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SHOULD THEORIES OF ASSET PARTITIONING BE REVISED?¹

William H. Widen²

“A mythical visitor from Mars, not having been apprised of the centrality of markets and contracts, might find the new institutional economics rather astonishing. Suppose that it (the visitor—I’ll avoid the question of its sex) approaches the Earth from space, equipped with a telescope that reveals social structures. The firms reveal themselves, say, as solid green areas with faint interior contours marking out divisions and departments.”—Herbert A. Simon.³

The Workshop Question and its Background

My current research focuses on the internal legal structure of consolidated groups of companies. I am particularly interested in how these internal structures interact with financing transactions (and the design of those transactions). In 2005, I focused my attention on case law developments in the Owens Corning bankruptcy. In that reorganization a lending syndicate of senior banks litigated a dispute with unsecured bond holders over whether the reorganization should use a technique known as “substantive consolidation.”

In a substantive consolidation, the internal corporate structure of the consolidated group is ignored. Assets from the various consolidated legal entities are pooled and all the creditors of the various members of the consolidated group are satisfied from this common pool. Without the substantive consolidation, each creditor would be satisfied first from the assets owned by its particular debtor. It is easy to see that creditors of a debtor with a relatively poor ratio of assets to liabilities would favor “consolidating” their debtor with another debtor which had a more favorable ratio of assets to liabilities. Conversely, creditors of debtors with a relatively higher ratio of assets to liabilities would oppose the substantive consolidation because it would reduce the bankruptcy dividend that they would receive. In Owens Corning, this amounted to a \$1 billion question.

¹ This paper relies on a study funded by the ABI Endowment Fund. It has benefited from comments received at a conference devoted to Commercial Law Realities jointly hosted by the University of Texas School of Law and the Harvard Law School held in April 2007 in Austin, Texas.

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³ From *Organizations and Markets* (reprinted in *THE FIRM AS AN ENTITY*, Biondi, Canziani & Kirat, eds. (2007) at p. 56).

In considering the Owens Corning case, it quickly became apparent that nobody had done serious empirical work to assess the frequency of use of substantive consolidation in reorganizations or the conditions of the doctrine's application. My prior published work, informed by my ongoing empirical investigation, explains how substantive consolidation doctrine might be reformulated. I now want to consider how this empirical work might be used to explain what Herbert Simon's Martian visitor would see with the social structure telescope—asset partitions, internal capital markets or faint interior contours?

For purposes of the workshop, I do not want to engage in debate over whether substantive consolidations effected in negotiated reorganization plans are “real” substantive consolidations or whether the standard for approval of a negotiated substantive consolidation should mirror the standard used to justify substantive consolidation in a contested case. By whatever name and pursuant to whatever standard, the fact remains that the asset partitions created by the internal organization of corporate entities in consolidate groups are being ignored. I want to consider the theoretical implications of this phenomenon.

To further this discussion, I present a summary of some current results from my ongoing ABI study.

I. Introduction

Uncertainty surrounds use of substantive consolidation doctrine in bankruptcy proceedings.⁴ The ABI report aims to replace some of this uncertainty with data. Conventional academic and judicial wisdom holds that, within consolidated groups, an important function (if not the primary function) of separate legal entities is their use to match specific assets with specific liabilities—this function is sometimes referred to as “asset partitioning.”⁵ The data presented in the report strongly suggest that the asset partitioning function plays a dramatically reduced role in explaining the structure of consolidated groups. In a majority of the large public bankruptcies examined, transaction participants use substantive consolidation to restructure companies—this restructuring technique destroys any matching of assets with liabilities by ignoring the separate legal entities that exist within the consolidated group. Though this fact does not prove that the asset partitioning function of corporate form is unimportant, it does suggest that asset

⁴ For a detailed discussion of the substantive consolidation technique, see William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 237 (2007) (collecting cases and secondary sources) [hereinafter *Corporate Form*].

⁵ See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000). Asset partitioning has two facets: providing a barrier between claims of corporate creditors and investors and preventing liquidation of assets committed to a business by individual shareholders. Recently Professors Hansmann and Kraakman further developed the theory of asset partitioning and noted the importance of the “unsettled” doctrine of substantive consolidation as a possible cost saving measure in reorganizations. See Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1401-02 (2006).

partitioning should play a dramatically reduced role in any explanation about the internal structure of consolidated groups.⁶

I believe that judicial respect for the corporate form within consolidated groups derives primarily from the perception that the general ability of the corporate form to create asset partitions plays an essential role in the success of capital raising activities. Decisions that weaken a cornerstone of successful capital markets are unwelcome events. Within a consolidated group, corporate forms (and, more broadly, other legal entity forms) do allow managers the potential to match specific creditors to specific asset pools. The alignment of creditors with assets via corporate form may prove cost effective because it is achieved without resort to traditional security devices, such as mortgages and pledge agreements (which also match creditors with assets but require additional transaction costs to implement). Substantive consolidation destroys a pre-arranged match between a creditor and an asset because it ignores corporate forms used to create the match by treating multiple legal entities as a single entity. In this view of the world, if courts routinely ignored these pairings, then the utility of a device vitally important to our capital markets would be destroyed.⁷ I believe such reasoning underlies various judicial admonishments that substantive consolidation should be rarely used.

The data presented in the report strongly suggest, however, that within consolidated groups separate legal entities are not used primarily to match assets with liabilities because the majority of large public company bankruptcies use substantive consolidation to accomplish reorganizations. This finding undercuts judicial statements that substantive consolidation should be used sparingly, calling into question the rationale behind limited use. This finding also casts doubt on the centrality of various academic theories of corporate form that are based on asset partitioning to understanding the structure of consolidated groups because, in light of the data, these theories no longer appear to explain the allocation of assets to liabilities in a majority of consolidated groups under the stress of insolvency.⁸ If asset partitioning is a factor in explaining the internal

⁶ One theory to explain the structure of consolidated groups suggests that legal entities are used to create capital markets within a single firm. See George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102 (2004). While the data suggest that, in a majority of cases, consolidated groups do not use legal entities to match assets with third party creditors, the data do not speak directly to the use of legal entities to create internal capital markets as a management tool. Ignoring legal entities for asset distributions to third party creditors is consistent with management having used legal entities for the purpose of internal allocation of resources.

