SUBSTANTIVE CONSOLIDATION: THE CACOPHONY CONTINUES©

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INTRODUCTION

> Substantive consolidation obliterates the corporate form. The essential attribute of the corporate form is that it partitions assets. Assets in one legal entity are available first for the creditors of that entity. The owner of the corporation can enjoy its assets only after the corporation has satisfied all of its debts. In the case of a wholly owned subsidiary, the creditors of the parent can look to the assets of the subsidiary only to the extent that the subsidiary can first meet all of its obligations. The corporate form enhances the ability to raise capital by calibrating precisely which claims go with which assets. It is thus not surprising that virtually every large enterprise today organizes its affairs in the same way as Owens Corning — as a corporate group.
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> Substantive consolidation undoes this partitioning. Assets that are contained in legally distinct corporate entities are lumped together. Claims that could be asserted against one or at most a subset of the entities can now chase all of the assets. Those with direct claims against a wholly owned subsidiary must now compete with the creditors of the parent. Inevitably, this commingling of assets and claims transfers value from one group of creditors to another.[1]

> I hope to convince you that [substantive consolidation] is the most important doctrine in corporate reorganization. Each year the allocation of billions of dollars among competing creditor groups turns on decisions by courts to approve or reject use of the doctrine. For this reason, I believe that courts and commentators should have clearly stated the parameters of substantive consolidation long ago. To date, however, no such clear formulation exists; the current state

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[1] Brief of Barry Adler et al. as Amici Curiae in Support of Appellant at 2–3, *In re* Owens Corning, 419 F.3d 195 (3d Cir. 2005). The law professors listed on the *amicus* brief include Robert K. Rasmussen of Vanderbilt Law School, Barry Adler of NYU School of Law, Susan Block-Lieb of Fordham University School of Law, G. Marcus Cole of Stanford Law School, Marcel Kahan of NYU Law School, Ronald Mann of the University of Texas Law School, and David A. Skeel, Jr. of the University of Pennsylvania Law School. The brief is mentioned on page 210 of the opinion.

> of substantive consolidation doctrine is a mess, leaving courts and reorganization participants adrift.[2]

As argued in the *amicus* brief quoted above, the "asset partitioning" aspect of corporate law allows parties involved in a lending transaction to define which assets will be available to repay corporate debts. Under the corollary principle of "structural subordination," creditors of the parent company may recover from the assets of the subsidiary company only after the subsidiary has paid all of its obligations. The principle of structural subordination is the flip-side of the better-known principle of limited liability.[3]

The *amicus* brief observes the fundamental challenge that substantive consolidation presents to the principles of structural subordination and asset partitioning.[4] The existence of judicial discretion to undo the partitioning limits the freedom of parties to structure business transitions. Absent carefully-tailored rules of decision for substantive consolidation, parties to business transactions will be unable to precisely calibrate which debts may be paid from which asset pools.

Both the professors that wrote the *amicus* brief as well as Professor Widen all acknowledge that substantive consolidation may result in the transfer of billions of dollars of value in bankruptcy cases. However, they part ways on the issue of whether substantive consolidation is a desirable law. Widen views substantive consolidation as the "most important doctrine in corporate reorganization" while the *amicus* brief focuses attention on the potential havoc the doctrine can play with creditor expectations. Few would disagree with Widen's assertion that at present the rules governing substantive consolidation "lack clarity, leaving courts and parties adrift."

This Article agrees that the current rules for substantive consolidation suffer from interpretive ambiguities. With that in mind, the Article asks, "Under which

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[2] William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 237, 238–39 (2007).

[3] Structural subordination means that creditors of a parent entity are subordinate to creditors of a subsidiary entity with respect to the subsidiary's assets. The principle of structural subordination applies even without the existence of a formal written subordination agreement. The *In re Owens Corning* opinion refers to the synonymous business term of "structural seniority." 419 F.3d at 212. The concept of "entity shielding" refers to the principle that assets contributed by the members of a business organization ordinarily are not available to pay the debts of the members. The concept originated in ancient Rome, became part of medieval Italian and English common law, and wound up part of American corporate law. *See* Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1336 (2006). Notably, the *In re Owens Corning* opinion observes that one or more of the subsidiaries were formed to "shield" assets from liabilities of affiliates. 419 F.3d at 200 n.3. The state law basis for the principles of structural subordination and entity shielding is further developed in Part III of this Article.

[4] The nature and effect of the substantive consolidation of affiliated entities closely resembles a corporate merger in which the rights of creditors of the affiliates are affected. *See* Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 764 (9th Cir. 2000) (noting substantive consolidation combines assets and liabilities from different legal entities into one pool); *cf.* Union Savs. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo), 860 F.2d 515, 518 (2d Cir. 1988) ("Substantive consolidation usually results in, *inter alia*, pooling the assets of, and claims against, the two entities; satisfying liabilities from the resulting common fund; eliminating inter-company claims; and combining the creditors of the two companies . . . .").

rule of decision should a bankruptcy court modify the structural subordination that state corporate law imposes on creditors of a parent corporation, vis-à-vis creditors of the subsidiary?" When should the "freedom of contract" principle, which allows parties to utilize multi-tiered corporate entities to partition assets and debts among entities, be disregarded in favor of the bankruptcy law values of efficiency and practicality? Should the rule of decision for substantive consolidation primarily take into account the conduct of the affiliated entities to be consolidated, or should the rule place greater weight on the conduct and expectations of creditors of the affiliated entities? Should reorganization policy trump state law-based rules that ordinarily impose structural subordination on creditors of a parent corporation?

Implicit in any set of rules for substantive consolidation are policy choices regarding the permeability of the corporate entity. This Article argues that deciding the correct rule for substantive consolidation ultimately requires making a policy choice between the "entity theory" and the "enterprise theory" of corporate group liability.[5] Under the entity theory of corporate groups, one member of the group is presumed not liable for the debts of the other members. Under the enterprise theory of corporate groups, one member of the group is presumed liable for the debts of the other members. If the enterprise theory of business organizations is the correct rule of corporate law liability, then it follows that affiliated entities should be consolidated in bankruptcy as a general rule. If the entity theory is selected as the correct rule of corporate law liability, it follows that substantive consolidation in bankruptcy should be rare.[6]

I. SUBSTANTIVE CONSOLIDATION IN THE POST-*GRUPO MEXICANO* WORLD

In *Owens Corning*, the United States Court of Appeals for the Third Circuit announced a rule of decision, if ultimately adopted by the United States Supreme Court, that should eliminate substantive consolidation but for the rarest of circumstances. The Third Circuit held substantive consolidation is permitted in only two narrow circumstances: (i) where prior to bankruptcy, the entities disregarded their separateness so significantly that "their creditors relied on the breakdown of entity borders and treated them as one legal entity"[7]; or (ii) where the entities' assets and liabilities are shown to be so "scrambled" that separating them during the bankruptcy case is "prohibitive and hurts all creditors."[8] Generally, *Owens Corning* is faithful to the values represented by the entity theory of business organization law.

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[5] The conclusion of this Article describes the debate over the "entity theory" versus the "enterprise theory" of business organizations.

[6] A related question is also presented: under the federal constitution that recognizes dual sovereigns (*i.e.*, the federal government and the state governments), should the choice between the entity theory or the enterprise theory of corporate liability be made by Congress or state legislatures?

[7] *In re Owens Corning*, 419 F.3d at 211.

[8] *Id.*

Remarkably, before announcing its standards for substantive consolidation, the Third Circuit *sua sponte*[9] questioned its authority to authorize substantive consolidation in light of the Supreme Court's 1999 decision in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bank Fund, Inc.*[10] This examination appears to have been prompted by an essay[11] I published suggesting *Grupo Mexicano* eliminated a fundamental tenet upon which substantive consolidation has been premised. As examined in my Prior Article, the power to grant substantive consolidation appears to have been premised upon the notion that federal courts sitting as "courts of equity" have a robust power to establish equitable rules of decision in bankruptcy cases. The assumption appears to have been that federal bankruptcy courts may exercise an inherent equitable lawmaking power so long as the resulting federal judge-made rule does not conflict with a federal statute.

Grupo Mexicano refocused the inquiry to whether a proposed equity-based rule of decision has support in eighteenth century English case law precedent. The Supreme Court held that the federal courts are limited to those equitable remedies exercised in the English Court of Chancery in 1789, the year that Congress enacted the First Judiciary Act. This principle will be referred to as the Equity Cutoff Rule.[12] Specifically, the Supreme Court held that federal district courts lack the equitable power to fashion a non-traditional preliminary injunction even where needed to protect general creditors from making preferential or fraudulent transfers. However, the reasoning of *Grupo Mexicano* is broader than its specific holding and indicates that federal courts cannot create new remedies as courts of equity. Federal courts lack the power to "create remedies previously unknown to equity jurisprudence."[13] Federal equitable powers are limited to those that have a long history.[14] As Adam Levitin elaborates:

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[9] *Id.* at 208–09. Inspection of the appellants' brief confirms the appellants did not challenge the authority of the bankruptcy court to grant substantive consolidation. *See generally* Brief of Appellant Credit Suisse First Boston, *In re* Owens Corning, 419 F.3d 195 (3d Cir. 2005). The issue only received limited discussion in *amicus* briefs. *See generally* Brief of Barry Adler et al., *supra* note 1; Brief for Loan Syndications and Trading Ass'n, Inc. and Clearing House Ass'n LLC as Amici Curiae in Support of Appellant, *In re* Owens Corning, 419 F.3d 195.

[10] 527 U.S. 308 (1999).

[11] *See generally* J. Maxwell Tucker, *Grupo Mexicano and the Death of Substantive Consolidation*, 8 AM. BANKR. INST. L. REV. 427 (2000) [hereinafter Tucker, *Grupo Mexicano*].

[12] The Supreme Court had long held that "[t]he 'jurisdiction' thus conferred . . . is an authority to administer in equity suits the principles of the system of judicial remedies which had been devised and was being administered by the English Court of Chancery at the time of the separation of the two countries." Atlas Life Ins. Co. v. W.I.S., Inc., 306 U.S. 563, 568 (1939). *See e.g.*, Stainback v. Mo Hock Ke Lok Po, 336 U.S. 368, 382 n.26 (1949) (quoting *Atlas Life*, 306 U.S. at 568); Guar. Trust Co. v. York, 326 U.S. 99, 105 (1945) ("The suits in equity of which the federal courts have had 'cognizance' ever since 1789 constituted the body of law which had been transplanted to this country from the English Court of Chancery."); Gordon v. Washington, 295 U.S. 30, 36 (1935) (noting term "suits in equity" connotes relief sought under principles of English Court of Chancery). *Grupo Mexicano*'s incremental but significant limitation on the scope of federal equity practices is that a party requesting equitable relief must demonstrate that English courts actually "exercised" the remedy prior to 1789. 527 U.S. at 328.

[13] *Grupo Mexicano*, 527 U.S. at 332.

[14] *Id.* at 308, 330–31.

> Underlying the [Supreme] Court's concern about unbridled equity powers is a concern about separation of powers. If there were no limits on federal courts' equity powers other than efficiency and practicality, it would be the courts, and not Congress, that would determine not only what remedies exist for the vindication of rights, but also, by extension, what rights exist, for "where there is a legal right, there is also a legal remedy." . . . As the Supreme Court recognized [in *Grupo Mexicano*], it cannot be the province of courts to create such rights; the Constitutional role of the courts is not to legislate. Legislation by politically unaccountable actors such as unelected Article III judges with life tenure and salary protection or even of bankruptcy judges, appointed by the Circuit Courts for terms, runs contrary to the entire notion of separation of powers.[15]

Grupo Mexicano arose out of a commercial law struggle between sophisticated noteholders and their borrower. The Supreme Court was clearly uneasy with the notion of lower courts "doing justice" instead of "doing law" in the creditor rights context. It may seem arbitrary to have selected 1789 English equity practice as the baseline for what is and is not permitted.[16] However, in our constitutional system of divided powers it is difficult to devise another rule for differentiating a federal court's proper exercise of equitable discretion from an improper legislative act.

In my Prior Article, I argued that the relatively recent equitable doctrine of substantive consolidation does not survive scrutiny under a *Grupo Mexicano* analysis. Tracing the origins of substantive consolidation to a series of Second Circuit opinions issued between 1963 and 1976, the Prior Article challenged the continued viability of substantive consolidation in light of *Grupo Mexicano's* bright line 1789 cutoff rule.

Admittedly the impact of *Grupo Mexicano* on substantive consolidation (and bankruptcy lawmaking practices in general) remains undetermined by the Supreme Court, and has received limited attention in the lower courts. In the decade following the *Grupo Mexicano* decision, some commentators and courts rejected

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[15] Adam J. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 AM. BANKR. L.J. 1, 51–52 (2006).

[16] Other recent Supreme Court cases demonstrate the Court's reliance upon eighteenth century practices and understandings as a basis for decision. See Cent. Va. Cmty. Coll. v. Katz, 546 U.S. 356, 357 (2006), in which both the Court's majority and minority opinions rely upon eighteenth century cases and practices as a basis to determine whether, notwithstanding the Eleventh Amendment, the states implicitly agreed to waive sovereign immunity with respect to suits brought in federal bankruptcy courts. See also District of Columbia v. Heller, 128 S. Ct. 2783, 2797–98 (2008), where both majority and minority opinions refer to eighteenth century cases as the basis for understanding the meaning of the Second Amendment right to bear arms. In hindsight, the notion that a federal court's ability to craft equitable remedies is constrained by eighteenth century practice, as held in *Grupo Mexicano*, is perhaps less remarkable now than when the Supreme Court issued its opinion in 1999. *See* 527 U.S. at 332–33.

my Prior Article's contention that the Equity Cutoff Rule eliminated substantive consolidation. In the *Owens Corning* opinion, the Third Circuit rejects the applicability of *Grupo Mexicano's* Equity Cutoff Rule to substantive consolidation, offering two reasons.[17] First, the *Owens Corning* opinion treats the Supreme Court's 1941 decision in *Sampsell v. Imperial Paper & Color Corp.*[18] as binding stare decisis precedent on the question of whether bankruptcy courts have a power to substantively consolidate.[19] Second, the *Owens Corning* opinion suggests that Article I bankruptcy courts are exempt from the lawmaking limitations imposed by *Grupo Mexicano* because they are "different in kind" from Article III courts.[20]

While substantive consolidation survived the *Grupo Mexicano* challenge in the Third Circuit, it has survived only in a limited form. The Third Circuit openly disagreed with an "enterprise law"-based consolidation standard established by the Eleventh Circuit. The Eleventh Circuit observed:

> There is, however, a "modern" or "liberal" trend toward allowing substantive consolidation, which has its genesis in the increased judicial recognition of the widespread use of interrelated corporate structures by subsidiary corporations operating under a parent entity's corporate umbrella for tax and business purposes.[21]

Disavowing the "liberal trend," the Third Circuit imposed the most restrictive standard that could be devised without completely banning the doctrine.[22] Other circuits have taken note. The Fifth Circuit, citing *Owens Corning*, observed "those jurisdictions that have allowed it emphasize that substantive consolidation should be used 'sparingly'".[23]

Is substantive consolidation a modern, progressive remedy that should apply to most corporate bankruptcies as suggested by Widen? Or should it be invoked "sparingly" as indicated by *Owens Corning*? A cacophony of opinions plagues those attempting to locate the correct rule of decision for substantive consolidation.

Consider the related question of whether a non-debtor entity may be substantively consolidated with the assets and liabilities of a debtor estate. At present, there is no "bright-line" answer to this question on a national level. The Ninth Circuit held that consolidation of non-debtors with a debtor is permitted.[24] In

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[17] *In re* Owens Corning, 419 F.3d 195, 208–09 n.14 (3d Cir. 2005) (repudiating application of *Grupo Mexicano's* Equity Cutoff Rule to substantive consolidation).

[18] 313 U.S. 215 (1941).

[19] *See In re Owens Corning*, 419 F.3d at 206.

[20] *See id.* at 209. I discuss this concept that has been called "Bankruptcy Exceptionalism" in Part II, *infra*.

[21] Eastgroup Props. v. S. Motel Ass'n, Ltd., 935 F.2d 245, 248–49 (11th Cir. 1991) (citations omitted).

[22] *In re Owens Corning*, 419 F.3d at 209 n.15.

[23] Wells Fargo Bank of Tex. v. Sommers (*In re* Amco Ins.), 444 F.3d 690, 696–97 n.5 (5th Cir. 2006) (citing *In re Owens Corning*, 419 F.3d at 208–09).

[24] *See* Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 771 (9th Cir. 2000) (adopting *Augie/Restivo* prerequisites for substantive consolidation: "either (1) the creditors dealt with the consolidated entities as if

contrast, the Fifth Circuit initially observed conflicting opinions with respect to whether such consolidation is permitted.[25] Several months later, the Fifth Circuit stated that substantive consolidation is not available in circumstances where all of the entities to be consolidated had not been placed into bankruptcy.[26] Which point of view is correct?

Questions raised by the *Owens Corning* and *Grupo Mexicano* decisions provoked Douglas G. Baird to observe that substantive consolidation now faces an "uncertain future" and that "the doctrine could evolve in any of three or more radically different directions."[27] Baird suggests the time is ripe for a "serious and thoughtful debate" regarding the legitimacy and scope of substantive consolidation.[28] Such debate has begun.

Widen has surveyed bankruptcy filings, and presents evidence that consolidation is a frequently used remedy.[29] His companion article, *Corporate Form and Substantive Consolidation*,[30] criticizes *Owens Corning's* stringent standard. Widen then offers a variety of economic and legal justifications for a proposed rule of decision that presumptively allows consolidation when lenders require guarantees from a corporate group. Similarly, commentators Amera and Kolod argue that *Owens Corning* strayed from the "basics" of consolidation taught by the Supreme Court in its *Sampsell* opinion.[31]

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they were the same, or (2) the affairs of the consolidated entities are so entangled that it would not be feasible to identify and allocate all of their assets and liabilities").

[25] *See In re Amco Ins.*, 444 F.3d at 695–96 n.3 (summarizing three positions taken by courts as (1) allowing consolidation as if parties were debtors, (2) allowing consolidation only after exercise of extreme caution, and (3) not allowing such consolidation for lack of jurisdiction over non-debtor).

[26] *See* People's State Bank v. Gen. Elec. Capital Corp. (*In re* Ark-La-Tex Timber Co.), 482 F.3d 319, 327 n.7 (5th Cir. 2007) (noting party's bankruptcy filing is condition precedent for proper substantive consolidation). Similarly, commentators remain divided over the legitimacy of non-debtor consolidation. *Cf.* Kurt A. Mayr, *Back to* Butner's *Basic Rule—the Fundamental Flaw of Nondebtor Substantive Consolidation*, 16 NORTON J. BANKR. L. & PRAC., 77, 88 (Feb. 2007) (concluding bankruptcy courts lack authority to substantively consolidate non-bankrupt entity with entity that files for bankruptcy); Kit Weitnauer, *Substantive Consolidation of Non-debtors: Another Perspective*, 23 AM. BANKR. INST. J. 1, 46 (May 2004) (concluding when facts supporting consolidation are established, most courts grant substantive consolidation called for by circumstances).

[27] Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C.L. REV. 5, 21 (2005).

[28] *Id.*

[29] William H. Widen, *Report to the American Bankruptcy Institute: Prevalence of Substantive Consolidation in Large Public Company Bankruptcies from 2000 to 2005*, 16 AM. BANKR. INST. L. REV. 1, 2 (2008) [hereinafter Widen Report]. Widen asserts that substantive consolidation is a "dominant technique" used to reorganize and liquidate large public company bankruptcies. *Id.* at 3. Widen takes issue with language found in circuit court opinions to the effect that substantive consolidation is an "extreme and unusual" remedy. *Id.* at 1–2, 1 n.3. Although Widen reports that the consolidation technique was used in over fifty percent of the cases examined, only two out of sixty-two cases examined resulted in an actual combination of legal entities. *Id.* at 5–6. Widen observes that parties to reorganization transactions have instead utilized several variants of the doctrine, which he defines as "Operative Deemed Consolidation," "Express Deemed Consolidation," and "Stealth Consolidation." *Id.* at 24–25.

[30] Widen, *supra* note 2, at 239.

[31] Seth D. Amera & Alan Kolod, *Substantive Consolidation: Getting Back to Basics*, 14 AM. BANKR. INST. L. REV. 1, 35 (2006) ("It is at least arguable that the *Owens* court committed reversible error by utterly ignoring the Supreme Court's rationale in the *Sampsell* decision.").

Other commentators rely upon the judge-made substantive consolidation doctrine to support a broader jurisprudential thesis. Adam Levitin considers substantive consolidation a valid exercise of a "federal common law of bankruptcy" and Jonathan Lipson suggests substantive consolidation exemplifies an emerging constitutional principle he calls "bankruptcy exceptionalism."[32]

On the other hand, *Owens Corning* has its apologists. Timothy E. Graulich argues that *Owens Corning* faithfully follows the *Sampsell* opinion, and that several "liberal" consolidation tests announced after 1978 are in error. Graulich relies in part on *Grupo Mexicano*, contending that it freezes the development of equitable remedies in bankruptcy to their status in 1978.[33]

Sabin Willett observes that *Owens Corning's* rigorous standard has the practical effect of making substantive consolidation unavailable except under the strict requirements of alter-ego law.[34] Openly skeptical of the legitimacy of substantive consolidation, Willett questions the utility of federal rule of decision that is redundant of state alter-ego.

This article continues the debate. Part II of this Article examines six questions raised in response to the Prior Article's assertion that *Grupo Mexicano* eliminated substantive consolidation: (i) Whether the Supreme Court authorized substantive consolidation in *Sampsell*, (ii) whether the English Chancellor exercised this remedy prior to 1789, (iii) whether section 105 of the Bankruptcy Code authorizes substantive consolidation, (iv) whether a "federal common law of bankruptcy" authorizes substantive consolidation, (v) whether substantive consolidation may be justified by the pre-Code practices rule, and (vi) whether an emerging principle called "bankruptcy exceptionalism" exempts bankruptcy courts from the Equity Cutoff Rule. This Article responds to each such question.

Part III surveys current federal law standards and proposes several "bright-line" standards for consolidation. However, Part III concludes that in promulgating standards for substantive consolidation, courts necessarily will engage in making "categorical judgments" regarding the priority of creditor claims in bankruptcy. Part III observes that the Supreme Court has banned bankruptcy courts from making "categorical judgments" regarding the priority of creditors.[35]

Finally, in Part IV, this Article surveys leading authorities in favor of the entity law and enterprise law approaches to affiliate corporate liability. Once the debate between these two approaches is settled, this Article argues the correct rule for substantive consolidation could be formed.

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[32] Levitin, *supra* note 15, at 1 ("Bankruptcy courts' equitable powers are routinely cited as the authority for common, if contested, non-Code Chapter 11 practices such as . . . substantive consolidation . . . ."); Jonathan C. Lipson, *Debt and Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 NOTRE DAME L. REV. 605, 638–39 (2007).

[33] Timothy E. Graulich, *Substantive Consolidation—A Post-Modern Trend*, 14 AM. BANKR. INST. L. REV. 527, 557 (2006).

[34] Sabin Willett, *The Doctrine of Robin Hood, A Note on "Substantive Consolidation*," 4 DEPAUL BUS. & COMM. L.J. 87, 104 (2005).

[35] United States v. Noland, 517 U.S. 535, 536 (1996) (allowing bankruptcy courts to make categorical judgments violates "separation of powers" principles).

II. A SURREPLY TO SIX ARGUMENTS THAT *GRUPO MEXICANO* DOESN'T MATTER

A. Sampsell: summary jurisdiction applied under the former Bankruptcy Act

The *Owens Corning* opinion redirects those searching for the source of the bankruptcy court's authority to grant substantive consolidation away from "equitable powers" and toward the Supreme Court's 1941 holding in *Sampsell*.[36] A curious "post-modern" reliance upon *Sampsell*[37] as a *stare decisis* holding on substantive consolidation has emerged in the decade following the issuance of the *Grupo Mexicano* opinion.[38]

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[36] *See In re* Owens Corning, 419 F.3d 195, 206 (3d Cir. 2005); Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 220 (1941).

[37] Prior to the *Grupo Mexicano* decision, most consolidation cases, including *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991), *Union Savings Bank v. Augie/Restivo Baking Co.* (*In re Augie/Restivo Baking Co.*), 860 F.2d 515 (2d Cir. 1988), *Drabkin v. Midland-Ross Corp.* (*In re Auto-Train Corp.*), 810 F.2d 270 (D.C. Cir. 1987), *Flora Mir Candy Corp. v. R.S. Dickson & Co.* (*In re Flora Mir Candy Corp.*), 432 F.2d 1060 (2d Cir. 1970), *Chemical Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966), and *Soviero v. Franklin National Bank of Long Island*, 328 F.2d 446 (2d Cir. 1964), made no reference whatsoever to *Sampsell*. In the aftermath of *Grupo Mexicano* and speculation that it by implication had repudiated substantive consolidation, two circuit courts expressly relied upon *Sampsell* as a *stare decisis*-quality holding on consolidation. *See In re* Owens Corning, 419 F.3d 195, 206 (3d Cir. 2005) (explaining Supreme Court previously stated support for substantive consolidation in *Sampsell*); Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 763–64 (9th Cir. 2000) (positing *Sampsell* gave bankruptcy courts power to use substantive consolidation). Notably, it does not appear that the *Grupo Mexicano* issue was briefed by the appellant in either *Bonham* or *Owens Corning*, and the *Bonham* opinion makes no reference to *Grupo Mexicano*. *See In re Bonham*, 229 F.3d at 750; *see also* Brief of Appellant, *In re Owens Corning*, 419 F.3d at 206; Brief of Appellant, *In re Bonham*, 229 F.3d at 750. Post-*Grupo Mexicano* essays defending substantive consolidation rely heavily upon the *Sampsell* opinion. *See, e.g.*, Ryan W. Johnson, *The Preservation of Substantive Consolidation*, 24 AM. BANK. INST. J. 44, 63 (Aug. 2005).

[38] A kind of historical revisionism as to the authority for substantive consolidation is evident in recent articles concerning the propriety of law firm legal opinions on the topic of substantive consolidation. *See generally* Graulich, *supra* note 33, at 539–47. Early bar committee reports concerning substantive consolidation opinions make no reference whatsoever to the *Sampsell* opinion. *See* Comm. on Bankr. & Corporate Reorganization of the New York City Bar Ass'n, *Structured Financing Techniques*, 50 BUS. LAW 527, 596 (1994) (proposing lawyers use form of legal opinion which states substantive consolidation is authorized under "general equity powers" and section 105); *see also* Tribar Opinion Comm., *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing and Chapter 11 Transactions*, 46 BUS. LAW 717, 725 (1990) (referring to bankruptcy court's "equitable powers" as source of authority to consolidate). Each of these early committee reports include dozens of citations to leading federal circuit court and bankruptcy court opinions, yet make no reference to *Sampsell*. *See, e.g.*, Comm. on Bankr. & Corporate Reorganization of the New York City Bar Ass'n, *supra*, at 596. In contrast, the Comm. on Structured Fin. & the Comm. on Bankr. & Corporate Reorganization of the New York City Bar Ass'n, *Special Report on the Preparation of Substantive Consolidation Opinions*, 64 BUS. LAW. 411, 414 (2009) [hereinafter Substantive Consolidation Opinions], proposes that lawyers take a "fresh look" at the reasoning they include in substantive consolidation opinions. In this 2009 report the committees suggest the authority for substantive consolidation "derives" from the Supreme Court's *Sampsell* opinion. *Id*. at 414. The absence of any reference to *Sampsell* in the committees' earlier reports suggests a general lack of reliance by practitioners on *Sampsell* as authority for substantive consolidation prior to the 1999 *Grupo Mexicano* opinion. In the fifty-eight years between the 1941 *Sampsell* opinion and the 1999 *Grupo Mexicano* opinion, lower courts and practitioners did not rely on *Sampsell* as binding *stare decisis* precedent on the topic of substantive consolidation, in the same sense that the Supreme Court has referred to such reliance interest as a basis to apply *stare decisis* to maintain earlier controversial holdings. *See e.g.*, Planned Parenthood v. Casey, 505 U.S. 833, 854–55, 865–

The point of view that *Sampsell* is a *stare decisis* holding is exemplified by the *Owens Corning* opinion: "[w]hat the Court has given as an equitable remedy remains until it alone removes it or Congress declares it removed as an option".[39] It is common ground that under rules of *stare decisis*, if the Supreme Court had affirmed a substantive consolidation order, only the Supreme Court would have authority to remove the remedy absent action by Congress.

However, does *Sampsell* truly give lower courts authority to grant substantive consolidation? The *Sampsell* opinion does not contain the phrase "substantive consolidation." Nor does *Sampsell* provide any rule of decision for the lower courts to apply to a consolidation request. Several professors, practitioners, and courts have taken a fresh look at *Sampsell* and openly disavow the belief that *Sampsell* constitutes a *stare decisis* ruling on this topic. Douglas G. Baird writes that "[t]he U.S. Supreme Court has never formally embraced the concept," and while Justice Douglas came the "closest to doing so," the *Sampsell* case merely involved a recovery of assets that had been fraudulently conveyed.[40] Sabin Willett concurs that *Sampsell's* holding did not amount to an endorsement of substantive consolidation.[41] Courts have noted "the consolidation order[] was not appealed and hence its validity was not in issue[,]"[42] and have distinguished *Sampsell* as a fraudulent transfer holding, not substantive consolidation.[43] One circuit court apparently reserved judgment on the significance of *Sampsell's* holding after briefing and argument on the issue.[44]

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69 (1992) (discussing importance of and reasons for adherence to precedent in accordance with doctrine of *stare decisis*).

[39] *In re Owens Corning*, 419 F.3d at 209 n.14. Several bankruptcy courts have reached a similar conclusion regarding *Sampsell*. *See In re* Am. Homepatient, Inc., 298 B.R. 152, 165 (Bankr. M.D. Tenn. 2003); *In re* Stone & Webster, Inc., 286 B.R. 532, 539 (Bankr. D. Del. 2002). However, the *Owens Corning* opinion reflects some doubt on the part of the Third Circuit as to the scope and import of *Sampsell*. 419 F.3d at 205. The opinion observes that the Supreme Court "at least indirectly and inadvertently" affirmed substantive consolidation. *Id*. at 206. Yet under rules of *stare decisis*, an "indirect" holding is insufficient to create binding precedent. *See infra* note 55 and accompanying text.

[40] *See* Baird, *supra* note 27, at 15 (indicating substantive consolidation is used in daily practice but it lacks solid foundation in law).

[41] *See* Willett, *supra* note 34, at 94, 100 (arguing *Sampsell* dealt primarily with fraudulent conveyance rather than substantive consolidation). *See generally* Mayr, *supra* note 26, at 81 (concluding issue of substantive consolidation was not decided in *Sampsell*); Christopher J. Predko, *Substantive Consolidation Involving Non-Debtors: Conceptual and Jurisdictional Difficulties in Bankruptcy*, 41 WAYNE L. REV. 1741, 1765 (1995) ("The only issue actually decided by the Court in *Sampsell* was the status of the creditor's claim." (citing *Sampsell*, 313 U.S. at 218)).

[42] *In re* Lease-A-Fleet, Inc., 141 B.R. 869, 874 (Bankr. E.D. Pa. 1992).

[43] *See In re* Am. Camshaft Specialties, Inc., 410 B.R. 765, 778 (Bankr. E.D. Mich. 2009) ("However, a careful reading of *Sampsell* reveals that the Supreme Court did not actually hold substantive consolidation to be an available remedy for bankruptcy courts, nor did it address what showing would be necessary to invoke the doctrine of substantive consolidation."); *see also In re* Julien Co., 120 B.R. 930, 934 (Bankr. W.D. Tenn. 1990) (describing *Sampsell* as involving individual debtor's transferring property in bad faith to avoid creditors).

[44] Wells Fargo Bank of Tex.v. Sommers (*In re* Amco Ins.), 444 F.3d 690, 696 n.5 (5th Cir. 2006). The author of this Article participated in the briefing and argument of the *Amco* appeal on behalf of the appellant. The *Sampsell* case was extensively briefed by the parties to the appeal. Notably, the first question directed to counsel for the appellant at oral argument was whether the Supreme Court had already approved

This Article argues *Sampsell's* actual holding is that a bankruptcy referee had "summary jurisdiction" over a corporation owned by the bankrupt and his immediate family members, such that the referee's order against such corporation was not subject to collateral attack in a subsequent proceeding. In evaluating *Sampsell* one should keep in mind the summary/plenary jurisdictional dichotomy under the Bankruptcy Act of 1898. Federal district courts served as bankruptcy courts, but employed a "referee" system to carry out most administrative tasks. Congress had limited the scope of the federal bankruptcy court's jurisdiction under the Bankruptcy Act, so that the state courts would play a significant role in adjudicating bankruptcy matters. Debtors and creditors had the right to insist on state court resolution of numerous issues, from a debtor's efforts to defend against an involuntary petition to the trustee's litigation to recover preferential and fraudulent transfers. Generally, the federal bankruptcy court could only exercise jurisdiction over property that the debtor had in his possession. If the debtor had transferred property to a creditor, the bankruptcy court could assert jurisdiction over the avoidance action against the creditor only if both parties consented.[45] During the Bankruptcy Act's jurisdictional regime, Congress and the courts used the term "summary" to characterize the bankruptcy court's jurisdiction over property the debtor possessed, and "plenary" to denote the court's more limited authority over property the debtor did not. Later dissatisfaction over this bifurcated jurisdictional regime ultimately led to an expansion of the bankruptcy court's subject matter jurisdiction as part of the Bankruptcy Reform Act of 1978.[46]

The judicial hearings that would ultimately lead to the Supreme Court's *Sampsell* opinion occurred before a bankruptcy referee having a summary jurisdiction of uncertain scope. The student of *Sampsell* will observe that the hearings before the referee occurred in two distinct judicial units.[47] The first judicial unit may be described as a "turnover" proceeding, and the second judicial unit may be described "claim objection" proceeding. No appeal was taken of the first judicial unit's order, pursuant to which the trustee took possession of the corporation's

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substantive consolidation in *Sampsell*. Yet in its reported opinion, the Fifth Circuit makes no reference to *Sampsell*, and expressly reserved for future decision the question of whether the bankruptcy court has the power to grant substantive consolidation.

[45] *See generally* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 147 (Princeton University Press 2001).

[46] *See, e.g.*, Jason C. Matson, *Running Circles Around Marathon? The Effect of Accounts Receivable as Core or Noncore Proceedings on the Article III Courts*, 20 BANKR. DEV. J. 451, 457 (2004) ("In response to criticism that the summary/plenary dichotomy under the 1898 Act led to additional delays, costs, and uncertainty to the participants in bankruptcies, and in response to the dramatic increase in the number of bankruptcies filed, Congress passed a sweeping reform of the Bankruptcy Code with the 1978 Reform Act." (citations omitted)). The Supreme Court would later declare Congress's attempt in 1978 to reform bankruptcy jurisdiction as unconstitutional. *See* N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 87 (1982).

[47] The concept that bankruptcy cases consist of several discrete judicial units is exemplified by the opinions allowing appeals of an order resolving a discrete unit in the larger bankruptcy case, so long as the order conclusively determine substantive rights. *See, e.g.*, Path-Science Labs., Inc. v. Greene County Hosp. (*In re* Greene County Hosp.), 835 F.2d 589, 594–96 (5th Cir. 1988).

assets. In the second judicial unit, a creditor of the corporation was denied its asserted priority claim, and appealed the adverse ruling to the Ninth Circuit.

