Substantive consolidation: when two become one

The effect upon debtors and creditors can be far-reaching and unanticipated

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Substantive consolidation is a legal concept whereby the court will treat separate legal entities as one. All assets and liabilities of both entities, with the exception of any extinguished inter-company liabilities, are consolidated. As a result, claims of creditors against the separate debtors instantly become claims against one entity.

In re Owens Corning, 419 F.3d 195, 205 (3rd Cir. 2005). The pooling of assets and liabilities may be far from what creditors intended when credit was extended or services were provided to the separate debtors. The sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors.

The Bankruptcy Code contains no express provision for substantive consolidation. Federal Rule of Bankruptcy Procedure 1015 provides for joint administration of cases, but not for the substantive consolidation of assets of two debtor estates or a nondebtor’s assets with those of a debtor’s estate. Courts have traditionally permitted substantive consolidation under the court’s general equity powers derived from 11 U.S.C. § 105(a). While there do not appear to be any court decisions outright barring substantive consolidation, the remedy is granted sparingly. See, In re Owens Corning, 419 F.3d at 205.

Prior to Owens Corning, two cases offered guidance to courts deciding whether to allow substantive consolidation. In Augie/Restivo Baking Co., Inc., the Second Circuit held that substantive consolidation may be allowed where: (1) creditors dealt with the entities as a single economic unit and did not rely upon their separate identity in extending credit; and (2) the affairs of the debtor are so entangled that consolidation will benefit all creditors. Id. at 518.

In re Auto-Train, Inc., 810 F.2d 270 (D.C. Cir. 1987), established a slightly different standard, holding that: (1) there must be a substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or to realize some benefit. Id. at 276. The court in Auto-Train noted that a creditor may object to consolidation where that creditor relied solely on the credit of one of the debtors and would be prejudiced by the consolidation. Id. However, consolidation might still be ordered where the benefits of consolidation “heavily outweigh the harm.” Id.

In Owens Corning, the Third Circuit posited a third standard for consolidation: a proponent of consolidation must establish that the entities (1) disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (2) post-petition, their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors. Id. at 211.

The proponent of consolidation establishes a prima facie case where there is a clear demonstration that, prior to the bankruptcy, the debtor entities disregarded corporate formalities, creating contractual expectations of creditors that they were in fact one indistinguishable entity. Id. at 212. The proponent must also show that in its prepetition course of dealing, it actually and reasonably relied upon the debtors’ alleged unity. Id.

A creditor can defeat consolidation under Owens Corning if it can establish that consolidation would have an adverse affect and that the creditor relied on the debtors’ separate existence. Id. The Owens Corning court found Auto-Train set too low of a bar for consolidation — requiring the court to simply determine whether some harm...
might be avoided or some benefit discerned by consolidation. Id. at 210. Rather, the Third Circuit aligned itself with the more stringent standard set by the Second Circuit in Augie/Restivo.

The Owens Corning court enunciated principles which might guide courts in determining whether consolidation should be ordered. First, courts should respect the entity separateness absent compelling circumstance which calls equity into play. Second, the harm substantive consolidation addresses must be the harm caused by the debtors in disregarding corporate distinction, not the harm resulting from actions of creditors. Harms caused by creditors are typically better addressed by the avoidance provisions of the Bankruptcy Code. Third, there must be more gained from substantive consolidation than merely administrative convenience. Fourth, the remedy should be rarely granted — only where there is no other more precise remedy provided under the Bankruptcy Code. Fifth, substantive consolidation may not be used offensively by any group for tactical advantage in the bankruptcy proceedings. Id. at 211.

The court noted that substantive consolidation is more pervasive than piercing the corporate veil, in that substantive consolidation it is not limited to equity or to a specific secured creditor but affects distribution to many innocent creditors. Id. at 205-206. This is perhaps why courts often profess a reluctance to allow substantive consolidation.

Substantive consolidation may also be ordered where the debtor has established separate entities to shield assets from the reach of its creditors. In re Tureaud, 45 BR 658 (Bankr. N.D. Okla. 1985). Courts have sparingly permitted substantive consolidation of a non-debtor entity with the estate of a debtor. There is a split of authority on this issue. Several courts have permitted consolidation of the nondebtor entity where such entity is the alter-ego of the debtor. In re 1948 Meridian Place, 15 BR 89 (D.C. Bankr. 1981), In re Crabtree, 39 BR 718 (Bankr. E.D. Tenn. 1984), Matter of Mumford, Inc., 115 BR 390 (Bankr. N.D. Ga. 1990).

Other courts have disallowed this type of consolidation where the affiliated entity is not itself a debtor. In re DRW Property Co., 82, 54 BR 489 (Bankr. N.D. Texas 1985); In re Julien Company, 120 BR 930 (Bankr. W.D. Tenn. 1990); In re Lease-A-Fleet, Inc., 141 BR 869 (Bankr. E.D. Pa. 1992); In re Circle Land and Cattle Corp., 213 BR 870 (Bankr. D. Kan. 1997). These courts declined to order consolidation, finding that nondebtor entities are “outside the scope” of the court’s jurisdiction absent specific statutory or common law authority permitting such extraordinary relief.

The U.S. Supreme Court did allow substantive consolidation of a non-debtor entity with the debtor in Sampsell v. Imperial Paper & Color Corporation, 313 U.S. 215 (1941). There, the individual debtor had improperly transferred property to the nondebtor corporation in bad faith. The Court held that the purpose of the non-debtor entity was primarily to avoid the individual’s creditors by placing the debtor’s assets beyond the reach of those creditors. Id. at 217-18. This decision reversed the Ninth Circuit, which held that a nondebtor corporation could not be deemed the alter-ego of the individual bankrupt debtor under state law.

The procedure to initiate a substantive consolidation proceeding is equally unsettled. In Auto-Train, the propo-