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The Doctrine of Robin Hood
A Note on “Substantive Consolidation”

Sabin Willett*

I. INTRODUCTION

Outside of Chapter 11, corporations are jealous of their distinct place on the earth. When a pedestrian slips on the terrazzo slab of its affiliate, your usual red-blooded corporation stoutly denies responsibility for the orthopedist’s bill. In the corporation’s view, Cain had it right.1 The state courts too will generally assume that Cain, Inc. is a very different person than Abelco, the special-purpose subsidiary that owns the offending slab. The two may share an address, a board of directors, and a slate of officers, yet the state courts will depart from the proposition that Cain, Inc. is responsible for Abelco’s debts2 only where in practical effect Abelco and Cain amount to the same entity.3 While this equitable leavening seems a logical exercise of state power (it is states, after all, that create corporations in the first place), one thing is sure: in the rough and tumble of corporate life east of Eden, corporations will resist it.

How bracing the change when we reach the Paradise of Chapter 11! Now it is Cain, Inc. itself (it, Abelco and 87 affiliates filed voluntary petitions for relief) that urges the court to ignore corporate niceties.

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* The author, of Bingham McCutchen LLP, is indebted to his partner Guy B. Moss, our firm’s dean of the law of substantive consolidation, as well as to Douglas G. Baird, Harry A. Bigelow Distinguished Service Professor, University of Chicago Law School, whose excellent article, Substantive Consolidation Today was published in the materials of the April 22, 2005 American College of Bankruptcy Symposium on the Future of Chapter 11, and anticipates many of the themes of this note, and to the much-lamented Eleanor Heard Gilbane, Esq., an associate recently departed from Bingham McCutchen to points south.

1. “Then the Lord said to Cain, ‘Where is Abel your brother?’ He said, ‘I do not know; am I my brother’s keeper?’” Genesis 4:09.

2. “Notwithstanding the fact that two corporations may be extremely interrelated, each is deemed to have an independent existence.” William Meade Fletcher, Fletcher Cyclopaedia of the Law of Private Corporations, §25 (2005). A parent corporation does not lose the benefits of limited liability by taking an active interest in the affairs of its subsidiary, using voting power, and entering into contracts with the subsidiary. See generally Nat’l Labor Relations Board v. Int’l Measurement & Control Co., 978 F. 2d 334 (7th Cir. 1992).

3. The corporate entity must be observed unless unusual conditions exist which require the courts to look behind the form to the substance. See Diamond Chem. Co. v. Atafina Chemicals, 268 F. Supp. 2d 1, 7 (D.C. Cir. 2003).
In bankruptcy this is called "substantive consolidation." It is a bankruptcy power few question. Yet no statute authorizes it, and almost nothing in the old books justifies the many modern boasts of an ancient lineage. Prior to August, 2005, when the Third Circuit decided *In re Owens Corning*, the opinions on the doctrine were in the main addled, and their wooly-minded discussions of "balancing of equities" and "net benefits to creditors" vexed the lawyer's effort to give practical advice to a client. In at last announcing an intelligible test, the Third Circuit has taken a step forward. As we will see, the path it has set out on may lead courts not to an answer but to a question: was there ever anything legitimate about the doctrine in the first place?

II. WHAT IS SUBSTANTIVE CONSOLIDATION?

Substantive consolidation "merges the assets and liabilities of the debtor entities into a unitary debtor estate to which all holders of allowed claims are required to look for distribution." It is a "device," as one commentator puts it: "Creditors seek substantive consolidation to enhance their position by corralling unencumbered assets of other related entities." Corralling unencumbered assets — they used to shoot horse thieves for that.

Why substantively consolidate? Do the math. "[C]reditors of a debtor whose asset-to-liability ratio is higher than that of its affiliated debtor must lose to the extent that the asset-to-liability ratio of the merged estates will be lower." Suppose Abelco and Cain, Inc. each has $100 of assets. Abelco has 100 creditors, each holding an allowed claim of $1. Cain, Inc. has 200 creditors, each holding an allowed claim of $1. (We are still in Paradise — there are no administrative expenses.) In separate reorganizations, Abelco creditors will receive 100-cent distributions, while Cain, Inc. creditors will receive 50 cents. If the estates are substantively consolidated, 300 holders of $1 allowed claims will pool to receive $200 of value. The Cain, Inc. creditors improve their distribution by 17 cents, while the Abelco's lose 33.

Courts may consolidate cases of artificial persons, like corporations,

4. 419 F.3d 195 (3d Cir. 2005).
5. *In re Hemingway Transp.,* Inc. et al., 954 F.2d 1, 11-12 (1st Cir. 1992); *See also In re Augie/Restivo Baking Co., Ltd.,* 860 F.2d 515, 518 (2d Cir. 1988) (substantive consolidation of two debtors usually results in "pooling the assets of, and claims against, the two entities; satisfying liabilities from the resulting common fund; eliminating inter-company claims; and combining the creditors of the two companies. ... ").
with those of natural persons; indeed, courts may consolidate estates of debtors and non-debtors, thus asserting wholesale power over assets and liabilities alike of entities existing under state law. The zero-sum principle always holds true: when estates are substantively consolidated, the rich are taxed to benefit the poor. The doctrine of substantive consolidation is thus the doctrine of Robin Hood.

Different courts regard this economic fact with different levels of concern. To the Ninth Circuit, it is not troubling, or even relevant. In In re Bonham, creditors of the corporation to be consolidated objected that the bankruptcy court failed to measure the particular harm to them. "The investors cite to no authority that requires any sort of cost-benefit analysis. Rather, substantive consolidation is premised on a sole aim: fairness to all creditors, and not on any formalistic cost benefit analysis." Other decisions, including Owens Corning, note that the "rough justice" of the remedy makes it appropriate only rarely and as a last resort. "Equality among creditors who have lawfully bargained for different treatment is not equity but its opposite," as Judge Friendly once put it. The note returns to this divergence in section III.

III. THE ROOTS OF SUBSTANTIVE CONSOLIDATION DOCTRINE

A. Section 105(a)

A confident jurisprudence traces the doctrine to equitable ancestry. We are told that Section 105(a) of the Bankruptcy Code ("Code") is the lawful heir and assign of section 2(a)(15) of the Bankruptcy Act of 1898 ("Act"), under which courts had identified the equitable power of the bankruptcy court substantively to consolidate.
Before turning to the Act precedents, a word or two of caution about Section 105(a) is appropriate. It is not a "roving commission to do equity."\textsuperscript{14} It enables only those rights that are validly created elsewhere.\textsuperscript{15} To begin with the easiest proposition, the section cannot be used to \textit{contradict} a plain statutory right.\textsuperscript{16}

One might plausibly argue that substantive consolidation does indeed contradict plain terms in the Code. Code definitions incorporate state law to tell us who may be a debtor. For example, a "corporation" may be a debtor, but a corporation is purely a creature of state law, and may be a debtor only when lawfully existing as a function of that law.\textsuperscript{17} The Code, in turn, makes clear that a case under title 11 may be commenced by or in respect of a single such entity.\textsuperscript{18} The "creditors" in a Chapter 11 case are the holders of claims against that entity (i.e., that singular creature of state or federal law).\textsuperscript{19}

