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Robert K. Rasmussen*

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THE PROBLEM OF CORPORATE GROUPS, A COMMENT ON PROFESSOR ZIEGEL

Robert K. Rasmussen[*]

Professor Ziegel's article provides a helpful guide to some of the issues that may arise in the insolvency of a corporate group that spans the United States and Canada.[1] There is much to learn from the piece. Professor Ziegel provides an insightful analysis of two types of problems that arise when an enterprise that has substantial operations in both the United States and Canada seeks relief under each nation's respective bankruptcy laws.[2] The legal organization can be arranged so that it will be many affiliated entities in each jurisdiction. Few, if any, enterprises that have substantial operations in two countries will have all of its assets housed in a single legal entity. This is true regardless of how tightly integrated the firm's operations are. In short, transnational firms are corporate groups.

The first, and somewhat easier, set of problems that Professor Ziegel examines revolves around whether all members of the corporate group can file for bankruptcy in the appropriate national forum.[3] If one assumes that the corporate group as a whole needs to be reorganized, Canada's somewhat more stringent requirement to file for reorganization raises the possibility that some members of the group could be left outside of the reorganization effort.[4] The fear is that failure to administer all of the assets of the enterprise

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* Professor of Law and Associate Dean for Academic Affairs, Vanderbilt Law School.

1. *See* Jacob S. Ziegel, *Corporate Groups and Crossborder Insolvencies: A Canada – United States Perspective*, 7 FORDHAM J. CORP. & FIN. L. 367 (2002).

2. *See infra* notes 3-5 and accompanying text.

3. Ziegel, *supra* note 1, at 375-77.

4. *See id.* at 376-77 The assumption that all legal entities need to be part of the restructuring is probably not valid for all corporate groups. *See* Robert K. Rasmussen, *A New Approach to Transnational Insolvencies*, 19 MICH. J. INT'L. L. 1, 28-29 (1997).

could impede, and perhaps doom, the reorganization effort.

The second, and more difficult, set of issues that Professor Ziegel focuses on arise once at least part of the corporate group has come within the jurisdiction of both countries' bankruptcy courts.[5] Inevitably, not all creditors will find themselves similarly situated. To be sure, there will be the commonplace difference between secured creditors and unsecured creditors. But corporate groups raise an additional problem. Even creditors whose claims have the same ostensible priority position may be facing the prospect of receiving radically different payouts.[6] For example, creditors of one member of the corporate group may have claims that in total roughly equal that member's assets. Such creditors face the happy fate of being paid in full. Creditors of another related entity, however, may have claims that vastly exceed the assets of that member. These creditors see the possibility of a return of pennies on the dollar. The latter group of creditors understandably would prefer to see all claims and assets of the corporate group lumped together, whereas the former group of creditors would insist on maintaining the legal separation among the affiliated entities. The question, in a nutshell, is to what extent should the courts respect the divisions made by the parties? This problem arises even in the context of a wholly domestic firm.[7] The problem only becomes compounded when competing legal systems struggle with the issue.

These problems are nettlesome. Professor Ziegel does an admirable job in setting forth the issues that a court, guided only by the common law, will face. In this comment, I want to make two brief points to help put these issues into context. Both points stem

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5. *Id.* at 376-80.

6. *See generally* Ziegel, *supra* note 1, at 381-82 (outlining the priority distribution issues that arise when the assets and liabilities among members of the group are intermingled that substantive consolidation becomes unavoidable).

7. The classic domestic treatment of this issue remains the exchange between then Professors Landers and Posner. *See* Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975); *see also* Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976); Jonathan M. Landers, *Another Word on Parents, Subsidiaries, and Affiliates in Bankruptcy*, 43 U. CHI. L. REV. 527 (1976).

