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The ABC's of Substantive Consolidation, Part II

By John B. Berringer and Dennis Artese

Part one of this two-part series discussed the equitable remedy of substantive consolidation and its availability in bankruptcy. As explained in part one, orders of substantive consolidation combine the assets and liabilities of separate and distinct, but related, legal entities into a single pool from which all claims against the consolidated debtors are satisfied. The merged companies' intercompany claims are extinguished and the creditors of the consolidated entities are combined for purposes of voting on plans of reorganization. It was concluded that, although creditors on the losing side of substantive consolidation are likely to continue to oppose the courts' power to grant such a remedy, the great weight of authority currently supports the proponents of substantive consolidation. With the understanding that orders of substantive consolidation potentially are available to debtors and creditors alike, we now focus on the legal standards, burdens and key factors courts apply in determining whether an order of substantive consolidation is proper in a given bankruptcy case.

The Standards, Burdens and Factors Courts Apply

Two similar tests have emerged to determine whether to substantively consolidate two or more related entities.

The first is a three-part burden-shifting test announced in *Auto-Train Corp. v. Midland-Ross Corp. (In re Auto-Train)*, 810 F.2d 270 (D.C. Cir. 1987). The *Auto-Train* test requires that the proponent of substantive consolidation show that (i) there

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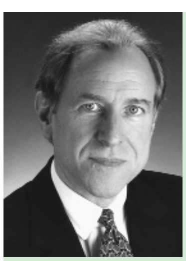
Howard D. Ressler

A Note from the Editor

The articles in this issue cover two areas of bankruptcy which have been receiving a great deal of attention lately. The first issue is substantive consolidation, which is discussed by John Berringer and Dennis Artese in the second part of an article that was published in the Winter edition of our newsletter. As pointed out then, substantive consolidation has been one of the most hotly contested issues in cases such as Enron, Worldcom, Kmart and Owens Corning. Our other article deals with the recent decision of the Seventh Circuit in the Kmart case and its likely impact on the future availability of critical vendor orders in bankruptcy. If you have any questions about the issues in either article, we encourage you to contact either the authors or one of our editors.

Attention Kmart Shoppers: We May Be Running Out of Critical Vendor Orders!

By Howard D. Ressler and Ely M. Kronenberg

The recent decision of the Seventh Circuit Court of Appeals in *In re Kmart Corp.*, 359 F.2d 866 (7th Cir. 2004), has stirred a debate about the availability of critical vendor payments in Chapter 11 cases.

What are Critical Vendor Payments?

In many Chapter 11 cases involving operating businesses, the standard array of first day motions includes a request to pay pre-petition obligations to some vendors. These "critical vendor motions" allege that (i) certain suppliers or service providers are critical to the debtor's ongoing business operations and (ii) these "critical vendors" will sever their business relationship with the debtor if their pre-petition claims are not paid in full. Debtors argue that the loss of such critical vendors will place the reorganization in jeopardy to the detriment of all creditors. Confronting such allegations, bankruptcy courts, especially in large corporate bankruptcy cases, have routinely authorized immediate payment of pre-petition obligations, even though they run afoul of several fundamental bankruptcy principles. In approving these critical vendor payments, bankruptcy courts rely on (i) the bankruptcy court's equitable powers under section 105(a) of the Bankruptcy Code, (ii) the doctrine of necessity, or both.

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The Decision of the Seventh Circuit in Kmart

The bankruptcy court in Kmart entered a critical vendor order, notwithstanding the debtor's failure to (i) give notice to disfavored creditors, (ii) identify the critical vendors that would be the beneficiaries of the order, or (iii) offer any supporting evidence. Pursuant to this order, the debtor paid approximately $300 million in pre-petition claims to 2,330 vendors. Ultimately, other unsecured creditors received only about 10¢ on the dollar, mostly in the form of stock in the reorganized Kmart. On appeal, the District Court reversed the bankruptcy court's order.

Recently, the Seventh Circuit affirmed the decision of the District Court, expressly rejecting the argument that the bankruptcy court's equitable powers under section 105(a) of the Bankruptcy Code can be used to authorize payment of pre-petition claims to critical vendors and further holding that the doctrine of necessity does not provide an independent basis to authorize such payments. Although the Seventh Circuit considered the possibility that critical vendor payments might be authorized under section 363(b)(1) of the Bankruptcy Code, it found that the evidentiary record in *Kmart* did not warrant such relief. Section 363(b)(1) provides that "[t]he trustee [or Debtor-in-Possession], after notice and hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate." According to the Seventh Circuit, since payment of pre-petition claims to critical vendors is a use of debtor's property other than in the ordinary course, 363(b)(1) might provide a statutory basis to allow such payments. However, the Court did not decide whether 363(b)(1) could provide authority to pay these pre-petition claims because the critical vendor order in *Kmart* was not supportable, regardless of how one were to interpret section 363(b)(1).

