A Unified Approach To Parent,
Subsidiary, and Affiliate Questions in
Bankruptcy*

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The owners of a business enterprise often choose to conduct their operations in the form of two or more separate corporations rather than as a single corporate entity. They may do so for a variety of reasons: to separate functions for administrative ease, to control many businesses with a minimal capital investment, to comply with various legal requirements, to minimize liability or to insulate certain assets from liability for other activities, and, probably most important, to avoid the predations of the ubiquitous tax collector.¹ Most commonly, they will own stock in one corporation (the parent) directly, and the parent corporation will, in turn, own stock in one or more other corporations (the subsidiaries).² An alternative method of organization is for a single stockholder, or group of stockholders, to own a controlling interest in a number of distinct corporations, generally referred to as "affiliates" or "affiliated cor-

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¹ See generally A. DEWING, FINANCIAL POLICY OF CORPORATIONS 980-87 (5th ed. 1953); Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations*, 18 LAW & CONTEMP. PROB. 473, 487-88 (1953).

² The parent may be a holding company, organized solely to own corporate stock, or it may also be a productive corporation in its own right.

porations.”³ As long as all the related corporations remain solvent, these forms of organization present few, if any, special legal difficulties. When one or more of a group of parent-subsidiary or affiliated corporations becomes a bankrupt, however, a number of problems may result from their interrelationship.⁴

This paper will examine the bankruptcy issues that most typically arise in the context of interrelated corporations. There are three major problem areas. First, when a subsidiary or affiliate is in bankruptcy, the propriety of allowing or subordinating the claims of the parent or related corporations against the bankrupt's assets will frequently be at issue. Second, in the same situation, creditors of the bankrupt may seek to disregard the separate corporate entities and attempt to reach the assets of the parent or affiliate to satisfy their claims. Finally, when several related companies are bankrupt, there will usually be spirited competition between the creditors of each corporate entity for whatever assets are available. Although all have a common source in the division of one business into more than one corporate entity, these three situations have commonly been analyzed individually under the legal rubrics of equitable subordination, piercing the corporate veil, and consolidation of related bankrupts. A unified approach, based on the rationale behind multiple incorporation, is long overdue.

Before turning to the discussion, some clarification of terms is in order. The terms “enterprise” or “business enterprise” refer to the combination of parent, subsidiary, and affiliated companies. The ultimate owners of the enterprise—be they stockholders of the parent or of the affiliates—are called “enterprise owners.” The separate corporations that make up the enterprise are either parents, subsidiaries, or affiliates; however, when it is appropriate to refer to such entities generally, the companies are called “constituent corporations” or “related companies.”

I. CORPORATE LAW BACKGROUND

Almost half a century ago Justice, then Judge, Cardozo noted

³ Because of administrative considerations, however, the affiliate form of organization is only feasible when the number of stockholders is rather small.

⁴ When the parent does not own 100% of the subsidiary's stock, various corporate law obligations may require officers and directors of the subsidiary to operate it with a view toward benefiting the subsidiary and all its stockholders, including the minority. Berle, *Subsidiary Corporations and Credit Manipulation*, 41 HARV. L. REV. 874, 889 (1928) [hereinafter cited as *Subsidiary Corporations*]. It will be assumed throughout this paper that no minority interests are at stake in the bankruptcy proceeding; this assumption appears to accord with reality in the majority of the bankruptcy cases.

that this area of the law was "enveloped in the mists of metaphor."⁵ With his admonition to pay attention to the actual facts of particular cases, certain elementary factors of corporate organization should be examined.

A. Investment Aims in Multi-Corporate Enterprises

The goal of investors in a single corporate enterprise is to gain the largest possible return on their investments consonant with the risks they wish to take. If the owners of an enterprise choose to fragment it into several constituent corporations—and we assume that they act as rational investors in doing so⁶—then they must believe that such a form of enterprise organization will maximize the return on their investment, given their acceptable level of risk. As noted above, in specific instances this maximization may result from a variety of factors; no matter how the end is achieved, the dominant motivation will always be maximization of return from the enterprise as a whole.

Because the enterprise owners seek to maximize the profitability of the entire enterprise in the light of acceptable risk, the profitability of any one constituent corporation is largely irrelevant to them, except as it contributes to the overall effort.⁷ In fact, since corporate or tax advantages may be obtained by operating one company at a loss or at the break-even point, the return on investment for the enterprise may even be increased by artificially depressing the profits of a constituent corporation. Enterprise owners may thus have an incentive to depart from the norms of financial organization generally followed in the case of single, unrelated corporate units.

For example, the courts often speak of a requirement of adequate capitalization for constituent corporations. Yet business considerations do not always justify ample capitalization; in fact, there may be substantial tax advantages in keeping capitalization at a relatively low level. While it is essential that the newly formed corporation have adequate funds to conduct its operations, from a financial standpoint, the designation of such funds as "invested capital" is irrelevant.

The same analysis applies to the commingling of funds or properties between constituent companies. If such commingling were to

⁵ *Berkey v. Third Ave. Ry. Co.*, 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926).

⁶ In many instances, however, the existence of multiple corporate entities may simply reflect a historically established fact lacking real business purpose.

⁷ See *Subsidiary Corporations*, *supra* note 4, at 882.

result in inadequate accounting, cost control, or verification procedures, it would certainly be detrimental to both corporations. But there is nothing per se wrong with commingling if it simply results in one constituent company using the funds or properties of another. In reality, to the owners of the enterprise, free commingling of funds and properties may be highly desirable in order to maximize overall productive use of the capital and resources of the enterprise.

Different organizational norms may also be observed at the management level. In a group of related corporations the locus of decision-making authority will be determined by the needs of the enterprise as a whole. Yet the courts often talk about the necessity that subsidiary and affiliated corporations have a separate and independent will, as if corporations themselves had some sort of incorporeal existence apart from their owners. Even if a subsidiary has its own management team, it would be naive to expect the enterprise owners to remain silent if they disagree with the subsidiary's policies; if heads roll, there is no doubt whose heads they will be.

B. Corporate Law Protection for Creditors

If the owners of an enterprise were required to create and maintain a substantial pool of assets in each corporation they established, the creditors of those corporations would be well protected against the possibility of insolvency or bankruptcy. Existing corporation laws, however, impose few such constraints on the owners at either the organizational or operational stage of the corporation's existence.

While the courts sometimes discuss a duty to capitalize the corporation adequately,⁸ the source and scope of such a duty is unclear. State corporation statutes clearly do not require corporate entities to be adequately capitalized as a prerequisite to engaging in most types of business activities: no states have more than a minimal capitalization requirement and none impose sanctions on companies that are inadequately capitalized.⁹ In all cases of inade-

⁸ See, e.g., *Costello v. Fazio*, 256 F.2d 903 (9th Cir. 1958); *International Tel. & Tel. Corp. v. Holton*, 247 F.2d 178 (4th Cir. 1957); *In re Lumber, Inc.*, 124 F. Supp. 302 (D. Ore. 1954).

⁹ See, e.g., TENN. CODE ANN. §§ 48-202(e)(iv), 48-514(1) (Supp. 1974) and TEX. BUS. CORP. ACT art. 3.02(A)(7), 3.05(A) (Supp. 1974), art. 4.12(E) (1956), requiring a minimum of \$1000 initial capitalization and prohibiting a reduction of capital below that amount. Delaware and New York have no specific requirement of a minimum amount of capital. DEL. CODE ANN. tit. 8, §§ 154, 242 (1974); N.Y. BUS. CORP. LAW §§ 102(a)(12), 506 (McKinney 1963). Shareholder liability is usually limited to paying any portion of the consideration for shares that remain unpaid. ABA-ALI MODEL BUS. CORP. ACT § 25 (1966). See also Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373, 1393-94 (1938).

quate capitalization, a creditor's ultimate remedy turns on the fortuity that a court will recognize a public policy obligation to adequately capitalize the corporation as the "price" for limited liability¹⁰ and will permit creditors to press their claims against related companies or against the ultimate owners of the enterprise. Without inquiring now into the legion of cases involving attempts to pierce the veil, it may be observed that the prospects of success are uncertain at best.

Even if the courts do permit the veil to be pierced, however, the net effect would simply be to encourage the enterprise owners to make an educated guess at the amount of capitalization that would insulate the enterprise and not the amount necessary to ensure that each constituent corporation will be a viable concern able to pay its creditors. Furthermore, this "sanction" does nothing to protect creditors against undercapitalization by those who may be judgment-proof or those who are sufficiently confident of the ultimate success of the enterprise to ignore the consequences of insolvency. Thus the possibility of piercing in the future, after the corporation has failed, provides little incentive for capitalizing the company adequately at its inception. Through low capitalization requirements and the uncertain prospect of veil piercing, the law has, to a large extent, placed the cost of promoting new businesses on the creditors of the corporation and, through them, on the public as a whole.

The scant protections creditors receive at the corporation's inception are supplemented by equally inadequate protections once the corporation becomes a going concern. Of course, creditors are totally unprotected if, for any reason, the corporation never earns any profits. If, however, the corporation begins to accumulate funds and property, creditors do receive some protection in the form of limitations on the corporation's ability to withdraw those assets from business use. While the corporation's managers may use corporate properties—however improvidently they wish—in an attempt to build the corporation's business,¹¹ there are some restrictions on uses which do not further that business.

One such restriction is the general corporate law limitation on the payment of dividends out of anything but "earned surplus" or

¹⁰ H. BALLANTINE, CORPORATIONS § 129, at 302-03 (rev. ed. 1946); see *Minton v. Cavaney*, 56 C.2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

¹¹ At least as to the creditors, Berle notes that the classic rule precludes them from complaining of mismanagement of the debtor corporation. *Subsidiary Corporations*, *supra* note 4, at 877 & n. 3.

"surplus."¹² But, since "surplus" is basically an accounting concept, unrelated to the wisdom of paying dividends, dividends may often be paid when it is improvident to do so. It is unlikely that such dividends can be recovered from the parent unless the capital of the corporation has been invaded or a fraudulent conveyance has occurred. Although directors may have some residual liability for negligence in paying out dividends unwisely, a recovery is unlikely if the malleable statutory standards have been met, since the payment of dividends available under the typical statutory "surplus test" is a matter within the "business judgment" of the directors.¹³ Since directors may be encouraged to pay dividends to a parent with the knowledge that the funds can be "gotten back" if needed, it should not be surprising that parent-subsidiary bankruptcy cases frequently include intercorporate dividends.¹⁴

The law of fraudulent conveyances, which provides a curious sort of creditor protection, forbids various transfers without fair consideration as well as transfers made with the intent to defraud creditors.¹⁵ There are three types of impermissible transfers without fair consideration. First, transfers by a corporation that is or will be rendered insolvent—that is, has or will have liabilities in excess of its assets—are fraudulent as to existing creditors. As a practical matter, the requirements of insolvency and existing creditors minimize the protection afforded by prohibiting this category of transfer since there is nothing to prevent dissipation of the corporation's resources until it is in dire straits, and future creditors may not

¹² See, e.g., DEL. CODE ANN. tit. 8, § 170(a) (1974); N.Y. BUS. CORP. LAW § 510(a) (McKinney Supp. 1974); ABA-ALI MODEL BUS. CORP. ACT § 45 (1966).

¹³ H. BALLANTINE, *supra* note 10, § 252 at 591 (the statutory provisions governing dividends are supplemented by the general duties of reasonable care and prudence in the management of the corporation).

¹⁴ See *Henry v. Dolley*, 99 F.2d 94 (10th Cir. 1938) (bankrupt parent's claim against its bankrupt subsidiary reduced by the amount of illegally paid dividends). In other cases, the declaration of dividends by the subsidiary, when it was without funds to pay them out, was a factor in the subordination of the parent's claim in its subsidiary. See *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939); *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948) (dissenting opinion); *In re Commonwealth Light & Power Co.*, 141 F.2d 734 (7th Cir.), *appeal dismissed*, 322 U.S. 766 (1944). See also Fuller, *supra* note 9, at 1393.

¹⁵ Conveyances may be declared fraudulent under state law or under § 67d of the Bankruptcy Act, 11 U.S.C. § 107 (1970). Most states have adopted either the UNIFORM FRAUDULENT CONVEYANCE ACT or some version of the STATUTE OF 13 ELIZABETH (1570) which prohibited transactions that were intended to defraud. The purpose of the Uniform Act was, at least in part, to codify and clarify the various presumptions and rules of law applied under the more general provisions of the common law. Section 67d is a slightly altered version of the Uniform Act. See generally Landers, *The Bankrupt's Spouse: The Forgotten Character in the Bankruptcy Drama*, (1974) UTAH L. REV. 709. The textual discussion assumes that the Uniform Act or § 67d is applicable; the results would not differ significantly in a common law state.

attack such a transfer even though it may have impaired the corporation's ability to pay its claims.

A second category encompasses transfers that leave the transferor, who is "about to engage in [a] business or transaction,"¹⁶ with unreasonably small capital; such transfers are fraudulent as to existing creditors and as to those parties who become creditors during the continuance of the business or transaction. While this rule furnishes somewhat greater protection in principle, the courts have not enforced the capitalization requirements very rigorously,¹⁷ and, as above, there is no protection if the transaction is completed before there are actual creditors.

The third category of fraudulent conveyances includes those conveyances without consideration by a debtor who believes he will incur debts beyond his ability to pay; such a transfer is fraudulent whether there are existing or future creditors. Again, only minimal protection is provided for creditors against proverbially optimistic debtors who see the dim light at the end of an ever-lengthening tunnel. In addition to the foregoing, conveyances for consideration may be attacked if the debtor had actual fraudulent intent. Such a finding is perhaps unlikely in the corporate context.

Outside of these rather narrow restrictions, the corporation is permitted to carry out transactions that do not benefit it and yet are not subject to attack.¹⁸ Moreover, even when the law of fraudulent conveyances operates, creditors receive only minimal protection: the managers of the enterprise are generally not personally liable,¹⁹ and the statute of limitations may bar an attack on

¹⁶ Bankruptcy Act § 67d(2)(b), 11 U.S.C. § 107(d)(2)(b) (1970), UNIFORM FRAUDULENT CONVEYANCES ACT § 5.

¹⁷ See *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*, 109 F.2d 924 (2d Cir. 1940) (court found no fraudulent conveyance even though when the subsidiary paid the parent's debt its capital was only \$1000 and its assets were never more than its liabilities). There are few cases involving a fraudulent conveyance by a debtor with unreasonably small capital, and virtually all of them also appear to fit within one of the other categories of fraudulent conveyances. See *Steph v. Branch*, 255 F. Supp. 526 (E.D. Okla. 1966), *aff'd*, 389 F.2d 233 (10th Cir. 1968) (also conveyance by insolvent without fair consideration); *In re Atlas Foundry Co.*, 155 F. Supp. 615 (D.N.J. 1957) (also an illegal circumvention of prohibitions against mortgaging a company's assets to finance purchase of its stock); 4 H. REMINGTON, BANKRUPTCY § 1644 (Henderson ed. 1957).

¹⁸ See Fuller, *supra* note 9, at 1389-94 (reaching the same conclusion for one-man corporations).

¹⁹ Neither § 67d of the Bankruptcy Act nor the Uniform Act provides for liability on the part of corporate officers of the transferor. While officers and directors might theoretically be liable as tort-feasors, no precedent to this effect has been found. Finally, while some states have enacted statutes imposing penalties on any party participating in such transfers, virtually all of the reported cases are more than a half century old. See generally 37 C.J.S. *Fraudulent Conveyances* §§ 466-68 (1943).

transfers more than one year earlier.²⁰

Since any gratuitous distribution to a related company constitutes a dividend,²¹ the law of fraudulent conveyances provides little protection for creditors beyond that already provided in state corporation statutes forbidding dividends that invade capital or that will render a corporation insolvent. This law operates independently only when payment of the dividend will leave the corporation in a highly precarious financial position—that is, without adequate capitalization to carry on its business or at the edge of insolvency.

Two points emerge from the foregoing discussion: first, when the owners of an enterprise operate it as separate constituent corporations, they have strong business motivations to operate those corporations with a view toward overall return on investment, without regard to the separate entity status each enjoys under the law; second, the law governing the formation and maintenance of corporations provides minimal protection for creditors of such constituent corporations by failing to mandate the formation and continuance of a viable corporate entity able to pay its debts. Under this system, the law relies primarily upon creditors to act to protect themselves and, on occasion, to bear the losses associated with one attribute of separate entity status—limited stockholder liability. Such a result would be explicable only if it reflected a policy judgment that the public benefits of corporate formation outweigh any harm to individual creditors of those corporations that do not survive.

C. Special Problems of Creditors of Multi-Corporate Enterprises

Although the law gives little protection to creditors of corporations generally, quite apart from the special problem of the multi-corporate enterprise, creditors of a constituent corporation may be exposed to greater risks than creditors of a single corporation.²²

²⁰ The statute of limitations under § 67d is one year. Under state law, either the statute may vary or the equitable doctrine of laches may apply. See Landers, *supra* note 15, at 732.

²¹ For a discussion of the relationship between illegal dividends, fraudulent conveyances, and other sections of the Bankruptcy Act see W. CARY, CASES AND MATERIALS ON CORPORATIONS 1489-90 (1969).

²² It bears noting that there may be various types of creditors seeking to recover from one or more of the constituent corporations. First, there are what might be called "voluntary creditors," that is, creditors who had some element of choice before entering into the transaction with a constituent company. Among such creditors are those who did investigate the credit-worthiness of the corporate debtor, those who did not investigate but who could have done so, and those who could not have been reasonably expected to inquire. In the latter category are relatively small buyers and sellers of goods who ordinarily fill orders without detailed inquiry. Superimposed upon the categories of creditors who either investigated or might have done so are creditors who may, in one way or another, have relied or not relied

First, the availability of funds from other corporations reduces the practical importance of adequate initial capitalization: constituent corporations can attract investments from related corporations more easily than new capital could be raised from groups of stockholders. Second, the danger of commingling assets and properties is greater between corporations themselves, than between corporations and shareholders. Third, there is a greater chance that, because its economic viability is tied to that of other corporations, the constituent corporation will be unable to develop the kind of independent profit-making activities that might be expected of single corporate units. In the final analysis, the subsidiary will be responsive to the dictates of the owners of the enterprise, who will be most interested in the overall return on their investment.

It is the thesis of this paper that, when any constituent corporation becomes bankrupt, the legal relations between the constituent companies should be determined in accordance with both the policy behind the various legal requirements and the business realities that motivate the managers of the corporation. Unfortunately, an examination of the relevant authorities suggests that many decisions in this area are being premised upon largely mythical corporate policies and practices. All too often the practical workings of the corporate enterprise are ignored and factors having no significance apart from bankruptcy are made determinative.

II. EQUITABLE SUBORDINATION OF CLAIMS

The present doctrine governing the subordination of claims of parent and affiliated corporations in the bankruptcy of a subsidiary or affiliate is based on two essential premises. First, there is the rule that the claim of the parent or affiliate will generally be allowed. The rationale for this rule is that the relationship between the claimant and the bankrupt is not enough, by itself, to overturn the normal consequences of separate corporate status. Second, the exception to this rule is that where the parent or the affiliate has

on the presence or responsibility of other constituent companies to satisfy their claims if necessary. The relying group includes those creditors who directly relied on the misrepresentation that another constituent company would pay or guarantee the debt, or that certain property belonged to the debtor that in fact belonged to another constituent company, belonged to the debtor, or those who relied on the appearance of strength given by a group of companies or even on the similarity of names between the debtor and its affiliates. These categories are not, of course, exclusive, and an infinite number of shadings and individual factual patterns may exist. The second group of creditors might be termed "involuntary" because they did not choose to enter into a transaction with the debtor company. The most common example of such creditors are accident victims or other tort plaintiffs.

somehow abused its dominant position, its claim will be subordinated or disallowed. To date, most of the learning has been addressed to this second issue, namely, the question of what constitutes a sufficient abuse of control to warrant subordination. In the past three generations, there have been a number of modifications—with varying degrees of subtlety—in the controlling verbal formulae; no purpose would be served by recounting the hoary details of that process of evolution. Instead, the present state of the law may be summarized as follows: some courts have decided the issue largely in conclusory terms by determining that the subsidiary or affiliate is an “instrumentality,” “mere instrumentality,” or “alter ego”²³ of the claimant, suggesting a parasitic relationship between the bankrupt and the claimant. Other courts have attempted to catalogue the applicable factors that, singly or in conjunction, warrant subordination.²⁴ While a complete list would be impossible, the major factors are: (1) fraud or other wrongdoing; (2) mismanagement in excess of simple negligence; (3) undercapitalization; (4) commingling of funds and properties; (5) failure to develop the subsidiary into an independently profitable business, and/or an overdependence of the business of the bankrupt upon that of the claimant; and (6) excessive control, indicated by a failure to observe the formalities of separate corporations.