from the fact that in modern financial practice, a firm's organizational structure, and by this I mean the number of distinct legal entities that comprise the corporate ground and the assets and obligations of each entity result from a conscious decision of the firm's managers. Moreover, sophisticated creditors are well aware of these decisions when they extend credit. The first point, which is noted in passing by Professor Ziegel, is that not all related entities of a group file for insolvency.[8] Bankruptcy of an enterprise does not imply that all of the assets will come before the bankruptcy court. This ability of the firm's managers and creditors to ensure that some assets remain beyond the reach of any bankruptcy court suggests hesitancy on imposing substantive consolidation on unwilling parties. The second, and more important, point is that creditors are increasingly adroit at structuring their transactions to ensure that asset allocation decisions rest with those with the largest economic stake in the enterprise. The point here is that creditors contract over both control right and cash flow rights. An approach to transnational insolvency that proceeds from the premise that coordination among bankruptcy courts is necessary to ensure that a firm's assets are put to their highest valued use rests uneasily with the increasing sophistication of financial contracting.

Professor Ziegel notes that when a corporate group files for insolvency both in the United States and Canada, it is not inevitable that all members of the group will be put into the bankruptcy proceeding.[9] For example, when the Loewen Group, a chain of funeral homes that took on more debt than it could service,[10] filed for reorganization in both the United States and Canada, roughly 200 of its 1100 affiliates remained outside of bankruptcy.[11] Similarly, in the recent Enron bankruptcy, only

8. *See generally* Ziegel, *supra* note 1, at 387-88.

9. *Id.* at 382.

10. On the formation and growth of the Loewen Group, see STUART C. GILSON, CREATING VALUE THROUGH CORPORATE RESTRUCTURING: CASE STUDIES IN BANKRUPTCIES, BUYOUTS, AND BREAKUPS 25-53 (2001). For a discussion of the enterprise's bankruptcy proceedings, see Charles S. Elson, VAND. L. REV. (forthcoming Fall 2002).

11. *See* Motion for Joint Administration, *In re* Loewen Group Int'l., Inc., No. 99-1244, 2002 U.S. Bankr. LEXIS 199 (Bankr. D. Del. Feb. 19, 2002). For a

fifteen entities of its more than 3,500 subsidiaries filed bankruptcy petitions.[12] When it comes to corporate groups, bankruptcy is not an all or nothing affair. Some entities go in; some stay out.

One obvious reason as to why all affiliated entities do not file for bankruptcy is the increasing use of special purpose vehicles ("SPVs") in structured finance.[13] In a securitization transaction, a firm transfers assets that it owns to an SPV. The SPV in turn, pays the firm for the assets that it receives. The money for the assets comes from selling notes issued by the SPV in the capital markets. A key attribute of a SPV is that it is bankruptcy remote. It is legally set up so that it will stay out of bankruptcy should the firm from which it bought the assets file for bankruptcy. Indeed, the whole point of the transaction is that this part of the corporate group will not file for bankruptcy should the firm encounter financial distress.

The fact that an enterprise can adopt a legal structure to ensure that some assets remain outside of bankruptcy implies that bankruptcy courts in both the United States and Canada should not be quick to reach for the doctrine of substantive consolidation. Corporate boundaries are no accident. They are increasingly designed to match creditor claims with certain assets. To be sure, while some are done as part of structured financing arrangements, one can partition assets for other purposes as well. The central point here is that whether or not a creditor ends up pursuing a claim in bankruptcy is more and more a matter of choice made at the time it lends money. A robust doctrine of substantive consolidation that forced the mingling of assets within a court's jurisdiction could create an additional incentive to ensure that assets never entered the bankruptcy forum in the first instance. If

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discussion of the Enron bankruptcy, see Douglas G. Baird & Robert K. Rasmussen, *The Four (or Five) Easy Lessons from Enron,* VAND. L. REV. (forthcoming 2002).

12. For a discussion of the Enron case, see Baird & Rasmussen, *supra* note 11.

13. For explanations of securitized transactions including SPVs, see generally STEVEN SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (2d ed. 1993); Steven Schwarcz, *The Alchemy of Asset Securitization,* 1 STAN. J. L. BUS. & FIN., 133, 135, 150-51 (1994); Claire Hill, *Securitization: A Low-Cost Sweetener for Lemons,* 74 WASH U. L.Q. 1061 (1996).

creditors could not rely on the fact that, for the purpose of determining payouts in bankruptcy, legal distinctions would not remain in place, they would be more likely to insist that the entity to which they extend credit is bankruptcy remote.

