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It Wasn't Me!: Dealing with Successor Liability, Alter Ego, Veil Piercing and Substantive Consolidation Issues with Respect to Insolvent Companies

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It Wasn't Me!!: Dealing with Successor Liability, Alter Ego, Veil Piercing and Substantive Consolidation Issues With Respect to Insolvent Companies

Alter Ego and Piercing the Corporate Veil

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I. ENTITY THEORY AND THE CORPORATE VEIL

The entity theory in corporations law holds that a corporation has a legal identity that is separate and distinguishable from the identities of its shareholders. *See Thomas Berkeley Consulting Engineer, Inc. v. Zerman*, 911 S.W.2d 692, 695 (Mo. App. 1995)("Ordinarily, a corporation is regarded as a wholly and separate legal entity, distinct from the members who compose it."); *Stamp v. Inamed Corp*., 777 F.Supp. 623, 626 (N.D. Ill. 1991)(referring to the entity theory as one of the "most important and pervasive principles underlying corporations law"). The creation of a separate legal identity is usually the principal reason that a business is incorporated. Incorporation helps to ensure that the business's owners are shielded from personal liability for the obligations of the corporation. As a result of the creation of a separate entity, a metaphorical "veil" is created between the corporation and its shareholders. When that veil is in place, a creditor cannot seek recovery from a shareholder for a corporation's legal obligations.

II. DISREGARDING THE CORPORATE VEIL BY PIERCING

The corporate veil is generally inviolable. It can be disregarded only in the "exceptional case" and "rare instances." *See, e.g., Winner Acceptance Corp. v. Return on Capital Corp*., 2008 WL 5352063, at *5 (Del. Ch. Dec. 23, 2008). Corporate separation should be "ignored with caution and only when the circumstances clearly justify it." *Doe 1631 v. Quest Diagnostics, Inc.*, 395 S.W.3d 8, 18 (Mo. banc. 2013)(quoting *Central Cooling & Supply Co. v. Director of Revenue, State of Mo*., 649 S.W.2d 546, 548 (Mo. banc. 1982). *see 66, Inc. v. Crestwood Commons Redevelopment Corp*., 998 S.W.2d 32, 40 (Mo. banc. 1999)(providing that Missouri law recognizes "narrow circumstances" in which the corporate veil can be pierced); *Lieberman v. Corporacion Experienca Unica, S.A*., 226 F.Supp.3d 451, 467 (E.D. Pa. 2016)(citing *In re Blatstein*, 192 F.2d 88, 100 (3d Cir. 1999)). However, public policy does not permit the entity theory of corporations to be used as a sword for the perpetration of fraud or injustice. In such circumstances, the distinction between a corporation and its shareholders can be set aside under the equitable doctrine of piercing the corporate veil. *Hok Sport, Inc. v. FC Des Moines, L.C.*, 495 F.3d 927, 936 (8th Cir. 2007)(recognizing that corporate veil piercing is a common law equitable remedy); *Blanks, et al. v. Fluor, et al*., 450 S.W.3d 308, 375 (Mo. App. 2014).

Corporate veil piercing is proper only "upon a showing by a third-party that it has been injured by an abuse of the corporate form." *In re Bridge Info. Sys., Inc.*, 325 B.R. 824, 833 (Bankr. E.D. Mo. 2005)(internal citations omitted). That is, it is a remedy that is available only to third persons.

The doctrine of alter ego may be used to pierce the corporate veil. As one court explained: "While a review of Eighth Circuit case law evinces a sometimes interchangeable treatment of the terms 'alter ego' and 'pierce the corporate veil,' as this Court understands it, the relationship between the two concepts is that a plaintiff can pierce the veil *by showing that an entity is another's* alter ego." *Tang v. Northpole Ltd. and Tofasco of Am., Inc.*, 314 F.R.D. 612, 618 n.4 (W.D. Ark. 2016)(citing *Epps v. Stewart Info. Svcs. Corp.*, 327 F.3d 642, 649 (8th Cir. 2003), and *Mixon v. Anderson (In re Ozark Restaurant Equipm't Co., Inc.)*, 816 F.2d 1222, 1225 (8th Cir. 1987))(emphasis in original).

There are two principal methods in which the corporate veil may be pierced: traditional corporate veil piercing[1] and reverse corporate veil piercing.[2] Each method will be discussed herein.

III. APPLICABILITY OF STATE LAW IN CORPORATE VEIL PIERCING

Just as the creation of a corporation is a matter of state law, the issue of whether the corporate veil can be pierced is a matter of state law. *Stoebner v. Lingenfelter*, 115 F.3d 576, 579 (8th Cir. 1997)(citing *Minnesota Power v. Armco, Inc.*, 937 F.2d 1363, 1367 (8th Cir. 1991)). As one court explained:

> When interpreting a state's laws, federal courts are bound by decisions of that state's highest court. When there is no state court precedent for the federal court to rely on, the federal court must predict how the state high court would rule. In doing so, the federal court should look to intermediate state court precedent as persuasive authority. Thus, this Court's task is to determine whether the high courts of Minnesota and Delaware would permit insider reversing veil piercing on the facts presented here.

Petters, 561 B.R. at 751 (internal citations omitted).

However, federal courts may find that applying state law on corporate veil piercing is not easily accomplished. While the law on traditional corporate veil piercing of an actual corporation is generally well-defined, the application of corporate veil piercing in other contexts might not be. For example, determining whether and when the corporate veil piercing can be applied to trusts is not a

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[1] Also referred to as "vertical veil piercing." *Kelly, et al. v. Opportunity Fin., L.L.C., et. al. (In re Petters Co.)*, 561 B.R. 738, 750 (Bankr. Minn. 2016).

[2] There also is a third type of piercing that has been recognized by a court in the Eighth Circuit: horizontal veil piercing. Horizontal veil piercing occurs when "a limited liability entity is considered to be the alter ego of another limited liability entity with the same owner. In this situation, a creditor with a claim against one of the limited liability entities seeks to disregard corporate separateness between the entities to reach assets belonging to both." *Petters*, 561 B.R. at 751 (citing *Walkovszky v. Carlton*, 223 N.E.2d 6 (1966)).

settled issue in many states (including Missouri), and the application of reverse corporate veil piercing is not as well-developed. When state law on corporate veil piercing is not clear, the federal court may have to "read the tea leaves" as to how the state supreme court might rule. The federal court may be required to prognosticate in the total absence of authority, or with only guidance from lower state court decisions, or even with only state court dicta to consider. This was the situation in which the U.S. Court of Appeals for the Tenth Circuit recently found itself in *United States v. Badger, et al*., 818 F.3d 563, 568 (10th Cir. 2016). In *Badger*, the court determined that, based on a lack of definitive case law but in light of language of state appellate court, Utah state law allowed reverse piercing.

IV. TRADITIONAL CORPORATE VEIL PIERCING[3]

A. Traditional Corporate Veil Piercing as Applied to Corporations

Traditional corporate veil piercing is the doctrine whereby "the corporate form will be disregarded and the personal assets of a controlling shareholder or shareholders may be attached in order to satisfy debts and liabilities of the corporation." *Badger,* 818 F.3d at 568 (quoting *NLRB v. Greater Kan. City Roofing*, 2 F.3d 1047, 1051 (10th Cir. 1993)). It is "based on the theory that the corporation was a sham or the 'alter ego' of the shareholder or perhaps an officer or director." *Mar-Kay Plastics, Inc. v. Reid Plastics, Inc. (In re Mar-Kay Plastics, Inc.)*, 234 B.R. 473, 480 (Bankr. W.D. Mo. 1999).

The law governing traditional corporate veil piercing of corporations and limited liability companies is well-established. One court recently observed that:

> [f]ormulations differ, but most states impose two requirements before piercing the veil. First, the court must find that the shareholder dominated the corporation to the point that it had no separate existence and was effectively his alter ego. Second, the court must conclude that failing to set aside the corporate entity and hold the shareholder liable would sanction a fraud or promote injustice.

Gierum v. Glick, et al., 568 B.R. 634, 658 (Bankr. N.D. Ill. 2017)(internal citations omitted).

Traditional corporate veil piercing requires a highly fact specific inquiry that "depends on the equities of the situation at hand." *Blanks*, 450 S.W.3d at 376. Further, the tests are applied narrowly. A showing of a mere identity of

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[3] This Survey looks at corporate veil piercing for purposes of liability. There also is a concept of veil piercing for the purposes of jurisdiction. KING FUNG TSANG, THE ELEPHANT IN THE ROOM: AN EMPIRICAL STUDY OF PIERCING THE CORPORATE VEIL IN THE JURISDICTIONAL CONTEXT, 12 Hastings Bus. L.J. 185 (2016).

shareholders, directors, or officers between two corporations is insufficient to find an identity of interests to pierce the veil, and that "merely showing that one has absolute control of a corporation does not of itself justify piercing the corporate veil." *See id.* Further, it is insufficient to show a "mere majority or stock control." *Mobius Mgmt. Sys., Inc. v. West Physician Search, L.L.C.*, 175 S.W.3d 186, 188 (Mo. App. 2005)(citing *Crestwood Commons*., 998 S.W.2d at 40).

Missouri's test for corporate veil piercing has been described as both two- and three-pronged. As one court explained, "it appears that the Missouri courts apply two tests interchangeably in order to determine whether the corporate veil should be pierced." *Fleming Companies, Inc. v. Rich*, 978 F.Supp. 1281, 1303 (E.D. Mo. 1997)(internal citations omitted).

The three-part test is referred to as the "instrumentality" test or "alter ego rule," *Greater St. Louis Constr. Laborers Welfare Fund, et al. v. Mertens Plumbing and Mechanical, Inc., et al.,* 552 F.Supp.2d 952, 955 (E.D. Mo. 2007), and provides that the corporate veil can be pierced upon a showing that:

> 1. Control, not mere majority or complete stock control, but complete domination, not only of finances, but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; and
>
> 2. Such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or dishonest and unjust act in contravention of plaintiff's legal rights; and
>
> 3. The aforesaid control and breach of duty must proximately cause the injury or unjust loss.

Id.; see also Hibbs v. Berger, 430 S.W.3d 296, 306-07 (Mo. App. 2014); *Collette, v. American Nat. Stores, Inc.,* 708 S.W.2d 273, 284 (Mo. App. 1986).

The two-part test also is referred to as an alter-ego test:

> The other test regularly applied by the Missouri courts is the alter ego test. Under the alter ego test, "when a corporation is so dominated by a person as to be a mere instrument of that person and is indistinct from the person controlling it, then the court will disregard the corporate form if to retain it would result in injustice." To pierce the corporate veil under the alter ego test, a plaintiff must show: first, the corporation must be controlled and influenced by persons or another corporation; second, evidence must establish

> that the corporate cloak was used as a subterfuge to defeat public convenience, to justify a wrong, or to perpetrate a fraud. Although not specifically set out in the standard two-prong alter ego test, as with the instrumentality test, implicit in the alter ego test is a "proximate clause" element, i.e. that the wrong done be the proximate cause of the injury to the third person who dealt with the corporation.

Fleming, 978 F.Supp. at 1303 (internal citations omitted); *see Edward D. Gevers Heating & Air Condition Co. v. R. Webbe Corp.*, 885 S.W.2d 771, 773-74 (Mo Ct. App. 1994)("To pierce the corporate veil, a plaintiff must meet a two-part test: first, the corporation must be controlled and influenced by persons or another corporation; second, evidence must establish that the corporate cloak was used as a subterfuge to defeat public convenience, to justify a wrong, or to perpetrate a fraud."). Further, "[i]mplicit in this test for piercing the corporate veil is the requirement that the wrong done be the proximate cause of injury to third persons who dealt with the corporation" *Id.* at 774 (internal citation omitted). This dovetails with Missouri law on alter ego, which provides that alter ego is shown when "(1) the individual completely dominates and controls the finances, policy and business practice of the other corporation; (2) such control was for an improper purpose . . . and (3) the alter ego's control of the corporation caused injury to the third party. *Dean v. United States*, 987 F.Supp. 1160, 1164 (W.D. Mo. 1997).

As such, although the Missouri test for corporate veil piercing has been described as both two- and three-pronged, the tests appear to have similar, and often overlapping, standards, albeit phrased differently. What is clear is that total domination of the corporation must be shown and that control must be the proximate cause of injury to another.

Factors that courts consider in determining whether the requisite level of control or domination have been shown include:

(1) the company was adequately capitalized for the undertaking;
(2) the company was solvent;
3) corporate formalities were observed;
(4) the controlling shareholder siphoned company funds; and
(5) in general, the company simply functioned as a façade for the controlling shareholder.

John P. Guidry and Simul-Vision Cable Sys., Ltd. v. Seven Trails West, L.L.C., 2014 WL 4386744, at *10 (E.D. Mo. Sept. 5, 2014). In addition, in the specific context of determining the degree of control that one corporation exercised over another corporation, Missouri courts have looked at whether:

(1) the parent corporation owns all or most of the capital stock of the subsidiary;
(2) the parent and subsidiary corporations have common directors or officers;
(3) the parent corporation finances the subsidiary;
(4) the parent corporation subscribes to all of the capital stock of the subsidiary or otherwise causes its incorporation;
(5) the subsidiary has grossly inadequate capital;
(6) the parent corporation pays the salaries and other expenses or losses of the subsidiary;
(7) the subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation;
(8) in the papers of the parent corporation or in the statements of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own;
(9) the parent corporation uses the property of the subsidiary as its own;
(10) the directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take their orders from the parent corporation in the latter's interest; and
(11) the formal legal requirements of the subsidiary are not observed.

Collette, 708 S.W.2d at 284 (citing *Northern Ill. Gas Co. v. Total Energy Leasing Corp*., 502 F.Supp. 412, 416-17 (N.D. Ill. 1980)).

B. Traditional Corporate Veil Piercing Law as Applied to Trusts

The law is less settled on the question of whether traditional corporate veil piercing can be applied to trusts.

1. The Metaphysical Problem with Applying Corporate Veil Piercing to a Trust: *Where's the Entity? Where's the Veil?*

A problem with applying veil piercing to trusts arises from the nature of a trust: a trust is a relationship—a relationship in which a trustee (who is liable for the trust's obligations) holds property for a beneficiary. A trust is not an entity, much less a corporation. *Sunbelt Environmental Servs., Inc. v. Rieder's Jiffy Market, Inc*., 138 S.W.3d 130, 134 (Mo. App. 2004)(observing that "a trust is not a legal entity"). That is, a trust is not an artificial person created under the law, and its character is not defined by entity theory.

