SUBSTANTIVE CONSOLIDATION: GETTING BACK TO BASICS

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I. INTRODUCTION

Substantive consolidation of the bankruptcy estates of legally separate debtors who are members of a corporate group has the potential to radically affect the rights of their creditors. In appropriate cases, consolidation has the effect of pooling the assets of these debtors and treating their respective liabilities as if they were incurred by a single entity. As the debt-to-asset ratios of the various debtors will almost certainly be different, consolidation will almost invariably redistribute wealth among the creditors of the various entities. A significant creditor of an individual debtor has an incentive to object if the asset-to-debt ratio of its obligor is higher than the pooled ratio of the entire corporate group. Similarly, a significant creditor whose claim is a liability of multiple members of the corporate group, and who, therefore, may receive multiple recoveries if corporate separateness is preserved, has an incentive to object. Accordingly, substantive consolidation has the potential to be a hotly contested issue in any bankruptcy in which it is raised.

The remedy of substantive consolidation has been a part of bankruptcy jurisprudence since at least the early 1900s. As discussed in more detail below, the tests for determining when consolidation is appropriate have developed over time, from tests that were more focused on the familiar alter-ego/veil-piercing factors employed in tort cases to tests focusing on the equities among the parties affected by consolidation. Over the course of this evolution and as litigants continue to raise every possible argument against granting consolidation, it appears that some of the fundamental precepts of this doctrine have become obscured in the debate.

The purpose of this article is to revisit these substantive consolidation fundamentals and to argue for the appropriate framework for determining the propriety of consolidation in a particular case. First, stripped of all the legalese and abstractions, the goal of substantive consolidation analysis is to make three determinations: (a) whether technically separate corporate entities abused the

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corporate form and, in fact, comprise a single business operation, (b) whether consolidation will remedy a harm caused by such conduct or benefit the collective creditor body, and (c) whether any prejudice will result from consolidation and how best to protect the interests of creditors that innocently relied on corporate separateness. Second, it is submitted that the test adopted by the Courts of Appeals for the DC and Eleventh Circuits provides the only truly workable analysis for determining whether substantive consolidation is appropriate. While the test articulated in the *Augie/Restivo* decision has been touted as more grounded in substantive consolidation and economic theory, the Second Circuit's opinion in that case has been misinterpreted, most notably by the Third Circuit Court of Appeals, to create a test that can never be satisfied and will invariably result in denial of a motion for substantive consolidation. Although consolidation is an equitable remedy that should be granted only in exceptional circumstances, the DC and Eleventh Circuit test leaves judges the ability to do equity, rather than sacrificing their discretion for the sake of transactional certainty. Third, to the extent this issue persists, district courts and bankruptcy courts have the power to grant substantive consolidation and, thus far, at least, the Supreme Court has not issued a decision that dictates otherwise.

II. SELECTED HISTORY OF SUBSTANTIVE CONSOLIDATION

Since the doctrine's inception, a number of different tests have been developed to determine the propriety of substantive consolidation.[1] These include the alter-ego factors test adopted from veil-piercing cases, the *Auto-Train* test and its variants, the so-called *Augie/Restivo* test and, most recently, the *Owens Corning* test. The two most prevalent tests, at least prior to *Owens*, were said to be the *Auto-Train* test and the *Augie/Restivo* test, articulated by the DC Circuit and Second Circuit Courts of Appeals, respectively. A review of the various tests reveals, however, that—with the exception of *Owens*, discussed at length below—the tests for when consolidation is appropriate are virtually identical, particularly when viewed against the background from which they developed. Thus, in order to properly apply current principles of substantive consolidation, it is necessary to review the cases in which the doctrine was originally conceived.

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[1] *See, e.g.*, Nesbit v. Gears Unlimited, Inc., 347 F.3d 72, 86–87 n.7 (3d Cir. 2003) (comparing substantive consolidation tests developed in different bankruptcy and circuit courts). *Compare, e.g.*, *In re* Vecco Constr. Indus., Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980) (establishing seven-factor substantive consolidation test), *and* Pension Benefit Guar. Corp. v. Ouimet Corp., 711 F.2d 1085, 1093 (1st Cir. 1983) (creating five-factor substantive consolidation test), *with* Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988) (utilizing two critical factors in substantive consolidation test), *and* Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276–77 (D.C. Cir. 1987) (considering two specific policies in substantive consolidation test).

Any discussion of substantive consolidation must begin with *Sampsell v. Imperial Paper & Color Corp.*[2] *Sampsell* is the only case in which the Supreme Court has considered the doctrine of substantive consolidation. Its approval of the doctrine is the principal basis for the doctrine's continued existence as a remedy not explicitly codified in the current bankruptcy law.[3] Moreover, it is impossible to understand the outlines of the doctrine without understanding *Sampsell* and the early decisions that *Sampsell* cites with approval. This article posits that later courts have gone astray by not taking *Sampsell* more seriously as a controlling precedent.

Sampsell involved a debtor, Wilbur Downey, who had operated an unincorporated paint and wallpaper business, as a result of which he had incurred a large debt to a particular creditor.[4] As a result, Imperial Paper refused to extend any credit to Downey. A few years before his personal bankruptcy, Downey, with his wife and son, incorporated Downey Wallpaper & Paint Co., apparently to enable him to continue in business and obtain additional credit from Imperial Paper.[5] Downey sold his inventory to the corporation for a note, a portion of which was paid and the remainder of which was converted to stock shortly before his bankruptcy. Downey, his wife and son each received stock and, except for qualifying shares, they did not pay any cash for the shares. Imperial Paper extended credit to the new corporation. The corporation kept separate books and records, but, obviously, was run by Downey and rented space from Downey in the premises in which he operated his original business.[6]

When Downey was adjudicated a bankrupt more than two years after formation of the corporation, his trustee, Sampsell, sought a turnover of the corporation's assets so that they could be administered by the trustee and marshaled for the benefit of Downey's creditors. The corporation, controlled by Downey and his family, contested the turnover petition but lost and did not appeal.[7] The decision in favor of the trustee included findings that the corporation was the alter ego of Downey, and that the transfer of inventory and issuance of stock for debt was a fraudulent transfer that had been intended to place those assets beyond the reach of creditors.[8] Imperial Paper had not been a party to the turnover proceedings and, thereafter, filed a claim in Downey's personal bankruptcy case asserting priority to the assets that the corporation had turned over to Downey's trustee. That claim of priority was disallowed by the referee on the ground that Imperial Paper had been

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[2] 313 U.S. 215 (1941).
[3] *See* discussion of the court's power to grant substantive consolidation, *infra* Section V.A. and accompanying notes.
[4] *See Sampsell*, 313 U.S. at 215 ("Downey had been engaged in business, unincorporated, and had incurred a debt to the predecessor of Standard Coated Products Corporation of approximately $104,000.").
[5] *See id.* (discussing incorporation of Downey Wallpaper & Paint Co.).
[6] *See id.* at 216 (describing debtor-creditor relationship between Downey and Imperial Paper).
[7] *See id.* at 216–17 (stating referee's findings from turnover hearing).
[8] *See id.*

aware of Downey's indebtedness and was instrumental in having him form the new corporation.[9]

The Court of Appeals for the Ninth Circuit reversed the decision of the referee disallowing Imperial Paper's claim of priority to the assets of its borrower, the corporation.[10] The Court of Appeals held that the finding of a fraudulent transfer did not justify the denial of a prior claim of Imperial Paper to the assets of its corporate debtor in the hands of the trustee of the controlling shareholder.[11] The court noted that the property that had been turned over to the trustee could not have been the inventory sold by Downey to the corporation more than two years previous and was mostly inventory sold to the corporation by Imperial Paper after the formation of the corporation. That inventory was not property the bankrupt, Downey, had ever owned or had possession of and, therefore, had not been transferred, let alone fraudulently transferred to the corporation.[12] Thus, the court ruled that the finding of a fraudulent transfer as to property that no longer existed and which the trustee had never received was immaterial to the question of whether a corporate creditor had a right to be paid from other corporate assets before the trustee for a shareholder of the corporation could retain any net assets.[13]

More significantly, the Court of Appeals also rejected the alter-ego justification for disallowance of Imperial Paper's claimed priority as to its corporate debtor's assets. The court concluded that, under California law, the corporation was not the debtor's alter ego.[14] Furthermore, even assuming alter-ego status, it found that disregard of the corporate form would be proper only if respect for the corporate form "would promote fraud, defeat justice or produce inequitable results."[15] On the contrary, the court found that such disregard would result in "a grave and palpable injustice" to Imperial Paper, which had financed the corporation as a stand-alone entity.[16]

In reversing the appellate decision, the Supreme Court stated:

> The legal existence of the affiliated corporation does not per se give it standing to insist on a plenary suit. In re Muncie Pulp Co., 2 Cir., 139 F. 546; W. A. Liller Bldg. Co. v. Reynolds, 4 Cir., 247 F. 90; In re Rieger, Kapner & Altmark, D.C., 157 F. 609; In re Eilers Music House, 9 Cir., 270 F. 915; Central Republic Bank & Trust

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[9] *See id.* at 217 (determining priority of Imperial Paper).

[10] *See* Imperial Paper & Color Corp. v. Sampsell, 114 F.2d 49, 52–53, (9th Cir. 1940) (giving creditor priority because borrower's property never became part of bankruptcy estate).

[11] *See id.* ("Appellant's claim should be allowed and, as a claim against the proceeds of the corporation's property, should be accorded priority, as prayed by appellant.").

[12] *See id.* at 52 (noting inventory sale by corporation and realizing debtor himself never owned such inventory).

[13] *See id.* (holding fraudulent transfer of property immaterial).

[14] *See id.* (deciding Downey Wallpaper & Paint Co. was not alter ego of Downey).

[15] *Id.*

[16] *Imperial Paper*, 114 F.2d at 52.

> Co. v. Caldwell, 8 Cir., 58 F.2d 721; Commerce Trust Co. v. Woodbury, 8 Cir., 77 F.2d 478; Fish v. East, 10 Cir., 114 F.2d 177.
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> Mere legal paraphernalia will not suffice to transform into a substantial adverse claimant a corporation whose affairs are so closely assimilated to the affairs of the dominant stockholder that in substance it is little more than his corporate pocket. Whatever the full reach of that rule may be, it is clear that a family corporation's adverse claim is merely colorable where, as in this case, the corporation is formed in order to continue the bankrupt's business, where the bankrupt remains in control, and where the effect of the transfer is to hinder, delay or defraud his creditors. In re Schoenberg, 2 Cir., 70 F.2d 321; In re Berkowitz, D.C., 173 F. 1013. And see Glenn, Liquidation, §§ 30–32. Cf. Shapiro v. Wilgus, 287 U.S. 348, 53 S.Ct. 142, 77 L.Ed. 355, 85 A.L.R. 128. Hence, Downey's corporation was in no position to assert against Downey's trustee that it was so separate and insulated from Downey's other business affairs as to stand in an independent and adverse position.[17]

The Court clearly rejected the Ninth Circuit's state law alter-ego and fraudulent transfer analyses in favor of the referee's summary proceeding determination that the corporation's assets were property of the debtor's estate because the corporation was controlled by a bankrupt and simply a continuation of the bankrupt's prior business, intended to protect that business from the debtor's pre-existing creditors so that it could obtain new credit.

Significantly, the Court viewed the question of subsidiary creditor priority as a separate and independent issue not bearing on the question of whether the subsidiary's assets should be "absorbed" into the bankruptcy estate.[18] Thus, the Court stated that where assets were ordered turned over to a trustee because they had been fraudulently transferred or:

> [W]here the relationship between the stockholder and the corporation was such as to justify the use of summary proceedings to absorb the corporate assets into the bankruptcy estate of the stockholder, *the corporation's unsecured creditors would have the burden of showing that their equity was paramount in order to obtain priority as respects the corporate assets*.[19]

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[17] Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 218 (1941) (internal citations omitted).
[18] *See id.* at 219 (distinguishing between creditors of corporation and creditors of stockholder).
[19] *Id.* (emphasis added).

Noting that the theme of the Bankruptcy Act was equality of distribution, the Court pointed out that "[t]o bring himself outside of that rule an unsecured creditor carries a burden of showing by clear and convincing evidence that its application to his case so as to deny him priority would work an injustice."[20]

Reference to the cases cited in the *Sampsell* opinion shows that *Sampsell* was a fair summary of prior case law. Several of the decisions in these cases are clearly premised on alter-ego principles.[21] As early as 1905, the Court of Appeals for the Second Circuit had upheld a summary turnover order of both the assets and stock of a corporation nominally owned by the shareholders of the bankrupt, Muncie Pulp Company.[22] Certain assets had been transferred indirectly by Muncie Pulp to the corporation to enable the corporation to supply fuel to Muncie Pulp.[23] Blending fraudulent transfer considerations and alter-ego theory, the court found that the shareholders had obtained their stock as "agents" of Muncie Pulp and had no colorable right to its ownership, and that the corporation existed solely as a creature of Muncie with no independent existence.[24] The court observed that "[t]he Great Western Company has no shadow of claim to the property in controversy, and to permit it, or its president, or shareholders, to dispose of such property, is to sanction a fraud upon the creditors of the pulp company."[25] The court found the turnover order to be well within the summary jurisdiction of the bankruptcy court over the

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[20] *Id.* "Such burden has been sustained by creditors of the affiliated corporation and their paramount equity has been established where there was no fraud in the transfer, where the transferor remained solvent, and where the creditors had extended credit to the transferee." *Id.* at 219–20.

[21] *See, e.g.*, Fish v. East, 114 F.2d 177, 198 (10th Cir. 1940) (basing decision for turnover order on theory Mines Company and Placers Company were alter-egos of one another); Commerce Trust Co. v. Woodbury, 77 F.2d 478, 480, 491 (8th Cir. 1935) (concluding sales company was only agency or department of lumber another company and affirming trial court's decision that sales company's assets should be administered by receiver of lumber company); Cent. Republic Bank & Trust Co. v. Caldwell, 58 F.2d 721, 735 (8th Cir. 1932) (deciding State Telephone Company was mere agent of Municipal Telephone Company and receiver was appropriately directed to take charge of whole assets); Oregon Eilers Music House v. Sitton (*In re* Eilers Music House), 270 F. 915, 927–29 (9th Cir. 1921) (remanding case to determine whether Oregon Eilers Music House was agent of bankrupt corporation because "[t]he bankruptcy court has jurisdiction in a summary proceeding to require a bankrupt or any agent or representative of the bankrupt in possession of its property, to turn it over to the trustee . . . ."); W.A. Liller Bldg. Co. v. Reynolds, 247 F. 90, 92 (4th Cir. 1917) (holding attempted transfer of property to corporation formed by debtor and relatives "was in fact no transfer thereof"); *In re* Rieger, Kapner & Altmark, 157 F. 609, 613 (Bankr. S.D. Ohio 1907) (referring to corporation as subsidiary and agent of partnership, and finding creditors could reach assets of corporation); *In re* Muncie Pulp Co., 139 F. 546, 548 (2d Cir. 1905) (recognizing subsidiary company was "a mere creature" of parent company and court could properly direct president of bankrupt company to turn over property in his control).

[22] *See Muncie Pulp*, 139 F. at 547–49 (affirming District Court's decision, which was "necessary for the preservation of the [bankruptcy] estate.").

[23] *See id.* at 546 (discussing transfer of property to new corporation).

[24] *See id*. at 548 ("The Great Western Company was undoubtedly a mere creature of the pulp company, having no independent business existence and organized solely for the purpose of facilitating the business of the latter.").

[25] *Id.*

assets of the debtor, Muncie Pulp, and not to require a plenary fraudulent transfer action.[26]

In 1907, a federal district court in Ohio, following *Muncie Pulp*, reached a similar conclusion and ordered the assets of a manufacturing corporation that had been acquired by the members of a partnership that acted as exclusive sales agent for the corporation, turned over to the receivers for the partners and their partnership.[27] In that case the corporation pre-dated the partnership and was acquired by the partners to assure the partnership with a source of supply. The partnership purchased the entire output of the corporation and the partnership and corporation kept separate books and records. As the partnership was failing, the partners took steps to reconstitute the board of the corporation so that it could continue to operate despite the partnership's insolvency.[28] Although there was no transfer from the partnership to the corporation that could be challenged as fraudulent, the court regarded the artificial separation of the manufacturing and sales business as inherently fraudulent.[29]

In effect, the court considered the attempt of the partners to ensure the continued operation of the corporation outside the bankruptcy of the insolvent partnership as a fraud that could be remedied by a turnover order:

> To deny the individual and partnership creditors participation in the administration of so much of the bankrupts' estate as may be found in possession of the corporation, and to compel such creditors to remain silent spectators until the corporate creditors shall have been paid in full out of the proceeds of the sales of the corporate property, or out of the profits of the business if it should be profitably continued, or until the corporate property is exhausted, is to deny them a right guaranteed by the bankrupt act, and to hinder and delay them in the pursuit of their legal remedies against the

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[26] *See id*. at 549 (discussing bankruptcy court's jurisdiction).

[27] *See In re* Rieger, Kapner & Altmark, 157 F. 609, 616 (Bankr. S.D. Ohio 1907) (extending receivership to property in possession of corporation as part of assets of partnership).