The fluidity of these concepts has permitted an ad hoc approach to the problem of subordination, spearheaded by the decisions of the Supreme Court itself. In the famous *Deep Rock* case,²⁵ the Court subordinated the claim of a parent corporation that had seriously undercapitalized its subsidiary and had run the subsidiary's business in such a manner as to make profitability unlikely. In *Pepper v. Litton*,²⁶ the Court concluded a long exegesis on truth,

²³ The “instrumentality” language was apparently first used in *In re Watertown Paper Co.*, 169 F. 252 (2d Cir. 1909). See also *In re Kentucky Wagon Mfg. Co.*, 71 F.2d 802 (6th Cir.), cert. denied, 293 U.S. 612 (1934); *In re Ostego Waxed Paper Co.*, 14 F. Supp. 15 (W.D. Mich. 1935). While the courts no longer rely on agency principles and subordinate rather than disallow the claims of parent corporations; see *In re Loewer's Gambrian Brewery Co.*, 167 F.2d 318, 320 (2d Cir. 1948) (L. Hand, J. concurring), they still use the terms “instrumentality” and “alter ego” to both state the problem and describe their conclusion. See, e.g., *Markow v. Alcock*, 356 F.2d 194 (5th Cir. 1966); *American Trading & Production Corp. v. Fischbach & Moore, Inc.*, 311 F. Supp. 412 (N.D. Ill. 1970).

²⁴ Some of the more useful discussions of these issues are Gleick, *Subordination of Claims in Bankruptcy Under the Equitable Power of the Bankruptcy Court*, 16 BUS. LAW. 611, 619 (1961); Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83, 90-113 (1961); Krottinger, *The “Deep Rock” Doctrine: A Realistic Approach to Parent-Subsidiary Law*, 42 COLUM. L. REV. 1124 (1942); Rembar, *Claims Against Affiliated Companies in Reorganization*, 39 COLUM. L. REV. 907, 922 (1939).

²⁵ *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939).

²⁶ 308 U.S. 295 (1939).

justice, and fair treatment of creditors by subordinating the claim of a controlling shareholder because of conduct designed to deprive the sole creditor of any participation in the bankrupt's estate. The hundreds of lower court cases involving the same question seem to turn on individual patterns, with the courts constantly emphasizing that each case must be decided on its own facts.²⁷

Rarely, if ever, does a court question the major premise of the subordination doctrine that, absent one or more of these subordinating factors, the claims of parent and affiliated corporations must be allowed to compete with claims of outside creditors for the assets of the bankrupt. The premise is vulnerable to two separate attacks. First, since the owners of the enterprise are concerned with maximizing return on their investment commensurate with the desired risk, any loan to the subsidiary or affiliate must be designed to maximize overall profits and thus is inherently more like risk capital than ordinary debt. Given that it is essentially risk capital, the "debt" owed to the related corporation should not be permitted to share *pari passu* with the true debts owed to other creditors.²⁸ Second, since the enterprise owner is concerned with maximizing return on his entire investment, decisions regarding the operation of the subsidiary or affiliate will be made with that goal in mind—not with a view to ensuring that the subsidiary will function as a viable corporate entity. Thus, in terms of the traditional test outlined above, the economic reality of the situation gives rise to a presumption that the parent has not used its control in the best interests of the subsidiary. To ensure that the creditors are treated fairly, the claim of the parent or affiliate must be subordinated.²⁹

²⁷ See, e.g., *Centmont Corp. v. Marsch*, 68 F.2d 460, 463 (1st Cir. 1933), *cert. denied*, 291 U.S. 680 (1934).

²⁸ See the concurring opinion of Judge Learned Hand in *In re Loewer's Gambrinus Brewery Co.*, 167 F.2d 318, 320 (2d Cir. 1948), arguing that it would be inequitable for a stockholder-creditor to enjoy all the gains of a successful business, yet limit his potential risks in a failing business to those of a creditor.

²⁹ Judge Frank, in *In re Loewer's Gambrinus Brewery Co.*, 167 F.2d 318 (2d Cir. 1948), writing for the majority, stated that creditors would not be required to prove an abuse of the corporate form in the case of affiliate corporations because the potential for abuse and the likelihood of concealment were so great. Judge Frank's opinion was apparently inspired by the Supreme Court's decision in *Pepper v. Litton*, 308 U.S. 295, 313 (1939), which, however, left open the same question as to one-man corporations. In *Schwartz v. Mills*, 192 F.2d 727 (2d Cir. 1948) (Frank, J., dissenting) the majority of the Second Circuit apparently abandoned the presumptive rule set forth in *Gambrinus*. See also Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343, 356 (1947) [hereinafter cited as *Enterprise Entity*].

It has been noted that in many cases creditors might have been better off if the shareholder had not infused additional funds into the bankrupt; future creditors would obviously have been much better off. See *Barlow v. Budge*, 127 F.2d 440, 445 (8th Cir.), *cert. denied*, 317 U.S. 647 (1942); N. LATTIN, R. JENNINGS, R. BUXBAUM, *CORPORATIONS CASES AND MATERIALS*

A. An Analysis of the Current Subordination Doctrine

Examination of two border-line cases will show that the present approach to the issue of subordination of the claims of a corporation in the bankruptcy of a related corporation is unsatisfactory. First, in *Comstock v. Group of Institutional Investors*³⁰ the Supreme Court upheld, by a five to four majority, the claim of the Missouri Pacific Railway Company (Mopac) in the assets of its subsidiary, the New Orleans Texas and Mexico Railway Company, in reorganization proceedings involving both corporations. The claim, as described by the dissenting justices, was for: (1) advances by Mopac to the New Orleans that were used almost immediately to pay dividends back to Mopac; (2) a debt, assumed by the New Orleans, which another subsidiary had allegedly owed to Mopac, although its obligation to pay was questionable; and (3) loans that had been used to acquire certain feeder lines that were arguably of little benefit to the New Orleans, but were probably of use to other lines in the Mopac system.³¹ The majority held that domination by the parent could not by itself require subordinating its claim, but would warrant subordination if coupled with a breach of fiduciary duty to the subsidiary. In this case, the corporate law authorized the payment of dividends under the circumstances, and Mopac had not been unjustly enriched by the transactions. Moreover, the majority accepted the finding of the lower courts that Mopac had administered the affairs of the New Orleans in good faith and to its overall benefit; accordingly the claims of the parent were allowed full participation in the reorganization.³²

The four dissenting justices argued that Mopac's "good faith" alone did not justify the allowance of its claim; the transactions creating the debt, they stated, had to be essentially fair to the controlled corporation—that is, in the nature of an arm's length bargain. Applying this standard, the dissenters found that the portion of the claim based on the loan used to make dividend payments should have been subordinated because Mopac's cash position was unaffected by the transaction while the New Orleans acquired a liability without an offsetting benefit. Further, they found that Mopac's claim on the transferred debt should be subordinated because the transaction benefited only Mopac; it acquired a more

153 (4th ed. 1968). The parent corporation does not, however, share the perspective of other creditors.

³⁰ 335 U.S. 211 (1948).

³¹ *Id.* at 240-51.

³² *Id.* at 228-30.

secure debtor in the New Orleans while the New Orleans became liable for another's debt. The third claim—for loans used to acquire feeder lines—was permissible in the dissenters' view since the decision to acquire the lines had been essentially a matter of business judgment, and the New Orleans could make the acquisition since it was a holding company in the Mopac system.³³

The second case is *Gannett Co. v. Larry*,³⁴ in which Gannett, a newspaper publisher, purchased the stock of a paper manufacturer. This business, operated as a subsidiary, was then partially converted into manufacturing newsprint in order to protect the parent publishing company against an expected future shortage of newsprint. When the shortage failed to materialize and Gannett realized that the business could never be operated profitably, it stopped the infusion of funds and the subsidiary filed a voluntary bankruptcy petition. When Gannett presented its claim for advances made to the subsidiary, the court subordinated the claim to those of other creditors. The rationale for the court's decision was that the paper company had been operated for the benefit of Gannett and thus it never had an opportunity to establish an independent business with the potential to be profitable.

The distinction between these two cases is elusive indeed. To be sure, the Court in the *Comstock* case did find that Mopac acted in good faith and that its stewardship was on the whole beneficial to the New Orleans. But this seems equally true of Gannett: accurate records were kept, funds were not commingled, and assets were not removed from the subsidiary. In fact, after it became clear that there would be no shortage of newsprint, Gannett poured considerable additional funds into the paper company in an attempt to make it profitable—even though such expenditures were probably unjustified from an investment standpoint. One is therefore at a loss to understand what "good faith" means in this context. The Supreme Court explains its determination of "good faith" as a sort of factual finding which is largely immunized from review. But as a governing concept, it seems to lack significance.

While there is no question that Gannett ran the subsidiary with an eye to its own benefit, it is also relatively clear that Mopac managed its subsidiaries with a view toward achieving the maximum profitability of the overall system, and there is no evidence whatever that Mopac made decisions that would favor the subsidi-

³³ *Id.* at 237-51.

³⁴ 221 F.2d 269 (2d Cir. 1955). Herzog and Zweibel regard this case as on the "outermost periphery" of subordination cases. Herzog & Zweibel, *supra* note 24, at 111.

ary at the expense of the Missouri Pacific. The majority in the *Comstock* case clearly recognized that the transactions in question did not benefit the subsidiary and thus they adopted a concept of "overall benefit" to the subsidiary from its relationship with the parent to cover their tracks. But, as in the *Gannett* case, the net result of all the "beneficial" activities was that the New Orleans went from solvency to insolvency while under Mopac's control. Indeed, the *Gannett* case may even be stronger than *Comstock* since the result of Gannett's transactions with the subsidiary was to infuse new cash into the paper company; two of the Missouri Pacific transactions—the loan used to pay dividends and the debt assumption—had no such effect, and the New Orleans received only the amorphous benefit of membership in the Mopac system.

One may legitimately ask, therefore, what Gannett did wrong that Mopac did right. It was certainly rational for Gannett to acquire the newsprint company and certainly rational for it to advance funds to that company. It was probably irrelevant whether the funds were placed in the subsidiary in the form of capital or loans. From Gannett's point of view, it was presumably a matter of indifference whether the subsidiary was profitable or not since the main purpose in acquiring it was not to earn income (although that undoubtedly would have been welcome), but rather to ensure against a shortage of newsprint. Of course Gannett controlled the subsidiary—the entire transaction would have made no sense if it had not.

It is not clear how the *Comstock* case differs. From the evidence it appears that the railroad systems of the New Orleans and its subsidiaries were intertwined with those of the Missouri Pacific; the Missouri Pacific advanced funds to subsidiaries of the New Orleans lacking adequate capital to make necessary improvements; the New Orleans declared a dividend, desirable for Mopac, but highly questionable in terms of the New Orleans' own financial condition; and the New Orleans purchased certain deficit-producing rail lines, unrelated to its existing lines, for the benefit of other parts of the Missouri Pacific system.

In both *Gannett* and *Comstock*, therefore, the parent corporations acted rationally by seeking to use the subsidiaries to benefit the entire enterprise. The different results in the two cases may perhaps be explained by the more heavyhanded nature of Gannett's use of its subsidiary. The Mopac system possessed a highly complex corporate structure—the New Orleans was itself a holding company within that structure. Gannett, on the other hand, evidently possessed only the one, recently acquired subsidiary. Instead of operating the newsprint facilities through the subsidiary, Gannett could

have absorbed them into its own asset pool. If the subsidiary's assets had been merged into Gannett, Gannett alone would have borne all the subsidiary's losses. The court may have reasoned that, given the possibility of this alternative means of securing newsprint "insurance" for the parent's main line of business, it would be unfair for Gannett's claims to compete in bankruptcy with those of the subsidiary's other creditors. In sum, the only explanation for the cases is that the attempt to benefit the enterprise was more blatant, the detriments to the subsidiary more apparent, and the outcome more disastrous.³⁵

The same ad hoc determination of fairness can be seen in the legion of cases involving attempts to subordinate or disallow the claims of a controlling corporation because it "undercapitalized" the now bankrupt subsidiary.³⁶ As noted above,³⁷ the determination of what constitutes adequate capitalization must be made without any real guidelines: state corporation statutes do not impose more than minimum capitalization requirements and the practical importance of capitalization is virtually non-existent where the subsidiary can rely on related corporations to infuse new funds when necessary. The amount of funds contributed that the owners wish to treat as "capital" will depend on many factors, such as tax considerations, the necessity of showing a certain capitalization in order to qualify for loans, and the risks inherent in the business. On the whole, the tendency is to keep "capital contributions" to a minimum, both for tax reasons and in order to retain flexibility in future investment decisions (since money never invested cannot be lost). Moreover, if the claims of the parents and affiliates are generally subordinated because of undercapitalization, the only result will be to add a new consideration to the decision: the amount of debt that, in light of capital, the bankruptcy court is likely to tolerate without subordination. The addition of such a consideration is completely unrelated to an appraisal of the needs of the business, puts a premium on planning and good guessing, and fails to promote any policy favored by either the corporate law generally or the Bankruptcy Act in particular.

As these cases demonstrate, the current approach to subordination makes little sense in terms of the business considerations that

³⁵ While the New Orleans was reorganized, Gannett's subsidiary had to be liquidated in straight bankruptcy proceedings.

³⁶ These cases are discussed in detail, without reconciliation, in E. LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* 146-51 (1936). See also Herzog & Zweibel, *supra* note 24, at 93-96.

³⁷ See note 9 *supra*.

lead to the formation of subsidiaries and affiliates. Control by, and benefit to, the parent or affiliate and even withdrawal or commingling of assets are entirely natural from a business point of view. The existing law seems to set up the subsidiary as an entity in a Platonic world of ideas and assume that it has both a will and *raison d'être* of its own. It follows therefore that each corporation will attempt to earn a profit for itself, govern itself, and follow an existence distinct from that of its owners. In reality, a subsidiary or affiliate has no such existence apart from the enterprise owners, and one would expect the owners to manipulate all the entities within the enterprise to maximize the profit-making potential of the whole.

It is clear from the foregoing that a uniform rule of subordination or nonsubordination is required in order to reflect the realities of corporate organization and to do away with the marshalling of irrelevant factors as aids to decision-making.³⁸ My preference is for outright subordination on the ground that all funds placed by a parent or affiliate in a related firm are based on the expectation of ultimate profit and are thus by nature distinguishable and distinct from the claims of creditors who lack an equity interest.³⁹ But more important than any particular rule is a penetration of the mists referred to by Justice Cardozo and an end to meaningless verbal fencing.

Some authorities have reached a result that, in many cases, will approximate a rule of outright subordination. They have suggested that to differentiate between risk capital that must be subordinated and a bona fide loan, the court should ask whether, under the same circumstances, an outside lender would have loaned the funds on the same terms as the claimant.⁴⁰ Almost invariably, the

³⁸ Bayne states flatly that *Deep Rock* should be abandoned as incapable of "accurate and intelligent application to facts and circumstances in litigation." Bayne, *The Deep Rock Doctrine Reconsidered II*, 19 *FORDHAM L. REV.* 152, 181 (1951). Rembar approaches this conclusion, but backs off. Rembar, *supra* note 24, at 915, 921. Prior to the *Deep Rock* decision other commentators expressed the opinion that no middle course seeking to subordinate only in certain instances would be practical. See Note, *Creditors' Rights Upon Insolvency of a Parent Corporation or Its Instrumentality*, 46 *HARV. L. REV.* 823, 828 (1933); E. LATTY, *supra* note 36, at 151-53.

³⁹ While this conclusion is somewhat inconsistent with the Supreme Court cases cited earlier, *supra* notes 30 & 34, some courts have apparently reached the same result. See *International Tel. & Tel. Corp. v. Holton*, 247 F.2d 178 (4th Cir. 1957); *In re Loewer's Gambrinus Brewery Co.*, 167 F.2d 318 (2d Cir. 1948). The Second Circuit explicitly abandoned its path-making decision in *Gambrinus* in light of the *Comstock* case, Judge Frank noting that the "strict rule" was compelled to yield. *Gannett Co. v. Larry*, 221 F.2d 269, 275 (2d Cir. 1955). But see *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957) (L. Hand, J., dissenting), where the court applied the strict test in a tax case.

⁴⁰ See *In re Trimble Co.*, 479 F.2d 103, 116 (3d Cir. 1973); *In re Hugh M. Morris, Trustee*

answer would be negative, indicating subordination. The essence of such a test is that if a commercial lender would have made the advance, then it was unnecessary for the parent or affiliate to "invest" its own funds to secure the benefits originally sought in organizing the subsidiary or affiliate, and therefore the advances may properly be characterized as true loans. In fact, a parent or affiliate investing its own funds acts irrationally if it does not consider whether borrowing from a third party would maximize the return on funds invested in the entire enterprise. Thus, in most cases involving the subordination issue the stockholders will have "lent" funds that no commercial lender would have considered advancing.⁴¹ Any test based on an analysis of what the parent would have done in an arm's length transaction would yield the same results as one of outright subordination.

B. The Proposed Bankruptcy Act

Section 4-406(a)(2) of the Proposed Bankruptcy Act⁴² directs subordination of the secured or unsecured claims of an officer, director or affiliate of the debtor. Section 1-102(4) defines "affiliate" to include a person who directly or indirectly controls 20 percent of the voting power of the debtor, and section 1-102(34) defines "person" to include a corporation. A corporation is also an "affiliate" when the same group owns 20 percent or more of the voting power of both the debtor and the related corporations. Thus, the claims of both parent corporations and affiliated corporations, as I have used that term, would be subordinated under the proposed Act.

It can only be assumed that the draftsmen of the Act were attuned to the sort of considerations outlined above when they made their recommendation since neither the Commission's Report nor the notes to its statutory recommendation provide any clue explaining this significant departure from present doctrine.⁴³ Such an omission is particularly surprising in the light of the extensive analytic comments that accompany many of the other recommended changes.

of Midland United Co., SEC Holding Co. Act Release No. 5317A, October 25, 1944; Rembar, *supra* note 24, at 916; Note, *Inadequately Capitalized Subsidiaries*, 19 U. CHI. L. REV. 872, 874 (1952).

⁴¹ See *Small v. Williams*, 313 F.2d 39, 42 (4th Cir. 1963) (corporation may have to borrow from shareholders when it cannot obtain credit from banks); *Stuart v. Larson*, 298 F. 223, 228 (8th Cir. 1924) (dictum).

⁴² The Proposed Bankruptcy Act was introduced first as H.R. 10792, 93d Cong., 1st Sess. (1973), and then re-introduced as H.R. 31, 94th Cong., 1st Sess. (1975).

⁴³ REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES - PART I 214 & n.208 (July 1973); *id.* - PART II, § 4-406, Note 3.

One valuable by-product of the Commission's recommendation, however, will be to still any lingering doubts about the power of the bankruptcy court to direct subordination. Some years ago, Professor Hill wrote a much cited, but little followed article in which he suggested that *Erie* considerations might apply to the subordination issue and that claims could therefore only be subordinated when in furtherance of some federal bankruptcy policy.⁴⁴ Professors Moore and Countryman, in contrast, have seen in the Bankruptcy Act broad latitude for the bankruptcy court to juggle the equities of competing claims.⁴⁵

The proposed Act resolves this uncertainty by providing explicit bankruptcy authority for subordination by the bankruptcy court. This provision would be invalid only if the constitutional bankruptcy authority was held not to authorize such a provision. Since not even the most ardent *Erie*-ists have contended that Congress lacks the authority to legislate on the subordination issue, one can assume that this issue has been resolved—if, of course, the Act is adopted with this provision.

III. PIERCING THE CORPORATE VEIL TO HOLD NONBANKRUPT CORPORATIONS LIABLE FOR DEBTS OF THEIR BANKRUPT SUBSIDIARIES AND AFFILIATES

Whether or not the claims of related corporations are subordinated in bankruptcy, the bankrupt's general creditors may attempt to reach the assets of related companies in order to satisfy their claims fully. Frequently, such an attempt is complicated by the need to consider the rights of creditors of the non-bankrupt related corporation that might be adversely affected by the veil piercing. To simplify the present discussion, however, it will be assumed that

⁴⁴ Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013 (1953).

