UNSCRAMBLING THE EGG WITH SUBSTANTIVE CONSOLIDATION OF ASSETS

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KEY POINTS

1. When chapter 11 cases with jointly administered debtors are converted to chapter 7, one of the biggest challenges facing trustees is the task of accurately demarcating co-mingled assets to determine the appropriate allocation to creditors.
2. Substantive consolidation of assets - the merging of assets and liabilities from multiple related debtors into one pool from which creditors are paid ratably - remains a strategic, yet less commonly used legal remedy that trustees and professionals can leverage to alleviate the burdens of this process with the court's approval.
3. Substantive consolidation can be a useful strategy when the appropriate circumstances are aligned. While it may not be right for every situation, it should not be ruled out and can enable a more equitable and efficient administration and allocation of the assets, particularly within chapter 7 liquidations.

Summary:

When chapter 11 cases with multiple debtors are converted to chapter 7, one of the biggest challenges facing trustees is the task of accurately demarcating co-mingled assets to determine the appropriate allocation to creditors of each estate. Substantive consolidation of assets - the merging of assets and liabilities from multiple related debtors into one pool from which creditors are paid ratably - remains a strategic, yet less commonly used legal remedy that trustees and professionals can leverage to alleviate the burdens of this process with the court's approval.

Despite its limited appearance in bankruptcy proceedings, professionals may find scenarios where substantive consolidation of assets can be beneficial above and beyond the reduction of administrative overhead and expenses. To fully understand where and when it can be useful, we can take a closer look at its implications for trustees, creditors and other professionals, as well as practical considerations for managing cases when it is employed as a strategy.

As jointly administered chapter 11 cases are converted to chapter 7 cases, it becomes the trustee's job to determine how much of the available cash and other assets should be allocated to each debtor in the jointly administered cases. In situations where there is no clear demarcation of the ownership of the assets in each estate, this process can become like trying to unscramble an egg for the trustee and other involved parties. Often in chapter 11 cases, it is not uncommon for jointly administered debtors to have their assets and liabilities entangled.

This is especially true for cases that have been ongoing for many years with inconsistent or unreliable accounting of each debtor's assets and liabilities. For example, in a chapter 11, substantially all of the debtors' assets might be sold in a single transaction without allocating the appropriate amount from sale proceeds to each debtor. Post-conversion to chapter 7, it could be impossible to determine the asset allocations among the separate debtors, which forces arbitrary (albeit reasoned) decisions to be made by a trustee about how this should be done. Likewise, creditors could be unfairly advantaged or disadvantaged depending on how the assets are allocated and how any co-mingled liabilities are allocated among the separate debtors.

In employing substantive consolidation as a tool, trustees and professionals should be aware of the rigorous standard to be met in order to use it within bankruptcy proceedings. It must be approved by the court and there are numerous factors that will go into the judge's decision to allow this remedy. Generally, it is permitted sparingly.

The Second Circuit employs the *Augie/Restivo* approach (*In Re Augie/Restivo Baking Company, Ltd.*) to determine allowance of substantive consolidation. It can be distilled into two critical inquiries: whether (i) "creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit"; or (ii) "the affairs of the debtors are so entangled consolidation will benefit all creditors."

Under the D.C. Circuit's *Auto-Train* approach (*In Re Auto-Train Corp, Inc.*), courts examine if there is a significant identity of the debtor entities and permitted substantive consolidation when its advantages outweighed potential risks.

The 2005 opinion in the Third Circuit in *In Re Owens Corning* established perhaps the harshest standard to determine whether substantive consolidation will be allowed. Absent consent, the Third Circuit requires proof that either "(i) prepetition [the debtors] 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." Effectively, the standard requires that there is no prejudice to any creditor in utilizing this approach as a legal remedy.

As the standard for allowing substantive consolidation can change by jurisdiction, it is critical for trustees to know the relevant standard in their jurisdiction.

Recent cases, including *In re Republic Airways Holdings Inc.* and *In re ADPT DFW Holdings*, have shown that substantive consolidation can be used appropriately and successfully. This raises the question among trustees and professionals as to whether it should be more accessible as a legal remedy.

The *Republic Airways* case provides an unprecedented example of "partial" substantive consolidation under a chapter 11 plan which the majority of creditors supported, while one creditor objected due to its specific issues and was "carved-out" from substantive consolidation. In this case, the bankruptcy court permitted substantive consolidation of assets based on evidence and the criteria established by *Augie/Restivo*, showing that the benefits were greater than potential risks to creditors. Further-

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more, the significant additional cost and time required to untangle assets in case was an important factor in this decision.

The case is unique in that Residco was carved-out from substantive consolidation treatment in an effort to resolve its objection to plan confirmation and the plan's proposed substantive consolidation. To resolve the objection, the plan was amended to allow flexibility for the Residco to choose whether its claims were subject to substantive consolidation or not based on how it would be treated in either scenario. While this case proceeded successfully, many experts do not consider it to be a "precedent," but rather a unique instance of how substantive consolidation can serve its purpose despite conflicting creditor interests.

The decision to utilize substantive consolidation hinges on a variety of factors and some view it more favorably than others. Among those who feel that it should be used as a last resort, the major concern is that it can compromise the recoveries to be gained by creditors in certain situations, and that it eliminates guarantees of the debtors, which can limit the rights of creditors who may benefit from these guarantees.

Proponents of substantive consolidation see the value of this approach when used appropriately and the potential benefits outweigh any downside. It is especially useful in situations where there are multiple affiliated debtors with assets and liabilities that are challenging to disentangle. In these cases, it eases the administrative burdens and reduces the costs and fees associated with attempting to allocate the assets of affiliated debtors based upon certain historical information and, often times, incomplete information.

For trustees considering substantive consolidation of assets, timing is critical. It's important to use this approach with caution because if done too soon, the debtor(s) may lose certain claims and defenses. For example, in situations where debtor A is paying debts for debtor B, it is possible that the trustee could claw the payment back as a fraudulent transfer. However, if the debtors' assets and liabilities have been substantively consolidated, trustees no longer are able to claim such fraudulent transfers by the debtor(s).

Substantive consolidation can be a useful remedy when the appropriate circumstances are aligned. While it may not be right for every situation, it should not be ruled out and can enable a more equitable and efficient administration and allocation of the assets, particularly within chapter 7 liquidations.

ENDNOTES:

[1] *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518 (2d Cir. 1988)

[2] *In Re Auto-Train Corp, Inc.*, 810 F.2d 270, 276-77 (D.C. Cir. 1987)

[3] *In Re Owens Corning*, 419 F.3d. 195, 211 (3d Cir. 2005) (emphasis added)