

SUBSTANTIVE CONSOLIDATION—A POST-MODERN TREND

TIMOTHY E. GRAULICH*

INTRODUCTION

The ability of creditors in bankruptcy to seek the "substantive consolidation" of the assets and liabilities of affiliated entities has been recognized for more than sixty years,¹ even though the doctrine has never been codified in any bankruptcy statute² (except in the limited case of spouses).³ Essentially, for purposes of distribution in bankruptcy, substantive consolidation treats multiple entities as if they were one.⁴ As a consequence, claimants can no longer recover on their claims from their original obligors; rather, claimants recover their ratable share of a common "hotchpot"⁵ consisting of the combined assets of the consolidated entities.

* Timothy E. Graulich is Counsel in the Corporate Department of Davis Polk & Wardwell. Davis Polk & Wardwell is counsel for the official committee of unsecured creditors in *In re Owens Corning*, Case No. 00-3837 (JKF) (Bankr. D. Del.), which the committee (being conflicted on the issue) took no position with respect to substantive consolidation in that case. The views expressed herein are solely the views of the author and do not necessarily represent the views of Davis Polk & Wardwell, or those parties or persons represented by Davis Polk & Wardwell.

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¹ In 1941, the Supreme Court (perhaps inadvertently) announced the birth of the doctrine when it held that the assets of an individual debtor could be "consolidated" with the assets of a corporation to which the individual had fraudulently transferred substantially all his assets. *See generally* *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941).

² Indeed, despite the sweeping breadth of the latest revisions to American bankruptcy law (*see* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23), there remains no statutory authority for substantive consolidation of corporate debtors in the current bankruptcy statute (*see* 11 U.S.C. §§ 101–1330 (2006) (the "Bankruptcy Code")). Nor was there any such provision in the Bankruptcy Code's predecessor statute. *See* Bankruptcy Act of 1898, Pub. L. No. 696, 30 Stat. 544 (1898) (the "Bankruptcy Act").

³ *See* 11 U.S.C. § 302(a) (2006) ("A joint case under a chapter of this title is commenced by the filing with the bankruptcy court of a single petition under such chapter by an individual that may be a debtor under such chapter and such individual's spouse."); *cf.* *Reider v. FDIC (In re Reider)*, 31 F.3d 1102, 1108–09 (11th Cir. 1994) (allowing substantive consolidation in spousal context, and finding consolidation should be generally allowed in cases where disentangling spousal estates is administratively difficult or specifically permitted only where proponent of consolidation meets exacting burden of proof); *In re Bippert*, 311 B.R. 456, 463–64 (Bankr. W.D. Tex. 2004) (stating substantive consolidation pursuant to section 302 should be allowed only when court finds substantial identity between financial affairs of spouses and, when based on equities of case, harm resulting from not allowing consolidation would outweigh ordering it).

⁴ *See* *FDIC v. Colonial Realty Co.*, 966 F.2d 57, 58 (2d Cir. 1992) ("The substantive consolidation of estates in bankruptcy effects the combination of the assets and the liabilities of distinct, bankrupt entities and their treatment as if they belonged to a single entity."); *see also* 2 COLLIER ON BANKRUPTCY ¶ 105.09[3] (Alan N. Resnick et al. eds., 15th ed. rev. 2006) ("In general, substantive consolidation results in the combination of the assets of both debtors into a single pool from which the claims of creditors of both debtors are satisfied ratably.").

⁵ *See* *Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.)*, 402 F.3d 416, 423 (3d Cir. 2005) ("Substantive consolidation treats separate legal entities as if they were merged into a single

Substantive consolidation provides a vital remedy for creditors who were wrongfully misled into extending credit to a debtor (usually because the debtor engaged in fraudulent conduct or otherwise misused its corporate form)⁶ or to do "rough justice" when the debtors' financial affairs are so commingled that it is impossible to unravel them without inflicting yet further economic injury on creditors.⁷ Notably, because of the *possibility* that innocent creditors could be harmed by consolidation (especially creditors of the debtor with the higher asset-to-liability ratio), every court of appeals to consider the issue has held that substantive consolidation is an "extraordinary" remedy that should rarely be invoked.⁸

Ironically, the future viability and enforceability of this vital remedy has been jeopardized by the evolution of a "modern" trend in favor of a "liberal" or more relaxed standard for application. Notwithstanding the appellate courts' repeated admonitions that substantive consolidation should be used only "sparingly," other decisions⁹—mostly bankruptcy court cases citing to unreported bankruptcy court

survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor."); *see also In re Owens Corning*, 419 F.3d 195, 205–09 (3d Cir. 2005) ("Consolidation restructures (and thus revalues) rights of creditors."); *Moran v. Hong Kong & Shanghai Banking Corp. (In re Deltacorp, Inc.)*, 179 B.R. 773, 777 (Bankr. S.D.N.Y. 1995) (eliminating multiple claims against consolidated debtors and allowing creditors only one recovery).

⁶ *See, e.g., Owens Corning*, 419 F.3d at 205 ("The concept of substantively consolidating separate estates begins with a commonsense deduction. Corporate disregard as a fault may lead to corporate disregard as a remedy."); *Soviero v. Franklin National Bank*, 328 F.2d 446, 448 (2d Cir. 1964) ("It is difficult to imagine a better example of commingling of assets and functions and of the flagrant disregard of corporate forms than as here demonstrated by the bankrupt."); *see also Mary Elizabeth Kors, Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381, 383 (1997) (discussing remedies for "corporate disregard").

⁷ *See, e.g., Chem. Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 848 (2d Cir. 1966) (finding equity allows consolidation, or "rough approximation of justice," in cases "where the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors"); *cf. In re Coles*, 14 B.R. 5, 6 (Bankr. D. Pa. 1981) (denying motion to consolidate because cases did not involve such a "hopelessly obscured interrelationship of debtors' debts").

⁸ *See, e.g., In re Bonham*, 229 F.3d 750, 767 (9th Cir. 2000) (revealing consolidation should be used "sparingly"); *Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)*, 860 F.2d 515, 518 (2d Cir. 1988) (indicating care should be taken in applying substantive consolidation); *Flora Mir Candy Corp. v. R.S. Dickson & Co. (In re Flora Mir Candy Corp.)*, 432 F.2d 1060, 1062 (2d Cir. 1970) (noting that substantive consolidation "is no mere instrument of procedural convenience . . . but a measure vitally affecting substantive rights"); *Kheel*, 369 F.2d at 847 ("The power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others."); *see also FDIC v. Hogan (In re Gulfcv Inv. Corp.)*, 593 F.2d 921, 928 (10th Cir. 1979) ("Consolidation has been used primarily when necessary to avoid fraud or injustice, but not for the purpose of promoting either or both.").

⁹ *See, e.g., In re Vecco Constr. Indus., Inc.*, 4 B.R. 407, 409 (Bankr. E.D. Va. 1980) (announcing liberal view toward substantive consolidation); *In re F.A. Potts & Co., Inc.*, 23 B.R. 569, 574 (Bankr. E.D. Pa. 1982) ("[S]ubstantive consolidation will inure generally to the benefit of the debtors and their creditors alike by helping the debtor to operate more efficiently and to file a feasible consolidated plan of reorganization."); *In re Richton Int'l Corp.*, 12 B.R. 555, 557 (Bankr. S.D.N.Y. 1981) (noting "the increased need for substantive consolidations occasioned by the interlocking directorates of modern corporations"); *In re Food Fair, Inc.*, 10 B.R. 123, 126 (Bankr. S.D.N.Y. 1981) (commenting on "increased need for substantive consolidation"); *In re Commercial Envelope Mfg. Co., Inc.*, No. 76-B-2354, 1977 WL 182366, at *4 (Bankr.

decisions—have announced a "liberal" or "modern" trend that would make substantive consolidation the rule, rather than the sparingly used exception described by the appellate decisions.

The adverse consequences of this liberal trend are numerous. First, the liberal-trend cases tend to be in direct conflict with a bedrock principle of American jurisprudence—corporate separateness. The core of the doctrine of corporate separateness is that legally distinct entities will be respected, unless the entities engaged in some form of misconduct.¹⁰ The liberal-trend cases turn this proposition on its head and essentially adopt a corporate enterprise theory (i.e., courts can treat affiliated entities engaged in a common enterprise as if they were one company). This result may often yield great utilitarian benefits, such as speed, streamlining creditor recoveries, eliminating often-thorny intercompany issues and avoiding time-consuming litigation. However, nowhere is it written that some creditors must sacrifice their economic and legal rights to make chapter 11 reorganizations more efficient. Moreover, even the chief virtue of substantive consolidation—equality of distribution—becomes vice if parties bargained for unequal treatment.¹¹

Second, the implementation of substantive consolidation often runs contrary to many settled creditor rights (including voting, distribution and priority rights) that, unlike substantive consolidation, are actually expressly codified in the Bankruptcy Code. While the occasional nullification of these rights may be appropriate and equitable in those rare cases in which either the debtors misled creditors (so that creditors had no legitimate expectation of any specific bankruptcy rights) or where all creditors will benefit from consolidation (so that creditors can be deemed to have consented to consolidation and to have waived these rights), it is manifestly inappropriate and inequitable to deprive creditors of these statutory rights based

S.D.N.Y. Aug. 22, 1977) (commenting upon cases in which consolidation was granted and stressing such facts which support remedy "seem to be ever present in this day of access to the Bankruptcy Court by parent companies and their multi-tiered subsidiaries"); *see also* Eastgroup Props. v. Southern Motel Assocs., Ltd., 935 F.2d 245, 249 (11th Cir. 1991) (adopting lax standard under which proponent of consolidation need only show "(1) there is substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid *some harm* or to realize *some benefit*" in order to establish prima facie case for consolidation); *Simon v. Brentwood Tavern, LLC (In re Brentwood Golf Club, LLC)*, 329 B.R. 802, 811 (Bankr. E.D. Mich. 2005) ("There is . . . a 'modern' or 'liberal' trend toward allowing substantive consolidation, due to the increased use of interrelated corporate structures for tax and other business purposes.").

¹⁰ *See, e.g.*, *United States v. Bestfoods*, 524 U.S. 51, 62 (1998) ("But there is an equally fundamental principle of corporate law . . . that the corporate veil may be pierced . . . when, *inter alia*, the corporate form would otherwise be misused to accomplish certain wrongful purposes . . ."); *Anderson v. Abbott*, 321 U.S. 349, 364 (1944) (finding doctrine of corporate separateness is "a principle of liability which is concerned with realities not forms"); *Chi., Milwaukee & St. Paul Ry. Co. v. Minneapolis Civic & Commerce Ass'n*, 247 U.S. 490, 501 (1918) (finding in light of corporate misconduct, courts will not "be blinded or deceived by mere forms or law but, regardless of fictions, will deal with the substance of the transaction involved as if the corporate agency did not exist and as the justice of the case may require.").

¹¹ *See Owens Corning*, 419 F.3d at 216 ("Substantive consolidation at its core is equity But it is hardly so for those creditors who have lawfully bargained [pre-petition] for unequal treatment by obtaining guarantees of separate entities."); *Kheel*, 369 F.2d at 848 (Friendly, J. concurring) ("Equality among creditors who have lawfully bargained for different treatment is not equity but its opposite . . .").

upon a supposed "liberal trend" in which consolidation is the rule, and not the rare exception. In fact, because bankruptcy courts may not use their general equitable powers to nullify specific provisions of the Bankruptcy Code, bankruptcy courts are without authority to implement the liberal trend. Relatedly, bankruptcy courts may not implement a liberal brand of consolidation because federal courts lack the ability to invent completely new and unprecedented equitable powers.¹²

Third, because liberal-trend cases tend to employ ad hoc balancing tests with a variety of different (and sometimes conflicting) factors, the application of substantive consolidation has become wholly unpredictable.¹³ For example, at least one court ordered consolidation to permit creditors of an *insolvent* company to be paid before the shareholders of its *solvent* affiliate¹⁴—a result that could never have been predicted in advance by the creditors or shareholders of either company. Similarly, another court¹⁵ ordered consolidation so that an administratively solvent estate could bear the costs of administration of its insolvent affiliate, thus intentionally reducing the recoveries of the administratively solvent company and fundamentally altering corporate law—again, a result that could not have been foreseen when creditors extended credit to the administratively solvent company.

The recent decisions in the *Owens Corning*¹⁶ cases provide both a real-world example of the dangers of the unchecked expansion of this liberal trend, and a blueprint for returning the doctrine to its traditional moorings—in other words, the framework for a post-modern trend that is both predictable and grounded in traditional principles.

Part I of this Article examines the doctrine of corporate separateness and the remedies for its abuse. Part II sets forth the evolution of substantive consolidation under the Bankruptcy Act, including key decisions from the Second Circuit. Part III analyzes substantive consolidation under the Bankruptcy Code, including

¹² See *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 322–23 (1999) (limiting equitable remedies "in the federal system" to "the broad boundaries of traditional equitable relief" because "[t]o accord a type of relief that has never been available before . . . [is] not [a rule] of flexibility but omnipotence"); see, e.g., *JSC Foreign Econ. Ass'n Technostroyexport v. Int'l Dev. and Trade Servs., Inc.*, 295 F.2d 366, 389 (S.D.N.Y. 2003) (explaining where "the plaintiff's action is one for money damages, and . . . the plaintiff asserts no lien or equitable interest in the assets it seeks to restrain, this Court lacks the power to grant the preliminary injunction it seeks"); *Dearborn Mid-West Conveyor Co., v. Pietrangelo*, No. 06-CV-14338, at *3 (E.D. Mich. Oct. 3, 2006) (relying on Supreme Court precedent "that historically, a court of equity could not issue such provisional relief [as the preliminary injunction requested] in the context of an action for money damages").

¹³ See *Kors*, *supra* note 6, at 384 ("Unfortunately, it is virtually impossible to predict when related entities will be consolidated."); see also *Nickless v. Avnet, Inc. (In re Century Elecs. Mfg., Inc.)*, 310 B.R. 485, 490 (Bankr. D. Mass. 2004) (referring to various circuit rulings each promoting different balancing tests); Felicia Ann Nadborny, Note, "Leap of Faith" into Bankruptcy: An Examination of the Issues Surrounding the Valuation of a Catholic Diocese's Bankruptcy Estate, 13 AM. BANKR. INST. L. REV. 839, 868–69 (2005) (identifying various consolidation tests applied by different bankruptcy courts).

¹⁴ See *In re Murray Indus., Inc.*, 119 B.R. 820, 832 (Bankr. M.D. Fla. 1990) (maintaining "[w]hile equity interest security holders are parties of interest, it is a generally accepted proposition that equitable sharing for the purpose of the Bankruptcy Code means an equitable sharing among creditors, not stockholders").

¹⁵ See generally *Eastgroup*, 935 F.2d at 250 (describing court's analysis of substantive consolidation).

¹⁶ 316 B.R. 168 (D. Del. 2004), *rev'd*, 419 F.3d 195 (3d Cir. 2005).

whether such doctrine survived the enactment of the Bankruptcy Code. Part IV examines the decisions by the district court and the Third Circuit in the *Owens Corning* chapter 11 cases, and identifies the fundamental flaws of the former and the merits of the latter. Finally, the conclusion submits that the Third Circuit's formulation of substantive consolidation in *Owens Corning* is consistent with substantive nonbankruptcy law and the Bankruptcy Code, enhances predictability and should be a template for the application of the doctrine in future cases.

I. CORPORATE SEPARATENESS AND REMEDIES FOR ITS ABUSE

Limited liability has been a hallmark¹⁷ of American¹⁸ corporate law since the mid-nineteenth century.¹⁹ "It is a general principle of corporate law deeply 'ingrained in our economic and legal systems' that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable

¹⁷ See, e.g., Kors, *supra* note 6, at 410 ("Limited liability, whatever its wisdom may be, is one of the fundamental ground rules of corporate law."); William O. Douglas & Carol M. Shanks, *Insulation from Liability through Subsidiary Corporations*, 39 YALE L.J. 193, 193–94 (1929) ("Limited liability is now accepted in theory and in practice. It is ingrained in our economic and legal systems. The social and economic order is arranged accordingly. Our philosophy accepts it. It is legitimate for a man or group of men to stake only a part of their fortune on an enterprise. Legislatures, courts and business usage made it so."); see also *On-Line Servs., Ltd. v. Bradley & Riley PC (In re Internet Navigator, Inc.)*, 301 B.R. 1, 6 (B.A.P. 8th Cir. 2003) ("[T]his Court is unwilling on this record to capsize the fundamental bulwark of corporate law that the corporate entity is separate and distinct from its individual members."). Indeed, the importance of limited liability is vital to the American economic system. See, e.g., *In re Kaiser*, 791 F.2d 73, 75 (7th Cir. 1986) ("The principle of limited liability, whereby a corporation's creditors cannot reach the personal assets of the shareholders (the shareholders' liability is limited to their investment in the corporation), is important to our capitalist system. It enables people to invest in business without hazarding their entire wealth on the venture. If it were not for limited liability, an investor who was risk averse would not invest equity capital in an enterprise that had debt, since if the enterprise failed its debts might exceed its assets; or would negotiate a waiver of personal liability with the lenders; or would charge a higher risk premium. He might insist that the enterprise buy insurance unlimited in amount (if this were possible) against any possible involuntary debt such as a large tort judgment. He might steer clear of equity investing altogether.").