⁴⁵ 3A W. COLLIER, BANKRUPTCY ¶ 63.08, at 1825-26.1 n.1; ¶ 65.06 (Moore, 15th ed. 1974); Countryman, *The Use of State Law in Bankruptcy Cases (Part I)*, 47 N.Y.U.L. REV. 407 (1972). See also Herzog & Zweibel, *supra* note 24, at 84. Such authority has been found in one or more of the following sections: § 2a(2) which empowers the bankruptcy court to allow, disallow, or reconsider claims; § 57d which also gives the court the power to disallow claims; § 57k which provides that claims already allowed may be reconsidered and rejected in whole or in part "according to the equities of the case," implying that the power to disallow the claims at the beginning of the action on equitable grounds exists a fortiori; and § 2a which gives the bankruptcy court equitable jurisdiction.

The jurisdiction issue has arisen again with the attempt to subordinate claims based on unconscionable contracts; the courts that have subordinated such claims have relied on the status of the federal bankruptcy courts as courts of equity. See *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864 (E.D. Pa. 1966); 67 COLUM. L. REV. 583 (1967). See generally Gordon, *Unconscionability in Bankruptcy: The Federal Contribution to Commercial Decency*, 66 NW. U.L. REV. 741 (1972).

such related corporations have sufficient assets to ensure payment of their own creditors' claims.

A. Source of Authority for Veil Piercing in Bankruptcy Proceedings

Although several bankruptcy cases have suggested that a parent could be liable for the debts of its subsidiary, the legal basis for this conclusion has not been carefully explored. In particular, a trustee's authority under the Bankruptcy Act to attempt to pierce the veil of the parent on behalf of the bankrupt subsidiary's creditors is unclear. One of the few cases in which the problem was raised was *Consolidated Rock Products Co. v. DuBois*.⁴⁶ In that case, creditors of two subsidiaries challenged the fairness of a reorganization plan allowing the stockholders of the parent to participate in a new company organized to receive all the assets of the parent and subsidiary corporations, and specifically, the failure of the plan to recognize any liability of the parent to the creditors of the subsidiary.

As an alternative holding,⁴⁷ Justice Douglas suggested that the parent could be held liable to creditors of the subsidiaries because of the enterprise-oriented nature of the operations conducted; by freely commingling assets and disregarding the formalities of separate corporate organization, the parent had, in effect, treated the subsidiaries "as mere departments of its own business."⁴⁸ As authority for the proposition that the assets of the parent may be reached under these circumstances, Justice Douglas cited a number of cases in which individual tort and contract creditors had been allowed to pierce the corporate veil under state or admiralty law.⁴⁹ He did not, however, pinpoint the source of the trustee's authority to press the creditor's claims against the parent in a bankruptcy proceeding.

There are four possible bases for such authority: first, the parent's conduct may give rise to an actionable claim in the subsidiary

⁴⁶ 312 U.S. 510 (1941).

⁴⁷ Justice Douglas also found that the trustee was empowered by the then § 77B(b) of the Bankruptcy Act to press claims on behalf of the subsidiaries' creditors against the parent on the basis of an "operating agreement" among the constituent corporations. The agreement had vested total control of all the assets of the constituent companies in the parent; under the agreement the parent had accumulated \$5 million in debts to its subsidiaries. If even a fraction of this claim had been allowed, the equity interests in the parent corporation would have been completely eliminated under the "absolute priority" doctrine. Under these circumstances, the Court held that the fairness of the plan could not be evaluated until the subsidiaries' claims had been adjudicated.

⁴⁸ 312 U.S. at 524.

⁴⁹ This holding ignored the fact that admiralty is not supposed to possess equitable powers.

that passes to the subsidiary's trustee pursuant to section 70a(5) of the Bankruptcy Act;⁵⁰ second, the authority to pierce the veil may derive from the general equitable powers of the bankruptcy court; third, the power may be based on section 70c of the Act⁵¹ which gives the trustee the status of certain types of creditors; and fourth, the authority may be a corollary of the requirement that a plan of reorganization be fair and equitable.⁵² Without extended discussion of the fourth alternative, it should be noted that there is no indication in Justice Douglas' opinion that this piercing authority is limited to reorganization cases; indeed, his citation of nonbankruptcy cases suggests the contrary. Moreover, the same doctrine has generally been thought applicable in straight bankruptcy cases.⁵³ Therefore, it is necessary to look to one of the first three alternatives.

1. *Section 70a(5) of the Bankruptcy Act.* This section vests the trustee of a bankrupt company with all of the bankrupt's transferable or leviable causes of action. Section 70a(5), however, gives the trustee only those causes of action that belong to the debtor corporation, not the remedies of a general creditor. Therefore, to reach the assets of the parent of the bankrupt subsidiary under this section, the trustee would have to show that the parent had committed a wrong to its subsidiary in its organization or operation that was actionable at the instance of the subsidiary itself.

It is difficult to discern any basis for a cause of action arising from the conduct of the parent vis-à-vis the subsidiary, without regard to its effect on creditors. Assume, for example, that the subsidiary is undercapitalized. The parent has no corporate law obligation to adequately capitalize the subsidiary,⁵⁴ and given the apparent legislative sanction of minimum capitalization, it would be exceedingly difficult to argue that a common law duty of adequate capitalization should be imposed. The subsidiary's claim would be equally questionable if the parent had used its control to destroy the subsidiary's chances to be profitable. Any claim that did exist would have to be based on the fiduciary duty of the majority shareholder toward a minority, rather than on a duty to the corporation as such.⁵⁵ Finally, although the commingling of assets and properties

⁵⁰ 11 U.S.C. § 110(a)(5) (1970).

⁵¹ 11 U.S.C. § 110(c) (1970).

⁵² Bankruptcy Act Ch. X, art. XI, § 221(2), 11 U.S.C. § 621 (1970).

⁵³ See *Long v. McGlon*, 263 F. Supp. 96 (D.S.C. 1967); *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W.D. Ark. 1951).

⁵⁴ See note 9 *supra*.

⁵⁵ Cf. *Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942); *Southern Pac. Co. v. Bogert*, 250 U.S. 483 (1919); *Kavanaugh v. Kavanaugh Knitting*

may give rise to a corporate action for an accounting, it is doubtful that it creates any affirmative obligation beyond that of disentanglement. As these examples demonstrate, it is difficult to identify any right of action that the trustee may inherit from the bankrupt subsidiary by virtue of section 70a(5).

2. *Federal Bankruptcy Law.* There appears to be no basis apart from the specific sections of the Bankruptcy Act to grant the trustee an affirmative right of action against a parent. Such a piercing of the veil is sharply distinguishable from the attempt to subordinate the claim of a controlling shareholder. The general equitable powers of the bankruptcy court, buttressed by specific statutory provisions,⁵⁶ provide at least an arguable basis for federal bankruptcy hegemony over the subordination issue. The power to pierce the corporate veil, however, involves not the allowance or ranking of claims, but rather the addition of assets to the bankrupt's estate. Such an enlargement of the estate on behalf of the bankrupt's creditors cannot be justified on the basis of the court's equitable powers, since it would conflict with the spirit of the specific property-passing provisions of section 70a and the provisions of sections 60, 67, and 70⁵⁷ that give the trustee various rights against the creditors of the bankrupt.

3. *Section 70c.* State law undoubtedly authorizes creditors of a debtor subsidiary to reach the assets of the parent corporation in certain cases. Section 70c of the Bankruptcy Act accords the trustee the status of a judgment creditor, execution creditor, and a creditor holding a lien on the bankrupt's property as of the date of the bankruptcy. The question is whether the status conferred on the trustee by section 70c authorizes him to assert an individual creditor's rights under state law to reach the assets of the parent to pay that creditor's claims.

To analyze the power of the trustee in this regard, it is necessary to recount some ancient history. Prior to the Bankruptcy Act of 1898,⁵⁸ insolvency proceedings were the province of the several states. Commonly, state statutes and/or state equity precedents authorized the appointment of an insolvency receiver who was charged with the responsibility of collecting the corporation's assets and distributing the proceeds to creditors. Three general categories of property passed to the receiver: first, property in which the debtor

Co., 226 N.Y. 185, 123 N.E. 148 (1919); H. HENN, *LAW OF CORPORATIONS* § 240 (1970).

⁵⁶ See note 45 *supra*.

⁵⁷ 11 U.S.C. §§ 96, 107, 110 (1970).

⁵⁸ Act of July 1, 1898, ch. 541, 30 Stat. 544-66.

had some legal or equitable interest; second, causes of action belonging to the debtor; and third, certain property which the debtor was estopped from claiming, such as property fraudulently conveyed or illegally paid dividends. Because of his essentially subrogational position, the receiver was not permitted to prosecute rights of action belonging solely to creditors of the debtor.

The impact of this distinction was felt most strongly in connection with various statutory rights of action of creditors against the directors or shareholders of insolvent corporations. Frequently, there was a right of action if (1) the shareholders had not paid their complete stock subscriptions; (2) the shareholders had received stock that had a higher par value than the value of the property or services contributed or the amount actually paid (watered or discount stock); (3) the shareholders had received shares without paying any consideration (bonus shares); (4) the directors paid dividends out of, or otherwise impaired, capital; and (5) shareholders might be assessed up to the par value of their shares. Many of the relevant statutory provisions condemned the impairment of capital without stating what would happen if the corporation took the prohibited action. As might be expected, courts differed on the question of who might sue for a violation of these provisions and, in particular, on the question of whether a receiver might bring the action. Some courts limited the right of action to the creditors of the corporation, while others extended such a right to the receiver as well. To some extent, the result seems to have been dictated by the attitude of the particular court toward the purpose of capitalization requirements. Thus, most courts that viewed capital as a "trust fund for the benefit of creditors" tended to permit suits by receivers.⁵⁹ On the other hand, most courts adopting the "holding out" or fraud theory limited the action to specific creditors—even though there is evidence that they did not actually require individual creditors to prove reliance.⁶⁰ For our purposes, however, it is important

⁵⁹ See *R.H. Herron Co. v. Shaw*, 165 Cal. 668, 133 P. 488 (1913) (receiver allowed to assert claim for unpaid stock because the "trustee" cannot release stockholders from their obligation and therefore the claim remains an asset of the corporation). See also *Sawyer v. Hoag*, 84 U.S. (17 Wall.) 610 (1873); H. BALLANTINE, *supra* note 10, § 349, at 805. The receiver stands in the shoes of the corporation and thus may assert any right belonging to the corporation. See J. HIGH, *RECEIVERS* § 315 (4th ed. 1910); 13A W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS*, § 6495 (Wolf ed. 1961); 12 *id.* § 5437 (Wolf ed. 1971); 3 *id.* § 1277 (Wolf ed. 1965); 16 *id.* § 7850 (Wolf ed. 1962).

⁶⁰ In *Hospes v. Northwestern Mfg. & Car Co.*, 48 Minn. 174, 192, 50 N.W. 1117, 1121 (1892), a much-cited decision rejecting the trust fund theory in favor of the holding out theory, the court established a rebuttable presumption that all subsequent creditors had relied on the credit of the corporation. For a criticism of this doctrine see Ballantine,

to emphasize that, once a court decided that the particular right of action was "personal" to the creditors, the unanimous result was to deny the receiver standing to vindicate that right.⁶¹

The state-created doctrine of "personal" creditor rights, unenforceable at the instance of insolvency receivers, was largely retained by the federal courts in interpreting the powers of a trustee under the Bankruptcy Act, even though the Act was otherwise construed to give trustees powers not enjoyed by state receivers. For example, section 70a(5) of the 1898 Act gave the trustee title to property that the bankrupt might have transferred or that might have been levied upon by his creditors. On its face, this provision simply clothed the trustee with power equivalent to that of the insolvency receiver under state law. Yet the Supreme Court interpreted the reference to creditors' levies in 70a(5) as giving the trustee rights to any of the bankrupt's property that could have been reached by the bankrupt's general creditors.⁶² Under the literal language of 70a(5) or its state law equivalent, such property would not have passed to the trustee or the state insolvency receiver because the bankrupt itself might have been estopped to assert title as against a third party transferee or pledgee.⁶³

In 1910, Congress added section 47a(2),⁶⁴ the predecessor of the strong-arm clause now contained in section 70c of the Act, giving the trustee a judicial lien on all property coming into the possession of the bankruptcy court and the status of a judgment creditor holding an execution returned unsatisfied as to the bankrupt's property not within the custody of the bankruptcy court. Section 47a(2) thus expanded the judicial gloss on section 70a(5) by giving the trustee the rights of a lien and execution creditor, in addition to those of a general creditor.⁶⁵

Stockholders' Liability in Minnesota, 7 MINN. L. REV. 79, 89-92 (1923). On the power of a receiver to assert creditor rights under a holding out theory, see generally H. BALLANTINE, *supra* note 10, § 353 at 814; H. HENN, *supra* note 55, § 171.

⁶¹ See, e.g., *Minneapolis Baseball Co. v. City Bank*, 66 Minn. 441, 69 N.W. 331 (1896); Note, *Power of Receiver for Corporations to Assert Causes of Action Vested Solely in Creditors*, 46 YALE L.J. 1229 (1937) [hereinafter cited as YALE NOTE]; 39 HARV. L. REV. 768 (1926).

⁶² See *Knapp v. Milwaukee Trust Co.*, 216 U.S. 545, 557 (1910); *Security Warehousing Co. v. Hand*, 206 U.S. 415, 422 (1907). These cases have been criticized on the ground that § 70a(5) was designed simply to give the trustee title to the bankrupt's property. Countryman, *supra* note 45, at 433-437.

⁶³ Most frequently, trustees used § 70a(5) in this connection to invalidate secret transfers and pledges that were invalid as to general creditors of the bankrupt for reasons such as lack of recording and failure to transfer possession.

⁶⁴ Act of June 25, 1910, ch. 412, § 8, 36 Stat. 840.

⁶⁵ Such an expansion was thought necessary because of the Supreme Court's decision in

Relying on their expanded powers under section 70a(5) and 47a(2), trustees soon began to pursue corporate directors and stockholders for various capital derelictions. The response of the courts to these attempts was basically twofold. First, the only rights of action passing to the trustee pursuant to section 70a(5) were those that belonged to the corporation.⁶⁶ If, for example, a state statute or common law rule provided that directors, officers, or stockholders were personally liable to the corporation itself for the failure to collect paid-in capital, overvaluation of property contributions, payment of impairing dividends, or the like, such a right could be enforced by the corporation.⁶⁷ But section 70a(5) did not empower the trustee to bring such actions on behalf of creditors in cases where the corporation had no analogous right. Second, when the trustee was asserting the rights of general creditors under 70a(5), or lien or execution creditors under 47a(2), it was necessary to identify specific property of the bankrupt in order to employ these sections to avoid the interests of third party transferees, mortgagees, and pledgees in that property. Thus an undistributed middle—cases involving rights of action belonging only to creditors but not relating to specific property—was left outside the coverage of the Bankruptcy Act.⁶⁸

This undistributed middle was, of course, equivalent to the pre-1898 learning denying equity receivers the power to bring actions “personal” to creditors. In fact, the doctrine was so well entrenched that the passage of the Bankruptcy Act of 1898, the 1910 amendments, and the clarifying amendments of 1950 and 1952⁶⁹ had little

York Mfg. Co. v. Cassell, 201 U.S. 344 (1906), holding that property that could be attacked by the bankrupt's lien creditors, but not by his general creditors, did not pass to the trustee. See 45 CONG. REC. 2277 (1910).

⁶⁶ Although the trustee's power to enforce corporate causes of action pursuant to § 70a(5) was not specified in that section until 1938, that power had been well recognized prior to the amendment. See 4A W. COLLIER, *supra* note 45, ¶ 70.28, at 380; Countryman, *supra* note 45, at 466.

⁶⁷ See *Harrigan v. Bergdoll*, 270 U.S. 560, 564 (1926); *Bayliss v. Rood*, 424 F.2d 142, 146 (4th Cir. 1970); *Gochenour v. Cleveland Terminals Bldg. Co.*, 118 F.2d 89, 93 (6th Cir. 1941); *In re Remington Auto & Motor Co.*, 153 F. 345, 347 (2d Cir. 1907); *Babbitt v. Read*, 215 F. 395, 412 (S.D.N.Y. 1914), *aff'd*, 236 F. 42 (2d Cir. 1916), *cert. denied*, 243 U.S. 648 (1917); *Falco v. Kaupisch Creamery Co.*, 42 Ore. 422, 70 P. 286 (1903); *Irving Trust Co. v. Gunder*, 234 App. Div. 252, 254 N.Y.S. 630 (1932); 4A W. COLLIER, *supra* note 45, ¶ 70.29[2], [3].

⁶⁸ See *In re Associated Oil Co.*, 289 F. 693 (6th Cir. 1923); *Seegmiller v. Day*, 249 F. 177 (7th Cir. 1918); *In re Jassoy Co.*, 178 F. 515 (2d Cir. 1910); *In re Huffman-Salver Roofing Paint Co.*, 234 F. 798 (N.D. Ala. 1916); *State Bank of Commerce v. Kenney Band Instrument Co.*, 143 Minn. 236, 173 N.W. 560 (1919) (dictum); *Hicklin v. Cummings*, 211 Iowa 687, 234 N.W. 530 (1931). See generally 4A W. COLLIER, *supra* note 45, ¶ 70.29[2], [3].

⁶⁹ The provisions of § 47a(2) were shifted to § 70c in 1938, Act of June 22, 1938, ch. 575, § 70, 52 Stat. 881. The amendment of 1950, Act of March 18, 1950, Pub. L. No. 81-461, § 64

or no discernible effect.⁷⁰ No court viewed these legislative developments as an opportunity to reevaluate the old learning, and none focused on the question of whether the outcome was rational in terms of the trustee's role under the Act and the other powers conferred on him by the Act.⁷¹

Since the bankruptcy court's view of the trustee's power vis-à-vis the personal rights of creditors was largely dictated by the learning developed in state insolvency proceedings prior to 1898, it seems reasonable to ask why the state courts so uniformly denied insolvency receivers the power to vindicate these personal creditor rights. There certainly was no objection to permitting the receiver to exercise the rights of creditors because the debtor itself might have been estopped from pursuing the action; state courts readily permitted receivers to trace fraudulently conveyed property and illegally paid dividends into the hands of transferees regardless of the debtor's right to recover the property.⁷² In some instances, the explanation may lie in the fact that, under the "holding out" theory, creditors could bring actions based on capital derelictions only if they had relied on the balance sheet and therefore on the apparent capital of the corporation. Since only certain creditors had this right to recovery, it is understandable that the receiver was not permitted to enforce the cause of action on behalf of all creditors.⁷³ Where, how-

Stat. 2, changed the status of the trustee, giving him the rights of a lien creditor on all property of the debtor whether or not in the control of the court. The 1952 amendments clarified the language of the section, Act of October 7, 1952, ch. 579, 66 Stat. 430. While the number of cases involving the question of the trustee's power to assert "personal" creditor rights became rather sparse, the few that were reported continued to view these rights of action as not passing to the bankruptcy trustee. See *In re Petroleum Corp. of America*, 417 F.2d 929, 934 & n.11 (8th Cir. 1969); *Fitzgerald v. Marshall*, 161 F. Supp. 470 (D. Colo. 1958).

⁷⁰ See, e.g., *Courtney v. Georger*, 228 F. 859 (2d Cir. 1915), *cert. denied*, 241 U.S. 660 (1916); *In re Jassoy Co.*, 178 F. 515 (2d Cir. 1910); *Courtney v. Croxton*, 239 F. 247 (6th Cir. 1917); cf. *Smalley v. Bernstein*, 165 La. 1, 18, 115 So. 347, 352 (1927), *cert. denied*, 277 U.S. 599 (1928) (citing no authority). See *Morris v. Sampsel*, 224 Wis. 560, 272 N.W. 53 (1937), *cert. denied*, 305 U.S. 608 (1938); *In re Huffman-Salvar Roofing Paint Co.*, 234 F. 798, 803 (N.D. Ala. 1916).

⁷¹ A few decisions disagreed with the general trend of authority and held that § 47a(2) empowered the trustee to enforce causes of action belonging to creditors. These opinions, however, neither analyzed the older cases, nor focused on the legislative history of § 47a(2), nor distinguished the substantial number of holdings to the contrary. See *In re Dalton Elec. Co.*, 7 F. Supp. 465, 468 (S.D. Miss. 1934); (alternative holding); *Grand Rapids Trust Co. v. Nichols*, 199 Mich. 126, 165 N.W. 667 (1917); *Bernard v. Carr*, 167 N.C. 481, 83 S.E. 816 (1914).

⁷² See *Mackall v. Pocock*, 136 Minn. 8, 161 N.W. 228 (1917); *Minneapolis Baseball Co. v. City Bank*, 66 Minn. 441, 443, 69 N.W. 331, 333 (1896) (dictum); *Minnesota Thresher Mfg. Co. v. Langdon*, 44 Minn. 37, 46 N.W. 310 (1890); *Rubenstein v. Berch*, 261 App. Div. 265, 25 N.Y.S. 2d 202 (1941); YALE NOTE, *supra* note 61, at 1230-31 (reviewing authorities).