In Chapter 7 cases, the claims of creditors are to be satisfied, if at all, from "property of the estate,"\textsuperscript{20} and "property of the estate" is itself defined by reference to that singular debtor. The estate consists of: "interests of the debtor [i.e. that singular entity again, not some other entity] in property;"\textsuperscript{21} property the trustee recovers under enumerated statutes;\textsuperscript{22} and certain property acquired by the debtor after the case commences.\textsuperscript{23} Congress was excruciatingly specific about those occasions when property of the estate was to include property of someone other than the debtor. Subsection (a)(2) of Section 541 sweeps in certain property interests of the debtor's spouse. Subsections (a)(6) and (7) make certain kinds of property generated by the

\begin{itemize}
\item \textsuperscript{14} Mirant Corp. v. Potomac Electric Power Co., 378 F.3d 511, 523 (5th Cir. 2004).
\item \textsuperscript{15} See, e.g., \textit{In re} Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004) (Section 105(a) does not support "critical vendor" relief; power conferred in the section is to implement rather than override express bankruptcy provisions).
\item \textsuperscript{16} ATD Corp. v. Advantage Packaging, Inc. (\textit{In re} ATD Corp.), 352 F.3d 1062, 1066 (6th Cir. 2003) (stating that Section 105(a) cannot be used to require the filing of a claim whose filing a code provision exempts); Noonan v. Secretary of Health & Human Services (\textit{In re} Ludlow Hosp. Soc'y, Inc.), 124 F. 3d 22, 28 (1st Cir. 1997) (stating that Section 105(a) cannot extend deadlines in contravention of Section 108); Diamond & Gold Connection, Inc. v. United States Fid. & Guar. Co. (\textit{In re} Diamond & Gold Connection, Inc.), 54 B.R. 917, 919 (Bankr. D. Mass. 1985) (stating that Section 105 cannot be used to revive expired contracts).
\item \textsuperscript{18} See 11 U.S.C. § 301 (2005) (case commenced by petition filed by "entity" but not "entities"); \textit{id.} § 101(15) (entity includes a "person" but not "persons"); \textit{id.} § 101(41) ("person" includes a "corporation" but not "corporations").
\item \textsuperscript{19} \textit{id.} § 101(10).
\item \textsuperscript{20} See \textit{id.} § 704(1).
\item \textsuperscript{21} \textit{id.} § 541(a)(1).
\item \textsuperscript{22} \textit{id.} § 541(a)(3).
\item \textsuperscript{23} \textit{id.} § 541(a)(3).
\end{itemize}
estate itself "property of the estate:" that is, certain proceeds, profits and the like,\textsuperscript{24} and all property later acquired by the estate itself.\textsuperscript{25} Thus, allowing estate property to be distributed to persons other than holders of claims against and interests in the debtor contradicts an elaborate and precise Code architecture. If substantive consolidation contradicts the Code, surely it cannot be enabled by Section 105(a).\textsuperscript{26}

It may be argued that Chapter 11 differs from Chapter 7. Nothing in Chapter 11 says what property may be used to satisfy creditor claims in a plan. That property might well include property that is not "property of the estate:" proceeds of the issuance of new securities, for example. Even so, Section 105(a) remains problematic as a source of authority for an equitable power to substantively consolidate bankruptcy estates. This is because many decisions say that the "rights" Section 105 enables must be \textit{statutory}, and there is no such right of substantive consolidation in the Code.\textsuperscript{27} The terms of the statute itself speak of "effectuating the provisions of this title." Section 105(a) is mortar, not bricks. Unless Congress somewhere provided for substantive consolidation, Section 105(a) cannot be used to create it.

### B. Section 1123(a)(5)

Some see a brick in Section 1123(a)(5)(C), which provides that a plan may include, as a means for its own implementation, the "merger or consolidation of the debtor with one or more persons."\textsuperscript{28} This section is authority for substantive consolidation according to \textit{Stone & Webster, Inc.}, and other decisions.\textsuperscript{29}

Using Section 1123(a)(5)(C) as support for substantive consolidation is a strange argument, for on its face Section 1123(a) seems rather to list the laundry than to make alterations. The debtor may retain all of its property,\textsuperscript{30} sell some or all of it,\textsuperscript{31} merge,\textsuperscript{32} amend its charter,\textsuperscript{33}

\begin{itemize}
  \item \textsuperscript{24} 11 U.S.C. § 541(a)(6) (2005).
  \item \textsuperscript{25} \textit{Id.} § 541(a)(7).
  \item \textsuperscript{26} At least one Second Circuit panel has sniffed at this argument. "Neither the Code, its legislative history, nor the logic which orders any linguistic interpretation, provides any real support for this argument." F.D.I.C. v. Colonial Realty Co., 966 F.2d 57, 60 (2d Cir. 1992).
  \item \textsuperscript{27} Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988); Jamo v. Katahdin Federal Credit Union \textit{(In re Jamo)}, 283 F.3d 392, 403 (1st Cir. 2002)\textsuperscript{37} (authority bestowed by Section 105 may be invoked only where "the equitable remedy dispensed by the court is necessary to preserve an identifiable right conferred elsewhere in the Bankruptcy Code." emphasis added); see Mirant Corp. v. Potomac Elec. Power Co. \textit{(In re Mirant Corp.)}, 378 F.3d 511, 523 (5th Cir. 2004).
  \item \textsuperscript{28} 11 U.S.C. § 1123(a)(5)(C) (2005).
\end{itemize}
issue securities, or engage in other activities. There is no suggestion that any of these references dispense with requirements that otherwise would apply to a sale of assets, the amendment of a charter, or the issuance of securities. All indications point the other way. For example, the Ninth Circuit has ruled that Congress did not intend Section 1123(a) to permit asset transfers in violation of state laws regulating utilities. We know the debtor may issue securities without registering them under the securities laws only because Congress enacted Section 1145.

Subsection (E) is similar. It provides that a plan may provide for the “satisfaction or modification of any lien.” Other statutes lay out the requirements for satisfaction and modification of liens. No one thinks that Section 1123 adds to or subtracts anything from the substantive rights of lienholders. It just tells us that lien treatment can be tucked into a plan. Thus Professor Baird calls the section a “thin reed to justify substantive consolidation,” and it seems that he has the better of the argument. There is no statutory brick for which Section 105 may act as mortar.

C. The Case Antecedents for Substantive Consolidation

Despite these considerable problems, there is overwhelming circuit-court support for the existence of judicial power of substantive consolidation under title 11. As noted above, the usual rationale is that Section 105(a) codified an Act provision which itself imported equitable doctrines recognized under the Act. In Bonham, the Ninth Circuit held that bankruptcy courts had general equitable power under

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31. Id. § 1123(a)(5)(B).
32. Id. § 1123(a)(5)(C).
33. Id. § 1123(a)(5)(I).
34. Id. § 1123(a)(5)(J).
35. Pacific Gas & Electric Co. v. California, 350 F.3d 932 (9th Cir. 2003).
36. 11 U.S.C. § 1145 (2005). That section describes securities that are exempt from filing, and securities that are not exempt from filing, and it seems like a lot of bother for Congress to have engaged in if Section 1123(a)(5)(J) spoke to the matter.
39. In re Bonham, 229 F.3d 750, 763 (9th Cir. 2000); In re Hemenway Transp., Inc., 954 F.2d 1, 12 (1st Cir. 1992); First National Bank of El Dorado v. Giller (In re Giller), 962 F.2d 796, 799 (8th Cir. 1992); Eastgroup Properties v. S. Motel Ass'n Ltd., 935 F.2d 245, 249 (11th Cir. 1991); Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987); In re Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988); see Nesbit v. Gears Unlimited, Inc., 347 F.3d 72, 87 (3d Cir. 2003) (applying bankruptcy “substantive consolidation” rules to Title VII case).
40. E.g. In re Bonham, 229 F.3d at 763.
the Bankruptcy Act substantively to consolidate estates of debtors and nondebtors, and affirmed a bankruptcy court order substantively consolidating the Chapter 7 estate of the debtor, who had operated a Ponzi-scheme involving frequent-flyer miles, with that of two non-debtor corporations she used to carry out the fraud. Bonham relied principally on Sampsell v. Imperial Paper & Color Corp.,\textsuperscript{41} advising that the Supreme Court there "acknowledged" the legitimacy of substantive consolidation.

Sampsell involved a California paperhanger, Downey, whose business had fallen on hard times. Personally indebted to a supplier, Downey formed a corporation and transferred his goods and supplies to it, taking stock in return. He also provided cash, which was accounted for as corporate debt. Two years later he was adjudged a voluntary bankrupt. The corporation was not a bankrupt, but Downey's trustee brought on a proceeding to marshal its assets, and the referee and reviewing courts upheld pooling the assets of the debtor Downey and non-debtor corporation. A corporate creditor challenged the consolidation, urging that it had a priority in the corporation's assets. The court rejected the challenge. In effect, it substantively consolidated debtor and non-debtor estates.