¹⁸ Limited liability has far more ancient roots, including under Roman, Byzantine and Islamic laws. See, e.g., Timothy P. Glynn, *Beyond "Unlimiting" Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 VAND. L. REV. 329, 336–37 (2004) (describing ancient doctrines from Roman and Byzantine law permitting "participants to allocate liability in a variety of ways").

¹⁹ See, e.g., Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387, 415 (1992) (noting "[b]y 1850, most states had enacted statutes providing for limited liability"); see also Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimizing Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 141 (2004) (discussing evolution of modern corporate law); Paul Mahoney, *Contract or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873, 892–93 (2000) ("The benefits of treating a business as something separate from its owners are so obvious and overwhelming that it has never required substantial governmental assistance to achieve.").

for the acts of its subsidiaries."²⁰ Indeed, in corporate matters, "[l]imited liability is the rule, not the exception."²¹

A corollary of the doctrine of limited liability is that creditors of a particular entity are entitled to the value of that entity (and only that entity) in the event of non payment.²² Indeed, the United States Supreme Court has held that bankruptcy laws must provide for an "equitable distribution of the debtor's assets among his creditors."²³

Corporate separateness, however, has never been absolute. Multiple remedies predating substantive consolidation have evolved to rectify the misuse of the corporate form by closely-related entities. Five of the more notable of these remedies (veil-piercing, equitable subordination of insider claims or interests, recharacterization, avoidance of fraudulent conveyances to an insider and turnover) are discussed separately below. The unifying theme of each of these remedies is that an insider may not misuse the benefits of the corporate form unfairly to advantage itself at the expense of third parties.

A. *Veil-Piercing*

Under appropriate circumstances, a court can "pierce" the veil of a corporation, thus allowing a creditor of one entity to assert a claim directly against (and to reach the assets of) an affiliate of that entity.²⁴ The law of veil-piercing, which depends upon individual state law, is no easy remedy to achieve, and is generally deemed to

²⁰ *Bestfoods*, 524 U.S. at 61 (quoting Douglas, *supra* note 17); *see* *Burnet v. Clark*, 287 U.S. 410, 415 (1932) (holding "a corporation and its stockholders are generally treated as separate entities"); *cf.* Del. Code Ann. tit. 8, § 102(b)(6) (1974) (maintaining shareholders are not liable for debt of corporations "except as they may be liable by reason of their own conduct or acts").

²¹ *Anderson*, 321 U.S. at 362.

²² This concept has been incorporated into the Bankruptcy Code in the form of the "absolute priority rule," which requires, among other things, that dissenting creditors be paid in full before the owners of the debtor may retain or acquire any value with respect to their equity interests. 11 U.S.C. § 1129(b)(2)(B)(ii) (2006) (providing plan may be found to be fair and equitable with respect to any dissenting class if "the holder of any claim . . . junior to the claims of such class will not receive or retain under the plan on account of such junior claim . . . any property"); *see also* *Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 441 (1999) (holding absolute priority rule requires classes of creditors be paid in full before any junior class may receive or retain anything under plan); *Travelers Insurance Co. v. Bryson Props. (In re Bryson Props.)* 961 F.2d 496, 503 (4th Cir. 1992) (same).

²³ *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 451 (1937).

²⁴ *See* I. Maurice Wormser, *Piercing the Corporate Veil of Corporate Entity*, 12 COLUM. L. REV. 496, 517 (1912) ("When the conception of a corporate entity is employed to defraud creditors, to evade an existing obligation, to circumvent a statute, to achieve a perpetual monopoly, or to protect knavery or crime, the courts will draw aside the web of entity, will regard the corporate company as an association of live, up-and-doing, men and woman shareholders, and will do justice between real persons."); *see also* *Pauley Petroleum Inc. v. Cont'l Oil Co.*, 239 A.2d 629, 633 (Del. 1968) (asserting separate entities of parent and subsidiary may be disregarded if there is proper showing of fraud, public wrong or in interest of justice); *Martin v. D.B. Martin Co.*, 88 A. 612, 616 (Del. Ch. 1913) (holding that interest of justice requires legal fiction of distinct corporate entities to be disregarded).

be the rare exception and not the rule.²⁵ Indeed, the Supreme Court has held that "[t]he doctrine of piercing the corporate veil . . . is a rare exception applied in the case of fraud or certain other exceptional circumstances, and usually determined on a case-by-case basis."²⁶

Under the law of most states, veil-piercing (and the corresponding disregard of corporate separateness) is appropriate only when two entities "operated as a single economic entity such that it would be inequitable" for a court "to uphold a legal distinction between them."²⁷ Courts are loathe to make this determination and pierce a corporate veil absent either a showing of fraud or that the corporation is the alter ego of its owner.²⁸

B. *Equitable Subordination of Insider Claims or Interests*

The Bankruptcy Code specifically provides a remedy to deal with a claimholder or equityholder who has engaged in inequitable conduct that has injured the debtor and/or its creditors—equitable subordination.²⁹ The doctrine of equitable subordination permits a bankruptcy court, under limited circumstances, to "demote"

²⁵ See, e.g., *Wallace v. Wood*, 752 A.2d 1175, 1183 (Del. Ch. 1999) (noting "[p]ersuading a Delaware court to disregard the corporate entity is a difficult task"); see also *Fletcher v. Atex, Inc.*, 68 F.3d 1451, 1458 (2d Cir. 1995) (pointing out courts will not disturb legal fiction of corporation unless there is sufficient reason to do so); *Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130, 132 (2d Cir. 1993) (holding corporations are "creature[s] of state law whose primary purpose is to insulate shareholders" and, therefore, state of incorporation has an interest in determining when this insulation will be stripped away).

²⁶ *Dole Food Co. v. Patrickson*, 538 U.S. 468, 475 (2003).

²⁷ *Harper v. Del. Valley Broadcasters, Inc.*, 743 F. Supp 1076, 1085 (D. Del. 1990); see also Official Comm. of Unsecured Creditors of Sunbeam Corp. v. *Morgan Stanley & Co, Inc. (In re Sunbeam Corp.)*, 284 B.R. 355, 365 (Bankr. S.D.N.Y. 2002) (reasoning "[t]he purpose of allowing the corporate veil to be pieced on an alter ego theory is to hold the party actually responsible for the inequitable conduct accountable and to prevent that corporation from using another corporation to shield itself from liability") (internal quotations and citations omitted).

²⁸ See, e.g., *Geyer v. Ingersoll Publ'n Co.*, 621 A.2d 784, 793 (Del. Ch. 1992) ("[C]ourt can pierce the corporate veil of an entity where there is fraud or where a subsidiary is a mere instrumentality or alter ego of its owner."); see also *Harper*, 743 F. Supp at 1085 ("Absent a showing of a fraud or that a subsidiary is in fact the mere alter ego of the parent, a common central management alone is not a proper basis for disregarding separate corporate existence.") (citations omitted); *Morris v. NYS Dep't of Taxation and Fin.*, 623 N.E.2d 1157, 1161 (N.Y. 1993) ("[P]iercing the corporate veil requires a showing that: (1) owners exercised complete domination over the corporation in respect to transaction attacked; and (2) that such domination was used to commit fraud or wrong against plaintiff which resulted in plaintiff's injury.").

²⁹ The doctrine of equitable subordination is codified in section 510(c) of the Bankruptcy Code, which provides as follows:

[A]fter notice and a hearing, the court may—

- (1) under principles of equitable subordination, subordinate for purposes of distribution all or part all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
- (2) order that any lien securing such a subordinated claim be transferred to the estate.

11 U.S.C. § 510(c) (2006).

a creditor's claim against (or an equityholder's interest in) a debtor, based upon that party's inequitable conduct. The widely accepted test of equitable subordination requires the confluence of three factors: inequitable conduct, injury or unfair advantage, and consistency (of remedy) with bankruptcy law.³⁰ If these factors are proven, all or part of an offending party's claims, liens, or equity interests may be "demoted," i.e., not paid until all other similarly ranked claims, liens or equity interests are first satisfied.³¹

The doctrine of equitable subordination thus prevents an insider from profiting from its control over the debtor at the expense of other creditors.³² As one court summarized the law:

To recapitulate: mere control or domination of a corporation is not proscribed by law and is in itself insufficient to justify piercing the corporate veil and subordinating claims. The fiction of a separate legal entity will be respected unless to the elements of domination and control are added certain factors which will motivate the bankruptcy court, sitting as a court of equity, to disregard the fiction. These "plus" factors may be fraud, plain and simple, or a history of spoliation, mismanagement and faithless stewardship which is tantamount to fraud; they may be simply the violation of rules of fair play and good conscience which amounts to a breach of the fiduciary standards of conduct owed to the corporation, a use of the powers of an "insider" for personal advantage to the detriment of creditors—all of which constitutes a "wrong" which equity will undo or intervene to prevent.³³

³⁰ See *Citicorp Venture Capital v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986–87 (3d Cir. 1998) (stating three-factor test for equitable subordination (citing *In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977))); *Summit Coffee Co. v. Herby's Foods (In re Herby's Foods)*, 2 F.3d 128, 130 (5th Cir. 1993) (reiterating three-part test of *Mobile Steel Co.*); Brian Leepson, Comment, *A Case for the Use of a Broad Court Equity Power to Facilitate Chapter 11 Reorganization*, 12 BANKR. DEV. J. 775, 802 (1996) (describing three-part test for equitable subordination).

³¹ 11 U.S.C. § 510(c)(1) (2006) ("[The court may] subordinate for purposes of distribution *all or part* of an allowed claim to all or part of another allowed claim.") (emphasis added); see also *Trone v. Smith (In re Westgate-California Corp.)*, 642 F.2d 1174, 1178 (9th Cir. 1981) (holding subordination is remedial, not punitive, and claims should only be subordinated to extent of harm inflicted or benefit derived); 4 COLLIER ON BANKRUPTCY ¶ 507.02[3], at 507–18 (Alan N. Resnick et al. eds., 15th ed. Rev. 2006) (expressing court's ability to "subordinate some or all of an allowed claim" under principles of equitable subordination).

³² See, e.g., *Pepper v. Litton*, 308 U.S. 295, 312 (1939) (identifying fraud by insiders as grounds for equitable subordination); *Ansel Props. v. Nutri/System of Fla. Assocs. (In re Nutri/System of Fla. Assoc.)*, 178 B.R. 645, 653 (E.D. Pa. 1995) (holding if claim arises from transaction for benefit of controlling parent corporation, claim against subservient debtor should be subordinated); William T. Vukowich, *Civil Remedies in Bankruptcy for Corporate Fraud*, 6 AM. BANKR. INST. L. REV. 439, 454 (1998) ("[I]nsiders' fraudulent conduct arms creditors with a potent case in favor of the equitable subordination of the insider's claim.").

³³ *In re Mid-Town Produce Terminal, Inc.*, 599 F.2d 389, 393 (10th Cir. 1979) (citing *Asa S. Herzog & Joel B. Zweibel, The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83, 112 (1961)).

While the considerations for subordinating the claim of an insider are similar to those of veil-piercing,³⁴ the remedy is different. Instead of allowing creditors of a debtor to assert direct claims against the offending insider of the debtor, the insider's claim against the debtor is subordinated—often resulting in no recovery with respect to such claim, thereby enhancing the relative recoveries of other creditors.

C. *The Recharacterization of the Claims of an Insider*

Related to (but distinct from) the remedy of equitable subordination is the doctrine of recharacterization.³⁵ Occasionally, an insider of a debtor may seek to misuse its relationship with the debtor to disguise an equity contribution as a loan (in order to obtain the distribution priority afforded to a creditor, while simultaneously seeking to preserve the upside potential of equity). Federal courts, including bankruptcy courts, have long had the authority to pierce through form and enforce substance.³⁶ Unlike equitable subordination, where the focus is exclusively on the acts of the claimholder, "the focus of the recharacterization inquiry is whether 'a debt actually exists,' or, put another way, we ask what is the proper

³⁴ See, e.g., *Koch Ref. v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1351 (7th Cir. 1987) ("The broad factors suggested by the court for subordination of a fiduciary's claim are quite similar to the basic alter ego requirements; and in both cases liability is imposed to reach an equitable result.") (citations omitted); cf. Peter J. Lahny IV, *Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation*, 9 AM. BANKR. INST. L. REV. 815, 863 (2001) (illustrating relationship between equitable subordination and veil piercing by postulating "[t]he doctrine of substantive consolidation evolved from the earlier common law doctrines of turnover, equitable subordination and piercing the corporate veil"). For example, courts have considered the following factors (many of which are also considered in the veil-piercing context): failure to observe corporate formalities; failure to pay dividends; siphoning of funds of the corporation by the dominant shareholder; commingling of identities or funds; fraud or a history of spoliation; mismanagement and faithless stewardship; a violation of the rules of fair play; or use of the corporation as a mere facade for the operations of the dominant stockholder. See *Nutri/System*, 178 B.R. at 658 (listing examples of inequitable conduct including "fraud," "breach of fiduciary duties," and "use of the debtor as a mere instrumentality or alter ego"); see also *In re Lifschultz Fast Freight*, 132 F.3d 339, 345 (7th Cir. 1997) (identifying insider's loan to undercapitalized corporation as possible indication of inequitable conduct); Herzog, *supra* note 33, at 98–104 (examining various forms of inequitable conduct, including fraud, illegality, breach of fiduciary relationship and use of debtor as alter ego).

³⁵ See *Cohen v. KB Mezzanine Fund II, L.P. (In re Submicron Sys. Corp.)*, 432 F.3d 448, 454 (3d Cir. 2006) (distinguishing recharacterization from equitable subordination); *Fairchild Dornier GmbH v. Official Comm. of Unsecured Creditors (In re Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225, 232 (4th Cir. 2006) ("Like disallowance, equitable subordination also differs markedly and serves different purposes from recharacterization. While a bankruptcy court's recharacterization decision rests on the *substance of the transaction* giving rise to the claimant's demand, its equitable subordination decision rests on its assessment of the *creditor's behavior*."); *Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 749 (6th Cir. 2001) (discussing differing functions and effects of recharacterization and equitable subordination).

³⁶ See *Pepper*, 308 U.S. at 304–05 (stating bankruptcy courts have authority to ensure "that substance will not give way to form, that technical considerations will not prevent substantial justice from being done"); see also 11 U.S.C. § 105 (2006) (granting bankruptcy court broad power to "carry out the provisions of [the Bankruptcy Code]"). See generally 1 NORTON BANKRUPTCY LAW & PRACTICE 2D, § 13 (2d ed. 1997) (exploring broad administrative powers granted to the bankruptcy court by section 105).

characterization in the first instance of an investment."³⁷ If a court determines that the "true" nature of an alleged loan is really an equity contribution, then the loan will be treated as equity for distribution purposes.

Importantly, the law does not bar loans to affiliates;³⁸ the law merely bars the deception of third parties. As described by the Seventh Circuit,

Insiders cannot use their superior knowledge of a company to deceive outsiders. If the insider causes the borrowing company to lie to the lender about its financial health—by disguising a pre-existing debt, for instance—the insider is guilty of misconduct. Even the "morals of the marketplace" forbid deceit.³⁹

D. *Fraudulent Conveyance*

The elder statesman of the exceptions to corporate separateness is the doctrine of fraudulent conveyance.⁴⁰ The doctrine of fraudulent conveyance has been codified in the Bankruptcy Code and the law of each of the states. Under the Bankruptcy Code, a debtor may "avoid any transfer . . . of an interest . . . or any obligation . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition" if such transfer was "fraudulent."⁴¹

³⁷ *Cohen*, 432 F.3d at 454.

