The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz

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The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz

Lynn M. LoPucki*

In *The Inherent Irrationality of Judgment Proofing*, Professor Steven L. Schwarcz raises interesting new arguments against my death of liability thesis. The sheer number of those arguments makes it impossible for me to respond to all of them. The core of Schwarcz’s insight is to divide judgment proofing structures into those negotiated at arm’s length and those constructed within a single corporate group. I consider his arguments regarding the first set of structures in Part I and the second set in Part II.2

I. ARM’S LENGTH TRANSACTION JUDGMENT PROOFING

To demonstrate the judgment proofing potential of asset securitization, in *The Death of Liability* I used the example of a hypothetical Exxon Corporation that sold all of its assets through a series of such transactions.3 The sales were to “bankruptcy-remote” trusts or corporations that the arm’s length purchasers established specifically for the purpose of the asset-securitization transactions. As part of those transactions, Exxon leased the assets back from the buyers and agreed to use them in substantially the same manner as before. From the proceeds of sale, Exxon first paid its creditors and then distributed the remainder to its shareholders as dividends. At the conclusion of these transactions, Exxon operated substantially the same business as before, but had neither assets nor liabilities. Exxon was judgment proof.

Schwarcz makes three principal arguments in response to this example. First, he argues that the asset securitization did not judgment proof Exxon,

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2. I do not address Professor Mooney’s essay, *Judgment Proofing, Bankruptcy Policy, and the Dark Side of Tort Liability*, 52 Stan. L. Rev. 73 (1999). The Stanford Law Review solicited pieces from Mooney and myself as replies to Professor Schwarcz’s article. However, only the first paragraph of what Mooney has written actually responds to Schwarcz. That paragraph states Mooney’s opinion of Schwarcz’s article (he considers it persuasive) without reason or support, and then moves on to a new topic.


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the payment of the dividend did. Second, he argues that creditors cannot be hurt by arm's length transactions such as these because the debtor receives equivalent value in return for the assets sold. Third, Schwarcz argues that asset-owning entities ("F2" in his examples) will find that the costs of participation in arm's length judgment proofing exceed the benefits. I respond to each of these arguments separately.

A. Is Asset Securitization a Judgment Proofing Technique?

Schwarcz is correct that Exxon could have securitized its assets without judgment proofing itself by paying the dividend,4 that Exxon could have sold its assets without securitizing them and still judgment-proofed itself by paying the dividend,5 and that Exxon could have judgment proofed itself even without selling or securitizing its assets, by distributing the assets to shareholders as a dividend.6 Schwarcz is wrong, however, in concluding that these possibilities refute my contention that asset securitization is a dangerous new threat to liability. To see the fallacy, consider by analogy the invention of a new tool that makes burglary easier. Neither the fact that the new tool has uses other than burglary nor the fact that burglaries could be accomplished without it would prove that the new tool was not a dangerous new threat to the security of homes. Asset securitization is under attack because it appears to be the most efficient, effective judgment proofing tool currently available.

Schwarcz’s principal goal in this section of the article seems to be to distance asset securitization—the innovative business transaction he pioneered while in practice—from its common consequence—reduction in the operating entity’s (F1’s) ratio of assets to liability risk.7 Schwarcz attempts to increase that distance by dropping the word “asset” from the phrase I

4. See Schwarcz, supra note 1, at 15 (“Only a subsequent disposition of that cash, unrelated to the securitization, would cause judgment proofing.”).
5. See id. at 13-14 (“F2 could finance the purchase of [Exxon’s] assets through traditional techniques, such as bank borrowing.”).
6. See id. at 14 n.59 (“F1 also could judgment proof itself absent a sale-leaseback by transferring its assets as dividends to its shareholders.”).
7. For examples of recent transactions that reduced firms’ ratios of assets to liability risk, see infra, note 21. Schwarcz responds by stating that “[i]n fact, the common consequence of a securitization is to leave [the ratio of assets to liability risk] unchanged.” See Steven L. Schwarcz, Judgment Proofing: A Rejoinder, 52 STAN. L. REV. 77, 79 (1999). His only support for that assertion is a citation to a hypothetical in his book on asset securitization. Id. at 79 n.14. The hypothetical proves my point, not his. Through asset securitization the firm in the hypothetical went from owning assets of 200 to owning assets of 110, without changing its operations and thus without changing its liability risk. Thus, his hypothetical is one in which the firm reduced its ratio of assets to liability risk through asset securitization.
used and treating the issuance of securities by $F2$ (the “securitization”) as
the entire transaction in question. By his now strained definition, Exxon,
the party Schwarcz himself refers to elsewhere as the “originator” of the “se-
curitization,” is not even a party to it:

Thus, $F1$ [Exxon], the very company that is in danger of becoming judgment-
proofed by securitization, would not technically be a party to the securitization
transaction. More substantively, securitization is merely a way of allowing $F2$
[the bankruptcy-remote vehicle] to finance the purchase of $F1$’s [Exxon’s] as-
sets, with $F1$ receiving the sale proceeds. Judgment proofing only could result
from $F1$’s disposition of those sale proceeds for less than their value. That dis-
position, if it occurred, would be independent of the securitization transaction.

Even if correct, Schwarcz’s argument for the “legitimacy” of asset securiti-
ization in no way refutes my thesis. Liability will be just as dead whether it
dies from asset securitization or from asset securitization followed by a typi-
cal disposition of the proceeds.

B. Does the Judgment Proofing Debtor Receive Equivalent Value in Re-

turn?