Research has not found case law applying Missouri law in a discussion of the distinction between an entity and a relationship, and how, if at all, this distinction may impact the application of corporate veil piercing to trusts.

However, such discussion has been offered in lower courts in the First and Second Circuits.

In *Babitt v. Vebeliunas (In re Vebeliunas)*, 252 B.R. 878, 886 (Bankr. S.D.N.Y. 2000), the bankruptcy court observed:

> [a trust] has no independent existence apart from the settlor, trustee and beneficiary. On the other hand, corporations do have an existence independent from their shareholders. For instance, a corporation may sue on its own behalf whereas a trust cannot. Indeed, only the trustee can bring suit on behalf of a trust.

Vebeliunas, 252 B.R. at 886 (internal citations omitted).

The court then continued, rejecting the application of veil piercing to trusts:

> the alter ego theory and doctrine of "piercing the corporate veil" originated strictly as devices of corporate law because a corporation has limited liability. They were developed in corporate law as equitable remedies to prevent injustice when shareholders seek to use the corporation to escape their personal liability. In other words, the theory developed to prevent one entity, the shareholder, from using another entity the corporation, as a shield against liability that is truly an obligation of the shareholder. Thus, the alter ego theory and the doctrine of "piercing the corporate veil" apply only in cases where there are entities involved which have their own distinct existence. A trust, however, as explained above is simply a relationship.
>
> A relationship does not exist aside from its participants. A corporation on the other hand does exist separate from its shareholders. It is this separate existence that permits a shareholder to be an alter ego of a corporation. Since a trust has no separate existence outside of its participants, it is not capable of having an alter ego. Thus, in the present case, the alter ego theory is inapplicable.

Id. at 887.

On appeal, the U.S. Court of Appeals for the Second Circuit determined that it was not required to decide whether New York state law allowed corporate veil piercing of a trust. *Citibank, N.A. v. Vebeliunas (In re Vebeliunas*), 332 F.3d 85, 91 (2d Cir. 2003). However, the court's use of the phrase "piercing the trust" might suggest that a trust is an entity with a veil to be pierced. But that amounts to conjecture about the appellate court's choice of language, since the court was not considering the issue of whether there is a "veil" to be pierced.

A bankruptcy court in the First Circuit also raised concerns about the application of alter ego and corporate veil piercing to trusts:

> Given that a trust is not an entity, it is impossible for a trust to be anybody's alter ego because alter-ego theory, which is simply one of the grounds to "pierce the corporate veil," is inescapably linked to the notion that one person or entity exercises undue control over another person or entity. However, a trust's status as a non-entity logically precludes a trust from being an alter ego. For instance, while a corporation, company, or other artificial entity is . . . a separate juridical person, and it therefore makes theoretical sense to talk of a corporation as potentially being somebody else's alter ego. However, it makes no sense to describe a nonentity like a trust as an alter-ego.

Butler v. Candlewood Road Partners, L.L.C. (In re Raymond), 529 B.R. 455, 463 (Bankr. D. Mass 2015)(quoting 2 RICHARD W. NENNO, ASSET PROTECTION: DOM. & INT'L L. & TACTICS, § 14A:20 (2014)); *see also U.S. v. Badger*, 818 F.3d at 572 (reasoning that "the criteria for applying the alter ego theory do not suggest such an exception [because the circumstances involved a trust], nor do we discern why one should be recognized. One can attempt to improperly escape a payment responsibility using any manner of entity, regardless of the connection between the two alter egos."); PATRICK JOHN MCGINLEY, 21 FLA. PRAC. ELEMENTS OF AN ACTION, § 807:2 (2015-16 ed.)("A 'corporate' veil cannot be pierced in the case of a trust, since the trust, which is not technically a corporation, 'being in nature of relationship between settlor, trustee and beneficiaries, had no independent existence, and was not capable of having an alter ego.'"); *see also Glick,* 568 B.R. at 665 (using quotation marks when referring to piercing a trust and observing that "[j]ust as Illinois has not yet recognized reverse piercing, it has yet to recognize piercing a trust's 'veil'.").

Candlewood also addressed the proposition that the proper target of an alter-ego inquiry is not the trust itself, but the trustee—a theory that could be a viable legal theory for the application of the alter-ego doctrine to trust transfers:

> Whereas applying alter-ego doctrine to trusts is conceptually unsound, applying the doctrine to trustees is a different proposition. Trustees are real persons, either natural or artificial, and, as a conceptual matter, it is entirely reasonable to ask whether a trustee is the alter ego of a defendant who made a transfer to the trust. Alter-ego doctrine can therefore provide a viable legal theory for creditors vis-à-vis trustees. However, once properly framed, the question can cause significant fact problems for plaintiffs, particularly if the trustee is a professional trustee or trust company. Alter-ego theory typically requires proof that the wrongful actor has somehow gained overbearing control of the alleged alter ego . . .

Candlewood, 529 B.R. at 463-64 (quoting NENNO, ASSET PROTECTION, § 14A:20).

However, other lower courts in the Second Circuit did not appear to share the concerns articulated in *Vebeliunas*. In *Pergament v. Maghazeh Family Trust, et al. (In re Maghazeh)*, 310 B.R. 5 (Bankr. E.D.N.Y. 2003), the bankruptcy court found support for the proposition that a trust is pierceable under New York law:

> [In its *Vebeliunas* opinion), the Second Circuit acknowledged that there is no written opinion from the New York Court of Appeals regarding whether courts may disregard the form of a trust where the trust was not formed for an illegal purpose and there was a separation between the beneficiary and the trustee. The Second Circuit went on to discuss New York State court decisions regarding the right to pierce trusts, and found that New York courts would do so where the "respective parties used trusts to conceal assets or engage in fraudulent conveyances to shield funds from adverse judgments." The Second Circuit did not find that piercing the trust was proper in the *Vebeliunas* case primarily because there was no evidence that the trust was used to conceal assets from the debtor's creditors. Furthermore, the debtor's wife purchased the assets of the trust with her own funds. In addition, the sharing of assets between a married couple is routine and the court could not find any evidence that the debtor exercised domination and control over the trust. In this case, although created at an earlier time, the Maghazeh Trust was used to engage in a fraudulent conveyance to shield the Debtor's interest in the mortgages purchased by the Debtor from Danmar LP. In other words, the Maghazeh Trust became a vehicle to shield the Debtor's assets from his creditors. In addition, all of the property owned by the Maghazeh Trust was funded by the Debtor.

Id. at 16-17 (internal citations omitted). The *Maghazeh* court further found support for trust piercing in New York law. *Id.* at 17. From this, the court determined that the subject trust was an alter ego and allowed it to be pierced.

In *United States v. Evseroff*, 2012 WL 1514860 (E.D.N.Y. Apr. 20, 2012), the district court determined that a trust could be pierced, principally because "there is no policy reason why veil piercing would apply only to corporations but not to trusts. The policy behind corporate veil piercing is to prevent a debt from using the corporate legal form to unjustly avoid liability. That policy applies equally to trusts." *Id.* at *13 (internal citations omitted).

2. Missouri Law on Applying Corporate Veil Piercing to a Trust

No court examining Missouri law on corporate veil piercing has addressed, head-on, whether a trust can be subject to corporate veil piercing, in light of the clear Missouri law providing that a trust is not an entity. Instead, the courts considering corporate veil piercing under Missouri law seem to have assumed that a trust is an entity like a corporation, with a veil.

***Loving Savior Church v. United States*, 728 F.2d 1085 (8th Cir. 1984).** In *Loving Savior*, the Eighth Circuit affirmed the lower court's determination that the Loving Savior Church was an alter ego of Dr. and Mrs. Anderson, the church's pastor and wife. The facts of *Loving Savior* are fairly typical of "tax protestor" cases. The Andersons, after obtaining tax protestor prepared forms, transferred their property from a family trust, then to the Loving Church. Thereafter, the Andersons, as tax protestors are wont to do, insisted that they had no taxable income, while titling everything to the church. The IRS, as it is wont to do, disagreed and levied on property titled to the church to satisfy the Andersons' tax debt. The Eighth Circuit affirmed the district court's determination that the levies were proper because the property transfers to the church were a sham and thus constituted a fraudulent transfer. It also affirmed the district court's finding that the Loving Savior Church was an alter ego of the Andersons.

Loving Church stands for the principle that a taxing authority may levy on the property that is held in the name of an alter ego of the taxpayer. However, how much *Loving Church* speaks to the issue of whether a trust may be pierced seems limited. *Loving Church* did not involve a trust; the alter ego in *Loving Church* was an unincorporated religious association, not a trust. *Loving Church* did not determine that *a trust* could be an alter ego. In addition, *Loving Savior* was issued per curiam. It seems unlikely that the language in this per curiam tax protestor opinion would have been crafted with an eye toward speaking to the unrelated issue of whether a trust can be corporate veil piercing.

***F.F.P. Enterprises and D&S Trust v. United States*, 830 F.2d 114 (8th Cir. 1987).** *F.F.P. Enterprises* involved trusts set up by family members to improperly avoid taxes. The district court held that the "trusts" were invalid and thus were never created—they were nothing other than alter egos. This is not the same as determining that a *properly created* trust can be subject to piercing. *F.F.P. Enterprises* did not involve trusts that were actually created and existed; it involved trusts that were invalid and thus never created in the first place. However, in addressing a standing issue, the Eighth Circuit stated that, because the trusts were a sham, the trusts were not "separate persons" apart from the family members. While this language might suggest that a trust could be a person, that seems to be reading a great deal into the Eighth Circuit's choice of vocabulary to explain a standing deficit where no properly created trust existed.

***Dean v. United States*, 987 F. Supp. 1160 (W.D. Mo. 1997).** In *Dean*, the district court considered a wrongful levy claim brought by married taxpayers against the IRS. The IRS levied against the property in a trust that had been created by the taxpayers—a trust that the IRS claimed was an alter ego of the taxpayers. The court recognized that "[w]hile the Missouri courts have never considered the alter ego doctrine in the context of a trust, the doctrine has been applied in the corporate context where an effort is being made to pierce the corporate veil." *Id.* at 1164. From this analysis, the court applied the three-prong corporate veil piercing test. There was no discussion of the distinction between trusts and corporations, entity theory, or whether a trust has a veil to pierce.

***Olsen v. Reuter (In re Reuter)*, 499 B.R. 655 (Bankr. W.D. Mo. 2013).** In *Reuter*, the bankruptcy court was asked "to extend the 'alter ego doctrine' to trusts or establish new bankruptcy law and pierce [a trust] so that it can be equitably disregarded and its assets be made available to the estate." *Id.* at 683. In its analysis, the court noted that "some courts have extended the [alter ego] doctrine to trusts, as well as corporations," *id.* at 679, and that "the alter ego doctrine is typically brought when attempting to pierce a corporate veil," *id.* at 680, pointing to *Ozark*, *Loving Savior*, *F.F.P. Enterprises*, and *Dean*. The bankruptcy court also observed that *Ozark* held that "because the nature of the alter ego theory of piercing the corporate veil makes it one personal to the corporate creditors rather than the corporation itself, the claim does not become property of the estate, nor is it enforceable by the trustee." *Id.* at 680. But, in the end, the court "elect[ed] not to decide definitively whether the doctrine would be applicable to trusts as it is to corporations and whether the Plaintiff has standing under the circumstances of this case." *Id.* at 683. It determined that it was not necessary to enter this terra incognita because, even if the doctrine applied to trusts and even if the plaintiff-trustee had standing, the complaint nevertheless failed to state a claim for relief under the facts. *Id.*

3. The *Scherping* Case

Although *United States v. Scherping*, 187 F.3d 796 (8th Cir. 1999), did not involve Missouri law, it is an Eighth Circuit case that should be noted for its language on the nature of trusts. *Scherping* involved two brothers who improperly used Minnesota business trusts. One of the issues that the Eighth Circuit determined was whether one of the trusts was subject to 28 U.S.C. § 6502 (a provision of the federal tax code that provides a six-year statute of limitations on collection by levy or court proceeding). The taxpayers argued that, under the Fifth Circuit's *United States v. Hall*, the case against the trust was brought out of time under § 6502. The Eighth Circuit, however, rejected this untimeliness argument, observing that *Hall* "expressly holds that § 6502 is inapplicable to bar a suit against third persons in aid of collecting a judgment against a taxpayer," and that, "[h]ere, there is no doubt that [the trust] is a third person." *Id*. at 801. The court then affirmed the district court's judgment, finding that the trusts were the alter ego of the taxpayers, and that the trusts were liable for the taxpayers' tax liabilities under the reverse corporate piercing doctrine under Minnesota law. *Id.* at 801-02. *Scherping* is important because it applied state (Minnesota) law to affirm the piercing of a trust. And, it refers to a trust as a person (a third person). However, it also may be appropriate to view *Scherping* narrowly. Tax cases can be a bit of a different animal, and *Sherping* did not include a broad discussion of how a trust can be a separate entity with a veil.

V. REVERSE CORPORATE VEIL PIERCING

A. Reverse Corporate Veil Piercing as Applied to Corporations

The second type of piercing is reverse corporate veil piercing, whereby "a corporation or other entity can be liable for the debt of someone who controls the entity." *Badger*, 818 F.3d at 568 (citing *Floyd v. IRS*, 151 F.3d 1295, 1298 (10th Cir. 1998)). Reverse corporate veil piercing is a less settled doctrine, even as applied to corporations and limited liability companies.

