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## Substantive Consolidation in Bankruptcy: A Primer

J. Stephen Gilbert

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# NOTES

## Substantive Consolidation in Bankruptcy: A Primer

I.	INTRODUCTION .....	208
II.	REQUIREMENTS AND CONSEQUENCES OF SUBSTANTIVE CONSOLIDATION .....	209
	A. <i>Consequences of Substantive Consolidation</i> .....	209
	B. <i>Bankruptcy Courts' Power to Consolidate</i> .....	210
	C. <i>Comparison to Joint Administration</i> .....	212
	D. <i>Flexibility of Substantive Consolidation</i> .....	213
	E. <i>Procedures for Consolidation</i> .....	214
	F. <i>Who May Be Consolidated</i> .....	214
	G. <i>Prerequisites for Substantive Consolidation</i> .....	215
	1. <i>Factors to Be Considered</i> .....	215
	2. <i>Misplaced Analogy to Corporate Law</i> .....	218
	3. <i>Reliance Interest of Creditors</i> .....	218
III.	EVOLUTION OF SUBSTANTIVE CONSOLIDATION THROUGH THE COURTS OF APPEALS .....	220
	A. <i>Introduction</i> .....	220
	B. <i>Stone v. Eacho</i> .....	221
	C. <i>Soviero v. Franklin National Bank</i> .....	222
	D. <i>Chemical Bank New York Trust Co. v. Kheel</i> .....	223
	E. <i>In re Flora Mir Candy Corp.</i> .....	224
	F. <i>In re Continental Vending Machine Corp.</i> .....	225
	G. <i>In re Gulfco Investment Corp.</i> .....	227
	H. <i>In re Augie/Restivo Baking Co.</i> .....	228
IV.	ANCILLARY ISSUES AND TACTICAL USES OF SUBSTANTIVE CONSOLIDATION .....	231
	A. <i>Individual Debtors and Statutory Exemptions</i> .....	231
	B. <i>Effective Date of Consolidation</i> .....	233
	C. <i>The Standard of Accounting Difficulties</i> .....	236

D. Consolidation with Nondebtors . . . . .	237
E. Appellate Standard of Review . . . . .	238
F. Consolidation Pursuant to a Plan of Reorganization . . . . .	239
G. Tactical Use of Substantive Consolidation . . . . .	241
1. Use by Attorneys to Assure Payment of Fees . . . . .	241
2. The Government As a Lien Creditor or Priority Holder . . . . .	242
3. Other Tactical Uses . . . . .	242
V. CONCLUSION . . . . .	243

## I. INTRODUCTION

Substantive consolidation is a powerful vehicle in bankruptcy by which the assets and liabilities of one or more entities are combined and treated for bankruptcy purposes as belonging to a single enterprise. Because substantive consolidation vitally affects the rights and interests of parties involved in bankruptcy proceedings, it is termed a matter "pregnant with consequence"<sup>1</sup> and should be used with caution. Substantive consolidation is not a common occurrence because it exacts strict requirements in order to protect the parties that it affects. Because substantive consolidation lacks clear statutory guidance, however, courts examine the facts of each case closely to ascertain whether consolidation is warranted.

The dearth of literature on the subject led one commentator to term substantive consolidation a "neglected corner of the law."<sup>2</sup> As corporations increasingly use multitiered structures to gain tax advantages and perform business operations, however, substantive consolidation must be understandable and predictable so that parties in bankruptcy proceedings may avoid undesirable changes to their security status.<sup>3</sup> In multi-entity cases in which the economic prejudice caused by continued entity separateness outweighs the potential prejudice that accompanies consolidation, bankruptcy's equitable remedy of substantive consolidation provides relief.<sup>4</sup> A creditor that lends to a specific entity must understand substantive consolidation so that the creditor's bargained for

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1. See *In re Commercial Envelope Mfg. Co.*, 14 Collier Bankr. Cas. (MB) 191, 193 (Bankr. S.D.N.Y. 1977).

2. Berry, *Consolidation in Bankruptcy*, 50 AM. BANKR. L.J. 343, 371 (1976).

3. See *In re Vecco Constr. Indus.*, 4 Bankr. 407, 409 (Bankr. E.D. Va. 1980). Substantive consolidation of a parent corporation and its subsidiaries has been utilized increasingly as a mechanism to deal with debtor corporations. *Id.* Furthermore, "[t]his relatively recent development has been given judicial effect without the benefit of statutory authority or approval by way of rule of procedure." *Id.*

4. See *In re Snider Bros., Inc.*, 18 Bankr. 230, 234 (Bankr. D. Mass. 1982).

expectation of satisfaction from the entity's assets will not be impaired. Debtors similarly should understand substantive consolidation in order to prepare effective reorganization plans and predict court action affecting estate assets. Further, a creditor, debtor, or any party in interest should understand how substantive consolidation can be used tactically to protect a priority interest or prevent a loss of assets. Part II of this Note explores the requirements and consequences of substantive consolidation. Part III analyzes the evolution of substantive consolidation through the circuit courts. Part IV addresses ancillary issues and the tactical uses of substantive consolidation. Part V concludes that substantive consolidation is not an ill-defined trap to be feared by creditors. Because an order for consolidation requires a delicate balance of equities, creditors can expect protection generally given to them under the Bankruptcy Code.

## II. REQUIREMENTS AND CONSEQUENCES OF SUBSTANTIVE CONSOLIDATION

### A. *Consequences of Substantive Consolidation*

Substantive consolidation in bankruptcy is a process by which the assets and liabilities of different entities are consolidated and treated as a single entity.<sup>5</sup> The consolidated assets create a single fund from which all of the claims against the consolidated debtors are satisfied.<sup>6</sup> Creditors of single entities before consolidation become joint creditors with all creditors of the consolidated debtors after the proceeding. These joint creditors share equally<sup>7</sup> in the assets of the consolidated estate.<sup>8</sup> Substantive consolidation also eliminates intercompany claims of the debtor companies<sup>9</sup> and duplicative claims against related debtors.<sup>10</sup> Creditors of the consolidated entities are combined for purposes of vot-

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5. 5 COLLIER ON BANKRUPTCY ¶ 1100.06[1], at 1100-31 to -32 (L. King 15th ed. 1979).

6. See *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988); *In re Parkway Calabasas, Ltd.*, 89 Bankr. 832, 836-37 (Bankr. C.D. Cal. 1988).

7. Unless separate provisions are made in the reorganization plan, all creditors of the consolidated entities will be treated equally at distribution. Tatelbaum, *The Multi-Tiered Corporate Bankruptcy and Substantive Consolidation—Do Creditors Lose Rights and Protection?*, 89 COM. L.J. 285, 285 (1984); see also *In re DRW Property Co.* 82, 54 Bankr. 489, 494 (Bankr. N.D. Tex. 1985); *In re Snider Bros., Inc.*, 18 Bankr. 230, 234 (Bankr. D. Mass. 1982) (recognizing the potential harm to the creditor of a more solvent debtor when this creditor is forced to share a common fund comprised of the assets of less solvent affiliated debtors).

8. Filing a bankruptcy petition automatically creates an "estate." See 11 U.S.C. § 541 (a) (1982 & Supp. V 1987). A bankruptcy filing affects the debtor's use of its property by creating "property of the estate." D. EPSTEIN, J. LANDERS & S. NICKLES, *DEBTORS AND CREDITORS* 734 (3d ed. 1987) [hereinafter *DEBTORS*]. The "property of the estate" generally includes all property of the debtor at the time of the bankruptcy filing. *Id.* at 735.

9. *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966); see *Parkway Calabasas*, 89 Bankr. at 836-37.

10. *Kheel*, 369 F.2d at 847; *DRW Property*, 54 Bankr. at 494.

ing on reorganization plans.<sup>11</sup> Because substantive consolidation dramatically affects the rights and interests of creditors and affiliated debtors,<sup>12</sup> the process should be used sparingly<sup>13</sup> and occurs only in unusual circumstances.<sup>14</sup>

Substantive consolidation threatens to prejudice the rights of creditors because separate debtors ordinarily will have different ratios of assets to liabilities. The creditor of a debtor whose asset-to-liability ratio is higher than that of its affiliated debtor will receive a proportionately smaller satisfaction of its claim because the asset-to-liability ratio of the merged estates will be lower.<sup>15</sup>

### B. Bankruptcy Courts' Power to Consolidate

No express statutory authority exists that empowers bankruptcy courts to order substantive consolidation.<sup>16</sup> Rather, courts find the power to impose substantive consolidation in the general "equity powers"<sup>17</sup> expressed in section 105 of the Bankruptcy Code.<sup>18</sup> A bankruptcy

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11. *Augie/Restivo*, 860 F.2d at 518; see 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[1], at 1100-32 n.1.

12. See *In re Flora Mir Candy Corp.*, 432 F.2d 1060, 1062 (2d Cir. 1970).

13. *Kheel*, 369 F.2d at 847; see *In re Donut Queen, Ltd.*, 41 Bankr. 706, 709 (Bankr. E.D.N.Y. 1984).

14. 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[1], at 1100-32.1 (stating that substantive consolidation is rare because of the potential inequalities caused when certain creditors are forced to share on a parity with creditors of a less solvent entity). One commentator has remarked that a presumption *against* substantive consolidation exists. Because substantive consolidation can upset the basic assumptions upon which lenders extend credit, courts should grant orders seeking consolidation cautiously. Substantive consolidation "can amount to changing the rules after the game has been played." Thornton, *The Continuing Presumption Against Substantive Consolidation*, 105 BANKING L.J. 448, 451 (1988).

15. See *Snider Bros.*, 18 Bankr. at 234.

16. See *Augie/Restivo*, 860 F.2d at 518; 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[1], at 1100-32. A debtor may, however, provide for consolidation in Chapter 11 bankruptcy. Section 1123(a)(5)(C) of the Bankruptcy Code expressly provides that a reorganization plan may include the merger or consolidation of the reorganized debtor with other entities. 11 U.S.C. § 1123(a)(5)(C) (1982). Of course, the debtor's creditors must approve such a plan through the voting process. See *DRW Property*, 54 Bankr. at 497-98.

17. See *Augie/Restivo*, 860 F.2d at 518 n.1; *Parkway Calabasas*, 89 Bankr. at 837 (noting that substantive consolidation is a creature of court-made law). The principle is well established that "'courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.'" *Pepper v. Litton*, 308 U.S. 295, 304 (1939) (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934)); see also *Berry*, *supra* note 2, at 351 (advising that a challenge directed at the court's lack of statutory authority is unlikely to succeed).

18. 11 U.S.C. § 105 (Supp. V 1987). The terms "Bankruptcy Code" and "Code" are used herein to denote provisions in Title 11, United States Code. Section 105 of the Bankruptcy Code is derived from § 2(a)(15) of the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed 1978). See 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[1], at 1100-32 n.2. Many of the leading substantive consolidation cases arose under the Bankruptcy Act. *Parkway Calabasas*, 89 Bankr. at 837 n.4. The Bankruptcy Code is silent on substantive consolidation. The prior cases, however, subject to any more recent case law, continue to be good law. *Id.* (perceiving "no policy of the Bankruptcy

court's broad equity powers may be exercised only in a manner consistent with the provisions of the Bankruptcy Code.<sup>19</sup> The equity powers enable a bankruptcy court to disregard separate corporate entities and to pierce the several corporate veils in order to satisfy the debts of a related entity.<sup>20</sup> Thus, when a corporation is a mere instrumentality or alter ego of the bankrupt corporation and has no independent existence, equity favors disregarding the separate corporate entities.<sup>21</sup> The Advisory Committee Notes to Bankruptcy Rule 1015<sup>22</sup> acknowledge the power to consolidate but state that Rule 1015 neither authorizes nor prohibits consolidation involving two or more separate debtors.<sup>23</sup> The Supreme Court tacitly approved the power to impose substantive consolidation in *Sampsel v. Imperial Paper & Color Corp.*<sup>24</sup>

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Code that would change the prior law on substantive consolidation"). Attempts by debtors to dismiss a case under the old Act and refile under the new Code, however, were prohibited expressly. *Central Trust Co. v. Official Creditors' Comm. of Geiger Enters.*, 454 U.S. 354, 357-60 (1982) (disallowing the debtor's attempt to dismiss its Chapter 11 case under the old Act in order to refile and consolidate substantively with its subsidiaries and affiliates under Chapter 11 of the new Code). See generally Tabb, *The Bankruptcy Reform Act in the Supreme Court*, 49 U. PITT. L. REV. 477, 482-85 (1988).

Section 105 (a) of the Bankruptcy Code reads:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a) (Supp. V 1987).

19. *In re J.M. Wells, Inc.*, 575 F.2d 329, 331 (1st Cir. 1978).

20. *In re Continental Vending Mach. Corp.*, 517 F.2d 997, 1000 (2d Cir. 1975), cert. denied, 424 U.S. 913 (1976); see *In re Gulfco Inv. Corp.*, 593 F.2d 921, 928 (10th Cir. 1979); *In re Tito Castro Constr.*, 14 Bankr. 569, 571 (Bankr. D.P.R. 1981). But cf. *infra* notes 77-81 and accompanying text (discussing the misplaced analogy of bankruptcy's process of substantive consolidation to corporate law's notion of piercing the corporate veil to impose liability).

21. *Gulfco Inv. Corp.*, 593 F.2d at 928.

22. BANKR. R. 1015. Rule 1015 governs the consolidation or joint administration of cases involving the same debtor or two or more related debtors. See 8 COLLIER ON BANKRUPTCY, *supra* note 5, Rule 1015 (a), (b), at 1015-1. Bankruptcy Rule 1015(b) provides:

If a joint petition or two or more petitions are pending in the same court by or against (1) a husband and wife, or (2) a partnership and one or more of its general partners, or (3) two or more general partners, or (4) a debtor and an affiliate, the court may order a joint administration of the estates.

