

# THE SUM AND SUBSTANCE OF SUBSTANTIVE CONSOLIDATION<sup>1</sup>

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## Introduction

Substantive consolidation jurisprudence, perhaps more than many other areas of bankruptcy law, is highly unpredictable. This is in part undoubtedly due to the lack of specific Bankruptcy Code provisions and unclear legislative intent regarding substantive consolidation, removing a possible anchor for judicial decision-making. Other reasons, however, are the seeming slowness of judicial opinions to adjust to the reality of 21<sup>st</sup> Century (or even 20<sup>th</sup> Century) corporate structures, and the fact that substantive consolidation's historical roots borrowed heavily from alter ego and similar doctrines, leaving a vestige in the opinions that some kind of wrongdoing is required to order substantive consolidation.

It is appropriate to use substantive consolidation as a tool to combat corporate fraud or sleight of hand that prejudice creditors, but it is inappropriate to allow a bogus "alter ego" requirement to prevent substantive consolidation when there is no fraud. Substantive consolidation is essentially a tool to carry out the chief purpose of the Bankruptcy Code -- to treat creditors equitably -- and, broadly speaking, is appropriate for two purposes even in the absence of fraud or wrongdoing: first, to give the creditors of the corporate enterprise the benefit of their bargain as they struck it prior to bankruptcy -- if creditors had relied on the credit of the enterprise as a whole, substantive consolidation would be warranted, but if they had relied on the credit of a single asset-rich (or asset-poor) subsidiary, substantive consolidation may not be appropriate;<sup>3</sup> and second, if the books, records, and financial affairs of a parent, subsidiaries and related businesses are so "hopelessly entangled" and disentangling them would cost the creditors more than they would gain, then substantive consolidation would be warranted.

The doctrine's "alter ego" past also has caused a seeming conservatism to creep into judicial decisions, to the effect that substantive consolidation should be "used sparingly," and some courts have expressed a "skepticism of the 'modern liberal trend' toward substantive consolidation."<sup>4</sup> To be sure, because of the inevitability that substantive consolidation will affect the size of some creditors' distributions, courts should not apply it in a knee-jerk fashion. However, in the modern world, creditors that deal with large public companies will either be able to persuade a

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<sup>3</sup> Courts have also expressed this in its negative mirror-image, "substantial identity:" if, objectively, the corporate entities making up the enterprise really had no practical independent existence from one another, then substantive consolidation may be appropriate. In other words, no creditor could reasonably argue that it had relied on the credit of a subsidiary or related entity. See discussion of "substantial identity" in connection with In re Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir. 1988), in section II.A.1., infra.

<sup>4</sup> In re World Access, Inc., 301 B.R. 217, 272 n. 57 (Bankr. N.D. Ill. 2003).

bankruptcy court that prior to bankruptcy they had relied on the credit of an individual subsidiary, or they will not be able to do so. Simply because there might be close cases should not make courts conservative in applying substantive consolidation -- making close calls is what courts sometime need to do. Admonitions to use this tool “sparingly” or expressions of skepticism for a “liberal trend” are not helpful. A full examination of the facts and circumstances of each case with a view toward determining whether substantive consolidation will assist in the equitable treatment of all creditors would be the enlightened approach.

Finally, there is one test that courts should make more use of -- although it must only be used with the overlay of the facts in any particular case. Large public corporate debtors essentially are structured in one of two ways: vertically integrated or horizontally integrated (or some hybrid, in which one corporate group or division resembles a vertically-integrated business and other subsidiaries or related entities are independent businesses). Although some courts have used this as a part of their analysis, most courts have been slow to adopt this way of looking at a business when applying the substantive consolidation tool. Such an analysis would assist courts in “screening” corporations as to the propriety of granting substantive consolidation, and in assigning the burden of proof, and, for large public corporations be at least as helpful as the often-recited Vecco factors.<sup>5</sup>

This article first looks at substantive consolidation’s legal framework, and then describes in detail the current tests most commonly employed by courts to analyze whether substantive consolidation should be granted, along with some related doctrines that have aided courts in their substantive consolidation determinations. The final section details the “vertical/horizontal” dichotomy and the reasons why courts should consider it more prominently in substantive consolidation analyses.

## **I. The Legal Framework for Substantive Consolidation**

### **A. In General**

Substantive consolidation derives from the Bankruptcy Court’s general equitable powers as set forth in section 105 of the Bankruptcy Code,<sup>6</sup> and also from section 1123(a)(5)(C).<sup>7</sup> Simply stated, substantive consolidation is simply the pooling of the assets and liabilities of related debtor entities into a unitary debtor estate from which all claims are paid. Creditors of consolidated

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<sup>5</sup> See section II.B.1(c)(iii), *infra*.

<sup>6</sup> See Augie/Restivo, 860 F.2d at 518 n. 1; FDIC v. Colonial Realty Co., 966 F.2d 57, 59 (2d Cir. 1992) (“Courts have consistently found the authority for substantive consolidation in the bankruptcy court’s general equitable powers as set forth in 11 U.S.C. § 105”).

<sup>7</sup> Section 1123(a)(5)(C) provides in part, “a plan [of reorganization] shall provide adequate means for the plan’s implementation, such as merger or consolidation of the debtor with one or more persons.” See e.g. In re Stone & Webster, Incorporated, 286 B.R. 532, 541 (Bankr. D. Del. 2002) (“Courts have held that [Section 1123(a)(5)(C)] indicates Congress’ intent that a chapter 11 debtor may merge or consolidate with other entities, including other debtors, as part of the reorganization process . . . substantive consolidation is expressly authorized by . . . § 1123(a)(5)(C)”). 286 B.R. at 541 (emphasis added).

debtors vote on a single plan of reorganization. Substantive consolidation also eliminates inter-company claims.<sup>8</sup>

Because of the asset pooling aspect, it can readily be seen that if a debtor group includes some subsidiaries with significant assets and some with few or no assets, the recovery of a creditor with a claim against an asset-rich subsidiary could be markedly larger if the claim were satisfied against the asset-rich subsidiary alone. If consolidation were granted, that creditor would have to share the combined assets of the consolidated business as a whole with all other creditors.<sup>9</sup> It is in large part because substantive consolidation virtually always prejudices certain creditors in this way that courts generally note that the doctrine should be used cautiously.<sup>10</sup>

## B. The Facts Are Paramount

The substantive consolidation inquiry is highly fact-specific.<sup>11</sup> To develop the factual background for a substantive consolidation analysis, an in-depth investigation of the factual context must be conducted, including a review of, *inter alia*: financial records (e.g., cash flow statements and tax returns), cash management systems, relevant corporate transactions, internal and external communications and representations, and contracts (both intra-corporate and with third-parties). In order to assess how creditors viewed the corporate debtor entity -- and thus the nature of their reliance on either the parent, a subsidiary, or the entity as a whole -- it is also essential to evaluate and characterize available evidence relating to those creditors, including publicly-available statements (including web sites, press releases, SEC and court filings, etc.), communications with the debtor's corporate entities and with third-parties, and the creditors' proofs of claim.

## II. Substantive Consolidation Tests Currently Favored by the Courts

Substantive consolidation is a particularly "slippery" area of bankruptcy law, and the standards to be applied are unsettled. "Substantive consolidation cases are to a great degree *sui generis*' . . . Thus precedents are of limited value. Instead, the Court must determine what equity requires."<sup>12</sup>

As might be expected with this kind of a jurisprudential environment, opinions are seemingly difficult to reconcile. One commentator expressed it this way:

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<sup>8</sup> See e.g. In re Augie/Restivo Baking, Co., 860 F.2d 515, 518 (2d Cir. 1988).

<sup>9</sup> "There are winners and losers in the [substantive consolidation] process. The creditors of the poorer estates may benefit from the pooling of assets of a more solvent estate, and those from the more financially solvent estates will be diluted." In re Bonham, 226 B.R. 56, 76 (Bankr. D. Alaska 1998).

<sup>10</sup> See In re Bonham, 229 F.2d 750, 767 (9th Cir. 2000); In re World Access, Inc., 301 B.R. 217, 272 (Bankr. N.D. Ill. 2003).

<sup>11</sup> In re Eagle-Picher Industries, Inc., 192 B.R. 903, 905 (Bankr. S.D. Ohio 1996) ("decisions on the subject are fact intensive, and decisions are made on a case-by-case basis").

<sup>12</sup> In re Augie/Restivo, 84 B.R. 315, 321 (Bankr. E.D.N.Y. 1988) (internal citation omitted). ("Sui generis" -- in a class by themselves. Black's Law Dictionary (6<sup>th</sup> Ed. 1990), at p. 1434)

Substantive consolidation is confusing because the courts employ a variety of tests and may also use two or more of these tests simultaneously . . . often without reconciliation of the cited precedent. Other courts have approved or denied substantive consolidation without analyzing any precedent or without relying on any expressed standard.<sup>13</sup>

It must therefore be kept in mind that any particular result might be difficult to predict.

A review of the various tests employed by the various circuits reveals that they are not all that different one from the other. As pointed out in Kors, the First Circuit has adopted the 5-factor test in Quimet v. Pension Benefit Guaranty Corporation, 711 F.2d 1085, 1093 (1<sup>st</sup> Cir. 1983); the Second and Ninth Circuits use the two-pronged inquiry of In re Augie-Restivo Baking Co., 860 F.2d 515 518 (2d Cir. 1988); in its recent decision in In re Owens Corning, 2005 WL 1939796 (3d Cir. Aug. 15, 2005) the Third Circuit adopted its own test, stating that a proponent of substantive consolidation must show either that prepetition creditors treated the entities as “one legal entity,” or that postpetition, the entities’ assets are “so scrambled that separating them is prohibitive and hurts all creditors”; the Fourth Circuit has not adopted a standard, but one recent bankruptcy court case used the Augie/Restivo test as the standard, In re Fas Mart Convenience Stores, Inc., 320 B.R. 587, 594 (Bankr. E.D. Va. 2004); the Fifth Circuit has not adopted a standard test, as noted in In re Permian Producers Drilling, Inc., 263 B.R. 510, 518 (W.D. Tex. 2000); the Eighth Circuit considers the 3-factor test in In re Giller, 962 F.2d 796, 799 (8<sup>th</sup> Cir. 1992); the D.C. Circuit follows a test set forth in In re Auto-Train, 810 F.2d 270, 276 (D.C. Cir. 1987), and the Eleventh Circuit bases their determinations on the test found in Eastgroup Properties v. Southern Motel Associates, Ltd., 935 F.2d 245, 249 (11<sup>th</sup> Cir. 1991). The Seventh Circuit has not specifically opined on the issue of substantive consolidation. The only lower court within the Seventh Circuit that has issued a written opinion discussing the various substantive consolidation tests is the bankruptcy court for the Northern District of Illinois. See In re World Access, Inc., 301 B.R. 217 (Bankr. N.D. Ill. 2003) (Sonderby, J.). Judge Sonderby, in denying substantive consolidation in this case discussed the tests used in both the Augie-Restivo and Eastgroup cases. After acknowledging courts’ general inclination against ordering substantive consolidation, Judge Sonderby remarked, “the Augie/Restivo standard is truer [than the Eastgroup test] to the principles that gave rise to the doctrine [of substantive consolidation].” Id. at 274.

Taking into account the disparate case law on substantive consolidation, it appears that the major factors courts will -- or at least should -- consider dispositive in determining whether to order substantive consolidation are:

1. Whether a creditor relied on an individual debtor’s credit when it decided to do business with that debtor, where such reliance was part of the benefit of that creditor’s bargain with the debtor; an affirmative answer would tend to defeat consolidation. This should be the most important factor.<sup>14</sup>

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<sup>13</sup> Mary Elisabeth Kors, Altered Egos: Deciphering Substantive Consolidation, 59 U. Pitt. L. Rev. 381, 397-98 (1998) (citations omitted) (collecting authorities) (hereinafter, “Kors”) at 397-98.

<sup>14</sup> In the context of larger corporations, lack of creditor reliance on individual subsidiaries, or conversely, creditor reliance on the enterprise as a whole, is generally a characteristic of vertically-integrated businesses; creditor reliance on individual stand-alone subsidiaries is generally a characteristic of horizontally-integrated businesses. This is discussed in more detail later (see Section III, infra).