There are two types of reverse corporate veil piercing: inside reverse corporate veil piercing and outside reverse corporate veil piercing. *Petters*, 561 B.R. at 750; *see also Hibbs*, 430 S.W.3d at 309 (discussing differences between inside and outside reverse veil piercing). Each type is characterized by whether the party seeking to pierce a limited liability entity's corporate veil is outside or inside the limited liability entity. *Petters*, 561 B.R. at 750. Inside reverse corporate veil piercing occurs when a limited liability entity's insider seeks to pierce the corporate veil so that the insider may use the entity's claims against third parties. *Id.* Outside reverse corporate veil piercing occurs when a limited liability entity's creditor seeks to hold the entity liable for the insider's obligation. *Id.* An outside reverse veil piercing claim originates from outside the limited liability entity, with liability then extending from the entity to the entity's insider. *Id.* But whatever the type, reverse piercing is controversial. *Glick,* 568 B.R. at 659; *see Candlewood*, 529 B.R. at 466 (observing that "[t]he veil piercing and alter ego allegations on which the Trustee bases these claims are a variation of a controversial form of corporate veil piercing known as reverse veil piercing," and citing cases in support). As the *Glick* court explained:

> Not all states endorse it. *In re Howland* . . . WL 3176649, at *3 (E.D. Ky. June 7, 2016)("Reverse veil piercing is by no means a widely accepted legal principle.") . . . *Boeing Co. v. KB Yuzhnoye*, No. CV 13–00730–AB (AJWx), 2016 WL 2851297, at *29 (C.D. Cal. May 13, 2016)("Reverse veil piercing is a highly controversial and intensely debated corporate law doctrine ...."); *ALT Hotel*, 479 B.R. at 801 (noting that courts are "deeply split on the theory"); 1 William Meade Fletcher, supra, § 41.70 at 322–25 (stating that "not all" jurisdictions recognize reverse piercing, and some that do recognize it "only under very limited circumstances"). So when a plaintiff makes a reverse piercing request, it is critical to know which state's law governs the request.

Id.

Whether reverse veil piercing of either type is available under Missouri law is unclear, although it appears it may be available—at least, in the context of a reverse piercing of the veil of a corporation. In 2014, the Missouri Court of Appeals in *Hibbs* considered the question of whether minority shareholders could pierce the corporate veil of their own company. The *Hibbs* court outlined the general theories of reverse corporate veil piercing, but noted that "this Court offers no guidance on the availability or acceptance of reverse veil piercing in Missouri," *Hibbs*, 430 S.W.3d at 310, and left the issue of reverse veil piercing in Missouri unaddressed. However, *Hibbs* observed that "besides equity, fairness to minority shareholders requires a bar on a *per se* rule that minority shareholders cannot pierce their own corporate veil. With increasing frequency, a number of jurisdictions have encountered and employed an alternate form of corporate veil piercing, commonly referred to as 'reverse piercing.'" *Id.* The court also noted that "if the trend in other jurisdictions is to permit *majority shareholders* to pierce the corporate veil for their benefit in appropriate circumstances, then so, too, should minority shareholders be granted the authority to pierce the corporate veil in 'appropriate circumstances.'" *Id.* (emphasis in the original). Thus, while the *Hibbs* court cautiously disavowed making a holding on the issue of reverse veil piercing under Missouri law, it offered reasoning that may suggest that Missouri law might not dismiss such piercing out of hand, given equitable considerations.

In re Loganbill, 554 B.R. 871, 890 (Bankr. W.D. Mo. 2016), the bankruptcy court determined that a seed corporation formerly owned by the chapter 12 debtors (but which they sold to family members for one dollar and then remained deeply engaged with running) was the alter ego of the debtors. In doing so, the court explained that "[t]echnically, this case presents a reverse piercing issue," but observed that "the analysis remains the same" as the three-part alter ego test articulated in *Dean*. *Id.* at 891 n.8. *Loganbill* suggests that reverse piercing—again, in the context of a corporation—is allowable under Missouri law.

B. Reverse Corporate Veil Piercing as Applied to Trusts

The law on whether reverse corporate veil piercing can apply to trusts is just as unsettled as the law on whether traditional corporate veil piercing can apply to trusts—only there is considerably less case law on the issue. No authority in Missouri law on the issue was found. The 2016 opinion of the Tenth Circuit Court of Appeals in *Badger* is an example of a relative recent decision determining that reverse veil piercing may be applied to trusts.

> Defendants argue that a trust cannot be subject to reverse piercing. But the criteria for applying the alter-ego theory do not suggest such an exception, nor do we discern why one should be recognized. One can attempt to improperly escape a payment responsibility using any manner of entity, regardless of the formal connection between the two alter egos. *See United States v.*

> *Vernon*, 814 F.3d 1091, 1101 [(10th Cir. 1991)](“[W]here . . .a non-owner is allowed by the nominal owner to dominate and control the corporation at issue, the corporation can be treated as the non-owner’s alter ego.”); *United States v. Scherping*, 187 F.3d 796, 802 (8th Cir. 1999)(trust was the taxpayers’ alter ego because it was a “sham entit[y] created on behalf of and used by taxpayers to evade payment of their federal income tax liabilities”). Badger cites no contrary authority. We believe that Utah courts would apply alter-ego doctrine to trusts.

Badger, 818 F.3d at 572.

VI. STANDING OF THE TRUSTEE TO BRING CLAIMS BASED ON CORPORATE VEIL PIERCING

A. Overview

A cause of action “belonging to the debtor at the commencement of the case are included within the definition of property of the estate.” *Ozark*, 816 F.2d at 1225. As the Eighth Circuit explained:

> Any of these actions that are unresolved at the time of filing then pass to the trustee as representative of the estate, who has the responsibility under Section 704(1) of asserting them whenever necessary for collection or preservation of the estate. For example, these sections give the trustee authority to bring an action for damages on behalf of a debtor corporation against corporate principals for alleged misconduct, mismanagement, or breach of fiduciary duty, because these claims could have been asserted by the debtor corporation, or by its stockholders in a derivative action. Accordingly, whenever a cause of action “belongs” to the debtor corporation, the trustee has the authority to pursue it in bankruptcy.

Id. (internal citations omitted). By the same token, “a bankruptcy trustee has no standing to sue third parties on behalf of the estate’s creditors, but may only assert claims held by the [debtor].” *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991). However, there is disagreement as to whether the trustee has standing to bring a claim based on a theory of corporate veil piercing. As the bankruptcy court in *Stamps v. Knobloch (In re City Communications, Ltd.)*, 105 B.R. 1018 (Bankr. N.D. Ga. 1989), observed:

> The issue of whether the Trustee has standing to assert an alter ego claim is one on which the courts do not agree. Several recent cases illustrate the division of the circuit courts on the issue of the Trustee's standing. In the cases of *Williams v. California First Bank (In re Chacklan Enterprises, Inc.)*, 859 F.2d 664 (9th Cir.1988) . . .

> and *Mixon v. Anderson (In re Ozark Restaurant Equipment Co., Inc.)*, 816 F.2d 1222 (8th Cir.1987) . . . the courts held the trustee has no standing. In the cases of *Koch Refining v. Farmers Union Central Exchange, Inc.*, 831 F.2d 1339 (7th Cir.1987) . . *In re SI Acquisition, Inc.*, 817 F.2d 1142 (5th Cir.1987) . . . and *St. Paul Fire and Marine Insurance Co. v. Pepsico, Inc.*, 884 F.2d 688 (2d Cir.1989), the courts held the trustee does have standing to pursue an alter ego claim.

Id. at 1020.

B. A "Case or Controversy" and Prudential Limitation

Determining whether a trustee has standing to assert a corporate veil piercing claim begins with the Constitution, as standing is a jurisdictional issue under Article III of the Constitution which must be addressed as a threshold matter. *Wagoner*, 944 F.2d at 119. For a federal court to have jurisdiction, Article III requires at least two showings. First, pursuant to the plain language of Article III, there be a "case or controversy." Second, the doctrine of "prudential limitation" requires that a party seeking to invoke the court's power have "a personal stake" in the outcome of the case or controversy. *Wight et al. v. BankAmerica Corp*, *et al*., 219 F.3d 79, 89 (2d Cir. 2000); *see also Pergament v. Yerushalmi, et al. (In re Yerushalmi)*, 487 B.R. 98, 105 (Bankr. E.D.N.Y. 2012)("As such, the legal rights asserted by the plaintiff must be his or her own."). These two requirements are interrelated. *Yersushalmi*, 487 B.R. at 105 (Bankr. E.D.N.Y. 2012)(observing that the case-or-controversy requirement includes the requirement that the party have a "personal stake").

As the Second Circuit has explained: "the 'case or controversy' requirement coincides with the scope of the powers the Bankruptcy Code gives a trustee; that is, if a trustee has no power to assert a claim because it is not one *belonging to the bankrupt estate*, then he also fails to meet the prudential limitation that the legal rights asserted must be his own." *Wagoner*, 944 F.2d at 119; *see also Mar-Kay Plastics*, 234 B.R. at 481 ("The question of standing can be rephrased as whether a cause of action belongs to a particular party."). Relying on the intersection of the "case and controversy" requirement and the prudential limitation doctrine, the Second Circuit held that a trustee "generally has no standing to sue third parties on behalf of the estate's creditors, 'but may only assert claims held by the bankrupt corporation itself.'" *Id.* (citing *Caplin v. Marine Midland Grace Trust Co. of N.Y.*, 406 U.S. 416, 434 (1972)). Thus, the boundaries of prudential limitation confine standing to matters in which the trustee has a "personal stake" in corporate veil piercing litigation.

Some courts begin their analysis of limitations on trustee standing with the 1972 U.S. Supreme Court case of *Caplin*, which held that a trustee has no standing to being an action on behalf of a debtor's bondholders against an indenture trustee. Interpreted narrowly, *Caplin* has been read to mean that a trustee lacks standing to pursue personal claims of a debtor's creditors, but not general claims. *City Communications*, 105 B.R. at 1020 (citing various cases applying *Caplin* by this narrow construction). Interpreted broadly, *Caplin* has been read to preclude standing for a trustee to bring any claim on behalf of creditors. *Id.* (citing cases). But under either interpretation, *Caplin* makes clear that there are standing limits for a trustee.

The Bankruptcy Code provides for limitations on trustee standing. Under the Bankruptcy Code, the trustee stands in the shoes of the debtor and has standing to bring any suit that the debtor could have instituted, were it not for the filing of the petition for bankruptcy relief. *See In re John Stewart Woodworking, Inc.*, 2017 WL 3098103, at *3 (Bankr. N.D.W.V. Jul. 20, 2017). As such, a trustee has standing to bring a cause of action against insiders of a corporation, if the debtor could have done so, were it not for the filing of the petition. *See id.* (citing *Mannuci v. Cabrini Med. Ctr. (In re Cabrini Med. Ctr.)*, 489 B.R. 7, 16 (S.D.N.Y. 2012)).[4] However, the Bankruptcy Code does not make the trustee a roving drone set loose in a bankruptcy case to accomplish "justice for all," with the freedom to assert corporate veil piercing claims on behalf of any aggrieved party. The trustee is not empowered under the Bankruptcy Code to stand in the shoes of the *estate's creditors*. To the contrary, the trustee's power to invoke corporate veil piercing could spring from only three statutory sources: Bankruptcy Code §§ 704 and 541; § 544(a); and § 105(a). *Halverson, et al. v. Schuster (In re Schuster)*, 132 B.R. 604, 608 (Bankr. D. Minn. 1991). And "§ 704 only empowers and requires the Trustee to 'collect and reduce to money the property of the estate,' and § 541(a)(1) limits the property of the estate to 'legal and equitable interests *of the debtor* in property as of the commencement of the case' (emphasis added), with only a few, nonmaterial exceptions." *Id.*

As such, under both case law and the Bankruptcy Code, the critical inquiry for determining whether a trustee has standing to bring a corporate veil piercing claim appears to be whether such a claim could have been brought by the debtor, such that the trustee would have the necessary "personal stake" in the litigation. This requires a determination of the "origin of the claim"—a determination that requires "careful analysis." *Stewart Woodworking*, 2017 WL 3098103, at *3.

C. Precedents from Courts Looking at Missouri Law

[4] If the trustee has standing, it likely is exclusive. As explained in *Stewart Woodworking*: "claims based on alter ego [and, by extension, corporate veil piercing] belong first to the chapter 7 trustee and can be brought by a creditor only if the trustee abandons the claim." *Stewart Woodworking*, 2017 WL 3098103, at *1.

***Mixon v. Anderson (In re Ozark Restaurant Equipm't Co., Inc.)*, 816 F.2d 1222 (8th Cir. 1987).** The Eighth Circuit precedent on the issue of whether a trustee has standing to assert a claim based on the alter ego theory of corporate veil piercing is *Ozark*. In that case, the Eighth Circuit considered whether the trustee had standing to assert, on behalf of the debtor-corporation's creditor, an alter ego action against the principals of the debtor-corporation. The court began its analysis by observing that § 704 requires the trustee to "collect and reduce to money the property of the estate." Thus, where state law makes obligations or liabilities run to the creditors personally, rather than to the debtor-corporation, such rights of action are not assets of the estate under § 541(a) and are not enforceable by the trustee. *Id*. at 1225. The court then considered Arkansas law and determined that, under Arkansas law, the obligations and liabilities of an action to pierce the corporate veil in Arkansas do not run to the corporation, but to creditors of the corporation—and thus, the trustee did not have standing. *Id.*

The Eighth Circuit also determined that the trustee did not have standing as a result of the strong-arm provision of § 544(a). *Id.* at 1226. It considered the language of § 544(a), its legislative history, and the pre-Bankruptcy Code *Caplin* case, and held that although "a trustee's rights and powers under Section 544 are extensive[, w]e do not believe, however, that they encompass the ability to litigate claims, such as the instant alter ego cause of action, on behalf of the debtor corporation's creditors." *Id.*

Last, the court rejected the argument that the equitable principles under the "necessary or appropriate" provision of § 105(a) created standing. The court acknowledged the somewhat draconian result, but pointed to the plain language of the statute: "[a]lthough this result may seem harsh in light of the bankruptcy court's clear findings that the corporate structure was abused, an opposite result would contradict the Code's directives." *Id.*

***Mann v. Michael Indus., Inc., et al. (In re Inland Shoe Manufacturing Co., Inc.)*, 90 B.R 981 (Bankr. E.D. Mo. 1988).** In 1988, the year after *Ozark* was decided, the court in *Inland Shoe* considered whether a trustee had standing to bring corporate veil piercing claims. The court relied on *Caplin* and *Ozark,* and then looked to Missouri law, and concluded that under Missouri law, the obligations and liabilities of an action to pierce the corporate veil in Missouri do not run to the corporation or its stockholders generally, but to third parties," *id.* at 986, and dismissed the count for lack of standing. Neither *Ozark* nor *Inland Shoe* framed its analysis in terms of a nuanced discussion of "general" claims based on a theory of corporate veil piercing versus creditor-specific corporate veil piercing claims.