Schwarcz argues that if a company wishes to judgment proof itself, it
would have to transfer its assets. He then goes on to say that

It is possible to divide potential recipients of the transfer into three categories:
the company’s creditors, the company’s owners (its shareholders), and third
parties other than creditors and owners. A transfer of assets to creditors would
be the antithesis of judgment proofing. . . . A transfer of assets to unrelated third
parties should not cause judgment proofing because no rational company will

8. See Schwarcz, supra note 1, at 13 (“Securitization has been alleged to be the most danger-
ous threat to liability.”). What I actually said was that “[asset securitization may be the silver
bullet capable of killing liability.” LoPucki, supra note 3, at 30 (emphasis added).

9. For example, Schwarcz notes that “on a formalistic level, only the entity [$F2$], and not
Exxon [$F1$], could sell that asset in a securitization transaction.” Schwarcz, supra note 1, at 14.

10. See Steven L. Schwarcz, Rethinking a Corporation’s Obligations to Creditors, 17 CAR-
DOZO L. REV. 647, 682 (1996) (stating that “[i]n a securitization, a company (the ‘originator’) can
obtain low cost, capital market financing by transferring its accounts receivable or other rights to
payment (‘receivables’) to a newly formed special purpose corporation, trust, or other legally sepa-
rate entity (the ‘SPV’).”).

11. Schwarcz, supra note 1, at 13 (footnote omitted).

12. See id. at 14 (“The possibility that securitization or other financing techniques might be
misused should not undermine their overall legitimacy.”) (footnote omitted).

13. See note 21 infra (giving examples showing that securitizers often distribute proceeds to
creditors and shareholders).

14. Schwarcz, supra note 1, at 16. In a footnote Schwarcz limits this statement to the judg-
ment-proofing of already established businesses. With respect to a new business, parties can create
a judgment proof structure without a transfer of assets by $F1$. See Lynn M. LoPucki, The Essential
give away its assets without demanding equivalent value in return. Thus, in an arm's length context, none of these transfers causes judgment proofing.\textsuperscript{15} Schwarcz's conclusion that these transfers do not cause judgment proofing is wrong as to the creditors and misleading as to the third parties.

To understand how payments to creditors judgment proof a debtor, consider an example in which Exxon has assets with a value slightly in excess of $40 billion and liabilities to unsecured bank lenders of exactly $40 billion. Exxon sells its assets for their fair market value and pays $40 billion of the proceeds to the banks. Exxon now has assets of nominal value and no liabilities. By leasing its assets back, it is able to continue to operate its business in the same manner as before the transaction. Prior to this transaction, a tort creditor who won a judgment against Exxon in the amount of $10 billion could reasonably have expected to recover eighty percent of that amount.\textsuperscript{16} After payment of the proceeds of the asset securitization to the banks, such a tort creditor would have been able to achieve only a nominal recovery. The investors who replaced the banks in Exxon's financial structure—the purchasers of securities in the asset securitization—would be the absolute owners of all of the assets used in Exxon's business. That is judgment proofing.\textsuperscript{17}

Schwarcz responds that although "it may be so" that "payment of voluntary creditors, such as bank lenders, could prejudice involuntary creditors, such as tort creditors," that "is irrelevant."\textsuperscript{18} He explains that "[p]referential payment by an insolvent company always could prejudice remaining creditors, which is precisely why bankruptcy law avoids such preferential payments."\textsuperscript{19} Schwarcz misses the point of my example. Exxon made the payments in my example while solvent, and long before the prebankruptcy preference period. They are not avoidable as preferences.\textsuperscript{20} Nor, I am confident, could Professor Schwarcz propose a law that made them avoidable without casting doubt on most of the asset securitization transactions described in footnote 21.

\textsuperscript{15} Schwarcz, supra note 1, at 16.
\textsuperscript{16} That is, as an unsecured creditor, the tort creditor would have been entitled to a pro rata share of Exxon's assets in the most likely legal proceeding, a chapter 11 reorganization.
\textsuperscript{17} Schwarcz misses this point by focusing on the debtor's equity rather than its assets. For example, he views the transaction in which RCPI loaned Rockefeller Center $1.3 billion in secured debt to buy Rockefeller Center as obviously not judgment proofing because the transaction "preserv[ed] the net worth that RCP enjoyed prior to the loan . . . ." Schwarcz, supra note 1, at 17 (footnote omitted). Schwarcz ignores the fact that the transaction put $1.3 billion worth of liability-generating assets in the hands of the debtor without measurably increasing the amount of assets available to pay the liabilities generated. To put it another way, RCPI's security interest assured that under no circumstances would the $1.3 billion the investors supplied be available to pay the liabilities generated as a result of the economic activity that $1.3 billion in financing made possible.
\textsuperscript{18} See Schwarcz, supra note 7, at 79.
\textsuperscript{19} See id.
Schwarcz’s assertion that an arm’s length transfer of assets to an unrelated third party does not cause judgment proofing is true on its face, but misleading in context. Firms that sell to third parties assets they continue to use generally have a plan for the use of those proceeds. For most firms whose asset securitization transactions have recently been reported in the press, that plan was to pay creditors or shareholders. To the extent the proceeds were so applied, those transactions reduced the assets available to future creditors, thereby judgment proofing the originators.