⁷³ See *Seegmiller v. Day*, 249 F. 177, 181 (7th Cir. 1918); *Courtney v. Croxton*, 239 F. 247, 250 (6th Cir. 1917).

ever, the substantive law did not require reliance—as in an action to impose shareholder liability in a “trust fund” jurisdiction—another explanation is required.

The most plausible explanation for these cases is that the state courts were attempting to protect the basic principle of limited liability for corporate shareholders against an open-ended attack by insolvency receivers. In an action to recover property fraudulently conveyed or dividends illegally paid, it is not harsh to hold the stockholder liable because his liability is limited to property or funds received gratuitously which appear to have unjustly enriched the stockholder at the expense of the corporation's creditors. But when shareholders who received shares they thought to be fully paid up are asked for additional funds, and a fortiori, when they are assessed for the full par value of their shares by virtue of a statutory provision, they are being asked to pay a liability that (1) was unanticipated; (2) was not bargained for, and indeed that the corporation would be estopped from enforcing; and (3) was far out of proportion to any benefits they received in obtaining the stock.⁷⁴ Such actions undermine the essential premise of limited liability—that a stockholder's risk is limited to his original investment. In denying the receiver the power to enforce creditors' rights in this area and thus limiting relief to those creditors who are willing to bring suit, courts may be attempting to maximize protection for shareholders in accordance with the principle of limited liability.⁷⁵

In 1966, there was a dramatic change in the Bankruptcy Act⁷⁶ that could be the basis for a reassessment of the logic behind a limitation of the trustee's power. Two subsections were added to section 70c giving the trustee new hypothetical statuses: subsection 70c(1) made the trustee a judgment creditor, and subsection 70c(2) made the trustee a creditor with an execution returned unsatisfied.⁷⁷

⁷⁴ See *Seegmiller v. Day*, 249 F. 177 (7th Cir. 1918) (trustee can recover dividends paid from capital from stockholder recipients, but not from directors who assented to payment); *Hilliard v. Lyman*, 138 F. 469, 470 (D. Vt. 1905) (again, protecting directors, the court noting that “[t]here is no limit to liability upwards”). When the creditors sue, they are limited to the amount of their deficiency from the estate of the bankrupt; the receiver, when he is allowed standing to sue, is not so limited. 16 W. FLETCHER, *supra* note 59, §§ 7847, 7848. A recent example of a court trying to protect such persons from the strong arm of the trustee is *In re Petroleum Corp. of America*, 417 F.2d 919, 935 (8th Cir. 1969). This notion finds some support in the variety of defenses available to shareholders when sued by creditors. See generally Bonbright, *Shareholders Defenses Against Liability to Creditors on Watered Stock*, 25 COLUM. L. REV. 408 (1925).

⁷⁵ See *In re Associated Oil Co.*, 289 F. 693, 697 (6th Cir. 1923); *Seegmiller v. Day*, 249 F. 177, 180-81 (7th Cir. 1918); *In re Crystal Spring Bottling Co.*, 96 F. 945, 946 (D. Vt. 1899).

⁷⁶ Act of July 5, 1966, Pub. L. No. 89-495, 80 Stat. 269.

⁷⁷ The trustee's status as a lien creditor on the property of the bankrupt was also moved to subsection 3 of section 70c.

Unlike the former section which gave the trustee a lien on the property of the bankrupt, these subsections do not purport to give the trustee a specific interest in such property; indeed, subsection 70c(2), which gives the trustee the status of a creditor with an unsatisfied execution, contradicts the notion that the trustee has an interest in specific property or in any property at all. Under these new provisions, the trustee's interest arises solely by virtue of his status as a creditor. It would be permissible to infer that, by these new provisions, Congress closed the existing gap that prevented trustees from using creditors' rights and remedies that were not fastened on specific property of the bankrupt, and overruled a considerable amount of the old learning in the process.

The major obstacle to such an inference is the lack of evidence in the legislative history that such a sweeping change was ever contemplated. The stated reason for the addition of subsection 70c(1), giving the trustee the status of a judgment creditor, was to clarify the trustee's power to avoid certain unrecorded tax liens; the stated reason for the addition of subsection 70c(2), giving the trustee the status of a creditor with execution returned unsatisfied, was to enable the trustee to invoke supplementary remedies under state law, such as for the return of property fraudulently conveyed, on behalf of creditors whose judgments were unsatisfied.⁷⁸ There is no hint in the legislative history, nor in the contemporaneous commentary by a number of leading bankruptcy experts who participated in the drafting of the legislation, that the amendments were also intended to reverse the longstanding rule that personal rights of creditors against third parties do not pass to the trustee.⁷⁹

Despite the lack of supporting legislative history, a strong argument can be made that the radical alteration in the language of 70c should permit a construction that would eliminate the old learning on creditors' personal rights. First, the maintenance of the old rule is an anomaly in the context of the broad powers of trustees under the Bankruptcy Act. In addition to giving the property of the bankrupt plus the rights of existing creditors to the trustee, sections 60, 67a, and 70c grant him the power to avoid transfers that no creditor can avoid and sections 67d and 70e give him the power to avoid certain liens and transfers *in toto*, not limited to the amount of the

⁷⁸ See H.R. REP. NO. 686, 89th Cong., 1st Sess. (1965).

⁷⁹ See Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L. REV. 149, 166-71 (1967); Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681 (1967). The effect of the 1966 amendments was left open in *In re Petroleum Corp. of America*, 417 F.2d 929, 935 & n.12 (8th Cir. 1969).

claim of the creditor whose rights the trustee is asserting. Second, there is no intelligent policy reason for maintaining the anomaly of denying certain creditors' powers to the trustee.⁸⁰ If this denial of the trustee's power is, as suggested above, ultimately based on a desire to preserve the principle of limited liability or, perhaps, on a feeling of sympathy for beleaguered directors, a better remedy would be to alter the state substantive provisions that grant the creditors such far-reaching rights. Recent developments in the class action area suggest that the protection afforded shareholders and directors by the rule against trustee enforcement may be severely curtailed in any case by the opportunity under present law for creditors to sue as a class to vindicate their individual rights on a collective basis.⁸¹ Third, since creditors of the bankrupt look to the trustee to represent them in collecting and pursuing claims, they would probably be quite surprised to learn that there is a class of cases in which they must initiate either individual or collective action in order to vindicate their rights.

The importance of this question for our purposes is not, however, to show that the bankruptcy trustee should be able to pursue shareholders and/or directors for improper dividends or the issuance of discount, watered, or bonus shares. Rather this discussion is an attempt to find an authoritative basis for piercing the corporate veil at the instance of the bankruptcy trustee. Section 70c should be adequate for this purpose.⁸² However, a caveat is in order: even if the trustee is granted standing to press the claims of creditors against a parent corporation, the success of that venture will still depend on the substantive provisions of the governing state law.⁸³

⁸⁰ See *State Bank of Commerce v. Kenney Band Instrument Co.*, 143 Minn. 236, 240, 173 N.W. 560, 562 (1919) (dictum); YALE NOTE, *supra* note 61, at 1234-35; H. BALLANTINE, *supra* note 9, at 782-83, 814-16. The authors of the Collier treatise seem to lean in this direction, although it is hard to tell. 4A W. COLLIER, *supra* note 45, ¶ 70.29[3], at 435 & nn.41-42.

⁸¹ FED. R. CIV. P. 23 should facilitate class actions on behalf of creditors. While some class actions in the past were successful, see *State Bank of Commerce v. Kenney Band Instrument Co.*, 143 Minn. 236, 173 N.W. 560 (1919), there were many defects under the older procedures, see YALE NOTE, *supra* note 61, at 1234.

⁸² In *Long v. McGlon*, 263 F. Supp. 96 (D.S.C. 1967), the court relied on the amended version of section 70c to find that the trustee had such power, but did not indicate that the result would have been different under the earlier version. *But cf. In re Petroleum Corp. of America*, 417 F.2d 929, 934 (8th Cir. 1969), stating that trustee's rights under old 70c relate only to "property in which the bankrupt has some interest or as to which the bankrupt might be the ostensible owner"; the court did not consider the effect of the 1966 amendments. The district court pierced the veil in *Eubanks v. Allstate Ins. Co.*, 441 F.2d 7 (5th Cir. 1971), but the basis of that decision was unclear and the Fifth Circuit affirmed on alternative grounds.

⁸³ The use of state law is implicit in the court's opinion in *Long v. McGlon*, 263 F. Supp. 96, 98 (D.S.C. 1967), the only judicial authority on the question. The Proposed Bankruptcy

B. An Analysis of Veil Piercing in the Bankruptcy of a Constituent Corporation

State courts have never been called upon to decide whether a trustee may pierce the corporate veil in order to augment a bankrupt's estate for the benefit of the bankrupt's creditors. They are quite familiar, however, with attempts by single creditors to pierce the veil in order to collect an individual debt. Therefore, to analyze the probable attitude of the states toward the former situation it is necessary to examine first the doctrine of limited liability and the circumstances under which state courts have overridden it at the instance of a single creditor to reach the assets of the stockholders, and then the logical application of this learning to bankruptcy cases. Before pursuing these lines of inquiry, it should be noted that piercing the veil is substantially different in a bankruptcy context than at the behest of a single creditor: in bankruptcy the parent's liability is potentially much greater since it extends to all of the corporation's creditors.⁸⁴

1. *The Policy of Limited Liability.* The origins of the doctrine of limited liability are obscure. The available evidence suggests that it was originally designed to facilitate the organization of businesses requiring more capital than was available from one or a small number of individuals. Limited liability may have been thought necessary to stimulate capital investment by assuring investors that their risk would be limited to their investment; such an assurance would have been especially welcome if the enterprise were to be managed by others.⁸⁵ Another possible explanation is that manufacturers and other mercantile enterprises had simply gained sufficient political clout to obtain limited liability for their owners, without reference

Act would clearly authorize trustees to prosecute actions on behalf of classes of creditors. See BANKRUPTCY COMMISSION REPORT-II, *supra* note 43, § 4-604(b)(2). However, it appears that the major purpose of that provision was to overrule *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972), which denied a reorganization trustee the standing to assert claims of misconduct by an indenture trustee on behalf of one group of bondholders. In contrast, restrictions on trustees' actions against shareholders and directors appear tied in with the underlying rights themselves, and it is questionable whether the proposed Act will alter the governing doctrine as discussed earlier. See BANKRUPTCY COMMISSION REPORT-II, *supra* note 43, § 4-604, note at ¶ 6.

⁸⁴ It should also be noted that the trustee will represent the claims of not only "widows and orphans" but also of creditors who could clearly be expected to look out for themselves.

⁸⁵ See Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts*, 61 HARV. L. REV. 1351 (1948). There has been some suggestion that the fact of limited liability was less important than other benefits of corporate organization. See T. VEBLEN, *ABSENTEE OWNERSHIP* ch. V (1923); Douglas & Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 YALE L.J. 193 (1929). See also Dix, *Adequate Risk Capital: The Consideration for the Benefits of Separate Incorporation*, 53 NW. U.L. REV. 478 (1958).

to its necessity as a stimulus to business organization.⁸⁶ In any event, it is relatively clear that the doctrine of limited liability was envisioned as a protection for individuals who invested in business enterprises. Insofar as the corporation itself could not pay its debts, society at large was to bear the costs of the corporate enterprise. Since state corporation statutes did not contain capitalization requirements or other devices providing some initial protection for creditors, this societal subsidization could prove quite extensive.

Yet the original conception of the operative role of limited liability was quite narrow. There is considerable evidence that the corporation originated as an attempt to organize individuals into a collective body that could act on its own, without regard to all the constituent individuals.⁸⁷ When corporation law was in its formative stages, corporations were of substantial size and were owned by a group of individual stockholders. The one-man or close corporation was a rarity, if it existed at all.⁸⁸ Thus it is doubtful that those who drafted and approved the first corporation statutes contemplated extending limited liability to the "one-man" corporation. In fact, it was not until 1897 that the House of Lords, in the famous *Salomon* case, made it clear that a single proprietor could incorporate his business to achieve limited liability.⁸⁹

Similarly, it is unlikely that the draftsmen of the early corporation statutes intended to permit an additional layer of limited liability for part of a business enterprise through the formation of subsidiary corporations. As a general rule, corporation statutes severely limited permissible corporate activities and did not permit one corporation to own stock in another. While the concept of limited liability was relatively fixed in America by 1830,⁹⁰ Professor Robinson's study of the early formation of holding companies indicates that it was not until 1832 that the first corporation was given authority to hold stock in another corporation, and, until the last years of the nineteenth century, such stock holdings were extremely rare.⁹¹ Be-

⁸⁶ The late Professor Dodd's study of the origin of the doctrine of limited liability in Massachusetts suggests that its original beneficiaries were largely manufacturing or utility enterprises of fairly substantial means. Dodd, *supra* note 85, at 1373.

⁸⁷ See A. BERLE, *STUDIES IN THE LAW OF CORPORATE FINANCE* 1-25 (1928). See generally H. TAYLOR, *LAW OF PRIVATE CORPORATIONS* chs. 1-2 (5th ed. 1902).

⁸⁸ See Cataldo, *supra* note 1, at 474-75 ("It is most doubtful whether the concept of corporate enterprise was ever intended or designed to embrace [the one man company]"); Fuller, *supra* note 9, at 1374 & n.4; I. WORMSER, *FRANKENSTEIN, INCORPORATED* 93-100 (1931); Note, *Judicial Supervision of the One Man Corporation*, 45 HARV. L. REV. 1084, 1089 (1932).

⁸⁹ *Salomon v. A. Salomon & Co., Ltd.*, [1897] A.C. 22.

⁹⁰ See Dodd, *supra* note 85, at 1371.

⁹¹ Robinson, *The Holding Corporation*—1, 18 YALE REV. 390, 400-07 (1910); 2 A. DEWING,

yond this time differential between the development of the concept of limited liability and the growth of the parent-subsidary form of organization, it appears that the original pressure to permit corporations to hold stock in others was not motivated by a desire to obtain limited liability. Rather, large corporations desired this power to expand their empires through the device of stock ownership in other companies, generally competitors.⁹²

The historical background indicates that limited liability was never intended to protect a parent corporation against liability for the debts of its subsidiary. More importantly, the policies justifying limited liability do not require a contrary result: only the entity responsible for the management of the subsidiary (the parent) will be held liable, and therefore a larger group of shareholders will not be held directly responsible for behavior over which they retain only theoretical control. Moreover, no individual stockholder is subjected to risks greater than his original investment.

If limited liability were being considered for the first time, a strong argument could be made that it should not be extended to the corporate parent vis-à-vis its subsidiary. At the present time, however, the principle of limited liability appears to be so ensconced as to preclude such a broad-scale attack. Thus, taking the doctrine of limited liability as given, the problem is to identify the situations in which it should be inapplicable, remembering, of course, that the bankruptcy court will be looking to state law to guide the determination.

2. *Piercing the Veil at the Instance of a Single Creditor.* Although the literature of veil piercing is gargantuan, most of it simply

supra note 1, at 968-69; H. TAYLOR, *supra* note 87, § 130 n.6; *Enterprise Entity*, *supra* note 29, at 344. In 1889, the Illinois Supreme Court declared that a corporation could not, as one of its incidental powers, hold stock in other corporations. *People ex rel. Peabody v. Chicago Gas Trust Co.*, 130 Ill. 268, 22 N.E. 798 (1889). *But see Booth v. Robinson*, 55 Md. 419, 433-34 (1881). It was not until 1889 that New Jersey amended its corporation statute to authorize corporations to hold stock in other corporations; prior to that time, corporations seeking to hold stock in other corporations had to obtain special and individual permission from the legislature. By 1910, only thirteen states had passed statutes definitely authorizing corporations to hold stock in other companies. Robinson, *The Holding Corporation-II*, 19 YALE REV. 13, 29 (1910). *See also* Douglas & Shanks, *supra* note 85, at 194 n.6.

⁹² Since it was frequently not feasible to obtain the assets of competitors directly, the purchase of stock was a necessary mechanism to the same end. Douglas & Shanks, *supra* note 85, at 193; Robinson, *supra* note 91, 18 YALE REV. at 400-07. The Supreme Court probably hastened the use of the parent-subsidary form by appearing to forbid the organization of industrial enterprises by means of a trust, but permitting a similar development by formation of holding companies. *United States v. E.C. Knight Co.*, 156 U.S. 1 (1895). The possibility of avoiding the antitrust laws by means of holding companies was foreclosed, however, by *Northern Sec. Co. v. United States*, 193 U.S. 197 (1904).

describes the various factual patterns that support piercing.⁹³ Devoid of any consistent doctrinal basis, the cases themselves defy any attempt at rational explanation.⁹⁴ This confusion has apparently been produced by a failure to identify what is at stake in a veil piercing case: the very principle of limited liability for the shareholders. As a result, the typical veil piercing case is an exercise in cataloging a number of factors in order to reach a normative conclusion that piercing is or is not appropriate.⁹⁵

Since state corporation laws allow limited liability without any exceptions, the question may well be asked why veil piercing should be permitted in any case. It could be argued that the legislature's clear intention to be generous in according this privilege is evidenced by the minimal requirements for setting up a corporation.⁹⁶ Unless there were an invalid incorporation or some basis for an estoppel, limited liability would be an iron-clad rule.

Although the origins of the doctrine of veil piercing are obscure, a literal application of the principle of limited liability has not been adhered to by the courts. Virtually all courts have demonstrated a willingness to depart from limited liability under some circumstances; the problem is essentially one of defining the appropriate circumstances.⁹⁷ If one could hypothesize the legislative intent in this

⁹³ The Great Depression was responsible for a substantial amount of learning on the subject. See, e.g., E. LATTY, *supra* note 36; Horowitz, *Disregarding the Entity of Private Corporations* (pts. 1-2), 14 WASH. L. REV. 285, 15 WASH. L. REV. 1 (1939-1940). Apart from this present effort, the past two decades have been largely spent in digesting the prior learning; perhaps the present economic travails will encourage a resurgence of interest. See also 2 G. HORNSTEIN, *CORPORATION LAW AND PRACTICE* §§ 751-59 (1959 and Supp. 1968).

⁹⁴ A good example is the sharp split of authority regarding the liability of a parent corporation on the lease assumed by a subsidiary established to sublet premises used in the parent's business. Compare *Darling Stores Corp. v. Young Realty Co.*, 121 F.2d 112 (8th Cir.), *cert. denied*, 314 U.S. 658 (1941); *Consolidated Sun Ray, Inc. v. Oppenstein*, 335 F.2d 801 (8th Cir. 1964), and *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344 (2d Cir. 1942), with *Majestic Co. v. Orpheum Circuit*, 21 F.2d 720 (8th Cir. 1927) and *North v. Higbee Co.*, 131 Ohio St. 507, 3 N.E.2d 391 (1936). The commentators disagree about the existence of applicable standards. See E. LATTY, *supra* note 36, at 191, who contends that the formula comes down to: "liability is imposed to reach an equitable result"; Ballantine, *Separate Entity of Parent and Subsidiary Corporations*, 14 CALIF. L. REV. 12, 15 (1925): "Unfortunately it does not seem to be possible to lay down any definite test as to when the usual immunity of the stockholder should be disregarded, but the courts assign various grounds which to a great extent are vague and illusory"; Note, *Disregarding Separate Corporate Entities to Preserve an Integrated Economic Structure*, 47 COLUM. L. REV. 109, 111 & n.13 (1947) (reviewing authorities).

⁹⁵ See, e.g., *National Bond Fin. Co. v. General Motors Corp.*, 238 F. Supp. 248 (W.D. Mo. 1964), *aff'd*, 341 F.2d 1022 (8th Cir. 1965).

⁹⁶ See note 9 *supra*.

⁹⁷ See, e.g., *Consolidated Sun Ray, Inc. v. Oppenstein*, 355 F.2d 801, 806 (8th Cir. 1964); *Steven v. Roscoe Turner Aeronautical Corp.*, 324 F.2d 157 (7th Cir. 1963); *Fisser v. International Bank*, 282 F.2d 231 (2d Cir. 1960).

area, it would probably be to permit separate incorporation, with its attendant privilege of limited liability, in the following circumstances: first, to encourage an existing business to expand into a new field by limiting its risk in doing so; second, to permit the insulation of parts of a business enterprise from the risks of other parts in circumstances where the separate parts might exist as separate businesses; and third, to satisfy various legal or administrative requirements. On the other hand, it is doubtful that the legislature intended to bestow the privilege of limited liability on attempts to divide one business into a number of mutually dependent units or to divide the business so that all the assets were in one company and all the liabilities were in another.