***Evans v. Robbins*, 897 F.2d 966 (8th Cir. 1990).** *Evans* is not a corporate veil piercing case, but should be noted in considering the standing of a trustee. In *Evans*, the bankruptcy court found that the debtors had fraudulently attempted to hide assets in "alter ego business entities," and ordered that they turn over to the trustee all the related assets, on the theory that the assets had never left the estate. Notably, the trustee did not pursue an alter ego claim to assert general liability (as was the case in *Ozark*); rather, he asserted the alter ego theory in his pursuit of the return of specific assets for the estate. This distinction supports the trustee's standing to bring an action based on alter ego, under the constitutional and statutory limits on standing.

***Block v. Warehouse Consultants, Inc. (In re Americana Servs. Inc.)*, 173 B.R. 650 (Bankr. W.D. Mo. 1994).** A few years later, the bankruptcy court in *Americana* considered the impact of *Evans*. The *Americana* court was called upon to determined a Rule 12(b)(6) request to dismiss a count in the trustee's complaint that was based on alter ego allegations. The defendants insisted that *Ozark* precluded the trustee from bringing such a claim. The *Americana* court rejected the defendant's argument—and the court's reasoning for that rejection suggests that *Evans* may stand for the proposition that *Ozark* is not as entirely preclusive as initially interpreted. The court opined that:

> *Evans v. Robbins* and the Missouri cases suggest that *Ozark Restaurant* is limited to alter ego actions intended to assign *general* liability for corporate debts to a third party. A trustee may maintain an alter ego action when that action is tied to *specific* assets or transactions. *See In re Kroh Bros. Dev. Co.,* 117 B.R. 499, 501 (W.D.Mo. 1989)("This Court believes that there is not merely a distinction, but a real difference between the determination made here as to the ownership of property from a[n] *alter ego* action claim suggesting that another entity has acted in a manner to render itself liable for another's debts.") The action may demonstrate unity of ownership with the estate or demonstrate the fraudulent nature of a conveyance due to the knowledge and intent of the parties.

Id. at 653.

***Mar-Kay Plastics, Inc. v. Reid Plastics, Inc. (In re Mar-Kay Plastics, Inc.)*, 234 B.R. 473, 480 (Bankr. W.D. Mo. 1999).** In *Mar-Kay Plastics*, the bankruptcy court was presented with "a unique variation on the traditional veil piercing scenario. The Debtor (a corporation) is seeking to use an alter ego theory to pierce its own corporate veil in order to take over a potential claim (against a third party) that belongs to the Debtor's shareholder." *Id.* at 480. The trustee, standing in the shoes of the debtor-corporation, sought to bring a claim based on such piercing theory. The court had to determine "whether a corporation has standing to bring an alter -ego claim against itself, and, if it does, can it bring such a claim for the purpose of taking over and asserting a claim that belongs to the shareholder. In terms of the present case, the issue is whether the Debtor can use the alter ego theory to assert a cause of action that belongs to its parent and sole shareholder, Mar–Kay Enterprises, against a third party, Reid Delaware." *Id.* at 480-81. In concluding that the trustee lacked standing, the court looked to *Caplin* and *Inland Shoe*, as well as to the *Osler v. Joplin Life Ins. Co*., 164 S.W.2d 295 (Mo. 1942), a Missouri Supreme Court case that has been interpreted to allow corporate veil piercing actions only "where the rights of third persons are concerned." The court also rejected the trustee's argument that *Americana* provided the trustee with standing, drawing numerous distinctions between the facts of that case and those of *Americana*. The court determined that the trustee lacked standing.

D. The *Stewart Woodworking* Case

Although it is not a Missouri or Eighth Circuit case, the recent opinion *Stewart Woodworking* from the bankruptcy court of the Northern District of West Virginia warrants highlighting in a discussion of trustee standing. According to *Stewart Woodworking*, the first step in determining whether standing exists is to evaluate whether the claim is really a corporate veil piercing claim in the first place—as versus being a direct claim against the corporation. As the court explained:

> Confusion results when courts mistakenly apply the term "piercing the corporate veil " to distinctly different causes of action against the individuals who stand behind the corporation. The true action to "pierce the corporate veil " is brought by parties injured by the corporation to hold liable those corporate officers, directors and/or stockholders whose fraudulent conduct of the corporation caused the injury to the plaintiffs. Liability for harm caused by the corporation is imposed upon the corporation's alter egos by disregarded corporate form.
>
> A completely different cause of action is one brought directly by the corporation (or derivatively by shareholders) against corporate alter egos for damage to the corporation itself through mismanagement or fraud.

Steward Woodworking, 2017 WL 3098103, at *3 (quoting *National City Bank of Minneapolis v. Lapides (In re Transcolor Corp.)*, 296 B.R. 343, 362 (Bankr. D. Md. 2003)). The distinction between bringing a direct claim and asserting the corporate veil piercing doctrine is important in determining standing:

> Because the bankruptcy trustee's standing to prosecute a lawsuit on behalf of the bankruptcy estate is the same as the debtor's standing absent the bankruptcy case, the trustee may assert corporate causes of action in the bankruptcy court against third parties who have injured the debtor, including insiders whose mismanagement may have created the necessity of filing the

bankruptcy petition in the first place.

Id. at 3 (quoting in *In re Transcolor Corp.*, 296 B.R. at 362). If the cause of action is a direct claim, then the standing analysis is straightforward, as compared to the analysis needed in a piercing action. After all, "[i]f the claim is a direct claim, then it is property of the estate, and the trustee has the authority to prosecute or settle the claim," *In re Transcolor Corp.*, 296 B.R. at 363, and thus, there is no dispute regarding standing.

Stewart Woodworking then provides that the next step is to "determine whether there is any other justifiable reason why the claim should be brought by the trustee rather than the creditor pursuing the claim." *Stewart Woodworking,* 2017 WL 3098103, at *4. In general, if the claims based on veil piercing theories are available to all creditors of the estate, courts generally find that the trustee has standing to bring the action, either under § 544(a) or under a theory of the trustee as an assignee for the benefit of creditors. *Id.* Included in that analysis is consideration of who would be harmed if the corporate veil is not pierced. *See, e.g., Koch Refining v. Farmers Unions Cent. Exch., Inc*., 831 F.2d 1339, 1349 (7th Cir. 1987)("To determine whether an action accrues individually to a claimant or generally to the corporation, a court must look to the injury for which relief is sought and consider whether it is peculiar and personal to the claimant or general and common to the corporation and creditors."). Where "the right to relief and the benefits of relief are peculiar to individual or groups of creditors, the right is not a generalized one that belongs to the debtor's estate." *Picard v. JPMorgan Chase & Co., et al.*, 460 B.R. 84, 96 (S.D.N.Y. 2011). In such a situation, the harmed creditor, and not the trustee, would have standing. *Cabrini*, 489 B.R. at 17 (recognizing that "a creditor has standing to bring an alter-ego claim when the harm alleged in support of the claim is personal to them; a creditor lacks standing to bring such a claim when the harm alleged is general."). The bankruptcy court looks to state law in determining who is the harmed party. *Steyr-Daimler-Puch of Am. Corp. v. Pappas*, 852 F.2d 132, 135 (4th Cir. 1988).

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It Wasn't Me!!: Dealing with Successor Liability, Alter Ego, Veil Piercing and Substantive Consolidation Issues With Respect to Insolvent Companies

Successor Liability Issues in §363 Sales[1]

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What's Old is New Again – Does the General Motors Decision Change Anything in 363 Sales?

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WHAT'S OLD IS NEW AGAIN - DOES THE GENERAL MOTORS DECISION CHANGE ANYTHING IN 363 SALES?

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Introduction

In *In re Motors Liquidation Co.*, 829 F.3d 135 (2d Cir. 2016), *cert denied*, 2017 WL 1427591 (Apr. 24, 2017) ("*General Motors*"), the United States Court of Appeals for the Second Circuit reversed a bankruptcy court determination that tort claimants were barred from asserting claims by the court's "free and clear" sale of assets pursuant to 11 U.S.C. § 363. The decision raises questions on both the type and extent of notice that must be provided to potential claimants in order to shield a purchaser from successor liability.

This paper first examines how each circuit addresses successor liability and 363 sales through a sampling of illustrative cases. Next, we examine the *General Motors* opinion itself. Finally, we consider the potential ramifications of *General Motors* in the Second Circuit and beyond.

The cases generally discuss one of two issues: (1) notice and due process requirements dependent upon whether the claimant is a creditor and known or unknown to the debtor; or (2) whether the potential successor claims are "interests" pursuant to §363 which are subject to being sold free and clear.

First Circuit

The First Circuit addressed the impact of complete lack of notice on successor liability in *In re Savage Indus., Inc.*, 43 F.3d 714 (1st Cir.1994). In *Savage Industries*, the debtor and manufacturer of firearms, sold its assets to Savage Arms. The sale order authorized the sale, and the debtor and Savage Arms subsequently entered into a private asset-purchase agreement that provided for a limited assumption of *pending* product liability claims, but no other assumption of liability. *Id.* at 717. Savage Arms completed the asset purchase and continued the manufacture of the identical lines of firearms previously manufactured by the debtor.

One year after the asset transfer, an individual (Taylor) injured by a firearm manufactured by the debtor brought a products-liability claim against the debtor in an Alaskan State court and, later, a retail distributor (Western Auto). *Id.* Taylor's suit was based on an injury that occurred post-petition, but shortly before the debtor sought approval of the asset sale. It is important to note that no notice of the bankruptcy, proposed sale or any other action in the bankruptcy, was given to Taylor.

Western Auto then filed a third-party complaint against Savage Arms for successor liability, demanding either indemnification or apportionment of damages. *Id.* Savage Arms then instituted an adversary proceeding in bankruptcy court for declaratory judgment and injunctive relief, seeking a determination that it did not acquire liability for the products-liability claims at issue. *Id.* at 718. The bankruptcy court enjoined further prosecution of Western Auto's third-party claims against Savage Arms and expressed concern that such successor liability actions might "chill" all-asset sales under chapter 11 by prompting potential purchasers to hedge their bids against unquantifiable future product liability costs. *Id.* at 718-19.

Focusing on the complete lack of notice to the tort claimant, the First Circuit reversed, stating as follows:

> Since Taylor and Western Auto, as "parties in interest," were never afforded "appropriate" notice of the chapter 11 proceeding, the chapter 11 plan, or the privately negotiated terms of the asset transfer agreement, not only do their state-law based successor liability claims against [Savage] Arms survive the chapter 11 proceeding but their claims against [the debtor] as well."
>
> . . . .
>
> These unresolved factual determinations [regarding the level of notice that would have sufficed] were for the bankruptcy court, had the parties to the all-asset transfer alerted the court to their intention to negotiate the "free and clear" transfer term at issue here. Even assuming direct notice were proven impracticable, however, [the debtor] concededly made no attempt to provide notice by publication, *see* Fed.R.Bankr.P. 2002(k); *Novak v. In re GAC Corp.,* 681 F.2d 1295, 1300 (11th Cir.1982) (direct mail unnecessary if class large); *In re Trump Taj Mahal Assocs.* 156 B.R. 928, 938–41 (Bankr. D.N.J.1993) (notice by publication may be adequate for "unknown" creditors).
>
> As it was never determined "appropriate in the particular circumstances" for [the debtor] and [Savage] Arms to dispense with all notice and opportunity to be heard on the part of potential claimants like Taylor and Western Auto, it would border on the bizarre to conclude that the third-party complaint Western Auto filed against [Savage] Arms in Alaska state court threatened disruption to any legitimate function served by the Bankruptcy Code priority scheme which [the Debtor] and [Savage] Arms subverted in their private negotiation of the asset transfer agreement. Furthermore, it cannot seriously be questioned that the central "notice and hearing" requirement prescribed by the Bankruptcy Code would be eviscerated were we to *presume,* as [Savage] Arms belatedly suggests, that an entire class of future product liability claimants was beyond the purview of "such notice ... and such opportunity for a hearing as [was] appropriate in the particular circumstances ...," Bankruptcy Code § 102(1)(A), 11 U.S.C. § 102(1)(A).

Id. at 721-22

Finally, the First Circuit dismissed the bankruptcy court's concern over potentially "chilling" future 363 sales as a "largely illusory concern [that] is entirely of the parties' own making, brought on by their mutual arrangement for affecting an all-asset transfer without regard to basic

Bankruptcy Code notice requirements." *Id.* at 722. The court expressly stated it was expressing no view as to whether section 363 enables the extinguishment of state-law based successor "product-line" liability claims. *Id.* at 723.

Similarly, recently the Bankruptcy Appellate Panel First Circuit in *Cousins Int'l Food Corp v Vidal*, 565 B.R. 450 (1st Cir. BAP 2017), relying upon the holding in *Savage*, held that the debtor's failure to list on its Schedules and Statement of Financial Affairs, or to give any actual notice whatsoever to a creditor suing for the pre-petition unlawful termination of his employment, precluded any relief for the purchaser of debtor's assets in a §363 sale, from the enforcement of the creditor of a judgment against the purchaser of the assets. The general awareness of the creditor of the pending bankruptcy did not satisfy the necessary due process requirements. In so holding, the BAP stated that "it is the duty of sale proponents such as [purchaser] to ensure that interested parties are afforded appropriate notice of the material terms of an all-asset transfer …" *Id* at 461.

Third Circuit

The seminal[1] case from the Third Circuit is *In re Trans World Airlines, Inc*., 322 F.3d 283, 284 (3d Cir. 2003). In *Trans World*, the court addressed two types of claims: (i) employment discrimination claims against TWA; and (ii) a Travel Voucher Program awarded to TWA's flight attendants in settlement of a sex discrimination class action. The issue in *Trans World* was whether such claims constituted "an "interest in such property" under 11 U.S.C. §363(f) sold by the debtor such that the debtor's assets could be sold "free and clear" of any such interest.

For both types of claims, the Third Circuit held that they were interests for purposes of §363(f) because it was the assets of the debtor that gave rise to the claims. "Had TWA not invested in airline assets, which required the employment of the EEOC claimants, those successor liability claims would not have arisen. Furthermore, TWA's investment in commercial aviation is inextricably linked to its employment of the [sex discrimination] claimants as flight attendants, and its ability to distribute travel vouchers as part of the settlement agreement." *Id.* at 290.

Finally, the Third Circuit relied on the priority scheme of the Bankruptcy Code and prudential concerns regarding bid chilling, as follows:

> To allow the claimants to assert successor liability claims against [the successor] American [Airlines] while limiting other creditors' recourse to the proceeds of the asset sale would be inconsistent with the Bankruptcy Code's priority scheme.