⁷ I suspect judicial concern centers on traditionally understood external capital markets, such as stock exchanges, and not the internal capital markets considered by Prof. Triantis. If judges were to accept Professor Triantis' theory about the importance of internal capital markets, at a surface level that acceptance might provide an additional reason to use substantive consolidation sparingly. However, such reference would be misplaced, in my view, because use of corporate form to create internal capital markets is primarily a management tool. As the bankruptcy proceeding looks forward to new management and not backwards, the destruction of any internal capital markets created by legal entity form should not have adverse consequences for either the consolidated group or the functioning of external capital markets. *Id.*

⁸ To be clear, I focus on the utility of asset partitioning's explanatory power within consolidated groups. I believe that the asset partitioning theory has far greater appeal in explaining the role of firms under central management and the relationship of these firms to individual investors. It is generally understood that more theoretical attention has been focused on firms rather than on the internal structure of firms. See David A.

structure of corporate groups, it would appear that it is merely one of many factors to be considered.

I began my study of substantive consolidation with the firm conviction that parties use the substantive consolidation technique as a tool to manage the complexity of organizational structure, to manage the complexity of case administration and to reduce transaction costs. Accordingly, I have considered three variables that might reflect organizational complexity: (i) the present value of debtor asset size (“PV Asset Size”); (ii) the number of significant subsidiaries reported by a debtor to the SEC (“SEC Subsidiaries”); and, (iii) the number of entities filed in a procedurally consolidated case (“Bankrupt Entities”). In addition to examining whether substantive consolidation usage differed against these three variables, I wanted to see whether use of substantive consolidation reduced the time spent in bankruptcy—and, more broadly, whether PV Asset Size, the number of Bankrupt Entities in the case or the number of SEC Subsidiaries seemed to have any bearing on the length of bankruptcy proceedings.

In a different line of inquiry, I wanted to investigate whether courts and transaction parties ignored corporate form more frequently in liquidation cases. Various practitioners had suggested that it made sense to ignore corporate forms when no entities survived the reorganization whereas ignoring corporate form might create problems for an emerging debtor. Thus, I compare the prevalence of substantive consolidation between the cases in which a debtor emerges from bankruptcy (“Emerge Cases”) and the cases in which no debtor emerges from bankruptcy (“Non-Emerge Cases”).

Lastly, I wanted to consider how courts and transaction parties dealt with the confusion and complexity surrounding substantive consolidation doctrine itself and explore the extent to which bargaining over reorganization plans takes place in the shadow of this muddled doctrine.

The report does not purport to provide a comprehensive answer to questions about substantive consolidation doctrine. It merely begins a dialog about the role of legal entities within consolidate groups and the management of complexity.

II. The Scope of the ABI Study

The ABI study reports on the prevalence of substantive consolidation in large public bankruptcy cases filed during the five year period from 2000 to 2004. The definition of a substantive consolidation bankruptcy appears in Appendix A.

All the cases in the study involve bankruptcies for companies that appear in the list of companies reported on by the WebBRD—the publicly available online bankruptcy resource database maintained by Professor Lynn M. LoPucki.⁹ The study focuses primarily on cases with a present value of reported balance sheet assets in excess of \$1 billion. The WebBRD reported 130 companies in this category as of September 1, 2007. The study also includes some data collected from the larger group of all public companies reported on by the WebBRD for this same time period. The WebBRD reported 342 companies in this category as of September 1, 2007. The present value of asset size as reported for this larger set of companies ranges from a low of \$249 million (DDI Corp.) to a high of \$120 billion (Worldcom, Inc.).

The smaller dataset drawn from the 130 companies with more than \$1 billion in present value of assets is referred to as the “**Jumbo Cases Dataset**”. The larger dataset that includes all cases reported on by the WebBRD for this time period is referred to as the “**All Cases Dataset**”. The **All Cases Dataset** includes the **Jumbo Cases Dataset**.

For purposes of analysis, this study omits cases that were dismissed, cases that are pending and cases for which primary source material was not available. The **Jumbo Cases Dataset** omits 8 cases on this basis (only one of which is omitted solely for lack of primary source material). Accordingly, 122 cases are analyzed from this set. The **All Cases Dataset** omits 52 cases on this basis (including the 8 omitted from the Jumbo Cases Dataset). [Forty cases lack primary source material in the **All Cases Dataset**.] Accordingly, 290 cases are analyzed in the **All Cases Dataset**.

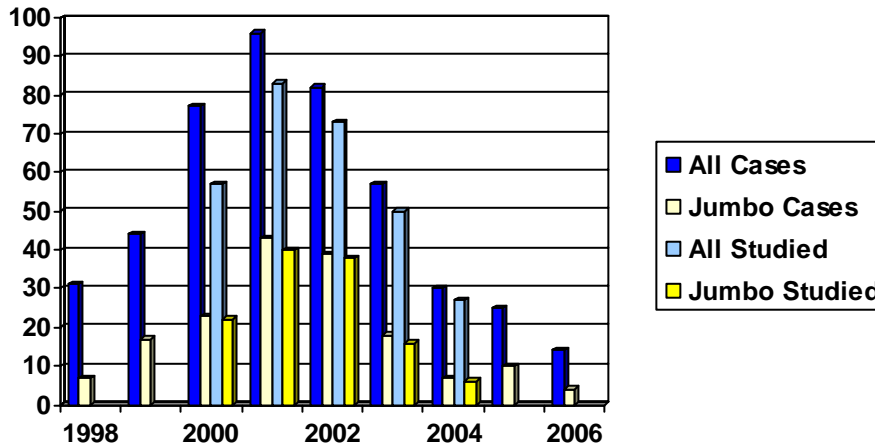
The bankruptcy filing activity for large public companies during the five year period of study is reflected in the Chart 1 below, as well as a graphic representation of the cases included for analysis. Cases from 1998 and 1999 are not included in the study both because filing activity was not particularly strong in those years and because I have found that publicly available documents are less accessible through PACER for years prior to 2000. Cases from 2005 and 2006 are not included because many cases from those years have not yet been completed.

Chart 1 shows the aggregate number of cases reported by the WebBRD from 1998 through 2006, as well as the aggregate number of cases filed with a PV Asset Value in excess of \$1 billion. For the years of the study, the table reflects the aggregate number of

⁹ The Bankruptcy Research Database (or “BRD”) is maintained by Professor Lynn M. LoPucki at the UCLA School of Law. An online version of this database appears under the name “WebBRD” and is available at <http://lopucki.law.ucla.edu/> (last visited September 6, 2007). Professor LoPucki has shared his entire database with Professor Widen to assist with this project. Additionally, Professor LoPucki has given valuable advice on research methods and related matters.

cases reported by the WebBRD, the aggregate number of cases filed with a PV Asset Value in excess of \$1billion, as well as the number of cases in each group examined by the study.