³⁸ *Dornier Aviation*, 453 F.3d at 234 (4th Cir. 2006) ("We think it important to note that a claimant's insider status and a debtor's undercapitalization alone will normally be insufficient to support the recharacterization of a claim."); *cf. Cohen*, 291 B.R. at 325, *aff'd*, 432 F.3d 448 (3d Cir. 2006) (finding undercapitalization insufficient to support equitable subordination of insider's claim in absence of other inequitable conduct); James H.M. Sprayregen et al., *Recharacterization from Debt to Equity: Lenders Beware*, AM. BANKR. INST. J., Nov. 2003, at 30 (providing overview of recharacterization).

³⁹ *Ljischultz*, 132 F.3d at 346 (quoting *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928) (Cardozo, C.J.)).

⁴⁰ A court's power to avoid a fraudulent conveyance is almost 500 years old. As noted by the Supreme Court:

The modern law of fraudulent transfers had its origin in the Statute of 13 Elizabeth, which invalidated "covinous and fraudulent" transfers designed "to delay, hinder or defraud creditors and others." English courts soon developed the doctrine of "badges of fraud": proof by a creditor of certain objective facts (for example, a transfer to a close relative, a secret transfer, a transfer of title without transfer of possession, or grossly inadequate consideration) would raise a rebuttable presumption of actual fraudulent intent. Every American bankruptcy law has incorporated a fraudulent transfer provision; the 1898 Act specifically adopted the language of the Statute of 13 Elizabeth.

BFP v. Resolution Trust Corp., 511 U.S. 531, 540–41 (1994) (citations omitted).

⁴¹ 11 U.S.C. § 548 (2006). Fraud for purposes of section 548 of the Bankruptcy Code may be either "actual fraud" or "constructive fraud." Actual fraud requires intent on behalf of the transferor to hinder, delay or defraud other creditors (11 U.S.C. § 548(a)(1)(A) (2006)), while constructive fraud is based on an evaluation of the financial condition or position of the debtor (11 U.S.C. § 548(a)(1)(B) (2006)). Relatedly, the Bankruptcy Code also authorizes the avoidance of certain transfers between an insolvent debtor and an insider made up to one year prior to the debtor's commencement of a bankruptcy case. *See* 11 U.S.C. §

In addition, the "strong arm" provisions of section 544(b)⁴² of the Bankruptcy Code allow a trustee to apply pertinent state fraudulent conveyance laws, which often carry longer statutes of limitations.⁴³

The fraudulent conveyance remedy is distinct from the remedies available under the doctrines of veil-piercing, equitable subordination and recharacterization. The remedy here is avoidance—the fraudulent conveyance is avoided and the property returned to the debtor. Notably, no other asset of the transferee is available for distribution to the debtor-transferor's creditors.

E. Turnover

Finally, courts of equity have traditionally had the power to order a "turnover" of property to the debtor which had previously been transferred improperly by the debtor to an affiliate. A turnover proceeding is a hybrid between the doctrines of fraudulent conveyance and veil-piercing in that the remedy is typically invoked when the debtor has fraudulently transferred substantial assets to a sham affiliate, and the disputed assets are substantially all the assets of that sham company.

A prominent example of a court compelling the turnover of assets to a trustee of the estate of a debtor is the Tenth Circuit's decision in *Fish v. East*.⁴⁴ In *Fish*, a mining company created a subsidiary and transferred assets to a subsidiary with the specific intent "to hinder and delay creditors" of the parent.⁴⁵ As a result, the Tenth Circuit held that the subsidiary was "merely a[n] . . . instrumentality"⁴⁶ of the parent. The court also noted that the personal property of the parent and subsidiary were "commingled without reasonable possibility of identification."⁴⁷ The court ordered a turnover and held that the "[c]orporate entity may be disregarded where not to do so will defeat public convenience, justify wrong or protect fraud."⁴⁸ The modern doctrine of substantive consolidation evolved from the bankruptcy court's equitable power under the Bankruptcy Act to compel a third party to turn over assets to the bankruptcy trustee.⁴⁹

547(b)(4) (2006). If the debtor is a corporation, an insider includes the debtor's directors, officers, control persons, partnerships in which the debtor is a general partner, general partners of the debtor, as well as relatives of any of these entities. See 11 U.S.C. § 101(37)(B) (2006).

⁴² "[T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim . . ." 11 U.S.C. § 544(b)(1) (2006).

⁴³ See, e.g., N.Y. C.P.L.R. § 213(8) (McKinney 2003) (stipulating up to six-year statute of limitations for fraud); see also Paul B. Lewis, *Can't Pay Your Debts, Mate? A Comparison of the Australian and American Personal Bankruptcy Systems*, 18 BANKR. DEV. J. 297, 310 n.57 ("Most state [fraudulent conveyance] statutes have significantly longer statutes of limitations.").

⁴⁴ 114 F.2d 177 (10th Cir. 1940).

⁴⁵ *Fish v. East*, 114 F.2d 177, 182 (10th Cir. 1940).

⁴⁶ *Id.* at 189.

⁴⁷ *Id.* at 191.

⁴⁸ *Id.*

⁴⁹ See, e.g., *Munford, Inc. v. TOC Retail, Inc. (In re Munford, Inc.)*, 115 B.R. 390, 398 (Bankr. N.D. Ga. 1990) ("Substantive consolidation is essentially a complex turnover proceeding because the debtor is asking

F. Comparisons to Substantive Consolidation

Substantive consolidation (described in detail below) is the most dramatic and far-reaching exception to corporate separateness. Veil-piercing (which has been described as a state law analogue for the doctrine of substantive consolidation⁵⁰)

allows the creditors of a subsidiary to reach the assets of the parent, but does not at the same time allow creditors of the parent to reach the assets of the subsidiary. In contrast, substantive consolidation puts all the assets in a common pool, and creditors of the various entities share pro rata.⁵¹

While equitable subordination and recharacterization permit the "demotion" of the claim or equity interest of an affiliate, neither permits creditors of the debtor to have a direct claim against the assets of such affiliate. Moreover, while fraudulent conveyances may be avoided, such avoidance does not permit the assertion of any other claim against the transferee. Finally, even turnover, the direct precursor of the doctrine of substantive consolidation, only permits the turnover of specific property. Substantive consolidation, on the other hand, combines *all* the assets and liabilities of affiliated entities, thereby profoundly affecting the creditors (and shareholders) of *each* entity.⁵² Given the far-reaching sweep of the remedy of substantive consolidation, it would seem incongruous for the doctrine to be capable of proper application on proof dramatically *less* than the proof necessary for any of these other, more limited, exceptions to corporate separateness (each of which requires proof of fraud or other serious corporate misconduct). But, as described below, this is the lynchpin of the so-called "modern trend"—authorizing consolidations on commonplace factors such as "consolidated financial statements"⁵³ and "the profitability of consolidation at a single physical location"⁵⁴—factors that in no way implicate debtor misconduct of any kind.

the nondebtor affiliated entity to bring into the estate assets in which the debtor asserts an unseparable interest."); *In re Julien Co.*, 120 B.R. 930, 936 (Bankr. W.D. Tenn. 1990) (same); *White v. Creditors Serv. Corp.* (*In re Creditors Serv. Corp.*), 195 B.R. 680, 692 (Bankr. S.D. Ohio 1996) (concluding because substantial consolidation was deemed appropriate, request for turnover funds was moot).

⁵⁰ See Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5, 11 (2005) (contending substantive consolidation is the federal analogue of veil-piercing); see also *Creditors Serv. Corp.*, 195 B.R. at 689 (noting "substantive consolidation is similar to the state law remedy of piercing the corporate veil based on a finding that the entities are alter egos").

⁵¹ Baird, *supra* note 50, at 12.

⁵² See *Creditors Serv. Corp.*, 195 B.R. at 691 (stating substantive consolidation "will alter the current dynamics and could conceivably prove so disruptive to the operations that the return to creditors would be affected"); *Flora Mir*, 432 F.2d at 1062 (explaining substantive consolidation is "a measure vitally affecting substantive rights"); Baird, *supra* note 50, at 12 (describing effects of substantive consolidation on creditors).

⁵³ See, e.g., *Vecco*, 4 B.R. at 410 (enumerating criteria to determine if consolidation is proper).

⁵⁴ *Vecco*, 4 B.R. at 410.

II. SUBSTANTIVE CONSOLIDATION—A NEW DOCTRINE EMERGES

A. *Early Substantive Consolidation Cases Under the Bankruptcy Act Consistently Required Proof of Fraud or Abuse of Corporate Form*

The year following the Tenth Circuit's decision in *Fish v. East*, the Supreme Court decided *Sampsell v. Imperial Paper & Color Corp.*,⁵⁵ a turnover case which, as stated above, is generally considered the progenitor of the doctrine of substantive consolidation. In *Sampsell*, an individual businessman named Downey became "hopelessly insolvent"⁵⁶ and thereafter filed for bankruptcy. Prior to his bankruptcy (but subsequent to his hopeless insolvency) Downey transferred substantially all of his assets to a newly formed corporation owned by himself, his wife and their son.⁵⁷ In bankruptcy, the trustee sought to consolidate Downey's estate with the assets and liabilities of the non-debtor corporation.⁵⁸ The referee⁵⁹ found the "corporation was 'nothing but a sham and a cloak' devised by Downey 'for the purpose of preserving and conserving his assets' for the benefit of himself and his family; and that the corporation was formed for the purpose of hindering, delaying and defrauding his creditors."⁶⁰ The referee ordered that the property of the corporation was property of the debtor's estate and was to be administered for the benefit of the creditors of the estate.⁶¹ Ultimately, the Supreme Court affirmed the referee's decision because, among other things, the only creditor of the non-debtor corporation to complain about the outcome had knowledge of the "fraudulent character"⁶² of the corporation. Because the only objecting creditor was a participant in the underlying fraud, the Supreme Court held that it was appropriate to "consolidat[e] the estates" of Downey and the corporation,⁶³ and thus the doctrine of substantive consolidation was born.⁶⁴

⁵⁵ 313 U.S. 215 (1941).

⁵⁶ See *Sampsell*, 313 U.S. at 217 ("[S]tock was issued in satisfaction of Downey's claim against the corporation, when Downey was hopelessly insolvent . . .").

⁵⁷ See *id.* at 215–217 (revealing prior to Downey's bankruptcy, Downey transferred his assets to a newly formed corporation owned by his family).

⁵⁸ See *id.* at 216 ("On petition of the trustee in bankruptcy, the referee issued an order to show cause directed to the corporation, Downey, his wife and son why the assets of the corporation should not be marshaled for the benefits of the creditors of the bankruptcy estate . . .").

⁵⁹ The referee under the Bankruptcy Act is the "functional equivalent" of the bankruptcy judge under the Bankruptcy Code. See *In re Lorax Corp.*, 307 B.R. 560, 563 (Bankr. N.D. Tex. 2004) (highlighting equivalence of Bankruptcy Act's referee and today's bankruptcy judge); see also *Anderson v. CBS*, 31 B.R. 161, 166 (Bankr. N.D. Ga. 1982) (noting "[a]s the referee became the norm in District Courts and later full time positions, by delegation and function, the referee became the *de facto* bankruptcy trial judge without *de jure* status, and the District Judge became, in effect, an appellate judge").

⁶⁰ *Sampsell*, 313 U.S. at 217.

⁶¹ See *id.* ("The referee accordingly ordered that the property of the corporation was property of the bankruptcy estate and that it be administered for the benefit of the creditors of the estate.").

⁶² *Id.* at 221 ("Furthermore, respondent had at least some knowledge as the fraudulent character of Downey's corporation.").

⁶³ *Id.* at 219–220 (discussing consolidation order and creditor's involvement in Downey's fraud).

⁶⁴ The term "substantive consolidation" itself, however, did not appear in any published decision for more than thirty years. See, e.g., *James Talcott, Inc. v. Wharton (In re Cont'l Vending Mach. Corp.)*, 517 F.2d 997, 1000 (2d Cir. 1975) ("The power to consolidate is one arising out of equity, enabling a bankruptcy court to

Sampsell's newly minted consolidation remedy was promptly applied by the Fourth Circuit in *Stone v. Eacho (In re Tip Top Tailors, Inc.)*.⁶⁵ In *Stone v. Eacho*, the Fourth Circuit consolidated the estates of a debtor corporation and its non-debtor subsidiary because the subsidiary had "no real existence,"⁶⁶ was inadequately capitalized, was a "mere instrumentality" or "corporate pocket" of the parent, and there was "no showing that business was done under [the subsidiary's corporate charter] or that any of the creditors knew anything about it or relied on it in any way."⁶⁷

Similarly, in *Todd Bldg. Corp. v. Heller (In re Clark Supply Co.)*,⁶⁸ the partners in a partnership transferred partnership assets to separate corporations owned by the partners and their families to isolate failing divisions and to protect valuable assets from partnership creditors.⁶⁹ Moreover, the corporations that continued to operate the failing divisions were inadequately capitalized.⁷⁰ The Seventh Circuit affirmed the consolidation of each of the corporations, holding that "[t]he doctrine of corporate entity will not be regarded when to do so would work fraud or injustice."⁷¹

Finally, in *Soviero v. Franklin National Bank*,⁷² the Second Circuit approved a turnover/consolidation remedy, but only because the trial record supported veil-piercing.⁷³ In *Soviero*, the trustee of the Raphan Carpet Corporation sought the turnover of the assets of (i) thirteen affiliated corporations, each of which used "Raphan" as part of its corporate name and was operated as a retail outlet for the parent, as well as (ii) a fourteenth affiliate that owned the property where the debtor was located.⁷⁴ None of the affiliates were in bankruptcy.⁷⁵ The referee determined the assets of the affiliates equitably belonged to the debtor and should be

disregard separate corporate entities, to pierce their corporate veils in the usual metaphor, in order to reach assets for the satisfaction of debts of a related corporation."); *Commercial Envelope*, 1977 WL 182366, at *1 ("Substantive consolidation, as will be seen, is now part of the warp and woof of the fabric of the bankruptcy process involving related debtors, though to be used sparingly."); *In re D.H. Overmyer Co., Inc.*, No. 73-B-1126, 73-B-1162, 73-B-1189, 73-B-1175, 1976 WL 168421, at *3 (S.D.N.Y. Mar. 26, 1976) ("[W]hether or not substantive consolidation is warranted . . . [it must be remembered] that it be 'used sparingly because of the possibility of inferior treatment of creditors of the corporate debtor who have dealt solely with that debtor, without knowledge of its inter-relationship with others.'" (citing *Kheel*, 369 F.2d at 847)).

⁶⁵ 127 F.2d 284, *reh'g denied*, 128 F.2d 16 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942).

⁶⁶ *Stone v. Eacho (In re Tip Top Tailors, Inc.)*, 127 F.2d 284, 288 (4th Cir. 1942) ("[W]here the business has been transacted by and the credit extended to the parent corporation, and whether the subsidiary has no real existence whatever, there is no reasons why the courts should not [consolidate].").

⁶⁷ *Id.* at 287–88.

⁶⁸ 172 F.2d 248 (7th Cir. 1949).

⁶⁹ See *Todd Bldg. Corp. v. Heller (In re Clark Supply Co.)*, 172 F.2d 248, 250 (7th Cir. 1949) (discussing purpose of asset transfer to "preserve[] diverted assets for the benefits of the [partners] and their families").

⁷⁰ See *id.* at 249–51 (demonstrating asset transfers led to inadequate capitalization).

⁷¹ *Id.* at 254.

⁷² 328 F.2d 446 (2d Cir. 1964).

⁷³ See *Soviero*, 328 F.2d at 448–49 (affirming trial court's turnover order).

⁷⁴ See *id.* at 446–47 (discussing bankruptcy trustee's effort to obtain assets of corporate debtor's fourteen affiliates).