BANKR. R. 1015(b).

23. See BANKR. R. 1015(b) advisory committee's note. Rather, "the propriety of consolidation depends on substantive considerations and affects the substantive rights of the creditors of the different estates." *Id.*

24. 313 U.S. 215, 219 (1941) (stating that "[t]he power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the [corporation's and shareholders'] creditors is complete"); see also *Parkway Calabasas*, 89 Bankr. at 837.

### C. Comparison to Joint Administration

Substantive consolidation must not be confused with the related procedure of joint administration.<sup>25</sup> Joint administration is a procedure by which courts hear two or more related cases of entities that have filed bankruptcy petitions as a single case.<sup>26</sup> The purpose of joint administration is to make case administration easier and less costly.<sup>27</sup> The process has been called a "creature of procedural convenience,"<sup>28</sup> because it avoids the duplication of effort that would result if cases involving related debtors were to proceed separately.<sup>29</sup>

The most significant difference between joint administration and substantive consolidation is that joint administration requires the estate of each debtor to be kept separate and distinct.<sup>30</sup> Joint administration does not affect the substantive rights of creditors and other interested parties.<sup>31</sup> Thus, administrative efficiency is achieved without sacrificing the parties' substantive rights.<sup>32</sup> Conversely, substantive consolidation effects a merger<sup>33</sup> of the consolidated debtors' estates, which creates a single estate that is recognized throughout the remaining bankruptcy process.<sup>34</sup>

Other significant differences between joint administration and substantive consolidation exist.<sup>35</sup> Because only a single estate remains after consolidation, interentity accounts and interentity claims are elimi-

25. Joint administration also is known as "procedural consolidation" *see* 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.07, at 1100-47, and "administrative consolidation," *Parkway Calabasas*, 89 Bankr. at 836. For a more thorough discussion of joint administration, *see* 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.07, at 1100-47 to -50; B. WEINTRAUB & A. RESNICK, BANKRUPTCY LAW MANUAL ¶ 1.08[3], at 1-30 (rev. ed. 1986).

26. *See Parkway Calabasas*, 89 Bankr. at 836.

27. *Id.*

28. *In re Steury*, 94 Bankr. 553, 553 (Bankr. N.D. Ind. 1988).

29. *Id.* at 553-54. The Advisory Committee Notes to Rule 1015 state that the combination of estates under joint administration allows the use of a single docket for the listing of filed claims, the combination of notices to creditors of different estates, and the joint handling of administrative matters. *See* BANKR. R. 1015 advisory committee's note; *see also supra* note 21.

30. *See* B. WEINTRAUB & A. RESNICK, *supra* note 25, ¶ 8.16, at 8-74.

31. *Id.* An order of joint administration should not have any substantive effect on the cases being administered and does not indicate a court's predilection toward substantive consolidation. *Tatelbaum*, *supra* note 7, at 285.

32. *See In re N.S. Garrott & Sons*, 63 Bankr. 189, 191 (Bankr. E.D. Ark. 1986).

33. Substantive consolidation's "nearest non-bankruptcy analogy is the merger of two corporations under state law." *Parkway Calabasas*, 89 Bankr. at 836.

34. *See id.* at 836-37. For a discussion of "estate," *see supra* note 8.

35. *But see* Seligson & Mandell, *Multi-Debtor Petition—Consolidation of Debtors and Due Process of Law*, 73 Com. L.J. 341, 346 (1968) (expressing the view that "[n]o useful purpose" is served in distinguishing procedural from substantive consolidation). The commentators state that "[i]t is doubtful that there can be a consolidation of separate entities which affects only procedural rights. It would seem that every consolidation, however characterized, is likely to have an impact upon the substantive rights of at least some of the parties involved." *Id.* at 347.

nated.<sup>36</sup> Creditors of specific entities no longer can look only to the assets of the debtor with which they bargained for satisfaction of their claims. Rather, creditors of the separate entities must look to the assets of the consolidated estate and become creditors of the consolidated entity.<sup>37</sup> In joint administration, however, the debtors' estates are separate and interentity claims survive.<sup>38</sup> Further, the creditors of each jointly administered entity may look only to the assets of the debtor with which they bargained for satisfaction of their claims.<sup>39</sup>

#### D. Flexibility of Substantive Consolidation

Substantive consolidation is not an absolute proposition.<sup>40</sup> Bankruptcy courts may order less than complete consolidation and may place conditions on the consolidation<sup>41</sup> in order to protect the interests of creditors or to effect an equitable remedy.<sup>42</sup> The circuit courts in *In re Gulfco Investment Corp.*,<sup>43</sup> *In re Flora Mir Candy Corp.*,<sup>44</sup> and *In re Continental Vending Machine Corp.*<sup>45</sup> suggest means by which certain creditor groups may be protected in consolidation.<sup>46</sup> Similarly, the court in *Chemical Bank New York Trust Co. v. Kheel*<sup>47</sup> admonished that "equity is not helpless to reach a rough approximation of justice to some rather than deny any to all."<sup>48</sup> Notwithstanding their significant discretionary authority, courts must adhere to bankruptcy's two fundamental policies of fair treatment of creditors and strict observance of priorities that exist between various creditor classes.<sup>49</sup>

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36. See *Parkway Calabasas*, 89 Bankr. at 837. In addition, parties may request that all duplicate claims for the same indebtedness be expunged and all cross-corporate guarantees of the debtors be eliminated and disallowed. See *In re Commercial Envelope Mfg. Co.*, 14 Collier Bankr. Cas. (MB) 191, 193 (Bankr. S.D.N.Y. 1977).

37. *Parkway Calabasas*, 89 Bankr. at 837; see also *N.S. Garrott & Sons*, 63 Bankr. at 191.

38. *Parkway Calabasas*, 89 Bankr. at 836.

39. *Id.* (noting that joint administration requires the respective entities to maintain separate banking and accounting records).

40. See *In re Steury*, 94 Bankr. 553, 556 (Bankr. N.D. Ind. 1988).

41. *Parkway Calabasas*, 89 Bankr. at 837.

42. See *In re Continental Vending Mach. Corp.*, 517 F.2d 997, 1001 (2d Cir. 1975), cert. denied, 424 U.S. 913 (1976); *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966) (stating that because substantive consolidation is premised on equity powers, bankruptcy courts can shape a remedy to fit the immediate problem).

43. 593 F.2d 921 (10th Cir. 1979); see *infra* notes 146-55 and accompanying text.

44. 432 F.2d 1060 (2d Cir. 1970); see *infra* notes 124-33 and accompanying text.

45. *Continental Vending*, 517 F.2d at 997; see *infra* notes 134-45 and accompanying text.

46. Other courts have been successful in tailoring consolidation to achieve an equitable result. See, e.g., *Steury*, 94 Bankr. at 557 (ordering consolidation and enjoining husband and wife debtors from invoking an Indiana statutory exemption by filing separate petitions).

47. 369 F.2d 845 (2d Cir. 1966).

48. *Id.* at 847.

49. See *Berry*, *supra* note 2, at 357; see also *Gulfco*, 593 F.2d at 927 (noting that secured creditors are to be placed in a different and superior class from unsecured creditors). The latter



### E. Procedures for Consolidation

Courts are not the only bodies that may initiate a proposal for consolidation. Requests for consolidation affirmatively may be made pursuant to a reorganization plan.<sup>50</sup> Additionally, so long as substantive consolidation is justified, whether the bankruptcy cases originally were filed as voluntary or involuntary petitions is irrelevant.<sup>51</sup> The party seeking consolidation, whether a creditor, trustee, party in interest, or debtor, bears the burden of proving the requisites of consolidation.<sup>52</sup> Absent a clear and convincing showing that consolidation is warranted, however, consolidation will not be granted.<sup>53</sup>

### F. Who May Be Consolidated

In substantive consolidation cases, the relationship between the entities to be consolidated is more important than the individual nature of each entity.<sup>54</sup> Thus, whether an entity is indistinguishable from its affiliates is more important than whether the entity is labeled a partnership, corporation, or subsidiary. There is no restriction, however, regarding the type of entity that may be consolidated. Entities subject to consolidation include individuals, partnerships, corporations, and their

policy also is known as the absolute priority rule. *Berry, supra* note 2, at 357. The absolute priority rule provides:

Beginning with the topmost class of claims against the debtor, each class in descending rank must receive full and complete compensation for the rights surrendered before the next class below may properly participate. Thus, the principle is applied as between senior and junior secured creditors, secured creditors and unsecured creditors, between unsecured creditors and stockholders, between different classes of stockholders, and, of course, between secured creditors as a whole and stockholders.

5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1125.02, at 1125-8. *See generally* *Norwest Bank Worthington v. Ahlers*, 108 S. Ct. 963 (1988); *Consolidated Rock Prods. v. Du Bois*, 312 U.S. 510, 520-21 (1941).

50. B. WEINTRAUB & A. RESNICK, *supra* note 25, ¶ 8.16, at 8-77; *see also* *Tatelbaum, supra* note 7, at 285 (noting that substantive consolidation can be effected by confirmation of a reorganization plan). Rather than liquidating, certain debtors may rehabilitate via a plan of reorganization pursuant to Bankruptcy Code's Chapter 11, Chapter 12, or Chapter 13. Unlike a Chapter 7 liquidation invoking a sale of the debtor's assets, a plan of reorganization enables a debtor to formulate a plan of prolonged payments to creditors who are paid from postpetition earnings of the debtor. *See DEBTORS, supra* note 8, at 710-12.

51. *Steury*, 94 Bankr. at 555; B. WEINTRAUB & A. RESNICK, *supra* note 25, ¶ 2.11, at 2-33; *see, e.g., In re Tureaud*, 59 Bankr. 973, 974 (N.D. Okla. 1986) (application for substantive consolidation granted in an involuntary bankruptcy case).

52. *Steury*, 94 Bankr. at 554; *see also In re Tito Castro Constr.*, 14 Bankr. 569, 571 (Bankr. D.P.R. 1981). One court has stated that "[a] necessary corollary of this proposition is that it is incumbent upon the party seeking consolidation to demonstrate that it would be prejudiced if the estates were to remain as separate." *In re Donut Queen, Ltd.*, 41 Bankr. 706, 709 (Bankr. E.D.N.Y. 1984).

53. *Tatelbaum, supra* note 7, at 286.

54. 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[1], at 1100-33.

affiliates.<sup>55</sup> Debtors even may be consolidated with nondebtors.<sup>56</sup> The most common occasion for substantive consolidation, however, is the consolidation of affiliated debtor corporations.<sup>57</sup>

### G. Prerequisites for Substantive Consolidation

#### 1. Factors to Be Considered

Because the application of substantive consolidation lacks statutory direction,<sup>58</sup> courts must examine the facts and circumstances of each case to determine whether consolidation is warranted.<sup>59</sup> Courts and commentators have attempted to catalog the various factors that warrant substantive consolidation.<sup>60</sup> Courts frequently cite seven paramount factors when considering a motion for consolidation.<sup>61</sup> The seven

55. *Id.* The treatise states that "the assets and liabilities of an individual debtor and an affiliated corporation can be consolidated as can assets and liabilities of (i) an individual and one or more partnerships, (ii) affiliated partnerships, (iii) affiliated partnerships and corporations, and (iv) affiliated corporations." *Id.*

56. *See id.* at 1100-46. The treatise notes, however, that when a motion for consolidation proposes the consolidation of nondebtors with debtors, other remedies often are available that are less drastic than substantive consolidation. If assets have been transferred fraudulently, a debtor's remedy ordinarily will be an action to recover a fraudulent conveyance under § 544 or § 548 of the Bankruptcy Code. If the assets were held without colorable claim, the debtor's remedy would be to seek a turn-over under § 542 of the Code. *Id.*

57. *Id.* at 1100-33.

58. *See supra* notes 16-24 and accompanying text.

59. "The result is that substantive consolidation cases are to a great degree *sui generis*." 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[1], at 1100-33 (footnote omitted); *see also* Tatelbaum, *supra* note 7, at 286.

60. Collier notes:

[C]ourts have focused special attention on the nature of the relationship between the entities to be consolidated and the effect of consolidation on the creditors of each entity. . . . Where consolidation has been granted, however, certain facts or combinations of facts exist and provide the predicate for consolidation. These factual predicates are as follows:

(i) creditors of the affiliates dealt with such affiliates as an economic unit and did not rely on their separate identity in extending credit;

(ii) assets of one entity have been transferred to another entity without fair consideration or with the intent to hinder, delay, or defraud creditors of the transferor and the transfer or transfers cannot be undone in a manner which would protect the rights of creditors of the transferor;

(iii) the affairs of the affiliated entities are so entangled that it would be costly and time-consuming to deal with them separately; and

(iv) the separate legal identities of affiliates ha[ve] not been preserved and piercing the corporate veil of one or more affiliates is required to protect the rights of creditors of a related affiliate.

5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[1], at 1100-33 to -34 (footnotes omitted).