Chart 1: Filing Activity During the Period of Study and the Scope of the Cases Studied



III. The Prevalence of Substantive Consolidation

The basic results on prevalence of substantive consolidation in large public bankruptcies reveal that a majority of large public bankruptcies are substantive consolidation cases.

Table A: The Prevalence of Substantive Consolidation in the All Cases Dataset and the Jumbo Cases Dataset

	Subcon Cases	Non-subcon Cases
All Cases Dataset (290)	159 (55%)	131
Jumbo Cases Dataset (122)	73 (60%)	49

In all but two of the cases classified as “substantive consolidation cases” the court approved use of substantive consolidation in some form.

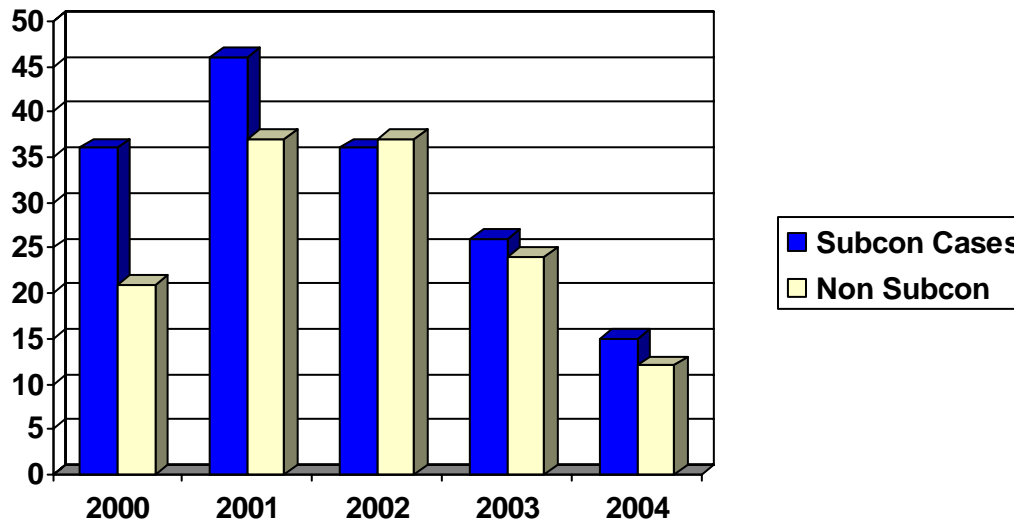
Significantly, frequent use of substantive consolidation is not heavily concentrated in the larger cases. Usage approaches 50% even in cases with a PV Asset Value of less than \$500 million. Substantive consolidation appears in less than 50% of these smaller cases because of the higher concentration of single debtor bankruptcies in this group. No single debtor case is classified as a substantive consolidation case. The frequency of substantive consolidation cases across asset size classes (both including and excluding single debtor cases) appears below.

Table B: The Prevalence of Substantive Consolidation Across Various Asset Size Classes for Cases Studied in the All Cases Dataset

	<\$500m	\$500m to < \$1b	\$1b to < \$10b	>\$10b
Single Debtor In				
Subcon	45 (49%)	41 (54%)	65 (60%)	8 (62%)
Non-subcon	47	35	44	5
Single Debtor Out				
Subcon	45 (62%)	41 (62%)	65 (66%)	8 (67%)
Non-subcon	28	25	34	4

Substantive consolidation cases appear frequently during each of the five years included in the study, as reflected in the chart below.

Chart 2: The Prevalence of Substantive Consolidation in the Cases Studied in the All Cases Dataset Across the Years included in the Study



From this data I conclude that the corporate form (and, more generally, a legal entity form of any type) as it appears in consolidated groups is not used primarily to match assets with liabilities. I reason that, if the corporate form were being used primarily to match assets with liabilities, then we would not expect to find so many cases in which the parties agree to ignore those asset partitions. I do not mean to suggest that the corporate form can not be used for such purposes. In many cases, the corporate form is used to match assets with liabilities, most notably in securitization transactions in which the corporate form is used in conjunction with security interests to achieve a corporate financing objective.

This data also create concern over theories that suggest corporate form may be used to create internal capital markets, though here the connection is less clear. To the extent an internal capital market is used as a management technique prior to bankruptcy, that technique may simply allocate funds acquired externally from a single source (or small number of sources) to various projects within the consolidated group. I can think of no compelling reason why an external financing source would insist upon maintaining partitions post-bankruptcy that were created to facilitate a failed management scheme. However, almost every substantive consolidation is a deemed consolidation. This means that legal entities are not actually combined as part of the reorganization. Rather, in cases in which a company survives bankruptcy, the legal entity structure that existed pre-filing may exist in substantially the same form following emergence from bankruptcy. Thus, if pre-filing asset partition structures were used by management to create internal capital markets, those same structures would exist following emergence from bankruptcy for use by new management. The pre-existing internal entity structure would be available for use in the reorganized company simply because the deemed consolidation did not destroy the structure.

Recently, academic observers have noted that the context of reorganization plan negotiation differs from the case law rhetoric of rarity because transaction participants often employ the substantive consolidation technique to reorganize companies.¹⁰ The academic intuition is shared by transaction participants as evidenced by the many reorganization documents that expressly comment on the frequency of use of the doctrine.¹¹ Only recently have I seen case law recognition that use of substantive consolidation need not be rare in negotiated restructurings.¹²

Despite the intuition that different rules may apply in the negotiated plan context than in the courtroom, no one had attempted to quantify the extent to which transaction participants use the doctrine to reorganize companies. As an example, in the recent Owens Corning bankruptcy,¹³ the parties and the amici were reduced to listing published decisions in contested cases in which substantive consolidation had been approved to show that substantive consolidation had been used many times. The list was intended to prove that use of the doctrine was widespread but such a claim is hard to support without a denominator indicating the size of the pool from which the cases were drawn (or, indeed, any details concerning the composition of the pool itself). Unfortunately, the

¹⁰ See Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5 (2005); Robert K. Rasmussen, et. al., Brief of Amici Curiae in Support of Appellant, *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005) (No. 04-4080).

