also* Postal Instant Press, Inc. v. Kaswa Corp., 162 Cal. App. 4th 1510, 1513, 1522 (Ct. App. 2008).
94. CAL. CORP. CODE § 17705.03 (West 2019).

any payment from Mr. Coley , and therefore filed a motion to "reverse pierce" the "corporate veil" of three of Mr. Coley's LLCs.[95] Mr. Coley is the de facto sole member of the three LLCs.[96] The court found the three LLCs were Mr. Coley's alter egos because they "operate as a single economic entity in which money flows free between them as [Mr.] Coley's whim."[97] The court rejected the argument that charging the interest of the judgment debtor to the LLC "is the exclusive remedy for a judgment creditor seeking access to the assets of an LLC's member" and held that the LLC could be regarded as the same person as Mr. Coley.[98]

The theory of asset partitioning offers a theoretical basis for the reverse piercing of the corporate veil. The relationship between the piercing and reverse piercing of the corporate veil has been unclear. Different states have adopted different attitudes towards reverse piercing.[99] In states that have accepted reverse piercing, courts have taken two approaches to its application. Some courts apply the determinants of traditional piercing to the context of reverse piercing. This approach is courts' most commonly adopted method[100] because it is a logical extension of the traditional piercing.[101] Some argue that the piercing and reverse piercing of the corporate veil are simply two sides of the same coin. In either position, the doctrine is not a separate cause of action but rather the means to impose liability from an underlying cause of action.[102] It is a "procedural device through which a plaintiff may assert facts and circumstances to persuade the court to impose the parent corporation's obligation on the subsidiary or *vice versa*."[103] In contrast, by rejecting the doctrine of reverse piercing in *Postal Instant Press, Inc. v. Kaswa Corp.*, the court opined that the rationales underlying the traditional veil piercing doctrine does not exist in reverse veil piercing.[104]

The analysis offered in this article has important implications. It suggests that courts should be more cautious when deciding reverse piercing cases than piercing cases. While the doctrine of the piercing of the corporate veil is a restriction on owner shielding, reverse piercing imposes restrictions on entity

95. Sky Cable, LLC v. DIRECTV, Inc., 886 F.3d 375, 381 (4th Cir. 2018).

96. *Id.* at 383.

97. *Id.* at 390.

98. *Id.* at 388.

99. *See* Hespe, *supra* note 84, at 77–80.

100. *See* Allen, *supra* note 76, at 13.

101. *See, e.g.*, Postal Instant Press, Inc., v. Kaswa Corp., 77 Cal. Rptr. 3d 96 (Ct. App. 2008); SEC v. Hickey, 322 F.3d 1123, 1130 (9th Cir. 2003) (Reverse piercing "flows from the traditional piercing theory.").

102. C.F. Trust Inc. v. First Flight LP, 140 F. Supp. 2d 628, 642 (E.D. Va. 2001).

103. Sec. Inv. Prot. Corp. v. Stratton Oakmont, Inc., 234 B.R. 293 (S.D.N.Y. 1999).

104. *See* Postal Instant Press, Inc. v. Kaswa Corp., 162 Cal. App. 4th 1510, 1513 (Ct. App. 2008).

shielding. Scholars generally believe that entity shielding is more important than owner shielding.[105] It is more difficult for the parties to use contracts to construct entity shielding than to construct owner shielding. Therefore, disregarding entity shielding may result in higher transaction and information costs.

In addition, the above theory also suggests that some of the factors courts consider in reverse piercing cases should be different from those considered in piercing cases. For example, based on the decision by Judge Learned Hand in *Kingston*, some consider "the degree to which the corporation dominates the insider" to be an important factor.[106] This article suggests, however, that the consideration of this factor in the context of reverse piercing does not achieve reasonable public policy goals. In a piercing case, the domination of the subsidiary by the shareholder may suggest that the subsidiary is merely an "alter ego" or a "mere instrumentality" of the shareholder and may be evidence of misrepresentation.[107] In the context of reverse piercing, however, the debtor could change priority claims and negatively affect the interests of the creditors by investing assets into a subsidiary, even if the subsidiary does not "dominate" the insiders. Thus, the theory of entity shielding suggests that the domination of the insider or shareholder by the subsidiary corporation should not be considered a determining factor in reverse piercing cases.

The theory of entity shielding also suggests that if a debtor has other assets besides equity interests in a new corporation, the creditor is generally required to seize the assets of debtors before it can reverse pierce to reach the assets of a subsidiary corporation.[108] Doing so limits the social costs of reverse piercing.

Additionally, the theory of asset partitioning can explain some of the factors considered by courts in current reverse piercing cases. First, scholars have noted that when tax authorities invoke the doctrine of reverse piercing (typically, to collect taxes owed by individuals) it is faced with less resistance,[109] making the doctrine a well-established theory in federal tax cases.[110] The theory of asset partitioning likewise suggests that the identity of the creditor should be a major factor in considering reverse piercing cases. Courts should offer stronger

105. *See supra* Section I. B. *See also generally* Hansmann & Kraakman, *supra* note 4.

106. *See* Crespi, *supra* note 8.

