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Know Your Limits: An Approach for Rejecting Substantive Consolidation of Nondebtors

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In *In re Concepts America*, the U.S. Bankruptcy Court for the Northern District of Illinois rejected a plaintiff/trustee's attempt to substantively consolidate a corporate chapter 7 debtor with seven nondebtor entities as a matter of law.[1] Although the court briefly noted in *dicta* that the plaintiff likely did not provide enough facts to justify substantive consolidation, the court dismissed the complaint for a more glaring reason: Nondebtor substantive consolidation is likely not an available remedy in the Seventh Circuit.[2]

The court arrived at this conclusion for two reasons: (1) No precedent exists in the Seventh Circuit permitting substantive consolidation of nondebtors; and (2) the Seventh Circuit takes a narrow view of bankruptcy courts' equitable powers under § 105 of the Bankruptcy Code.[3] While the holding of this case is significant, it should not come as a surprise, for even a cursory survey of Seventh Circuit precedent reveals a common theme: a narrow view of bankruptcy courts as "courts of equity" as that relates to their authority under § 105(a).[4]

Functions and Controversy

Substantive consolidation "permits a bankrupt entity, perceived to be part of a different, larger ... more solvent entity, to be combined with the solvent entity so that the assets of both are available to both entities' creditors."[5] Substantive consolidation generally results in "pooling the assets of, and claims against, the ... entities; satisfying liabilities from the resultant common fund; eliminating intercompany claims; and combining the creditors of the two companies for purposes of voting on reorganization plans."[6]

Only two Code provisions address the concept of consolidation: (1) 11 U.S.C. § 302, which pertains to estates of spouses; and (2) 11 U.S.C. § 1123(a)(5)(C), which permits consolidation only in the context of a confirmed reorganization plan. However, substantive consolidation has been used with increasing frequency by trustees in order to pool the assets of operating *nondebtors* into the estate of a chapter 7 *debtor*. Without an express origin for such an application of substantive consolidation in the Bankruptcy Code, trustees rely on the equitable reach of 11 U.S.C. § 105(a) in seeking such a remedy.

As the Second Circuit has stated: "The power to consolidate is one arising out of equity, enabling a bankruptcy court to disregard separate corporate entities, to pierce their corporate veils ... to reach assets for the satisfaction of debts of a related corporation."[7] While the standard varies by circuit, all courts seem to engage in a fact-intensive analysis, with the overriding equitable consideration being whether "consolidation will benefit all creditors, both those of the current debtors and those to be forcibly made debtors."[8] In addition, to substantively consolidate nondebtors, most courts require that the facts must demonstrate fraud or disregard of the corporate form among several entities, similar to a state law alter-ego analysis.[9]

While substantive consolidation of two *debtors* is a generally accepted practice, the question of whether a bankruptcy court can direct the substantive consolidation of *nondebtor third parties* with a debtor already in bankruptcy has generated a great deal of controversy in recent years. A split in authority has emerged over the use of substantive consolidation of nondebtors. To date, each circuit court that has considered the issue — the Second, Third, Sixth, Eighth, Ninth and Tenth Circuits — has recognized a bankruptcy court's authority to impose the remedy.[10] Courts allowing substantive