61. *See Holywell Corp. v. Bank of New York*, 59 Bankr. 340, 347 (Bankr. S.D. Fla. 1986), *appeal dismissed sub nom. Miami Center Ltd. Partnership v. Bank of New York*, 820 F.2d 376 (11th Cir. 1987), *cert. denied*, 109 S. Ct. 69 (1988). Additionally, courts mention ten factors culled from *Fish v. East*, 114 F.2d 177 (10th Cir. 1940), in which the court listed factors arising from disregarding the limited liability of corporations that are relevant to substantive consolidation. The factors from *Fish* follow:

factors include:

- (1) The presence or absence of consolidated financial statements;
- (2) The unity of interests and ownership between various corporate entities;
- (3) The existence of parent and intercorporate guarantees on loans;
- (4) The degree of difficulty in segregating and ascertaining individual assets and liabilities;
- (5) The existence of transfers of assets without formal observance of corporate formalities;
- (6) The commingling of assets and business functions;
- (7) The profitability of consolidation at a single physical location.<sup>62</sup>

Because consolidation into a single fund affects numerous interests, the existence of any set of factors will not guarantee an order for consolidation.<sup>63</sup> Furthermore, courts may ignore the presence or absence of certain factors in order to fashion relief equitably under consolidation.<sup>64</sup>

Ascertaining whether certain factors exist is merely an initial step in the courts' process of considering the propriety of substantive consolidation. Several courts list relevant factors without ranking their importance.<sup>65</sup> These courts apply each factor to a case's facts, but the absence

- (1) Parent owns all or majority of capital stock of subsidiary.
- (2) Parent and subsidiary have common directors or officers.
- (3) Parent finances subsidiary.
- (4) Parent subscribes to all capital stock or otherwise causes its incorporation.
- (5) Subsidiary has grossly inadequate capital.
- (6) Parent pays salaries or expenses or losses of subsidiary.
- (7) Subsidiary has substantially no business except that with parent or no assets except those conveyed to it by the parent.
- (8) Parent refers to subsidiary as a department or division.
- (9) Directors or officers of subsidiary do not act independently in interest of subsidiary but take orders from parent.
- (10) Formal legal requirements of subsidiary as a separate and independent corporation are not observed.

See *id.* at 191.

62. *Holywell Corp.*, 59 Bankr. at 347 (citing *In re Donut Queen, Ltd.*, 41 Bankr. 706, 709 (Bankr. E.D.N.Y. 1984) (summarizing seven factors stated in *In re Vecco Constr. Indus.*, 4 Bankr. 407, 410 (Bankr. E.D. Va. 1980))); see *Tatelbaum, supra* note 7, at 287; see also *supra* note 60 (listing "factual predicates").

63. Although courts list relevant competing factors and balance them to ensure that consolidation will be beneficial, "[c]learly, there is no formulaic resolution." *In re Tureaud*, 59 Bankr. 973, 975 (Bankr. N.D. Okla. 1986); see also *In re DRW Property Co.* 82, 54 Bankr. 489, 495 (Bankr. N.D. Tex. 1985) (stating that the set of factors alone should not be dispositive of the issue of substantive consolidation). "[T]he fact that corporate formalities may have been ignored, or that . . . debtors are associated . . . in some way, does not by itself lead inevitably to the conclusion that it would be equitable to merge otherwise separate estates." *In re Donut Queen, Ltd.*, 41 Bankr. 706, 709 (Bankr. E.D.N.Y. 1984) (quoting *In re Snider Bros., Inc.*, 18 Bankr. 230, 234 (Bankr. D. Mass. 1982)).

64. See *Tatelbaum, supra* note 7, at 288 (but noting that a majority of factors is necessary to sustain the burden of proof for consolidation); see also *In re Augie/Restivo Baking Co.*, 84 Bankr. 315, 321 (Bankr. E.D.N.Y.) (stating that "the [c]ourt must determine what equity requires"), *rev'd*, 860 F.2d 515 (2d Cir. 1988).

65. *Tureaud*, 59 Bankr. at 975; see, e.g., *Augie/Restivo*, 860 F.2d at 518 (2d Cir. 1988);

of one or more factors will not necessarily defeat a request for consolidation.<sup>66</sup> The Second Circuit ultimately noted that the respective analyses of the factors are merely efforts to determine two critical facts: (1) whether creditors dealt with the entities as a single economic unit and did not extend credit to the entities with reliance on their separate identities; and (2) whether the economic affairs of the debtors are so entangled that consolidation will benefit all creditors.<sup>67</sup>

Other courts use the factors to perform a balancing test.<sup>68</sup> Specifically, the equities favoring consolidation are balanced against the equities favoring continued debtor separateness.<sup>69</sup> These courts require that the benefits of consolidation outweigh the harm that consolidation would cause to creditors.<sup>70</sup> Courts recognize that the cited factors merely aid the ultimate determination of whether consolidation is warranted<sup>71</sup> and observe a two-step analysis in that determination. First, a need for consolidation must exist.<sup>72</sup> Second, the benefits of consolidation must outweigh whatever harm it might create.<sup>73</sup> When factors conflict or when critical factors are absent, courts determine whether the benefits of consolidation outweigh any detriment to objecting parties.<sup>74</sup>

Finally, substantive consolidation must not impair the policies of the Bankruptcy Code. Equal treatment of creditor classes is one of bankruptcy's primary goals.<sup>75</sup> Thus, substantive consolidation must not benefit one group of creditors to the detriment of similarly situated creditor groups.<sup>76</sup>

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*Holywell Corp.*, 59 Bankr. at 347; *In re Manzey Land & Cattle Co.*, 17 Bankr. 332, 337 (Bankr. D.S.D. 1982) (granting a request for consolidation made by debtor farmers in pre-Chapter 12 case); *In re Richton Int'l Corp.*, 12 Bankr. 555, 558 (Bankr. S.D.N.Y. 1981); *In re Vecco Constr. Indus.*, 4 Bankr. 407, 410 (Bankr. E.D. Va. 1980).

66. See *Holywell Corp.*, 59 Bankr. at 341, 347. *Holywell* noted that many courts apply a seven-part objective inquiry into the interrelationships of the entities to be consolidated, but "not all of [the factors] must be found to support consolidation." *Id.* at 347.

67. *Augie/Restivo*, 860 F.2d at 518.

68. *Tureaud*, 59 Bankr. at 976; see, e.g., *DRW Property*, 54 Bankr. at 489.

69. *Donut Queen*, 41 Bankr. at 709.

70. See, e.g., *DRW Property*, 54 Bankr. 489, 495 (Bankr. N.D. Tex. 1985) (citing *Donut Queen*, 41 Bankr. at 709).

71. See *In re Steury*, 94 Bankr. 553, 554 (Bankr. N.D. Ind. 1988). The factors serve as "nothing more than sign posts along the road." *Id.*

72. See, e.g., *In re Lewellyn*, 26 Bankr. 246, 251 (Bankr. S.D. Iowa 1982).

73. See, e.g., *Steury*, 94 Bankr. at 554; *Augie/Restivo*, 84 Bankr. at 321; *Lewellyn*, 26 Bankr. at 251 (stating that "[i]n addition to need the court must find that the consolidation will be fair to creditors").

74. See *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987).

75. See *id.* at 276-77; *Stone v. Eacho*, 127 F.2d 284, 288 (4th Cir. 1942).

76. See *Lewellyn*, 26 Bankr. at 252 (granting a request for consolidation after determining that consolidation would not tend to improve the financial position of any group of creditors over another).

## 2. Misplaced Analogy to Corporate Law

The factors evaluated on a motion for substantive consolidation appear similar to an analysis of piercing the corporate veil. Like piercing the corporate veil, substantive consolidation ignores artificial structures legally defining the consolidated entities. Ultimately, however, such an analogy is misplaced<sup>77</sup> because the corporate law doctrine of limited liability is not involved.<sup>78</sup> Rather, substantive consolidation is more like the corporate law notion of enterprise liability because substantive consolidation does not seek to hold shareholders liable for the acts of their incorporated entity.<sup>79</sup> Substantive consolidation more closely resembles the bankruptcy rule of subordination because competition for the consolidated assets is between creditors alone.<sup>80</sup> Thus, substantive consolidation ignores artificial legal structures but looks only to the combined assets of the consolidated entities for satisfaction of all claims against the collective group.<sup>81</sup>

## 3. Reliance Interest of Creditors

Courts are sensitive to creditors' expectations of seeking satisfaction from the specific entity to which the creditor has extended credit. Creditors' reliance on the separateness of their debtors is important because voluntary creditors assess the risks of lending to a particular debtor and adjust the terms of the credit agreement accordingly.<sup>82</sup> Con-

77. See *DRW Property*, 54 Bankr. at 496; *infra* note 81.

78. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589, 634 (1975).

79. The corporate law policy of limited liability is not disturbed by bankruptcy consolidation. The policy of limited liability is designed to protect stockholders "who, by definition, are not involved when the parent [corporation] is a bankrupt." *Id.* at 632. Enterprise liability, however, presumes that an artificial division of a single economic enterprise into two or more separate corporations should not be permitted to defeat a plaintiff's recovery merely because the plaintiff dealt with a particular corporation with insufficient assets to satisfy the judgment. Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343, 348 (1947). See generally L. SOLOMON, D. SCHWARTZ & J. BAUMAN, *CORPORATIONS LAW AND POLICY* 258-63 (2d ed. 1988).

80. Section 510 of the Bankruptcy Code provides for subordination of claims. See 11 U.S.C. § 510 (1982 & Supp. V 1987). Subordinated claims receive payments after certain other claims. See *DEBTORS*, *supra* note 8, at 818. See generally Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 16 VAND. L. REV. 83 (1961).

81. Piercing the corporate veil may not be necessary to effect a consolidation. *Lewellyn*, 26 Bankr. at 253. *Lewellyn* further noted:

While many of the considerations leading to a decision to consolidate may also lead to a conclusion that corporate identities should be disregarded, such a conclusion is not compelled. The standard for consolidation, . . . that "the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors,["] does not require any "piercing of the corporate veil."

*Id.* (quoting *In re Wm. Glucken Co.*, 457 F. Supp. 379, 384 (S.D.N.Y. 1978)).

82. Indeed, Judge Friendly based his concurrence in *Kheel* on the basis that the objecting

solidation threatens to destroy the bases of such risk calculations by creating a new entity from which the creditors must look for payment. If a solvent subsidiary is consolidated with its insolvent parent, creditors of the subsidiary suffer a decreased return on their claims because assets of the subsidiary must be used to satisfy the claims of both the subsidiary's and the parent's creditors.<sup>83</sup> Even more threatening is bankruptcy's recognition of priority claims after consolidation. Claims of priority creditors of a poorer company will be paid before the claims of the general creditors of a wealthier company.<sup>84</sup>

Thus, creditors that extend credit to specific entities may not receive their expected return if forced to share the assets with creditors of consolidated entities. Courts, therefore, respect and promote bankruptcy's policy of fair treatment of creditors and will not order substantive consolidation if it would deny such creditors the benefit of their bargains.<sup>85</sup> In the words of Judge Friendly, "[e]quality among creditors who have lawfully bargained for different treatment is not equity but its opposite . . . ."<sup>86</sup>

A presumption exists, however, that creditors have not relied solely on the credit of a particular entity that is subject to consolidation.<sup>87</sup> When objecting to a request for consolidation, a creditor that claims reliance on an entity's separateness must show both an inquiry into that debtor's independent financial health and an absence of evidence, such as guarantees or consolidated financial statements, that would tend to indicate interrelationships within a larger enterprise.<sup>88</sup> If a cred-

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party failed to establish that it relied on the separate credit of its mortgagor. *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 848-49 (2d Cir. 1966) (Friendly, J., concurring). See generally Thornton, *supra* note 14, at 448.

83. See *Tatelbaum*, *supra* note 7, at 285 (stating that "[t]his is particularly exasperating to a credit manager who must explain the situation to senior management after reliance upon financial data of the solvent entity").

84. See *Landers*, *supra* note 78, at 630.

85. *But see id.* at 639 (noting that a rule rejecting consolidation which is "aimed at protecting creditors who 'dealt with' the enterprise in ignorance of its [multi]corporate structure, protects too large and amorphous a group and conflicts with the basic realities of multi-corporate enterprises").

86. *Kheel*, 369 F.2d at 848 (Friendly, J., concurring). Different considerations are present when the creditor claiming reliance on separateness is the parent or related affiliate of the debtor. An order of consolidation appears less harsh to these creditors. When the veil of the parent or affiliate is pierced, the managers of the larger enterprise are put on notice that mere nominal corporate status will not shield one entity from enterprise liability. If the owners of the parent and affiliates perceive the risks to be too great, they either can avoid engaging in the respective business, conduct it as part of the parent's or affiliate's existing operations, or establish and maintain the subsidiary as a viable corporate entity. An outside creditor has none of these options. *Landers*, *supra* note 78, at 632.

87. *In re Lewellyn*, 26 Bankr. 246, 251-52 (Bankr. S.D. Iowa 1982).

88. *Landers*, *supra* note 78, at 630; see also *In re Donut Queen, Ltd.*, 41 Bankr. 706, 710 (Bankr. E.D.N.Y. 1984) (movant for consolidation failed to demonstrate that it was aware of the

itor makes such a showing, the court will order consolidation only if the demonstrated benefits outweigh the harm.<sup>89</sup>

When creditors have not relied on the credit of a particular entity,<sup>90</sup> the practical economic and operational reality of a single enterprise suggests the need for a consolidation approach for multiple bankruptcies. In such a nonreliance case, consolidation is compelling because it would seem artificial to treat the entities as separate simply because of the fortuitous occurrence of bankruptcy.<sup>91</sup>

One commentator has noted that a heavy handed application of the reliance test is not warranted.<sup>92</sup> Professor Landers reasons that courts' heightened sensitivity to creditors that have relied on the credit of a particular entity is anomalous because the doctrine of separate incorporation is not designed as a protection for creditors.<sup>93</sup> Rather, he advocates a more restricted use of the reliance test so that the exception will not swallow the basic principle of consolidation.<sup>94</sup>

### III. EVOLUTION OF SUBSTANTIVE CONSOLIDATION THROUGH THE COURTS OF APPEALS

#### A. Introduction

Substantive consolidation lacks statutory direction and, thus, is a creature of case law.<sup>95</sup> A review of the cases that address consolidation is enlightening<sup>96</sup> because substantive consolidation depends almost en-

debtors' interrelationships and that it treated the debtors as a single enterprise).

89. *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987) (citing *In re Continental Vending Mach. Corp.*, 517 F.2d 997, 1001 (2d Cir. 1975), *cert. denied*, 424 U.S. 913 (1976)).

90. These creditors typically include involuntary creditors, creditors who make no inquiry regarding the credit standing of their debtor, and creditors who rely on a group of debtors with knowledge of their interconnectedness. See Landers, *supra* note 78, at 630.