C. Do the Costs of Judgment Proofing Outweigh the Benefits?

To explain why he thinks it irrational for an owning entity (F2) to participate in a transaction that judgment proofs an operating entity (F1) Schwarcz defines and uses two variables. He designates “the amount of value that judgment proofing is expected to take from [judgment] creditors” as $\Delta$, and “the amount of compensation that F2 [the asset-owning entity] would require” for participating in the transaction as $\kappa$. Schwarcz concedes

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21. See, e.g., Case Capital Announces Pricing of ABS Transaction, BUS. WIRE, Mar. 10, 1999 (announcing that proceeds of a $759.5 million asset-backed securitization would be used "to repay outstanding debt and to fund [Case’s] growing portfolio of receivables"); Cherokee Declares $5.50 Cash Distribution; Completes $48.0 Million Securitization; Changes Fiscal Year End, BUS. WIRE, Dec. 23, 1997 (describing a transaction in which $48 million of proceeds from an asset securitization would be distributed to shareholders); Credit Acceptance Corp. Announces Completion of First Securitization, BUS. WIRE, July 8, 1998 (noting that the proceeds of a $50 million securitization “were used to reduce indebtedness under the company’s line of credit and revolving credit facilities"); DCR Rates Illinois Power Company’s $100 Million Issuance ‘BBB+’, PR NEWSWIRE, Sept. 11, 1998 (announcing that Illinois Power proposed that proceeds of a $864 million securitization would be “used to repay debt and repurchase common and preferred stock primarily proportional to the existing capital structure"); Mazda to Securitize Finance Unit’s Loan Claims, JII PRESS TICKER SERVICE, Feb. 22, 1999 (stating that Mazda Credit Corp. would use the proceeds of a 100 billion yen securitization “to repay borrowings"); PSE&G Files Stipulation with the Board, PR NEWSWIRE, Mar. 17, 1999 (announcing that the net proceeds of a $2.475 billion securitization would be used “to refinance or retire utility debt and/or equity”). See also David T. Brown et al., Asset Sales By Financially Distressed Firms, 1 J. CORP. FIN. 233, 239-40, 242 (1994) (describing a sample of 62 asset sales by distressed firms and noting that the proceeds of 30 of those sales were used to repay debt).

Whether Schwarcz disagrees with my assertion that most asset securitization is to pay creditors and/or shareholders is unclear. In the context of non-arm’s length judgment proofing, Schwarcz states that “[i]t is simply unrealistic to assume that the primary purpose of raising capital is to distribute it to shareholders.” Schwarcz, supra note 1, at 16 n.70. He may mean to say only that most capital is raised for purposes other than paying shareholders.

22. This does not mean that all asset securitizations tend to judgment-proof the debtor. A debtor might retain the proceeds of a securitization in cash as a means of increasing the debtor’s liquidity or use them to purchase more assets similar to those it securitized. However, if the debtor employed the proceeds to expand its liability-generating operations, the effect would be to increase the total liability risk without necessarily increasing the debtor’s assets. The debtor would have lowered its ratio of assets to liability risk, which is soft judgment proofing.

23. Schwarcz, supra note 1, at 17.

24. Id. at 18.
that “judgment proofing may occur” if χ is less than Δ. Schwarcz notes that χ must exceed F2’s judgment proofing costs or F2 would have no incentive to enter into the transaction. He then discusses four categories of such costs: financing premiums, increased liability risks, reputation costs, and agency costs. Schwarcz argues that the costs in each category are large and concludes that in total they “may well exceed Δ.” He then notes that the operating entity (F1) will need to keep some portion of Δ to reward it for the judgment proofing effort, which further reduces the amount of costs the judgment proofing transaction can carry. Schwarcz then adds reference to other costs that judgment proofing will impose on the operating entity, which include tax on the sale of assets, loss of liquidity, increased risk of bankruptcy, high agency costs as a result of possible liquidation, and possible civil and criminal liability for directors and shareholders as a result of judgment-proofing the company. Finally, Schwarcz adds that the owning company (F2) will be risk averse in deciding whether to engage in the transaction because it would do so solely for gain rather than to avoid loss. He concludes that “[a]s an economic matter, therefore, arm’s length judgment proofing is a dubious strategy.”

The first thing to note about this argument is the absence of any attempt to quantify Δ or any of the factors that supposedly combine to overwhelm it. Schwarcz is arguing that simply because there are a lot of factors and they seem, as he describes them, large, they must add up to more than Δ. Absent quantification, however, there is no reason to suppose that Schwarcz’s long list of judgment proofing costs adds up to more than the single benefit he notes.

The second thing to note about his argument is its failure to take into account the great variation among companies in their liability risks and judgment proofing costs. Today, Δ is high for a tobacco company, a gun manufacturer, or an orthopedic surgeon. Reputational costs may loom large for companies with famous trademarks that seek capital in public markets, but may be minimal for no-name companies that finance internally and market under the brand names of others. This error leads Schwarcz into the appar-

25. Id.
27. Id. at 24.
28. See id. at 24 (“It would be irrational for F1 to offer compensation to F2 that approaches Δ, the value of F1’s assets. Delta is the most that F1 could lose absent judgment proofing.”) (footnote omitted).
29. See id. at 25.
30. See id. at 27-28.
31. Id. at 25.
ent paradox that judgment proofing is irrational, and should not occur, even though it clearly is occurring in some industries.\textsuperscript{33}

Schwarcz has omitted from his calculation three significant benefits of judgment proofing transactions. First, the devices used to judgment proof debtors—asset securitization, leasing, trademark licensing, cash management systems, and others—provide sufficient economic benefits that businesses frequently use them even when they intend no judgment proofing effect. These benefits do not disappear simply because a particular user \textit{does} intend judgment proofing effects. The judgment proofer who uses any of these devices gets both the economic benefits of the device and $\Delta$. To put it another way, in some cases $\Delta$ will be a bonus for use of a device that was already cost effective based on its other advantages.\textsuperscript{34} In those cases, the marginal cost of judgment proofing is zero.

