2005

Substantive Consolidation Today

Douglas G. Baird

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Abstract: In large corporate reorganizations, bankruptcy judges often confirm plans of reorganization that call for "substantive consolidation" of the different corporate entities comprising the corporate group. Substantive consolidation allows the general creditors of the various entities to share in a common pool of assets; it often simplifies a reorganization and wins broad support among the creditors. Nevertheless, a statutory basis for the doctrine is hard to find, and the lower court practice is often at odds with the doctrine as spelled out in appellate court opinions. The emerging debate over the proper scope of substantive consolidation shows how much bankruptcy law remains a common-law discipline whose contours are shaped in the courtroom as well as in Congress.

Introduction

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 is the most sweeping change in bankruptcy law in a quarter century.[1] Much of bankruptcy law, however, remains judge-made, and here the area is in considerable flux. This Article focuses on the question of substantive consolidation, a bankruptcy-law analogue to veil-piercing, to show how judges can shape the legal landscape as much as legislators.[2]

Part I of this Article sets out the background through a hypothetical. Part II examines substantive consolidation as commonly practiced in the bankruptcy courts.[3] Part III reviews the evolution of the doctrine and shows how modern practice has lost its moorings

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[1] *See generally* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (to be codified in scattered sections of 11 U.S.C., 12 U.S.C., 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

[2] Many excellent overviews of substantive consolidation exist. *See generally* Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. Pitt. L. Rev. 381 (1998).

[3] *See infra* notes 6–49 and accompanying text.

and is likely to be vulnerable if the U.S. Supreme Court confronts the question.[4]

I. The Mechanics of Substantive Consolidation

A large business often consists of many corporate entities. When the parent corporation declares bankruptcy, each entity typically files its own Chapter 11 petition, and the cases are then administratively consolidated. One judge presides over all the cases, and one set of lawyers represents the various debtors. The separateness of the legal entities is preserved, and the general creditors of each entity share the entity's assets with the other general creditors of that entity. In a number of complex reorganizations—WorldCom being a recent example—those running the reorganization want to take the next step and substantively consolidate the various cases. Under substantive consolidation, the liabilities and assets of the various entities are put into the same pot, and the assets are distributed ratably among the general creditors. Under this scheme, some general creditors fare better and others worse.

Enhancing the rights of some creditors at the expense of others in this fashion requires justification. In some cases, the institutional lenders have already treated the business as a single entity. For them, unscrambling the many intercorporate relationships introduces complexities to the reorganization without corresponding benefits. Figuring out the exact pro rata share does not make sense, especially if virtually all the players have already agreed on a plan of reorganization.

The following hypothetical reflects a common pattern. Premium Paint is one of the largest manufacturers, distributors, and retailers of paint and paint-related merchandise in the Midwest.[5] It consists of six separate corporations. Premium Paint Co., Inc., is a publicly traded Delaware corporation that serves as a holding company for its subsidiaries. RetailCo operates most of the retail paint and paint-related stores; NewRetailCo operates the balance. Several years ago, Premium acquired NewRetailCo from a competitor and assumed all of its debt, including long-term unsecured notes. Aside from intercorporate obligations (of which there are many), NewRetailCo is in the best financial shape of any of the subsidiaries. ManufacturerCo manufac-

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[4] *See infra* notes 50–81 and accompanying text.

[5] These facts are loosely based on *In re Standard Brands Paint Co.*, 154 B.R. 563, 564–65 (Bankr. C.D. Cal. 1993), and to a lesser extent, on *Flora Mir Candy Corp. v. R.S. Dickson & Co.* (*In re Flora Mir Candy Corp.*), 432 F.2d 1060, 1061–62 (2d Cir. 1970).

tures paint and paint-related items. DistributorCo is the distribution subsidiary for paint manufactured by ManufacturerCo. RealtyCo owns or manages real estate holdings, including those where RetailCo and NewRetailCo operate the retail paint stores.

The six corporations operate together as a functional whole. Separate books and records are kept for internal purposes, but the debtors report to the SEC on a consolidated basis. The institutional creditors that lend to any entity typically secure cross-guarantees from the others. Cash from each Premium Paint entity is swept every day into one common account. Intercompany accounts are kept, but no cash changes hands and no accounts are ever closed out. Assets such as computer software are shared, as is office space. Employees of the different entities work together in planning new products and advertising campaigns. Overhead costs are divided among the different entities according to a formula fixed long ago.

In fine print, invoices indicate the separate corporate status of the different entities, but other communications are less clear. All the entities use the Premium Paint logo on their stationery, advertising, and press releases. They usually also include their own names. For example, RetailCo's letterhead reads, beneath the Premium Paint logo, "RetailCo, a member of the Premium Paint Group." DistributorCo's letterhead reads, beneath the same logo, "DistributorCo, a division of Premium Paint." "Divisions" at Premium Paint, however, do not always correspond with discrete legal entities. ManufacturerCo is divided into several product lines (such as Premium Outdoor and Premium Metallic), and occasionally these have identified themselves as "divisions" of Premium Paint, even though they are part of ManufacturerCo and not separate legal entities.