91. *Id.* at 630-31.

92. See *id.* at 640.

93. *Id.*; see also *id.* at 592.

94. *Id.* at 640 (suggesting that the Second Circuit's avoidance of consolidation in order to protect creditors that may have relied on debtor separateness approaches the level of "exception[s] . . . swallow[ing] the basic principle of consolidation"). Professor Landers suggests that the estates of affiliated entities in bankruptcy should be consolidated because:

(1) they are likely to be operated with a view to overall profitability; (2) creditors are likely to perceive the separate companies as a group and to expect payment from the group; and (3) whether any one company has a significant amount of assets to satisfy claims is likely to be either fortuitous or the result of an attempt to favor certain creditors over others. Exceptions should, however, be recognized upon a showing of either reliance by a general creditor or of certain factors obviating the inherent enterprise tendencies of multi-corporate units.

*Id.* at 640-41.

95. See *supra* notes 16-24 and accompanying text.

96. See *In re Snider Bros., Inc.*, 18 Bankr. 230, 234 (Bankr. D. Mass. 1982). The *Snider* court provides a helpful examination of the following cases: *In re Continental Vending Mach. Corp.*, 517 F.2d 997, 997 (2d Cir. 1975), *cert. denied*, 424 U.S. 913 (1976); *In re Flora Mir Candy Corp.*, 432 F.2d 1060 (2d Cir. 1970); *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 845 (2d Cir.

tirely on the facts of each situation and on the presence, absence, and conflicts of the discrete factors.<sup>97</sup> Although the facts of each case vary, courts generally follow a uniform approach when considering a motion for substantive consolidation.

The issue of substantive consolidation has received little attention in the circuit courts, and the Supreme Court has approved it only tacitly.<sup>98</sup> Some appellate decisions mention substantive consolidation merely in dicta<sup>99</sup> or within the context of the court's consideration of other issues.<sup>100</sup> The majority of the appellate decisions are from the Second Circuit, yet uniformity appears among the remaining circuits, federal district courts, and bankruptcy courts. This section of the Note examines the evolution of substantive consolidation through the courts of appeals. From *Stone v. Eacho*<sup>101</sup> to *In re Augie/Restivo Baking Co.*,<sup>102</sup> the circuit courts have progressed from each decision ultimately to display, perhaps surprisingly, a uniform mode of analysis in an area of law critically dependent upon a proper balance of equities.

### B. *Stone v. Eacho*

In *Stone v. Eacho*<sup>103</sup> the Fourth Circuit allowed substantive consolidation in a case involving a motion to consolidate a bankrupt New Jersey parent corporation, Tiptop Tailors, with one of its stores separately incorporated in Virginia. The court allowed consolidation based on findings that the subsidiary was not treated as a separate entity and that the subsidiary's creditors dealt with the parent and subsidiary as one entity. Further, the parent paid the bills of the Virginia store from its New Jersey office. Thus, the court held that the Virginia creditors must have known that the New Jersey parent was part of the enterprise

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1966); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964). See *Snider*, 18 Bankr. at 234-38.

97. See *supra* notes 60-74 and accompanying text.

98. See *supra* note 24 and accompanying text; see also *In re Tureaud*, 59 Bankr. 973, 976 (Bankr. N.D. Okla. 1986) (discussing *Sampsel v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941)). The Supreme Court denied certiorari in *Continental Vending*, 517 F.2d 997 (2d Cir. 1975), *cert. denied*, 424 U.S. 913 (1976).

99. The Fifth Circuit in *In re S.I. Acquisition, Inc.*, 817 F.2d 1142, 1154 n.13 (5th Cir. 1987), offered substantive consolidation as means for a creditor to make defendants of a state court action parties to the bankruptcy proceeding. See *Pension Benefit Guar. Corp. v. Ouimet Corp.*, 711 F.2d 1085, 1092-93 (1st Cir. 1983) (offering substantive consolidation as precedent for piercing the corporate veil in bankruptcy situations).

100. Although determining the issue of the validity of a *nunc pro tunc* order of consolidation, the court in *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987), discussed the appropriate setting and policies of substantive consolidation but, for argument's sake, assumed that consolidation was proper in the case.

101. 127 F.2d 284 (4th Cir. 1942).

102. 860 F.2d 515 (2d Cir. 1988).

103. 127 F.2d 284 (4th Cir. 1942).



engaged in the Virginia business.<sup>104</sup> The court stated that it would look beyond nominal corporate forms and treat the assets and liabilities of the subsidiary as those of the parent.<sup>105</sup>

### C. *Soviero v. Franklin National Bank*

The focus on creditor reliance again appears in *Soviero v. Franklin National Bank*.<sup>106</sup> The court in *Soviero* affirmed an order consolidating Raphan Carpet Corporation and thirteen of its affiliates. The determinative factor in *Soviero* was that creditors dealt with Raphan and its affiliates as a single enterprise and could not demonstrate reliance on any single affiliate.<sup>107</sup>

A secured creditor of one of the Raphan affiliates objected to substantive consolidation on the ground that consolidation is proper only when it can be shown that a subsidiary was organized to hinder, delay, or defraud creditors.<sup>108</sup> The court, however, found unity of interest and ownership common to all entities and stated that adherence to the theory of separate corporations would be unfair to creditors.<sup>109</sup>

Thus, the court did not permit consolidation simply because of a commingling of assets and disregard for corporate formalities. Rather, the court recognized that an injustice to creditors would occur absent consolidation.<sup>110</sup> The court suggested that when consolidation is otherwise proper, creditors that knew or should have known of the unity of interests and operations within the enterprise may be precluded from subsequently claiming prejudice from consolidation.<sup>111</sup>

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104. *Stone*, 127 F.2d at 287-88. Without consolidation, the Virginia creditors could have been paid in full from the assets of the Virginia store. Creditors of the New Jersey parent, however, would have received less than 30% of their claims. If the claim of the New Jersey parent corporation against its Virginia subsidiary were treated on a parity with the Virginia creditors' claims, the Virginia creditors would have received substantially less than the parent corporation's creditors. See 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[2], at 1100-36 (analyzing *Stone*).

105. *Stone*, 127 F.2d at 288-89.

106. 328 F.2d 446 (2d Cir. 1964).

107. See 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[2], at 1100-38 (stating that "*Soviero* underscores the theme of creditor reliance articulated in *Stone v. Eacho* and this theme is of critical importance in subsequent cases"). Subordinate facts in *Soviero* also compelled consolidation. The president and secretary of Raphan were the sole directors and shareholders of the affiliates. Raphan maintained accounting records for the affiliates at its principal place of business, creditors were issued consolidated financial information, Raphan signed all of the affiliates' leases, and the proceeds from sales by the affiliates were deposited into Raphan's account. Stationery and advertising referred to the affiliates as "branches," not separate corporations. See *Soviero*, 328 F.2d at 447-48.

108. See *Soviero*, 328 F.2d at 448.

109. *Id.*

110. See *In re Snider Bros., Inc.*, 18 Bankr. 230, 235 (Bankr. D. Mass. 1982) (analyzing *Soviero*).

111. See *id.* at 235.

## D. Chemical Bank New York Trust Co. v. Kheel

*Chemical Bank New York Trust Co. v. Kheel*<sup>112</sup> introduced a new justification for substantive consolidation.<sup>113</sup> The Second Circuit determined that consolidation was warranted because the cost of untangling the “hopelessly” obscured financial records of the debtors would exceed the benefit that would accrue from the disentangled records.<sup>114</sup> The court enunciated a rigorous standard that coupled expense and difficulty with the practical impossibility of restructuring the financial records before allowing consolidation.<sup>115</sup> This standard requires the problem of disentanglement to be so egregious that it threatens the realization of any net assets.<sup>116</sup> Many subsequent parties urging consolidation have attempted *Kheel’s* entanglement argument but have fallen short of its strict standard.<sup>117</sup>

*Kheel* involved the liquidation of eight shipping companies that one individual owned or controlled. In addition, the companies operated in disregard of any corporate separateness.<sup>118</sup> Creditor Chemical Bank argued that substantive consolidation was improper absent a finding that a creditor dealt with a group believing it to be a single entity.<sup>119</sup> The court noted that the corporations shifted funds, made intercorporate loans, regularly paid each other’s obligations, and made withdrawals and payments from and to corporate accounts without sufficient recordkeeping.<sup>120</sup> The court affirmed consolidation because the expense to reconstruct the financial records of the debtors would extinguish any

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112. 369 F.2d 845 (2d Cir. 1966).

113. See 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[2], at 1100-38. Prior to *Kheel*, substantive consolidation had been granted only in three situations: (1) if assets of an affiliate were fraudulently transferred; (2) if creditors did not rely on the credit of a particular entity; and (3) if creditors successfully could assert claims against a debtor’s affiliate on alter-ego grounds. *Id.*

114. *Kheel*, 369 F.2d at 847. The onerous costs that the court sought to avoid are those costs imposed by §§ 503 and 507 of the Bankruptcy Code. Section 507(a)(1) gives first priority status to administrative expenses allowed by § 503(b). See 11 U.S.C. § 507(a)(1) (1982). Section 503(b)(4) gives administrative expense status to services performed by an accountant or attorney for the estate. See *id.* § 503(b)(4).

115. *Kheel*, 369 F.2d at 847. Such a restructuring would be necessary to determine intercorporate claims, liabilities, and ownership of assets. See *id.*

116. *Id.*

117. See *infra* note 131 and accompanying text (*In re Flora Mir Candy Corp.*); *infra* note 154 and accompanying text (*In re Guloco Inv. Corp.*); *infra* note 170 and accompanying text (*In re Augie/Restivo Baking Co.*); see also *infra* notes 210-20 and accompanying text (discussing the standard of accounting difficulties).

118. The United States, a major creditor, moved for consolidation of the proceedings. Attempts at a plan of reorganization had failed. *Kheel*, 369 F.2d at 846. The United States District Court for the Southern District of New York granted the motion and Chemical Bank appealed. *Id.*

119. *Id.* at 847.

120. *Id.* at 846.

chance of recovery to the prepetition creditors.<sup>121</sup> In addition to avoiding the time and effort of disentangling the debtors' affairs, consolidation facilitated the previously infeasible determination, allowance, and classification of claims of creditors prior to the preparation and submission of a plan for liquidation.<sup>122</sup>

Judge Friendly's concurring opinion espoused a more cautious and protectionist stance. He conceded that the impossibility of an accurate assessment of the financial condition of debtors might warrant consolidation. He felt, however, that every reasonable endeavor should be made to reach a close approximation to protect the reliance interest of creditors that, without knowledge of the interrelationships within a larger enterprise, relied on the credit of a single entity.<sup>123</sup>

### E. *In re Flora Mir Candy Corp.*

A unanimous court in *In re Flora Mir Candy Corp.*<sup>124</sup> agreed with Judge Friendly's emphasis on the reliance interest. *Flora Mir* illustrates that substantive consolidation is not warranted when the harm to objecting creditors outweighs the concerns of the parties seeking consolidation.<sup>125</sup> The *Flora Mir* court addressed consolidation within the context of one parent company and twelve subsidiaries and affiliates that had filed for individual reorganization relief. In *Flora Mir* debentures had been issued six years prior to the date that the issuer, Meadors, Inc. (Meadors), was acquired by Flora Mir Candy Corporation (Flora Mir).<sup>126</sup> During a chain of transactions culminating with Flora Mir's acquisition of Meadors, Meadors's debenture holders brought an action in state court against two Flora Mir companies and Meadors for fraud.<sup>127</sup> The debtors moved for consolidation.

The court refused to consolidate Meadors with the other debtors, noting that the inequities of consolidation clearly outweighed its bene-

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121. See *id.* at 847; see also 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[2], at 1100-39 (analyzing *Kheel*). The court further noted that *Soviero* does not require the party seeking consolidation affirmatively to prove that the party objecting to consolidation dealt with the entities as one. To the contrary, whether a creditor relied solely on the credit of a single entity is an available defense for the objecting creditor. See *Kheel*, 369 F.2d at 847; *In re Snider Bros., Inc.*, 18 Bankr. 230, 235-36 (Bankr. D. Mass. 1982).

122. *Kheel*, 369 F.2d at 847.

123. *Id.* at 848. Judge Friendly stated: "Equality among creditors who have lawfully bargained for different treatment is not equity but its opposite . . ." *Id.* (Friendly, J., concurring).

124. 432 F.2d 1060 (2d Cir. 1970).

125. See *Snider Bros.*, 18 Bankr. at 236-37 (analyzing *Flora Mir*).

126. Meadors was organized in 1961 to manufacture and sell candy. In 1963, however, Meadors was sold to Keebler Company. The Meadors debenture holders gave up their conversion privileges as part of the sale to Keebler. See *Flora Mir*, 432 F.2d at 1061.

127. See *id.* at 1061.

fits.<sup>128</sup> The Meadors debentures had been issued six years prior to Flora Mir's acquisition of Meadors. Clearly these creditors had not relied on the credit of any consolidated group.<sup>129</sup> Further, consolidation not only would eliminate Meadors's claim against Flora Mir for misappropriation of assets but also would permit the creditors of Flora Mir and the other companies to share in any recovery awarded in the state court action involving the debenture issue.<sup>130</sup> The court emphatically stated its doubt that any showing of accounting difficulty could warrant consolidation in such a situation.<sup>131</sup> The court recognized that consolidation would be unfair to the debenture holders, even though most general creditors had treated the debtors as one.<sup>132</sup> Significantly, the primary asset of Meadors was its misappropriation claim against Flora Mir, a claim between affiliates that substantive consolidation would have eliminated.<sup>133</sup>

#### F. *In re Continental Vending Machine Corp.*

*In re Continental Vending Machine Corp.*<sup>134</sup> illustrates that substantive consolidation may be achieved pursuant to a plan for reorganization. The reorganization plan in *Continental Vending* proposed consolidation of the unsecured claims against a parent and its subsidi-

128. *Id.* at 1062-63. The court heard testimony regarding a multitude of intercompany transactions and the difficulty of disentangling them. This testimony had little to do with Meadors, however, which had transacted little business after its acquisition. *Id.* at 1061-62. The Meadors debenture holders opposed consolidation. *Id.* at 1062. Nevertheless, the referee had signed an order directing consolidation that prompted the appellate court to state:

[T]he referee signed, without any material change, findings of fact and conclusions of law submitted by the attorneys for the debtors and entered an order directing . . . consolidat[ion]

. . . .