1 *Audette v. Kasemir (In re Concepts Am.)*, No. 14 B 34232, 2018 WL 2085615, at *6 (Bankr. N.D. Ill. May 3, 2018).
2 *Id.* at *6 ("[W]ere [the Seventh Circuit] presented with the question, [it] would not allow substantive consolidation of a bankruptcy debtor with entities that are not under the protection of the Bankruptcy Code.").
3 *Id.* at *4 ("[The Seventh] Circuit has shown a distinct lack of enthusiasm for a bankruptcy court's use of 11 U.S.C. § 105 and for creating rights based entirely on considerations of equity.") (citations omitted).
4 *See, e.g., Matter of Lapiana*, 909 F.2d 221, 223-24 (7th Cir. 1990) (stating that bankruptcy process is not "a flight of redistributive fancy or a grant of free-wheeling discretion such as the medieval chancellors enjoyed," and noting that Seventh Circuit "deprecate[s] flaccid invocations of 'equity' in bankruptcy proceedings").
5 Samuel R. Maizel and Arnold M. Quittner, "Substantive Consolidation of Debtors and Non-Debtors in Bankruptcy Proceedings," *Norton Annual Survey of Bankr. L.*, Westlaw, 2002 Ann. Surv. of Bankr. Law 4.
6 *Union Savs. Bank v. Augie/Restivo Baking Co. Ltd. (In re Augie/Restivo Baking Co. Ltd.)*, 860 F.2d 515, 518 (2d Cir. 1988).
7 *James Talcott Inc. v. Wharton (In re Cont'l Vending Mach. Corp.)*, 517 F.2d 997, 1000 (2d Cir. 1975).
8 *SE Prop. Holdings LLC v. Stewart (In re Stewart)*, 571 B.R. 460, 470 (Bankr. W.D. Okla. 2017).
9 *See, e.g., Simon v. New Ctr. Hosp. (In re New Ctr. Hosp.)*, 187 B.R. 560, 568-69 (E.D. Mich. 1995) (finding that debtors and nondebtor corporations were alter egos); *Bracaglia v. Manzo (In re United Stairs Corp.)*, 176 B.R. 359, 369-70 (Bankr. D.N.J. 1995) (holding that nondebtor might be consolidated with debtor where debtor used nondebtor entities as instrumentalities of fraud); *In re Baker & Getty Fin. Servs. Inc.*, 78 B.R. 139, 142 (Bankr. N.D. Ohio 1987) (consolidating two nondebtor individuals who formed Ponzi scheme).

consolidation of nondebtors generally base their decisions on the facts of their particular case and the breadth of the equitable reach of § 105(a).[11]

A minority of courts have held that nondebtor substantive consolidation is not permitted at all,[12] generally citing concerns of jurisdiction, due process or conflicts with the Bankruptcy Code for commencing an involuntary bankruptcy under § 303.[13] Most notably, courts rejecting the remedy have found that substantive consolidation of nondebtors goes beyond the Code's jurisdictional limitations[14] and have considered an action for substantive consolidation to be an end around the rigorous requirements of filing an involuntary petition pursuant to § 303 of the Bankruptcy Code.[15]

In re Concepts America: Substantive Consolidation Not Available

The debtor in *Concepts America* was a holding and management company for a group of restaurants that were owned, controlled and operated by a small ownership group.[16] The trustee alleged that the debtor and certain nondebtor entities failed to maintain corporate formalities, and that their affairs were so entangled and funds were so comingled that consolidation of the nondebtors with the debtor would benefit all creditors.[17] The defendants (mostly operating restaurants) moved to dismiss the substantive-consolidation claim under Rule 12(b)(6) of the Federal Rules of Civil Procedure, arguing that the trustee failed to state a claim because substantive consolidation of nondebtors is not a remedy available in the Seventh Circuit.

The bankruptcy court began its analysis by noting a split of authority over substantive consolidation of nondebtors,[18] and also stating that the Seventh Circuit (and every court within the Seventh Circuit) has yet to definitively weigh in on the issue.[19] Although no court within the Seventh Circuit had expressly ruled on the subject, the bankruptcy court pointed out that courts in the Seventh Circuit have approached the idea "cautiously."[20] Based on that precedent (or lack thereof), the court posed a rhetorical challenge: "Would the Seventh Circuit follow its sister Circuits and hold that the equitable remedy of substantive consolidation of nondebtors is permitted?"[21]

To answer this question, the court stated that in cases not involving substantive consolidation, the Seventh Circuit has shown "a distinct lack of enthusiasm for a bankruptcy court's use of 11 U.S.C. § 105 and for creating rights based entirely on considerations of equity."[22] Although the court noted that a recent Seventh Circuit panel "endorsed the exercise of a court's equitable powers when it serves one of the central objectives of the Bankruptcy Code" in *In re Caesars Entertainment Operating Co. Inc.*,[23] it ultimately concluded that *Caesars* was "an outlier in the universe of Seventh Circuit precedent concerning the use of equity in bankruptcy courts."[24] The bankruptcy court found the Seventh Circuit's opinion in *In re Kmart* — a rejection of the "doctrine of necessity" under § 105(a) as "just a fancy name for a power to depart from the Code"[25] — as "a more typical example" of the Seventh Circuit's narrow interpretation of § 105(a).[26]