This hypothesis assumes that there is a model of corporateness inherent in the legislative grant of corporate personality, a significant departure from which would cause the loss of that aspect of corporateness known as limited liability.⁹⁸ The model for corporateness requires both economic viability and the observance of certain procedural formalities. While this proposed test is not precise or capable of quantification, it is possible to reconcile most of the piercing cases by reference to its criteria.

A number of considerations are useful in determining whether or not a subsidiary is operated as a viable business, with the proper observance of the procedural formalities of separate corporateness. First, and probably foremost, the subsidiary must have an adequate capitalization to carry out its intended business.⁹⁹ As already noted,¹⁰⁰ this requirement is not found in the corporation statutes; rather, it must be based on the assumption that the legislative policy contemplated more than nominal capitalization, but declined to specify precise amounts because the figures would vary in relation to the nature and size of the business. Second, the enterprise must be organized and managed to ensure that the subsidiary has a realistic potential for profitability. If the subsidiary is compelled by unfavorable long-term contracts to sell goods at an unjust-

⁹⁸ See *Enterprise Entity*, *supra* note 29; cf. *Rembar*, *supra* note 24, at 915.

⁹⁹ See *G.E.J. Corp. v. Uranium Aire, Inc.*, 311 F.2d 749 (9th Cir. 1962); *Luckenbach S.S. Co. v. W. R. Grace & Co.*, 267 F. 676 (4th Cir.), *cert. denied*, 254 U.S. 644 (1920); *American Trading & Production Corp. v. Fischbach & Moore, Inc.*, 311 F. Supp. 412 (N.D. Ill. 1970); *Portsmouth Cotton Oil Ref. Corp. v. Fourth Nat'l Bank*, 280 F. 879 (M.D. Ala.), *aff'd*, 284 F. 718 (5th Cir. 1922); *Cataldo*, *supra* note 1, at 495-96; *Douglas & Shanks*, *supra* note 85, at 214; Note, *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122, 1128-30 (1958) [hereinafter cited as HARVARD NOTE]. If a corporation is adequately capitalized at its inception but loses money in its normal operations, then the veil will not be pierced because the stockholder (parent) has paid the "price" for limited liability. See *id.* at 1129.

¹⁰⁰ See note 9 *supra*.

tifiably low price, if it is obliged to make excessive rental or interest payments to the parent, or if its profits are regularly drained off in improvident dividends, this requirement will not be satisfied.¹⁰¹ Third, the subsidiary must not be excessively dependent on the parent. For example, if the subsidiary's sole function were to act as a marketing agent or supplier for the parent, a court might be inclined to pierce the veil,¹⁰² especially if investors would be unlikely to organize an independent, nonsubsidiary corporation that would engage in the same business. Similarly, when the parent pays most of the subsidiary's bills because the subsidiary's operating funds are insufficient, courts may well conclude that the subsidiary is overly dependent.¹⁰³ Fourth, the parent must treat its subsidiary as a separate entity. Thus, corporate formalities must be observed, assets and properties may not be commingled,¹⁰⁴ and the public image of the subsidiary as a separate corporation must be preserved.¹⁰⁵ The rationale for giving weight to procedural observances is essentially one of estoppel; the parent should not be permitted to hold the subsidiary out to the world as an integral part of its operation and then call foul when a creditor attempts to hold it liable for the subsidiary's debts.¹⁰⁶

¹⁰¹ See *Joseph R. Foard Co. v. Maryland*, 219 F. 827 (4th Cir. 1914) (subsidiary was forced to pay parent management fee equal to net earnings); *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W.D. Ark. 1951) (contract with parent required sale of lumber substantially below market price and at loss to subsidiary); *Erickson v. Minnesota & Ontario Power Co.*, 134 Minn. 209, 158 N.W. 979 (1916); *Wallace v. Tulsa Yellow Cab Taxi & Baggage Co.*, 178 Okla. 15, 61 P.2d 645 (1936). But see *Bartle v. Home Owners Coop. Inc.*, 309 N.Y. 103, 127 N.E. 832 (1955) (subsidiary could not earn profit, yet veil was not pierced because the majority failed to see any fraud, misrepresentation, or illegality in the incorporation or operation of the subsidiary).

¹⁰² See *Commerce Trust Co. v. Woodbury*, 77 F.2d 478 (8th Cir.), *cert. denied*, 296 U.S. 614 (1935); *Hamilton Ridge Lumber Sales Corp. v. Wilson*, 25 F.2d 592 (4th Cir. 1928); *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W.D. Ark. 1951).

¹⁰³ See *Consolidated Sun Ray, Inc. v. Oppenstein*, 335 F.2d 801 (8th Cir. 1964); *Joseph R. Foard Co. v. Maryland*, 219 F. 827 (4th Cir. 1914).

¹⁰⁴ See *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510 (1941); *Consolidated Sun Ray, Inc. v. Oppenstein*, 325 F.2d 801, 805 (8th Cir. 1964); *Darling Stores Corp. v. Young Realty Co.*, 121 F.2d 112 (8th Cir.), *cert. denied*, 314 U.S. 658 (1941); *Joseph R. Foard Co. v. Maryland*, 219 F. 827 (4th Cir. 1914); *Ross v. Pennsylvania Ry.*, 106 N.J.L. 536, 148 A. 741 (1930); cf. *Francis O. Day Co. v. Shapiro*, 267 F.2d 669 (D.C. Cir. 1959). But see *Bergenthal v. State Garage & Trucking Co.*, 179 Wis. 42, 190 N.W. 901 (1922) (court refused to pierce veil even though the businesses were operated out of the same office and plaintiff had not specified which she wished to deal with).

¹⁰⁵ See *Steven v. Roscoe Turner Aeronautical Corp.*, 324 F.2d 157 (7th Cir. 1963); *Kings-ton Dry Dock Co. v. Lake Champlain Transp. Co.*, 31 F.2d 265, 267 (2d Cir. 1929); *American Trading & Production Corp. v. Fischbach & Moore, Inc.*, 311 F. Supp. 412 (N.D. Ill. 1970); *Douglas & Shanks*, *supra* note 85, at 197.

¹⁰⁶ See *Sisco-Hamilton Co. v. Lennon*, 240 F.2d 68, 69 (7th Cir. 1957) ("the parent corporation cannot sit back on its charter and avoid tort responsibility for its delinquent

Two other factors, while not technically applicable to this viability-procedural observance analysis, are sometimes relevant. First, while the doctrine would theoretically call for piercing regardless of whether the stockholder were an individual or a controlling corporation, courts may have a greater proclivity to reach corporate, as opposed to individual, stockholders.¹⁰⁷ This apparent discrepancy in treatment may be explained by the origin of the corporate form of organization as a protection against unlimited personal liability: since disregard of the corporate fiction in the context of related corporations does not involve additional liability for the individual stockholder, the basic policy behind limited liability remains undisturbed.

Second, while the doctrine should apply equally to tort and contract cases, some commentators have also observed a greater reluctance on the part of the courts to pierce the veil in contract cases.¹⁰⁸ This reluctance undoubtedly stems from the view that contract creditors are better able to protect themselves by investigating the subsidiary before they engage in business with it. While such an expectation may be unrealistic in the many situations where a full credit investigation would not be economically feasible, there can be little doubt that many contract creditors are able to protect themselves. Under these circumstances, it is not unreasonable for the courts to estop creditors from denying the existence of the very entity with which they have been dealing.¹⁰⁹

The foregoing analysis of the viability-procedural observance test may well appear to contradict the argument made in an earlier section that doctrines based on the independent entity status of constituent corporations are necessarily fictional. To recapitulate

child"); *Coston v. Manila Elec. Co.*, 24 F.2d 383 (2d Cir. 1928); *Stark Elec. Ry. v. McGinty Contracting Co.*, 238 F. 657, 661-63 (6th Cir. 1917); HARVARD NOTE, *supra* note 99, at 1125, 1130.

¹⁰⁷ See *Zubik v. Zubik*, 384 F.2d 267, 273 (3d Cir. 1967), *cert. denied*, 390 U.S. 988 (1968); *Walkovszky v. Carlton*, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966); E. LATTY, *supra* note 36, at 192-201 (1966); *Rembar*, *supra* note 24, at 908-09.

¹⁰⁸ See *Rembar*, *supra* note 24, at 911; E. LATTY, *supra* note 36, at 201-05; *Cataldo*, *supra* note 1, at 475-78; HARVARD NOTE, *supra* note 99, at 1129 & n.58; *cf.* *Saloman v. A. Salomon & Co.*, [1897] A.C. 22, 44-46.

¹⁰⁹ See *Fisser v. International Bank*, 282 F.2d 231, 239 (2d Cir. 1960), holding that the veil should not be pierced where creditor had full information about status of subsidiary; *New York Trust Co. v. Carpenter*, 250 F. 668, 673, 678 (6th Cir. 1918); *North v. Higbee Co.*, 131 Ohio St. 507, 3 N.E.2d 391 (1936) (no reliance by certificate holders); *cf.* *Weisser v. Mursam Shoe Corp.*, 127 F. 2d 344 (2d Cir. 1942) (holding contract creditor raised triable issue of fact by alleging he was misled into not making appropriate inquiries). See also *Zubik v. Zubik*, 384 F.2d 267 (3d Cir. 1967), *cert. denied*, 390 U.S. 988 (1968), denying recovery against sole stockholder to a tort creditor who knew of the subsidiary's dependence.

that argument: it is inherent in the parent-subsidary structure that the owners of the enterprise will have little or no concern with the independent profitability of the constituent corporations of their enterprise, as distinct from the overall enterprise. Thus control, capitalization, inter-corporate financial transactions, separate profitability, and similar factors are doomed to failure as effective tests. The doctrine of limited liability, on the other hand, assumes that the subsidiary will have an independent drive to profitability. Because this assumption does not accord with reality,¹¹⁰ there is always something vaguely metaphysical¹¹¹ about the factors suggested by the viability-procedural observance approach, factors that would not be considered by an investor seeking to maximize the return on his overall investment. Something of this view seems to lurk in Judge Learned Hand's statement that in veil piercing actions, the courts must rely on an observance of "the form [rather] than . . . the substance of the control Some such line must . . . be drawn, if shareholding alone does not fuse the corporations in every case."¹¹² Yet, in order to preserve the concept of limited liability in this context, some standard must be found for distinguishing cases where piercing is appropriate from those where it is not.

Some commentators have suggested that a more rational test would be based on some sort of "line of business" concept on the theory that corporations should not have the power to accord limited liability to individual departments of one operation.¹¹³ Aside from the definitional difficulties in determining the relevant line of business, there is a much more fundamental problem with such a test: even if a parent and subsidiary corporation maintain completely separate lines of activity, the owners of the enterprise still have every incentive to operate the subsidiary with a view toward obtaining the maximum profitability of the entire enterprise. Thus, the same elements of common control and the same shuttling of funds to maximize overall utility will occur; decisions about expan-

¹¹⁰ As Professor Berle noted, "there is . . . a plain interest on the part of the parent as dominant stockholder and of the subsidiary management, as its dummy, to exercise the corporate power not for the benefit of the corporate enterprise but for other interests which may or may not be clearly disclosed." *Subsidiary Corporations*, *supra* note 4, at 882.

¹¹¹ Cf. Fuller, *supra* note 9, at 1379.

¹¹² *Kingston Dry Dock Co. v. Lake Champlain Transp. Co.*, 31 F.2d 265, 267 (2d Cir. 1929).

¹¹³ See E. LATTY, *supra* note 36, at 196, 199 (there are "limits to limited liability" where a "single economic enterprise" is involved). This notion also appears to be at the heart of Professor Berle's well-known theory of enterprise liability. *Enterprise Entity*, *supra* note 29. Professor Berle did not, however, provide any concrete indication of how the scope of the enterprise might be delineated.

sion, dividends, or the like will still be based on an enterprise analysis rather than on an assessment of the needs of the particular subsidiary. Hence the conclusion that the veil should be pierced in all parent-subsidiary cases regardless of the respective lines of business of the parent and subsidiary seems inescapable.¹¹⁴

The arguments above, based on the economic realities of corporate organization, might prove persuasive to a legislative body considering some sort of statute restricting limited liability as between parent and subsidiary companies.¹¹⁵ At the present time, however, the laws of virtually every state have been interpreted to allow a parent to obtain limited liability by separately incorporating its subsidiary.¹¹⁶ It is this policy of limited liability that makes it impossible to support piercing in all cases by analogy to the subordination cases discussed earlier. Although there is little analytic reason for inconsistent rules, the practical constraints of the existing statutory framework make a consistent judicial rule based on economic reality impossible.

The proposed viability-procedural observance test attempts to distinguish instances where there is some corporate justification for limited liability from those cases where the subsidiary never becomes a viable entity, in the face of incorporation requirements that provide scant protection for future creditors of the enterprise. Under the test a parent will be held for the debt of its subsidiary when (1) it impairs the viability of the subsidiary as a separate business entity either at its inception or in its administration or fails to observe the procedural formalities that would identify the subsidiary as a separate corporation; except (2) a creditor who was in a position to inquire cannot reach the parent's assets when a reasonable investigation of the financial status of the subsidiary and its

¹¹⁴ Cf. *Portsmouth Cotton Oil Ref. Corp. v. Fourth Nat'l Bank*, 280 F. 879 (M.D. Ala. 1921), *aff'd*, 284 F. 718 (5th Cir. 1922), holding a corporation liable for the debts of its subsidiary, whose affairs it dominated, even though each corporation had a completely separate line of business.

¹¹⁵ Wisconsin has enacted a statute restricting the limited liability of officers of insolvent corporations for damages awarded under a Consumer Act. WIS. STAT. ANN. § 425.310 (1974). New York still provides that the ten largest stockholders have unlimited liability to wage earners. N.Y. BUS. CORP. LAW § 630(a) (McKinney Supp. 1973).

¹¹⁶ See *Bartle v. Home Owners Coop., Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955); *North v. Higbee Co.*, 131 Ohio St. 507, 3 N.E.2d 391 (1936); *American Trading & Production Corp. v. Fischbach & Moore, Inc.*, 311 F. Supp. 412 (N.D. Ill. 1970); cf. *Anderson v. Abbott*, 321 U.S. 349, 361-62 (1944); *Elenkrieg v. Siebrecht*, 238 N.Y. 254, 260, 144 N.E. 519, 521 (1924). One can regard this issue as being essentially resolved in *Berkey v. Third Avenue Ry. Co.*, 244 N.Y. 84, 155 N.E. 58 (1926). The majority opinion of Justice (then Judge) Cardozo and the dissent of Judge Crane clearly focus the question of the separate existence of the subsidiary.

relation to its parent would have indicated the shallowness of the subsidiary's resources. As in the approach to subordination suggested herein, this equation disregards factors inherent in the parent-subsidiary relationship, even though they are widely recounted in veil-piercing cases. For example, since stockholders always control the corporation,¹¹⁷ control—both in the policy making and operational sense—is always a brooding presence regardless of whether it is actually exercised. The degree to which control is exercised will vary, depending on the parent's perception of the most efficient use of the subsidiary. Thus whether the constituent corporations share officers or directors is largely irrelevant.¹¹⁸ Also missing from the proposed equation are the labels that many courts have used in desperation in veil-piercing cases: descriptions of the subsidiary as an "alter-ego," "instrumentality," "agent" or the like are conclusory, and generalized discussions about fraudulent and unjust conduct do no more than state the problem.¹¹⁹ Finally, the test does not require a showing of fraudulent activity, concealment, or any other form of tortious or illegal activity.¹²⁰ While such activity would support piercing, a requirement that illegality be a factor would limit piercing to cases where the transfers were avoidable in any case.

The main advantage of the viability-procedural observance doctrine is that it produces standards conforming to the corporate law that can be applied in a rational manner. To some extent, the doctrine compels the court to compare the subsidiary corporation with an independent enterprise, a model that serves as a proper norm of corporate activity. If the operations of the subsidiary deviate greatly from that norm, the parent corporation forfeits the legislative grant of limited liability.

3. *Bankruptcy Authority.* There is a surprising dearth of bankruptcy authority on the veil piercing question. Most bankruptcy cases are either subordination cases or cases where two or more related companies are bankrupt and the true contest is be-

¹¹⁷ See *Fisser v. International Bank*, 282 F.2d 231, 238 (2d Cir. 1960); *American Trading & Production Corp. v. Fischbach & Moore, Inc.*, 311 F. Supp. 412 (N.D. Ill. 1970); E. LARRY, *supra* note 36, at 218; Rembar, *supra* note 24, at 910; Cataldo, *supra* note 1, at 488-89; Douglas & Shanks, *supra* note 85, at 196.

¹¹⁸ See *Berger v. Columbia Broadcasting System, Inc.*, 453 F.2d 991 (5th Cir.), *cert. denied*, 409 U.S. 848 (1972); *Steven v. Roscoe Turner Aeronautical Corp.*, 324 F.2d 157 (7th Cir. 1963); Cataldo, *supra* note 1, at 488-89; HARVARD NOTE, *supra* note 99, at 1126-28.

¹¹⁹ See Horowitz, *supra* note 93, 14 WASH. L. REV. at 286-87; Cataldo, *supra* note 1, at 497; Douglas & Shanks, *supra* note 85, at 195-96.

¹²⁰ See *National Marine Service, Inc., v. C.J. Thibodeaux & Co.*, 501 F.2d 940, 942 (5th Cir. 1974); *Francis O. Day Co. v. Shapiro*, 267 F.2d 669 (D.C. Cir. 1959).

tween creditors of the respective corporations. Most trustees have been content to subordinate the claims of corporate parents without attempting an affirmative recovery against the parent.¹²¹ Yet as noted above, the Supreme Court did indicate in *Consolidated Rock Products v. Du Bois*¹²² that a parent corporation could be liable for the debts of its subsidiary. In that case the Court suggested a conventional test for piercing based on commingling of funds, failure to observe the proper formalities, and the maintenance of a unified operation with the subsidiary functioning as a department of the parent. Yet this case is not strong authority. First, there was no attempt to require the parent to respond to an affirmative judgment. The litigation was between creditors of the subsidiaries and stockholders of the parent as claimants in a reorganization proceeding. To the extent that the creditors prevailed, the stockholders would have received a lesser interest in the reorganized company. Second, even though it suggested that a veil piercing action might be appropriate, the Court was oblivious to the source of the applicable law—state law (and if so what state's), federal bankruptcy law, or federal common law.

The only reported decision holding the parent liable to the creditors of a bankrupt subsidiary is *Henderson v. Rounds and Porter Lumber Co.*¹²³ In that case the court cited traditional veil piercing cases decided at the instance of a single creditor and suggested that the test to be used was whether the parent dominated and manipulated the affairs of the bankrupt subsidiary for its own benefit and to advance its own interest. The requisite abuse of control was easily found since the parent had forced the subsidiary to sell its wood flooring at a substantial loss and at a price far below the current market price. Moreover, there was substantial evidence that the parent knew that if the practice continued, the subsidiary would

¹²¹ See *Palmer v. Stokely*, 255 F. Supp. 674 (W.D. Okla. 1966), holding that fraudulent intercompany transfers may be set aside; despite having a basis for piercing the veil, the trustee evidently failed to argue that the parent should be liable for all the bankrupt's debts. In several cases, courts that subordinated claims of parent corporations refused to hold those same parents liable for the debts of their subsidiaries. In *Centmont Corp. v. Marsch*, 68 F.2d 460 (1st Cir. 1933), *cert. denied*, 291 U.S. 680 (1934), the claim of the parent corporation in its bankrupt subsidiary was subordinated. But in *Marsch v. Southern New England R.R.*, 230 Mass. 483, 120 N.E. 120 (1918), the same creditor who had procured the subordination failed in his attempt to reach the parent's assets. See Cataldo, *supra* note 1, at 497 n.95.

¹²² 312 U.S. 510 (1941).

¹²³ 99 F. Supp. 376 (W.D. Ark. 1951). The corporate veil was pierced to reach an individual stockholder in *Eubanks v. Allstate Ins. Co.*, 441 F.2d 7 (5th Cir. 1971), but the Court of Appeals rested its decision on a Georgia statute making the organizers of a corporation liable for all its debts if they have failed to provide minimum capitalization.

ultimately be forced into bankruptcy. The court did not attempt a comprehensive analysis of the problem of piercing in bankruptcy.¹²⁴

Since state law must be applied to the veil piercing issues and since the matter is intimately related to the requirements the state imposes for limited liability, it would seem appropriate for bankruptcy courts to adopt the proposed viability-procedural observance test.¹²⁵ The test appears to strike a proper balance between the state-created right of limited liability and the economic realities of multiple incorporation. But in applying this test, the courts should not consider the fact that some general creditors might be estopped from recovering from the parent for the subsidiary's debt. This conclusion is based partly on a countervailing notion of estoppel: since it is the parent's conduct or lack of it that neutralizes the statutory policy of limited liability, the parent should not be heard to complain. A second reason on the bankruptcy level is that, in analogous actions when the trustee prosecutes rights of particular creditors, the benefits accrue equally to all general creditors and not only to those creditors whose rights the trustee is asserting.¹²⁶ Since the trustee's power in essence comes from that of the creditors, there should be no distinction among different general creditors.