The board of directors of each subsidiary consists entirely of officers of the parent. The debtors, however, have always paid meticulous attention to corporate formalities, such as holding meetings and keeping minutes. Institutional lenders know they are dealing with different legal entities, as do the largest trade vendors. There is disclosure of the corporate structure in an exhibit to Premium Paint's 10-K and some discussion of some of the entities in the body of the 10-K and footnotes to the company's financial statements. Nevertheless, most trade vendors and the public at large are not aware of the distinctions among individual members of the group. On-the-ground employees are not always completely aware of the different entities either. They sometimes blur the lines in accounting for costs and recording intercompany transactions.

Premium Paint files for Chapter 11, and the plan that emerges consolidates the claims against all the entities. Substantive consolidation avoids the complications that arise from sorting out both the many intercorporate balances and the rights that different creditors have against the various entities. The competing groups of creditors may reach agreement with one another, and the court may then approve what is, for practical purposes, a consensual plan.

But what happens if the negotiations fail? Can Premium Paint's plan be confirmed over the objection of the creditors? As with many other aspects of modern Chapter 11 practice, the debtor's ability to confirm such a plan is not clear. Those most likely to raise objections to the Premium Paint plan are the noteholders of NewRetailCo. They lent to NewRetailCo before it became part of the Premium Paint group. Existing practice in the bankruptcy courts suggests that substantive consolidation in a case such as Premium Paint might be appropriate, but, as we shall see, there is good reason to be skeptical.

II. The "Functional" Approach to Substantive Consolidation

Someone wanting to argue in favor of substantive consolidation for Premium Paint might begin by invoking *Drabkin v. Midland-Ross Corp.* (*In re Auto-Train Corp.*).[6] As read by other courts, *Auto-Train* requires a three-part inquiry.[7] First, those proposing substantive consolidation have to show "a substantial identity between the entities to be consolidated."[8] The presence of consolidated financial statements and a seamless interaction among the various entities, such as what we see with Premium Paint, may be sufficient to make such a showing.[9] Second, proponents need to show that "consolidation is necessary to avoid some harm or to realize some benefit."[10] Here, the difficulty of sorting out Premium Paint's many intercorporate transactions and the need to protect the vast majority of creditors who thought they were dealing with a single business might well satisfy this test.[11]

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[6] *See* 810 F.2d 270, 276 (D.C. Cir. 1987).

[7] *Auto-Train* discusses substantive consolidation only in dictum and purports to follow the cases in the Second Circuit. Nevertheless, other courts have managed to tease out of it a test for substantive consolidation that is distinctly different from that of the Second Circuit and is far less demanding.

[8] *Auto-Train*, 810 F.2d at 276.

[9] *See* Soviero v. Franklin Nat'l Bank, 328 F.2d 446, 447–48 (2d Cir. 1964).

[10] *Auto-Train*, 810 F.2d at 276.

[11] *See* First Nat'l Bank of El Dorado v. Giller (*In re* Giller), 962 F.2d 796, 799 (8th Cir. 1992); Eastgroup Props. v. S. Motel Ass'n, 935 F.2d 245, 250 (11th Cir. 1991); *In re* World-

At this point, the burden shifts to the opponent of consolidation to show that "it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation."[12] Under our facts, only the noteholders of NewRetailCo can argue that they relied on the separate form of NewRetailCo. So long as these creditors consent to the plan, there may be no one to rebut the presumption of consolidation. Even if a few of these noteholders do dissent, they may not be able to show that the harm to them outweighs the benefits that everyone else enjoys from the consolidation.

The dissenting noteholders of NewRetailCo may have to contend with two additional issues as well. First, if the premerger noteholders of NewRetailCo approve, as a class, the proposed substantive consolidation plan, an unhappy individual noteholder holding a claim within that class may be out of luck. This is true because the typical case today does not involve substantive consolidation in the traditional sense. The entities retain their separate identities after the reorganization. (Indeed, the failure to do this will trigger tax liabilities.) Substantive consolidation is done for distributional purposes only, whereby the proposed plan pays out different claims as if the entities were consolidated, but the entities are not actually consolidated. As such, if the other members of the class accept their distributions under the plan, the dissenter can insist only on receiving what it would have received in a Chapter 7 liquidation, which may have been little or nothing.[13]

A second issue that dissenting noteholders may face is the difficulty of showing that substantive consolidation prejudices them, given that complex intercorporate liabilities are present. This issue exists even if the dissenting noteholders as a class reject the plan. Suppose NewRetailCo has assets of $100 and its only creditors, the old NewRetailCo noteholders, are owed $100. They would be paid in full if each corporate entity were treated separately. But let us assume that after consolidation, the NewRetailCo noteholders and all the other creditors receive only forty cents on the dollar. Absent intercorporate liabilities, the noteholders are worse off than they would have been without consolidation.