107. Peter B. Oh, *Veil-Piercing*, 89 TEX. L. REV. 81, 84, 139 (2010).

108. *See* M.J. v. Wisan, 371 P.3d 21, 79 (Utah 2016) ("Thus, reverse piercing should be a tool of last resort; too-frequent imposition of such liability could 'bypass [ ] normal judgment-collection procedures' in a manner prejudicing 'non-culpable shareholders.'") (quoting Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557 (10th Cir. 1990)); *In re* Phillips 139 P.3d 639, 647 (Colo. 2006) ("Furthermore, as piercing the corporate veil is an extraordinary remedy, the availability of alternative, adequate remedies must be considered by the trial court." (citation omitted)).

109. *See* Allen, *supra* note 76.

110. *See* United States v. Scherping, 187 F.3d 796, 803 (8th Cir. 1999).

protection to non-adjusting creditors because they are unable to protect themselves through other means such as contracts. The tax authority generally does not have a chance to negotiate with the debtor and thus cannot secure the protection of its credit claims through contracts, unlike many other creditors. Entity shielding may thus prevent the authority from realizing its claims. For instance, suppose that a corporation has invested substantially all its assets into a subsidiary. In such a case, without entity shielding, the tax authority can seize only the equity interest in the subsidiary, which may be difficult to liquidate. Moreover, the tax authority represents the interests of the public. It is thus reasonable for courts to offer stronger protection to the tax authority by disregarding entity shielding.

The theory of asset partitioning also shows that courts should consider the number of investors in reverse piercing cases. Currently, in the few cases in which courts have upheld reverse piercing claims, the debtor has been the sole shareholder or the major shareholder of the subsidiary corporation.[111] In such a scenario, reverse piercing would not incur substantial information costs for other shareholders. For example, in *Curci*, the court found that the debtor owns 99 percent of the ownership interest in the LLCs and thus "there simply is no 'innocent' member of JPBI that could be affected by reverse piercing here."[112] Similarly, in *Sky Cable*, the court held that:

> Reverse veil piercing is particularly appropriate when an LLC has a single member because this circumstance alleviates any concern regarding the effect of veil piercing on other members who may have an interest in the assets of an LLC. . . . Therefore, when an entity and its sole members are alter egos, the rationale supporting reverse veil piercing is especially strong.[113]

When an LLC is determined to be the alter ego of its sole member, this finding permits a court to treat the LLC as "identical" to its member since the alter ego and the member are effectively the same entity.[114]

The mingling of assets is another important factor. Reverse piercing often does not significantly affect the information costs for creditors when the assets of the subsidiary corporation are mingled with those of the shareholders and other sibling corporations. In *Sky Cable*, for example, one key factor that the court noticed was that "Mr. Coley and these three LLCs have engaged in a

111. *See, e.g.*, Sky Cable, LLC v. DIRECTV Inc., 886 F.3d 375 (4th Cir. 2018); *In re* Friedlander Cap. Mgmt. Corp., 411 B.R. 434 (S.D. Fla. 2009).

112. Curci Invs., LLC v. Baldwin, 14 Cal. App. 5th 214, 217 (Ct. App. 2017).

113. Sky Cable LLC v. DIRECTV Inc., 886 F.3d 375, 387 (4th Cir. 2018).

114. *Id.* at 389.

continuous commingling of funds."[115] The court found that "Mr. Coley directed that one LLC transfer funds to another LLC to pay certain expenses." Thus, even if there were creditors of the LLCs, they probably cannot take advantage of the asset partitioning arrangement and need to monitor the financial status of Mr. Coley and his other LLCs. Therefore, reverse piercing does not significantly raise information costs.

Current studies have not considered imposing restrictions on the total amount and scope of the liabilities of a subsidiary corporation under the reverse piercing of the corporate veil. The theory of asset partitioning suggests that reverse piercing would be much less costly if the subsidiary were responsible only for the liabilities that existed prior to the transfer of assets into the subsidiary.[116] Hence, the information costs would be limited, given that the creditors of the subsidiary do not need to constantly worry about the financial status of its shareholders. Reverse corporate veil piercing incurs higher information costs when a subsidiary corporation is potentially liable for all the liabilities that its shareholder incurs, even after the investment in the subsidiary corporation is made, because any change in the financial status of a shareholder affects the interests of the subsidiary corporation.

So far, it seems that courts have not differentiated liabilities arising before or after the transfer of assets. For example, in the case of *Curci*, the liabilities were created after the formation of the LLC.[117] The court held that since the debtor virtually held all interests in the LLC and controlled its actions, it would be in the interest of justice to disregard the separate nature of the LLC and allow the plaintiff to access LLC's assets to satisfy the judgment against the debtor.[118] If there are other creditors of the LLC, such an approach may incur higher information costs since the debts incurred by the LLC's shareholder at any time would affect the creditors' interests. Therefore, reverse piercing in this context may generate higher social costs compared to successor liability.

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115. *Id*. at 382.

