When Is it Too Late for Substantive Consolidation?

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Ross S. Barr and Mark G. Douglas

The substantive consolidation of two or more entities is an important tool available to a bankruptcy court overseeing the cases of related entities whose financial affairs are hopelessly entangled or whose separate corporate identities otherwise have been disregarded by those in control or the companies' creditors. In deciding whether to consolidate two or more estates, a court must conduct a factually intensive inquiry and carefully balance the competing concerns of all interested parties. Most courts acknowledge that the remedy should be invoked only under narrowly defined circumstances, given the significant potential for prejudice to creditors and other stakeholders in a bankruptcy case.

A bankruptcy court's discretion in directing the substantive consolidation of legally-constituted entities or individuals is broad — it may extend to the consolidation of debtors with non-debtors, or retroactive consolidation of entities to a point in time preceding a consolidation request. Even so, as demonstrated by a ruling recently handed down by the Fifth Circuit Court of Appeals, such discretion is not unlimited. In *In re Amco Insurance*, the Court of Appeals held that the bankruptcy court abused its discretion in *nunc pro tunc* substantively consolidating a debtor corporation with its non-debtor sole shareholder because the court had previously authorized a secured creditor of both entities to pursue its remedies against the shareholder in state court.

Substantive Consolidation

The bankruptcy court is a court of "equity." Although the distinction between courts of equity and courts of law largely has become irrelevant in modern times, courts of equity traditionally have been empowered to grant a broader spectrum of relief in keeping with fundamental notions of fairness as opposed to principles of black-letter law. As explained by the U.S. Supreme Court nearly 70 years ago, this means that a bankruptcy court can exercise its discretion to produce fair and just results, "to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." The remedies available to a bankruptcy court in exercising this broad equitable mandate include the power to invalidate pre-bankruptcy transfers that are fraudulent or preferential, the ability to "pierce the corporate veil" if a subsidiary is nothing more than its parent's "alter ego," and the power to reorder the priority of claims or interests in cases of misconduct.

A bankruptcy court also can treat the assets and liabilities of two or more separate but related entities as inhering to a single integrated bankruptcy estate. In this case, creditors of each of the entities involved look to the common pool of assets for satisfaction of their claims. This remedy is referred to as "substantive consolidation."

The Bankruptcy Code does not expressly authorize substantive consolidation (although it recognizes that a chapter 11 plan may provide for the consolidation of a "debtor with one or more persons" as a means of implementation). Rather, substantive consolidation is a product of judicial gloss. Courts generally find authority for the remedy in the broad equitable powers conferred in section 105(a) of the Bankruptcy Code, which authorizes the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the

Bankruptcy Code. However, because of the dangers of forcing creditors of one entity to share equally with creditors of a less solvent debtor, courts generally hold that it is to be used sparingly and have labeled substantive consolidation an "extraordinary remedy."

Courts disagree as to whether the remedy can be exercised to consolidate debtors with non-debtors. The majority rule favors the practice under appropriate circumstances, with the caveat that increased caution should be exercised in assessing the propriety of the remedy. Some courts hold otherwise, citing jurisdictional concerns and/or ruling that substantive consolidation should not be used to circumvent the involuntary bankruptcy petition procedures of the Bankruptcy Code. Finally, some bankruptcy courts have ordered substantive consolidation of two different entities retroactive to a date preceding the date of the request (*nunc pro tunc*).

The Standard for Substantive Consolidation

Different standards have been employed by courts to determine the propriety of substantive consolidation. Common to all of these tests is a fact-intensive examination and an analysis of consolidation's impact on creditors. For example, in *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, the Eleventh Circuit adopted a modified version of the standard articulated by the District of Columbia Circuit in *In re Auto-Train Corp., Inc.*, under which the proponent of consolidation must demonstrate that (i) there is substantial identity between the entities to be consolidated, and (ii) consolidation is necessary to avoid some harm or to realize some benefit.

Factors that may be relevant in satisfying the first requirement include:

(1) fraud or other complete domination of the corporation that harms a third party;

(2) the absence of corporate formalities;

(3) inadequate capitalization of the corporation;

(4) whether funds are put in and taken out of the corporation for personal rather than corporate purposes;

(5) overlap in ownership and management of affiliated corporations;

(6) whether affiliated corporations have dealt with one another at arm's length;

(7) the payment or guarantee of debts of the dominated corporation by other affiliated corporations;

(8) the commingling of affiliated corporations' funds; and

(9) the inability to separate affiliated corporations' assets and liabilities.

The Second Circuit established a somewhat different standard for gauging the propriety of substantive consolidation in *In re Augie/Restivo Baking Co., Ltd.* There, the Court concluded that the factual elements considered by the courts are "merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."

The *Augie/Restivo* test recently was adopted by the Ninth Circuit in *In re Bonham*. Many other circuit and lower courts have adopted tests similar to the *Augie/Restivo* and *Eastgroup* standards. The Third Circuit recently addressed the question for the first time in *In re Owens Corning*, reversing a bankruptcy court order authorizing the deemed consolidation of the estates of a parent company and its subsidiaries that effectively nullified inter-company guarantees. In doing so, the Third Circuit opted for an "open ended, equitable inquiry" rather than the factor-based analysis employed by many courts.