Intercorporate liabilities, however, cloud the issue considerably. NewRetailCo owes money to ManufacturerCo, RealtyCo, and Distribu-

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Com, Inc., No. 02-13533 (AJG), 2003 WL 23861928, at *16, 37 (Bankr. S.D.N.Y. Oct. 21, 2003).

[12] *Auto-Train*, 810 F.2d at 276.

[13] This is the effect of the "best interests of the creditors" test embedded in 11 U.S.C. § 1129(a)(7)(2000).

torCo for paint purchases, rent, and advertising and other expenses. There are objections to the formula used to apportion overhead. Workers paid by other divisions may have worked for NewRetailCo. If NewRetailCo and the other entities enter into a comprehensive settlement of intercorporate obligations in which NewRetailCo has net obligations of $60 or more, the dissenting creditors will be unable to show that substantive consolidation prejudices them. If they cannot show prejudice, they have not met the burden that the third prong of the *Auto-Train* test places on them.[14]

The *Auto-Train* test has morphed into long laundry lists.[15] This array of tests and factors, however, suggests that substantive consolidation is plausible in a case such as Premium Paint, where everything, including cash, is centrally managed and controlled and where the different legal entities function as a unit, rather than as a mere collection of discrete businesses under one corporate umbrella. We have substantial identity, benefits from consolidation, and relatively few who can show reliance on corporate separateness. The harm that the creditors suffer from the plan may be modest relative to the benefits of a fast and efficient reorganization, especially if intercorporate transfers make uncertain creditors' payout under a stand-alone plan.

The WorldCom reorganization showed how the pressures to ensure a speedy reorganization can be overwhelming.[16] As in our hypothetical, the *WorldCom* plan proposed substantive consolidation for distributional purposes only.[17] The reorganization did not affect the legal and organizational structure of the various WorldCom entities themselves for tax or any other purposes.[18] Again, as in the hypothetical, a group of noteholders stood in a position analogous to the note-

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[14] *Auto-Train*, 810 F.2d at 276.

[15] *See, e.g.*, *Giller*, 962 F.2d at 799 (three-factor test); *Eastgroup Props.*, 935 F.2d at 249–50 (two-part test in which court can incorporate *In re Vecco Construction* or *Pension Benefit Guaranty Corp. v. Ouimet* factors); Pension Benefit Guar. Corp. v. Ouimet Corp., 711 F.2d 1085, 1093 (1st Cir. 1983) (five nonexclusive factors); *In re* Vecco Constr., 4 B.R. 407, 410 (E.D. Va. 1980) (a seven-factor test). The Third Circuit summarized the state of the law of substantive consolidation obliquely in *Nesbit v. Gears Unlimited*, 347 F.3d 72, 86 n.7 (3d Cir. 2003), when it asked whether a business consisting of a number of different legal entities should be treated as one for purposes of Title VII, which applies only if a firm employs a minimum number of workers. *Id.* at 85–86.

[16] *See In re WorldCom*, 2003 WL 23861928, at *37.

[17] *Id.* at *6.

[18] *See* Debtors' Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code at 46 (filed May 23, 2003), *In re* WorldCom, Inc., No. 02-13533 (AJG), 2003 WL 23861928 (Bankr. S.D.N.Y. Oct. 21, 2003), *available at* http://www.elaw4enron.com/WorldcomDisclosure.htm.

holders of NewRetailCo: they had lent to MCI before WorldCom acquired it.[19] Hence, these creditors could easily show that they had not dealt with WorldCom as a single entity. The plan of reorganization as originally proposed, however, would pay some of them nothing—even though creditors of a parent, who were structurally junior to them, would enjoy substantial distributions.[20]

The court allowed substantive consolidation in an unpublished opinion.[21] Two factors proved decisive. First, as often happens in bankruptcy practice, the major parties reached a deal with one another.[22] The court did not face the concerted opposition among the parties that would have led, among other things, to a strongly contested appeal of the decision. Second, and much more importantly, both the size and number of intercorporate transfers were staggering.[23] In a single month, for example, more than 600,000 transactions took place.[24] Millions of transactions flowed through intercompany accounts, and these totaled one *trillion* dollars.[25]

Although the court allowed substantive consolidation in this case, one can doubt whether the decision was as cut and dried as the court made it seem. The *WorldCom* court was located in the Second Circuit and thus had to apply the test that the Second Circuit set out in 1988 in *Union Savings Bank v. Augie/Restivo Baking Company, Ltd.* (*In re Augie/Restivo Baking Co.*).[26] In *Augie/Restivo,* the Second Circuit held that substantive consolidation was appropriate only when (1) the creditors had dealt with the entities as single economic units and had not relied on their separate identities or (2) the debtors' affairs were so entangled that consolidation would benefit all creditors.[27]

The first circumstance serves as the bankruptcy analogue for piercing the corporate veil.[28] The two doctrines are not quite the

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[19] *In re WorldCom,* 2003 WL 23861928, at *5.