The first ray of light for the Meadors debenture holders in many years was shed when their petition to review this order came before a district judge possessed of robust common sense. On examining the evidence [the district judge] found it to be "grossly insufficient to prompt a court of equity" to consolidate Meadors with the other debtors. . . .

The decision was so manifestly correct that we should hardly have written an opinion were it not to make it plain that referees should not order consolidation on so flimsy a basis as was done here.

*Id.* (footnotes omitted).

129. *See id.* at 1062-63.

130. *Id.* at 1063. These claims by Meadors and its debenture holders were transactions in which the other companies' creditors "had not the slightest legitimate interest." *Id.*

131. *Id.* The court also noted that although consolidation would facilitate an expedient consummation of a reorganization plan, this desirable objective was subordinate to the rights of the debenture holders. *Id.*

132. *See id.* (noting that the general trade creditors may be content to take what they can get for the past debts); *see also In re Snider Bros., Inc.*, 18 Bankr. 230, 236 (Bankr. D. Mass. 1982) (analyzing *Flora Mir*). The court felt that equity required the isolation of the debenture holder group from the other creditors. *See id.*

133. *See* 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[2], at 1100-41.

134. 517 F.2d 997 (2d Cir. 1975), *cert. denied*, 424 U.S. 913 (1976).

ary. The plan did not, however, call for the collateral for the secured claims to be consolidated, and the plan precluded the secured creditor's position from being elevated or improved.<sup>135</sup> The Second Circuit upheld the plan as fair and equitable to the creditors.

The holding of *Continental Vending* is more complex than the simple maxim that unsecured claims may be consolidated while secured claims remain unconsolidated.<sup>136</sup> The court merely denied the benefits of consolidation to the secured creditor<sup>137</sup> because that creditor had obtained exactly what it bargained for.<sup>138</sup> The case addressed the bankruptcy of a parent corporation, Continental Vending Machine Corp. (Continental), and its wholly owned subsidiary, Apco, Inc. (Apco). The interested secured creditor of both entities was James Talcott, Inc. (Talcott).<sup>139</sup>

The court predicted that liquidation of Talcott's security in Apco would yield a surplus while the sale of the Continental security would result in a deficiency.<sup>140</sup> Talcott sought to apply the surplus of its Apco lien to the Continental deficiency,<sup>141</sup> but the consolidation plan provided that a secured creditor's claim could not be elevated or improved as a result of the consolidation.<sup>142</sup> The court found that Talcott did not have a lien on the Apco surplus, Talcott's secured claim against Apco

135. See *id.* at 1000 n.3.

136. See 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[2], at 1100-42. "In *Continental Vending*, secured claims were not left unconsolidated while unsecured claims were consolidated. Instead the court refused to consolidate collateral pools since the lender did not bargain for cross-collateral." *Id.*

137. See *Snider Bros.*, 18 Bankr. at 237.

138. *Continental Vending*, 517 F.2d at 1002.

139. *Id.* at 999. Talcott financed each corporation. Talcott's security in Continental was represented primarily by mortgages on vending machines. *Id.* From Apco, Talcott received assignments of accounts receivable. *Id.* Significantly, however, the security agreements with each corporation contained no cross-collateralization agreement or guarantee for the other's debts. Thus, no provision allowed Talcott to set off the obligations of one corporation against the collateral that it held to secure debts of the related corporation. *Id.*

140. *Id.*

141. On appeal Talcott argued that because improvement of some creditors' positions is inherent in consolidation, it would be unfair to permit unsecured creditors to improve their positions while denying secured creditors such improvement. *Id.* The court dispensed with this argument by holding that Talcott would receive "exactly what it bargained for." *Id.* at 1001.

Alternatively, Talcott argued that the broad language of each of its security agreements permitted the Apco lien to cover the Continental deficit. *Id.* at 999. The court conceded that the security agreements contained broad language but found that the Apco agreement "did not go so far as to cover the debts of Continental." *Id.* at 1000. No further lien on Apco property could exist because the Apco obligation was satisfied. *Id.*

142. *Id.* at 999. The originally proposed plan for reorganization included a complete merger of the assets and liabilities of the two corporations. The cited *caveat* against secured creditor consolidation, however, was added to the plan by an amendment by the trustee when Talcott made known its intention to apply the Apco surplus to the Continental deficiency. See Berry, *supra* note 2, at 366-67.

was satisfied,<sup>143</sup> and its unsecured claim against Continental was not impaired.<sup>144</sup> Further, by negotiating separate security agreements with Continental and Apco, Talcott certainly did not deal with the corporations in a mistaken belief that the two were one. *Continental Vending* warns secured creditors that substantive consolidation will not increase automatically a secured position by attaching a lien on the consolidated estate.<sup>145</sup>

### G. *In re Gulfco Investment Corp.*

Although the secured creditor in *Continental Vending* was not entitled to improve its position, secured creditors in general received protection in *In re Gulfco Investment Corp.*<sup>146</sup> The Tenth Circuit considered substantive consolidation in *Gulfco*, which involved the proposed consolidation of a parent, Gulf South Corp., with its subsidiaries.<sup>147</sup> The court held that consolidation could not be used to eliminate a creditor's security for the purpose of making the secured creditor an unsecured creditor.<sup>148</sup> A group of creditors that opposed the district court's order for consolidation brought the appeal.<sup>149</sup> A parent company pledged 51 percent of the stock of its subsidiary as security for a 1.8 million dollar loan.<sup>150</sup> The creditor objected to consolidation of the subsidiary with its parent because consolidation would deprive the creditor

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143. *Continental Vending*, 517 F.2d at 1000.

144. *See id.* at 1002. Reasoning that Talcott's lien property was not prejudiced by the intercompany transfers of assets that prejudiced the unsecured creditors, the court held that consolidation of secured creditors was unnecessary because that group was not harmed. "Thus, it can be seen clearly that consolidation is not a matter of simply showing corporate interrelationship, but harm thereby as well." *In re Snider Bros., Inc.*, 18 Bankr. 230, 237 (Bankr. D. Mass. 1982). For a critical view of the majority's opinion in *Continental Vending*, see Berry, *supra* note 2, at 368-70 (attacking the majority's view that Talcott got "exactly what it bargained for" on grounds that consolidation is not designed to satisfy the expectations of its parties (quoting *Continental Vending*, 517 F.2d at 1002)).

145. A secured creditor, however, successfully might assert a claim against property improperly in the hands of a consolidated affiliate if such property constitutes the proceeds of the secured party's collateral. *See* 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[2], at 1100-42, -43.

146. 593 F.2d 921 (10th Cir. 1979).

147. The corporate conglomerate is so complex that the court appended a chart to the opinion for clarity. *See id.* at 932. The case, however, concerns only two subsidiaries, Delta Mortgage Corp. and Horseshoe Development Corp. *Id.* at 923, 924. The district court found that the creditors believed Delta and Horseshoe to be solvent. *Id.* at 924.

148. *Id.* at 927.

149. *See id.* at 924. The district court ordered consolidation based on what it called overwhelming accounting difficulties. It held that the presence of common control coupled with the *Fish v. East* factors, *see supra* note 61, warranted consolidation. *Gulfco*, 593 F.2d at 923. The court of appeals noted that the strongest difference between *Gulfco* and *Fish* is that neither subsidiary in *Gulfco* was organized fraudulently. *Id.* at 929.

150. *Gulfco*, 593 F.2d at 924.

of the benefit of the pledged stock.<sup>151</sup>

The court held that consolidation may not be used to strip a secured creditor of its security. The court recognized the bankruptcy courts' broad powers and discretion, but noted that this authority does not allow courts to ignore the absolute priority rule.<sup>152</sup> The court affirmed the *Continental Vending* holding that security may not be used to benefit other creditors while the secured creditors remain unsatisfied.<sup>153</sup> The court also renounced the district court's finding that consolidation was warranted simply because the stock comprising the creditor's security was too difficult to value. Rather, the court emphatically warned that administrative convenience, expediency, and accounting difficulties were inadequate to warrant treatment of a secured creditor as unsecured<sup>154</sup> and stated that consolidation may not be used as a means of avoiding valuation.<sup>155</sup>

#### H. *In re Augie/Restivo Baking Co.*

Substantive consolidation received little notice in the courts of appeals after *Gulfc*. Bankruptcy and district courts using the standards and guidance enunciated in the circuit court cases discussed above, however, frequently decided the issue.<sup>156</sup> Finally, nine years after *Gulfc*, the Second Circuit addressed substantive consolidation in *In re*

151. *Id.* at 924. Horseshoe was considered solvent by its creditors. *Id.*

152. *Id.* at 926-27. For an explanation of the absolute priority rule, see *supra* note 49.

153. *Gulfc*, 593 F.2d at 927.

154. *Id.* Furthermore, the court held that the secured creditor, in this situation, would be entitled to have its security, the Horseshoe shares, valued for purposes of assuring the secured creditor of its proper priority in any proposed reorganization plan. *Id.*

The case also involved certain guarantees that the debtors gave in connection with certain loans. The court noted that the guarantee by Horseshoe running to one creditor entitled that creditor to status as an unsecured creditor of Horseshoe. *Id.* The court further noted, however, that if a creditor has claims against more than one debtor arising out of the same transaction, that creditor is entitled to only one satisfaction. *Id.* Once consolidation is ordered, the guarantees, which represent multiple claims, are eliminated. Thus, the court held, the unsecured creditor has only one claim per transaction to be satisfied from pooled resources. *Id.* at 928.

One treatise, however, argues that this holding is incorrect:

On this point the court was wrong. Under the Code, a claim in respect of the guarantee of a defaulted obligation is entitled to treatment on a parity with other unsecured claims. A creditor owed \$10 by a debtor subsidiary will have allowed claims in both the subsidiary proceeding and in that of the parent guarantor. If the distribution to creditors of the subsidiary equals 25% of claims and to creditors of the parent equals 10% of claims, the creditor receives a 35% recovery. If there is substantive consolidation and there is no other duplicate claims, his recovery is approximately 18%.

5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[2], at 1100-43 n.32 (citation omitted).

155. *Gulfc*, 593 F.2d at 930. The court added that substantive consolidation "of unsecured creditors may be an appropriate solution for some of the debtor corporations, but in no event can secured creditors be deprived of their secured status . . ." *Id.*

156. See, e.g., *In re DRW Property Co.* 82, 54 Bankr. 489 (Bankr. N.D. Tex. 1985); *In re Donut Queen, Ltd.*, 41 Bankr. 706 (Bankr. E.D.N.Y. 1984).

*Augie/Restivo Baking Co.*<sup>157</sup> The court denied consolidation, holding that the course of dealing and expectations of the parties did not justify consolidation.<sup>158</sup>

The case addressed the bankruptcy of Augie/Restivo Baking Co., Ltd. (Augie/Restivo) and Augie's Baking Company, Ltd. (Augie). Prior to 1985, Augie and Restivo Brothers Bakers, Inc. (Restivo) were unrelated, family-run, wholesale bakeries. In January 1985, however, Augie and Restivo effected an exchange of stock after which Restivo changed its name to Augie/Restivo Baking Company, Ltd. The original Augie, however, was not dissolved.<sup>159</sup>

The two entities borrowed from separate banks. Prior to 1985, Union Savings Bank (Union) loaned Augie 2.1 million dollars secured by Augie's real property. Augie later obtained a second loan from Union secured by its accounts receivable, inventory, and equipment. Restivo, on the other hand, had been a borrower from Manufacturer's Hanover Trust Company (Hanover).<sup>160</sup>

The credit extended after the 1985 stock exchange created the basis for creditor Union's objection to the order of consolidation. Prior to the debtors' bankruptcies, Hanover had advanced approximately 2.7 million dollars to Augie/Restivo. After Augie/Restivo and Augie were forced into bankruptcy in 1986, Hanover entered into a series of cash collateral stipulations with Augie/Restivo.<sup>161</sup> The loans were secured by assets of the debtor-in-possession,<sup>162</sup> Augie/Restivo, and therefore granted Hanover a superpriority administrative expense claim.<sup>163</sup> The

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157. 860 F.2d 515 (2d Cir. 1988).

158. *Id.* at 519.

159. *See id.* at 516-17. Augie's affairs, however, were discontinued, and Restivo became the sole operating company. A single set of books and financial statements were maintained under the name of Augie/Restivo. *Id.* at 517.

160. *Id.* at 516-17.

161. *Id.* at 517. Section 363(a) and (c)(2) of the Bankruptcy Code address the use of cash collateral by a debtor continuing business after filing a petition. *See* 11 U.S.C. § 363(a), (c)(2) (1982 & Supp. V 1987). In a cash collateral agreement, a debtor typically will deposit funds in a specified account, and the creditor will make loans to the debtor up to an amount represented by the deposited funds. The Augie/Restivo agreement stipulated that the accounts receivable of Augie/Restivo constituted cash collateral. *Augie/Restivo*, 860 F.2d at 517.

162. In most Chapter 11 cases the debtor will remain in possession of property of the estate as "debtor-in-possession." A debtor will continue to operate its business as debtor-in-possession until the bankruptcy court grants a party in interest's request for appointment of a trustee. The debtor-in-possession's use of the property of the estate is subject to the supervision of the bankruptcy judge pursuant to § 363 of the Bankruptcy Code. *See* DEBTORS, *supra* note 8, at 734-35.

