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The Essential Structure of Judgment Proofing

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In order to insulate itself against debts resulting from unfavorable judgments, a business entity may seek to operate unencumbered by significant assets. In this essay, Professor Lynn LoPucki revisits this issue of "judgment proofing" and responds to arguments that large businesses cannot operate in judgment-proof conditions. He identifies a single structure that describes virtually all judgment proofing: a division of risks of liability and assets into two or more separate entities sharing a symbiotic relationship. An "operating entity" conducts the business activities and carries the risks of tort liability, while an "owning entity" owns the business assets. While the two entities are bound together by contract, the bifurcation of assets and risks shields the business from judgment debt. Professor LoPucki argues that current law cannot collapse the two entities into one for purposes of satisfying judgments, and concludes that large businesses of any type can successfully render themselves judgment-proof.

In The Judgment Proof Problem, Steve Shavell demonstrated that judgment-proof debtors have suboptimal incentives to exercise care or purchase liability insurance. Such debtors will tend to impose above-optimal levels of risk on third parties and to carry insufficient liability insurance. Carried to its logical extreme, the "judgment-proof problem" is that judgment-proof debtors can commit torts with impunity.

The immediate implications of Shavell's 1986 observations were in the fields of tort and insurance law. But concern about judgment-proof debtors quickly spread to the fields of corporate and commercial law as scholars in those fields recognized the broader implications of Shavell's analysis. The revered institutions of corporate limited liability and secured credit were, in Shavell's terms, judgment proofing. Whenever they mattered at all, they generated the judgment-proof problem.

In response to the skewed incentives of judgment-proof debtors, corporate and commercial law scholars proposed drastic changes in established doctrine. Those proposals included abolishing corporate limited liability,2

* A. Robert Noll Professor of Law, Cornell Law School. The author acknowledges the intellectual contributions of Lucian Bebchuk, Frances Foster, Louis Kaplow, Joseph Weiler, and other participants in the Harvard Law School workshop.

2. See, e.g., Henry Hansmann & Reinier Kraakman, Toward Unlimited Shareholder Liability
granting tort creditors priority over secured creditors,\textsuperscript{3} and carving out a portion of secured creditors’ collateral for the benefit of unsecured creditors.\textsuperscript{4} The most troubling critique of each such proposal was the same: debtor-strategists would be able to end run the reforms.\textsuperscript{5}

In \textit{The Death of Liability},\textsuperscript{6} an article published ten years after \textit{The Judgment Proof Problem}, I argued that the proposed reforms were futile. Not only would adjustments to the liability system fail to restore mathematically precise levels of deterrence,\textsuperscript{7} but judgment proofing would overwhelm and destroy that system.\textsuperscript{8}

A persistent objection to \textit{The Death of Liability} thesis has been that large businesses cannot practically operate in judgment-proof conditions.\textsuperscript{9} For example, in his response to \textit{The Death of Liability}, Professor James J. White argues that lenders and other contract creditors force large businesses to maintain substantial unencumbered equities on which tort creditors are able to free-ride.\textsuperscript{10} A broader version of the objection notes that unencumbered cushions of equity serve a variety of functions within the large firm, some of which are not yet well understood. No one has yet demonstrated that significant numbers of large firms can operate without cushions of equity.

The discussion of this objection has been hampered by the wide variety of forms in which large businesses and judgment proofing exist. Demonstrating that firms of a particular variety can employ a particular device to operate in judgment-proof condition does not necessarily prove that firms of other varieties could do so. Attempts to discuss the objection typically dissipate into disputes over the practicality of employing a particular judgment-proofing device.

\textit{For Corporate Torts}, 100 \textit{Yale L.J.} 1879, 1900, 1932-34 (1991) (summarizing possible arguments in favor of abandoning corporate limited liability in order to realign incentives).
\textsuperscript{5} See \textit{id. at 1396-97}.
\textsuperscript{7} The “liability system” is the system by which courts enter and enforce judgments for money damages.
\textsuperscript{8} See LoPucki, \textit{supra} note 6, at 6-7, 89-90 (describing the effect of judgment proofing on the liability system).
\textsuperscript{10} See \textit{id. at 1396-97}.
proofing device in a particular industry. The problem is complicated by an almost complete lack of probative empirical evidence. As a result, the debate has been locked in the academic equivalent of door-to-door fighting.