⁷⁵ See generally *id.* at 446–49 (implying affiliates had not filed for bankruptcy).

administered as part of its bankruptcy estate, and the district court confirmed the turnover order.⁷⁶

The Second Circuit affirmed and upheld the consolidation because the affiliates were but mere instrumentalities of the debtor with no separate existence of their own.⁷⁷ The court considered, among other things, that the debtor corporation financed the affiliates, paid their debts, was liable for their leases, and paid their advertising and insurance charges.⁷⁸

Indeed, the court found that the subsidiaries existed only to defraud the taxing authorities and held the following:

It is difficult to imagine a better example of commingling of assets and functions and of the flagrant disregard of corporate forms than as here demonstrated by the bankrupt. One gains the distinct impression that the bankrupt held up the veils of the fourteen collateral corporations primarily, if not solely, for the benefit of the tax gatherer, but otherwise completely disregarded them. Even Salome's could not have been more diaphanous.⁷⁹

Notably, however, despite the unquestioned availability of the power to consolidate estates, courts traditionally remained reluctant to implement the extraordinary remedy without proof of fraud or other serious abuse. For example, in *Maule Industries, Inc. v. L.M. Gerstel*,⁸⁰ the bankruptcy trustee of Ludwig Corporation sought an order consolidating its estate with Ludwig Bros., Inc., a non-debtor affiliate in a then-pending state court receivership.⁸¹ The trustee's petition alleged (i) Ludwig Corporation controlled and directed Ludwig Bros., Inc. as a corporate instrumentality, (ii) the two corporations had substantially the same officers, directors and stockholders and (iii) the affairs, funds and activities of the two corporations had been so intermingled as to render them indistinguishable.⁸²

Relying upon state veil-piercing and fraudulent conveyance law, the Fifth Circuit affirmed the district court's denial of consolidation and noted the rather "meager showing" made by the trustee.⁸³ The court noted that the affiliate is an entirely separate corporation from the bankrupt Ludwig Corporation, and *prima facie*, is a legitimately separate legal entity. Courts are reluctant to pierce the

⁷⁶ See *id.* at 447 ("[T]he Referee determined that the assets of the Affiliates and Realty belonged to the bankrupt and that they should be administered as part of the bankrupt estate. The Referee's findings and turnover order were confirmed by the District Court.")

⁷⁷ See *id.* at 448–49 (affirming referee's conclusion that affiliates were only instrumentalities of bankrupt with no separate existence of their own).

⁷⁸ See *id.* at 448–49.

⁷⁹ *Soviero*, 328 F.2d at 448.

⁸⁰ 232 F.2d 294 (5th Cir. 1956).

⁸¹ *Maule Indus., Inc. v. L.M. Gerstel*, 232 F.2d 294, 295 (5th Cir. 1956) (discussing trustee's effort to consolidate estate of debtor with non-debtor affiliate corporation).

⁸² See *id.* at 295–96.

⁸³ See *id.* at 296–97 (discussing affirmation of district court's denial of consolidation).

corporate veil and destroy the important fiction under which so much of the business of the country is conducted, and will do so only under such compelling circumstances as required such action to avoid protecting fraud, or defeating public or private rights.⁸⁴

Additionally, the court noted that "the petition and the proof must show that the corporation whose property is sought to be brought into the bankruptcy proceeding was organized or used to hinder, delay or defraud the creditors of the bankrupt, and constitutes mere 'legal paraphernalia' observing form only and not existing in substance or reality as a separate entity."⁸⁵

B. The Second Circuit Establishes a Bankruptcy-Specific Theory for the Doctrine of Substantive Consolidation

From the Supreme Court's 1941 decision in *Sampsel*, through the Second Circuit's 1964 decision in *Soviero*, each appellate turnover/consolidation case turned on the application of state law (i.e., fraudulent conveyance and/or veil-piercing) or a "federal common-law variation of basic corporate law principles."⁸⁶ That would all change with the Second Circuit's decision in *Chemical Bank New York Trust Co. v. Kheel*.⁸⁷ In *Kheel*, eight debtor shipping companies, which were owned and controlled by one individual, were operated as a single unit with little or no attention paid to corporate formalities.⁸⁸ The referee recommended consolidation, and the district court granted that remedy.⁸⁹ The Second Circuit affirmed on the basis that the interrelationship of the group was hopelessly obscured so that the time and expense necessary to attempt to unscramble them was so substantial as to threaten the realization of any net assets for all creditors.⁹⁰

The trustee for the bondholders under an indenture of one of the debtors objected to consolidation because of the alleged absence of fraud or proof that all creditors knowingly dealt with the group as a unit and relied on the group for payment.⁹¹ The Second Circuit ruled, for the first time, that consolidation could also be based upon the *hopeless* commingling of assets and liabilities:

⁸⁴ *Id.* at 297.

⁸⁵ *Id.*

⁸⁶ Baird, *supra* note 50, at 16 (discussing substantive consolidation before Supreme Court's *Soviero* decision); *see also Soviero*, 328 F.2d at 447–48 (discussing appropriateness of piercing corporate veil); *Stone*, 127 F.2d at 288 (relying on federal common law in bankruptcy proceeding).

⁸⁷ 369 F.2d 845 (2d Cir. 1966).

⁸⁸ *See Kheel*, 369 F.2d at 846 ("[T]he debtor corporations were operated as a single unit with little or no attention paid to the formalities usually observed in independent corporations.").

⁸⁹ *See id.* at 846 (confirming referee recommended consolidation and district court granted motion for consolidation).

⁹⁰ *See id.* at 847 (noting consolidation is appropriate if "interrelationships" of group are "hopelessly obscured and the time and expense necessary . . . to unscramble them . . . threaten[s] the realization of any net assets for all of the creditors").

⁹¹ *See id.* ("[Appellant] contends that consolidation of assets and liabilities as to appellant is beyond the court's power absent a showing that it knowingly dealt with the group as a unit and relied on the group for payment.").

While the record in the *Soviero* case indicates that there was evidence that the Bank had dealt with the bankrupt and its affiliates as one, the opinion does not make this a necessary foundation for the result. Moreover, we have here an additional factor not present in *Soviero* or *Stone v. Eacho*, the expense and difficulty amounting to practical impossibility of reconstructing the financial records of the debtors to determine intercorporate claims, liabilities and ownership of assets. The power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others. *Yet in the rare case such as this, where the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.*⁹²

In a concurring opinion, Judge Friendly indicated consolidation based upon "obscurity" should be only a last resort and that courts should generally first endeavor to "reach the best possible approximation in order to do justice to a creditor who had relied⁹³ on the credit of one—especially to [*sic*] creditor who was ignorant of the loose manner in which corporate affairs were being conducted."⁹⁴

In *Flora Mir Candy Corp. v. R.S. Dickson & Co. (In re Flora Mir Candy Corp.)*,⁹⁵ the Second Circuit made plain the level of "obscurity" that must be present in order to implicate the last resort remedy of consolidation—*hopeless* obscurity. The debtors must be *unable* to "unscramble" their assets and liabilities (at least without depleting the estate in the process and thereby reducing or eliminating creditor recoveries).⁹⁶ The court further held that no amount of obscurity is

⁹² *Id.* (emphasis added).

⁹³ Judge Friendly's concern for an objecting creditor's reliance on corporate separateness is consistent with other Bankruptcy Act cases. *See, e.g., Sampsell*, 313 U.S. at 219 (noting objection to turnover/consolidation overruled because objecting creditor did not rely on corporate separateness and was aware affiliate was a sham); *Hogan*, 593 F.2d at 929 (reversing order approving consolidation and noting, even in situations in which consolidation is permissible, creditors who can demonstrate reliance on "outward appearance" of corporate separateness must be awarded priority at same time as consolidation itself); *Stone*, 127 F.2d at 290 (approving turnover/consolidation and ordering creditors believing they extended credit to subsidiary be afforded supplemental hearing so their "equities" would be preserved).

⁹⁴ *Kheel*, 369 F.2d at 848 (Friendly, J., concurring).

⁹⁵ 432 F.2d 1060 (2d Cir. 1970).

⁹⁶ *Flora Mir*, 432 F.2d at 1063 (holding there was no evidence debtors' interrelationships were so obscure that "unscrambling" them threatened creditor recoveries); *see Bonham*, 229 F.3d at 764 (indicating Second Circuit had noted several circumstances where substantive consolidation is proper, including where creditors of consolidated entities treated entities as unit and business affairs were "hopelessly entangled"); *see also Kheel*, 369 F.2d at 847 ("[T]he interrelationships of the group are hopelessly obscured and the time and

sufficient to permit consolidation in the face of an objection by a creditor who relied upon the existence of separate entities in extending credit.⁹⁷

C. The Second Circuit Synthesizes Existing Precedent into a Two-Prong Test

In its landmark *Union Saving Bank v. Augie/Restivo Banking Co. (In re Augie/Restivo Banking Co.)*⁹⁸ decision, the Second Circuit surveyed and synthesized the body of substantive consolidation case law and articulated a two-prong, disjunctive "shorthand" test for substantive consolidation.⁹⁹ In this test, the Second Circuit sought to combine the three major themes of substantive consolidation jurisprudence: (1) *Sampsell's* reliance on the nonbankruptcy law of veil-piercing and fraudulent conveyance, (2) *Kheel's* hopeless obscurity theory and (3) the persuasive concern for the innocent creditor who may be harmed by consolidation.¹⁰⁰

The Second Circuit framed its test as follows:

An examination of those cases . . . reveals that these considerations are merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and "did not rely on their separate identity in extending credit," . . . or (ii) whether the affairs of the debtor are so entangled that consolidation will benefit all creditors¹⁰¹

With respect to the first prong, it is clear that the *Augie/Restivo* court was looking to the reliance of the *proponents* of substantive consolidation, i.e., whether creditor-proponents of substantive consolidation were misled into believing that multiple companies were, in fact, one. A second form of reliance was also in play in *Augie/Restivo*, namely, the reliance interest of a creditor objecting to substantive consolidation. Even if proponents of substantive consolidation could demonstrate they were duped into extending credit to a shell entity, substantive consolidation

expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors . . .").

⁹⁷ *Flora Mir*, 432 F.2d at 1063. See generally Seth D. Amera & Alan Kolod, *Substantive Consolidation: Getting Back to Basics*, 14 AM. BANKR. INST. L. REV. 1, 18–19 (2006) (discussing Judge Friendly's opinion in *Flora Mir*).

⁹⁸ 860 F.2d 515 (2d Cir. 1988).

⁹⁹ *Augie/Restivo*, 860 F.2d at 518 (announcing two-prong test of whether creditors dealt with entities in single economic unit without relying on separate identity when extending credit or whether affairs of debtors are so entangled that consolidation benefits all creditors); see *Bonham*, 229 F.3d at 766 (describing two-prong second circuit test applied by Second Circuit); *Munford*, 115 B.R. at 395 n.1 ("[T]he two factors are admittedly a synthesis of the more specific factors which were popular with other courts that considered the substantive consolidation question, and the Court feels comfortable in consulting with earlier decisions that discuss these specific factors.").

¹⁰⁰ See *supra* note 93 and accompanying text.

¹⁰¹ *Augie/Restivo*, 860 F.2d at 518 (emphasis added) (citations omitted).

could still not be deployed to harm a creditor who knew it was dealing with multiple entities. Specifically, the Second Circuit held as follows:

[W]here . . . creditors . . . knowingly made loans to separate entities and no irremediable commingling of assets has occurred, a creditor cannot be made to sacrifice the priority of its claims against *its* debtor by fiat based on the bankruptcy court's speculation that it knows the creditor's interest better than does the creditor itself.¹⁰²

As to the second prong, the Second Circuit concluded that "hopeless intermingling" was a proper basis for consolidation because no creditor would be harmed, and, thus, the remedy was essentially consensual:

[E]ntanglement of the debtors' affairs . . . involves cases in which there has been a commingling of two firms' assets and business functions. Resort to consolidation in such circumstances, however, should not be Pavlovian. Rather, substantive consolidation should be used only after it has been determined that *all creditors* will benefit because untangling is either impossible or so costly as to consume the assets. . . . Commingling, therefore, can justify substantive consolidation only where "the time and expense necessary even to attempt to unscramble them [is] so substantial as to threaten the realization of any net assets for all the creditors," or where no accurate identification and allocation of assets is possible. In such circumstances, all creditors are better off with substantive consolidation.¹⁰³

D. *The Auto-Train Balancing Test*

Although most appellate courts agree on the principles underlying substantive consolidation, "[n]o uniform guideline for determining [its application] has emerged."¹⁰⁴ Even prior to the Third Circuit's decision in *Owens Corning*, many courts, including several courts of appeal, have adopted (either expressly or implicitly) the *Augie/Restivo* formulation.¹⁰⁵ Other courts,¹⁰⁶ however, have adopted

¹⁰² *Id.* at 520.

¹⁰³ *Id.* at 519 (emphasis added) (citation omitted).

¹⁰⁴ *Bonham*, 229 F.3d at 765.

¹⁰⁵ *See, e.g., Bonham*, 229 F.3d at 771 ("Our abecedarian prerequisite to ordering substantive consolidation is that the two factors set forth in *Augie/Restivo* must be satisfied."). The Sixth Circuit has similarly held that substantive consolidation is appropriate where "the interrelationships of the debtors are hopelessly obscured and the time and expense necessary to unscramble them is substantial as to threaten any net assets for all creditors." *First Nat'l Bank of Barnesville v. Raforth (In re Baker & Getty Financial Services, Inc.)*, 974 F.2d 712, 720 (6th Cir. 1992); *see also Gulfco*, 593 F.2d at 929–30 (noting complex intercompany relationships were insufficient to justify consolidation; assets and liabilities must be hopelessly commingled or enterprise must have been established to hinder, delay or defraud creditors).

one of a variety of balancing tests, often fashioned upon the D.C. Circuit's decision in *Auto-Train*.¹⁰⁷

In *Auto-Train*, the D.C. Circuit established a balancing test for determining whether substantive consolidation should be given retroactive effect:

Because the consolidation proceeding will already have established a substantial identity between the entities to be consolidated, this inquiry begins with the proponent of *nunc pro tunc* making a showing that *nunc pro tunc* is necessary to achieve some benefit or avoid some harm. Following this showing, a potential preference holder may challenge the *nunc pro tunc* entry of the consolidation order by establishing that it relied on the separate credit of one of the entities to be consolidated and that it will be harmed by the shift in filing dates. If a potential preference holder meets this burden, the court must then determine whether the benefits of *nunc pro tunc* outweigh its detriments.¹⁰⁸

While subsequent cases (including the district court in *Owens Corning*, discussed in Part IV, *supra*) have construed the *Auto-Train* formulation as an entirely different test permitting consolidation on some relaxed standard, it is not at all evident that the *Auto-Train* court was attempting to break any new ground with this formulation. Obviously, it cannot be viewed as a rejection of the *Augie/Restivo* formulation (*Augie/Restivo* was decided after *Auto-Train*). Moreover, the *Auto-Train* court specifically relied upon the Second Circuit's decisions in *Flora Mir* and *Kheel* in defining "substantial identity."¹⁰⁹ Finally, *Auto-Train* denied the retroactive application of substantive consolidation because of the harm it would inflict upon an innocent creditor.¹¹⁰ Notwithstanding these important distinctions, the *Auto-Train* balancing test has been subsequently interpreted as permitting consolidation based upon the loosely defined trigger of "substantial identity"—potentially a far cry from the fraud or other serious abuse traditionally required.¹¹¹ Moreover, this balancing test has been held to permit consolidation even though some creditors

¹⁰⁶ See, e.g., *Eastgroup*, 935 F.2d at 249 (applying D.C. standard to determine whether to substantively consolidate entities); *In re Lewellyn*, 26 B.R. 246, 251 (Bankr. S.D. Iowa 1982) (utilizing balancing test to determine approval of substantive consolidation); *In re Snider Bros., Inc.*, 18 B.R. 230, 234 (Bankr. D. Mass. 1982) (endorsing balancing of "economic prejudice of continued debtor separateness versus the economic prejudices of consolidation").

¹⁰⁷ *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 277 (D.C. Cir. 1987) (establishing balancing test to determine appropriateness of consolidation in D.C. Circuit).

¹⁰⁸ *Drabkin*, 810 F.2d at 277.

¹⁰⁹ *Id.* at 276 (citing to *Flora Mir* and *Kheel* for establishment of substantial identity).

¹¹⁰ *Id.* at 277–78 (holding estate should not be consolidated *nunc pro tunc* because creditor unaware of interrelationship between entities would be harmed by resulting outcome).

¹¹¹ See, e.g., *Eastgroup*, 935 F.2d at 249 (explaining proponent of substantive consolidation must first show substantial identity between entities); *Lewellyn*, 26 B.R. at 252 (acknowledging substantial identity as an important factor in approving substantive consolidation); *Snider*, 230 B.R. at 237–38 (indicating use of substantial identity to overrule objections to consolidation).

may have relied upon the separate credit of the debtors in dealing with them, provided that the benefit to the estate of consolidation "heavily" outweighs the harm to creditors.¹¹² This formulation is inherently unpredictable, contrary to prior law and (as demonstrated below) the construct favored by the courts who espouse the so-called "modern trend."