1. Just the Facts

The following is a chronological presentation of the facts as reported in the two[48] *Sampsell* opinions:

- In 1933, Downey incurred a business related debt of approximately $125,000 to Standard Coatings. Later that year Downey negotiates a "workout" of his debt and agrees to give Standard Coatings all "net proceeds" from his ongoing textile business.
- In April 1936, Downey seeks to purchase wallpaper products on credit from Imperial Paper. Downey is told that Imperial Paper will not extend credit to him unless the Standard debt is settled.[49]
- In response, Downey forms a corporation called "Downey Wallpaper and Paint Co." Downey, his wife, and his son were the sole stockholders, directors and officers of this corporation. Downey never owned more than 1/3 of the shares of Downey Wallpaper, although it also appears that the wife and son paid nothing for their shares. Downey transfers his personal inventory of goods to Downey Wallpaper in exchange for a $7500 note.[50] A notice of bulk sale from Downey to Downey Wallpaper is filed of record.
- Downey's attorney reports these developments to Imperial Paper. Thereafter from 1936 through 1938, Imperial Paper extends $5400 of unsecured credit to Downey Wallpaper.
- In 1938, Downey files for bankruptcy.
- Downey Wallpaper did not file bankruptcy (notably neither the Ninth Circuit's opinion nor the Supreme Court opinion report that Downey Wallpaper was in bankruptcy).
- When Downey filed personal bankruptcy in 1938, the goods owned by Downey Wallpaper were not the same goods that Downey had transferred to Downey Wallpaper back in 1936.[51]

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[48] Certain facts not found in the Supreme Court's *Sampsell* opinion may be found in the earlier Ninth Circuit *Sampsell* opinion reported at 114 F.2d 49 (9th Cir. 1940), *rev'd*, Sampsell v. Imperial Paper Corp., 313 U.S. 215 (1941).

[49] 114 F.2d at 50–52.

[50] *Id.* at 50–51.

[51] *Id.* at 49–52.

Judicial Unit I: the Bankruptcy Referee's Turnover Order

- Paul W. Sampsell is appointed bankruptcy trustee for Downey.
- Upon the petition of the trustee, the bankruptcy referee issues a "show cause order" directed at Downey Wallpaper, Downey, and his wife and son, as to why the corporate assets should not be "marshaled" for the benefit of Mr. Downey's creditors.
- Downey files an answer.
- The referee finds that the transfer of the goods to the corporation was not in good faith, was made to defraud creditors, and that the corporation was nothing more than a "sham and a cloak."
- On April 7, 1939 an order granting the turnover is issued in favor of the trustee. No appeal is taken. Pursuant to the order, the trustee takes possession of the corporation's assets.[52]

Judicial Unit II: the Imperial Claim Objection Order

- Imperial Paper files a proof of claim in Downey's bankruptcy case for $5400, stating that as a corporate creditor it was entitled to priority.
- Trustee objects to the Imperial claim and asserts the priority should be denied.[53]
- The bankruptcy referee denies Imperial the requested priority claim per order of September 28, 1939.[54]
- Imperial appeals.
- In reversing the bankruptcy referee's denial of the requested priority claim, the Ninth Circuit "revisits" the merits of the turnover order issued in Judicial Unit I. This Article uses the term "revisits" because the Ninth Circuit held that: (i) since the corporation's goods on hand when Downey later filed bankruptcy were not the same goods that Downey had transferred to Downey Wallpaper when he set up that entity, no fraudulent transfer could have occurred, and (ii) because Downey did not own all or even a majority of the stock of Downey Wallpaper, it could not be his alter-ego under California law. The Ninth Circuit went beyond reviewing the merits of the debt owed to Imperial, but instead examined the substantive merits of the turnover order issued in

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[52] *Id.* at 52.

[53] Notably, the reported *Sampsell* opinions do not indicate that the trustee contested the amount of Imperial's claim, or challenged Imperial's right to participate as a general unsecured creditor in Downey's personal bankruptcy case. Rather, the trustee's objection appears aimed at Imperial's assertion of a right to priority over other creditors.

[54] 114 F.2d at 49.

Judicial Unit I. Concluding that the turnover order was incorrect, the Ninth Circuit reversed the referee's denial of Imperial's priority claim.

- The Supreme Court grants the Trustee's, Sampsell's, petition for review.
- The Supreme Court holds that the bankruptcy referee had jurisdiction to issue the turnover order, and thus the Ninth Circuit erred by permitting Imperial to make a collateral attack on the turnover order issued in the First Judicial Unit. Furthermore, the Court held that Imperial was not a lien creditor and Imperial had knowledge of the fraudulent character of Downey's corporation. Thus, Imperial failed to establish a right to priority claim treatment.

2. *Sampsell* amounts to an application of summary jurisdiction (and little else)

Under the former Bankruptcy Act, "summary jurisdiction" referred to the bankruptcy referee's subject matter jurisdiction. A "substantial adverse claimant" could defeat the summary jurisdiction of the bankruptcy referee. If Downey Wallpaper—the corporation owned by Downey's family members—were a substantial adverse claimant, then the referee lacked "summary jurisdiction," which is another way of saying the referee lacked subject matter jurisdiction. If Downey Wallpaper were a substantial adverse claimant, the referee's turnover order could be collaterally attacked, meaning that the substantive merits of the order could be reviewed in a separate judicial proceeding.

However, *Sampsell's ratio decidendi*[55] is that the bankruptcy referee had sufficient summary jurisdiction to grant a turnover order against the family-owned corporation. Consequently, the turnover order could not be collaterally attacked. *Sampsell* clarified that in addition to summary jurisdiction over property in the possession of the bankrupt, the referee's summary jurisdiction also extended to a corporation owned by the bankrupt and members of his immediate family, at least where badges of fraud existed at the time of formation of the corporation. In such circumstance, the bankruptcy trustee was not required to bring a plenary action in a state court.

With the jurisdictional ruling in place, the Court's remaining rulings in *Sampsell* were preordained. Consistent with well-established principles, the Court ruled the referee's turnover order against Downey Wallpaper could not be collaterally attacked by Imperial in a new proceeding. Imperial's contentions made in Judicial Unit II, such as Imperial's claim that Downey Wallpaper could not be Downey's

[55] *Ratio decidendi* is a Latin phrase meaning the reason for the decision. The process of determining the *ratio decidendi* is an analysis of what the court actually decided – essentially, based on the legal points about which the parties in the case actually fought. *See generally* BLACK'S LAW DICTIONARY 1290 (8th ed. 2004). With this in mind, if the Supreme Court "indirectly and inadvertently" affirmed substantive consolidation—as stated in *Owens Corning*—such indirect ruling would not constitute the actual *ratio decidendi* and thus would not constitute binding precedent.

alter-ego under California law, were rendered irrelevant.[56] Finally, because the Bankruptcy Act did not grant Imperial a statutory priority (such as the priority status granted to taxing authorities), the Court held that Imperial must share in the assets collected by the bankruptcy trustee pro rata with Downey's other creditors.

3. Lessons learned by *Sampsell's* reliance upon the "no collateral attack" doctrine

Justice Douglas observed that the referee's turnover order against Downey Wallpaper could not be "collaterally attacked."[57] What is the significance, for purposes of the substantive consolidation debate, of the Court's reliance upon the collateral attack principle to decide *Sampsell*?

The subject matter jurisdiction of the federal courts refers to the power of the courts to properly assume the determination of a case. As the Supreme Court has recognized, "jurisdiction to decide is jurisdiction to make a wrong as well as a right decision."[58] The "no collateral attack" principle recognizes that courts may on occasion make incorrect decisions, but that countervailing policies of finality must prevail. The "no collateral attack" principle precludes a subsequent challenge to an otherwise final order, regardless of whether the specific relief granted in the final order was correct from a substantive point of view, so long as the court that issued the order had subject matter jurisdiction to issue that general kind of order.[59]

The Supreme Court's recent *Travelers Indemnity Co. v. Bailey*[60] opinion sheds further light on when a bankruptcy court has sufficient subject matter jurisdiction to issue an order that cannot later be collaterally attacked, regardless of the substantive correctness of the order. In an earlier phase of the Johns-Manville proceeding, the bankruptcy court had issued an order approving a settlement of insurance "policy claims" that could have been asserted against non-bankrupt Travelers based upon the policies it had issued in favor of bankrupt Johns-Manville. In connection with the approval of the settlement in 1986, the bankruptcy judge issued a broad injunction restraining all persons from commencing or continuing any suit or proceeding for policy claims against Travelers.

Over a decade later Travelers returned to bankruptcy court in the Johns-Manville case seeking a "clarifying order" confirming that the 1986 injunction applied to plaintiff Bailey. Notably Bailey asserted Travelers had breached a direct legal duty to Bailey. Thus Bailey argued as a matter of substantive law the bankruptcy court administering the Johns-Manville bankruptcy lacked the power to

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[56] Sampsell v. Imperial Paper Corp., 313 U.S. 215, 218–19 (1941).

[57] *Id.* at 219.

[58] Pope v. United States, 323 U.S. 1, 14 (1944) (citing Fauntleroy v. Lum, 210 U.S. 230, 234–35 (1908); Burnet v. Desmornes, 226 U.S. 145, 147 (1912)).

[59] See, for example, *Chicot County Drainage Dist. v. Baxter State Bank*, 308 U.S. 371, 374, 376–78 (1940), where the Supreme Court cited the no collateral attack principle and refused to permit review of a plan of debt adjustment, even though the statute upon which the adjustment was based had been held unconstitutional in another case.

[60] 129 S. Ct. 2195 (2009).

enjoin Bailey's direct claim against non-bankrupt Travelers. On appeal Bailey persuaded the Second Circuit that the bankruptcy court could not enjoin Bailey's direct claims against Traveler's over which the bankruptcy court had no jurisdiction.

The Supreme Court reversed. Justice Souter, writing for the Court, noted that the issue of the bankruptcy court's subject-matter jurisdiction to enjoin direct suits against Travelers could have been challenged by an appeal of the 1986 injunction order. But the issue of whether or not the 1986 injunction was a proper exercise of the bankruptcy court's jurisdiction and power could not be collaterally attacked in the latter appeal.

Citing the Restatement (Second) of Judgments, the *Travelers Indemnity Co. v. Bailey* majority opinion provides examples of the kind of orders that if issued by a bankruptcy judge would be so far out of bounds that the court's subject matter jurisdiction could later be collaterally attacked. Justice Souter observes: "This is not a situation, for example, in which a bankruptcy court decided to conduct a criminal trial, or to resolve a custody dispute, matters 'so plainly beyond the court's jurisdiction' that a different result might be called for."[61]

Applying these principles to *Sampsell*, the referee's summary order directing that the bankrupt's family owned corporation turnover its assets to the trustee was not plainly beyond the referee's jurisdiction. It was not as if the referee in *Sampsell* imposed a criminal sentence against the bankrupt in a summary proceeding. However, the Supreme Court's refusal to allow Imperial to make a collateral attack against the referee's turnover order was no more an endorsement of the substantive correctness of the order than what occurred in *Travelers Indemnity Co. v. Bailey*. Indeed the Court expressly disclaimed having decided whether the bankruptcy judge actually had the substantive power to bar Bailey's direct claim against Travelers.[62]

Recognizing the distinction between a court's subject matter jurisdiction and a court's substantive power to grant relief to a party before it is the key to unlocking *Sampsell's* true *ratio decidendi*. A bankruptcy court may have subject matter jurisdiction over a controversy, yet lack the power to act.[63] The concept of "summary jurisdiction" under the former Bankruptcy Act refers to whether the bankruptcy referee had subject matter jurisdiction over the controversy before the referee. If the bankrupt had possession of property subject to a lien, the referee had subject matter jurisdiction to rule with respect to such lien. However, the Bankruptcy Act's summary jurisdictional grant did not invest the referee with say, the power to avoid a preference. Rather, another statute (or other source of

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[61] *Id.* at 2206 n.6.

[62] *See id.* at 2198 ("[The Court does] not resolve whether a bankruptcy court . . . could properly enjoin claims against nondebtor insurers that are not derivative of the debtor's wrongdoing.").

[63] See, for example, *Feld v. Zale Corp.* (*In re Zale Corp.*), 62 F.3d 746, 751 (5th Cir. 1995), in which the Fifth Circuit observed "[s]ubject matter jurisdiction and power are separate prerequisites to the court's capacity to act. Subject matter jurisdiction is the court's authority to entertain an action between the parties before it. Power under section 105 is the scope and forms of relief the court may order in an action in which it has jurisdiction."

substantive law) provides the judicial power to avoid the preference.[64] While a referee may have had summary jurisdiction over a bankrupt's family owned corporation, such subject matter jurisdiction does not grant the court an additional legislative-type power to announce substantive rules of decision concerning the corporation's liability to the bankruptcy trustee.

In *Sampsell*, Justice Douglas established the predicate for the Court's application of the "no collateral attack" principle, explaining the referee had summary jurisdiction to issue the turnover order against the family corporation. He emphasized that "there can be no question but that the jurisdiction of the bankruptcy court was properly exercised by summary proceedings" and the "legal paraphernalia" interposed by the debtor in that case was not sufficient to require the bankruptcy trustee to resort to a more formal plenary suit.[65] The Court's conclusion that the bankruptcy referee had summary jurisdiction over the trustee's petition against Downey Wallpaper necessarily leads to the conclusion that the referee's order could not be collaterally attacked. With the predicate for the "no collateral attack" principle established, the Court did not need to reach the merits of the turnover order. The Court did not rule on the correctness of the turnover order from a substantive point of view.

If the Supreme Court had been of the view that the referee correctly applied a federal substantive law remedy—now known as substantive consolidation—against the family owned corporation, there would have been no need for the Court to engage in the collateral attack analysis. If the bankruptcy referee had the power (under substantive law) to grant substantive consolidation, *Sampsell's* reliance upon the rule against collateral attack is rendered superfluous. By holding that the bankruptcy referee had summary jurisdiction, the Supreme Court was not required to reach the substantive merits of the turnover order.

The Supreme Court's *Sampsell* opinion stands in sharp contrast from that of the Ninth Circuit. The Ninth Circuit's *Sampsell* opinion reviewed the substantive merits of the turnover order, and concluded the bankruptcy referee erred in applying fraudulent transfer law and alter-ego law principles. In contrast, the Supreme Court did not reach the substantive merits of the turnover order, relying instead on the "no collateral attack" principle to preclude Imperial's attempt to re-litigate the trustee's right to the property.

Twenty-five years after deciding *Sampsell*, the Supreme Court referred back to *Sampsell* as authority for the proposition that the "normal rules of *res judicata* and collateral estoppel apply to the decisions of bankruptcy courts," and if a creditor's claim is rejected, "its validity may not be relitigated in another proceeding."[66] This subsequent citation to *Sampsell* indicates that the Supreme Court construes

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[64] *See, e.g.*, Tex. Indus., Inc. v. Radcliff Materials, Inc., 451 U.S. 630, 640–41 (1981) ("The vesting of jurisdiction in the federal courts does not in and of itself give rise to authority to formulate federal common law, . . . nor does the existence of congressional authority . . . mean federal courts are free to develop a common law . . . until Congress acts." (citation omitted)).

[65] Sampsell v. Imperial Paper & Color Corp , 313 U.S. 215, 218 (1941).

[66] Katchen v. Landy, 382 U.S. 323, 334 (1966) (citations omitted).

Sampsell to be an "issue preclusion" decision, rather than the "fountainhead" of substantive consolidation as more recently claimed.[67]

4. If *Sampsell* is *stare decisis* on the issue of a power to consolidate, why the continuing controversy over substantive consolidation of debtors with non-debtors?

Another basis upon which to evaluate whether *Sampsell* is a *stare decisis* ruling on substantive consolidation is to assess whether courts later perceived themselves bound by the decision. If *Sampsell* really were a *stare decisis* ruling on substantive consolidation, it should also constitute a *stare decisis* ruling that a non-bankrupt entity may be consolidated with a bankrupt affiliate. This is because the family owned corporation (Downey Wallpaper) was not in bankruptcy, yet was required to surrender its assets to Downey's trustee under a process some now claim amounts to a substantive consolidation.[68]

Yet in the post-*Sampsell* era, some courts have adopted a bright-line test that a non-bankrupt entity cannot as a matter of law be substantively consolidated with one that has filed a bankruptcy case.[69] To be sure, other courts have held that a non-debtor affiliate can be substantively consolidated with a debtor.[70] However, it is inexplicable that if *Sampsell* is a *stare decisis* ruling on substantive consolidation, lower courts perceive themselves free to split over whether they have the power to consolidate the assets and liabilities of a non-debtor with those of a debtor.

I argue that courts have split (and remain free to split) over this issue because *Sampsell* is not a *stare decisis* ruling on substantive consolidation. Because the

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[67] *See, e.g.*, Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1623 (2008) (discussing *Sampsell* as "fountainhead" case for substantive consolidation as entangled with fraudulent transfer).

[68] Amera and Kolod's article includes a detailed account of *Sampsell's* facts, and the article does not report that the Downey Wallpaper corporation was in bankruptcy. *See generally* Amera & Kolod, *supra* note 31. Kenneth C. Kettering concurs that only Downey (not the family owned corporation) filed bankruptcy. *See* Kettering, *supra* note 67, at 1623. Kettering describes substantive consolidation as an "equitable override of the ordinary axiom that each entity's assets and liabilities stand on their own." *Id.* at 1625. Kettering acknowledges that the Supreme Court in more recent times "has expressed skepticism in other settings about the authority of federal courts generally, and bankruptcy courts in particular, to exercise substantive powers based upon equitable competence that is not founded on an explicit statutory grant," citing *Grupo Mexicano*, among other authorities. *See id.* at 1625 n.242. Ultimately, he dismisses such challenges to substantive consolidation on the basis that "a pedigree so long and deep is its own authority." *Id.* at 1625.

[69] *See* Peoples State Bank v. Gen. Elec. Capital (*In re* Ark-La-Tex Timber Co.), 482 F.3d 319, 327 n.7 (5th Cir. 2007); *In re* Lease-A-Fleet, Inc., 141 B.R. 869, 875–77 (Bankr. E.D. Pa. 1992); *In re* DRW Prop. Co., 54 B.R. 489 (Bankr. N.D. Tex. 1985); *In re* Alpha & Omega Realty, Inc., 36 B.R. 416 (Bankr. D. Idaho 1984). An article which captures this ongoing debate is Predko, *supra* note 41 (arguing that courts should not substantively consolidate estates of non-debtors with estates of debtors).

[70] *See* Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 771 (9th Cir. 2000) (permitting consolidation of debtor and non-debtor when "the assets of all of the consolidated parties are substantially the same"); *In re* Alico Mining, Inc., 278 B.R. 586, 588 (Bankr. M.D. Fla. 2002) (recognizing bankruptcy courts may grant substantive consolidation between debtor and non-debtor if "the affairs of the entities are inextricably intertwined or that creditors dealt with them as a single economic unit"). See also Weitnauer, *supra* note 26, at 44–46, providing many citations to opinions where courts have allowed the substantive consolidation of a non-debtor into a debtor estate.

Sampsell decision turned on whether subject matter jurisdiction existed, lower courts remain free to independently analyze the merits of the issue. At present, lower courts have not relied upon *Sampsell* in the manner usually expected of binding precedent.

5. *Sampsell's* enigmatic phrase: "consolidating the estates"

One might reasonably ask: How have several courts reached the erroneous conclusion that the Supreme Court authorized substantive consolidation in *Sampsell*? I argue the confusion flows from transferring the term "consolidating"—having a peculiar meaning in contemporary bankruptcy parlance—backwards several decades to Justice Douglas's use of the word in the following *Sampsell* passage:

> Furthermore, there was no appeal from the order entered in the summary proceedings. It therefore could not be collaterally attacked in the proceedings by which respondent sought priority for its claim.
> That conclusion, of course does not mean that the **order consolidating the estates** did, or in the absence of the respondent as a party, could determine what priority, if any, it had to the corporate assets.[71]

Application of contemporary meanings to words and phrases found in judicial opinions issued six decades ago can be hazardous. The legal meaning to be assigned to the words should depend on the intention of the opinion's author, not their contemporary meanings. The following is an illustration:

> While walking in the desert near the border between the United States and Mexico, you come across marks in the sand forming the figures "REAL," and you wonder what these marks mean. Your first step will be to guess whether the marks were made by an English-speaking or Spanish-speaking agent. If you think the marks were made by an English speaker, you probably will interpret them to mean something like "real" in the sense of "actual" or "existing." If you suppose instead that the marks were made by someone speaking Spanish, then you will understand them to mean something like the English term "royal." But if you think the marks were made by no one, and were instead simply the fortuitous effect of wind on the desert sand, then you will not

[71] Sampsell v. Imperial Paper Corp., 313 U.S. 215, 219 (emphasis added).

> suppose the marks actually mean anything at all; they are merely a strange accident devoid of meaning.[72]

Similarly, the reader of *Sampsell* encounters the phrase "order consolidating the estates."[73] If you suppose (as I do) that *Sampsell* is a ruling about the extent of a bankruptcy referee's subject matter jurisdiction, then you may construe the phrase "order consolidating the estates" as a colorful (but redundant) phrase that refers to the earlier "order entered in the summary proceedings."[74] However, if you suppose that *Sampsell* announces a new doctrine—later named substantive consolidation—then you necessarily will construe Justice Douglas's use of the phrase "order consolidating the estates" as authorizing a new judge-made substantive right.

I argue that Justice Douglas was simply using a picturesque phrase rather than announcing a brand new substantive rule of federal law.[75] While the phrase "order consolidating the estates" may have described a practical consequence of the referee's turnover order, the context in which the phrase is used does not indicate the Court ruled upon the substantive correctness of the order. Rather, the "order consolidating the estates" phrase is simply used in a transition paragraph in which Justice Douglas frames the next issue, whether the referee could have determined Imperial's priority claim in the absence of Imperial as a party.

The phrase "order consolidating the estate" is reminiscent of the phrase "old stockholders make a fresh contribution" that Justice Douglas used in *Case v. Los Angeles Lumber Products Co, Ltd.*[76] Courts and practitioners later have cited Justice Douglas' "fresh contribution" phrase as authority for the "new value exception" or "new value corollary" to the absolute priority rule.[77] However, colorful phrases do not make substantive law. The Supreme Court later observed in *In re 203 N. LaSalle St. Partnership* that even though "counsel for one of the parties here has described the *Case* observation as 'black-letter' principle, it never rose above the technical level of *dictum* in any opinion of this Court . . . ."[78]

Under rules of *stare decisis*, only the Court's *ratio decidendi* must be followed in future cases.[79] The *ratio decidendi* of *Sampsell* is that the referee had summary

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[72] STEVEN D. SMITH, LAW'S QUANDARY 108–09 (Harvard University Press 2006) (recounting hypothetical case devised by Paul Campos).

[73] 313 U.S. at 219.

[74] *Id*.

[75] To further add context, it should be noted that the Supreme Court had announced *Erie v. Tompkins*, 304 U.S. 64 (1938), just three years earlier, thus commencing a new era that shunned reliance upon federal common law rules of decision.

[76] 308 U.S. 106, 121 (1939).

[77] *See, e.g.*, 526 U.S. 434, 445 (1999).

[78] Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 445 (1999).

[79] See also *Kaye v. Hughes & Luce, LLP*, No. 3:06-CV-01863-B, 2007 WL 2059724, at *6 (N.D. Tex. July 13, 2007), which notes two kinds of *dicta*, namely *obiter dictum* and judicial *dictum*. This opinion notes that *obiter dictum* is "an observation or judicial comment made during the course of delivering a judicial opinion, but one that is unnecessary to the decision in the case and therefore not precedential." Judicial dictum is "an opinion by a court on a question that is directly involved, briefed, and argued by counsel, and even passed on by the court, but that is not essential to the decision." *Id.* This opinion notes that judicial dictum is generally

jurisdiction to issue the turnover order against the bankrupt's family owned corporation. I argue the Supreme Court similarly would construe the *order consolidating the estates* phrase as mere dicta. Justice Douglas' picturesque reference to "consolidation" constitutes *obiter dicta*, not the rule for which *Sampsell* stands.

This Article also construes the word "consolidating" as redundant. The *Sampsell* opinion makes reference to the "order entered in the summary proceedings"[80] and later to the "order consolidating the estates"[81] and then later refers to the fact that "title to the property fraudulently conveyed has vested in the bankruptcy trustee of the grantor."[82] Does each such phrase have an independent meaning necessary to the outcome of the opinion? Of course not. While the phrase *order consolidating the estates* makes for a more lively opinion on an otherwise dry topic, substantively the phrase is redundant of the early "order entered in the summary proceedings" phrase. Justice Douglas' passing reference to the *order consolidating the estates* amounts to a judicial comment made during the course of delivering a judicial opinion, which was unnecessary to the decision in the case. The opinion could have twice used the "order entered in the summary proceedings" phrase instead of the "order consolidating the estates" without changing the outcome of the *Sampsell* opinion.

Notably, in *Marshall v. Marshall*, Justice Ginsburg, writing for the Court, treated similar language used by the Court six decades earlier as redundant, noting "[r]edundancy in this context, we do not doubt, is preferable to incoherence."[83] Treating the phrase "order consolidating the estates" as redundant to "order entered in the summary proceedings" is preferable to treating the phrase as an inadvertent license for federal courts to modify state corporate law.

Confusion over the scope of *Sampsell's* holding may also arise from the Court's use of the word "jurisdiction." The word "jurisdiction" has many meanings, as explained by Justice Ginsburg, again writing for the Court:

> "Jurisdiction," this Court has observed, "is a word of many, too many, meanings." This Court, no less than other courts, has sometimes been profligate in its use of the term . . . . On the subject-matter jurisdiction/ingredient-of-claim-for-relief dichotomy, this Court and others have been less than meticulous.[84]

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entitled to greater weight. *Id.* Under this dichotomy, Justice Douglas' vague reference to "consolidating" was unnecessary to the decision, and therefore should not constitute precedent.

[80] Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 218 (1941).

[81] *Id.* at 219.

[82] *Id.* at 221.

[83] Marshall v. Marshall, 547 U.S. 293, 311 (2006).

[84] Arbaugh v. Y&H Corp., 546 U.S. 500, 510–11 (2006) (quoting Steel Co. v. Citizens for a Better Env't, 523 U.S. 83, 90 (1998)); *see also* Kontrick v. Ryan, 540 U.S. 443, 455 (2004) (stating "clarity would be facilitated if courts and litigants used the label 'jurisdictional'" only when referring to "subject-matter jurisdiction"). These cases teach that references to a federal court's "jurisdiction" normally mean its subject matter jurisdiction.

Such confusion may have led the Ninth Circuit to conclude *Sampsell's* reference to the referee's "jurisdiction"[85] constituted a "tacit" approval of substantive consolidation.

However, as Justice Ginsburg has suggested with respect to "jurisdiction" generally, *Sampsell's* reference to "jurisdiction" should be construed to mean "subject matter jurisdiction."[86] Jurisdiction in the subject matter sense refers to the power of the federal courts to properly assume the determination of a case. Jurisdiction to decide a case is jurisdiction to make a wrong as well as a right decision.[87] *Sampsell's* holding that the referee had subject matter jurisdiction to issue the order consolidating the estates does not mean the Court decided whether the order was right or wrong from a substantive point of view. To affirm a bankruptcy referee's order on the basis it had subject matter jurisdiction, and to protect it from collateral attack, is not the same as affirming the substantive merits of an order.

6. Concluding thoughts on *Sampsell*

Sampsell was decided just three years after the Court's Justices dramatically narrowed the concept of "federal common law" in the landmark *Erie* decision.[88] Writing for the Court, Justice Brandeis observed that the notion of federal common law "rests upon the assumption that there is a transcendental body of law outside of any particular State."[89] Rejecting the notion of a federal common law, the Court vindicated Justice Holmes' earlier view that the "common law is not a brooding omnipresence in the sky, but the articulate voice of some sovereign or quasi sovereign that can be identified . . . ."[90]

The notion that three years after *Erie* the Supreme Court invented a new federal substantive law out of whole cloth, eventually to be called substantive consolidation, suggests that the Justices were suffering from amnesia. The doctrine of substantive consolidation had not been articulated by Congress, state legislatures, or state common law courts in 1941. Why would the Justices reverse the course they set in *Erie*, and instead rely upon what amounts to some transcendental body of

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[85] *E.g.*, *Sampsell*, 313 U.S. at 218 ("There can be no question but that the jurisdiction of the bankruptcy court was properly exercised by summary proceedings."). The Ninth Circuit has treated this statement as a "tacit" approval of substantive consolidation. *See* Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 764 (7th Cir. 2000) ("[T]he substantive consolidation of two estates was first tacitly approved [in *Sampsell*] by the Supreme Court in the context of a debtor who had abused corporate formalities and allegedly made fraudulent conveyances of the debtor shareholder's assets to the corporation.").

[86] *See* BLACK'S LAW DICTIONARY 991 (4th ed. 1951) (defining "jurisdiction" as "the authority by which courts and judicial officers take cognizance of and decide cases").

[87] Pope v. United States, 323 U.S. 1, 14 (1944).

[88] Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).

[89] *Id.* at 79 (quoting Black & White Taxicab Co. v. Brown & Yellow Taxicab Co., 276 U.S. 518, 533 (1928)).

[90] S. Pac. Co. v. Jensen, 244 U.S. 205, 222 (1917) (Holmes, J., dissenting).

federal substantive law to decide the merits of *Sampsell*? The more plausible view is that the Justices did not change course, but merely construed the scope of the bankruptcy court's summary jurisdiction and then applied the well-established no collateral attack doctrine.

Today *Sampsell* serves as a testament to the difficulties faced by courts and practitioners in construing the scope of the referee's summary jurisdiction under the former Bankruptcy Act. With the passage of the Bankruptcy Reform Act of 1978 and its revamp of the bankruptcy court jurisdictional statute, *Sampsell's* actual holding has little application in contemporary practice. If the claim that *Sampsell* is stare decisis on substantive consolidation is ever made to the Supreme Court, this Article predicts the Court will disclaim paternity of the doctrine.[91]

B. The remedy of substantive consolidation was not "exercised" by the English Chancellor

Grupo Mexicano generally requires the proponent of an equitable remedy to provide English precedent that the remedy was "exercised" by the Chancellor prior to 1789. The opinion is not fairly read to authorize expansion of historic equitable remedies into new areas (such as corporate law) by use of analogies. The practical problem with *Grupo Mexicano's* Equity Cutoff Rule is that it seems to require courts to examine ancient legal texts to find support for equitable remedies.

However, the Supreme Court has approved reliance upon secondary sources such as legal treatises. In *Great West Life & Annuity Insurance Company v. Knudson*,[92] Justice Scalia explains that in evaluating whether non-traditional equitable relief is available, "[r]arely will there be need for any more 'antiquarian inquiry' . . . than consulting, as we have done, standard current works such as Dobbs, Palmer, Corbin, and the Restatements, which make the answer clear."[93]

An inspection of Dobbs, Palmer, Corbin, and the Restatements provides no historic equitable authority for the substantive consolidation doctrine. That is hardly surprising. As discussed in my Prior Article, the origins of the uniquely federal doctrine of substantive consolidation can be traced to four decisions from the Second Circuit in the 1960s and 1970s.[94]

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[91] The Third Circuit appears to have hedged its bet that *Sampsell* is binding authority, commenting the Supreme Court "at least indirectly and perhaps inadvertently" authorized substantive consolidation. *In re* Owens Corning, 419 F.3d 195, 206 (3d Cir. 2005). Notably the issue of whether *Sampsell* constitutes a binding precedent was not briefed in the *Owens Corning* appeal, as the appellant never directly challenged the authority of the bankruptcy court to consolidate; rather the appeal centered on the correct standard to be applied. *See generally In re Owens Corning*, 419 F.3d 195.

[92] 534 U.S. 204 (2002).

[93] *Id.* at 217.

[94] As discussed in my Prior Article, *Grupo Mexicano and the Death of Substantive Consolidation*, the Second Circuit's four seminal cases upon which the uniquely federal doctrine of substantive consolidation is based are: *James Talcott, Inc. v. Wharton (In re Cont'l Vending Mach. Corp.*), 517 F.2d 997, 1000–02 (2d Cir. 1975); *Flora Mir Candy Corp. v. R.S. Dickson & Co.* (*In re Flora Mir Candy Corp.*), 432 F.2d 1060, 1062–64 (2d Cir. 1970); *Chemical Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966); *Soviero*

Nevertheless, a challenge to my prior article, *Grupo Mexicano and the Death of Substantive Consolidation (Grupo Mexicano)'s* assertion that substantive consolidation is an equitable remedy of recent vintage has been made by William H. Widen.[95] Notably, Widen accepts the proposition that the validity of substantive consolidation must withstand scrutiny under *Grupo Mexicano*'s Equity Cutoff Rule. Widen asserts the Equity Cutoff Rule is not violated because he contends substantive consolidation may be traced back to a seventeenth century English opinion. Widen cites *Naylor v. Brown*, [96] in which an English court determined the rights of creditors of the Woodmongers Company. A bond initially had been titled in the Company. Plaintiff Naylor loaned money to the Company. Subsequently, the Company assigned the bond to Sir William Wild, as trustee for the Company's owners. The debts owed to Naylor remained unpaid upon the Company's later demise. The English court avoided the assignment from the Company to Sir William Wild so that the bond could be used to pay the Company's debts owed to "Strangers" (the Company's non-member creditors, including Naylor) before payment of debts owed to the members of the Company.

Widen argues that the assignment of the bond by the Company to Sir William Wild is analogous to a modern day "asset partitioning" as between a parent company and its corporate subsidiary. I disagree. Sir William Wild, who served as trustee, was not a "subsidiary" of the Company in the modern corporate law sense, but instead, Sir Wild received an assignment (in substance a pledge) of a specific asset (the bond) of the Company. The *Naylor v. Brown* opinion indicates the court was also influenced by the fact certain members (who were beneficiaries of Sir Wild's trust) had "set their Names"[97] to the debt instrument held by Naylor to induce him to make the loan to the Company. While such members had not legally bound themselves to repay Naylor, under these facts, the court concluded the Company's attempt to prefer insiders was inequitable, and the court further observed that: "as Bankrupts usually do, who knowing they shall break, pay such Friends as they like best."[98]

I conclude that *Naylor v. Brown* is appropriately classified as an early example of the remedy now known as "equitable subordination" in the sense the bond debt was held for the benefit of the member insiders. This principle has been codified in

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v. Franklin National Bank of Long Island, 328 F.2d 446, 448 (2d Cir. 1964). I will refer to these opinions as the "pre-Code Four" in this Article. The term "substantive consolidation" appears for the first time in 1977. *See In re* Commercial Envelope Mfg. Co., No. 76 B 2354, 1977 WL 182366, at *1 (Bankr. S.D.N.Y. Aug. 22, 1977); *see also* Tucker, *Grupo Mexicano*, *supra* note 11, at 432. Notably each of these opinions predate the Supreme Court's opinions in *Butner* and *Grupo Mexicano*, both of which reject the applicability of federal judge-made rules and remedies.

[95] *See* Widen, *supra* note 2, at 317.

[96] (1674) 23 Eng. Rep. 44 (Ch.).

[97] *Id.* at 45.

[98] *Id.* at 44.

section 510(c) of the Bankruptcy Code. Thus I do not construe *Naylor v. Brown* as seventeenth century authority for substantive consolidation.[99]

The doctrine of substantive consolidation did not emerge until well into the twentieth century. This assertion is corroborated by the article by Henry Hansmann, Reinier Kraakman, and Richard Squire[100] tracing the historical development the concept of "entity shielding" in business organization law. Starting from ancient Roman times, through medieval Italy, early modern England, to the contemporary United States, the concept of "entity shielding" has played an important role in the capital formation of business enterprises. Absent fraud, assets contributed by members to a business organization are "shielded" from creditors of the owners. The entity shielding principle was clearly adopted in the English partnership law. The principle known as the "jingle rule" denied creditors of a partner a direct claim on partnership assets, and vice versa. The emergence of the jingle rule is inconsistent with the notion that the eighteenth century English Chancellor would have allowed a substantive consolidation remedy.