[28] *See id*. at 611 (setting forth relevant activity of partnership).

[29] *See id.* at 613 (refusing to consider partners' intent in determination of fraud).

> This is as unusual as it would be for a natural person, doing business in his correct name, to designate himself, or contract with himself, as his own agent regarding another branch of his business conducted by himself under a fictitious name, and to hold himself out to the public as two distinct persons. That he should so represent himself and keep for his two kinds of business separate books and separate bank accounts might give him a double line of credit, and might hinder and delay his creditors in reaching his assets in case of insolvency, but a court of equity, having knowledge of the fact, would have no difficulty in brushing aside the subterfuge, and subjecting the whole of his property to the payment of his debts.

Id.

> bankrupts and their property, *and is, consequently, fraudulent in law, however honestly the partners may have intended to deal with their creditors in case of insolvency*.[30]

Notably, while the court did not decide that the partnership creditors would share pro rata in the assets, it certainly regarded that as a possibility.[31]

Skipping ahead thirty years, to one year before the *Sampsell* decision, the Court of Appeals for the Tenth Circuit likewise found an alter-ego situation that required disregard of the corporate form to prevent inequity. In *Fish v. East*,[32] the court noted that the "[c]orporate entity may be disregarded where not to do so will defeat public convenience, justify wrong or protect fraud."[33] The court found the "instrumentality rule" applicable and identified several factors as being relevant to the inquiry.[34] A brief review of these factors makes clear that the questions sought to be answered by this analysis were (i) whether the subsidiary was, in fact, a business entity separate from the parent corporation and (ii) whether enforcement of the entities' legal separateness was unjust to the parent's creditors. Ultimately, the court found the subsidiary to be an instrumentality of the debtor and granted consolidation to correct the diversion of assets by insiders from the debtor to the subsidiary.[35] Once again, it was apparent in *Fish* that the subsidiary had no substance as a business entity. Its assets and liabilities had been arbitrarily

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[30] *Id*. (emphasis added).

[31] *See id.* ("The individual partnership creditors have a direct interest in the corporate assets, for, assuming, without deciding, that the innocent corporate creditors must first be paid out of the corporate property, the residue, if any, would pass for administration to the trustee in bankruptcy.").

[32] *Fish v. East*, 114 F.2d 177 (10th Cir. 1940).

[33] *Id.* at 191 (citing, *e.g.*, Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939)).

[34] Specifically, the court stated:

> The instrumentality rule here has application. The determination as to whether a subsidiary is an instrumentality is primarily a question of fact and degree. The following determinative circumstances are recognized: (1) The parent corporation owns all or majority of the capital stock of the subsidiary. (2) The parent and subsidiary corporations have common directors or officers. (3) The parent corporation finances the subsidiary. (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation. (5) The subsidiary has grossly inadequate capital. (6) The parent corporation pays the salaries or expenses or losses of the subsidiary. (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation. (8) In the papers of the parent corporation, and in the statements of its officers, 'the subsidiary' is referred to as such or as a department or division. (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation. (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

Id.

[35] *See id*. (applying instrumentality rule).

determined by the parent for the parent's purposes.[36] In that circumstance, the court found no reason to be bothered by the delay and expense of litigation between the two entities, as if each had some independent existence. Also, as in some prior cases, *Fish* left open the question as to whether creditors of the subsidiary who claimed to have relied on its assets might have a prior claim as to those assets.

Thus, read in conjunction with the cases it cites, the Supreme Court's decision in *Sampsell* reveals several things about consolidation. First, it appears that the doctrine is not a creature of state law, but an exercise of the bankruptcy court's power to determine the assets of a debtor within its jurisdiction.[37] Second, it appears that consolidation is a form of relief related to fraudulent transfer law, but is not strictly limited to cases in which fraudulent transfers have been proven and, in fact, is an alternative to fraudulent transfer litigation. The Supreme Court expressly approved use of a summary turnover proceeding to pull assets into an estate without the need to prove in a plenary proceeding that the assets were transferred by the debtor in violation of fraudulent transfer laws or that the state law test for piercing the corporate veil had been satisfied. Third, consolidation *is* warranted when a subsidiary is the alter ego of its parent and enforcement of the artificial separation would produce a result akin to a fraudulent transfer. Fourth, *Sampsell* holds that the question of the treatment of the claims of the various creditors of consolidated debtors is a separate question from the question of whether the debtors should be consolidated. Fifth, *Sampsell* holds that creditors of a debtor subject to a consolidation motion are not necessary parties to the motion and, therefore, can be bound by its outcome so long as their right to assert priority of treatment is preserved. Sixth, *Sampsell* actually holds that once consolidation has been ordered based on the findings of either fraudulent transfers or an instrumentality relationship, the burden shifts to an objecting creditor to establish the existence of equitable considerations entitling its claim against its particular debtor to priority over the claims of other creditors as to that debtor's assets.

Since *Sampsell* and *Fish*, there have been several cases that have discussed the "factors" for a court to consider when faced with deciding whether the relationship of a debtor to another entity is such that the estates should be substantively consolidated. More recently, the most popular of these factor recitations is contained in *In re Vecco Construction Industries, Inc*.[38] The *Vecco* court

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[36] *See id*. (revealing abuse of subsidiary to raise money for parent).

[37] What constitutes property of an estate is an issue of federal bankruptcy, not state, law. Lines v. Frederick, 400 U.S. 18 (1970); Segal v. Rochelle, 382 U.S. 375 (1966); Page v. Edmunds, 187 U.S. 596 (1903); In re Missouri, 7 B.R. 974, 980 (D. Ark. 1980), *aff'd* 647 F.2d 768 (8th Cir. 1981), *cert denied,* 454 U.S. 1162 (1982); S. REP. NO 95-989, at 82 (1978), H.R. REP. NO. 95-595, at 367–68 (1977) ("[T]he result of *Segal* is followed, and the right to a refund is property of the estate."); 5 COLLIER ON BANKRUPTCY ¶541.LH[3][a] (15th ed. rev. 2004) (reliance on state law tests of property were scrapped from section 541 to eliminate dependence on nonbankruptcy law).

[38] *In re* Vecco Constr. Indus., Inc., 4 B.R. 407 (Bankr. E.D. Va. 1980); *see In re* Permian Producers Drilling, Inc., 263 B.R. 510, 518 (Bankr. W.D. Tex. 2000) (citing *Vecco* for elements most commonly used by courts in determining whether substantive consolidation is warranted); *see also* Peter J. Lahny IV

summarized the criteria it had found trial and appellate courts had considered in addressing substantive consolidation and listed the following factors for determining whether consolidation is appropriate:

> First, the degree of difficulty in segregating and ascertaining individual assets and liability. Second, the presence or absence of consolidated financial statements. Third, the profitability of consolidation at a single physical location. Fourth, the commingling of assets and business functions. Fifth, the unity of interests and ownership between the various corporate entities. Sixth, the existence of parent and inter-corporate guarantees on loans. Seventh, the transfer of assets without formal observance of corporate formalities.[39]

Once again, a glance at these factors informs the reader that the purpose of the inquiry is to determine whether legally separate entities are actually part of a unified business operation. *Vecco* is still cited with approval and is influential in substantive consolidation analysis today.[40] At this point, comparison to the alter-ego analysis conducted in connection with "piercing the corporate veil" is warranted. Courts have recognized that the early substantive consolidation cases basically applied alter-ego or veil-piercing tests in assessing the propriety of substantive consolidation[41] and others have observed the continuing similarity between these doctrines.[42] Nevertheless, some courts and commentators have argued that the analogy of substantive consolidation to veil-piercing is misplaced.[43] The goal of

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[hereinafter Lahny IV], *Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation*, 9 AM. BANKR. INST. L. REV. 815, 867 (2001) ("Today, the most commonly accepted factor analysis is that of the *Vecco Construction* case and that is the analysis pointed to by the commentators on asset securitization.").

[39] *Vecco*, 4 B.R. at 410.

[40] *See, e.g.*, Nesbit v. Gears Unlimited, Inc., 347 F.3d 72, 86 n.7 (3d Cir. 2003) (outlining *Vecco*'s seven-factor test); Eastgroup Props. v. S. Motel Ass'n., 935 F.2d 245, 249 (11th Cir. 1991) (suggesting proponent of consolidation "may want to frame his argument using the seven factors outlined in *In re Vecco Construction Industries, Inc.*"); *Permian Producers Drilling*, 263 B.R. at 518 (noting *Vecco* factors contain most commonly cited elements for test of substantive consolidation).

[41] *See, e.g.*, Reider v. FDIC (*In re* Reider), 31 F.3d 1102, 1105 (11th Cir. 1994) ("Early decisions in the corporate context applied essentially an alter ego or pierce the corporate veil test in assessing the propriety of substantive consolidation."); *In re* Stone & Webster, Inc., 286 B.R. 532, 539 (Bankr. D. Del. 2002) (same); *see* Pension Benefit Guar. Corp. v. Ouimet Corp., 711 F.2d 1085, 1092–93 (1st Cir. 1983) (collapsing substantive consolidation under the term of "piercing the corporate veil in bankruptcy situations" and outlining considerations involved in the determination).

[42] *See, e.g.*, *In re* Creditors Serv. Corp., 195 B.R. 680, 689 (Bankr. S.D. Ohio 1996) (pointing out practical similarity between doctrines); *In re* Cooper, 147 B.R. 678, 683 (Bankr. D. N.J. 1992) ("[T]here is a substantial overlap between the grounds for and remedies of piercing the corporate veil and substantive consolidation.").

[43] *See, e.g.*, Helena Chem. Co. v. Circle Land & Cattle Corp. (*In re* Circle Land & Cattle Corp.), 213 B.R. 870, 874–75 (Bankr. D. Kan. 1997) (criticizing comparison between doctrines because "substantive consolidation does not seek to hold shareholders liable for acts of their incorporated entity," but instead "requires the general creditors of the separate entities to share in pooled assets"); *see also* J. Stephen Gilbert,

piercing the corporate veil is to hold shareholders liable for the acts their incorporated entity, which is accomplished by a limited merger (in the case of parent and subsidiary corporations) for the benefit of a particular creditor.[44] Veil-piercing is employed to remedy fraud or injustice.[45] In supposed contrast, substantive consolidation ensures the equitable distribution of property to all creditors by merging the assets of legally separate corporations into a single pool of assets for distribution.[46] Substantive consolidation does not seek to hold shareholders liable for corporate actions, or so the argument goes.[47]

It is respectfully submitted that focusing on the differences between substantive consolidation and veil-piercing, rather than highlighting the similarities, has contributed confusion to an already complex area of law. It is inarguable that the two doctrines are different and that the ultimate relief pursuant to each is different. But the differences between the two doctrines are more a product of differences in the contexts in which they are invoked, rather than differences in the purpose of employing the alter-ego analysis.[48] Historically, both doctrines were intended to

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Note, *Substantive Consolidation in Bankruptcy: A Primer*, 43 VAND. L. REV. 207, 218 (1990) [hereinafter Gilbert] (stating analogy is misplaced because substantive consolidation is more akin to corporate law notion of enterprise liability); *cf. In re* Owens Corning, 419 F.3d 195, 206 (3d Cir. 2005) (discussing subtle differences between "piercing the corporate veil" and substantive consolidation, and remarking "[s]ubstantive consolidation goes in a different direction (and in most cases further) than [piercing the corporate veil] . . . ."); *Creditors Serv. Corp.*, 195 B.R. at 689 (explaining substantive consolidation "ensures the equitable distribution of property to all creditors, while on the other hand, piercing the corporate veil is a limited merger for the benefit of a particular creditor."); *Cooper*, ` B.R. at 683–84 (recognizing material differences between doctrines despite practical similarities).

[44] *See Circle Land & Cattle Corp*., 213 B.R. at 874 (analogizing corporate piercing to a merger of two corporations under state law); *Creditors Serv. Corp.*, 195 B.R. at 689 ("[P]iercing the coporate veil is a limited merger for the benefit of a particular creditor."); *In re* Bonham, 226 B.R. 56, 89 (Bankr. D. Alaska 1998) (characterizing "piercing the corporate veil" as "limited merger").

[45] *E.g.*, Fletcher v. Atex, Inc., 68 F.3d 1451, 1458 (2d Cir. 1995) (requiring plaintiff to demonstrate overall element of unfairness or injustice in order to prevail on claim); *see Cooper*, 147 B.R. at 683 (emphasizing veil-piercing is employed to remedy fraud or other injustice); Walkovszky v. Carlton, 18 N.Y.2d 414, 417 (1966) (recognizing use of veil-piercing to combat fraud or achieve equity).

[46] *See Creditors Serv. Corp.*, 195 B.R. at 689 (calling substantive consolidation "an extreme remedy" because it creates common pool of assets and extinguishes "the intercorporate liabilities of the consolidated entities."); *Cooper*, 147 B.R. at 683 (utilizing merger of entities "to correct prior harm or prevent future harm to creditors."); *see also* Gilbert, *supra* note 43, at 218 (observing substantive consolidation looks "to the combined assets of the consolidated entities for satisfaction of all claims against the collective group.").

[47] *See* Helena Chem. Co. v. Circle Land & Cattle Corp. (*In re* Circle Land & Cattle Corp.), 213 B.R. 870, 874 ("Unlike piercing the corporate veil, substantive consolidation does not seek to hold shareholders liable for acts of their incorporated entity."); *see also* Gilbert, *supra* note 43, at 218 ("[S]ubstantive consolidation is more like the corporate law notion of enterprise liablity because substantive consolidation does not seek to hold shareholders liable for the acts of their incorporated entity"); Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589, 632 (1975) (noticing bankruptcy consolidation is based on policy designed to protect stockholders). The importance of this distinction is not immediately apparent. Whether a proponent of consolidation seeks to hold a parent company "liable" for the debts of its subsidiary or simply wants parent company assets available to pay for the debts of the subsidiary appears, as a practical matter, to be irrelevant.

[48] *See generally Cooper*, 147 B.R. at 684 (discussing specifics of veil-piercing and substantive consolidation situations). Generally, veil-piercing is employed outside of bankruptcy, in two-party or three-party disputes brought by one creditor against one debtor and a related entity, and the benefit sought is solely

remedy unfairness caused by an alter-ego or instrumentality relationship between the entities at issue.[49]

It does a disservice to an understanding of substantive consolidation to fail to recognize that the initial focus of the analysis is properly on the factors tending to establish the "excessive unity" of the affected entities. Unity becomes excessive when it appears that the allocation of assets and liabilities between the separate entities is arbitrary and, thus, not a reasonable basis for determining creditor recoveries without being corrected through expensive fraudulent transfer proceedings. "Alter-ego," "instrumentality" and "economic unit" are simply shorthand terms to refer to those situations when the factors establish excessive unity.

Truly separate corporations will never be substantively consolidated. Ultimately, substantive consolidation (like veil-piercing) boils down to the issue of when the court should exercise its equitable power to disregard the corporate fiction because the corporations involved effectively disregarded it themselves.[50] Accordingly, the "factor analysis" properly remains influential in modern substantive consolidation jurisprudence and it is critical to an understanding of this doctrine that its genesis was in the attempt to determine whether related entities abused the corporate form such that artificial corporate structures should be ignored and the entities' assets should be pooled for distribution to creditors. The reasoning of the earlier court decisions was premised on the notion that, when entities are effectively alter-egos and the allocation of assets and liabilities between them is not based on economic reality, such allocation is arbitrary and unreliable, and should neither control creditor recoveries nor put creditors in the position of spending inordinate amounts to prove fraudulent transfers. Thus, it has always been and

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for the creditor bringing the action. Substantive consolidation, on the other hand, requires the court to consider the benefits and potential detriments to all debtors and creditors concerned with the relevant bankruptcy proceedings. *See id.*

[49] *See* Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381, 390–91 (1998) [hereinafter Kors] ("The alter ego theme of domination and interdependence would underlie not just piercing the corporate veil, but the other corporate disregard remedies of turnover . . . and equitable subordination."). While this article does not subscribe to several of the conclusions stated in Professor Kors' article, she appears to be one of the few commentators that, at least, acknowledges this fundamental link between the two doctrines. *See generally* Lahny IV, *supra* note 38, at 861–66 (discussing history of substantive consolidation); Douglas C. Michael, *To Know a Veil*, 26 J. CORP. L. 41, 43–46 (2000) (describing origins of veil-piercing).

[50] It should be rather obvious, now, why practically every court to address substantive consolidation has noted that these cases are *sui generis* and why courts applying a factor analysis have warned that no one factor is determinative. Whether related entities actually comprise a single operation is a highly fact-specific inquiry and the factors discussed above are merely guideposts in making that determination. *Compare In re* Murray Indus., Inc., 119 B.R. 820, 829 (Bankr. M.D. Fla. 1990) (noting factor analysis merely facilitates balancing equities and, thus, there is no clear litmus test for consolidation and such cases are largely *sui generis*), *with* DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 684 (4th Cir. 1976) (noting circumstances relevant to disregarding corporate form necessarily vary in each case and, thus, each case is to be regarded as *sui generis*). *See* Kors, *supra* note 49, at 397 ("Substantive consolidation cases repeatedly stress that each case is *sui generis*.").

continues to be a goal of substantive consolidation analysis to determine whether the entities to be consolidated are, in fact, one operation.