116. Another way to look at it is that the court should prevent evasion of liabilities but not avoidance of future liabilities. This distinction has long been recognized under English common law. *See, e.g*., Gilford Motor Co. v. Horne, [1933] 1 Ch 935; Jones v. Lipman, [1962] 1 WLR 832. *See also* Prest v. Petrodel 19 [2013] UKSC 34. ("I conclude that there is a limited principle of English law which applies when a person is under an existing legal obligation or liability or subject to an existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control. The court may then pierce the corporate veil for the purpose, and only for the purpose, of depriving the company or its controller of the advantage that they would otherwise have obtained by the company's separate legal personality.").

117. *See* Curci Invs., LLC v. Baldwin, 14 Cal. App. 5th 214, 218 (Ct. App. 2017).

118. *See* Curci Invs., LLC v. Baldwin, 14 Cal. App. 5th 214, 217 (Ct. App. 2017).

C. Substantive Consolidation

The substantive consolidation doctrine in the United States also allows courts to disregard entity shielding. According to this rule, the court will treat two or more related corporations as one entity in a bankruptcy proceeding, and the creditors of different corporations may be treated equitably during the procedure.[119] The power of substantial consolidation arises from the bankruptcy court's equitable powers under Section 105 of the Bankruptcy Code.[120] Section 105 fundamentally disregards the legal personality of corporations and the partitioning of assets.[121] Thus, courts often consider this a power to be exercised only under very unusual circumstances.[122] It has been noted that there is a "modern trend" towards making substantive consolidation the rule in bankruptcy, rather than the exception.[123] Such an approach has been criticized by some scholars.[124] A liberal interpretation of this doctrine directly contravenes the doctrine of corporate separateness. Besides, the application of substantive consolidation conflicts with the arrangement of settled creditor rights.[125] Moreover, because courts have adopted various tests for granting substantive consolidation, the implementation of substantive consolidation is unpredictable.[126]

When the court decides whether to substantively consolidate entities, it mainly considers the following two standards: (1) whether creditors dealt with the entities as a single economic unit and (2) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.[127] To address the issue of whether the separate entities share the same substantial identity, the court uses multifactor analysis to decide this issue case by case. For example, in *In re Vecco Constr. Indus.*, the court considered the following factors to judge whether the separate entities share the same substantial identity: (1) "the degree of

119. *See In re* Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988).

120. *See* 11 U.S.C. § 105 (1994).

121. *See* Graulich, *supra* note 8, at 529 ("First, the liberal trend cases tend to be in direct conflict with a bedrock principle of American jurisprudence—corporate separateness.").

122. *See In re* Gandy, 299 F.3d 489, 499 (5th Cir. 2002); Graulich, *supra* note 8, at 528.

123. *See* Graulich, *supra* note 8, at 528–29 ("Notwithstanding the appellate courts' repeated admonitions that substantive consolidation should be used only 'sparingly,' other decisions - mostly bankruptcy court cases citing to unreported bankruptcy court decisions-have announced a 'liberal' or 'modern' trend that would make substantive consolidation the rule, rather than the sparingly used exception described by the appellate decisions.").

124. *Id.* at 553 ("While the reported decisions appear to uniformly hold that substantive consolidation remains a viable remedy under the Bankruptcy Code, several commentators have suggested that the doctrine is no longer valid.").

125. *Id.* at 529.

126. *Id.* at 530 ("the application of substantive consolidation has become wholly unpredictable").

127. *See In re* Auto-Train Corp., 810 F.2d 270, 276 (D.C. Cir. 1987).

difficulty in segregating and ascertaining individual assets and liabilities;" (2) "the presence or absence of consolidated financial statements;" (3) "the profitability of consolidation to a single physical location;" (4) "the commingling of assets and business functions;" (5) "the unity of interests and ownership between the various corporate entities;" (6) "the existence of parent and intercorporate guarantees on loans;" and (7) "the transfer of assets without formal observance of corporate formalities."[128] The court stressed that all of these factors should be considered simultaneously and that no one factor is dispositive.[129] To address the second standard indicating the potential benefits or damages brought by the consolidation, the court will consider it case by case.[130]

Currently, the court does not have a unified standard, and it is generally difficult to predict the outcomes of cases, which has been criticized by scholars.[131] Scholars have identified many theoretical grounds for substantive consolidation, including the difficulties of disentanglement, administrative benefits,[132] creditors' actual and reasonable reliance,[133] fraudulent conveyance,[134]

128. *See In re* Vecco Constr. Indus., 4 B.R. 407, 410 (E.D. Va. 1980). Of course, the test standards will be different in every courts. *See* John A. Pearce II & Ilya A. Lipin, *Special Purpose Vehicles in Bankruptcy Litigation*, 40 HOFSTRA L. REV. 177 (2011).

129. *Id.*

130. In recent years, the Third Circuit Court has articulated a test for substantive consolidation, which arguably alleviates the uncertainty associated with the doctrine. First, the entity disregards the corporate separateness and there must be a reliance on the breakdown of entity borders by their creditors. Second, the entity's assets and liabilities are so mixed that the separation of these assets and liabilities hurts all creditors. *See In re* Owens Corning, 419 F.3d 195 (3rd Cir. 2005), as amended (Nov. 1, 2007); Graulich, *supra* note 8, at 563.

131. *See generally* Pearce & Lipin, *supra* note 128; Graulich, *supra* note 8, at 530 ("Third, because liberal-trend cases tend to employ ad hoc balancing tests with a variety of different (and sometimes conflicting) factors, the application of substantive consolidation has become wholly unpredictable.").