¹¹ See e.g., *In re Metropolitan Mortgage & Securities Co., Inc.*, Case No. 04-00757, Third Amended Disclosure Statement With Respect to Third Amended Joint Reorganization Plan of Metropolitan Mortgage & Securities Co., Inc. and Summit Securities, Inc. at 64 (Bankr. E.D.Wash. Sept. 23, 2005).

¹² See *In re James River Coal Co.*, --- B.R. ----, 2007 WL 438244 (Bankr.E.D.Va., Feb 08, 2007)(NO. 05-03550, 06-03037-KRH)(citing Professor Baird).

¹³ *In re Owens Corning*, 316 B.R. 168 (Bankr. D. Del. 2004), rev'd, 419 F.3d 195 (3d Cir. 2005), cert. denied sub noms. *McMonagle v. Credit Suisse First Boston*, 126 S. Ct. 1910 (2006) and Official Representatives of Bondholders and Trade Creditors of Debtors of Owens Corning v. Credit Suisse First Boston, 126 S. Ct. 1910 (2006).

listed cases shared only publication in common. This lack of structured information led to my preliminary investigation into the prevalence of substantive consolidation.¹⁴

IV. Case Duration

Substantive consolidation cases take longer to complete than non-substantive consolidation cases. In the All Cases Dataset, the average time spent in bankruptcy for a substantive consolidation case is 558 days whereas the average time spent in bankruptcy for a non-substantive consolidation case is 440 days. The table below reflects the average days in bankruptcy across different asset size classes. The number of cases included in the averages reported appears in a parenthetical following the day count.

Table C: The Duration of Bankruptcy Proceedings Across Various Asset Size Classes in the All Cases Dataset

	<\$500m	\$500m to < \$1b	\$1b to < \$10b	>\$10b
Single Debtor In				
Subcon	569 days (45)	473 days (41)	578 days (65)	775 days (8)
Non-subcon	460 days (47)	379 days (35)	448 days (44)	614 days (5)
Single Debtor Out				
Non-subcon	363 days (28)	378 days (25)	519 days (34)	521 days (4)
Single Debtor Cases (40)	604 days (19)	380 days (10)	208 days (10)	990 days (1)

Interestingly, Jumbo Cases involving a single debtor took an average of only 279 days to complete whereas the substantive consolidation cases in the Jumbo Cases Dataset took an average of 600 days to complete, suggesting that substantive consolidation does not follow from a simple and swift decision to treat multiple entities as a single entity. In the Jumbo Cases Dataset, substantive consolidation cases that eventually treat multiple entities as a single entity take over twice as long to complete as a true single entity case. Analysis of transaction documents in Jumbo Cases suggests that courts often approve substantive consolidation as part of a compromise and settlement of actual or threatened litigation. One factor leading to longer proceedings in substantive consolidation cases may be the time needed to negotiate these settlements. Thus, use of substantive consolidation doctrine may be a time saving device (when compared with litigation) even though the substantive consolidation cases take longer to complete than true single debtor cases. In the All Cases Dataset, the duration of single debtor cases increases significantly, suggesting that single debtor cases do not differ dramatically from multiple debtor cases in which substantive consolidation is not used.

¹⁴ William H. Widen, *Prevalence of Substantive Consolidation in Large Bankruptcies from 2000 to 2004: Preliminary Results*, 14 AM. BANKR. INST. L. REV. 47 (2006).

When considering single debtor cases, one should be mindful that many single debtor cases involve companies that are members of consolidated groups. Of the 40 single debtor cases in the All Cases Dataset, 26 debtors reported subsidiaries to the SEC. Thus, substantive consolidation was a real option, and not merely a theoretical possibility, in many of the single debtor cases.¹⁵ A single debtor case may involve an entity that is a member of a complex consolidated group. The report suggests that, in some of these single debtor cases, transaction participants considered substantive consolidation as an option (and rejected it) prior to the bankruptcy filing. The reported percentage of single debtor cases in which the debtor reported subsidiaries to the SEC undercounts the possible opportunities for use of substantive consolidation because a debtor may have subsidiaries that are not reported to the SEC.

The single debtor cases in which multiple subsidiaries are present in the consolidated group may provide signature examples in which management of the consolidated group did, in fact, use legal entities to match assets with liabilities, illustrating the dominant academic theories. We also note many substantive consolidation cases in which the number of Bankrupt Entities is less than the number of SEC Subsidiaries. The large number of cases in which the number of Bankrupt Entities is less than the number of SEC Subsidiaries suggests to us that, within the consolidated group, different legal entities were used for different purposes. Legal entities sometimes reflect conscious asset partitioning within a group but the presence of a legal entity simply is not a reliable marker for an asset partition of this sort. Use of substantive consolidation does not require that all entities within the consolidated group be substantively consolidated. Selections must be made. For example, consolidated groups may use legal entities to organize the holding of valuable assets that are operated without significant liabilities that need restructuring. In such a case, no purpose is served by filing the asset holding companies into bankruptcy. In other cases, some subsidiaries may operate solvent business units that have been separated from the insolvent units by legal entity form.¹⁶

¹⁵ Though it is possible, as a matter of existing substantive consolidation doctrine, to substantively consolidate a debtor with a non-debtor, we believe that debtor/non-debtor consolidations are rare. We believe the better view, as suggested by a recent case, *In re Ark-La-Tex Timber Co., Inc.*, --- F.3d ---, 2007 WL 766208 (5th Cir.(La.) Mar 15, 2007) (NO. 06-30105) at fn. 7, *superceding* *In re Ark-La-Tex Timber Co., Inc.*, 477 F.3d 295 (5th Cir. 2007)(opinion withdrawn), is that substantive consolidation of a debtor with a non-debtor should only occur if the non-debtor is subjected to the jurisdiction of the bankruptcy court (which typically would occur by virtue of a later bankruptcy filing against the non-debtor, with the procedural consolidation of the two cases forming the first step towards use of substantive consolidation).

¹⁶ Recent scholarship considers the extent to which consolidated groups may adopt compromise financial structures. See Edward M. Iacobucci and George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 Va. L. Rev. 101 (2007). “If a single firm combines asset groups that have markedly divergent capital-structure ‘demands’ . . . the integrated firm adopts a blended capital structure different from that which the corresponding segregated firms would choose.” *Id.* at 106. I believe that the findings in the report related to the number of SEC Subsidiaries as compared to the number of Bankrupt Entities will prove relevant to evaluation and refinement of theories of blended capital structure. However, such an investigation is beyond the scope of the report.