As a means of overcoming that limitation, this essay argues that all, or substantially all, judgment proofing has a single essential structure: a symbiotic relationship between two or more entities, in which one of the entities generates disproportionately high risks of liability and another owns a disproportionately high level of assets. Through the contract that unites them, the two entities allocate between them the gains from judgment proofing.

Typically, the asset-owning entity guarantees payment of selected contract obligations of the liability-generating entity (the “operating entity”) as necessary for the latter to continue in business. This guarantee does not encompass the tort obligations of the operating entity. The guarantee may be a simple contract, or may be a regulated form such as a standby letter of credit or payment insurance. In some cases, no guarantee may be issued. Thus, it is possible to describe all, or substantially all, judgment-proofing mechanisms, whether employed by large businesses, small businesses, or individuals, in a single model. This model makes it possible to identify the assumptions necessary to prove that any business or individual can operate in a judgment-proof condition.

This essay focuses on the application of this model in the context of the large firm because skepticism about the practicality of judgment proofing has focused on that context. In that context, proof of the model relies upon two propositions. The first, argued in Part I, is that any large business can be divided into two components—one with the bulk of the tort liability, the other with the bulk of the assets and the contract liability—and the division can be accomplished without significant change in the operation of the business. The second, argued in Part II, is that the law cannot collapse the two parts into one because it cannot find a principle for inclusion; that is, it cannot separate the two parts from each other or from the business environment. The essay concludes that large businesses of any type can operate in a judgment-proof condition.

I. SPLITTING BUSINESSES INTO ASSET-OWNING AND OPERATING ENTITIES

Judgments are enforced only against assets owned by the judgment debtor. To own no assets is to be judgment-proof. Some businesses do operate without owning assets of significant value. For example, a busi-
ness may lease all of the assets used in its operations or may have granted a security interest in those assets to secure a debt in excess of the value of the assets. In either case, the debtor is judgment-proof in the sense that the debtor has no assets from which the creditor can recover.

Others have argued, however, that it is impractical to operate a large business in such a posture. Efficiency requires that the business have unencumbered assets. Such a "cushion" of unencumbered assets is necessary to enable the business to meet its financial obligations during periods when the business is not profitable. A business without unencumbered assets would be swamped—and bankrupted—by the slightest adversity.

Accepting for purposes of argument that such a cushion is necessary, it does not follow that it is impossible to operate a large business in a judgment-proof condition. Though the business and the assets are both necessary, they need not be contained in the same legal entity. The judgment proofer's solution to the problem described in the preceding paragraph is to separate the business into two or more legal entities that continue in a symbiotic relationship. One of these entities, the "owning entity," owns the unencumbered assets of the business. The other, the "operating entity," engages in the potentially liability-generating activity.

Why does this separation defeat liability? In nearly every instance, liability is generated by employees, but damages can only be collected from assets. Figure I shows that liability is initially a link between the tort victim and the employee of the business. The doctrine of respondeat superior transmits the liability to the employing (operating) entity. Once liability has been fixed against that entity, it can be collected from the assets owned by that entity. The weakness in the liability system is the lack of any generally applicable requirement that operating entities own assets.

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14. See, e.g., White, supra note 9, at 1394-1412 (describing numerous barriers to corporate judgment proofing).

15. Statutes require liability insurance or financial responsibility in some specific circumstances. See id. at 1410 n.175 (providing examples of such circumstances).
To complete the judgment-proof structure, the judgment proofer introduces a second entity to own the assets of the business. As shown in Figure II, the two entities ordinarily are linked by contract. The contract performs two functions. First, it welds the two entities into a single business and assures that the business will have full use of the resources of both entities to the extent needed. Second, it insulates against liability. That is, the nature of the contract is such that judgment creditors of the operating entity are not legally entitled to recover their judgments from the assets of the owning entity.
Several different types of contracts are used in various judgment-proofing schemes:

1. **Lessor-lessee.** To the extent that the assets of the business are real or tangible personal property, they are placed in the owning entity and leased to the operating entity.\(^{16}\) Judgment creditors of the lessee can take only the lessee's interest in the lease. If the rental is month-to-month at market rates, the lessee's interest will be of negligible value.