2. Whether the affairs of the parent and subsidiaries are “hopelessly entangled,” such that the effort to untangle them would be so time-consuming and cost so much that creditors would actually be better off if the attempt to disentangle was not made; an affirmative answer to this question would tend to support consolidation.
3. Whether there is so-called “excessive unity” between the parent and subsidiaries. In other words, for all practical purposes the subsidiaries had no independent existence. If so, consolidation would be warranted (again, a manifestation of the vertical v. horizontal inquiry).

It is obvious that even these criteria contain some overlap, and any given result would be dependent on the facts and circumstances of the particular case. An analysis of the two most oft-used tests -- Augie/Restivo and Eastgroup -- is helpful in providing a context for further analysis.<sup>15</sup>

#### A. The Augie/Restivo Test

More streamlined than other tests, the Augie/Restivo test distills substantive consolidation down to two critical inquiries: “(1) whether creditors dealt with the entities as a single economic unit and ‘did not rely on their separate identity in extending credit,’ or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.”<sup>16</sup> Courts generally have found that substantive consolidation under Augie/Restivo may be ordered if either one of the foregoing prongs is satisfied.<sup>17</sup>

##### 1. The First Augie/Restivo Prong -- Substantial Identity/Creditor Reliance

The first prong of the Augie/Restivo test sets forth two necessary requirements.<sup>18</sup> First, for substantive consolidation to be proper under Augie/Restivo, creditors must have dealt with the entities to be consolidated as a single economic unit. Second, creditors must not have relied on the separate identity of the consolidated entities in extending credit.<sup>19</sup> Augie/Restivo involved a request for the consolidation of two bakeries that had attempted a merger. The first of these entities, Augie’s Baking Company Ltd. (“Augie’s”), had obtained \$2.4 million in credit secured by its real property, inventory, equipment, and accounts receivable from Union Savings Bank (“Union”).

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<sup>15</sup> Even these two tests have been described as “similar but not identical.” In re Eagle-Picher Industries, Inc., 192 B.R. 903, 905 (Bankr. S.D. Ohio 1996); see also In re GC Companies, Inc., 274 B.R. 663, 672 (Bankr. D.Del. 2002) (“Both tests provide a similar analysis”).

<sup>16</sup> In re Augie-Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988).

<sup>17</sup> See In re Bonham, 229 F.3d at 766 (“The presence of either [Augie/Restivo] factor is a sufficient basis to order substantive consolidation.”); In re 599 Consumer Elecs., Inc., 195 B.R. 244, 248 (S.D.N.Y. 1996) (“Conceivably, substantive consolidation could be warranted on either ground; the Second Circuit’s use of the conjunction “or” [in Augie/Restivo] suggests that the two cited factors are alternatively sufficient criteria.”); In re Reider, 31 F.3d 1102, 1108 (11th Cir. 1994) (“The presence of either factor justifies substantive consolidation”).

<sup>18</sup> Essentially collapsing together the “substantial identity” and “creditor reliance” portions of the Eastgroup test. See section II.B, infra.

<sup>19</sup> Augie/Restivo, 860 F.2d at 518. Unlike the Eastgroup test, which expressly shifts the burden from the proponent of consolidation to an objecting creditor once a substantial identity among entities is proved, the Augie/Restivo test is silent as to which party bears the burden of proof. However, it would be prudent to assume that the proponent of consolidation must carry the burden to satisfy the requirements of the first prong of the Augie/Restivo test.

Without Union's knowledge, Augie's had entered into an agreement with another bakery, Restivo Brothers Bakers, Inc. ("Restivo"), by which Restivo would acquire all of Augie's stock in exchange for fifty percent of Restivo's stock. The purchase agreement did not transfer Augie's real property or equipment to Restivo, and Augie's remained owner of such property.<sup>20</sup>

Restivo then changed its name to Augie/Restivo and moved certain operations to Augie's plant. Augie's affairs were wound up and Restivo became a sole operating company, keeping a single set of books and records and issuing financial statements in the name Augie/Restivo. However, Augie's was never dissolved. Manufacturers Hanover Trust Company ("MHTC") subsequently loaned Augie/Restivo \$2.7 million and received a separate guarantee of Augie/Restivo's obligation from Augie's, including a mortgage (subordinate to that of Union's) on Augie's real property.<sup>21</sup>

Augie/Restivo and Augie's eventually filed for bankruptcy under Chapter 11. During the bankruptcy case, a number of cash collateral orders involving MHTC converted MHTC's \$2.7 million in prepetition loans to postpetition superpriority administrative debt. Eventually the debtors moved for substantive consolidation of Augie/Restivo and Augie's. If consolidation were granted, the equity in Augie's would be used to pay the debts of Augie/Restivo, which would have included the \$2.7 million superpriority administrative claim of MHTC and certain other priority tax liabilities. Although Union's loan secured by its mortgage on Augie's real property would remain intact, a certain portion of its loan was undersecured such that Union's claim would be junior to MHTC's superpriority debt. Finding that such a result was not justified, the Second Circuit overturned the lower court decisions approving consolidation. The Second Circuit reasoned:

The course of dealing and expectations in the instant case do not justify consolidation. It is undisputed that Union's loans to Augie's were based solely upon Augie's financial condition and, at the time the loans were made, Union had no knowledge of the negotiations between Augie's and Restivo. MHTC also operated under 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 . . . Union's claims against Augie's assets are thus clearly superior to those of MHTC. Given these circumstances, the fact that trade creditors may have believed that they were dealing with a single entity does not justify consolidation. Upon a proper showing, the interests of trade creditors can be protected by their participating in Augie's case as creditors of that entity. The fact that they may have been unaware of Augie's separate corporate status is not cause for subordinating Union's claims to those of MHTC by substantively consolidating the estates.<sup>22</sup>

It is significant that the Second Circuit found consolidation would unfairly benefit MHTC who was aware of the debtors' separate corporate status all along. This finding implies a logical corollary. If MHTC, knowing the separate identity of the debtors, was prevented from obtaining the benefit of consolidation at the expense other creditors, which also knew of the separate identities of the debtors, then creditors of one related corporate entity that did not likely

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<sup>20</sup> Id. at 517.

<sup>21</sup> Id.

<sup>22</sup> Id. at 519.

rely on the separate credit of another related corporate entity arguably should be precluded from opposing consolidation, when a failure to consolidate would result in a benefit accruing to them at the expense of other creditors, which may have believed the two entities were one and the same. In other words, in determining whether to order consolidation a court should seek to ensure that creditors obtain the benefit of their bargain -- nothing more and nothing less. Otherwise, certain creditors might choose to oppose or support consolidation depending on which result would better fit them, irrespective of where they actually placed reliance.<sup>23</sup>

In addition, it should be noted that in Augie/Restivo the Second Circuit would not allow unsecured trade creditors' impressions of the debtors' operations as a single unit to trump the expectations of a secured creditor. This point from Augie/Restivo makes logical sense and can be fully reconciled with the facts of this case. As noted, consolidation in Augie/Restivo would have resulted in Union, which had clearly relied on the separate identity of the entities, having its claim subordinated. To avoid this injustice, the court used its "equitable" judgment in finding that Union's status should not be compromised for the benefit of lower priority creditors even though they may have relied to some extent on the single status of the debtors.<sup>24</sup> As explained by the Second Circuit in Augie/Restivo, courts attempt to protect the sanctity of certain credit transactions by including a creditor reliance component in the substantive consolidation analysis:

[C]reditors who make loans on the basis of the financial status of a separate entity expect to be able to look to the assets of their particular borrower for satisfaction of that loan. Such lenders structure their loans according to their expectations regarding that borrower and do not anticipate either having the assets of a more sound company available in the case of insolvency or having the creditors of a less sound debtor compete for a borrower's assets. Moreover, lenders' expectations are central to the calculation of interest rates and other terms of loans, and fulfilling those expectations is therefore important to the efficiency of credit markets. Such efficiency will be undermined by imposing substantive consolidation in circumstances in which creditors believed they were dealing with separate entities.<sup>25</sup>

Thus, the Augie/Restivo court was not going to deprive Union (particularly as a secured creditor) the benefit of its bargain based on the fact that certain unsecured creditors might have been unaware of the fact that Augie's was actually a separate entity.

## **2. The Alternative Augie/Restivo Prong -- Entanglement of the Debtors' Affairs**

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<sup>23</sup> As explained by one commentator: "When creditors have not relied on the credit of a particular entity, the practical economic and operational reality of a single enterprise suggests the need for a consolidation approach for multiple bankruptcies. In such a no reliance case, consolidation is compelling because it would seem artificial to treat the entities as separate because of the fortuitous occurrence of bankruptcy." J. Stephen Gilbert, Substantive Consolidation in Bankruptcy: A Primer, 43 Vand. L. Rev. at 220; see also, J. Landers, A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy, 42 U. CHI. L. REV. 589, 630 (1975) (describing no reliance creditors as involuntary creditors).

<sup>24</sup> See Augie/Restivo, 860 F.2d at 519. This decision illustrates how the facts of the individual situation influence courts' opinions. In Augie/Restivo, creditor reliance -- often the paramount factor -- was outweighed, in the court's eyes, by other factors. In many other cases, substantive consolidation was granted where creditor reliance was shown.

<sup>25</sup> Id. at 518-19.

The Augie/Restivo court also noted that an alternative means of procuring a substantive consolidation order would be to prove that the debtors' affairs were so entangled that consolidation would benefit all creditors. However, entanglement of related entities' affairs would justify consolidation under Augie/Restivo only where "the time and expense necessary . . . 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."<sup>26</sup> Procurement of a substantive consolidation order under this financial entanglement standard may be quite difficult, and therefore may not occur often. For example, the fact that a parent entity may experience administrative accounting difficulties in separating out the affairs of its subsidiaries is likely not sufficient under Augie/Restivo to warrant substantive consolidation of such entities. Rather, such disentanglement must seemingly rise to the level of threatening the success of the reorganization itself.<sup>27</sup>

## B. The Eastgroup Test

To establish a prima facie case under Eastgroup,<sup>28</sup> a debtor bears the initial burden of first establishing that there is "(1) a substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or realize some benefit."<sup>29</sup> If the prima facie case is established, a presumption arises that creditors have not relied solely on the credit of one of the entities involved.<sup>30</sup>

An objecting creditor may rebut the presumption by establishing that it relied on the separate credit of an entity subject to substantive consolidation.<sup>31</sup> In this sense, creditor reliance functions as an affirmative defense to substantive consolidation.<sup>32</sup> If an objecting creditor is

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<sup>26</sup> Augie/Restivo, 860 F.2d at 519 (internal citations and quotations omitted); see also In re Bonham, 229 F.3d at 767. Although the Augie/Restivo court spoke of "any assets," other cases have indicated that consolidation may be warranted if disentangling the debtor's affairs would substantially reduce creditor recoveries.

<sup>27</sup> See Matter of New Center Hosp., 187 B.R. 560, 569 (E.D. Mich. 1995) ("[E]ven when the financial relationships among the parties to be consolidated are capable of being untangled, the affairs of the parties may nonetheless be 'inextricably intertwined.' If intercompany debts and transfers are numerous and the operations are interdependent, the parties are 'entangled' even if a detailed analysis of the records could ultimately identify the true assets and liabilities of the separate entities"). See also In re Murray Indus., Inc., 119 B.R. 820, 831 (Bankr. M.D. Fl. 1990) (stating that it would be virtually impossible to allocate value of intangible assets). Courts had expressed the same sentiment even before Augie/Restivo. See e.g. In re DRW Property Co., 82, 54 B.R. 489 (Bankr. N.D. Tex. 1985) (holding that accounting difficulties supported by expert testimony that disentangling books and records of debtors would require six additional months of audit work and cost nearly two million dollars did not warrant substantive consolidation); Chemical Bank New York Trust Co. v. Kheel, 369 F.2d 845 (2d Cir. 1966) (the problem of disentangling debtors' records must be so egregious that it threatens the realization of any net assets for the estates for substantive consolidation to be proper).

