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Substantive Consolidation of Debtor and Non-Debtor Entities

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Introduction

Based on section 105's grant of equitable powers, bankruptcy courts have the power to substantively consolidate debtors.[1] Substantive consolidation pools the assets of separate legal entities and treats them as one, allowing each entity's liability to be satisfied out of the common pool. Although it has been accepted that courts have the power to consolidate a debtor with other related debtors, it its less clear when courts can consolidate a debtor with a non-debtor, or if courts have the authority to do so at all.[2] [3]

Even though most courts have determined that they do have the power to substantively debtors with non-debtor entities, the reluctance of some courts to recognize the power at all reflects a larger trend.[4] Because consolidation impacts the creditors of all entities involved, "the remedy of substantive consolidation is rarely granted."[5] When the entity targeted for consolidation is a non-debtor, the threat to its creditors is even higher than when consolidating

[1] *See* 11 U.S.C. § 105(a).
[2] *See In re Bonham*, 229 F.3d 750, 765 (9th Cir. 2000) (allowing the consolidation of debtors with non-debtors); The Official Committee of Unsecured Creditors v. The Archdiocese of Saint Paul and Minneapolis, 562 B.R. 755, 761 (D. Minn. 2016) (refusing to consolidate a debtor with non-debtors).
[3] The Official Committee of Unsecured Creditors has appealed this decision to the Eight Circuit. As of the date of this article, the Eighth Circuit has yet decide the appeal.
[4] *See In re Logistics Info. Sys., Inc.*, 432 B.R. 1, 11 (D. Mass. 2010) ("[T]he majority of bankruptcy courts have found non-debtor consolidation to be appropriate in some circumstances.").
[5] *In re Circle Land & Cattle Corp.*, 213 B.R. 870, 875 (Bankr. D. Kan. 1997).

debtors. Thus, a party seeking substantive consolidation of a debtor with a non-debtor must meet a heavier burden to show that the benefits outweigh the potential harms.

Discussion

I. The Bankruptcy Court's Equitable Powers Likely Extend to the Ability to Substantively Consolidate Debtors and Non-Debtor Entities

Bankruptcy courts have been granted broad equitable powers.[6] Courts have recognized that these powers extend to the power to substantively consolidate a debtor with other debtor entities.[7] The courts may not, however, exercise their equitable powers in a manner that contravenes other provisions of the Code.[8] Courts have disagreed whether the substantive consolidation of a debtor with a non-debtor would contravene the specifically laid out process for involuntary bankruptcy. While it has been established that courts can substantively consolidate multiple debtor entities, some courts have been reluctant to consolidate debtors with non-debtor entities.[9] However, it is likely that under at least some circumstances courts can and will substantively consolidate a debtor with a non-debtor entity.

A. Substantive Consolidation in Relation to Involuntary Bankruptcy Provisions

Courts have disagreed whether substantive consolidation is a separate remedy from involuntary bankruptcy or a tool that improperly bypasses involuntary bankruptcy procedure. The issue with substantively consolidating a debtor with a non-debtor is that it can be viewed as circumventing the requirements of involuntary bankruptcy. Courts have held that because there are specific provisions laying out the process for involuntary bankruptcy, anything that cuts out

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[6] *See* 11 U.S.C. § 105(a).
[7] *See In re Giller*, 962 F.2d 786 (8th Cir. 1992); *In re Owens Corning* 419 F.3d 195, 211 (3d Cir. 2005); *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515 (2d Cir. 1988); *In re Auto-Train Corp.,* 810 F.2d 270, 276 (D.C. Cir. 1987).
[8] *See* Law v. Siegel, 134 S. Ct. 1188, 1194 (2014).
[9] *See* Official Committee of Unsecured Creditors v. The Archdiocese of Saint Paul and Minneapolis, 562 B.R. at 762–63 (holding that not only did the court lack the authority to substantively consolidate debtor with non-debtor nonprofit, but also that even it did have the authority, it would decline to do so under the circumstances there).

that process is circumventing the Code.[10] Substantive consolidation of a debtor with a non-debtor is effectively forcing a non-debtor into bankruptcy without following the procedure laid out in the Code.[11]

Further, courts have questioned whether they have jurisdiction over non-debtors and their assets. For example in *In re Circle Land & Cattle Corp.*, the court reasoned that to substantively consolidate a non-debtor farmer with a debtor would improperly extend subject matter jurisdiction over a non-debtor.[12] Additionally, the court in *In re Pearlman* asserted that "substantive consolidation is purely a bankruptcy remedy and does not extend to the assets and affairs of a non-debtor."[13]