2. **Secured lender-borrower.** Secured lenders have priority over the judgments of tort creditors. When this type of contract is employed, the operating entity will hold title to the assets of the business, but the owning entity will have a security interest in the assets that secures a debt in an amount roughly equal to the value of the assets. Again, the operating entity's interest in the assets, and consequently, the value that judgment creditors can reach, will be negligible.\(^{17}\)

3. **Buyer-seller.** If the assets of the business are accounts receivable generated by the operating entity, the contract will provide for sale of the accounts to the owning entity as the accounts are generated.\(^{18}\) The arm's-length sale is for the full value of the receivables. The operating entity then distributes the proceeds of the sale to its shareholders as dividends, before incurring tort liability.

4. **Franchisor-franchisee.** To the extent that the assets of the business are trademarks and business systems, the owner of those assets becomes the franchisor and the users the franchisees. Courts generally hold that franchisors are not liable for the torts of their franchisees.\(^{19}\)

5. **Licensor-licensee.** Assets such as computer programs, trademarks, and other intellectual property may be licensed from the owning entity to the operating entity. Use of the licensor's trademark by the licensee does not render the licensor liable for the torts of the licensee or leave the trademark vulnerable to seizure for torts committed by an entity operating under its banner.\(^{20}\)

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\(^{16}\) See, e.g., N.L.R.B. v. Fullerton Transfer & Storage Ltd., 910 F.2d 331, 333-35, 340-42 (6th Cir. 1990) (involving use of lessor-lessee judgment proofing to defeat labor claims).

\(^{17}\) For an example of the use of this structure, see LoPucki, supra note 11, at 1423-24.


\(^{19}\) See, e.g., O'Banner v. McDonald's Corp., 670 N.E.2d 632-35 (Ill. 1996) (holding that McDonald's was not liable for slip and fall at franchisee's restaurant); Mobil Oil Corp. v. Bransford, 648 So.2d 119, 121-22 (Fla. 1995) (holding that Mobil Oil was not liable for assault by employee of franchisee).

\(^{20}\) See Yoder v. Honeywell Inc., 104 F.3d 1215, 1222-24 (10th Cir. 1997) (holding that a parent company was not liable for defective products manufactured and sold by its subsidiary under the trademark of the parent company), cert. denied, 118 S. Ct. 55 (1997); RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 14 cmt. d (Proposed Final Draft 1997).
6. Parent-subsidiary. The owning entity may own not only the assets used in the business, but also the stock of the operating entity. This structure is the most convenient, because it justifies transfer of excess earnings of the operating entity to the owning entity as dividends. Theoretically, the parent-subsidiary structure is vulnerable to a court’s disregarding of the subsidiary as a separate entity. In practice, courts rarely extend liability to a parent company. As a result, parent-subsidiary is probably the most common of the contracts employed in judgment-proof structures.

Because the owning and operating entities divide the unified business between them, the two entities together have all of the characteristics of the unified business. Together, they own the same assets, conduct the same operations, employ the same people, and have the same creditworthiness. If the contractual relationship is other than a parent-subsidiary relationship, each entity will issue stock to its owners. Together, the two stockholdings will be the equivalent of the stock in the unified business, but with one important advantage: The bifurcated business will be judgment-proof. It will not have to pay its tort liability.