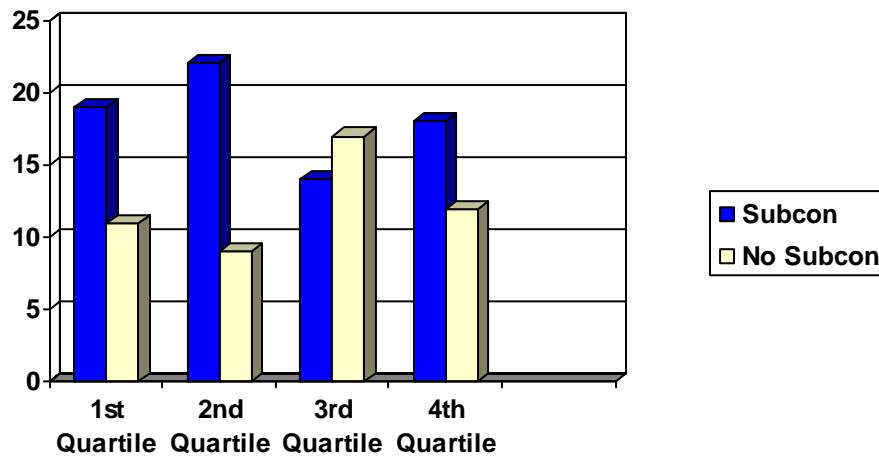
V. Case Complexity as Reflected in Asset Size, SEC Reported Subsidiaries and Bankrupt Entities

One might attempt to explain use of substantive consolidation as a technique to manage reorganizations for particularly complex corporate groups. On this theory, one might expect to find greater use of substantive consolidation in more complex cases. To test this idea, the report uses (i) the present value of reported asset size (“PV Asset Size”), (ii) the number of SEC reported subsidiaries (“SEC Subsidiaries”) and (iii) the number of bankrupt entities in a procedurally consolidated case (“Bankrupt Entities”), as proxies for corporate group complexity. Though the report finds that the substantive consolidation cases tended, on average, to have larger PV Asset Size, more SEC Subsidiaries and more Bankrupt Entities, the differences were modest. Only in the case of Bankrupt Entities does the report find material differences between substantive consolidation and non-consolidation cases—suggesting that substantive consolidation is a case management tool. The complexity addressed by substantive consolidation is the litigation complexity rather than a more general complexity associated with the consolidated group structure. No single debtor cases use substantive consolidation, even though these single debtor cases almost always involve an entity in a corporate group that had reported multiple SEC Subsidiaries. The report suggests that, in many of these single debtor cases, the decision not to use substantive consolidation as a strategy may have been made prior to filing the bankruptcy petition. These findings suggest that, although management of consolidated group complexity may be part of the substantive consolidation story, transaction participants do not turn to the doctrine simply out of a necessity arising from complexity in organizational structure—at least complexity reflected in asset size or multiple legal entities within a consolidated group. Rather, substantive consolidation appears more frequently when the circumstances of the case have required that multiple legal entities file for bankruptcy making the bankruptcy proceeding more complex.

The charts below reflect results from the ongoing investigation of the key variables selected for analysis. Some excerpts from a binary logistic regression run on SPSS 15.0 appear as Appendix B to this presentation. These excerpts suggest the statistical significance of the chosen variables and their degree of explanatory power. As I read the regression output, the number of Bankrupt Entities is a significant variable but has limited explanatory power. The duration of the bankruptcy proceeding has statistical significance, but even less explanatory power (and, could not be used in a predictive model in any event). The number of SEC Subsidiaries is not statistically significant. The PV of Asset Value is worthless. Eliminating single debtor cases from the pool reduces explanatory power. Testing for collinearity is negative (I had expected to find it between the number of SEC Subsidiaries and the number of Bankrupt Entities).

Because the data do not bear out my initial notions of how to measure the type of consolidated group complexity that substantive consolidation may be used to address, future research will try to measure the impact of at least three new categorical variables: the presence of secured debt, the presence of inter-company guarantees and the presence of subordinated debt. I welcome suggestions for other variables that might explain the substantive consolidation.

Chart 3: Frequency of Substantive Consolidation Grouped by Quartiles Ordered by PV Asset Value: Jumbo Cases Studied



[Charts Continue on Next Page]

Chart 4: Average Asset Values by Quartiles: Jumbo Cases Studied

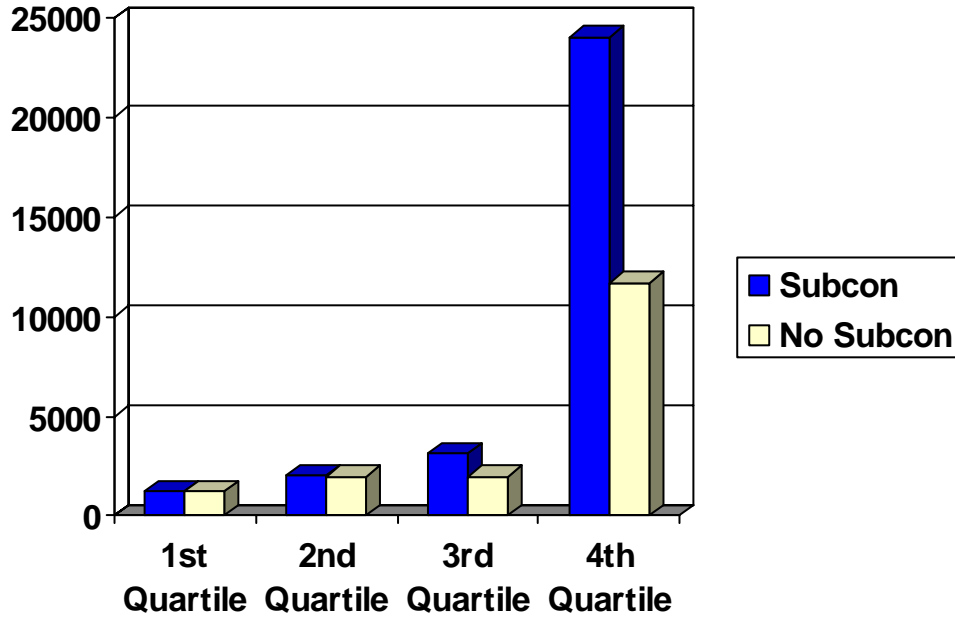


Chart 5: Average Asset Values by Quartiles: Jumbo Cases Studied (Outliers Removed)