[1] Another notable Third Circuit case is *Conway v. White Trucks, A Div. of White Motor Corp.*, 885 F.2d 90, 97 (3d. Cir. 1989), in which a litigant (Conway) was barred from asserting successor liability claims against Volvo after failing to pursue his claims against the debtor. Although Conway argued he did not have notice of the debtor's case until months after the bar date, the Third Circuit noted he took no steps to seek permission to file a late claim and never raised notice defects before the bankruptcy court. *Id.* at 96.

The Third Circuit examined the imposition of state-law successor liability claims and held that Pennsylvania law would preclude successor liability where the plaintiff failed to make any effort to assert his potentially available remedies in bankruptcy or in a pending lawsuit against the original manufacturer. *Id.* at 97.

> Moreover, the sale of TWA's assets to American at a time when TWA was in financial distress was likely facilitated by American obtaining title to the assets free and clear of these civil rights claims. Absent entry of the Bankruptcy Court's order providing for a sale of TWA's assets free and clear of the successor liability claims at issue, American may have offered a discounted bid. This is particularly likely given that the EEOC has been unable to estimate the number of claims it would pursue or the magnitude of the damages it would seek. The arguments advanced by appellants do not seem to account adequately for the fact that American was the only entity that came forward with an offer that complied with the court-approved bidding procedures for TWA's assets and provided jobs for TWA's employees.
>
> The Bankruptcy Court found that, in the absence of a sale of TWA's assets to American, "the EEOC will be relegated to holding an unsecured claim in what will very likely be a piece-meal liquidation of TWA. In that context, such claims are likely to have little if any value." *In re Trans World Airlines, Inc., et al.,* No. 01-00056, slip op. at 23, 2001 WL 1820326 (Bankr. D. Del. Mar.27, 2001). The same is true for claims asserted pursuant to the Travel Voucher Program, as they would be reduced to a dollar amount and would receive the same treatment as the unsecured claims of the EEOC. Given the strong likelihood of a liquidation absent the asset sale to American, a fact which appellants do not dispute, we agree with the Bankruptcy Court that a sale of the assets of TWA at the expense of preserving successor liability claims was necessary in order to preserve some 20,000 jobs, including those of [the Travel Voucher Program claimants] and the EEOC claimants still employed by TWA, and to provide funding for employee-related liabilities, including retirement benefits.

Id. at 292-93.

<u>Fourth Circuit</u>

In deciding *Trans World*, the Third Circuit relied heavily on the Fourth Circuit's decision in *In re Leckie Smokeless Coal Co.,* 99 F.3d 573 (4th Cir.1996). In *Leckie,* the Fourth Circuit held that, regardless of whether the purchasers of the debtors' assets were successors in interest, section 363(f) empowered the bankruptcy court to properly extinguish all successor liability claims arising under the Coal Act through an order transferring the debtors' assets free and clear of such claims. *See id.* at 576. The Fourth Circuit held that claims to collect Coal Act premium payments from the debtors' successors in interest were asserting interests in property that had already been sold through the section 363 sale, reasoning as follows:

> [W]hile the plain meaning of the phrase "interest in such property" suggests that not all general rights to payment are encompassed by the statute, Congress did not expressly indicate that, by employing such language, it intended to limit the scope of section 363(f) to *in rem* interests, strictly defined, and we decline to adopt such a restricted reading of the statute here.

Id. at 582. The Fourth Circuit explained that the claimants had interests in the debtors' transferred property because there was a relationship between the claimants' right to demand premium payments from the debtors and the use to which the debtors had put their assets. *See id.*

Fifth Circuit

In re Mooney Aircraft, Inc., 730 F.2d 367 (5th Cir.1984) was decided under the Bankruptcy Act, but is still instructive (and, candidly, perhaps the closest on-point case from the Fifth Circuit Court of Appeals). The debtors sold their assets subject to the full amount of all valid liens, but free and clear of all other claims, liabilities, liens, encumbrances, mortgages and security interests. 730 F.2d at 369-70. Post-sale, the debtors' assets were sold several more times, and were ultimately acquired by Mooney Aircraft Corporation ("Mooney").

Before the sale, Leo Foster acquired an aircraft manufactured by the debtor. Over a year after the debtors' case was closed, Mr. Foster and a passenger, William Bradshaw, were killed when Mr. Foster's plane crashed. The Foster and Bradshaw families filed wrongful death claims in California State Court against the successor, Mooney, and others. *Id.* at 371.

After years of litigation in the State Court, Mooney filed with bankruptcy court an application to reopen the predecessor debtors' cases and to enjoin the California wrongful-death proceedings. The bankruptcy court permanently enjoined the Foster and Bradshaw claimants from proceeding, finding as follows:

> Suits filed by the [Fosters and Bradshaws] herein and presently pending against [Mooney] in the Supreme Court in and for the County of Los Angeles, California seek to impose against [Mooney] as a "successor" to the assets of [the debtors] products liability claims arising from the manufacture of an airplane by [the debtors] in 1958. Such imposition of "successor" liability would contravene the literal terms, purpose and intent of the Court's Order of March 14, 1969 [to sell the assets free and clear of all claims], would seriously impair the ability of this Court to liquidate a bankrupt's estate at the highest value and transfer title to the bankrupt's assets free of all claims, and would alter the bankruptcy scheme among creditors.

Id. at 372.

The district court reversed, holding that the Fosters and Bradshaws were not bound by the sale order because they were not provided notice.

The Fifth Circuit went a step further, and held the bankruptcy court lacked jurisdiction to reopen a case based on a claim that arose following the closing of the case. *Id.* at 373. It did reiterate that a sale free and clear is ineffective to divest the claim of a creditor who did not receive notice (such as the Fosters and Bradshaws), citing *Factors' and Traders' Ins. Co. v. Murphy*, 111 U.S. 738, 4 S.Ct. 679, 28 L.Ed. 582 (1884), and further stated that because the Fosters and Bradshaws held no claim against the debtors' estates, their claim was not impacted by the sale order and the bankruptcy court's injunction was unnecessary to protect or effectuate a bankruptcy order that did not apply to the Fosters' and Bradshaws' future claim.

A more recent Fifth Circuit case is *In re Placid Oil Co.*, 753 F.3d 151, 157 (5th Cir. 2014), in which creditors argued that they could not be barred from bringing asbestos-related claims because the debtor knew that its employees had been exposed to asbestos but did not notify them before the cut-off date for asserting claims.

The Fifth Circuit affirmed the bankruptcy court's finding that the asbestos claimants were "unknown" creditors at the time of the debtor's bankruptcy case because the debtor had no specific knowledge of any actual injury to the claimants prior to the debtor's plan confirmation. *Id.* As unknown creditors, the claimants' receipt of constructive notice through publication in a newspaper of national circulation was sufficient to satisfy due process. *Id.* at 155. The Fifth Circuit concluded that it had "never required bar date notices to contain information about specific potential claims," and "declin[ed] to articulate a new rule that would require more specific notice for unknown, potential asbestos claimants." *Id.* at 154, 158.

<u>Sixth Circuit</u>

Another coal case! In *Al Perry Enter., Inc. v. Appalachian Fuels, LLC*, 503 F.3d 538, 539 (6th Cir. 2007), the debtor (Bowie Resources) sold assets to Appalachian Fuels, including a coal-purchase contract with the Tennessee Valley Authority ("TVA"). The plaintiff, Al Perry Enterprises ("Perry") and the debtor were parties to a brokerage agreement pursuant to which the debtor would pay Perry commissions for coal purchased through contracts obtained by Perry (such as the contract with the TVA). *Id.* Prepetition, a dispute between the debtor and Perry arose, resulting in an agreed judgment that provided for the debtor's continued payment of Perry on the TVA contract and the debtor's agreement to assume its contractual obligations to Perry under the agreed judgment should it file for bankruptcy. *Id.*

Bankruptcy followed, as did the debtor's proposal to sell assets, including the TVA contract, to an initial purchaser. *Id.* at 539-40. Perry objected to the proposed cure amount of zero, but the sale fell through, and Perry's objection was never adjudicated.

The debtor later proposed a sale to Appalachian Fuels, but Perry failed to renew his objection to that sale. *Id.* at 540.

Perry objected only after the sale was consummated and he was not paid the commissions to which he claimed he was entitled. *Id.* at 541

While the asset purchase agreement disclosed the assumption of the TVA agreement, it did not expressly provide for the assumption of Perry's broker agreement with the debtor. *Id.* The Sixth Circuit thus held that the effect of the bankruptcy court's order was to extinguish Perry's claim unless it was expressly assumed by Appalachian Fuels as part of the purchase agreement. *Id.*

Not to be deterred, Perry also argued that Appalachian Fuels assumed all liabilities "relating to" or "arising in connection with" the TVA contract and that Perry's claims for commissions on coal sold pursuant to the TVA contract is a liability "relating to" and "arising in connection with" the TVA contract. *Id.* at 543.

The Sixth Circuit disagreed and reasoned as follows:

> Bowie's obligation to pay commissions on coal sales is not explicitly mentioned anywhere in the purchase agreement or the bankruptcy court order approving the sale of assets. The obligation to pay commissions to Perry is "related to" and "arising in connection with" the separate contract between Bowie and Perry and not from any obligation created by the TVA contract itself.

> . . . .
>
> Adoption of the interpretation of the purchase agreement argued by Perry would result in the assumption of a myriad of obligations by the buyer of an executory contract even though those obligations were not created by the executory contract and were not expressly referred to in an asset purchase agreement or an order of the bankruptcy court.

Id. at 543-44. To the extent Perry based his failure to object on his perception of language in the asset purchase agreement, "[i]t made this assumption at its peril." *Id.* at 543.

Seventh Circuit

In *ITOFCA, Inc. v. MegaTrans Logistics, Inc.*, 322 F.3d 928, 932 (7th Cir. 2003), MegaTrans was the successor to a purchaser of software sold through a 363 sale. ITOFCA participated in the development of the software and participated in the bankruptcy case, but did not object to the sale process. Years later, ITOFCA sued MegaTrans for copyright infringement, alleged ITOFCA owned the copyright in the software, and the debtor sold only a license to use the software, not the copyright itself. *Id.* at 930. The question was not whether ITOFCA had notice of the sale order itself, but whether the sale order provided adequate notice that the debtor intended to transfer the copyright itself.

In rejecting ITOFCA's contentions that the sale order did not transfer the copyright, Judge Possner reasoned that because the sale order transferred the right to sell additional copies of the software (which exceeded the scope of a license), the copyright was transferred by implication. *Id.* The Seventh Circuit additionally held that "when a bankruptcy court approves the sale of an asset of the debtor, a person who has notice of the sale cannot later void it on the ground that he is the asset's real owner." *Id.* (citing *La Preferida, Inc. v. Cerveceria Modelo, S.A. de C.V.,* 914 F.2d 900, 908 (7th Cir. 1990)[2]; *In re Met–L–Wood Corp.,* 861 F.2d 1012, 1016 (7th Cir. 1988); *Veltman v. Whetzal,* 93 F.3d 517, 520–21 (8th Cir. 1996); *In re Edwards,* 962 F.2d 641, 643–44 (7th Cir. 1992)).

In a concurring opinion, perhaps foreshadowing the due process concerns and the scope of sale orders discussed at length in *General Motors*, Judge Ripple questioned whether the bankruptcy sale order actually conveyed a copyright and, accordingly, whether claim preclusion was appropriate. *Id.* at 732-33 (Ripple, J., concurring). Judge Ripple expressed his concerns as follows:

> [A]s noted by many courts, "[d]oubts are resolved against preclusion." *In re Associated Vintage Group, Inc.,* 283 B.R. 549, 562 (B.A.P. 9th Cir. 2002) (citing *Harris v. Jacobs,* 621 F.2d 341, 343 (9th Cir. 1980)). As stated by the Second Circuit, "although the principles of *res judicata* should not be frugally applied, a reasonable doubt as to what was decided in the first action should preclude the drastic remedy of foreclosing a party from litigating an essential

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[2] In *La Preferida,* after Corona had declared bankruptcy, the bankruptcy court, "correctly or incorrectly, ... purported to sell *all* of Corona's trademarks" from Corona itself to another company, Modelo. *La Preferida,* 914 F.2d at 908. The plaintiff, La Preferida, participated in the bankruptcy litigation and was later bound by the bankruptcy court's determination when future litigation arose. *Id.* at 909.

> issue." *McNellis v. First Fed. Sav. & Loan Ass'n of Rochester*, 364 F.2d 251, 257 (2d Cir. 1966) (internal citations omitted) (finding that lower court's disposition concerning a supplemental complaint was "ambiguous" and thus refusing to apply claim preclusion for action based on same transaction as that in supplemental complaint). ***The rationale for this rule is evident. If it is ambiguous and subject to reasonable doubt whether or not the plaintiff ever got a first bite (or even the opportunity to take a first bite) at the apple, to bar that claim forever would be unfair and would act as "a trap for the unwary."*** *Andersen [v. Chrysler Corp.]*, 99 F.3d [846, 852 (7th Cir. 1996)]. Certainly, if the party asserting claim preclusion cannot establish and the reviewing court cannot determine whether the claim was disposed by or ought to have been brought in the prior action, there is no guarantee that the party being precluded understood the situation either.

Id. at 742 (Ripple, J., concurring) (footnote omitted) (emphasis added). Ultimately, Judge Ripple concurred in the majority opinion as a result of his conclusion that the terms of the bankruptcy sale order were sufficiently clear to preclude ITOFCA's belated claims of ownership. *Id.* at 733-34 (Ripple, J., concurring)

Eighth Circuit

More from TWA!

In *Cibulka v. Trans World Airlines, Inc.*, 92 Fed.Appx. 366 (8th Cir. 2004) (per curiam), the Eighth Circuit considered a similar issue to that considered in *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003) by the Third Circuit. Whereas the Third Circuit addressed EEOC claims by an unknown number of potential claimants, *see id.* at 543-44, the Eighth Circuit addressed a single disability discrimination claim by a single litigant (Cibulka). 92 Fed.Appx. at 367.

The bankruptcy court rejected Cibulka's attempt to impose successor liability because: (i) the bankruptcy court possessed equitable authority to permit the sale free and clear of successor liability claims; and (ii) the public interest did not favor jeopardizing the job security of 20,000 TWA employees "at the expense of preserving successor liability claims that would be rendered unenforceable absent a sale of substantially all of TWA's assets as a going concern." *Id.* at 368.