No corporate constituent need be inconvenienced by the new structure. Finance theorists have pointed out that a business is merely a web of contracts among the various constituents—shareholders, creditors, employees, suppliers, customers, and others. In the judgment-proof structure, two entities rather than one are involved. But that fact in no way restricts the constituents in their contracting with one another. The only difference is one of form: In the unified business, the constituents contract with reference to a single entity, whereas they contract with reference to two or more in the judgment-proof business. In contracting with reference to the entities of the judgment-proof business, each constituent can obtain exactly the same rights against other constituents that it would have obtained in a unified structure. For example, an employee can contract for his or her employment with the operating entity and obtain a guarantee of payment from both the owning and the operating entities. The constituent supplying the capital used to buy assets will place them in the owning entity, which will lease them to the operating entity. Whatever return on investment the constituent would have ex-

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21. See Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 CORNELL L. REV. 1036, 1058 (1991) (reporting that only 226 of the 1572 veil-piercing cases studied were tort cases, and that the court pierced the corporate veil in only 70 of those tort cases).

22. See LoPucki, supra note 6, at 20-23 (discussing parent-subsidiary judgment proofing).

23. The shares in the two entities might or might not be in common ownership. If they are, the likelihood that the two will be collapsed into one will be higher.

tracted from a unified company, the constituent can extract from the operating company as "rent." The amount of that rent can be made to fluctuate with the success or failure of the business, in whatever manner the parties choose.25

Through a standby letter of credit, a loan, or a guarantee from the owner, an effective "cushion of equity" can be made available to the operating entity and its contract creditors without making it available to its tort creditors.26 For example, the owning entity might provide a line of credit through a "blocked account" that would enable the operating entity to operate with absolutely no cash on hand.27 Or, the owning entity might guarantee various contract debts of the operating entity in return for a fee linked to the revenues or the profits of the operating entity. Persons contracting with the operating entity would do so in reliance on the financial strength of the owning entity. Alternatively, the owning entity might contract with third parties for the resources needed in the business and lease them to the operating entity. Either way, the contract creditors have full recourse and the tort creditors none.

Of course, the owning entities must be compensated for their guarantees. The simplest form of compensation is a fixed fee, as a bank would charge for a standby letter of credit. More complex forms would tie the amount of compensation to the revenues or profits of the operating company. An example would be a shopping center lease that links the rent payable for space to the net sales of the lessee's business.28 At the extreme, the owning company might provide all of the equity—most of it in the form of a guarantee—in return for all of the profits. That is commonly the arrangement when a parent company finances the business of its subsidiary.

By lending its credit to a judgment-proof operating entity, the owning entity creates a moral hazard problem.29 Because the operating entity will not suffer the loss if the guarantees are called upon, it will tend to rely recklessly on the guarantees. In order to protect itself, the owning entity could own the stock of the operating entity and elect directors who would not act opportunistically. But the owning entity can also achieve roughly equivalent

25. See, e.g., Harmont Plaza, Inc. v. Commissioner, 64 T.C. 632, 635 (1975) (describing lease agreement providing for rent in an amount equal to 2.5% of tenant's net sales up to $8.5 million plus 1.25% of the next $2 million, plus 1% of net sales over $10.5 million).

26. See, e.g., In re Iowa R.R. Co., 840 F.2d 535, 541 (7th Cir. 1988) ("Collecting carriers with shaky finances may be required to post bonds, secure letters of credit, or find other ways to assure that they turn over [money they owe to others]. The economy teems with such devices.").


28. For an example of such a lease, see Harmont Plaza, Inc., 64 T.C. at 633-35.

protection without formal legal control. The symbiotic relationship that exists between truly independent owning and operating entities is held together by three kinds of advantages. The first is the prospect for mutual gain that would have held all of the constituents of the unified business together, had the business not been split into owning and operating entities. That is, the constituents will want to contract with the entities of the judgment-proof business for the same reasons they would have wanted to contract with the entity of the unified business. The second advantage is the continuing savings from externalizing the tort liability that the unified business would have had. Working together, the entities of the judgment-proof business have the same earning power as the unified business, but lower costs of liability. They can divide the savings between them by contract. The third advantage is saving the transaction costs that would have to be incurred to redeploy the assets and constituents of the business if the owning and operating entities severed their relationship. So long as these advantages exceed the amounts that the operating entity could capture from the owning entity through opportunism, the operating company has an incentive to cooperate with the owning entity—even though the owning entity has no effective remedy by suit for money damages. That incentive assures that even if the contractual arrangement between the entities of the judgment proof business were severed—for example, by the bankruptcy of the operating entity—the two entities would choose to recontract and continue their profitable partnership.