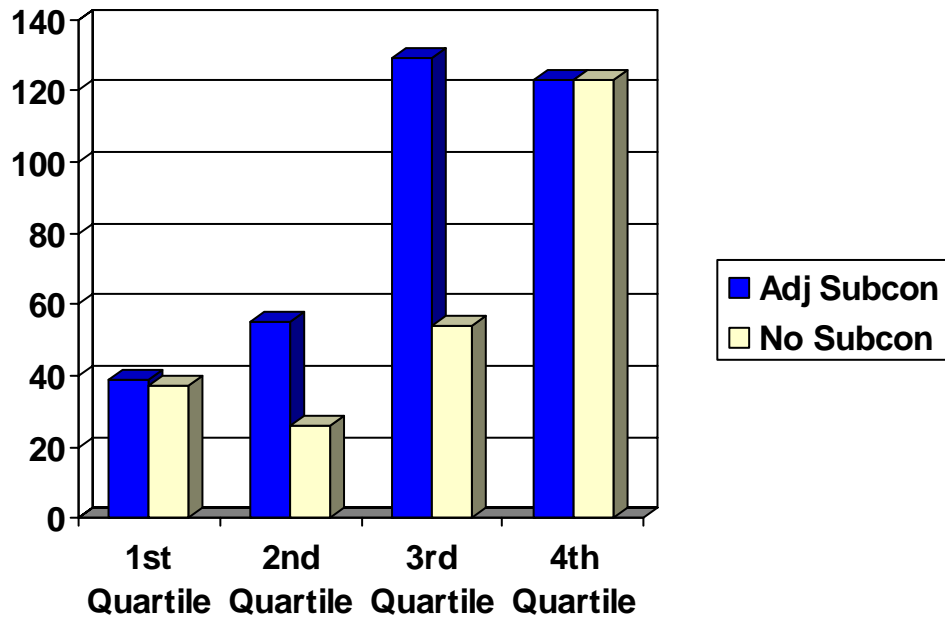


Chart 6: Average SEC Subs by Quartiles: Jumbo Cases Studied

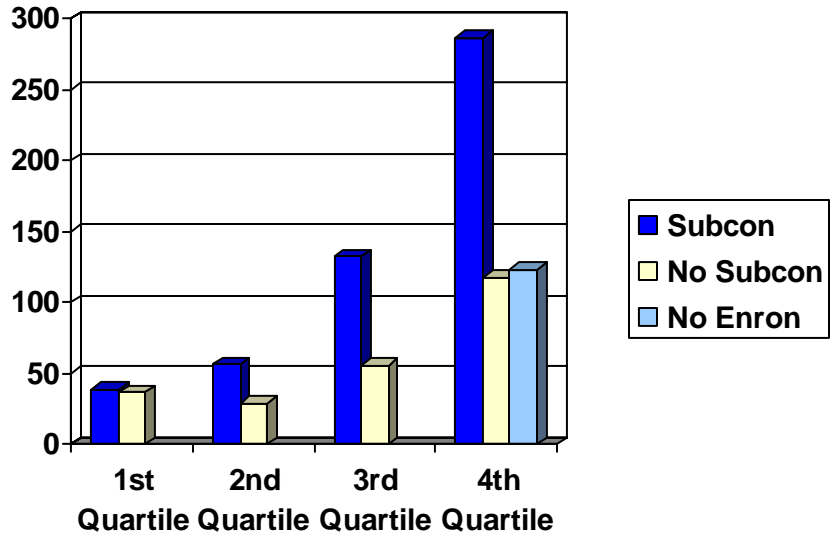


Chart 7: Average Proceeding Length by Quartiles: Jumbo Cases Studied

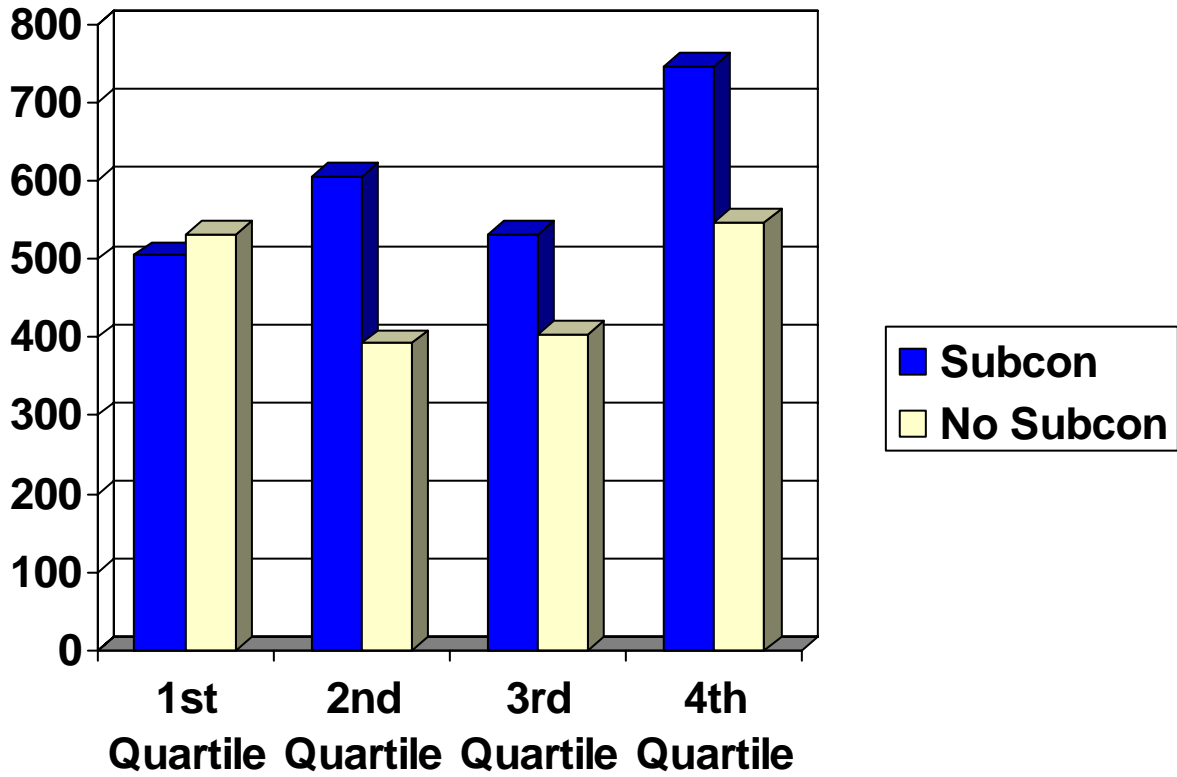
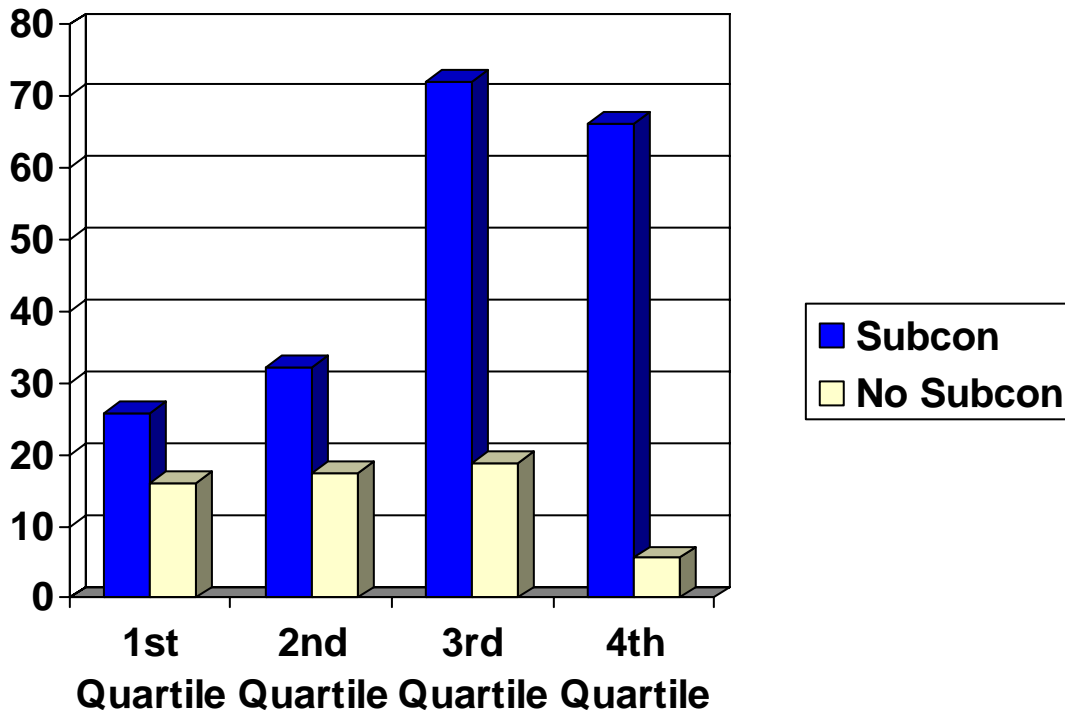


Chart 8: Average Number of Bankrupt Entities by Quartiles: Jumbo Cases Studied



VI. Deemed Consolidations

Though fact checking remains ongoing, the report currently identifies only two cases that possibly involved an actual consolidation of legal entities rather than a “deemed” consolidation. The significant percentage of deemed substantive consolidations conflicts with the sentiment expressed by some courts that deemed consolidations are not real substantive consolidations. The deemed consolidation phenomenon suggests that the separate existence of legal entities is important within consolidate groups, but not primarily for the reason that asset partitioning matches specific assets with specific liabilities. The data suggest that other factors influenced the decision to preserve asset partitions because the existing partitions were ignored in making distributions to creditors.

VII. Emerge Cases versus Non-Emerge Cases

Though substantive consolidation appears more frequently in Jumbo Cases in which no company emerged from bankruptcy, it also appears often in cases in which a company does emerge from bankruptcy. Of the 49 Non-Emerge Cases examined so far, 35 were substantive consolidation cases whereas in the 68 Emerge Cases examined to date, 34 were substantive consolidation cases. Significant usage of the substantive consolidation technique in Emerge Cases suggests that corporate form is not ignored just in situations where one might argue that continued attention to corporate formalities does not matter to the transaction participants. Continued vitality of the various corporate forms within a

consolidated group matters in Emerge Cases and yet, in half the Emerge Cases in the Jumbo Cases Dataset, these same corporate forms were ignored in structuring distributions to creditors. This finding further suggests that preservation of existing legal entity forms matters to transaction participants but not for the purpose of matching assets with liabilities.

VIII. Bargaining in the Shadow of Law