Hansmann, Kraakman, and Squire also observe that English corporate law only began to develop with respect to private corporations in 1844, when Parliament enacted a statute permitting incorporation as a matter of right.[101] This also refutes the notion that the substantive consolidation doctrine could have first evolved in seventeenth century chancery cases.[102]

The hypothesis that the remedy of substantive consolidation can be traced back to seventeenth century English practice suffers from another problem. If English courts had invented this remedy in the seventeenth century, one would reasonably expect to encounter this remedy in contemporary English jurisprudence. Yet a contemporary English lawyer has written that English courts have not adopted the

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[99] Widen also cites section 502 of the Bankruptcy Code—which governs the allowance of claims—as a statutory source of authority for substantive consolidation. Widen argues creditors could file a proof of claim for substantive consolidation in the cases of the affiliated debtors. However, the existence of a "claim" is determined by reference to state law or applicable non-bankruptcy law. *See* Raleigh v. Ill. Dep't of Revenue, 530 U.S. 15, 20 (2000). Substantive consolidation has no existence outside of a bankruptcy case.

[100] *See* Hansmann et al, *supra* note 3, at 1402 (discussing how doctrine of substantive consolidation arose).

[101] *Id.* at 1386 (stating Parliament was induced in 1844 to enact statute allowing incorporation).

[102] Ryan W. Johnson also asserts that substantive consolidation was exercised prior to 1789. *See* Johnson, *supra* note 37, at 63. Relying upon William Cooke's historic treatise, THE BANKRUPT LAWS, which in turn discusses *Ex Parte Haydon* and *Ex Parte Hodgson*, Johnson reports these eighteenth century cases hold that: "debts whether sole or joint ought to be paid out of the bankrupt's estate, which is comprised out of his separate estate, and of his moiety on the joint estate and therefore [the partnership creditor] should come in *pari passu* with the separate creditors." *Id.* at 63 n.23. Johnson argues that by allowing a partnership creditor to share *pari passu* with the separate creditors of the partner, English courts have ordered substantive consolidation. *Id.* I argue Johnson has made an unwarranted extension of the actual holding of these eighteenth century partnership cases. Normally, the "jingle rule" denied a creditor of an insolvent partnership a claim against the insolvent partner. *See, e.g., In re* Eber-Acres Farm, 82 B.R. 889, 893 (Bankr. S.D. Ohio 1987) (providing example of "jingle rule" violation). However, under the peculiar circumstances of *Ex Parte Haydon* and *Ex Parte Hodgson*, the English court allowed a partnership creditor to participate as a creditor in the partner's bankruptcy estate. *See* Johnson, *supra* note 37, at 63 n.23. These cases do not authorize a pooling of all assets and liabilities of a general partnership with one or more of the general partner thereof. *Id.* There is a fundamental difference between allowing a claim against a partner and the pooling of all assets and liabilities in the modern sense of substantive consolidation. *Id.*

substantive consolidation doctrine, viewing it instead as an American law development.[103] Professor Schmitthoff also has concluded that English law has not yet begun to grapple with the problem of corporate group liability.[104]

Another hurdle to those hoping to prove substantive consolidation was exercised by the eighteenth century Chancery court can be found in the Supreme Court's *Central Virginia Community College v. Katz*[105] opinion. Writing for the Court, Justice Stevens notes:

> More generally, courts adjudicating disputes concerning bankrupts' estates historically have had the power to issue ancillary orders enforcing their *in rem* adjudications. *See, e.g.*, 2 W. BLACKSTONE, COMMENTARIES ON THE LAW OF ENGLAND 486 (1766) (noting that the assignees of the bankrupt's property—the eighteenth century counterparts to today's bankruptcy trustees—could "pursue any legal method of recovering [the debtor's] property so vested in them" and could pursue methods in equity with the consent of the creditors).[106]

If eighteenth century equity practice required creditor consent, it follows that the English chancellor lacked the power to grant substantive consolidation without the consent of creditors.[107] Justice Steven's observation tends to further refute the notion that the English Chancellor exercised a power to impose substantive consolidation over the objection of creditors. In sum, the argument that substantive consolidation was "exercised" by the pre-1789 English Chancellor lacks support in the historical record, and lacks intuitive appeal.

C. Tethering section 105(a) orders to a "provision" of the Code.

Since the publication of the Prior Article, courts and commentators have continued to debate the viability of section 105(a) of the Bankruptcy Code as statutory authority for substantive consolidation as well as other remedies unique to bankruptcy. The first sentence of section 105(a) of the Bankruptcy Code states that a bankruptcy court "may issue any order, process, or judgment that is necessary or

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[103] *See* Simon Bowmer, *"To Pierce or Not to Pierce" The Corporate Veil and Why Substantive Consolidation is Not an Issue Under English Law*, 15 J. INT'L BANKING L. 193 (2000); *see also* Substantive Consolidation Opinions, *supra* note 38, 418 (substantive consolidation is creature of U.S. bankruptcy law).

[104] *See* C.M. Schmitthoff, LEGAL PROBLEMS OF MULTINATIONAL CORPORATIONS 71, 82 (K. Simmonds ed. 1977).

[105] 546 U.S. 356 (2006).

[106] *Id.* at 370 (emphasis added).

[107] I agree with the proposition that the bankruptcy court that has subject matter jurisdiction over the assets of the debtor may issue a binding order of consolidation with another debtor with the consent of the creditors. *See* Conclusion Part B., *infra* (proposing such practice be labeled "consensual consolidation").

appropriate to carry out the provisions of"[108] the Bankruptcy Code. Section 105(a) empowers bankruptcy courts to issue decrees necessary to carry out substantive provisions of the Bankruptcy Code. For example, a sale free and clear of liens[109] is a substantive power authorized by section 363(f) of the Bankruptcy Code. Assume the bankruptcy court grants a sale free and clear, but a lienholder is unhappy with the result, and commences foreclosure of its lien notwithstanding such order. Issuance of a section 105(a)-based injunction against such lienholder would carry out the provisions of section 363(f) of the Bankruptcy Code. If a lienholder could disregard sales free and clear, prices achieved at bankruptcy sales would be seriously depressed. While an injunction to enforce section 363(f) is not expressly authorized by the Bankruptcy Code, application of section 105(a) powers to enforce the benefits of section 363(f) is faithful to the text of section 105(a).

1. Survey of recent section 105(a) decisions generally

The Prior Article[110] argues that section 105(a) fails as an independent source of substantive authority for substantive consolidation because exercise of section 105(a) powers is textually conditioned upon there being a "provision" of the Bankruptcy Code to be carried out by a section 105(a) order.[111] A common thread in many reported opinions is that valid section 105(a) orders are tethered to aiding the bankruptcy court's enforcement of another statutory provision of the Bankruptcy Code. Since the Prior Article, several Second and Seventh Circuit opinions have recognized that a proposed exercise of section 105(a) powers must be tied to a provision of the Bankruptcy Code. For example, in *In re Dairy Mart Convenience Stores, Inc.*, the Second Circuit explains:

> The equitable power conferred on the bankruptcy court by section 105(a) is the power to exercise equity in carrying out the *provisions* of the Bankruptcy Code, rather than to further the purposes of the Code generally, or otherwise to do the right thing. This language "suggests that an exercise of section 105 power be

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[108] 11 U.S.C. § 105(a) (2006).

[109] 11 U.S.C. § 363(f) (2006).

[110] *See* Tucker, *Grupo Mexicano*, *supra* note 11, at 445.

[111] *See, e.g.*, New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (*In re* Dairy Mart Convenience Stores, Inc.), 351 F.3d 86, 92 (2d Cir. 2003) ("The equitable power conferred on the bankruptcy court by section 105(a) is the power to exercise equity in carrying out the *provisions* of the Bankruptcy Code, rather than to further the purposes of the Code generally, or otherwise to do the right thing. This language 'suggests that an exercise of section 105 power be tied to another Bankruptcy Code section and not merely to a general bankruptcy concept or objective.'" (quoting 2 COLLIER ON BANKRUPTCY ¶ 105.01[1], at 105-6) (Alan N. Resnick et al. eds., 15th ed. rev. 2006))). See also Jamo v. Katahdin Fed. Credit Union (*In re* Jamo), 283 F.3d 392, 403 (1st Cir. 2002), which declares that section 105 may be invoked only if the equitable remedy dispensed by the Court is necessary to preserve an identifiable right inferred elsewhere in the Code.

> tied to another Bankruptcy Code section and not merely to a general bankruptcy concept or objective."[112]

In another decision, the Second Circuit notes that "section 105(a) does not provide bankruptcy courts with a roving writ, much less a free hand. The authority bestowed thereunder may be invoked only if, and to the extent that, the equitable remedy dispensed by the court is necessary to preserve an identifiable right conferred elsewhere in the Bankruptcy Code."[113] The Seventh Circuit views section 105(a) as a "means to enforce the Code rather than an independent source of substantive authority."[114]

As its name suggests, substantive consolidation is a "substantive" rule of law. Substantive consolidation modifies the principle of structural subordination, and alters asset-to-debt ratios of affiliated entities by pooling their assets and liabilities in a manner unknown to state law.[115] Because section 105(a) is not an independent source of substantive authority, section 105(a) standing alone fails as authority for substantive consolidation under these Circuit Court authorities.

2. *Stone & Webster* relies upon section 105(a) but fails to apply basic rules of statutory sequencing

The *In re Stone & Webster, Inc.* opinion[116] rejects the assertion that *Grupo Mexicano* adversely impacts substantive consolidation. As discussed below, this opinion purports to link section 105(a) with another provision of the Code in order to establish a statutory basis for consolidation. In the *Stone & Webster* bankruptcy case, the official creditors committee had proposed a chapter 11 plan that provided for the substantive consolidation of a holding company and seventy-two subsidiaries. Prior to requesting confirmation, the creditors committee filed a separate motion for substantive consolidation. An objection was filed by the equity committee, asserting that consolidation was invalid under *Grupo Mexicano*. The bankruptcy court, citing a combination of *Sampsell*, section 1123(a)(5)(C) of the Bankruptcy Code, and section 105(a) of the Bankruptcy Code, rejected the equity committee's contention.[117]

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[112] 351 F.3d at 92 (quoting 2 COLLIER ON BANKRUPTCY ¶ 105.01[1], at 105-6).

[113] *In re Jamo*, 283 F.3d at 403.

[114] *In re* UAL Corp., 412 F.3d 775, 778 (7th Cir. 2005).

[115] It is well-established that substantive consolidation is quite different from "joint administration" allowed by procedural rule FED. R. BANKR. P. 1015, concerning bankruptcy cases of affiliates. The Advisory Committee Note states "consolidation, as distinguished from joint administration, is neither authorized nor prohibited by this rule." FED. R. BANKR. P. 1015 advisory committee's note.

[116] 286 B.R. 532 (Bankr. D. Del. 2002). *Stone & Webster* has been favorably reviewed by David B. Stratton, *Equitable Remedies in Bankruptcy Court: Grupo Mexicano, Substantive Consolidation and Beyond*, 22 AM. BANKR. INST. J. 24 (Mar. 2003).

[117] *In re Stone & Webster*, 286 B.R.at 534–36. The inadequacies of section 1123(a)(5)(C) of the Bankruptcy Code as authority for substantive consolidation were addressed in, *Grupo Mexicano*. Tucker, *Grupo Mexicano, supra* note 11, at 449 ("The text of section 1123(a)(5)(C) provides no authority for the

It is the *Stone & Webster* court's construction of the "best interest test"[118] that merits attention at this point. The equity committee argued that the plan's substantive consolidation provisions failed the "best interests of creditors test" set forth in section 1129(a)(7) of the Bankruptcy Code. The equity committee argued that the Debtors' chapter 11 plan could not meet the test because the holding company creditors would receive less than 100 percent if consolidated with the subsidiaries, but holding company creditors would be paid in full if not consolidated.[119]

Before confirming a plan that provides for section 1123(a)(5)(C)-based consolidation, this Article argues a bankruptcy court is first required to make a chapter 7 liquidation analysis on a non-consolidated basis for each entity that is proposed to be consolidated in a chapter 11 plan. Since chapter 7 lacks any statutory authority for consolidation (and as discussed above, *Sampsell* fails as authority for consolidation in chapter 7), an entity-by-entity measurement is required. The following chart depicts the impact (measured by asset-to-debt ratios) in a hypothetical chapter 7 liquidation similar to that described in *Stone & Webster*, of a solvent parent corporation and its insolvent wholly-owned subsidiary, as stand-alone entities, then as a substantively consolidated single entity.

	Parent Company	***Subsidiary Company***	***Consolidated Estate***
Assets	$3,000,000	$4,000,000	$7,000,000
Debts	$2,000,000	$8,000,000	$10,000,000
Asset/Debt Ratio	150%	50%	70%

Substantive consolidation under a chapter 11 plan of such parent and subsidiary takes value from the "richer" parent bankruptcy estate as measured by debt-to-asset ratios and gives value to the "poorer" subsidiary estate. What protects against such result? The "best interest test" guards against that result. Some courts have

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exercise of the remedy of substantive consolidation *independent* of the confirmation of the plan."). Sabin Willett shares my skepticism. *See* Willett, *supra* note 34, at 91 (noting use of section 1123(a)(5)(C) as grounds to establish substantive consolidation is "strange argument"). Widen acknowledges that section 1123 was not intended to establish a federal rule of substantive consolidation: "The reality is that, though section 1123 expressly contemplates mergers and consolidations, this reference likely refers to conventional state law procedures that sometimes are followed as part of a reorganization plan." Widen, *supra* note 2, at 224 (emphasis added).

[118] *See* 11 U.S.C. § 1129(a)(7)(A)(ii). This statutory best interest test "is an individual guaranty to each creditor or interest holder that it will receive at least as much in reorganization as it would in liquidation." 7 COLLIER ON BANKRUPTCY, ¶ 1129.03[7], at 1129-45 (Alan N. Resnick et al. eds., 15th ed. rev. 2002). Paragraph (7) of subsection 1129(a) requires a comparison between what each member of a class will receive under a plan and what such claimant would receive in liquidation. 7 COLLIER ON BANKRUPTCY, ¶ 1129.03[7][b][iii], at 1129-47.

[119] *In re Stone & Webster*, 286 B.R. at 544. The Commercial Finance Association made a similar "best interest" test argument in the *Owens Corning* appeal; however, the Third Circuit concluded that it was not required to reach that argument. *In re* Owens Corning, 419 F.3d 195, 209 n.14 (3d Cir. 2005).

recognized that the best interest test requires a comparison of creditor recoveries without consolidation, against the outcome if estates are consolidated.[120]

However, the *Stone & Webster* opinion rendered such entity-by-entity liquidation analysis irrelevant as a matter of law. *Stone & Webster* reasons (in my opinion incorrectly) that such entity-by-entity measurement amounts to an "apples and oranges" comparison, and orders that hypothetical chapter 7 "best interest test" be made on a consolidated basis.[121] I will refer to this rule as the "*Stone & Webster* Consolidation Rule."[122]

The *Stone & Webster* Consolidation Rule is flawed because it applies section 105(a) and section 1123(a)(5)(C) out of proper statutory sequencing to authorize what amounts to consolidated balance sheet accounting for purposes of determining whether a plan complies with the section 1129(a)(7) best interest test. A plan proponent's proposed use of section 105(a) and section 1123(a)(5)(C) to consolidate separate entities under a chapter 11 plan must await approval of the plan at a confirmation hearing. The plan proponent must scale the hurdles of chapter 11, including the best interest test, before the plan may be confirmed.[123] To grant substantive consolidation premised upon section 105(a) and section 1123(a)(5)(C) prior to confirmation fails the statutory sequencing required by the Bankruptcy Code.

As demonstrated by the Supreme Court's holding in *Florida Department of Revenue v. Piccadilly Cafeterias, Inc.*,[124] statutory sequencing matters in chapter 11. The Piccadilly debtor attempted to use the section 1146 "stamp tax" exemption out of sequence. Section 1146 exempts sales made under a confirmed plan from stamp taxes. Piccadilly argued that since section 1123(a)(5)(D) of the Bankruptcy Code allows a chapter 11 plan to provide for a sale of assets, Piccadilly should be allowed to immediately exercise the section 1146 stamp tax exemption, so long as Piccadilly eventually filed a plan providing for a sale of such assets. The Supreme Court would have none of this, holding instead that statutory sequence governing confirmation and implementation of a plan under chapter 11 mandated that the plan be confirmed prior to any utilization of the stamp tax exemption.

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[120] *See, e.g., In re* Steury, 94 B.R. 553, 555 (Bankr. N.D. Ind. 1988) ("Before embarking upon a broad discussion of the intricacies of bankruptcy law, it is appropriate to first consider the relative rights of the debtors and their creditors under state law. In this way we will have a standard against which any prejudice, that might befall either of them, can be measured.").

[121] *In re Stone & Webster*, 286 B.R at 545 (noting if substantive consolidation is warranted, then hypothetical chapter 7 should also be done on consolidated basis).

[122] In *In re New Century TRS Holdings, Inc.*, the court made reference to the *Stone & Webster* Consolidation Rule, but concluded it did not need to reach the merits of that rule because the New Century plan was supported by a stand-alone liquidation analysis for each debtor. 390 B.R. 140, 164 n.27 (Bankr. D. Del. 2008), *rev'd on other grounds*, 407 B.R. 576 (D. Del. 2009).

[123] *See In re* Iridium Operating LLC, 478 F.3d 452, 466 (2d Cir. 2007) (denying plan confirmation because no explanation was provided for why junior creditors were getting priority); Pension Benefit Guar. Corp., Cont'l Airways v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983).

[124] 128 S. Ct. 2326 (2008).

Similarly, the provisions of section 1123(a)(5)(C), which authorize "consolidation" under a plan, may be implemented only under a plan that has been confirmed. The *Stone & Webster* court ignored proper statutory sequencing, relying upon section 105(a) and section 1123(a)(5)(C) to authorize a consolidated best interest test analysis, notwithstanding confirmation had not yet taken place. The Supreme Court's subsequent disposition of *Piccadilly Cafeterias* demonstrates that *Stone & Webster's* reasoning is flawed, and that parties may not reap the benefits of plan provisions (whether authorized in section 1123 or section 1146) before confirmation.

3. Other recent cases citing section 105(a) and substantive consolidation

Since the Prior Article, the Ninth Circuit issued the *Bonham*[125] opinion, which affirmed a substantive consolidation order citing both *Sampsell* and section 105(a) of the Bankruptcy Code.[126] While the precise scope of the challenge made by the parties opposing consolidation is unclear, an assertion of some sort was made before the Ninth Circuit that substantive consolidation failed to survive the codification of the Bankruptcy Reform Act of 1978. The Ninth Circuit rejected this challenge, stating 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. Thus in the context of a Ponzi scheme tainted bankruptcy case, the Ninth Circuit affirmed the bankruptcy judge's consolidation of debtor and non-debtor entities involved in the scheme.

The Fifth Circuit recently had the opportunity to affirm consolidation orders in reliance upon section 105(a), but declined to do so. In the *Amco* appeal, a bankruptcy court granted a "*nunc pro tunc*" substantive consolidation of a corporate debtor and its individual stockholder citing section 105 as authority.[127] The Fifth Circuit concluded the bankruptcy judge erred in granting such consolidation.[128] The court reserved for later decision the fundamental question of whether the bankruptcy court even had a power to consolidate.

The Second Circuit's influential *Augie/Restivo* opinion can be read only to agnostically report that "[c]ourts have found the power to consolidate substantively in the court's general equitable powers as set forth in 11 U.S.C. § 105(a)" [129] without

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[125] Alexander v. Compton (*In re* Bonham), 229 F.3d 750 (9th Cir. 2000).

[126] *See id.* at 764.

[127] Wells Fargo Bank of Tex. v. Sommers (*In re* Amco Ins.), 444 F.3d 690 (5th Cir. 2006).

[128] In reversing the consolidation orders below, Judge Jolly, writing for the Fifth Circuit, refers to substantive consolidation in the way that one might refer to a foreign law: "Without deciding whether the bankruptcy court has the power to order substantive consolidation, we do note that **those jurisdictions** that have allowed it emphasize that substantive consolidation should be used 'sparingly.'" *Id.* at 696, n.5 (emphasis added) (citing *In re* Owens Corning, 419 F.3d 195, 208–09 (3d Cir. 2005); *In re Bonham*, 229 F.3d at 767; Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988); 2 COLLIER ON BANKRUPTCY, ¶ 105.09[1][d] (Alan N. Resnick et al. eds., 15th ed. rev. 2005)).

[129] 860 F.2d at 518 n.1.

actually reaching that conclusion.[130] Another leading substantive consolidation opinion, *In re Auto-Train Corporation*,[131] makes no reference to section 105(a) in its discussion of the doctrine. The *Owens Corning* opinion dodged the section 105(a) issue by stating "we need not address" whether "section 105(a) allows consolidation outside a plan."[132] The Third Circuit instead relied on *Sampsell* and federal common law.

Since the Prior Article, other commentators have evaluated use of section 105(a) of the Bankruptcy Code as authority to grant substantive consolidation. At least five commentators have concluded section 105(a) presents an inadequate basis for the doctrine.[133] However, three other contentions that section 105(a) should be construed to allow substantive consolidation merit comment.

4. The section 105(a) redundancy argument

Section 105(a) is rendered redundant (it is argued) if interpreted only to authorize a bankruptcy court to exercise powers granted elsewhere in the Bankruptcy Code. This argument is premised upon the canon that statutes should not be construed to render any portion thereof redundant.[134] Under this argument, section 105(a) is not constrained by the provisions of the Bankruptcy Code, and thus section 105(a) permits bankruptcy judges to exercise lawmaking powers.

However, construing section 105(a) as a general delegation of Congressional lawmaking powers to bankruptcy courts (as needed to avoid making section 105(a) redundant of the rest of the Code) violates the constitutional separation of powers principle.[135] Under the canon of constitutional avoidance (i.e., where a statute can

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[130] To be sure, the Second Circuit later seemed more comfortable in its reliance upon section 105 in *FDIC v. Colonial Realty Co.*, 966 F.2d 57, 59 (2d Cir. 1992).

[131] Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270 (D.C. Cir. 1987).

[132] 419 F.3d at 209 n.14 (3d Cir. 2005).

[133] *See generally* Alan M. Ahart, *The Limited Scope of Implied Powers of a Bankruptcy Judge: A Statutory Court of Bankruptcy, Not a Court of Equity*, 79 AM. BANKR. L.J. 1 (2005) (concluding substantive consolidation is not authorized by section 105); Daniel B. Bogart, *Resisting the Expansion of Bankruptcy Court Power Under Section 105 of the Bankruptcy Code: The All Writs Act And An Admonition From Chief Justice Marshall*, 35 ARIZ. ST. L.J. 793 (2003) (concluding substantive consolidation is not authorized by section 105); Mayr, *supra* note 26 (concluding substantive consolidation is not authorized by section 105); Steve H. Nickles & David G. Epstein, *Another Way of Thinking About Section 105(a) and Other Sources of Supplemental Law Under the Bankruptcy Code*, 3 CHAP. L. REV. 7 (2000) (observing aggressive uses of section 105 to achieve non-statutory remedies, including substantive consolidation, may violate constitutional separation of powers principles).

[134] *See, e.g.*, United States v. Alaska, 521 U.S. 1, 59 (1997) ("The Court will avoid an interpretation of a statute that 'renders some words altogether redundant.'" (quoting Gustafson v. Alloyd Co., 513 U.S. 561, 574 (1995))).

[135] *See* Nickles & Epstein, *supra* note 133, at 20 (aggressive uses of section 105 to achieve non-statutory remedies, including substantive consolidation, may violate constitutional separation of powers principles); s*ee also* United States v. Noland, 517 U.S. 535, 538–43 (1995).

fairly be interpreted so as to avoid a constitutional issue, it should be so interpreted), courts reach the constitutionality of a statute only if necessary.[136]

In the section 105(a) context, the canon against redundancy conflicts with the canon of constitutional avoidance. In the case of two conflicting canons, the canon against redundancy is subservient to the canon of constitutional avoidance. Allowing some degree of statutory redundancy is preferable to the alternative of holding section 105(a) unconstitutional.[137]

A similar redundancy argument could be made with respect to the All Writs Act, which provides: "The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law."[138] The All Writs Act permits federal courts to issue orders that are "necessary or appropriate" to effectuate the purposes of some statute, law or court order otherwise implicit in the jurisdiction of that court.[139] Its text is similar to that found in section 105(a).

In a sense, the All Writs Act is redundant of the federal statutes which it is intended to effectuate. However, courts have observed that "the All Writs Act, by itself, creates no jurisdiction in the district courts", but rather "empowers courts only to issue writs in aid of jurisdiction previously acquired on some other independent ground."[140]

One commentator uses redundancy to argue section 105(a) should not be construed as a general grant of equity powers:

> As a mater of statutory interpretation, the support for section 105(a) as authorizing bankruptcy equity powers is weak. The word

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[136] Under the doctrine of constitutional avoidance, "where an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress." Edward J. DeBartolo Corp. v. Fla. Gulf Coast Bldg. & Constr. Trades Council, 485 U.S. 568, 575 (1988); *see also* Zadvydas v. Davis, 533 U.S. 678, 689 (2001) ("'[I]t is a cardinal principle' of statutory interpretation . . . that when an Act of Congress raises 'a serious doubt' as to its constitutionality, 'this Court will first ascertain whether a construction of the statute is fairly possible by which the question may be avoided.'" (quoting Crowell v. Benson, 285 U.S. 22, 62 (1932))). Constitutional avoidance is a "cardinal principal" of constitutional law that "has for so long been applied by [the Supreme Court] that is it beyond debate." *Edward J. DeBartolo Corp*, 485 U.S. at 575. The Supreme Court has on several occasions applied to acts of Congress "[a] restrictive meaning for what appear to be plain words" where "such a restrictive meaning must be given if a broader meaning would generate constitutional doubts." United States v. Witkovich, 353 U.S. 194, 199 (1957). In *Witkovich*, the wording of the challenged statutory section "read in isolation and literally" conferred on the Attorney General "authority to require whatever information he deems desirable of aliens whose deportation has not been effected within six months after it has been commanded." *Id.* But the Court, rejecting "the tyranny of literalness," and relying instead on the doctrine of constitutional avoidance, held that the "appropriate construction" was "to limit the statute to authorizing all questions reasonably calculated to keep the Attorney General advised regarding the continued availability for departure of aliens whose deportation is overdue." *Id.* at 199, 202.

[137] One commentator is openly resigned to the notion that some redundancy is required to sensibly interpret the Bankruptcy Code. *See* Mark S. Scarberry, *Interpreting Bankruptcy Code Sections 502 and 506: Post-Petition Attorneys' Fees in a Post-*Travelers *World*, 15 AM. BANKR. INST. L. REV. 611, 618–19 (2007).

[138] *See* 28 U.S.C. § 1651(a) (2006).

[139] *See, e.g.*, United States v. N.Y. Tel., 434 U.S. 159, 172–78 (1977).

[140] Brittingham v. U.S. Comm'r, 451 F.2d 315, 317 (5th Cir. 1971).

> "equity" does not appear in section 105. This is not an accidental omission. Congress used the word "equity" (in the sense of justice and not ownership) and "equitable" in fifteen distinct Code provisions. A general grant of equity powers in section 105(a) would render the Code's direction for the court to act in accordance with principles of equity in specific circumstances redundant.[141]

5. The dynamic duo of section 105(a) and section 1123(b)(6)

In *United States v. Energy Resources Co*,[142] the Supreme Court observed:

> [t]he Bankruptcy Code does not explicitly authorize the bankruptcy courts to approve reorganization plans designating tax payments as either trust fund or nontrust fund. The Code, however, grants the bankruptcy courts residual authority to approve reorganization plans including "any . . . appropriate provision not inconsistent with the applicable provisions of this title." 11 U.S.C. § 1123(b)(5); *see also* § 1129. The Code also states that bankruptcy courts may "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Code. 11 U.S.C. § 105(a).[143]

Consistent with the arguments made above, the Supreme Court approved a section 105(a)-based injunction that was tethered to a section 1123(b)(6)-authorized plan provision.[144] Given the open ended discretion implicated by the phrase "any other appropriate provision" as granted to a successful plan proponent by section 1123(b)(6), the combined use of section 105(a) and section 1123(b)(6) allows a degree of creativity in the protection of parties to chapter 11 plan related settlements.[145]

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[141] *See* Levitin, *supra* note 15, at 31–32.

[142] 495 U.S. 545 (1990).

[143] *Id*. at 549.

[144] *See* 11 U.S.C. § 1123(b)(6) (2006) (providing plan may "include any other appropriate provision not inconsistent with the applicable provisions of this title").

[145] However, in order to access the combined power of section 105(a) and section 1123(b)(6), the plan proponent must first achieve confirmation of the plan in compliance with the hurdles established by section 1129 of the Bankruptcy Code. *See* 11 U.S.C. §1129 (2006) (listing requirements for confirmation of plan). Before a substantive consolidation could be granted using section 105(a) and section 1123(b)(6), the plan proponent would be required to comply with the best interest test. Tucker, *Grupo Mexicano, supra* note 11, at 449. For the same reasons developed in my Prior Article, *Grupo Mexicano, supra* at pages 448–50, a party prejudiced by a chapter 11 plan's proposed consolidation (whether the plan is premised upon section 1123(b)(6) or section 1123(a)(3)) may assert the best interest test to block confirmation of the plan. *Id.* at 448–450, 449 n.113. As argued above, the Supreme Court's *Picadilly Cafeteria* opinion, 128 S. Ct. 2326 (2008), teaches that a plan proponent may not receive the benefits of plan confirmation out of sequence. *See supra* text accompanying notes 123–24.

Citing *Energy Resources*, the Seventh Circuit held that a bankruptcy court has the power to release a non-debtor from creditor liability over the timely objection of creditors by using section 105(a) to implement the "residual authority" to release third parties if "appropriate" to carry out a plan release provision founded upon section 1123(b)(6).[146] Similarly, the Sixth Circuit in *In re Dow Corning*[147] has held that enjoining a non-consenting creditor under a chapter 11 plan is "not inconsistent" with the Code. The Sixth Circuit affirmed the issuance of a section 105(a) injunction against a non-consenting creditor, in connection with confirmation of a chapter 11 plan that contained a section 1123(b)(6) based injunction provision.

However, the *Dow Corning* opinion comments upon a question not decided in *Energy Resources*—whether an order issued under section 105(a) may grant a nontraditional equitable remedy. The bankruptcy judge had concluded that *Grupo Mexicano* precluded the novel injunction provided for in the Dow Corning plan. In reversing, the Sixth Circuit's opinion states "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."[148] The opinion cites *United States v. First National City Bank*[149] in support of the assertion that section 105(a) is not limited to traditional equity jurisprudence. However, as developed further below, *First National City* does not construe section 105(a); rather, it construes a provision of the Internal Revenue Code.

First National City concerned the propriety of a pre-judgment garnishment issued to enforce a foreign taxpayer's obligation. The prejudgment garnishment had been served on a domestic bank. The Internal Revenue Code provision in question gave the district court the power to grant injunctions "necessary or appropriate for the enforcement of the internal revenue laws."[150] Justice Douglas, writing for the Supreme Court, upheld use of a non-traditional pre-judgment writ in favor of the tax collector, reasoning that "[c]ourts of equity may, and frequently do, go much farther

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[146] *See* Airadigm Commc'ns., Inc. v. Fed. Commc'ns Comm'n (*In re* Airadigm Commc'ns, Inc.), 519 F.3d 640, 657 (7th Cir. 2008).

[147] Class Five Nev. Claimants v. Dow Corning Corp. (*In* re Dow Corning Corp.), 280 F.3d 648, 656 (6th Cir. 2002).

[148] *Id.* at 658. This reference to *Grupo Mexicano* and section 105(a) appears to be dictum. The *Dow Corning* injunction was not premised solely upon section 105(a). Rather, Dow Corning's plan followed the *Energy Resources* lead, and tethered its section 105(a) injunction to its chapter 11 Plan provision authorized by section 1123(b)(6). *Id.* at 656. It was not necessary to determine whether standing alone, section 105(a) authorizes non-traditional equitable remedies as otherwise banned by *Grupo Mexicano.* Notably, a lower court within the Sixth Circuit earlier had rejected a request for non-traditional injunctive relief pursuant to section 105, and treated *Grupo Mexicano* as a limitation on the scope of equitable remedies permitted. *See* Victoria Alloys, Inc. v. Fortis Bank SA/NV (*In re* Victoria Alloys, Inc.), 261 B.R. 424, 435–36 (Bankr. N.D. Ohio 2001) (holding *Grupo Mexicano* does not allow court to grant equitable relief even if allowed under section 105(a)); *see also In re* Herrera, 380 B.R. 446, 452 n.9 (Bankr. W.D. Tex. 2007) ("Section 105(a) does not authorize a court to create remedies previously unknown to equity jurisprudence." (citing Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308, 332 (1999))).

[149] 379 U.S. 378 (1965).

[150] 26 U.S.C. § 7402(a) (2006).

both to give and withhold relief in furtherance of the **public interest** than they are accustomed to go when only private interests are involved."[151]

Unlike the Internal Revenue Code's tax collection provisions, section 105(a) of the Bankruptcy Code does not serve the "public interest." Generally, section 105(a) only serves the interests of particular debtors or creditors in their private controversies. There is no general public interest in whether creditors of a parent company receive sixty cents on the dollar if substantive consolidation is granted, instead of say twenty cents if consolidation is denied.[152]

This Article argues the more appropriate statute upon which to build section 105(a) jurisprudence is the All Writs Act.[153] The All Writs Act permits all federal courts to issue orders "necessary or appropriate" to effectuate the purposes of a statute, law or court order otherwise implicit in the jurisdiction of that court.[154]

Decisions under the All Writs Act provide the more apt analogy because section 105(a) mirrors the All Writs Act, not just in language, but also in purpose. Some bankruptcy courts have referred to section 105(a) as the Bankruptcy Code's "all writs" provision.[155] Section 105(a) is derived from section 2(a)(15) of the

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[151] *First Nat'l City*, 379 U.S. at 383 (emphasis added) (quoting Virginian R.R. Co. v. Sys. Fed'n, 300 U.S. 515 (1937)).

[152] A creditor's "right" to substantive consolidation fails the Supreme Court's public right test found in *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 42 n.4 (1989). In upholding a right to a jury trial involving a 'private right,' the Court observed that a case involves a "public right" if it "arise[s] between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments," *id.* at 51 n.8 (quoting Crowell v. Benson, 285 U.S. 22, 50 (1932)), or involves "a seemingly private right" created by Congress "that is so closely integrated into a public regulatory scheme as to be a matter appropriate for agency resolution with limited involvement by the Article III judiciary," *id.* at 54 (quoting Thomas v. Union Carbide Agric. Prods. Co., 473 U.S. 568, 593–94 (1985)). Under this framework, a lender's request that a subsidiary be substantively consolidated with a parent would not present a "public right" as it "does not arise between the Government and persons subject to its authority in connection with the performance of the constitutional functions of the executive or legislative departments." A creditor's request that a subsidiary be substantively consolidated with a parent does not involve "a seemingly private right" created by Congress, as Congress has not established a remedy of substantive consolidation. Further, substantive consolidation is not "so closely integrated into a public regulatory scheme as to be a matter appropriate for agency resolution with limited involvement by the Article III judiciary"—indeed, it is the Article III judiciary that has established the rules of decision for substantive consolidation. *See also In re* Clay, 35 F.3d 190, 193 (5th Cir. 1994) (stating bankruptcy issues are not generally a "public right" that can be delegated to Article I court without a jury trial).

