

Substantive Consolidations in Bankruptcy: A Flow-of-Assets Approach

Substantive consolidation may be viewed as a remedy needed to protect creditors of an enterprise from subtle transfers of assets that may accompany interaffiliate transactions. In this Comment the author suggests that the interplay between an enterprise creditor's legitimate needs and the corporate and bankruptcy law doctrines of limited liability and subordination of interaffiliate claims results in a need to evaluate petitions for substantive consolidation in light of the past flow of assets between bankrupt affiliates.

Substantive consolidation in bankruptcy involves "piercing the corporate veil" between affiliated¹ bankrupt corporations to form one "consolidated" entity for the purposes of the bankruptcy proceeding.² Consolidation normally consists of the elimination of all interaffiliate

1. Generally, corporations can be related in two ways: as parents and subsidiaries, in which case the parent corporation owns the shares of the subsidiary; or as affiliates, in which case two corporations share common ownership. Both relationships result in an equal danger that one corporation's profitability may be sacrificed for the sake of the enterprise. Hence, the issues that arise in a substantive consolidation proceeding are the same, regardless of whether the corporation is a parent, subsidiary, or affiliate. Throughout the remainder of this Comment, except where it is otherwise provided, all related corporations will be described with the term "affiliate." This approach is in accordance with BANKRUPTCY RULE 901(3), which reads in part:

"Affiliate" of a bankrupt means (A) a corporation 25 per cent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the bankrupt, or (B) a person who directly or indirectly owns, controls, or holds with power to vote, 25 per cent or more of the outstanding voting securities of the bankrupt, or (C) a corporation 25 per cent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by a person who directly or indirectly owns, controls, or holds with power to vote, 25 per cent or more of the outstanding voting securities of the bankrupt . . .

2. When affiliated corporations are in bankruptcy, there are theoretically two "veils" that may be pierced: the veil between the various affiliates, and that separating the entire enterprise from its individual shareholders. One court described the difference between the two as follows:

[I]t is one thing to assert that a corporation is a fragment of a larger corporate combine which actually conducts the business. . . . It is quite another to claim that the corporation is a "dummy" for its individual stockholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends. . . . Either circumstance would justify treating the corporation as an agent and piercing the corporate veil to reach the principal but a different result would follow in each case. In the first, only a larger corporate entity would be held financially responsible . . . while, in the other, the stockholder would be personally liable. . . . Either the stock-

claims and the placing of all assets³ into a "hotchpot" to be shared by the creditors of all affiliates.⁴ Since "the theme of the Bankruptcy Act is equality of distribution,"⁵ the creditors generally will share *in pari passu* in the consolidated assets.

Although the consolidation process itself is relatively straightforward, determining whether consolidation is equitable in a given case is difficult. Unfortunately, both the case law and commentary are in utter confusion. In an important case, *Chemical Bank New York Trust Co. v. Kheel*,⁶ the Second Circuit has offered one standard for consolidation: the affiliated bankrupt corporations should be consolidated when the interrelationships between the affiliates are so "hopelessly obscured" that the affairs of the affiliates cannot be disentangled at a reasonable

holder is conducting the business in his individual capacity or he is not. If he is, he will be liable; if he is not, then, it does not matter—insofar as his personal liability is concerned—that the enterprise is actually being carried on by a larger "enterprise entity".

Walkovszky v. Carlton, 18 N.Y.2d 414, 418-19, 223 N.E.2d 6, 8-9, 276 N.Y.S.2d 585, 588-89 (1960). Substantive consolidations are limited solely to piercing the veil between affiliates. They do not involve imposing personal liability upon the individual owners.

3. For the purposes of this Comment, an "asset" will be defined as anything, tangible or intangible, of value to a corporation.

4. Substantive consolidations are not specifically authorized by either the Bankruptcy Act or the Bankruptcy Rules. Rather, they derive from a bankruptcy court's equitable jurisdiction. *Bank of Marin v. England*, 385 U.S. 99 (1966).

Generally, the bankruptcy proceedings of two affiliated corporations are substantively consolidated by first filing a motion under BANKRUPTCY RULE 116(c)(4) to have both proceedings transferred to the same forum. For tactical reasons it is often best to proceed next with a Rule 117(b)(4) motion for a joint administration or procedural consolidation. At this point, a decision must be made whether to consolidate before or after the plan of liquidation. Dicta in the case law indicates that the latter alternative is preferable unless the "exigencies of the situation" dictate otherwise. *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966).

Whether a trustee can directly bring the assets of a solvent affiliate into the proceedings depends upon whether the court can assert summary jurisdiction over the assets, which in turn depends upon whether the affiliate's claim is "colorable." If the claim is not colorable the assets must be reached by way of plenary proceedings.

Substantive consolidation should be distinguished from "procedural" or "administrative" consolidation, in which related estates are administered jointly for administrative convenience only and which involve no consolidation of either assets or liabilities.

The courts have often confused substantive consolidations with turnover-of-assets cases, in which assets of one affiliate are turned over to the trustee of another affiliate. Where a "turnover" is accompanied by the piercing of the corporate veil and the equal treatment of creditors, the procedure is a substantive consolidation in all but name. *See, e.g., Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964). For the purposes of this analysis, such a procedure will be considered to constitute a substantive consolidation.

5. *Sampsell v. Imperial Paper Corp.*, 313 U.S. 215, 219 (1941).

6. 369 F.2d 845 (2d Cir. 1966).

7. *Id.* at 847.

cost.⁷ In the same case, Judge Friendly argued in an influential concurring opinion⁸ for another standard: affiliated corporations should not be consolidated if to do so would unjustly affect the claim of a creditor who had reasonably "relied on the credit of one [affiliate]."⁹ Yet a third standard was apparently applied in *Anaconda Building Materials v. Newland*,¹⁰ where the Ninth Circuit refused to approve a consolidation that would have benefited the creditors of a parent corporation that had already "benefited from the operation of the subsidiaries, and not vice versa."¹¹

The existing commentary is equally problematic. One author has argued that affiliated bankrupts should *always* be substantively consolidated unless a creditor had specifically relied on the separateness of its debtor.¹² In response, another author has argued the opposite: that substantive consolidation should *never* be ordered except when, owing to enterprise¹³ manipulation, a creditor was misled into relying on greater capitalization than in fact existed.¹⁴ A third commentator does not suggest a new proposal, but simply notes that "the specific operative facts are bound to be given great weight in reaching a decision."¹⁵

The current state of the law is such that a "consensus" theory of substantive consolidation cannot be found. It is the thesis of this Comment that this confusion can be resolved only if the courts adopt a new approach to substantive consolidation. It will be suggested that such an approach, utilizing a standard based on the past flow of assets be-

8. Judge Friendly's position has been supported by several commentators. See, e.g., Seligson & Mandell, *Multi-Debtor Petition—Consolidation of Debtors and Due Process of Law*, 73 COM. L.J. 341 (1968); Note, 8 B.C. INDUS. & COM. L. REV. 963 (1968).

9. 369 F.2d at 848. Judge Friendly did concede that there would be some instances in which even an "approximation" of each affiliate's assets would be "impossible or prohibitively expensive." *Id.* He believed, however, that *Kheel* was not such a case.

10. 336 F.2d 625 (9th Cir. 1964).

11. *Id.* at 625.

12. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975) [hereinafter cited as Landers I]; Landers, *Another Word on Parents, Subsidiaries, and Affiliates in Bankruptcy*, 43 U. CHI. L. REV. 527 (1976) [hereinafter cited as Landers II].

13. The term "enterprise" will be used to describe the business entity composed of all corporations engaged in the common pursuit of profit. Although the definition envisions that all components of the enterprise will be responsible to a nearly identical set of owners, in rare cases bankruptcy courts have treated separately owned corporations as part of one entity for the purposes of reorganization. *In re Pittsburgh Rys. Co.*, 155 F.2d 477 (3d Cir.), cert. denied, 329 U.S. 731 (1946).

14. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976) [hereinafter cited as Posner].