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is substantial identity between the entities to be consolidated; and (ii) consolidation is necessary to avoid some harm or to realize some benefit. Once this *prima facie* case is made, a presumption arises that creditors have not relied solely on the credit of one of the entities involved. The burden then shifts to an objecting creditor to show that (i) it has relied on the separate creditworthiness of one of the entities to be consolidated; and (ii) it will be prejudiced by substantive consolidation. Finally, if an objecting creditor sustains its burden, the court may order consolidation only if it determines that the demonstrated benefits of consolidation heavily outweigh the harm. *See Eastgroup Prop. v. Southern Motel Ass'n*, 935 F.2d 245, 249 (11th Cir. 1991).

Courts have articulated several non-determinative factors to be considered in determining whether a proponent of substantive consolidation has established a *prima facie* case. These factors include: (i) the presence or absence of consolidated financial statements; (ii) the unity of interests and ownership between various corporate entities; (iii) the existence of parent and inter-company loan guarantees; (iv) the degree of difficulty in separating and ascertaining individual assets and liabilities; (v) the existence of transfers of assets without formal observance of corporate formalities; (vi) the commingling of assets and business functions; and (vii) the profitability of consolidation at a single physical location. *See Bonham v. Compton (In re Bonham)*, 229 F.3d 750, 766 n.11 (9th Cir. 2000).

The second test, adopted by the Second Circuit in *Augie/Restivo Baking Co. v. Augie/Restivo Baking Co. (In re Augie/Restivo)*, 860 F.2d 515 (2d Cir. 1988), requires consideration of two independent factors: (i) whether the creditors of consolidated entities treated the entities as a single economic unit and did not rely on their separate creditworthiness in extending credit; or (ii) whether the business affairs of the consolidated entities were so hopelessly entangled that substantive consolidation would benefit all creditors. *See, e.g., In re Augie/Restivo*, 860 F.2d at 518. Substantive consolidation is proper under this test where either factor is present.

The first factor is based on the concept that, in structuring its loans, a lender typically does not anticipate having access to the assets of some other entity in the event that its borrower becomes insolvent. Nor does a lender expect to compete for its borrower's assets with a creditor of a less reliable debtor. *See id*. at 518-19. Consolidation under the second factor involves the commingling of two entities' assets and business functions. It should be used, however, "only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets." *Id*. at 519.

In keeping with its equitable nature, many courts warn that substantive consolidation should be used "sparingly" because of its potential for unfair treatment of creditors that dealt solely with a particular debtor without knowledge of that debtor's interrelationship with others. *Flora Mir Candy Corp. v. R.S. Dickson & Co. (In re Flora Mir Candy Corp.)*, 432 F.2d 1060, 1062-63 (2d Cir. 1970). Nevertheless, even those courts which heed this warning do not pause to issue orders of substantive consolidation where the circumstances of a particular bankruptcy case warrant such a finding in accordance with the above-mentioned factors.

For instance, in *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 218-19 (1941), the United States Supreme Court approved the substantive consolidation of two estates where a debtor had abused corporate formalities and was alleged to have conveyed the debtor shareholder's assets to the related corporation in fraud of creditors. Applying the Second Circuit's test annunciated in *Augie/Restivo*, the Ninth

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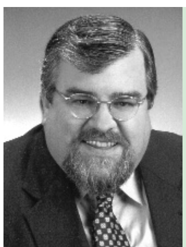

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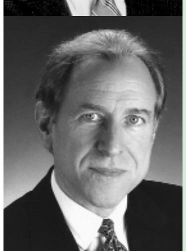

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Status of Critical Vendor Payments in the Future

While the *Kmart* case is not binding on bankruptcy courts outside of the Seventh Circuit, the decision may nevertheless have a significant impact on bankruptcy courts in other jurisdictions. In the future, a debtor may need to demonstrate, and not merely allege, that its "critical vendors" will refuse to deliver goods unless their pre-petition claims are paid in full. This may be difficult, since the debtor will have to show that the vendor is prepared to act against its own economic interest. It goes without saying that, if a vendor has the ability to sell to the debtor post-petition at a competitive rate, the vendor should be less inclined to sever its business relationship with the debtor. Further, the debtor will have to show that allowing critical vendor payments will be in the best interests of all creditors. In a case such as *Kmart*, where a debtor relies on numerous vendors for numerous products, proving that the remaining creditors are better off—or at least as well off—as they would have been had the critical vendor payments not been made, would require a complex economic analysis.