After recognizing the Third Circuit's logic in *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003), the Eighth Circuit agreed "with the analysis of the bankruptcy court and the Third Circuit" and held that Cibulka is not entitled to proceed on a theory of successor liability against American Airlines, and the district court's dismissal of his action did not violate public policy. *Id.*

Ninth Circuit

In re Ex-Cel Concrete Co., Inc., 178 B.R. 198, 205 (9th Cir. BAP 1995), the Bankruptcy Appellate Panel for the Ninth Circuit flatly rejected *In re Edwards*, 962 F.2d 641 (7th Cir.1992),[3]

[3] In *Edwards* the Seventh Circuit upheld the decision of the Bankruptcy Court as affirmed by the District Court dismissing an adversary proceeding of a secured creditor whose property was sold for less than the amount of its

and held that lack of notice deprived the bankruptcy court of *in personam* jurisdiction needed to adjudicate a potential claimant's rights.[4] In *Ex-Cel Concrete*, notice of a 363 sale was delivered to the creditor's prior attorney, but not the creditor itself. *Id.* at 203. "[S]ervice on unauthorized counsel did not provide notice. The court's finding that the mailing of notice to an unrelated party satisfied due process concerns is clearly erroneous." *Id.* at 204.

In rejecting *Edwards* and holding that the good-faith purchaser took the property subject to the creditor's lien, the Ninth Circuit B.A.P. stated that it "respectfully disagree[s] with *Edwards* to the extent that it allows considerations, such as the exigent needs of the bankruptcy system or the innocence or good faith of third parties involved in bankruptcy sales, to justify departures from due process standards in adjudicating property rights. . . . The secured creditor . . . was not required to abdicate its right to notice and a hearing." *Id.* at 205.

<u>Tenth Circuit</u>

In *Flores v. United States Repeating Arms Co., Inc.*, 19 Fed. Appx. 795, 796-97 (10th Cir. 2001), a family (Flores) brought a products liability suit against United States Repeating Arms based on an alleged defect in a firearm manufactured by United States Repeating Arms' predecessor, which filed for bankruptcy years earlier.

The district court granted summary judgment in favor of United States Repeating Arms and held there was no successor liability. *Id.* at 797.

In affirming, the Tenth Circuit recognized that under Oklahoma law, the general rule is that "where one company sells or otherwise transfers all its assets to another company, the latter is not liable for the debts and liabilities of the transferor." *Id.* (citing *Pulis v. United States Elec. Tool Co.*, 561 P.2d 68, 69 (Okla. 1977)). In *Pulis*, the Oklahoma Supreme Court recognized four exceptions to this general rule:

> (1) Where there is an agreement to assume such debts or liabilities (2) Where the circumstances surrounding the transaction warrant a finding that there was a consolidation or merger of the corporations, or (3) that the transaction was fraudulent in fact or (4) that the purchasing corporation was a mere continuation of the selling company.

Id.

The Tenth Circuit rejected Flores's contention that the fourth exception applied, because under Oklahoma law, a common identity of directors, officers and stockholders before and after the sale is required to impose such exception. *Id.* Because no such evidence was presented, the Tenth Circuit affirmed the district court's summary judgment ruling. *Id.* at 797-98.

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debt without any notice to the secured creditor. The Seventh Circuit stated that "neither do we think that [the secured creditor] has displayed such diligence and zeal in the matter to cause us to question the strict rule in favor of the bona fide purchaser at a bankruptcy sale." *Id.* At 645-646.

[4] Because *Ex-Cel Concrete* involved a secured creditor that faced losing a lien that secured debt of over $400,000, 178 B.R. at 201, there was no discussion of the creditor's ability to establish prejudice as a result of the due process violation.

Eleventh Circuit

In *Epstein v. Official Comm. of Unsecured Creditors of the Estate of Piper Aircraft Corp. (In re Piper Aircraft, Corp.)*, 58 F.3d 1573, 1577 (11th Cir. 1995), the Eleventh Circuit developed the "Piper Test" to determine whether an individual has a claim against a debtor manufacturer.

The bankruptcy court had appointed Appellant Epstein as the legal representative for the "Future Claimants," defined to include:

> All persons, whether known or unknown, born or unborn, who may, after the date of confirmation of Piper's Chapter 11 plan of reorganization, assert a claim or claims for personal injury, property damages, wrongful death, damages, contribution and/or indemnification, based in whole or in part upon events occurring or arising after the Confirmation Date, including claims based on the law of product liability, against Piper or its successor arising out of or relating to aircraft or parts manufactured and sold, designed, distributed or supported by Piper prior to the Confirmation Date.

Id. at 1575. Epstein's claim against the debtor's estate was disallowed after the bankruptcy court determined that the Future Claimants did not hold claims as defined by section 105(5).

In affirming both the bankruptcy court and district court, the Eleventh Circuit developed the "Piper Test" for determining whether

> We therefore modify the test used by the district court and adopt what we will call the "Piper test" in determining the scope of the term claim under § 101(5): an individual has a § 101(5) claim against a debtor manufacturer if (i) events occurring before confirmation create a relationship, such as contact, exposure, impact, or privity, between the claimant and the debtor's product; and (ii) the basis for liability is the debtor's prepetition conduct in designing, manufacturing and selling the allegedly defective or dangerous product. The debtor's prepetition conduct gives rise to a claim to be administered in a case only if there is a relationship established before confirmation between an identifiable claimant or group of claimants and that prepetition conduct.

Id. at 1577. Having thus defined its Piper Test, the Eleventh Circuit quickly determined that the Future Claimants failed the Piper Test and did not hold clams because there was "no preconfirmation exposure to a specific identifiable defective product or any other preconfirmation relationship between [the debtor] and the broadly defined class of Future Claimants." *Id.* at 1578.

Second Circuit

In re Motors Liquidation Co., 829 F.3d 135 (2d Cir. 2016), *cert denied*, 2017 WL 1427591 (Apr. 24, 2017) ("*General Motors*")

General Motors grapples with nearly every major issue present in our sampling of cases from other circuits: post-confirmation jurisdiction; the scope of a free and clear sale provision; whether creditors were known or unknown to the seller; the type of notice required; whether a due process violation and prejudice were established; considerations of extraordinary circumstances; a desire to enable a successful reorganization; and the interplay of all of the foregoing on the priority scheme and purpose of the bankruptcy code itself.

To say the facts of *General Motors* are unique is an understatement.

On June 1, 2009, General Motors Corporation ("Old GM") filed for bankruptcy. During the financial crisis of 2007 and 2008, as access to credit tightened and consumer spending diminished, Old GM posted net losses of $70 billion over the course of a year and a half. *Id.* at 143. The U.S. Department of the Treasury ("Treasury") loaned billions of dollars from the Troubled Asset Relief Program ("TARP") to buy the company time to revamp its business model. When Old GM's private efforts failed, President Barack Obama announced to the nation a solution—"a quick, surgical bankruptcy." *Id.*

On June 2, 2009, the bankruptcy court ordered GM to provide actual notice of the proposed section 363 sale order (Sale Order) to all known creditors of GM and publication notice (in newspapers, etc.) to all unknown creditors. *Id.* at 146. In early July 2009, the bankruptcy court approved the sale and entered an order authorizing, among other things, the sale of GM's assets "free and clear of all liens, claims, encumbrances, and other interests of any kind or nature whatsoever, including rights or claims based on any successor or transferee liability." *Id.*

The new General Motors LLC ("New GM") emerged following a 363 sale just forty days post-petition. *Id.* at 143.

What creditors – and New GM – did not know was that, for years, Old GM had been aware of a defect in certain ignition switches that had nevertheless been installed in millions of vehicles. *Id.* at 149-150. With minimal force, the "switch from hell" (as the switch was called inside Old GM) could be switched into the "accessory" or "off" position, causing not only a loss of control of the vehicle, but additionally causing airbags to become inoperable in the event of a crash. *Id.* The defective switches led to numerous accidents, and multiple deaths, well before Old GM's bankruptcy case, but was not publicly disclosed until 2014 (years after consummation of the sale to New GM). *Id.*

After tort claimants began asserting claims against New GM, New GM sought to enforce the free and clear provisions of the sale order in bankruptcy court. *Id.* at 150. Among other holdings, the bankruptcy court determined that "Ignition Switch Plaintiffs" were entitled to actual notice, which they did not receive, but that they had failed to show prejudice because the bankruptcy court stated it still would have approved the sale. *Id.* at 151.

The Second Circuit considered four issues on appeal, three of which are relevant here: (1) the bankruptcy court's jurisdiction to enforce the sale order; (2) the scope of the power to sell assets "free and clear" of all interests; and (3) the procedural due process requirements with respect to notice of such a sale. *Id.* at 152.

(1) Jurisdiction

First, the Second Circuit rejected certain claimants' contentions that the bankruptcy court lacked jurisdiction to enjoin their claims or issue a new injunction. The Second Circuit held that a bankruptcy court's decision to interpret and enforce a prior sale order falls under the "arising in" jurisdiction of 28 U.S.C. § 1334. *Id.* at 153.

> An order consummating a debtor's sale of property would not exist but for the Code, *see* 11 U.S.C. § 363(b), and the Code charges the bankruptcy court with carrying out its orders, *see id.* § 105(a) (providing that bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title"). Hence, a bankruptcy court "plainly ha[s] jurisdiction to interpret and enforce its own prior orders."
>
> . . . .
>
> Accordingly, we agree that the bankruptcy court had jurisdiction to interpret and enforce the Sale Order.

Id. at 153-54. *But see In re Mooney Aircraft, Inc.*, 730 F.2d 367, 373 (5th Cir.1984) (holding bankruptcy court lacked jurisdiction to reopen a case based on a claim that arose following the closing of the case).

(2) The Scope of "Free and Clear"

The Second Circuit next determined whether the scope of the bankruptcy court's Sale Order applied to (1) pre-closing accident claims, (2) economic loss claims arising from the ignition switch defect or other defects, (3) independent claims relating only to New GM's conduct, and (4) Used Car Purchasers' claims (i.e., the claims of individuals who purchased Old GM cars *after* the 363 sale closed).

The Second Circuit determined that pre-closing accident claims fell clearly within the scope of the Sale Order, and that, while a closer call, the economic loss claims arising from the ignition switch defect or other defects also fell within the scope of the Sale Order because such claims, although contingent, were based on Old GM's conduct and flow from operation of Old GM's business. *Id.* at 157.

But claims in the latter two categories (independent claims relating only to New GM's conduct and Used Car Purchasers' claims) were not within the scope of the Sale Order because they were based on New GM's conduct and (for Used Car Purchasers' Claims) were not related to any contact with Old GM prior to bankruptcy. *Id.*

(3) Procedural Due Process Requirements

Having determined that pre-closing accident claims and economic loss claims arising from the ignition switch defect or other defects were within the scope of the Sale Order, the Second Circuit then analyzed whether procedural due process was satisfied.

First, the Second Circuit agreed with the bankruptcy court's finding that Old GM knew or should have known of the ignition switch claims, such claimants were entitled to actual notice, not merely notice by publication:

> If the debtor knew or reasonably should have known about the claims, then due process entitles potential claimants to actual notice of the bankruptcy proceedings, but if the claims were unknown, publication notice suffices.

Id. at 159 (citing *Chemetron Corp. v. Jones*, 72 F.3d 341, 345–46 (3d Cir. 1995)). *Accord In re Placid Oil Co.*, 753 F.3d 151, 155 (5th Cir. 2014); *In re Savage Indus., Inc.*, 43 F.3d 714, 721-22 (1st Cir.1994).

The Second Circuit also addressed concerns raised by New GM regarding *its* lack of knowledge and the underlying importance of the 363 sale:

> New GM essentially asks that we reward debtors who conceal claims against potential creditors. We decline to do so. *See* [*Grogan v. Garner*, 498 U.S. 279, 286–87 (1991)].
>
> Finally, we address a theme in this case that the GM bankruptcy was extraordinary because a quick § 363 sale was required to preserve the value of the company and to save it from liquidation. See New GM Br. 34 ("Time was of the essence, and costs were a significant factor."). Forty days was indeed quick for bankruptcy and previously unthinkable for one of this scale. While the desire to move through bankruptcy as expeditiously as possible was laudable, Old GM's precarious situation and the need for speed did not obviate basic constitutional principles. Due process applies even in a company's moment of crisis. *Cf. Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 425, 54 S.Ct. 231, 78 L.Ed. 413 (1934) ("The Constitution was adopted in a period of grave emergency.").

Id. 160-61.

Having determined that inadequate notice was provided, the Second Circuit then examined whether prejudice had been established. Without deciding whether prejudice is a required element when there is inadequate notice, the Second Circuit held that because it could not find with fair assurance that the outcome of the sale would have been the same, a procedural due process violation existed. *Id.* at 163. The Second Circuit held that the emergency need for the sale and the risk of the plaintiffs disrupting the closing may have actually resulted in an accommodation to the plaintiffs had they been afforded notice, as follows:

> While we agree that liquidation would have been catastrophic, we are confident that Old GM, New GM, Treasury, and the bankruptcy court itself would have endeavored to address the ignition switch claims in the Sale Order if doing so was good for the GM business. The choice was not just between the Sale Order as issued and liquidation; accommodations could have been made.

Id. at 166.

Potential Ramifications

At first blush, *General Motors* appears to impose a harsh result (successor liability) on a good faith purchaser. And that may be a fair takeaway. But no single portion of the Second Circuit's holding lacks support from other circuit courts. For instance, the Second Circuit's adherence to principles of due process despite claims of exigent circumstances is consistent with the holdings of both *In re Savage Indus., Inc.*, 43 F.3d 714 (1st Cir.1994) and *In re Ex-Cel Concrete Co., Inc.*, 178 B.R. 198, 205 (9th Cir. BAP 1995). And the Second Circuit's approach to determining the scope of the free and clear sale order is largely consistent with the approach taken in *In re Trans World Airlines, Inc.*, 322 F.3d 283, 284 (3d Cir. 2003).

We have no doubt that courts across the country can distinguish *General Motors* based on the unique facts of that case. Old GM's failing to appropriately address defective ignition switches and notify claimants of whom they were or should have been aware presents an atypical fact pattern indeed.

Nevertheless, practitioners are correctly viewing *General Motors* with trepidation, and it will unquestionably impact 363 sales – particularly those involving manufacturers subject to products liability claims – not just in the Second Circuit, but nationwide.