15. Ashe, *The Corporate Entity in Bankruptcy: Subordination—Consolidation—Merger*, 46 AM. BANKR. L.J. 291, 304 (1972).

tween the bankrupt affiliates, would lead to more predictable and more equitable results in straight bankruptcy proceedings, Chapter X reorganizations, and Chapter XI arrangements.¹⁶

I

TOWARD A THEORY OF SUBSTANTIVE CONSOLIDATION

Before examining the doctrines that underlie substantive consolidation, it is necessary to analyze the transactions that give rise to a need for such an equitable remedy. With today's complex forms of business organization, the scope of a business enterprise often extends beyond a distinct corporation to include its nominally independent affiliates.¹⁷ Such enterprises are often controlled by a single management, and, accordingly, the affiliates comprising them will often engage in inter-related activities. Not uncommonly, the profitability of any given affiliate might be sacrificed for the good of the whole enterprise.¹⁸

16. In all three types of proceedings the fundamental issue is the same: is it equitable to treat the creditors of all bankrupt affiliates equally? There are, however, differences between Chapter X reorganizations and Chapter XI arrangements that are of some significance in a substantive consolidation context. Foremost of these is the likely unavailability of Chapter XI in situations where the debt is publicly held and widely distributed. See *In re Manufacturer's Credit Corp.*, 395 F.2d 833 (3d Cir. 1968). See also *SEC v. American Trailer Rentals Co.*, 379 U.S. 594 (1965).

There are also differences in the standard that must be met for approval by the bankruptcy judge. The judge must find that a Chapter X reorganization is "fair and equitable," Bankruptcy Act § 221(2), 11 U.S.C. § 621 (1970), while Chapter XI arrangements must be found to be "for the best interests of the creditors," *id.* § 336(2), 11 U.S.C. § 766 (1970). These standards differ, particularly with regard to the "absolute priority rule." *SEC v. United States Realty Co.*, 310 U.S. 434, 452 (1940). In practice, however, the variance between the standards has no significant effect in substantive consolidation proceedings. Compare *In re Flora Mir Candy Corp.*, 432 F.2d 1060 (2d Cir. 1970), and *In re Hal Computer Inc.*, BANKR. L. REP. (CCH) ¶ 65,304, with *Anaconda Bldg. Materials Co. v. Newland*, 336 F.2d 625 (9th Cir. 1964), and *In re Continental Vending Mach. Corp.*, 517 F.2d 997 (2d Cir. 1975), *cert. denied*, 424 U.S. 913 (1976).

17. There are numerous incentives for operating an enterprise in the form of affiliated corporations. Some of the more compelling include the following: for administrative convenience, to maintain the good will of an acquired company, to gain tax advantages available to smaller corporations, to avoid restrictions on foreign corporations, to limit liability, and to manipulate credit. See A. DEWING, FINANCIAL POLICY OF CORPORATIONS 980-85 (5th ed. 1953); Landers I, *supra* note 12, at 589. See also Berle, *Subsidiary Corporations and Credit Manipulation*, 41 HARV. L. REV. 874, 878-79 (1928).

18. The ways in which such sacrifices can be accomplished are limitless. Some of the more common devices include the following: sales for inadequate consideration, loans at excessively favorable terms, uncompensated use of personnel and equipment, and an affiliate's uncompensated guarantee of another affiliate's debt. See *In re Continental Vending Mach. Corp.*, 517 F.2d 997 (2d Cir. 1975), *cert. denied*, 424 U.S. 913 (1976); *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966); *G.E.J. Corp. v. Uranium Aire, Inc.*, 311 F.2d 749 (9th Cir. 1962); *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344 (2d Cir. 1942); *Stone v. Eacho*, 127 F.2d 284 (4th Cir. 1942); *Trustees System Co. v. Payne*, 65 F.2d 103 (3d Cir. 1933); *New*

From the creditor's standpoint, a transaction that harms its debtor can be detrimental because it almost necessarily impairs the prospects for repayment.¹⁹ Aside from foresighted contracting,²⁰ however, a creditor can do little to protect itself against the risk that the profitability of its debtor will be sacrificed in favor of affiliated corporations. As long as each affiliate can pay its debts, there is no effective legal constraint on the fragmentation of a single enterprise into many smaller corporations and the possible abuses that might follow. Only after both the privilege to incorporate is abused and the affiliate becomes insolvent does the corporate law provide significant protection. At that time, if abuse is evident, the courts will "pierce the corporate veil" to hold the shareholders liable for the corporation's debt.²¹

In this "standard" alter ego case only shareholder limited liability is at stake; thus the decision to pierce turns on whether the individual shareholders deserve limited liability.²² Substantive consolidations are

York Trust v. Island Oil & Transp. Corp., 56 F.2d 580 (2d Cir. 1932); Hillebrand v. Sav-Co., 353 F. Supp. 19 (E.D. Ill. 1972); Henderson v. Rounds & Porter Lumber Co., 99 F. Supp. 376 (W.D. Ark. 1951); Lopp v. Peerless Serum Co., 382 S.W.2d 620 (Mo. 1964); Lowendahl v. Baltimore & O.R.R. Co., 247 App. Div. 144, 287 N.Y.S. 62, *aff'd*, 272 N.Y. 360, 6 N.E.2d 56 (1936); Platt v. Bradner Co., 131 Wash. 573, 230 P. 633 (1924).

19. Such transactions, of course, are also detrimental to minority shareholders. Their interests, however, are protected by well-established principles of corporate law. The most important of these is the liability of directors for mismanagement.

The existence of affiliated corporations, with boards under common control, creates a *prima facie* case of director conflict of interest. Assuming that there is not a quorum of "independent" directors, any "arm's-length" bargaining between the affiliates will be largely illusory. See M. FEUER, *PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS* 42 (1961). The common control of the two affiliates does not affect the high duty of loyalty owed by the directors to the shareholders of each individual affiliate. Thus, the courts have long subjected the fairness of transactions between related corporations to close scrutiny, and have created a cause of action in favor of the "harmed" affiliate against both the benefited affiliate and the directors. See, e.g., *Sinclair Oil Co. v. Levien*, 280 A.2d 717 (Del. 1971); *Chelrob, Inc. v. Barrett*, 293 N.Y. 442, 57 N.E.2d 825 (1944); *Everett v. Phillips*, 288 N.Y. 227, 43 N.E.2d 18 (1942); N. LATTIN, *THE LAW OF CORPORATIONS* 272-82, 290-94 (2d ed. 1971).

In a substantive consolidation this cause of action would be vested in the trustee of the "harmed" affiliate. Regarding the equities this approach creates, see text accompanying notes 72-75 *infra*.

20. For example, a creditor may seek guarantees from other affiliated corporations, an amortized loan, limits on total indebtedness, limits on dividends, a minimum capitalization, or perhaps even some form of collateral. The importance of these contractual protections to a creditor of an affiliate are stressed by Professor Posner. Posner, *supra* note 14, at 503-05.

21. See generally Comment, *Disregarding the Corporate Entity: Contract Claims*, 28 OHIO ST. L.J. 441-65 (1967). Since these shareholders may be other affiliates, the effect of piercing the veil is often to protect creditors of affiliates, whose separateness was abused by the shareholders, by allowing them to reach the assets of the entire enterprise.

22. See, e.g., *Sell v. United States*, 336 F.2d 467 (10th Cir. 1964); *Allied Chem. Corp. v. Randall*, 321 F.2d 320 (7th Cir. 1963); *Mull v. Colt Co.*, 178 F. Supp. 720

significantly different. Conceptually, the shareholders are not involved; their corporation's remaining assets belong entirely to its creditors. The only issue is whether the bankrupt affiliates will be administered as separate corporations, or whether the veil between them will be pierced to create one large bankrupt entity.²³ The parties in interest will be the creditors of the affiliates, who are intimately concerned with how the enterprise assets are distributed.²⁴ Thus, a simple examination of shareholder/creditor equities creates a misleading picture. A creditor's reliance on even fraudulent representations by the bankrupt's shareholders or management should not be used to grant or deny a consolidation, because such an action would affect the rights of other creditors not parties to the transaction. Instead, in substantive consolidation the relative equities of both sets of creditor/litigants must be examined to determine whether piercing the veil will be equitable.