[153] 28 U.S.C. § 1651(a) (2006) ("The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law.").

[154] *See, e.g.*, United States v. N.Y. Tel. Co., 434 U.S. 159, 172–78 (1977) (describing how courts have issued commands under All Writs Act).

[155] *See, e.g., In re* DRW Prop. Co., 54 B.R. 489, 494 (Bankr. N.D. Tex. 1985) (acknowledging section 105(a) empowers courts "to issue 'orders' necessary to carry out the provisions of the code"; collecting cases).

Bankruptcy Act of 1898,[156] which is derived from the federal All Writs Act,[157] which in turn was derived from section 14 of the First Judiciary Act of 1789.[158]

In *De Beers Consol. Mines, Ltd. v. United States*,[159] the Supreme Court held the All Writs Act did not create equitable discretion in a district court to grant non-traditional pre-judgment injunctive relief. *Grupo Mexicano* later cites back to the *DeBeers* decision, rejecting the alternative argument that federal courts may issue pre-judgment asset freeze orders based upon the All Writs Act.[160] In the context of a private debt collection suit in federal court—which is far more analogous to a bankruptcy proceeding than a tax collection case—*Grupo Mexicano* relies upon *DeBeers*, rather than *First National City*,[161] in construing how much leeway federal courts have to develop equitable remedies.

The Supreme Court has further explained that the All Writs Act does not authorize federal courts to issue ad hoc writs whenever compliance with statutory procedures appears inconvenient or less appropriate.[162] Lower courts have observed that the All Writs Act, by itself, creates no jurisdiction in the district courts, but rather empowers courts only to issue writs in aid of jurisdiction previously acquired on some other independent ground.[163] Unless there is a genuine need to issue an injunction against related or parallel state court proceedings in order for a federal court to fully adjudicate a controversy, relief under the All Writs Act will normally be denied.[164]

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[156] The Bankruptcy Act of 1898 § 2(a)(15), ch. 541, 30 Stat. 544, 546 (repealed 1978).

[157] 28 U.S.C. § 1651(a) (2006).

[158] Judiciary Act of 1789 § 14, ch. 20, 1 Stat. 73, 81–82; *see also* Pa. Bureau of Corrs. v. U.S. Marshall Serv., 474 U.S. 34, 40–41 (1985) ("The All Writs Act originally was codified in section 14 of the Judiciary Act of 1789, 1 Stat. 81–82 . . . .").

[159] 325 U.S. 212 (1945).

[160] Grupo Mexicano de Desarrollo, S.A. v. Alliance Bank Fund, Inc., 527 U.S. 308, 326 n.8 (1999).

[161] Irve J. Goldman, *Can You Freeze Assets in a Fraudulent Conveyance Action after* Grupo Mexicano*?*, 24 AM. BANKR. INST. J. 54, 54 (May 2005), comments on *Rubin v. Pringle (In re Focus Media Inc.*), 387 F.3d 1077, 1079 (9th Cir. 2004), in which the Ninth Circuit rejected the argument that *Grupo Mexicano* limits the power of a bankruptcy judge to grant a pre-judgment asset freeze. Goldman disagrees with the Ninth Circuit's reasoning, but argues that *In re Focus Media* was decided correctly. *See* Goldman, *supra*, at 79. Goldman argues section 105(a) authorizes a pre-judgment asset freeze based upon the *First National City* case and the "strikingly similar" language found in the Internal Revenue Code. *See id.* See also *Green v. Drexler* (*In re Feit & Drexler, Inc.*), 760 F.2d 406, 414–15 (2d Cir. 1985), which approved a pre-judgment asset freeze based upon section 105(a) and *First National City*. Again, this Article argues the "public interest" principle upon which the Supreme Court decided *First National City* may not be transferred to section 105(a) jurisprudence. Neither *Focus Media* nor *Feit & Drexler* examines whether All Writs Act jurisprudence (including *DeBeers*) inform whether section 105(a) should be construed to allow a non-traditional equitable remedy. If section 105(a) powers are eventually construed by the Supreme Court to allow a pre-judgment freeze order, perhaps the rationale would be that such freeze is "necessary and appropriate" to carry out the fraudulent conveyance provisions of section 548 and post petition transfer provisions of section 549 of the Bankruptcy Code. *See* 11 U.S.C. § 105(a) (2006) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").

[162] *See Pa. Bureau of Corr.*, 474 U.S. at 43 (denying writ pursuant to All Writs Act).

[163] Brittingham v. Comm'r, 451 F.2d. 315, 317 (5th Cir. 1971).

[164] *See, e.g.*, Official Comm. of Asbestos Claimants of G-I Holdings, Inc. v. Bldg. Materials Corp. of Am. (*In re* G-I Holdings, Inc.), 327 B.R. 730, 743 (Bankr. D.N.J. 2005) (declining to enjoin, at request of

Section 105(a) jurisprudence should be informed by the All Writs Act jurisprudence. *Dow Corning's* reliance upon opinions construing the Internal Revenue Code is flawed because there is no general "public interest" in most bankruptcy controversies. Because section 105(a) mirrors the All Writs Act, not just in language, but also in purpose, this Article argues that non-traditional equitable remedies (including substantive consolidation) are unavailable under section 105(a).[165]

6. What does *Marrama* add to section 105(a) jurisprudence?

In *Marrama v. Citizens Bank of Massachusetts*,[166] the Supreme Court held that a debtor forfeited his right to convert his chapter 7 case to chapter 13, notwithstanding the seemingly unqualified conversion right provided by section 706(a) of the Bankruptcy Code. The Court relied upon a "bad faith" exception that it located in the text of section 707(d), which provides that "a case may not be converted to another chapter if the debtor may not be a debtor under that chapter."

The *Marrama* majority opinion, authored by Justice Stevens, also upheld the forfeiture based upon text located in second sentence of section 105(a). This text grants a bankruptcy judge broad authority to take any action necessary "to prevent an abuse of process."[167] The *Marrama* opinion concludes such broad authority to prevent abuse of process may include denying a debtor's motion to convert to chapter 13.

Summarizing the function of section 105(a)'s second sentence, Justice Stevens wrote:

> [T]he broad authority granted to bankruptcy judges to take any action that is necessary or appropriate "to prevent an abuse of process" described in § 105(a) of the Code is surely adequate to authorize an immediate denial of a motion to convert filed under § 706 in lieu of a conversion order that merely postpones the

creditors committee, regularly scheduled payment due under promissory notes issued by debtor's non-debtor affiliate).

[165] With respect to the interplay between section 105(a) and the All Writs Act, one commentator concludes that bankruptcy courts should first attempt to utilize section 105(a) of the Code, so long as the remedy sought can be attributed to "carrying out the provisions" of the Code. Michael D. Sousa, *Equitable Powers of a Bankruptcy Court: Federal All Writs Act and § 105 of the Code*, 25 AM. BANKR. INST. J. 28, 70 (2006). If it cannot be tethered to a provision of the Code, the commentator argues that secondarily a bankruptcy court may be able to utilize the All Writs Act to protect the jurisdiction of the court. *Id.* However, as noted above, in *De Beers* the Supreme Court held the All Writs Act does not authorize non-traditional equitable remedies, so reliance upon the All Writs Act is qualified. 325 U.S. at 219–23.

[166] 549 U.S. 365 (2007).

[167] 11 U.S.C. § 105(a) (2006).

> allowance of equivalent relief and may provide a debtor with an opportunity to take action prejudicial to creditors.[168]

However, *Marrama* does not resuscitate section 105(a) as a statutory authority for substantive consolidation. First, courts that have relied upon section 105(a) as authority for substantive consolidation rely upon the first sentence of section 105(a), and not the text of second sentence of section 105(a), which is the text actually construed in *Marrama*. Second, the *Marrama* opinion construes such text to qualify a procedural right to a hearing found elsewhere in the Code, i.e., the right to convert from chapter 7 to chapter 13. *Marrama* does not expand section 105(a) into a lawmaking source which authorizes courts to invent non-traditional equitable remedies.

D. Should "federal common law" replace equity powers?

Shunning reliance upon section 105(a), the Third Circuit declares: "Substantive consolidation, a construct of federal common law, emanates from equity."[169] Building on that premise, Adam J. Levitin's thoughtful essay advocates a federal common law of bankruptcy.[170] Levitin first demonstrates that continued reliance upon section 105(a) and "court of equity" powers to construct novel bankruptcy rights is fatally flawed under the bankruptcy statutory regime. Levitin then proposes reliance upon federal common law principles in lieu of the "court of equity" rationale.[171] Levitin's argument may be summarized as follows:

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[168] 549 U.S. at 375.

[169] *In re* Owens Corning, 419 F.3d 195, 205 (3d Cir. 2005).

[170] Levitin, *supra* note 15, at 3 ("[T]his article proposes using federal common law as an alternative framework for analyzing non-Code practices.").

[171] *Id.* at 81–87. The frequent use by Congress and the Supreme Court of the "court of equity" label fairly raises the question: what is meant by the phrase "court of equity"? *Id.* at 6. While I commented on this in my Prior Article, *Grupo Mexicano*, at 435, three additional examples may aid assessment of the "court of equity" phrase. First, the automatic stay and the bankruptcy discharge both constitute kinds of injunctions. Injunctive relief traditionally was available from an English court of equity. Levitin, *supra* note 15, at 51. In this sense the two most routine orders issued by bankruptcy courts are fundamentally equitable remedies. Second, describing a bankruptcy court as a "court of equity" is consistent with the Supreme Court's observation that in "determining what would constitute a successful rehabilitation involves the balancing the interest of the affected parties – the debtor, creditors, and employees." Nat'l Labor Relations Bd. v. Bildisco, 465 U.S. 513 (1983). At present the Bankruptcy Code makes twenty-five statutory references to decisions that are to be made "according to the equities of the case" or in the "interest of justice". In such circumstances, a bankruptcy court functions more like a "court of equity" (rather than an English law court) because of the broad discretion granted by statute to balance the interest of the affected parties. Third, a bankruptcy court functions as a "court of equity" when applying "traditional" equitable principles, such the application of equitable tolling principles in *Young v. United States*, 535 U.S. 43 (2002). In view of the Bankruptcy Code's numerous statutory provisions having roots in equity practice, I am not of the view that courts also need to conclude that Congress has delegated equitable lawmaking powers to bankruptcy judges to provide substance to the bankruptcy court's "court of equity" label.

> (i) A "court of equity" should be understood to mean a "court with federal common lawmaking power."[172]
> (ii) While the legislative history to section 510(c) [173] says "the bankruptcy court will remain a court of equity," Congress really meant to say that the "bankruptcy court will remain a court with common lawmaking powers."[174]
> (iii)Reading "court of equity" to really mean a "court with federal common lawmaking power" is supported by the pre-Code practices doctrine, which has in effect been ratified by Congress' repeated amendments to the Bankruptcy Code that have left the doctrine unchanged.[175]

Levitin forcefully makes the following policy argument in favor of a federal common law of bankruptcy:

> Indeed, federal common law is arguably more important than ever for the successful operation of the bankruptcy system. Reorganization techniques have only become more complex under the Code. Shouldn't bankruptcy courts have the flexibility to adapt to these techniques? Most other areas of federal law have agencies with rule-making authority that give those areas of law the flexibility to adapt to new developments via interstitial lawmaking. Bankruptcy is unique among major areas of federal law in lacking an administrative agency with rule-making power. The Office of the United States Trustee does not have rule-making power for the bankruptcy system. The Judicial Conference makes the Bankruptcy Rules, but these operate quite differently than, say, regulations promulgated by the EPA; Bankruptcy Rules, like the Federal Rules of Civil Procedure, are essentially procedural. Why shouldn't bankruptcy judges, who, like agencies, are Article I

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[172] Levitin, *supra* note 15, at 75. Levitin concedes that normally it is reckless to read Congress's use of "X" to mean "Y". *Id.* (noting use of term "equity" in bankruptcy context can be better described as "federal common lawmaking").

[173] 11 U.S.C. § 510(c) (2006), the legislative history of which is found at H.R. Rep. No. 95-595, at 359 (1977), carries forward a power to equitably subordinate claims recognized in pre-Code caselaw.

[174] Reliance upon the legislative history to section 510(c) as support for the notion of a federal common law of bankruptcy must be balanced against the Supreme Court's restrictive approach to judge-made rules of equitable subordination. As discussed *infra* Part III, the Supreme Court held in *Noland* that even if Congress had intended to give bankruptcy courts some leeway in equitably subordinating claims under section 510(c), courts may not make "categorical judgments" which are "legislative in nature" in bankruptcy cases. United States v. Noland, 517 U.S. 535, 541 (1995). This suggests the Supreme Court may hold invalid any attempted delegation by Congress of general common lawmaking powers to the bankruptcy courts.

[175] I comment on the pre-Code practices doctrine *infra* Section II.E.

> entities with particular technical expertise, have similar interstitial lawmaking powers?[176]

The notion that bankruptcy courts have interstitial lawmaking powers has merit. Controversies before the bankruptcy courts repeatedly have and will continue to expose statutory ambiguities that require judicial interpretation. When bankruptcy judges engage in statutory interpretation, they exercise interstitial lawmaking powers.

However, the issue under evaluation in this Article is whether substantive consolidation can be justified under a federal common law of bankruptcy. There is a fundamental distinction between interstitial lawmaking and traditional common lawmaking. Levitin concedes that substantive consolidation falls within the latter category:

> The Supreme Court's definition encompasses both interstitial lawmaking and more traditional common lawmaking, such as creation of new rights of action or rules of decision. Non-Code practices tend to fall within the narrower ambit of the Court's definition. They range from interstitial lawmaking, that is filling in the gaps where Congress has not spoken but working with the statutory structure—*e.g.*, pre-plan payments for pre-petition debts or cross-collateralization—to creating rules of decision and rights of action—substantive consolidation, non-debtor releases, and channeling injunctions other than those issued under 11 U.S.C. § 524(g).[177]

Substantive consolidation exemplifies the traditional common law method used by English judges in announcing the rules of decision. As the Supreme Court has explained, "what one might call 'federal common law' in the strictest sense, *i.e.*, a rule of decision that amounts, not to simply an interpretation of a federal statute or a properly promulgated administrative rule, but, rather, to the judicial 'creation' of a special federal rule of decision."[178]

This Article is concerned with an exercise of federal common law powers in the strict sense, the judicial creation of a special federal rule authorizing substantive consolidation in bankruptcy cases. I argue that exercise of a federal common law of bankruptcy in this strict sense runs counter to Supreme Court precedent.

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[176] Levitin, *supra* note 15, at 63–64.

[177] *Id.* at 66–67.

[178] Atherton v. Fed. Deposit Ins. Corp., 519 U.S. 213, 218 (1997) (citing Tex. Indus., Inc. v. Radcliff Materials, Inc., 451 U.S. 630, 640–43 (1981)). Levitin cites *Radcliff* as a leading authority on federal common law. Levitin, *supra* note 15, at 67.

1. A federal common law of bankruptcy runs contrary to the Supreme Court's jurisprudence

a. Substantive consolidation fails the Kimball Foods *test*

It is common ground that Article I, section 1 of the U.S. Constitution vests legislative power in Congress, not the judiciary. Under the Bankruptcy Clause, Congress presumably is empowered to enact a federal law of substantive consolidation that modifies state corporate law principles in the context of bankruptcy cases. However, the fact that Congress may have the legislative power to enact a federal law of substantive consolidation does not authorize federal courts to exercise lawmaking powers when Congress has not acted. The Supreme Court has explained: "[w]hether latent federal power should be exercised to displace state law is primarily a decision for Congress."[179] The existence of a federal statutory scheme does not show that Congress intended the federal courts to promulgate federal common law rules to implement the statutes for "'Congress acts . . . against the background of the total *corpus juris* of the states.'"[180]

Since the landmark *Erie* decision of 1938, the Supreme Court repeatedly has directed lower federal courts to look to state law for the sources of substantive law, rejecting the notion that federal courts have a general "common law" lawmaking power.[181] In the landmark decision of *United States v. Kimbell Foods, Inc.*[182], the Supreme Court established a durable test limiting reliance upon of federal common law rules.[183] Under *Kimball Foods*, a federal court must evaluate: (1) whether a uniform national rule is required to effectuate the federal program's purpose; (2) whether application of a state law rule would conflict with a policy underlying the federal program; and (3) whether application of a uniform federal rule would upset existing relationships predicated on state law.[184]

I submit that a federal common law rule of substantive consolidation would not pass muster under *Kimbell Foods*. The first prong of *Kimball* involves evaluation of whether a "uniform national rule" of substantive consolidation is "required" to effectuate the "purpose" of the Bankruptcy Code. It is insufficient under *Kimball* that the proposed common law rule is only "helpful" or "useful" in effectuating the purpose.

Substantive consolidation is not required to carry out the purpose of the Bankruptcy Code. This is shown by the Code's reliance upon state marital property

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[179] Wallis v. Pan Am. Petroleum Corp., 384 U.S. 63, 68 (1966).

[180] *Id.* at 68 (quoting HART & WECHSLER, THE FEDERAL COURTS AND THE FEDERAL SYSTEM 435 (1953)).

[181] *See* Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78 (1938) (holding because "[t]here is no federal general common law," state substantive law applies to all cases not "governed by the Federal Constitution or by Acts of Congress"); *see also* City of Milwaukee v. Ill. , 451 U.S. 304, 312 (1981) ("Federal courts, unlike state courts, are not general common-law courts and do not possess a general power to develop and apply their own rules of decision.").

[182] *See* United States v. Kimbell, 440 U.S. 715 (1979).

[183] *Id.* at 728–29

[184] *Id.*

laws to determine what property owned by a non-debtor spouse is property of the estate. If nationwide uniformity in the treatment of a non-debtor spouse's property were required to carry out the purpose of the Bankruptcy Code, then it is plausible that a uniform rule governing the treatment of property of non-debtor corporate affiliates might be required as well. But the opposite is true, and since the Bankruptcy Code builds upon a patchwork of different state marital property laws, no uniformity is required.

Consider the circumstance where a husband files bankruptcy but his wife does not. Nine states apply community property rules to determine which of the non-debtor spouse's assets are liable for the debtor's debts. The remaining forty-one states follow common-law based rules. In community property jurisdictions, property of the debtor's estate includes all interests of the debtor and the debtor's spouse in community property that is "liable for an allowable claim against the debtor."[185]

In such jurisdictions, the federal bankruptcy court must look to local law to determine whether property interests of the non-debtor spouse may be included in the debtor's bankruptcy estate. In Texas, a community property state, a non-debtor's spouse's separate management community property is not liable for contract based liabilities, but is liable for tort based liabilities.[186]

Establishment of a federal common law bankruptcy rule of non-debtor spousal property liability might simplify the administration of bankruptcy cases. In cases where there has been "excessive entanglement" of the assets of the debtor with those of the non-debtor spouse, the non-debtor spouse's property could be deemed property of the estate, under a "helpful" federal common law rule. Such federal rule would simplify administration and increase recoveries by creditors.

However, such a uniform national rule of non-debtor spousal property liability is not required (in the *Kimball Foods* sense) to effectuate the purposes of the Bankruptcy Code. The "equality of distribution" purpose of Bankruptcy Code can be accomplished without resort to a federal common law based "excessive entanglement" rule. Whatever state law says belongs to the non-debtor spouse, to the exclusion of the spouse's creditors, is outside of the bankruptcy estate. The value of the remaining marital property then provides the numerator in the calculation of pro rata dividend to creditors.

Similarly, state law provides rules of decision that define when assets of one corporate affiliate are (or are not) liable for the debts of another affiliate.[187] A uniform national rule of substantive consolidation is no more required to effectuate

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[185] 11 U.S.C. § 541(a)(2) (2006).

[186] *See* TEX. FAM. CODE ANN. § 3.202 (Vernon 2002) (providing "[u]nless both spouses are personally liable as provided by this subchapter, the community property subject to a spouse's sole management, control, and disposition is not subject to … any nontortious liabilities that the other spouse incurs during marriage" and further providing "[a]ll community property is subject to tortious liability of either spouse incurred during marriage").

[187] The state laws that govern when assets of one corporation are liable for an affiliate are discussed further *infra* Part III of this Article.

the purposes of the Bankruptcy Code than is a uniform rule concerning the inclusion of marital property so required.

Some might argue that a distinct purpose applies to chapter 11 cases. One purpose behind chapter 11 is to encourage reorganization of debtors. Perhaps a federal common law rule of substantive consolidation is required to effectuate chapter 11's purpose of reorganization.

However, there is not a single purpose behind chapter 11 that provides a lodestar against which to formulate federal common law rules of bankruptcy. In *Piccadilly Cafeterias*,[188] the Supreme Court observed:

> [T]his Court has rejected the notion that "Congress had a single purpose in enacting Chapter 11." Rather, Chapter 11 strikes a balance between a debtor's interest in reorganizing and restructuring its debts and the creditors' interest in maximizing the value of the bankruptcy estate. The Code also accommodates the interests of the States in regulating property transfers by "'generally [leaving] the determination of property rights in the assets of a bankrupt's estate to state law.'" Such interests often do not coincide, and in this case, they clearly do not.[189]

Chapter 11 is the product of countless legislative compromises. It is a legislative compromise between a debtor's goal to restructure its debts, and the creditor's goal to maximize recovery. While reorganization of debt is a significant purpose of chapter 11, it is not the sole purpose. With multiple, conflicting purposes behind our bankruptcy laws, how can courts be certain whether a uniform national rule of substantive consolidation is required to effectuate the purposes of chapter 11? While use of substantive consolidation may be instrumental in facilitating reorganization, consolidation may reduce (rather than maximize) recoveries of certain creditors. Consolidation clearly hurts creditors of the corporation having a higher asset to debt ratio than that of the consolidated affiliate. Absent a single, paramount policy objective behind chapter 11, how does a court determine whether "reorganization" values should be given greater weight than a creditor's assertion of state law rights to "maximize" its recovery?

b. Butner's *continuing influence*

The Supreme Court's bankruptcy precedents, in particular those decided since 1980, lend little support for the concept of a federal common law of bankruptcy.[190]

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[188] Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc., 128 S. Ct. 2326 (2008).

[189] *Id.* at 2339 (internal citations omitted).

[190] For a forceful argument that the federal circuit courts often have erred in their development of federal common law, see generally Ronald H. Rosenberg, *The Ultimate Independence of the Federal Courts: Defying the Supreme Court in the Exercise of Federal Common Law Powers*, 36 CONN. L. REV. 425 (2004).

The Court's landmark *Butner*[191] decision brought bankruptcy law in line with the Court's post-*Erie*[192] philosophical approach. *Butner* rejected reliance upon what amounted to a federal common law rule to determine whether rents should be included as "property of the estate" holding instead that the determination of property rights should be made in accordance with state law.

In *Barnhill v. Johnson*,[193] the Supreme Court again shunned reliance upon a federal common law of bankruptcy. The Court noted that because the Bankruptcy Code's definition of "transfer" includes references to "property" and "interest[s] in property" which lack specific federal statutory definitions, state law rules of decision must be consulted.[194] *Barnhill* reaffirmed the *Butner* principle that in the absence of any controlling federal law to the contrary, "property" and "interests in property" are creatures of state law.[195]

Rosenberg argues that Supreme Court expressed its "policy regarding the freedom of the lower federal courts to announce rules of decision under their federal common lawmaking powers." Rosenberg, *supra*, at 501–02.

> Originating in the *Kimball Foods* case decided in 1979 and concluding with [*United States v.*] *Bestfoods*[, 524 U.S. 51, 63 (1998)], the unmistakable policy is one of judicial restraint and presumptive reliance on state law theory in the absence of an alternate federal statutory direction or a significant conflict with federal law. The Court's rhetoric over the years has become increasingly severe in its tone and less open to improvisation in the name of federal common law. These cases have emphasized that statutory gap-filling exercises do not routinely authorize federal courts to develop specialized federal rules of decision. As Justice Scalia wrote in the *O'Melveny & Meyers* case[, 512 U.S. 79, 87 (1994)], "matters left unaddressed in . . . a scheme [of federal statutory regulation] are presumably left subject to the disposition provided by state law." State law is to fill the gap in all cases except those truly exceptional, "few and restricted" ones where there is a "significant conflict between some federal policy or interest and the use of state law. " [*O'Melveny*, 512 U.S. at 87.] These are strong words that tip the balance towards the use of state law in cases before the federal courts.

Rosenberg, *supra*, at 502.

[191] Butner v. United States, 440 U.S. 48 (1979).

[192] Erie v. Tompkins, 304 U.S. 64 (1938); *see also* City of Milwaukee v. Ill., 451 U.S. 304, 312 (1981) ("Federal courts, unlike state courts, are not general common-law courts and do not possess a general power to develop and apply their own rules of decision.").

[193] 503 U.S. 393 (1992).

[194] *Id.* at 400–01; *see also* 11 U.S.C. § 101(54)(D) (2006) (defining "transfer" for Code purposes).

[195] 503 U.S.at 398. *Butner* recognizes that a "federal interest" may on occasion require a different result that would occur under certain applications of state law, stating: "Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." 440 U.S. at 55. An example of when a "federal interest" overrides state law is provided by section 541(c) of the Bankruptcy Code, which prevents certain state law-based forfeitures of a debtor's property. However, the Ninth Circuit has rejected a bankruptcy trustee's argument that there is a generic federal interest in "bankruptcy estate augmentation," noting that such generic federal interest may interfere with *Butner's* goals of avoiding uncertainty, forum shopping and creditor windfalls. *See* Gaughan v. Edward Dittlof Revocable Trust (*In re* Costas), 555 F.3d 790, 798 (9th Cir. 2009). Curiously, one bankruptcy court, in denying motions to dismiss an adversary case, reasoned that there is a federal interest in "the equitable and efficient distribution of a debtor's property among its creditors" as a basis to conclude that *Butner* had not implicitly overruled *Sampsell's* creation of the federal remedy of substantive consolidation. *See* Gold v. Winget (*In re* NM Holdings Co., LLC), 407 B.R. 232, 277–79 (Bankr. E.D. Mich. 2009) ("[T]he Court is not aware of any case, holding that . . . *Butner* eliminated

In *Raleigh v. Illinois Department of Revenue*,[196] the Court was called upon to determine whether state or federal law rules of decision govern the allowance of a claim. Extending the *Butner* principle to allowance of claims under section 502 of the Bankruptcy Code, the Court observes that: "Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditor's entitlements, but are limited to what the Bankruptcy Code itself provides."[197]

Levitin recognizes that *Butner* stands as an obstacle to proponents of an expansive federal common law of bankruptcy. In an effort to narrow the import of *Butner*, Levitin argues *Butner* precludes reliance upon a federal common law of bankruptcy only to the extent it conflicts with state law.[198] So long as the proposed federal common law rule does not conflict with state law, Levitin suggest that bankruptcy courts are authorized to promulgate such rules.

However, the Supreme Court's holding in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*,[199] undermines Levitin's hypothesis. Because the federal bankruptcy system operates outside of the state court debt collection system, certain kinds of controversies may arise in bankruptcy cases that cannot occur in a state court. One such issue that cannot arise absent a federal bankruptcy case is whether a general unsecured creditor may be allowed a state contract-law-based claim against the estate for the attorney fees it incurred during a bankruptcy case.

The Ninth Circuit, in *Fobian*, announced a federal common law rule of decision, namely that attorney fees are not recoverable in bankruptcy for litigating issues "peculiar to federal bankruptcy law."[200] If Levitin's construction of *Butner* were correct, the Ninth Circuit's *Fobian* rule should have survived. This is because the *Fobian* rule does not "conflict" with state law, because it addressed an issue that cannot arise outside of a federal bankruptcy case.

However, the Supreme Court's opinion in *Travelers Casualty* does not support the notion that federal courts are free to invent federal common law rules so long as they do not conflict with state law. The problem with the *Fobian* rule was not that it conflicted with state law, but rather it lacked "textual support" in the Bankruptcy Code:

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the bankruptcy court's power to order substantive consolidation."). This Article has already argued that *Sampsell* did not authorize substantive consolidation, so in a sense this Article agrees that *Butner* does not overrule *Sampsell's* actual holding. While this Article agrees there is a recognized federal policy of "equality of distribution" among creditors of a debtor in bankruptcy, it does not follow that there is a federal interest in enhancing what constitutes the "debtor's property" to be distributed equally by use of a federal common law rule of substantive consolidation to sweep in property of the debtor's affiliates. Such federal interest in creditor equality does not override state community property laws governing what property of the non-debtor spouse is swept into the estate.

[196] 530 U.S. 15 (2000).

[197] *Id.* at 24–25.

[198] Levitin, *supra* note 15, at 76.

[199] 549 U.S. 443 (2007).

[200] Fobian v. W. Farm Credit Bank (*In re* Fobian) 951 F.2d 1149, 1153 (9th Cir. 1991).

> The *Fobian* rule finds no support in the Bankruptcy Code, either in § 502 or elsewhere. In *Fobian*, the court did not identify any provision of the Bankruptcy Code as providing support for the new rule. Instead, the court cited three of its own prior decisions . . . . The absence of textual support is fatal for the *Fobian* rule. Consistent with our prior statements regarding creditors' entitlements in bankruptcy, see, *e.g.*, *Raleigh*, *supra*, at 20, we generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed. See 11 U. S. C. § 502(b). Neither the court below nor PG&E has offered any reason why the fact that the attorney's fees in this case were incurred litigating issues of federal bankruptcy law overcomes that presumption.[201]

The *Travelers Casualty* opinion does not indicate bankruptcy courts are free to adopt federal common law that does not conflict with state law. *Travelers Casualty* teaches that reliance upon federal common law rules of decision wholly lacking "textual support" in the Bankruptcy Code is flawed.

Levitin's proposed constraint on *Butner* is incorrect. The Supreme Court requires some modicum of textual support before federal courts may then exercise their federal common law interstitial powers.[202] The absence of textual support was fatal to the *Fobian* rule. The absence of textual support should prove fatal to a federal common law rule of substantive consolidation.

c. The circuit courts are presently mixed on whether there is a federal common law of bankruptcy

At this point there appears to be some conflict among the circuit courts. The Fifth Circuit, citing the *Kimbell Foods* test, has rejected reliance upon a federal common law of bankruptcy. In *Walker v. Cadle Co. (In re Walker)*,[203] the Fifth Circuit declined to invent a federal common law right of contribution among parties which violated the automatic stay in bankruptcy cases, reasoning that "bankruptcy is not an area where the courts have wide discretion to fashion new causes of action."[204]

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[201] *Travelers*, 549 U.S. at 452–53 (citing Raleigh v. Ill. Dept. of Revenue, 530 U.S. 15, 20 (2000)).

[202] Even if the Supreme Court were to limit *Butner* to situations where the federal common law rule "conflicts" with state law, it is doubtful that substantive consolidation would survive. Substantive consolidation conflicts with the state law based principle of structural subordination. *See infra* Conclusion.

[203] 51 F.3d 562 (5th Cir. 1995).

[204] *Id.* at 567. See *St. Paul Travelers Insurance Co. v. Century Asphalt Materials, LLC (In re Contractor Technology, LTD)*, 529 F.3d 313 (5th Cir. 2008), where a trustee avoided payments due to a contractor under section 549. The contractor obtained an order that supposedly tolled its deadline to timely file a bond claim with respect to the avoided transfer. The court held that the bankruptcy court lacked the power to do so, and declined to apply an equitable tolling rule. "Concededly, there are occasions where the bankruptcy court can

The Ninth Circuit rejected reliance upon a federal common law rule in the bankruptcy context. In *Norfolk Southern Railway Co. v. Consolidated Freightways Corp. (In re Consolidated Freightways Corp.)*,[205] the Ninth Circuit declined to rely upon a proposed federal common law rule to decide the merits of a bankruptcy claim.

The Seventh Circuit construes *Butner* and *Travelers Casualty* as establishing a presumption that rights under state law count in bankruptcy unless the Code says otherwise.[206] Since the Bankruptcy Code is silent on substantive consolidation, presumably the Seventh Circuit would look to only state law to determine whether consolidation is permitted.

The Third Circuit describes substantive consolidation as a "construct of federal common law."[207] However, it is uncertain whether the Third Circuit has adopted Levitin's robust view of a federal common law of bankruptcy. *Owens Corning*'s reference to federal common law could be read as simply an indirect reference to the Supreme Court's *Sampsell* opinion.

Within the Sixth Circuit, an internal division over the proper use of federal common law to decide bankruptcy appeals is exemplified by the splintered decision of *Americredit Financial Services, Inc. v. Long (In re Long)*.[208] The lead opinion authored by Judge Merit relies upon a principle of interpretation described as "the equity of the statute" to establish a uniform federal rule to fill a statutory gap found in section 1325(a) of the Bankruptcy Code. Judge Cox's concurring opinion finds no necessity to rely on a federal common law rule, and concludes that state law should fill in the gap. The third opinion, authored by Judge Clay, concludes the result and reasoning of both his colleagues is incorrect.

2. Is an "unreviewable" federal common law of bankruptcy of any value?

Levitin argues that "federal common law is channeled by precedent and judicially devised tests" and that it will channel judicial "discretion into the multi-factored rules of decision that are so frequently the hallmark of common lawmaking."[209] Levitin vision that "federal common law is flexible yet principled,

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override state law which frustrates its statutory mission. Here, however, the bonding company's duty to pay rested in state law. And the power of the bankruptcy court did not extend to creating liabilities existing neither in federal or state law." *Id.* at 321.

[205] 443 F.3d. 1160 (9th Cir. 2006).

[206] *See In re* Wright, 492 F.3d 829, 832–33 (7th Cir. 2007) (explaining *Butner* holds presumption rights under state law count in bankruptcy unless Code states otherwise). Similarly, also subsequent to *Travelers*, a bankruptcy appellate panel has concluded that where state law allows an unsecured prevailing party attorney fees, that the "Bankruptcy Code itself provides the answer to this issue (by not specifically disallowing postpetition fees . . . ." *In re* SNTL Corp., 380 B.R. 204, 222 (B.A.P. 9th Cir. 2007) (quoting *In re* New Power Co., 313 B.R. 496 (Bankr. N.D. Ga. 2004)).

[207] *In re* Owens Corning, 419 F.3d 195, 205 (3d Cir. 2005).

[208] 519 F.3d 288 (6th Cir. 2008).

[209] Levitin, *supra* note 15, at 83, 86.

unlike equity which is merely flexible" is enticing.[210] However, implicit in Levitin's federal common lawmaking regime is a fully functioning bankruptcy appeals system.[211]

Unfortunately, the rule of "equitable mootness" frustrates the development of a coherent federal common law of bankruptcy. Under the rule of equitable mootness, federal circuit courts may avoid reaching the merits of bankruptcy controversies, and instead may opt to dismiss appeals as moot. To demonstrate how the equitable mootness rule disrupts the development of binding precedent, I will make use of the *Stone & Webster* opinion.

a. The federal common law rule of Stone & Webster

As noted above, in the chapter 11 bankruptcy case of *In re Stone & Webster, Inc.*,[212] the official creditors committee proposed a chapter 11 plan that provided for the substantive consolidation of a holding company and 72 subsidiaries. Prior to requesting confirmation, the creditors committee filed a separate motion for substantive consolidation. An objection was filed by the equity committee, asserting that consolidation was invalid, and demanding an entity-by-entity liquidation analysis.

However, the *Stone & Webster* court ruled that such entity-by-entity liquidation analysis was irrelevant as a matter of law. Under the *Stone & Webster* Consolidation Rule the hypothetical chapter 7 "best interest test" is to be made on a consolidated basis.[213]

Under Levitin's vision, judge-made rules such as the *Stone & Webster* Consolidation Rule will be eventually channeled into federal common law precedent. However, to become binding precedents, rules such as the *Stone & Webster* Consolidation Rule must be affirmed by the federal circuit courts. Only

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[210] *Id.* at 83.