132. It is sometimes held that the rationale for substantive consolidation is the cost of "sorting out the various rights and obligations." Baird, *supra* note 10, at 16 ("In that case, the Second Circuit relied not on the lack of separateness of the legal entities but on the sheer cost of sorting out the various rights and obligations."). *See, e.g.*, Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381, 413 (1998) ("A majority of courts justify substantive consolidation by pointing to the intermingling of assets and liabilities and the resulting difficulties of disentanglement"), 414–15 ("Other general administrative benefits that courts have cited in support of consolidation include (i) increased likelihood of successful reorganization by enhancing the debtor's operating viability; (ii) savings of administrative expenses from confirming one plan for consolidated entities instead of separate plans; or (iii) use of financial capacity of one entity to finance the others."); William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 237, 268 (2007) ("Given hopeless entanglement, all creditors might benefit from substantive consolidation rather than spending funds to disentangle the mess. Indeed, in some cases, it may be impossible to separate the financial affairs of members of a corporate group, and spending funds to attempt the impossible makes little sense.").

133. Kors, *supra* note 132, at 419 ("By protecting the expectations of creditors, substantive consolidation reflects the bargain that creditors have sought *ex ante* and does not weaken the certainty of the law. Finally, protecting justifiable reliance promotes equity.").

134. Baird, *supra* note 10, at 15 ("As late as 1964, one could still argue that substantive consolidation required a fraudulent conveyance.").

and the corporate veil piercing doctrine.[135] Scholars have noted that substantive consolidation may evolve in different directions. Courts may adopt a narrow interpretation of the doctrine and uphold claims raised by creditors only when the debtors' affairs are too entangled and separating them may generate significant costs.[136] Courts may even get rid of the doctrine altogether.[137] Alternatively, they may more actively apply substantive consolidation when the debtors "function as a single whole."[138]

This article supports the third and broadest interpretation of substantive consolidation. It seeks to show that respecting the separateness of corporate entities may generate both costs and benefits and courts should retain the power to disregard entity shielding when the costs outweigh the benefits.[139] The substantive consolidation doctrine essentially disregards the legal personality of members of a corporate group.[140] As a result, the creditors of different members may be treated equally and can recover from the pool of assets of the corporate group. This disrupts the asset partitioning arrangement. Thus, the theory of asset partitioning can provide a theoretical basis for substantive consolidation and be employed to analyze the costs and benefits.

The theory of asset partitioning offers a theoretical basis for several factors that courts should consider in substantive consolidation. First, the doctrine of substantive consolidation usually applies to members of a corporate group when the number of outside investors is small. One major factor to consider is the "unity of interests and ownership between the various corporate entities."[141] From the perspective of the theory of asset partitioning, substantial consolidation would raise the information and monitoring costs for the corporation's creditors. Creditors would need to consider not only the assets of the corporation with which they are trading but also the risks of the corporation's shareholders and other sibling corporations. However, since there is only one shareholder in these member corporations, the corresponding information and monitoring costs are relatively limited.

The theory of asset partitioning also explains other factors, such as "the degree of difficulty in segregating and ascertaining individual assets and

135. Widen, *supra* note 132, at 269 ("The second rationale for substantive consolidation traces its origins to the veil piercing doctrine.").

136. *See* Baird, *supra* note 10, at 21.

137. *See id*. at 22.

138. *See id*. at 21.

139. *Id*. at 21 ("Given the uncertain future of substantive consolidation, the time is ripe for a serious and thoughtful debate. The doctrine could evolve in any of three or more radically different directions.").

140. Hansmann & Squire, *supra* note 5, at 252 ("In American law, the most important de-partitioning remedies are veil piercing, enterprise liability, and substantive consolidation.").

141. *In re* Vecco Constr. Indus., 4 B.R. 407, 410 (E.D. Va. 1980).

liability," "the presence or absence of consolidated financial statements," "the commingling of assets and business functions," and "the existence of the parent and intercorporate guarantees on loans." Under entity shielding, a corporate group can put projects with very different risks into different subsidiary corporations, and creditors can better take advantage of their expertise in some areas. For example, a corporation may separate the oil business and public utilities into different corporations so that creditors can focus on monitoring a particular kind of business and make more efficient lending decisions. Consequently, the corporation's overall financing costs would be reduced. Thus, when applying the doctrine of substantive consolidation, the court should pay attention to the independence of business risks among members of different corporations. If the businesses of the affiliated corporations are closely connected and one corporation's financial distress may affect another corporation, the benefits of asset partitioning decrease. For example, when there are mutual guarantees between sibling corporations, the default of one of the corporations may trigger the liabilities of another. Creditors therefore cannot focus solely on the financial status of a particular corporation when transacting but must consider the asset status of the corporate group as a whole.[142] In such cases, the corporation's general business is not financially independent, and asset partitioning does not generate the social benefits of reducing information costs and financing costs. Correspondingly, disregarding entity shielding will not cause excessive social costs.