IV. THE PROBLEM OF RELATED BANKRUPTS AS ENTITIES SEPARATE OR CONSOLIDATED IN BANKRUPTCY

All of the foregoing analysis was based on the assumption that only one of the constituent corporations—an affiliate or a subsidiary—would be in bankruptcy. Different problems arise when a bankrupt parent owns the stock of solvent subsidiaries or when both the parent and its subsidiary, or several affiliates, become bankrupt at about the same time.

If the parent is bankrupt, it is settled that the stock it holds in its subsidiary is an asset that can be sold for the benefit of creditors.¹²⁷ If the subsidiary is able to pay all of its creditors and the

¹²⁴ The precedential posture in *Henderson* was as follows: a state court action was brought by the trustee in bankruptcy and the creditors; the defendants removed on diversity grounds. While the court found the question of the creditors' standing "not free from doubt," it nevertheless allowed all claims to be adjudicated. The same general disregard of the standing question was apparent in *Long v. McGlon*, 263 F. Supp. 96 (D.S.C. 1967), in which an action to pierce the corporate veil withstood a motion to dismiss.

¹²⁵ The two reported cases seem to apply the same veil piercing standard in bankruptcy that is applied in cases brought by a single creditor. *Long v. McGlon*, 263 F. Supp. 96 (D.S.C. 1967); *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W.D. Ark. 1951).

¹²⁶ *Moore v. Bay*, 284 U.S. 4 (1931).

¹²⁷ See *Wilson v. Williams Hardware Co.*, 32 F.2d 103, 104 (4th Cir. 1929); *In re Seatrade Corp.*, 255 F. Supp. 696, 702 (S.D.N.Y.), *aff'd sub nom.*, *Chemical Bank v. Kheel*, 369 F.2d

parent's holdings in its stock can then be sold at a price sufficient to discharge the liabilities of the parent in full, the creditors of neither parent nor subsidiary would have any particular interest in how the subsidiary is treated for bankruptcy purposes. As might be expected, such cases are quite rare. Usually, the assets of the parent and the subsidiary, taken together, are insufficient to satisfy all the creditors' claims: if the subsidiary is solvent and its creditors are paid first, the funds that remain will generally be inadequate to pay the creditors of the parent in full, and if the subsidiary is insolvent, there will be no funds left over for creditors of the parent. Thus, in the typical situation, the contest is between creditors of the parent or an affiliate on the one hand, and creditors of the subsidiary or the other affiliate on the other. Since the parent or affiliate is insolvent in the bankruptcy sense, that is, its liabilities to creditors exceed its assets, no stockholder interests remain to be protected.

There are two approaches that can be used in adjusting the competing interests of these groups of creditors. One is to maintain the separate identities of the companies, largely ignoring the relationship between them. Where both constituent corporations are bankrupt, each bankrupt may file claims in the other's bankruptcy proceeding (subject to possible subordination), assets will be allocated between the bankrupts in proportion to their respective interests in the properties, and the resulting estates will be distributed to each company's individual creditors. To the extent that creditors have claims against both bankrupts for the same obligation, they may file claims in both bankruptcies, though they will be entitled to only one satisfaction. Where only the parent is bankrupt, the subsidiary may be liquidated, its creditors paid, and the surplus given to the parent's trustee; alternatively, the subsidiary's stock may be sold, leaving it to the new owners of the stock to pay the subsidiary's liabilities.

The other approach is to consolidate the assets and liabilities of the parent and subsidiary, forcing creditors of both companies to look to a common pool of assets for satisfaction of their claims. While the law governing the treatment of creditors holding claims against both companies for the same obligation is not well developed, it seems likely that such creditors will be relegated to a single

845 (2d Cir. 1966) (assets of wholly owned subsidiary included in estate of bankrupt); *cf.* *Commerce Trust Co. v. Woodbury*, 77 F.2d 478 (8th Cir.), *cert. denied*, 296 U.S. 614 (1935). Several cases have indicated that, absent a consolidation or turnover order, a reorganization court has no direct power over the assets of a subsidiary of the debtor. *In re South Jersey Land Corp.*, 361 F.2d 610 (3d Cir. 1966); *In re Adolf Gobel, Inc.*, 80 F. 2d 849 (2d Cir. 1936). *But cf.* *Greenhall v. Carnegie Trust Co.*, 180 F. 812 (S.D.N.Y. 1910).

claim.¹²⁸ Finally, and perhaps most significantly, all intercompany claims will be eliminated.

When one of the constituent corporations is in significantly better financial condition than the other, the differences between consolidation, on the one hand, and separate bankruptcy proceedings or the liquidation of a solvent subsidiary, on the other, will be dramatic. If the bankrupts are consolidated, the claims of priority creditors of the poorer company will be promoted ahead of the claims of general creditors of the wealthier company, and those general creditors will now have to share the assets of the wealthier company with general creditors of the poorer company.¹²⁹ If the wealthier company is a solvent subsidiary of a bankrupt parent, consolidation means that its creditors will receive something less than the payment in full they would have received absent the consolidation.

A. An Analysis of Consolidation in Bankruptcy

To focus the consolidation issue more precisely, the first case considered will be the simple one where no creditor who may be adversely affected by the consolidation can show specific reliance on the credit of any of the constituent corporations involved in an enterprise bankruptcy. A creditor who claims to have so relied must show (1) an inquiry into the debtor's ability to pay the debt and (2) the absence of any evidence, such as a cross-guarantee or a substantial inquiry into the financial status of related corporations, indicating recognition by the creditor of the interrelationships within the enterprise.¹³⁰ Those creditors who would be unable to show reliance under this test include, among others, involuntary creditors, creditors who made no investigation of the credit standing of their debtor, and creditors whose conduct suggests that they were probably relying on a group of debtors rather than on an individual company.

Where no creditors have relied on the credit of a particular constituent corporation, the enterprise factors discussed in other contexts suggest the need for a consolidation approach to multiple

¹²⁸ *Rhedom Realty Corp. v. Mammoth Mart, Inc.*, 397 F. Supp. 381 (D. Mass. 1975); see Landers, *supra* note 15, at 752 n.198.

¹²⁹ See *In re Seatrade Corp.*, 255 F. Supp. 696 (S.D.N.Y.), *aff'd sub nom.*, *Chemical Bank v. Kheel*, 369 F.2d 845 (2d Cir. 1966); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942).

¹³⁰ See *Stone v. Eacho*, 128 F.2d 16 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942) (opinion on denial of rehearing); cf. *In re Associated Gas & Elec. Co.*, 149 F.2d 996, 1006 (2d Cir.), *cert. denied*, 326 U.S. 736 (1945).

bankruptcies. If the owners of the enterprise treat it as a single entity and seek to maximize its overall profitability, it is necessarily artificial for the law to treat the companies as separate entities simply because bankruptcy has intervened.¹³¹ The case for a consolidated approach is clearest where the wealthiest company was the one selected by the owners of the enterprise to be profitable and the other corporations served as mere adjuncts to assure its profitability.

But consolidation would also seem in order when the owners attempt to set up somewhat independent companies. In this situation they still have good reason to shuttle assets and capital between the various companies,¹³² and, despite the best of intentions, it is frequently fortuitous which of several constituent companies of a bankrupt group will wind up with substantial assets. These normal "pooling" tendencies are likely to be exacerbated when one company encounters financial or business reverses, as the owners of the enterprise attempt to keep the failing corporation afloat. Thus in many instances one constituent company may have used a substantial portion of its resources to help another constituent company.¹³³ Moreover, the corporation that appeared to be in the most desperate financial straits may even wind up with substantially more assets than the corporation that was apparently the stronger until it assisted its affiliate. While the helping corporation may have a claim in the bankruptcy of its affiliate—unless it is subordinated or disallowed—it may not be able to recoup fully the aid it has given if the separate identity of corporations is maintained in bankruptcy. Quite apart from the sufficiency of saleable assets, however, no amount of bankruptcy preparation of balance sheets could reallocate the time of key personnel spent on one or another constituent company, the lost opportunities resulting from an overcommitment of resources to a struggling company, and similar intangible factors.¹³⁴ The net effect, therefore, may be that the creditors of the helping corporation contribute part of their recovery for the benefit of the creditors of the helped corporation.¹³⁵ It is difficult to imagine any bankruptcy policy which seeks to promote such a result.

¹³¹ See *Commerce Trust Co. v. Woodbury*, 77 F.2d 478 (8th Cir.), *cert. denied*, 296 U.S. 614 (1935); *In re Manufacturers' Credit Corp.*, 278 F. Supp. 384 (D.N.J.), *aff'd and appeal dismissed*, 395 F.2d 833 (3d Cir. 1968).

¹³² See *Enterprise Entity*, *supra* note 29, at 355-56. A good recent example is *In re Unishops, Inc.*, 494 F.2d 689 (2d Cir. 1974).

¹³³ *Exchange Nat'l Bank v. Meikle*, 61 F.2d 176, 179 (9th Cir. 1932); *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*, 109 F.2d 924, 928 (2d Cir. 1940).

¹³⁴ See *Subsidiary Corporations*, *supra* note 4, at 882.

¹³⁵ See *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942).

As the foregoing illustrates, the attempt to allocate claims to one or another bankrupt company is artificial at best and in some cases may result in serious injustice. A policy favoring consolidation of related corporations in bankruptcy as a general matter would alleviate a considerable portion of this harshness.¹³⁸ Moreover, the corporate law policy of permitting separate incorporation as a means to obtain limited liability is not disturbed by bankruptcy consolidation because that policy is designed to protect stockholders who, by definition, are not involved when the parent is a bankrupt.

Different considerations arise when one or more creditors of a constituent corporation can show that they specifically relied on the credit of that corporation. When the law tells a parent corporation that its claims in its subsidiary will be subordinated as a matter of law or that its veil will be pierced if its subsidiary is prevented from becoming a viable corporate entity, it is setting forth intelligible rules for corporate managers to follow in governing their conduct. In the case of subordination, corporate parents and affiliates are, in effect, warned that their situation is qualitatively different from that of other creditors and that they cannot expect parity with those creditors. The parent or affiliate can take steps to avoid subordination by attempting to borrow the funds from an outsider whose claim will not be subordinated. Similarly, when the rule is that the veil of the parent or affiliated corporation may be pierced, the managers of the enterprise are put on notice that nominal corporate status will not shield one company from what is essentially an enterprise liability when the subsidiary or affiliate has never become a viable corporation. If the owners perceive the risks to be too great, they can either avoid engaging in the proposed business, conduct it as part of the existing operations, or establish and maintain the subsidiary as a distinct and viable corporate entity.

The outside creditor of a constituent corporation has none of these options. Creditors who have relied specifically on the credit of a particular constituent corporation and then are forced to share in a consolidated bankruptcy with the creditors of other companies of which they were unaware find themselves in quite a different predic-

¹³⁸ See *Exchange Nat'l Bank v. Mickle*, 61 F.2d 176 (9th Cir. 1932); *Wilson v. Williams Hardware Co.*, 32 F.2d 103 (4th Cir. 1929). This proposal seems consistent with the enterprise approach recommended by Professor Berle, although he never specifies a method to determine which subsidiaries and affiliates are components of a particular enterprise. See *Enterprise Entity*, *supra* note 29. See also Note, *The "Deep Rock" Doctrine: Inexorable Command or Equitable Remedy?* 47 COLUM. L. REV. 800, 812 (1947) [hereinafter cited as COLUMBIA NOTE] (favors consolidation, but suggests that many cases will be so complicated that compromise will be necessary).

ament than the one they bargained for. Moreover, they have no practical means of protecting themselves. Unless they hold unusually dominant positions, creditors have limited power to affect the corporate stockholding relationships their immediate debtor has with other companies. Creditors also have little power to affect the business transactions of their debtors; consequently, they can have little impact on the profitability or lack thereof of particular transfers.¹³⁷ Because they are unable to protect themselves and may not even realize that they need protection, creditors who can demonstrate reliance on one constituent company must be accorded different treatment.¹³⁸

B. The Existing Case Law on Consolidation in Bankruptcy

The foregoing analysis suggests that the enterprise nature of the operations of related companies requires consolidation in bankruptcy unless there is a demonstration that consolidation would substantially prejudice a creditor who had specifically relied on one of the constituent companies.¹³⁹ The courts, however, have not analyzed the consolidation issue in terms of the enterprise factors examined above, but rather have handled it as an offshoot of the problem of piercing the corporate veil, considering the same kinds of factors deemed relevant in the veil piercing cases. In my view, this is erroneous. As noted above, the enterprise factors had to be abandoned as guides for decision in the veil piercing cases only because of the need to protect the legislatively mandated doctrine of limited liability. In subordination cases, on the other hand, the enterprise factors should be applied since they accord with corporate realities

¹³⁷ While transfers for the benefit of a related company may be attacked as fraudulent conveyances, this remedy is only effective if the creditor monitors the activities of the transferor closely enough to learn of the transfer and if the transferee remains sufficiently solvent to respond in damages.

¹³⁸ See *New York Trust Co. v. Island Oil & Transp. Co.*, 56 F.2d 580, 582 (2d Cir. 1932) (dictum); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), cert. denied, 317 U.S. 635 (1942) (dictum); *In re Associated Gas & Elec. Co.*, 149 F.2d 993, 1006 (2d Cir.), cert. denied, 326 U.S. 736 (1945); *Hollander v. Henry*, 186 F.2d 582, 586 (2d Cir.), cert. denied, 341 U.S. 949 (1951); *Subsidiary Corporations*, supra note 4, at 891. This distinction was apparently recognized in *Fish v. East*, 114 F.2d 177 (10th Cir. 1940), although the court did not specifically pass on the rights of creditors of the subsidiary. *Id.* at 199 & nn. 5, 6.

¹³⁹ If only one, or a small number of creditors have relied, and their claims are relatively small, it may be possible to treat them as individual creditors by estimating how much they would receive from their debtor and treating the other creditors in terms of the bankrupts as consolidated. Cf. *Irving Trust Co. v. Kaminsky*, 22 F. Supp. 362 (S.D.N.Y. 1937). It is probably unlikely that enough creditors will be able to demonstrate sufficient reliance to upset the principle of consolidation. Cf. *Cregg v. Electri-Craft Corp.*, 175 Misc. 964, 25 N.Y.S. 2d 920 (Sup. Ct.), modified and aff'd, 263 App. Div. 788, 31 N.Y.S.2d 845 (1941).

and do not interfere with any legislative policy. The issue of consolidation in bankruptcy resembles subordination since the competition is between creditors alone and therefore the doctrine of limited liability is not involved. A test based on the enterprise analysis of corporate decision-making developed herein—not on the largely mythical theory that the owners will respect the corporate integrity of constituent companies—is therefore proper for both the issues of subordination and consolidation in bankruptcy. Consolidation should generally be ordered except where the enterprise owners clearly had reason to treat the constituent corporations as separate entities or when consolidation would adversely affect creditors who had specifically relied on the credit of a particular constituent.

Unfortunately, the existing case law provides little guidance on the consolidation issue either in terms of the applicable legal principles or the factual situations warranting consolidation.¹⁴⁰ In most cases involving multiple bankruptcies, courts have been content to subordinate the claim of one bankrupt in the bankruptcy of the other, without addressing the more fundamental question of consolidation.¹⁴¹ Subordination without consolidation will be doubly unfair to creditors of the creditor bankrupt if the debtor bankrupt is the wealthier company: on the one hand, the wealthier bankrupt is treated as a separate entity and the creditors of the poorer corporation cannot reach its assets; on the other hand, however, the corporations are considered sufficiently unified that the claim of the poorer company will be subordinated and thus will probably not be satisfied even in part. In other cases, courts have skirted the substantive consolidation issue by ordering an administrative consolidation of the assets and liabilities of related bankrupts¹⁴² and deferring the question of treatment of creditors of the consolidated bankrupts until some undesignated later date.¹⁴³

¹⁴⁰ Despite the fact that there must have been scores of cases in which the issue has been faced, the number of reported cases is miniscule.

¹⁴¹ *Henry v. Dolley*, 99 F.2d 94 (10th Cir. 1938); *Centmont Corp. v. Marsch*, 68 F.2d 460 (1st Cir. 1933), *cert. denied*, 291 U.S. 680 (1934). In some subordination cases, courts have suggested that the parent's insolvency should make a difference on the subordination question, but have not taken the further step of ordering consolidation. See *Rembar*, *supra* note 98, at 919-20.

¹⁴² In an administrative consolidation, which is purely procedural, the same trustee administers the segregated assets and liabilities of two or more bankrupts. Unless otherwise designated, the term "consolidation" will be used to refer to a substantive consolidation—a judicially-directed merger of the bankrupt estates. See text at note 168 *infra*.

¹⁴³ Some cases do not express a view as to the rights of creditors, whereas others have suggested that creditors of the various companies might receive separate treatment. See *Fish v. East*, 114 F.2d 177, 199 (10th Cir. 1940); *Central Republic Bank & Trust Co. v. Caldwell*,

The reported cases have generally been easily decided because the courts could point to blatant abuses of the separate corporate entities in the enterprise structure and therefore did not have to rely on the kinds of enterprise factors noted herein. Thus the cases often show a classic commingling of assets and properties.¹⁴⁴ The courts did not have to rely on the inherent possibility that such commingling would occur; they could cite its actual existence.¹⁴⁵ In other instances there were inadequately capitalized firms totally dependent on other constituent companies for payment of normal operating expenses.¹⁴⁶ Elsewhere, nominally separate entities presented a unified public image through common advertising, similar names, reference to the separate entities as divisions or departments of the dominant company, and the like.¹⁴⁷ The cases have also involved multi-corporate participation in business dealings, cross-guarantees of separate obligations, one corporation's use of funds or property ostensibly belonging to another or the payment of one corporation's bills by another.¹⁴⁸ Finally, in some cases one business was split into

58 F.2d 721, 735 (8th Cir. 1932); *In re Eiler's Music House*, 270 F. 915, 925 (9th Cir.), *cert. denied*, 257 U.S. 646 (1921); *In re Rieger, Kapner & Altmark*, 157 F. 609, 613 (S.D. Ohio 1907).

¹⁴⁴ See *Consolidated Rock Prods. v. DuBois*, 312 U.S. 510 (1941); *In re Cintra Realty Corp.*, 413 F.2d 302 (2d Cir. 1969); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *In re Clark Supply Co.*, 172 F.2d 248 (7th Cir. 1949); *Fish v. East*, 114 F.2d 177 (10th Cir. 1940); *Trustees Sys. Co. v. Payne*, 65 F.2d 103 (3d Cir. 1933); *Central Republic Bank & Trust Co. v. Caldwell*, 58 F.2d 721, 724-25, 732-35 (8th Cir. 1932); *Page v. Arkansas Natural Gas Corp.*, 53 F.2d 27, 37-39 (8th Cir. 1931), *aff'd*, 286 U.S. 269 (1932); *Hamilton Ridge Lumber Sales Corp. v. Wilson*, 25 F.2d 592 (4th Cir. 1928); *In re Eiler's Music House*, 270 F. 915 (9th Cir.), *cert. denied*, 257 U.S. 646 (1921); *In re Rieger, Kapner & Altmark*, 157 F. 609 (S.D. Ohio 1907).

¹⁴⁵ In fact, in some cases, the assets of particular constituent companies could only be determined by reference to figures prepared by a common accounting group that arbitrarily allocated assets and expenses among the related companies. See *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964).

¹⁴⁶ See *In re Associated Gas & Elec. Co.*, 149 F.2d 996, 1002, 1005 (2d Cir.), *cert. denied*, 326 U.S. 736 (1945); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942); *Trustees Sys. Co. v. Payne*, 65 F.2d 103 (3d Cir. 1933); *cf. In re Security Prods. Co.*, 310 F. Supp. 110 (E.D. Mo. 1969).