[20] *Id.*

[21] *Id.* at *37.

[22] *Id.* at *16.

[23] *Id.* at *11.

[24] *In re WorldCom,* 2003 WL 23861928, at *11.

[25] *Id.*

[26] *Id.* at *35 (citing Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518–19 (2d Cir. 1988)). The Ninth Circuit also follows the *Augie/Restivo* test. *See* Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 766 (9th Cir. 2000).

[27] 860 F.2d at 518.

[28] For example, the cases of an individual and a corporation were substantively consolidated in *Alexander,* 229 F.3d at 758, 766. Substantive consolidation may be appropriate

same. Veil-piercing allows the creditors of a subsidiary to reach the assets of the parent, but does not at the same time allow creditors of the parent to reach the assets of the subsidiary.[29] In contrast, substantive consolidation puts all the assets in a common pool, and creditors of the various entities share in it pro rata.[30] Nevertheless, both doctrines apply when the debtor has disregarded separateness so significantly that creditors treated the different corporations as one legal entity.[31] The idea is that the affairs of the two corporations are so closely entwined that each lacks a separate existence for all practical purposes. In the *WorldCom* case, however, the reliance of the MCI noteholders on MCI as a separate entity made it hard to justify substantive consolidation on these grounds.[32]

It was more plausible in *WorldCom* to rely on the second prong of *Augie/Restivo*.[33] This prong recognizes that keeping the corporations' affairs separate must be practical. We need to look at the costs of sorting out the affairs of two related corporations if they are treated as one entity versus if they are treated as two.[34] Even though the corporations are sufficiently separate such that we would not pierce the corporate veil outside of bankruptcy, their affairs may have become so entangled and their assets so meager that unscrambling the mess may not be worth the cost.[35] When the administrative costs of sorting out the obligations of the two corporations dwarf the benefits that any group of creditors might reap from keeping the corporations separate, it is in everyone's interest to consolidate the two.[36] But the *WorldCom* plan wiped out some creditors entirely, whereas they might have received something once the accounts were sorted out. Even if the accounts could never be completely reconciled, one might still be

between other kinds of entities as well, such as between partners and partnerships or even between two individuals. *See* FDIC v. Colonial Realty Co., 966 F.2d 57, 59–61 (2d Cir. 1992).

[29] *See, e.g., In re* Owens Corning, 419 F.3d 195, 206 (3d Cir. 2005).

[30] *See, e.g., id.*

[31] *See id.* at 205–06.

[32] The court, however, concluded otherwise. *See In re WorldCom*, 2003 WL 23861928, at *37 (finding the first prong of *Augie/Restivo* was satisfied because "a substantial portion of creditors dealt with the Debtors as a single economic unit and did not rely on the separate identity of any particular Debtor entity in extending credit").

[33] *See id.* ("The facts amply demonstrate that the Debtors' operational and financial affairs are so entangled that the accurate identification and allocation of assets and liabilities either could never be accomplished, or, even if it could be accomplished, would take so long and be so costly such that creditors as a whole would be substantially harmed by the effort. Thus, disentangling the financial affairs of the Debtors is a practical impossibility.").

[34] *See Augie/Restivo*, 860 F.2d at 519.

[35] *See id.*

[36] *See id.*; *see also In re* The Leslie Fay Cos., 207 B.R. 764, 779–80 (Bankr. S.D.N.Y. 1997).

able to find that enough assets remained in the relevant entity for the creditors to receive something.

When the bankruptcy court—and everyone else—wants to confirm a plan and enable a business to exit rapidly from Chapter 11, there is a natural tendency to find that substantive consolidation is possible under whatever test is supposed to apply. Bankruptcy judges enjoy considerable discretion, and they are often willing to allow practical considerations to trump legal principle. Some courts of appeals, however, resist any interpretation of the Bankruptcy Code that is made chiefly to accommodate pragmatic concerns.[37] This reluctance is illustrated most vividly in the Third Circuit's recent decision in *In re Owens Corning*.[38]