Since the creditors of the various affiliates have probably had no prior transactions with one another, when determining whether a motion for consolidation is meritorious it is necessary to look for factors that bear indirectly on the relative equities of the two sets of creditor/litigants. In most substantive consolidation cases such a factor is readily available. When related corporations engage in intra-enterprise transactions, each affiliate tends to strike friendlier bargains with the others than it would with outside parties.²⁵ As long as all the af-

(S.D.N.Y.), *appeal dismissed sub nom.* Mull v. Ackerman, 279 F.2d 25 (2d Cir. 1959); Shafford v. Otto Sales Co., 149 Cal. App. 2d 428, 308 P.2d 428 (1st Dist. 1957).

23. The need for a substantive consolidation inquiry may arise in two ways. The various affiliates may have filed or been subject to separate petitions (*e.g.*, *Anaconda Bldg. Materials Co. v. Newland*, 336 F.2d 625 (9th Cir. 1964)) or the disregard of the separateness of one bankrupt affiliate may force an entire enterprise into insolvency (*e.g.*, *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964)). In the latter scenario a preliminary standard alter-ego question is normally raised when the trustee of one affiliate seeks to assert control over the assets of another affiliate in a summary turnover proceeding. *Id.* A turnover order will almost certainly force the formerly solvent affiliate into bankruptcy, at which time a motion for substantive consolidation can be made. See note 4 *supra*.

24. Substantive consolidation litigation essentially is a dispute between the creditors of two affiliated corporations over how the assets of the corporations should be distributed. As a practical matter, a request for consolidation will arise only when representatives of an affiliate will gain by having the estates of both bankrupts consolidated. Accordingly, the petitioner, always associated with an affiliate with a relatively low asset/debt ratio, seeks to improve its situation through consolidation with an affiliate possessing a higher asset/debt ratio. Of course, parties associated with the relatively healthier affiliate will oppose the motion.

In voluntary proceedings, the motion to consolidate will probably be made by the bankrupt corporation itself. In involuntary proceedings, it will generally be made by either the creditors or the trustee. The parties opposing the motion are generally creditors of the stronger affiliate, whose recovery would be reduced due to consolidation. Compare *In re Flora Mir Candy Corp.*, 432 F.2d 1060 (2d Cir. 1970), with *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966).

25. See *Landers I*, *supra* note 12, at 590-92.

filiates benefit equally from the transactions over the long run, no creditor has cause to complain. If the benefits tend to flow in one direction, however, the transactions strengthen one affiliate at the expense of another, with the net effect of a gratuitous transfer. The assets reachable by one affiliate's creditor are diminished while those of the other are increased.²⁶ Recognition of this fact provides the key for determining the relative equities of the opposing sets of creditors in a substantive consolidation case. If one set of creditors was harmed by the intra-enterprise transactions, the other set invariably must have benefited to a corresponding degree.

It is therefore proposed that the courts analyze the flow of assets between affiliates to determine when to order substantive consolidation. When the flow has been substantially unequal over the long run—that is, when the benefits of intra-enterprise transactions have been skewed in favor of one affiliate at the expense of another affiliate—substantive consolidation should be available to the harmed affiliate or its trustee or creditors upon proof of the existence of a net deficit in the debtor's intra-enterprise transactions. As will be shown, this proposal does not suffer from the inadequacies of the leading alternatives advanced in current case law and commentary.

II

CURRENT CASE LAW AND COMMENTARY

Despite the confusion in the current law of substantive consolidation, two distinct themes run throughout the cases and commentary:²⁷ (1) the reliance norm (the notion that a decision whether to consolidate should be based on some analysis of creditor reliance); and (2) administrative impracticality (the notion that affiliated bankrupts

26. Analytically, the law of substantive consolidations bears obvious similarities to the law of fraudulent conveyances. Both involve reconciling the conflicting claims of creditors to transferred assets. See generally Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977). See also notes 70-71 *infra* and accompanying text.

27. Early cases provide some support for a third proposition: that some form of fraud must be proved before a court will approve a motion to consolidate. See *Maule Indus., Inc. v. Gerstel*, 232 F.2d 294 (5th Cir. 1956); *First Nat'l Bank v. Walton*, 146 Wash. 367, 262 P. 984 (1928). See also *In re Clark Supply Co.*, 172 F.2d 248 (7th Cir. 1949). Today the fraud requirement is thoroughly discredited. The vast majority of consolidation cases either ignore any need to prove fraud (see, e.g., *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966); *Exchange Nat'l Bank v. Meikle*, 61 F.2d 176 (9th Cir. 1932); *New York Trust Co. v. Island Oil & Transp. Corp.*, 56 F.2d 580 (2d Cir. 1931)) or specifically refuse to require proof of fraud (see, e.g., *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *Hamilton Ridge Lumber Sales Corp. v. Wilson*, 25 F.2d 592 (4th Cir. 1928); *In re Eilers Music House*, 270 F. 915 (9th Cir.), *cert. denied*, 257 U.S. 613 (1921)).

should be consolidated whenever it is impractical to separate their past affairs).

A. The Reliance Norm

1. The Dilemma of Conflicting Reliance

In the vast majority of cases the decision whether to consolidate is based on some analysis of creditor reliance.²⁸ Since, however, the principled use of reliance in a substantive consolidation requires an evaluation of the reliance of two independent groups of creditors, a dilemma is created when the reliance-based equities of the opposing creditors are equally compelling.²⁹ For example, one set of creditors may move for consolidation by claiming reliance on the assets of the entire enterprise,³⁰ while another group of creditors opposes the motion on the ground that they relied on the separate assets of their debtor.³¹ The courts and commentators³² invariably have dealt with this dilemma simply by finding the requisite reliance for the creditor they favor and by overlooking the equities on the other side. Consequently, the equities in virtually all substantive consolidation cases are presented in a one-sided fashion, regardless of whether reliance is used in support of³³

28. See *In re Flora Mir Candy Corp.*, 432 F.2d 1060 (2d Cir. 1970); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *Maule Indus., Inc. v. Gerstel*, 232 F.2d 294 (5th Cir. 1956); *In re Associated Gas & Elec. Co.*, 149 F.2d 996 (2d Cir.), *cert. denied*, 326 U.S. 736 (1945); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942); *Jackson v. M.H. Thomas Inv. Co.*, 46 F.2d 252 (5th Cir. 1931); *In re Eilers Music House*, 270 F. 915 (9th Cir.), *cert. denied*, 257 U.S. 613 (1921). Cf. *In re John Koke Co.*, 38 F.2d 232 (9th Cir.), *cert. denied*, 282 U.S. 840 (1930) (consolidation of the bankruptcies of an individual and his wholly owned corporation). See also *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 848 (Friendly, J., concurring).

29. This dilemma has been recognized by two commentators, neither of whom has suggested any method of resolving it, other than by ignoring the reliance of one group of creditors. Ashe, *supra* note 15, at 304; Posner, *supra* note 14, at 524.

30. See *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *In re Eilers Music House*, 270 F. 915 (9th Cir.), *cert. denied*, 257 U.S. 613 (1921).

31. See *In re Flora Mir Candy Corp.*, 432 F.2d 1060 (2d Cir. 1970). See also *Commerce Trust Co. v. Woodbury*, 77 F.2d 478 (8th Cir.), *cert. denied*, 296 U.S. 614 (1935).

32. See text accompanying notes 50-54 *infra*.

33. See *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *Hollander v. Henry*, 186 F.2d 582 (2d Cir.), *cert. denied*, 341 U.S. 949 (1951); *In re Associated Gas & Elec. Co.*, 149 F.2d 996 (2d Cir.), *cert. denied*, 326 U.S. 736 (1945); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942); *Fish v. East*, 114 F.2d 177 (10th Cir. 1940); *Trustees System v. Payne*, 65 F.2d 103 (3d Cir. 1933); *New York Trust Co. v. Island Oil & Transp. Corp.*, 56 F.2d 580 (2d Cir. 1932); *In re Eilers Music House*, 270 F. 915 (9th Cir.), *cert. denied*, 257 U.S. 613 (1921). See also *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 848 (Friendly, J., concurring).

or in opposition to consolidation.³⁴ The total lack of case law in which the conflicting equities of creditors are weighed and evaluated betrays a judicial reluctance to confront the dilemmas created by the use of reliance in substantive consolidations.