¹⁴⁷ See *Consolidated Rock Prods. v. DuBois*, 312 U.S. 510 (1941); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *Trustees Sys. Co. v. Payne*, 65 F.2d 103 (3d Cir. 1933). At least some of these situations involved nominally separate sales subsidiaries or affiliates that sold only the product of the dominant company. See *Arnold v. Phillips*, 117 F.2d 497 (5th Cir.), *cert. denied*, 313 U.S. 583 (1941) (dictum); *Commerce Trust Co. v. Woodbury*, 77 F.2d 478 (8th Cir.), *cert. denied*, 296 U.S. 614 (1935); *Hamilton Ridge Lumber Sales Corp. v. Wilson*, 25 F.2d 592 (4th Cir. 1928); *In re Hal Computer, Inc.*, 2 CCH BANKR. L. REP. ¶ 65,304 (M.D. Fla. 1974); *In re Rieger, Kapner & Altmark*, 157 F. 609 (S.D. Ohio 1907). *But see Anaconda Building Materials Co. v. Newland*, 336 F.2d 625 (9th Cir. 1964); *First Nat'l Bank v. Walton*, 146 Wash. 367, 262 P. 984 (1928).

¹⁴⁸ See *Consolidated Rock Prods. v. DuBois*, 312 U.S. 510 (1941); *In re Clark Supply Co.*, 172 F. 248 (7th Cir. 1949); *Fish v. East*, 114 F.2d 177 (10th Cir. 1940); *Barr & Creelman Mill*

an operating company and a subsidiary or affiliate whose sole function was to own the physical properties; the courts have not allowed the attempted isolation of the assets of what is essentially a single enterprise to determine the result in bankruptcy.¹⁴⁹

As might be expected, this kind of unitary operation has not escaped the notice of creditors. Creditors who do business with a group of companies under the control of one individual, a small group, or family often understand that their prospects for payment rise or fall with the enterprise. Creditors must appreciate this situation when the wrong company pays the bill or when a constituent company executes a guarantee.¹⁵⁰ In sum, many bankrupts are consolidated, for all intents and purposes, long before the bankruptcy court is asked to put its imprimatur upon the union. The probability that creditors know of the common operations of the constituent companies has permitted courts to order consolidation without a careful exploration of the doctrinal basis for their action.

It appears that the Second Circuit, at least, may be groping towards the kind of approach suggested herein. *In re Seatrade Corp.*¹⁵¹ was a classic case for consolidation. The bankrupts were eight shipping companies, all dominated by Manuel E. Kulukundis and members of his family. The companies were clearly operated as a single enterprise; assets were shifted from one to another as funds were needed and there were numerous cross-guarantees between them. When bankruptcy intervened, Seatrade was the wealthiest company, although it was more by accident than by design.

In dealing with this situation, the court stated that the power to order consolidation should be used sparingly because of the possibility of unfairness to creditors who did not know of the interrelationships leading to consolidation. But here, since the administrative cost of disentangling the commingled assets would eat up all

& Plumbing Supply Co. v. Zoller, 109 F.2d 924, 927 (2d Cir. 1940); *In re Eiler's Music House*, 270 F. 915 (9th Cir.), cert. denied, 257 U.S. 646 (1921); *In re Hal Computer, Inc.*, 2 CCH BANKR. L. REP. ¶ 65,304 (M.D. Fla. 1974); *In re Manufacturer's Credit Corp.*, 278 F. Supp. 384 (D.N.J.), *aff'd and appeal dismissed*, 395 F.2d 833 (3d Cir. 1968); Berle, *supra* note 110, at 892; cf. *In re Unishops, Inc.*, 494 F.2d 689 (2d Cir. 1974) (in which consolidation was not sought); *In re Parkview-Gem, Inc.*, 2 CCH BANKR. L. REP. ¶ 65,309 (8th Cir. 1974) (same). But see *Markow v. Alcock*, 356 F.2d 194 (5th Cir. 1966). See also cases at nn. 184-186 *infra*.

¹⁴⁹ See *In re Plymouth Dyeing Co.*, 323 F.2d 134 (3d Cir. 1963), *appeal dismissed*, 375 U.S. 998 (1964); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *In re Clark Supply Co.*, 172 F.2d 248 (7th Cir. 1949); *Enterprise Entity*, *supra* note 29.

¹⁵⁰ *New York Trust Co. v. Island Oil & Transp. Co.*, 56 F.2d 580, 582 (2d Cir. 1932) (guarantee); *In re Security Prods. Co.*, 310 F. Supp. 110 (E.D. Mo. 1969); COLUMBIA NOTE, *supra* note 136, at 812.

¹⁵¹ *Chemical Bank v. Kheel*, 369 F.2d 845 (2d Cir. 1966), *aff'g In re Seatrade Corp.*, 255 F. Supp. 696 (S.D.N.Y. 1966).

the bankrupts' estates, the court chose a result which was potentially unjust to a few creditors rather than certainly unjust to all. Yet the court did not confine its discussion to the situation where the cost of disentanglement was excessive, but rather seemed to approve consolidation in a wide range of cases where related companies had been operated as a single enterprise. Judge Friendly reacted to this approach in a strongly worded concurrence arguing that consolidation was to be strictly limited to cases, such as *Seatrade*, where the creditors had clearly been aware of the companies' method of doing business.

The court's result, though not explicitly based on an enterprise analysis, makes sense in those terms. The corporations were operated as a unit, the separate corporations existing for tax or business reasons or, in some cases, for no apparent reason at all. To the extent one can ascribe a purpose to each corporate entity, it was not to do its utmost to be profitable, but rather to strengthen the Kulkundis empire. In this sense, the constituent corporations acted rationally; it would be artificial to ascribe separate wills to them only upon the happenstance of bankruptcy.

A paradigm case for nonconsolidation, on the other hand, was *In re Flora Mir Candy Corp.*¹⁵² In that case, the Meadors company was organized as an independent, locally-owned candy manufacturer in 1961. Meadors' debentures, issued at that time, remained outstanding throughout a series of transactions beginning in the mid-1960's in which the stock of Meadors was successively sold to Keebler Company, Atlantic Services, Inc., and Flora Mir. The Meadors debenture holders alleged that all three of these purchasers had in some way or another conspired to siphon off substantial assets from Meadors to pay for their acquisitions; prior to the bankruptcy proceedings the debenture holders had brought an action to recover the allegedly diverted funds. By the time Meadors was acquired by Flora Mir, the owner of a group of candy manufacturers, in late 1968, Meadors was largely defunct and therefore was not in any way integrated into the overall Flora Mir operation. When Flora Mir filed a Chapter XI petition in May of 1969, the referee ordered the consolidation of Flora Mir and its twelve subsidiaries, including Meadors. If this consolidation had been upheld, all intercompany claims—including the claim of the debenture holders against Flora Mir for its wrongful conduct—would have been eliminated, any claim against Keebler and Atlantic would have become an asset of

¹⁵² 432 F.2d 1060 (2d Cir. 1970).

the consolidated debtors, and the Meador debenture holders would have been required to compete for satisfaction of their other claims with Flora Mir creditors of equal rank.

The district court rejected the proposed consolidation; in affirming, Judge Friendly felt obliged to write an opinion in order to ensure that referees would not order consolidation in the future on such a "flimsy" basis.¹⁵³ Speaking for the court, he noted the following crucial factors. First, the Meador debenture holders became creditors when Meadors was independent and when they could not have known about the other companies. Second, it would have been unfair to eliminate the Meadors claim against Flora Mir, which did not arise out of inter-corporate manufacturing transactions, and unfair to allow other creditors of Flora Mir to participate in any recovery against Keebler and Atlantic since those transactions long antedated the acquisition by Flora Mir. Judge Friendly also uttered a broad dictum, reiterating his warning in *Seatrade* against consolidation in such cases. In his view, even though the companies might have been interrelated when credit was extended, the equitable remedy of consolidation was still to be directed sparingly because of the possibility of unfair treatment of creditors who dealt with one debtor without knowledge of the interrelationship with others.¹⁵⁴

Leaving Judge Friendly's warning aside, the *Flora Mir* case fits well with the analysis suggested earlier on three counts. First, the creditors in question had clearly relied on Meadors alone. Second, because of Meadors' late arrival in the Flora Mir group, the argument that individual companies within an enterprise have little incentive to profit individually, but rather will further the interests of the group, does not apply; there was no possibility that Meadors, like the *Seatrade* Corporation, had artificially become the rich company at the expense of the other constituent companies. Third, creditors of Flora Mir could not have relied on Meadors being part of the group available to pay their claims since Meadors had never been an active company within the group.

Judge Friendly's concern, manifested in both *Seatrade* and *Flora Mir*, with protecting the interests of creditors who "dealt with" one company not knowing of the interrelationship presents the most serious challenge to the proposed consolidation doctrine. Yet, as suggested earlier, knowledge of the interrelationship is likely

¹⁵³ *Id.* at 1062.

¹⁵⁴ *Id.*

to be the rule rather than the exception. Moreover, the term "dealt with" is ambiguous; it is unclear how the concept applies to involuntary creditors or creditors who were unconcerned with the finances of the debtor as compared with those creditors, if any, who specifically relied on the credit of the particular debtor. Finally, Judge Friendly's approach fails to consider the likelihood that there has been substantial prejudice to the creditors of the other constituent companies because of the basic fact that constituent companies have no incentive to profit individually and, indeed, will strive to benefit the ultimate owners of the enterprise even at the expense of their own profitability.¹⁵⁵ A rule rejecting consolidation in the absence of extraordinary circumstances, aimed at protecting creditors who "dealt with" the enterprise in ignorance of its corporate structure, protects too large and amorphous a group and conflicts with the basic realities of multi-corporate enterprises.

A more rational test would be a functional one, presuming that the normal enterprise factors compel consolidation but permitting exceptions where the usual incentives to operate separate businesses as a single enterprise are absent or where creditors have actually relied on the credit of one of the separate companies. While there is no doctrine on the subject, the courts appear to recognize these exceptions in fact. In *Flora Mir*, for example, consolidation was improper since the subsidiary conducted substantially all of its operations before it became integrated into the larger corporate group. A similar example is *In re Beck Industries, Inc.*,¹⁵⁶ in which Beck purchased the stock of a going concern, the contract of sale specifically required the subsidiary to be maintained as a separate entity, and the subsidiary was a separate party to the contract. More importantly, the arrangement was carried out in fact; the old management of the subsidiary was essentially retained, its operations were not integrated into those of the parent's, and there was evidence that the sellers of the subsidiary's stock, as creditors of both Beck and the subsidiary, expected to look to the subsidiary in

¹⁵⁵ See *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), cert. denied, 317 U.S. 635 (1942).

¹⁵⁶ 479 F.2d 410 (2d Cir.), cert. denied, 414 U.S. 858 (1973); accord, *In re Adolf Gobel, Inc.*, 80 F.2d 849 (2d Cir. 1936). In *In re Commonwealth Light & Power Co.*, 141 F.2d 734 (7th Cir.), appeal dismissed, 322 U.S. 766 (1944), the parent was a general creditor of the subsidiary and had sold an issue of debentures secured by the subsidiary's stock. The stock was sold and the parent's trustee claimed priority as a creditor in the proceeds. The court subordinated this claim—thus promoting the interest of the debenture holders, above the interests of the parent's other creditors, as pledgees of the equity interest in the subsidiary on the ground that the parent had a fiduciary duty to exercise its control to preserve the interests of the pledgees. *Id.* at 736, 739.

case of a breach of contract. Given the operation of the subsidiary as a functioning, independent concern, the Second Circuit quite properly refused to adopt a consolidation approach.

There is some indication that courts in ordering consolidation have also been sensitive to the plight of creditors who could show actual reliance on the credit of one of the constituent companies—despite the fact that the doctrine of separate incorporability was not designed as a protection for creditors. In the somewhat confused case of *Commerce Trust Co. v. Woodbury*,¹⁵⁷ creditors claimed to have relied on the existence of the subsidiary as a separate debtor in foregoing collection of debts and in advancing additional funds. The opinion may be criticized in that the creditors who relied on the independence of the subsidiary apparently would not have been prejudiced by consolidation. Yet this is a factual matter that does not undermine the basic principle that the separateness of the subsidiary should be recognized when creditors are relying on it and would be prejudiced if it were disregarded.¹⁵⁸ In any event, caution in the use of the reliance standard is necessary so that the exception will not swallow the basic principle of consolidation; the Second Circuit's rule, avoiding consolidation in order to protect those who may have relied, goes a long way toward producing just that result.¹⁵⁹

C. The Significance of Fraud or Illegal Activity

The foregoing discussion has suggested that the estates of constituent corporations in bankruptcy should be consolidated be-

¹⁵⁷ 77 F.2d 478 (8th Cir.), *cert. denied*, 296 U.S. 614 (1935). A similar case is *First Nat'l Bank v. Walton*, 146 Wash. 367, 262 P. 984 (1928).

¹⁵⁸ See also *Sampsell v. Imperial Paper & Color Co.*, 313 U.S. 215 (1941). This notion of reliance might explain the Supreme Court's dictum in that case that where the estates of a dominant stockholder and a solvent corporation were consolidated, the corporation's creditors would be entitled to priority over the stockholder's personal creditors unless there had been a fraudulent conveyance from the stockholder to his corporation. *Id.* at 219-220.

¹⁵⁹ For a more restricted use of the reliance principle, see *Stone v. Eacho*, 128 F.2d 16 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942) (court doubts that any creditor could have relied). *Cf. Hollander v. Henry*, 186 F.2d 582, 586 (2d Cir.), *cert. denied*, 341 U.S. 949 (1951); *In re Associated Gas & Elec. Co.*, 149 F.2d 993, 1006 (2d Cir.), *cert. denied*, 326 U.S. 736 (1945). The reliance principle may explain to a certain extent the decision in *Anaconda Building Materials Co. v. Newland*, 336 F.2d 625 (9th Cir. 1964), in which trade creditors of a home-building corporation sought to pierce the veil of the subsidiary acceptance corporations and share pro rata with the creditors of the subsidiaries. The subsidiaries and the parent were all insolvent. The court's rejection of the claim may have been based on the fact that the subsidiaries sold debentures to the public on the representation that the proceeds would be secured by home mortgage loans and that the subsidiaries would observe certain requirements concerning the maintenance of cash and securities. Thus, debenture holders could have been found to have relied on the credit of the subsidiaries.

cause: (1) they are likely to be operated with a view to overall profitability; (2) creditors are likely to perceive the separate companies as a group and to expect payment from the group; and (3) whether any one company has a significant amount of assets to satisfy claims is likely to be either fortuitous or the result of an attempt to favor certain creditors over others. Exceptions should, however, be recognized upon a showing of either reliance by a general creditor or of certain factors obviating the inherent enterprise tendencies of multi-corporate units. It has also been suggested that this proposed approach is generally consistent with the results found in the existing case law, although, admittedly, most of the cases have presented "easy" situations and therefore have not prompted explicit rationalizations for the doctrine of consolidation. A disquieting note, however, has been interjected by some cases that have suggested that, to order consolidation, it is necessary to show some element of fraud or illegal activity in the establishment or conduct of the subsidiary or affiliate,¹⁶⁰ and there is at least some Supreme Court support for such a view.¹⁶¹

At the outset, it is not at all clear what the terms "fraud" and "illegal activity" mean in this context. Such "fraud" is clearly not co-extensive with common law fraud: a requirement that the creditors must have been misled into thinking that they were dealing with a different enterprise than their actual debtor would be plainly inconsistent with the cases, which generally downgrade the importance of finding actual reliance by creditors. Instead, the courts that discuss fraud appear to equate it with fraudulent conveyances or other transactions between the companies that are somehow illegal under state law.¹⁶² The law of fraudulent conveyances provides an extremely unsteady basis for consolidation, however, since it cannot be used to reach some transfers that are as harmful to creditors of the constituent companies as the proscribed transfers. Thus, transfers by a solvent to an insolvent company will deplete assets of the transferor but are safe from attack. Moreover, cases of commingling of assets or artificial allocation of assets and expenses may not be reached by the restrictions on fraudulent transfers. The kind of enterprise factors noted previously—such as the allocation of corpo-

¹⁶⁰ See, e.g., *Maule Ind. v. Gerstel*, 232 F.2d 294 (5th Cir. 1956); *In re Clark Supply Co.*, 172 F.2d 248, 254 (7th Cir. 1949); cf. *Anaconda Building Materials Co. v. Newland*, 336 F.2d 625 (9th Cir. 1964).

¹⁶¹ In *Sampsel v. Imperial Paper & Color Co.*, 313 U.S. 215 (1941), the Supreme Court did not explicitly require proof of fraud, but the opinion is replete with references to fraudulent activity. See also *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 322 (1939).

¹⁶² See *Sampsel v. Imperial Paper & Color Co.*, 313 U.S. 215 (1941).

rate opportunities among constituent companies—creates an artificial situation that does not involve any type of fraudulent or illegal activity assailable in the courts. In short, the presence of fraudulent conveyances or illegal transactions does not affect the likelihood that the creditors of one constituent company will be prejudiced vis-à-vis those of another. The attempt to rely on fraud here appears to be a reversion to the individual corporate will theory discarded elsewhere.¹⁶³

The suggestion that fraud or illegal activity is required for consolidation may have been somewhat dispelled by *Soviero v. Franklin National Bank*,¹⁶⁴ a case involving a bankrupt retail carpet establishment in which the trustee sought to bring into the estate the properties of thirteen affiliates, all owned by the Raphan family. Twelve of the affiliates operated similar retail establishments; the thirteenth company, the Realty Corp., owned the land and building upon which the bankrupt was located. The Second Circuit affirmed the issuance of a turn-over order on conventional grounds: the bankrupt had paid all the obligations of the affiliates and collected all the proceeds of sales; it had signed leases, provided security deposits, and sometimes paid rent for the affiliates; the bankrupt itself had fostered the notion that it was part of a consolidated enterprise by using consolidated financial statements and common names; the trappings of separateness in the form of separate records, inventory, and payment of normal operating expenses were absent; and the land and building had been conveyed to Realty without consideration.¹⁶⁵ It is implicit in the opinion that no creditor had relied on the credit of one of the affiliates. The court summarily rejected the creditor bank's argument that fraud was required before Realty's creditors could be put on a par with those of the bankrupt.

Apart from the fraud issue, the facts of the case illustrate the rationality of the basic principle urged in this paper for consolidation cases. Thus, assume that the bankrupt had been more careful and kept records separately for the companies, that each company had separate accounts and paid its own bills, had segregated inventory, and that the transfer of real estate had been for adequate consideration. Would the situation really have been any different? Each store had overwhelming incentives to aid its affiliates and thus

¹⁶³ See text at note 136 *supra*.

¹⁶⁴ 328 F.2d 446 (2d Cir. 1964). See also *Hamilton Ridge Lumber Sales Corp. v. Wilson*, 25 F.2d 592 (4th Cir. 1928).

¹⁶⁵ In directing the turnover, Judge Lumbard noted that even Salome's veil "could not have been more diaphanous." 328 F.2d at 448.

maximize the profits of the Raphan enterprise. It is doubtful that any creditor singled out any one affiliate as its debtor, but instead, relied on the group and ultimately, on Henry Raphan. The chances are that if the formalities had been observed, the distribution of assets among the affiliates would have been fairly arbitrary and, to a large extent, would have depended on the figures allocated by the bookkeeper to various costs shared by all those in the enterprise.¹⁶⁶ Any approach other than consolidation in this type of case would exalt form over substance.

D. Procedure for Consolidating Related Bankrupts

Thus far questions about procedures for consolidation where related companies are in bankruptcy have been ignored; many of these questions remain unanswered by the case law. The Bankruptcy Rules¹⁶⁷ sharply distinguish between an administrative consolidation in which one trustee administers two or more estates but keeps the assets and liabilities of each debtor separate and a substantive consolidation of assets and liabilities. The Rules, however, specify neither standards for ordering substantive consolidation nor procedures by which it is to be accomplished, but instead deal only with the purely procedural question of administrative consolidation.¹⁶⁸

The easiest approach to begin with is to recognize that, as a practical matter, no court is likely to direct substantive consolidation unless administrative consolidation has been ordered as well. The simplest case occurs when the separate companies have all filed bankruptcy petitions in the same district; then Rule 117 would allow the court to order a joint administration of the estates. A motion for administrative consolidation, made by a trustee of one of the estates or a creditor of one of the bankrupts in one (or perhaps both) of the proceedings, would presumably be necessary. This motion could be combined with a motion to require a substantive consolidation or the interested parties could await a decision on the administrative consolidation. Tactically, those parties that desire consolidation might be better off seeking an administrative consolidation first, using that order to support a later substantive consolidation motion.¹⁶⁹

¹⁶⁶ An example of a case where the formalities were observed is *Commerce Trust Co. v. Woodbury*, 77 F.2d 478 (8th Cir.), *cert. denied*, 296 U.S. 614 (1935). One can question, however, whether such an observance made any difference to creditors.