On the other hand, one must assume that vendors will assert whatever leverage is available to insist that a debtor provide some preferential treatment. In light of the *Kmart* decision, however, vendors who have become accustomed to the benefits of critical vendor status should not be surprised if a debtor reverts to offering alternative benefits, such as cash in advance or cash on delivery.

Obviously, the debtor's business, the circumstances surrounding the bankruptcy and other factors will dictate whether a debtor can successfully obtain a critical vendor order. The Seventh Circuit, however, has signaled that the days when debtors could merely allege, as opposed to prove, the necessary elements of a critical vendor motion may be over. ■

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Circuit affirmed the bankruptcy court's order of substantive consolidation, noting that two non-debtor corporations "were but instrumentalities of the bankrupt with no separate existence of their own." *In re Bonham*, 229 F.3d at 766-67. Similarly, in *Giller v. Giller (In re Giller)*, 962 F.2d 796 (8th Cir. 1992), the Eight Circuit affirmed an order substantively consolidating six corporate debtors where their sole or majority shareholder ignored corporate form and fraudulently transferred assets. In *Eastgroup Prop.*, 935 F.2d at 250, the Eleventh Circuit consolidated two debtors where, among other things, the debtors were commonly owned. They shared employees and facilities; funds were transferred between them; one debtor paid unsecured debts of the other; and, absent substantive consolidation, equity interest holders would have received a substantial distribution while a majority of creditors would have received only a small portion of their claims.

Conclusion

Although different tests have emerged to determine whether substantive consolidation is proper in a given bankruptcy case, two common themes can be identified. Courts will focus on the degree to which two or more entities are interrelated (*i.e.*, substantial identity) and the reasonable expectations of the creditor at the time it extended credit (*i.e.*, reliance on the separate credit of one entity). These themes will be evaluated in an equitable context and courts will be mindful of the effect that substantive consolidation will have on the bankruptcy estate and its creditors. ■

Upcoming Events

September 9, 2004

Due to the overwhelmingly favorable response to our "Keeping the Horse in the Barn: Critical Junctures in Bankruptcy" seminar, we are pleased to announce that we will repeat the program at the Harvard Club, New York City, on September 9, 2004, from 12 noon to 2 p.m. The speakers include **Larry Henin**, **Andrea J. Pincus**, **J. Andrew Rahl, Jr.**, **Howard D. Ressler**, **Mark D. Silverschotz** and **Michael J. Venditto**. The program will include a "role-playing discussion" of "First Day" issues in the hypothetical case of "All Washed Up, Inc.," which is certain to generate more lively debate among the panelists playing the roles of counsel to the Debtor, the bondholders/unsecured creditors and secured lenders. To reserve a seat, please register on line at www.andersonkill.com or contact Michele Elie by telephone (212-278-1318) or e-mail (melie@andersonkill.com). As always, CLE credits and lunch are free. We hope to see you there.

September 21, 2004

Michael J. Venditto and **Mark D. Silverschotz** will speak on Chapter 11 Issues—Plan, Confirmation, and Post-Confirmation Issues on Tuesday, September 21, 2004, at 3:00 p.m. at the National Association of Attorneys General annual seminar on Bankruptcy from a Government Perspective to be held on September 19-22, 2004, at the Hotel Washington in Washington. For more information, please visit our website at www.andersonkill.com.

November 29-30, 2004

J. Andrew Rahl, Jr. again will co-chair and speak at the Distressed Investing 2004 Conference sponsored by Renaissance American Management & Beard Group. Andy also will host a wine tasting event at the conference on Monday evening, November 29, 2004, at The Plaza Hotel in New York City. For more information, please contact ahenderson@renaissanceamerican.com, call (800) 726-2524 or visit http://www.renaissanceamerican.com.

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We hope you have found this issue of the Bankrupcy & Restructuring Advisor informative. We invite you to contact the department Chair or the Editors, listed below, with your questions and/or concerns.

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