E. The So-Called "Modern Trend"

Shortly after the enactment of the Bankruptcy Code, the Bankruptcy Court for the Eastern District of Virginia announced in *In re Vecco Construction Industries, Inc.*¹¹³ the development of a modern or liberal trend in favor of a diminished standard for the approval of substantive consolidation.

In *Vecco*, the parent company filed a petition for relief under chapter XI of the Bankruptcy Act.¹¹⁴ Thereafter, the parent's four subsidiaries each commenced cases under the then-recently enacted Bankruptcy Code.¹¹⁵ The parent and its subsidiaries sought substantive consolidation to "ensure the development and implementation of a meaningful Plan of Arrangement."¹¹⁶

Notably, substantive consolidation likely would have been appropriate in *Vecco* even under traditional standards. Among other important factors, the debtors had effected a *de facto* pre-petition consolidation and ownership of all the enterprise's assets were listed on the combined books of the company as owned by the parent only.¹¹⁷ Prior to bankruptcy, the parent had also assumed all the liabilities of the subsidiaries.¹¹⁸ In short, the affiliates had no independent existence.

Notwithstanding that these facts would have supported consolidation under traditional standards, the *Vecco* court gratuitously announced the development of a new "liberal" trend that favored substantive consolidation (presumably at a relaxed standard which would not have passed muster under established case law) with its observation that "[d]ue to the organizational make-up evidenced by the now common-place multi-tiered corporations in existence today, substantive consolidation of a parent corporation and its subsidiaries has been increasingly

¹¹² See, e.g., *Eastgroup*, 935 F.2d at 249 (providing approval of consolidation as long as benefits "heavily" outweigh harm); *Lewellyn*, 26 B.R. at 251 (holding creditor reliance should defeat consolidation unless "it is clear that the economic prejudice of continued debtor individuality substantially outweighs the economic prejudice of consolidation"); *Snider*, 230 B.R. at 238 (suggesting substantive consolidation may be approved despite presence of creditor reliance).

¹¹³ 4 B.R. 407, 409 (Bankr. E.D. Va. 1980).

¹¹⁴ *Vecco*, 4 B.R. at 408 ("The debtor . . . filed a petition for relief under [c]hapter XI of the Bankruptcy Act . . .").

¹¹⁵ *Id.* at 409 ("Vecco's four subsidiary corporations filed individual petitions under [c]hapter 11 . . .").

¹¹⁶ *Id.* at 409.

¹¹⁷ See *id.* at 409 (commenting schedules filed by Vecco list all of the corporate group's assets and liabilities, rather than segregating them among Vecco's subsidiaries).

¹¹⁸ See *id.* at 408 ("Vecco made little, if any, effort to segregate the subsidiaries' accounts receivable, disbursements or income. Nor did Vecco attempt to segregate the assets or liabilities of the subsidiaries.").

utilized as a mechanism to deal with corporations coming within the purview of the Act."¹¹⁹

Vecco's announcement of an unprecedented new trend did not go unnoticed. For example, in *Eastgroup*,¹²⁰ the Eleventh Circuit used the "liberal" trend to turn the traditional doctrine of substantive consolidation on its head. In that case, the debtors consisted of two partnerships, SMA and GPH.¹²¹ A single chapter 7 trustee was appointed for both estates.¹²² SMA owned motel properties and GPH operated them.¹²³ SMA and GPH dealt with each other based upon a written management agreement.¹²⁴ Like many other affiliated companies, SMA and GPH had common ownership, some common employees, and centralized cash management.¹²⁵

The Eleventh Circuit found two factors critical in its substantive consolidation analysis. First, the estate of GPH was so deeply insolvent that it would be unable to pay the costs of its chapter 7 administration, while SMA had sufficient assets to make a distribution to unsecured creditors.¹²⁶ Second, on at least one occasion, GPH misled a single roofing contractor into believing it owned a particular hotel, when the hotel was, in fact, owned by SMA.¹²⁷ In light of the "liberal" trend favoring substantive consolidation, the court approved substantive consolidation.¹²⁸

In so doing, however, the court never addressed how substantive consolidation could possibly be fair or equitable to the creditors of SMA. Neither SMA nor its creditors were guilty of any misrepresentation, and yet their recovery from the assets of the comparatively less insolvent company would be diluted by the claims of the administratively insolvent estate. Moreover, there was no allegation that GPH and SMA were alter egos or that their affairs were so entangled that disentanglement would be impossible or prohibitively expensive. In short, through the use of its equitable powers, the court ordered consolidation under circumstances in which consolidation was manifestly *inequitable* (harmful to SMA's creditors and a windfall to GPH's creditors).

Similarly, in *In re Murray Industries, Inc.*,¹²⁹ the debtors were in the business of manufacturing boats.¹³⁰ During the course of their chapter 11 cases, the debtors

¹¹⁹ *Id.* at 409.

¹²⁰ 935 F.2d 245 (11th Cir. 1991).

¹²¹ *Eastgroup*, 935 F.2d at 246–47 (noting SMA was a limited partnership and GPH was a corporation).

¹²² *See id.* at 247.

¹²³ *See id.* at 246 (commenting GPH's sole business was to operate motel businesses owned or leased by SMA).

¹²⁴ *See id.* at 247 (indicating written agreements between SMA and GPH concerned management and operation of eleven motel properties).

¹²⁵ *See id.* (discussing affiliations between SMA and GPH).

¹²⁶ *Eastgroup*, 935 F.2d at 250 n.15. (noting bankruptcy trustee testified "that absent consolidation, there were no funds available" in GPH cases to pay general unsecured creditors or to pay administrative claims).

¹²⁷ *See id.* at 248 ("There is evidence, however, that GPH represented—to at least one of the companies with which it did business, Specialty Roofing and Waterproofing, Inc.—that it owned the property where the creditor was to perform certain work, when, in fact, SMA owned the particular property.").

¹²⁸ *See id.* 248, 251–52.

¹²⁹ 119 B.R. 820 (Bankr. M.D. Fla. 1990).

¹³⁰ *See Murray*, 119 B.R. at 822 (Bankr. M.D. Fla. 1990) (discussing business operations of debtor).

sought and were granted authority to sell substantially all their assets, including their intangible assets.¹³¹ The single most valuable intangible asset owned by the debtors was the name Chris-Craft.¹³² The Chris-Craft name was clearly owned solely by the parent-holding company.¹³³ Based upon the value of the Chris-Craft name, if corporate separateness was respected, the shareholders of the holding company would receive a distribution with respect to their equity interests and creditors of the insolvent subsidiaries would receive little or no recovery.¹³⁴

In a decision that crystallizes the inherent flaws in the "modern" trend, the court ordered consolidation based upon its subjective view that the rights of creditors (even creditors of a completely insolvent company) trump the rights of *all* shareholders (even shareholders of a legally distinct and solvent company).¹³⁵ By ordering consolidation, the court inequitably delivered a recovery to unsecured creditors at the expense of the stockholders of a solvent company.

Other "liberal trend" cases have similarly been decided on grounds that pre-petition lenders and vendors could not have reasonably foreseen when extending credit.¹³⁶ This is a core danger of the liberal trend—divorced from its traditional standards, the remedy becomes inherently unpredictable and unsettles many contractual and state law rights and expectations based upon subjective views of equity.¹³⁷

¹³¹ See *id.* at 826 (noting court-approved sale because purchase price "far exceeded anybody's expectations," bidding was fairly conducted, bidders were given "sufficient factual information," and bidding was not collusive).

¹³² See *id.* at 831 (stating purchase price paid by OMC was not for "hard assets," but rather intangibles like Chris-Craft name because it was "the only viable economic endeavor of the operating entities").

¹³³ See *id.* (noting Chris-Craft name was not transferred to subsidiaries).

¹³⁴ See *id.*

¹³⁵ See *id.* at 832 ("[T]he fact that while creditors may be adversely affected by a substantive consolidation, this alone is not controlling and the bankruptcy court must weigh the conflicting interests which should be balanced in such way as to reach a rough approximation to some rather than to deny justice to all.").

¹³⁶ See *F.A. Potts & Co.*, 23 B.R. at 569 (approving consolidation because of benefit of alleviating parent company's short-term cash shortage and facilitation of filing of plan of reorganization by increasing opportunity of consolidated debtors to obtain long-term financing); see also *Richton*, 12 B.R. at 558 (finding "key factor" to consolidation was its belief equity would be best served by paying creditors of debtors and non-debtors from common fund, regardless of their respective asset-to-liability ratios).

¹³⁷ See, e.g., *R2 Inv.*, *LDC v. World Access, Inc.* (*In re World Access, Inc.*), 301 B.R. 217, 272 n.57 (Bankr. N.D. Ill. 2003). There, the court stated:

Although certain courts have observed a "modern" trend toward more "liberal" application of the doctrine ... this Court is skeptical of the "liberal" approach. In this regard, Collier makes the following observation: Because this area of the law is based strictly on equitable principles without a statutory basis, it will continue to evolve. *In this area, however, the potential harm to innocent creditors on which the [Second Circuit's] admonition was based should continue to give the courts pause before expanding the doctrine, despite the modern trend.*

Id. (quoting 2 COLLIER on Bankruptcy ¶ 105.09[1][d] (Lawrence P. King et al. eds., 15th ed. 2003)) (emphasis added); see also *Murray*, 119 B.R. at 829 (pointing out there is no clear litmus test under modern trend and cases are to great degree "sui generic").

In order to fully appreciate the unpredictable and illegitimate nature of the liberal trend, one need only look at the factors¹³⁸ that courts adhering to such trend find relevant to the consolidation inquiry. It has been said that the dependence by courts on an endless list of "factors" and "balancing tests" (and, worse still, the combination of factors *and* balancing tests) generally belies the fact that the doctrine being applied is itself without a firm legal basis.¹³⁹ This is particularly true of the liberal trend. For example, the following factors are among those that courts applying the liberal trend have considered in evaluating substantive consolidation:

1. The presence or absence of consolidated financial statements.
2. The unity of interest and ownership between various corporate entities.
3. The existence of parent and intercorporate guarantees of loans.
4. The degree of difficulty in segregating and ascertaining individual assets and liabilities.
5. The transfer of assets without formal observance of corporate formalities.
6. The commingling of assets or business functions.
7. The profitability of consolidation at a single location.¹⁴⁰
8. The parent owns a majority of the subsidiary's stock.
9. The entities have common officers or directors.
10. The subsidiary is grossly undercapitalized.
11. The subsidiary transacts business solely with the parent.
12. Both entities disregarding the legal requirements of the subsidiary as a separate corporation.¹⁴¹

¹³⁸ It has been recently argued that a "factor analysis" is a vital component of "modern substantive consolidation jurisprudence." See *Amera*, *supra* note 97, at 12 ("Accordingly, the 'factor analysis' properly remains influential in modern substantive consolidation jurisprudence and it is critical to an understanding of this doctrine that its genesis was in an attempt to determine whether related entities abused the corporate form such that artificial corporate structures should be ignored and the entities' assets should be pooled for distribution for creditors.") (emphasis added). Unfortunately, many (if not most) of the factors considered in "liberal trend" cases have little to do with determining whether a debtor abused its corporate form.

¹³⁹ See Sabin Willett, *The Doctrine of Robin Hood—A Note on "Substantive Consolidation"*, 4 DEPAUL BUS. & COM. L.J. 87, 102 (2005) ("When the informing principle of a 'doctrine' was so vacuous, one could be pretty sure what was coming: factors. Rather than define the doctrine, the courts would list factors, preferable lots of factors. So it went with substantive consolidation."); see also *In re Permian Producers Drilling, Inc.*, 263 B.R. 510, 518 (W.D. Tex. 2000) ("[W]hile several courts have recently attempted to delineate what might be called the 'elements of consolidation,'... only real criterion is... the economic prejudice of continued debtor separateness versus the economic prejudice of consolidation.").

¹⁴⁰ These first seven factors are the so-called *Vecco* factors. See *Vecco*, 4 B.R. at 410 (stating and elaborating on seven factors); see also *In re Mortgage Inv. Co.*, 111 B.R. 604, 610 (Bankr. W.D. Tex. 1990) (applying *Vecco* factors); *Holywell Corp. v. Bank of N.Y.*, 59 B.R. 340, 347 (S.D.Fla.1986) (same).

¹⁴¹ Factors eight through twelve are set forth in *Pension Benefit Guaranty Corp. v. Ouimet Corp.*, 711 F.2d 1085, 1093 (1st Cir. 1983) (establishing and applying factors eight through twelve); see also *Nesbit v. Gears Unlimited, Inc.*, 347 F.3d 72, 87 n.7 (3d Cir. 2003) (noting First Circuit in *Pension Benefit* "passed five nonexclusive factors a court should consider when contemplating substantive consolidation"); *In re Chateaugay Corp.*, 141 B.R. 794, 801 (S.D.N.Y. 1992) (elaborating on court's application of factors in *Pension Benefit*).

13. The existence of a single integrated cash management system.¹⁴²
14. The use of a common name by parent and subsidiary.¹⁴³
15. The common use of intercompany transactions.¹⁴⁴

While a few of these factors are relevant to the consolidation inquiry (e.g., commingling and disregard of the corporate form), many more are routine corporate relationships having no bearing on whether the strong presumption in favor of corporate separateness should be ignored (e.g., common ownership, integrated cash management, common board members, etc.).¹⁴⁵ And some of these factors are internally inconsistent and contradictory. For example, several courts have identified the presence of guaranties as a factor weighing in favor of substantive consolidation, presumably because such guaranties are evidence of an identity of interest among the debtors.¹⁴⁶ But guaranties may also be the best possible evidence that an objecting creditor knew it was dealing with separate entities, thus cutting against substantive consolidation.¹⁴⁷

¹⁴² See *In re GC Cos., Inc.*, 274 B.R. 663, 672 (Bankr. D. Del. 2002), *aff'd in part, rev'd in part on other grounds*, 298 B.R. 226 (D. Del. 2003) (approving consolidation because, among other things, debtors utilized a single integrated cash management system).

¹⁴³ See *GC Cos., Inc.*, 274 B.R. at 672 (relying upon, among other things, existence of common corporate name to approve substantive consolidation).

¹⁴⁴ See *id.* (finding use of intercompany transactions helped to support substantive consolidation).

¹⁴⁵ See generally *Owens Corning*, 419 F.3d 195 (3d Cir. 2005) (denying consolidation even with existence of certain factors); see also *World Access*, 301 B.R. at 276 ("It is true that certain of the factors set forth in *Eastgroup Properties* as potentially relevant to the required prima facie showing are present here. The Debtors published consolidated financial statements . . . ; they filed consolidated tax returns; there is unity of ownership; the companies have overlapping officers and boards of directors; and there are intercorporate guarantees (including, *inter alia*, the guaranty by New World Access of the Convertible Notes) and a centralized cash management system. These phenomena are, however, quite common in today's corporate groups. The same is true of the high level corporate oversight services that New World Access officers and administrative staff provided with respect to cash management, insurance, tax compliance, and legal functions. While these factors have some relevance to the propriety of consolidation, other more important factors have not been established in this case, including the commingling of assets, poor record keeping causing great difficulty in the segregation of individual assets and liabilities, and transfers made without formal observance of corporate formalities.").

¹⁴⁶ See *Vecco*, 4 B.R. at 410 (listing existence of parent and inter-corporate guarantees as factor in favor of consolidation); *In re Drexel Burnham Lambert Group Inc.*, 138 B.R. 723, 766 (Bankr. S.D.N.Y. 1992) (pointing to numerous intercompany guarantees to approve consolidation).