¹⁶⁷ 28 U.S.C. § 2075 (1970).

¹⁶⁸ See Advisory Committee's Note to BANKRUPTCY RULE 117.

¹⁶⁹ If the bankrupts have been administratively consolidated when the motion for sub-

The matter is a bit more difficult, however, when the bankruptcy proceedings of related corporations are pending in separate districts. Rule 116(c) authorizes a motion to determine the court or courts in which actions involving affiliated bankrupts shall proceed; pursuant to this rule, the court in which the motion is made apparently has the authority to consolidate the proceedings in one court.¹⁷⁰ The motion for administrative consolidation is to be made in the court in which the first bankruptcy petition was filed. There is some question whether a motion for substantive consolidation could be joined with the motion for administrative consolidation in this situation since the court hearing the motion presumably does not have jurisdiction over the assets of the affiliates that filed petitions in other courts until all the proceedings are moved to a single court and that court makes the order directing substantive consolidation. Nevertheless, the court hearing the motion for administrative consolidation should be able to determine the substantive consolidation issue as well because both involve many of the same issues and proofs.

When the bankrupt's trustee attempts to reach the assets of a nonbankrupt subsidiary or affiliate, then of course there is no alternative bankruptcy proceeding available for procedural maneuvering. In such a case, the trustee must bring an action against the nonbankrupt in order to compel the inclusion of its assets in the bankrupt estate. In some cases the bankrupt, in its capacity as a creditor of the subsidiary or affiliate, may be able to file a petition for involuntary bankruptcy against the nonbankrupt corporation, and, in other cases, the bankrupt as a stockholder may compel the directors to file a voluntary petition.¹⁷¹ If the subsidiary or affiliate is adjudicated bankrupt, a motion to consolidate its assets with the bankrupt parent's may be made as described above.

In a number of cases, however, trustees of the bankrupt have, for some reason, not initiated separate bankruptcy proceedings against the subsidiary or affiliate, but rather, have sought to invoke the summary jurisdiction of the bankruptcy court by petitioning for

stantive consolidation is made, the court may have to appoint a receiver to protect the interest of the separate companies. Such an appointment should only be necessary, however, if the court finds that the interests of creditors of the various bankrupts are not adequately represented by those creditors participating in the motion to consolidate. BANKRUPTCY RULES 117(c), 201(a)(3).

¹⁷⁰ See *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942).

¹⁷¹ See *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942); *In re Todd Bldg. Corp.*, 172 F.2d 254 (7th Cir. 1949). The petition may be filed in the district where proceedings against the bankrupt are pending. BANKRUPTCY RULE 116(a)(4).

an order to compel the subsidiary or affiliate to turn over its assets to the bankrupt's trustee.¹⁷² When this procedure is followed, the most difficult question will frequently be whether the bankruptcy court has summary jurisdiction to issue the turnover order. Unfortunately, the law of consolidation has become enmeshed with the esoteric learning governing summary jurisdiction. The resulting doctrinal confusion in both areas should not be surprising.

The basic principles governing summary jurisdiction are easily stated. The bankruptcy court has summary jurisdiction over property which is (1) in the actual possession of the bankrupt or its agent or (2) in the actual possession of a third party whose claim to it is colorable;¹⁷³ constructive possession is therefore vested in the bankrupt.¹⁷⁴ In the case of constituent companies, it may be found that the bankrupt has actual possession of the property involved, thus giving the court the power to determine whether the property should be included in the bankrupt's estate.¹⁷⁵ More commonly, however, the property is in the possession of a nominally separate subsidiary or affiliate and a determination that the subsidiary's claim to the property is colorable is therefore required.

If reliance is placed on the colorable claim basis for summary jurisdiction, two separate issues must be faced. First, the court must determine the substantive standard for ordering consolidation. Second, given that substantive standard, the court must decide whether the nonbankrupt company has a noncolorable basis to resist consolidation. The first issue was discussed in the foregoing section; thus only the second will be considered now.

In the well-known case of *Harrison v. Chamberlin*,¹⁷⁶ the Supreme Court stated that a claim is colorable if the only disputed questions of fact or law it raises are insubstantial and do not involve some "fair doubt and reasonable room for controversy."¹⁷⁷ The lower courts have generally interpreted this test as requiring the disputed issue to be at least fairly arguable. Since a denial of summary jurisdiction removes the decision of questions of fact from the bank-

¹⁷² Under the Bankruptcy Rules, it would be necessary for the trustee to commence an adversary proceeding against the subsidiary. BANKRUPTCY RULE 701(1).

¹⁷³ See text at note 177 *infra*.

¹⁷⁴ See Landers, *supra* note 15, at 741-42 (reviewing authorities).

¹⁷⁵ See *In re Eiler's Music House*, 270 F. 915 (9th Cir.), *cert. denied*, 257 U.S. 646 (1921); *Fish v. East*, 114 F.2d 177, 188-89 (10th Cir. 1940); *Hamilton Ridge Lumber Sales Corp. v. Wilson*, 25 F.2d 592 (4th Cir. 1928); *cf. Bank of California v. McBride*, 132 F.2d 769, 771-72 (9th Cir. 1943).

¹⁷⁶ 271 U.S. 191 (1926).

¹⁷⁷ *Id.* at 195.

ruptcy judge, it would seem reasonable for the test for summary jurisdiction to be analogous to the test for summary judgment in civil trials. Under this standard, cases simply presenting disputed issues of law would be appropriate for summary jurisdiction.¹⁷⁸

While the courts have not explicitly moved this far in establishing standards for summary jurisdiction in consolidation cases, it appears that in many decisions this approach has been adopted in fact. Thus, in several cases where there were no material factual disputes over the organization of the various constituent companies, the courts have held summary jurisdiction proper even though disputed legal issues existed.¹⁷⁹ In other cases, the denial of summary jurisdiction was apparently intermixed with denial of consolidation on the merits; in at least some of these cases, the trustee must be faulted for his failure to develop a full picture of the relations of the companies involved.¹⁸⁰ But if a full presentation reveals the presence of disputed factual issues, there is no alternative under present law but to bring a separate action in an appropriate state or federal court to recover the assets.¹⁸¹

E. Applying the Consolidation Principle in Bankruptcy

If the substantive and procedural obstacles to consolidation are overcome, a number of technical questions, for which there is little bankruptcy precedent, remain to be considered.

1. *Filing of Claims.* Creditors have six months after the first date set by the bankruptcy court for the first meeting of creditors to file their claims.¹⁸² If two bankrupt estates are consolidated, the court will invariably order timely claims filed in either original proceeding to be considered valid in the consolidated proceeding. The

¹⁷⁸ See Landers, *supra* note 15, at 742-43.

¹⁷⁹ See *Sampson v. Imperial Paper & Color Co.*, 313 U.S. 215 (1941); *In re Cintra Realty Corp.*, 413 F.2d 302 (2d Cir. 1969); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *In re Plymouth Dyeing Co.*, 323 F.2d 134 (3d Cir. 1963), *appeal dismissed*, 375 U.S. 998 (1964); *In re Clark Supply Co.*, 172 F.2d 248 (7th Cir. 1949); *Fish v. East*, 114 F.2d 177, 189 (10th Cir. 1940); *Central Republic Bank & Trust Co. v. Caldwell*, 58 F.2d 721, 725 (8th Cir. 1932). In some of these cases, the issue of the respective rights of creditors of the various companies was postponed for later consideration.

¹⁸⁰ See *Fox Jewelry Corp. v. Lee*, 264 F.2d 720 (5th Cir.), *cert. denied*, 361 U.S. 815 (1959). In *Maule Ind. v. Gerstel*, 232 F.2d 294 (5th Cir. 1956), it is not clear why the state court receiver of the subsidiary, who appeared at the hearing and interposed no jurisdictional objection, did not consent to summary jurisdiction.

¹⁸¹ Bankruptcy Act § 23, 11 U.S.C. § 46 (1970). Adoption of the Proposed Bankruptcy Act will resolve all of these jurisdictional issues in favor of jurisdiction before the bankruptcy judge. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES-II, *supra* note 43, §§ 2-201(a)(5), (9).

¹⁸² BANKRUPTCY RULE 302(e).

question remains, however, whether an additional period of time should be given. It can be argued that creditors of the poorer company might not have bothered to file because the prospects of recovery were so bleak before the consolidation. The reply to this argument is that in many bankruptcies creditors do not know within six months of bankruptcy whether assets will be available, and if they decide not to file, they are not included even if unforeseen assets do happen to materialize; it is irrelevant that the unforeseen assets result from the consolidation rather than from some newly found property or unexpected recovery. Although there is no firm authority on this point, perhaps the bankruptcy judge should give a short extension only to creditors who were affirmatively led to believe that filing would be useless.¹⁸³ If the six month period has not expired for one of the consolidated bankrupts, its creditors must be given at least the balance of the time to file. If the consolidation is accomplished by a turnover, notice must be given to creditors of the subsidiary or affiliate involved that they have six months to file claims. In such cases it is at least arguable that creditors of the other company should also be given the balance of the time left.

2. *Avoidance of Transfers.* Several sections of the Bankruptcy Act avoid transfers made within four months or a year of bankruptcy.¹⁸⁴ Some of these sections require a finding that the bankrupt was insolvent at the time of the transfer. This requirement raises three related questions. First, where insolvency is required, is it the insolvency of the particular transferor or the insolvency of the related corporations that is relevant? Second, if the companies became bankrupt at different times, is the applicable date for determining the four month and one year periods the date of the first filing or the date on which the petition regarding the particular transferor was filed? Third, if one of the companies made a transfer to or for the benefit of another constituent company that would have been fraudulent if separate companies had been involved, does the consolidation affect the fraudulent character of the transfer? At the present time, there is virtually no authority to help in deciding these questions.

All these questions are in reality species of the same problem: the extent to which the principle of consolidation should be permit-

¹⁸³ Cf. BANKRUPTCY RULES 302(e)(3), (4). The latter provision directs the bankruptcy judge to allow creditors additional time to file claims if it appears that an initial determination that there would be no dividend is erroneous.

¹⁸⁴ Bankruptcy Act § 67d, 11 U.S.C. § 107(d) (1970). When state law is used to attack the transfer under § 70e, 11 U.S.C. § 110(e), a longer period of time may be employed.

ted to reach back in time to affect the character of transactions undertaken by one of the constituent companies. A logical solution would be to apply the same test for pre-bankruptcy consolidation as has been suggested for post-bankruptcy consolidation. Thus, consolidation of the affairs of constituent companies would reach back in time unless creditors could demonstrate substantial reliance on the separate status of one of the constituent companies and substantial prejudice from recognition of the consolidation.

3. *Fraudulent Conveyances.* A typical transaction involving related companies occurs when one constituent company (*C-1*) makes a purchase or repays a debt, using funds or collateral belonging to its constituent company (*C-2*) to effectuate the transaction with the third party seller or creditor (*T*). The transfer of the funds or property of *C-2* to *T* may be attacked by the creditors of *C-2* as a fraudulent conveyance. Both the Uniform Act and section 67d of the Bankruptcy Act declare transfers to be fraudulent when they are without fair consideration and the transferor is in one of various states of financial distress—that is, when the transferor is insolvent, has unreasonably small capital, or expects to incur debts that it will be unable to pay. “Fair consideration” requires that property be received or an antecedent debt satisfied. While not explicitly stated, the clear import of the statutes is that the party receiving the property or the party whose debt is satisfied must be the transferor (*C-2*). The receipt of property by a related company (*C-1*) or the satisfaction of a debt of a related company, therefore, would not satisfy this requirement.¹⁸⁵ Yet, both the Uniform Act and section 67d provide that if the transferee (*T*) gives new value or property, the transfer is immune from attack to the extent of the new value so long as the transferee acted in good faith. But in the triangular situation outlined above, the transferee may not be immunized because the new consideration passes, not to the transferor, but rather to another constituent corporation. *T* is clearly exposed to attack as a fraudulent transferee.

As a practical matter, a transfer by one constituent corporation for the benefit of another constituent company may make good sense both for the enterprise as a whole and for the transferee. Indeed, the managers of the enterprise would be acting irrationally if they failed to use the resources of one company to salvage another,

¹⁸⁵ See *In re B-F Bldg. Corp.*, 312 F.2d 691 (6th Cir. 1963); *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*, 109 F.2d 924 (2d Cir. 1940); *In re Security Prods. Co.*, 310 F. Supp. 110 (E.D. Mo. 1969); *Bennett v. Rodman & English, Inc.*, 2 F. Supp. 355 (E.D.N.Y.), *aff'd*, 62 F.2d 1064 (2d Cir. 1932).

if such assistance would ultimately enhance the profitability of the corporate enterprise. And the transferee (*T*) is interested in additional sales or the payment of an antecedent debt and therefore is usually unconcerned with the source of payment. In this case there is no fraudulent transfer in the traditional sense; but, to the extent that *T* places new value in the hands of a company other than the transferor (*C-2*), the transferor's creditors should have access to the property received. This result is accomplished by consolidation. Insofar as an antecedent debt of *C-1* is paid, the transferee (*T*) has received a classic preference and the overall estate of the consolidated debtors has been depleted by the amount of the payment.

From the viewpoint of *C-2*'s creditors, however, there are two crucial differences between an attack as a fraudulent conveyance and as a preferential transfer: first, a conveyance alleged to be fraudulent may be attacked if made within one year (and sometimes substantially longer) of the filing of the bankruptcy petition, while a preferential transfer must have occurred within four months of the petition; second, a preferential transfer is voidable only if the transferee had reason to know of the bankrupt's insolvency, while fraudulent transfers are voidable without regard to the transferee's knowledge. Consequently, in the case of consolidation the trustee's attempt to attack a transfer by *C-2* to pay an antecedent debt of *C-1* as a fraudulent conveyance should be successfully resisted by relying on the enterprise nature of the separate bankrupts and on the absence of any factors supporting separate recognition of the various bankrupts.¹⁸⁶ The recipient of the payment should, however, still be vulnerable to a preference claim, since the transfer to him drained off assets that would otherwise have been shared by all the creditors of the enterprise.

4. *Insolvency.* The trustee for consolidated debtors may attempt to avoid pre-bankruptcy transfers pursuant to sections 60, 67a, or 67d of the Bankruptcy Act. All these sections require that the bankrupt be insolvent at the time of the transfer. It is unclear whether the determination of insolvency must be made on the basis of the assets and liabilities of the transferor alone or on a consolidated basis for all the constituent companies.

¹⁸⁶ *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823, 830 (5th Cir. 1959), *cert. denied*, 362 U.S. 962 (1960); *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*, 109 F.2d 924 (2d Cir. 1940); *McNellis v. Raymond*, 287 F. Supp. 232, 238-39 (N.D.N.Y. 1968), *modified on other grounds*, 420 F.2d 51 (2d Cir. 1970); *cf. In re Security Prods. Co.*, 310 F. Supp. 110 (E.D. Mo. 1969), holding that a bank cannot resist fraudulent conveyance by argument that joint debtors should be treated as one; there is no indication that bank sought formal consolidation.

Several factors favor determining insolvency on a consolidated basis. First, as noted above, an enterprise analysis suggests that fortuities largely determine which assets will wind up in the hands of a particular constituent company, especially if there have been substantial inter-company transfers or if most of the tangible property has been placed in a single corporate unit. Second, from the point of view of creditors of the enterprise, symmetry requires comparable treatment of pre-bankruptcy transfers and post-bankruptcy claims. If creditors of the richest constituent company must share *pari passu* with creditors of poorer ones, there seems to be no good reason to treat a creditor differently simply because he happened to get paid before bankruptcy. The purpose of the lien avoidance and anti-preference provisions is to ensure that creditors who try to get some advantage over their fellows prior to bankruptcy receive equal treatment; such a purpose would be frustrated by applying the principle of consolidation differently to those creditors who participated in voidable transactions before the bankruptcy and those who must compete for the bankrupt's assets afterwards.¹⁸⁷ Third, in some cases where there was not even a formal consolidation of the subsidiary and parent, the payment has been treated as preferential because the subsidiary's property was considered to be that of the parent.¹⁸⁸ In these cases, insolvency must be determined on an overall basis; there seems to be no reason to apply a different rationale when a formal consolidation is ordered.

Assuming that in the usual case insolvency should be determined on a consolidated basis, the question remains whether an exception should be made when the creditor can show reliance on a particular entity in receiving a preferential payment or acquiring a voidable lien. The answer is negative. A creditor may rely on the corporation in extending credit because he is still awaiting performance on the corporation's part. But a creditor receiving payment or obtaining a voidable lien is, by definition, not relying on anything because he is receiving payment.¹⁸⁹ In other words, a creditor might say that he would not have extended credit if he had expected a

¹⁸⁷ In most of these cases, the creditor will be protected because he had no reason to know of the debtor's insolvency. If the transferor is solvent, then the transferee presumably must have reason to know of both the possibility of consolidation and the insolvency of the various corporations as consolidated.

¹⁸⁸ See text at note 172 *supra*; *Siegel v. Municipal Capital Corp.*, 102 F.2d 905 (2d Cir. 1939); *Hillebrand v. Sav-Co*, 353 F. Supp. 19 (E.D. Ill. 1972); *cf.* *Bank of California v. McBride*, 132 F.2d 769 (9th Cir. 1943).

¹⁸⁹ But see *Exchange Nat'l Bank v. Meikle*, 61 F.2d 176, 182 (9th Cir. 1932) (dissenting opinion).

group of companies to be consolidated, but he cannot rationally claim to have accepted payment or acquired a lien in reliance on the solvency of one company. For, if he had known the companies were insolvent, his only course of action would have been to accept the payment or lien anyway and hope the transfer or lien would be invulnerable by the time the bankruptcy petition was filed.

5. *Four Month and One Year Periods.* The final issue is whether the four and twelve month periods for determining which transactions may be avoided should run from the date of the bankruptcy of the first constituent company or the date of the bankruptcy of the individual constituent company that engaged in the transaction. Once again, if creditors of the different constituent companies are to be treated on an equal basis for the purpose of claims, there seems to be little reason to treat pre-bankruptcy creditors who receive payments of antecedent debts or voidable liens any differently. Moreover, in at least some "consolidation" cases, the consolidation is accomplished by a turnover order and there is no separate bankruptcy petition. In such a case, the effect of the turnover is to declare the date of one company's bankruptcy to be the date for all. Finally, as with the insolvency determination, creditors do not rely on the four month or one year periods in engaging in such transactions; thus there is no reliance interest that must be protected by individualized treatment.

CONCLUSION

Some years ago when Congress was conducting an investigation of the various acquisitions of the International Telephone and Telegraph Company, one of the company's witnesses was asked whether ITT officials rented cars more frequently from Avis after Avis became a subsidiary of ITT. His response was that he certainly would "encourage" it, the implication being that it made good business sense to rent cars from Avis rather than from an unrelated company.¹⁹⁰

This approach seems so obvious that one wonders why anyone should have expected a different answer. Obvious to us, perhaps, but not to the many courts that have considered the issues raised by related corporations in the bankruptcy context. On the contrary, judicial doctrine seems bent on distinguishing a class of real corporations that happen to be subsidiaries from a class of evil, parasitic subsidiaries that happen to be corporations. The practical result is

¹⁹⁰ *Hearings on Investigation of Conglomerate Corporations Before the Antitrust Subcomm. of the House Comm. on the Judiciary*, 91st Cong., 1st Sess., ser. 23, pt. 3, at 102 (1969).

that the claims of parent companies are sometimes subordinated and sometimes not, parents sometimes must pay the whole bill for their bankrupt subsidiaries and sometimes may get by without contributing anything, and related bankrupts are sometimes treated as separate entities and are sometimes consolidated. Current decision making tends to be whimsical, and the hackneyed expression that "each case must be decided on its own facts" serves the yeoman's task of substituting for reasoned analysis.

This paper has suggested that the owners of an enterprise have numerous business incentives to operate it in a manner that maximizes the profits of the entire enterprise, without regard to the profitability of the individual components of that enterprise. A resolution of parent-subsidiary issues on the basis of the existence of actual harm or commingling of assets, of adequate record keeping or the observation of the formalities of separate existence, is therefore inherently unrealistic. Although a theory of complete fusion would be consistent with the realities of multiple incorporation, such a result would be in direct conflict with the corporate law that permits separate incorporation of subsidiaries and related companies and permits creditors to transact business with one separate company. A compromise position must therefore be adopted in certain instances. Accordingly, the principle of complete fusion cannot be applied where it undercuts statutory provisions for limited liability, where the usual enterprise factors are inoperative, or where creditors have actually relied on one of the corporate entities. This compromise takes account of realities and protects those whom the statutes have designated as deserving of protection.