To minimize the amount the operating entity could capture through opportunism, the owning company would retain the right to terminate the relationship to the maximum extent consistent with the business needs of the operating company. For example, the owning entity might extend guarantees only to specific suppliers for specified times or retain the right to cancel guarantees already given, which would give the owning entity substantial leverage over the operating entity. This leverage would be similar in source and effect to the leverage that bank lenders commonly seek over their borrowers in the absence of bankruptcy. The owning entity, like a bank, could use its leverage to maintain access to the books, records, and operations of the operating entity. Through that access, the owning entity could discover opportunistic activity at its inception and prevent its maturation. That

30. See, e.g., In re M. Paolella & Sons, Inc., 161 B.R. 107, 111-13 (Bankr. E.D. Pa. 1993) (involving a bank’s letter of credit to debtor’s suppliers that provided for cancellation by the bank at any time by notice to the suppliers).

31. See, e.g., Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1358 (7th Cir. 1990) (holding that a bank need not “loan more money or give more advance notice of termination than its contract requires”); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 754 (6th Cir. 1985) (involving a $3.5 million line of credit with the repayment of the balance due “on demand”). Debtors can often negate this kind of leverage by filing bankruptcy. But that is not true of leverage that comes from an as-yet unperformed contract to extend credit. Such contracts are unenforceable in bankruptcy, even if enforceable outside bankruptcy. See 11 U.S.C. § 365(c)(2) (1994).
monitoring could assure that the operating entity would meet its obligations to the owning entity even while predictably shirking its obligations to the tort creditors.

II. THE IMPRACTICABILITY OF COLLAPSING ENTITIES

In the example used in the previous Part, the two halves of the bifurcated business were created by dividing the previously unified business. Thus, it might seem easy for the courts to collapse the two entities into one at the request of an aggrieved tort creditor. But creation of the owning and operating entities by division in that example was merely to illustrate that the two parts could constitute a working whole. The cooperating entities could also form independently of each other—separate sets of investors, brought together by investment bankers or brokers to contract at arm’s length.32 The investors in each of the entities would regard their own business—owner or operator—as complete in itself and merely in a contractual relationship with the other. On what principle could a court collapse the two into one?

The principle most often suggested is “enterprise.” That is, the court should determine the scope of the business enterprise and collapse all of the “constituent parts . . . functioning as an integral part of a united endeavor” into one.33 The problem with that approach is that the boundaries of the modern enterprise are ethereal and transitory.34 This is particularly true with regard to whether assets are owned by the enterprise, and therefore “inside” it, or leased by the enterprise, and therefore “outside” it. This distinction means everything to the judgment creditor, who can recover only from the assets of its judgment debtor. Yet to the promoter who sets up the potential judgment debtor’s business, the decision to own the assets or lease them may be of very little consequence. Some airlines raise additional capital to own their aircraft, others lease them. The same is true of factories, offices, and stores. Subtle changes in the business environment can quickly alter the pattern.35 One such change may be the perception that liability constitutes a significant threat to the business.

32. For an example of such an arm’s-length relationship between owning and operating entities, see the discussion of Rockefeller Center Properties, in text accompanying note 47 infra.


34. See, e.g., Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 311 (1976) (“The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships . . . . [I]t makes little or no sense to try to distinguish those things which are ‘inside’ the firm (or any other organization) from those things that are ‘outside’ of it.”).

35. See, e.g., Neal Templin, Building Tension: REIT Revolution Hits an Unexpected Bump: Opposition by Clinton, WALL ST. J., Jan. 30, 1998, at A1 (describing boom in Real Estate Investment Trusts, or REITs, resulting from change in tax laws combined with an innovative business
The boundaries of the modern business enterprise are also ethereal and transitory with regard to employees and operations. Workers may be "inside" the business as employees, bringing the potential tort liability for their error and omissions with them. But the same tasks may be performed by independent contractors, who are "outside" the business, though they look suspiciously like employees and may even be former employees. This game is not played solely at the lower levels of the enterprise. Businesses of all sizes occasionally contract to be managed by a separate entity—a management company—rather than hire executives as employees. Businesses may "outsource" other functions that traditionally were part of the enterprise, including bookkeeping, sales, marketing, finance, and even manufacturing. It may now be possible for a business to outsource all functions at the same time, a concept sometimes referred to as a "virtual company."