For these reasons, the court held that "were it presented with the question, the Seventh Circuit would not allow substantive consolidation of a bankruptcy debtor with entities that are not under the protection of the Bankruptcy Code." The court therefore dismissed the trustee's substantive consolidation count.

Seventh Circuit Limitations on Bankruptcy Courts' Equitable Authority and Power

Although the bankruptcy court's holding is significant, it should not come as a surprise given the Seventh Circuit's "narrow view of a bankruptcy court's use of its equity powers."[27] This point is evident when one observes the Seventh Circuit's treatment of bankruptcy courts' equitable authority under § 105(a), and the court's tendency to deny relief based solely on equity.

For example, in *Matter of Lapiana*, the Seventh Circuit colorfully stated that the bankruptcy process is not "a flight of redistributive fancy or a grant of free-wheeling discretion such as the medieval chancellors enjoyed," further noting that the Seventh Circuit "deprecate[s] flaccid invocations of 'equity' in bankruptcy proceedings."[28] Similarly, the court has observed that § 105 "affords bankruptcy courts considerably less discretion than meets the eye, and in no sense constitutes a roving commission to do equity," but § 105(a) "is limited and cannot be used in a manner inconsistent with the commands of the Bankruptcy Code."[29] In *In re Chicago, Milwaukee, St. Paul & Pacific R.R.*, the Seventh Circuit stated that "[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be."[30]

Given this understanding of bankruptcy courts' authority, the Seventh Circuit and its courts have declined to use § 105(a) broadly[31] or grant certain forms of relief that are

10 *See Audette v. Kasemir (In re Concepts Am. Inc.)*, No. 14 B 34232, 2018 WL 2085615, at *4 (Bankr. N.D. Ill. May 3, 2018); *see also* Kara Bruce, "Non-Debtor Substantive Consolidation: A Remedy Built on Rock or Sand?," 37 *Bankr. L. Letter* No. 3, at 2 n.18 (listing courts that permitted nondebtor substantive consolidation).

11 *In re Harmon*, 512 B.R. 321 (Bankr. N.D. Ga. 2014) ("Surveying the cases, it is clear that the appropriateness of substantive consolidation is necessarily reliant on the equities of each case's particular facts, and the possibility that equity favors substantive consolidation of a debtor with its nondebtor counterpart is not precluded *per se*.").

12 *In re Pearlman*, 462 B.R. 849, 854 n.28 (Bankr. M.D. Fla. 2012) (listing cases declining to substantively consolidate debtors and nondebtors).

13 *See* Bruce, *supra* n.10 at 3 (discussing these concerns and citing cases).

14 *In re Horsley*, No. 99-30458 JAB, 2001 WL 1682013, at *7 (Bankr. D. Utah Aug. 17, 2001) ("As a court of limited jurisdiction, this Court only obtains jurisdiction over an entity by the filing of a petition, either voluntarily or involuntarily pursuant to 11 U.S.C. §§ 301 or 303.").

15 *See Pearlman*, 426 B.R. at 854-55 ("[A]llowing substantive consolidation of nondebtors under § 105(a) circumvents the stringent procedures and protections relating to involuntary bankruptcy cases imposed by § 303 of the Bankruptcy Code.").

16 No. 14 B 34232, 2018 WL 2085615, at *1-2 (Bankr. N.D. Ill. May 3, 2018).

17 *Id.* at *2.

18 *Id.* at *3-4.

19 *Id.* at *4.

20 *Id.* (citations omitted).

21 *Id.*

22 *Id.* (citing cases).

23 *Caesars Entm't Operating Co. Inc. v. BOKF NA (In re Caesars Entm't Operating Co. Inc.)*, 808 F.3d 1186 (7th Cir. 2015).