In *In re Owens Corning*, the district court had confronted a set of facts even weaker than those seen in the Premium Paint example yet allowed substantive consolidation under a variation of the *Auto-Train* test.[39] The court held that two circumstances together created a prima facie case for consolidation: (1) a central committee exercised common control over the operations and finance of the subsidiaries, and (2) the subsidiaries were created for the convenience of the parent, primarily for tax reasons.[40] The remaining question under the *Auto-Train* test was whether creditors relied on the separateness of the entities.[41] Here, the court found that the failure to track the finances of the individual subsidiaries was fatal:

> There can be no doubt that the Banks relied upon the overall credit of the entire Owens Corning enterprise. Each Bank's commitment was to the entire enterprise. The decision as to whether funds would be borrowed by the parent company, or by one or more of the subsidiaries, was made by the borrowers, not by the lenders. All of Owens Corning's

[37] Judge Easterbrook's opinion in *In re Kmart*, rejecting the doctrine of necessity, is a typical example. *See* 359 F.3d 866, 871 (7th Cir.) (calling the doctrine of necessity "just a fancy name for a power to depart from the Code"), *cert. denied*, 125 S. Ct. 495 (2004). Many courts embrace literal interpretations of the Bankruptcy Code. *See, e.g.*, RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra Corp.), 361 F.3d 257, 266–70 (4th Cir. 2004) (insisting on literal interpretation of rules governing assumption of executory contracts); Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 749–50 (9th Cir. 1999) (same).

[38] *See In re Owens Corning*, 419 F.3d at 207–12.

[39] *In re* Owens Corning, 316 B.R. 168, 169–70, 171, 172 (Bankr. D. Del. 2004).

[40] *Id.* at 171.

[41] *Id.*

> financial reporting was done on a consolidated basis, and only that consolidated information was provided to the Banks.
>
> It is also important to note that, in seeking and obtaining guarantees from the 'substantial' subsidiaries, the Banks knew only that each guarantor had assets with a book value of $30 million or more; the Banks had no information about the debts of such subsidiaries.
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> In short, there is simply no basis for a finding that, in extending credit, the Banks relied upon the separate credit of any of the subsidiary guarantors.[42]

It was not sufficient that the banks counted on the corporate separateness to ensure their own priority position. As is often the case when applying the *Auto-Train* test, the burden of showing substantial identity is relatively light, and the burden of showing reliance on the part of the creditor resisting substantive consolidation is heavy.[43]

The Third Circuit flatly rejected this approach, holding that substantive consolidation was possible only under "compelling circumstances."[44] It focused squarely on the principles set out in *Augie/Restivo* and required proponents of substantive consolidation to show either: "(i) [P]repetition [the different debtors] disregarded separateness so significantly [that] their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) [P]ostpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[45]

Applying this test to the facts, the case was easy. Indeed, the court questioned whether there could ever be a "deemed" substantive consolidation such as in *WorldCom.* The entities could not be both so entangled as to justify consolidation and yet so distinct that it was possible and desirable to keep them separate after bankruptcy.[46]

Quite apart from which test was being used, however, the outcome in *In re Owens Corning* was almost foreordained. The district court decision had broken too much china. Substantive consolidation in such a case would have effectively undermined bank loans, totaling $2 billion, which had been made in a conventional and commercially

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[42] *Id.* at 172.
[43] *See, e.g.*, *Eastgroup Props.*, 935 F.2d at 251–52.
[44] *In re Owens Corning,* 419 F.3d at 210–11.
[45] *Id.* at 211.
[46] *Id.* at 214–15.

reasonable way.[47] Allowing substantive consolidation would have unsettled too many established practices.[48]

Still left undecided are the burdens on the proponents of substantive consolidation in going forward, in the Third Circuit and elsewhere, when the affected lenders are not as careful and attention to corporate form is more casual. In reaching its decision in *In re Owens Corning*, the Third Circuit took pains to affirm the existence of the substantive consolidation doctrine and the power of bankruptcy courts to order substantive consolidation under appropriate circumstances.[49] The foundations of the doctrine itself, however, are less solid than even the Third Circuit made them out to be. One cannot be confident that other courts of appeals will likewise affirm the existence or the legitimacy of the doctrine.

III. The Uncertain Future of Substantive Consolidation

Substantive consolidation lacks the solid foundation one usually expects of doctrines so firmly embedded in day-to-day practice. The U.S. Supreme Court has never formally embraced the concept. Justice William O. Douglas came closest to doing so in 1941 in *Sampsell v. Imperial Paper & Color Corp.*, but that case involved a recovery of assets that had been fraudulently conveyed from one corporate entity to another.[50] Moreover, the objecting creditor "had at least some knowledge as to the fraudulent character of [the] corporation."[51] As late as 1964, one could still argue that substantive consolidation required a fraudulent conveyance.[52]

The first cases to develop substantive consolidation as a doctrine separate from fraudulent conveyance law relied squarely on corporate law and the power to pierce the corporate veil.[53] The first opinions came out shortly after the 1938 U.S. Supreme Court decision in *Erie Railroad v. Tompkins*,[54] at a time when courts had not yet absorbed *Erie*'s full impact. If they had, courts might have rationalized the location of the doctrine in federal common law as part of their inherent

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[47] *Id.* at 216.