[211] *See, e.g., In re* Adelphia Commc'ns, Corp., 361 B.R. 337, 342 (S.D.N.Y. 2007). In granting a motion for stay pending appeal, this district court stressed that appellate review:

> is the guarantee of accountability in our judicial system [and] no single judge or court can violate the Constitution and laws of the United States, or the rules that govern court proceedings, with impunity, because nearly all decisions are subject to appellate review . . . . [W]e, as a nation, are governed by the rule of law [and] [t]hus, the ability to appeal a lower court ruling is a substantial and important right.

Id.

[212] 286 B.R. 532 (Bankr. D. Del. 2002). *Stone & Webster* has been favorably reviewed by David B. Stratton. *See* Stratton, *supra* note 116, at 61–62 (detailing court's analysis of using Supreme Court precedence and statutory authority).

[213] *In re Stone & Webster*, 286 B.R. at 545 ("If this Court determines that substantive consolidation is warranted . . . then it would seem to follow that the hypothetical chapter 7 analysis should also be done on a substantive consolidation basis"); *see also In re* New Century TRS Holdings Inc., 390 B.R. 140, 164 n.27 (Bankr. D. Del. 2008) (referencing *Stone & Webster* Consolidation Rule, but concluding it did not need to reach merits of rule because New Century plan was supported by stand-alone liquidation analysis for each debtor).

the federal courts of appeal and the Supreme Court have the power to establish binding bankruptcy law precedent.

The validity of the *Stone & Webster* Consolidation Rule has yet to be tested before a court of appeals.[214] One hurdle is that the *Stone & Webster* ruling was interlocutory in character. The bankruptcy court reserved final judgment on whether substantive consolidation should be granted.[215] But even if an appeal had been taken from a final order confirming the consolidated *Stone & Webster* plan, it is unlikely that the *Stone & Webster* Consolidation Rule would have been reviewed on the merits by the court of appeals. This is because appeals of chapter 11 plans are routinely dismissed under the equitable mootness rule.

b. Equitable mootness is incompatible with a federal common law of bankruptcy

A student of the common law reviews judicial opinions issued by English and American appellate courts. These appellate courts established many venerable common law rules still followed today. The important interpretive role of the appellate courts in the bankruptcy context has been recognized as well. A study published by the Federal Judicial Center observed "it is beyond dispute that the surest way to move toward stability and predictability in bankruptcy law is to obtain more authoritative decisions from the court of appeals."[216]

However, as a practical matter, it is difficult to obtain authoritative decisions from the court of appeals on bankruptcy issues. This is because of the "equitable mootness" rule. The equitable mootness rule means that "an appeal should be dismissed as moot when, even though effective relief could conceivably be fashioned, implementation of that relief would be inequitable."[217] The equitable

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[214] See *In re Owens Corning*, 419 F.3d 195, 209 n.14 (3d Cir. 2005), which declined to reach this argument.

[215] *In re Stone & Webster*, 286 B.R. at 546 ("Whether a substantive consolidation provision in a particular plan . . . is warranted by the facts of this case remains for later determination.").

[216] *See* JUDITH A. MCKENNA & ELIZABETH C. WIGGINS, ALTERNATIVE STRUCTURES FOR BANKRUPTCY APPEALS 37 (2000), *available at* http://www.fjc.gov/public/pdf.nsf/lookup/BankrApp.pdf/$file/BankrApp.pdf.

[217] *See* Official Comm. of Unsecured Creditors of LTV Aerospace and Def. Co. v. Official Comm. of Unsecured Creditors of LTV Steel Co. (*In re* Chateaugay Corp.), 988 F.2d 322, 325 (2d Cir. 1993). The bankruptcy rule of equitable mootness rule is not based upon the Constitution, a statute, or a holding of the Supreme Court. As part of the Bankruptcy Reform Act of 1978, Congress specifically identified the sorts of bankruptcy court orders that, absent a stay pending appeal, will become unreviewable on appeal. *See* 11 U.S.C. § 363(m) (2006) (specifying that certain sales of property of debtor's estate to purchaser in good faith cannot be amended or reversed on appeal, unless sale is stayed during appeal's pendency); 11 U.S.C. § 364(e) (2006) (similar rule for good-faith extensions of credit). In substance, Congress codified a "bona fide" purchaser for value rule that was specifically designed to encourage bidding for assets of a bankrupt entity. After Congress enacted the Bankruptcy Code in 1978, the Ninth Circuit took that principle further, insulating an entire "plan of arrangement" from appellate review and establishing "the principle of dismissal of an appeal for lack of equity." *See* Trone v. Roberts Farms, Inc. (*In re* Roberts Farms, Inc.), 652 F.2d 793, 798 (9th Cir. 1981) ("[F]ailure to seek stays coupled with a substantial change of circumstances would justify dismissal of the appeal for lack of equity."). In the ensuing years, other courts of appeals invoked

mootness rule frustrates the development of binding federal common law rules of bankruptcy by Article III courts of appeals. That is, the equitable mootness rule effectively removes bankruptcy courts from the supervision of Article III courts of appeal causing rulings on many issues, such as the *Stone & Webster* Consolidation Rule, become effectively unreviewable.[218]

"equitable" factors to dismiss some bankruptcy appeals, although they have not agreed about the limits of the rule or the factors dictating its application. *See generally In re* Cont'l Airlines, 91 F.3d 553 (3d Cir. 1996) (en banc); Baker & Drake, Inc. v. Pub. Serv. Comm'n of Nev. (*In re* Baker & Drake, Inc.), 35 F.3d 1348 (9th Cir. 1994); *In re* UNR Indus., Inc., 20 F.3d 766 (7th Cir. 1994); *In re* Chateaugay Corp., 988 F.2d 322 (2d Cir. 1993); Rochman v. Ne. Utils. Serv. Group (*In re* Pub. Serv. Co.), 963 F.2d 469 (1st Cir. 1992); Halliburton Serv. v. Crystal Oil Co. (*In re* Crystal Oil Co.), 854 F.2d 79 (5th Cir. 1988); Cent. States v. Cent. Transp., Inc., 841 F.2d 92 (4th Cir. 1988); Miami Ctr. P'ship v. Bank of N.Y., 838 F.2d 1547 (11th Cir. 1988); Tompkins v. Frey (*In re* Bel Air Assocs.), 706 F.2d 301 (10th Cir. 1983); Metro Prop. Mgmt., Inc. v. Info. Dialogues, Inc. (*In re* Info. Dialogues, Inc.), 662 F.2d 475 (8th Cir. 1981). The most substantial public debate over the validity of the equitable mootness rule is found in the Third Circuit's opinion for *In re Continental Airlines*. 91 F.3d at 558–559. In *Continental Airlines*, a bankruptcy appeal was dismissed as "equitably moot" by the Third Circuit by a vote of seven to six. *Id.* at 567. Circuit Judge Samuel Alito wrote in dissent that the majority's decision created "bad precedent" and further observing the "curious doctrine of 'equitable mootness'" permits courts of appeals "to refuse to entertain the merits of live bankruptcy appeals over which they indisputably possess statutory jurisdiction and in which they can plainly provide relief." *Id.* (Alito, J., dissenting). As then Judge Alito noted in dissent, it is possible that equitable mootness doctrine is invalid. *Id.* at 569–570. The Supreme Court rejected a laches argument that sounds very similar to an equitable mootness claim in *Northern Pacific Railway Co. v. Boyd*, 228 U.S. 482, 510 (1913). Further, the equitable mootness doctrine, to the extent it creates a new equitable remedy, may itself be subject to the Equity Cutoff Rule of *Grupo Mexicano*, and it has the potential of making the bankruptcy court a court of "first and last resort" without adequate review by the Article III judiciary, which may present yet another separation of powers problem. *See* N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 87 (1982) (holding Bankruptcy Act of 1978 unconstitutionally removed "most, if not all, of 'the essential attributes of the judicial power' from the Art. III district court, and has vested those attributes in" bankruptcy courts). However, because most of the federal circuit courts have recognized equitable mootness to some degree, I will assume that equitable mootness will render a significant bankruptcy court's rulings unreviewable by courts of appeal and the Supreme Court, which calls into the question whether the virtue of a federal common law of bankruptcy (predictability) will likely be achieved.

[218] *See, e.g.*, ACC Bondholder Group v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns), 361 B.R. 337, 368 (S.D.N.Y. 2007). The district court granted the bondholder's motion for stay pending appeal on the condition the bondholders pledged a $1.3 billion cash bond. Ultimately the cash was not pledged, the plan was consummated, and any review by a court of appeal was mooted. ACC Bondholder Group v. Adelphia Commc'ns Corp. (*In re* Adelphia Commc'ns), 367 B.R. 84, 89–90 (S.D.N.Y. 2007). Regardless of whether one considers this result fair, the point is that no binding precedent will be established with respect to the issues presented in the Adelphia chapter 11 plan, which included a substantive consolidation provision that the district court observed was "unlikely" to be correct under the Second Circuit's rigorous standards. *See In re* Adelphia Commc'ns, 368 B.R. 140, 218–19 (Bankr. S.D.N.Y. 2007); *see also* Happy v. Equity Bank SSB (*In re* Green Aggregates Inc.), No. 08-51075, 2009 WL 1143202, at *2 (5th Cir. April 28, 2009). In this unreported opinion the Fifth Circuit dismissed as equitably moot an appeal of a chapter 11 Plan confirmation order that provided for the substantive consolidation of a debtor with a non-debtor entity. To be sure, the Fifth Circuit may have reigned in the equitable mootness doctrine to some degree, and perhaps other circuit courts will follow. *See* Tech. Lending Partners, LLC v. San Patricio County Cmty. Action Agency (*In re* Patricio County Cmty. Action Agency), 575 F.3d 553, 559 (5th Cir. 2009) (questioning whether equitable mootness has any application in chapter 7 cases, and finding equities of this appeal in chapter 7 context was not significantly different from general civil appeal in which money judgment was entered, but no stay pending appeal obtained); *see also* Wooley v. Faulkner (*In re* SI Restructuring, Inc.), 542 F.3d 131, 136–37 (5th Cir. 2008) (holding challenge to disbursement of attorney's fees after confirmation of plan was not equitably moot); Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (*In re* Pac. Lumber), 584

Opinions issued at the bankruptcy court level are often in conflict. Bankruptcy judges provide the trial-court-level adjudication of a substantial part of the commercial law cases in the United States, and conflicting opinions rendered in bankruptcy cases complicate the ability of businesses and lawyers to structure transactions. Because of equitable mootness, parties are faced with the dismal prospect of having bankruptcy judges citing other bankruptcy court opinions, although such opinions are not binding precedent.

Because equitable mootness rule frustrates the development of binding "precedent and judicially devised tests," this Article argues that Levitin's vision of a predictable federal common law of bankruptcy will not be achieved. The federal common law of bankruptcy will be plagued by a cacophony of conflicting lower court opinions on many important issues, as exemplified by the *Stone & Webster* Consolidation Rule. A federal common law of bankruptcy is incompatible with equitable mootness.

3. Other Supreme Court teachings on federal common law

a. Insolvency is not a license to create federal common law

The rules applicable to the liquidation of insolvent banks are analogous to the liquidation insolvent bankruptcy estates.[219] Notably in the context of the liquidation of insolvent banks, the Supreme Court has discouraged use of federal common law rules. In *O'Melveny & Meyers v. Federal Deposit Insurance Corp.*, [220] the Court unanimously reversed a federal common law scheme of corporate law that had displaced traditional matters of state concern. The FDIC had proposed federal common law rules to regulate corporate governance and determine when the knowledge of corporate directors may be imputed to the corporation. The FDIC argued that with respect to insolvent banks under its regulatory jurisdiction, federal common law rules should determine the outcome of the adjudication of its claims. The FDIC further contended that use of federal common law should not be offensive, because the "content of the federal common law rule corresponds to the rule that would independently be adopted by most jurisdictions."[221] Justice Scalia, writing for the Court, forcefully admonished the FDIC, stating that its first assertion was "so plainly wrong," that "[t]here is no federal general common law," and even if "there were a federal common law on such a generalized issue (which there is not), we see no reason why it would necessarily conform to that independently . . . adopted by most jurisdictions."[222]

F.3d 229, 243 (5th Cir. 2009) (holding equitable mootness doctrine did not bar review of whether plan's treatment of secured claims was fair and equitable).

[219] *See* Sexton v. Dreyfus, 219 U.S. 339, 346 (1911) ("The view that we adopt [regarding allowance of post-petition interest] . . . is somewhat sustained by analogy in the case of insolvent banks.").

[220] 512 U.S. 79 (1994).

[221] *Id.* at 84 (quoting Brief for the Respondent 15, n.3).

[222] *Id.* at 83–84 (quoting Erie R. Co, v. Tompkins, 304 U.S. 64, 78 (1938)).

In *Atherton v. Federal Deposit Insurance Corp.*,[223] the issue was whether courts should look to state law, a federal statute, or federal common law to find the applicable standard to measure the legal propriety of a bank officer's actions. The Supreme Court held that absent a significant conflict between some federal policy or interest and state law, courts must refrain from fashioning rules of federal common law. Justice Breyer, writing for the Court, rejected the FDIC's assertion that the need for uniformity mandated a federal common law rule of decision, thereby reaffirming one of *Kimbell Foods*' central premises by stating, "to invoke the concept of uniformity . . . is not to prove its need."[224] The Court held that the federal statute provided a liability floor (gross negligence), and that state law would provide the rule of decision if the state liability standard exceeded that of gross negligence. The crux of the opinion was that a significant conflict between a federal policy and state law did not exist, making reliance on or creation of federal common law improper.

These Supreme Court cases refute the point of view that courts should be allowed to formulate federal common law rules to resolve insolvency cases. Clearly the Court found little merit with the argument in the context of insolvent banks.

b. Federal common law does not supplant state corporate laws in the environmental law context

The Supreme Court has also eschewed reliance upon federal common law principles in a CERCLA case where doing so would upset state corporate law principles.[225] In *Bestfoods*,[226] the Supreme Court addressed the issue of whether a parent corporation could have derivative liability for response costs due to its participation in or exercise of control over a subsidiary firm liable under CERCLA. The Court held that: (1) a parent corporation may be charged with derivative CERCLA liability as an "owner" for its subsidiaries' actions in operating a polluting facility only when state law allows the "corporate veil to be pierced;"[227] (2) the "participation and control" test employed by the district court to evaluate a parent corporation's control of a subsidiary may not be used to impose CERCLA liability; and (3) a parent corporation may be held liable as an "operator" under CERCLA in instances other than the parent's sole operation of, or joint venture with, a subsidiary. Justice Souter expressed this point by noting that CERCLA's failure to deal with the particular issue of parent/subsidiary liability did not mean that the "entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute."[228] Congressional silence regarding "a matter as fundamental as the liability implications of corporate ownership demands application of the rule that '[i]n order to abrogate a common-law principle, the statute must speak directly to the question addressed by the common law.'"[229]

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[223] 519 U.S. 213 (1997).

[224] *Id.* at 220 (referencing Kimbell Foods, 440 U.S. 715, 730 (1979)).

The Court has also rejected a federal common law right of contribution arising under CERCLA.[230]

c. The federal common law of admiralty

Article III of the Constitution contains a direct grant of judicial power to federal courts over cases involving admiralty and maritime jurisdiction.[231] Admiralty is an area where the Supreme Court has recognized a legitimate role for federal common law in the strict sense. Civil proceedings filed with federal district courts within their admiralty jurisdiction are presumptively governed by federal law, not state law.[232] The governing federal law is maritime law, which is made not only in treaties, Acts of Congress, and federal regulations, but also in the decisions of courts, both state and federal.[233]

When maritime law is made by judges in case law decisions, it is made in a manner similar to that for making common law, and such judge-made law is commonly referred to as "general" maritime law to distinguish it from law made otherwise—that is, in treaties, statutes, and regulations.[234] General maritime law is recognized as substantive law made sometimes by federal judges that survived the landmark *Erie* decision.[235]

Notably in the context of an admiralty decision, the Supreme Court contrasts the lawmaking powers of Article III federal courts exercising admiralty jurisdiction

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[225] *See, e.g.*, United States v. Bestfoods, 524 U.S. 51, 63 (1998) (declining to displace state corporation law using federal alter ego common law to fashion CERCLA remedy against parent company).

[226] *Id.* at 51.

[227] *Id.* at 63–64.

[228] *Id.* at 63 (quoting Burks v. Lasker, 441 U.S. 471, 478 (1979)).

[229] *Id.* (quoting United States v. Texas, 507 U.S. 529, 534 (1993)).

[230] *See* Cooper Indus., Inc. v. Aviall Servs., Inc., 543 U.S. 157, 162 (2004) (stating Congress now "provide[s] an express cause of action for contribution").

[231] *See* U.S. CONST. art. III, § 2. In section 9 of the Judiciary Act of 1789, Congress vested federal district courts with jurisdiction to hear cases of admiralty and maritime jurisdiction. JUDICIARY ACT, ch. 20, § 9, 1 Stat. 73, 76–77 (1789). The Judiciary Act of 1789 does not contain the word "bankruptcy" or a similar provision concerning bankruptcy.

[232] *See* Yamaha Motor Corp. U.S.A. v. Calhoun, 516 U.S. 199, 206 (1996) (discussing watercraft collision on navigable waters comes within federal admiralty laws); E. River S.S. Corp. v. Transamerica Delaval Inc., 476 U.S. 858, 864 (1986) (discussing ships engaged in maritime commerce were also subject to admiralty law).

[233] *See* Norfolk S. Ry. Co. v. James N. Kirby Pty, Ltd., 543 U.S. 14, 23 (2004) ("Because the grant of admiralty jurisdiction and the power to make admiralty law are mutually dependent, the two are often intertwined in our cases.").

[234] *See E. River S.S. Corp.*, 476 U.S. at 864–65 (1986) ("Drawn from state and federal sources, the general maritime law is an amalgam of traditional common-law rules, modifications of those rules, and newly created rules.").

[235] *See* Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938) (exempting substantive matters governed by United States Constitution, which include maritime laws, from requirement that "the law to be applied in any case is the law of the State").

with the limited lawmaking power of the bankruptcy courts.[236] In contrast to admiralty courts, the court observed the "equitable lawmaking power of bankruptcy courts [is] limited by statute."[237] Bankruptcy courts are different in kind from admiralty courts.

4. Conclusion of federal common law discussion

Levitin is onto something. Sensing a general discomfort with reliance upon equity powers,[238] Levitin proposes courts swap unbridled discretion (equity powers) for the "rule of law" (in the form of federal common law).

However, do bankruptcy judges really have a common law flexibility to deal with new business practices? Levitin argues they do,[239] citing the Supreme Court's recognition of the flexibility of the Bankruptcy Clause in *Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Railway Co.*[240] However, the Court only addressed the constitutionality of Congress' exercise of its Article I lawmaking powers under the Bankruptcy Clause—not the propriety of judge-made lawmaking authority under the Bankruptcy Clause.

The English common law method is ill-suited to balance the policy considerations that should be taken into account by lawmakers in formulating rules for substantive consolidation. State law governs corporate mergers, alter ego, property ownership, and creditor's rights. A federal common law rule of substantive consolidation displaces state law based expectations on such issues.

In making common-law decisions, a judge has to make normative judgments about which laws are best, and so the judge's moral values are in play. Assume a bankruptcy judge's moral values are shaped by the philosophy of "survival of the fittest." Such a judge might give more weight to the "first in time first in right" principle instead of notions of equality of creditors. Such judge's common law rule may reward a creditor who was first to attach assets of a non-debtor parent

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[236] *See* Norfolk Shipbuilding & Drydock Corp. v. Garris, 532 U.S. 811, 820 (2001) (noting play of tradition for Article III courts).

[237] *Id.* at 820 (citing Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, 527 U.S. 308, 332–33 (1999)).

[238] *See, e.g.*, United States v. Frontone, 383 F.3d 656, 659 (7th Cir. 2004). The court states:

> [W]hile the Bankruptcy Code is indeed a code of debtors' rights (hence the "fresh start" rationale), it is equally a code of creditors' remedies . . . . What is most important is that it is the Code itself—not bankruptcy judges, district judges, circuit judges, or even Supreme Court Justices, exercising a free-wheeling 'equitable' discretion—that strikes the balance between debtors and creditors.

Id.

[239] *See* Levitin, *supra* note 15, at 81 (discussing bankruptcy courts' need to consider efficiency and fairness when balancing interests of creditor and debtor).

[240] Cont'l Ill. Nat'l Bank & Trust, Co. v. Chi., Rock Island & Pac. Ry., 294 U.S. 648, 671 (1935) (noting Bankruptcy Clause of Constitution has capacity to adapt to conditions arising from developing business activities).

company. Such judge would deny consolidation with a debtor subsidiary if such consolidation prejudiced the creditor who is "first in time and right."

Levitin argues "it is hard to think that Congress would *not* have wanted federal judges to have common lawmaking power in bankruptcy."[241] I disagree. In each round of amendments to the Bankruptcy Reform Act of 1978, Congress has included more detailed Code provisions, effectively reducing the judiciary's remaining interstitial lawmaking discretion. For example, in the 2005 amendments, judicial discretion to adjust deadlines within which a trustee or debtor may assume or reject leases was sharply curtailed.[242] Repeatedly, Congress chooses not to let bankruptcy judges develop rules in a common law fashion.

In speech after speech given by Senators from both major political parties during Supreme Court justice nominee confirmation hearings, we hear that Congress should "make the law" and the role of judges is to "enforce the law." In this environment, I find it hard to fathom Congress wants bankruptcy judges to exercise federal common lawmaking powers on issues not addressed in federal statutes.[243]

E. The "pre-Code practices" rule does not authorize substantive consolidation

If federal common law is unavailable as a basis for substantive consolidation, and Congress has not directly addressed substantive consolidation by statute, may Congress be deemed to have adopted a judge-made consolidation rule by implication? If Congress can be viewed as approving substantive consolidation by implication, the separation of powers concerns underlying *Grupo Mexicano* might be avoided.

The Supreme Court has recognized a principle called the "pre-Code practices" rule in which judicial opinions continue to serve as binding precedents, notwithstanding an intervening statutory enactment.[244] In *Midlantic National Bank*

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[241] Levitin, *supra* note 15, at 77.

[242] *See* 11 U.S.C. § 365(d)(4) (2006) (indicating court may extend deadline for trustee's assumption or rejection of lease only for 90 days upon motion of trustee and subsequent extension subject to lessor's written consent).

[243] Even if Congress intends that bankruptcy judges have some leeway to announce common law rules, the Supreme Court may not allow such delegation of duties. As shown *infra* Part III in the *Noland* opinion the Supreme Court has imposed constitutional restrictions on the ability of Congress to grant bankruptcy courts leeway to perform legislative functions. *See* United States v. Noland, 517 U.S. 535, 542 (1996) ("[S]tatements in legislative history cannot be read to convert leeway for judicial development of a rule . . . into delegated authority to revise statutory categorization.").

[244] *See* John R. Sand & Gravel Co. v. United States, 552 U.S. 130, 136 (2008) ("The Court does not presume that the 1948 revision [to the Tucker Act] worked a change in the underlying substantive law 'unless an intent to make such a change is clearly expressed.'" (internal quotation marks omitted) (quoting Keene Corp. v. United States, 508 U.S. 200, 209 (1993))). *But see* Dewsnup v. Timm, 502 U.S. 410, 433 (1992) (stating pre-Code practice is not determinative when contradictory statutory text exists). The pre-Code practices rule is not unique to bankruptcy law. The Supreme Court has applied a similar past-practices rule to construe provisions of the Federal Tort Claims Act.

v. New Jersey Department of Environmental Protection,[245] the Supreme Court observed:

> The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications.[246]

The Court has further stated that it "will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure."[247] Thus, under a broad interpretation of the pre-Code practices rule, certain pre-1978 precedents allowing substantive consolidation might be considered as having been adopted by implication.

However, this Article argues that the pre-Code practices doctrine is only a rule of statutory construction. As a rule of statutory construction, it may not be used to carry prior rules - such as substantive consolidation - that lack any statutory support in the text of the Bankruptcy Code.

The pre-Code practices rule may not be invoked absent an ambiguous statute requiring judicial interpretation. Notably, in each of the following Supreme Court's pre-Code practices opinions, the Court examines prior practices only as an aid to its interpretation of text found within the Bankruptcy Code.

- *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot.*, 474 U.S. 494 (1986) (interpreting 11 U.S.C. § 554(a)).
- *Kelly v. Robinson*, 479 U.S. 36 (1986) (interpreting 11 U.S.C. § 523(a)(7)).
- *United Savings Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd*., 484 U.S. 365 (1988) (interpreting 11 U.S.C. § 362(d)(1)).
- *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) (interpreting 11 U.S.C. § 1129(b)).
- *United States v. Ron Pair Enters., Inc*., 489 U.S. 235 (1989) (interpreting 11 U.S.C. § 506(b)).
- *Penn. Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552 (1990) (interpreting 11 U.S.C. § 523(a)(7)).
- *Cohen v. De la Cruz*, 523 U.S. 213 (1998) (interpreting 11 U.S.C. § 523(a)(2)(A)).

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[245] 474 U.S. 494 (1986).

[246] *Id.* at 501 (citations omitted).

[247] *See* Cohen v. de la Cruz, 523 U.S. 213, 221 (1998) (quoting Pa. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 563 (1990)).

- *Dewsnup v. Timm*, 502 U.S. 410 (1992) (interpreting 11 U.S.C. § 506(d)).
- *Travelers Cas. & Surety Co. of Am. v. Pac. Gas & Elec.*, 549 U.S. 443 (2007) (interpreting 11 U.S.C. § 502(b)(1)).

The Court's application of the pre-Code practices rule in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric* further illustrates this point.[248] Rejecting the Ninth Circuit's "*Fobian* rule" the Court reasoned:

> In light of the broad, permissive scope of § 502(b)(1), and our prior recognition that "the character of [a contractual] obligation to pay attorney's fees presents no obstacle to enforcing it in bankruptcy," it necessarily follows that the *Fobian* rule cannot stand . . . . "We . . . will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure."[249]

This passage indicates the pre-Code practices have been taken into account to arrive at the proper interpretation of section 502(b)(1). *Travelers Casualty* reinforces what the Court held earlier in *Hartford Underwriters Insurance Co. v. Union Planters Bank*,[250] that "while pre-Code practice informs our understanding of the language of the Code . . . it cannot overcome that language. It is a tool of construction, not an extra textual supplement."[251]

This Article argues that the "pre-Code practices" rule is a Court-endorsed method to interpret ambiguous Bankruptcy Code text.[252] Absent ambiguous statutory text to interpret, the pre-Code practices rule may not be invoked. Without ambiguous Bankruptcy Code text concerning substantive consolidation that requires resort to pre-Code practices to interpret, the pre-Code practices rule fails to provide an independent source of authority for substantive consolidation. No ambiguous text authorizing substantive consolidation exists in the Bankruptcy Code.

1. Sources of pre-Code practices confusion

One might parse language from Supreme Court opinions in an effort to broaden

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[248] 549 U.S. 443, 454–55 (2007) (showing pre-Code bankruptcy practices are not definitive proof of anything without Bankruptcy Code proof).

[249] *Id.* at 453–54 (quoting *Cohen*, 523 U.S. at 221 (citation omitted)); Sec. Mortgage Co. v. Powers, 278 U.S. 149, 154 (1928)).

[250] 530 U.S. 1, 10 (2000) (limiting standing to assert section 506(c) surcharge to trustee, in which context creditor had asserted that based upon practice under prior Bankruptcy Act and in equity receiverships, parties other than trustee were permitted to charge secured creditor).

[251] *Id.*

[252] Notably, in determining whether the plain meaning of the bankruptcy statute is ambiguous, the Court looks to "the existing statutory text, and not the predecessor statutes." *See* Lamie v. U.S. Trustee, 540 U.S. 526, 534 (2004).

the pre-Code practices rule beyond a rule of statutory interpretation. For example, in *Midlantic National Bank*,[253] the Court observed:

> The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a **judicially created concept**, it makes that intent specific. The Court has followed this rule with particular care in **construing the scope of bankruptcy codifications**.[254]

Similarly in *Dewsnup v. Timm*,[255] the Court explained:

> **When Congress amends the bankruptcy laws, it does not write "on a clean slate."** Furthermore, this Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history. Of course, where the language is unambiguous, silence in the legislative history cannot be controlling. But, **given the ambiguity here**, to attribute to Congress the intention to grant a debtor the broad new remedy against allowed claims to the extent that they become "unsecured" for purposes of § 506(a) without the new remedy's being mentioned somewhere in the Code itself or in the annals of Congress is not plausible, in our view, and is contrary to basic bankruptcy principles.[256]

In each paragraph, the initial highlighted phrases, if parsed from the remaining opinion text, could be read to mean that the pre-Code practices rule permits "any practice" that occurred during the Bankruptcy Act era to be carried forward.[257] However, in both passages, the second bold phrase confirms that the Court applied

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[253] 474 U.S. 494, 501 (1986).

[254] *Id.* (citations omitted) (emphases added).

[255] 502 U.S. 410 (1992).

[256] *Id.* at 419–20 (citations omitted) (emphases added).

[257] Based in part upon the emphasized text quoted from *Midlantic*, Levitin argues that if Congress intends for legislation to change the interpretation of a judicially created concept, the Supreme Court requires that Congress make that intent specific. Levitin argues that a "federal common law of bankruptcy" is a pre-1978 judicially created concept. Levitin then argues that because Congress did not clearly repudiate use of a federal common law of bankruptcy in the Bankruptcy Code, it survives as a source of lawmaking authority. *See* Levitin, *supra* note 15, at 59. I respectfully disagree with such construction of *Midlantic*. The Supreme Court has not approved use of the pre-Code practices rule to carry-forward a practice lacking any textual support in the Bankruptcy Code. The Eleventh Circuit has observed that while under pre-Code practice bankruptcy courts enjoyed extensive equitable powers, such powers have been significantly curtailed under the Bankruptcy Code. It then ruled that since the pre-Code "rule of explicitness" lacks textual support, such rule did not survive the enactment of the Bankruptcy Code. *See* Chem. Bank v. First Trust of N.Y. (*In re* Se. Banking Corp.), 156 F.3d 1114, 1122 (11th Cir. 1998).

its pre-Code practices rule to interpret an ambiguous provision of the current Bankruptcy Code.

In *Ron Pair*, Justice Blackmun, writing for the Court, emphasized that the pre-Code practices rule that had been announced in *Midlantic National Bank* arose in the context of a statute needing interpretation:

> *Kelly* and *Midlantic* make clear that, in an appropriate case, a court must determine whether Congress has expressed an intent to change the interpretation of a judicially created concept in enacting the Code. But *Midlantic* and *Kelly* suggest that there are limits to what may constitute an appropriate case. **Both decisions concerned statutory language which, at least to some degree, was open to interpretation**. Each involved a situation where bankruptcy law, under the proposed interpretation, was in clear conflict with state or federal laws of great importance.[258]

The requirement that a party must present ambiguous statutory text before invoking the pre-Code practice rule, leaves substantive consolidation without support. On the topic of substantive consolidation, there is no ambiguous text. Instead, statutory silence is encountered.

2. How should courts interpret statutory silence?

The purpose of statutory interpretation is to determine congressional intent. The preferred approach is to apply the plain meaning of the text.[259] In circumstances where the plain meaning is not self evident, the Supreme Court has employed a variety of principles, including pre-Code practices, dictionary definitions, comparison with other sections, *expression unius est exclusion alterius* and legislative history. However, none of this speaks to what to do in the situation where the statutory scheme is silent, as is the situation with substantive consolidation.[260]

In the context of a decision under the Clean Water Act, Justice Scalia, writing for the Supreme Court, vividly describes the problem confronting courts when legislation is silent:

> Congress takes no governmental action except by legislation. What the dissent refers to as "Congress' deliberate acquiescence" should

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[258] United States v. Ron Pair Enters., 489 U.S. 235, 245 (1989) (emphasis added).

[259] *See, e.g.*, Lamie v. U.S. Trustee, 540 U.S. 526, 534 (2004) (discussing methods of statutory interpretation when ambiguous).

[260] Judge Richard Posner notes the difficulty of reconciling canons of statutory construction: "For every canon one might bring to bear on a point there is an equal and opposite canon. This is an exaggeration; but what is true is that there is a canon to support every possible result." RICHARD A. POSNER, THE FEDERAL COURTS: CRISIS AND REFORM 276 (Harvard University Press) (1985).

> more appropriately be called Congress's failure to express any opinion. We have no idea whether the Members' failure to act in 1977 was attributable to their belief that the Corps' regulations were correct, or rather to their belief that the courts would eliminate any excesses, or indeed simply to their unwillingness to confront the environmental lobby.[261]

Similarly we have no idea whether the Congress' failure to address substantive consolidation in 1978 was attributable to Congress' belief that the Second Circuit's standards were correct, its unwillingness to confront a lobby group, or the legislature's general lack of awareness that a "corporate group" problem existed in bankruptcy cases. Because substantive consolidation had been so rarely encountered by parties and courts by 1978, most likely it failed to show up on legislators "radar screen" when the Bankruptcy Code reforms were debated.

The Supreme Court addressed the problem of statutory silence in the bankruptcy context in *Lamie v. United States Trustee*.[262] In this opinion the Court considered whether Congress' failure to include the term "debtor's attorney" in an awkwardly worded passage of the Bankruptcy Code nonetheless allowed judicial resort to prior practices to determine whether the legislature implicitly allowed administrative payments to such attorneys. Justice Kennedy, writing for the Court, rejected such contention, and observed: "[Petitioner's] argument would result 'not [in] a construction of [the] statute, but, in effect, an enlargement of it by the court, so that what was omitted, presumably by inadvertence, may be included within its scope.'"[263]

Similarly resort to the pre-Code practices rule to permit substantive consolidation amounts not to a construction of the Bankruptcy Code but rather a judicial enlargement of it. In the absence of an ambiguous statutory text, there is no basis to rely upon the pre-Code practices rule to justify the continued validity of substantive consolidation under the notion that Congress implicitly adopted it.

3. How should courts determine whether the pre-Code practice was sufficiently widespread and well recognized to justify a conclusion of implicit adoption?

If the Supreme Court were to expand the pre-Code practices rule beyond its limited statutory interpretation function, a series of additional problems would be presented. How many court decisions are required before the pre-Code practice is sufficiently established that Congress would necessarily have thought it had to

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[261] Rapanos v. United States, 547 U.S. 715, 750 (2006).

[262] 540 U.S. 526, 538 (2004) (concluding, via statutory interpretation, "that § 330(a)(1) does not authorize compensation awards to debtors' attorneys from estate funds, unless they are employed as authorized by § 327").

[263] *Id.* (quoting Iselin v. United States, 270 U.S. 245, 251 (1926)).

address the practice in the Bankruptcy Code? Will a couple of circuit court opinions suffice? Will a couple of bankruptcy court opinions suffice?

This problem received comment in the Supreme Court's opinion interpreting section 506(c) of the Bankruptcy Code. In *Hartford*,[264] a creditor asserted that based upon several lower court opinions decided under the prior Bankruptcy Act, parties other than the trustee were permitted to surcharge a secured creditor. The Supreme Court rejected this contention: "It is questionable whether these precedents establish a bankruptcy practice **sufficiently widespread and well recognized** to justify the conclusion of implicit adoption by the Code."[265]

How widespread and well recognized was substantive consolidation, measured by reported opinions decided on or before 1978? The origins of the uniquely federal doctrine of substantive consolidation can be traced to four opinions from the Second Circuit between 1963 and 1976.[266] A bankruptcy court then christened the term "substantive consolidation" within a year before the passage of Bankruptcy Code in 1978.[267] When Congress passed the current Bankruptcy Code in 1978, it appears that only one federal circuit (the Second Circuit) expressly treated substantive consolidation as a federal doctrine separate and distinct from state alter ego law. Leading circuit court precedents such as *Augie Restivo*, *Auto-Train* and *Owens Corning* had not yet been decided. The embryonic status of the federal substantive consolidation doctrine, localized in Second Circuit jurisprudence as of 1978, does not justify a conclusion that Congress adopted the doctrine by implication.[268]

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[264] Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 9 (2000) ("Petitioner cites a number of lower court cases, however, in which—without meaningful discussion of the point—parties other than the trustee were permitted to pursue such charges under the Act . . . .").