2. *The Manipulation of Reliance*

The courts' attempts to avoid the dilemma of conflicting claims of reliance often result in reconstructions of ambiguous acts of creditors to find a pattern of reliance that will resolve the case.³⁵ The facts of *Hamilton Ridge Lumber Sales Corp. v. Wilson*³⁶ suggest the way in which subtle manipulations of reliance can determine the outcome of a controversy.

In *Hamilton Ridge Lumber* a financially distressed lumber company was forced by its creditor-bank to readjust its account by creating a subsidiary sales corporation. The subsidiary purchased a large portion of the parent's lumber inventory for five of its own \$25,000 notes, and the parent used the notes to pay its indebtedness to the bank. The effect of the transaction was to secure the bank's debt by the assets that had been transferred to the subsidiary and to insulate these assets from the company's other creditors.³⁷ Eventually, the parent became bankrupt and both the trustee and the bank claimed the proceeds from the sale of the lumber. Since most of the bankrupt's creditors were unaware that the lumber had been sold to a wholly owned subsidiary the court was concerned with their reliance on enterprise assets. On the other hand, the bank also had relied when it accepted the subsidiary's notes in satisfaction of its claim against the parent.

Rather than attempting to solve the dilemma raised by the conflicting equities, the court analyzed the case as one of a creditor being

34. See *In re Flora Mir Candy Corp.*, 432 F.2d 1060 (2d Cir. 1970); *Anaconda Bldg. Materials v. Newland*, 336 F.2d 625 (9th Cir. 1964); *Maule Indus., Inc. v. Gerstel*, 232 F.2d 294 (5th Cir. 1956); *Jackson v. M.H. Thomas Inv. Co.*, 46 F.2d 252 (5th Cir. 1931). Cf. *In re John Koke Co.*, 38 F.2d 232 (9th Cir.), *cert. denied*, 282 U.S. 840 (1930) (consolidation of the bankruptcies of an individual and his wholly owned corporation).

35. Despite this sort of manipulation, some hierarchy of reliance exists. Simple theories of estoppel support the notion that a creditor should always be *bound* by its past reliance. See *New York Trust Co. v. Island Oil & Transp. Co.*, 56 F.2d 580 (2d Cir. 1932); *In re John Koke Co.*, 38 F.2d 232 (9th Cir.), *cert. denied*, 282 U.S. 840 (1930). The dilemma of conflicting reliance arises only when reliance is used as the basis of rights to be asserted against creditors of other affiliates.

36. 25 F.2d 592 (4th Cir. 1928).

37. This form of a preference is not subject to attack by the trustee in bankruptcy if it takes place more than 4 months before bankruptcy. Bankruptcy Act § 60, 11 U.S.C. § 96 (1970).

bound by its own past reliance. One of the bank's agents, as part of the readjustment, had been appointed custodian of the subsidiary's lumber. Because the custodian had allowed the parent to continue to sell the lumber that belonged to the subsidiary,³⁸ the court dismissed the bank's claim of reliance on the ground that it had disregarded the subsidiary's separateness.³⁹ Accordingly, the court refused to recognize the disputed transaction as either a sale or a valid pledge, and the bank became a general creditor with respect to the consolidated assets.

The case, however, could easily have been decided differently. Had it desired to find in favor of the bank, the court would have focused on a different fact—the custodian's procedure that required the parent to replace whatever lumber it shipped from the subsidiary's inventory. This procedure would have made the bank's reliance on the separateness of the subsidiary supportable in spite of the shipments.

Some cases are not as subtle as *Hamilton Ridge Lumber* in conveniently interpreting the facts to find the appropriate type of reliance. In a few insightful cases the manipulations appear to be an intentional distortion. *Exchange National Bank v. Meikle*,⁴⁰ for example, involved two affiliates—Fred Herrick Lumber Co. and Milwaukee Lumber Co.—that, except for qualifying shares, were both wholly owned by Mr. Fred Herrick. The Fred Herrick Lumber Co. had been indirectly financed by Mr. Herrick through the Milwaukee affiliate, which ascribed the payments to the "Fred Herrick Advance Account." Upon the bankruptcy of the Fred Herrick Co., the trustee attempted to recover as a voidable preference payments that the bankrupt had made to Exchange National Bank. In determining whether the bankrupt was insolvent at the date of the payment, the characterization of the transfer from the affiliate was crucial. If, due to the transfer, the bankrupt became indebted to its affiliate, the bankrupt would have been insolvent and the trustee would prevail on his claim that the payment to the bank constituted a preference. On the other hand, if no debt was created, the payment would not be voidable. Thus, the question of the existence of the debt, and therefore the outcome of the case, turned on whether the affiliates were to be treated as separate entities.

In making its determination the court noted that there had been "complete disregard of corporate organization and identity"⁴¹ and that

38. 25 F.2d at 595.

39. *But see* Commerce Trust Co. v. Woodbury, 77 F.2d 478 (8th Cir.), *cert. denied*, 296 U.S. 614 (1935), where in a factually similar transaction the court protected the subsidiary's creditor's reliance.

40. 61 F.2d 176 (9th Cir. 1932). *Meikle* is not a substantive consolidation case. It is, however, a situation analogous to substantive consolidation, in that the court is confronted with the dilemma of reconciling conflicting claims of creditor reliance.

41. 61 F.2d at 179.

the source of the transfer, the "Fred Herrick Advance Account," had always been used by Mr. Herrick as a "bank" for his personal living expenses. Nevertheless, the court, using a reliance argument, decided against piercing. Although acknowledging the bank's contention that it would not have given credit had it been aware that the "Fred Herrick Advance Account" constituted a liability, the court chose to protect the interests of a totally hypothetical set of relying creditors:

[A]s the title to the money remained in the Milwaukee Lumber Company, and was not transferred by any corporate act, it is the creditors of the lumber company who must first be considered. The record gives us no facts concerning the creditors of the Milwaukee Lumber Company, but if there be any it is not right to destroy capriciously whatever assets they may have considered security for their money and to leave them completely unprotected.⁴²

Meikle illustrates the extent to which reliance is capable of being manipulated.

3. *The Logical Flaw in Applying Reliance to Substantive Consolidation Cases*

Reliance is essentially an estoppel argument. In the substantive consolidation context it is based on equities that arise out of the transactions between the creditor and the debtor enterprise. Hence it is said that the creditor relied on the enterprise assets or an affiliate's separate status. In substantive consolidation, however, the controversy is between creditors of the various affiliates who typically have had no prior contact with one another. The past reliance of one creditor should not be used to bind another creditor who was not party to the primary transaction.⁴³ Nevertheless, the courts have permitted sets of opposing creditors to assert against each other equities derived from transactions with third parties. The lack of any principled basis for preferring either creditor's reliance is the primary cause of the manipulations discussed earlier.⁴⁴

Difficult equitable problems also occur when a creditor attempts to assert reliance in a substantive consolidation framework. Reliance

42. *Id.* at 181.

43. Generally, to be effective an equitable estoppel must be mutual and reciprocal. *White v. Croker*, 13 F.2d 321 (5th Cir. 1926). Thus, an estoppel operates neither in favor of nor against persons who were not parties to the transaction out of which the estoppel arose. *Eldred v. Bell Tel. Co.*, 119 U.S. 513 (1886).