This article also suggests that substantive consolidation should distinguish different types of creditors. The major problem with respecting asset partitioning arrangements within corporate groups is that it may harm the interests of non-adjusting creditors. While non-adjusting creditors are barred from crossing the boundaries of corporations to reach the assets in a sibling corporation, adjusting creditors can rely on intercorporate guarantees to disregard the corporate boundaries. Hence, this may raise suspicion that the partitioning arrangement is merely set up to transfer wealth from the non-adjusting creditors to the adjusting creditors and corporations.[143] Under these circumstances, substantive consolidation may be more efficient and can protect the non-adjusting creditors who could not obtain the guarantee since they did not have a chance to negotiate with the corporations.

142. The presence of consolidated financial statements, the difficulty of segregating the assets into different corporations, and the commingling of assets and business functions would suggest that creditors cannot focus on a single member of the corporation in their transactions and must consider the corporate group as a whole.

143. For similar analyses, see Lopucki, *supra* note 7; Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 1, 3, 7–8, 11 n.28 (1981).

The analysis above can be illustrated by *In re Owens Corning* (hereinafter referred to as "*Owens Corning*").[144] In this case, Owens Corning ("OCD") had many subsidiaries for different business purposes.[145] Each of them maintained its financial records and was a separate legal entity.[146] Many of OCD's products contained asbestos, which caused many people to develop diseases and subsequently sue the corporation for product liabilities.[147] In 1997, OCD then took out a $2 billion loan from several banks.[148] OCD's subsidiaries guaranteed that in the event of a default by OCD, the leading banks, including Credit Suisse First Boston ("CSFB") would have direct claims against the guarantor for payments under the credit agreement between OCD and the banks.[149] In light of OCD's asbestos liability, the banks insisted on guarantees from OCD's subsidiaries because these subsidiaries had valuable assets and fewer debts. This agreement also included clauses designed to protect the corporate separateness of OCD and its subsidiaries.[150] Under this agreement, the subsidiaries were prohibited from merging with other subsidiaries and OCD.[151]

Facing the growing asbestos claims, OCD filed for reorganization under Chapter 11 in 2000.[152] In 2003, the debtors and some unsecured creditors proposed a plan of substantive consolidation that pooled all assets and liabilities of the subsidiaries into the parent company and transferred all the subsidiaries' creditors to the parent company.[153] The banks rejected this proposed consolidation but the District Court allowed the substantive consolidation.[154] CSFB appealed on behalf of the banks and the Third Circuit held that the "deemed" consolidation should not be permitted.[155]

While substantive consolidation may disrupt financing transactions like those used by OCD, many factors in *Owens Corning* may lead courts to lean

144. *In re* Owens Corning, 419 F.3d 195 (3rd Cir. 2005), as amended (Nov. 1, 2007).

145. *Id.* at 200 ("OCD and its subsidiaries (which include corporations and limited liability companies) comprise a multinational corporate group. Different entities within the group have different purposes.").

146. *Id.* ("Each had a specific reason to exist separately, each maintained its own business records, and intercompany transactions were regularly documented.").

147. *See* David Cay Johnston, *Owens Corning Settling Most of Its Asbestos Cases*, N.Y. TIMES (Dec. 16, 1998), https://www.nytimes.com/1998/12/16/business/owens-corning-settling-most-of-its-asbestos-cases.html ("Plaintiff lawyers who did not participate in the settlement said the company faced years of litigation as about 3,000 people a month develop asbestos-related disease and sue the company.").

148. *In re* Owens Corning, 419 F.3d 195, 201 (3rd Cir. 2005), as amended (Nov. 1, 2007).

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.* at 202.

154. *Id.*

155. *Id.* at 196.

towards disregarding entity shielding in line with the law and economics analysis. First, OCD was the only shareholder of the subsidiaries,[156] thus eliminating the concern that substantive consolidation may adversely affect the interest of other investors. Second, the CSFB, the creditor of the subsidiary corporation, did not rely on its financial status alone. The court found that:

> There can be no doubt that the Banks relied upon the overall credit of the entire Owens Corning enterprise. Each Bank's commitment was to the entire enterprise. The decision as to whether funds would be borrowed by the parent company, or by one or more of the subsidiaries, was made by the borrowers, not by the lenders. All of Owens Corning's financial reporting was done on a consolidated basis, and only that consolidated information was provided to the Banks.[157]

The District Court also found that "there [was] simply no basis for a finding that, in extending credit, the Banks relied upon the separate credit of any of the subsidiary guarantors,"[158] and that "[a]ll of the subsidiaries were dependent upon the parent company for funding and capital."[159] Thus, the benefits of entity shielding in allowing different creditors to take advantage of their specialties and knowledge in certain businesses in different subsidiaries did not seem to be significant. Third, and most importantly, the identity of creditors might have affected the decision of the District Court. Most of the tort liabilities were incurred by the parent corporation whereas the valuable assets had been put in the subsidiaries. Since the subsidiaries offered guarantees under the credit agreement, CSFB obtained prior claims over the assets of the subsidiaries. Such an arrangement may be viewed as harming the interests of the tort victims given that they lack the opportunity and knowledge to negotiate with the corporation. Banks are sophisticated creditors and thus should be able to evaluate the risks and protect themselves through contracts. They were thus in a better position when compared with the numerous tort victims who stood to lose their chances of recovering damages from the assets of OCD.