The second benefit of judgment proofing Schwarcz omits is the freedom of the judgment proof business to engage in high-tort-risk activity with impunity. Schwarcz argues that the gain from judgment proofing a firm is limited to the value of a firm’s assets before the judgment proofing.\textsuperscript{35} It is not. To illustrate, assume that before judgment proofing, a firm has assets of 200. The firm considers a series of business opportunities sequentially. The average expected return from each opportunity is 100, but each also has a 50% chance of generating, along with that return, a tort liability of 300. If the non-judgment proof firm’s capital falls below 200, to avoid operating in a judgment proof condition the firm must replenish its capital (perhaps through a contribution from shareholders);\textsuperscript{36} if the firm’s capital rises above 200 the

\textsuperscript{33} See id. at 1430-32 (describing judgment proofing in the tobacco industry). See also Christopher Drew & Andy Newman, \textit{Taxi Owners Deftly Dodge Claims of Accident Victims}, N.Y. TIMES, May 24, 1998 (describing judgment proofing in the New York City taxicab industry). Schwarcz claims that “the law’s evolution has recently limited judgment proofing even in [the New York taxicab] context," but fails to note that the evolution to which he refers occurred \textit{before} the \textit{New York Times} expose of judgment proofing cited in this footnote. Schwarcz, supra note 7, at 83. Similarly, Schwarcz makes much of RJR Nabisco’s rejection of a blatant judgment proofing plan, but fails to note that the plan adopted instead, spinning off RJR, is a subtler, more sophisticated example of judgment proofing. When tobacco plaintiffs eventually sue to reach Nabisco’s assets they will be met with a variety of reliance arguments based on a complete separation between RJR and Nabisco that occurred many years before.

\textsuperscript{34} See LoPucki, supra note 14, at 158-59 (describing REITs as an example of this in the real estate market); LoPucki, supra note 32, at 1433-34 (offering the example of a hypothetical airline achieving this end).

\textsuperscript{35} Schwarcz defines $\Delta$ as “the amount of value that judgment proofing takes from [potential future involuntary] creditors.” Schwarcz, \textit{supra} note 1, at 29-30. He also claims that “$\Delta$ is limited to the value of $F1$’s interest in the assets used in its business. That is because, absent judgment proofing, $F1$’s creditors could claim only against those assets.” \textit{Id}. at 20.

\textsuperscript{36} Schwarcz apparently contemplates that the non-judgment proof firm would not replenish its capital when the capital was depleted by losses. Absent this assumption, Schwarcz’s assertion holds, but only because the “non-judgment proof” firm becomes judgment proof and does not pay all its tort liabilities in later rounds. Without the replenishment assumption, the comparison would
firm distributes the excess to shareholders. Under these assumptions, the firm’s payoffs will be identical with regard to each successive opportunity. The firm will decline to pursue the opportunities because, with respect to each, it has only a 50% chance of a net gain of 100 and it has a 50% chance of a net loss of 200, resulting in an expected return from each opportunity of a loss of 50.37

If the same firm could become judgment proof by shedding its assets and remain judgment proof by distributing any gains to shareholders before undertaking the next opportunity, the firm would pursue all the opportunities. Because the firm gains 100 from each opportunity and pays no liabilities, its gain (300) will exceed the assets of the non-judgment proof firm (200) after pursuit of the third opportunity. Ultimately, the gains from judgment proofing are limited only by the number of opportunities the firm can pursue.

The error in Schwarcz’s reasoning should be apparent. The gains from judgment proofing are not, as he supposes, merely the gains from protecting the debtor’s finite assets. The gains from judgment proofing are gains from the externalization of liability. Those gains are limited only by the opportunities the debtor has to profit by wrongfully inflicting losses on others. Such opportunities are virtually unlimited. To make the same point another way, judgment proofing opens the door to “business” opportunities not available to asset-heavy companies. When a judgment proof company and a non-judgment proof company are direct competitors, the non-judgment proof company may have to shed its assets to survive.

The third benefit Schwarcz omits from his calculation is that judgment proofing eliminates the deadweight cost of risk management borne by non-judgment proof firms. If the firm buys insurance, that cost includes the cost of maintaining a risk management department, the cost of selecting and contracting for insurance, and the amount by which premiums paid exceed the amount paid tort creditors by the insurer. To the extent the firm self-insures, those costs are the administrative costs of assessing, defending, and paying claims against the company.38

Schwarcz also overstates the costs of arm’s length judgment proofing. The overstatement is largely attributable to his assumption that when an otherwise viable firm owes debt in excess of its ability to pay, liquidation is not measure the gain from judgment proofing, but only the gain from one type of judgment proofing rather than another.

37. (.5 x 100) + (.5 x -200) = -50. A more intuitive way of describing the non-judgment proof firm’s reluctance is that a firm with greater assets will have a lower propensity to commit torts. In this context, that means a lower propensity to pursue the opportunity.

38. See LoPucki, supra note 3, at 44 (quantifying the total costs of liability for the average large company (which includes A) at about $5 million per year).
likely to result. Such liquidations are possible, but they would occur only when the bankruptcy system malfunctioned. The ordinary outcome would be for the firm to discharge its tort debt in bankruptcy while continuing its operations. Empirical evidence shows this to have been universally the case for the past twenty years with regard to large public company bankruptcies.

Schwarcz concedes the point with regard to large public companies. He disputes it with regard to small companies, but the distinction is not important. Both large and small companies frequently liquidate in bankruptcy. Whether a company liquidates is not, however, a function of how much debt it has. Rather, it depends on whether—ignoring the firm’s debt—the firm’s future earnings stream is worth more than the proceeds that would result from its liquidation (such firms are referred to as “viable” or merely in “financial” as opposed to “economic” distress).