<sup>28</sup> Eastgroup Properties v. Southern Motel Assoc. Ltd., 935 F.2d 245 (11th Cir. 1991).

<sup>29</sup> Eastgroup, 935 F.2d at 249 (citations omitted) (emphasis added).

<sup>30</sup> Id.

<sup>31</sup> Id.

<sup>32</sup> See e.g. In re Snider Bros., Inc., 18 B.R. 230, 236 (Bankr. D. Mass. 1982) ("affirmative proof that a creditor or class of creditors had looked solely to the credit of one corporation would be a defense to consolidation").

successful in carrying this burden, substantive consolidation might still be ordered, but only if the court determines that the demonstrated benefits of consolidation “heavily” outweigh the harm.<sup>33</sup>

### **1. First Eastgroup Prong -- “Substantial Identity”**

As observed above, the substantive consolidation inquiry is extremely fact-dependent and fact-intensive.<sup>34</sup> Therefore, it is helpful to analyze the facts, which tend to indicate, or cut against, a “substantial identity” between the corporate entities involved in the particular case. A discussion of this prong is by necessity far-ranging and involves review of case law not confined to substantive consolidation alone, but benefits from review of analogous common law doctrines and accounting principles, which touch upon the treatment of affiliated entities.

#### **a) An Entity’s Inability to Operate as a Stand-Alone Business**

The court in In re Richton International<sup>35</sup> granted substantive consolidation, noting, “this case differs from most substantive consolidation motions” because “there would be no great difficulty in breaking out the financial data for each company.”<sup>36</sup> However, the court did find it significant that “it would be impossible for these Debtor companies to operate on a stand alone basis without the aid of the other operations, both foreign and domestic, that are part of the Richton group.”<sup>37</sup> Therefore, the relevant inquiry according to the Richton court is whether an examination of the business of the related entities tends to support the proposition that one cannot operate on a “stand-alone basis.” For example, can it be shown that without one entity in the corporate group, another entity in the group would not have access to the products that make its own business valuable -- and viable? If so, it would appear to be a good example of corporate interdependence, in the same sense used in the Richton case. The Richton court placed importance on this element as a factor supporting substantive consolidation.

#### **b) Third Parties’ Perception That They Were Dealing with a Unitary Entity as Indicating “Substantial Identity”**

The court in Richton also stated in its discussion of “substantial identity”: “Yet even [the court in Chemical Bank v. Kheel (another leading substantive consolidation case)] considered intertwined [sic] financial statements as only one factor to be considered. What is present in this case is a situation akin to what was found by the court in the Soviero case, that many creditors dealt with International, Sportswear and Jewelry as one entity.”<sup>38</sup> Following are questions that might be asked

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<sup>33</sup> Eastgroup, 935 F.2d at 249.

<sup>34</sup> See e.g. In re Eagle-Picher Industries, Inc., 192 B.R. 903, 905 (Bankr. S.D. Ohio 1996) (“A review of the case law dealing with substantive consolidation makes it clear that decisions on the subject are fact intensive, and decisions are made on a case-by-case basis.”) Case law cautions that “this ‘substantial identity’ element is not to be interpreted too narrowly, because many courts use a variety of factors to determine substantial identity.” In re Standard Brands Paint Co., 154 B.R. 563, 569 (Bankr. S.D. Cal. 1993).

<sup>35</sup> 12 B.R. 555 (Bankr. S.D.N.Y. 1981).

<sup>36</sup> 12 B.R. at 558.

<sup>37</sup> Id.

<sup>38</sup> 12 B.R. at 558. Chemical Bank is discussed infra at section II.2(a); Soviero is discussed infra at section II.2(b).

about the way in which third parties have perceived the entities, and therefore how they might affect the propriety of substantive consolidation:

- Are the debtor's DIP loans secured by all assets of the parent and its subsidiaries, with no special distinction made for assets that happen to currently appear on a subsidiary's unconsolidated balance sheet? Prior to bankruptcy did the subsidiary have a separate line of credit, or were credit facilities for the parent and its subsidiaries negotiated and procured by the parent's treasury staff?<sup>39</sup>
- Have creditors filed proofs of claim against the subsidiary or against the parent? How many creditors are listed as creditors of subsidiaries on the debtor's bankruptcy schedules? Even though it may be impossible to know what creditors' subjective beliefs may have been prior to bankruptcy, it might be revealing to look at available objective evidence, for example lists of clients displayed on these creditors' web sites and press releases -- do they suggest that these vendors either believed, or wished their own stakeholders to believe, that they were dealing with the parent and not the subsidiary?
- Did the subsidiary's creditors know they were dealing with the larger parent entity, and not with the subsidiary individually? Prior to bankruptcy did any creditors ever request any credit information or credit reports on the subsidiary? Did any creditors ever ask for separate financial statements or a list of trade references for the subsidiary, as opposed to the parent, before granting credit? Did the subsidiary have its own D&B number? Answers to these questions might shed some light on whether creditors of the subsidiary were relying on the subsidiary's separate credit, and might also suggest that objections to substantive consolidation by the subsidiary's trade creditors may be unlikely -- i.e., it may be unlikely that any trade creditor of the subsidiary could credibly assert that they had looked solely to the credit of the subsidiary.

### c) The Vecco Factors

The substantial identity test as refined in Eastgroup had its genesis in a set of seven factors listed in In re Vecco Construction Indus., Inc.<sup>40</sup> As noted by the Eleventh Circuit in Eastgroup, "the proponent [of consolidation] may want to frame his argument using the seven factors outlined in In re Vecco Construction, Inc."<sup>41</sup> Many courts have done just that.<sup>42</sup> However, courts have noted

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<sup>39</sup> See In re Murray Indus., 119 B.R. 820, 824 (Bankr. M.D. Fla. 1999) (court considered the fact that credit facilities were negotiated by parent company for enterprise as a whole as a factor supporting substantive consolidation).

<sup>40</sup> 4 B.R. 407, 410 (Bankr. E.D. Va. 1980).

<sup>41</sup> Eastgroup, 935 F.2d at 249.

<sup>42</sup> See e.g. In re Murray Industries, Inc., 119 B.R. 820, 830 (Bankr. M.D. Fla. 1990); Eastgroup Properties v. Southern Motel Assoc. Ltd., 935 F.2d 245, 249 (11th Cir. 1991); In re Baker & Getty Financial Services, Inc., 78 B.R. 139, 142 (Bankr. N.D. Ohio 1987), aff'd 974 F.2d 712 (6th Cir. 1992); In re Snider Bros., Inc., 18 B.R. 230, 234 (Bankr. D. Mass. 1982); In re Augie/Restivo, 84 B.R. 315, 321 (Bankr. E.D.N.Y. 1988), rev'd after district court aff'd, 860 F.2d 515 (2d Cir. 1988); In re DRW Property Co. 82, 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985); In re Steury, 94 B.R. 553, 554 (Bankr. N.D. Ind. 1988); In re Luth, 28 B.R. 564, 566 (Bankr. D. Idaho 1983); In re Donut Queen, 41 B.R. 706, 709

that the Vecco factors by themselves should not be dispositive of the substantive consolidation issue.<sup>43</sup>

The more of the Vecco factors are present, the stronger the case for substantive consolidation. The Vecco factors are:

- Presence of consolidated financial statements
- Unity of interest and ownership between various corporate entities
- Existence of parent and inter-corporate guarantees or loans
- Degree of difficulty in segregating and ascertaining individual assets and liabilities
- Existence and transfer of assets without formal observance of corporate formalities
- Commingling of assets and business functions
- Profitability of consolidation at a single physical location

**(i) Presence of consolidated financial statements**

Are the subsidiary's financial results separately reported in public consolidated statements?<sup>44</sup> In addition to being one of the Vecco factors, some courts have specifically indicated that provision of consolidated financial statements is a factor supporting substantive consolidation.<sup>45</sup>

Although it would be expected that most large public companies have bookkeeping entries recording the parent's and the subsidiary's transactions (relevant to the "hopeless entanglement" issue discussed below) it may be critically important for the substantive consolidation decision to

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E.D.N.Y. 1984); In re New Center Hospital, 179 B.R. at 856; Holywell Corp. v. Bank of New York, 59 Bankr. 340, 347 (S.D. Fla. 1986); In re Mortgage Inv. Co. of El Paso, 111 B.R. 604, 610 (Bankr. W.D. Tex. 1990).

<sup>43</sup> See In re Donut Queen Ltd., 41 B.R. 706, 709-10 (Bankr. E.D.N.Y. 1984); In re Snider Bros., Inc., 18 B.R. 230, 234 (Bankr. D. Mass. 1982); In re Steury, 94 B.R. 553, 554 (Bankr. N.D. Ind. 1988); In re Cooper, 147 B.R. 678, 682 (Bankr. D.N.J. 1992). In re DRW Property Co. 82, 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985) ("Rather, the [Vecco factors] should be evaluated within the larger context of balancing the prejudice resulting from the proposed order of consolidation with the prejudice the movant alleges it suffers from debtor's separateness"); In re Creditors Service Corp., 195 B.R. 680, 690 (Bankr. S.D. Ohio 1996) ("The factors merely provide the framework to assist the court's inquiry whether harm will result in the absence of consolidation").

<sup>44</sup> Lowell Staats Min. Co., Inc. v. Pioneer Uravan, Inc., 878 F.2d 1259, 1264 (10<sup>th</sup> Cir. 1989) ("The Internal Revenue Code allows a parent corporation to file consolidated income tax returns with its subsidiaries when the parent owns at least eighty percent of the subsidiary. 26 U.S.C. § 1501 . . . Section 1501 allows a parent corporation to shelter taxable income from a profitable subsidiary by offsetting it against losses from an unprofitable subsidiary. It is a common business practice."). 878 F.2d at 1264.

<sup>45</sup> See e.g. Holywell Corp. v. Bank of N.Y., 59 B.R. 340, 347 (S.D. Fla. 1986); In re Donut Queen, Ltd., 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984); In re Richton International, 12 B.R. 555, 557 (Bankr. S.D.N.Y. 1981) ("Thus, all [financial] information generally available to the public upon which creditors could have relied in determining the credit-worthiness of any of the Debtors was normally available only on a consolidated basis."); In re Owens-Corning, 316 B.R. 168, 172 (Bankr. D. Del. 2004) (bank creditors only provided with consolidated financial information).

learn how many of the subsidiary's creditors had -- or were apparently interested in -- financial data broken out for the subsidiary as a separate entity.

How straightforward is the company's 10K as to the subsidiary's separate identity? Is the subsidiary identified as a wholly-owned subsidiary of the parent? Is the subsidiary identified as a reporting segment of the parent's operations? Do the public filings describe any distinct functions of the subsidiary within the parent organization? In short, are the company's SEC filings ambiguous or do they support the view that the parent and subsidiaries are all part of the same interdependent business?

It is worth noting that GAAP requires consolidated financial reporting when the parent entity owns a majority of the voting common shares of the subsidiary.<sup>46</sup> There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.<sup>47</sup> "Control" is defined as "the ability of one entity to direct the activities of another, so as to accomplish the former's objectives."<sup>48</sup> The concept of "control" in GAAP appears to be close to the concept of "ultimate control" described in section 2(a)(v)(b), infra, as a factor supporting "substantial identity" of entities. This public accounting perspective tends to support the concept that large public parent companies control the operations of their subsidiaries, and create "substantial identity" between them.

Finally, consolidated financial statements are prepared primarily for the benefit of creditors and shareholders.<sup>49</sup> Therefore, it could be argued that in a large public business (as opposed to a closely-held business with possibly "entangled" financials) the presumption is that creditors look at the company as a whole to determine creditworthiness. This would also support the "substantial identity" of the companies.<sup>50</sup>

**(ii) Unity of interest and ownership between various corporate entities**

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<sup>46</sup> Wiley GAAP 2004 (2003), p.428; see also Volkswagenwerk Aktiengesellschaft v. Beech Aircraft Corp., 751 F.2d 117, 121 n. 3 (2d Cir. 1984).

<sup>47</sup> Accounting Research Bulletin-51, *Consolidated Financial Statements* ("ARB-51"), ¶ 1.