We expect to see heightened demands by purchasers for increased pre-sale due diligence (to identify potential claimants), together with increased expenses and objections that naturally result from prophylactic sale notices. And we can of course foresee purchasers demanding increased sale protections and/or decreased purchase prices. Each effort to increase finality and eliminate successor liability will be coupled with decreased efficiency and delay of the sale process.

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It Wasn't Me!!: Dealing with Successor Liability, Alter Ego, Veil Piercing and Substantive Consolidation Issues with respect to Insolvent Companies

Current Issues in Substantive Consolidation

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CURRENT ISSUES IN SUBSTANTIVE CONSOLIDATION

I. Very generally – the landscape from 40,000 feet.

A. Definition. "Substantive consolidation" may be generally defined as the combination or "consolidation" of the assets and the liabilities of multiple entities in a bankruptcy case, resulting in a single "consolidated" entity. On a basic level, the unencumbered assets of the entities consolidated are pooled as though owned by the resulting single, consolidated entity. Likewise, the general, unsecured liabilities of the consolidated entities become liabilities of the single, consolidated entity, entitled to participate in the pooled assets of that entity for payment of their claims.

B. Code authority. The Bankruptcy Code[1] provides no express authorization for substantive consolidation, although, in chapter 11 cases, Code section 1123(a)(5)(C) specifies that a plan may provide for consolidation of "the debtor with one or more persons" as a permitted means for its implementation. More controversially, and more often in chapter 7, rather than chapter 11 cases, courts have created the remedy of substantive consolidation using the base authority of Code section 105(a), which authorizes the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code]."

C. Supreme Court jurisprudence. The most noteworthy early example of substantive consolidation occurred when the United States Supreme Court upheld a bankruptcy referee's consolidation of an individual debtor's estate with that of a non-debtor corporation, wholly owned by the debtor and his family. In upholding the non-debtor's substantive consolidation, the

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[1] 11 U.S.C. § 101, *et seq.* Citations to the Bankruptcy Code in these materials will be simply, "Code section ____.'"

Supreme Court observed that the "power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete." *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) (applying substantive consolidation to thwart efforts to place assets rightfully belonging to a bankruptcy case debtor, obtained through fraudulent transfers to a non-debtor, beyond the reach of the debtor's creditors).

D. Contexts used. Substantive consolidation appears in bankruptcy cases in two contexts: (1) consolidation of related bankruptcy debtor entities; and (2) consolidation of bankruptcy debtor entities with entities not debtors in bankruptcy cases.

1. Multiple Debtors. Substantive consolidation of multiple debtor entities, *i.e.* entities which are each debtors in separate bankruptcy cases, may occur to effect marshalling of estates of two or more debtors in bankruptcy cases.[2] In business bankruptcy cases, and perhaps mislabeled as such, substantive consolidation is often effected in chapter 11 reorganization cases.[3] As noted above, the base authority for

[2] Consolidation is to be distinguished from joint administration of cases under Rule 1015(b), Fed. R. Bankr. P. In joint administration, assets and creditor claims are not pooled, although the two or more estates may be ordered without such pooling, provided that the court has first "give[n] consideration to protecting creditors of different estates against potential conflicts of interest." Joint administration is outside of the scope of these materials.

[3] At least one scholarly article has distinguished this type of consolidation, referring to it as a "deemed" consolidation, noting:

> For the purposes of voting, distribution and/or cramdown, claims are estimated as if the formally distinct entities were consolidated; however, the reorganized corporate group that emerges from bankruptcy is not consolidated and may retain its pre-bankruptcy structure.

Andrew Brasher, Substantive Consolidation: A Critical Examination 5 (2006) (unpublished manuscript), http://www.law.harvard.edu/programs/corp_gov/papers/Brudney2006_Brasher.pdf. Brasher noted that both doctrines achieve essentially the same result, but deemed consolidations substantive consolidation in these cases is Code section 1123(a)(5)(C), as well as Code section 105(a).

In the multiple-bankruptcy debtor cases, the entities to be substantively consolidated are typically related, affiliate entities. There, bankruptcy judges are most often requested to, and often do, order substantive consolidation of the related entities by means of confirmation of a joint reorganization plan for all of the entities to be included in the consolidation.

In some multiple-debtor entity scenarios, the substantive consolidation effects a merger, with a single entity emerging as the reorganized debtor – with all entities' assets and liabilities dealt with by the plan. In other instances, plans provide for the substantive consolidation to be only effective for plan purposes, most importantly providing for treatment of creditors of all entities, but providing for post-confirmation emergence of the debtor entities as separate entities (reorganized by settlement of creditor claims as governed by the plan).[4]

Another typical aspect of multiple-debtor substantive consolidations, again typically effected by chapter 11 plans, is treatment of inter-company claims. Most of these plans eliminate inter-company claims. Where a plan provides for essentially a merger of the substantively-consolidated entities, inter-company ownership structures may also be eliminated.

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have the added benefit of maintaining the separate legal personalities of subsidiaries before and after reorganization for "tax purposes, regulatory reasons, to secure post-petition financing or to more easily sell a group of assets pursuant to a plan." *Id.*

[4] *See* fn. 1 discussing "deemed" consolidations.

Multiple-debtor substantive consolidations through chapter 11 plans may raise numerous plan confirmation issues under Code section 1129 and related provisions. One obvious issue which may arise is the propriety of creditor classifications provided by such a plan. *See* Code sections 1122 and 1129(a)(1). Another issue may be whether the plan satisfies the "best interests of creditors test," so that dissenting creditors within an accepting class will receive or retain consideration with a value of at least what would be received in a liquidation. *See* Code section 1129(a)(7). A third issue may be whether the plan may be confirmed over the objection of a dissenting class. *See* Code section 1129(b). Discussion of these issues relating to substantive consolidation, as well as many others that may be raised in the chapter 11 plan confirmation process context, are beyond the scope of these materials.

2. Debtor entities consolidated with non-debtors. Substantive consolidation of a debtor entity in a bankruptcy case with a non-debtor entity is the second context often seen. Here, with no other statutory provision of the Bankruptcy code to provide authority, the base authority for substantive consolidation in these cases is Code section 105(a). As this type of substantive consolidation is the most likely contested and controversial, it is the principal focus of these materials.

Most often in these debtor/non-debtor substantive consolidation scenarios, chapter 7 trustees or creditors in chapter 7 cases are the proponents of substantive consolidation. The remedy is almost always described in the opinions and orders of the courts as an "extraordinary remedy" to be used "sparingly." *See, e.g., In re Bonham*, 229 F.3d 750, 767 (9th Cir. 2000). The courts then go on to state that the remedy of substantive consolidation is to be invoked within the bankruptcy court's broad, but not statutorily defined, equitable powers conferred by Code section 105(a). *See Matter of Munford, Inc.*, 115 B.R. 390, 397 (Bankr. N.D. Ga. 1990) ("[S]ubstantive consolidation itself is 'entirely a creature of court-made law,' yet courts recognize it as a valid application of § 105(a)." (citations omitted)); *In re Bauman*, 535 B.R. 289, 295 (Bankr. C.D. Ill. 2015) ("The court's authority to undertake the remedy is premised upon the general equitable power conferred by section 105(a) of the Bankruptcy Code.") (citing *In re Cyberco Holdings, Inc.*, 734 F.3d 432, 439 (6th Cir. 2013)).

As noted above, one effect of substantive consolidation is a pooling of assets of all consolidated entities to pay creditors of all. Unless the situation is fortunate enough that consolidation results in a single solvent entity, with combined assets sufficient to pay all combined debts (which seems seldom to occur), the effect may be to force creditors of a more solvent entity to share equally with creditors of one or more less solvent ones. *See In re Auto-Train Corp., Inc.*, 810 F.2d 270, 276 (D.C. Cir. 1987) ("[B]ecause every entity is likely to have a different debt-to-asset ratio, consolidation almost invariably redistributes wealth among the creditors of the various entities."); *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518 (2d Cir. 1988) (substantive consolidation poses possibility of "forcing creditors of one debtor to share on a parity with creditors of a less solvent debtor.").

Because substantive consolidation will most often result in benefitting one entity's creditors to the detriment of creditors of another, courts have been reluctant to use the "extraordinary" remedy of substantive consolidation.

II. What substantive consolidation is not – three similar, but different remedies.

In the context of what typically are chapter 7 cases in which the trustee or creditor interests seek to include non-debtor entity assets in a pool to pay liabilities of a bankruptcy case debtor (as well as those of the non-debtor), as discussed in part I.D.2 above, other similar, but different remedies may be considered. As with substantive consolidation, the alternative remedies often are used seeking to mitigate fraudulent use of otherwise legally separate entities (including individuals, corporations and other entity forms).

These remedies against non-debtor entities include, among others, commencement of an involuntary bankruptcy, actions to recover avoidable fraudulent transfers, and actions to pierce the veil of non-debtor entities. Substantive consolidation of non-debtor entities, relying on Code section 105(a), does not conflict with the purposes of the Bankruptcy Code and its Code section 303 provisions for involuntary bankruptcy, Code section 548 providing for fraudulent transfer actions, or state law veil-piercing actions, although they may provide the same results.

Although beyond the scope of these materials, a brief discussion of these remedies, which may be alternatives to substantive consolidation, follows.

A. Involuntary bankruptcy petition. Code section 303 provides authority for involuntary bankruptcy filings by one or several creditors. That section requires the target debtor entity be insolvent. The requirement of target debtor insolvency would defeat the very purpose of substantive consolidation, which is to bring unencumbered assets into the pool available to pay creditors of the original debtor, for which a trustee or creditor using that remedy seeks to enhance.

Several courts have addressed the distinction between substantive consolidation and involuntary bankruptcies. As one court noted, "[S]ubstantive consolidation and the right to file an involuntary petition are two entirety different remedies. Compelling the Trustee to file an involuntary bankruptcy petition under 11 U.S.C. § 303 would defeat the very purpose of substantive consolidation." *In re S & G Fin. Servs. of S. Florida, Inc.*, 451 B.R. 573, 582 (Bankr. S.D. Fla. 2011); *see also Munford*, 115 B.R. at 397 ("[S]ubstantive consolidation of a nondebtor's assets with those of a debtor is substantially different from the involuntary petition remedy of § 303; and, therefore, it does not circumvent the requirements of that provision."). Likewise, "Substantive consolidation focuses on the debtor's interrelationship with others, using equitable principles to consolidate assets and liabilities; whereas involuntary bankruptcy focuses on the debtor's financial relationship with its creditors and whether the debtor is paying its debts as they become due." *OMS, LLC v. Bank of Am., N.A.*, 2015 WL 12712307, at *3 (C.D. Cal. Nov. 6, 2015). "An involuntary bankruptcy involves totally different inquiries than substantive consolidation." *Id.*

B. <u>Avoidance of fraudulent transfers action</u>. Fraudulent transfer actions brought under Code section 548 or state law counterparts generally require a showing of fraud or intent to hinder or delay creditors. That showing, often very difficult to prove, is not required for substantive consolidation. *See S & G Fin. Servs*, 451 B.R. at 583 ("The standard for alleging a claim under 11 U.S.C. § 548 is more stringent than that for alleging substantive consolidation as a substantive consolidation claim 'does not require a finding of fraud or an intent to hinder and delay creditors.'" (citation omitted)).

C. Veil piercing action. An action to pierce or disregard the corporate (or other entity) veil requires a finding that the target non-debtor entity is the alter ego of the debtor, which is not required for substantive consolidation. The proponent of the veil-piercing remedy seeks to ignore the limited liability of the target, as compared with substantive consolidation, which seeks to ignore entity shielding. "Whereas veil piercing seeks to hold shareholders vicariously liable for corporate wrongs, '[s]ubstantive consolidation goes in a direction different (and in most cases further) than [that].'" *In re Howland*, 674 F. App'x 482, 488 (6th Cir. 2017) (quoting *In re Owens Corning*, 419 F.3d 195, 206 (3d Cir. 2005)). "It brings all the assets of a group of entities into a single survivor. Indeed, it merges liabilities as well." *Owens Corning*, 419 F.3d at 206.

In effect, piercing the veil is a creditor's remedy against equity, while substantive consolidation is a creditor's remedy against another creditor. Another way of describing the difference is that piercing the veil is "vertical consolidation" (*e.g.* parent and subsidiary) while substantive consolidation is "horizontal consolidation" (*e.g.* subsidiary and subsidiary). Brasher, *supra*, at 7. Unlike veil piercing, substantive consolidation does not require a finding that the nondebtor entities are alter egos of the debtor.

III. Standards for Substantive Consolidation.

A. Fact-intensive examination. Common to all tests is a fact-intensive examination and analysis. *See* 2 Collier on Bankruptcy ¶ 105.09[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

B. Commonly-cited cases/tests. Among others, the following cases are often cited for defining the following test factors required for substantive consolidation:

1. *In re Owens Corning*, 419 F. 3d 195, 211 (3rd Cir. 2005):

> In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.

(Footnotes omitted).

2. *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518 (2d Cir. 1988): The Second Circuit identified two critical factors: "(i) whether creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit,' or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors." (Internal citations omitted).

3. *In re Auto-Train Corp., Inc.*, 810 F.2d 270, 276 (D.C. Cir 1987): A 3-part test determines whether substantive consolidation may be effected: (1) whether a substantial identity between the entities exists; (2) whether consolidation is necessary to avoid some harm or to realize some benefit; and (3) if a creditor objects on the basis that it relied on the separate credit of one of the entities to its prejudice, the benefits of consolidation must outweigh the harm.

C. Analysis of impact on creditors – necessary to avoid some harm or realize some benefit. The D.C. Circuit's test requires a court, before ordering consolidation, to "conduct a searching inquiry to ensure that consolidation yields benefits offsetting the harm it inflicts on objecting parties." *Auto-Train Corp.*, 810 F.2d at 276 (citation omitted). In cases where this is made a requirement, if a creditor objects on the grounds that it relied on the separate credit of one of the entities to its prejudice, the court may only order consolidation "if it determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm." *Id*. (citation omitted).