The Court was applying an ancient and familiar rule of law, to be sure, but the rule was not a rule about consolidating corporations — it was the Statute of 13 Elizabeth. As Justice Douglas wrote, "in this case there was a fraudulent conveyance."\textsuperscript{42} The lower courts found that the formation of the family-controlled corporation and the transfer to it of Downey's stock in trade was an intentional fraudulent conveyance — the corporation is described melodramatically as a mere "sham and a cloak." The complaining creditor turns out to have been a party to the scheme. The Court noted that "consolidation, of course, does not mean that the order consolidating the estate did, or in the absence of the [creditor] as a party could, determine what priority, if any, [the creditor] had to the corporate assets. All questions of fraudulent conveyance aside, creditors of the corporation would normally be entitled to satisfy their claims out of corporate assets prior to any participation by the creditors of the stockholder. Such priority, however would be denied if the corporation's creditors were parties to a fraudulent transfer of the stockholders' assets to the corporation."\textsuperscript{43} Douglas sums up: "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between

\textsuperscript{41} 313 U.S. 215 (1941).
\textsuperscript{42} Id. at 220.
\textsuperscript{43} Id. (emphasis added).
the several creditors is complete."\textsuperscript{44} Taking inventory, then, \textit{Sampsell} gives us (i) a garden-variety fraudulent conveyance remedy, (ii) a dictum that runs counter to substantive consolidation, and (iii) a Douglas flourish. That's... it? That's the Supreme Court's Act jurisprudence for substantive consolidation? Surely there must be more.

But there isn't more. When we turn to the precedent Justice Douglas saw as relevant, we find no older authorities for consolidation. The decision cites \textit{Taylor v. Standard Gas & Electric},\textsuperscript{45} a case involving the equitable subordination of the claim — in a single bankruptcy case — of a dominant shareholder, \textit{Pepper v. Litton};\textsuperscript{46} the familiar chestnut treating — in a single bankruptcy case — a judge's power to subordinate a claim for equitable reasons; and \textit{Bird & Sons Sales Corp. v. Tobin},\textsuperscript{47} a decision that — once again, in a single bankruptcy case — a prepetition subordination agreement was enforceable in bankruptcy. Going still further, we find many variations on the theme that corporations are creatures of state law, endowed by their state creators with property rights, which may be altered only by Act of Congress.\textsuperscript{48} What we do not find is a federal judicial power of substantive consolidation.

Manifestly, \textit{Sampsell} is a fraudulent conveyance decision. When A's bankruptcy trustee avoids a discrete conveyance to B, A's creditors reach B's property. When, as happened in \textit{Sampsell}, all of B's assets are property fraudulently conveyed from A, then pooling B's assets is simply a remedy in aid of the bankruptcy court's power to avoid fraudulent transfers. This decision is hardly authority for substantive consolidation of separate persons based on \textit{Fish} tests, or the greater good of the people, or "net benefit" to unspecified creditors, or any of the other themes that have grown up in the literature. In short, we do not have an ancient jurisprudence under the Act. We do not have even a single Supreme Court holding. \textit{Sampsell} has received false billing. It does not support any notion of an independent equitable power to reshuffle entities that exist under state law. Quite the contrary, its dictum rejects substantive consolidation.

It was only a generation later that people began to be confused about this. As Professor Baird notes, the early substantive consolida-

\textsuperscript{44} \textit{Id.} at 219.
\textsuperscript{45} 306 U.S. 307 (1939).
\textsuperscript{46} 308 U.S. 295 (1939).
\textsuperscript{47} 78 F.2d 371 (8th Cir. 1935).
\textsuperscript{48} See discussion, \textit{infra} at § D.
tion all depended either on this kind of fraudulent conveyance, 49 or the underlying state law of veil piercing. 50

D. Constitutional Problems

The problems run deep. Not only is there no direct authority for a power of substantive consolidation, there are substantial barriers.

1. Bankruptcy Power

A general bankruptcy power of substantive consolidation is hard to square with boundaries the Supreme Court has drawn to limit federal judicial power to interfere with creditors’ rights. “Bankruptcy courts,” Justice Souter has written, “are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors’ entitlements, but are limited to what the Bankruptcy Code itself provides.” 51 The tension between state and federal law is uneasy, but there is general accord that bankruptcy courts must look in the first instance to state law for the creation of property interests. Except where Congress has otherwise determined, property interests are created and defined by state law, and state laws are suspended by federal bankruptcy statutes “only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress.” 52

This proposition is usually heard in describing property of the estate, but no reason appears why the rule should differ for property of creditors - that is to say, claims. As the Uniform Commercial Code recognizes, “accounts,” which are rights to payment of a monetary obligation, are a form of property. 53 They may be collateral for an obligation, 54 and may be bought and sold. Because claims are as much a form of property as is property of the estate, the measuring tape for one should be like that of the other: state law, except where Congress has spoken, and then according to statute. Congress may itself create and limit property interests. It may create federal claims (federal tax claims come to mind) and enact limitations as to state-law claims, as for example with the cap on rejection damages available to a landlord under Section 502(b)(6). But short of an Act of Congress,

49. See, e.g., Soviero v. Franklin National Bank of Long Island, 328 F.2d 446, 448 (2d Cir. 1964).
50. See Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940); Stone v. Eachon (In re Tip Top Tailors, Inc.), 127 F.2d 284, 288 (4th Cir. 1942).
54. Id. at 9-102(12)(B).
creditor claims, like estate property, are in the first instance creatures of state law.\textsuperscript{55}

\textit{Vanston Bondholders Protective Comm. v. Green} illustrates.\textsuperscript{56} It involved the effort to collect compound interest, or "interest on interest." The majority held this inconsistent with federal bankruptcy principles. Justice Frankfurter concurred in the result, but only because the interest was uncollectible as a matter of underlying state law. His analysis bears quoting at length, for it appears to have won the day with our current Supreme Court.

The business of bankruptcy administration is to determine how existing debts should be satisfied out of the bankrupt's estate so as to deal fairly with the various creditors. The existence of a debt between the parties to the alleged debtor/creditor relationship is independent of bankruptcy and precedes it. Parties come in a bankruptcy court with their rights and duties already established, except insofar as they subsequently arise during the course of bankruptcy administration or as part of its conduct. Obligations to be satisfied out of the bankrupt's estate thus arise, if at all, out of tort or contract or other relationship created under applicable law. And the law that fixes legal consequences to transactions is the law of the several states... Except for the very limited obligations created by Congress... a debt is not brought into being by federal law. The fact that subsequent to the creation of a debt a party comes into a bankruptcy court has no relevance to the rules concerning the creation of the obligation. If there was no valid claim before bankruptcy, there is no claim for a bankruptcy court either to recognize or reject.\textsuperscript{57}

This, as we will see below, is almost indistinguishable from what Justice Souter has written for modern majorities, and the principle is simply incompatible with substantive consolidation.

A claim is a relationship: a debt of a particular person. This is why obligations of Mr. Gates are different than obligations of a Chapter 7 debtor; and why obligations of the People's Republic of Bangladesh trade at different discounts than those of the United States. If a debt is defined by state law (or Act of Congress), then the identity of the obligor is also a question for state law. We may illustrate this proposi-

\textsuperscript{55} Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 161 (1946) ("What claims of creditors are valid and subsisting obligations... is to be determined by reference to state law"); see Bryant v. Swofford Bros., 214 U.S. 279, 290-91 (1909) ("in bankruptcy the construction and validity of such a contract must be determined by the local laws of the State"); Security Mortgage Co. v. Powers, 278 U.S. 149, 153-54 (1928); c.f. In re A.J. Lane Co., 113 B.R. 821, 823 (Bankr. Ma. 1990) (Section 506(b) of the Bankruptcy Code puts a federal standard, beyond state law, as to what is reasonable).

\textsuperscript{56} Vanston, 329 U.S. at 169-70.