It should be further noted that substantive consolidation in this context would not adversely affect the benefits of entity shielding in overcoming the "debt overhang" problem.[160] Suppose that another corporation, facing significant tort

156. *In re* Owens Corning, 316 B.R. 168 (D. Del. 2004), rev'd and remanded, 419 F.3d 195 (3d Cir. 2005), as amended (Nov. 1, 2007) ("There existed substantial identity between . . . OCD and its wholly-owned subsidiaries.").

157. *Id.* at 172.

158. *Id.*

159. *Id.* at 168.

160. *See* Hansman & Squire, *supra* note 5, at 257.

liabilities like the OCD, discovers a valuable project to invest in. It then invests significant valuable assets into a new subsidiary corporation to pursue that project and obtain financing from certain banks. The banks would then become the creditors of the subsidiary corporation but not those of the parent corporation. In this scenario, the theory of asset partitioning may suggest that courts should not disregard entity shielding on the grounds of substantive consolidation because the subsidiary corporation operates independently financially. By contrast, in *Owens Corning*, the banks did not rely simply on the businesses in the corporate subsidiaries. Rather, they treated OCD and its subsidiaries as an economic unit. The benefits of entity shielding thus become much smaller.

D. Bankruptcy Remoteness of Securitized Assets

In addition to the aforementioned doctrines on restricting and disregarding entity shielding, courts sometimes disregard entity shielding under a very specific, yet common, arrangement—asset securitization. In a typical asset securitization transaction, an originator invests part of its assets (underlying assets) into a special purpose vehicle (SPV) that has a separate legal personality. The SPV then issues asset-backed securities (ABS) to investors to raise money.

While asset securitization transactions have been common, a court may grant equitable relief that restrict or disregard the bankruptcy remoteness of securitized assets during bankruptcy proceedings. An influential example is the *LTV Steel Co. (LTV)* case.[161] In 1994, LTV conducted an asset securitization transaction. It set up a subsidiary (Sales Finance Co.) and sold the rights of its accounts receivable to Sales Finance Co. on a continuing basis.[162] Then, Abbey National loaned $270 million to Sales Finance Co. for the latter to purchase the rights to the accounts receivable from LTV.[163] After obtaining the loan, Sales Finance Co. transferred the funds to LTV in a single payment.[164] In 1998, LTV set up another

161. *See In re* LTV Steel Co., 274 B.R. 278 (N.D. Ohio 2001). This case has been widely cited by scholars in the discussion of asset securitization. *See, e.g.*, Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1582 (2007) (referring to this case as "the sole case in which a challenge to the doctrinal foundations of securitization resulted in a contested adjudication"). *See also* Daniel J. Bussel, *Corporate Governance, Bankruptcy Waivers, and Consolidation in Bankruptcy*, 36 EMORY BANKR. DEV. J. 99, 132 (2020) ("Arrangements of this sort famously failed their first courtroom encounter with the realities of bankruptcy in *In re* LTV Steel Company.").

162. *See In re* LTV Steel Co., 274 B.R. 278, 280 (N.D. Ohio 2001).

163. *Id.*

164. *See* Memorandum of Points and Authorities A) in Further Support of Objection by Abbey National Treasury Services PLC to the Interim Order Entered on December 29, 2000, B) in Opposition to Debtors' Emergency Motion for (1) Order Granting Interim Authority to Use Cash Collateral, and (2) Scheduling and Establishing Deadlines Relating to a Final Hearing and C) in Further Support of Abbey's Motion for Expedited Discovery and Evidentiary Hearing, *In re* LTV Steel Co., 2001 WL 37118875 (Bankr. N.D. Ohio 2001).

subsidiary, LTV Steel Products. LTV then entered into a similar contract with LTV Steel Products, selling the rights and interests in LTV's inventories to the new subsidiary. LTV Steel Products then used the inventories as collateral to obtain loans totaling $30 million from Chase Manhattan and other bank institutions.[165] After transferring the rights to and interests from its accounts receivable and inventory to the two subsidiaries, LTV lost almost all of its liquid assets.[166]

In December 2000, LTV and its subsidiaries applied for bankruptcy, and they requested that the court allow them to continue to use their cash collateral, including accounts receivable and inventory. Abbey National, which was the creditor of LTV's subsidiaries, asked the court to modify the interim cash collateral order, arguing that the title of the account receivable was owned by Abbey National and that allowing LTV to use these interim cash collaterals would harm its interests. Abbey National claimed that the transactions between LTV and LTV's subsidiaries were legally binding; thus, LTV did not have any rights to these accounts receivable, and the cash collateral did not belong to LTV's bankruptcy estate.

The court decided that preventing LTV from using the cash collateral would force LTV to stop its business,[167] which "would put thousands of people out of work, would deprive 100,000 retirees of needed medical benefits, and would have more far-reaching economic effects on the geographic areas where [LTV] does business."[168] If LTV could continue to use the cash collateral, LTV could keep running its business and fulfill its duties to its employees, consumers, retirees and creditors. The bankruptcy court concluded that allowing LTV to use the cash collateral would not damage the interest of Abbey National. Furthermore, since Abbey National had the priority claim on the bankruptcy estate of LTV's subsidiaries, the interest of Abbey National was well preserved. Thus, the court ruled that "the equities of this situation highly favor Debtor."[169]

The theory of asset partitioning can, at least in part, explain the court's decision in the LTV case. Many of the benefits of asset securitization result from entity shielding. Asset securitization allows the originators to single out a part of its asset that will not be influenced by the management from the originators for the purpose of financing. Investors in the SPV may focus on their assets without

165. *See In re* LTV Steel Co., 274 B.R. 278, 280 (N.D. Ohio 2001).