[48] *Id.*

[49] 419 F.3d at 205–09.

[50] 313 U.S. 215, 219–220 (1941).

[51] *Id.* at 221.

[52] *See* Soviero v. Franklin Nat'l Bank, 328 F.2d 446, 448 (2d Cir. 1964).

[53] *See, e.g.*, Stone v. Eacho (*In re* Tip Top Tailors, Inc.), 127 F.2d 284, 288 (4th Cir. 1942); Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940).

[54] 304 U.S. 64 (1938).

power to flesh out the interstices of bankruptcy law with common-law reasoning. As it was, however, they did not invoke any special power of bankruptcy courts as courts of equity, but simply looked to nonbankruptcy law. As the Fourth Circuit stated in 1942 in *Stone v. Eacho (In re Tip Top Tailors, Inc.)*:

> It is well settled that courts will not be blinded by corporate forms nor permit them to be used to defeat public convenience, justify wrong or perpetrate fraud, but will look through the forms and behind the corporate entities involved to deal with the situation as justice may require.[55]

In these cases, courts relied on common-law principles, not on a doctrine peculiar to bankruptcy or courts of equity:

> 'Although we know of no instance in which it has been done in matters of receivership, we cannot see why . . . the law does not impose upon a court the same duty in a receivership matter when, as here, the facts are substantial enough to justify, indeed to compel, a finding that the five corporations were so identified with the parent corporation as to be a part of it.'[56]

Even into the 1960s, substantive consolidation was merely a federal common-law variation of basic corporate law principles:

> It is difficult to imagine a better example of commingling of assets and functions and of the flagrant disregard of corporate forms than as here demonstrated by the bankrupt. One gains the distinct impression that the bankrupt held up the veils of the fourteen collateral corporations primarily, if not solely, for the benefit of the tax gatherer, but otherwise completely disregarded them. Even Salome's could not have been more diaphanous.[57]

Substantive consolidation finally acquired a rationale rooted in bankruptcy policy in *Chemical Bank New York Trust Co. v. Kheel.* In that case, the Second Circuit relied not on the lack of separateness of the legal entities but on the sheer cost of sorting out the various rights and obligations:

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[55] 127 F.2d at 288.
[56] *Id.* at 289 (quoting Tr. Sys. Co. of Pa. v. Payne, 65 F.2d 103, 107 (3d Cir. 1933)).
[57] *Soviero*, 328 F.2d at 448.

> [W]here the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.[58]

This rationale was at the center of the typical cases decided by bankruptcy judges in the 1970s. In *In re Commercial Envelope Manufacturing Co.*, unscrambling the various transactions might well have proved impossible for the bankruptcy court:

> Many of the day to day operations have occurred as though the debtors were one consolidated and integrated entity. The effusion of time and money would be almost prohibitive were any sophisticated effort to make sense out of the complex of cross lines undertaken. . . . [D]ue to the immense internal confusion, even if the expense of an audit were undertaken, there could be no assurance that it would be successful in unscrambling the relationships.[59]

But even with this additional rationale, the Second Circuit permitted substantive consolidation only in the rarest of circumstances. For instance, *Flora Mir Candy Corp. v. R.S. Dickson & Co. (In re Flora Mir Candy Corp.)* involved multiple subsidiaries and "a multitude of intercompany transactions, many without apparent business purpose."[60] The court adopted the district court's finding that this state of affairs, standing alone, was "grossly insufficient" to allow substantive consolidation, especially because the objecting creditor, like the noteholders of NewRetailCo in our example, entered the picture before the debtor joined the corporate group.[61]

A court that follows the doctrine as developed in the Second Circuit is unlikely to allow substantive consolidation in cases such as Premium Paint. Common control, consolidated financials, and modern cash management are not enough to justify substantive consolidation grounded in veil-piercing and alter-ego actions, especially where corporate formalities have been followed and the separate entities will be maintained going forward. The cost-saving rationale of substantive

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[58] Chem. Bank. N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966).
[59] 3 Bankr. Ct. Dec. (LRP) 647, 650 (Bankr. S.D.N.Y. Aug. 22, 1977).
[60] 432 F.2d 1060, 1061 (2d Cir. 1970).
[61] *Id.* at 1062.

consolidation is similarly unlikely to be available. To have an impact, these costs must threaten to leave *every creditor* worse off.[62] Untangling obligations among different corporate entities may be expensive, but it will rarely come close to consuming so much of the estate as to undo the structural priority some creditors enjoy over others when corporate form is respected. The trillion-dollar mess in *WorldCom* is exceptional, and even there the court might have been able to do more than simply throw up its hands. As the court noted in *In re Owens Corning*, perfection is not required, and some inaccuracies can be tolerated.[63]