\textsuperscript{57} Id.
tion with several lines of cases. For example, one line discerns impairment under Section 1124 not only where an obligation is modified, but where the obligor is somehow substituted or modified. "The substitution of a new debtor, although solvent, is a fundamental alteration of a creditor's rights."58

Another line of cases holds that bankruptcy courts lack the power to overcome a state-court determination that a corporation has been dissolved as a matter of state law: "How long and upon what terms a state-created corporation may continue to exist is a matter exclusively of state power."59 "The circumstances under which the power shall be exercised and the extent to which it shall be carried are matters of state policy."60 In their different ways, these decisions all illustrate a common proposition: that the definition of the obligor is as firmly domiciled in state law as the definition of the obligation. The law that defines a debt necessarily defines her who owns and him who owes it. If that law is for states or Congress, not the federal courts, then what courts cannot achieve by modifying the obligation, they surely cannot achieve by modifying the obligor.

The modern Court has seized on this theme. "Creditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code," the Court wrote, in deciding that bankruptcy courts are not free to ignore state-law burdens of proof in deciding claims.61 To be sure, the courts generally have recognized as "property rights" in creditors only secured claims, not unsecured claims.62 Yet the Court has acknowledged limits to the judicial power respecting claims that suggest there are limits incompatible with power to redefine obligators. "The 'basic federal rule' in bankruptcy is that state law governs [the substance of claims]"63 . . . Congress having "generally left the determination of property rights in the assets of a bankrupt's estate to state law."64 Justice Souter writes, "Congress of course may do what it likes with entitlements in bankruptcy, but there is no sign that Congress meant to

64. Id. at 57.
alter the burdens of production and persuasion on tax claims.” As the Second Circuit put it in *Augie/Restivo*, where creditors “knowingly made loans to separate entities and no irremediable commingling of assets has occurred, a creditor cannot be made to sacrifice the priority of its claims against its debtor by fiat based on the bankruptcy court’s speculation that it knows the creditor’s interests better than does the creditor itself.”

Justice Souter summed up this way:

Bankruptcy courts do indeed have some equitable powers to adjust rights between creditors. See, e.g., § 510(c) (equitable subordination). That is, within the limits of the Code, courts may reorder distributions from the bankruptcy estate, in whole or in part, for the sake of treating legitimate claimants to the estate equitably. But the scope of a bankruptcy court’s equitable power must be understood in the light of the principle of bankruptcy law discussed already, that the validity of a claim is generally a function of underlying substantive law. Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors’ entitlements, but are limited to what the Bankruptcy Code itself provides.

Again and again, from *Vanston Bondholders Protective Committee* to *Raleigh* to *United States v. Noland* to the echoes in *Grupo Mexicano*, to the Court’s 2004 decision in *Lamie v. United States Trustee*, the message from the modern Court is to build remedies with bricks made by the states and Congress, but not to point with equitable mortar where bricks do not exist.

In sum, since the Constitution does not grant to Congress under the bankruptcy clause power to take claims, they ought not be taken through the artifice of shuffling obligors. That is not to say that Congress cannot enact legislation that limits claims. It does so all the time. Nor is it a constitutional problem that a claim arising under state law against Abelco either reaches or does not reach Cain, Inc. under the governing state law of Abelco’s corporate form. But adjusting claims by the whimsical fiat of substantive consolidation, which lacks a statute and until recently (as we will see below) lacked any

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66. 860 F.2d 515, 520 (2d Cir. 1988).
68. 517 U.S. 535, 543 (1996) (rev’g equitable subordination of tax penalty claims, holding that the exercise of equitable subordination power may not be “at the level of [a] policy choice at which Congress itself operated in drafting the Code.”).
intelligible rule, raises a problem of constitutional dimension. While Congress might give courts power to substitute one form of property for another, as by provision of adequate protection and or of "indubitable equivalence," and Congress may even decide to subordinate the right of one form of property (a landlord's claim for breach) to another (a tax claim), a court — particularly a court acting without statutory grant — cannot simply rewrite claims without interfering with what is, in any practical sense, property.

2. The Federal Equity Power

If the roots of substantive consolidation doctrine were always in thin soil, they may have been unearthed by Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., which held that a federal court lacked general equitable power to issue a prejudgment injunction against disposition of assets by a defendant. Absent a grant by Congress, the federal courts have only the equity jurisdiction that existed in the English Court of Chancery in 1789, when the Judiciary Act was adopted. Scholars have argued that there is no evidence that the Chancery Court recognized substantive consolidation. Since the bankruptcy court is simply a judicial unit of the district court, there is no equitable power to order the remedy. They urge that the decision broadly indicates that the federal courts lack equitable powers other than those that existed as of the Judiciary Act and have long been recognized. We have already seen that substantive consolidation outside the realm of fraudulent transfers or corporate veil-piercing rights is a recent construct.

Some authorities disagree with this view. Judge Walsh, in the Stone & Webster decision, found Grupo Mexicano inapplicable because of Justice Scalia's specific reference to bankruptcy power as a historically equitable power of the district court. But that rather

72. See id. § 1129(b)(2)(ii).
74. See J. Maxwell Tucker, Grupo Mexicano and The Death of Substantive Consolidation, 8 Am. Bankr. Inst. L. Rev. 427, 427 (2000), see also J. Maxwell Tucker, Has the Supreme Court Eliminated Substantive Consolidation?, 35 No. 23 Bankr. Ct. Dec. (LRP) 3 (April 25, 2000); see also, Vieth v. Jubelirer, 541 U.S. 267, 278 (2004) ("The judicial power created by Art. III § 1, of the Constitution is not whatever judges choose to do. . . or even whatever Congress chooses to assign then.. . .It is the power to act in the manner traditional for English and American courts.")
76. In re Stone & Webster, 286 B.R. at 537-38.
begs the question, for we are asking whether substantive consolidation is a part of that bankruptcy power. Scholarship has turned up no substantive consolidation decisions as of 1789, nor as of 1889. Even Sampsell in 1941 is nothing more than a fraudulent conveyance case. This is not the firmly-rooted doctrine to which Justice Scalia was referring. Indeed, substantive consolidation is a doctrine generally applied to corporations, and in 1789 the American business corporation was in its cradle. Historians identify only six native-born business corporations that had come into being in colonial times; only twenty more were added during the thirteen years preceding the adoption of the federal constitution. At the turn of the Eighteenth Century, the idea remained strange to the Supreme Court: its decisions handled the business corporation with the awkwardness of a bachelor uncle holding an infant nephew. With the idea of the limited-liability business corporation so novel in 1789, it is not credible to suggest that sophisticated equitable doctrines had yet arisen for merging corporate entities in insolvencies.

Professor Baird aptly criticizes the Stone & Webster rationale by arguing that substantive consolidation is not a traditional bankruptcy power at all. He notes an interesting fact. The phrase itself is a parvenu: “substantive consolidation” never appears in the decisions until 1975, the same year in which the remedy at issue in Grupo Mexicano first appeared. Whatever the reach of its holding, Grupo Mexicano illustrates a restrictive view of the general equity power of the federal courts. Justice Scalia quotes Joseph Story (in turn quoting Selden):

For law we have a measure, and know what to trust to — Equity is according to the conscience of him, that is Chancellor; and as that is larger, or narrower, so is Equity. ‘T is all one, as if they should make the standard for measure the Chancellor’s foot. What an uncertain measure would this be? One Chancellor has a long foot; another a short foot; a third an indifferent foot. It is the same thing with the Chancellor’s conscience.”

Substantive consolidation interferes with the creditor’s claim by changing the mix of claims at a given entity. It ignores the corporate form that is to be given effect under state law. It does this without statutory grant by any legislature — state or federal — and until recently without anything like a predictable judicial rule. It is the mod-

77. See Fletcher, supra note 3, § 2.
78. See generally Head Amory v. Providence Insurance Co., 6 U.S. 127 (1804) (formalistic requirements must be observed to give rise to corporate obligation).
79. See In Re Continental Vending Machine Corp., 517 F.2d 997 (2d Cir. 1975); Douglas Baird, supra note 38, at 11-12.
80. Grupo Mexicano, 527 U.S. at 332-33.
ern chancellor's foot, out of step with modern Supreme Court bankruptcy jurisprudence.