<sup>48</sup> Wiley GAAP 2004, p. 429.

<sup>49</sup> ARB-51; Miller GAAP Guide (2004 Ed.), p. 8.14.

<sup>50</sup> In the recent Third Circuit Owens Corning decision, the court stated that "[W]e cannot conceive of a justification for imposing the rule that a creditor must obtain financial statements from a debtor in order to rely reasonably on the separateness of that debtor." 2005 WL 1939796 at \*11. One could argue that there are potential justifications, such as the fact that the specific purpose of financial statements is to give creditors and investors information about the entity; a complete lack of financial statements would be a very good reason for a creditor and investor to be on its guard; the subsuming of a corporate entity's financial statements within those of a parent or affiliate would be a strong indication that the entity had no separate existence; a creditor or investor that did not inquire whether separate financial statements were available would seemingly be negligent and perhaps violating its fiduciary duties to its own stakeholders. The Third Circuit did state in footnote 25 that "a creditor's lack of diligence is relevant only insofar as it bears on the credibility of its assertion of reliance on separateness." Id.

Is the parent enterprise based on one business or industry, under the same umbrella brand? Was formation of the various subsidiaries tax-driven, or to perform specialized tasks within the corporation, with the entire enterprise as a symbiotic whole?

The [modern] enterprise [has become] increasingly fragmented among the parent and its subsidiary companies. Increasingly, a complex corporation, that is, a group of companies collectively constituting the enterprise, carr[y] on business activity. The subsidiary corporation [i]s, most frequently, not a business in and of itself. Most frequently, the subsidiary [i]s only a part of fragment of the larger business of its parent corporation. For reasons of tax, accounting, political, or administrative convenience . . . the parent [chooses] to allocate portions of the business among the separate corporate components under is common control and direction.<sup>51</sup>

The enterprise view looks at a corporate group as a unit rather than at the various entities to which the fragmented operations of the group have been allocated by the parent for the convenience of the group as a whole.<sup>52</sup> This view recognizes the essential unity of a group enterprise rather than the separate legal entity of each company within the group.<sup>53</sup> Is this view reflected in the parent's SEC filings? Of course, a parent company's public filings are one of the principal means that third parties, including creditors, obtain information about the business and to some degree help third parties to form a "picture" of the business. Does the parent appear to be sending the message that it is one entity, or enterprise?

The Supreme Court, in a 1972 opinion deciding the constitutionality of a state tax statute, reviewed the corporate structure of Mobil Oil Corporation, which the Court described as a "worldwide petroleum enterprise."<sup>54</sup> The Court went on to observe that the form of the corporate structure was irrelevant, and changing from subsidiaries to divisions would work "no change in the underlying economic realities of a unitary business."<sup>55</sup>

However, "the law has been slow to recognize this crucial difference."<sup>56</sup> The World Access court, for instance, rejected the "enterprise" view in favor of a stricter observance of corporate entities.<sup>57</sup> Put more bluntly, "enterprise liability is simply not the law."<sup>58</sup> As time goes on, it may be likely

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<sup>51</sup> Philip I. Blumberg, The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations (1983), § 101.1 at pp. 5-6 ("Blumberg I"). See also Soviero, 328 F.2d at 448 (debtor created corporate affiliates principally, if not solely, for tax benefits); In re Eagle-Picher Industries, Inc., 192 B.R. 903, 907 (Bankr. S.D. Ohio 1996) ("[I]t is well established that retention of corporate form for the purpose of securing tax benefits presents no obstacle to substantive consolidation").

<sup>52</sup> Berle, The Theory of Enterprise Entity, 47 Colum. L. Rev. 343 (1947).

<sup>53</sup> Gower, The Principles of Modern Company Law 213 (3d Ed. 1969).

<sup>54</sup> Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 435 (1980).

<sup>55</sup> Id. at 441.

<sup>56</sup> Blumberg I, § 101.2 at p.4.

<sup>57</sup> See World Access, 301 B.R. at 276.

<sup>58</sup> Kors at 438.

courts will treat the “modern” corporation more liberally on the issue of substantive consolidation than in the somewhat narrow cases of the past. It would be prudent for the practitioner to review prior decisions of the bankruptcy judge in question to determine whether she might take the “modern” enterprise view or a more restrictive view, or may give some insight on whether she is likely to view corporations as unitary enterprises, or take the more rigid view of preserving corporate form over substance.<sup>59</sup>

**(iii) Existence of parent and inter-corporate guarantees or loans**

Did the debtor’s prepetition or DIP financing commitments involve intra-corporate guarantees? Creditors’ demands for guarantees from a parent tend to indicate that they saw the parent and the subsidiary as a single cohesive unit with which they were conducting business.<sup>60</sup> It would be difficult for a party that demanded a guarantee from a parent to say that it was relying on the separate credit of the subsidiary. Cases have cited the existence of inter-corporate guarantees as a factor supporting substantive consolidation.<sup>61</sup> Obviously, inter-corporate guarantees are ubiquitous in modern corporate financial structures.<sup>62</sup> This is an example of a factor that is of some use to support an argument, but is by no means dispositive. The accumulated weight of a number of facts and factors must either carry the day or not.<sup>63</sup>

**(iv) Degree of difficulty in segregating and ascertaining assets and liabilities of individual corporate entities**

As a large public corporation with rigorous reporting requirements, it would not be surprising for the parent to have professional accounting practices in place.<sup>64</sup> Therefore, for internal

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<sup>59</sup> It is interesting to note that the IRS has stated that a substantive consolidation for purposes of a bankruptcy reorganization has no independent tax significance and does not result in the creation of a single taxable entity. For example, in FSA 19995206 (December 29, 1999) a bankruptcy court ordered the substantive consolidation of several related partnerships. The group argued that the bankruptcy order merged the partnerships so that a partner in a single partnership would be deemed to be a partner in all the partnerships. The IRS disagreed, stating that a substantive consolidation is a bankruptcy notion and not a tax notion. The IRS ruled that the substantive consolidation had no tax significance and “did not serve to merge or consolidate the partnerships for any purpose other than the bankruptcy proceeding.” See also TAM 7905078 (stating that a consolidation order did not result in the creation of a single taxable entity); but cf. PLR 9105042 (treating several corporations that were substantively consolidated as a single entity for purposes of making computations under the old stock-for-debt exception (now repealed) to the discharge of indebtedness rule).

<sup>60</sup> See *In re Manzey Land & Cattle Co.*, 17 B.R. 332, 337 (Bankr. D.S.D. 1982); *Richton*, *supra*, 12 B.R. at 558.

<sup>61</sup> See e.g. *Holywell Corp. v. Bank of N.Y.*, 59 B.R. 340, 347 (S.D. Fla. 1986); *In re Donut Queen, Ltd.*, 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984).

<sup>62</sup> See e.g. *Calvert v. Huckins*, 875 F.Supp. 674, 679 (E.D. Cal. 1995) (intra-corporate guarantees are a “common business practice and a normal feature of parent-subsidiary relationships”).

<sup>63</sup> In the recent Third Circuit *Owens Corning* opinion, the court held this factor to be extremely important. Prepetition Owens Corning had negotiated a credit agreement with inter-subsidiary guarantees that the bank regarded as a major part of the bargain. By attempting to invoke substantive consolidation, the debtors were attempting to negate the prepetition bargain struck with the lenders. See 2005 WL 1939796 at \*1-2, \*10-11.

<sup>64</sup> Public business enterprises are required to report financial information about “reportable operating segments,” which are “components of an enterprise about which separate financial information is available that is evaluated regularly by the

purposes a parent can usually break out financial results and statements for its subsidiaries separately. In sum, although most “hopeless entanglement” cases (as discussed below) deal with situations where related entity accounting was facially deficient or non-existent, it is possible that even “meticulously kept” financial records may not be an accurate reflection of reality and may require complex and expensive disentangling.

**(v) Existence and transfer of assets without formal observance of corporate formalities**

Possibly relevant inquiries for this Vecco factor might include:

Have corporate assets been transferred among subsidiaries? If so, was any meaningful consideration exchanged at the time of these transfers? Have employees transferred back and forth among related corporate entities, and if so, were these transfers made with or without consideration? Has there been any sort of inter-corporate employment agreements in place governing these transfers?

Are subsidiaries required to use the parent’s cash management system? Do subsidiaries make requests to the parent’s treasury staff for cash to pay their bills? Most large corporate enterprises pool cash for perfectly rational economic reasons without necessarily becoming prime candidates for substantive consolidation, so this fact must be considered corroborative rather than dispositive.<sup>65</sup>

Do the parent and subsidiaries act with or without the benefit of any formal contracts governing aspects of their relationship, for example: is there a formal contract in place governing the subsidiary’s participation in the parent’s cash management system?

Do subsidiaries have their own staff for support functions or centralized services such as legal counsel, payroll and benefits, accounting, IT and HR services? Even if there is no formal contract, do the subsidiaries pay the parent for these services?

**(vi) Commingling of assets and business functions**

Do senior officers and directors of the subsidiary have simultaneous senior management roles at the parent? Do overlapping directors and/or officers make it clear that the parent enterprise is driving the subsidiary’s decisions? Are subsidiaries required to obtain approval of the parent’s senior management for their budgets and major capital expenditures? Do the parent and subsidiary share customer data and who owns this data? Do the parent and subsidiary cross-license any technology, and if so, is there an agreement in place, is there consideration paid under the agreement, and is such consideration at a market rate?

**(vii) The profitability of consolidation at a single physical location**

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chief operating decision maker in deciding how to allocate resources and in assessing performance.” Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 131 (1997) at p.4.

<sup>65</sup> See e.g. World Access, *supra*, 301 B.R. at 276.

Are the parent's and subsidiary's businesses at the same or in separate locations? If the subsidiary is in a separate location, under which company's name is the lease? Where do senior officers have their offices? (This factor may also bear on the question of the subsidiary's ability to be profitable as a standalone business.)

## **2. Second Eastgroup Prong -- Necessity of Consolidation to Realize Some Benefit or to Avoid Some Harm**

The second prong of the prima facie case under the Eastgroup standard involves assessment of the benefit or harm that would result from substantive consolidation. For example, substantive consolidation would benefit a parent company's creditors by allowing them to receive a higher return by adding an asset-rich subsidiary to the parent's estate. In contrast, consolidation would harm the subsidiary's creditors because the recovery on their claims would be diluted if they were forced to share with the parent's creditors. However, simply focusing on the inevitable benefits and harms generated by the zero-sum redistribution of a finite pool of assets is of questionable utility in evaluating the prospects of substantive consolidation in a particular case. After all, "because every entity is likely to have a different debt-to-asset ratio consolidation almost invariably redistributes wealth among the creditors of the various entities."<sup>66</sup> Save for the elimination of intercompany claims, substantive consolidation does not alter the overall amount of assets and liabilities within a particular group of corporate debtors. Substantive consolidation merely lumps these assets and liabilities together to achieve a more equitable distribution.

As a result of the prejudice that consolidation inevitably imposes upon certain creditors, a common inquiry that runs through many court decisions on the subject is whether substantive consolidation will produce benefits (apart from the simple redistribution of assets, which would only benefit certain creditors) offsetting any such prejudice.<sup>67</sup> As one court phrased it, "the ultimate question is whether or not it is fair to authorize substantive consolidation after having balanced the record."<sup>68</sup>

### **a) Hopeless Financial Entanglement**

Based on this principle of fairness, the typical harm that is sought to be avoided under an order for substantive consolidation is "the expense or difficulty of sorting out the debtor's records

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<sup>66</sup> In re Auto-Train Corp., 810 F.2d at 276.

<sup>67</sup> See Eastgroup, 935 F.2d at 251 ("We have to determine whether 'consolidation yields benefits offsetting the harms it inflicts on objecting parties.'") (quotation omitted). However, cf. In re Owens Corning, 2005 WL 1939796 (3d Cir. August 15, 2005) at \*11, in which the court specifically overruled the lower court by suggesting that "mere benefit to some creditors, or administrative benefit to the Court, falls far short" of a justification for substantively consolidating debtors' estates.