163. *Augie/Restivo*, 860 F.2d at 517. Section 507 of the Bankruptcy Code provides for the priority of unsecured claims against the estate. Certain administrative expenses receive first priority. *See* 11 U.S.C. § 507 (1982 & Supp. V 1987). Two other Code sections, however, allow for certain claims to receive superpriority status and these claims will receive payment before the § 507(a)(1) administrative expense claims. *See id.* §§ 364(c)(1), 507(b) (1982).

Section 507(b) grants superpriority status to creditors that permit the debtor to use property



cash collateral stipulations repeatedly were renewed until the entire amount of Hanover's prepetition loans to Augie/Restivo had been converted into postpetition, superpriority administrative expense debt.<sup>164</sup> Substantive consolidation would allow the equity in Augie's assets to be used to pay the debts of Augie/Restivo and Restivo, including the 2.7 million dollar superpriority administrative expense claim to Hanover.<sup>165</sup> Although Union's first loan secured by Augie's real property would continue to have priority as to that property, Union's second, undersecured loan would be subordinated to Hanover's superpriority claim.<sup>166</sup>

The basis of the court's denial of consolidation stemmed from recognition of lenders' expectations when extending credit to a specific entity.<sup>167</sup> The court found that Union's loans to Augie were based solely on Augie's financial position.<sup>168</sup> Similarly, the court found that Hanover had extended credit with knowledge that it was dealing with separate entities.<sup>169</sup>

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secured by a lien in the debtor's reorganization. To the extent that the protection given to those creditors is inadequate, the creditor will receive a superpriority. *See id.* § 507(b); *see also* S. REP. No. 989, 95th Cong., 2d Sess. 68-73 (1978). Section 364(c)(1) grants priority over all administrative expenses, including § 507(b) claims. *See* 11 U.S.C. § 364(c)(1) (1982). Sections 364(c) and 364(d) empower the bankruptcy court to authorize the debtor-in-possession (or trustee) to incur debt with superpriority status. Such a superpriority may be authorized only if the debtor-in-possession is unable to obtain credit and adequate protection of the original lien holder's interest exists. *See* DEBTORS, *supra* note 8, at 987.

164. *Augie/Restivo*, 860 F.2d at 517. This debt was secured by Augie/Restivo's accounts receivable and a subordinated mortgage on Augie's real property. *Id.*

165. The Augie assets also would be used to pay Augie/Restivo's and Restivo's priority tax liabilities of more than \$1.2 million. *Id.* at 517; *cf.* *Holywell Corp. v. Bank of New York*, 59 Bankr. 340 (Bankr. S.D. Fla. 1986), *appeal dismissed sub nom. Miami Center Ltd. Partnership v. Bank of New York*, 820 F.2d 376 (11th Cir. 1987), *cert. denied*, 109 S. Ct. 69 (1988). In *Holywell* the court recognized that substantive consolidation in the Chapter 11 reorganization involved the combination of the debtors' assets and liabilities as well as the elimination of interdebtor claims. The court, however, held that interdebtor claims incurred under the authorization of the bankruptcy court are excepted from elimination. *Id.* at 347 & n.6 (noting that certain interdebtor loans were allowed by the bankruptcy court to enable debtors to continue operations).

166. *Augie/Restivo*, 860 F.2d at 517.

167. *Id.* at 518-19. "[L]enders structure their loans according to their expectations regarding that borrower and do not anticipate either having the assets of a more sound company available . . . or having the creditors of a less sound debtor compete for the borrower's assets." *Id.* The court recognized that interest rates and loan terms are based on these expectations. "[F]ulfilling those expectations is therefore important to the efficiency of credit markets." *Id.* at 519. Substantive consolidation would undermine such efficiency when creditors rely on the credit of specific entities. *Id.*

168. The court also found that Union had no knowledge of the negotiations between Augie and Restivo at the time that it made the loan. *Id.* The court held that Union's claim against Augie's real estate was superior to that of Hanover and that "the undesirability of consolidation is as clear in [this] case as it was in . . . *Flora Mir.*" *Id.* at 520.

169. Hanover sought and received a guarantee from Augie of Hanover's loans to Augie/Restivo, including a subordinated mortgage on Augie's real property. *Id.* at 519. The court held that the fact that trade creditors might have believed that they were dealing with a single entity was insufficient to justify consolidation. *Id.* The court looked at Hanover as the principal beneficiary of

The court also dismissed an argument that the entanglement of the debtors' affairs warranted consolidation.<sup>170</sup> In keeping with *Kheel*, *Augie/Restivo* advised that substantive consolidation should be granted only if all creditors will benefit because untangling is either impossible or so costly that it will consume the assets of the estate.<sup>171</sup> Although *Augie/Restivo* is the most recent appellate decision, it does not advance new standards or factors. Like the decisions before it, *Augie/Restivo* balances the interests of parties to be affected by consolidation and respects the reliance interest of creditors that expect satisfaction of claims solely from the particular entity to which credit was extended.

#### IV. ANCILLARY ISSUES AND TACTICAL USES OF SUBSTANTIVE CONSOLIDATION

##### A. Individual Debtors and Statutory Exemptions

Substantive consolidation is not restricted to the corporate setting. Bankruptcies of individuals may be consolidated with other individual bankruptcies or with the bankruptcy of any affiliated entity.<sup>172</sup> The court in *In re Steury*<sup>173</sup> noted that the often cited factors for substantive consolidation usually arise in a corporate setting and, therefore, have little relevance to proceedings involving individual debtors.<sup>174</sup> Therefore, the court applied a two-step approach in which it stated that first, a need for consolidation must be demonstrated, and second, the benefits of consolidation must outweigh the harm it creates.<sup>175</sup> *Steury* involved a trustee's motion to consolidate the separate involuntary bankruptcies filed against husband and wife debtors who opposed consolidation.

*Steury* illustrates the significance of substantive consolidation in the individual debtor context because of the availability of statutory exemptions under state law and the Bankruptcy Code.<sup>176</sup> Each debtor

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consolidation and noted that Hanover was not deceived and knew that it was dealing with separate corporate entities. *Id.*

170. *Id.* The bankruptcy court supported its order to consolidate by finding that it was "doubtful if [the debtors' affairs] could ever be unknotted." *Augie/Restivo*, 84 Bankr. at 321.

171. Neither condition was met in the case. *Augie/Restivo*, 860 F.2d at 519. For a discussion of accounting difficulties in *Kheel*, see *supra* notes 112-17 and accompanying text.

172. See *supra* notes 55, 56, and accompanying text.

173. 94 Bankr. 553 (Bankr. N.D. Ind. 1988).

174. *Id.* at 554.

175. *Id.*; see *supra* notes 72, 73, and accompanying text.

176. Generally all prebankruptcy property in which the debtor has an interest becomes "property of the estate," but an individual debtor may exempt certain property from property of the estate. Section 522 of the Bankruptcy Code addresses what property an individual debtor may exempt. See 11 U.S.C. § 522 (1982 & Supp. V 1987); see also DEBTORS, *supra* note 8, at 740. Section 522(d) contains a list of the federal exemptions that the Bankruptcy Code gives to an individual. 11 U.S.C. § 522(d) (1982 & Supp. V 1987). Section 522(b)(1), however, recognizes that

spouse in *Steury* claimed an Indiana exemption expressly available only in bankruptcy.<sup>177</sup> The exemption concerns property held in tenancy by the entireties and is not available if the debtors' cases are consolidated. The debtors claimed that substantive consolidation inappropriately prejudiced them by requiring forfeiture of the exemption.<sup>178</sup>

The court carefully examined the effect of the exemption both in and out of bankruptcy before ultimately ordering a partial consolidation. The court noted that because consolidation would aggregate the assets and liabilities of each debtor, all creditors, whether joint or individual, would become joint creditors of the consolidated estate and would no longer be required to claim only the assets of the individual debtor. Therefore, creditors that were not joint creditors prior to consolidation could reach all the assets of the other debtor as well as the entireties property after consolidation. The claims that could be satisfied from the entireties property therefore would be increased.<sup>179</sup> The court was concerned, however, because consolidation would reduce the distribution to some creditors at the expense of others.<sup>180</sup> Thus, creditors with joint claims would be required to share the proceeds of the entireties property with creditors who otherwise would have no claim to it.<sup>181</sup>

states may have enacted their own list of exemptions. If a state has "opted out" of the federal exemptions, the debtor must use the exemptions available under state law. *See id.* § 522(b)(1); *see also* DEBTORS, *supra* note 8, at 741.

177. State law exemptions generally allow debtors a right to certain property free from creditors in any judicial process. *See* DEBTORS, *supra* note 8, at 127. The *Steury* debtors invoked IND. CODE § 34-2-28-1(a)(5). This statute provides that the debtor may exempt the following:

Any interest the judgment debtor has in real estate held as a tenant by the entireties on the date of the filing of the petition for relief under the bankruptcy code, *unless* a joint petition for relief is filed by the judgment debtor and spouse, *or individual petitions of the judgment debtor and spouse are subsequently consolidated.*

IND. CODE ANN. § 34-2-28-1(a)(5) (Burns 1986) (emphasis added).

178. *See Steury*, 94 Bankr. at 555. Because the exemption involved property held in tenancy by the entireties, the court recognized that a creditor of only one spouse could not reach the property for satisfaction of its claim. A joint creditor, however, could reach this property for satisfaction of a joint spousal obligation. Thus, outside of bankruptcy, joint creditors could reach the entire value of the entireties property. *Id.* Because separate bankruptcy petitions had been filed, however, joint creditors could not reach the equity in the entireties property. Thus, the exemption would remove completely the entireties property and its proceeds from the bankruptcy estate. *Id.* Consequently, this property would not be available to satisfy any claim, joint or individual, against the debtors. Thus, the court recognized that joint creditors would be required to share with all other creditors the few other assets in the debtors' estates. *Id.* Absent consolidation, prejudice to the creditors clearly would result.

179. *Id.* at 556.

180. *Id.* *See generally* Pedlar, *Community Property and the Bankruptcy Reform Act of 1978*, 11 ST. MARY'S L.J. 349, 353-54 (1979) (expressing a similar concern for creditors in the context of community property).

181. *See Steury*, 94 Bankr. at 556.

Therefore, the court exercised its equity powers<sup>182</sup> and held that the debtors' cases should be consolidated but only to the extent that the proceeds of the debtors' entireties property would be available for payment of joint claims against the debtors.<sup>183</sup> The court rejected the debtors' argument that no partial substantive consolidation could occur and held that equity allowed the court to shape a remedy to correct the problem.<sup>184</sup>

### B. Effective Date of Consolidation

What is the effective date of the consolidated entity's bankruptcy filing? Often economics will force some related entities into bankruptcy before others. Parent company management similarly may desire to file bankruptcy for only certain subsidiaries or affiliates. Entities also may face involuntary bankruptcy in which the creditors choose the time to file a bankruptcy petition. Because each of these entities could qualify as debtors within the Bankruptcy Code, they may be involved in bankruptcy independently of the others.<sup>185</sup> If the entities are consolidated, however, it is important to determine the proper date from which to measure the rights of debtors and creditors in the event of bankruptcy.<sup>186</sup>

In *In re Tureaud*<sup>187</sup> the bankruptcy proceeding began when an involuntary petition was filed against the debtor in October 1982. In June 1983, however, the trustee filed an application for substantive consolidation. The bankruptcy court granted the trustee's application and, in

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182. *Id.*; see *supra* note 17 and accompanying text.

183. *Steury*, 94 Bankr. at 557.

184. *Id.*

185. Bankruptcy Code § 101(12) defines "debtor" as a "person or municipality concerning which a case under this title has been commenced." 11 U.S.C. § 101(12) (1982). Section 101(35) defines "person" to include an individual, partnership, or corporation. *See id.* § 101(35) (Supp. V 1987); *see also id.* § 109 (1982 & Supp. V 1987) (stating the requirements for "debtor" status under the several bankruptcy chapters).

186. The filing date is significant in bankruptcy. Rights of creditors and debtors are measured against the filing date in several contexts. The filing of a petition in voluntary bankruptcy begins the case. *Id.* § 301. Involuntary cases are commenced by the filing of a petition by a qualified entity other than a debtor. *See id.* § 303(b) (1982 & Supp. V 1987).

Significantly, the filing of a petition operates as a stay against subsequent proceedings by creditors to recover claims against the debtor. *Id.* § 362(a). The allowance of certain claims against the bankrupt are measured from the filing date. *See, e.g., id.* § 502(b)(6) (landlord's claims); *id.* § 502(b)(7) (employee's damages); *id.* § 503(b)(1) (administrative expenses). Also, the filing date measures what property comprises property of the estate. *See id.* § 541(a).

The trustee primarily is interested in the effective date of filing because fraudulent transfers and preferences are measured by this date. A transfer made by a debtor on or within 90 days of the filing of the petition may be deemed a preference and avoided by the trustee. *See id.* § 547(b)(4). Similarly, the trustee may avoid fraudulent transfers made on or within one year before the filing of the petition. *Id.* § 548(a).

187. 59 Bankr. 973 (Bankr. N.D. Okla. 1986).