24 2018 WL 2085615, at *5.

25 359 F.3d 866, 871 (7th Cir. 2004).

26 2018 WL 2085615, at *5.

27 *In re Geneva ANHX IV LLC*, 496 B.R. 888, 901 (Bankr. C.D. Ill. 2013).

28 909 F.2d 221, 223-24 (7th Cir. 1990).

29 *Vill. of Rosemont v. Jaffe*, 482 F.3d 926, 935 (7th Cir. 2007) (quoting *Noonan v. Sec. of HHS (In re Ludlow Hosp. Soc. Inc.)*, 124 F.3d 22, 27 (1st Cir. 1997)).

30 791 F.2d 524, 528 (7th Cir. 1986). The Seventh Circuit has even banned the term "equitable mootness" from its "(local) lexicon." *In re UNR Indus.*, 20 F.3d 766, 769 (7th Cir. 1994).

31 *See, e.g., Disch v. Rasmussen*, 417 F.3d 769, 778 (reversing bankruptcy court's revocation of debtor's discharge under § 105); *Ross v. H&Q Life Sci. Invs. (In re Abtox Inc.)*, No. 00 A 00661, 2003 WL 23857206, at *2 (Bankr. N.D. Ill. March 5, 2003).

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available in other jurisdictions under that provision.[32] Most notably, in *In re Kmart Corp*., the court practically eliminated critical-vendor motions in the Seventh Circuit because of its limited application of § 105.[33] The court held that § 105(a) does not provide a bankruptcy court with the authority to authorize distributions outside the priority scheme: Section 105 "does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by § 105(a) is one to implement rather than override."[34]

Other recent decisions are also instructive, such as *In re Caesars Entertainment Operating Co. Inc*., wherein the court held that § 105 does not permit a court to disband a creditors' committee,[35] and *In re ShoreBank Corp*., wherein the court determined that § 105 does not provide a court with "an ability to 'review' the U.S. Trustee's committee appointments."[36] In both cases, the court departed from other jurisdictions that offered the same relief.

32 *See, e.g., Official Comm. of Unsecured Creditors v. NewKey Grp. LLC (In re SGK Ventures LLC)*, 521 B.R. 842, 861 (Bankr. N.D. Ill. 2014) (noting that unlike other circuits, "it is unlikely that the Seventh Circuit would find that the equitable power of a bankruptcy court allows treating a creditor's claim in a manner not stated in the Code") (citation omitted).

33 359 F.3d 866 (7th Cir. 2004).

34 *Id.* at 871.

35 526 B.R. 265, 269-70 (Bankr. N.D. Ill. 2015).

36 467 B.R. 156, 162-63 (Bankr. N.D. Ill. 2012). This case notes that other courts took this position, but found that the concerns are "no longer valid" because BAPCPA changed the applicable statute.

Conclusion

The bankruptcy court's analysis in *Concepts America* demonstrates that a creditor would be hard-pressed to convince a Seventh Circuit panel that § 105 or considerations of equity permit substantive consolidation of nondebtors. Although the bankruptcy court does not speak for the Seventh Circuit, its analysis indicates that unless the Bankruptcy Code or underlying state law[37] provides a basis for the relief, a party should treat the age-old adage that "bankruptcy courts are courts of equity" as the exception, not the rule.

In addition, *Concepts America* provides guidance for attorneys litigating a request for substantive consolidation of nondebtors pursuant to § 105(a). Practitioners should be aware of the circuit-level case law within their jurisdictions limiting or expanding the bankruptcy court's equitable powers under § 105(a) as a basis for analyzing of the parameters for the application of this extraordinary remedy.[38] abi

37 The U.S. Supreme Court has stated that the property interests of a debtor must be determined in accordance with state law, rather than "undefined considerations of equity." *Butner v. United States*, 440 U.S. 48, 56 (1979).

38 *See In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005) (calling substantive consolidation a "'rough justice' remedy [that] should be rare and, in any event, one of last resort after considering and rejecting other remedies").