[265] *Id.* at 10 (emphasis added).

[266] The Second Circuit's four seminal cases upon which the uniquely federal doctrine of substantive consolidation is based are found *supra* note 37. *See* Soviero v. Franklin Nat'l Bank, 328 F.2d 446, 446–47 (2d Cir. 1964) (determining whether specific assets belonged to bankrupt estate); *see also* Chem. Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966) ("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."); *c.f.* Union Sav. Bank v. Augie/Restivo Banking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988) ("The sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors."); Flora Mir Candy Corp. v. B.S. Dickson & Co. (*In re* Flora Mir Candy Corp.), 432 F.2d 1060, 1062 (2d Cir. 1970) (stating consolidation in bankruptcy affects substantial rights).

[267] The term "substantive consolidation" appears for the first time in 1977 in *In re Commercial Envelope Manufacturing Co.*, No. 76 B 2354, 1977 WL 182366, at *1 (Bankr. S.D.N.Y. Aug. 22, 1977). This Article argues that the Supreme Court has never ruled on substantive consolidation. *See supra* Part II, section (i).

[268] That is not to say there was no "prior practice" whatsoever of any form of "consolidation" in any other circuit court's bankruptcy opinions prior to 1978. For example, the word "consolidation" appears in each of the following circuit court opinions issued prior to 1978. *See, e.g.*, Mfrs. Credit Corp. v. Sec. Exch. Comm'n (*In re* Mfrs. Credit Corp.), 395 F.2d 833, 846 (3d Cir. 1968) (affirming "consolidation," but nevertheless allowing certain individual debtor entities to retain certain separate rights if not insolvent); Todd Bldg. Corp. v. Heller (*In re* Clark Supply Co.), 172 F.2d 248, 254 (7th Cir. 1949) (based upon referee's finding that affiliate of corporate debtor had been formed for purpose of evading creditors, and based upon state law based alter ego factors, holds referee had summary jurisdiction sufficient to "consolidate" the entities, similar to Supreme Court's subject matter jurisdiction holding in *Sampsell*); Stone v. Eacho (*In re* Tip Top Tailors, Inc.), 127 F.2d 284, 287 (4th Cir. 1942) (consolidation approved using state corporate law concept of where one corporation is "'mere agency or corporate pocket'" or "mere instrumentality" of other); Withers v. White

The following passage from the Supreme Court's decision in *National Labor Relations Board v. Bildisco & Bildisco*,[269] sheds further light on application of the pre-Code practices rule:

> The Union and the Board argue that in light of the special nature of rights created by labor contracts, Bildisco should not be permitted to reject the collective-bargaining agreement unless it can demonstrate that its reorganization will fail unless rejection is permitted. This very strict standard was adopted by the Second Circuit [in a case] under the former Bankruptcy Act three years before § 365(a) was passed by Congress. Under the canon of statutory construction that Congress is presumed to be aware of judicial interpretations of a statute, the Board argues that Congress should be presumed to have adopted the interpretation of the Second Circuit when it enacted § 365(a).[270]

However, the Supreme Court rejected the Board's argument and found its pre-Code practices argument based upon a single circuit's opinions to be unconvincing.

(*In re* Foley), 4 F.2d 154, 157 (9th Cir. 1925) (declining to reverse "consolidation" that had been granted on legal grounds not directly reviewed in opinion, and declining to require separate trustee be appointed for two entities, Ninth Circuit observed consolidation order did not prevent creditors' rights from being "fully protected as if two estates were divorced for purpose of administration"). While circuit court level opinions using phrases such as "corporate pocket" in conjunction with "consolidation" exist prior to 1978, what is absent from the judicial opinions outside of the Second Circuit is a federal law rule of consolidation that is entirely separate and distinct from state alter ego law concepts. *See In re* Bonham, 226 B.R. 56, 77 (Bankr. D. Alaska 1998) ("In some cases, an *alter ego* analysis is involved in determining if entities should be consolidated.").

As argued in the Prior Article at page 432, beginning in the 1960s, the Second Circuit departed from state corporate law "alter ego" principles such as "mere instrumentality" and invented a uniquely federal common law rule of consolidation. *See* Tucker, *Grupo Mexicano*, *supra* note 11, at 432. The fundamental principles established by the Second Circuit are found *supra* note 37. The Second Circuit would later observe the fundamentally different purposes served by state "alter ego" law and federal "substantive consolidation" law: "The focus of piercing the corporate veil is the limited liability afforded to a corporation; whereas, the focus of substantive consolidation is the equitable treatment of all creditors." Fed. Deposit Ins. Corp. v. Colonial Realty Co., 966 F.2d 57, 61 (2d Cir. 1992).

After the enactment of Bankruptcy Reform Act of 1978, the Second Circuit restated, and most other federal circuit courts announced, their own rules of decisions for substantive consolidation, most traceable to some extent to the holdings of the pre-Code Four. The rules later announced by the Second Circuit in *Augie/Restivo*, by the Eleventh Circuit in *Eastbrook Properties*, and the Third Circuit in *Owens Corning* are discussed in depth *infra* Part III.

But the issue at hand whether the "prior practice" of granting substantive consolidation using federal law rules of decision was sufficiently widespread in 1978 that courts should assume Congress adopted the doctrine by implication. This Article argues "prior practice" in 1978 of granting substantive consolidation using only federal law-based rules of decision was limited to the jurisprudence of the Second Circuit. The Second Court's rudimentary pre-1978 rules were not restated into a complete doctrine until its *Augie/Restivo* opinion of 1988. Given the narrow recognition of the doctrine as of 1978, it is not sensible to conclude Congress adopted the doctrine of substantive consolidation by implication.

[269] 465 U.S. 513 (1984).

[270] *Id.* at 524.

Similarly only a single circuit (again the Second Circuit) had adopted uniquely federal rules of consolidation when the 1978 Bankruptcy Code was enacted.

4. Graulich's synthesis of the pre-Code practices rule and *Grupo Mexicano*

A plausible alternative application of the pre-Code practices rule to substantive consolidation has been proposed by Timothy Graulich.[271] Graulich argues that substantive consolidation remains a valid remedy, if confined to that narrow remedy recognized in the Supreme Court's 1941 *Sampsell* opinion, coupled with the Second Circuit's four consolidation opinions decided prior to 1978.[272] Graulich argues the *Owen Corning* correctly restated the governing principles fixed as of 1978. Graulich has proposed a synthesis of the pre-Code practices rule with the *Grupo Mexicano* Equity Cutoff Rule. Although concluding that the consolidation doctrine survived the enactment of the Bankruptcy Code in 1978, Graulich argues that courts lack the authority to expand the doctrine beyond its status in 1978. Graulich argues *Eastgroup Properties*[273] was wrongly decided because it expands the reach of the doctrine beyond its narrow scope as measured by1978 vintage caselaw.[274]

If Graulich is correct, there might be some validity to Levitin's complaint that the pre-Code practices rule unduly restricts the development of a federal common law of bankruptcy:

> The pre-Code practices doctrine is problematic. First, it places an arbitrary limit on the development of the federal common law of bankruptcy. By authorizing pre-Code non-Code practices, there is an implicit exclusion of post-Code non-Code practices. This distinction makes little sense. Bankruptcy law existed as a matter of statute both before and after 1978. The Court has recognized the existence of federal common law of bankruptcy from before 1978. Why should there not be post-1978 federal common law? While the 1978 Code might affect pre-Code federal common law, there is no reason to think that it precludes a continuing development of federal common law of bankruptcy[.][275]

In my view, Graulich's theory of substantive consolidation is viable only if *Sampsell* constitutes a stare decisis holding on substantive consolidation. As

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[271] *See* Graulich, *supra* note 33, at 528–29.

[272] *See supra* note 37 (stating major Second Circuit cases before *Grupo Mexicano* do not mention *Sampsell*).

[273] Eastgroup Props. v. S. Motel Ass'n, 935 F.2d 245 (11th Cir. 1991); *see supra* note 20.

[274] *See* Graulich, *supra* note 33, at 548 (ordering consolidation where consolidation creates inequity). While I disagree with Graulich's premise that the Supreme Court authorized substantive consolidation in *Sampsell*, his synthesis of the pre-Code practices rule and *Grupo Mexicano* may appeal to some seeking a middle ground to preserve a narrow form of substantive consolidation.

[275] Levitin, *supra* note 15, at 63.

discussed in Part II.A above, this Article rejects the proposition that *Sampsell* approves substantive consolidation.[276]

In sum, this Article argues that because the Bankruptcy Code is silent on the issue of substantive consolidation, the pre-Code practices rule does not come into play. Because there is no relevant text (ambiguous or otherwise) on the subject, there is no need to refer back to pre-Code practices in order to construe non-existent text on the topic of substantive consolidation.

F. Bankruptcy exceptionalism: the notion that bankruptcy law is "different in kind"

"Bankruptcy Exceptionalism" is an emerging concept, which argues that Article I bankruptcy courts are exempt from the rules generally applicable to the Article III federal courts, including the holding of *Grupo Mexicano*. Bankruptcy Exceptionalism has been explored in a paper authored by Jonathan C. Lipson[277] examining the relationship between bankruptcy and constitutional law. The Constitution provides that Congress shall have the power to make "uniform laws on the subject of Bankruptcies."[278] Lipson's paper identifies what he calls an as yet unnoticed theme in the constitutional implications of bankruptcy, and writes that "Bankruptcy [E]xceptionalism is an operating principle that helps to explain why we have a Bankruptcy Clause and how it has sometimes permitted or compelled exceptions to constitutional rules, standards, norms, and values in order to accommodate the exigencies of financial distress."[279] However, Lipson concedes that Bankruptcy Exceptionalism is not a constitutional theory, "it is a description of what appears to be happening, not a statement of what should be happening, or why."[280] As shown below, while some lower courts appear to have relied upon Bankruptcy Exceptionalism as a basis to avoid the Equity Cutoff Rule, it is far from clear that the Supreme Court would endorse this rationale.

1. Owens Corning

The *Owens Corning* opinion relies on a kind of Bankruptcy Exceptionalism. In holding that *Grupo Mexicano*'s Equity Cutoff Rule does not apply in the bankruptcy law context, the Third Circuit reasons: "[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."[281]

However, the Supreme Court has provided strong signals that bankruptcy courts are not "different in kind" in a lawmaking sense. In *Norfolk Shipbuilding &*

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[276] *See supra* Part II (suggesting *Sampsell* does not authorize lower courts to grant substantive consolidation).
[277] Lipson, *supra* note 32.
[278] U.S. CONST. art. I, § 8, cl. 4.
[279] Lipson, *supra* note 32, at 606.
[280] *Id.* at 675.
[281] *In re* Owens Corning, 419 F.3d 195, 209 n.14 (3d Cir. 2005).

Drydock Corp. v. Garris,[282] Justice Scalia observed immediately after citing *Grupo Mexicano* that the "equitable lawmaking power of bankruptcy courts [is] limited by statute."[283] *Norfolk Shipbuilding* arose in the context of an admiralty claim. The *Norfolk Shipbuilding* opinion recognizes a distinction between admiralty law's long tradition of judge-made common law rules, with bankruptcy law, which is fundamentally a statutory regime. The *Norfolk Shipbuilding* opinion signals that *Grupo Mexicano* applies to bankruptcy courts, and that *Grupo Mexicano*'s reasoning limits a bankruptcy judge's lawmaking authority.[284]

2. Stone & Webster

Stone & Webster relies upon a kind of Bankruptcy Exceptionalism, reasoning that *Grupo Mexicano* held that "bankruptcy law provides a court with authority to grant remedies not administered by courts of equity . . . ."[285] in 1789. The *Stone & Webster* opinion relies upon the following quote from *Grupo Mexicano* for the proposition that "bankruptcy law" is exempt from the Equity Cutoff Rule:

> [W]e suspect there is absolutely nothing new about debtors' trying to avoid paying their debts, or seeking to favor some creditors over others . . . [t]he law of fraudulent conveyances and bankruptcy was developed to prevent such conduct . . . .[286]

Stone & Webster's conclusion that bankruptcy courts are excepted from *Grupo Mexicano's* limitations upon equity lawmaking is flawed. The law of fraudulent conveyances and bankruptcy are examples of statutory law—not products of the common law tradition. Fraudulent transfer acts, as enacted in England and in the Bankruptcy Code, protect creditors from a debtor from fraudulently conveying its assets.[287] The Bankruptcy Code provides creditors with a variety of "non-traditional" but nonetheless statutory remedies for debtor misconduct, including the right to file an involuntary bankruptcy petition and to seek appointment of a trustee

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[282] 532 U.S. 811 (2001).

[283] *Id.* at 820 (stating inability of bankruptcy court to grant equitable remedies outside of statutes).

[284] *See* Great W. Life & Annuity Ins. Co. v. Knudson, 534 U.S. 204, 209 (2002) (stating *Grupo Mexicano*'s Equity Cutoff Rule applies to request for equitable relief under ERISA, which like Bankruptcy Code is "comprehensive and reticulated statute . . . ." (quoting Mertins v. Hewitt Assocs., 508 U.S. 248, 251 (1993))); Freytag v. Comm'r of Internal Revenue, 501 U.S. 868, 879 (1991). *Freytag* is a case involving a non-Article III tribunal analogous to a non-Article III bankruptcy judge, in which the Supreme Court held in the context of the Appointments clause that non-Article III courts exercise the judicial power of the United States. This suggests that the Court's Article III-based holdings—such as *Grupo Mexicano*—apply to non-Article III courts when they exercise federal judicial power.

[285] *In re* Stone & Webster Inc., 286 B.R. 532, 538 (Bankr. D. Del. 2002) (explaining ability of bankruptcy court to grant equitable remedies outside boundaries of equity courts).

[286] Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308, 322 (1999) (internal citations omitted).

[287] *See* 11 U.S.C. §§ 547–49 (2006) (permitting avoidance of fraudulent transfers).

to take possession of the debtor's property.[288] The reference to "bankruptcy law" found in *Grupo Mexicano* does not signal that bankruptcy judges are exempt from the Equity Cutoff Rule. Rather, the Court has signaled that creditors should avail themselves of statutory remedies, rather than appealing to non-traditional equitable requests.[289]

3. Katz

Proponents of Bankruptcy Exceptionalism might tout the Supreme Court's decision in *Central Virginia Community College v. Katz*,[290] as an endorsement of the principle. *Katz* held that the States waived sovereign immunity "in proceedings necessary to effectuate the *in rem* jurisdiction of the bankruptcy courts."[291] In so doing the Supreme Court excepted such *in rem* bankruptcy suits (i.e. a preference action) from the general rule of sovereign immunity stated in *Seminole Tribe*. Thus, with respect to certain "core" bankruptcy matters, specifically preference and discharge claims, the Supreme Court concluded that the States waived their sovereign immunity defense, and federal courts may exercise subject matter jurisdiction over such claims against the States.

The *Katz* decision has encouraged speculation that the Supreme Court will exempt bankruptcy judges from *Grupo Mexicano's* lawmaking limitations.[292] This speculation is unwarranted. It is one thing to conclude that implicit in the 1789 constitutional ratification process that the States waived sovereign immunity with respect to *in rem* bankruptcy proceedings. It is quite another to conclude that the Constitution grants bankruptcy courts lawmaking authority.[293]

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[288] *See* 11 U.S.C. § 303(a), (g) (2006) (explaining ability of creditor to file involuntary bankruptcy for debtor).

[289] *Stone and Webster's* flawed construction of *Grupo Mexicano* as exempting bankruptcy courts from the 1789 equitable lawmaking limitations imposed on other federal courts has been followed by a bankruptcy court in denying a motion to dismiss a substantive consolidation count. *See In re* NM Holdings Co., 407 B.R. 232, 269–71 (Bankr. E.D. Mich. 2009) (stating *Grupo* does not act as limit on ability of bankruptcy court to grant equitable remedies).

[290] 546 U.S. 356 (2006).

[291] *Id.* at 378.

[292] *See* Randolph J. Haines, *Federal Principles in Bankruptcy After* Katz, 15 AM. BANKR. INST. L. REV. 135, 145 & nn. 57–58 (2007) (listing case law discussing *Grupo Mexicano*, suggesting bankruptcy courts not subject to equitable relief rules). However, the notion that bankruptcy judges are "different in kind" in a lawmaking sense than Article III federal district judges suffers from a fundamental statutory problem. Section 151 of title 28 states that bankruptcy judges constitute a "unit" of the district court, and describes bankruptcy judges as a "judicial officer of the district court . . . ." 28 U.S.C. § 151 (2006). Since federal district judges are constrained by *Grupo Mexicano's* Equity Cutoff Rule, it would be most odd if bankruptcy judges, who receive their judicial power by means of a jurisdictional referral from the district court, have an equitable lawmaking power greater than their assignors.

[293] As discussed *infra* Part III, the Supreme Court's *Noland* opinion imposes constitutional based limitations on a bankruptcy court's ability to modify priorities in bankruptcy, even where the Bankruptcy Code seems to permit some degree of judicial leeway. The *Noland* opinion further undercuts the theory of Bankruptcy Exceptionalism.

Exceptionalism in the broadest context may be defined as the perception that a country, society, institution, movement, or time period is "exceptional" (i.e. unusual or extraordinary) in some way, and thus does not conform to normal rules, general principles, or the like. Exceptionalism is the subject of cases such as *Boerne v. Flores*.[294] In *Boerne*, the Supreme Court declared the Religious Freedom Restoration Act of 1993 unconstitutional, a law that attempted to give religious institutions special exemptions from otherwise neutral, generally applicable laws (such as zoning ordinances). Religious belief does not except an organization from general rules of law. In a culture committed to the rule of law, legislative branches conduct the hearings and inquiry as to whether exceptions should be made to laws of general application.

Exceptionalism in the broadest sense impairs ordered liberty based upon the rule of law. Bankruptcy Exceptionalism will result in a perception that bankruptcy courts are places where laws of general applicability are suspended. This is not a desirable outcome. When laws—including bankruptcy laws—are riddled with exceptions, freedom is undermined. If a corporation's boundaries are permeable in bankruptcy cases, parties are no longer free to partition assets among corporate affiliates. Parties are unable to organize their transactions with confidence. The premise that the Supreme Court will exempt bankruptcy courts from the constraints upon the federal judicial power exemplified by *Grupo Mexicano* using a Bankruptcy Exceptionalism rationale is unpersuasive.[295]

G. Conclusion to Part II

A decade after the Supreme Court's *Grupo Mexicano* decision the legitimacy of substantive consolidation remains problematic. Part II of this article has argued that each of the six responses to *Grupo Mexicano* suffer from difficulties. If timely asserted by litigants in future cases, the Supreme Court may decide whether *Grupo Mexicano* applies to bankruptcy courts generally and to substantive consolidation specifically.[296] This Article has argued it does, and that substantive consolidation should not be permitted absent consent by creditors.

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[294] 521 U.S. 507 (1997).

[295] For additional arguments as to why bankruptcy law should not be considered "exceptional," see Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 989 (2004). Mooney states: "[The] parallel rationales for federal systems of bankruptcy law and diversity jurisdiction support . . . [the] core principle that bankruptcy law, like trans-substantive civil procedure law, generally should serve the interest of and respect rightsholders' nonbankruptcy legal entitlements." *Id.* at 989.

[296] The constitutional arguments made herein are less likely to be given weight if thrown in an appeals brief like a "Hail Mary" pass. See *Adelphia Business Solutions, Inc. v. Abnos*, 482 F.3d 602, 604–05 (2d Cir. 2007), where a lower court had authorized—based upon equitable powers—a retroactive rejection of a lease. All parties had conceded before the lower court that it had such equitable power. *See id.* at 607. Then on appeal to the Circuit Court, the landlord argued *Grupo Mexicano* precludes retroactive equitable relief. *See id.* at 606–07. While the Second Circuit did not reject this argument out of hand, the court exercised its discretion to treat the issue as waived, as the parties failed to argue the issue in the lower courts. *See id.* at 607. A similar procedural problem is hinted at in *Wells Fargo Bank of Texas N.A. v. Sommers* (*In re Amco*

However, what if *Grupo Mexicano* does not bar substantive consolidation? If the Supreme Court were to conclude that it had approved substantive consolidation in *Sampsell*, or that Bankruptcy Exceptionalism exempts bankruptcy courts, then the next question would be: What standard for substantive consolidation should be adopted? Should the Supreme Court's choice be between the restrictive *Owens Corning* test and the more discretionary *Eastgroup Properties* test? Should the Court adopt yet other standards? May the Court adopt any of these tests and be faithful to its holding in *Noland*? This article addresses these issues in Part III.

III. WHAT STANDARDS SHOULD GOVERN SUBSTANTIVE CONSOLIDATION?

A variety of rules for substantive consolidation are found in judicial opinions and law review articles. With the aid of the following hypothetical fact pattern (the "Hypothetical"), I will survey the leading circuit court opinion based rules, as well as several proposed rules. Thereafter I will return to the related question of whether the promulgation of such rules amounts to a legislative function.

A. Making "scrambled eggs"

Assume that a company called "Acme Widgets" (the "Parent") acquires from an unaffiliated seller 100 percent of the common stock of a company later renamed "Acme Glass and More" (the "Subsidiary"). Both entities were properly incorporated under the laws of the State of Blackacre. Under Blackacre law, the remedy of alter ego is not allowed absent a showing of actual fraud. Assume the Parent did not acquire or use the Subsidiary to perpetrate a fraud.

Prior to its acquisition by the Parent, the Subsidiary had leased a warehouse (the "Premises") from the Landlord. The lease permits the Subsidiary to place signage bearing the name of the Subsidiary and its affiliates at the entrance to the Premises.

After the acquisition and with the consent of the Subsidiary's managers (who are the same individuals as the Parent's managers), the Parent stored raw materials on the Premises. The Subsidiary did not require that the Parent pay any subrental to the Subsidiary for Parent's use of the Premises.

A year after the acquisition, Parent requested that Seller, a manufacturer of materials used to make widgets, deliver goods on credit. At the Parent's request, the materials were delivered to the Premises. The Parent later failed to pay for the materials. Eventually, the Seller obtains a chapter 7 involuntary bankruptcy order against the Parent.

Insurance), 444 F.3d 690, 693–94 (5th Cir. 2006), as the Fifth Circuit observed the *Grupo Mexicano* issue was raised for the first time at the district court appeal level, not in the first instance before the bankruptcy court. Parties must raise issues in the lower courts if they wish to preserve the same for review in the courts of appeal and the Supreme Court. *See, e.g.*, Puckett v. United States, 129 S. Ct. 1423, 1428 (2009) (discussing importance of timely raising claims in district court, which is in best position to adjudicate dispute).

The trustee appointed in the Parent's bankruptcy case asserts an ownership interest in all goods and raw materials located on the Premises. The trustee further asserts the automatic stay protects such assets from seizure by any creditor, including the Landlord. Assume that the goods located on the Premises are "scrambled" in the sense that it will be difficult to segregate their ownership as between Parent and Subsidiary. In view of the uncertainty as to ownership of the goods and raw materials, the Parent's trustee, the unpaid Seller and Landlord agree the goods should be auctioned with the proceeds escrowed pending determination of the ownership of the goods. The auction yields a net of $100,000.

The bankruptcy trustee of Parent then moves for a turnover order against the Subsidiary, combined with a request for substantive consolidation of the Subsidiary with the Parent, and notifies the Landlord and all known creditors of the Parent of this request. The Landlord, holding claims for unpaid rent, objects to consolidation. The trustee obtains a bid from an accounting firm stating it will charge $25,000 to issue a professional opinion regarding to the respective ownership of the goods and materials that had been located on the Premises.

Assume the Hypothetical facts above are established at a hearing before a bankruptcy court. What rules of decision apply to the Parent trustee's request for substantive consolidation? What should be the outcome of the trustee's request for consolidation?

B. Who owns the eggs?

The Parent trustee's request for "turnover" relief under section 542(a) of the Bankruptcy Code initiates an inquiry of whether the property found on the Premises is "property" that the trustee may "use, sell or lease" under other provisions of the Code. The search for a Bankruptcy Code definition of "property" ultimately leads to section 541(a)(1) of the Bankruptcy Code, which provides that "property" of the "bankruptcy estate" includes "all legal or equitable interests of the debtor in property as of the commencement of the case."[297]

At least initially, the issue of whether the Parent's interest in the goods located on the Premises constitutes "[p]roperty of the estate" of the Parent is a federal law question involving interpretation of a federal statute.[298] In interpreting whether a debtor's interest in property might include property of relatives or affiliates, Congress was "excruciatingly specific about those occasions when property of the estate was to include property of someone *other* than the debtor."[299] Other than certain interests in community property of a debtor's spouse, Congress did not

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[297] 11 U.S.C. § 541(a)(1) (2006).

[298] *See* Official Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines, Inc.), 928 F.2d 565, 569 (2d Cir. 1991) (beginning inquiry with definition of "property of the estate" from section 541(a)(1)).

[299] Willett, *supra* note 34, at 90.

include property of affiliates or insiders among the items automatically swept into the debtor's estate.[300]

However, federal law provides little practical guidance on what property will be swept into the Parent's bankruptcy estate. The Supreme Court interpreted section 541(a)(1)'s predecessor in a manner that significantly qualifies a lower court's reliance upon federal law to determine ownership of property. In the absence of any controlling federal law to the contrary, "property" and "interests in property" are creatures of state law.[301] Because the Bankruptcy Code does not provide a specific federal rule of decision with respect to whether the goods and materials found on the Premises constitute property of the Parent's bankruptcy estate, state law rules of decision must be consulted.

1. Using state law property rules

State law provides a series of rules that will enable a bankruptcy court to decide the merits of the Parent trustee's turnover request.[302] State corporate statutes generally provide that a stockholder, partner, or member of a business organization does not own a direct interest in the assets of the business organization.[303] Thus, a Parent trustee's showing that the Parent owns 100 percent of the common stock of the Subsidiary does not provide a sufficient basis to grant the Parent trustee a turnover of assets in the possession of the Subsidiary.[304]

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[300] *See* 11 U.S.C. § 541 (2006) (detailing property included in estate). Section 541(a)(2) of the Code brings in certain property of the debtor's spouse. *See* 11 U.S.C. § 541(a)(2) (2006) (stating estate comprised of "all interests of the debtor and the debtor's spouse in community property" meeting certain conditions).

[301] *See, e.g.*, Butner v. United States, 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."); s*ee also In re* Wright, 492 F.3d 829, 832 (7th Cir. 2007) ("The Supreme Court held in *Butner* . . . that state law determines rights and obligations when the Code does not supply a federal rule." (citation omitted)).

[302] *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-701 (2009) (describing member's interest in limited liability company as personal property). In keeping with principles of federalism, the Supreme Court has rejected efforts to create a de facto federal law of corporations. *See, e.g.*, CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987) ("[S]tate regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law."). The court also states, "[n]o principal of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations . . . ." *Id.*

[303] *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-701 (2009). By way of example, section 18-701 of the Delaware Limited Liability Company Act provides: "A limited liability company interest is personal property. A member has no interest in specific limited liability company property." *See id.* An example of this principle is found in *In re Aldape Telford Glazier, Inc.*, 410 B.R. 60, 65 (Bankr. D. Idaho 2009) (stating debtor, being sole member of dissolved LLC, may not treat assets of LLC as its own, prior to winding down process).

[304] Similar provisions can be found in state partnership acts and state corporation statutes. This rule provides the basis for the related principle of structural subordination. Because the parent entity and derivatively its creditors have no interest in the assets of the subsidiary, the creditors of the subsidiary have priority to the assets of the subsidiary under the rule of absolute priority. *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (2006) (regarding class of unsecured claims, "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . .").

State laws generally follow the English common law presumption that possession is nine-tenths of the law.[305] In the Hypothetical, the Premises had been leased to the Subsidiary, thus establishing a presumption that the Subsidiary has the exclusive right to possession of the Premises. Because the Subsidiary has lawful possession of the Premises, the Subsidiary is presumed to own all of the goods and materials located on the Premises. While such presumption is rebuttable, the Trustee has no evidence to rebut the presumption, unless the Parent Trustee spends $25,000 to obtain an opinion from an accounting firm. Under the Hypothetical facts, the Parent trustee's turnover action fails.[306]

Generally, under state law rules of decision, creditors of a subsidiary have priority to the subsidiaries' assets vis-à-vis creditors of the parent corporation. Because this principle applies without the requirement of a formal subordination agreement, the principle is sometimes called "structural subordination."[307] By reason of the state-law-based rule of structural subordination, parties are free to employ two or more corporate entities to achieve an "asset partitioning" among affiliates. Absent fraud, parties to a transaction may reasonably assume that assets partitioned in a subsidiary entity should be available first for the creditors of the subsidiary, and assets partitioned into a parent entity should be available first for the creditors of that parent.

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[305] *See, e.g.*, Willcox v. Stroup, 467 F.3d 409, 412 (4th Cir. 2006) The court states:

> That possession is nine-tenths of the law is a truism hardly bearing repetition . . . . The importance of possession gave rise to the principle that "[p]ossession of property is indicia of ownership, and a rebuttable presumption exists that those in possession of property are rightly in possession." The common law has long recognized that "actual possession is, prima facie, evidence of a legal title in the possessor."

Id. (citations omitted).

[306] Some might argue this state law based outcome in favor of the Subsidiary's creditors to be arbitrary. However, the "possession is nine-tenths of the law" rule protects a diligent seller of goods who verifies that the purchaser owns or leases the premises where the goods are to be shipped. *See id.* (reiterating "[t]he presumption of law is that the person who has possession has the property." (quoting Jeffries v. Great W. Ry. Co., 119 E.R. 680, 682 (1985))).

[307] In *In re Moore*, 379 B.R. 284, 295 (Bankr. N.D. Tex. 2007), Judge Jernigan noted with respect to the common law remedy of "reverse veil piercing" recognized in some jurisdictions, that such a remedy:

> arguably perverts established Bankruptcy Code priorities and state law creditor rights provisions, by putting creditors of an individual shareholder on a parity with creditors of the corporation (when logic suggests they should, at best, merely step into the shoes of the individual shareholder vis-à-vis the corporation—not share pari passu with the corporation's preexisting creditors).

Id. Implicit in this statement is that "structural subordination" is the norm in a parent subsidiary bankruptcy context.

2. Using the emerging state law theory of "enterprise liability" and quasi-partnership rules

To be sure, some state laws may provide a basis to disregard structural subordination. An emerging theory of enterprise liability offers a basis to hold an entire "business enterprise" liable for the debts of any member of the enterprise. Emerging business enterprise rules complicate the ability of parties to partition assets and liabilities among affiliates. In Texas, the business enterprise rule had been defined as an "equitable doctrine which treats two inter-related corporations as one under partnership-type principles."[308] The Texas law business enterprise theory had been premised upon the assumption that affiliated corporations do not operate as separate entities, but rather integrate their resources to achieve a common business purpose. Based upon such assumption, some courts have held corporate affiliates may be held jointly and severally liable for the debts incurred in pursuit of that common business purpose.[309] California courts unquestionably have recognized enterprise liability.[310] While several Texas courts of appeal had approved the business enterprise theory, the Texas Supreme Court later rejected it.[311]

Though the business enterprise theory and the alter ego theory are similar in purpose, they are distinct theories.[312] Unlike the alter ego theory, the business

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[308] *See* N. Am. Van Lines, Inc. v. Emmons, 50 S.W.3d 103, 121 (Tex. App. 2001) (referring to "single enterprise doctrine" as one that treats interrelated corporations as one for partnership purposes).

[309] *See* Nat'l Plan Adm'rs, Inc. v. Nat'l Health Ins. Co., 150 S.W.3d 718, 744 (Tex. App. 2004), *rev'd*, 235 S.W.3d 696 (Tex. 2007) (positing corporations that integrate their resources to achieve common business purpose can be held liable for debts incurred by each constituent corporation); *In re* U-Haul Int'l, Inc., 87 S.W.3d 653, 657 (Tex. App. 2002) (indicating when corporations seek to achieve common business purpose and integrate their resources, they will be held liable for each other's debts).

[310] *See* Pan Pac. Sash & Door Co. v. Greendale Park, Inc., 333 P.2d 803, 807 (Cal. App. 1958) (supporting claim for enterprise liability by stating confusion and unjust result would be accomplished if separate identities of entities were maintained).

[311] *See* SSP Partners v. Gladstrong Invs. (USA) Corp., 275 S.W. 3d 444 (Tex. 2008) (holding single business enterprise theory is inconsistent with legislative intent). *SSP Partners* has effectively overruled *Carlson Manufacturing, Inc. v. Smith*, 179 S.W.3d 688 (Tex. App. 2005) (describing purpose of single business enterprise theory). *See also* Bridgestone Corp. v. Lopez, 131 S.W.3d 670, 681 (Tex. App. 2004) (recognizing single business enterprise theory as equitable doctrine), *vacated*, No. 04-0563, 2005 Tex. LEXIS 164, at *2 (Tex. Feb. 8, 2005), *appeal dismissed*, No. 13-02-526-CV, 2005 WL 977562 at *2 (Tex. App. Apr 28, 2005); Nat'l Plan Adm'rs, Inc., 150 S.W.3d 718, 744 (Tex. App. 2004) (establishing outcome of single business enterprise determination); *In re* U-Haul Int'l, 87 S.W.3d 653, 657 (Tex. App. 2002) (noting corporations that "integrate resources to achieve a common business purpose" may be each liable for debts incurred by the other "in pursuit of that business purpose"); El Puerto de Liverpool, S.A. de C.V. v. Servi Mundo Llantero S.A. de C.V., 82 S.W.3d 622, 636–37 (Tex. App. 2002) (noting single business enterprise theory arises from partnership principles); *Emmons*, 50 S.W.3d at 120 (stating liability under single business enterprise theory is appropriate under exceptional circumstances); Paramount Petroleum Corp. v. Taylor Rental Ctr., 712 S.W.2d 534, 536 (Tex. App. 1986) (establishing single business enterprise theory from prior case law).

[312] *See Bridgestone*, 131 S.W.3d at 682 (illustrating distinction between single business enterprise theory and alter ego theory); *Emmons*, 50 S.W.3d at 119 (recognizing similar purpose between single business enterprise theory and alter ego theory); Aluminum Chems. (Bolivia), Inc. v. Bechtel Corp., 28 S.W.3d 64, 68 (Tex. App. 2000) (rejecting proposed synonymity of single business enterprise and alter ego theories).

enterprise theory requires no proof of fraud—instead courts that apply the single business enterprise theory rely on analogies to partnership principles of liability.[313]

Returning to the Hypothetical, assume that the State of Blackacre follows the rule of enterprise liability. Under this rule, the Subsidiary is liable for the Parent's debt to Seller simply because the Parent and Subsidiary have a common business purpose. If enterprise liability is the applicable state law rule, does it follow that the Parent trustee is entitled to a turnover of all property located within the Premises from the Subsidiary?

Arguably not, if the enterprise law theory of liability is premised upon partnership law principles. While partnership law may impose liability upon all partners for the debts of a partnership, state law treats the property owned by the partnership as separate from the property owned by the partners.[314] The Bankruptcy Code builds upon the state law based distinction between assets owned by the partnership and assets owned by the partners.[315] Generally following the historic "jingle rule" of partnership law, the Bankruptcy Code provides that creditors of the partners and creditors of the partnership have different priority rights to their respective asset pools.