A. Substantive Consolidation in the Second Circuit.

Following the *Sampsell* decision, little happened in the development of substantive consolidation for about twenty years.[51] Then, beginning with *Soviero v. Franklin National Bank of Long Island*,[52] the Second Circuit Court of Appeals issued a string of decisions that continues to shape interpretations of the modern doctrine.[53]

Soviero involved a single business conducted through a group of affiliated corporations under common ownership, one of which had become a bankrupt.[54] Although the court did not recite a list factors it could consider, the court did find, among other things, that: the affiliated entities to be consolidated with the debtor had the same two directors and stockholders; the debtor financed the organization of these affiliates and they had no working capital; the debtor provided all funds required by these entities and simply made book entries to record these "loans and exchanges;" inventories were arbitrarily assigned to each of the affiliates at the end of the year where they were reflected in the consolidated financial statement and relied upon for tax purposes; the debtor paid for, among other things, all the affiliates' advertising charges, union dues and welfare payments, insurance and accounting charges, and at the end of the year charged each affiliate with an arbitrary portion thereof by bookkeeping entries; suppliers billed the debtor for merchandise shipped to the affiliates; and the debtor provided guarantees to purchasers from the affiliates.[55]

> From these and many other facts, the Referee concluded that the [entities to be consolidated] were but instrumentalities of the bankrupt with no separate existence of their own. Consequently, there existed a unity of interest and ownership common to all

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[51] *See In re* Owens Corning, 419 F.3d, 195, 207 (3d Cir. 2005) (observing "[l]ittle occurred" in substantive consolidation for two decades). *See generally* Reider v. FDIC (*In re* Reider), 31 F.3d 1102, 1105 (11th Cir. 1994) (tracing history of substantive consolidation); Kors, *supra* note 49, at 392–94 (analyzing *Sampsell* and substantive consolidation).

[52] Soviero v. Franklin Nat'l Bank of Long Island, 328 F.2d 446 (2d Cir. 1964).

[53] *See Owens Corning*, 419 F.3d at 207 (pointing out specific cases "that brought substantive consolidation as a remedy back into play and premise its modern-day understanding."); *Reider*, 31 F.3d at 1105 ("[A] series of decisions from the Second Circuit articulated the contours of substantive consolidation which continue to guide current case law in this area."); *see also* Kors, *supra* note 49, at 395 ("During the late 1960s and early 1970s, the Second Circuit issued several substantive consolidation decisions that remain influential.").

[54] *See Soviero*, 328 F.2d at 446 (noting corporation was composed of thirteen separate corporations).

[55] *See Soviero*, 328 F.2d at 447–48.

> corporations, and that to adhere to the separate corporate entities theory would result in an injustice to the bankrupt's creditors.[56]

Noting that it would be difficult to imagine a better example of commingling of assets and functions, and of flagrant disregard for the corporate form, the court found that the facts left a distinct impression that the debtor "held up the veils of the fourteen collateral corporations primarily, if not solely, for the benefit of the tax gatherer," but otherwise completely ignored corporate separateness.[57] *Soviero* is significant for its continued focus on the arbitrariness of asset and debt allocations when the corporate form has been abused. Strict enforcement of that arbitrary allocation would itself have resulted in injustice to creditors.

The Second Circuit next considered substantive consolidation in *Chemical Bank New York Trust Co. v. Kheel*.[58] The *Kheel* court found, among other things, that: the debtors were all owned or controlled by the same individual and were operated as a single unit, little or no attention was paid to the corporate formalities observed by truly independent companies, the officers and directors of the debtors were substantially the same and were controlled by the owner, and funds were shifted between the debtors such that they were effectively pooled, without sufficient record keeping.[59] In fact, the court found that the evidence supported the referee's conclusion that "auditing of the corporations' financial condition and especially the intercompany relationships would entail great expenditure of time and expense without assurance that a fair reflection of the conditions of the debtor corporations would in the end be possible."[60] Thus, in the first instance, the *Kheel* court also rather obviously focused on such abuses of the corporate form as would normally lead to a conclusion that the allocation of assets and liabilities between the relevant entities was arbitrary and without economic reality.

The party objecting to consolidation in *Kheel* was a secured lender of one of the debtors, whose mortgage was under attack and who feared that it would become an unsecured creditor of that debtor. The lender wanted to avoid having to share a single pool of assets in the event it became unsecured.[61] The lender argued that "consolidation of assets and liabilities as to [it was] beyond the court's power absent a showing that it knowingly dealt with the group as a unit and relied on the group for payment."[62] Citing *Soviero*, the Court of Appeals specifically rejected the notion that substantive consolidation requires a showing that creditors knowingly relied on the debtors to be consolidated as a group. The court stated that, "[w]hile the record in the *Soviero* case indicates that there was evidence that the Bank had dealt with

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[56] *Id.* at 448.
[57] *Id.*
[58] 369 F.2d 845 (2d Cir. 1966).
[59] *See id.* at 846 (affirming District Court's decision to grant motion for consolidation).
[60] *Id.*
[61] *See id.* at 846–47.
[62] *Id.* at 847.

the bankrupt and its affiliates as one, *the opinion does not make this a necessary foundation for the result*."[63] As will be discussed further below, this holding demonstrates that—at least, prior to *Augie/Restivo*—the Second Circuit had not held that substantive consolidation requires proof that the parties relied on their belief that the related entities were a single enterprise. What mattered was the objective fact that they were a single enterprise.

It was the court's next conclusion, however, for which the *Kheel* case is arguably most noted. The court found that, unlike certain earlier consolidation cases, the *Kheel* case presented an additional factor: "the expense and difficulty amounting to practical impossibility of reconstructing the financial records of the debtors to determine intercorporate claims, liabilities and ownership of assets."[64] In an oft-cited passage, the court found that:

> The power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others. Yet in the rare case such as this, where the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.[65]

Thus, the *Kheel* court found that, where the finances of the entities to be consolidated are hopelessly entangled, substantive consolidation can be ordered in spite of an innocent creditor's reliance on the separate credit of these entities. Due to "hopeless entanglement," the *Kheel* majority concluded that substantive consolidation was justified, over the objection of the secured lender in that case.[66]

It is critical to understand, however, that the "hopeless entanglement" aspect of substantive consolidation doctrine was not propounded as a second or alternative ground for obtaining relief, but was simply an additional factor the court considered in finding consolidation appropriate.[67] It seems rather apparent that the *Kheel* majority's discussion of hopeless financial entanglement was included to justify its

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[63] *Id.* (emphasis added).

[64] *Kheel*, 369 F.2d at 847; *see* Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5, 16–17 (2005) [hereinafter Baird] (recognizing *Kheel* court emphasized cost of sorting out various rights and obligations); Kors, *supra* note 49, at 382 (pointing out "the cost of sorting out the entangled records [in the *Kheel* case] would have been immense.").

[65] *Kheel*, 369 F.2d at 847.

[66] *See id*.

[67] *See id.* ("[W]e have here an additional factor not present in *Soviero* . . . ."); *In re* Richton Int'l Corp., 12 B.R. 555, 558 (Bankr. S.D.N.Y. 1981) (noting even *Kheel* court considered financial entanglement as only one factor to be considered); *In re* Vecco Constr. Indus., Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980) (observing *Kheel* court established new "criterion" for substantial consolidation).

decision to consolidate, despite the possibility that there was a creditor that had relied on debtor separateness. The opinion does not state that hopeless entanglement is required under all circumstances, nor does it make any comment on the relevance of "non-hopeless" financial entanglement to the determination of a substantial identity between corporate debtors. Far from making "hopeless entanglement" the sole ground for consolidation, the opinion does not even make it a ground. Consolidation was granted based on the presence of the instrumentality factors, and hopeless entanglement was considered in addition to these factors, not as an alternative to them. That is clear from Judge Friendly's concurring opinion.

Judge Friendly wrote a concurring opinion in the *Kheel* case that has also had an important impact on substantive consolidation law. Frequently cited by those opposing consolidation, Judge Friendly stated that "[e]quality among creditors who have lawfully bargained for different treatment is not equity but its opposite . . . ."[68] In making that statement, however, he was expressing his disagreement with the majority's conclusion that hopeless entanglement could justify the refusal to attempt to reach the best possible approximation of the debtors' finances in order to do justice to a creditor that had relied on the separate credit of one of the debtors.[69] Judge Friendly's position on this point did not carry the day and is not the law in the Second Circuit or elsewhere. It is important to recognize, however, that Judge Friendly did not take issue with the majority's analysis that consolidation was warranted based on instrumentality factors. It is apparent that his objection was to the majority's finding that hopeless entanglement relieved the court of having to preserve an objecting creditor's right to prove its reliance on the separate credit of its debtor, thus blurring the previous distinction between consolidation and priority of distribution.[70]

Significantly, though, Judge Friendly did join in affirming the decision to consolidate because the *objecting party* failed to prove that *it* had relied on the

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[68] *Kheel*, 369 F.2d at 848 (Friendly, J., concurring).

[69] *See id*. (encouraging court "to make every reasonable endeavor" to determine best possible approximation); *see also* Sabin Willett, *The Doctrine of Robin Hood: A Note on "Substantive Consolidation*,*"* 4 DEPAUL BUS. & COM. L.J. 87, 89 (2005) [hereinafter Willett] (noting substantive consolidation is based on "fairness to all creditors, and not on any formalistic cost benefit analysis.").

[70] Significantly, even Judge Friendly recognized that creditor reliance might have to yield where debtor finances were really hopelessly entangled, but he did not believe such was the case in *Kheel*. *See Kheel*, 369 F.2d at 848 (Friendly, J., concurring) (differentiating *Kheel* facts from precedents relied upon by majority).

> In contrast Commerce Trust Co. v. Woodbury, 77 F.2d 478 (8 Cir.), cert. denied, 296 U.S. 614, 56 S.Ct. 134, 80 L.Ed. 435 (1935), held that a court of equity will protect the rights of a creditor who relied on the credit of a subsidiary although the subsidiary was "[merely] an agency or department of the [parent]." While such considerations would have to yield to practicalities if even an approach to a proper accounting within the corporate group was impossible or prohibitively expensive, the situation here was not that aggravated.

Id.

separate credit of its obligor. This is particularly notable, considering the fact that the lender in *Kheel* held a mortgage to which only one of the debtors was a party.[71] Judge Friendly found that the objecting party had to come forward with something more than the mortgage in light of the extensive evidence of the intermingling of the debtors' affairs.[72]

In other words, Judge Friendly generally accepted that consolidation was justified by "instrumentality" evidence. In his opinion, the fact that one corporation was the mere instrumentality of another did justify consolidation, but did not warrant disregarding the priority claim of a creditor that had relied on its obligor's separateness without knowledge of the instrumentality relationship. Second, Judge Friendly believed that once a creditor established that reliance on separateness, its rights could not be defeated by the mere fact that recreating accurate inter-company records might be expensive. In his view, an approximation would do to reconstruct the records. Third, Judge Friendly set a rather high burden for the objecting creditor. It was not sufficient for it to show that it had structured its relationship to involve security from a single member of the corporate group. It appears that its asserted lack of awareness of the inter-relationships of the debtors had to be supported by evidence because language used by Judge Friendly in his concurrence suggests that the fact of interrelationship itself gave rise to a presumption of knowledge of that interrelationship by creditors. This shift in burden, from consolidation proponent to objector, would become an integral part of the current *Auto-Train* test.

Shortly after *Kheel*, in *Flora Mir Candy Corp. v. R.S. Dickson & Co.*,[73] Judge Friendly wrote for the majority and demonstrated that, properly applied, substantive consolidation protects innocent creditors that demonstrably relied on the separate credit of one of the debtors. Generally, *Flora Mir* involved a debtor, Meadors, Inc., which had sold a certain amount of debentures. Subsequent to the sale of these debentures, Meadors was bought and sold through a series of transactions, accomplished in part by the purchasers using Meadors's assets to fund the purchases. Shortly after the final purchase by Flora Mir and several years after the debentures were issued, Meadors became defunct and ceased operations. The Meadors debenture holders sued the parties to the purchases and sales of Meadors for, among other things, misappropriation of Meadors's assets.[74]

About six months later, Flora Mir, Meadors and about ten other Flora Mir subsidiaries filed for bankruptcy.[75] The debtors immediately made a motion for substantive consolidation that was opposed by the debenture holders, but which was

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[71] *See Kheel,* 369 F.2d at 846.

[72] *See id.* at 848–49 (Friendly, J., concurring) ("While the mortgage indenture itself is some evidence . . . the Government's proof of long continued intermingling of the affairs of the various Kulukundis companies required the Chemical to come forward with at least something more.").

[73] 432 F.2d 1060 (2d Cir. 1970).

[74] *See id.* at 1061–63.

[75] *See id*. at 1061.

initially granted by a referee. A district judge set aside the consolidation insofar as it included Meadors, and the Court of Appeals affirmed. The reason for affirming the decision not to consolidate Meadors was the clear reliance of the objecting creditors on the separate credit of Meadors and the extreme prejudice to these creditors that would result from consolidation.[76]

The Meadors debenture holders very obviously relied on the separate credit of Meadors and could not have relied on the debtors as an economic unit because Meadors had no affiliation with the other debtors at the time the debentures were sold.[77] While there was evidence that trade creditors of the other debtors had considered the debtors as a group, the court treated it as immaterial because Meadors did little business after its acquisition by Flora Mir and was defunct shortly thereafter.[78] Thus, the trade creditors could not plausibly have relied on Meadors in extending credit to the debtors as a group. Additionally, there was evidence that the debtors' finances were hopelessly entangled. Nevertheless, this evidence consisted of testimony from an accountant who had reviewed records from the period following Meadors having become defunct.[79] The *Flora Mir* court found that the debtors' finances were not hopelessly obscured and that, whatever problems there may have been concerning the intercompany accounts between the other debtors, Meadors's finances were not inseparable.[80]

Moreover, the Meadors debenture holders would have been extremely prejudiced by consolidation. Aside from having to share Meadors's assets with the creditors of the other debtors, the misappropriation claims of Meadors against the other debtors would have been wiped out and the debenture holders would have had to share any recovery from the misappropriation lawsuit against nondebtors with the creditors of the other debtors.[81] Presented with the manifest prejudice of consolidation to the debenture holders, the court rejected "[t]he nub of counsel's argument[,] that only consolidation [would] permit the quick consummation of an arrangement under chapter XI."[82] While recognizing that consolidation might indeed be desirable, the court was unwilling to impose the costs of consolidation on innocent creditors and in this context stated that the objecting creditors could not be made to sacrifice their rights simply for expedience.[83] Interestingly, Judge

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[76] *See id*. at 1062 (mentioning procedural posture of substantive consolidation).

[77] *See id*. (showing debentures had been issued six years before Flora Mir acquired Meadors).

[78] *See id.* ("Meadors . . . had transacted little business after its acquisition by Flora Mir in June 1968 and none since November of that year.").

[79] *See Flora Mir*, 432 F.2d at 1061–62.

[80] *See id.* at 1063 (distinguishing *Flora Mir* facts from *Kheel* facts).

[81] *See id.*

[82] *Id*.

[83] *See id.* ("[Consolidation] may indeed be desirable but not at the cost of sacrificing the rights of Meadors' debenture holders."). *See generally In re* Richton Int'l Corp., 12 B.R. 555, 556 (Bankr. S.D.N.Y. 1981) (emphasizing duty to carefully scrutinize evidence because consolidation affects substantive rights of parties); Jonathan Hightower, *The Consolidation of the Consolidations in Bankruptcy*, 38 GA. L. REV. 459, 470 (2003) ("The effects of substantive consolidation on a bankruptcy case can be quite significant because,

Friendly's *Flora Mir* opinion suggests that consolidation might have been appropriate in that case had the proponents of consolidation respected the rights of the debenture holders to Meadors' assets, rather than trying to profit from consolidation.[84]

At this point it is important to note that *Flora Mir* did not discuss any reliance that must be demonstrated by the proponent of consolidation. Nowhere does the opinion state that a party moving for consolidation must demonstrate that creditors relied on the entities to be consolidated as a unit. Rather, consistent with *Soviero* and *Kheel*, *Flora Mir* focused on the reliance of the objecting creditors on the separate credit of one of the debtors and the prejudice to those creditors that would have resulted from consolidation. That reliance on separateness was established by the fact that the objectors had extended credit to their debtor *before that debtor became part of the corporate group.* Obviously, the debtors had not been an economic unit when they had extended credit and they unquestionably relied on the credit of their debtor.

James Talcott, Inc. v. Wharton (In re Continental Vending Machine Corp.),[85] is the last case in which the Second Circuit Court of Appeals addressed substantive consolidation before its landmark decision in *Augie/Restivo*. Again, the court reaffirmed the principles discussed above:

> The power to consolidate is one arising out of equity, enabling a bankruptcy court to disregard separate corporate entities, to pierce their corporate veils in the usual metaphor, in order to reach assets for the satisfaction of debts of a related corporation. While it does not require that the creditors knowingly deal with the corporations as a unit, *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966), it should nevertheless be "used sparingly" because of the possibility of unfair treatment of creditors who have dealt solely with the corporation having a surplus as opposed to those who have dealt with the related entities with deficiencies.[86]

Thus, the court succinctly reiterated the core substantive consolidation principles in the Second Circuit at that time. First, substantive consolidation is an equitable remedy whereby bankruptcy courts essentially pierce the corporate veil of a company in order to satisfy the debts of a related company. Second, the doctrine

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as the name indicates, it drastically affects the substantive rights of the parties."); Lahny IV, *supra* note 38, at 861 (asserting consolidation is no mere procedural instrument).