<sup>68</sup> Murray Indus., 119 B.R. at 830 (emphasis added); see also F.D.I.C. v. Colonial Realty Co., 966 F.2d 57, 61 (2d Cir. 1992) ("Only through a searching review of the record, on a case-by-case basis, can a court ensure that substantive consolidation effects its sole aim: fairness to all creditors.") (emphasis added) (citations omitted); In re Continental Vending Machine Corp., 517 F.2d 997 (2d Cir. 1975), cert. denied, 424 U.S. 913 (1976) (upholding fairness of plan that did not call for secured claims to be consolidated thus precluding secured creditor from improving position; under consolidated plan secured creditor would end up receiving exactly what it had bargained for); In re Flora Mir Candy Corp., 432 F.2d 1060, 1063 (2d Cir. 1970) (denying substantive consolidation based on "near certainty of unfair treatment" of debenture holders who would be stripped of the benefit of their bargain if consolidation were allowed).

to determine separate assets and liabilities of each affiliated entity.”<sup>69</sup> Courts generally base this reasoning on the fact that, under certain circumstances, it would not be fair (or sensible) for administrative dollars to be spent to unscramble the affairs of a group of debtors unless creditors as a whole would stand to gain a benefit. However, the cases focusing on the need to untangle debtors’ books and records have noted that consolidation based on such grounds should only be ordered in cases where the debtors’ financial affairs are “hopelessly” entangled.<sup>70</sup> Indeed, the seminal case introducing the concept of “hopeless financial entanglement” -- Chemical Bank -- found that the debtors’ records were so obscured that “the time and expense necessary even to attempt to unscramble them [would be] so substantial as to threaten the realization of any net assets for all creditors.”<sup>71</sup> This could be a fairly strict standard to meet.<sup>72</sup>

### **b) Consolidation is Necessary to Ensure that Creditors’ Expectations Are Met**

Although the financial entanglement cases represent a typical example of substantive consolidation (because most court opinions on the subject involve entities with some degree of scrambled assets and liabilities), hopeless financial entanglement should be regarded as a sufficient, but not a necessary, element of substantive consolidation.<sup>73</sup> Commentators have suggested that “We must recognize that the multi-tiered corporation, generally a public company employing the services of certified public accountants, will generally be keeping books and records from which the financial condition of the parent and its subsidiaries or affiliates will be clearly indicated. In such cases, consolidation should not be denied where the corporate veil can be pierced by a showing of

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<sup>69</sup> In re Bonham 229 F.3d at 764-65 (quotation omitted).

<sup>70</sup> See Chemical Bank New York Trust v. Kheel, 369 F.2d 845 (2d Cir. 1966) (finding that cost of untangling the hopelessly obscured financial records of the debtors would exceed the benefit that would accrue to creditors); In re DRW Property Co. 82, 54 B.R. 489 (Bankr. N.D. Tex. 1985) (holding that accounting difficulties supported by expert testimony that disentangling books and records of debtors would require six additional months of audit work and cost nearly two million dollars did not warrant substantive consolidation).

<sup>71</sup> Chemical Bank, 369 F.2d at 847 (emphasis added).

<sup>72</sup> The Chemical Bank court also noted that classification of claims against the debtors’ estates would not have been feasible absent consolidation. Id. (consolidation “makes possible what has heretofore not been feasible, determination, allowance and classification by the trustees of claims of creditors prior to the preparation and submission of a plan of liquidation”).

<sup>73</sup> See e.g., Soviero v. Franklin Nat’l Bank of Long Island, 328 F.2d 446 (2d Cir. 1964) (permitting consolidation even though entities kept individual accounting records because debtor entities’ assets and functions were inextricably linked; only through consolidation could “all creditors receive the equality of treatment which it is the purpose of [bankruptcy] to afford”) (internal quotations omitted); Stone v. Eacho (In re Tip Top Tailors, Inc.), 127 F.2d 284, 289 (4th Cir. 1942) (finding that consolidation was the fair result because, among other things, there was no evidence that creditors dealt with debtors separately, particularly when myriad facts demonstrated that subsidiary was “instrumentality or adjunct” of parent); Chemical Bank, 369 F.2d at 847 (finding that costs of financial disentanglement were “an additional factor not present in Soviero or Stone v. Eacho”) (emphasis added); Richton Int’l, 12 B.R. at 558-59 (permitting substantive consolidation based on debtors’ inability to operate on a “stand alone basis” and the fact that creditors dealt with debtors as one entity, notwithstanding the fact “that there would be no great difficulty in breaking out the financial data for each company”); Murray Indus., 119 B.R. at 829 (citing to Richton for the proposition that financial entanglement as described in Chemical Bank is not a necessary requirement for consolidation); Augie/Restivo, 860 F.2d at 518 (specifically delineating between two alternative grounds for substantive consolidation -- substantial identity and creditor reliance or financial entanglement).

sufficient yardsticks as to warrant consolidation as set forth in the Vecco case.”<sup>74</sup> As a result, a financial entanglement argument might most appropriately be raised to overcome a claim of creditor reliance on the separate identity of the debtor entities.<sup>75</sup>

So even if the “hopeless entanglement” standard of the benefit/harm analysis cannot be met, a debtor could still demonstrate other ways in which a subsidiary’s consolidation with its parent would create benefits offsetting its harms. For example, the debtor might frame its case as follows: as a result of the subsidiary’s and the parent’s substantial identity, creditors dealt with both entities as a cohesive unit such that they would not have looked to the separate credit of the subsidiary (or the parent, for that matter) for satisfaction of their claims. Thus, because consolidation of the subsidiary’s and the parent’s estates would be in complete accord with creditors’ reasonable -- as opposed to post hoc -- expectations, such creditors would effectively not suffer any harm if the subsidiary’s and the parent’s estates were consolidated. In effect, consolidation would be necessary to ensure that creditors of the parent and the subsidiary were treated equitably under a plan, for they would receive nothing more or nothing less than they would reasonably have expected based on their dealings with the parent and the subsidiary. To support this argument the parent and the subsidiary could rely on those cases that have reasoned when creditors deal with entities as a single economic unit, consolidation represents the best means to achieve an equitable distribution of estate assets. In such cases, consolidation ensures that expectations of creditors are satisfied.<sup>76</sup>

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<sup>74</sup> Benjamin Weintraub and Alan N. Resnick, Consolidation in Bankruptcy Reorganization of Multi-tiered Corporations--Chemical v. Kheel Revisited, (From the Bankruptcy Courts) Vol. 14 U.C.C. L.J. at p. 184 (Fall, 1981).

<sup>75</sup> As the Eastgroup case in fact held. See section II.B, supra. See also Chemical Bank, 369 F.2d at 848 (Friendly, J. concurring) (noting that while “a court of equity will protect the rights of a creditor who relied on the credit of a subsidiary although the subsidiary was ‘merely’ an agency or department of the parent’ . . . such considerations would have to yield to the practicalities if even an approach to a proper accounting within the corporate group was impossible or prohibitively expensive . . .”) (internal quotations omitted); Auto-Train, 810 F.2d at 159 (holding that trustee’s concern “for the cost of disentangling corporate books” not sufficient to override proof of creditor reliance when elimination of retroactive feature of substantive consolidation order would provide creditor that proved reliance with benefit of its bargain by insulating such creditor from preference liability).

<sup>76</sup> One of the seminal cases developing this line of reasoning is Soviero v. Franklin Nat’l Bank of Long Island, 328 F.2d 446, 447-448 (2d Cir. 1964). Soviero involved the consolidation of multiple debtors operating in the carpet business. The court found that consolidation was appropriate based on a number of facts demonstrating a unity of interests among the various entities. Among the facts in Soviero showing the heavy interdependence of the debtor entities were that: the various entities accounted for transactions among themselves, but no real money actually appeared to change hands; the parent provided all working capital to its affiliates; and the parent remained liable on its affiliates’ obligations to their various creditors by guaranteeing their leases, providing them with security deposits, and paying for their losses.<sup>76</sup> Thus, without the parent, the affiliates in Soviero would simply not have existed; they essentially functioned as instrumentalities of the parent.<sup>76</sup> The Soviero court therefore found consolidation to be appropriate because “there existed a unity of interest and ownership common to all corporations, and that to adhere to the separate corporate entities theory would result in injustice to the bankrupt’s creditors.”<sup>76</sup> In other words, because the creditors of the entire enterprise in Soviero treated the parent and its subsidiaries as one business, consolidation would best approximate the fairest distribution of the debtors’ assets among their creditors. See also Stone v. Eacho (In re Tip Top Tailors, Inc.), 127 F.2d 284 (4th Cir. 1942) (creditors would not suffer any undeserved harm if consolidation were ordered, and consolidation would prevent certain distributional inequities); In re Murray Industries, 119 B.R. 820, 824 (Bankr. M.D. Fla. 1999) (consolidation ordered to allow all corporate entities to share value of intangible asset owned by parent (“Chris-Craft” brand), value which the other entities helped create); In re Richton International, 12 B.R. 555, 558 (Bankr. S.D.N.Y. 1981) (by ordering consolidation, court ensured that creditors’ received a distribution that reflected their perceptions of, and dealings with, the Richton Group of companies).

**c) Objecting Trade Creditors' Rebuttal of Prima Facie Case under Eastgroup -- Reliance On a Subsidiary's Separate Identity in Extending Credit**

“Affirmative proof that a creditor or class of creditors had looked solely to the credit of one corporation would be a defense to consolidation.”<sup>77</sup> In determining creditor reliance, the key consideration is not how the debtors viewed themselves, but how creditors perceived the debtors. As the D.C. Circuit said in Auto-Train:

While it may be true that Auto-Train and Railway [the two entities subject to potential consolidation] operated internally as one entity, this bears little on the issue of [the objecting creditor's] reliance on Railway's apparent separateness. Far more probative is the overwhelming evidence that Railway and Auto-Train continually maintained the appearance of separate corporations in the public eye.<sup>78</sup>

Creditor perceptions can be determined by objective evidence illustrating how debtors held themselves out to the world or how creditors themselves behaved in their dealings with the debtors.<sup>79</sup> Although courts have not explicitly stated whether the subjective beliefs of particular creditors should be accounted for in determining creditor reliance, some courts have effectively interjected such a component.<sup>80</sup> Finally, even if an objecting creditor can show actual reliance on the separate credit of a particular debtor, substantive consolidation may still be warranted where such reliance was unreasonable under the circumstances.<sup>81</sup> Thus, if a creditor arguably knew or should have known of the close association of debtors, then such creditor would be deemed to have dealt with the debtors with full knowledge of their consolidated operation.<sup>82</sup>

**d) The Demonstrated Benefits of Consolidation “Heavily” Outweigh the Harm under Eastgroup**

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<sup>77</sup> Snider Bros., 18 B.R. at 236.

<sup>78</sup> Auto-Train, 810 F.2d at 277-78.

<sup>79</sup> See id. (evaluating debtors' representations of corporate separateness in public filings with the SEC); World Access, 301 B.R. at 274 (finding that creditors' maintenance of separate contracts and invoicing accounts for each debtor entity supported creditors' perceptions that the debtors were separate entities).

<sup>80</sup> See e.g., World Access 301 B.R. at 287-90 (evaluating testimony from noteholders as to their personal impression as to where cash was housed in debtors' business structure).

<sup>81</sup> See Eastgroup, 935 F.2d at 249 n.11.

<sup>82</sup> Id.

If an objecting creditor is able to establish reliance on the separate identities of the subsidiary and the parent, a debtor would then likely have to demonstrate hopeless entanglement of their financial affairs to establish that the demonstrated benefits of consolidation “heavily” outweigh its harms.<sup>83</sup> However, as discussed above, it appears that it might be difficult for a debtor to prevail in making such an argument.

If this ultimate portion of the Eastgroup test were implicated, the debtor might request partial substantive consolidation to the extent that such remedy would not affect creditors that did rely on the subsidiary’s separate credit.<sup>84</sup> Under such a scenario, those creditors that could come forward and prove reliance on the subsidiary’s separate credit might be carved out of a substantive consolidation order.