IV. **Defining and Applying the Doctrine: When May Courts Substantively Consolidate?**

A. *Defining a Standard*

From a murky past, one proceeds to a murkier present. When may entities be substantively consolidated? Before August, 2005, no one could answer this question intelligibly.81

The rule is that “[e]ach entity in a [debtor] group must be treated as separate for purposes of satisfying its creditors.”82 But for long years, courts have defined an exception with platitudes. We were told that the test was whether “the benefits of consolidation outweigh the harm to creditors.”83 Or whether the “benefits of consolidation outweigh the economic prejudice . . . to creditors.”84 Or whether, “[o]n balance, consolidation foster[s] a net benefit among all holders of unsecured claims.”85 A hundred more decisions might be arrayed here, all with variations on this theme.

The “benefits of consolidation” must “outweigh the prejudice to creditors.” In the zero sum of consolidation, creditors of one entity gain and creditors of the other lose, so what kind of weighing are we talking about? How taking from Peter to pay Paul is a “net” benefit to anyone but Paul, and how Paul’s gain is to be weighed against Peter’s loss — *none of this is ever defined*. If a mob seizes private property, the beneficiaries may be numerous and hungry, the property holders few. Does that “outweigh” the prejudice? How numerous? How hungry? How few? More candid than most, one court admits: “as to substantive consolidation, precedents are of little value.”86

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81. To test this assertion, the reader should get hold of a “nonconsolidation opinion” given by an American law firm in any large commercial financing transaction that predated *Owens Corning*. Chances are it will exceed 20 pages and fail to contain a rule on which the client may rely. If it contains plain words setting out to the reader an intelligible rule that reliably will predict the outcome of cases, then the writer is a genius, or has committed malpractice, or both.

82. See *Mirant Mid-Atlantic, LLC v. Morgantown OL1 LLC (In re Mirant Corp.),* 327 B.R. 262, 272 (Bankr. N.D. 2005); *In re N.S. Garrott & Sons, 63 B.R. 189, 192 (Bankr. E.D. Ark. 1986)* (“Creditors of the insolvent Eastern Arkansas Printing Company have no legal right to look to the assets of the solvent N.S. Garrott & sons for payment of their claims.”); *In re Scholz, 57 B.R. 259, 262 (Bankr. N.D. Ohio 1986)* (the creditors of each bankrupt have the right to look to the assets of each individual estate for satisfaction of the obligations.”); See also *In re Cash, 1994 Bankr. LEXIS 2059, *4 (Bankr. N.D. Ohio Dec. 15, 1994).

83. *In re Giller, 962 F.2d 796, 799 (8th Cir. 1992).*

84. *Eastgroup Properties v. Southern Motel Assoc., 935 F.2d 245, 249 (11th Cir. 1991).*

85. *In re Hemingway Transp., Inc., 954 F. 2d 1, 12 (1st Cir. 1992).*

When the informing principle of a "doctrine" was so vacuous, one could be pretty sure of what was coming: factors. Rather than define the doctrine, the courts would list factors — preferably lots of factors. So it went with substantive consolidation. In *Fish v. East*, the Tenth Circuit promulgated ten:

1. The parent owns all or a majority of the capital stock of the subsidiary;
2. The parent and subsidiary have common directors or officers;
3. The parent finances the subsidiary;
4. The parent subscribes to all capital stock or otherwise causes its incorporation;
5. The subsidiary has grossly inadequate capital
6. The parent pays salaries or expenses or losses of the subsidiary
7. The subsidiary has substantially no business except with the parent or no assets except those conveyed to it by the parent;
8. The parent refers to the subsidiary as a department or a division;
9. The directors and officers of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent; and
10. The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

Ten factors are scarcely enough, so the Eleventh Circuit added four more:

11. Whether the estates were commonly owned;
12. Whether the estates had common officers;
13. Whether the entities had written agreements about the management and operation of the business assets, and specifically whether funds flowed between the two; and
14. Whether the two entities operated out of the same (central) office and whether any of the employees performed tasks for both companies.

Other cases listed other factors. For example, in *In re Vecco Construction Industries* the court provides seven factors, and in *Pension Benefit Guaranty Corp. v. Ouimet Corp.*, five. Are all factors equal? How many factors need be satisfied to justify consolidation? Six *Fish* Factors? Eight *Eastgroups*? "Clearly, there is no formulaic resolution."

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87. 114 F.2d 177, 191-92 (10th Cir. 1940).
90. 711 F.2d 1085 (1st Cir. 1983).
91. Heller & Co. v. Langenkamp (*In re Tureaud*), 59 B.R. 973, 975 (N.D. Okla. 1986); see generally *In re Owens Corning*, 419 F.3d 195, 210 (3rd Cir. 2005) ("Too often the factors in a check list fail to separate the unimportant from the important, or even to set out a standard to make the attempt.").
To "factors" courts added another darling of the bench: the hocus pocus of shifting burdens. One leading decision required first that the proponent of substantive consolidation show "a substantial identity between the entities to be consolidated" (common enough with affiliates), and that consolidation is "necessary to avoid some harm or realize some benefit" (broad enough to include all prayers for relief in all lawsuits filed since Blackstone). At this point, the burden shifted to the objector, to show that "it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation."\textsuperscript{92} It scarcely need be added that this was all cut from whole cloth. And it was puzzling. The creditor of the more solvent estate will always be prejudiced (even if trivially so). As for relying on separate credit, that is what a contract is: reliance on the counterparty's separate credit.

Did any of this add up to a rule that people could apply? Suppose we alter the hypothetical. Abelco has only Donald Trump as a creditor. He holds an allowed claim of $100, while Cain, Inc. has 200 hard-working tradespeople holding $1 claims. If we substantively consolidate, one tycoon will be harmed, while 200 working men and women will be helped. Does that matter? Does it matter that the percentage gain to the Cain, Inc. creditors is greater than the percentage contribution of Mr. Trump? Before August, 2005, no one knew. So courts said what they always say when applying a vague principle and random lists of factors: that they must use a "case by case" analysis,\textsuperscript{93} or make a "searching inquiry,"\textsuperscript{94} or both.\textsuperscript{95} In a pinch, resort was made to adverbs.\textsuperscript{96}

The bar deserved — and in \textit{Owens Corning}, at long last got — better than this. Article III of the Constitution requires that every federal judicial proceeding be a "case by case" inquiry, and every judicial inquiry is searching, or at least we hope so. That judges shall decide the case before them, and not some other case, and that they shall do so carefully tells us nothing about what the rule of decision will be.\textit{Owens Corning} has taken a step to putting most of this right, but only in dictum. Before turning to the case, it is well to consider its progenitor \textit{Augie/Restivo}, and some of the problems of application that developed as Court struggled to apply its standard.

\textsuperscript{92} Drabkin v. Midland-Ross Corp. (\textit{In re Auto-Train Corp.}), 810 F.2d 270, 276 (D.C. Cir. 1987). In a more recent case, the Third Circuit embraced this "test." \textit{In re Nesbit}, 347 F.3d 72, 86 (3d Cir. 2003).
\textsuperscript{93} See FDIC v. Colonial Realty Co., 966 F. 2d 57, 61 (2d Cir. 1992).
\textsuperscript{94} \textit{In re Auto-Train}, 810 F.2d at 276.
\textsuperscript{95} Colonial Realty Co., 966 F. 2d at 61.
\textsuperscript{96} Eastgroup Properties v. Southern Motel Assoc., 935 F.2d 245, 249 (benefits must heavily outweigh burdens).
B. Augie/Restivo

In the Augie/Restivo decision, the Second Circuit distilled the factors to two ‘critical’ questions: (1) did the creditors deal with the entities as a single economic unit and not rely on their separate identities in extending credit to them? and (2) are the economic affairs of the debtors so entangled that consolidation will benefit all creditors? The court reversed an order substantively consolidating two debtors because creditors of one entity would suffer harm, even though business functions were commingled, the creditors were not deceived, and the assets themselves were traceable. By contrast, Colonial Realty, which upheld substantive consolidation, noted a finding that “the witnesses have established the entanglement of these estates and the fact that creditors generally relied on the three entities when they dealt with all of them or one of them.” There is some hope in this. In this perplexing corner of the law sometimes the decisions applying the doctrine are sometimes more sensible than their words.