Ample evidence supports the view that substantive consolidation doctrine matters to transaction participants who are negotiating reorganization plans. In many cases (approximately 77% of the time), transaction documents (principally disclosure statements) refer to substantive consolidation factors developed in contested cases as justifying use of substantive consolidation as part of a negotiated reorganization plan. Transaction documents in some cases go so far as to mention actual cases (approximately 38% of the time). The report suggests that recognition of the importance of case law in the context of negotiated plans of reorganization relates to the fact that courts often approve use of substantive consolidation as part of the compromise and settlement of claims. To justify approval of a settlement, a court must consider the case law as applied to the facts of the case in sufficient detail to decide whether the settlement is within a range of reasonableness under the circumstances. This posture requires consideration of case law even if all parties in the negotiation agree on use of substantive consolidation. It is for this reason that the parameters of substantive consolidation doctrine matters in the context of consensual reorganizations.

IX. Tentative Conclusions

The most basic practical lesson from the ABI study is that creditors who rely simply on legal entities to match assets with liabilities are deluding themselves. The prevalence of substantive consolidation in large public bankruptcies reveals that the simple asset partition created by a legal entity is a particularly unreliable method of matching assets with liabilities. This much is clear. The judicial rhetoric that substantive consolidation should be used sparingly provides cold comfort in light of its widespread use in large public bankruptcies.

To be sure, a reliable asset partition may employ a legal entity as part of a matching strategy. However, to insure the integrity of the asset partition under the stress of insolvency (i.e. the only circumstance that really matters to a creditor), a creditor must supplement the asset partition with additional steps, such as strict covenant packages and security interests. Securitization transactions provide the classic example of enhancement of the asset partition created by a legal entity. External regulatory regimes, such as those applicable to banks, insurance companies and public utilities, similarly may provide another type of supplement to the legal entity form that helps preserve the integrity of an asset partition created by a legal entity.