[84] Moreover, there is nothing to suggest that if such creditors, instead of attempting to profit from a quick consolidation, had sat down with the Meadors' debenture holders in an effort to develop an equitable plan whereby Meadors' creditors would retain the assets particularly pertinent to them, with a reasonable adjustment in their other rights, the debenture holders would have turned a deaf ear. *See Flora Mir*, 432 F.2d at 1063.

[85] 517 F.2d 997 (2d Cir. 1975).

[86] *Id*. at 1000–01 (citations, except *Kheel*, omitted).

does *not* require that creditors have knowingly dealt with the related corporations as a unit, so long as they are in fact a unit. But, third, courts must cautiously apply this doctrine because a creditor that dealt with only one of the related entities may be treated unfairly through consolidation (*i.e.*, it may have relied on the separate credit of its debtor without knowledge of the debtor's affiliate relationships and, thus, would be prejudiced by consolidation).

Ultimately, the court in *Continental Vending* affirmed a reorganization plan that included consolidation, but did not allow a secured creditor's lien on the assets of one debtor to thereby extend to the assets of the other debtor to be consolidated. The court did not allow the secured creditor to improve its position at the expense of unsecured creditors where the court found that the debtors' inter-corporate dealings had not diminished the creditor's liens nor resulted in the transfer of lien property.[87] Thus, the court recognized that the arbitrary allocation of assets and liabilities among affiliates provided grounds for pooling as to unsecured creditors but did not, by itself, provide a basis for modifying the rights of a secured creditor who had relied on a defined pool of collateral owned by one debtor. In other words, substantive consolidation for the benefit of this creditor was not warranted because it could not demonstrate that it was harmed by any lack of corporate formalities among the debtors.[88]

It is interesting to compare the early *Sampsell*-era cases to the later substantive consolidation cases from the Second Circuit. While some courts have suggested that there was a significant transformation in the doctrine,[89] it appears that the underlying rationales for consolidation in these decisions are really quite similar. Irrespective of whether one uses "alter-ego" or "instrumentality" terminology, the cases discussed above generally acknowledged the propriety of consolidating technically separate entities where they ignored corporate formalities, conducted themselves as a unified economic entity and, thus, there was reason to believe that the allocation of assets and liabilities between them was arbitrary.

The significant difference between the earlier and later cases is the way they dealt with the protection of creditors who reasonably relied on the separate credit of their obligor. The *Sampsell*-era cases apparently regarded consolidation and priority as separate issues. Accordingly, a court could effectively grant

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[87] *See id.* at 1001–02.

[88] *See id.* at 1001 (finding consolidation unnecessary because interests of secured creditor were not materially or adversely affected); *In re* Snider Bros., Inc., 18 B.R. 230, 237 (Bankr. D. Mass. 1982) (discussing *Continental Vending* and concluding, "Thus, it can be seen clearly that consolidation is not a matter of simply showing corporate interrelationship, but harm thereby as well.").

[89] *See e.g.*, Helena Chem. Co. v. Circle Land & Cattle Corp. (*In re* Circle Land & Cattle Corp.), 213 B.R. 870, 876 (Bankr. D. Kan. 1997) ("The decisional focus has shifted from alter ego factors to the effect of the consolidation on the general unsecured creditors of the two entities."); *In re* Standard Brands Paint Co., 154 B.R. 563, 568 (Bankr. C.D. Cal. 1993) ("As time progressed, caselaw evolved from looking at entanglement/bad acts as the justification for substantive consolidation to analyzing substantive consolidation in terms of balancing the benefits that substantive consolidation would bring against the harm that substantive consolidation would cause.").

consolidation in one proceeding and then address a creditor's claim to priority in a separate proceeding. Assuming the relationship between the entities "was such as to justify use of summary proceedings" to pool the corporate assets, the unsecured creditors seeking priority would have the burden of demonstrating their equitable entitlement to priority.[90] If that burden was met, courts would preserve a creditor's priority to the specific assets of its debtor despite consolidation.[91]

Under the more modern doctrine, as developed from the above-referenced Second Circuit case law, the consolidation and priority issues appear to have become merged into a single proceeding in which a creditor that can prove reliance on separateness can defeat consolidation, unless hopeless financial entanglement can be shown. A proponent of consolidation still needs to demonstrate abuse of the corporate form such that it would be unjust to enforce corporate separateness. It needs to show that consolidation would remedy a harm caused by such abuse or otherwise achieve a benefit to the bankruptcy estates that is attributable to correcting such abuse. Irrespective of whether a proponent makes this showing, absent hopeless entanglement, consolidation cannot be used to prejudice the rights of an innocent, unsecured creditor that actually relied on the separate credit of one of the entities to be consolidated. But consolidation can still be granted where the finances of the relevant entities are "hopelessly entangled" such that consolidation would be to the benefit of all creditors. Significantly, however, neither the earlier nor the later line of cases discussed above required that proponents of consolidation demonstrate their reliance on the unity of the entities to be consolidated, only that the entities in fact functioned as a unified enterprise.

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[90] *See* Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941) (placing burden on unsecured creditors to show their equity was paramount); *cf.* New York Trust Co. v. Island Oil & Transp. Corp., 56 F.2d 580, 582–83 (2d Cir. 1932) (describing situation affecting position of priority of creditors).

[91] *See, e.g.*, Commerce Trust Co. v. Woodbury, 77 F.2d 478, 491 (8th Cir. 1935) (finding trial court erred in refusing to give unsecured creditor priority). Specifically, the court ultimately held:

> We conclude that, because the sales company was only an agency or department of the lumber company; because it was wholly dominated and controlled by the latter; because it performed no new function, and because it was a mere splitting up of the lumber company's business, the trial court was correct in requiring it to be taken over and administered by the receiver of the lumber company. But we are constrained to the view that the facts, the situation and the law, did not warrant the court in refusing to adjudge that appellants be first paid out of the assets of the sales company, nor do the facts and the law, in the view we take of the case, warrant the judgments against appellants, that they repay to the receiver what they have already been paid on their claims . . . . If, after paying all debts of the sales company, including the debts due to the appellants, there shall be a surplus, it shall be regarded as an asset of the lumber company for the payment of its general creditors; if there shall not be among the assets of the sales company sufficient funds to pay all of its debts, including those of the appellants, the residue of such debts should be allowed as general claims against the lumber company.

Id.; *see* Hollander v. Henry, 186 F.2d 582, 586 (2d Cir. 1951) (dismissing issue of priority where no creditor tried to demonstrate reliance on apparent separation of businesses).

Having reviewed the evolution of substantive consolidation, there is now a context in which to properly interpret the currently prevailing tests set forth in the *Auto-Train* and *Augie/Restivo* decisions.

B. The Auto-Train and Augie/Restivo Decisions

In *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp., Inc.)*,[92] the Court of Appeals for the District of Columbia articulated the test commonly referred to as the *Auto-Train* test.[93] The *Auto-Train* court noted that, "[b]efore ordering consolidation, a court must conduct a searching inquiry to ensure that consolidation yields benefits offsetting the harm it inflicts on objecting parties."[94]

First, a proponent must show that there is a substantial identity between the parties to be consolidated.[95] This first part of the *Auto-Train* analysis is essentially the alter-ego analysis, as had been used in the early substantive consolidation cases.[96] Not surprisingly, then, it has been recognized that utilizing the factor analysis employed in *Vecco* may be helpful in determining whether there is the requisite substantial identity.[97]

Turning to the equitable component, a proponent of consolidation must also demonstrate that consolidation is necessary to avoid some harm or realize some benefit.[98] The *Auto-Train* court observed that consolidation is typically ordered to

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[92] 810 F.2d 270 (D.C. Cir. 1987).

[93] Some have noted that test for consolidation articulated by the *Auto-Train* court was *dicta*. While this is true, it is also true of the *Augie/Restivo* test and the *Owens Corning* test. In each of these cases, the Court of Appeals went far beyond what was necessary to decide and attempted to state general rules not necessary for decision of the case before it. Nevertheless, this article discusses the "*Auto-Train* test" because that is what the test has come to be known as and referred to by almost every court to address the issue since the *Auto-Train* decision. Notably, it has been adopted by numerous courts, including the Eleventh Circuit. *See* Eastgroup Props. v. S. Motel Assoc., 935 F.2d 245, 249 (11th Cir. 1991) (adopting *Auto-Train* test).

[94] *Auto-Train*, 810 F.2d at 276 (citing *In re* Snider Bros., Inc., 18 B.R. 230, 237–38 (Bankr. D. Mass. 1982)).

[95] *See id.* (establishing first prong necessary for proponent's prima facie case of consolidation).

[96] *See In re* Genesis Health Ventures, Inc., 266 B.R. 591, 618 (Bankr. D. Del. 2001) (noting "'first part of this [*Auto-Train* test] mirrors that used by courts to determine whether corporations are alter egos of one another.'"); *In re* Standard Brands Paint Co., 154 B.R. 563, 569 (Bankr. C.D. Cal. 1993) (summarizing first prong as carry over from old alter ego line of cases). *But see* Christopher J. Predko, Note, *Substantive Consolidation Involving Non-Debtors: Conceptual and Jurisdictional Difficulties in Bankruptcy*, 41 WAYNE L. REV. 1741, 1764 (2005) (suggesting *Auto-Train*'s requirement for substantial identity is "a lower threshold than the alter-ego standard.").

[97] *See* Eastgroup Props. v. S. Motel Assoc., 935 F.2d 245, 249–50 (11th Cir. 1991) (listing *Vecco* factors and emphasizing their usefulness to courts); *see also* Katherine D. Kale, *Securitizing the Enterprise: Enterprise Liability and Transferred Receivables in Bankruptcy*, 20 BANKR. DEV. J. 311, 333–34 (2004) [hereinafter Kale] (discussing factor analysis from *Vecco*); Kors, *supra* note 49, at 405 (stating alter ego factors may be useful in establishing first prong of *Auto-Train* test).

[98] *See Eastgroup*, 935 F.2d at 249 (stating second prong of *Auto-Train*'s test); Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987), (setting forth second prong of proponent's burden to establish *prima facie* case for consolidation); Simon v. Brentwood Tavern, LLC (*In re* Brentwood Golf Club, LLC), 329 B.R. 802, 812–13 (Bankr. E.D. Mich. 2005) (applying second prong of *Auto-Train* test).

avoid the expense and difficulty of sorting out affiliated debtors' respective assets and liabilities.[99] Courts have also ordered substantive consolidation in order to avoid harm to creditors that would otherwise have been caused from abuse of the corporate form by the entities to be consolidated.[100]

A proponent that has demonstrated substantial identity and that consolidation will avoid harm or realize benefit has made a *prima facie* case for consolidation under the *Auto-Train* test.[101] In other words, substantive consolidation is appropriate where a movant has shown that the entities to be consolidated abused the corporate form and that such abuse would result in detriment to unsecured creditors if corporate separateness would continue to be observed. Then, consistent with Judge Friendly's concurrence in *Kheel*, once the *prima facie* case has been made under the *Auto-Train* test, the burden shifts to an *objecting creditor* to establish that it relied on the separate credit of one of the entities to be consolidated and that it will be prejudiced by consolidation.[102] Absent such showing by an objecting creditor, substantive consolidation is warranted.

But what if an objecting creditor does make such a showing? At this point, the *Auto-Train* court generalized from the majority opinion in *Kheel* and arguably went astray in doing so. Since *Kheel* had recognized that harm to a creditor who had relied on separateness caused by consolidation may be outweighed by the benefits of consolidation where the finances of the entities to be consolidated are hopelessly obscured,[103] the *Auto-Train* court generalized that a court may order consolidation if

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[99] *See Eastgroup*, 935 F.2d at 249 (recognizing court's equitable powers to order substantive consolidation); *see* Chem. Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966) (finding need for equitable consolidation where "interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors . . . ."); *see also* Jordan A. Kroop, *Baseball and the "Abecedarian Prerequisite" to Substantive Consolidation*, 19 AM. BANKR. INST. J. 22, 22 (2001) (demonstrating use of substantive consolidation to "avoid the unwieldy (or impossible) task of figuring out which entity owns what, and who owns what to whom.").

[100] *See, e.g.*, *Eastgroup*, 935 F.2d at 251 (explaining consolidation would prevent harm to one debtor's creditors that would otherwise result from that debtor's payment of unsecured obligations of another debtor); *In re* Permian Producers Drilling, Inc., 263 B.R. 510, 519 (Bankr. W.D. Tex. 2000) (affirming bankruptcy court's decision to order substantive consolidation to prevent harm to unsecured creditors).

[101] *See Eastgroup*, 935 F.2d at 249 (explaining *prima facie* case in *Auto-Train*); Reider v. FDIC (*In re* Reider), 31 F.3d 1102, 1108 (11th Cir. 1994) (determining debtor spouses must satisfy *Eastgroup* analysis to establish *prima facie* showing for substantive consolidation); *see also* Kale, *supra* note 97, at 333 (asserting proponent's showing of two prongs of *Auto-Train* standard establishes *prima facie* case).

[102] *See Eastgroup*, 935 F.2d at 249 (noting after *prima facie* case is made, presumption arises that creditors have not relied solely on credit of one of entities involved); *see* Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987) (declaring when proponent makes out *prima facie* case, "creditor may object on the grounds that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation."); Chem. Bank New York Trust Co. v. Kheel, 369 F.2d 845, 848 (2d Cir. 1966) (Friendly, J., concurring).

[103] *See, e.g.*, James Talcott, Inc. v. Wharton (*In re* Cont'l Vending Mach. Corp.), 517 F.2d 997, 1001 (2d Cir. 1975) ("[T]he inequities [that consolidation] involves must be heavily outweighed by practical considerations such as the accounting difficulties (and expense) which may occur where the

it determines that the benefits of consolidation heavily outweigh the harm.[104] This statement, which suggests that the injury to one creditor might be outweighed by the benefits to other creditors, a notion that offended Judge Friendly in his *Kheel* concurring opinion, is the one questionable portion of the *Auto-Train* test, which rather faithfully and systematically summarized the substantive consolidation precedents from the Second Circuit. What is unfortunate is that *Auto-Train* failed to pick up on the *Sampsell* rule and Judge Friendly's suggestion in *Flora Mir* that in this situation consolidation could still be granted if the objecting creditor were compensated for, or protected against, injury. If the benefits of consolidation truly outweighed its harm, awarding such compensation would preserve those benefits without inflicting injury.

Then, however, the Second Circuit issued its next landmark substantive consolidation opinion in *Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*.[105] The *Augie/Restivo* case involved the consolidation of the bankruptcy proceedings of Augie's Baking Company ("Augie's") and Restivo Brothers Bakers, Inc. ("Restivo").[106] Originally, Augie's and Restivo were completely separate companies.[107] Augie's had borrowed money from Union Savings Bank ("Union") and Restivo had borrowed money from Manufacturers Hanover Trust Company ("MHTC"). Union's first loan of $2.1 million was secured by Augie's real estate. Augie's borrowed an additional $300,000 that was secured by inventory, equipment and accounts.[108] Subsequent to Union's loans to Augie's, Augie's and Restivo entered into an agreement whereby Restivo would buy all of Augie's stock. Restivo changed its name to Augie/Restivo Baking Company, Ltd. ("Augie/Restivo"), moved its operations and some equipment to Augie's plant, and wound up Augie's affairs.[109]

After this, Augie/Restivo was the sole operating company and kept a single set of books.[110] Augie's, however, continued in existence and did not actually transfer its real estate to Augie/Restivo, thus remaining the legal owner of such property.[111] MHTC made further loans to Augie/Restivo and, significantly, it received a guarantee from Augie's that included a subordinated mortgage on Augie's real

interrelationships of the corporate group are highly complex, or perhaps untraceable."); *Kheel*, 369 F.2d at 847 (detailing case where groups' finances were "hopelessly obscured").

[104] *See Auto-Train*, 810 F.2d at 276 (citing *James Talcott, Inc. v. Wharton* (*In re Cont'l Vending Mach. Corp.*), 517 F.2d 997, 1001 (2d Cir. 1975)) ("If a creditor makes such a showing, the court may order consolidation only if it determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm."); *see also*, Bruce H. White & William L. Medford, *Substantive Consolidation Redux:* Owens Corning, 24 AM. BANKR. INST. J. 30, 30 (2005) ("Most courts and commentators view *Auto-Train* as having liberalized the standard for substantive consolidation."); Kale, *supra* note 97, at 335 ("Other courts employ a less stringent standard and allow consolidation if the benefits 'merely' outweighs the harm.").

[105] 860 F.2d 515 (2d Cir. 1988).

[106] *See id.* at 516.

[107] *Id.*

[108] *See id.* at 516–17.

[109] *See id.* at 517.