39. See Schwarcz, supra note 1, at 18 (asserting that “F2 would demand compensation in excess of ordinary market-rate lease rentals because F1, being judgment proof, may go bankrupt during the lease term, creating a risk that the rentals will remain unpaid”); id. at 19 (asserting that “because F1 is judgment proof, it might go bankrupt during the lease term”) (footnote omitted); id. at 21 (arguing that bankruptcy might prevent a judgment proof debtor from paying future rentals under a lease); id. at 25 (“F1 almost certainly would liquidate in bankruptcy, depriving managers of their jobs.”) (footnote omitted); id. at 31 (“And if F1 or F2 is forced to liquidate, its officers may well be able to find jobs with F3.”). That supposed liquidation drives many of the costs Schwarcz attributes to judgment proofing.

40. The Bankruptcy Research Database lists two bankruptcy cases by or against large, publicly held companies in the period 1980-1998 resulting from patent infringement liability (Smith International and Paragon Trade Brands), eight resulting from mass tort (Hillsborough Holdings, Lone Star Industries, National Gypsum, Manville, Eagle-Picher, UNR Industries, AH Robins, and Dow Corning) and one resulting from an intentional tort (Texaco). None of these cases resulted in the liquidation of the company. Search of Bankruptcy Research Database, Lynn M. LoPucki (Oct. 1999) (search for records using query NameCommon and TortCause = “Mass tort” or “Other tort” or “Environmental” or “Patent”). Of the 239 companies in that database for which the result is known, 30 (13%) were liquidated. See id.

41. See Schwarcz, supra note 7, at 82 (“True, but large public companies are least likely to attempt to judgment-proof themselves, whereas small companies usually liquidate in bankruptcy.”) (footnote omitted).

42. See Lynn M. LoPucki & William C. Whitford, Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies, 78 CORNELL L. REV. 597, 605 (1993) (noting that “Nearly all [large, public companies in Chapter 11] liquidate some assets and a few liquidate all assets.”). Schwarcz argues that intentional judgment proofing would be a defense to discharge. See id at 83. But corporate debtors that propose to continue in business are statutorily entitled to discharge all their debts despite their fraudulent prebankruptcy conduct. See 11 U.S.C. § 1141(d) (1988) (permitting objections to discharge only against individual debtors).

43. That is, the bankruptcy process seeks first to maximize the value of the company, and only after accomplishing that to distribute that value among those with entitlements.

44. See, e.g., Barry E. Adler, A Theory of Corporate Insolvency, 72 N.Y.U. L. REV. 343, 344 (1997) (“It is an axiom of finance theory that a firm’s financial health—its ability to pay its debts—is not synonymous with the firm’s economic health—its ability efficiently to provide goods or services. It is commonly observed, therefore, that a debt-laden firm can suffer financial distress while maintaining economic viability.”); Carlos J. Cuevas, The Myth of Fiduciary Duties in Corporate Reorganization Cases, 73 NOTRE DAME L. REV. 385, 409-10 (1998) (“A firm is in economic dis-
Deliberately judgment proofed firms are the type least likely to liquidate in bankruptcy. Typically their distress will be the result of tort debt that exceeds their assets, that is, financial distress. Only by coincidence would it include economic distress from noncompetitive products, weak markets, poor management, or the like. That, not the size of the companies involved, is the reason for the low rate of liquidation of companies owing primarily tort claims.

Nor does the bankruptcy reorganization of an insolvent, yet viable, firm necessarily threaten the firm’s lessors. Viable firms ordinarily need the assets they lease to continue their business. As a condition of keeping those assets, bankruptcy law requires that debtor firms pay their lessors in full, including past and future rents and damages to the lessor resulting from any breach that has occurred. Debtors are free to reject leases and can be expected to do so when the rental rates are above the market. The parties can, however, eliminate that risk by agreeing, at the time of leasing, to adjust the rent payable to the market rent periodically. At the time of bankruptcy, the transaction costs involved in switching to another lessor would prevent rejection. By these means, lessors can effectively contract to be made whole when their viable lessees reorganize. It follows that lessors need bear no substantial risk from bankruptcy so long as their debtors remain viable.

Lessors do bear a risk of loss in the bankruptcy of a judgment proof nonviable debtor. Such a debtor will be liquidated, and the lease may not be performed. But judgment proofing substantially increases neither the risk that a debtor will be nonviable nor the anticipated amount of the lessor’s loss when nonviability occurs. To understand why, assume that F1, a firm with revenues of 200, securitizes all of its assets by selling them to F2, a trust established for the sole purpose of acquiring those assets, for 1000. F1 distributes the proceeds to shareholders. Because the post-transaction F1 operates exactly the same business the pretransaction debtor would have, using exactly the same assets, the post-transaction F1 has no substantially greater risk of economic distress than the pretransaction debtor would have had.

should be liquidated immediately. On the other hand, a firm that is in financial distress has financial problems which are primarily related to its capital structure; enterprises that are experiencing financial distress are viable companies and should be reorganized.” (footnote omitted).


46. If the debtor considers its variable rent rate a problem, it may be able to swap with a third party for a fixed rate.

47. See LoPucki, supra note 14, at 153-56 (discussing aspects of asset use in businesses divided into owning and operating entities).