Hope, yes, but isn’t this beginning to sound awfully similar to veil-piercing doctrine? Courts tell us that the law of substantive consolidation is not simply a restatement of the state law of alter ego and veil piercing, but why not? States propose limited-liability entities and may dispose of them. Indeed, the older cases seemed to pose the question whether federal bankruptcy courts could import state rules regarding the corporate form, concluding that they could. Why their veil-piercing doctrines should have any less force than their rules for corporate creation does not appear.


99. 966 F.2d 57, 58 (2d Cir. 1992).

100. In re Bonham, 226 B.R. 56, 77 (Bankr. D. Alaska 1998), aff'd, 229 F. 3d 750 (9th Cir. 2000); see also Reider v. FDIC (In re Reider), 31 F.3d 1102, 1105 (11th Cir. 1994) (finding of substantially shared identities, a factor for piercing the corporate veil, is only one of the factors for substantive consolidation); Phar-Mor Inc. v. Coopers & Lybrand, 22 F.3d 1228, 1239 (3rd Cir. 1994) (drawing distinction between substantive consolidation and piercing the corporate veil); Colonial Realty Co., 966 F.2d at 61 (substantive consolidation has a “narrower focus” than veil piercing); J. Stephen Gilbert, Note, Substantive Consolidation in Bankruptcy: A Primer, 43 VAND. L. REV. 207, 211 (1990); cf. U.S. v. Hoyt, 47 Fed. Appx 834, 838 (9th Cir. 2002) (substantive consolidation allows the bankruptcy court to disregard separate corporate entities to pierce their corporate veils in the usual metaphor, in order to reach assets for the satisfaction of debts of a related corporation).

101. Stone v. Eacho, 127 F.2d 284, 289 (5th Cir. 1942); see generally Trustees System Co. v. Payne, 65 F.2d 103 (receivers may access veil-piercing rules).
Two overarching elements are required by most jurisdictions to pierce the corporate veil. There must be such blurring of the lines that the separate personalities of the entities no longer exist. And the circumstances must show that adherence to separate corporate existence would sanction a fraud or promote injustice. Apart from reversing the order of the test elements, this articulation does not seem that different from the rule of Augie/Restivo. "Injustice" is not present merely because a creditor of a nonconsolidated entity receives less money than if he held a claim against a consolidated entity. But it might exist where he had good reason to believe he was dealing with their collective credit. Entities that mislead the public by ill-capitalized subsidiaries, or observe corporate distinctions as a matter only of form, are not entitled to the protections of separate liability. Still, state courts frown on veil piercing as a means to subvert contract rights or readjust intercreditor rights. As one court put it, because voluntary creditors of corporations are generally able to inspect the financial structure of a corporation and have the ability to discover risk of loss, they will receive "little sympathy." The second factor applied by Augie Restivo is really one of administrative practicality. Suppose that Cain, Inc. has 87 subsidiaries, and their finances are simply impossible to disentangle. Accounts were intermingled; bills rendered to one entity were paid by another; no separate boards were maintained; the boards never met; whom creditors contracted with depended on which box of stationery was put into the printer. Creditors of the group might rationally conclude either that they did not, in fact, do business with separate entities, or, more subtly, that the cost of trying to disentangle and separately treat these entities is not worth the chance that some may profit by so doing. Creditors might therefore deem it advantageous to proceed on a consolidated basis. In such a case it might well be that the net savings in avoided administrative cost is worth even the maximum "give" by a creditor of the most profitable affiliate.

To illustrate, let us return to Abelco and Cain, Inc., each of which has $100 in assets. Suppose now that Abelco has 100 creditors holding $1 in allowed claims, while Cain, Inc. has 105 creditors. Chapter 11 costs of administering each estate would be $10. Absent administrative considerations, substantive consolidation still represents a taking.
from Abelco's creditors for the benefit of Cain, Inc.'s, albeit at a trivial scale. But Abelco's creditors would rationally trade the marginally-better return from a separate estate for the $5 in saved administrative expenses. Left to themselves, Abelco creditors would receive 90 cents ($100 less $10 in administrative costs divided by 100 claims). Cain, Inc. creditors, left to themselves, recover 85.7 cents ($100 less $10 in administrative costs divided by 105 claims). Substantively consolidated, both sets of creditors receive 92.5 cents ($200 less $10 in administrative costs divided by 205 claims). Everybody wins. The richer estate is still the greater giver, but at some level matters are so close that the net savings in administrative cost can justify consolidation.

In Augie/Restivo, the court recognized that substantive consolidation should be used "only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consumer the assets."105 This seems consistent with Chemical Bank New York Trust Co. v. Kheel,106 in which the Second Circuit approved a substantive consolidation, but only because the affairs of the debtors were so "hopelessly obscure" that all creditors would benefit by avoiding the cost of unsnarling them.

In the rare case such as this, where the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.107

In Nesbit, the court noted, "[m]ore colloquially, the question is whether the "eggs" — consisting of the ostensibly separate companies — are so scrambled that we decline to unscramble them."108

This admits of two practical cases. In one, substantial consolidation is necessary because there is no alternative. No one can tell Cain, Inc. from Abelco, and no one can distinguish the creditors of one from the creditors of the other. Under state law, the creditors of either company could pierce the corporate veil to reach the assets of both companies. A bankruptcy court will have no choice.

In the second case, the estates can be disentangled, but only at great cost. The distinct creditor bodies of each favor - by their votes - treat-

105. 860 F.2d 515, 519 (2d Cir. 1988).
106. 369 F.2d 845, 847 (2d Cir. 1966).
107. Id. See also Nesbit v. Gears Unlimited, Inc., 347 F. 3d 72, 86 (3d Cir. 2003), cert. denied, 124 S. Ct. 1714 (2004) (applying in employment case "factors courts use in deciding when substantively to consolidate two or more entities in the bankruptcy context.").
108. See Nesbit, 347 F.3d at 86.
ment as consolidated entities. Creditors of Cain, Inc. and Abelco may agree to take equal dividends and save the administrative costs of litigating prior items. But here, "substantive consolidation" ought not be a judicial power, but rather an exercise of the creditor franchise, through plan voting provisions.

C. Problems of Application

Imposition of substantive consolidation presents a number of practical inconsistencies and problems.

1. Interference with voting scheme

In many cases, courts approved substantive consolidation on the grounds that without it, a plan could not be confirmed. One court put it this way: "One of the policies behind the enactment of Chapter 11 is to give a debtor one meaningful and reasonable chance to rehabilitate. The Court finds substantive consolidation in this case furthers that intent of Congress." There must be a charm about this proposition; so far as the writer knows, no Court has put the opposite and obviously correct one, that Congressional intent is disserved by substantive consolidation. Congress enacted a list of detailed requirements for the confirmation of plans. It used plain words. "The court shall confirm a plan only if all of the following requirements are met." It would be hard to express in clearer words a legislative intent that plans not be confirmed unless each and every Code requirement is met. To employ a non-statutory device because the statutory rules block confirmation is to flout, not to serve, Congressional intent.

The error appears most plainly in the context of voting. One creditor may dominate a class in one affiliate in a jointly-administered case. Its rejection of the plan will prevent confirmation under 11 U.S.C. § 1129(a)(8), unless the debtor can meet the cramdown tests of section 1129(b). It is no answer to say that that rejection is grounds to substantively consolidate the affiliate with affiliated entities, so that the creditor's vote may be diluted with a more numerous class. The creditor class of the less solvent debtor will naturally approve treatment that improves its distribution at the expense of the objecting

creditor's. This approach plainly violates what Congress intended: that plans of reorganization *not* be confirmed for that affiliate unless the statutory tests are met. The Code nowhere suggests that if the tests are unmet, corporations should be reshuffled in order to meet them.