To illustrate the problem a court would face in determining the boundaries of an enterprise without reference to its form, consider the example of an $80 million judgment for food poisoning at a hypothetical fast-food restaurant franchise. The negligent employees were employed by Franchisee, Inc. Under the doctrine of respondeat superior, that corporation is liable, but it owns nothing. The land and building are owned by and leased from a Real Estate Investment Trust (REIT) that owns hundreds of such properties. The equipment in the restaurant is owned by and leased from a national leasing company. The trademark and business systems are owned by the franchisor, Franchisor, Inc. The franchise agreement provides that the franchise is not property and that Franchisor, Inc. can cancel it at any time, with or without cause.

For a court to identify the boundaries of the business in this illustration may be impossible. Reliance on the legal form of the transactions yields the result that the franchisee's enterprise has no assets. Holding the franchisee's enterprise to own all assets indispensable to the business adds nothing. Regardless of the type of asset considered, some businesses operate without owing it, or at least without having any equity in it. For example, many businesses lease the real estate they occupy and the equipment they use. A decision to include in the enterprise all of the assets used in the business would create more problems than it would solve. For instance, airports are used in the businesses of airlines, but no one advocates permitting judgment

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38. See LoPucki, supra note 11, at 1433-34 (describing "virtual judgment proofing").
creditors of a bankrupt airline to levy on those airports and collect from them. One may be tempted to say that the airport is outside the enterprise because it is used by several businesses. Yet to limit the "enterprise" to assets used exclusively by the business would give up too much. Under this regime, the debtor could shield assets, such as its aircraft, simply by sharing use with another airline.

Nor is it clear in the illustration under discussion what "enterprise" we are talking about. Is it the local franchise or the national chain? If the enterprise is the national chain, shouldn't it also include all firms, regardless of separate ownership, whose entire business is supplying goods or services to the chain? An affirmative answer to this question would expose thousands of suppliers to liability that they do not have under current law.

The search for the boundaries of the "enterprise" will fail. It is an effort to distinguish the substance of a business organization from its form, but in substance there are no sharp boundaries among businesses. Firms in independent ownership link to one another through formal contract, informal business relationship, or some combination of the two. The firms themselves are often composed of numerous legal entities which may be completely or partially owned by one another. These contractual webs extend throughout the economy. To hold the entity that commits the tort and all contractually related entities liable would be to hold the entire American economy liable.

As strategists have manipulated the flexible boundaries of firms and enterprises, those firms and enterprises have tended to bifurcate into owning and operating entities. Whether the bifurcation results from judgment proofing, tax avoidance, regulatory evasion, or considerations of economic efficiency, the effect is the same. After bifurcation, operating entities have fewer assets available to satisfy the same or greater liability.

Consider, for example, the recent boom in REITs. REITs raise money in public markets and use it to buy hospitals, manufacturing facilities, car dealerships, office buildings, and other revenue-generating real property. The REIT buys only the real estate, not the business. Typically, it leases the real estate back to the "operating company." (In our terminology, the REIT is the owning entity.) A recent article in the Wall Street Journal carried a prediction that in ten years REITs would have $1.3 trillion dollars in assets—50% of the investment-grade real estate in the United States. The same article quoted the CEO of a REIT boasting that he could "buy a company like McDonald's [Corporation], put the real estate in the REIT, and use the oper-

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39. The distinction between a "firm" and an "enterprise" as I use the terms here is that a "firm" is owned by a single set of investors and managed by a single person or group. An "enterprise" may consist of two or more firms joined by contract in a single business endeavor.
40. See note 34 supra.
41. See Templin, supra note 35.
ating corporation to run the restaurant chain. The article describes the boom in REITs as tax-motivated and does not mention liability. But the result is judgment proofing.