Retroactive Substantive Consolidation in *AMCO Insurance*

In September 2000, automobile insurance broker Rehmat A. Peerbhai approached a bank seeking financing both for himself and on behalf of AIG Corp., an auto insurance company of which he was the sole shareholder. The bank agreed to extend financing to both, but required Peerbhai to guarantee the loan to AIG. When AIG materially breached the loan agreement, the bank sued in state court to enforce its rights both under the loan agreement and the guarantee.

AIG filed a chapter 7 petition on February 4, 2002. Thereafter, the bankruptcy court approved an agreement between the bank and the chapter 7 trustee modifying the automatic stay to allow the state court litigation to proceed against Peerbhai. The bank and Peerbhai reached a settlement shortly thereafter under which Peerbhai confessed to a judgment secured by a lien on his residence.

Three months later, the chapter 7 trustee sought bankruptcy court authority to substantively consolidate AIG and Peerbhai, retroactively effective as of the date that AIG filed for bankruptcy. Although Peerbhai was not a debtor in bankruptcy at that time, he later filed a chapter 11 petition and his bankruptcy case was converted to a chapter 7 liquidation.

The bankruptcy court ruled that substantive consolidation was appropriate because Peerbhai had, among other things, used AIG as his alter ego to commit fraud against his creditors. Additionally, the court reasoned that: (1) substantive consolidation would benefit all creditors and not unfairly prejudice any creditor because the financial affairs of AIG and Peerbhai were so entangled that the assets of each could not be segregated; (2) substantive consolidation would avoid the harm of AIG's creditors receiving virtually nothing in the bankruptcy case due

primarily to Peerbhai's looting of AIG; (3) the bank would not be unfairly harmed by substantive consolidation due to its knowledge of the circumstances surrounding the execution of the settlement agreement; (4) the fact that the parties were essentially a single financial entity could not have been ignored by the bank or any other reasonably diligent party extending credit to Peerbhai; and (5) substantive consolidation should be effective as of AIG's petition date because at all relevant times Peerbhai and AIG operated as one financial entity. The ruling effectively invalidated the authority conferred by the bankruptcy court upon the bank nearly twenty months earlier because *nunc pro tunc* consolidation would nullify any liens granted under the settlement agreement.

Following an unsuccessful appeal to the district court, the bank appealed the ruling to the Fifth Circuit. The Court of Appeals noted that the bankruptcy court's order modifying the automatic stay caused the bank to expend significant time and money prosecuting the state court litigation and reaching a settlement. Moreover, the Fifth Circuit emphasized, by requesting that the consolidation be effective as of AIG's petition date (so that the bank would be returned to its pre-settlement status), the chapter 7 trustee sought to undo what he had earlier authorized. According to the Court of Appeals, "[w]e think it was a little late for this reversal of course."

Although section 105(a) grants bankruptcy courts certain equitable powers, the Fifth Circuit cautioned that such power is not unlimited and does not "permit courts to act as roving commissions to do equity." It held that the bankruptcy court erred in applying substantive consolidation retroactively because the bank invested time and money pursuing a settlement based on the trustee's acquiescence in modifying the stay and because "nothing in the record

suggest[ed] that the trustee knew anything more at the later date when he asked the court to grant substantive consolidation than he reasonably could have known at the time the agreed order was entered into."

Analysis

Substantive consolidation of affiliated debtors' estates in a negotiated plan of reorganization as a means of simplifying a complicated corporate structure is not uncommon, particularly as corporate structures increasingly are driven by tax considerations that may cease to become viable once an affiliated network of companies files for bankruptcy. As illustrated by *AMCO Insurance*, substantive consolidation in contexts other than a negotiated consensual chapter 11 plan is much less common, and demands careful examination of the impact that consolidation will have on all stakeholders in the bankruptcy case.

The Fifth Circuit's ruling also demonstrates that although a bankruptcy court has considerable discretion to order substantive consolidation, such discretion is not unfettered, particularly in cases involving the consolidation of non-debtors and/or retroactive consolidation. If the circumstances demonstrate that substantive consolidation would be fundamentally unfair or otherwise prejudicial due to events that have occurred during the course of the bankruptcy case, a consolidation order may be open to challenge. Finally, *AMCO Insurance* illustrates the importance of strategic planning during a bankruptcy case — every stakeholder should carefully consider the possible ramifications of taking a position that may later compromise its ability to seek certain kinds of relief from the court.

Interestingly, the Fifth Circuit declined to address the bank's argument that a bankruptcy court's power to order consolidation was effectively eliminated by the U.S. Supreme Court's 1999 ruling in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, where the Court ruled that a preliminary injunction issued to prevent a possible fraudulent transfer of assets is an improper use of a federal court's equity powers. The court below had found *Grupo Mexicano* to be inapposite because it did not involve the remedy of substantive consolidation and was otherwise factually distinguishable. The Fifth Circuit confined its ruling to the impropriety of *nunc pro tunc* consolidation under the circumstances, observing that "[g]iven that the order of substantive consolidation, in the absence of a *nunc pro tunc* order, appears likely to be fruitless, there is the probability that the issue will not arise on remand."

Wells Fargo Bank of Texas N.A. v. Sommers (In re Amco Insurance), 444 F.3d 690 (5th Cir. 2006).

Pepper v. Litton, 308 U.S. 295 (1939).

Eastgroup Properties v. Southern Motel Assoc., Ltd., 935 F.2d 245 (11th Cir. 1991).

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

Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.), 860 F.2d 515 (2d Cir. 1988).

In re Bonham, 229 F.3d 750 (9th Cir. 2000).

In re Owens Corning, 419 F.3d 195 (3d Cir. 2005).

Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308 (1999).