

Substantive Consolidation and Nondebtor Entities: The Fight Continues

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Although it has been described as an “extraordinary remedy,” the ability of a bankruptcy court to order the substantive consolidation of related debtor-entities in bankruptcy (if circumstances so dictate) is relatively uncontroversial, as an appropriate exercise of a bankruptcy court’s broad (albeit nonstatutory) equitable powers. By contrast, considerable controversy surrounds the far less common practice of ordering consolidation of a debtor in bankruptcy with a nondebtor.

Whether a bankruptcy court has the power to grant this remedy was the subject of an important ruling recently handed down by a Florida bankruptcy court. In *In re S & G Fin. Servs. of S. Fla., Inc.*, the court denied a motion to dismiss a chapter 7 trustee’s complaint seeking to substantively consolidate a debtor and two of its nondebtor affiliates. The court ruled that “it is well within this Court’s equitable powers to allow substantive consolidation of entities under appropriate circumstances, whether or not all of those entities are debtors in bankruptcy” and that “this Court has jurisdiction over non-debtor entities to determine the propriety of an action for substantive consolidation insofar as the outcome of such proceeding could have an impact on the bankruptcy case.”

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 that preceded enactment of the Bankruptcy Code in 1978. Today, 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.”

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 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 addressed the issue for the first time in *In re Owens Corning*, opting for an “open ended, equitable inquiry” rather than a factor-based analysis, as employed by many courts.

Consolidation of Debtors and Nondebtors?

Courts disagree as to whether the remedy can be exercised to consolidate debtors with nondebtors. The majority rule permits such a consolidation 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.

A bankruptcy court's substantive consolidation of entities not in bankruptcy has been vigorously critiqued, and criticisms have been based on a range of issues, from a lack of authority under the Bankruptcy Code to constitutional due process. One commentator, Kurt Mayr, has posited that every court decision applying substantive consolidation to nondebtors is based on the assumption that the "federal equity power can be used to expand the scope of 'property of the debtor's estate' to include non-debtor assets where the elements of substantive consolidation are satisfied." According to Mayr, this assumption is faulty because it directly contradicts the Supreme Court's mandate in *Butner v. U.S.* that the "basic federal rule is that state law governs" property interests in bankruptcy.

At the time his article was published in 2007, Mayr noted that the *Butner* argument had apparently not been presented to any court considering substantive consolidation with regard to nondebtor entities. This changed in *S & G*.

S & G

For the five-year period prior to filing for chapter 7 protection in Florida in March 2010, S & G Financial Services of South Florida, Inc. (the "Debtor"), was engaged in the business of making short-term mortgage loans. To finance its mortgage-lending activities, the Debtor obtained funding from various "investors." These investors were individuals or entities to whom the Debtor offered attractive potential returns and security on their investments in the form of full or partial assignments of the mortgages the Debtor originated. At the time of its filing, Jorge Galceran was the sole officer, director, and shareholder of the Debtor. In addition, Galceran was

the sole member and manager of two limited liability companies: S & G Financial Services, LLC (“S & G”), and Merrick Financial Group, LLC (“Merrick”).

Prior to the petition date, one of the Debtor’s investors obtained a judgment against the Debtor for approximately \$850,000. The investor later caused writs of garnishment to be served on two of the Debtor’s banks, resulting in the freezing of the Debtor’s accounts. Subsequently, S & G opened a bank account at a separate institution and began depositing checks payable to the Debtor into that account. Galceran also instructed certain of the Debtor’s mortgagors to make checks payable to Merrick in order to circumvent the writs of garnishment.

Once in bankruptcy, the chapter 7 trustee filed an adversary proceeding seeking, in separate counts, to substantively consolidate the Debtor with nondebtors S & G and Merrick. The complaint alleged that because Galceran diverted assets of the Debtor to S & G, the Debtor’s financial statements were inaccurate as to receivables owed to the Debtor. Further, the trustee alleged that S & G had no legitimate business purpose independent of the Debtor and that because the finances of the Debtor were so intermingled with those of S & G and Merrick, equity dictated that the nondebtor entities should be substantively consolidated with the Debtor.

The defendants moved to dismiss, arguing that section 105 of the Bankruptcy Code is not a source of authority for establishing jurisdiction over a nondebtor entity. The defendants asserted that allowing the substantive consolidation of the nondebtors with the Debtor would amount to allowing the rule of equity to redefine the defendants’ property interests, which should be defined by reference to state law under *Butner*. Furthermore, they argued, the trustee could

utilize sections 303 (involuntary petitions) and 548 (avoidance of fraudulent transfers) of the Bankruptcy Code to achieve the same results against S & G and Merrick, without resorting to substantive consolidation.

The Bankruptcy Court's Decision

The bankruptcy court ruled that the chapter 7 trustee had adequately pled a cause of action for substantive consolidation so as to survive a motion to dismiss. The court found that it had jurisdiction to consider the substantive consolidation of nondebtor entities with the Debtor and that it was well within the court's equitable powers to allow substantive consolidation of entities under appropriate circumstances, whether or not all of those entities are debtors in bankruptcy.