48. In responding to their cash-flow problems, the managers may make mistakes that render the firm nonviable. Sophisticated judgment proofers would, however, replenish their working capital rather than alter their operations. New working capital would be available to them in most cases—in or out of bankruptcy—for the simple reason that they are a viable firm. See Lynn M. LoPucki, A General Theory of the Dynamics of the State Remedies/Bankruptcy System, 1982 Wis. L. Rev. 311, 325-27 (1982) (illustrating that a viable firm may continue to operate at a loss).
Because the post-transaction \( F_1 \) has no cushion of assets with which to pay its liabilities, the likelihood that excessive debt will force it into bankruptcy is higher than the likelihood would have been in the absence of judgment proofing. But in such a debt-driven bankruptcy, a viable \( F_1 \) will reorganize and make its lessor, \( F_2 \), whole. Those who invested in the owning entity associated with a nonviable, judgment proof debtor fare no worse in bankruptcy than those who invested in an otherwise identical nonviable, non-judgment proof debtor. In or out of bankruptcy, both sets of investors have access to all cash flows of the pretransaction debtor (200) and all assets of the pretransaction debtor (1000).

To put it another way, \( F_2 \)'s investors were not disadvantaged by removal of the assets of \( F_1 \) in the judgment proofing process, because those assets were removed to \( F_2 \). In fact, \( F_2 \) is in a better position after judgment proofing than it would have been had it lent its investment to \( F_1 \), because it need not compete with other creditors of \( F_1 \) for those assets and in addition will not be as vulnerable to the bankruptcy proceeding.\(^49\) Because the investors' risk is actually reduced by the judgment proofing transaction, charging the judgment proof debtor a financing premium would be irrational.\(^50\)

Schwarcz also exaggerates the increased liability risks from judgment proofing in two respects.\(^51\) First, he erroneously asserts that judgment proofing will increase the total assets vulnerable to judgment creditors of \( F_1 \), because creditors may be able to recover from assets of \( F_2 \) that otherwise would not have been available to them.\(^52\) But if \( F_2 \) is part of a sophisticated arm's length judgment proofing scheme, it will own no assets other than those \( F_1 \) would have owned but for the scheme. Second, Schwarcz asserts that the liability imposed on \( F_1 \) and \( F_2 \) for use of a judgment proofing scheme can exceed the liability that would have been imposed in the absence of judgment proofing because the "creditors also might be able to recover

\(^49\) As the owners of the assets, lessors have greater rights in bankruptcy than even secured creditors. For example, lessors generally are entitled to payments while the case is pending. See Lynn M. Lopucki, Strategies for Creditors in Bankruptcy Proceedings 717-27 (3d ed. 1997) (describing strategies for obtaining "rent" payments during chapter 11 reorganization). Secured creditors generally are not. See id. at 523-26 (describing strategies for restricting payments to secured creditors during chapter 11 reorganization).

\(^50\) Schwarcz himself has argued that asset securitization generally reduces the costs of financing in comparison with secured or unsecured lending. See Steven L. Schwarcz, The Universal Language of Cross-Border Finance, 8 Duke J. Comp. & Int'l L. 235, 236 ("Thus, companies that otherwise cannot obtain financing now can do so; and companies that can obtain financing now may be able to do so at lower cost.") (footnote omitted).

\(^51\) Schwarcz, supra note 1, at 21.

\(^52\) The passage is less than clear, stating that "[the future claims of \( F_1 \)'s creditors] may even exceed \( \Delta \)—which, recall, is limited to the value of \( F_1 \)'s interest in its assets even if the amount of future involuntary claims is greater—because \( F_1 \)'s creditors could assert their entire claims against \( F_2 \)." Id. at 22 (emphasis in original) (footnotes omitted).
punitive and treble damages." However, Schwarcz cites not a single case in which punitive or treble damages have ever been imposed for judgment proofing. The cases he does cite demonstrate that courts do not award punitive or treble damages for even the clumsiest and most egregious cases of judgment proofing. The most courts do about judgment proofing schemes is to unravel them. What that means to a judgment proofer is that there is no harm in trying.

I have previously acknowledged the existence of some reputational costs to the operating entity (F1) in judgment proofing schemes. Schwarcz now seeks to add reputational costs to the owning entity (F2):

[The potential reputational cost] is caused by the bad publicity arising out of judgment proofing and includes the following risks: that F2’s debt rating may be lowered by rating agencies, impairing F2’s ability to obtain capital market financing; that consumers may refuse to buy F2’s products for fear that F2 will not stand behind its warranties (or provide future parts and services); that F2 may have difficulty obtaining trade credit; that F2 may impair its relationships with governmental entities; and that F2 and its officers and directors may even become subject to criminal liability, including under the Racketeer Influenced and Corrupt Organizations Act ("RICO").

In fact, the typical owning entity (F2) will suffer none of these reputational effects. That entity will not risk an existing reputation, it will be a new corporation or trust set up for the sole purpose of holding title to the assets. The entity will conduct no other business. Rating agencies would be concerned with the risk that the transaction might not withstand attack, but only to the extent of the liability courts might impose. They would have no reason to downgrade further on the basis of “reputation.” Reputation with consumers would not be a problem because F2 would sell no products. Trade credit would not be a problem because F2 would seek none.