According to *In re Archdiocese of Saint Paul and Minneapolis*, to substantively consolidate a debtor with a nonprofit non-debtor entity would contravene section 303(a) because the entities targeted for consolidation are usually exempt from involuntary bankruptcy.[14] Section 303(a) prohibits forcing "a corporation that is not a moneyed, business, or commercial corporation," including eleemosynary[15] institutions, into bankruptcy.[16] Although involuntary bankruptcy and substantive consolidation are considered distinct remedies, substantive consolidation would effectively force a non-debtor nonprofit entity into bankruptcy against its will.[17] Under analogous circumstances, the court in *In re Circle Land & Cattle Corp.* held that it could not substantively consolidate a debtor with a non-debtor farmer because farmers are

[10] *In re Pearlman*, 462 B.R. 849, 851 (Bankr. M.D. Fla. 2012).
[11] *See* Official Committee of Unsecured Creditors v. The Archdiocese of Saint Paul and Minneapolis, 562 B.R at 762–63.
[12] 213 B.R. at 876–77 ("Using § 105 to support an equitable order of substantive consolidation of a non-debtor with a debtor is, in effect, taking jurisdiction over the non-debtor corporation without express statutory authority.").
[13] 462 B.R. at 851.
[14] 553 B.R. 693, 703–04 (Bankr. D. Minn. 2016), aff'd Official Committee of Unsecured Creditors v. The Archdiocese of Saint Paul and Minneapolis, 562 B.R. 755 (D. Minn. 2016).
[15] Eleemosynary institutions include churches, schools, and charitable organizations and foundations. *Black's Law Dictionary* defines eleemosynary as "[o]f, relating to, or assisted by charity; not-for-profit." bars the involuntary bankruptcy of "a corporation that is not a moneyed, business, or commercial corporation." (10th ed. 2014).
[16] 11 U.S.C. § 303(a).
[17] *See In re* Archdiocese of Saint Paul and Minneapolis, 553 B.R. at 703–04.

excepted from involuntary bankruptcy.[18] Thus, it seems that courts are very reluctant to substantively consolidate a debtor with a non-debtor, especially when the non-debtor falls into the category of entities usually excepted from involuntary bankruptcy.

B. Substantive Consolidation as a Tool for Realizing a Debtor's Total Assets

Despite some courts' reluctance to consolidate debtors with non-debtors, many courts have allowed the consolidation of a debtor with a non-debtor under certain circumstances.[19] For example, some courts have allowed substantive consolidation when non-debtors have been determined to be alter egos of the debtor.[20] In cases like these, substantive consolidation is justified because the consolidation is not involuntarily dragging non-debtors into bankruptcy. Rather, consolidation is recognizing that the debtor and non-debtor entities are not truly separate and that the consolidation is necessary to reach the debtor's true assets.

Courts that have allowed the consolidation of a debtor with non-debtors have reasoned that because substantive consolidation and involuntary bankruptcy are distinct remedies, substantive consolidation does not circumvent the involuntary bankruptcy process.[21] Also, if a party seeking substantive consolidation was required to meet all the provisions necessary for involuntary bankruptcy, it would defeat the purpose of substantive consolidation.[22] The argument is that substantive consolidation is completely independent of involuntary bankruptcy and is meant to be an alternate means to bring a non-debtor's assets into a debtor's estate.[23]

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[18] 213 B.R. at 876.
[19] *See In re* Logistics Info. Sys., Inc., 432 B.R. at 11 ("The majority of bankruptcy courts have found non-debtor consolidation to be appropriate in some circumstances."); *In re* Bonham, 229 F.3d at 765.
[20] *In re United Stairs Corp.*, 176 B.R. 359, 371 (Bankr. D. N.J. 1995) (holding that alter egos are not entitled to the procedural safeguards of section 303).
[21] *See Matter of Munford, Inc.*, 115 B.R. 390, 397–98 (Bankr. N.D. Ga. 1990).
[22] *See id.* ("[T]he insolvency requirement of § 303 would subvert the entire purpose of substantive consolidation in this case, which is to recover assets from a financially sound affiliated entity."); *see also In re S & G Fin. Servs. of S. Florida, Inc.*, 451 B.R. 573, 582 (Bankr. S.D. Fla. 2011) ("Compelling the Trustee to file an involuntary bankruptcy petition under 11 U.S.C. § 303 would defeat the very purpose of substantive consolidation.").
[23] *See* Matter of Munford, Inc., 115 B.R. at 397–98.