#### e) The Owens-Corning Case

The recent case of In re Owens-Corning<sup>85</sup> is a major pronouncement regarding the doctrine of substantive consolidation. In the bankruptcy court the debtors, “joined by most of the creditor groups,”<sup>86</sup> sought substantive consolidation. A bank consortium that had committed to lending the Owens-Corning parent and certain of its subsidiaries more than \$2 billion opposed the request. Relying principally on the fact that the Owens-Corning parent and each major subsidiary had guaranteed all loans, the banks argued that they would be unfairly prejudiced by substantive consolidation because (i) they relied on the subsidiaries’ separate existences in making the loans and (ii) the banks’ claims were directly against the subsidiaries, and therefore superior to the indirect claims other creditors held against the subsidiaries.<sup>87</sup> The district court granted substantive consolidation, finding that (a) there was substantial identity between the parent and its subsidiaries;<sup>88</sup> (b) substantive consolidation “would greatly simplify and expedite the successful completion of this

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<sup>83</sup> See e.g. Chemical Bank, 369 F.2d at 848 (Friendly, J. concurring) (noting that while “a court of equity will protect the rights of a creditor who relied on the credit of a subsidiary although the subsidiary was (‘merely an agency or department of the (parent)’ . . . such considerations would have to yield to the practicalities if even an approach to a proper accounting within the corporate group was impossible or prohibitively expensive . . .”) (internal quotations omitted); Auto-Train 810 F.2d at 159 (where trustee’s single “concern for the cost of disentangling the corporate books” was not sufficient to rebut creditor’s reliance on separate credit of entities when elimination of *nunc pro tunc* feature of consolidation order would acknowledge such reliance by allowing creditor that relied on separate credit of debtor to avoid preference liability).

<sup>84</sup> See, e.g., Stone v. Eacho, (4th Cir. 1942) 128 F.2d 16 (per curiam) (denying a rehearing requested by creditors claiming that they could show that they extended credit to separate debtor based on fact that such creditors’ concerns could be heard in consolidated proceedings); In re Continental Vending Machine Corp., 517 F.2d 997 (2d Cir. 1975), cert. denied, 424 U.S. 913 (1976) (allowing plan that consolidated all but secured claims); In re Interstate Stores, Inc., 15 CBC 634, 640-41 (Bankr. S.D.N.Y. 1978) (approving separate substantive consolidations of debtor entities in the toy business and those in the general retail business).

<sup>85</sup> 2005 WL 1939796 (3d Cir. August 15, 2005).

<sup>86</sup> In re Owens Corning, 316 B.R. 168, 169 (D. Del. 2004).

<sup>87</sup> Id., at 170.

<sup>88</sup> Id., at 171. Although the court did not mention it, from the facts recited, it certainly appeared that the subsidiaries could have no independent existence (i.e., no “separate mind,” see section II.C(b) below), and could not have operated as stand-alone entities. The Third Circuit’s opinion emphasized additional facts not mentioned in the lower court decision, and came to a different conclusion. See 2005 WL 1939796 at \*1-2, especially n. 3.

entire bankruptcy;<sup>89</sup> and (iii) that “it would be exceedingly difficult to untangle the financial affairs of the various entities.”<sup>90</sup> Therefore, the court held that the proponents had established a prima facie case for substantive consolidation.

Regarding the banks’ rebuttal of the prima facie case, the court found that “there is no doubt that the Banks relied upon the overall credit of the entire Owens Corning enterprise,”<sup>91</sup> and noted that the parent company, not the banks, decided on which subsidiary’s books any particular loan would appear. The court held that there was “simply no basis for finding that, in extending credit, the Banks relied upon the separate credit of any of the subsidiary grantors.”<sup>92</sup> The court specifically held that “the very existence of these cross-guarantees is a further reason for approving substantive consolidation.”<sup>93</sup> The court also justified its decision on the basis that the banks’ claim could be appropriately dealt with in the plan of reorganization, and thus they were not without remedy.<sup>94</sup>

The Third Circuit reversed. The court clearly felt that the debtors were using substantive consolidation in a bad faith effort specifically to overturn their obligations against the lender banks, and also were concerned that the debtors were seeking a “deemed” consolidation.<sup>95</sup> The court reviewed the history of the substantive consolidation remedy, and enunciated five “principles:” (i) entity separateness should be respected, (ii) substantive consolidation addresses harms caused by debtors, not creditors, (iii) “mere” benefit to case administration is not a sufficient “harm” to invoke substantive consolidation, (iv) because substantive consolidation “may profoundly affect creditors’ rights and recoveries” its use should be “rare,” and (v) substantive consolidation may not be used “offensively,” *viz.* to “disadvantage tactically a group of creditors.”<sup>96</sup> These principles are not new and have been discussed elsewhere in this article. The court applied these principles to the facts of the case and said:

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<sup>89</sup> Id. at 171. Later in the opinion the court called substantive consolidation “a virtual necessity.” Id. at 172.

<sup>90</sup> Id.

<sup>91</sup> Id.

<sup>92</sup> Id. at 172.

<sup>93</sup> Id.

<sup>94</sup> Although not cited in this opinion, there is a similarity to the Flora Mir Candy case (432 F.2d 1060, 1063 (2d Cir. 1970)), discussed in section II.B.2, supra. In that case, the court found that the bondholders would not have a remedy, and would be stripped of the benefit of their bargain, if substantive consolidation were granted.

<sup>95</sup> A “deemed consolidation” is one “under which a consolidation is deemed to exist for purposes of valuing and satisfying creditor claims, voting for or against the Plan, and making distributions for allowed claims under it. Plan § 6.1. Yet ‘the Plan would not result in the merger of or the transfer or commingling of any assets of any of the Debtors or Non-Debtor Subsidiaries, . . . [which] will continue to be owned by the respective Debtors or Non-Debtors.’ Plan § 6.1(a). Despite this, on the Plan’s effective date ‘all guarantees of the Debtors of the obligations of any other Debtor will be deemed eliminated, so that any claim against any such Debtor and any guarantee thereof . . . will be deemed to be one obligation of the Debtors with respect to the consolidated estate.’ Plan § 6.1(b). Put another way, ‘the Plan eliminates the separate obligations of the Subsidiary Debtors arising from the guarant[e]es of the 1997 Credit Agreement.’ Plan Disclosure Statement at A-9897.” 2005 WL 1939796 at \*2.

<sup>96</sup> Id. at \*9.

With the principles we perceive underlie use of substantive consolidation, the outcome of this appeal is apparent at the outset. Substantive consolidation fails to fit the facts of our case and, in any event, a “deemed” consolidation cuts against the grain of all the principles.

2005 WL at \*10.<sup>97</sup> Two of the court’s “principles” (nos. 2 and 3) include the notion of “harm.” It could be argued that there is no particular reason why substantive consolidation needs to be limited to situations where there is “harm.” One can conceive of situations in which substantive consolidation would be helpful in a plan context, but where there is no “harm” to rectify. For instance, a debtor group in which virtually only the parent company has any assets. In such a case, no creditors are ostensibly “harmed” by invoking substantive consolidation. Another example might be substantive consolidation proposed in a plan and does not attract any objections. The fact that substantive consolidation does not always have to be viewed as a “remedy” to rectify “harm” is supported by § 1123(a)(5)(C) (“merger or consolidation of the debtor with one or more persons” as a means of implementing a plan).<sup>98</sup>

The essence of the Owens Corning opinion is in fact consistent with the theory espoused in this article, i.e., that courts could use the “horizontalness” or “verticalness” of a business as a preliminary screen, or test, to determine whether substantive consolidation should be considered. The Third Circuit clearly emphasized the “legal separateness” of the Owens Corning businesses as a major factor in denying consolidation.<sup>99</sup>

### **C. Related Judicial Doctrines Relevant to Analyzing the Relationship Among Related Corporate Entities May Reinforce the “Substantial Identity” Between Parent and Subsidiary**

Courts have used other analyses developed in different contexts, such as corporate veil-piercing (the doctrine from which substantive consolidation is derived),<sup>100</sup> to conduct an analogous examination to “substantial identity.” The ability to match the particular facts of the case to these analyses may tend to corroborate the “substantial identity” among the parent and its subsidiaries.

#### **a) The “Instrumentality” Doctrine**

Courts have developed the “instrumentality” doctrine “so as to affix liability where it justly belongs.”<sup>101</sup> The theory holds one corporation liable for the debts of another when the

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<sup>97</sup> Because of the fairly egregious facts presented, the Third Circuit’s is useful to illustrate what facts should *not* warrant substantive consolidation, but perhaps not as helpful in illustrating what facts *should* warrant this remedy.

<sup>98</sup> See In re Stone & Webster, Incorporated, 286 B.R. 532, 541 (Bankr. D. Del. 2002).

<sup>99</sup> “Each subsidiary was a separate legal entity.” Id. at \*1. See also the court’s footnote 3, which emphasizes that many of the Owens Corning businesses were standalone entities. This clearly fits our model of a “horizontal” business, which, we suggest below, is a characteristic that does not favor the imposition of substantive consolidation.

<sup>100</sup> But see Stephen M. Bainbridge, Abolishing LLC Veil Piercing, 2005 U. Ill. L. Rev. 77 (2005).

<sup>101</sup> Krivo Indus. Supply Co. v. Nat’l Distillers and Chem. Corp., 483 F.2d 1098, 1103 (5<sup>th</sup> Cir. 1973).

corporation “expressly or impliedly assumes responsibility for the debts of another corporation by ‘indicating to the creditors of the other corporation that it stands behind those debts as a guarantor,’” or when the corporation misuses another corporation “by treating it, and using it, as a mere business conduit for the purposes of the dominant corporation.”<sup>102</sup> In order for the instrumentality doctrine to apply, “the dominant corporation must have controlled the subservient corporation,” and “the evidence must establish that the dominant corporation exerted ‘actual, operative, total control’ such that the subservient corporation has ‘no separate mind, will or existence of its own and [was] but a business conduit’ for the dominant corporation.”<sup>103</sup>

The iPCS case provides a good illustration. Among the facts enumerated by the iPCS court to support the “control” factor was (i) the requirement that the subservient corporation submit its plans to the dominant corporation for funding and implementing a wireless network; (ii) the dominant corporation exercised “substantial influence over the business operations and financial performance of the subservient corporation;” and (iii) the dominant corporation required the subservient corporation to participate in a cash management system.<sup>104</sup> Presence or absence of some of these factors are relevant to the question of whether the subsidiary might be viewed as an “instrumentality” of the parent. It does not appear to be necessary to prove that the subsidiary is a “sham” or “dummy” entity, but the closer the subsidiary is to being an “instrumentality,” the stronger the case that might be made for substantive consolidation.<sup>105</sup>

#### b) “Alter Ego” and “Ultimate Control”

Other courts have created related variations on the Vecco theme of substantial identity, which might be helpful to apply to the facts of any particular case in order to give a slightly different view. For instance, one court has stated that in determining whether the parent corporation is the alter ego of its subsidiary, the following factors may be considered: (1) common employees; (2) common offices; (3) centralized accounting; (4) payment by one corporation of wages of the other corporation’s employees; (5) common business name; (6) services rendered by employees of corporation on behalf of the other corporation; (7) undocumented transfers of funds between corporations; and (8) unclear allocation of profits and losses between corporations.<sup>106</sup> Another court has suggested that “substantial identity” exists for the purposes of substantive consolidation when

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<sup>102</sup> In the Matter of iPCS, Inc., 297 B.R. 283, 294 (Bankr. N.D. Ga. 2003), quoting Krivo, *supra*.

<sup>103</sup> Id. See also In re Global Waste Company, 207 B.R. 542, 546 (Bankr. N.D. Ohio 1997); In re Valley-Vulcan Mold Co., 237 B.R. 322, 332 (6<sup>th</sup> Cir. BAP 1999).

<sup>104</sup> 297 B.R. at 295.

<sup>105</sup> The court in Calvert v. Huckins, 875 F.Supp. 674 (E.D. Cal. 1995) found the presence of the following facts not enough to establish that a subsidiary was an “instrumentality” of the parent: parent ownership of subsidiary stock; interlocking directors and officers; incorporation of subsidiary’s financial statements into parent’s; guarantee by parent of subsidiary’s promissory note; and counsel for the parent providing legal services for the subsidiary. 875 F.Supp. at 678-79. The court stated that, to establish the subsidiary as a “mere instrumentality” of the parent “requires some showing that the parent corporations not only dictate general policies, but that they also control ‘how the company will be operated on a day-to-day basis.’” 875 F.Supp. at 679.