44. As the court discovered in *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966), reliance is an inappropriate factor in some cases for an entirely different reason. Where there has been extensive intermingling, the administrative expenses necessary to protect reliance may be totally out of proportion to any gain to be derived therefrom. *Id.* at 847. See text accompanying notes 55-62 *infra*.

is most frequently asserted in opposition to a motion for consolidation. Generally, this sort of *defensive* reliance will be used only when the debtor corporation has benefited from the intermingling of assets and hence is stronger than its affiliates.⁴⁵ This use of reliance can be criticized for two reasons. First, if the creditor's transaction occurred before the affiliate benefited from the intermingling of enterprise assets, maintaining the affiliate's separateness would result in a windfall for its creditors. Since the debtor was actually strengthened by the intermingling, the creditor would not be harmed if its reliance on separateness were not protected.⁴⁶ Second, if the extension of credit took place during or after intermingling beneficial to the debtor affiliate, then basing the claim of reliance on separateness may be unreasonable or unmeritorious⁴⁷ because the intermingling would have been disclosed in a thorough credit check.⁴⁸

In other situations reliance can be used *offensively* in support of a motion for consolidation. Here, too, reliance may not merit protection. If the creditor in fact relied on enterprise assets in contracting with one corporation, good business practices would dictate that such reliance be backed by guarantees from other affiliates.⁴⁹

4. Attempts to Modify the Reliance Norm

Two proposals have recently been advanced that would have the effect of avoiding the dilemma of conflicting reliance by focusing analy-

45. But see *In re Flora Mir Candy Corp.*, 432 F.2d 1060 (2d Cir. 1970), in which a "looted" corporation's creditors desired to maintain separateness in order to benefit from a corporate suit pending against the looters. See text accompanying notes 74-75 *infra*.

46. Only detrimental reliance should be protected. *Hampton v. Paramount Pictures Corp.*, 279 F.2d 100 (9th Cir.), *cert. denied*, 364 U.S. 882 (1960).

47. To claim an estoppel a party must lack knowledge of both the true facts and the means of obtaining the truth of the facts in question. *Moss v. Underwriters' Report, Inc.*, 12 Cal. 2d 266, 83 P.2d 503 (1938); *Safeway Steel Products, Inc. v. Lefever*, 117 Cal. App. 2d 489, 256 P.2d 32 (2d Dist. 1953); *McCarthy v. Union Pac. Ry. Co.*, 58 Wyo. 308, 131 P.2d 326 (1942).

48. Public creditors who purchase corporate bonds based on a prospectus showing separateness might be excepted from this argument. See generally *Anaconda Bldg. Materials Co. v. Newland*, 336 F.2d 625 (9th Cir. 1964). If such reliance were considered "reasonable," it still would be a theoretically inappropriate factor on which to base a substantive consolidation decision, since protecting such reliance would foreclose the rights of third parties. Nevertheless, the creditors might merit protection in a *postconsolidation* equitable adjustment of claims (see text accompanying notes 80-85 *infra*) if they could not protect themselves against such misrepresentation through suits brought under the federal securities acts. See Securities Act of 1933, §§ 11-13, 15, 17, 15 U.S.C. §§ 77k-77m, 77o, 77q (1970); Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78 (1970).

49. See *In re John Koke Co.*, 38 F.2d 232 (9th Cir.), *cert. denied*, 282 U.S. 840 (1930); *New York Trust Co. v. Carpenter*, 250 F. 668 (6th Cir. 1918).

sis on just one set of creditors. Professor Jonathan M. Landers of the University of Illinois has recently proposed what he terms a "unified approach" to substantive consolidation problems.⁵⁰ He contends that since affiliated corporations are managed to maximize enterprise profitability, strong incentives exist to commingle funds, to undercapitalize, and in general to subordinate the interests of each individual affiliate for the betterment of the enterprise. Given this thesis, he recommends that when both parent and subsidiary are bankrupt, the estates should always be consolidated⁵¹ and all creditors should share equally unless there has been "specific reliance" on a debtor's separateness by a creditor.⁵²

The simplicity of the proposal is disarming. By focusing only on reliance on separateness, however, it fails to provide a reasoned solution whenever there is reliance by opposing sets of creditors. Such a situation could typically occur in a parent/subsidiary enterprise in which the subsidiary obtains financing from creditors who rely on its separate assets. If the parent subsequently loots the subsidiary so that

50. Landers I, *supra* note 12. Professor Landers' proposal regarding substantive consolidation is part of a larger article on the status of affiliated corporations in bankruptcy, in which he proposes "with some significant exceptions" that

- (1) the parent's debt in its affiliate should always be subordinated;
- (2) creditors of the subsidiary should be able to pierce the veil of the parent; and
- (3) if both parent and subsidiary are bankrupt, the estates should be consolidated and all creditors should share equally.

Landers II, *supra* note 12, at 528.

51. This proposal is itself open to criticism. It runs directly contrary to decades of precedent holding unanimously that the separate existence of a corporation will not be disregarded solely because 100 percent of its stock is held by another corporation. *See, e.g.,* *Martin v. Development Co. of America*, 240 F. 42 (9th Cir. 1917). Professor Landers avoids a direct confrontation with precedent by his analysis of "business motivations" to undercapitalize, to commingle funds, and to dominate a subsidiary's management. Landers I, *supra* note 12, at 596-97. The results of these "motivations" are all factors that are used to demonstrate a "unity of interest" under the traditional common law test for alter ego. *See Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940). The existence of a motivation to do something, however, does not mean that the corresponding action will follow. Thus, Professor Landers seems to be guilty of the fallacy of finding a "unity of interest" among affiliates simply because there are motivations for there to be one. Indeed, the only harm from alter-ego transactions stems from the facts that prove unity of interest. In a situation in which such facts cannot be proven, regardless of whatever motivations may be present, any harm from enterprise management will be either trivial or nonexistent.

52. There is a two-part definition to "specific reliance":

A creditor who claims to have so relied must show (1) an inquiry into the debtor's ability to pay the debt and (2) the absence of any evidence, such as a cross-guarantee or a substantial inquiry into the financial status of related corporations, indicating recognition by the creditor of the interrelationships within the enterprise.

Landers I, *supra* note 12, at 630. By protecting this type of reliance, Professor Landers in effect protects the creditors of the benefited affiliate, since they would generally be the only parties to suffer as a result of consolidation.

the parent is relatively more healthy, and the entire enterprise eventually goes bankrupt, the creditors of the "harmed" subsidiary would naturally seek to consolidate. Professor Landers, however, totally ignores their equities. His "unified approach" would base the decision whether to consolidate entirely on the equities of the creditors of the "benefited" parent. If they had "specifically relied" on separateness, he would refuse the motion to consolidate, regardless of whether the creditors had in fact benefited from the alter ego. Thus, Professor Landers' approach to substantive consolidation does not result in a principled solution to the dilemma of conflicting reliance. At best, it arbitrarily prefers one set of relying creditors over the other.

In response to the Landers article, Professor Richard A. Posner of the University of Chicago has proposed an essentially opposite approach to substantive consolidation. He would apply a "misrepresentation test" to allow consolidation only "where the creditor of one of the affiliates reasonably relied on an appearance of greater capitalization than in fact existed."⁵³ This offensive use of creditor reliance to obtain consolidation contrasts with Professor Landers' recognition of defensive reliance to oppose consolidation. His proposal, however, is no improvement over Landers'. It still entails ignoring the reliance of an entire, albeit different, set of creditors, and for that reason is but an arbitrary solution to the dilemmas posed by substantive consolidations.⁵⁴

The lesson to be learned from both the Landers and Posner modifications is that a principled approach to substantive consolidation must reject reliance entirely. Mere modification of the old norm cannot equitably resolve the dilemmas that the use of reliance creates.

B. Administrative Impracticality

An alternative theme of some recent case law is that the bankruptcy proceedings of affiliated corporations should be consolidated whenever it is impractical to separate their financial affairs. The outstanding ex-

53. Posner, *supra* note 14, at 523-24. In the absence of such reliance, Professor Posner would maintain the affiliates' separateness. *Id.* By protecting this type of reliance, he in effect protects the creditors of the "harmed" affiliate, since they generally would be the parties to improve their claims through consolidation.