If the Parent and Subsidiary are viewed as a partnership-like single business enterprise, then the rights of their respective creditors should be governed by state partnership law rules, and section 723 of the Bankruptcy Code. Under state partnership law rules, assets of one partner are not deemed property of another partner, nor of the partnership. Upon application of such state law rules to the Hypothetical, the Parent trustee's request for turnover of the assets located on the Premises should be denied.[316] The "Subsidiary Partner" would be presumed to own all property in its possession under state law property rules.[317] The "Parent Partner" would have no direct rights to "partnership" property or property of its partners.

In sum, if state partnership law informs how corporate affiliates engaged in a single business enterprise should be treated in bankruptcy, the Parent trustee's turnover action against the Subsidiary fails. While the business enterprise theory may allow the Seller to assert a claim directly against the Parent (the party to the contract) and the Subsidiary (the other participant in a single business enterprise),

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[313] *See Bridgestone*, 131 S.W.3d at 682 (quoting *Emmons*, 50 S.W.3d at 119); Formosa Plastics Corp., USA v. Kajima Int'l, Inc., 216 S.W.3d 436, 480 (Tex. App. 2006) (Castillo, J., concurring) (rejecting argument TEX. BUS. CORP. ACT ANN. art. 2.21(A)(2) requires showing of fraud under single business enterprise theory).

[314] The Revised Uniform Partnership Act (1997) provides the following rules of decision with respect to property owned by a partnership. Section 201 provides that "a partnership is an entity distinct from its partners." UNIF. P'SHIP ACT § 201(a) (1997). Section 203 provides that "[p]roperty acquired by a partnership is property of the partnership and not of the partners individually." UNIF. P'SHIP ACT § 203 (1997).

[315] *See* 11 U.S.C. § 723(c) (2006) (limiting allowance of claims against general partners based on whether claim is secured by property of partner or property of partnership).

[316] The creditor of the parent might have a direct state law-based claim against the subsidiary. With respect to a creditor that made a contract to deliver goods to the parent Acme Widget, but whose goods were received by the subsidiary, state law may recognize the creditor holds a common law "assumpsit" (restitution) claim against the subsidiary.

[317] *See supra* note 286.

the enterprise theory as construed by the cases discussed herein does not result in a pooling of the assets of such entities.[318]

3. Using a gaggle of federal substantive consolidation standards

Will the Parent trustee's request for turnover fare better under federal law, specifically the doctrine of substantive consolidation? The short answer is "maybe," depending upon which standard a court applies to the request.

a. Using rules of decision derived from federal circuit court opinions

Several federal circuit court opinions provide rules of decision for substantive consolidation. Under these rules, the Parent trustee may be entitled to a turnover of the property on the Premises. This is because substantive consolidation modifies state law ownership rules by "pooling assets." The Second Circuit has explained that substantive consolidation results in a "pooling the assets of, and claims against, the two entities; satisfying liabilities from the resultant common fund."[319] Substantive consolidation permits a federal bankruptcy court to modify the structural subordination rights based otherwise held by the Landlord to the assets of the Subsidiary.

(i) The Second Circuit's *Augie/Restivo* Test

The Second Circuit has established that substantive consolidation may be granted under the following rule of decision:

> (iv)"Whether creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit'", or
> (v) "Whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[320]

In applying this standard to the facts of the Hypothetical, the evidence is inconclusive whether creditors dealt with the entities as a "single economic unit"

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[318] *See* discussion *supra* Part II.B.2 (reasoning because business enterprise liability is based upon principles of state partnership law, property of parent corporation will not be pooled with property of subsidiary corporation for purposes of creating Parent's bankruptcy estate). As a concluding note, one commentator bluntly states: "enterprise liability is simply not the law." Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381, 437–38 (1998) (discussing how enterprise liability would require courts to engage in uncertain determination of scope of corporation's business). My point in discussing enterprise liability is to show that even where recognized, it remains a theory of liability, and has not yet been extended to alter state property law rules among the members of enterprise.

[319] Union Savings Banks v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988) (describing practical effects of substantive consolidation).

[320] *Id.*

and "did not rely on their separate identity." On the one hand, the Landlord did not require the Parent to guarantee the lease, so in a sense the Landlord did not rely on the collectively creditworthiness of both the Parent and Subsidiary. On the other hand, the Landlord did not require a financial statement from the Subsidiary tenant, so the Landlord had little or no basis to differentiate the assets and liabilities of the Subsidiary from those of an affiliate. The lease allowed the Subsidiary and its affiliates to place signage on the Premises, so the Landlord knew that more than one entity might use the Premises. Under these hypothetical facts, it is debatable whether the Landlord relied on the Subsidiary's "separate identity" when the Premises were leased.

A court might conclude that the affairs of the Parent and Subsidiary are so entangled that consolidation will benefit all creditors. The rationale would be that the administrative cost of sorting out the assets and liabilities is so high that a court should imply all reasonable creditors would consent to substantive consolidation in order to avoid the administrative cost. Twenty-five percent of the $100,000 of auction proceeds would be consumed in obtaining an accountant's opinion as to how the ownership of the assets should be allocated. Avoidance of that significant expense necessarily "benefits all creditors" of both the Parent and Subsidiary.

However, the "benefits all creditors" inquiry faces an internal interpretative dilemma. The entities to be consolidated usually will have different debt-to-asset ratios. Substantive consolidation invariably redistributes wealth among the entities' creditors.[321] Substantive consolidation presumptively hurts some creditors. If the entities have different debt-to-asset ratios, it follows that not all creditors will benefit from consolidation.

Augie/Restivo's command that consolidation "benefit all creditors" might be construed to really mean "all reasonable creditors would agree that consolidation will be beneficial to all." A commentator has argued that the remedy of substantive consolidation in the "scrambled egg" line of cases "represents the courts' efforts to do 'rough justice' and is essentially a consensual remedy."[322] No reasonable creditor, fully informed of the "hopelessly commingled" facts, would refuse to consent to consolidation. If this is what *Augie/Restivo* commands, courts have wiggle room to make a paternalistic finding that an objecting creditor would be better off with consolidation. But in the Hypothetical, is the Landlord "unreasonable" in demanding the Parent Trustee incur the $25,000 accounting fee to sort out ownership? Since under the "possession is nine tenths of the law," that Landlord might prefer to gamble that the accountants opinion will be insufficient to rebut the presumption the assets are owned by the Subsidiary.

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[321] *See* Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987) (concluding "because every entity is likely to have a different debt-to-asset ratio, consolidation almost invariably redistributes wealth among the creditors of the various entities").

[322] *See* Graulich, *supra* note 33, at 554 (noting substantive consolidation in these cases is not solely product of courts' exercise of equitable power under section 105(a) of Bankruptcy Code, but also furthers trustee's section 704(a)(1) duty to "close such estate as expeditiously as is compatible with the best interests of parties in interest").

The *Augie/Restivo* test represents a significant federal law departure from state corporate law rules. Evidence that creditors "dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit'"[323] would be irrelevant in a traditional alter-ego suit brought under state law. One undesirable consequence of *Augie/Restivo*'s holding that creditors' perceptions are relevant, is that the totality of each creditor's dealings with the debtor and its affiliate's conduct becomes "discoverable" under procedural law. If the conduct of every affected creditor is relevant and thereby discoverable, the litigation expense attendant to a substantive consolidation trial easily could outweigh the supposed improvement of creditor recoveries.

All things considered, it is difficult to predict whether a court that follows *Augie/Restivo* would or would not substantively consolidate the Subsidiary with the Parent under the Hypothetical's facts. The Landlord may be able to defeat consolidation by claiming it does not "benefit" from consolidation, but the trustee has a plausible case because the Landlord did not truly rely on the separate credit of the Subsidiary, and that the assets are sufficiently scrambled that all reasonable creditors would consent to consolidation.

(ii) Eleventh Circuit's *Eastgroup Properties* Test

The Parent trustee may prevail in a consolidation request if the court were to apply the following rule of decision, known as the *Eastgroup Properties*[324] test:

> [T]he proponent of substantive consolidation must show that (1) there is substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or to realize some benefit. When this showing is made, a presumption arises "that creditors have not relied solely on the credit of one of the entities involved." Once the proponent has made this prima facie case for consolidation, the burden shifts to an objecting creditor to show that (1) it has relied on the separate credit of one of the entities to be consolidated; and (2) it will be prejudiced by substantive consolidation.[325]

The Eleventh Circuit explains that "substantial identity" is a term of art that refers back to elements for consolidation found in the bankruptcy court opinion *In*

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[323] *In re Augie/Restivo*, 860 F.2d at 518 (suggesting courts are less likely to permit substantive consolidation when creditors believe they are dealing with individual, distinct entities and base loans on such expectations).

[324] *See* Eastgroup Props. v. S. Motel Ass'n, 935 F.2d 245, 249 (11th Cir. 1991) (adopting D.C. Circuit's standard by which courts may determine whether to permit substantive consolidation).

[325] *Id.* (citations omitted).

re Vecco Construction Industries, Inc.[326] The *Vecco* opinion lists the following factors, although proof of all such factors is not required:

> (1) The degree of difficulty in segregating and ascertaining individual assets and liabilities;
> (2) The presence or absence of consolidated financial statements;
> (3) The profitability of consolidation at a single physical location;
> (4) The commingling of assets and business functions;
> (5) The unity of interests and ownership between the various corporate entities;
> (6) The existence of parent and inter-corporate guarantees on loans; and
> (7) The transfer of assets without formal observance of corporate formalities.[327]

Under the Hypothetical facts, if the court follows *Eastgroup Properties*, the Parent trustee will likely prevail. The Parent trustee will be able to establish a "benefit" from substantive consolidation—creditors of the Parent will be able to share ratably with those of the Subsidiary in the pooled assets, and a $25,000 accounting fee is avoided. The Parent trustee will be able to establish several "substantial identity" elements, such as the commingling of assets and business functions, and the Parent's 100 percent ownership of the Subsidiary, resulting in unity of interests and ownership.

Under the *Eastgroup Properties* test, the burden then shifts to the creditor of the Subsidiary (here the Landlord) to defeat consolidation. The inquiry turns on whether the Landlord "relied" sufficiently on the separate credit of the Subsidiary. Under the Hypothetical, the Landlord did not request a financial statement from the Subsidiary, so the Landlord cannot be said to have relied upon the specific assets and liabilities recorded in such a statement. The lease allowed the Subsidiary and its affiliates to place signage on the Premises, so the Landlord knew or should have known that more than one entity would use the Premises, and thus did not insist that strict corporate "boundaries" be observed. Thus, the Landlord will likely fail to persuade the court that it relied on the "separate credit" of the Subsidiary.

The *Eastgroup Properties* rule frequently will deny creditors of a corporate subsidiary the priority they might expect to have under the principle of structural subordination. The *Eastgroup Properties* decision was influenced by writings of Phillip Blumberg. Professor Blumberg argued that while traditional Anglo-American corporation law rests on the principle that each corporation is a separate legal unit, this inherited corporate law jurisprudence no longer serves the needs of modern society, in which economic activity is conducted in complex multi-tiered

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[326] 4 B.R. 407, 409 (Bankr. E.D. Va. 1980).
[327] *Id.*

corporate structures.[328] While some might consider *Eastgroup Properties'* reliance upon the emerging enterprise theory as a progressive development, at least one commentator has observed enterprise theory "is simply not the law."[329]

Ultimately the *Eastgroup Properties* test suffers from serious interpretive ambiguities. What constitutes a legitimate "benefit" to be achieved by consolidation? What constitutes sufficient creditor "prejudice" to block consolidation? In response to these interpretive problems, the Third Circuit parts ways with the Eleventh Circuit.

(iii) The Third Circuit's *Owens Corning* Test

In *In re Owens Corning*, banks successfully appealed a consolidation order that prejudiced their rights to collect from the subsidiary guarantors.[330] Rejecting the Eleventh Circuit's *Eastgroup Properties* rule of decision, the Third Circuit announced a stringent restatement of the *Augie/Restivo* test, having the following components:

- A prima facie case for [substantive consolidation] typically exists when, based on the parties' prepetition dealings, a proponent proves corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity.
- Proponents who are creditors must also show that, in their prepetition course of dealing, they actually and reasonably relied on debtors' supposed unity.
- Creditor opponents of consolidation can nonetheless defeat a *prima facie* showing under the first rationale if they can prove they are adversely affected and actually relied on debtors' separate existence.[331]

In the Hypothetical facts, there is no evidence the Landlord knew the Subsidiary ignored corporate formalities; rather, the Landlord simply tracked when the Subsidiary paid its rent. While the Landlord knew that the Subsidiary had the right to allow its affiliates to place their signage on the Premises, that alone appears to be an inadequate basis to impute knowledge of sloppy business practices for purposes of the *Owens Corning* analysis. Since the Landlord was unaware that the

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[328] PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS xxxiii (1985) (positing his book "is a study of the increasing unacceptability of the concept of entity and the emergence of doctrine of enterprise law . . . . This change of enormous significance in our legal system reflects a growing unwillingness . . . to accept . . . the reality of the modern business enterprise in a complex industrialized international society."). The debate between proponents of enterprise law versus entity theory is chronicled *infra* Conclusion.

[329] Kors, *supra* note 318.

[330] 419 F.3d 195, 203–04 (3d Cir. 2005) (noting order granting substantive consolidation "weigh[s] heavily in favor of our jurisdiction to consider the appeal").

[331] *Id.* at 212 (internal citations omitted).

Subsidiary ignored corporate formalities, the Landlord could not have "relied upon the breakdown" of entity borders. Critically, under the *Owens Corning* test, it is not sufficient that a corporate debtor violated corporate law duties; rather, what matters is that the creditor knew that the debtor failed to follow corporation formalities, and the creditor then relied upon the breakdown of the formalities. Thus, under this initial prong of the *Owens Corning* rule, the Landlord may defeat consolidation.

Owens Corning further restates *Augie/Restivo*'s "benefits all creditors" rule to hold that consolidation is allowed where "assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[332] *Owens Corning* cautions, however, "[n]either the impossibility of perfection in untangling the affairs of the entities nor the likelihood of some inaccuracies in efforts to do so is sufficient to justify consolidation."[333]

The Hypothetical assumes the assets are "scrambled" (meaning a significant degree of error is expected attempting to decide ownership). The accountant's opinion will cost 25 percent of the $100,000 value of the assets. Is a $25,000 cost of separating the goods prohibitive and hurtful to all creditors? The *Owens Corning* opinion suggests that if the cost is one percent of the debts, that such a cost is not prohibitive.[334] While many will agree that it makes no sense to consume "most" (greater than 50 percent) of the assets, *Owens Corning* (and the other circuit court tests) leaves unresolved whether consumption of say 25 percent of the assets in order to determine ownership is "prohibitive" or "hurtful" to creditors.

Concluding comments on federal circuit court tests.

The above hypothetical presentation is designed to show that the question of whether a court would substantively consolidate the assets of the Parent and Subsidiary, is a function of whether the court applies the *Augie/Restivo*, *Eastgroup Properties*, or *Owens Corning* test. Application of each of these tests involves interpretation (and a degree of guesswork). Therefore, application of these different tests yields different outcomes.

Notably, *Augie/Restivo*, *Eastgroup Properties*, and *Owens Corning* pay homage to the foundational principles announced by the Second Circuit its pre-Code consolidation opinions of: *Soviero v. Franklin National Bank of Long Island*, *Chemical Bank New York Trust Co. v. Kheel*, *In re Flora Mir Candy Corp. v. R.S. Dickson & Co.*, and *In re Continental Vending Machine Corp.* (the "pre-Code Four").[335] As noted at the outset of this article, a lively debate has developed among commentators as to which circuit's test is faithful to the pre-Code Four.[336]

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[332] *Id.* at 211.

[333] *Id.* at 214.

[334] *Id.* at 215 & n.26 (untangling assets permissible where court could not "imagine that it would cost . . . even 1% of the [creditors'] asserted $1.6 billion claim").

[335] The full citations to the pre-Code Four are found *supra* note 93.

[336] *See supra* Part I (discussing differing views on circuit court jurisprudence since pre-Code Four decisions).

Owens Corning narrowly construes the holdings of the pre-Code Four so as to minimize federal law interference with the state-corporate-law-based entity theory. Of the federal circuit court tests discussed above, *Owens Corning's* rule is the most faithful to the policies underlying the entity theory of corporation law.

However, each of the leading federal circuit court tests shares one critical attribute in common. Each test constitutes a judge-made rule of general applicability that modifies the principle of structural subordination.[337] Each such judge-made rule provides the state law priority rules may be modified upon the showing of certain general facts, although as noted above, the key factors vary among the circuits.

b. Using proposed federal rules of decision for consolidation

William H. Widen describes the current state of the substantive consolidation jurisprudence as a "mess, leaving courts and reorganization participants adrift."[338] Widen proposes to reformulate the rules of decision for substantive consolidation.[339] This Article will survey the alternative rules for substantive consolidation proposed by Widen and others, and then offers several "bright-line" rules for consideration.

(i) Widen's rule: consolidation should be granted upon a showing that a creditor holds guarantees from multiple affiliates

Widen is of the view that substantive consolidation "is the most important doctrine in corporate reorganization."[340] However, he disagrees with much of the accepted wisdom concerning consolidation. Widen argues "appropriate occasions for use of substantive consolidation are neither few nor far between."[341] Widen argues that substantive consolidation is justified under four scenarios:

> (1) The Necessity Scenario: Substantive consolidation is justified where there is extremely poor record keeping, a failure to observe corporate forms, and the only practical alternative is pooling the assets of the subject companies;
> (2) The Pareto Scenario: Substantive consolidation is justified where it dispenses with the potential transaction costs associated with administering separate estates and distributes the savings achieved to improve each creditor's position;
> (3) The Kaldor-Hicks Scenario: Substantive consolidation is justified where (a) "those creditors benefiting from the

[337] Consequently each circuit court test may run afoul of the principle announced in *United States v. Noland*, 517 U.S. 535 (1996), discussed *infra* Part III.B.3.c.
[338] Widen, *supra* note 2, at 239.
[339] *Id.* at 239.
[340] *Id.* at 238.
[341] *Id.* at 255.

> consolidation could afford to pay those creditors harmed by the consolidation and still be better off financially" and (b) "those creditors harmed by the consolidation could not afford to bribe those benefiting from the consolidation to forego consolidation"; and
> (4) The Wealth Transfer Scenario: Substantive consolidation is justified where "the aggregate amount of losses suffered as a result of substantive consolidation by creditors harmed in the consolidation exceeds the aggregate amount of transaction cost savings realized by imposing substantive consolidation."[342]

Widen argues "[t]he classic wrong committed by a company in a substantive consolidation case is some form of misrepresentation in which the company misleads a class of creditors into thinking that more assets support their loans than in fact exist."[343] Widen observes that the *Owens Corning* parent company sold promissory notes that did not disclose the risk of structural subordination. Widen argues the note purchasers were misled by such omission into believing that the assets of the entire *Owens Corning* corporate group would be available. He contends the Third Circuit should first have determined whether failure to disclose the structural subordination risk amounts to a material omission—i.e. a "wrong" to correct. Widen argues this was an adequate "wrong" to invoke consolidation. He then argues the Third Circuit should have determined whether use of substantive consolidation would result in a countervailing second wrong, by harming the syndicated lenders' legitimate reliance interest in such structural subordination, and concludes that such reliance interest was not demonstrated.

Widen proposes that courts apply substantive consolidation to police the use by lenders of guarantees executed by all members of a corporate group. Unlike secured credit which requires public notice for lien perfection, "syndicated guarantees squeeze without systematic notice."[344] He observes a "squeeze down" effect may result when such guarantees permit a creditor to make a double recovery against multiple entities. In such a context, a creditor with recourse against only one entity (i.e. a single-source creditor) is placed at a disadvantage, and can be easily misled into believing that more assets are available.

In other contexts, such as allowance of an under secured claim, or allowance of a general partnership creditor's claim against a partner, Congress has made an explicit policy choice protective of the "single-source" creditor. One example is found in section 506(a) of the Bankruptcy Code, which bifurcates the secured portion of a claim secured by a lien, from the unsecured portion. Section 506(a) precludes the secured creditor from asserting its entire claim to two separate "pools"

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[342] *Id.* at 281–91.
[343] *Id.* at 294.
[344] *Id.* at 309–10. "Syndicate guarantees" in this context refers to subsidiary guarantees as typically required by a syndicate of lenders to a corporate group of borrowers.

of recovery: (i) the collateral; and (ii) the remaining unpledged assets available to all creditors. Another example is found in section 723 (c) of the Bankruptcy Code, which precludes assertion of a partnership creditor's claim against both: (i) the bankrupt partnership; and (ii) the bankrupt partner. Widen views substantive consolidation as a valid judge-made supplement to these statutory rules protective of the "single-source" creditor. He argues:

> Simply put, substantive consolidation doctrine can be used to balance the equities when we find that intercompany guarantees divide creditors into various camps of single-source creditors competing with a multiple-source creditor that benefits from the web of intercompany guarantees. Substantive consolidation in this context removes the unfairness of the squeeze-down effect.[345]

Widen argues consolidation presumptively should be granted to remove the "unfairness" of the squeeze down effect resulting from syndicated guarantees, which unlike secured credit are generally hidden from the public view. The syndicate lenders would be required to rebut the presumption by evidence establishing that consolidation will result in a countervailing "wrong" to the syndicate lenders.

While Widen has made a plausible policy argument that "hidden" syndicated guarantees result in a wrongful squeeze down effect on single-source creditors, the argument conflicts with other well-established legal principles. The notion that a single-source creditor (such as a noteholder that only has recourse against a parent company) may be misled by its inability to have recourse to assets of the subsidiaries ignores the principle that one is charged with knowledge of the law. A creditor is charged with knowledge of the principle of limited liability, which limits the corporate creditor's recourse against its debtor's shareholders. Similarly a creditor of such corporation's shareholder is charged with knowledge of the principle of structural subordination. The principle of structural subordination is an implied term of any bargain with a corporate shareholder. Absent the principle of structural subordination, it would be impossible to raise capital using the corporate form; each shareholder would be required to monitor the solvency of each other shareholder to protect his investment from creditors of the other shareholders.[346]

Should the existence of intercompany guarantees establish a presumption in favor of consolidation? Apparently the Committee on Structured Finance and the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York would disagree. These Committees observe: "[t]he

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[345] Widen, *supra* note 2, at 309–10.

[346] The historic and policy concerns that have led to the principle of structural subordination (also referred to as "entity shielding") are explored by Hansmann et al., *supra* note 3, at 1340, in which they observe business organization law requires the impairment of recourse held by creditors of stockholders "without their contractual consent (and often even without notice)."

court in *Owens Corning* similarly clarified the illogic of relying on the mere existence of intercompany guarantees as the basis for ignoring the separateness of the subsidiary. It is only because the subsidiary is separate that the parent must guarantee the obligations in order to incur liability to the third party."[347]

Widen's presumptive consolidation rule will diminish the ability of parties to rely upon the principle of structural subordination. If bankruptcy courts are empowered to diminish such principle, Hansmann, Kraakman, and Squire argue: "[i]t is critical, however, that when bankruptcy courts apply entity-trimming doctrines such as substantive consolidation, they do so with a healthy appreciation for the history and economic functions of entity shielding."[348]

(ii) The Vertical/Horizontal rule for Consolidation

Building upon the leading circuit court tests, James H.M. Sprayregen, Jeffrey W. Gettleman, and Jonathan P. Friedland[349] propose a "vertical/horizontal continuum" rule of consolidation:

> By the way of analogy, it is useful to contrast the two poles of the vertical/horizontal continuum. On the horizontal end of the continuum would be a "conglomerate"-type business that grew by acquisition. Postacquisition these once-independent businesses are run as subsidiaries and are basically stand-alone manufacturing businesses, located remotely from the parent's headquarters. Undoubtedly the trade creditors of these businesses continued to deal with these stand-alone subsidiaries in substantially the same way after the acquisition as before. At the same time, the parent was a mere holding company—having no business of its own other than managing other businesses—and therefore there was no "substantial identity" between the parent and the stand-alone subsidiaries. This structure is perhaps the epitome of the horizontally-integrated corporation.
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> Second, the opposite end of the continuum can be exemplified by, for instance, a vertically-integrated natural resource company. Such a company is characterized by a single business—producing and selling energy from natural resources—with innumerable subsidiary and affiliate businesses formed to assist in carrying out this business. These subsidiaries and affiliates are in general not stand-alone businesses but rather were formed for tax or other

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[347] Substantive Consolidation Opinions, *supra* note 38, at 417.

[348] Hansmann et al., *supra* note 3, at 1402.

[349] *See* James H.M. Sprayregen, Jonathan P. Friedland, & Jeffrey W. Gettleman, *The Sum and Substance of Substantive Consolidation*, NORTON ANNUAL SURVEY OF BANKRUPTCY LAW 1 (2005).

> strategic reasons or to allow the company to operate in foreign countries. This structure is the template for the vertically-integrated corporation . . . .
> We emphasize that we are not suggesting courts use the vertical/horizontal analysis as a knee-jerk solution to all substantive consolidation inquiries. Rather, it should be a corroborating tool to be used in appropriate factual situations. We would submit, however, that to the extent the "horizontalness" or "verticalness" of the corporation in question approaches the template for one of the polar types of organizational structure, the court should initially apply the horizontal/vertical analysis to create a preliminary presumption of the appropriateness or inappropriateness of substantive consolidation. In other words, if the court is looking at a Horizontally Integrated/Conglomerate Enterprise picture, the presumption would be not to grant substantive consolidation; if it is looking at an Vertically Integrated Enterprise picture, the presumption would be in favor of substantive consolidation. However, the initial presumption should, of course, be subject to rebuttal by the facts of the individual case.[350]

Under the Hypothetical, the Parent and Subsidiary would constitute a vertically integrated business. Thus the remedy of substantive consolidation is presumed to apply under this proposed "vertical/horizontal continuum" rule.

(iii) Brasher's Rule for Consolidation

Andrew Brasher[351] has proposed the following rules of decision for consolidation, which take into account whether the creditors' claims are based in contract or tort law:

> 1. *Presumption of Consolidation—When a substantial percentage of unsecured claims are held by involuntary creditors [(i.e. tort creditors)], there should be a presumption to substantively consolidate the assets and liabilities of all a corporate parent's wholly-owned subsidiaries.*[352]
> 2. *Defeating consolidation as to one claim—A claim should not be consolidated if a creditor can show that it objectively relied on the separate credit of its debtor subsidiary.*[353]

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[350] *Id.* at 21–22, 26 (illustrations and footnotes omitted).

[351] *See* Andrew Brasher, *Substantive Consolidation: A Critical Examination*, *available at* http://www.docstoc.com/docs/3877070/Substantive-Consolidation-Substantive-Consolidation-A-Critical-Examination-Andrew-Brasher-abrasher (last visited February 2, 2010).

[352] *Id.* at 42.

[353] *Id.* at 44.

> 3. *Defeating consolidation as to all claims—A creditor will be able to prevent substantive consolidation upon proving that the entities were functionally separate businesses.*[354]

Brasher's rules emulates community property laws which provide that a spouse's separate community property is not liable for contractual debts of the debtor spouse, but is liable for the torts. Applying Brasher's rules to the Hypothetical would likely result in consolidation, as the Landlord did not require a financial statement from the Subsidiary, and took no steps to distinguish the creditworthiness of the Subsidiary from any affiliate.

(iv) Bright line rules for consolidation

It is submitted that the rules discussed above suffer from a significant degree of indeterminacy. Reasonable minds can disagree as to how the rules apply to specific facts. Such indeterminacy may allow judges to achieve "fair" results tailored to the facts of specific cases, but at a cost. This cost is the litigation expense attendant to a substantive consolidation controversy, which will likely be greater if the court may take into account a wide range of relevant factors. Limiting the court's fact finding inquiry to specific "bright-line" factors can reduce litigation expense and provide a more efficient outcome.

Mary Elizabeth Kors has argued "[w]hile economic efficacy 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."[355] This Article proposes the following bright-line rules for consolidation in bankruptcy cases.

In formulating proposed bright-line rules, one cannot ignore the underlying legal context in which the rule will be applied. There are two competing notions of what the normative law of corporate groups should be, the "entity theory" and the "enterprise theory." I argue that the following Bright Line Rules 1, 2 and 3 should govern consolidation in bankruptcy cases where the "entity theory" remains the governing corporate law principle. In jurisdictions where the "enterprise theory" of corporate law governs, I argue that Bright Line Rules 1, 2, 4 and 5 should govern consolidation in bankruptcy cases.

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[354] *Id*.

[355] Kors, *supra* note 318, at 410–11. Circuit Judge Reavley of the Fifth Circuit, in authoring an en banc opinion, recently commented on the importance of predictable rules:

> The law rules best by being predictable and consistent. It is predictability that enables people to plan their investments and conduct, that encourages respect for law and its officials by treating citizens equally, and that enables an adversary to settle conflict without going to court in the hope of finding judges who will choose a favored result.

See Wheeler v. Pilgrim's Pride Corp., 591 F.3d 355, 363 (5th Cir. 2009).

Proposed Bright-Line Rule 1. Substantive consolidation shall not be allowed unless one target of the proposed consolidation owns at least 80 percent of the equity securities of the other entity to be consolidated.

This proposed bright-line rule would replace the "substantial identity" between the entities factor, by fixing the minimum quantity of ownership required before substantive consolidation is permitted. No one would suggest that a small investor in a public company, holding say 0.001 percent of the common stock, should be a target for substantive consolidation with such company. Lawmakers would likely agree that something more than 50 percent ownership should be a prerequisite to consolidation. My proposal to eliminate consolidation unless the parent corporation owns at least 80 percent of the subsidiary, is similar to the common law rule followed in some jurisdictions concerning "reverse piercing" of the corporate veil of a wholly-owned corporation.[356] Absent an 80 percent or more concentration of ownership in the parent, holders of significant minority ownership positions could find their investment rendered worthless by reason of the target being saddled with the debts of the majority owner.

Alternatively, a minimum ownership rule could be made consistent with the generally accepted accounting principle requiring financial reporting on a consolidated basis when one entity "controls" another by reason of its ownership of 50 percent of its voting stock.[357] A bright-line rule that conditions consolidation upon reaching a precise minimum ownership threshold will promote greater certainty in financial transactions.

Proposed Bright-Line Rule 2. All entities to be consolidated must be debtors in a Title 11 bankruptcy case.

Several policy arguments support a bright line rule that all entities to be consolidated must be debtors in bankruptcy. At present, neither the Bankruptcy Code nor the Bankruptcy Rules contain provisions protective of the interests of creditors and other stakeholders having an interest in the non-debtor affiliate that is

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[356] *See, e.g.*, Scholes v. Lehmann, 56 F.3d 750, 758 (7th Cir. 1995) ("Reverse piercing is ordinarily possible only in one-man corporations, since if there is more than one shareholder the seizing of corporation's assets to pay a shareholder's debts would be wrong to the other shareholders.").

[357] The Financial Accounting Standards Board ("FASB") has for many years developed standards to determine which entities should be included in consolidated financial statements. The Accounting Research Bulletin No. 51, Consolidated Financial Statements (ARB 51) was adopted in 1959. *See Consolidated Financial Statements*, ACCT. RES. BULL. No. 51 (Am. Inst. Certified Pub. Accountants, New York, N.Y., 1959). Under ARB 51, consolidated financial statements are required when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies, where control is defined as having ownership of a majority voting interest (*i.e.*, over 50 percent of the outstanding voting shares of another company). The FASB continues to evaluate the merits of more expansive meanings of "control" to be determined by (a) a parent's decision-making ability (that is, not shared with others) that enables it to guide the ongoing activities of its subsidiary; and b) a parent's ability to use that power to increase the benefits that it derives and limit the losses that it suffers from the activities of that subsidiary.

to be consolidated with the debtor, or that otherwise guide the exercise of the supposed judicial discretion in this area. Granting a substantive consolidation order against a non-debtor entity is tantamount to an involuntary bankruptcy order. If an involuntary bankruptcy were commenced in accordance with section 303 of the Bankruptcy Code, the putative debtor would be entitled to notice and opportunity to be heard on whether it belongs in bankruptcy. As provided in section 303, only certain creditors have standing to file an involuntary petition.

One commentator notes that allowing a substantive consolidation between a debtor and a non-debtor entity results in:

> an amorphous "quasi-bankruptcy" that leaves open significant issues such as, among others: (a) when and to whom does/did the automatic stay apply?; (b) who (particularly where there are separate boards and officers of the putative debtors) has the power to formulate and propose a plan of reorganization regarding the augmented estate?; (c) to what types of transactions do the avoidance powers extend (e.g., are they applied nunc pro tunc to the date of the debtor's filing, or do the nondebtor's transactions after the debtor's bankruptcy filing but before consolidation become potentially avoidable postpetition transactions)?; (d) when do statutes of limitations and statutory deadlines (e.g., exclusivity period to file a plan) begin with respect to the nondebtor affairs?; (e) must the creditors' committee be reconstituted to adequately represent the creditors of the nondebtor?; and (f) does the consolidated estate satisfy the requirements for a voluntary or involuntary bankruptcy filing (e.g., if involuntary, is the consolidated estate generally paying its undisputed debts as they become due within the meaning of Bankruptcy Code § 303(h)(1))?[358]

Creditors of a non-debtor entity having knowledge that its affiliate is in bankruptcy, will have a legitimate concern that their dealings with the non-debtor may later be "unraveled" if the non-debtor entity is later substantively consolidated with the affiliate. Such creditors may cease providing credit to the non-debtor affiliate, perhaps leading to further financial distress and bankruptcy. Creditors may also perceive the necessity to monitor the financial health of affiliates of their borrower, which will tend to increase the cost of credit.

Finally, what rule should govern if affiliated debtors do not file simultaneous bankruptcy cases? If the enterprise theory applies, I suggest that the petition date of the subsequent cases should relate back to the date of the initial bankruptcy filing. However, if the creditor changed positions in reliance upon the fact the affiliate was

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[358] Mayr, *supra* note 26, at 85.

not in bankruptcy, an exception to the post-petition avoidance powers under section 549 of the Code would be warranted.

Proposed Bright-Line Rule 3. Substantive consolidation may be granted if (i) all creditors of the entities to be consolidated consent to the relief, or (ii) with respect to any creditor that refuses to consent, such consent has been unreasonably withheld under the circumstances. A creditor may be deemed to have unreasonably withheld its consent if its refusal is based upon considerations other than a bona fide belief that separate case administration will enhance the distributions on account of the creditor's claim.

At present, the "entity theory" of business organizations remains the default rule of corporate law. If the corporate law values represented by the entity theory are paramount, then a bright-line rule that substantive consolidation is only available if all parties consent preserves those values.

To be sure, the problem of commingled assets will present administrative challenges in an entity theory jurisdiction. As noted above, *Augie/Restivo* attempted to solve the scrambled-eggs problem by its inquiry: "[W]hether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[359] *Owens Corning* later held that a commingling of assets justifies consolidation only when separately accounting for the assets and liabilities of the distinct entities benefit every creditor—that is, when every creditor will benefit from the consolidation.[360] However, the premise that consolidation can ever benefit "all creditors" includes an inherent contradiction. Creditors of the entity having the high asset-to-debt ratio are invariably prejudiced by consolidation with an entity with a lower asset-to-debt ratio. When a court grants substantive consolidation on the basis that the assets and liabilities of the affiliates have become so scrambled that all will benefit from consolidation, such court's unarticulated reasoning might be that a reasonable person, with knowledge of the facts, would consent to consolidation under such circumstances.