II. The Standard for Substantively Consolidating a Debtor with a Non-Debtor is Higher than for the Consolidation of Multiple Debtor Entities

Circuit courts have established different standards for deciding when substantive consolidation is warranted. The D.C. Circuit has held that substantive consolidation of a debtor is warranted when there is a "substantial identity" between the entities to be consolidated and consolidation is necessary to avoid some harm or to realize some benefit.[24] The Eighth Circuit, drawing on *Auto-Train*, has held that when considering whether to substantively consolidate debtors, courts should look at (1) the necessity of consolidation due to the interrelationship among the debtors; (2) whether the benefits of consolidation outweigh the harm to creditors; and (3) the prejudice resulting from not consolidating debtors.[25] Although the test is meant to be flexible and not mechanically applied, courts have often considered the difficulty of separating the entities, the extent to which finances have been comingled, whether there are consolidated financial statements, unity of interest and ownership, disregard for corporate formalities, and the existence of parent and inter-corporate guarantees on loans.[26]

The Second Circuit and Third Circuit have both applied a similar test where a party seeking to substantively consolidate debtors must show that the entities targeted to be consolidated disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity, or that the entities' assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.[27]

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[24] *See In re* Auto-Train Corp., 810 F.2d at 276.
[25] *In re* Giller, 962 F.2d at 799 (allowing for substantive consolidation when abuses of corporate form and fraudulent conveyances made consolidation necessary).
[26] *In re Vecco Construction Industries, Inc.*, 4 B.R. 407, 410 (Bankr. E.D. Va. 1980).
[27] *See In re* Owens Corning, 419 F.3d at 211; *In re* Augie/Restivo Baking Co., Ltd., 860 F.2d at 515; *see also In re* Bonham, 229 F. 3d at 766 (adopting the *Augie/Restivo* test and applying it when consolidating a debtor and non-debtor).

When deciding whether to consolidate a debtor with non-debtor entities, the Ninth Circuit adopted the *Augie/Restivo* test.[28] As with the substantive consolidation of a debtor with other debtor entities, a party seeking to consolidate a debtor with non-debtor entities must show that the finances are inextricably intertwined.[29] Only when the movant can meet the pleading requirement of showing that the debtor and non-debtor have an inseparable interest, substantive consolidation may be granted.[30]

While substantive consolidation of a debtor and non-debtor is possible, the standard is more stringent than for consolidating debtors.[31] Courts have been reluctant to consolidate a debtor with a non-debtor except under extraordinary circumstances.[32] Additionally, courts that have recognized the power to substantively consolidate a debtor and non-debtor have exercised that power cautiously.[33]

Common throughout the tests is that substantive consolidation must be necessary. No single factor can automatically trigger substantive consolidation. For example in *Augie/Restivo,* the court said "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

[28] *See In re* Bonham, 229 F.3d at 766.
[29] *See* Matter of Munford, Inc., 115 B.R. at 397–99.
[30] *See id.*
[31] *See In re Lease-a-Fleet, Inc*., 141 B.R. 869, 872–73 (Bankr. E.D. Pa. 1992) ("While consolidation of debtor and non-debtor entities is possible, it should be undertaken only in the most unusual circumstances").
[32] *See id.* at 874 ("It is therefore not surprising to this court to find that placing an involuntary non-debtor consolidate in such an unusual circumstance, betwixt and between the Bankruptcy Code, should be reserved for unusual circumstances which might justify such a conceptually-strange measure.").
[33] *See In Re* Logistics Info. Sys., Inc., 432 B.R. at 12 ("While such power should be used cautiously, the great weight of cases supports the authority of bankruptcy courts to order substantive consolidation of debtors and non-debtors."); *see also In re Howland*, No. 16-5499, 2017 WL 24750 at *5 (6th Cir. Jan. 3, 2017) ("Substantive consolidation is an 'extreme' measure, only to be used 'sparingly,' especially when consolidating a non-debtor entity.").

realization of any net assets for all the creditors[.]'"[34] Another important factor that every court considers is potential harm to creditors. For example in *Augie/Restivo*, the Court held that "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."[35] Further, one court said that the courts should "ask are any creditors going to be hurt by this consolidation and, if the answer to that is yes (or more properly, if the one seeking consolidation cannot prove the opposite), consolidation should be denied in almost every case."[36]

Conclusion

Meeting the standard to substantively consolidate a debtor and a non-debtor is difficult. While some courts have been reluctant to substantively consolidate a debtor and a non-debtor because it can be viewed as circumventing the involuntary bankruptcy process, the courts that have allowed substantive consolidation of a debtor and non-debtor have applied a stricter standard than when consolidating multiple debtors. First, it is generally more difficult to show that a debtor and a non-debtor entity are so inextricably intertwined that consolidation is necessary than it is for related debtor entities. Second, because all creditors must be equitably treated, it is much harder to show that the creditors of the non-debtor entities will not be harmed. Therefore, even when courts assert that they have the ability to substantively consolidate debtor and non-debtor entities, they often decline to do so because of the demanding burden moving parties face in showing that the entities are sufficiently intertwined and that no creditors will be harmed.

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[34] *In re* Augie/Restivo Baking Co., Ltd., 860 F.2d at 519
[35] *Id.*
[36] *In re* Circle Land & Cattle Corp., *213 B.R.* at 875–76; *see also In re Amco Ins.*, 444 F.3d 690, 695 (5th Cir. 2006) ("This Court has stated that substantive consolidation affects the substantive rights of the parties and therefore is subject to heightened judicial scrutiny").