There is another way to look at voting, of course, sometimes forgotten by a debtor-friendly bench. Where it is in their interest to do so, creditors may actually vote, "Yes." Substantive consolidation may be implemented by vote. That is to say, Cain, Inc. and Abelco's creditors may agree that it is too expensive to sort out which of them ought to have a 40-cent, and which a 60-cent, distribution. There may be uncertainties as to intercompany claims. There may be sensible reasons to treat creditors of different estates the same way. Congress has said this is appropriate, because it has allowed the accepting vote of an impaired class to govern the treatment of its members. The point is that the vote must be conducted debtor-by-debtor, and where the vote is rejection, that exercise of the creditor franchise should be respected by the bankruptcy courts. A "no" vote is not an impediment to be subverted. It is an exercise of the creditor franchise entitled to judicial respect. The point is that it is for the creditors, not the court, to decline to unscramble the eggs.

2. Inconsistency with Other Plan Confirmation Rules

Under Section 1129(a)(7), a single objecting creditor, whether part of an accepting class or not, can scuttle a plan by showing that her distribution would be better in a liquidation. What happens in substantive consolidation? Must the Section 1129(a)(7) test be met for the separate estates, or is it enough to satisfy the test in the consolidated estate? In *Stone & Webster*, Judge Walsh ruled that the test need be applied solely to the consolidated entity.\(^\text{112}\) This seems logically correct. If it is sound to consolidate estates for plan confirmation purposes, then all of the plan tests would seem best applied to the consolidated debtor. But where consolidation is accomplished on loose or unpredictable grounds, the doctrine assaults what appears to be a core Congressional purpose.

Suppose, for example, that Cain, Inc. is out of business, but solvent — like the debtor in *Integrated Telecom Express, Inc.*\(^\text{113}\) It has sufficient cash on hand to satisfy all of its creditors. Abelco, on the other hand, is insolvent. Suppose further that Bank made an unsecured

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113. 384 F. 3d 108 (3d Cir. 2004).
loan to Cain, Inc., on the strength of Cain, Inc.'s audited financial statements. Bank now finds itself in a jurisdiction where a court simply "balances" the "net benefit" to the Abelco creditors of consolidation, finds the prejudice to Bank (a modest haircut on a full payment) is but a small price to pay for the public good, and consolidates.

Congress left Bank with a lifeline. Under Section 1129(a)(7), it could call a halt of this confiscation if, on a liquidation, it would fare better. Whatever bankruptcy may do to state law rights, it cannot force creditors to restructure debts in a manner that is economically less attractive than liquidation. With substantive consolidation, that protection is gone.

3. Mutant Forms and Other Mischief

a. The District Court Decision in Owens-Corning

That loose substantive consolidation rules admit of substantial mischief was well illustrated by Judge Fullam's decision in In re Owens Corning.114 The district judge focused on the operational control model, common with large consolidated entities, in which planning, marketing, manufacturing and sales are conducted along a divisional and product line structure, rather than by separate subsidiaries. Subsidiaries did not have independent management or financial control, and were established "for the convenience of the parent company, primarily for tax reasons."115 This model is not unusual, and in the modern corporate group it is often the case that while business is conducted on a divisional basis, each of the separate subsidiaries is separately accounted for, that "joint" overhead costs (for lease space and management, for example) are rationally allocated, and intercompany transfers are accounted for in the company's books and records. The court noted that "it would be exceedingly difficult to untangle the financial affairs of the various entities." This seems odd, given that public audits of Owens Corning were conducted on a regular basis. It does not appear from the reported decision whether the court's view arises from a failure to account for intercompany transactions, or from the alleged difficulty of assessing the fairness of those transactions, but likely it was the latter. The court notes that intercompany transfers of cash were made without interest (suggesting that there were reliable records of the transfers themselves), and that calculations of royalties are "subject to question" (suggesting that the royalty charges were identifiable).

115. Id. at 171.
The court then considered whether the objecting banks had adequately proved that "they relied upon the separate credit of the subsidiaries." One would think that a suite of separate guaranties and covenants would settle that question, but, by a neat trick, the court turned commercial finance on its head. Because the banks obtained guarantees from all of the entities, it held, they "relied upon the overall credit of the entire Owens Corning enterprise." In other words, because the banks encumbered the highest and best assets, what they really wanted was the lowest common denominator. Precisely the opposite is true: the banks obtained guaranties, as any lender does, in order to access the credit of the most creditworthy obligor. The court points out that some intercompany guaranties might be voidable as fraudulent transfers. That may be so, and if it is so (if for example there was no consideration to the guarantor) the banks would lose the credit support of the discrete guarantor. But that is hardly grounds to consolidate all guarantors with the principal. The point is soundly grasped in Augie/Restivo. Judge Winter's opinion bears quoting at length:

Creditors who make loans on the basis of the financial status of a separate entity expect to be able to look to the assets of the 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 the borrower's assets. Such expectations create significant equities. 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 which creditors believed they were dealing with separate entities.

b. Momentary Consolidation

Where Congress writes no rule, an enterprising debtors' bar will write for it. Substantive consolidation expanded into an even more mischievous form. In Stone & Webster, Chief Judge Walsh left a troubling footnote advising that he saw nothing in Section 1123(a)(5)(C) that would limit the consolidations it authorizes to "a consolidation of corporate entities that outside of bankruptcy could

116. Judge Fullam's decision appears to be driven by an apprehension that the Owens Corning Chapter 11 cases had gone on long enough. The banks, he said, might yet be entitled to separate treatment in a plan. Id. at 172. He signs off his opinion by saying, "the parties would be well-advised to settle their differences." Id. at 173. Indeed.

only be structured as provided in the state corporation law.”118 Thus a debtor, the court wrote, might proceed to substantively consolidate “estates,” but not debtor entities. Judge Fullam approved just such a scheme in Owens Corning. Consolidation would occur only for purposes of “confirmation and consummation of the plan.”

If debtors are being consolidated for “plan purposes,” but left apart as separate corporate entities post exit, we have entered a truly lawless realm. This is simply a strategem to avoid taxes and beat the vote requirements. Nothing in the statutes or the Act decisions supports such a thing. All pretense — even to intellectual legitimacy — is gone. If equity requires the collapse of entities, how is it that those entities are to be turned loose on future creditors as independents? By collapsing debtors into a larger, weaker consolidated entity for just long enough to count votes, and then returning the entities to their previous identity, the debtors swamp the blocking position in dollar and number that would have existed in at least one of the discrete entities, and confirm “consensually.” The debtors avoid cramdown requirements and the application of Section 1129(a)(7) to discrete creditors. Consolidation for “plan purposes” simply takes from creditors a power Congress gave them.

4. Joint Administration

If a consolidated group files, is it necessary for each debtor to have its own set of professionals and who should bear the costs? This problem is universally addressed through joint administration orders, which permit one proceeding (and often one set of professionals) to administer related cases,119 but such orders generally proclaim chastely that they should not be deemed to be substantive consolidation. Like all fig leaves, this one requires us not to look too closely. Who is attending to the interests of separate corporate entities? In the real world, demonstrating asset values is not so easy. It may require expert testimony, and that may in turn necessitate separate professionals. Nor does joint administration grapple with how rationally to allocate administrative expense: A split is not necessarily fair. Suppose Abelco is an energy conglomerate. It has assets of $3 billion and liabilities of $8 billion. Cain, Inc. is a special purpose subsidiary, cre-

118. In re Stone & Webster, Inc., 286 B.R. 532, 543 n. 7 (Bankr. D. Del., 2002); see also In re Giller, 962 F.2d 796, 799 (8th Cir. 1992); see In re Genesis Health Ventures, Inc., 266 B.R. 591, 618-20 (Bankr. D. Del. 2002) (approving “deemed consolidation” that would dissolve upon exit, without analysis on relative impact on creditors of different estates).