Put somewhat differently, there is no preordained legal structure of an enterprise. The same economic activity could, as a legal matter, be housed in a single firm, a parent with a bunch of subsidiaries or a host of related entities. Legal notions of what a "firm" consists of simply have no unbreakable tether to economic reality. You may have two legally distinct firms the assets of which reside in what may economically be viewed as a single firm. The only reason for the legal existence of two firms rather than one may be to assign particular creditors to particular assets. This distinction between the legal definition of the firm and an economic conception of the firm explains why it can often be the case that a firm leaves bankruptcy with many fewer subsidiaries than it had when it entered bankruptcy. The assets may have remained the same; they are simply in a different legal configuration.[14]

The question of substantive consolidation is whether or not to ignore the partition that the parties adopted. A court has no power to ignore such partitioning to the extent that carved out assets remain outside of bankruptcy.[15] This being the case, bankruptcy courts should be hesitant to obliterate carefully designed partitions inside of bankruptcy. To be sure, as Professor Ziegel notes, substantive consolidation is warranted where the creditors all agree it is in their economic interests.[16] In some situations, the cost of keeping the legal entities distinct while running the bankruptcy

14. It is also the case that some of the assets may have been sold during the reorganization proceeding. On the tendency to sell assets in reorganization, see Lynn LoPucki & William Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 139 U. PA. L. REV. 125 (1990). Still the dramatic reduction in the number of subsidiaries reported by Professor Ziegel most likely can be explained in large part by the redrawing of the legal lines around the enterprise's assets.

15. PHILIP J. BLUMBERG, THE LAW OF CORPORATE GROUPS: BANKRUPTCY LAW § 18.02, at 417-18 (1985) (providing a review of corporate substantive consolidation in bankruptcy).

16. Ziegel, *supra* note 1, at 385-86.

proceedings may be such that every creditor is better off if the assets and claims are simply lumped together. A decision by all the creditors to go this route resembles contract modification, which is generally thought to be unobjectionable. When, however, some creditors find it in their interest to maintain the legal separation for which they contracted, a bankruptcy court should be very reluctant to disregard the structure that the parties have adopted.

The increased attention that parties have given to the possibility of bankruptcy when they structure the lending relationship, however, has broader implications than the doctrine of substantive consolidation. Substantive consolidation is, by definition, a sorting out of which claims go against which assets.[17] The more important question, at least from a general welfare perspective, is how these assets will be deployed. As a first order of proposition, the aggregate wealth of society is affected more by how the assets are deployed rather than how ownership claims are divvied up. In short, the size of the pie is more important than the size of the slices. Or, in the language of modern finance, control rights have a bigger societal impact than do priority rights.[18]

Control rights are important because, at least implicitly, they have been at the heart of the argument for a transnational insolvency system that coordinated the actions of various domestic bankruptcy courts. For over one hundred years, academics have pined for a system to handle transnational insolvencies.[19] These

17. For a general review of substantive consolidation in bankruptcy, see Lisa Poulin, *Last in Line, Practical Business Guidelines for Dealing with Substantive* Consolidation, 1998 A.B.I. J. LEXIS 282 (1998) (providing a review of the problems creditors can face in substantive consolidation); Ulrik Bang-Pederson, *Asset Distribution in Transnational Insolvencies: Combining Predictability and Protection of Local Interests*, 73 AM. BANKR. L.J. 385, 419-20 (1999) (describing the structure of substantive consolidation in bankruptcy).

18. *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921 (2001).

19. *See* John Lowell, *Conflict of Laws as Applied to Assignments for Creditors*, 1 HARV. L. REV. 259, 264 (1888); *see also* Melissa K.S. Alwang, *Annual Survey Issue: International Insolvencies: Note: Steering the Most Appropriate Course Between Admiralty and Insolvency: Why an International Insolvency Treaty Should Recognize the Primacy of Admiralty Law Over Maritime Law*, 64 FORDHAM L. REV. 2613, 2613 (1996); Claudia Tobler, *Managing Failure in the*

self-styled universalists often predicate their argument on the need to ensure that a single court is given an opportunity to orchestrate a sensible allocation of an enterprises assets. They posit that absent a coordinated proceeding, there will be a tendency toward inefficient liquidations. The core notion is that if countries were to operate their insolvency proceedings independently of each other, creditors in each country, seeking to maximize their own payoffs, will focus only on the entity against which they will have a claim, and will forego working with the creditors of other members of the group. This lack of coordination could lead to a failure to preserve the synergy that may exist among the various group members who inhabit different nations. Enterprises that have a going concern surplus will be forced to close their doors because each bankruptcy within each country will focus single-mindedly on the assets within its national borders.[20]