I argue that in an entity theory regime, the power to consolidate should be tethered not to findings about "excessive entanglements" but rather to the principle of creditor consent. Consolidation should be granted only after a notice is given which informs creditors that the debtor and its debtor affiliate are alleged to be hopelessly entangled, and that consolidation will result in the pooling of the assets and liabilities. Reasonable creditors would likely consent to consolidation under such circumstances. Their consent may be expressly obtained or implied by the absence of objection within a reasonable notice period.

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

[360] *In re* Owens Corning, 419 F.3d 195, 214 (3d Cir. 2005).

Of course conditioning consolidation upon unanimous creditor consent would allow "hold-outs" to block a reasonable consolidation request. Such a hold-out might block consolidation for reasons unrelated to the merits of the request.

However, allowing bankruptcy courts to grant consolidation over the objection of a creditor whose consent has been unreasonably withheld provides a solution to the problem of hold-outs. This leeway would prevent creditors from withholding consent in the hope that some other creditor might buy them off. Leases often have clauses that require a landlord's consent, but protect the tenant by providing that such consent shall not be unreasonably withheld. This principle could be applied to hold-outs in bankruptcy cases, without significant damage to the corporate law values behind the entity theory.

This is because if the objecting creditor articulates a plausible, coherent position as to why he believes separate administration of the bankruptcy estates will result in a higher recovery for the objecting creditor, the bankruptcy court would not have the discretion to substitute its judgment. So long as a "reasonable creditor" could reach the conclusion that consolidation will prejudice its recovery, the creditor's objection should be sustained if the entity theory is to be preserved.[361]

Proposed Bright-Line Rule 4. Substantive consolidation may not be granted if a creditor establishes it required a partition of the debtor's assets and liabilities from the affiliates as a condition to extending credit to its debtor.

What if, as a matter of state corporate law, the "enterprise theory" is accepted, such that each affiliate corporation is presumptively liable for the debts of the others? In such a regime, it may follow as a general rule that the assets and liabilities of affiliated corporations should be consolidated in bankruptcy.

If consolidation becomes the default rule in bankruptcy, a policy question emerges whether lenders and borrowers should be allowed some degree of "freedom of contract" to partition assets into a specific borrowing entity that is exempt from consolidation? One argument in favor of such exemption is that it could reduce the creditor's financial monitoring costs. Richard Posner observed that substantive consolidation complicates a lender's evaluation of the credit worthiness of a particular borrower:

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[361] Even in an "entity theory" regime, I recommend favorable consideration of one other bright line consolidation rule, a default rule in favor of substantive consolidation where a Ponzi scheme is established. A "Ponzi scheme" is a fraudulent investment plan in which the investments of later investors are used to pay earlier investors, giving the appearance that the investments of the initial participants dramatically increase in value in a short amount of time. A bright line rule where corporate affiliates used by a promoter to carry out Ponzi scheme should be substantively consolidated with the promoter found guilty of such scheme, may be a sensible policy choice. Even defenders of the entity theory of corporate groups recognize a fraud-based exception to the theory is warranted. It makes little sense to protect the corporate law fiction in circumstances where corporations have been used as instruments to carry out Ponzi schemes.

> If piercing the veil is allowed, the parent's creditors are exposed to an additional risk—that the parent's assets may be diverted to satisfy the claims of the subsidiary's creditors. To determine the parent's creditworthiness, therefore, prospective creditors of the parent must also investigate the subsidiary's creditworthiness. Acquiring the necessary information will become even more complicated if we allow not only the subsidiary's creditors to reach the assets of the parent, but the parent's creditors to reach the assets of the subsidiary . . . .[362]

Hansmann, Kraakman, and Squire argue:

> [A] firm and its owners can often reduce the monitoring costs of creditors if the firm's assets (already protected from personal creditors) can be subpartitioned again and pledged to subsets of business creditors with specialized lending expertise in particular lines of business. This benefit is one of the principal reasons for the formation of wholly owned corporate subsidiaries and other special-purpose entities.[363]

Parties to "structured lending" transactions strive to isolate the assets of a borrowing entity from the bankruptcies of affiliates. Lenders in such transactions

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[362] Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 517 (1975-1976). Posner further argues that:

> To the extent that one of the bankrupts has greater assets relative to the claims of its own creditors than the other has, consolidation harms those creditors and helps the affiliate's creditors. The prospect of consolidation means that a creditor can make a total evaluation of the risks that he faces only by considering the risk of insolvency of the borrower's affiliates as well as the risk of insolvency of the borrower itself.

Id. at 518.

[363] Hansmann et al., *supra* note 3, at 1345 n.29 (2006). The Fifth Circuit echoed this reasoning in *Bank of New York Trust Co. v. In re Pacific Lumber (In re Pacific Lumber)*, 584 F.3d 229 (5th Cir. 2009), noting that:

> Substantive consolidation is of special concern in cases involving special purpose entities like Scopac. Special purpose entities are often used in securitized lending because they are bankruptcy-remote, that is, they decrease the likelihood that the originator's financial trouble will affect the special purpose entity's assets serving as collateral for the notes. Nevertheless, there is a danger that a court will substantively consolidate the two entities, using the value of the investors' collateral to satisfy the originator's debts. If courts are not wary about substantive consolidation of special purpose entities, investors will grow less confident in the value of the collateral securing their loans; the practice of securitization, a powerful engine for generating capital, will become less useful; and the cost of capital will increase.

Id. at 249 n.25.

require the assets to be held in "special purpose entities" ("SPEs"). These are business organizations designed, among other things, to provide a vehicle to isolate assets from those owned by affiliates who might later file bankruptcy. At present, SPE qualifications are not defined by reference to statutory law; rather, this form of lending transaction is governed by "guidelines" issued by commercial rating agencies.[364] Such SPEs would qualify as partitioned entities for purposes of this bright-line rule.

However, I propose a broader safe-harbor. In any transaction where a creditor has conditioned an extension of credit upon (i) a specific entity's ownership of assets that are intended to support repayment of the credit, and (ii) such entity's having no other debts, except as needed to preserve and maintain such asset, such a "specifically partitioned entity" should be exempt from consolidation.[365]

If lawmakers establish a bright-line rule that a corporation that meets certain SPE eligibility criteria may not be substantively consolidated, the increased credit monitoring costs of an "enterprise law" regime may be averted. Lenders will no longer find it necessary to investigate (or obtain covenants) regarding the creditworthiness of the partitioned entity's affiliates. A bright-line rule that exempts a partitioned entity from consolidation provides certainty allowing lenders to reduce the cost of monitoring their borrowers. In sum, if enterprise liability provides the normative rule for affiliated debtors, this article argues that lawmakers should craft a bright-line rule exempting partitioned entities from the scope of any substantive consolidation order issued concerning its affiliates.[366]

Proposed Bright-Line Rule 5. An affiliate may not be consolidated with another affiliate if such entities have been affiliated less than two years from the initial petition date of a member of the affiliated group.

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[364] Robert K. Rowell, *Single Purpose Entities Give Borrowers More Leverage*, BUS. ENTITIES, Jul/Aug 2005, at 32, 32–34, *available at* 2005 WL 2002582 (discussing commercial rating agencies guidelines governing SPEs). Widen acknowledges that "a reliable asset partition may employ a legal entity as part of a matching strategy" and that "[s]ecuritization transactions provide the classic example of enhancement of the asset partition created by a legal entity." Widen Report, *supra* note 29, at 29. Widen appears to be referring to the use of SPEs in which assets are segregated and matched with specific liabilities. *See* Lee Gilliam, *Accounting Consolidation versus Capital Calculation: The Conflict Over Asset-Backed Commercial Paper Programs*, 9 N.C. BANKING INST. 291, 297–98 (2005) (describing use of SPEs where assets are segregated and matched with liabilities).

[365] Kenneth C. Kettering has suggested that a safe harbor be recognized for transfers by an originator to an SPE of accounts receivables, notes and other rights to payments. *See* Kettering, *supra* note 67, at 1727. Kettering views this aspect of the securitization industry as "benign" in contrast to more aggressive attempts to securitize the core assets of a business, such as its intellectual property or inventory. *See id.* I would leave it to the legislative branch to conduct such hearings as necessary to decide whether only financial assets, such as accounts, may be partitioned.

[366] If parties are permitted to establish entities whose assets are outside of the consolidated pool, lawmakers should also address the corollary question of: What public notice should be given so that creditors of an affiliate are not misled into believing that all affiliates assets are available under the general rule of consolidation? One solution would be to require the SPE designation be contained in its publicly filed organization documents or certificates.

Consider the plight of a creditor that has made a lending decision based upon the credit-worthiness of an entity. Later, the entity experiences a change of ownership, and becomes part of a new affiliated group. Under the enterprise theory, the entity may be liable for the debts of the group that acquired it.

Cases such as *Flora Mir Candy Corp. v. R.S. Dickson & Co. (In re Flora Mir Candy Corp.)*,[367] demonstrate the need to protect creditors of an entity that is later acquired by an unaffiliated entity. While creditors may bargain for covenants which require their consent to a merger or change of ownership, a change of affiliation may occur without notice, or without the creditor's consent. It seems appropriate to provide a bright-line rule that prevents consolidation of a recently acquired entity.

> *c. How much substantive consolidation reform may be accomplished in the federal courts in light of United States v. Noland?*

This Article agrees with Widen's observation that parties are struggling against a backdrop of "serious underlying confusion" over the current state of the substantive consolidation doctrine.

> Rather, from a former transaction lawyer's perspective, I consider most, if not all, of the instances of ambiguity and drafting "work arounds" to be attributable to conscious attempts by lawyers and courts to use drafting techniques to address ambiguities inherent both in Bankruptcy Code statute sections and in substantive consolidation case law with which both judges and transaction participants are well versed. My strong belief is that judges and transaction participants are consciously papering over problems that exist in both statue and case law. In effect, the transaction participants are working with judges to fix broken statues and doctrine because the show must go on.[368]

Most bankruptcy practitioners would agree there is room for improvement in the rules of decision for substantive consolidation. Perhaps improved rules of decision for substantive consolidation should be offered up by litigants in cases

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[367] 432 F.2d 1060, 1062–63 (2d Cir. 1970) (finding improper consolidation where debentures issued more than six years before corporation acquired by parent and misappropriation claim against parent would be wiped out permitting creditors to recover based on transactions prior to acquisition by parent).

[368] Widen Report, *supra* note 29, at 25–26. For an example of such an attempted "work around," see *In re New Century TRS Holdings, Inc.*, 390 B.R. 140, 161 (Bankr. D. Del. 2008), in which the plan proponents disclaimed relying upon substantive consolidation, yet included plan provisions which emulate certain results of substantive consolidation. The bankruptcy court viewed the plan as a series of inter-related compromises rather than a substantive consolidation. *See id.* However on appeal the District Court reversed, concluding that the Debtors' attempt to distinguish their plan from a conventional substantive consolidation failed, and that a substantive consolidation had been granted without compliance with the stringent *Owens Corning* standards. *See In re* New Century TRS Holdings, Inc., 407 B.R. 576, 591–92 (D. Del. 2009).

before the courts. One such effort was made before the Fifth Circuit Court of Appeals. The brief filed by the appellant in the *Amco* appeal[369] presented two questions regarding substantive consolidation: (i) did it survive *Grupo Mexicano*, and if so, (ii) what standard should be followed by courts in the Fifth Circuit? On the latter issue, the appellant offered several bright-line rules for substantive consolidation. For example, the appellant argued that the Fifth Circuit should hold that a non-debtor entity may not be consolidated with a debtor as a matter of law.

Two days before oral argument, the Fifth Circuit *sua sponte* made the following insightful inquiry to all counsel:

> "The panel assigned to this case would like you to be prepared at oral argument to address whether and to what extent *U.S. v. Noland*, 517 U.S. 535 (1996), and *U.S. v. Reorganized CF&I Fabricators of Utah, Inc*., 518 U.S. 213 (1996), apply or should be applied to this case."[370]

Neither party had cited these cases in their briefs. Nor had the lower courts made reference to these cases in their opinions. Is there a lesson to be learned from the Fifth Circuit panel's inquiry?

In *United States v. Noland*,[371] the Internal Revenue Service ("IRS") filed a claim against a corporate debtor for a non-compensatory tax penalty, which would ordinarily have been entitled to first priority under the Bankruptcy Code.[372] The bankruptcy court, even in the absence of misconduct on the part of the IRS, equitably subordinated the claim under section 510(c) of the Bankruptcy Code. This was done to avoid the perceived unfairness of permitting the IRS's penalty claim to take precedence over the claims of innocent creditors.[373] The Sixth Circuit had affirmed the bankruptcy court's equitable subordination of the IRS claim, finding that "[t]o hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around."[374]

The Supreme Court reversed, holding that courts were not authorized to subordinate entire classes of claims in derogation of Congress' scheme of priorities

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[369] *See* Wells Fargo Bank of Tex. N.A. v. Sommers (*In re* Amco Ins.), 444 F. 3d 690 (5th Cir. 2006). The author of this Article represented the appellant in that appeal.

[370] Question received from the Clerk of the Fifth Circuit Court of Appeals on or about July 28, 2005, directed to all counsel involved in the *Wells Fargo Bank of Tex. v. Sommers* (*In re Amco Ins.*) appeal, case number 04-20841.

[371] 517 U.S. 535 (1996).

[372] *See id*. at 537 (indicating IRS filed claim for taxes, penalties, and interest but parties disagreed over whether tax penalties should be given priority).

[373] *See id*. (citing *In re* First Truck Lines, Inc. 141 B.R. 621, 629 (Bankr. S.D. Ohio 1992)) (noting bankruptcy court emphasized preference for compensating actual loss).

[374] *Id.* at 538 (quoting United States v. Noland (*In re* First Truck Lines, Inc.), 48 F.3d 210, 218 (6th Cir. 1995) (explaining it is unfair for tax penalties to take priority and such penalties should be subordinated)).

established in the Bankruptcy Code.[375] Justice Souter stated that "Congress could have, but did not, deny noncompensatory postpetition tax penalties the first priority given to other administrative expenses, and bankruptcy courts may not take it upon themselves to make that categorical determination under the guise of equitable subordination."[376] The *Noland* court held the Sixth Circuit's categorical judgment was legislative in nature; they "are not dictated or illuminated by principles of equity and do not fall within the judicial power of equitable subordination."[377] In the companion case of *United States v. Reorganized CF&I Fabricators of Utah, Inc.*,[378] the Court confirmed that the "categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination under § 510(c)."[379]

What is surprising about *Noland*, is that one can read the reference to "principles of equitable subordination" found in the legislative history of section 510(c) to suggest that Congress intended to delegate some lawmaking powers on the subordination issue to federal bankruptcy judges. Justice Souter, writing for the Court in *Noland*, acknowledged that "Congress meant to give courts some leeway to develop the [equitable subordination] doctrine [citation omitted], rather than to freeze the pre-1978 law in place."[380] However, rather than treating this legislative history as a license for federal judges to write the law of equitable subordination, the Supreme Court instead "checked" Congress' attempted delegation of legislative powers. Even if section 510(c) may be read as a delegation of equitable lawmaking powers to the federal courts, the Supreme Court imposed an independent, constitutionally driven restraint.[381]

What lawmaking "leeway" may Congress constitutionally delegate to the bankruptcy courts? Justice Souter explains that Congress' reference to the judge-made "'principles of equitable subordination'" permits courts to make "exceptions to a general rule when justified by particular facts."[382] However, courts may not engage in a "categorical reordering of priorities" as that must take place at the "legislative level" of consideration.

What lesson is learned from *Noland* and *Reorganized CF&I* regarding the "leeway" that bankruptcy courts might have to announce rules for substantive

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[375] *See id.* at 543 (explaining Congress did not expressly deny tax penalties first priority and thus, courts cannot contradict statutory language).

[376] *Id.* at 543.

[377] *See id.* at 540–41 (quoting Burden v. United States, 917 F.2d. 115, 122 (3d Cir. 1990) (Alito, J., concurring in part and dissenting in part).

[378] 518 U.S. 213 (1996).

[379] *Id.* at 229 (finding same type of equitable subordination principal violation as in *United States v. Noland*, 517 U.S. 535, (1996)).

[380] *Noland*, 517 U.S. at 540.

[381] *See id.* (suggesting too much delegation of power to courts by Congress would blur lines of separation of powers). In view of the Court's constitutionally driven limitations on a bankruptcy court's lawmaking authority, this Article argues that *Noland* also undercuts the notion of Bankruptcy Exceptionalism discussed *supra* Part II.

[382] *Id.* (stating answer turns on Congress's intent to separate legislature from judiciary).

consolidation? Consider the state law based structural subordination rule, namely that creditors of a subsidiary corporation have priority to the subsidiary's assets vis-à-vis the creditors of a parent. *Augie/Restivo* in substance holds that if creditors dealt with the parent and subsidiary as a "single economic unit" and did not rely on their "separate identity" then the principle of structural subordination may be disregarded. This Article argues that this amounts to a "categorical judgment" of the type condemned in *Noland.* The Second Circuit's pronouncement in *Augie/Restivo* was not limited to the specific facts of that case. The *Augie/Restivo* test is a categorical rule that has been made applicable to other creditors and debtors in other cases before the Second Circuit. The *Augie/Restivo* rule reaches that "level of generality" that is "legislative in nature" and thereby appears invalid under *Noland's* separation of powers principle.

Eastgroup Properties suffers from the same problem. The *Eastgroup Properties* opinion authorizes courts to disregard structural subordination upon a showing that: (1) there is substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or to realize some benefit. *Eastgroup Properties* likewise makes a "categorical judgment" concerning structural subordination that is "legislative in nature."

It is difficult to imagine a judge-made rule for substantive consolidation of any real value that would not suffer from *Noland*'s prohibition against categorical judgments. This results in a dilemma. For a rule of law to be of any value, the rule should be sufficiently "general" that it may be applied in similar circumstances. Yet *Noland* holds it is not the province of the federal courts to make categorical judgments that will decide priority disputes in future bankruptcy cases.

If courts have a power to grant consolidation (whether by reason of *Sampsell* or some other source of authority), yet courts are unable to announce categorical rules of decision, a kind of lawless anarchy will result. Court decisions consisting of a series of fact findings, without reference to a general rule of decision that guides their exercise of judicial power, is anathema to the rule of law. One court might find creditors of the parent are exempted from the structural subordination because of facts a, b, and c. Another court finds creditors of the parent are exempted from the general rule because of facts x, y, and z. Absent a categorical rule that governs substantive consolidation, the length of the Chancellor's foot emerges as the metric for decision.

CONCLUSION

A. A legislative decision between "enterprise law" versus "entity law" is warranted

The tension between the need for legal standards to decide substantive consolidation disputes, and the constitutional limitations upon the judiciary's power to formulate rules of decision is nothing new. Congress enacted a federal statute related to the issue in dispute, namely the Bankruptcy Code, but did not directly

address the problem. Justice William O. Douglas, writing on behalf of the Court, observed:

> [T]he claim now asserted, though the product of a law Congress passed, is a matter on which Congress has not taken a position. It presents questions of policy on which Congress has not spoken. The selection of that policy which is most advantageous to the whole involves a host of considerations that must be weighed and appraised. That function is more appropriately for those who write the laws, rather than for those who interpret them.[383]

Congress has enacted a series of bankruptcy acts, yet Congress has yet to take a position on what standards should govern substantive consolidation. In this vacuum, commentators and courts have provided inconsistent standards. This is hardly surprising in view of a lack of consensus over what purpose substantive consolidation serves. Is substantive consolidation the "most important doctrine in corporate reorganization" or is it a narrow remedy to be used only when creditors knowingly condone their debtors' open disregard of corporate separateness?

This Article argues that promulgating rules governing substantive consolidation prior to reaching a legislative consensus regarding the respective merits of entity theory and the evolving enterprise theory of corporate law is placing the "cart before the horse." If the proposed substantive consolidation rule is intended to provide an exception to the entity theory, the rule would likely provide that consolidation may not be granted unless specified elements are shown. If the proposed substantive consolidation rule is intended to provide an exception to the enterprise theory then the rule should be that consolidation will be granted unless certain "safe harbor" elements are shown.

Thus, underlying this debate over what standards should govern substantive consolidation is the tension between proponents of the traditional entity theory and the evolving enterprise theory of corporate law. The traditional entity theory treats a corporation as an artificial person separate from shareholders and affiliates. The concept of entity shielding developed by Hansmann, Kraakman, and Squire demonstrates how the entity theory allowed corporations to serve a capital raising function.[384]

Phillip Blumberg, however, has argued that the entity theory emerged in a largely agrarian society where the role of business was very different from its role today. The corporation was typically very small and owned by a relatively small group of individuals. Blumberg argues that corporate law should abandon the entity

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[383] United States v. Gilman, 347 U.S. 507, 511–13, (1953); *see also* Nw. Airlines, Inc. v. Transp. Workers Union of Am., 451 U.S. 77, 98 (1980).

[384] *See* Hansmann et al., *supra* note 3, at 1350 (discussing how entity shielding reduces cost for owners and allows individuals to make equity investments in numerous firms).

theory in favor of an enterprise theory approach.[385] The enterprise theory would impose liability upon all members of a corporate group, and would pool the assets so that all of the group's assets would be available to satisfy debts of an insolvent member.[386]

The analogous "single business enterprise" theory is traceable to an article by Adolf A. Berle, which advocated the removal of limited liability when there had been "excessive fragmentation" of a business into presumably artificial corporate forms. Berle argued that creditors ought to be able to recover from any member of a group of corporations that act in tandem and are deemed to constitute an "enterprise." [387]

The views expressed by Blumberg and Berle stand in stark contrast with that of others who have concluded that permitting parents, subsidiaries, and affiliates separate corporate existence will result in the owners of those entities actually being able to put more resources and adequate insurance coverage at their disposal, since they will be in a position to take advantage of economies of scale.[388] English law follows the entity theory, and English business law principles are influential in many foreign jurisdictions. Before legislatures alter corporate law in the United States in favor of the relatively uncharted enterprise theory, consideration should be given as to the impact such change may have on investment in the United States.

The process of devising sound rules for substantive consolidation will require policy choices regarding the permeability of the corporate form. When should the

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[385] *See generally* Phillip I. Blumberg, BLUMBERG ON CORPORATE GROUPS xi–xii, 1–5 (Aspen Publishers 2d ed. 2009). Professor Jonathan M. Landers published an article in 1975 that argued substantive consolidation should be the default rule in bankruptcy (stating two approaches can be used when related entity is bankrupt: maintain separate identities of each corporation, or consolidate assets and liabilities of both companies). *See* Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589, 628–33 (1975) (discussing if consolidation occurs priority creditors of poorer corporation will be ahead of general creditors of wealthier corporation).

[386] *See* Landers, *supra* note 385, at 629–30. A variant of enterprise liability may be observed in the regulated sphere of bank holding companies. The Federal Reserve's "source of strength" regulation provides in relevant part: "A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner." 12 C.F.R. § 225.4(a)(1) (1991). While a court of appeals concluded such regulation exceeded the Federal Reserve's authority, the Supreme Court reversed on other grounds. *See* Bd. of Governors of the Fed. Reserve Sys. v. MCorp Fin., Inc., 502 U.S. 32, 34 (1991) (discussing bank holding company filed for bankruptcy and subsequently commenced action against Board seeking to enjoin prosecution of two administrative proceedings, one being a violation of 12 C.F.R. § 225.4(a)(1)).

[387] *See* Adolf A. Berle, Jr., *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343, 350 (1947) (stating "liabilities are dealt with in accord with the business, instead of the legal fact of corporate entity").

[388] *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 101 n.19 (1985) (discussing insurance as alternative to limited liability); *see also* Stephen B. Presser, *The Bogalusa Explosion, "Single Business Enterprise," "Alter Ego," and Other Errors: Academics, Economics, Democracy, and Shareholder Limited Liability: Back Towards a Unitary "Abuse" Theory of Piercing the Corporate Veil*, 100 NW. U. L. REV. 405 (2006) (discussing effect of Bogalusa explosion on limited liability and analyzing current state of limited liability rule). Presser further observes that "[i]n 1911, the President of Columbia University, Nicholas Murray Butler, stated that the invention of the 'limited liability corporation' was 'the greatest single discovery of modern times.'" *Id.* at 409 (quoting STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL § 1:1, at 1–5 (14th ed. 2004)).

benefits that parties derive from using multiple corporations to partition assets, be ignored in favor of efficiency and practicality? Those favoring the enterprise theory will argue that as a general rule, the values of efficiency and practicality trump concerns regarding parties' ability to partition assets. Proponents of the enterprise theory will find an *Owens Corning*'s restrictive rule a step backward. On the other hand, proponents of "bright-line" tests will disfavor the *Eastbrook Properties*' balancing test approach.

Further complicating bankruptcy reform in this area is a federalism-driven concern as to whether the enterprise theory versus entity theory debate should be settled by state legislatures or by Congress. Corporate law traditionally has been viewed as the province of state statutes and state regulation.[389] To be sure the federal securities acts enacted in the 1930's exemplify a federalization of certain aspects of corporate law. Substantive consolidation, by imposing the pooling of assets and liabilities in a manner unknown under state law, represents another potential federalization of state corporate law. Whether such federalization by an act of Congress is warranted involves a separate policy choice.[390]

Having Congress resolve the enterprise theory versus entity theory debate at the federal level would provide a uniform national set of rules. However, having a set of special substantive consolidation rules for corporate liability that apply only in federal bankruptcy cases could be viewed as an unwelcome intrusion by Congress on matters of state corporate and creditors' rights law. The sounder approach may be for proponents of the enterprise theory (or proponents of laws seeking more predictability) to publish a proposed "Uniform Affiliated Corporation Act" for adoption by state legislatures.[391]

Thereafter Congress could amend the Bankruptcy Code as needed to integrate the uniform corporate affiliate liability principles into the administration of federal bankruptcy cases. We already have two examples where state laws governing liability of affiliates have been integrated into federal bankruptcy law. States adopting community property laws have established which assets of a non-debtor spouse may be liable for the debts of the other.[392] The federal Bankruptcy Code builds upon these state law principles in defining "property of the estate" to include

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[389] This federalism policy concern is exemplified by *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 89 (1987), in which the Court notes "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law." The Court further noted that it "is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares." *Id.* at 91.

[390] *See* BFP v. Resolution Trust Corp., 511 U.S. 531, 544 (1994). The Supreme Court ordinarily expects "clear and manifest" statement from Congress to authorize unprecedented intrusion into traditional state authority.

[391] At this point in time, the "entity theory" appears to be the default rule in all of the States, so the burden presumably would be upon proponents of the "enterprise theory" to propose such changes to corporate law. *Cf.* Joseph H. Sommer, *The Subsidiary: Doctrine Without a Cause?*, 59 FORDHAM L. REV. 227, 268–69 (1990) (observing popularity of enterprise theory and obsoleteness of entity theory).

[392] *See, e.g.*, TEX. FAM. CODE ANN. § 3.202 (Venon 1997) (indicating when community property is subject to liability).

a non-debtor spouse's interest in community property of that is liable for the debts of the spouse.[393]

Other state laws, such as the Uniform Partnership Act, establish the rights of partnership creditors to the property of the partnership and the partners thereof. Federal bankruptcy law regulates the application of these state law rules in bankruptcy, by specifying when in bankruptcy a creditor of a partnership may have a claim against the bankrupt partner.[394]

Similarly a "Uniform Affiliated Corporation Act" could establish the standards for deciding when one corporation is liable for the debts of an affiliate. State legislatures, in furtherance of their power to regulate corporations, should decide whether liability attaches simply by one corporation's affiliation with another.[395] The Bankruptcy Code should be amended to operate in tandem with such state legislative determinations, in much the same way as sections 541(a)(2)(A) and 723 of the Bankruptcy Code regulate the treatment of community and partnership property.

It is plausible that Congress, in the exercise of its Article I bankruptcy powers, might conclude it is unwise to rely solely upon a patchwork of varying state laws on the issue of affiliated corporations. Congress might insert a set of "Uniform Affiliated Corporation Act" provisions into the Bankruptcy Code. Even then Congress could allow the States to "opt out" of "Uniform Affiliated Corporation Act" as it has allowed with respect to property exemptions, which have traditionally been considered a concern of state law.[396]

B. Remembering Pluto

In the decade since the *Grupo Mexicano* decision, substantive consolidation has moved to a more tenuous place in the bankruptcy universe. The restrictions upon substantive consolidation relief announced in *Owens Corning* have initiated a much needed reevaluation of the doctrine. Such reevaluation could lead to an outcome

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[393] *See* 11 U.S.C. § 541(a)(2) (2006) (bankruptcy estate is made up of "[a]ll interests of the debtor and the debtor's spouse in community property as of the commencement of the case . . . under the sole, equal, or joint management and control of the debtor . . . ").

[394] *See* 11 U.S.C. § 723(c) (2006) ("Notwithstanding section 728(c) of this title, the trustee has a claim against the estate of each general partner in such partnership that is a debtor in a case under this title for the full amount of all claims of creditors allowed in the case concerning such partnership.").

[395] While the full range of issues to be addressed by such a Uniform Affiliated Corporation Act is beyond the scope of this Article, any such act should address conflict of laws. This is because it is common in large affiliated groups since corporations may have more than one state of incorporation as well as more than one principal place of business. Such proposed Uniform Affiliated Corporation Act might provide that the law of the state of incorporation of the ultimate parent governs the rules for enterprise liability for members of the group.

[396] This is the solution that Congress selected with respect to exempt property, which traditionally had been considered a state law matter. When providing for a uniform set of federal law exemptions, Congress allowed the States to opt out by specific legislation action. *See* 11 U.S.C. § 522(b)(2) (2006) ("Property listed in this paragraph is property that is specified under subsection (d), unless the State law that is applicable to the debtor under paragraph (3)(A) specifically does not so authorize.").

reminiscent of that befalling Pluto. For most of the twentieth century, Pluto was unquestionably one of the nine planets in our solar system. However, in 2006, the International Astronomical Union, an accredited scientific body, redefined the term "planet" and removed Pluto from the list.

Most practitioners of bankruptcy law (whether lawyers or judges) that came of age after the Bankruptcy Reform Act of 1978 have been taught that "substantive consolidation" is an appropriate exercise a federal bankruptcy judge's equitable powers. However, the ultimate institution that approves or rejects federal judicial innovations, the Supreme Court, has yet to weigh in on substantive consolidation. The Supreme Court may well conclude that substantive consolidation does not meet the Court's rigorous standards for valid federal judge made law.[397]

Such a ruling would leave courts on occasion with "messy" bankruptcy cases having seemingly "scrambled" assets. I have argued that state law rules of decision provide sufficient rules even in such messy cases. Admittedly state law rules may be cumbersome. Well-informed creditors may choose to be pragmatic, and consent to a pooling of assets and liabilities in order to avoid the expense of sorting things out. Creditor consent to a pooling will often be given by well-informed creditors. I refer to such form of relief as "consensual consolidation" so as not to be confused with a remedy of substantive consolidation that may be imposed by judicial fiat.

While consensual consolidation lacks direct statutory authority, a consensual consolidation order concerning the estates of affiliated debtors should not be subject to a collateral attack. *Sampsell* held that an order directing turnover of assets of the bankrupt's affiliate was not subject to collateral attack, even where the legitimacy of the substantive merits of the order was in doubt. Bankruptcy courts administering estates of affiliated debtors should continue to have subject matter jurisdiction to issue a consolidation order, even if they lack a substantive power to do so.[398]

Further, a "consensual consolidation" of affiliated debtors may occur under a chapter 11 Plan. It is common ground that section 1123(a)(5)(C) of the Bankruptcy Code permits a plan to propose consolidation. It is also common ground that with proper disclosures, reasonable creditors may consent to consolidation by voting to accept a plan that provides for consolidation.[399]

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[397] It might be argued that the substantive consolidation doctrine is now "too big to fail," in the way Kettering has argued that while securitizations have a dubious legal foundation there is a risk of systematic economic failure if securitizations are disrupted. *See* Kettering, *supra* note 67, at 1633–34 (arguing securities are "too big to fail"). However, I am skeptical that any particular business interest significantly relies upon the elusive doctrine of substantive consolidation in developing their business models. The securitization industry does not rely on the existence of the doctrine; rather, as Kettering notes, the industry goes to great lengths to avoid application of the doctrine to its financial products.

[398] *See* 28 U.S.C. § 1334(e) (2000) ("The district court in which a case under title 11 is commenced or is pending shall have exclusive jurisdiction--(1) of all the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate; and(2) over all claims or causes of action that involve construction of section 327 of title 11, United States Code, or rules relating to disclosure requirements under section 327."); *see also* Travelers Indemnity v. Bailey, 129 S. Ct. 2195, 2206 (2009) (holding no collateral attack permitted so long as order is plausible exercise of subject matter jurisdiction).

[399] I consider several variants of the substantive consolidation doctrine, described as "Operative Deemed Consolidation," "Express Deemed Consolidation" and "Stealth Consolidation" to be examples of consensual

Outside of such forms of consensual consolidation, there remains substantial disagreement over what standards should be applied. This Article has argued the Supreme Court has signaled that the lower courts should avoid making policy judgments regarding the priorities of creditors in bankruptcy. Making rules for substantive consolidation requires policy judgments concerning the priority that creditors of one entity should have in the bankruptcy case of an affiliate. By resolving "messy" cases using substantive consolidation, lower courts may only delay the development of a comprehensive legislative response to the problem.[400]

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consolidations under a plan. *See* Widen Report, *supra* note 29, at 24–25 (discussing "Operative Deemed Consolidation," "Express Deemed Consolidation," and "Stealth Consolidation"). In the Third Circuit, the notion of "deemed consolidation" absent consent, appears to be a dead letter. *See In re* Owens Corning, 419 F.3d 195, 202 (3d Cir. 2005) ("[T]he Plan Proponents sought a form of what is known as a 'deemed consolidation,' under which a consolidation is deemed to exist for purposes of valuing and satisfying creditor claims, voting for or against the Plan, and making distributions for allowed claims under it."). Notably in *In re New Century TRS Holdings, Inc.*, 390 B.R. 140, 166 (Bankr. D. Del. 2008), a bankruptcy court bound by *Owens Corning* confirmed a plan under the theory that the plan constituted as a series of inter-related compromises rather than a deemed substantive consolidation. On appeal the District Court for the District of Delaware reversed, concluding that the Debtors' attempt to distinguish their plan from a conventional substantive consolidation failed, and that a substantive consolidation had been granted without compliance with the stringent *Owens Corning* standards. See Memorandum Opinion issued in *In re New Century TRS Holdings, Inc.*, 407 B.R. 576, 591–92 (D. Del. 2009). Thus, the viability of such hybrid forms of substantive consolidation, absent consent of all creditors, is called further into doubt.

[400] The argument that the Bankruptcy Code should be construed expansively to authorize substantive consolidation should be balanced against the observations of Daniel B. Rodriguez & Barry R. Weingast, *The Paradox of Expansionist Statutory Interpretations*, 101 NW. U. L. REV. 1207 (2007):

> Many citizens want both Congress to pass more progressive legislation and the courts to interpret existing legislation in a progressive manner, for example, by expanding the scope and coverage of these regulatory statutes. Though progressives pursue these agendas side-by-side, our analysis reveals that progressives can realize only one of these two events. A tradeoff exists between these two strategies; that is, as courts pursue broad interpretations of progressive legislation, Congress is less likely to enact new progressive legislation. We call this insight the *paradox of judicial expansionism*: Expansionary reading of existing statutes by judges inhibits congressional passage of new progressive legislation.

Id. at 1209. If this paradox is accurate, we are unlikely to achieve a legislative response to the "unfairness" that substantive consolidation is intended to correct, so long as courts construe the Bankruptcy Code expansively to allow this judge-made doctrine to continue.