Beyond the practical conclusion, I want to make the stronger theoretical point that, in light of the evidence, asset partitioning can provide only a partial explanation for the

internal structure of consolidated groups. Certainly, management of a consolidated group and its creditors *may* use legal entities as part of a strategy to match assets and liabilities. This matching may well have taken place in many of the single debtor cases studied that involved debtors that were members of multi-entity consolidated groups. However, the data suggests that, in the majority of cases, the internal structure of legal entities within a consolidated group are not being used to partition assets. From this it would be wrong to conclude, however, that management of consolidated groups and creditors are indifferent to internal structure. The extensive use of the “deemed” substantive consolidation technique suggests that the management of consolidated groups elect to preserve internal group structure (while simultaneously ignoring the asset partitioning function available by use of multiple legal entities) for a variety of reasons.

At one extreme, legal entities may be preserved simply to save the costs associated with effecting business combinations under state law. In many cases, management interests and creditor interests will be aligned by pursuit of these cost savings.¹⁷ In other cases, preservation of internal consolidated group structure may facilitate goals other than asset partitioning. Three non-exhaustive examples illustrate other possible goals furthered by use of a legal entity: separate legal entities are used (i) for tax planning,¹⁸ (ii) to facilitate creation of security interests for creditor groups¹⁹ and (iii) to provide incentives for management personnel of separate internal business operations within a consolidated group.²⁰ The fact that the deemed substantive consolidation technique receives extensive use in cases in which a debtor emerges from bankruptcy (and not simply in liquidation cases), strengthens the conclusion that internal group structure matters (even if it does not matter primarily for the asset partitioning function).

This study is a first step in defining the space within which emerging theories about the structure of consolidated groups must rise or fall—regardless of whether those theories rely on simple transaction cost savings, internal capital markets, blended capital structures or otherwise. At a minimum, however, this study shows that additional theories are needed to explain the structure of consolidated groups because the basic theory of asset partitioning is unable to carry the theoretical burden by itself in light of the facts.

¹⁷ The different economic circumstances in which cost savings might be realized are discussed in *Corporate Form and Substantive Consolidation*, supra note 4.

¹⁸ An example of legal entity use for tax planning is the intellectual property holding company designed to avoid state taxes at issue in the *Owens Corning* cases. See *Corporate Form and Substantive Consolidation*.

¹⁹ The use is broader than securitization transactions. An example would be the collection of intellectual property in a single legal entity, coupled with a pledge of the equity interests in the legal entity. Such a technique may be used to avoid the need to comply with Federal law governing perfection of security interests in intellectual property. Different techniques used to create security interests are discussed in William H. Widen, *Lord of the Liens: Towards Greater Efficiency in Secured Syndicated Lending*, 24 CARD. L. REV. 1577 (2004).

²⁰ An example would be granting warrants or options to management of a subsidiary company exercisable upon a sale of the subsidiary. Additionally, internal capital markets might be structured to provide other incentives. Cf. *Internal Capital Markets*, supra.

Appendix A

Definition of a Substantive Consolidation Case:

For purposes of the ABI study, a “Substantive Consolidation Bankruptcy” is a large public company federal bankruptcy case in which either (a) settlement of substantive consolidation litigation preceded approval of a reorganization plan or liquidation or (b) a plan of reorganization proposed substantive consolidation of two or more entities involved in related bankruptcy proceedings. For purposes of this classification, substantive consolidation is considered part of a bankruptcy plan or liquidation if the plan or liquidation provides (i) for the actual combination of two or more legal entities, (ii) for voting on the plan as if two or more entities were a single entity (whether or not the plan combines the entities) or (iii) for distributions as if two or more entities were combined (whether or not the plan combines the entities). If a debtor proposed that two or more entities be consolidated prior to implementation of a plan, substantive consolidation is considered part of a subsequent plan. A plan proposing substantive consolidation does not need to have been approved for the case to count as a Substantive Consolidation Bankruptcy.

The scope of the definition includes a so-called “deemed” substantive consolidation as a Substantive Consolidation Bankruptcy. In a “deemed” substantive consolidation distinct legal entities are not combined. Instead, either votes on a plan, plan distributions, or both, are computed “as if” the legal entities had been combined.

Appendix B: Selected Results from a binary logistic regression

JUMBO CASES:

Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 ^a	PVAsset	.000	.000	.110	1	.740	1.000
	NumBkrptEnts	.031	.011	8.120	1	.004	1.032
	SECSUBNum	-.001	.001	1.334	1	.248	.999
	DaysIn	.000	.000	1.199	1	.274	1.000
	Constant	-.532	.351	2.295	1	.130	.587

a. Variable(s) entered on step 1: PVAsset, NumBkrptEnts, SECSUBNum, DaysIn.

Single debtors omitted from JUMBO CASES:

Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 ^a	pvasset	.000	.000	.211	1	.646	1.000
	numbkrptents	.022	.010	4.702	1	.030	1.022
	secsubnum	-.001	.001	.602	1	.438	.999
	daysin	.000	.000	.350	1	.554	1.000
	Constant	-.075	.381	.039	1	.844	.928

a. Variable(s) entered on step 1: pvasset, numbkrptents, secsubnum, daysin.

ALL CASES:

Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 ^a	PVAsset	.000	.000	.025	1	.875	1.000
	NumBkrptEnts	.042	.010	16.522	1	.000	1.043
	SECSUBNum	-.002	.001	2.347	1	.126	.998
	DaysIn	.001	.000	3.952	1	.047	1.001
	Constant	-.674	.228	8.723	1	.003	.510

a. Variable(s) entered on step 1: PVAsset, NumBkrptEnts, SECSUBNum, DaysIn.

Single debtors omitted from ALL CASES:

Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 ^a	pvasset	.000	.000	.011	1	.916	1.000
	numbkrptents	.022	.009	6.191	1	.013	1.022
	secsubnum	-.001	.001	.257	1	.612	.999
	daysin	.001	.000	4.034	1	.045	1.001
	Constant	-.188	.249	.569	1	.451	.829

a. Variable(s) entered on step 1: pvasset, numbkrptents, secsubnum, daysin.