[110] *See id.*

[111] *See Augie/Restivo*, 860 F.2d at 517 (noting Augie's legal existence after acquisition).

property.[112] Obviously, MHTC was aware of the relationship between the two companies.

Sixteen months later, Augie/Restivo and Augie's were forced into bankruptcy. The bankruptcy cases of the two entities were kept separate for an additional 20 months.[113] During this period, MHTC financed the operations of Augie/Restivo and, as a result, its entire loan of $2.7 million became a first priority administrative expense claim and lien against Augie/Restivo, but not Augie's.[114] At this point, Augie/Restivo proposed a plan to sell its assets and moved for consolidation. The motion was granted, but the sale never occurred.[115] As a result, MHTC claimed that its administrative claims entitled it to the equity in Augie's assets, leaving Union with an undersecured $300,000 loan.[116] Union appealed the order of substantive consolidation and the Second Circuit reversed the decision, articulating an analysis that other courts have come to describe as the predominant test for the propriety of consolidation.[117]

From the above facts, it appears that the outcome of the case should have been controlled by *Flora Mir* and *Continental Vending* and that, under these cases, MHTC was not entitled to priority over Union regardless of whether consolidation was ordered. Indeed, the *Augie/Restivo* decision stated that it was based on the *Soviero*, *Kheel*, *Flora Mir* and *Continental Vending* decisions, discussed above, as well as several lower court decisions; *viz. In re D.H. Overmyer Co.*;[118] *In re Donut Queen, Ltd.*;[119] *In re Richton Int'l Corp.*;[120] *In re Food Fair, Inc.*;[121] and *In re Commercial Envelope Mfg. Co*.[122] The *Augie/Restivo* court cited these precedents for the proposition that there are numerous considerations relevant to whether substantive consolidation is equitable and then attempted to distill the principles from them into what has come to be called the *Augie/Restivo* test. The court stated that "[a]n examination of those cases . . . reveals that these considerations are merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending

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[112] *See id.*

[113] *See id.*

[114] *See id.* ("Over time, . . . the entire amount of MHTC's pre-petition loans to Augie/Restivo, $2.7 million, had been converted to post-petition super-priority administrative debt . . . .").

[115] *See id.*

[116] *See id.* ("Union's subsequent now undersecured $300,000 loan will be subordinated to MHTC's super-priority administrative debt.").

[117] *See, e.g.*, Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 766 (9th Cir. 2000) (comparing *Auto-Train* test with *Augie/Restivo* test and stating "[t]he Second Circuit's approach is more grounded in substantive consolidation and economic theory; it is also more easily applied.").

[118] *In re* D.H. Overmyer Co., Nos. 73-B-1126, 73-B-1162, 73-B-1189, 73-B-1175, 1976 WL 168421, at *7–9 (S.D.N.Y. Mar. 26, 1976).

[119] *In re* Donut Queen, Ltd., 41 B.R. 706, 711.

[120] *In re* Richton Int'l Corp., 12 B.R. 555, 557 (Bankr. S.D.N.Y. 1981).

[121] *In re* Food Fair, Inc., 10 B.R. 123, 126 (Bankr. S.D.N.Y. 1981).

[122] *In re* Commercial Envelope Mfg. Co., Nos. 76-B-2354, 76-B-2355, 76-B-2356, 76-B-2357, 1977 WL 182366, at *1 (Bankr. S.D.N.Y. Aug. 22, 1977).

credit,' . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[123]

The Second Circuit found that the facts in *Augie/Restivo* did not justify substantive consolidation under either of these two factors. With respect to the first, the court concluded that the course of dealing and expectations in that case did not justify consolidation.[124] The court entirely skipped over any consideration of whether the two debtors had been operated as a single entity such that enforcing separateness would create an injustice. Instead, it focused on the expectations of the two principal creditors, the one injured by and the one benefited by consolidation. The court correctly observed that Union had made its loans to Augie's based solely on Augie's financial condition and without any knowledge of the negotiations between Augie's and Restivo.[125] Further, in the court's view, MHTC had dealt with Augie's and Augie/Restivo as separate corporate entities when it had made certain loans to Augie/Restivo, but obtained a separate guarantee from Augie's that included a subordinated mortgage on a specific asset of Augie's (its real property).[126]

With respect to the second factor of the *Augie/Restivo* test, the Court of Appeals found that, as of the stock purchase, each debtor company's inventory, liabilities and receivables were identifiable and that records existed of all subsequent transactions. Thus, the court found that commingling of assets and business functions did not reach the level of "hopeless obscurity" necessary to warrant consolidation.[127]

There does not appear to be any dispute that the second prong of the *Augie/Restivo* test requires that the finances of the entities to be consolidated be hopelessly entangled. As it had done in *Flora Mir*, the Second Circuit again made

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[123] Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988); *accord* Chem. Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966) (permitting consolidation "where the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors . . . ."); Soviero v. Franklin Nat'l Bank of Long Island, 328 F.2d 446, 448 (2d Cir. 1964) (holding consolidation proper because "there existed a unity of interest and ownership common to all corporations, and that to adhere to the separate corporate entities theory would result in an injustice to the bankrupt's creditors.").

[124] *See Augie/Restivo*, 860 F.2d at 519.

[125] *See id.* ("It is undisputed that Union's loans to Augie's were based solely upon Augie's financial condition, and that, at the time the loans were made, Union had no knowledge of the negotiations between Augie's and Restivo."). In this respect, toward the end of its opinion, the court noted the clear similarity between the case presented in *Augie/Restivo* and the case presented in *Flora Mir*. *See id.* at 520–21.

[126] *See id.* at 519 ("MHTC also operated on the assumption that it was dealing with separate entities. MHTC thus sought and received a guarantee from Augie's of MHTC's loans to Augie/Restivo in 1985, including a subordinated mortgage on Augie's real property.").

[127] *Id.*; *see* Chem. Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966) (holding commingling can justify substantive consolidation only where "the time and expense necessary even to attempt to unscramble them [is] so substantial as to threaten the realization of any net assets for all the creditors . . . ."). *See generally* Gray v. O'Neill Props. Group, L.P. (*In re* Dehon, Inc.), No. 02-41045, 2004 Bankr. LEXIS 1470, at *12 (Bankr. D. Mass. Sept. 24, 2004) (noting substantive consolidation should be done with concern for equitable treatment of all creditors).

clear in *Augie/Restivo* that hopeless entanglement of some records (such as those created after Augie's ceased to operate) does not matter if there are accurate records predating the corporate intermingling and from which separate assets could be identified. While there may be some room for discussion as to whether disentanglement must be literally impossible or practically impossible,[128] mere difficulty in sifting through the finances of the related debtors would not, by itself, justify consolidation.[129] The real issues of interpretation, and the real differences from the *Auto-Train* test, arise in the application of the first prong of the *Augie/Restivo* test.

III. AUTO-TRAIN VERSUS AUGIE/RESTIVO AND ITS PROGENY

The primary distinction between the application of the *Auto-Train* and *Augie/Restivo* tests revolves around which of the interested parties should bear the burden of establishing reliance. Pursuant to *Auto-Train*, once a *prima facie* case is established, an objecting party has the burden of proving its reliance on debtor separateness to defeat a motion for consolidation. *Augie/Restivo*, however, arguably places an initial burden on the proponent of consolidation to prove its reasonable reliance on corporate unity in order to make its *prima facie* case for relief. Although interpreting *Augie/Restivo* to require proponent reliance is

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> To prevail on substantive consolidation, the [proponents] are not required to prove that an allocation of assets and liabilities to the various legal entities cannot be achieved under any circumstances. Rather, it is sufficient to demonstrate that it would be so costly and difficult to untangle the Debtors' financial affairs, such that doing so is a "practical impossibility," making substantive consolidation appropriate.

In re Worldcom, Inc., No. 02-13533, 2003 WL 23861928, at *36 (Bankr. S.D.N.Y. 2003). *See Kheel*, 369 F.2d at 847 (ordering substantive consolidation because of "expense and difficulty amounting to *practical impossibility* of reconstructing the financial records of the debtors to determine intercorporate claims, liabilities and ownership of assets.") (emphasis added); Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 766–67 (9th Cir. 2000) (adopting *Augie/Restivo* test and stating entanglement factor is satisfied if disentangling debtors' affairs would be "needlessly expensive and possibly futile"); *In re* Affiliated Foods, Inc., 249 B.R. 770, 780 (Bankr. W.D. Mo. 2000) (ordering substantive consolidation when separating debtors' accounts "would be 'a real nightmare'" and achieving separate allocation "would probably not be possible"); *Worldcom*, 2003 WL 23861928, at *36 ("Alternatively, the [proponents] must show that it is not possible to create *accurate* financial data for each legal entity." (citing Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 519 (2d Cir. 1988))) (emphasis in original).

[129] That being said, in accordance with *Kheel* (upon which this part of the test is ultimately based), hopeless financial entanglement is necessary to substantive consolidation where there is a creditor that relied on the separate credit of an entity to be consolidated. Hopeless entanglement is not required under all circumstances and extensive, but not hopeless, entanglement remains relevant to the analysis. *See, e.g., In re* Richton Int'l Corp., 12 B.R. 555, 558 (Bankr. S.D.N.Y. 1981) (noting even *Kheel* court considered financial entanglement as only one factor to be considered). *See* Chem. Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966) (utilizing factor of amount of difficulty and expense of "reconstructing the financial records of the debtors to determine intercorporate claims, liabilities and ownership of assets."); *In re* Snider Bros., Inc., 18 B.R. 230, 238 (Bankr. D. Mass. 1982) (naming unity of interest, possible harm or prejudice due to rejection of consolidation, and intermingling of funds as factors of consolidation).

appealing because it is easier in application, it also creates an insurmountable obstacle to obtaining substantive consolidation. As a practical matter, the pre-*Augie/Restivo* approach is superior because its balanced approach at least gives proponents a chance to establish a right to equitable relief, while still protecting those creditors that would be damaged by virtue of their reliance on separateness.

Before turning to a more in depth critique of requiring proponent reliance for consolidation, it is submitted that *Augie/Restivo* can, and should be, interpreted to avoid this requirement. Although rather inarticulately put, the first prong of the test is aimed at determining whether there are creditor reliance issues that would make consolidation of related corporate entities inequitable. A review of the cases upon which the *Augie/Restivo* court was relying makes it clear that the court had two scenarios in mind that would be inappropriate for ordering consolidation.

Most obviously, and consistent with *Kheel* and *Flora Mir*, *Augie/Restivo* again reaffirmed the principle that consolidation of related corporations is inappropriate where it would prejudice a creditor that relied on corporate separateness.[130] The first prong of *Augie/Restivo* also recognizes, however, that consolidation is inappropriate where it would inure to the benefit of a proponent of consolidation that had actually treated the relevant entities separately and relied on separate debtor identities in originally extending credit.[131] Accordingly, consolidation may be appropriate where creditors did not specifically treat related debtors as distinct corporate entities by relying on their individual financial conditions in extending them credit.

To put it mildly, the court in *Augie/Restivo* did more to confuse substantive consolidation analysis than to clarify it when the court tried to summarize almost the entirety of the case law that came before it into one "factor." First, it is not entirely clear why the court did not simply apply its own decisions that are directly on point. Under well-established precedent, particularly *Flora Mir*, the fact of Union's clear reliance on separateness unquestionably entitled it to the protection of

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[130] *See, e.g.*, *Augie/Restivo*, 860 F.2d at 519 (showing Union Bank clearly made its loans to entity proposing consolidation based only on its financial condition and without knowledge of its negotiations with other entity to be consolidated); *see also* Flora Mir Candy Corp. v. R.S. Dickson Co. (*In re* Flora Mir Candy Corp.), 432 F.2d 1060, 1062 (2d Cir. 1970) (reasserting consolidation should be done only sparingly and not as an instrument of "procedural convenience," but rather "a measure vitally affecting substantive rights."); *Kheel,* 369 F.2d at 847 ("The power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others.").

[131] *See, e.g.*, *Augie/Restivo*, 860 F.2d at 519 (noting MHTC Bank obtained separate guarantee and subordinated mortgage from one entity for loans made to related entity, thus relying specifically on separate identity and property of first entity); James Talcott, Inc. v. Wharton (*In re* Cont'l Vending Mach. Corp.), 517 F.2d 997, 999 (2d Cir. 1975) (observing creditor obtained separate and substantively different security agreements from each relevant debtors without cross-collateralization provisions, and would receive under reorganization plan exactly what it had bargained for with each debtor in terms of security); *In re* Cooper, 147 B.R. 678, 682 (Bankr. D. N.J. 1992) (citing *Continental Vending* for "a secured creditor with a consensual lien is only entitled to such collateral as it bargained for.").

its priority to Augie's assets.[132] Similarly, as in *Continential Vending*, the court could have allowed consolidation, but prevented MHTC from obtaining a windfall by not allowing MHTC's administrative claim to extend to Augie's assets. The court could simply have found that substantive consolidation for the benefit of MHTC was not warranted because MHTC did not demonstrate that it was harmed by the lack of corporate formalities between the debtors.[133] Second, the court inexplicably fails even to discuss the requisite interrelationships or unity between the entities to be consolidated, despite the fact that it was purporting to summarize existing precedents.

Thus, the problem with the first prong of the *Augie/Restivo* test is that the court vastly oversimplified the analysis without explaining what it meant when it referred to determining "whether creditors *dealt with* the entities as a single economic unit." Accordingly, it is not entirely clear what showing a proponent must make to satisfy this prong of the test. The court could have meant this factor to subsume the instrumentality analysis and the reliance analyses from, among other cases, *Flora Mir* and *Continental Vending*. But the language used by the *Augie/Restivo* court can also be, and has been, interpreted by some as requiring evidence that the proponents of consolidation, if not that all creditors, "dealt" with the entities to be consolidated as if they were a single economic unit.[134] In other words, *Augie/Restivo* can be construed as requiring proof that creditors expected that all of the assets of the related debtors would be available to repay their debts.

But this interpretation of *Augie/Restivo* has to be incorrect for several reasons. To begin with, the *Augie/Restivo* court explicitly stated that it was distilling the principles in the *Soviero*, *Kheel*, *Flora Mir*, *Continental Vending*, *Donut Queen*, *Richton*, *Food Fair*, *Commercial Envelope*, and *D.H. Overmyer Co.* decisions into what it characterized as two critical factors in substantive consolidation doctrine.[135] None of these cases, including *Augie/Restivo* itself, say that a proponent must show that creditors relied on an expectation that the debtors' assets would be pooled to satisfy their respective debts. In fact, several of these cases state just the opposite.

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[132] *Cf. Augie/Restivo*, 860 F.2d at 520 (noting undesirability of consolidation was as clear as it was in *Flora Mir*).

[133] *See supra* notes 87–88 and accompanying text.

[134] *See, e.g., In re* 599 Consumer Elecs., Inc., 195 B.R. 244, 249 (S.D.N.Y. 1996) (interpreting *Augie/Restivo* test as requiring creditors to have "treated the debtors as a single entity"); *In re* Huntco Inc., 302 B.R. 35, 39 (Bankr. E.D. Mo. 2003) (explaining determination of whether consolidation is necessary should focus on interrelationship among debtors, whether their creditors relied on that interrelationship, and whether they treated debtors as single entity); R^2 Invs., LDC v. WA Telcom Prods. Co., (*In re* World Access, Inc.), 301 B.R. 217, 286–87 (Bankr. N.D. Ill. 2003) (finding debtors failed to establish creditors dealt with them as a single economic unit under *Augie/Restivo*); *see also In re* Owens Corning, 419 F.3d 195, 207–08 (3d Cir. 2005) (discussing *Augie/Restivo* test and substantive consolidation as equitable remedy); *infra* notes 146–151 and accompanying text.

[135] Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988).

As noted above, the *Kheel* court specifically rejected the argument that a prerequisite for consolidation was a showing that the objecting party dealt with the related entities as a unit.[136] In *Continental Vending*, the Second Circuit Court of Appeals reaffirmed this aspect of *Kheel*, stating that consolidation "does not require that the creditors knowingly deal with the corporations as a unit . . . ."[137] In *In re D.H. Overmyer Co., Inc.*, the court reiterated this observation from *Continental Vending* and focused on the objecting creditors' failure to demonstrate reliance on separateness.[138] Finally, the court in *Commercial Envelope* noted the *Kheel* court's apparent reluctance to place the burden on the moving party of demonstrating that the entities to be consolidated were dealt with as one, "preferring that the objecting creditor establish that it relied on [a] particular separate entity."[139] Considering that the *Augie/Restivo* court was synthesizing these cases rather than overruling them, a burden on the proponent of consolidation to establish reliance on unity could not have been what the *Augie/Restivo* court was attempting to establish.[140]

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[136] *See* Chem. Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966) (finding appellant's argument that court must find creditors knowingly dealt with debtors as a unit was flawed because this knowledge is not a requirement for consolidation); Reider v. FDIC (*In re* Reider), 31 F.3d 1102, 1106 (11th Cir. 1994) (noting *Kheel* court "rejected the argument that *Soviero*'s holding required a showing in every case that a creditor knowingly dealt with the debtors as a unit and relied on the collective assets for payment."); *In re* Snider Bros., Inc., 18 B.R. 230, 235 (Bankr. D. Mass. 1982) (stating *Kheel* court noted *Soviero* does not require proponent of consolidation to prove objector dealt with debtors as one).