¹⁴⁷ See, e.g., *Augie/Restivo*, 860 F.2d at 519 ("The course of dealing and expectations in the instant case do not justify consolidation . . . MHTC also operated on the assumption that it was dealing with separate entities. MHTC thus sought and received a guarantee from Augie's of MHTC's loans to Augie/Restivo in 1985, including a subordinated mortgage on Augie's real property."); *Gulfco*, 593 F.2d at 928 ("The court was not authorized to eliminate the guarantees running to ICB and the Pratts absent compelling equitable reasons for doing so."); *World Access, Inc.*, 301 B.R. at 287 (stating guarantees to WorldCom supported court's finding that creditors did not deal with debtors as a "single economic unit" and there was no "substantial identity among debtors"); *In re 599 Consumer Elecs., Inc.*, 195 B.R. 244, 249 (Bankr. S.D.N.Y. 1996) ("The Court in *Augie/Restivo* specifically held that a bank's insistence on separate loan guarantees by related corporations displays an understanding that the related corporations are separate entities."); *In re Donut Queen, Ltd.*, 41 B.R. 706, 711 (Bankr. E.D.N.Y. 1984) ("Dunkin' Donuts point to the fact that LIT required both Donut Queen and Bapajo to guarantee its loan to Westbury Donuts as indicative of an

The undue emphasis of factors on a checklist (especially without any distinction between those factors demonstrating abuse and those factors simply demonstrating common ownership) makes the application of this brand of substantive consolidation less predictable and more arbitrary than if based upon the length of the Lord Chancellor's foot.¹⁴⁸ Given the bankruptcy and nonbankruptcy rights and expectations set aside by substantive consolidation,¹⁴⁹ the very validity of the doctrine requires more—that is, more predictable outcomes and more respect for basic corporate and bankruptcy principles.

interconnection between these former entities. This court derives a contrary implication from the evidence. LIT recognized the limited financial resources of Westbury Donuts as a distinct economic unit. In light of Westbury Donut's limited creditworthiness, LIT required the additional assurances of two distinct economic entities and required formal guarantees in recognition that they were indeed distinct. In essence, Dunkin' Donuts is attempting to capitalize on the business acumen of LIT, notwithstanding that it, Dunkin' Donuts, has failed to exercise the same degree of diligence.").

¹⁴⁸ As noted by the Supreme Court in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999), unbounded judicial discretion leads to arbitrary results because of subjective notions of equity:

If, indeed, a Court of Equity in England did possess the unbounded jurisdiction, which has been thus generally ascribed to it, of correcting, controlling, moderating, and even superceding the law, and of enforcing all the rights, as well as charities, arising from natural law and justice, and of freeing itself from all regard to former rules and precedents, it would be the most gigantic in its sway, and the most formidable instrument of arbitrary power, that could well be devised. It would literally place the whole rights and property of the community under the arbitrary will of the Judge, acting, if you please, *arbitrio boni judicis*, and it may be, *ex aequo et bono*, according to his own notions and conscience; but still acting with a despotic and sovereign authority. A Court of Chancery might then well deserve the spirited rebuke of Seldon; "For law we have a measure, and know what to trust to—Equity is according to the conscience of him, that is Chancellor; and as that is larger, or narrower, so is Equity. T is all one, as if they should make the standard for the measure the Chancellor's foot. What an uncertain measure would this be? One Chancellor has a long foot; another a short foot; a third an indifferent foot. It is the same thing with the Chancellor's conscience.

Id. at 332–33 (quoting 1 Commentaries on Equity Jurisprudence § 19, at 21).

¹⁴⁹ See *Woburn Assocs. v. Kahn (In re Hemingway Transport, Inc.)*, 954 F.2d 1, 11–12 (1st Cir. 1992) (describing rights set aside by substantive consolidation); see also *In re Steury*, 94 B.R. 553, 554 (Bankr. N.D. Ind. 1988) (highlighting substantive consolidation effects on bankruptcy rights); Kors, *supra* note 6, at 446–47 ("Consolidation would deny creditors the benefit of their bargain . . . Substantive consolidation can add a large element of uncertainty to credit transactions, which thrive on certainty. Uncertainty increases credit costs. More fundamentally, it seems blatantly unfair to change the ground rules *ex post facto* on a creditor who did exactly what corporate law allows, namely, reliance on the individual credit of a legal entity. Thus, equity and efficiency's demand for clear and certain rules requires that we protect the expectations of contract creditors who justifiably contracted in reliance on the sole credit of 'their' (wealthier) creditor.").

III. SUBSTANTIVE CONSOLIDATION AND THE BANKRUPTCY CODE

As stated above, the Bankruptcy Code has no specific provision that authorizes substantive consolidation in business cases.¹⁵⁰ Despite this lack of express authority, it has been held that the "equitable power [of substantive consolidation] undoubtedly survived the enactment of the Bankruptcy Code" and "[n]o case has held to the contrary."¹⁵¹

While the reported decisions appear to uniformly hold that substantive consolidation remains a viable remedy under the Bankruptcy Code, several commentators have suggested that the doctrine is no longer valid.¹⁵² The arguments against the continued viability of substantive consolidation primarily focus on (i) a bankruptcy court's authority to apply a remedy not expressly provided for in the Bankruptcy Code and (ii) a federal court's inability to fashion new equitable remedies. As demonstrated below, while these arguments should not be a bar to the enforcement of traditional notions of substantive consolidation, they do demonstrate the illegitimate nature of the liberal trend.

A. *The Liberal Trend Violates Section 105 of the Bankruptcy Code*

Courts have traditionally located the authority for substantive consolidation in section 105 of the Bankruptcy Code.¹⁵³ The argument against the continued vitality of substantive consolidation goes as follows: Section 105, standing alone, cannot authorize any remedy. As noted by the Supreme Court, "whatever equitable powers remain in the bankruptcy court must and can only be exercised within the confines of the Bankruptcy Code."¹⁵⁴ Similarly, it is well settled that section 105 is not an

¹⁵⁰ See *Augie/Restivo*, 860 F.2d at 518 ("Substantive consolidation has no express statutory basis but is the product of judicial gloss."); *Donut Queen*, 41 B.R. at 708–09 (noting power to consolidate separate corporate debtors comes from general equity jurisdiction); see also FED. R. BANKR. P. 1015, Advisory Committee Note (1983) ("[Rule 1015] does not deal with the consolidation of cases involving two or more separate debtors . . . Consolidation . . . is neither authorized nor prohibited by this rule.").

¹⁵¹ *Bonham*, 229 F.3d at 765.

¹⁵² See Daniel B. Bogart, *Resisting the Expansion of Bankruptcy Court Power Under Section 105 of the Bankruptcy Code: The All Writs Act and an Admonition from Chief Justice Marshall*, 35 ARIZ. ST. L.J. 793, 810–11 (2003) (arguing substantive consolidation may not be fair to all creditors); Judith Resnik, *Constricting Remedies: The Rehnquist Judiciary, Congress, and Federal Power*, 78 IND. L.J. 223, 266 (2003) (noting bankruptcy judges are restrained in their ability to order substantive consolidation since it is not detailed in Bankruptcy Code); J. Maxwell Tucker, *Grupo Mexicano and the Death of Substantive Consolidation*, 8 AM. BANKR. INST. L. REV. 427, 428 (2000) ("In light of the Grupo Mexicano decision, the 20th Century doctrine of substantive consolidation should be pronounced dead.").

¹⁵³ Section 105(a) of the Bankruptcy Code provides in pertinent part: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a) (2006). See *Owens Corning*, 419 F.3d at 208 (noting section 105(a) of Bankruptcy Code gives courts authorization to exercise substantive consolidation); Katherine D. Kale, *Securitizing the Enterprise: Enterprise Liability and Transferred Receivables in Bankruptcy*, 20 BANKR. DEV. J. 311, 331–32 (2003) (commenting how bankruptcy courts, despite not "being specifically authorized," rely on section 105(a) to order substantive consolidations).

¹⁵⁴ *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988).

authorization to convert the court into a "roving commission to do equity"¹⁵⁵ and may be used only to implement powers already expressed in the provisions of the Bankruptcy Code.¹⁵⁶ Therefore, since there is no specific statute authorizing substantive consolidation, so the argument goes, substantive consolidation is not authorized and is illegitimate.¹⁵⁷

As to traditional substantive consolidation precepts, this line of argument fails for several reasons. First, the *Sampsell* line of cases (i.e., the first prong of the *Augie/Restivo* test) expressly relies upon state law (or the federal common law analogue of state law).¹⁵⁸ As a result, reliance on section 105 is wholly unnecessary for this theory of substantive consolidation because the power to consolidate devolves from nonbankruptcy law. Second, the *Kheel* "hopeless intermingling" line of cases (i.e., the second prong of the *Augie/Restivo* test), simply represents the courts' efforts to do "rough justice" and is essentially a consensual remedy because all creditors benefit.¹⁵⁹ Moreover, the exercise of substantive consolidation in these "hopeless intermingling" cases implements and facilitates the trustee's duties under section 704(1) of the Bankruptcy Code to "close such estate as expeditiously as is compatible with the best interests of the parties in interest."¹⁶⁰ Third, the Bankruptcy Code expressly provides that a chapter 11 plan may provide for the

¹⁵⁵ See, e.g., *United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986) ("[S]tatute does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity."); *Switzer v. Wal-Mart Stores, Inc.*, 52 F.3d 1294, 1302 (5th Cir. 1995) (stressing powers under bankruptcy statute "[do] not . . . constitute a roving commission to do equity").

¹⁵⁶ See *In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004) ("[T]he power to conferred by [section]105 is one to implement rather than override."); *Schwartz v. Aquatic Dev. Group, Inc. (In re Aquatic Dev. Group)*, 352 F.3d 671, 680 (2d Cir. 2003) (affirming provisions contained in section 105(a) are meant to be executed within parameters of Bankruptcy Code itself); *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 19 (Bankr. M.D. Fla. 2005) (remarking how section 105(a) is not meant to overrule "other provisions of . . . Bankruptcy Code").

¹⁵⁷ Tucker, *supra* note 152, at 447 (commenting that no specific statute gave courts power to authorize substantive consolidation). A somewhat related, but equally unavailing, argument is that, because Congress has specifically authorized the substantive consolidation of the estates of spouses, Congress intended to prohibit the remedy as to all other parties. See, e.g., Bogart, *supra* note 152, at 810 (indicating that bankruptcy courts do not know how to "take the hint" when Congress limits their power). Given, however, the well-settled nature of the remedy under the Bankruptcy Act (the Supreme Court decided *Sampsell* more than thirty years prior to enactment of the Bankruptcy Code), it can be assumed that Congress would have specifically mentioned the doctrine if it intended to eliminate it. See, e.g., *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) (commenting that if there is a well settled pre-Code practice, it is assumed "Congress must have enacted the Code with a full understanding of this practice When Congress amends the bankruptcy laws, it does not write 'on a clean slate.' Furthermore, this Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.").

¹⁵⁸ See *supra* Part II.A (describing early substantive consolidation cases).

¹⁵⁹ See *Kheel*, 369 F.2d at 847.

¹⁶⁰ 11 U.S.C. § 704(1) (2006). See Ryan W. Johnson, *The Preservation of Substantive Consolidation*, AM. BANKR. INST. J., July/Aug. 2005, at 44, 63 (commenting when trustee attempts to substantively consolidate two entities because they are too "intermingled for efficient administration, [section] 105(a) of the Code may be invoked in furtherance of the trustee's duty in [section] 704 to close the estate expeditiously, and to examine and object to proofs of claim.").

"merger or consolidation" of the debtor with another entity.¹⁶¹ As a result, the Bankruptcy Code provides sufficient statutory predicates for the use of section 105 to authorize substantive consolidation¹⁶² (at least substantive consolidations that involve true consolidations and not just "deemed" consolidations).

This does not mean, however, that the Bankruptcy Code provides a valid basis for any brand of substantive consolidation. Indeed, the so-called liberal-trend cases find no basis in the Bankruptcy Code. First, there is no authority in the Bankruptcy Code to consolidate entities if such entities would have been respected as separate entities under applicable nonbankruptcy law.¹⁶³ Indeed, "[t]he more the power of substantive consolidation departs from traditional veil-piercing, the harder it is to locate the power inside the Bankruptcy Code."¹⁶⁴ As a result, the more liberal the application of substantive consolidation, the more likely a court will find the doctrine is invalid altogether. Second, the liberal trend was only announced *after* the enactment of the Bankruptcy Code, while the doctrine of substantive consolidation was developed *prior to* the enactment of the Bankruptcy Code.¹⁶⁵ Assuming that Congress intended to preserve the doctrine, there is no basis for concluding that the doctrine survived enactment of the Bankruptcy Code in some watered-down form. Third, there can be no dispute that section 105 cannot be used to nullify other, more specific provisions of the Bankruptcy Code.¹⁶⁶ Substantive consolidation, however, often contradicts multiple sections of the Bankruptcy Code, such as a creditor's right to vote on the plan of its debtor (and that plan alone),¹⁶⁷ a creditor's right to demand that its debtor's plan be in the "best interests" of

¹⁶¹ See 11 U.S.C. § 1123(a)(5)(C) (2006) (notwithstanding any otherwise applicable non-bankruptcy law, chapter 11 plans may provide for "consolidation of the debtor with one or more persons . . ."); see also Daniel J. Carragher, *The Narrowing Preemptive Power of Chapter 11*, AM. BANKR. INST. J., Feb. 2004, at 32, 33 (2004) (listing requirements needed for filing of chapter 11 plans); Tucker, *supra* note 152, at 448 (indicating section 1123(a)(5)(C) of Bankruptcy Code gives bankruptcy court power to order consolidation only if chapter 11 plan is on file).

¹⁶² See *In re WorldCom, Inc.*, No. 02-13533, 2003 Bankr. LEXIS 1401, at *103 (Bankr. S.D.N.Y. Oct. 31, 2003) ("The Bankruptcy Code itself contemplates that substantive consolidation may be used to effectuate a plan of reorganization."); see also *In re Stone & Webster, Inc.*, 286 B.R. 532, 540-43 (Bankr. D. Del. 2002) (finding statutory basis for allowance of substantive consolidation in chapter 11 cases); *Standard*, 154 B.R. at 567 (stating section 1123(a)(5)(C) provides only source of statutory reference for consolidation).

¹⁶³ See *In re A.H. Robins Co.*, 182 B.R. 128, 134 n.5 (Bankr. E.D. Va. 1995) (explaining equitable provisions exercised by courts must be 'strictly confined' within established boundaries set forth by Code); see also Tucker, *supra* note 152, at 449 ("Section 105 cannot be used to expand the use of section 1123(a)(5)(C) outside the context of a chapter 11 plan since 'when a specific Code section addresses an issue, a court may not employ its equitable powers to achieve a result not contemplated by the Code.'").

¹⁶⁴ Baird, *supra* note 50, at 21.

¹⁶⁵ See *supra* Part II.A (describing early substantive consolidation cases).

¹⁶⁶ See *In re Combustion Eng'g, Inc.*, 391 F.3d 190, 236 (3d Cir. 2004) ("The general grant of equitable power contained in [section] 105 cannot trump specific provisions of the Bankruptcy Code, and must be exercised within the parameters of the Code itself."); see also *In re Zale Corp.*, 62 F.3d 746, 760 (5th Cir. 1995) ("A [section] 105 injunction cannot alter another provision of the [C]ode.").

¹⁶⁷ See 11 U.S.C. § 1126(a) (2006) ("The holder of a claim or interest allowed under section 502 of this title may accept or reject a plan. If the United States is a creditor or equity security holder, the Secretary of the Treasury may accept or reject the plan on behalf of the United States.").

creditors,¹⁶⁸ a creditor's right to impose the "absolute priority" rule,¹⁶⁹ and a creditor's right to enforce the seniority of its claims.¹⁷⁰ These contraventions of bankruptcy law are exacerbated if substantive consolidation is granted on a nonconsensual basis based upon facts that would not support the disregard of corporate separateness under nonbankruptcy law. Fourth, many of the liberal-trend cases are "deemed" consolidations, i.e., consolidations for distribution purposes only. Because section 1123(a)(5)(C) contemplates an actual consolidation, nonconsensual "deemed" consolidations appear to lack statutory authority. In short, section 105 is not and cannot be the basis for the implementation of a "liberal" form of substantive consolidation.

B. The Liberal Trend Violates the Holding of Grupo Mexicano

In *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*,¹⁷¹ the Supreme Court held that federal courts lack the authority to enjoin pre-judgment transfers of assets because there was no legislative authority for that extraordinary remedy and because such remedy did not exist at the adoption of the Judiciary Act of 1789.¹⁷² Specifically, the Court held the following:

The equitable powers conferred by the Judiciary Act of 1789 did not include the power to create remedies previously unknown to equity jurisprudence. Even when sitting as a court of equity, we have no authority to craft a "nuclear weapon"¹⁷³ of the law advocated here.¹⁷⁴

Arguing by analogy, some commentators contend that the *Grupo Mexicano* doctrine invalidates substantive consolidation, because substantive consolidation did not as exist as a doctrine until the Supreme Court first announced it

¹⁶⁸ See 11 U.S.C. § 1129(a)(7) (2006) (providing each dissenting creditor must receive at least as much as such creditor would have received in liquidation).