The only governmental entity likely to be involved would be the Securities Exchange Commission. Schwarcz does not explain why the SEC would be hostile to F2, a solvent, arm’s length buyer of assets for their full market value, or why it would seek to inflict a penalty on F2 that ultimately would be borne by innocent public investors. Nor should the officers and directors of F2 have anything to fear from the SEC, plaintiffs, or prosecutors. Their

53. Id. at 22 (footnote omitted).
54. See, e.g., Schmoll v. Acand, Inc., 703 F. Supp. 868 (D. Or. 1988) (thwarting an egregious judgment proofing scheme by holding Raytech (F2) liable for asbestos claims against Raymark (F1), but failing to impose punitive or treble damages).
55. See LoPucki, supra note 3, at 51-54.
56. Schwarcz, supra note 1, at 23 (footnotes omitted).
57. Schwarcz argues that “an assetless F2” is “unrealistic.” Schwarcz, supra note 7, at 78 n.10. But every asset securitization transaction begins with the creation of just such an asset-less F2 to accept the transfer of assets.
58. The examples Schwarcz cites are not examples of civil or criminal liability for judgment proofing; they are examples of civil or criminal liability for mismanagement that harmed the firm.
fiduciary duty was to their own investors and they discharged it admirably. Moreover, the stigma of participation in a judgment proofing scheme is far less than Schwarcz supposes, as evidenced by the fact that CEOs and investors in liability-prone businesses now occasionally discuss their judgment proofing strategies openly.59

Schwarcz’s argument that F1 might incur income or capital gains taxes on its judgment proofing transfer of assets to F2 is interesting because it raises the possibility that the law might at some future time define and tax judgment proofing transactions as a means of limiting them.60 But in the context of current law, Schwarcz makes too much of the tax argument. First, newly forming firms would acquire the assets in the entity that would hold them permanently, so no taxable transaction would be required. Second, existing firms would only be at risk when and to the extent that their bases in the assets exceeded the proposed sale prices. Third, Schwarcz suggested in an earlier work that it might be possible to structure an asset securitization to be a sale for debtor-creditor purposes but a secured loan for tax purposes.61 Fourth, even an existing firm with a low-basis asset, such as a steel mill, could judgment proof without incurring tax by transferring its operations rather than the steel mill to F2. That is, F1 would continue to own the mill and the new company, F2 would operate it.62

In most cases, judgment proofing is not without cost. F2 must have separate management, and F2 may wish to indemnify them and/or insure them against personal liability. These costs are, however, dwarfed by the potential benefits from judgment proofing. As I discussed in The Death of Liability, the total cost of liability risk and management for a large company is, on average, about $5 million annually.63 For some large companies, those potential direct savings from judgment proofing would be much higher than for others, making the former prime candidates for judgment proofing.


59. See Constance L. Hays, Fighting RJR, Icahn Demands That It Spin Off Nabisco Stake, N.Y. Times, Mar. 12, 1999, at Cl (describing debate between Steven F. Goldstone, CEO, and Carl Icahn, shareholder, over how to best protect the assets of Nabisco from the “liability from lawsuits over smoking”).

60. See Schwarcz, supra note 1, at 13 (“FL, however, would have an immediate and significant disincentive against engaging in this threshold transaction: It would be taxed on the sale income.”) (footnote omitted).


62. This strategy of no tax transfer is analogous to the strategy of no transfer by FL that defeated the application of fraudulent transfer law. See LoPucki, supra note 3, at 28.

63. See id. at 44-45.
II. NON-ARM'S LENGTH TRANSACTION JUDGMENT PROOFING

Schwarcz acknowledges that the costs of non-arm’s length judgment proofing, are considerably lower than the costs of arm’s length judgment proofing, and does not dispute that “computerization will make the logistics of judgment proofing easier and cheaper.” He considers the cost argument “irrelevant,” however, because “legal liabilities” are “the real deterrent to judgment proofing.”

In support of his position he reviews eight legal doctrines that potentially regulate non-arm’s length judgment proofing—(1) fraudulent transfer, (2) substantive consolidation, (3) corporate veil piercing, (4) corporate law restrictions on dividends, (5) director’s fiduciary duties to creditors, (6) lender liability, (7) prima facie tort, and (8) civil and criminal liability under RICO—and concludes that “[j]udgment proofing ... is regulated by laws that not only restrict a company’s ability to judgment-proof itself but also may impose costs on the parties participating in the judgment proofing transaction.” After mentioning the empirical evidence Professor James J. White presented in opposition to the death of liability thesis, Schwarcz ultimately concludes that “[e]xisting constraints on judgment proofing ... already appear adequate, and the law is likely to evolve additional restrictions as necessary.”

In fact, none of these eight doctrines constitutes a substantial threat to sophisticated judgment proofing. As to the first, fraudulent transfer, Schwarcz acknowledges that strategists can set up judgment proof structures without the liability generating company transferring anything, rendering fraudulent transfer law irrelevant. Though Schwarcz argues vigorously for his second and third theories, substantive consolidation and corporate veil piercing, he has not challenged my assertions in The Death of Liability that (1) only one misdeed—undercapitalization—is necessary to judgment proof an entity, and (2) undercapitalization alone is generally considered an insuf-

64. See Schwarcz, supra note 1, at 29-31 (stating that financing premiums, federal taxation, and the concern about criminal liability under RICO are less significant in non-arm’s length judgment proofing).
65. Schwarcz, supra note 7, at 84.
66. Id.
68. Id. at 47 (footnote omitted).
69. See id. at 11. Schwarcz is apparently unconvinced by my refutations of White’s empirical evidence, see LoPucki, supra note 32, at 1415-22, but cuts off further debate by failing to explain his reasons.
70. Schwarcz, supra note 1, at 53.
71. See id. at 35 (“Fraudulent conveyance law does not, however, protect against the use of structures in which F1, the operating company, is undercapitalized at its creation. Because there is no transfer of assets, fraudulent conveyance law does not apply.”) (footnote omitted).
72. See LoPucki, supra note 3, at 28.
ficient basis for disregard of the corporate entity.\textsuperscript{73} It follows from my assertions that these two theories for corporate disregard generally can operate only against judgment proofers careless enough to commit an unnecessary misdeed in the course of their planning.