[137] James Talcott, Inc. v. Wharton (*In re* Cont'l Vending Mach. Corp.), 517 F.2d 997, 1001 (2d Cir. 1975) (citing Chem. Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966)) (discussing power to consolidate); *see In re* Gainesville P-H Props., Inc., 106 B.R. 304, 305 (Bankr. M.D. Fla. 1989) ("The exercise of [substantive consolidation] power does not require as a precondition that creditors knowingly deal with corporations as a unit." (citing *Continental Vending*, 517 F.2d at 1001)).

[138] *See In re* D.H. Overmyer Co., Nos. 73-B-1126, 73-B-1162, 73-B-1189, 73-B-1175, 1976 WL 168421, at *9 (S.D.N.Y. Mar. 26, 1976) (analyzing rules from *Continental Vending* and finding creditors made no showing they dealt solely with corporation at issue); *In re* Drexel Burnham Lambert Group Inc., 138 B.R. 723, 763–64, 764 n.8 (Bankr. S.D.N.Y. 1992) (discussing factors considered by courts in determining whether to approve substantive consolidation and citing *Kheel*, *Soviero*, *Overmyer*, and *Commercial Envelope* cases).

[139] *In re* Commercial Envelope Mfg. Co., Nos. 76-B-2354, 76-B-2355, 76-B-2356, 76-B-2357, 1977 WL 182366 , at *5–6 (Bankr. S.D.N.Y. Aug. 22, 1977) (discussing *Kheel* and *Continental Vending* for proposition that consolidation does not require creditors knowingly dealt with the debtors as a unit). Notably, the *Commercial Envelope* court specifically found that the objecting creditor failed to show that it dealt solely with one of the debtors to be consolidated. *See id.*

[140] *Donut Queen* was the only case cited by *Augie/Restivo* that even approaches support for such an interpretation. The *Donut Queen* court found that the proponent of consolidation failed to demonstrate the existence of any of the *Vecco* factors, except for unity of ownership and interest. *See In re* Donut Queen, Ltd., 41 B.R. 706, 710 (Bankr. E.D.N.Y. 1984). The court then found that the proponent also failed to establish it was aware of any interrelatedness between the debtors and that it treated the debtors as a unified entity. *See id.* The denial of substantive consolidation in the *Donut Queen* case appears to be primarily based upon the failure of the proponent to prove any significant interrelationship between the debtors. *See id.* at 711. To the extent, however, that *Donut Queen* can be read as requiring that creditors relied on the debtors as a unified entity, it should be noted that *Augie/Restivo* did not cite *Donut Queen* for this proposition and the Bankruptcy Court for the Eastern District of New York could not have overruled the above-cited decisions from the Second Circuit Court of Appeals and the Southern District of New York.

Interestingly, in *Alexander v. Compton (In re Bonham)*,[141] the Ninth Circuit Court of Appeals declared that it was adopting *Augie/Restivo*[142] and yet it placed the burden on the objecting creditors to "overcome the presumption that they did not rely on the separate credit" of the entities to be consolidated.[143]

This notwithstanding, the Court of Appeals for the Third Circuit recently addressed the propriety of substantive consolidation and placed the burden of establishing reliance on unity squarely on the proponents of consolidation. The Court of Appeals began its analysis in *In re Owens Corning* by expressing its clear preference for the *Augie/Restivo* test over what it considered to be the insufficiently stringent test from *Auto-Train*.[144] The court opined that the *Auto-Train* test fails to capture the few circumstances in which consolidation may be considered and "allows a threshold not sufficiently egregious and too imprecise for easy measure."[145] It also criticized the use of factor approaches to the issue of consolidation because, in its opinion, they often result in rote tallying of factors without sufficient regard for the principles that give the rationale for substantive consolidation.[146] The court expressed these principles to be:

> (1) The general expectation of state law, bankruptcy law and commercial markets is that courts will respect entity separateness absent compelling circumstances calling equity, and then possibly substantive consolidation, into play.
> (2) Substantive consolidation addresses harms caused by debtors, while the harms caused by creditors are typically remedied by other provisions of the Bankruptcy Code.
> (3) Mere benefit to the administration of the bankruptcy case is not a harm justifying substantive consolidation.
> (4) Substantive consolidation is extreme and should be considered as a last resort, after other remedies have been considered and rejected.

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[141] 229 F.3d 750 (9th Cir. 2000).
[142] *See id.* at 766 (quoting *Augie/Restivo*).
[143] *Id.* at 767 (citing *Auto-Train*).
[144] *See In re* Owens Corning, 419 F.3d 195, 210 (3d Cir. 2005) (rejecting *Auto-Train* test).
[145] *Id.* This objection is unfounded. *Auto-Train* would approve consolidation in every case in which *Owens* would permit it. It would also preclude consolidation in most, if not all, cases where a creditor is prejudiced. The main difference between *Auto-Train* and *Owens*, as we shall see, is that *Owens* precludes consolidation in cases where it is beneficial, but where an objecting creditor cannot sustain the burden of proving reliance on separateness.
[146] *See id.* ("This often results in rote following of a form containing factors where courts tally up and spit out a score without an eye on the principles that give the rationale for substantive consolidation (and why, as a result, it should so seldom be in play).").

> (5) Substantive consolidation may be used defensively to remedy identifiable harms, but may not be used offensively as a tactic to disadvantage other creditors.[147]

Against the backdrop of these supposed principles,[148] the *Owens* court articulated its test for consolidation:

> In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) pre-petition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) post-petition their assets and liabilities are

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[147] *Id.* at 211.

[148] Some observations concerning these "principles" are warranted. Unless Owens was also abolishing veil-piercing, alter-ego liability and, perhaps, recharacterization of debt as equity, its zeal to enforce "market expectations" in the context of substantive consolidation appears aberrational. Secondly, given the very long history of alter-ego/instrumentality analysis, substantive consolidation and corporate veil-piercing, there is hardly any basis for suggesting that the markets can reasonably expect separateness to be respected in virtually every case, regardless of the debtors' failure to respect it in the operation of their unified business. Nor is any demonstration provided that the "certainty" of respecting separateness in an inappropriate situation is economically or socially preferable to disregarding it, so long as the reasonable reliance on separateness of innocent creditors is protected. It is generally argued that what "markets" favor is not respect for a particular outcome, such as enforcing separateness in all cases, but certainty and predictability of result. *See* Kors, *supra* note 49, at 411. This counsels for clearer rules to identify "instrumentality" not rejection of the remedy of consolidation based on instrumentality. Kors recognizes that it is appropriate to override the state law rules if an administrative benefit will result. *See id.* at 412.

The second principle is implicitly contemptuous of the idea that "innocent" creditors should have their distributions reduced because of harms caused by the debtors' disregard of entity separateness. Accordingly, the court points out that provisions in the Bankruptcy Code were created for those harms actually caused by creditors. This Article rejects the notion, presupposed by this second principle, that innocent creditors are punished by consolidation, without regard for whether these innocent creditors can demonstrate any reliance on entity separateness. *See infra* notes 152–60 and accompanying text. Moreover, there is no reason why substantive consolidation cannot be used in conjunction with these other provisions in the Code to remedy harms caused by creditor misconduct in connection with an alter-ego situation.

The third and fourth principles are contrary to prior case law and misstate a major purpose of consolidation, which is to avoid the expense, delay and difficulty of resorting to fraudulent transfer or similar litigation. "When [courts order consolidation], it is typically to avoid the expense or difficulty of sorting out the debtor's records to determine the separate assets and liabilities of each affiliated entity." Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987) (citing Chem. Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966)). "The legal existence of the affiliated corporation does not per se give it standing to insist on a plenary suit." Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 218 (1941). Consolidation to make administration easier and cheaper is clearly warranted. *See* Kors, *supra* note 49, at 385, 411–12. What courts should not do is disregard the rights of a creditor that innocently relied on entity separateness simply because it would make administration easier. *See* Flora Mir Candy Corp. v. R.S. Dickson & Co., 432 F.2d 1060, 1063 (2d Cir. 1970) (finding benefit of quicker administration does not warrant unfair treatment to creditor). There is no reason why administrative benefit cannot be factored into the decision to consolidate, so long as there is no creditor that relied on separateness or such a creditor is adequately protected.

> so scrambled that separating them is prohibitive and hurts all creditors.[149]

Although it felt the second prong required no further explanation, the court clarified that a *prima facie* case under the first prong typically exists when, "based on the parties' pre-petition dealings, a proponent proves corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity."[150] In addition, creditor proponents must demonstrate that they actually relied on the debtors' supposed unity and that their reliance was reasonable. Assuming a *prima facie* case could be made, opponents could still defeat a motion for consolidation under the first rationale by showing that they would be adversely affected and that they actually relied on debtor separateness.[151] While it is not entirely clear whether the *Owens* court was trying to clarify *Augie/Restivo* or establish its own test, it clearly came down on the side of placing the burden of establishing reliance on unity on the proponents of consolidation.

Whether pursuant to the test as stated in *Augie/Restivo* or *Owens*, it simply makes no sense to require a proponent of consolidation to prove creditor reliance on the unity of the entities to be consolidated. According to *Owens*, proponents must have reasonably relied on the debtors' disregard of the corporate form such that it created contractual expectations that they were dealing with the debtors as one entity.[152] Although substantive consolidation is an extreme remedy that should only rarely be granted, it is not immediately apparent how this test can ever be satisfied.

Initially, a proponent must establish that it was aware of the debtors' disregard of corporate formalities. A creditor that was unaware of the economic unity of, and abuse of the corporate form by, a group of debtors could not establish that it "dealt with" or "treated" these debtors as a single economic unit. On the other hand, a creditor that was aware of the interrelationships between the debtors but dealt with only one, without making contractual arrangements with the rest, would be held to its bargain and estopped from arguing that it should be allowed to look to the assets of any company other than its own debtor. Such a creditor would never be able to establish that it reasonably relied on its ability to obtain payment from one corporate entity on a contract that it knowingly made with another legally distinct entity. In other words, if a creditor was unaware of the alter-ego relationship of the

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[149] *In re* Owens Corning, 419 F.3d 195, 211 (3rd Cir. 2005) (footnotes omitted).

[150] *Id.* at 212 (footnotes omitted).

[151] *See id.* (stating *prima facie* case as proof of corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one entity).

[152] Neither *Augie/Restivo* nor *Owens* actually makes clear whether a proponent must demonstrate only its own reliance or reliance by creditors generally. This article focuses on the former because it is practically impossible for a proponent to satisfy the test with respect to its own reliance. It is even more unlikely that a creditor would be able to prove as a matter of fact that every creditor of every debtor actually and reasonably relied on entity unity in deciding to extend credit to its debtor.

debtors, it could not have relied on them as a single entity and, if it was aware of that relationship but did nothing to protect itself, then it did not act reasonably.

This leaves only the creditor that was aware of the debtors' unity and obtained agreements from all of the related debtors to make payment on the debt. Assuming it would even want consolidation for some reason, this creditor would not be able to establish that consolidation would remedy an identifiable harm caused to it by debtor entanglement because it would have a direct claim against each of the related debtors without substantive consolidation. *Owens* never actually explains how a proponent can successfully make a case for substantive consolidation without ignoring the first prong of the test entirely and proving hopeless financial entanglement of the debtors.

Moreover, placing such a high burden on a proponent just to make a *prima facie* case enables any creditor to defeat consolidation in virtually any case, whether or not that creditor itself reasonably relied on separateness and regardless of the benefits consolidation may provide. If consensual consolidation is permitted (as it is by *Owens*), no purpose is served by effectively giving every single creditor a veto over consolidation without having to prove that it is being unjustly injured. Such a veto is inconsistent with the notion of bankruptcy as a collective remedy that deprives each individual creditor of the right to veto debtor action unless its demands are met and, instead, permits a debtor to act to maximize aggregate value so long as the economic value of individual rights is protected.

Leaving such practical matters aside momentarily, placing the burden of proof of reliance on unity on the proponents of substantive consolidation also completely ignores the historical background of this doctrine. Inexplicably, while *Sampsell* is repeatedly cited as the cornerstone of consolidation jurisprudence, it is treated as the Supreme Court's inchoate and contentless approval of consolidation in general, rather than as an unanimous Supreme Court decision with particular holdings and implications that bind the lower courts. In *Owens*, the Third Circuit relied heavily on the authority of *Sampsell* in support of its conclusion that substantive consolidation continues to exist as an available remedy, despite the Supreme Court's decision in *Grupo Mexicano*,[153] and yet it felt free to completely disregard the actual analysis of *Sampsell*. In particular, the Third Circuit explicitly rejected a "factors" approach and thereby, implicitly, rejected the alter-ego/instrumentality rationale for consolidation that *Sampsell* had approved. Instead, *Owens* replaced that analysis with a requirement of proof of either creditor "reliance on unity" of the corporations or hopeless entanglement of their corporate affairs. The *Owens* court also refused to separate the question of consolidation from the question of an objecting creditor's priority of claim. Both of these findings are contrary to the

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[153] *See In re* Owens Corning, 419 F.3d 195, 209 n.14 (3d Cir. 2005) ("What the Court has given as an equitable remedy remains until it alone removes it or Congress declares it removed as an option."); *see also infra* notes 177–84 and accompanying text (stating authority of bankruptcy courts to preside under general equity powers).

Sampsell decision. It is at least arguable that the *Owens* court committed reversible error by utterly ignoring the Supreme Court's rationale in the *Sampsell* decision.

Substantive consolidation was developed to remedy harm caused by abuses of the corporate form, which results not from creditor reliance on unity but from the deception of creditors by an apparent debtor separateness that is arbitrary and unreal. The relevant "factors" from the early cases all dealt with the actual interrelatedness of the entities to be consolidated, not creditor reliance. Creditors can be injured by their debtor's abuse of the corporate form, without being aware of it until after the fact. Requiring knowledge of, and reliance on, such abuse as a condition to obtaining relief from it would be like requiring a creditor to prove knowledge of, and reliance on, the voidability of a fraudulent transfer as a condition to avoiding it.

It would eviscerate the whole point of the doctrine to limit the availability of consolidation to those creditors that were aware of the loose and interdependent manner in which debtors had conducted business, but had protected themselves such that they "reasonably relied" on the debtors' joint credit. This nonsensical interpretation of the law would leave completely unprotected innocent creditors that dealt with one part of a unified enterprise, without any reason to suspect the harm being caused to them from the debtors' disregard of the corporate form in the debtors' own internal dealings. Significantly, there have been numerous cases where substantive consolidation was granted without any particular finding of creditor reliance on the economic unity of the entities to be consolidated.[154]

Nevertheless, the position accepted by the Third Circuit and, most likely, the Second Circuit, remains that substantive consolidation is only appropriate where debtor finances are hopelessly entangled or when there is creditor reliance on the economic unity of the debtors. In an article extensively cited with approval in the *Owens* decision, Professor Kors rejects the notion that consolidation is justified by the fact that entities are alter egos of each other, unless creditors also reasonably

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[154] *See, e.g.*, Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 767 (9th Cir. 2000) (affirming substantive consolidation where non-debtor estates were but instrumentalities of debtor with no separate existence of their own); First Nat'l Bank of Barnesville v. Rafoth (*In re* Baker & Getty Fin. Servs., Inc.), 974 F.2d 712, 720 (6th Cir. 1992) (affirming district court's finding that objecting bank did not meet its burden of proving the debtors were not treated as one); First Nat'l Bank of El Dorado v. Giller, (*In re* Giller), 962 F.2d 796, 798–99 (8th Cir. 1992) (focusing on abuses of corporate form); *In re* Affiliated Foods, Inc., 249 B.R. 770, 784 (Bankr. W.D. Mo. 2000) (finding entities so intertwined as to be practically inseparable and indistinguishable); Bracaglia v. Manzo (*In re* United Stairs, Corp.), 176 B.R. 359, 369 (Bankr. D. N.J. 1995) (weighing economic prejudice of continued debtor separateness against economic prejudice of substantive consolidation); *In re* Gucci, 174 B.R. 401, 413–14 (Bankr. S.D.N.Y. 1994) (noting failure of objecting parties to demonstrate reliance on separateness, without any mention of creditor reliance on pooling of assets); *In re* Standard Brands Paint Co., 154 B.R. 563, 572 (Bankr. C.D. Cal. 1993) (finding first prong of *Augie/Restivo* was satisfied because no creditor could have relied on the separate identity of the subsidiaries or parent due to the entities' consolidated financial reporting and fact that they held themselves out as a consolidated unit); *In re* Orfa Corp. of Philadelphia, 129 B.R. 404, 415 (Bankr. E.D. Pa. 1991) (noting inter-company guarantees negated claim of separate reliance by objecting creditor, without discussion of other creditor reliance on unity of the entities to be consolidated).

relied on the entities' collective credit as a result.[155] She repeatedly poses the question in her article why the fact that two entities are alter egos of one another justifies disregard of the corporate entity. The clear implication from both Professor Kors's article and the *Owens* opinion is that creditors of the poorer debtors are not legally harmed by debtor abuse of the corporate form, unless such creditors can demonstrate reliance.[156] On the other hand, consolidation supposedly punishes creditors of the wealthier debtors unfairly[157] by violating their contractual expectations concerning the particular entity with which they contracted.[158]

It is respectfully submitted that the answer to why consolidation may be justified where entities are alter-egos is fairly straightforward. It is inherently unfair to stand on corporate formality, where the debtors failed to do so themselves, when to do so would deny some creditors claims to greater funds and give other creditors a windfall simply as a result of happenstance concerning which entity was holding which assets at the time of the bankruptcy filing. Consolidation is appropriate where an individual or corporation completely dominates a group of affiliated entities, ignores corporate formalities and shuffles money between them as if the entities are mere departments of a larger operation or little more than "corporate pockets." In such circumstances, the separate books and records of the various entities (assuming they even exist) would be arbitrary and unreliable, and, thus, not a reasonable basis for determining creditor recoveries without first being corrected

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[155] *See generally* Kors, *supra* note 49, at 385 (positing protection of creditor is fair when a creditor has actually and reasonably relied on collective credit of related legal entities); *see also In re* Owens Corning, 419 F.3d 195, 211 n.9 (3rd Cir. 2005) (providing usual scenario, where creditors are misled by debtors' actions and incorrectly perceive multiple entities as one); *In re* 599 Consumer Elecs. Inc., 195 B.R. 244, 250 (Bankr. S.D.N.Y. 1996) (holding bankruptcy court failed to detail factual findings regarding hopeless entanglement of appellees' affairs and other debtors, which might have justified consolidation).