<sup>106</sup> Rio Grande Valley Gas Co. v. Edinburg, 59 S.W.3d 199, 208-09 (Tex. App. 2000).

“one entity exercise[es] ultimate control over the assets” of the other.<sup>107</sup> Or, in the words of the iPCS court, the subsidiary never had a totally “separate mind.”<sup>108</sup>

### **III. Substantive Consolidation of Horizontally and Vertically Integrated Business Enterprises**

#### **A. An Additional Tool for Courts to Use In Substantive Consolidation Analysis Is Patent But Unused**

Analysis of corporations as vertically-integrated or horizontally-integrated should be utilized to a greater extent by courts in substantive consolidation analysis. As set forth above, when considering the propriety of substantive consolidation, courts’ analyses have focused on (i) the relationship of the parent to the subsidiary (“substantial identity”), and (ii) the relationship of the creditors to the subsidiary (“creditor reliance”). Picking up on these cases, commentators have argued in favor of limited liability between horizontally-related corporations and substantive consolidation of vertically-integrated corporations.<sup>109</sup> We not only think this distinction is appropriate, but that it deserves far more consideration than case law has yet given it.

By way of analogy, it is useful to contrast the two poles of the vertical/horizontal continuum. On the horizontal end of the continuum would be a “conglomerate”-type business that grew by acquisition.<sup>110</sup> Post-acquisition these once-independent businesses are run as subsidiaries, and are basically stand-alone manufacturing businesses, located remotely from the parent’s headquarters. Undoubtedly the trade creditors of these businesses continued to deal with these stand-alone subsidiaries in substantially the same way after the acquisition as before. At the same time, the parent was a mere holding company -- having no business of its own other than managing other businesses -- and therefore there was no “substantial identity” between the parent and the stand-alone subsidiaries. This structure is perhaps the epitome of the horizontally-integrated corporation. (This is illustrated by Figure 1.)

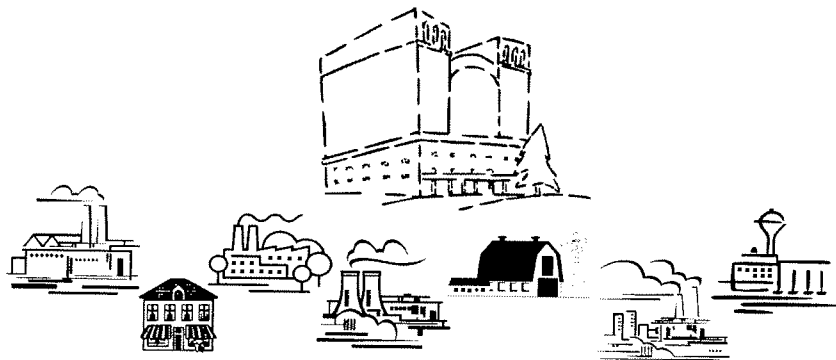
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<sup>107</sup> In re Reider, 31 F.3d 1102, 1106 (11<sup>th</sup> Cir. 1994).

<sup>108</sup> See also e.g. Astrocom Electronics, Inc. v. Lafayette Radio Electronics Corporation, 404 N.Y.S.2d 742, 744 (Sup. Ct. App. Div. 1978) (“A subsidiary corporation over which the parent corporation exercises a very considerable amount of control in everyday operations may be considered an instrumentality or agent of the parent corporation”); In re Tureaud, 59 B.R. 973, 976 (N.D. Okla. 1986), where one of the factors the court used to determine whether a subsidiary was an “instrumentality” was, “the subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.” See also 2 COLLIER ON BANKRUPTCY ¶ 105.09[3] (15<sup>th</sup> Rev. Ed. 2004) (“[I]f the separate existence of the two companies was a mere fiction, then consolidation simply recognizes the existing reality that . . . all property was held in a single entity”).

<sup>109</sup> Frost, Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups, 44 Hastings L. J. 449, 492-98 (1993); see also Blumberg, The Law of Corporate Groups: Problems in the Bankruptcy or Reorganization of Parent and Subsidiary Corporations, Including the Law of Corporate Guaranties (2002-3 Supplement) at § 10.18 n.6 (“Blumberg II”).

<sup>110</sup> See e.g. U.S. v. New York Great Atlantic & Pacific Tea Co., 67 F.Supp. 626, 638 (N.D. Ill. 1946) (“horizontal integration” is “combination under one management of a number of similar industries on the same level”); see also <http://www.quickmba.com/strategy/horizontal-integration/>; Phillip Areeda & Donald Turner, Conglomerate Mergers: Extended Interdependence and Effects on Interindustry Competition as Grounds for Condemnation, 127 U Pa. L. Rev. 1082 (1979).

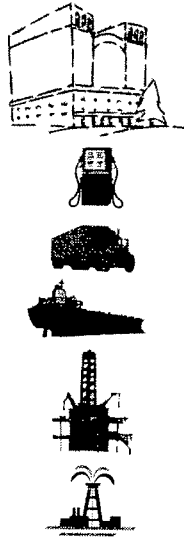


**Figure 1 -- Horizontally-Integrated Enterprise/Conglomerate**

Second, the opposite end of the continuum can be exemplified by, for instance, a vertically-integrated natural resource company. Such a company is characterized by a single business -- producing and selling energy from natural resources -- with innumerable subsidiary and affiliate businesses formed to assist in carrying out this business.<sup>111</sup> These subsidiaries and affiliates are in general not stand-alone businesses, but rather were formed for tax or other strategic reasons, or to allow the company to operate in foreign countries. This structure is the template for the vertically-integrated corporation. (This is illustrated by Figure 2.)

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<sup>111</sup> See e.g. <http://www.quickmba.com/strategy/vertical-integration/>; 35 ILCS 5/1501(a)(27) (including as part of the definition of “unitary business group” “. . . where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member)” (emphasis added); see also hearings before the subcommittee on anti-trust and monopoly of the Committee on the Judiciary United States Senate, 94th Congress, First Session, on S2387 and related bills, Vertical Integration Part I, hearings September 23-26, October 29- 31, November 12, and 19, 1975 (“Vertical integration is an efficient form of industrial organization which is commonly used by a great number of American companies, both large and small, in order to better serve the consumer at lower costs. In addition to petroleum, some other industries which have integrated companies include autos, food, newspapers, steel, tobacco, beer, machinery, communications, papers, nonferrous metals, chemicals, rubber products, textiles, and stone, glass, and clay.”)



**Figure 2 -- Vertically-Integrated Enterprise**

If a corporation is composed of more-or-less paper entities whose separate existence is driven by factors such as tax issues and whose creditors really are relying on the larger enterprise, it might not offend a court's sense of equity to "combin[e] the assets and liabilities of separate and distinct legal entities into a single pool and treat[ ] them as if they belong to one entity."<sup>112</sup> However, it might well offend a court's sensibilities to impose substantive consolidation on creditors whose customer is clearly a stand-alone entity. To such creditors, the subsidiary is the business they deal with, and the subsidiary's affiliation with the parent is, to the creditors, fairly irrelevant. It would appear that the relationship between parent and subsidiary in a vertically-integrated corporation (or corporate group) displays "substantial identity," and that creditors rely on the credit of the entire corporation or group.<sup>113</sup> On the other hand, in a horizontally-integrated business the subsidiaries do not share "substantial identity" with the parent and the creditors of each stand-alone subsidiary are likely to have relied on the credit of the subsidiary, rather than the parent.<sup>114</sup>

The groundwork to support a vertical/horizontal analysis has in fact clearly been laid by the seminal substantive consolidation cases and their tests discussed above, and therefore only a short step would seemingly need to be taken by courts to make more use of the vertical/horizontal dichotomy as an analytical tool (even though courts have apparently heretofore perceived it as

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<sup>112</sup> In re GC Companies, Inc., 274 B.R. 663, 672 (Bankr. D. Del. 2002) aff'd in part rev'd in part 298 B.R. 226 (D. Del. 2003).

<sup>113</sup> One court has boldly stated, "A situation involving a parent holding company and an operating subsidiary filing bankruptcy conjunctively suggests an appropriate case for substantive consolidation." In re Mortgage Investment Co. of El Paso, 111 B.R. 604, 609-10 (Bankr. W.D. Tex. 1990).

<sup>114</sup> cf. World Access, 301 B.R. at 217 (where consolidation was not permitted in part because entities were brought into corporate family through outside acquisitions). The recent Third Circuit Owens Corning decision made it clear in the recitation of the facts not only that the corporate debtor entities were separate, but that the credit agreement that was at the heart of the decision actually *required* the debtor entities to be kept separate. The court also pointed out that at least one subsidiary joined the corporate family through an acquisition. See 2005 WL 1939796 at \*1-2, including n. 3.

requiring a giant leap into the unknown). The following chart illustrates again how similar the more popular tests and the vertical v. horizontal inquiry are at their respective cores:

<b>Substantive Consolidation Indicator</b>	<b>Does Indicator Support Substantive Consolidation?</b>	<b>Potential Presence in Vertically-Integrated Corporation</b>	<b>Potential Presence in Horizontally-Integrated Corporation/Conglomerate</b>
Augie/Restivo I: Substantial Identity -- Creditors Dealt with Parent and Sub as Single Economic Unit	Yes	Yes	No
Augie/Restivo I: Creditor Reliance -- Creditors Relied on Subs' Separate Identity in Extending Credit	Yes	Yes	No
Augie/Restivo II: Entanglement of Debtor's Affairs	Yes	Yes	No
Eastgroup I: Substantial Identity -- Entity's Inability to Operate as a Stand-Alone Business	Yes	Yes	No
Eastgroup I: Substantial Identity -- Third Parties' Perception that they were Dealing with a Unitary Entity	Yes	Yes	No
Vecco 1: Consolidated Financial Statements	Yes	Required by GAAP	Required by GAAP
Vecco 2: Unity of Interest and Ownership between Corporate Entities	Yes	Yes	No
Vecco 3: Existence of Parent and Inter-	Yes	More Likely	Less Likely

Corporate Guarantees and Loans			
Vecco 4: Difficulty in Segregating and Ascertaining Assets and Liabilities of Individual Corporate Entities	Yes	More Likely	Less Likely
Vecco 5: Existence and Transfer of Assets Without Observing Corporate Formalities	Yes	Much More Likely	Much Less Likely
Vecco 6: Commingling of Assets and Business Functions Among Parent and Subs	Yes	Much More Likely	Much Less Likely
Vecco 7: Single Physical Location	Yes	Yes	No
Eastgroup II: "Hopeless Financial Entanglement"	Yes	Much More Likely	Much Less Likely
Eastgroup II: Creditors' Expectations Are Met In Dealing With Sub	Yes	Yes	No
"Instrumentality" Doctrine -- Sub is "Mere Conduit" for Parent	Yes	Much More Likely	Much Less Likely
Sub is Alter Ego of Parent	Yes	Much More Likely	Much Less Likely
Parent Exercises "Ultimate Control" Over Sub's Assets	Yes	Much More Likely	Much Less Likely
Sub Did Not Have "Separate Mind"	Yes	Much More Likely	Much Less Likely

We emphasize that we are not suggesting courts use the vertical/horizontal analysis as a knee-jerk solution to all substantive consolidation inquiries. Rather, it should be a corroborating tool to be used in appropriate factual situations. We would submit, however, that to the extent the “horizontalness” or “verticalness” of the corporation in question approaches the template for one of the polar types of organizational structure, the court should initially apply the horizontal/vertical analysis to create a preliminary presumption of the appropriateness or inappropriateness of substantive consolidation. In other words, if the court is looking at a “Horizontally Integrated/Conglomerate Enterprise” picture, the presumption would be not to grant substantive consolidation; if it is looking at an “Vertically Integrated Enterprise” picture, the presumption would be in favor of substantive consolidation.<sup>115</sup> However, the initial presumption should, of course, be subject to rebuttal by the facts of the individual case.