The problem with this argument is that one cannot conclude that there must be a single proceeding to resolve financial distress from the fact that a corporate group spans more than one country. The individual entities in each country are already protected by the applicable bankruptcy regime of that country. To the extent that there is a going concern surplus attributable to the assets in a single country, domestic law responds to this concern. It may well be that there is no going concern surplus attributable to the interactions between the assets in one country and the assets in the other. For some firms, administering assets separately may bring larger returns to the firm's owners than would a single, transnational insolvency proceeding. There is no normative reason to assume that a priori various entities across borders have a greater value when put under a single control structure. Indeed, we live in a world where the cost of contracting is decreasing. The ability to

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New Global Economy: The U.N.C.I.T.R.A.L. Model Law on Cross-Border Insolvency, 22 B.C. INT'L & COMP. L. REV. 383, 396; Andrew T. Guzman, *Internal Bankruptcy: In Defense of Universalism,* 98 MICH. L. REV. 2177, 2178 n.4 (2000) (providing numerous sources which advocate universalism to address transnational insolvencies); Jay Lawrence Westbrook, *The Global Solution to Multinational Defaults,* 98 MICH. L. REV. 2276 (2000).

20. For a more detailed description of this argument, and a critique, see Rasmussen, *supra* note 4; Robert K. Rasmussen, *Resolving International Bankruptcy Law Through Private Ordering,* 98 MICH. L. REV. 2252 (2000).

recreate the functions of a firm via contract puts a cap on any potential going concern surplus.

The crucial question in modern bankruptcy law is who makes the asset allocation decision.[21] In firms free from financial distress, control rights tend to be exercised by the board of directors. The board decides who runs the firm on a day-to-day basis, and the board must approve all major transactions that the firm makes.[22] How these control rights should be exercised when the firm becomes insolvent has been the subject of debate.[23] Traditionally, academics in the area of transnational insolvency have focused on ex-post solutions to this problem.[24] They have assumed that coordination was needed to prevent inefficient liquidations. Bankruptcy courts had to work together to ensure that the correct decision was made.[25]

The increasing use of capital structures crafted with insolvency in mind, such as special purpose vehicles that are bankruptcy remote, suggests a different solution to the problem. Increasingly, control rights are allocated on a state contingent basis. The debtor and its creditors structure their affairs so that those whose money is at stake are the ones making the crucial decisions.[26] They may put some assets in a corporate form to ensure that they never come before a bankruptcy court. Lending agreements can be crafted so that the firm can only continue to get working capital with the blessings of its creditors. Venture capital contracts may give the venture capitalist the power to terminate the enterprise when things are not going well. Indeed, bankruptcy practice in the United States has changed radically over the last ten years, in large part because sophisticated parties have learned to craft contracts

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21. *See* Baird & Rasmussen, *Control* Rights, *supra* note 18.

22. *See generally* JOHN CARVER & MIRIAM M. CARVER, YOUR ROLES AND RESPONSIBILITIES AS A BOARD MEMBER, VOL. 2 (1996) (providing an explanation of the general duties of a corporate board of directors).

23. *See infra* notes 24-25 and accompanying text.

24. *See generally* sources cited, *supra* note 19.

25. For an extended discussion of going concern surplus and its relationship to bankruptcy law, see Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy* (unpublished draft, on file with the Fordham Journal of Corporate & Financial Law).

26. *See id.*

with an eye toward what will happen should the firm hit hard times. American bankruptcy courts today are less likely to decide how assets should be used than they were a decade ago.