Asset securitization, one of the fastest growing segments of the U.S. capital markets, provides a second example of this growing bifurcation. In an asset securitization transaction, a company sells its accounts receivables to a “bankruptcy-remote vehicle”—a corporation or trust set up for the sole purpose of buying the receivables with money raised from public investors. Interestingly, the charters of these bankruptcy-remote vehicles provide that they can own things, but cannot do anything except hold title for the investors. The effect of an asset securitization is to remove from the operating company one of its principal assets, its accounts receivable. The professionals engaged in these transactions insist simultaneously that (1) the transactions are not motivated by a desire to reduce the assets available to creditors of the operating company, and (2) it is critical to the asset securitization transaction that the buyer’s interest in the receivables cannot be disturbed by a later bankruptcy of the operating company.

I previously reported the curious bifurcation of the ownership of Rockefeller Center prior to its bankruptcy in 1994. The real property was owned and operated by two partnerships (“Rockefeller Center Properties”) which were in turn owned by corporations owned by the Rockefeller family and Mitsubishi interests. Rockefeller Center Properties—formally the title-holders but in our terminology the operating entities—were judgment-proof because the real property, worth about $1.3 billion, was encumbered by a mortgage in approximately the same amount. The mortgage lender was Rockefeller Center Properties, Inc., a public company whose sole business was the making of this loan. Together, the lender and borrower were worth $1.3 billion, but their legal structure divided them into a judgment-proof operating company and a liability-free mortgage holder.

42. Id.
43. For a discussion of the appropriate definition of “judgment proofing,” compare LoPucki, supra note 11, at 1421-22, with White, supra note 9, at 1363 n.2.
44. See LoPucki, supra note 6, at 24 (describing the growth of asset securitization).
45. See, e.g., Schwarz, supra note 18, at 146-51 (arguing that asset securitization transactions reduce net financing costs without harming unsecured creditors).
46. See id. at 135 (“The [securitization transaction], however, must be structured as ‘bankruptcy remote’ to gain acceptance as an issuer of capital market securities.”).
47. See LoPucki, supra note 11, at 1423-24 (describing the prebankruptcy ownership structure of Rockefeller Center).
CONCLUSION

The bifurcation of large businesses into asset-owning companies and operating companies may or may not be motivated in significant part by a conscious intention to become judgment-proof. That matters little, because the effect of bifurcation is to reduce the aggregate value of the assets exposed to liability. That is the very essence of judgment proofing.

The model of the bifurcated enterprise presented in this essay is designed to illuminate the practical problems of judgment proofing large businesses. But the structure thus exposed—an entity engaged in liability-generating activity without assets of its own, in symbiotic relationship with an asset-owning entity that often selectively guarantees the operating entity’s nontort debt—is familiar. It is the basic structure of all judgment proofing, including that of small businesses and individuals. The crudest form of individual judgment proofing, in which one spouse owns the assets while the other incurs the judgments, is giving way to a more sophisticated form in which a self-settled spendthrift trust owns the assets while the settlor incurs the judgments.48 Among small businesses the forms have remained relatively stable. The two most common are (1) a corporation engaged in risky business with minimal assets, owned by wealthy individuals who assist by guaranteeing selected debts,49 and (2) a corporation or individual engaged in risky business with assets fully encumbered to a bank or other arm’s-length investor who incurs no tort liability.50 In each of these examples, owning and operating entities are clearly distinguishable.

The essential structure of judgment proofing, two entities in a symbiotic relationship, reveals its resilience. The liability-prone entity will tend to specialize in activity that risks tort liability while its “partner” will tend to specialize in the safekeeping of assets. Seeking to discover and root out these symbiotic relationships one by one in litigation is, for the law, a hopeless task.51 Symbiotic business relationships are ubiquitous; they are the fabric of which an economy is made.

50. See LoPucki, supra note 6, at 14-19 (describing secured debt judgment-proofing strategies).
51. Elsewhere, I have discussed an alternative response—requiring financial responsibility of every entity as a condition of participation in the economy—and concluded that it solves the problem to only a limited degree. See id. at 78-89; LoPucki, supra note 11, at 1432-33.