Cases in fact regularly have granted substantive consolidation to vertically-integrated corporations.<sup>116</sup> One example of many is In re Interstate Stores, Inc.<sup>117</sup>, which was a case involving 188 subsidiaries. The court ultimately approved one substantive consolidation of the subsidiaries in the toy business (“Toys-‘R’-Us”) and a separate consolidation of the parent and subsidiaries in the general retail business, on the ground that the toy group had constituted a separate business and had “operated as a single economic entity to the trade.”<sup>118</sup> The court deemed significant the fact that the corporation was in two totally separate businesses with separate creditor groups for each. The mere fact that they were managed by a single parent was not dispositive for substantive consolidation purposes.

To further illustrate the vertical/horizontal point, and also how indirectly-related case law could be used to support such a substantive consolidation analysis, it is helpful to review the recent case of In re Envirodyne Industries, Inc., 354 F.3d 646 (7th Cir. 2004). The court first notes that “[t]he Illinois income tax statute requires firms that constitute a ‘unitary business group’ to file a consolidated (called a ‘combined’) return. The quoted term signifies ‘a group of persons related

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<sup>115</sup> Adopting this approach would save much time and money; U.S. Trustees often question the appropriateness of substantive consolidation even where no other party in interest opposes it. If the initial presumption were to change from substantive consolidation being an “extraordinary remedy” in all cases to an appropriate remedy in appropriate cases, debtors might avoid the time and money currently spent supporting their case for substantive consolidation in virtually all cases.

<sup>116</sup> See also, In re Cardinal Industries, Case No. 2-89-02779, United States Bankruptcy Court for the Southern District of Ohio (parent and 33 subsidiary and affiliate companies engaged in “vertically integrated business” substantively consolidated; referred to in In re Cardinal Industries, 151 B.R. 843, 845 (Bankr. S.D. Ohio 1993), In re Cardinal Industries, 121 B.R. 518, 521 (Bankr. S.D. Ohio 1990); In re Standard Brands Paint Company, 154 B.R. 563, 565 (Bankr. S.D. Cal. 1993) (consolidation of 5 vertically-integrated subsidiaries); In re GC Companies, Inc., *supra*, 274 B.R. 663 (consolidation of 31 “vertically-integrated” subsidiaries); In re Murray Industries, 119 B.R. 820 (Bankr. M.D. Fla. 1999) (consolidation of 11 vertically-integrated subsidiaries); In re Apex Oil Co., 101 B.R. 92, 93 (Bankr. E.D. Mo. 1989) (court notes that parent, 54 other debtors and 37 additional non-debtor entities were engaged in “a vertically integrated business engaged in, inter alia, the refining, marketing and trading of petroleum products;” in In re Apex Oil Co., 118 B.R. 683, 692 (Bankr. E.D. Mo. 1990) the court granted substantive consolidation as part of the debtors’ plan of reorganization: “The Consolidated Debtors’ businesses were and are mutually dependent, vertically integrated, and operated, in many respects, as segments of a single common enterprise”).

<sup>117</sup> 15 CBC 634, 640-41 (Bankr. S.D.N.Y. 1978).

<sup>118</sup> 15 CBC at 640-41.

through common ownership whose business activities are integrated with, dependent upon and contribute to each other.’ They must be ‘functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member).’”<sup>119</sup> Judge Posner then analyzed the debtor’s structure, noting that it owned subsidiaries in both the food packaging and steel businesses, operating in multiple jurisdictions, some overseas. The court noted that “there is no integration between the food-packaging subsidiary and the steel subsidiary--no common pension or welfare plans, no common employee handbook, no joint advertising--the two companies constituting spokes with a hub at Envirodyne but no rim, except, of course, that Envirodyne files consolidated tax returns on behalf of all its subsidiaries and therefore must provide the legal and accounting services required for the preparation of the returns.”<sup>120</sup> Importantly for our analysis, the court found:

The statute, however, says that the members of a unitary business group must depend on and contribute to each other. It cannot be enough that each depends on and contributes to its parent. The concept of the unitary business group, to be a constitutional basis for taxing income earned out of state, must identify a genuine multistate enterprise--an enterprise that generates income which can't confidently be ascribed to a particular state in which the enterprise operates. If a holding company owns two unrelated companies that operate in two different states, the state in which one of them operates cannot tax the income of the other just because the two are affiliates and each is under the control of their common parent. By the same token--since what is sauce for the goose is sauce for the gander--one of the affiliates can't use the other's losses to reduce its own tax liability. If Envirodyne owned a money-losing rickshaw operator in Mandalay, it could not reduce the income from its food-packaging operations in Illinois by the losses of its rickshaw operation.<sup>121</sup>

The court held that debtor and its affiliates were not a unitary business group entitled to file an Illinois combined tax return. Although the issue of creditor reliance was not before the court, given the unrelatedness of the food packaging and steel businesses, presumably the two businesses had virtually separate groups of trade creditors, and viewed as a whole, Envirodyne would not be a good candidate for substantive consolidation.<sup>122</sup> Because all states have some form of a unitary tax statute, it might be helpful for a practitioner to analyze whether the debtor corporation in question passes the “unitary taxpayer” test as an aid to analyzing the appropriateness of substantive consolidation.

It is worthwhile to finally observe that the vertical/horizontal analysis urged here should be familiar ground for courts in yet another way -- being really quite similar to the well-known horizontal and vertical analysis used by courts to determine whether a debtor’s transaction is

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<sup>119</sup> 354 F.3d at 647 (internal citations omitted).

<sup>120</sup> Id. at 649.

<sup>121</sup> Id.

<sup>122</sup> The issue of substantive consolidation was not litigated in the Envirodyne Industries bankruptcy case. Before Envirodyne’s bankruptcy the steel business ceased operating, therefore the issues discussed in this article did not arise. This Envirodyne litigation concerned a pre-petition claim of the Illinois Department of Revenue.

within the ordinary course of business. See e.g. In re Crystal Apparel, Inc., 220 B.R. 816, 831 (Bankr. S.D.N.Y. 1998) (“Typically courts examine the “horizontal” and “vertical” dimensions of a debtor's business to address these policies reflected in the Code and to determine whether a transaction is outside the ordinary course of business”).

## **B. Skepticism of the “Liberal Trend” in Substantive Consolidation Appears to Be Off-Styled But Not Well-Supported**

Some courts, for example World Access, *supra*, have stated that they are “skeptical” of the “‘modern’ trend toward more ‘liberal’ application of the [substantive consolidation] doctrine.”<sup>123</sup> The court cites as the only authority for this sentiment a passage from Collier on Bankruptcy expressing that courts should exercise caution in expanding the doctrine because of the potential harm to “innocent creditors.”

Case law has been slowly adjusting to -- but lagging -- “modern” changes in the corporation. Many courts and commentators have observed that it was only relatively recently (in judicial time) that corporations were authorized to hold stock in another corporation,<sup>124</sup> and courts in the past therefore tended to take a rigid view of the separateness of parent corporations and their subsidiaries.<sup>125</sup> While in the real world the “modern” multi-tiered corporation is now common, it was not necessarily common while the law of substantive consolidation was originally being developed, and therefore language reflecting rigid views on corporate structures is still found in some opinions.<sup>126</sup>

More courts may slowly be adopting an “enterprise” view of the corporation, departing from courts’ former rigid adherence to limited liability among subsidiaries of the same parent corporation. Augie/Restivo recognized the significance of this trend: “Courts have recognized a recent, increased need for substantive consolidation owing to the prevalence of parent and subsidiary corporations with interlocking directorates.”<sup>127</sup> In the progenitor Vecco case the court said, “Due to the organizational makeup evidenced by the now commonplace multi-tiered corporations in existence today, substantive consolidation of a parent corporation and its subsidiaries has been increasingly utilized as a mechanism . . . This . . . arises from the result of increased judicial recognition of the widespread use of interrelated corporate structures by subsidiary corporations operating under a parent entity’s corporate umbrella for tax and business planning

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<sup>123</sup> In re World Access, *supra*, 301 B.R. at 272 n.57.

<sup>124</sup> Prior to 1889 no state allowed a corporation to hold stock of other corporations. A. Chandler, Strategy and Structure: Chapters in the History of the Industrial Enterprise (1962) at pp. 30-31.

<sup>125</sup> See e.g. Boise Cascade Corp. v. Wheeler, 419 F.Supp. 98, 102 (S.D.N.Y. 1976) (“[I]t is axiomatic that a corporation is a ‘creature of the law, endowed with a personality separate and distinct from that of its owners’” (quoting Berger v. Columbia Broadcasting System, Inc., 453 F.2d 991, 994 (5<sup>th</sup> Cir. 1972))).

<sup>126</sup> In the recent Third Circuit opinion in Owens Corning, discussed elsewhere in this article, the court had a serious problem with the fact that the remedy sought to be employed by the debtors was a “deemed” consolidation, i.e., a “pretend” consolidation for purposes of the plan (and, to defeat the banks’ claims). The last paragraph of the opinion states that a “deemed” consolidation, such as the debtors here attempted “fails to even qualify for consideration [for substantive consolidation].” 2005 WL 1939796 at 14.

<sup>127</sup> Augie/Restivo, *supra*, 84 B.R. at 320, *rev’d* after district court *aff’d*, 860 F.2d 515 (2d Cir. 1988)

purposes.”<sup>128</sup> Commentators have chimed in as well: “Substantive consolidation of a parent corporation and its subsidiaries has been utilized increasingly as a mechanism to deal with debtor corporations”<sup>129</sup>

In sum, courts appear to be fashioning more “liberal” remedies because such remedies are needed to match the reality of the current corporate environment -- hardly a justification for “skepticism.” To say that in some cases there may be “innocent creditors” whose rights should be protected seems hardly different from the “balancing of harms” test courts already employ.<sup>130</sup>

## Conclusion

It is quite clear that -- whether analyzed using the Augie/Restivo, Eastgroup, Owens Corning, or other tests found in the case law -- the stronger the facts of any particular case are in demonstrating either (i) substantial identity between the parent and subsidiaries, (ii) creditor reliance on the credit of the entire enterprise, or (iii) “hopelessly entangled” financial affairs of a corporate group, the stronger the case for substantive consolidation. Courts should abandon their apparent distrust of the “modern, liberal trend” in granting substantive consolidation because such an underlying viewpoint arguably does not assist the analysis. The facts of the case are paramount, and should be the focus of the court’s inquiry. Finally, given the nature of 21<sup>st</sup> Century large, public corporate structures, in cases where there is an absence of fraud, courts should consider adopting an additional screen in their substantive consolidation analysis -- whether the corporation (or parts of it) are horizontally integrated or vertically integrated. An initial finding that a debtor group is vertically integrated would establish a presumption in favor of substantive consolidation, with the burden on opponents to demonstrate why it was not appropriate (e.g., creditor reliance on the credit of one subsidiary). However, if the court found the debtor group to be horizontally integrated, the presumption would be that substantive consolidation is not appropriate, and the burden would be on proponents to demonstrate otherwise (e.g., “substantial identity,” “no separate mind”, a “mere instrumentality”). In either case, the analysis would proceed to the next step with the burden of proof firmly in the right place.

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<sup>128</sup> In re Vecco, supra, 4 B.R. at 409; see also In re S.I. Acquisition, 58 B.R. 454, 462 (W.D. Tex. 1986) (same).

<sup>129</sup> J. Stephen Gilbert, Substantive Consolidation in Bankruptcy: A Primer, 43 Vand. L. Rev. 207, 208 n. 3 (1990).

<sup>130</sup> In cases dealing with “modern” multi-tiered corporate entities, courts have referred to a presumption against creditor reliance on the credit of a particular affiliate, rather than on that of the group as a whole, and have imposed on the creditor the burden to show sole reliance on the credit of the affiliate in question in order to defeat substantive consolidation. See e.g. In re Lewellyn, 26 B.R. 246, 252-52 (Bankr. S.D. Ia. 1982); In re Food Fair, Inc., 10 B.R. 123, 127 (Bankr. S.D.N.Y. 1981); In re Commercial Envelope Mfg. Co., Inc., 1977 WL 182366, \*5 (Bankr. S.D.N.Y. 1977).