This change in domestic bankruptcy practice suggests a shift in our aspirations for transnational insolvencies. While this comment is not the place for a sustained treatment of the issue, let me offer a few general thoughts on how the problem of transnational insolvencies should be approached through the lens of control rights. Rather than seeking solutions that lead to coordinated proceedings, we should strive to have proceedings that do not interfere with the parties' allocation of control rights. If parties have jiggered their corporate structure so that some entities in the corporate group remain outside of bankruptcy, courts should not attempt to revisit that decision. Similarly, if they have structured their affairs so that the assets in the respective countries can be administered separately, little is to be gained by trying to coordinate the proceedings. We should only have coordinated proceedings when the parties have structured control of the enterprise in a way designed to benefit from coordinated, as opposed to separate, insolvency proceedings.

While there has yet to be any systematic work done on the question, it may well be that the lesson of respecting control right allocations matters less for United States-Canadian insolvencies than for other transnational insolvencies. The role that a country's bankruptcy law plays in the allocation of control rights cannot be isolated from the effects of the country's general corporate law.[27] The two work together to support any given country's system of corporate governance.[28] The risk created by a world in which transnational insolvencies would be handled by a single jurisdiction would be that there could be a mismatch between corporate law and bankruptcy. It is precisely where legal regimes differ significantly that the parties have an incentive to ensure each entity is handled by the appropriate legal system. The risk of having a bankruptcy law that is out of sync with the general corporate law that governs a firm's activity, however, is relatively low in the

27. *See* David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325 (1998).

28. *See generally id.*

United States-Canada situation. The United States and Canadian bankruptcy laws are functionally similar.[29] This implies that putting, say, American bankruptcy law on top of general Canadian corporate law runs little risk of upsetting settled expectations. In such a situation, a debtor and its creditors may implement a financial structure that would best be handled through a coordinated proceeding.

Consider, for example, the outcome of the Loewen Group case.[30] The trend in the funeral industry is toward consolidation.[31] It thus may make a good deal of sense to ensure that the enterprise is administered as a single entity, which is what in fact happened in the case.[32] In the *Loewen Group*, the Canadian and American bankruptcy courts agreed to cooperate, with the United States Bankruptcy Court taking the lead.[33] What is interesting is the way in which the United States Bankruptcy Court acted.[34] The Court, rather than deciding how to deploy the assets of the Loewen Group, hired a search firm to put together a new board of directors.[35] The new board, rather than the Bankruptcy Court, had the primary authority for deciding what actions will maximize the value of the firm.[36] This is an innovative solution to ensure that control rights are lodged with those who have the requisite expertise to exercise them so as to maximize the value of the firm. While this procedure may not be the appropriate one for every financially distressed firm, it provides an example of the innovation

29. *See* Lynn M. LoPucki & George Triantis, *A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies,* 35 HARV. INT'L. L.J. 267 (1994).

30. *In re* Loewen Group Int'l., Inc., No. 99-1244, 2002 U.S. Bankr. LEXIS 199 (Bankr. D. Del. 1999).

31. *Id.* at *5-*8 (explaining Loewen Group's consolidation and merger tactics).

32. *See* E. Bruce Leonard, *The Developing Use of Protocols in Major Cross-Boarder Filings*, 1999 ABI J. LEXIS 140, *6-*8 (1999) (providing a review of Loewen's cross boarder petition).

33. *See* Oresteses Pasparakis & Ogilby Renault, *Reconciling Chapter 11 with Restructurings in Canada Recent Developments in The Loewen Group, Inc.*, 2002 ABI J. LEXIS 13, *2 (2002).

34. *See* GILSON, *supra* note 10 at 25-53.

35. *Id.*

36. *Id.*

that is occurring in bankruptcy practice today. The general thrust of these innovations is to cede to market participants asset allocation decisions, and leave to a court the sorting out of conflicting claims.

In sum, Professor Ziegel's work reminds us that a modern enterprise is typically composed of a number of affiliated firms. This corporate structure tends to reflect conscious financial planning rather than economic fundamentals. The challenge for insolvency law, both domestic and transnational, is to sort out the issues raised while remembering that the first obligation is to do no harm.

Notes & Observations