Acknowledging that the federal courts are split on the issue, the *S & G* court noted that, among the circuit courts of appeal, only the Ninth Circuit—in *In re Bonham*—has held that a court may order substantive consolidation of debtor and nondebtor entities. Other circuit courts, however, have implicitly acknowledged a bankruptcy court's authority to consolidate debtor and nondebtor entities. Moreover, the *S & G* court cited to bankruptcy-court rulings in Florida and Georgia (and elsewhere) that have expressly recognized a bankruptcy court's ability to substantively consolidate a debtor with a nondebtor.

Like the Ninth Circuit in *Bonham*, the court in *S & G* relied on the precode U.S. Supreme Court ruling in *Sampsell v. Imperial Paper and Color Corp.* for the proposition that “equality of distribution” is the core of bankruptcy jurisprudence from which the theory of substantive consolidation emanates. In *Sampsell*, the bankruptcy referee had decided that the debtor formed a nondebtor corporation simply to continue the debtor's previously unincorporated business and

that prepetition transfers made to this “sham” corporation were fraudulent. The bankruptcy court in *Sampsell* ordered the corporation to be liquidated and the assets transferred to the debtor’s bankruptcy estate. Notably, however, this de facto consolidation of estates was not an issue before the Supreme Court, which granted certiorari to decide only the issue of the priority of a creditor’s claim as to the liquidated assets.

The *S & G* court distinguished seemingly adverse case law, noting that some courts have viewed the application of substantive consolidation to nondebtors as an impermissible use of the court’s equitable power to exercise jurisdiction over nondebtors without express statutory authority. In the *S & G* court’s view, such holdings mistakenly “conflat[e] jurisdiction with power.” In fact, the bankruptcy court clearly had jurisdiction to consider the substantive-consolidation issue because “the outcome of the proceeding could conceivably have an effect on the estate being administered in bankruptcy.” According to the court, whether section 105 authorized the relief requested is a separate issue, and one that is not logically parallel to the jurisdictional question.

The *S & G* court then addressed the defendants’ contention that it was in “conflict with the purposes of the Bankruptcy Code” to substantively consolidate nondebtors under section 105 when sections 303 and 548 of the Bankruptcy Code—as well as a veil-piercing theory under state law—were available to achieve the same effect. The court rejected this argument, holding that each doctrine is separate and distinct from substantive consolidation and should not be used as a replacement. First, compelling the trustee to file involuntary petitions against the defendants under section 303, which requires that the target entity be insolvent, would “defeat the very purpose of substantive consolidation,” which in this case was “to recover assets from a

financially sound affiliated entity.” Second, and similarly, the fraudulent-transfer requirements under section 548 invoke different legal principles and demand a showing of fraud or intent to hinder or delay creditors. Finally, unlike veil piercing, substantive consolidation does not require a finding that the nondebtor entities are alter egos of the debtor. In sum, the court concluded, substantive consolidation is simply a remedy in addition to, rather than an alternative for, involuntary bankruptcy petitions, avoidance of fraudulent transfers, and veil piercing.

Outlook

Commentators critical of the practice of substantively consolidating debtor entities with nondebtors have objected to reliance on *Sampsell* to justify the remedy. According to some critics, the Supreme Court in *Sampsell* merely decided an issue of claim priority with regard to nondebtor assets that had been liquidated and added to the debtor’s estate, and that the case should be viewed, at most, as a “tacit approval” of the substantive consolidation ordered by the bankruptcy court. Nevertheless, *S & G* describes *Sampsell* as “the seminal case on substantive consolidation.”

Interestingly, although the *S & G* court refers to the defendants’ *Butner* argument, *Butner* itself is not cited anywhere (let alone discussed) in the *S & G* decision. Instead, the court relies on *Sampsell* without even attempting to resolve the tension presented by the Supreme Court’s later decision in *Butner*. As such, *S & G* leaves to future courts the task of reconciling *Sampsell* and *Butner* with respect to consolidating debtor and nondebtor entities.

Kapila v. S & G Fin. Servs., LLC (In re S & G Fin. Servs. of S. Fla., Inc.), 2011 WL 96741 (Bankr. S.D. Fla. Jan. 11, 2011).

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

Kurt A. Mayr, *Back to Butner's Basic Rule—the Fundamental Flaw of Nondebtor Substantive Consolidation*, 16 Norton J. Bankr. L. & Prac., 77 (Feb. 2007).

Butner v. U.S., 440 U.S. 48 (1979).

Sampsell v. Imperial Paper and Color Corp., 313 U.S. 215 (1941).

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

Christopher J. Predko, *Substantive Consolidation Involving Non-Debtors: Conceptual and Jurisdictional Difficulties in Bankruptcy*, 41 Wayne L.R. 1741 (1994).