[156] *See Owens*, 419 F.3d at 211 n.19 ("This rationale is meant to protect in bankruptcy the pre-petition expectations of those creditors."); Kors, *supra* note 49, at 419 ("Creditors' actual and reasonable reliance on the legal unity among legally distinct entities in extending credit may justify substantive consolidation."); *In re* Donut Queen, Ltd., 41 B.R. 706, 711 (Bankr. E.D.N.Y. 1984) (denying motion for consolidation because creditor "took no steps to ascertain the financial creditworthiness of [debtor] and did not in its course of dealing treat [both debtors] as one entity.").

[157] *See, e.g.*, *Owens*, 419 F.3d at 206 ("The bad news for certain creditors is that, instead of looking to assets of the subsidiary with whom they dealt, they now must share those assets with all creditors of all consolidated entities, raising the specter for some of a significant distribution diminution."); Kors, *supra* note 49, at 433 ("[A]buse by shareholders or other affiliates does not justify punishing unaffiliated creditors who were not responsible for the lack of formalities and who will now suffer in consolidation, especially in light of the lack of injury to others."); *see also In re* Genesis Health Ventures, Inc., 403 F.3d 416, 423 (3d Cir. 2005) (indicating effect of substantive consolidation is scrambling of debtors' assets, which results in claim of creditors against consolidated survivor.)

[158] *See* Kors, *supra* note 49, at 410 ("Amorphous exceptions, like substantive consolidation, detract from the certainty of limited liability and may have a profound impact on the rights of creditors, denying them the benefit of their bargain and substantially reducing their recoveries."); *Id.* at 438 (rejecting enterprise liability theory as support for consolidation, arguing that "[c]reditors extending credit would not be able to determine with any precision the liabilities for which their debtor will be responsible and the assets that will be available to satisfy their claims."); *see also* Reider v. FDIC (*In re* Reider), 31 F.3d 1102, 1106 (11th Cir. 1994) (observing careful consideration of creditors' rights must be taken into account before ordering consolidation).

through expensive fraudulent transfer proceedings. Moreover, creditors have a right to rely on an expectation that the assets of their debtors will not be siphoned off by, or even simply shared with, other corporate entities just because these entities are related to their debtors. Accordingly, creditors of poorer debtors are actually damaged when entities abuse the corporate form to these ends.

By comparison, the "justified expectations" of the creditors of wealthier debtors are not at issue unless these creditors can demonstrate that they justifiably relied on the separate assets of a particular debtor. There is no harm in treating interrelated debtors as a single economic unit where objecting creditors did not expect otherwise or treated the debtors that way themselves. For example, while consolidation may well reduce the recovery of a particular creditor, that creditor is not "harmed" by consolidation if it did not actually rely on the particular assets and liabilities of a particular debtor in extending credit. The harm comes from treating a creditor that did rely on the financial health of a particular debtor as if that creditor had assumed the risk of doing business with related entities in much poorer financial health. Courts in the Second Circuit clearly recognized this, at least prior to *Augie/Restivo*, and, thus, an objecting creditor could defeat an otherwise meritorious motion for consolidation by proving reliance on separateness.

Despite its critics, the *Auto-Train* test remains true to the underlying substantive consolidation precedents on which it is based and provides creditors with an avenue to seek equitable relief for the harm caused by abuse of the corporate form. It also recognizes the potential harm that can be done by consolidation and protects the expectations of creditors that relied on the corporate separateness of the entities involved. *Auto-Train* is only defective if it is interpreted to allow the injured innocent creditor's rights to be sacrificed to the majority of creditors without compensation or protection. But since the *Auto-Train* test was itself just a summary of prior case law, not an attempt to supplant it, resort to that prior law would reveal that the Bankruptcy Court has the power to order consolidation so long as it adequately protects the economic value of the rights of a creditor who relied on separateness.[159] On the other hand, whether through application of *Augie/Restivo* or *Owens*, requiring proof of reasonable reliance on corporate unity to establish a *prima facie* case for relief is a significant departure from the precedents predating *Augie/Restivo*. Whereas the hopeless entanglement of *Kheel* had once provided an

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[159] The analogy to adequate protection of security interests under 11 U.S.C. sections 361 and 362(d)(1) is obvious. The collective remedy of bankruptcy requires that the property rights of a secured creditor be respected by providing that creditor with adequate protection of the value of its lien, while taking away its veto over the debtor's use of its collateral. It is ironic, and irrational, to give the contractual expectations of a creditor greater rights to defeat consolidation than a secured creditor has to protect its property rights. Preserving the economic value of the reliance interest of a creditor who relied on separateness adequately protects that economic interest while preserving the benefit for the estate generally of consolidation. *See* Kors, *supra* note 49, at 450 ("In many cases, courts may be able to obtain the practical benefits of consolidation, while simultaneously protecting creditors' actual and reasonable reliance on the separate status of one debtor entity, through partial consolidation.").

additional ground for granting consolidation,[160] *Augie/Restivo* and *Owens* have effectively made it the only ground. Moreover, essentially giving each creditor a veto over consolidation simply by objecting, thereby triggering a requirement of proof that all creditors reasonably relied on corporate unity, vastly departs from all prior precedent and has nothing to recommend it.

IV. CONCLUSION

Professor Kors suggests that, "[w]hile economic efficiency may not be the only relevant value, efficiency enhancing rules are preferable," and that "the value of legal rules may not be their 'rightness' but their certainty."[161] Be that as it may, "[e]quity is 'the correction of the law wherein it is defective by reason of its universality.' . . . . Because '[e]very system of laws must necessarily be defective[,] cases must occur to which the antecedent rules cannot be applied without injustice, or to which they cannot be applied at all.'"[162]

No one disputes that respect for corporate boundaries and limited liability should be the rule in the vast majority of cases. Multi-tiered corporate structures and structured financing have become prevalent in today's business environment. Thus, it is necessary to our economy that the law protects the limited liability essential to this structuring. But it is also necessary that the law protects creditors from the harm caused when those corporate structures are abused. Perhaps more now than at its inception, courts sitting in bankruptcy need a principled approach to substantive consolidation in order to balance these competing interests.

While it may not always be easy for judges to determine whether there is sufficient corporate interrelatedness and harm to justify consolidation, *Auto-Train* clearly articulated a test that remains true to the fundamentals upon which it is based and strikes the requisite balance. *Owens* and *Augie/Restivo* drastically reduce judges' discretion in connection with substantive consolidation and effectively sacrifice equity for the sake of certainty.

V. AFTERWORD: THE COURT'S POWER TO GRANT SUBSTANTIVE CONSOLIDATION

While the focus of this article has been on fundamental substantive consolidation principles and their proper application to an appropriate case, an issue remains as to the propriety of substantive consolidation as a remedy at all. Parties opposing substantive consolidation frequently argue that the court simply does not have the authority to grant consolidation in the first place. Substantive

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[160] *See* Chem. Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966) (considering additional factor when ordering consolidation); *In re* Richton Int'l Corp., 12 B.R. 555, 558 (Bankr. S.D.N.Y. 1981) (noting *Kheel* court considered financial entanglement as additional factor).

[161] Kors, *supra* note 49, at 410–11.

[162] FDIC v. Colonial Realty Co., 966 F.2d 57, 60 (2d Cir. 1992).

consolidation developed as a common law doctrine and the Bankruptcy Code (and the Bankruptcy Act before it) does not specifically provide for substantive consolidation as an available remedy.[163] Thus, the current basis for the court's power to grant consolidation is not entirely clear.

Creative litigants have argued that fairly recent Supreme Court precedents foreclosed the availability of consolidation under modern bankruptcy jurisprudence. More specifically, it has been argued that consolidation contravenes the dictates of *Grupo Mexicano de Desarollo, S.A. v. Alliance Bond Fund, Inc.*[164] in that it is a judicially-created equitable remedy that did not exist in 1789, the year Congress enacted the First Judiciary Act. Separately, it has also been argued that finding authority for consolidation pursuant to section 105 of the Code conflicts with several Supreme Court and appellate decisions to the effect that section 105 cannot be used to create substantive rights otherwise unavailable under the Code.[165] These arguments all seem to ignore the fact that no federal court has found that courts lack the power to grant consolidation and that a court sitting in bankruptcy not only has the authority, but has the obligation to determine the entities that properly constitute the debtors before it and the assets that should properly be considered as belonging to those debtors.

A. Grupo Mexicano Decision

The *Grupo Mexicano* decision essentially held that federal courts do not have the power to grant a preliminary injunction that freezes the assets of a debtor in order to preserve a fund to satisfy a judgment in a pending lawsuit by a creditor seeking money damages.[166] The Court reasoned that such preliminary injunctions were improper because they did not exist at the time of the enactment of the Judiciary Act of 1789 and that the Act did not confer the power to create remedies previously unknown to equity jurisprudence.[167] Although *Grupo* did not discuss or have anything to do with substantive consolidation, some have argued that its reasoning directly applies to the courts' power to grant such relief. Since multi-tiered corporations did not exist in England in 1789, the argument goes, an

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[163] *See* Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 765 (9th Cir. 2000) (noting substantive consolidation survived enactment of Bankruptcy Code, despite fact it was not codified); Reider v. FDIC, 31 F.3d 1102, 1105 (11th Cir. 1994) (explaining Bankruptcy Act had no express statutory authorization for consolidation); *cf.* Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988) ("Substantive consolidation has no express statutory basis but is a product of judicial gloss.").

[164] U.S. 308 (1999).

[165] *See, e.g., In re* Permian Producers Drilling, Inc., 263 B.R. 510, 516 (Bankr. W.D. Tex. 2000).

[166] *See Grupo Mexicano*, 527 U.S. at 333. Under current English practice, such injunctions are authorized by statute and are referred to as *Mareva* injunctions. *Grupo*, 527 U.S. at 327-28.

[167] *See Grupo Mexicano*, 527 U.S. at 332 (resolving preliminary injunctions "in this forum is incompatible with the democratic and self-deprecating judgment" in equity jurisprudence).

equitable remedy disregarding the formalities rendering related companies technically distinct would exceed the authority of federal courts.[168]

Initially, it must be noted that the only cases to directly address the issue have found that substantive consolidation survived the *Grupo* decision.[169] In *In re Stone & Webster, Inc.*,[170] the court observed that the *Grupo* holding had nothing to do with substantive consolidation or the bankruptcy court's power to grant it and found it "highly doubtful" that *Grupo* controls the issue of the court's power to grant such relief.[171] The court emphasized that the Supreme Court itself appeared to except bankruptcy law from the purview of its *Grupo* decision[172] and that the Court had focused on the fact that the type of relief sought in the *Grupo* case had been specifically disclaimed by longstanding precedent.[173] By comparison, substantive consolidation was recognized by the Supreme Court as early as 1941 and has roots extending back to the Bankruptcy Act of 1898.[174] The court further noted that the Advisory Committee for the Bankruptcy Rules apparently believed consolidation to be available under the Bankruptcy Code and that the power to consolidate is, arguably, derived from Code section 105.[175] Ultimately, however, the *Stone &*

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[168] *See* J. Maxwell Tucker, Grupo Mexicano *and the Death of Substantive Consolidation*, 8 AM. BANKR. INST. L. REV. 427, 444 (2000) ("Until the practice of multi-tiered corporate enterprises became commonplace, there was little need for a doctrine of substantive consolidation.").

[169] *See In re* Owens Corning, 419 F.3d 195, 208–09 n.14 (3d Cir. 2005) (finding *Grupo Mexicano* did not affect power of bankruptcy court to grant consolidation); *In re* Am. Homepatient, Inc., 298 B.R. 152, 165 (Bankr. M.D. Tenn. 2003) (arguing nothing in *Grupo Mexicano* bars court "from authorizing substantive consolidation where appropriate."); *In re* Stone & Webster, Inc., 286 B.R. 532, 540 (Bankr. D. Del. 2002) (reporting no published opinions interpret *Grupo Mexicano* to hold substantive consolidation is no longer available remedy in bankruptcy cases); Official Comm. of Asbestos Claimants v. G-I Holdings, Inc. (*In re* G-I Holdings, Inc.), Nos. 01-30135, 01-3065, 2001 WL 1598178, at *7 (Bankr. D. N.J. Apr. 6, 2001) (recognizing Committee's standing to move for substantive consolidation and authority of bankruptcy court to order it, notwithstanding *Grupo Mexicano*).

[170] *In re Stone & Webster, Inc.,* 286 B.R. 532 (Bankr. D. Del. 2002).

[171] *Id.* at 537–38.

[172] *See id.* at 538 ("[In] *Grupo Mexicano*, the majority opinion strongly suggests that bankruptcy law provides a court with authority to grant remedies not administered by courts of equity at the time of the enactment of the Judiciary Act."); Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Incl, 527 U.S. 308, 322 (1999) (rejecting Justice Ginsburg's dissenting argument that equity must be able to keep pace with increasing complexities of modern business relations, noting there is nothing new about debtors' trying to avoid their debts and stressing that "[t]he *law of fraudulent conveyances and bankruptcy was developed to prevent such conduct*; an equitable power to restrict a debtor's use of his unencumbered property before judgment was not.") (emphasis added).

[173] *See Stone & Webster*, 286 B.R. at 538 (quoting language from *Grupo Mexicano*).

[174] *See id*. (tracing judicial recognition of substantive consolidation). *See generally* Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941) (upholding consolidation while noting "power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete."); Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 765 (9th Cir. 2000) ("[E]ven though substantive consolidation was not codified in the statutory overhaul of bankruptcy law in 1978, the equitable power undoubtedly survived enactment of the Bankruptcy Code. No case has held to the contrary.").

[175] *See* 11 U.S.C. § 105(a) (2006) (allowing court to issue any order, process, or judgment necessary or appropriate to carry out provisions of Bankruptcy Code); *Stone & Webster*, 286 B.R. at 539 ("[T]he power to substantively consolidate is arguably derived from the bankruptcy court's general equitable powers as

Webster court determined that Code section 1123 controlled the case before it and stated that it did not have to determine whether *Grupo* was applicable.[176]

Recently, in *In re Owens Corning*,[177] the Third Circuit Court of Appeals more definitively rejected the argument that the *Grupo* decision precludes any further use of substantive consolidation as an equitable remedy.[178] To start, the court found that consolidation is attributable to the Supreme Court's decision in *Sampsell v. Imperial Paper & Color Corp*.[179] The *Owens* court made clear that "[w]hat the Court has given as an equitable remedy remains until it alone removes it or Congress declares it removed as an option."[180] Additionally, the court observed that *Grupo* was not a bankruptcy case and that the core issue in *Grupo* was the extent of the federal courts' general, unarticulated equity authority, which could only be justified by reference to the equity authority that existed in 1789.[181] The *Owens* court found that "[t]he extensive history of bankruptcy law and judicial precedent renders the issue of equity authority in the bankruptcy context different to such a degree as to make it different in kind."[182] Like *Stone & Webster*, the *Owens* court also pointed out that, in *Grupo*, the Supreme Court had used the existence of authority in the bankruptcy context in support of its argument against finding such authority under the courts' generalized, equity powers pursuant to the Judiciary Act of 1789. Thus, the *Grupo* decision distinguished between equitable authority in bankruptcy and the general equitable authority of federal courts.[183] Again like *Stone*

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provided in Bankruptcy Code section 105(a)."); *see also Bonham,* 229 F.3d at 764–65 (tracing historical development of substantive consolidation and reaffirming its validity subsequent to enactment of current Bankruptcy Code).