166. *See* Robert Stark, *Viewing the LTV Steel ABS opinion in its proper context. (asset-backed securitization)*, 27 J. CORP. L. 211, 221 (2002).

167. *See In re* LTV Steel Co., 274 B.R. 278, 280 (N.D. Ohio 2001).

168. *See id. at* 286.

169. *Id.*

considering the managerial behavior of the originator.[170] Therefore, asset securitization reduces agency costs, alleviates information asymmetry,[171] and allows investors to take advantage of their special knowledge and expertise in particular businesses.[172]

Despite these benefits, asset securitization may also be employed to harm the interests of certain creditors, generating the agency costs of debt.[173] When a firm puts its valuable and liquid assets into SPVs, these assets would first be used to pay off the SPVs' creditors before they can be liquidated and collected by the originator's creditors. Asset securitization thus may harm the interest of the originator's creditors, especially its non-adjusting creditors.

The adverse impacts of entity shielding on non-adjusting creditors are comparable to those in secured financing. Scholars have long noted that there are conflicts of interests between secured and unsecured creditors and debated whether granting priorities to secured creditors is efficient under bankruptcy law.[174] Secured financing lowers the financial costs for the debtor because it allows the debtor to provide different rights to creditors with different preferences. However, a debtor may be able to transfer value from unsecured creditors (who are usually non-adjusting creditors such as employees and tort victims) to secured creditors (who are usually sophisticated financial creditors).[175]

There is reason to believe that the potential adverse impacts of entity shielding on unsecured creditors are more significant than secured financing. Currently, bankruptcy law provides many restrictions on secured creditors´

170. *See* Edward M. Iacobucci & Ralph A. Winter, *Asset Securitization and Asymmetric Information*, 34 J. LEGAL STUD. 161 (2005).

171. *See* Hill, *supra* note 23.

172. *See* Hansmann & Kraakman, *supra* note 4.

173. *See* Lopucki, *supra* note 7. Securitization is in essence a form of financing corporations. Thus, its social effects and cost analysis can be based on corporate finance theories. First proposed by F. Modigliani and M. Miller in 1958, the capital structure irrelevant theory, also frequently referred to as Modigliani-Miller theorem (MM theorem), illustrates that the value of the corporation is irrelevant to its corporate structure. MM theorem posits that in a perfect market, firms can never enhance its value by altering its corporate financial structure. MM theorem applies not only to the common types of financial instruments such as equity and debt instrument, but also hybrid securities and asset-backed securities. When the assumptions of the MM theorem hold, asset securitization does not generate social benefits. *See generally* RICHARD A. BREALEY, PRINCIPLES OF CORPORATE FINANCE (Stewart C. Myers & Franklin Allen eds. 2014). As Miller noted, a firm is like a pizza, various capital structure is like the different ways of separating the pizza; but regardless of how the pizza is cut into smaller slices, the overall size of the pizza will not change. Miller often elaborates MM with the following saying: "You better cut the pizza in four pieces because I'm not hungry enough to eat six." *See* Oliver Hart, *Financial Contracting*, 39 J. ECON. LIT. 1079–80 (2001).

174. *See* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1143 (1979).

175. *See* Schwartz, *supra* note 143 at 1, 3, 7–8, 11 n.28.

rights.[176] Secured property rights are still part of the bankruptcy estate and thus may be used in reorganization plans so long as the secured creditors receive adequate protection.[177] Asset securitization, however, excludes SPVs from the bankruptcy procedures.[178] When bankruptcy occurs, the SPV is often considered to be "bankruptcy remote." When a firm transfers important assets into the SPV, those assets become controlled by the SPV, which is a separate legal person. The SPV thus may not allow the originator to continue to benefit from the assets when it becomes insolvent, heightening the risk of bankruptcy for the originator. If courts respect entity shielding, the ABS investors can obtain stronger rights over the assets compared with secured creditors.[179]

In the *LTV* case, if the court had respected the SPVs' legal personality, LTV would not have been allowed to continue using the transferred assets. The SPVs had ownership of the assets and thus could exclude LTV from using them. The court's decision essentially disregarded the entity shielding arrangement and considered the SPVs and LTV to be essentially the same legal entity. The costs and benefits of such a decision can thus be analyzed according to the theory of asset partitioning.

First, an important question that the court could have considered is whether the value of the accounts receivable was closely related to the risk management of the originator's business.[180] In the *LTV* case, the assets of LTV that were transferred include the accounts receivable generated during the business activities of LTV. As scholars note, one of the major conditions for asset securitization to be efficient is that the "cash flows that are securitized are relatively insensitive to managerial effort."[181] If the accounts receivable

176. Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 128 (1997) ("The principal reason firms choose asset securitization over secured finance is that, by completely segregating assets from the operating entity, asset securitization avoids bankruptcy redistributions from secured creditors to unsecured creditors and equity owners.").