Schwarcz acknowledges that his fourth theory—that corporate law restricts the payment of dividends that would judgment proof the company—"may not restrict judgment proofing against future involuntary creditors."
\textsuperscript{74} The reason, Schwarcz explains, is that statutes in some states, including Delaware, permit the payment of dividends up to the brink of insolvency.\textsuperscript{75} That accommodates even "hard" judgment proofing designed to deny any recovery whatsoever to future involuntary creditors. Schwarcz also notes that the judgment proofer can always make one of those statutes applicable through its selection of a state of incorporation.\textsuperscript{76}

The last four theories of liability Schwarcz puts forth as deterrents to judgment proofing are imaginative extensions of existing law conceived by him for his article. None has been suggested or endorsed by any court or other commentator as a remedy for judgment proofing. Courts are unlikely to ever employ them against sophisticated judgment proofing techniques because those techniques are based on principles so deeply ingrained in our law, culture, and economic system that no court would see the techniques as objectionable—let alone want to challenge them.\textsuperscript{77} Thinking hypothetically and in the abstract, probably most courts would gladly extend Schwarcz's eight theories to strike down "judgment proofing." But when they encounter concrete examples of sophisticated judgment proofing, they recognize what they themselves regard as the very engines of the American economy—asset securitization, leasing, secured credit, and corporate limited liability. To judgment proof requires no more than these devices accomplish in their ordinary use.

Corporate limited liability provides an excellent example. The Sixth Circuit recently upheld a judgment proofing scheme in which a single business was divided among three corporations—one to hire truck drivers, a second to own trucks, and a third to own real property—against a National La-

\textsuperscript{73} See id. at 22-23.
\textsuperscript{74} See Schwarcz, supra note 1, at 39 n.200.
\textsuperscript{75} See id.
\textsuperscript{76} See id.
\textsuperscript{77} As to corporate limited liability, the Supreme Court recently stated that "[i]t is a general principle of corporate law deeply 'ingrained in our economic and legal systems' that a parent corporation . . . is not liable for the acts of its subsidiaries." United States v. Bestfoods, 524 U.S. 51, 61 (1998) (quoting William O. Douglas & Carrol M. Shanks, Insulation from Liability Through Subsidiary Corporations, 39 YALE L.J. 193 (1929)).
bor Relations Board back-pay order.\textsuperscript{78} Two years later, the Eighth Circuit wrote that

The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke. That is the whole purpose of the doctrine, and those who have the right to decide such questions, that is, legislatures, believe that the doctrine, on the whole, is socially reasonable and useful. We think that the doctrine would largely be destroyed if a parent corporation could be held liable simply on the basis of errors in business judgment.\textsuperscript{79}

Just last year, the Supreme Court held a parent company not liable under CERCLA as an operator of a toxic waste facility.\textsuperscript{80} The court did so even though the parent's employees served as president and chief executive officer of the subsidiary that operated the facility; the parent actively participated in, and at times controlled, the policy-making decisions of the subsidiary; and the parent actively participated in and exercised control over day-to-day decision making at the subsidiary.\textsuperscript{81} That decision effectively gives asset-owning parents the ability to direct both the policy and day-to-day decision making of liability generating subsidiaries and reap the benefits of their operations, without incurring liability for the subsidiaries' wrongful acts.

These decisions are not aberrations. They represent a broad legal and policy consensus in favor of non-arm's length judgment proofing (though not by that name). In his review of 3800 judicial opinions in which parties sought to pierce the corporate veil, Professor Robert Thompson found that those parties succeeded in about 40\% of reported cases.\textsuperscript{82} When a plaintiff sought to pierce within a corporate group, the success rate was only 34\%.\textsuperscript{83} When that plaintiff was a tort creditor, the success rate fell to 12\%.\textsuperscript{84} That low success rate masks an even lower attempt rate. Only 76 (2\%) of the 3800 parties seeking to pierce were tort plaintiffs seeking to reach the assets of a parent corporation, and only 9 (0.2\%) were tort plaintiffs who succeeded in that.\textsuperscript{85} Those low rates suggest the existence of a much larger number of similarly situated tort plaintiffs who did not even try. Contrary to Schwarcz's implication,\textsuperscript{86} the odds of piercing the corporate veil used in non-arm's length judgment proofing are truly minuscule. Considering the deference courts pay to corporate limited liability, the mystery is why any com-

\textsuperscript{78} NLRB v. Fullerton Transfer & Storage, Ltd., 910 F.2d 331 (6th Cir. 1990).
\textsuperscript{79} Radaszewski v. Telecom Corp., 981 F.2d 305, 311 (8th Cir. 1992).
\textsuperscript{81} See id. at 68-70.
\textsuperscript{82} See Robert B. Thompson, Piercing the Veil Within Corporate Groups: Corporate Shareholders as Mere Investors, 13 CONN. J. INT'L L. 379, 384, 387 (1999).
\textsuperscript{83} See id. at 386.
\textsuperscript{84} See id.
\textsuperscript{85} See id.
\textsuperscript{86} See Schwarcz, supra note 1, at 31 (stating that in non-arm's length judgment proofing, F3 may "become directly subject to claims by F1's creditors, through the doctrine[] of piercing the corporate veil").
pany would retain the risk of tort liability when the formation of a subsidiary can so easily externalize it.

III. CONCLUSION

Schwarz correctly identifies the pivotal issue on which the future of judgment proofing depends: Do the benefits of judgment proofing exceed the costs? He misses some judgment proofing benefits and his arguments do not support the level of costs he asserts exists. Ultimately, the answer to the question he poses varies from firm to firm and changes over time. But the fact that we have now focused on the issue of costs versus benefits demonstrates that this debate has crossed an important threshold. We no longer suppose that any structural impediment to judgment proofing exists in law.