[176] *Stone & Webster*, 286 B.R. at 540 ("In reaching my conclusion today I do not have to determine whether *Grupo Mexicano's* limitation on the equitable remedies administered by district courts has application here . . . ."); *see* John B. Berringer & Dennis J. Artese, *The ABCs of Substantive Consolidation*, 121 BANKING L.J. 640, 642 (2004) [hereinafter Berringer & Artese] ("[T]he [*Stone & Webster*] court . . . reject[ed] the Grupo Mexicano argument . . . [and] concluded that a bankruptcy court's power to issue orders of substantive consolidation is derived from Bankruptcy Code Section 1123(a)(5)(c) . . . ."); Willett, *supra* note 69, at 99 ("Judge Walsh, in the *Stone & Webster* decision, found *Grupo Mexicano* inapplicable . . . ."). Be that as it may, at least one bankruptcy court adopted the *Stone & Webster* rationale and found that "[n]othing about *Grupo Mexicano* bars this court from authorizing substantive consolidation where appropriate." *In re* Am. Homepatient, Inc., 298 B.R. 152, 165 (Bankr. M.D. Tenn. 2003).

[177] *In re* Owens Corning, 419 F.3d 195 (3d Cir. 2005).

[178] *See id*. at 208–09 n.14.

[179] Sampsell v. Imperial Paper & Color Corp, 313 U.S. 215 (1941); *see id.* at 219 (revealing Court's discussion of consolidating estates); *Owens*, 419 F.3d at 208–09 n.14 ("Consolidating estates (indeed, consolidating debtor and non-debtor entities) traces to the Supreme Court's *Sampsell* decision in 1941.").

[180] *Owens*, 419 F.3d at 208–09 n.14.

[181] *See id.* ("[A]t the core of *Grupo Mexicano* was the extent of general, unarticulated equity authority in the federal courts (which, the Court held, can only be justified by reference to 1789 equity authority)."); *see also* Baird, *supra* note 64, at 20 (discussing *Owens* court's reference to *Grupo Mexicano*'s discussion of equity powers of court and substantive consolidation); Willett, *supra* note 69, at 99 (affirming Supreme Court's discussion and view of equitable powers and substantive consolidation in *Grupo Mexicano*).

[182] *Owens*, 419 F.3d at 208–09 n.14.

[183] *Cf. In re* Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002). The issue in *Dow* was whether a bankruptcy court has the authority to enjoin a non-consenting creditor's claims against a non-debtor to facilitate a chapter 11 reorganization plan. The court found that bankruptcy courts do have such power pursuant, in part, to Bankruptcy Code Section 105 and specifically rejected the argument that bankruptcy

& Webster, the *Owens* court found authority for consolidation in Code section 1123 and declined to address whether section 105(a) provides an alternative source of authority for consolidation.[184] Nevertheless, while the question remains as to whether substantive consolidation is a proper exercise of section 105 power, there is significant authority for the argument that *Grupo* is irrelevant to that analysis.

Furthermore, courts have long recognized "the . . . equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud or injustice."[185] As discussed more above, modern substantive consolidation developed from the more traditional alter-ego, veil-piercing doctrines.[186] While there may be some differences in the grounds for and effects of these two doctrines, they are clearly both aimed at accomplishing the same overall goal: fair treatment of parties that dealt with corporate entities that did not themselves respect the corporate form.[187] Rooted in established principles of

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courts are precluded from issuing such injunctions by the *Grupo Mexicano* decision. The court found that Section 105(a) was a statutory grant of power other than the Judiciary Act of 1789 and, thus, that the bankruptcy court was not constrained by the *Grupo* decision to the traditional equity jurisprudence discussed therein. *See id.* at 658 ("We conclude that due to this statutory grant of power, the bankruptcy court is not confined to traditional equity jurisprudence and therefore, the bankruptcy court's *Grupo Mexicano* analysis was misplaced."); *see also* Paul P. Daley & George W. Shuster, Jr., *Bankruptcy Court Jurisdiction*, 3 DEPAUL BUS. & COM. L.J. 383, 435 n.49 (describing holding in *Dow*).

[184] *See Owens*, 419 F.3d at 208–09 n.14 (indicating Section 1123(a) allows for consolidation, and refusing to address "[w]hether § 105(a) allows consolidation . . . ."); *see also* Berringer & Artese, *supra* note 176, at 642 (reconfirming *Stone & Webster* court held consolidation is derived from Section 1123(a)); Willett, *supra* note 69, at 110–11 (indicating *Owens* court, like *Stone & Webster* court*,* found authority for consolidation in Section 1123).

[185] Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322 (1939); *see* Flynn v. Greg Constr. Co., Inc., No. 01-3391, 2003 WL 22598297, at *6 (6th Cir. Nov. 7, 2003) (acknowledging corporate fictions may be disregarded in interest of "'public convenience, fairness and equity'"); Pearson v. Component Tech. Corp., 247 F.3d 471, 484–85 (3d Cir. 2001) (describing different veil-piercing scenarios where courts disregard corporate fiction); First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba, 462 U.S. 611, 629 (1983) (affirming principle of separate corporate entities when fraud or injustice result); DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 683 (4th Cir. 1976) (noting separate entity theory may not be recognized in situations resulting in injustice or inequity); Quinn v. Butz, 510 F.2d 743, 757–58 (D.C. Cir. 1975) (indicating distinct corporate entities must be disregarded in interest of public convenience, fairness, and equity); Stone v. Eacho (*In re* Tip Top Tailors, Inc.), 127 F.2d 284, 288 (4th Cir. 1942) (pointing to well-established principle of disregarding corporate entities when justice may require); Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940) (authorizing consolidating corporate entities when not doing so will "defeat public convenience, justify wrong or protect fraud.").

[186] *See* Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 764 (9th Cir. 2000) ("Substantive consolidation 'enabl[es] a bankruptcy court to disregard separate corporate entities, to pierce their corporate veils in the usual metaphor, in order to reach assets for the satisfaction of debts of a related corporation.'"); Simon v. Brentwood Tavern, LLC (*In re* Brentwood Golf Club, LLC), 329 B.R. 802, 811 (Bankr. E.D. Mich. 2005) (defining substantive consolidation as merger of two or more apparent entities into single estate allowing assets and liabilities to be joined into common fund of assets creating single body of creditors); *In re* Cooper, 147 B.R. 678, 681 (Bankr. D. N.J. 1992) (noting substantive consolidation is corollary of bankruptcy court's power to disregard corporate form).

[187] *Compare* Flynn v. Greg Constr. Co., Inc., No. 01-3391, 2003 WL 22598297, at *6 (6th Cir. Nov. 7, 2003) (recognizing where disregarding corporate form is necessary in interests of justice, courts deal with substance of transaction as if corporate agency did not exist), *and* Labadie Coal Co. v. Black, 672 F.2d 92, 96 (D.C. Cir. 1982) (authorizing disregard for separate corporate entities when limited liability is outweighed by competing value of basis fairness to parities dealing with corporation), *with Bonham*, 229

equity, substantive consolidation would appear to be a straightforward exercise of the courts' equitable power to prevent the use of the corporate form to achieve or protect an injustice.

Considering the long history of substantive consolidation and the equitable principle behind disregard of the corporate form, and the fact that *Grupo* was not a bankruptcy case and had nothing to do with consolidation, it appears highly unlikely that the *Grupo* decision resolves the issue of the courts' power to grant substantive consolidation.

B. Power to Grant Substantive Consolidation under Section 105

"The Supreme Court has long recognized that bankruptcy courts are equitable tribunals that apply equitable principles in the administration of bankruptcy proceedings. The enactment of the Code in 1978 increased the degree of regulation Congress imposed upon bankruptcy proceedings, but it did not alter bankruptcy courts' fundamental nature."[188] Under the current Bankruptcy Code, bankruptcy courts have general equitable powers pursuant to section 105(a).[189] Numerous courts have found that section 105 gives a court authority to grant substantive consolidation under appropriate circumstances.[190]

F.3d at 764 (discussing primary purpose of substantive consolidation as ensuring equitable treatment of all creditors); *see* Soviero v. Franklin Nat'l Bank of Long Island, 328 F.2d 446, 448–49 (2d Cir. 1964) (endorsing court's ignoring subsidiary corporations so all creditors receive equality of treatment); *Cooper*, 147 B.R. at 684 ("It is safe to infer, however, that where the owners of a corporation have ignored the corporate form, courts of equity will be inclined to do so as well under both doctrines.").

[188] *See* Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 567 (3d Cir. 2003) (indicating enactment of Bankruptcy Code increased Congress' regulation on bankruptcy proceeding, but did not alter bankruptcy courts' "fundamental nature"); *In re* Coleman, 426 F.3d 719, 726 (4th Cir. 2005) (noting Bankruptcy Code "bestows certain equitable powers" on bankruptcy courts); Sasson v. Sokoloff, 424 F.3d 864, 869 (9th Cir. 2005) (recognizing bankruptcy court's retention of traditional powers under Bankruptcy Code).

[189] *See Bonham*, 229 F.3d at 764 ("At present, consistent with its historical roots, the power of substantive consolidation derives from the bankruptcy court's general equity powers as expressed in section 105 of the Bankruptcy Code."); Reider v. FDIC, 31 F.3d 1102, 1107 (11th Cir. 1994) (discussing bankruptcy courts' general equitable power under Section 105 of the Code to order substantive consolidation in certain contexts); Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988) (pointing to "sole purpose" of substantive consolidation as equitable treatment of all creditors).

[190] *See*, *e.g.*, *Bonham*, 229 F.3d at 764 (reading Section 105 of Code as authorizing courts to use powers to issue substantive consolidation); FDIC v. Colonial Realty Co., 966 F.2d 57, 59 (2d Cir. 1992) ("Courts have consistently found the authority for substantive consolidation in the bankruptcy court's general equitable powers as set forth in 11 U.S.C. section 105."); *In re* Permian Producers Drilling, Inc., 263 B.R. 510, 516–17 (Bankr. W.D. Tex. 2000) (affirming power of Bankruptcy Court to issue substantive consolidation under Code); *In re* Alico Mining, Inc., 278 B.R. 586, 588 (Bankr. M.D. Fla. 2002) (determining function of substantive consolidation as allowing bankruptcy court to disregard separate corporate entities in order to reach assets for satisfaction of debts of related corporation); *In re* Affiliated Foods, Inc., 249 B.R. 770, 775 (Bankr. W.D. Mo. 2000) (indicating authority to substantively consolidate cases in order to effectuate provisions of Bankruptcy Code); White v. Creditors Serv. Corp., 195 B.R. 680, 688–89 (Bankr. S.D. Ohio 1996) (noting broad equitable power detailed in Section 105(a) has been recognized as basis for ordering substantive consolidation); *In re* Richton Int'l Corp., 12 B.R. 555, 557 (Bankr. S.D.N.Y. 1981) (endorsing

Nevertheless, an argument remains that substantive consolidation exceeds the grant of equitable power under section 105. Section 105 states, in pertinent part, that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of title 11.[191] The Supreme Court has said, "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code[]" and, thus, held that section 105 cannot be used in a manner that conflicts with the Code.[192]

Some courts have given section 105 a more restrictive reading, finding that it "does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity."[193] Accordingly, one could argue that section 105's equitable authority can only be used in connection—but not in conflict—with another section of the Code. Arguably, then, substantive consolidation usually does not meet these criteria and, thus, is not authorized by the Code under most circumstances.

Initially, it is an interesting question whether substantive consolidation creates "substantive rights" and, thus, runs afoul of the above-referenced interpretation of section 105 at all. Similar to a so-called alter-ego claim, while disregarding the corporate form undoubtedly affects substantive rights, substantive consolidation does not itself create any underlying contract or tort claims. It does not create an independent cause of action, but rather furnishes a potential means to reach the assets of a corporate shareholder where respecting the corporate form would limit a claimant only to its immediate debtor.[194] Moreover, disregarding the corporate form

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court's authority to disregard separate corporate structures and create a single estate is derived from general equity jurisdiction).

[191] 11 U.S.C. § 105 (2006).

[192] *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206–07 (1988) (restricting bankruptcy court's equitable powers within confines of Bankruptcy Code); *In re* Fesco Plastics Corp., 996 F.2d, 152, 154 (7th Cir. 1993) (recognizing bankruptcy court can only exercise its power within limits of Bankruptcy Code); Lisanti v. Lubetkin (*In re* Lisanti Foods, Inc.), 329 B.R. 491, 497–98 (Bankr. D. N.J. 2005) (defining bankruptcy court's power to confirm a plan and consolidate assets must be governed overall by Bankruptcy Code).

[193] United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986); *see* Jamo v. Katahdin Fed. Credit Union, 283 F.3d 392, 403 (1st Cir. 2002) (explaining equitable powers available are those derived from the Bankruptcy Code); United States v. Pepperman, 976 F.2d 123, 131 (3d Cir. 1992) (finding Section 105(a) does not create any new substantive rights); Southern Ry. Co. v. Johnson Bronze Co., 758 F.2d 137, 141 (3d Cir. 1985) (noting Section 105(a) does not allow for the creation of rights not already available). *But see* Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 568 (3d Cir. 2003) (stating bankruptcy courts can use their equitable powers "to craft flexible remedies that, while not expressly authorized by the Code, effect the result the Code was designed to obtain."); Barron v. Texas Guar. Student Loan Corp. (*In re* Barron), 264 B.R. 833, 844 (Bankr. E.D. Tex. 2001) (arguing that, while Section 105(a) does not constitute a roving commission to do equity, it cannot be interpreted such that it is effectively written out of Code).

[194] *Cf.* Conopco, Inc. v. S.K. Foods, No. 98-C-1882, 1999 WL 965554, at *3 (N.D. Ill. Sept. 30, 1999) (noting alter-ego doctrine does not create substantive rights and duties, but rather "a proper claim involving an 'alter ego' must be grounded on a well-pled underlying cause of action such as tort, contract, or both."); Drexel Burnham Lambert, Inc. v. Luzinski, No. 89-C-3553, 1989 WL 152988, at *4 (N.D. Ill. Nov. 14, 1989) (same); 1 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.10 (perm. ed., rev. vol. 1999) (stating rationale behind alter-ego theory).

(whether through substantive consolidation or piercing) is not the product of some ill-defined notion of a roving equity power, but the result of highly developed doctrines of law founded upon the cardinal equitable principle that the corporate fiction will not be used to accomplish or preserve injustice.

This notwithstanding, in many cases, ordering consolidation would be appropriate to carrying out any number of provisions in the Code as they pertain to corporate debtors. "[C]ourts have universally recognized substantive consolidation as a tool for properly defining the relevant group of assets and liabilities of the bankruptcy estate."[195] It would seem beyond argument that a remedy that results in properly defining the assets and liabilities of debtors directly carries out the numerous Code provisions dealing with the disposition of debtor assets and liabilities. Moreover, in what appears to be the only case to directly address the issue, the court in *In re Permian Producers Drilling, Inc.* specifically rejected the argument that substantive consolidation exceeds section 105(a)'s grant of equitable authority.[196] The court found that, "[r]ather than violate any provisions of the Bankruptcy Code, substantive consolidation facilitates the underlying purpose of bankruptcy proceedings by allowing the court to attach a pool of assets that should have been included since the commencement of the bankruptcy case."[197] It also noted that interpreting section 105 to limit a court's equity power to only issuing orders already expressly allowed for by other provisions in the Bankruptcy Code would render section 105 superfluous and redundant to already existing provisions.[198]

Irrespective of whether one finds the *Permian* rationale completely convincing, the fact remains that, "even in an era of limited equity power, no federal court has found that the bankruptcy court's power to order substantive consolidation falls

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[195] *In re* Permian Producers Drilling, Inc., 263 B.R. 510, 521 (Bankr. W.D. Tex. 2000) (citing Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 765 (9th Cir. 2000)).

[196] *See id.* at 516 ("Rather than violate any provisions of the Bankruptcy Code, substantive consolidation facilitates the underlying purpose of bankruptcy proceedings by allowing the court to attach a pool of assets that should have been included since the commencement of the bankruptcy case.").

[197] *See id.* (citing 2 COLLIER ON BANKRUPTCY ¶ 105.09[3]) ("[I]f the separate existence of the two companies was a mere fiction, then consolidation simply recognizes the existing reality that . . . all property was held in a single entity.").

[198] *See Permian*, 263 B.R. at 517 (refusing to limit bankruptcy court's equity power under Section 105(a)); Barron v. Texas Guar. Student Loan Corp. (*In re* Barron), 264 B.R. 833, 844 (Bankr. E.D. Tex. 2001):

> While a bankruptcy court must always exercise due caution to insure that its equitable powers are being exercised even-handedly and in a manner consistent with the provisions of the Bankruptcy Code, . . . the scope of that restriction should not be exaggerated to the point at which bankruptcy courts feel powerless to act unless a party can present a specific textual quotation which precisely identifies the availability of a specific remedy.

Id.

outside these limits."[199] Accordingly, while proponents of consolidation will undoubtedly continue to face arguments concerning the courts' lack of power to grant such relief, the success or failure of a motion for substantive consolidation will almost certainly be more dependent on the application of the test chosen for determining whether consolidation is appropriate in a given case.

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[199] *Permian*, 263 B.R. at 517; *see In re* Owens Corning, 419 F.3d, 195, 208–09 (3d Cir. 2005) (realizing no court has invalidated substantive consolidation, though remembering that nearly all courts have said that it should be used "sparingly"); Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 765 (9th Cir. 2000) ("Thus, even though substantive consolidation was not codified in the statutory overhaul of bankruptcy law in 1978, the equitable power undoubtedly survived enactment of the Bankruptcy Code. No case has held to the contrary.").