54. To his credit Professor Posner recognizes that both sets of creditors may have equally compelling equities. *Id.* at 524. Unfortunately, he views any resulting inequities in a utilitarian sense, as a necessary evil for the greater good: to "discourage borrowers from using the corporate form to mislead creditors . . ." *Id.* The fallacy of this reasoning is that some forms of deception will go unredeemed. Clearly, creditors may be equally misled when they extend credit to a corporation, believing it to be autonomous, when in fact it is a dominated part of a larger enterprise. See text accompanying notes 50-52 *supra*. Professor Posner's proposal ignores the equities of such creditors.

ample of this proposition is the majority opinion in *Chemical Bank New York Trust Co. v. Kheel*,⁵⁵ which involved the disposition of the assets of an insolvent shipping empire. The enterprise consisted of eight affiliates, which the referee found were "operated as a single unit with little or no attention paid to the formalities usually observed in independent corporations"⁵⁶ Upon motion by a major creditor the assets and liabilities of the corporations were consolidated. Chemical Bank, a creditor of one of the stronger affiliates, appealed. It opposed consolidation, contending that its ability to satisfy its claim should not be diminished "absent a showing that it knowingly dealt with the group as a unit and relied on the group for payment."⁵⁷

Although there was ample precedent to place this burden of proof on the proponents of consolidation,⁵⁸ the court chose to depart from precedent by affirming the consolidation without resort to reliance arguments.⁵⁹ It distinguished the present case on the basis of "the expense and difficulty amounting to practical impossibility of reconstructing the financial records of the debtors to determine intercorporate claims, liabilities, and ownership of assets."⁶⁰

The majority opinion in *Kheel* undoubtedly states a correct proposition of law. If the relationships between affiliates are so obscured that it is impossible to disentangle their affairs, of course their bankruptcy proceedings should be consolidated.⁶¹ In such a situation even

55. 369 F.2d 845 (2d Cir. 1966). See also *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964).

56. 369 F.2d at 846.

57. *Id.* at 847.

58. The majority supported its position with *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964), and *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), cert. denied, 317 U.S. 635 (1942). Judge Friendly, in his concurring opinion, correctly noted that both opinions actually cut in the opposite direction—in favor of protecting the bank's reliance. He concurred, however, with the majority on the ground that Chemical Bank had not proved that it had relied. Judge Friendly's position is a relatively liberal version of the reliance norm, in light of cases such as *Meikle* and *Maule*, which put the burden of proof on the party seeking to pierce. See generally *Seligson & Mandell*, *supra* note 8, at 341-44; Note, *supra* note 8.

59. The significance of *Kheel* as a departure from the reliance norm may be seen by considering the ease with which the majority could have invoked reliance to support its holding. It need only have argued that the inter-affiliate transactions were so numerous that a reasonable creditor must have relied on the assets of the entire enterprise. There would have been ample support for such an argument. See *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), cert. denied, 317 U.S. 635 (1942).

60. 369 F.2d at 847.

61. The court's holding is captured in one key sentence:

Yet 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 are so substantial as to threaten the realization of any net

a simplistic reliance argument could not seriously be advanced. If a court could not determine the assets of each affiliate, neither could a "relying" creditor.

The difficulty with *Kheel* is that its holding is a virtual truism, and consequently of little use in resolving the tough problems that arise in substantive consolidation litigation. Rarely, if ever, do consolidation cases arise in which the affairs of the affiliates are so obscured that some estimate of each affiliate's assets cannot be made. Indeed, Judge Friendly in his concurring opinion states that even *Kheel* was not such a case. The opinion thus begs the hard question: if the intra-enterprise relationships are only *partially* obscured, when is it equitable to consolidate?⁶²

C. Precedent Supporting a Flow-of-Assets Approach

Most cases decided in terms of reliance or administrative impracticability would have been resolved identically had a flow-of-assets approach been adopted.⁶³ Since judges can manipulate reliance⁶⁴ but

assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than to deny it to all.

Id.

62. Judge Friendly seems to answer the question with a version of the reliance norm. He would consolidate except when a creditor had reasonably relied on separate-ness. The majority also uses language that supports a similar conclusion:

The power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with the debtor without knowledge of its relationship with others.

Id.

63. Reliance: See *Sampsel v. Imperial Paper Corp.*, 313 U.S. 215 (1941); Consolidated Rock Co. v. Du Bois, 312 U.S. 510 (1941); *In re* Flora Mir Candy Corp., 432 F.2d 1060 (2d Cir. 1970); *Anaconda Bldg. Materials Co. v. Newland*, 336 F.2d 625 (9th Cir. 1964); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942); *Trustees System Co. v. Payne*, 65 F.2d 103 (3d Cir. 1933); *Exchange Nat'l Bank v. Meikle*, 61 F.2d 176 (9th Cir. 1932); *New York Trust Co. v. Island Oil & Transp. Corp.*, 56 F.2d 580 (2d Cir. 1932); *Jackson v. M.H. Thomas Inv. Co.*, 46 F.2d 252 (5th Cir. 1931); *Hamilton Ridge Lumber Sales Co. v. Wilson*, 25 F.2d 592 (4th Cir. 1928); *In re* Eilers Music House, 270 F. 915 (9th Cir.), *cert. denied*, 257 U.S. 613 (1921).

Administrative impracticability: See *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966). The court affirmed a substantive consolidation on the basis of the administrative difficulty of separating the estates of the bankrupt affiliates. See text accompanying notes 55-62 *supra*. Nevertheless, in his concurring opinion, Judge Friendly noted that an "approximation" of each affiliate's assets was possible. Such approximations were contained in the preliminary financial statements of the various affiliates, which showed that Seatrade Corporation, Chemical Bank's debtor, was substantially indebted to the other affiliates. Note, *supra* note 8, at 971. Since Seatrade had thus benefited from the intra-enterprise transactions, Chemical Bank would have had no standing to oppose the motion for substantive consolidation under the flow-of-assets approach.

64. See text accompanying notes 27-42 *supra*.

have no power over the past flow of assets, it appears as if the flow constitutes a common denominator unifying what otherwise would appear to be an ad hoc use of reliance.

*Anaconda Building Materials Co. v. Newland*⁶⁵ best illustrates how the flow-of-assets approach would work. The case involved a parent corporation and four wholly owned subsidiaries, all of which were operated as one enterprise. The parent was in the business of selling prefabricated homes, and the subsidiaries were formed to take mortgages on the homes using funds raised by the sale of their debenture bonds to the public. Upon insolvency, creditors of the parent moved that the assets of all of the affiliates be consolidated and shared pro rata by all of the creditors. Since the subsidiaries were healthier than the parent, the debenture holders objected.

The court's decision not to consolidate focused primarily on which group of creditors had benefited from the flow of assets.⁶⁶ Since the asset flow among the affiliates demonstrated a net indebtedness of the parent to the subsidiaries, Judge Hamley emphasized that the creditors of the parent occasionally had benefited from the use of money of the subsidiaries.⁶⁷ Conversely, he noted that the subsidiaries' debenture creditors had not been "unjustly enriched at the expense of the [parent's] creditors."⁶⁸ His analysis of the relative equities between the two sets of creditors, based on the extent to which they were harmed or benefited by the flow of assets, provides a well-reasoned and fair result. This approach may be more evenly and objectively administered than the use of reliance, and consequently it invites less manipulation of the facts.

III

APPLYING A FLOW-OF-ASSETS APPROACH

A. *The Threshold Standard for Consolidation*

Stated generally, the equitable remedy of substantive consolidation should be used only upon a showing that the corporate form has been abused to such an extent that creditors are unable to reach the

65. 336 F.2d 625 (9th Cir. 1964).

66. There are still isolated references to reliance in the opinion. The predominate focus, however, is on the flow of assets. *Id.* at 627.

67. *Id.*

68. *Id.* at 628. An analysis of the flow of assets is also suggested by the court in *In re Continental Vending Mach. Corp.*, 517 F.2d 997 (2d Cir. 1975), *cert. denied*, 424 U.S. 913 (1976), in which a decision to prohibit secured creditors from benefiting from a consolidation is supported with the observation that "there is no evidence in the record that there were any intercompany transfers to the detriment of secured creditors" *Id.* at 999.

transferred assets of the debtor affiliate through methods of creditor protection available under traditional corporate law. If the affiliated corporations have in fact operated as separate entities, the creditors need not be protected through consolidation. Any net deficit from the interaffiliate transfers will probably result in provable debts reachable by the trustee in bankruptcy. Moreover, to order consolidation simply because there has been a net flow of assets between the affiliated corporations would be to disregard the legislative directive allowing affiliates to incorporate separately.