January 1985, filed an order substantively consolidating the debtors' estates.<sup>188</sup> A creditor of the consolidated affiliates objected to the bankruptcy court's selection of June 1983, the date of the trustee's application for consolidation, as the effective date of consolidation. The creditor argued that October 1982, the date of the involuntary petition filing, should be the effective date.<sup>189</sup> Nevertheless, the court affirmed the bankruptcy court's selection of June 1983 as the effective date, holding that because nondebtors were included in the bankruptcy proceeding, the bankruptcy court was not rigidly fixed to the date of the involuntary petition's filing.<sup>190</sup>

In *In re DRW Property Co.* 82<sup>191</sup> debtor real estate partnerships requested substantive consolidation of the debtor entities with over one hundred related nondebtor partnerships.<sup>192</sup> Although the debtors filed voluntary petitions in 1985, they sought substantive consolidation as of January 1, 1982, primarily for federal income tax purposes.<sup>193</sup> The court denied consolidation<sup>194</sup> and held that it was unaware of any authority that would allow substantive consolidation of the debtor entities into a single limited partnership effective three years prior to the bankruptcy filings.<sup>195</sup>

In *In re Evans Temple Church of God in Christ and Community Center, Inc.*<sup>196</sup> the court held that the substantive consolidation of two cases permitted the debtors to use the date of the earlier debtor's filing to determine whether a payment made by the last debtor to file qualified as a preference.<sup>197</sup> The court noted that when the assets and liabili-

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188. *Id.* at 974-75.

189. *Id.* at 977. The creditor cited *United States v. Marxen*, 307 U.S. 200, 207 (1939), for the proposition that the substantive rights of a creditor against a bankrupt are fixed as of the filing of the petition. *Tureaud*, 59 Bankr. at 977. The trustee, however, cited *Bank of Marin v. England*, 385 U.S. 99, 103 (1966), to emphasize the "essentially equitable nature" of bankruptcy courts. *Tureaud*, 59 Bankr. at 977-78. The court finally conceded that it did not know of a case that discussed "this precise issue." *Id.* at 978.

190. *Tureaud*, 59 Bankr. at 978 (noting that because of the bankruptcy court's equity powers, its choice of June 7, 1983, as the effective date of consolidation did not constitute an abuse of discretion).

191. 54 Bankr. 489 (Bankr. N.D. Tex. 1985).

192. *Id.* at 491.

193. *Id.* The application for substantive consolidation, effective Jan. 1, 1982, was filed in anticipation of a deadline of Sept. 1985 set by the bankruptcy court for the filing of plans of reorganization. Substantive consolidation with the 109 nondebtor partnerships was sought in order to form a single limited partnership for all purposes. The application for substantive consolidation additionally requested a final determination that all assets and liabilities of the consolidated partnerships were "merged" into the consolidated partnership as of Jan. 1, 1982, three years prior to the bankruptcy filings. *Id.*

194. *Id.* at 492.

195. *Id.* at 497.

196. 55 Bankr. 976 (Bankr. N.D. Ohio 1986).

197. *Id.* at 981.

ties of two debtors clearly are not separable and substantive consolidation is warranted, the preference provisions of the Bankruptcy Code require that the creditors of the consolidated debtors receive similar treatment.<sup>198</sup> The court found that the creditors would be protected only by allowing the last debtor that filed bankruptcy the opportunity to assume the earlier debtor's filing date.<sup>199</sup>

In *In re Auto-Train Corp.*<sup>200</sup> the trustee moved to consolidate the assets and liabilities of a subsidiary into the estate of the parent, effective as of the date of the parent's bankruptcy filing. Such a *nunc pro tunc*<sup>201</sup> order would enable the trustee to recover as a preference a payment that the subsidiary made to a creditor.<sup>202</sup>

The District of Columbia Circuit, however, held that the *nunc pro tunc* order was improper because it unduly prejudiced the creditor who received the alleged preferential payment.<sup>203</sup> The court assumed that substantive consolidation was appropriate<sup>204</sup> and addressed the issue of

198. *Id.* at 982 (analyzing the policy behind bankruptcy's preference avoidance provisions).

199. *Id.* at 983. When a case is substantively consolidated a court is making the following determination:

[T]he assets and liabilities of one debtor are substantially the same assets and liabilities of the second debtor, or that the two are hopelessly intertwined, and that the unsecured creditors of both debtors would best be protected by pooling the assets and liabilities of the two debtors.

*Id.* at 982.

200. 810 F.2d 270, 273 (D.C. Cir. 1987).

201. One authority has defined *nunc pro tunc*:

Now for then. A phrase applied to acts allowed to be done after the time when they should be done, with a retroactive effect, *i.e.*, with the same effect as if regularly done. *Nunc pro tunc* entry is an entry made now of something actually previously done to have effect of former date.

BLACK'S LAW DICTIONARY 964 (5th ed. 1979) (citations omitted). The *Auto-Train* court examined the divergent treatment of orders *nunc pro tunc* by courts:

Some have said [that orders *nunc pro tunc*] are allowable only to make the record reflect something that actually happened but was not recorded, some that [the orders] may be entered to achieve equity even though so doing supplies an action that did not occur on the earlier date. But even courts taking the broader view have only granted such orders under extraordinary circumstances *where they will not prejudice any party or frustrate the purposes of the Bankruptcy Code*.

*Auto-Train*, 810 F.2d at 275 (citations omitted) (emphasis added). "Accordingly, even on the expansive view of the role of a *nunc pro tunc* order, we find it unjustifiable in the present case." *Id.* at 276 n.5.

202. *Auto-Train*, 810 F.2d at 273. The creditor objected to the motion for consolidation and resulting avoidance of the transfer on the grounds that the bankruptcy court lacked the power to consolidate the subsidiary into the parent's estate *nunc pro tunc*. *Id.* The bankruptcy court ruled in favor of the trustee. *Id.*

203. *Id.* at 275-76. Although the Bankruptcy Code compels certain transferees to restore to the debtor property received within 90 days of the date that the debtor files a petition, "it would thwart the Code's policies to require transferees to disgorge solely on the basis of a bankruptcy filing by their debtor's apparently distinct affiliate." *Id.* at 276.

204. *Id.*

giving the consolidation order a retroactive effect. The court ruled that once consolidation is deemed appropriate, a bankruptcy court must undertake an additional balancing process before exercising its equitable *nunc pro tunc* powers.<sup>205</sup> A consolidation order should be granted *nunc pro tunc* only when the retroactive effect will yield greater benefits than the harm it inflicts.<sup>206</sup> Similar to the original question of the propriety of consolidation, the court posited that the party favoring a *nunc pro tunc* order must show some benefit to be achieved by its allowance. A creditor that holds an allegedly preferential payment can challenge such a showing by proving reliance on the separate credit of an entity to be consolidated and showing that the creditor will be harmed by a shift in the filing dates.<sup>207</sup>

*Auto-Train* especially is concerned with the detrimental effect that retroactive treatment of a consolidation order will visit on bankruptcy's twofold policy of preventing creditors from racing to the courthouse and facilitating equality of distribution among creditors.<sup>208</sup> The court feared that ordering consolidation *nunc pro tunc* without consideration of a transferee's reliance on an entity's separateness would accelerate the race among creditors. Such a rule would heighten creditors' reluctance to extend credit to troubled companies and would incite creditors to demand satisfaction of their claims upon any showing of weakness by the debtor.<sup>209</sup>

### C. The Standard of Accounting Difficulties

*Chemical Bank New York Trust Co. v. Kheel*<sup>210</sup> granted substantive consolidation on the ground that the financial records and affairs of the respective debtors were so hopelessly obscured that to untangle them would threaten any recovery to creditors.<sup>211</sup> Similarly, *In re Commercial Envelope Manufacturing Co.*<sup>212</sup> allowed substantive consolidation because of the difficulty and astronomical cost of performing an

205. *Id.*

206. *Id.* at 277 (noting that this inquiry closely parallels the balancing test used for motions for consolidation).

207. Such a challenge was successful in *Auto-Train*. If the challenger meets this burden, the court must then determine whether the benefits of a *nunc pro tunc* order outweigh its detriments. *Id.* at 277.

208. *Id.* at 276-77; see Thornton, *supra* note 14, at 456.

209. *Auto-Train*, 810 F.2d at 277.

210. 369 F.2d 845 (2d Cir. 1966).

211. See *id.* at 847 (2d Cir. 1966); *supra* notes 112-23 and accompanying text. The extent to which the assets of separate debtors are "hopelessly obscured" must be determined on a case-by-case basis. *In re DRW Property Co.* 82, 54 Bankr. 489, 496 (Bankr. N.D. Tex. 1985). For a discussion of administrative expenses and their priority status, see *supra* note 114.

212. 14 Collier Bankr. Cas. (MB) 191 (Bankr. S.D.N.Y. 1977).

audit necessary to disentangle the debtors' assets and liabilities.<sup>213</sup> Under these high standards, proponents of consolidation who base their argument on accounting difficulties rarely succeed.<sup>214</sup>

Substantive consolidation is not a matter of procedural convenience.<sup>215</sup> The court in *In re Gulfco Investment Corp.*<sup>216</sup> advised that if detailed, certified audits are not possible, at least some accounting studies and evaluations should be made.<sup>217</sup> In addition, even in cases in which accounting barriers favor consolidation, if an objecting creditor can demonstrate that the assets and liabilities of its particular debtor are sufficiently distinct from the other debtors', the court may refuse to consolidate that debtor.<sup>218</sup>

In *In re DRW Property Co.* 82<sup>219</sup> proponents of consolidation argued that the expense of unscrambling the debtor entities' relationships would consume all of the assets available for creditors. Despite expert testimony that disentangling the books and records of the debtors would require six additional months of audit work costing approximately two million dollars, the court held that the problem of accounting difficulties was insufficient to invoke an order of substantive consolidation.<sup>220</sup> Thus, an argument for consolidation based solely on accounting difficulties is insufficient to invoke substantive consolidation when the reliance interests of creditors are threatened.

#### D. Consolidation with Nondebtors

Entities that may be consolidated include individuals, partnerships, corporations, and related affiliates, including nondebtors.<sup>221</sup> Consolidation of debtor and nondebtor entities, although possible, should occur only in unusual circumstances.<sup>222</sup> Such consolidation threatens solvent entities. A separate, solvent entity may be forced into liquida-

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213. *Id.* at 194.

214. *See supra* note 117 and accompanying text.

215. *In re Flora Mir Candy Corp.*, 432 F.2d 1060, 1062 (2d Cir. 1970).

216. 593 F.2d 921 (10th Cir. 1979); *see supra* notes 146-55 and accompanying text.

217. *Gulfco*, 593 F.2d at 930. The studies and evaluations are necessary because further action in substantive consolidation cases is dependent wholly on the underlying facts. *See id.*

218. *See, e.g., Flora Mir*, 432 F.2d at 1063 (noting that although there might have been problems with the intercompany accounts among the other debtors in the case, the accounting problems respecting Meadors were few).

219. 54 Bankr. 489, 495-96 (Bankr. N.D. Tex. 1985) (involving real estate debtors).

220. *See id.* at 496-97. The court noted that reconciliation of accounts could be done on a property, but not a partnership, basis. Such an absence of consolidation would allow secured creditors to reach rents generated from specific real estate properties. *See id.* at 497.

221. *See supra* notes 55, 56, and accompanying text.

222. 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[3], at 1100-46. Cases consolidating debtors with nondebtors include *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941), and *In re Tureaud*, 59 Bankr. 973 (Bankr. N.D. Okla. 1986).



tion through consolidation with a bankrupt affiliate, further threatening the solvent entity's creditors.<sup>223</sup> The Supreme Court in *Sampsel v. Imperial Paper & Color Corp.*<sup>224</sup> noted that the creditors of the nondebtor would be entitled to satisfy their claims out of the nondebtor's assets before any participation by the creditors of the debtor. Finally, in order to fulfill procedural due process requirements, the bankruptcy court may not take any action that would prejudice the creditors of the nondebtor without giving them an opportunity to be heard.<sup>225</sup>

### E. Appellate Standard of Review

United States district courts have jurisdiction to hear appeals from final judgments, orders, and decrees from interlocutory orders of bankruptcy judges entered in core and noncore proceedings.<sup>226</sup> Appeals in bankruptcy cases generally reach the courts of appeals through 28 U.S.C. section 158(d).<sup>227</sup> In core proceedings, the bankruptcy judge's conclusions of law are subject to de novo review, but findings of fact merely are subject to a clearly erroneous standard.<sup>228</sup>

In *In re Tureaud*<sup>229</sup> the court addressed the standard of review re-

223. Seligson & Mandell, *supra* note 35, at 346. "In that situation all that the trustee should be entitled to recover should he the equity in the related entity and that could well be obtained without forcing that entity into a pending bankruptcy proceeding." *Id.*

224. 313 U.S. 215, 219 (1941).

225. Seligson & Mandell, *supra* note 35, at 345; see also Comment, *Substantive Consolidation: The Back Door to Involuntary Bankruptcy*, 23 SAN DIEGO L. REV. 203, 210 (1986) (expressing due process concerns of nondebtors).

226. 28 U.S.C. § 158(a) (Supp. V 1987); see S. SNYDER & L. PONOROFF, *COMMERCIAL BANKRUPTCY LITIGATION* § 4.01, at 4-1, -2 (1989). Core proceedings include those that affect liquidation of the estate or adjustment of the debtor-creditor relationship. See 28 U.S.C. § 157(b)(2)(A)-(O) (Supp. V 1987); see also *infra* notes 230, 231, and accompanying text.

227. The statute states: "The courts of appeals shall have jurisdiction of appeals from all final decisions, judgments, orders, and decrees entered under subsections (a) and (b) of this section." 28 U.S.C. § 158(d) (Supp. V 1987); see *United States v. Nicolet, Inc.*, 857 F.2d 202, 204 (3d Cir. 1988). The procedural rules governing appeals differ based on the court to which the appeal is brought. Appeals from bankruptcy courts to district courts are governed by Part VIII of the Bankruptcy Rules. S. SNYDER & L. PONOROFF, *supra* note 226, § 4.03, at 4-26. Appeals to the courts of appeals are governed by the Federal Rules of Appellate Procedure. *Id.* An appeal in a core proceeding is commenced by filing a notice of appeal in conformity with Bankruptcy Rule 8001(a). *Id.* § 4.03[1], at 4-27. Bankruptcy Rule 8002(a) requires that the notice of appeal be filed within ten days from the judgment or order that is the subject of appeal. BANKR. R. 8002(a); S. SNYDER & L. PONOROFF, *supra* note 226, § 4.03[2], at 4-30.