In many substantive consolidation disputes, the creditors' reliance on corporate separateness seems a critical issue. Both *Flora Mir* and *Union Savings Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)*—cases in which the Second Circuit denied substantive consolidation—involved creditors who could show that they dealt with their respective debtors as distinct entities.[64] Moreover, Judge Ambro of the Third Circuit couches his formulation of the test in *In re Owens Corning* in terms of reliance.[65] The logic of substantive consolidation, at least as developed in the Second Circuit, however, suggests such an emphasis on reliance is not appropriate. Reliance is irrelevant to the cost-saving prong of *Augie/Restivo*, and the other prong is satisfied only when conditions are such that veil-piercing or alter-ego actions could be brought outside of bankruptcy.[66] These are available when there is deliberate undercapitalization, misrepresentation, or failure to follow corporate formalities.[67] Establishing these has little to do with reliance.

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[62] *See In re* Owens Corning, 419 F.3d 195, 211 & n.20 (3d Cir. 2005); *Chem. Bank*, 369 F.2d at 847.

[63] *See* 419 F.3d at 214 ("Neither the impossibility of perfection in untangling the affairs of the entities nor the likelihood of some inaccuracies in efforts to do so is sufficient to justify consolidation."). In reaching this conclusion, the Third Circuit relied on the analysis of the court in *R2 Investments, LDC v. World Access, Inc. (In re World Access Inc.)*. *See id.* at 214–15. In *R2 Investments*, the court had stated that "perfection is not the standard in the substantive consolidation context." R2 Invs., LDC v. World Access, Inc. (*In re* World Access Inc.), 301 B.R. 217, 279 (Bankr. N.D. Ill. 2003).

[64] Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 519 (2d Cir. 1988); *In re Flora Mir Candy Corp.*, 432 F.2d at 1062–63.

[65] *In re Owens Corning*, 419 F.3d at 212. At the same time, however, he rejects suggestions that lenders must engage in elaborate gymnastics to prove actual reliance. *See id.* at 212–14.

[66] *See* 860 F.2d at 518–19.

[67] *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1072 (1991).

A debate over different approaches to substantive consolidation, however, should not obscure a more fundamental problem. One cannot be sure that an appellate court would allow substantive consolidation at all, particularly given that the Supreme Court has never adopted it. Far from providing a basis for substantive consolidation, cases such as *Sampsell* rely explicitly on fraudulent conveyance doctrine and thus underscore the need to find an explicit grant of power somewhere.[68] Section 1123(a)(5)(C) of the Bankruptcy Code may be a possible source of support.[69] This section provides that "[n]otwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . . provide adequate means for the plan's implementation, such as . . . merger or consolidation of the debtor with one or more persons."[70]

This section provides a thin reed for justifying substantive consolidation, however. The language "notwithstanding any otherwise applicable nonbankruptcy law" cannot sensibly be read as a broad grant of power. It cannot, for example, give the debtor the ability to merge itself with any third party it pleases, whether that party wants the merger or not. Even if the provision contemplates "consolidation" under Chapter 11 that could not have taken place elsewhere, nothing suggests that such a consolidation can compromise the otherwise valid claims of creditors of each entity. This section does not itself grant a substantive right.

The absence of any clear statutory authority in the Bankruptcy Code throws into question the viability of the doctrine in an appellate court that focuses on the language of the Bankruptcy Code and refuses to look beyond it.[71] Substantive consolidation is, as the term suggests, a *substantive* power. In the view of some courts, substantive powers such as this are permitted only to the extent that they grow out of substantive provisions of the Bankruptcy Code. Courts have stated again and again that substantive powers cannot be derived from section 105 of the Bankruptcy Code.[72]

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[68] In permitting substantive consolidation, Justice Douglas, writing for the Court in *Sampsell*, explicitly relied on the existence of a fraudulent conveyance. 313 U.S. at 220.

[69] *See In re* Stone & Webster, 286 B.R. 532, 540–41 (Bankr. D. Del. 2002) (citing Bankruptcy Code provision § 1123(a)(5)(C) as permitting substantive consolidation).

[70] 11 U.S.C. § 1123(a)–(a)(5)(C) (2000).

[71] *See* J. Maxwell Tucker, Grupo Mexicano *and the Death of Substantive Consolidation*, 8 AM. BANKR. INST. L. REV. 427, 432 (2000).