If, however, the intra-enterprise relationship is complex and results in transfers between affiliates that are difficult to appraise, substantive consolidation may be the sole remedy realistically available to the harmed creditor. Any claim against the bankrupt intra-enterprise debtor would probably be subordinated under the *Deep Rock* doctrine.⁶⁹ In addition, any attempt to use the fraudulent conveyance law⁷⁰ to protect against uncompensated transfers would probably fail owing to difficult problems of proof.⁷¹

Recognition of a need to prove a threshold level of disregard of affiliate separateness before piercing the veil is simply an extension of the *Kheel* holding that affiliates should be consolidated whenever their affairs cannot be disentangled. Defining the threshold in terms of alternative methods of creditor protection, however, may incline the courts to assess the appropriateness of substantive consolidation in a manner more meaningful to the parties involved in the litigation.

B. *Standing to Move for Consolidation*

It will not always be in the best interests of a "harmed" affiliate's creditor to consolidate, because consolidation may present disadvantages to the creditor even while it enlarges the pool of reachable assets. An example is the shareholder's derivative action for mismanagement against the responsible officers and directors.⁷² Upon bankruptcy, this cause of action passes to the trustee.⁷³ If the creditors and innocent minority shareholders of the harmed affiliate are ever to benefit from an eventual recovery, it is essential that the estate of the bankrupt be kept separate from the rest of the enterprise. Consequently, the de-

69. See notes 76-78 *infra* and accompanying text.

70. See Bankruptcy Act § 67(d)(2), 11 U.S.C. § 107 (1970).

71. A net flow of assets from one affiliate to another may be accomplished by hundreds or even thousands of isolated transactions. When a significant transfer of assets is visible only when the transactions are summed, the burden of proving that each transaction lacked "fair consideration" would likely prove insurmountable. See generally Landers I, *supra* note 12, at 648-49.

72. See note 19 *supra*.

73. See *Vincel v. White Motors Corp.*, 521 F.2d 1113 (2d Cir. 1975).

cision to move for consolidation must rest ultimately with the harmed parties. The courts, therefore, should require proof that the moving party was harmed by a net deficit in intra-enterprise transactions before granting the motion.

*In re Flora Mir Candy Corp.*⁷⁴ is illustrative. In this case the harmed creditors opposed a consolidation that would have deprived them of most of the benefit of a pending suit for mismanagement. Although the controversy was decided in their favor on reliance grounds,⁷⁵ it could have been more simply resolved by holding that the unharmed creditors lacked standing to move for consolidation.

Conversely, when the creditor of a harmed affiliate has made the requisite proof, the motion to consolidate always should be granted since related bankruptcy law doctrines may increase the need for the remedy provided by substantive consolidation. Specifically, under the *Deep Rock* doctrine⁷⁶ interaffiliate claims are subordinated to those of outside creditors if the dominant affiliate has abused the separate status of the other affiliates.⁷⁷ Without consolidation the creditors of the weak affiliate may be damaged twice when a quantifiable debt has been created by a net transfer of assets. They are harmed, first, from the intra-enterprise transactions that weakened their debtor, and second, by the subordination of the debtor's claim against the "benefited" affiliate.⁷⁸

The existence of *Deep Rock* problems, pending lawsuits, or any number of other factors may mitigate in favor of either consolidating or maintaining separateness. The final decision must rest on factors unique to each case. Thus, the courts should defer to the harmed creditors regarding the most beneficial approach.⁷⁹

C. Postconsolidation Equities

Despite its apparent rigidity in objectively predicting when substantive consolidation is appropriate, the flow-of-assets formula does

74. 432 F.2d 1060 (2d Cir. 1970).

75. *Id.* at 1062-63.

76. This doctrine derives its name from the bankrupt in the leading case on the topic, *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939). See generally Krottinger, *The "Deep Rock" Doctrine: A Realistic Approach to Parent-Subsidiary Law*, 42 COLUM. L. REV. 1124 (1942).

77. Under section 4-406(a)(2) of the proposed Bankruptcy Act, H.R. 31, 94th Cong., 1st Sess. (1975), the *Deep Rock* doctrine is codified and extended to subordinate the claims of any affiliate, regardless of whether abuse of the corporate form has been shown. If this Act is adopted, the need for a flow-of-assets approach to substantive consolidation will be even more acute.

78. See Landers I, *supra* note 12, at 629.

79. In *Flora Mir* Judge Friendly suggested this approach by responding to the suggestion that the harmed creditors would actually be better off due to the consolidation with the retort, "They do not think so." 432 F.2d at 1063.

not preclude flexibility in determining how to distribute the assets to prevent windfall gains to some creditors. Once the estates are consolidated, the bankruptcy court may evaluate the relative equities of the creditors and distribute the assets accordingly.⁸⁰

The case law supports such a postconsolidation consideration of equities. The leading decision, *Sampsell v. Imperial Paper Corp.*,⁸¹ involved a man who fraudulently transferred personal assets to his wholly owned corporation. In a subsequent bankruptcy proceeding the trustee of the estate moved for and received an order consolidating the assets of both the individual and his corporation. Imperial Paper, a creditor of the corporation, but not a party to the original proceeding,⁸² later filed a claim for priority in the distribution of the funds received from the corporation's liquidation. The Supreme Court, per Justice Douglas, recognized the power of the bankruptcy court to give postconsolidation priorities, but held that Imperial had not satisfied the necessary burden of proof:

The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete. . . . But the theme of the Bankruptcy Act is equality of distribution. . . . To bring himself outside of that rule an unsecured creditor carries a burden of showing by clear and convincing evidence that its application to his case so as to deny him priority would work an injustice.⁸³

A creditor who seeks to maintain priority after consolidation will rarely meet this heavy burden of proof, for this same creditor has probably benefited from the intra-enterprise transactions. This hypothesis is borne out in the case law. Before *Sampsell*, courts frequently gave creditors of the stronger affiliate priority after consolidation.⁸⁴ After the decision, however, consolidated assets have almost always been distributed among creditors *in pari passu*.⁸⁵ Nevertheless, the possibility of priority distribution to deserving creditors adds necessary flexibility to a decision to consolidate and recognizes that a bankruptcy court is a court of equity.

80. See *Pepper v. Litton*, 308 U.S. 295 (1939).

81. 313 U.S. 215 (1941).

82. A creditor whose claim would be affected by a consolidation must be given an opportunity for a hearing before the consolidation can alter its rights. See *Seligson & Mandell*, *supra* note 8, at 348.

83. 313 U.S. at 219.

84. See *Commerce Trust Co. v. Woodbury*, 77 F.2d 478 (8th Cir.), *cert. denied*, 296 U.S. 614 (1935); *Jackson v. M.H. Thomas Inv. Co.*, 46 F.2d 252 (5th Cir. 1931); *In re Eilers Music House*, 270 F. 915 (9th Cir. 1921).

85. See *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *In re Associated Gas & Elec. Co.*, 149 F.2d 996 (2d Cir.), *cert. denied*, 326 U.S. 736 (1945); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), *cert. denied*, 317 U.S. 635 (1942).

D. Recurrent Problems: Priorities and Floating Liens

At times, a possible windfall to creditors of the harmed corporation has caused unjustifiable judicial reluctance to order substantive consolidation. The windfall factor should not pose a problem when only general creditors are involved in the litigation, because each would receive a proportionate share of the consolidated assets. In this case consolidation merely redistributes the benefits from the intra-enterprise transaction in an equitable manner. When priority creditors⁸⁶ or creditors holding "floating liens"⁸⁷ on an affiliate's assets are involved, however, the situation ostensibly is different. Consolidation may extend a priority creditor's lien over the entire enterprise to give that creditor a disproportionate share of the total assets.