177. *Id.* ("[I]f the asset securitization fails to completely segregate the assets by eliminating all of the debtor-originator's ownership interest, the securitized assets will be property of the estate and available for use in the reorganization—subject, of course, to the requirement of adequate protection.").

178. The doctrine of substantive consolidation may restrict the rights of the SPV. *See supra* Section II. C. for a detailed discussion.

179. This is similar to the "tragedy of anticommons," in which multiple parties have "rights respecting the objects in the regime, and no one, consequently, is ever privileged to use any of them." *See* Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621, 667 (1998).

180. Plaintiff raised the claim that the transfer of assets did not constitute a "true sale" because the risks had not been transferred, but failed to offer a strong argument as to why this was the case. *See* Debtors' Memorandum of Points and Authorities in Response to Emergency Motion by Abbey National Treasury Services PLC for Modification of Interim Order Granting Authority to Use Cash Collateral, *In re* LTV Steel Co., 2001 WL 37118877 (Bankr. N.D. Ohio Jan. 17, 2001).

181. *See* Iacobucci & Winter, *supra* note 170, at 171 ("At the heart of our hidden-action explanations of asset securitization are two conditions that are satisfied in many such transactions. First, our

generated were still heavily affected by the management of the originator, such a transaction structure could not effectively reduce the monitoring cost of investors—the ABS investors would still need to consider the risks of LTV rather than simply focusing on the SPVs. The social benefits of reducing the creditors' information costs generated by entity shielding thus would be limited.

Second, a common characteristic of asset securitization transactions is that the originator remains the sole shareholder of the subsidiary corporation to which the liquid assets have been transferred. This was the case in the LTV bankruptcy, where LTV was the subsidiaries' exclusive shareholder. Disregarding entity shielding and allowing LTV to continue to use the assets in the subsidiaries thus did not affect the interests of any outside shareholders and did not generate additional information costs.

Third, entity shielding may negatively affect the interests of non-adjusting creditors. After LTV transferred its liquid assets to its subsidiaries, LTV's remaining assets were difficult to liquidate to pay off its creditors.[182] LTV could obtain financing at lower costs through asset securitization. However, many employees could be adversely affected if LTV could not use the assets invested in the SPVs, and the local economic development would also be influenced. The potential adverse impact on the non-adjusting creditors may explain why the court imposed restrictions on entity shielding and granted equitable relief to LTV to use the cash collateral.[183] It should be noted, however, that whether asset securitization promotes efficiency is still a debatable issue and needs to be empirically examined.[184]

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explanations assume that the cash flows that are securitized are relatively insensitive to managerial effort.").

182. *See* Pearce & Lipin, *supra* note 128, at 194.

183. *See id.* at 204.

184. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 146 (1994) ("Only an empirical study would fully answer this question. Such a study is not only beyond the scope of this article, but difficult to envision given that the corporate finance world rarely lends itself to controlled experiments."). It is also possible that asset securitization still reduces information costs to some extent even when the value of the securitized assets depends significantly on the performance of the originator. For a discussion of how asset securitization reduces information costs, see Iacobucci & Winter, *supra* note 170 at 146. The court's decision in the LTV case can be viewed as a moderate approach when the court doubts that there might be other potential benefits of this arrangement—it merely granted an interim order for LTV to continue to use the cash collateral, restricting the SPVs' rights to exclude the originator from using the underlying assets. In doing so, the rights of the SPVs' investors (Abbey National) were still adequately protected. *See* Robert Stark, *Viewing the LTV Steel ABS Opinion in Its Proper Context*, 27 J. CORP. L. 211, 225–26 (2002). This is consequently different from completely disregarding entity shielding, which would also disregard the priority of the claims of the SPVs' investors. The court's decision can be viewed as a less radical approach to restricting entity shielding compared with successor liability, the reverse piercing of the corporate veil, and substantive consolidation.

CONCLUSION

The doctrine of piercing of the corporate veil has long been accepted as necessary to address the potential problem of limited liability in some cases to protect creditors. Some scholars go further to suggest that unlimited liability should be the norm in protecting corporate tort creditors.[185] However, courts have been reluctant to reverse pierce the corporate veil and disregard entity shielding. This article suggests that like limited liability, entity shielding also generates both social costs and benefits and should be limited or disregarded to protect creditors in some circumstances. While courts in the United States sometimes disregard entity shielding, they do so without clear theoretical guidance and are often too concerned about contravening the principle of corporate separateness.

This article identifies four major factors that courts should consider in disregarding entity shielding: whether the debtor transferred substantially all its assets, the financial independence of the corporation, the identity of the creditors, and the number of investors in the subsidiary corporation. In addition, this article argues that it is possible to impose restrictions on the total amount and scope of the liabilities to alleviate the social costs incurred by disregarding entity shielding. The theoretical analysis offered in this article provides guidance to courts in applying the relevant doctrines in the future to protect vulnerable groups.

185. *See generally* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability For Corporate Torts*, 100 YALE L.J. 1879 (1991).