[72] To be sure, 11 U.S.C. § 105(a) reads, in part, "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a) (2000). As Judge Easterbrook notes, however, "[t]he power conferred

There is still another reason to question the continued viability of substantive consolidation. In the 1999 decision *Grupo Mexicano de Desarrollo v. Alliance Bond Fund, Inc.*, the U.S. Supreme Court found that, in the absence of explicit congressional authorization, district courts lack the power to issue preliminary injunctions to protect the rights of general creditors.[73] The reasoning of *Grupo Mexicano* is broader than its narrow holding and suggests that federal courts cannot create new powers as courts of equity. Courts lack the power to "create remedies previously unknown to equity jurisprudence."[74] Equitable powers are limited to those that have a long history.[75] New rules can "radically alter the balance between debtors' and creditors' rights which has been developed over centuries through many laws—including those relating to bankruptcy, fraudulent conveyances, and preferences."[76]

The court in *In re Owens Corning* cited this language in rejecting the idea that *Grupo Mexicano* is inconsistent with substantive consolidation.[77] By taking explicit note of bankruptcy rules that emerged over time, the Supreme Court in *Grupo Mexicano* was apparently distinguishing them from the judicially created doctrine it struck down in that case.[78] But the Supreme Court's endorsement of bankruptcy doctrines that have developed over time does not extend to substantive consolidation. Unlike the law governing preferences and fraudulent conveyances, this doctrine did not develop over "centuries." Cases such as *Sampsell* do not provide any additional support for substantive consolidation as a long-standing doctrine because they rely instead on fraudulent conveyance, veil-piercing, or other well-established doctrines.[79] Substantive consolidation emerged as a distinct power apart from veil-piercing and fraudulent conveyance actions only in the 1960s and 1970s. Indeed, the first use of the term "substantive consolidation" in a reported opinion was not until 1975—the same year the remedy struck down in *Grupo Mexicano* was first identified.[80]

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by § 105(a) is one to implement rather than override." *In re* Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004).

[73] 527 U.S. 308, 333 (1999).

[74] *Id.* at 332.

[75] *See id.* at 330–32; *see also* Tucker, *supra* note 71, at 440, 442–45.

[76] *Grupo Mexicano,* 527 U.S. at 331.

[77] *In re Owens Corning,* 419 F.3d at 208 n.14.

[78] *Grupo Mexicano,* 527 U.S. at 331.

[79] *Id.*; *Sampsell,* 313 U.S. at 221.

[80] *See* Talcott Inc. v. Wharton (*In re* Cont'l Vending Mach. Corp.), 517 F.2d 997, 1004 n.3 (2d Cir. 1975).

Substantive consolidation doctrine lives in a peculiar netherworld. The more a substantive consolidation claim looks like a fraudulent conveyance claim, the more likely it is that the court will demand the dispute be resolved on that basis. The more the power of substantive consolidation departs from traditional veil-piercing, the harder it is to locate the power inside the Bankruptcy Code. The bankruptcy judge does have some discretion to fill the interstices, but, as Judge Posner and others are quick to remind us, "[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be."[81]

CONCLUSION

Given the uncertain future of substantive consolidation, the time is ripe for a serious and thoughtful debate. The doctrine could evolve in any of three or more radically different directions. A variant of the test used in *Auto-Train* may continue to live in the bankruptcy courts, even as the courts give lip service to *In re Owens Corning* and *Augie/Restivo.* When a corporate group functions as a single whole, courts may be quick to find "substantial identity." They may be easily persuaded that creditors relied on the debtor as a single legal entity.[82] Such reasoning is hard to resist when, in cases such as *WorldCom,* confirmation will lead to a quick exit from bankruptcy and the creditors overwhelmingly support the plan. For this reason, every prudent lender is well advised to document reliance on corporate separateness as part of every extension of credit.

Alternatively, in the wake of *In re Owens Corning,* there may be a revival of the *Augie/Restivo* test. Substantive consolidation may be allowed only under narrow and extraordinary circumstances. Courts might permit it only when each debtor so lacks a separate identity that the legal forms should no longer be recognized or when the different debtors' affairs are so entangled and assets so meager that unscrambling the mess is not worth the cost.[83] One can also imagine approaches that combine elements of *Auto-Train* and *Augie/Restivo* or that go in still different directions altogether.

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[81] *In re* Chi., Milwaukee, St. Paul & Pac. R.R., 791 F.2d 524, 528 (7th Cir. 1986).

[82] *See, e.g., In re* Standard Brands Paint Co., 154 B.R. 563, 573 (Bankr. C.D. Cal. 1993).

[83] *See In re* Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005); Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988).

Finally, there is the possibility that a court could extend the reasoning in *Grupo Mexicano* or otherwise find that the doctrine does not exist. They might decide that veil-piercing actions under nonbankruptcy law and the trustee's avoiding powers may be deemed sufficient. For practitioners who have lived with the doctrine for decades and never doubted its existence, such a possibility seems remote. But we have been surprised before.