228. BANKR. R. 8013; S. SNYDER & L. PONOROFF, *supra* note 226, § 4.03[3], at 4-38. Both factual findings and conclusions of law in a noncore proceeding are reviewed de novo. See *In re Production Steel, Inc.*, 48 Bankr. 841, 844 (Bankr. M.D. Tenn. 1985). *But cf.* S. SNYDER & L. PONOROFF, *supra* note 226, § 2.04, at 2-18 to -19 (noting that although bankruptcy judge's factual findings in noncore proceedings may be reviewed de novo, "the district judge is not likely to receive new evidence and normally accepts the bankruptcy judge's findings if supported by the record").

229. 59 Bankr. 973, 975 (Bankr. N.D. Okla. 1986).

quired of district courts in substantive consolidation cases. The court addressed the distinction between core and noncore bankruptcy proceedings discussed in section 157 of the Bankruptcy Amendments and Federal Judgeship Act of 1984 and concluded that a substantive consolidation order may be characterized as a core proceeding pursuant to section 157(b)(2)(O).<sup>230</sup> Core proceedings primarily include those that affect liquidation of the estate or adjustment of the debtor-creditor relationship.<sup>231</sup> Therefore, the court deferred to the bankruptcy court's decision that the proceeding was a core proceeding and held that the bankruptcy court's order should be reviewed under the clearly erroneous standard for findings of fact and the de novo standard for conclusions of law.<sup>232</sup>

#### F. Consolidation Pursuant to a Plan of Reorganization

Consolidation may be achieved by an express proposal in a reorganization plan.<sup>233</sup> Through reorganization plans, debtors seek approval for substantive consolidation from the creditors that vote on the plan. Because of the growth of conglomerates and the increasing number of interconnected corporations, more reorganizations likely will involve substantive consolidation.<sup>234</sup> Critically, creditors who oppose a plan's proposal of substantive consolidation must timely object to the proposal during the plan's confirmation hearing. Because the creditor in *In re Sweetwater*<sup>235</sup> failed to object to a proposal for substantive consolidation in the bankruptcy court, the creditor was precluded from raising the objection on appeal.

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230. See *id.* 28 U.S.C. § 157(b)(2)(O) states that "[c]ore proceedings include . . . proceedings affecting the liquidation of the assets of the estate . . ." 28 U.S.C. § 147(b)(2)(O) (Supp. V 1987). The bankruptcy judge must determine whether a proceeding is core or noncore. See *id.* § 157(b)(3); S. SNYDER & L. PONOROFF, *supra* note 226, § 2.04, at 2-19. The *Tureaud* court noted that the bankruptcy judge determined that the consolidation proceeding was a core proceeding. This finding was bolstered by the fact that a final order was entered in the bankruptcy court rather than a mere submission of proposed findings of fact and conclusions of law. Such submissions are required for noncore proceedings. See 28 U.S.C. § 157(c)(1) (Supp. V 1987).

231. See *supra* note 226; see also *In re Wood*, 825 F.2d 90, 97 (5th Cir. 1987) (distinguishing core from noncore proceedings).

232. *Tureaud*, 59 Bankr. at 975.

233. See B. WEINTRAUB & A. RESNICK, *supra* note 25, ¶ 8.16, at 8-77; see, e.g., *In re Apex Oil Co.*, 101 Bankr. 92, 94 (Bankr. E.D. Mo. 1989); *supra* notes 134, 135, and accompanying text; see also *supra* note 50 (discussing reorganization plans within the Bankruptcy Code).

234. B. WEINTRAUB & A. RESNICK, *supra* note 25, ¶ 8.16, at 8-78. Substantive consolidation most often arises in multicorporate petitions. R. AARON, BANKRUPTCY LAW FUNDAMENTALS, § 2.04[3], at 2-26 (1989).

235. 57 Bankr. 354, 359 (Bankr. D. Utah 1985). Like final judgments, confirmed plans of reorganization are binding on all parties, and issues that could have been raised pertaining to such plans are barred by the doctrine of res judicata. *In re Silver Mill Frozen Foods, Inc.*, 23 Bankr. 179, 183 (Bankr. W.D. Mich. 1982); see *In re Sanders*, 81 Bankr. 496, 498 (Bankr. W.D. Ark. 1987).

Section 1122(a) of the Bankruptcy Code restricts the classification of creditors under a plan of reorganization.<sup>236</sup> If the relative rights and priorities of two classes of creditors are the same, the plan may not treat the classes differently unless both classes accept the plan, or the proposed treatment provides each class with property having substantially equal value.<sup>237</sup> In a substantive consolidation case, however, a creditor originally having a claim against a more solvent company may be entitled to more favorable treatment under the plan than a creditor with a claim against a less solvent entity, notwithstanding that the two claims have equal rights and priorities.<sup>238</sup>

Unless a reorganization plan proposing substantive consolidation receives unanimous approval from the creditors, the court must make an independent determination of whether consolidation is appropriate.<sup>239</sup> If approved, a plan of reorganization could eliminate accounting and litigation expenses necessary to straighten debtor affairs and financial records. Conversely, without disentangled records, the bankruptcy court will have difficulty ascertaining whether Bankruptcy Code section 1129(a)(7) is satisfied because the court will be required to determine what each creditor would receive in a Chapter 7 liquidation absent consolidation.<sup>240</sup>

Commentators recognize that section 1129(b)'s unfair discrimination test may present problems in a case concerning the substantive consolidation of two debtors, one of which has issued subordinated debt.<sup>241</sup> The commentators note that whether the unsecured debt of the

236. 11 U.S.C. § 1122(a) (1982).

237. 5 COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 90.10[5], at 90-184 to -185 (S. Herzog and L. King 1981).

238. Both may be general unsecured claims. *Id.* ¶ 90.10[5], at 90-185 n.37; see also *In re Interstate Stores, Inc.*, 15 Collier Bankr. Cas. (MB) 634, 642-43 (Bankr. S.D.N.Y. 1978).

239. 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.06[4], at 1100-46 to -47.

240. *Id.* at 1100-47. Section 1129(a)(7) of the Code states:

(a) The court shall confirm a plan only if all of the following requirements are met:

. . . .

(7) With respect to each impaired class of claims or interests—

(A) each holder of a claim or interest of such class—

(i) has accepted the plan; or

(ii) will receive or retain under the plan . . . property of a value . . . that is not less than the amount that such holder would so receive . . . under [C]hapter 7 . . . .

11 U.S.C. § 1229(a)(7) (1982 & Supp. V 1987).

241. See Fortgang & Mayer, *Valuation in Bankruptcy*, 32 UCLA L. Rev. 1061, 1125 (1985). Section 1129(b)(1) states:

[I]f all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court . . . shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

11 U.S.C. § 1129(b)(1) (1982).

consolidated corporation is entitled to the subordination provisions is not clear. Subordinated debenture holders presumably bargain for subordination to the debt of only one corporation.<sup>242</sup> If the terms of debenture holders' indenture permit a merger, however, they arguably are not affected adversely by substantive consolidation.<sup>243</sup>

### G. Tactical Use of Substantive Consolidation

#### 1. Use by Attorneys to Assure Payment of Fees

The court in *In re Parkway Calabasas, Ltd.*<sup>244</sup> expressed surprise about the frequent lack of objection to motions for substantive consolidation. Unsecured creditors typically comprise the group that fails to object. The court reasoned that this class of creditors likely has lost hope or interest by the time a bankruptcy proceeding advances to the point when substantive consolidation is requested.<sup>245</sup>

The court skeptically proposed, however, that more sinister reasons for a lack of objection may be present. The court noted that often but a single trustee, a single law firm representing the trustee, a single committee of unsecured creditors, and a single law firm representing this committee exist.<sup>246</sup> This situation creates a "hopelessly irresolvable" conflict of interest on a motion for substantive consolidation.<sup>247</sup> Curiously, the court noted, the attorneys are not immobilized by the conflict. Rather, they usually support a motion for consolidation.<sup>248</sup> The court feared, therefore, that support for consolidation was motivated by the selfish purpose of assuring payment for fees incurred while performing services for an administratively insolvent estate.<sup>249</sup>

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242. Fortgang & Mayer, *supra* note 241, at 1125.

243. *See id.*

244. 89 Bankr. 832 (Bankr. C.D. Cal. 1988).

245. *Id.* at 835 n.3. Nevertheless, the unsecured creditors' committees and counsel actively should be seeking the best interests of the "disillusioned creditors" and scrutinizing the effect of substantive consolidation for possible unfairness. *Id.*

246. *Id.*

247. *Id.* Because a particular debtor may have a cause of action against any of its affiliates, a common trustee for an affiliated group faces a conflict of interest. Substantive consolidation would appear to resolve this conflict by combining the assets and liabilities of the affiliates. Substantive consolidation, however, may benefit one creditor group at the expense of another and a trustee's recommendation for substantive consolidation "creates a conflict of interest in and of itself." 5 COLLIER ON BANKRUPTCY, *supra* note 5, ¶ 1100.07, at 1100-50.

248. *Parkway Calabasas*, 89 Bankr. at 835 n.3.

249. *Id.* As a penalty for this conflict, the court suggested a reduction or complete denial of compensation. *Id.* For a recent administrative consolidation case denying fees to attorneys who were not disinterested, see *In re Petro-Serve, Ltd.*, 97 Bankr. 856 (Bankr. S.D. Miss. 1989).

## 2. The Government As a Lien Creditor or Priority Holder

The United States successfully argued for consolidation in *Chemical Bank New York Trust Co. v. Kheel*.<sup>250</sup> The Government, a creditor holding a statutory tax lien, feared the depletion of available assets if attempts were made to unscramble the debtors' financial affairs.<sup>251</sup> Because of the United States' enhanced tax lien status, Judge Friendly was unimpressed with the Government's argument for equality among creditors.<sup>252</sup> Nevertheless, the majority approved consolidation on the unprecedented basis of accounting difficulties.<sup>253</sup>

Similarly, the FDIC argued successfully against consolidation in *In re Gulfco Investment Corp.*<sup>254</sup> The FDIC recognized that absent consolidation, it would recover one hundred percent if allowed to pursue a subsidiary guarantee. In a consolidation, however, the FDIC would be relegated to an unsecured status and would recover only twenty percent of its claim.<sup>255</sup>

## 3. Other Tactical Uses

Substantive consolidation may be used tactically to achieve what bankruptcy otherwise would deny. In *In re Steury*<sup>256</sup> substantive consolidation was used by the trustee to bring exempt property into the bankruptcy estate. Similarly, in *In re Parkway Calabasas, Ltd.*<sup>257</sup> the substantive consolidation of two debtors effected a merger of the two and eliminated what would have been a fraudulent transfer. The court in *Unsecured Creditors Committee v. Leavitt Structural Tubing*<sup>258</sup> suggested that a committee of creditors could have sought substantive consolidation in order to give the committee standing to bring an appeal from an order approving a plan of reorganization. Finally, the court in *In re S.I. Acquisition, Inc.* suggested substantive consolidation as a

250. 369 F.2d 845 (2d Cir. 1966); see *supra* notes 112-23 and accompanying text.

251. See Berry, *supra* note 2, at 359.

252. "[T]he argument for equality has a specially hollow ring when made by the United States whose priority over other creditors will necessarily be enhanced by having the assets of all these corporations thrown into [the] hotchpot." *Kheel*, 369 F.2d at 848 (Friendly, J., concurring).

253. *Id.* at 847; see *supra* note 114 and accompanying text.

254. 593 F.2d 921 (10th Cir. 1979).

255. *Id.* at 925; see also *supra* notes 146-55 and accompanying text (discussing *Gulfco*).

256. 94 Bankr. 553 (Bankr. N.D. Ind. 1988); see *supra* notes 172-84 and accompanying text.

257. 89 Bankr. 832, 839 (Bankr. C.D. Cal. 1988). The merger of the debtors would eliminate both the harm to one and the unjust enrichment of the other. The harm to debtor Granada's creditors would be eliminated because the asset pool available to pay them would be increased by the addition of debtor Phase I's assets to the pool, including the "enrichment" payment to Phase I. *Id.*; see also *supra* notes 196-207 and accompanying text (discussing preferences).

258. 55 Bankr. 710, 711-12 (Bankr. N.D. Ill. 1985). Because the case involved merely procedural consolidation and the committee could not demonstrate that it was an "aggrieved person" with the right to appeal, the committee's appeal was dismissed. *Id.*

means to bring defendants in a state court action into the bankruptcy proceeding when court action otherwise would be precluded by bankruptcy's automatic stay.<sup>259</sup>

#### V. CONCLUSION

Substantive consolidation in bankruptcy is a powerful tool. Yet, for a doctrine that affects so vitally the substantive rights of creditors and debtors, the Bankruptcy Code provides scant statutory guidance governing substantive consolidation's application. But because substantive consolidation requires careful analysis of rights, interests, and factual predicates, perhaps the courts may best determine on an ad hoc basis when and how far substantive consolidation will be applied.

With the increased use of complex corporate structures, substantive consolidation likely will appear more frequently in reorganization plans and bankruptcy litigation. Debtors, creditors, incorporators, and their respective affiliates and attorneys should be apprised of substantive consolidation's efficacy in order to plan for a more profitable and predictable operation of business affairs. But substantive consolidation is not an ill-defined trap to be feared. Certain enterprises and their related affiliates may be suited for consolidation. Debtors, creditors, and courts are best served by knowing and following the proper analysis to determine the propriety of substantive consolidation in each case. Creditors can find assurance in the courts' careful practice to grant requests for consolidation only in terms consistent with the provisions of the Bankruptcy Code.

*J. Stephen Gilbert\**

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259. See *In re S.I. Acquisition, Inc.*, 817 F.2d 1142, 1154 n.13 (5th Cir. 1987).

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