119. See Fed. R. Bankr. 1015(a). The Advisory Committee note provides that the “[c]onsolidation, as distinguished from joint administration, is neither authorized nor prohibited by the rule.” Id. at 1015(b) advisory committee’s note.
ated solely for the purpose of owning and operating the Cain, Inc. plant. Cain, Inc.'s asset, the plant, is worth $500 million, and Cain, Inc. has liabilities of $600 million. It operates in compliance with regulations through an able contractor. It has reliable sources of fuel supply and customers for power offtake. None of its creditors agitates for foreclosure or sale. Margins have tightened in the power industry, and Cain, Inc. is overleveraged, but left to its own devices, it could swiftly negotiate and confirm a stand-alone plan; indeed, it likely could have completed a work-out outside of Chapter 11. Should Cain, Inc. be allocated 16 percent of the group expenses (on the basis of asset ratios)? Or 7.5% (comparing liabilities to liabilities)? At either level, the tradeoff is unlikely to be to Cain, Inc.'s advantage. Abelco incurs $50 million in professional fees a year. Should Cain, Inc.'s creditors be taxed for a share of all this administrative cost?

D. Owens Corning: the Third Circuit Decision

Earlier this year the Third Circuit issued a significant retrenchment on the doctrine of substantive consolidation. In *In re Owens-Corning*, the Court of Appeals reversed a district court ruling that permitted the debtors to proceed with confirmation of a plan of reorganization premised on "deemed consolidation." "Deemed consolidation" is the absurd mischief that had grown up in Delaware particularly, in which estates were "consolidated" for purposes of plan confirmation and then returned to their unconsolidated state for exit. The narrow holding of that case is that such deemed consolidations are unlawful under the Bankruptcy Code, but the decision contains a broader analysis of the doctrine of substantive consolidation, and a narrowed restatement of when it may be applied.

*Owens Corning* involved a joint filing of a number of affiliated entities. Although there may have been some "sloppy bookkeeping," the subsidiaries maintained an accounting system reliable enough to permit audits, both pre- and post-petition. A bank syndicate loaned $2 billion and obtained guaranties from solvent subsidiaries. The district court approved of plan provisions that would have allowed momentary substantive consolidation of the estates — i.e. for long enough to approve a vote and dilute the banks' distribution — and then permit

120. It has engaged a mega firm as lead counsel, another large national firm as local counsel, a third firm as conflicts counsel, a fourth as special securities counsel, a fifth as special litigation counsel. There is a bondholder committee and a creditors' committee and a shareholders' committee; there are a few secured lenders; there is an examiner and a fee-review committee. All have counsel and local counsel. Six groups of professionals have financial advisors.

121. *In re Owens Corning*, 419 F.3d 195, 200-01 (3d Cir. 2005).
the debtors to exit Chapter 11 as separate corporate entities. The Third Circuit reversed. Its narrow holding is that deemed consolidation is unlawful: "[s]uch deemed schemes we deem not Hoyle."\textsuperscript{122} The Court said, "what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."\textsuperscript{123} At its core, this decision builds on \textit{Augie/Restivo}: either the Debtors' prepetition conduct must have been such as to render corporate separateness a fiction, or it must be practically impossible to disentangle the books. Significantly, the Court excludes any of the vague "balancing tests" so glibly adopted by other courts, commenting that "commingling justifies consolidation only when separately accounting for the assets and liabilities of the distinct entities will reduce the recovery of every creditor."\textsuperscript{124} To apply its rule, the Court sketched out a new (and somewhat more intelligible) list of five "principles," (not "factors"):  
1. Courts should respect entity separateness absent compelling circumstances.  
2. The harms to be remedied by substantive consolidation must be those caused by the debtors, not the creditors.  
3. Mere benefit to administration is not enough.  
4. The remedy should be used rarely and as a last resort.  
5. Substantive consolidation might be used defensively "to remedy the identifiable harms caused by entangled affairs," but not "offensively (for example . . . to disadvantage tactically a group of creditors in the plan process or to alter creditor rights.)."\textsuperscript{125}  

V. TOWARDS A REDEFINITION OF SUBSTANTIVE CONSOLIDATION  

By limiting substantive consolidation to more predictable situations, the Third Circuit has done a great service. But scrutiny of its test leaves a question: is there anything to this doctrine that is not already supplied by state law? We are told that a bankruptcy judge may consolidate entities where, during the prepetition period, those entities so disregarded separateness that their creditors relied on the breakdown of entity borders and treated them as one legal entity. In this respect a bankruptcy judge does no more than her state-court counterpart ap-

\textsuperscript{122} Id. at 216.  
\textsuperscript{123} Id. at 211.  
\textsuperscript{124} Id. at 214 (emphasis in original).  
\textsuperscript{125} Id. at 211.
plying doctrines of "veil-piercing" that exist in the law of every state. We then read that a bankruptcy judge may consolidate entities where, during the postpetition period their assets and liabilities are so scrambled that the cost and difficulty of separating them would hurt even the creditors of the more valuable estate. This again is no more power than a state-court judge would have under state law. Future cases will elucidate the doctrine, but it may well be that the courts will come to recognize not only that there is no historical legitimacy to "substantive consolidation," but that, as limited by the Third Circuit, there is simply no need for it.

Substantive Consolidation, to the extent it adds something to state-law principles of veil piercing and yet is less precise than fraudulent transfer law, is more confiscatory. Because fraudulent transfer focuses on discrete transactions, courts can, at least in theory, pool back into an estate those assets — and only those assets — that should never have left it. This leaves creditor liabilities attaching to the right groups of assets. Substantive consolidation is rougher justice. Because it pools all assets and liabilities together, then even those that properly belong to one group of creditors are pooled for the benefit of all. Suppose, again, using Abelco and Cain, Inc. as an example, two bond issues. Both are issued by Cain, Inc. (the weaker debtor), but the first is guaranteed by Abelco and the second is not. The second issue carries a higher interest rate to reflect the higher risk. If the estates are substantively consolidated, holders of the first issue lose the benefit of their bargain — a priority in distress — that they paid for through lower returns. This proposition can most easily be demonstrated by institutional debt, but it may play out in subtler ways, through trade terms afforded Abelco, but not Cain, Inc., higher pricing, and the like.

Outside the truly consensual context — i.e. where separate accepting votes are obtained from creditor classes of each separate debtor — substantive consolidation might be reconsidered and addressed solely as a Section 544(a) "superpower" of the hypothetical lien and judgment creditor. Section 105(a) enables the courts to fashion relief in aid of this broad statutory power, and two kinds of substantive consolidation are immediately evident: substantive consolidation in aid of fraudulent transfer powers, and substantive consolidation in aid of the debtor's power as a hypothetical judgment creditor.

First, in aid of the debtor's power to avoid transfers, a court might collapse corporate entities where it is shown, as it was in Sampsell, that all of the property of the transferee derives improperly from the
transferor. Suppose that Cain, Inc., while insolvent, formed Abelco, and thereafter from time to time — still being insolvent — transferred property to it. At the time the two entities filed, all of Abelco’s property is either property fraudulently transferred to it by Cain, Inc., or proceeds thereof. Substantive consolidation is appropriate because it accomplishes, in a more efficient way, what could be accomplished through a series of discrete avoidance claims brought under Sections 544 and 548.

By contrast, substantive consolidation would not be available merely because Cain, Inc. transferred Edenacre to Abelco. The remedy for that fraudulent transfer is avoidance of the transfer itself, not destruction of the corporate entity. Abelco’s creditors have no legitimate claim to Edenacre, but by the same token Cain, Inc.’s creditors have no legitimate claim to Abelco’s other assets.

States propose corporations, and ought to dispose of them as well. Owens Corning is progress, but no bankruptcy court should be in the business of defining the persons who appear before it. Bankruptcy courts should rather apply only those rules written for them by the state whose law provides the operative rules of corporate creation.