1. Statutory Priorities

The problem of statutory priorities was encountered in *Kheel*, where the consolidation was originally proposed by the government, which held a priority tax lien against one of the affiliates. In a critical dictum Judge Friendly noted that "the argument for equality has a specially hollow ring when made by [a creditor] whose priority over other creditors will necessarily be enhanced by having the assets of all these corporations thrown into hotchpot."⁸⁸ The affiliates were nevertheless consolidated. The court therefore must have implicitly recognized that notions of equality should not be a factor, since priorities inherently treat creditors unequally.

Statutory priorities represent the judgment of the legislature that upon liquidation of a bankrupt estate, certain creditors should be paid first. Any resulting inequality among creditors can be justified by the broader social purpose that the priority is intended to serve. Accordingly, if a court is convinced that a group of affiliates has been operated as a consolidated enterprise, there is no reason not to extend the statutory priority over all of them. Any inequities that result derive from the concept of priorities itself, rather than from the consolidation.⁸⁹

86. Under section 64 of the Bankruptcy Act, 11 U.S.C. § 104 (1970), the following kinds of debts are given priorities: (1) costs of administration of the bankrupt's estate; (2) wages and commissions; (3) costs of creditors in successfully opposing the confirmation of the bankrupt's arrangement or wage earner's plan; (4) taxes; and (5) other statutory priorities.

87. The Uniform Commercial Code validates the use of "floating liens" in financing transactions. U.C.C. §§ 9-204 to -205. The widespread use of this security device indicates that this issue will arise frequently.

88. 369 F.2d at 848.

89. See generally *id.*; *Hollander v. Henry*, 186 F.2d 582 (2d Cir.), *cert. denied*, 341 U.S. 949 (1951).

2. Floating Liens

Floating liens create a much greater difficulty because of their consensual origin.⁹⁰ Consolidation would extend the creditor's lien over the entire enterprise, whereas the lien creditor originally contracted with an affiliate whose collateral certainly did not include the entire assets of the consolidated estates. This problem is suggested by the facts of *In re Continental Vending Machine Corp.*⁹¹ Continental Vending Machine Corporation (Continental) and its wholly owned subsidiary, Continental Apco, Inc. (Apco), each entered into a financing agreement with James Talcott, Inc. (Talcott), a factor. Under the contract Talcott would finance each corporation in exchange for Continental's "mortgages and other security devices" and Apco's "accounts receivable, chattel security devices and various other liens."⁹² Talcott also took a "floating" lien⁹³ from each affiliate that gave Talcott an interest in all existing and after-acquired property.⁹⁴ Although Talcott was obviously well secured, its agreement failed to include a cross-collateralization clause in the two contracts. Thus, each affiliate's debt was secured only to the extent of its assets.

Upon the bankruptcy of both Continental and Apco, the liquidation of Talcott's liens left a surplus in the Apco account and a deficit in the Continental account. After the liquidation of the Talcott liens, Continental's trustee moved for a substantive consolidation.⁹⁵ The motion

90. The distinction between consensual and statutory liens in substantive consolidations is recognized. *E.g.*, *In re Continental Vending Mach. Corp.*, 517 F.2d 997, 1001 (2d Cir. 1975), *cert. denied*, 424 U.S. 913 (1976).

91. *Id.*

92. *Id.* at 1002.

93. The relevant clause read:

You [Talcott] shall be entitled to hold all sums and all property of the undersigned, at any time to its credit or in your possession or upon or in which you may have a lien or security interest, as security for any and all obligations of the undersigned at any time owing to you and/or to any company which may now or hereafter be your subsidiary, no matter how or when arising and under this or any agreement or otherwise, and including all obligations for purchases made by the undersigned from any other concern factored by you or such subsidiary.

Id.

94. Prior litigation between the parties interpreted the lien to give Talcott "a right to hold 'all property' of Continental in which Talcott might have or obtain a security interest, as security for any and all obligations of [Continental] at any time owing to [Talcott]." *In re Continental Vending Mach. Corp.*, 491 F.2d 813, 820 (2d Cir. 1974).

95. Judge Anderson, in a spirited dissent, raises an interesting point regarding the timing of the trustee's motion for consolidation. If the consolidation had taken place *before* the liquidation of Talcott's collateral, the Apco and Continental liens would have merged to cover the assets of the entire enterprise, and no surplus would have existed until the entire Talcott claim had been satisfied. Since Talcott was not responsible for the timing of the motion for consolidation, it appears inequitable that its rights should be diminished by the delay. 517 F.2d at 1005.

was granted but with the proviso that the consolidation not be used to improve the claim of any secured creditor. Talcott, which had hoped to apply its Apco lien to the Continental deficit, appealed.

The court of appeals upheld the bar to Talcott's participation in the consolidation as a secured creditor on the ground that Talcott had obtained "exactly what it bargained for: secured creditor status to the extent that its collateral was adequate."⁹⁶ This argument, however, overlooks that Talcott, with its floating lien, had relied on *specific* collateral no more than had the general creditors. All had relied on the entire assets of their debtor. Thus, Talcott's reliance on separateness weakly distinguishes Talcott from the general creditors who were permitted to improve their claims through consolidation.⁹⁷

Although the opinion is arguably correct in a technical sense,⁹⁸ it was probably influenced by an understandable fear that if the lien were recognized, the general creditors would receive nothing.⁹⁹ A more principled approach to the problem would recognize that even a lienholder creditor of the harmed affiliate suffers from the transfer of assets¹⁰⁰ and, at least in principle, deserves to have the benefits of the transactions equalized through consolidation.

Consideration of the lienholders' equities, such as the possibility of a windfall, should be postponed until after consolidation, at which time opposing parties may invoke *Sampsel* and argue that extending the lien would constitute an injustice to them.¹⁰¹ In determining the appropriate scope of the lien, the postconsolidation court's inquiry should be governed by ordinary contract principles. It should determine how much security was in fact bargained for, given that neither party intended the lien to cover the assets of the entire enterprise. The result would be equitable to all creditors and compatible with the principles of substantive consolidation.

CONCLUSION

The need to accommodate the conflicting claims of opposing sets of creditors to the assets of a bankrupt enterprise marks the difference

96. *Id.* at 1002.

97. Judge Anderson noted this point in his dissent: "Even though Talcott may have dealt separately with each debtor and relied on the assets of each for its protection . . . the same can be said for probably most, if not all, of the unsecured creditors." *Id.* at 1005.

98. Under U.C.C. § 9-205, a debtor is entitled to complete freedom of disposition of collateral. This section applies notwithstanding the existence of a floating lien.

99. Talcott's unsatisfied claim against Continental totaled \$820,000, while the surplus in Apco was only \$380,000. 517 F.2d at 999.

100. 517 F.2d at 1005 (Anderson, J., dissenting).

101. The party seeking to be given priority status, however, would have the burden of proof. See text accompanying notes 80-85 *supra*.

between substantive consolidation cases and standard alter ego controversies. Concepts of reliance, borrowed from cases in which only shareholder limited liability is at stake, cannot equitably resolve a dispute between two sets of relying creditors: to heed one creditor's claim of reliance on corporate separateness is to ignore another's claim of reliance on enterprise integration. Substantive consolidation procedures should recognize that the insolvent debtor is no longer interested in the distribution of its assets and that, consequently, its role in the prior transfer is irrelevant.

This Comment has proposed that the use of any form of reliance to determine the appropriateness of substantive consolidation be discarded in favor of an approach that examines the net flow of assets between the various affiliates of the bankrupt enterprise. After a threshold determination that the creditors of a harmed affiliate are unable to protect themselves by traditional methods of creditor protection and upon a subsequent showing that the affiliate has suffered net losses from these intra-enterprise transfers, the harmed creditors should have standing to move for consolidation of the bankrupt enterprise. This enables them to escape the double harm otherwise resulting from the *Deep Rock* subordination of their debtor's intra-enterprise claims. In most instances it will be to a harmed creditor's advantage to consolidate. If it is not beneficial, however, the procedure should not be ordered; each creditor should be left to satisfy itself from the assets of its own debtor. Less susceptible to manipulation than the reliance norm and more helpful than a standard based on administrative impracticality, the proposed approach, if adopted, would provide not only fairer results, but also a simpler and more predictable method of determining when substantive consolidation is appropriate.

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