¹⁶⁹ See 11 U.S.C. § 1129(b)(2)(B) (2006) (preventing equityholders from recovering or retaining any property unless unsecured creditors are paid in full). Consolidation of a valuable subsidiary with its parent allows the parent to continue to own the subsidiary, without payment in full to the subsidiary's creditors.

¹⁷⁰ See 11 U.S.C. § 510(a) (2006) ("A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law.").

¹⁷¹ 527 U.S. 308 (1999).

¹⁷² *Grupo Mexicano*, 527 U.S. at 332.

¹⁷³ The Supreme Court used the phrase "nuclear weapon" to describe the specific injunction—the so-called *Mareva* injunction—at issue in *Grupo Mexicano*. The injunction has been described as a "nuclear weapon of the law," both because it is a "powerful tool of general creditors" and completely contrary to previously well-established law (the first *Mareva* injunction issued in 1975). See *id.* at 327–29 (explaining English Court of Appeal decision in *Mareva Compania Naviera S.A. v. International Bulkcarriers S.A.*, 2 Lloyd's Rep. 509 (1975)).

¹⁷⁴ *Id.* at 332.

approximately 150 years *after* the enactment of the Judiciary Act.¹⁷⁵ This argument is deficient, at least as to "traditional" notions of substantive consolidation. First, as set forth above (and unlike in *Grupo Mexicano*), there is statutory authority for substantive consolidation.¹⁷⁶ Second, even the proponents of this *Grupo Mexicano* argument concede that federal courts have the power to invoke substantive consolidation when they "follow state corporate law 'alter ego' principles."¹⁷⁷ Third, *Sampsell* was decided two years *after* the Supreme Court held that a federal court's equitable authority "is an authority to administer in equity suits the principles of the system of judicial remedies which had been devised and was being administered by the English Court of Chancery at the time of the separation of the two countries."¹⁷⁸ In other words, the Supreme Court approved a turnover/consolidation remedy in *Sampsell* two years *after* it held that the equitable authority of a federal court was "frozen" as of 1789. Obviously, if the Supreme Court was not concerned that substantive consolidation was unavailable under the Judiciary Act of 1789, neither should courts today, at least as to the traditional concepts of substantive consolidation.

Notably, however, the "liberal" application of substantive consolidation likely runs afoul of the holding of *Group Mexicano*. The liberal form of substantive consolidation is analogous to the *Mareva* injunction at issue in *Grupo Mexicano* in at least two important ways. First, both are significant departures from prior practice. As described in Part II.A, the liberal or modern trend cases advocate a relaxed standard for substantive consolidation, despite the fact that the courts of appeal are unanimous that the remedy should be seldom used. Similarly, the *Mareva* injunction was a "dramatic departure from prior practice."¹⁷⁹ Second, both the *Mareva* injunction and the liberal trend cases would bestow an overwhelming advantage to certain creditors, an advantage never granted by any legislature (as colorfully described by the Supreme Court, a "nuclear weapon of the law").¹⁸⁰ Notably, it was the perceived abuse of this judicially created equitable doctrine that caused the Supreme Court to invalidate the practice altogether. Similarly, the unchecked "liberal" expansion of substantive consolidation could lead to its own demise.

¹⁷⁵ See, e.g., Tucker, *supra* note 152, at 427–28 (indicating remedy of substantive consolidation was not a remedy available to the English Court of Chancery in 1789 and thus "should be pronounced dead"); Baird, *supra* note 50, at 20 (discussing *Grupo Mexicano* holding against recently developed doctrine of substantive consolidation).

¹⁷⁶ See *supra* Part III.A (discussing statutory authority for substantive consolidation).

¹⁷⁷ See, e.g., Tucker, *supra* note 152, at 431 (stating limitation on federal equitable powers is not invoked where federal courts follow state corporate law "alter ego" principles in consolidation of corporations).

¹⁷⁸ *Atlas Life Ins. Co. v. W.I. S., Inc.*, 306 U.S. 563, 568 (1939); see also *Markham v. Allen*, 326 U.S. 490, 494 (1946) (stating federal courts lack equitable authority to probate wills because there was no such equitable authority under Judiciary Act of 1789).

¹⁷⁹ *Grupo Mexicano*, 527 U.S. at 328.

¹⁸⁰ See *id.* at 329; see also *Credit Agricole Indosuez v. Rossiyskiy Kredit Bank*, 94 N.Y.2d 541, 550–51 (N.Y. 2000) ("[W]idespread use of [*Mareva* injunction] would drastically unbalance existing creditors' and debtors' rights.").

IV. OWENS CORNING AND THE REJECTION OF THE LIBERAL TREND

Owens Corning, one of the largest manufacturers of roofing and insulation materials in the United States, filed a case under chapter 11 of the Bankruptcy Code on October 5, 2000.¹⁸¹ Owens Corning's chapter 11 filing was necessitated by its substantial tort liability, estimated by the District Court of Delaware to be \$7 billion.¹⁸² Through 1973, Owens Corning and its subsidiary Fibreboard Corporation produced various products containing asbestos—a mineral¹⁸³ that has been found to cause asbestosis and other respiratory diseases after prolonged exposure.¹⁸⁴ Even though Owens Corning and Fibreboard Corporation had not produced any asbestos-containing products for more than twenty-five years, their asbestos liability continued to mount because of the long latency period for certain asbestos-related diseases¹⁸⁵ and the resulting "elephantine mass"¹⁸⁶ of asbestos litigation—arguably involving many "unimpaired" claimants with no discernable injury.¹⁸⁷ As with numerous other manufacturers, Owens Corning was unable to properly defend or settle the numerous claims brought against it and sought bankruptcy protection.¹⁸⁸

¹⁸¹ *Owens Corning*, 322 B.R. at 719.

¹⁸² *Id.* at 725 (estimating dollar amount of debtor's tort liability based on litigation projections).

¹⁸³ *Id.* at 722 (identifying other asbestos-containing products distributed by Owens Corning); see, e.g., John P. Kincade, *Issues in School Asbestos Hazard Abatement Litigation*, 16 ST. MARY'S L.J. 951, 953 (1985) ("Asbestos is the generic name for naturally occurring minerals which separate into fiber."); see also *Owens Corning and Fibreboard Corporation Announce Merger Agreement*, PR NEWSWIRE, May 28, 1997, <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/127865&EDATE=>

(commenting on Fibreboard's commitment to resolving company's asbestos problems).

¹⁸⁴ See, e.g., *Brennan v. Norton*, 350 F.3d 399, 415 n.11 (3d Cir. 2003) (Asbestos is "a 'toxic material,' whose 'fibers break down into microscopic, friable particles that can be easily inhaled. Friable particles remaining in the lung often produce asbestos related diseases such as asbestosis, lung cancer, and mesothelioma.'" (quoting Arthur A. Schulcz, *Recovering Asbestos Abatement Costs*, 10 GEO. MASON U. L. REV. 451, 452–53 (1988))); Michelle J. White, *Asbestos Litigation: Procedural Innovations and Forum Shopping*, 35 J. LEGAL STUD. 365, 367 (2006) ("Asbestosis and mesothelioma are both uniquely associated with asbestos exposure."). See generally *Teg-Paradigm Envtl., Inc. v. United States*, 2006 U.S. App. LEXIS 24520, at *1–3 (determining that asbestos-containing material must be abated to comply with trade custom).

¹⁸⁵ See *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 822 n.1 (1999) (stating latency period for certain asbestos-related diseases is forty years or more); see also Richard L. Revesz, *Environmental Regulation, Cost-Benefit Analysis, and the Discounting of Human Lives*, 99 COLUM. L. REV. 941, 952 (1999) ("The use of asbestos products does not necessarily result in immediate exposure; instead, exposure occurs when the product containing the asbestos begins to disintegrate.").

¹⁸⁶ *Fibreboard Corp.*, 527 U.S. at 821 (1999) (submitting elephantine mass of asbestos tort claims prompts litigation); see *In re Joint E. & S. Dist. Asbestos Litig.*, 237 F. Supp 2d 297, 335 (E.D.N.Y. 2002) (suggesting federal legislation as most appropriate resolution to problem of "elephantine mass of asbestos [litigation]" (quoting *Fibreboard Corp.*, 527 U.S. at 821)).

¹⁸⁷ See *In re Federal-Mogul Global, Inc.* 330 B.R. 133, 139 (D. Del. 2005) (analyzing expert testimony regarding asbestos-related injury from previous cases); Griffin B. Bell, *Asbestos Litigation & Tort Law: Trends, Ethics & Solutions: Asbestos & the Sleeping Constitution*, 31 PEPP. L. REV. 1, 1 (2003) ("Asbestos litigation now stands as the only part of our tort system in which people who can show no real physical injury are routinely allowed to recover.").

¹⁸⁸ *Credit Suisse*, 322 B.R. at 720 (stating company filed bankruptcy when there were approximately 188,000 pending claims against it); see, e.g., *Nat'l Cas. Co. v. First State Ins. Group*, 430 F.3d 492, 494 n.1 (1st Cir. 2005) ("[C]laims pressed against asbestos manufacturers, are now rare: the pool of funds available

A. *Owens Corning's Corporate and Capital Structure*

Owens Corning Delaware, the corporate parent of the Owens Corning companies, is both a holding company and an operating company.¹⁸⁹ It was Owens Corning Delaware that produced and sold asbestos-containing products.¹⁹⁰ Owens Corning Delaware owns numerous domestic and foreign subsidiaries, including Fibreboard Corporation.¹⁹¹

In 1997, Owens Corning Delaware entered into a \$2 billion credit agreement with its pre-petition lenders.¹⁹² Because of Owens Corning Delaware's well-known (but then-unquantified) asbestos liability, the pre-petition lenders insisted upon guaranties from Owens Corning Delaware's "significant subsidiaries."¹⁹³ Other than the guarantor liability and certain inter-company obligations, the guarantor subsidiaries had essentially no debt and, in certain instances, extremely valuable assets, such as Owens Corning's intellectual property and the stock of its foreign subsidiaries.¹⁹⁴

B. *The Substantive Consolidation Motion*

In January 2003, the Owens Corning debtors filed a chapter 11 plan that provided for the substantive consolidation of the estate of Owens Corning Delaware and seventeen of its debtor and non-debtor subsidiaries.¹⁹⁵ Substantive consolidation would have had the effect of eliminating the Banks' guaranties, thus

to cover this type of claim was largely depleted by the 1990s as the asbestos manufacturers went bankrupt."); *Combustion Eng'g*, 391 F.3d at 201 ("[M]ounting asbestos liabilities have pushed otherwise viable companies into bankruptcy.").

¹⁸⁹ See *Owens Corning*, 419 F.3d at 200 n. 3 ("Owens-Corning Fiberglass Technology, Inc . . . was created as an intellectual property holding company to which [Owens Corning Delaware] assigned all of its domestic intellectual property."); A History of Innovation, <http://www.owenscorning.com/acquainted/about/history> (last visited Oct. 30, 2006) (providing overview of Owens Corning company history).

¹⁹⁰ See Dana K. Astrachan, Note, *Anderson v. Owens-Corning Fiberglass Corp.: Asbestos Manufacturers and Strict Liability: Just How Strict Is It?*, 23 PAC. L.J. 1807, 1846 (1992) (noting instance where Owens Corning manufactured products containing asbestos); A History of Innovation: The 1990s, <http://www.owenscorning.com/acquainted/about/history/1990.asp> (last visited Oct. 30, 2006) (giving brief synopsis of asbestos litigation against Owens Corning).

¹⁹¹ See *Owens Corning*, 419 F.3d at 200 n.3 (describing Owens Corning Delaware's corporate structure, including its ownership of Fibreboard Corporation); William S. Katchen, *Lessons on Substantive Consolidation: Third Circuit Reverses Order Substantively Consolidating Owens Corning*, Sept. 19, 2005, available at <http://www.duanemorris.com/alerts/alert1969.html> (stating Owens Corning acquired Fibreboard Corporation prior to 1997).

¹⁹² *Owens Corning*, 419 F.3d at 201 ("A \$2 billion loan from the Banks to OCD closed in June 1997.").

¹⁹³ *Id.* ("At this time OCD faced growing asbestos liability and a poor credit rating that hindered its ability to obtain financing. When CSFB was invited to submit a bid, it included subsidiary guaranties in the terms of its proposal.").

¹⁹⁴ *Id.* at 200 n.3 (stating Owens Corning Delaware had intellectual property assets valued at over \$500 million).

¹⁹⁵ *Id.* at 201-02 ("OCD and seventeen of its subsidiaries (collectively, the "Debtors") . . . and certain unsecured creditor groups . . . proposed a reorganization plan . . . predicated on obtaining 'substantive consolidation' of the Debtors along with three non-Debtor OCD subsidiaries.").

making the substantial value of the subsidiaries available to all creditors of Owens Corning Delaware.¹⁹⁶ Not surprisingly, substantive consolidation was supported by nearly every significant creditor constituency of the parent (except, of course, for the pre-petition bank lenders).¹⁹⁷

C. *The District Court Decision*

The District Court of the District of Delaware considered the substantive consolidation issue in the context of the *Auto-Train* balancing test, as interpreted by *Eastgroup*.¹⁹⁸ In a decision that perhaps best embodies the unpredictable nature of the liberal trend, the district court held that the proponents had met their twin burdens of demonstrating both a substantial identity among the companies to be consolidated and the benefits to be achieved by consolidation.¹⁹⁹ As to substantial identity, the district court found determinative that (i) a central committee exercised common control over decision making for the subsidiaries and (ii) the subsidiaries were chiefly created for tax reasons.²⁰⁰ In other words, there was not a hint that Owens Corning had committed any fraud or in any way had abused its corporate form to the harm of a single creditor. Similarly, the district court found substantive consolidation would be beneficial because it would "greatly simplify and expedite" emergence from chapter 11 and because it would obviate any hypothetical challenge to Owens Corning's books and records.²⁰¹ Notably, these benefits are likely present in every case because substantive consolidation *always* streamlines issues (granting a plaintiff a judgment without the burden of actually proving its case certainly expedites trials) and creditors can *always* challenge book entries. If the extraordinary and seldom-used remedy of substantive consolidation can be deployed on such facts, then the remedy is neither extraordinary, nor will it be seldom used. But this is the legacy of the liberal trend—creating a test *always* satisfied.

¹⁹⁶ See *id.* at 202 (describing how substantive consolidation "pools all assets and liabilities of the subsidiaries into their parent and treats all claims against the subsidiaries as transferred to the parent").

¹⁹⁷ *Owens Corning*, 419 F.3d at 202 ("The Banks objected to the proposed consolidation."). Due to a conflict between its bank and bondholder members, the official committee of unsecured creditors took no position on consolidation.

¹⁹⁸ *Owens Corning*, 316 B.R. at 170. Notably, the district court also cited *Augie/Restivo*, but significantly diluted *Augie/Restivo's* actual holding. *Id.* at 171. In *Augie/Restivo*, the Second Circuit held that consolidation is appropriate if the affairs of two companies were so hopelessly entangled "that consolidation will benefit *all* creditors." *Owens Corning*, 860 F.2d at 518 (emphasis added). In a subtle but important difference, the *Owens Corning* district court described the *Augie/Restivo* standard as "whether the affairs of the two companies are so entangled that consolidation will be *beneficial*." *Owens Corning*, 316 B.R. at 171.

¹⁹⁹ *Owens Corning*, 316 B.R. at 172 ("I have concluded that substantive consolidation should be permitted, not only because of its obvious advantages . . . but also because I see no reason why the Banks' claim cannot be appropriately dealt with in a consolidation plan of reorganization.").

²⁰⁰ *Id.* ("All of the subsidiaries were controlled by a single committee . . . without regard to the subsidiary structure . . . Subsidiaries were established for the convenience of the parent company, primarily for tax reasons.").

²⁰¹ *Id.*

Having concluded that the proponents had established a prima facie case, the burden under *Eastgroup* then shifted to the pre-petition bank lenders to demonstrate reliance on corporate separateness.²⁰² Instead of focusing on whether the lenders extended credit in reliance on the separate existence of the guarantors,²⁰³ the district court examined whether it subjectively believed the lenders had sufficient information about the guarantors so as to have relied upon their separate "creditworthiness" in extending credit.²⁰⁴ Ultimately, the district court (applying its own credit metrics) determined that the lenders did not have sufficient information²⁰⁵ about the value of the guarantors and, therefore, presumably extended credit to the "entire Owens Corning enterprise."²⁰⁶ Again, it does not promote reliability and predictability for a court to apply a subjective after-the-fact test and second-guess creditors as to whether they made good business decisions. Moreover, the court's decision was conspicuously silent as to why the lenders' business judgment was relevant to whether there was any cause to ignore the legal separateness of a major American corporation, as well as the basis for casting aside all of the legal rights and expectations associated with such separateness.

D. Third Circuit Decision

The Third Circuit²⁰⁷ reversed the district court and articulated the standard for substantive consolidation in bankruptcy cases in the Third Circuit. The decision is essentially an explication of *Augie/Restivo* and a firm rejection of the liberal trend case law.²⁰⁸

The Third Circuit identified the following five over-arching themes, thus avoiding the pitfall of reliance upon a checklist of factors²⁰⁹ that could be

²⁰² See *Owens Corning*, 316 B.R. at 171 (holding once a prima facie case for consolidation has been established "burden would then shift to the objecting creditor, to show (1) that it relied on the separate credit of one of the entities to be consolidated, and (2) that it will be prejudiced by substantive consolidation").

²⁰³ See *id.* at 171.

²⁰⁴ See *id.* (finding once proponents of substantive consolidation had established prima facie case, "the next question is whether the Banks have proved that they relied upon the separate credit of the subsidiaries").

²⁰⁵ See *id.* at 172 ("In short, there is simply no basis for a finding that, in extending credit, the Banks relied upon the separate credit of any of the subsidiary guarantors. This is not to say that the guarantees were not important to the Banks. The guarantees greatly simplified the administration of the Credit Agreement, and protected the Banks from having their claim subordinated to subsequent indebtedness of the subsidiary guarantors.").

²⁰⁶ *Id.* ("There can be no doubt that the Banks relied upon the overall credit of the entire Owens Corning enterprise.").

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

²⁰⁸ See *id.* at 209 n.15 ("Thus we disagree with the assertion of a 'liberal trend' toward increased use of substantive consolidation—e.g., *Eastgroup* . . ."); see also *In re Lisanti Foods, Inc.*, 2006 WL 2927619, at *7 ("In *Owens Corning*, the Third Circuit began by 'expressing its clear preference for *Augie/Restivo* over what it considered to be the insufficiently stringent test from *Auto-Train*."); cf. *In re Amco Ins.*, 444 F.3d 690, 697 n.5 (5th Cir. 2006) ("[T]hose jurisdictions that have allowed [substantive consolidation] emphasize that substantive consolidation should be used 'sparingly.'") (quoting *Owens Corning*, 419 F.3d at 208–09).

²⁰⁹ The court, emphasizing that the reliance on factors often causes parties to miss the point entirely, i.e., whether or not any harm has been committed that requires a remedy at all, concluded: "This often results in rote following of a form containing factors where courts tally up and spit out a score without an eye on the

misapplied in subsequent decisions. These themes are the following:

1. Limiting the cross-creep of liability by respecting entity separateness is a fundamental ground rule. As a result, the general expectation of state law and of the Bankruptcy Code, and thus of commercial markets, is that courts respect entity separateness absent compelling circumstances calling equity (and even then only possibly substantive consolidation) into play.
2. The harms substantive consolidation addresses are nearly always those caused by *debtors* (and entities they control) who disregard separateness. Harms caused by creditors typically are remedied by provisions found in the Bankruptcy Code (e.g., fraudulent transfers, sections 548 and 544(b)(1), and equitable subordination, section 510(c)).
3. Mere benefit to the administration of the case (for example, allowing a court to simplify a case by avoiding other issues or to make post-petition accounting more convenient) is hardly a harm calling substantive consolidation into play.
4. Indeed, because substantive consolidation is extreme (it may affect profoundly creditors' rights and recoveries) and imprecise, this "rough justice" remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies (for example, the possibility of more precise remedies conferred by the Bankruptcy Code).
5. While substantive consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used offensively (for example, having a primary purpose to disadvantage tactically a group of creditors in the plan process or to alter creditor rights).²¹⁰

principles that give the rationale for the substantive consolidation (and why, as a result, it should so seldom be in play)." *Owens Corning*, 419 F.3d at 210; *see also Bonham*, 229 F.3d at 765–66 n.10 (9th Cir. 2000) (considering "checklist of factors"); *cf. Amera*, *supra* note 97, at 16 ("Consolidation was granted based on the presence of the instrumentality factors, and hopeless entanglement was considered in addition to these factors, not as an alternative to them.").

²¹⁰ *Owens Corning*, 419 F.3d at 211; *see Reider*, 31 F.3d at 1108 (recognizing under the Second Circuit test, substantive consolidation may be warranted if "affairs of debtors are so entangled that consolidation will benefit all creditors"); *see also Evans Temple Church of God in Christ & Cmty Ctr., Inc., v. Carnegie Body Co. (In re Evans Temple Church of God in Christ)*, 55 B.R. 976, 981 (Bankr. D. Ohio 1986) ("Substantive consolidation is employed in cases where the interrelationships of the debtors are hopelessly obscured and the time and expense necessary to attempt to unscramble them is so substantial as to threaten the realization of any net assets for all of the creditors."). *See generally* Kors, *supra* note 6, at 381 (summarizing process through which there is "merger of two or more legally distinct (albeit affiliated) entities into a single debtor with a common pool of assets and a common body of liabilities").

In other words, the *Owens Corning* court made clear that substantive consolidation should not be used as a panacea for whatever ails a chapter 11 estate—substantive consolidation is a creditor's remedy and may only be used to rectify a specific harm caused by the debtor.²¹¹

The Third Circuit articulated its substantive consolidation test as follows:

The upshot is this. In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) [pre-petition] they disregarded separateness so significantly their creditors relied²¹² on the breakdown of entity borders and treated them as one legal entity, or (ii) [post-petition] their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.²¹³

* * *

Proponents of substantive consolidation have the burden of showing one or the other rationale for consolidation. The second rationale needs no explanation. The first, however, is more nuanced. A *prima facie* case for it typically exists when, based on the parties' [pre-petition] dealings, a proponent proves corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity.²¹⁴

* * *

Proponents who are creditors must also show that, in their [pre-petition] course of dealing, they actually and reasonably relied on debtors' supposed unity. Creditor opponents of consolidation can nonetheless defeat a *prima facie* showing under the first rationale if they can prove they are adversely affected and actually relied on debtors' separate existence.²¹⁵

²¹¹ See *Owens Corning*, 419 F.3d at 205 ("The concept of substantively consolidating separate estates begins with a commonsense deduction. Corporate disregard as a fault may lead to corporate disregard as a remedy.").

²¹² Indeed, the Third Circuit made clear that (unlike in *Eastgroup*), proof of reliance ends the inquiry—at least as to that creditor. See *Owens Corning*, 419 F.3d at 210 ("If an objecting creditor relied on the separateness of the entities, consolidation cannot be justified vis-à-vis the claims of that creditor."). The court left open the issue as to whether a court could nevertheless order a partial consolidation—treating the objecting creditor as if there were no consolidation, and consolidating for each other creditor. See *id.* at n.16 ("This opens the question whether a court can order partial consolidation.").

²¹³ *Id.* at 211.

²¹⁴ *Id.* at 212 (citations omitted).

²¹⁵ *Id.* (citations omitted).

The court proceeded to find that the resolution of the case was then "easy" on the facts presented—Owens Corning's affairs were not so scrambled that unscrambling them would reduce the recovery to all creditors.²¹⁶ On the contrary, the books had been reconciled and only hypothetical concerns about perfection remained.²¹⁷

Moreover, there was little, if any evidence presented at trial to suggest that creditors were generally misled into believing that Owens Corning, a public company making regular public filings, was indistinguishable from its subsidiaries.²¹⁸ Indeed, the bank lenders knew they were dealing with multiple companies, as evidenced by the guaranties themselves.²¹⁹ While the district court found that the bank lenders knew insufficient information regarding the value of the subsidiaries so as to have relied upon their *creditworthiness*, the Third Circuit made clear that it is separate entities that are important.²²⁰

The Third Circuit believed that other considerations "doomed" consolidation as well. First, the district court had ordered consolidation and reserved for the confirmation hearing consideration of the extent of a priority for the bank lenders' claims.²²¹ The Third Circuit held that "holding out the possibility of later giving priority to the Banks on their claims does not cure an improvident grant of substantive consolidation. Among other things, the prerequisites for this last-resort remedy must still be met no matter the priority of the Banks' claims."²²²

Second, the Owens Corning debtors made plain that a principle benefit to be achieved through consolidation was the avoidance of litigation, specifically, fraudulent conveyance and veil-piercing claims. Indeed, the debtors' fear of litigation caused the district court to conclude that consolidation was a "virtual necessity."²²³ The Third Circuit, however, made clear that substantive consolidation

²¹⁶ See *id.* at 199 ("While this area of law is difficult and this case important, its outcome is easy with the facts before us.").

²¹⁷ See *id.* at 215 (discussing nature of imperfection in "substantive consolidation context").

²¹⁸ See *Owens Corning*, 419 F.3d at 212–14 ("[T]here was no evidence of the [pre-petition] disregard of the OCD entities' separateness.").

²¹⁹ See *id.* at 213 ("[G]uarantees were intended to provide 'structural seniority' to the banks, and were thus fundamentally premised on an assumption of separateness.") (internal quotations and citations omitted).

²²⁰ See *id.* at 214 ("We agree with the Banks that 'the reliance inquiry is not an inquiry into lenders' internal credit metrics. Rather, it is about the *fact* that the credit decision was made in reliance on the existence of separate entities' . . . Here there is no serious dispute as to that fact.") (citations omitted). This holding is consistent with prior appellate holdings. See, e.g., *Bonham*, 229 F.3d at 766 (adopting Second Circuit's approach requiring consideration of "whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit"); *Hemingway Transp.*, 954 F.2d at 12 n.16 (holding "consolidation should not be permitted . . . if holders of unsecured claims reasonably relied on the fact that the related debtors were *distinct entities* at the time credit was extended"); *Augie/Restivo*, 860 F.2d at 518 (noting critical inquiry was whether creditor "did not rely on their separate identity in extending credit.").

²²¹ *Owens Corning*, 419 F.3d at 215 (discussing first consideration).

²²² *Id.*

²²³ *Owens Corning*, 316 B.R. at 172 ("I have concluded that substantive consolidation should be permitted . . . because it is a virtual necessity . . ."); see *Helena Chem. Co. v. Circle Land & Cattle Corp. (In re Circle Land & Cattle Corp.)*, 213 B.R. 870, 875 (Bankr. D. Kan. 1997) (requiring a showing of "necessity" for substantive consolidation).

is a remedy in its own right and may not be used as a surrogate to avoid litigating other claims.²²⁴ This is particularly true because consolidation will often hand one party a litigation victory, without the necessity of proving its case.²²⁵

Finally, the Third Circuit was very troubled by the fact the "deemed" or "pretend" nature of the consolidation—described by the Third Circuit as "several zip (if not area)—codes away from anything resembling substantive consolidation."²²⁶ The deemed nature of the consolidation underscored that consolidation was not undertaken in that case to remedy any harm. After all, if the debtors had duped creditors into wrongly believing they were one integrated company, why allow them to continue to deceive?²²⁷

CONCLUSION

Substantive consolidation remains an important and viable equitable remedy

²²⁴ See *Owens Corning*, 419 F.3d at 215.

²²⁵ *Owens Corning*, 419 F.3d at 215. The Third Circuit opined:

[S]ubstantive consolidation should be used defensively to remedy identifiable harms, not offensively to achieve advantage over one group in the plan negotiation process (for example, by deeming assets redistributed to negate plan voting rights), nor a 'free pass' to spare Debtors or any other group from proving challenges, like fraudulent transfer claims, that are liberally brandished to scare yet are hard to show. If the Banks are so vulnerable to the fraudulent transfer challenges Debtors have teed up (but have not swung at for so long), then the game should be played to the finish in that arena.

Id.; see *Amco Ins.*, 444 F.3d at 696–97 n.5 (emphasizing substantive consolidation is not free pass to spare Debtors from obligation of proving challenges); Bruce H. White & William L. Medford, *Practice and Procedure: Substantive Consolidation Redux: Owens Corning*, AM. BANKR. INST. J., Nov. 2005, at 47 (noting substantive consolidation is defensive shield and used sparingly).

²²⁶ *Owens Corning*, 419 F.3d at 216 (quoting *Genesis Health Ventures, Inc. v. Stapleton*, 402 F.3d 416, 424 (3d Cir. 2005)); Kit Weitnauer, *Third Circuit Restricts Substantive Consolidation in Owens Corning*, AM. BANKR. INST. J., Oct. 2005, at 26 (noting Third Circuit's rejection of "deemed" consolidation as substantive consolidation); cf. William Widen, *Prevalence of Substantive Consolidation in Large Bankruptcies from 2000 to 2004: Preliminary Results*, 14 AM. BANKR. INST. L. REV. 47, 50 (2006) (indicating court conflict over whether "deemed" consolidation should be considered substantive consolidation).

²²⁷ *Owens Corning*, 419 F.3d at 216.

If Debtors' corporate and financial structure was such a sham before the filing of the motion to consolidate, then how is it that post the Plan's effective date this structure stays largely undisturbed, with the Debtors reaping all the liability-limiting, tax and regulatory benefits achieved by forming subsidiaries in the first place? In effect, the Plan Proponents seek to remake substantive consolidation not as a remedy, but rather a stratagem to "deem" separate resources reallocated to OCD to strip the Banks of rights under the Bankruptcy Code, favor other creditors, and yet trump possible Plan objections by the Banks. Such "deemed" schemes we deem not Hoyle.

Id.; see Baird, *supra* note 50, at 14 ("[E]ntities could not be both so entangled as to justify consolidation and yet so distinct that it was possible and desirable to keep them separate after bankruptcy."); Willett, *supra* note 139, at 111 (noting in nonconsensual plan, "[i]f debtors are being consolidated for 'plan purposes,' but left apart as separate corporate entities post exit, we have truly entered a lawless realm").

under the Bankruptcy Code. There can be, however, too much of a good thing. If the rigorous standards for substantive consolidation are watered down, the remedy becomes chaotic and unpredictable, and likely illegal, because of the evisceration of otherwise settled nonbankruptcy law and rights.

The inherent dangers of the unprincipled liberal trend in favor of substantive consolidation can be summed up as follows:

Courts appear to analyze substantive consolidation under a variety of different tests and with an eye toward protecting various reliance interests. Yet these approaches are little more than legitimating devices for an ad hoc application of a doctrine that significantly affects corporate risk allocation. A doctrinal analysis of substantive consolidation can only provide an illustration of how difficult it is to predict instances in which it will be applicable. The only guide to predicting case outcomes is a general impression that courts harbor some vague concerns about protecting creditor expectations. The primary difficulty with substantive consolidation is that its application is uncertain and unprincipled.²²⁸

The Third Circuit's decision in *Owens Corning* is a significant step towards restoring principle and predictability in this critical area of bankruptcy law. In fact, despite concerns that the Third Circuit's decision in *Owens Corning* has killed the doctrine of substantive consolidation,²²⁹ in reality, the decision has likely done quite the opposite, setting forth principles capable of clear application and, thereby, preserving the doctrine for those few instances where there is "a nearly 'perfect storm' needed to invoke it."²³⁰

²²⁸ Christopher W. Frost, *Organizational Form, Misappropriation of Risk, and the Substantive Consolidation of Corporate Groups*, 44 HASTINGS L.J. 449, 461 (1993).

²²⁹ See, e.g., *Amera*, *supra* note 97, at 2 (noting *Owens Corning* test "can never be satisfied and will invariably result in denial of a motion for substantive consolidation"); *Weitnauer*, *supra* note 226, at 70 (noting difficulty in proving substantive consolidation in Third Circuit); see also *Willett*, *supra* note 139, at 112 (suggesting substantive consolidation is only applied in narrow circumstances).

²³⁰ *Owens Corning*, 419 F.3d at 216; see *Amco Ins.*, 444 F.3d at 696–97 n.5 (stating substantive consolidation only occurs in rare instances).