IV. Substantive Consolidation of Non-Debtors.

A. Overview of the Issue. While substantive consolidation of debtor entities appears to be growing in prominence and more widely accepted, substantive consolidation of non-debtor entities is "controversial." Kara Bruce, *Non-Debtor Substantive Consolidation—A Remedy Built on Rock or Sand?*, 37 No. 3 Bankruptcy Law Letter NL 1 (March 2017). Courts and commenters that have concluded that non-debtor substantive consolidation is inappropriate "have stressed that § 105 is not a source of substantive rights and have identified a number of concerns—jurisdictional, due-process-related, and practical—with applying § 105 to draw non-debtors into a bankruptcy case." *Id.* (footnotes omitted). Additionally, "a chief concern is that non-debtor substantive consolidation works an end run around the stringent requirements for involuntary bankruptcy contained in § 303 of the Code." *Id.* "By design, § 303 is 'not user-friendly.' It contains a number of procedural hurdles that creditors must follow to successfully mount an involuntary petition." *Id*. (footnotes omitted) (citations omitted).

B. Cases allowing substantive consolidation of non-debtor entities. The following presents a sample of cases approving of substantive consolidation of non-debtor entities*:* *In re Tureaud*, 45 B.R. 658 (Bankr. N.D.Okla.1985), *aff'd* 59 B.R. 973 (N.D. Okla. 1986) (substantive consolidation granted on motion of trustee in main bankruptcy case upon showing that such consolidation would simplify the administration of the assets and liabilities of various entities); *Bonham v. Compton (In re Bonham)*, 229 F.3d 750 (9th Cir. 2000); *Soviero v. Franklin Nat'l Bank of Long Island*, 328 F.2d 446 (2nd Cir. 1964) (for lack of separateness); *Chemical Bank*

New York Trust Co. v. Kheel, 369 F.2d 845 (2nd Cir. 1966) (substantively consolidating non-debtors because of commingling of assets and failure to maintain separate and adequate books and records); *Simon v. New Center Hospital (In re New Center Hospital)*, 187 B.R. 560 (E.D. Mich. 1995) (for alter ego reasons); *White v. Creditors Service Corp. (In re Creditors Service Corp.)*, 195 B.R. 680 (Bankr. S.D. Ohio 1996); *Bracaglia v. Manzo (In re United Stairs Corp.)*, 176 B.R. 359 (Bankr.D.N.J.1995) (substantive consolidation of non-debtor appropriate where debtor transferred property to non-debtor in bad faith and so as to place such assets beyond reach of original debtor's creditors, i.e. for reasons supported by *Sampsell*); *In re 1438 Meridian Place, N.W., Inc.*, 15 B.R. 89 (Bankr. D.C. 1981) (for inadequate books and records); *In re Crabtree*, 39 B.R. 718 (Bankr. E.D. Tenn. 1984) (for alter ego reasons); *Matter of Baker & Getty Fin. Svcs., Inc.*, 78 B.R. 139 (Bankr. N.D. Ohio 1987); *In re United Stairs Corp.*, 176 B.R. 359 (Bankr. D.N.J. 1995); *In re Creditors Service Corp.*, 195 B.R. 680 (Bankr. S.D. Ohio 1996).

C. <u>Cases disallowing substantive consolidation of non-entities</u>. The following presents a sample of cases holding substantive consolidation of non-debtor entities is not permitted: *In re Pearlman*, 462 B.R. 849 (Bankr. M.D. Fla. 2012); *In re Circle Land and Cattle Corp.*, 213 B.R. 870, 877 (Bankr. D. Kan. 1997); *In re Julien Co.*, 120 B.R. 930 (Bankr. W.D. Tenn. 1990); *In re DRW Property Co.* 82, 54 B.R. 489 (Bankr. N.D. Tex. 1985); *In re Alpha & Omega Realty, Inc.*, 36 B.R. 416 (Bankr. D. Idaho 1984).

D. <u>Eighth Circuit vs. Tenth Circuit authority</u>. There appears to be a split of authority in recent bankruptcy cases out of the Eighth and Tenth Circuits with respect to whether it is appropriate to substantively consolidate non-debtor entities. In the Eighth Circuit, the court in *In re: Archdiocese of St. Paul and* Minneapolis, 553 B.R. 693 (Bankr. D. Minn. 2016), *aff'd* 562

B.R. 755 (D. Minn. 2016) held that substantive consolidation could not be used to subvert the principals of involuntary bankruptcy, while in the Tenth Circuit, *SE Property Holdings, LLC v. David A. Stewart, et al. (In re: Stewart)*, Adv. No. 16-1117-JDL, 2017 WL 1740365, at *8 (Bankr. W.D. Okla. May 3, 2017) recognized that under limited circumstances, a court has the discretion to substantively consolidate a debtor's estate with non-debtors.[5] *But see In re Circle Land & Cattle Corp.*, 213 B.R. 870 (Bankr. D. Kan. 1997) (concluding the court could not substantively consolidate non-debtor farmers because that would violate the principles of involuntary bankruptcy). These and other relevant cases from the Eighth and Tenth Circuit are discussed further in the below sections.

E. Additional relevant case law - *Kapila v. S & G Financial Services, LLC (In re S & G Financial Services of South Florida, Inc.)*, 451 B.R. 573, 582 (Bankr. S.D. Fla. 2011).

1. Background. The chapter 7 trustee filed an adversary proceeding against two non-debtor entities. The sole officer, director, and shareholder of the debtor corporation also served as the sole member and manager of the two non-debtor entities.

[5] However, in a subsequent ruling, the *In re Stewart* court granted a motion to dismiss an amended complaint seeking substantive consolidation for failure to allege facts supporting consolidation; specifically, facts to show that substantive consolidation would benefit *all* of the estates' creditors, both those of the current debtors and those to be forcibly made debtors. *In re Stewart*, No. 15-12215-JDL, 2017 WL 3575698, at *4 (Bankr. W.D. Okla. Aug. 17, 2017). The court noted that in its previous order it "reluctantly recognized that under very limited circumstances it had the discretion, to be exercised sparingly on a highly fact-specific case-by-case basis, to substantively consolidate a debtor's estate with non-debtors" if the movant meets the required elements. *Id.* at *2. In concluding the movant did not state sufficient facts for substantive consolidation, the court emphasized, "Better, we think, to ask are any creditors going to be hurt by this consolidation and, if the answer to that is yes (or more properly, if the one seeking consolidation cannot prove the opposite), consolidation should be denied in almost every case." *Id.* at *5 (quoting *Circle Land & Cattle*, 213 B.R. 870, 875-76 (Bankr. D. Kan. 1997).

The trustee sought to substantively consolidate each of the two entities with the debtor under Code section 105.

2. Motion to Dismiss. The non-debtor entities filed motions to dismiss under Fed. R. Civ. P. 12(b)(6), arguing substantive consolidation is not an appropriate cause of action against non-debtor parties, and that allowing such a cause of action would allow a rule of equity to re-define the defendants' property interests. *Id.* at 577.

3. Held. (1) The court had jurisdiction over non-debtor entities for substantive consolidation and it was within its equitable powers to allow substantive consolidation over non-debtor entities; (2) Substantive consolidation was not governed by the standards of involuntary bankruptcies, fraudulent transfers, or state law alter ego claims; and (3) The trustee adequately pled a claim for substantive consolidation.

4. Analysis.

a. Summary of Authority. The court noted, "While the majority of courts recognize substantive consolidation of multiple bankruptcy cases, . . . courts are split on the issue of whether bankruptcy courts have the authority to substantively consolidate debtor and non-debtor entities." *Id.* at 579 (internal citations omitted). The court recognized that the Ninth Circuit allowed non-debtor consolidation in *Bonham v. Compton (In re Bonham),* 229 F.3d 750 (9th Cir. 2000), and noted that other circuits have indirectly acknowledged the concept, citing *Auto-Train*, 810 F.2d 270 and *Owens Corning*, 419 F.3d at 205. *Id.* at 580.

b. Jurisdiction and Equitable Power. The court distinguished cases holding substantive consolidation of non-debtors was inappropriate, including *In* *re Circle Land and Cattle Corp.*, discussed below. *Id.* at 581. With respect to *Circle Land and Cattle* and similar cases, the court noted that those courts viewed the application of substantive consolidation over non-debtors as an "impermissible use of the court's equitable power to take jurisdiction over a non-debtor without express statutory authority to do so," but emphasized that "[c]onflating jurisdiction with power obscures the issue." *Id.* Instead, the court relied on authority recognizing that a bankruptcy court's jurisdiction over non-debtors can be broad if "the outcome of the proceeding could conceivably have an effect on the estate being administered in bankruptcy." *Id.* at 582 (citing *Miller v. Kemira, Inc. (In re Lemco Gypsum, Inc.*), 910 F.2d 784, 788 (11th Cir. 1990)). The court held that it was well within its equitable powers under *Sampsell* to allow substantive consolidation of non-debtors under appropriate circumstances, and it had jurisdiction over those entities as the outcome could have an impact on the bankruptcy case. *Id.*

c. Involuntary Bankruptcy. According to the court, "[S]ubstantive consolidation and the right to file an involuntary petition are two entirety different remedies. Compelling the Trustee to file an involuntary bankruptcy petition under 11 U.S.C. § 303 would defeat the very purpose of substantive consolidation." *Id.* at 582 (citation omitted). As noted by the *Munford* court, imposing the insolvency requirement from Code section 303 on substantive consolidation would subvert the entire purpose of substantive consolidation, "which is to recover assets from a financially sound affiliated entity." *Id*. (quoting *Matter of Munford, Inc.*, 115 B.R. 390, 397 (Bankr. N.D. Ga. 1990)).

d. Recovery of Transfers. Recovery of transfers pursuant to Code section 548 also invokes different legal principles. "The standard for alleging a claim under 11 U.S.C. § 548 is more stringent than that for alleging substantive consolidation as a substantive consolidation claim 'does not require a finding of fraud or an intent to hinder and delay creditors.'" *Id*. at 583 (quoting *In re Alico Mining, Inc.*, 278 B.R. 586, 588 (Bankr. M.D. Fla. 2002)).

e. Alter Ego. "[S]tate corporate law and federal bankruptcy law are separate and distinct concepts;" therefore, the court was not required to find that the debtor was the alter-ego of the defendants to apply the substantive consolidation doctrine. *Id*.

f. Adequate Pleading. The court relied on the Eleventh Circuit's test requiring that "(1) the movant must show that there is substantial identity between the entities to be consolidated; and (2) that consolidation is necessary to avoid some harm or to realize some benefit." *Id*. (citing *Eastgroup Properties v. S. Motel Ass'n, Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991)) (additional citation omitted). Once the proponent has satisfied this burden, the burden shifts to an objecting creditor to show "(1) it has relied on the separate credit of one of the entities to be consolidated; and (2) it will be prejudiced by substantive consolidation." *Id*. at 584 (citing *Eastgroup*, 935 F.2d at 249). The court found sufficient allegations of comingling of assets and interrelationship of the parties, and that the potential benefit for creditors would outweigh the potential harm to the non-debtor entities. *Id*.

V. 8th Circuit Jurisprudence.

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

1. Substantive Consolidation test. The Eighth Circuit recognized three factors to consider in determining whether substantive consolidation is appropriate: "1) the necessity of consolidation due to the interrelationship among the debtors; 2) whether the benefits of consolidation outweigh the harm to creditors; and 3) prejudice resulting from not consolidating the debtors." *Giller*, 962 F.2d at 799 (citing *In re N.S. Garrott & Sons*, 48 B.R. 13, 18 (Bankr. E.D. Ark. 1984)).

Other courts have described the Eighth Circuit's test as a variant of the D.C. Circuit's *Auto-Train* test. *See In re Bonham*, 229 F.3d 750, 766 n.11 (9th Cir. 2000); *In re Petters Co., Inc.*, 506 B.R. 784, 798 (Bankr. D. Minn. 2013) (noting that "despite the brevity of the Eighth Circuit's discussion [in *Giller*], it clearly reflects the touchstones of *Auto–Train* and *Eastgroup*").

2. Analysis.

a. Interrelationship. The court noted that testimony established that one of the Debtors financed the other Debtors, but no regular repayment schedule had been established. All Debtors were headquartered in one building, but none paid rent. Additionally, one Debtor used its assets to secure loans to another Debtor, and employees of two Debtors performed uncompensated services for the others. The court concluded that "there is evidence in the record indicating the necessity of consolidating the interrelated Debtors." *In re Giller*, 962 F.2d at 799.

b. Benefits vs. Harm. The court concluded that "the benefits of consolidating the Debtors outweigh the harms because the lawsuits may generate sufficient funds to pay creditors of the insolvent Debtors while still preserving the recovery by the creditors of the solvent Debtor." *Id.*

c. Prejudice. As only one of the Debtors was solvent, the bankruptcy court had concluded that the Debtors could not pay for the accountants and lawyers necessary to pursue fraudulent conveyance and preference causes of action. *Id*. at 798. "The bankruptcy court therefore determined that the 'only hope' of obtaining monies to pay the unsecured creditors was to consolidate the Debtors and use the consolidated entity's assets to finance the lawsuits." *Id*. at 798-799. In light of this, the Eighth Circuit held, "Failure to consolidate the Debtors would prejudice the creditors of the insolvent Debtors because the insolvent Debtors could not afford to bring legal actions to recover transferred assets." *Id.* at 799.

B. *In re: Archdiocese of St. Paul and* Minneapolis, 553 B.R. 693 (Bankr. D. Minn. 2016), *aff'd* 562 B.R. 755 (D. Minn. 2016).

1. Background.

a. Voluntary chapter 11 filed by Archdiocese of Saint Paul and Minneapolis.

b. The unsecured creditors' committee moved to substantively consolidate the debtor and 200 non-debtor Catholic entities, including 187 parishes, schools, Catholic Community Foundation of Minnesota and others.

c. Several personal injury creditors joined in the committee's motion.

d. The debtor and numerous targeted entities objected.

e. The court ordered that Fed. R. Bankr. P. 7012(b) applied, which incorporated Fed. R. Civ. P. 12. As a result, objectors filed motions for judgment on the pleadings under Fed. R. Civ. P. 12(c) and motions to dismiss for failure to state a claim under Fed. R. Civ. P. 12(b).

2. <u>Motion/Objections – 3 arguments</u>.

a. <u>Standing</u>. Debtor and targeted entities urged that the creditors' committee lacked standing to request substantive consolidation, arguing that only a trustee or debtor-in-possession would have standing to pursue, as with turnover, avoidance or recovery actions regarding property of the estate. The court recognized that the 8th Circuit had not ruled on whether a creditors' committee has standing to pursue substantive consolidation.

b. <u>Motion v. Adversary Proceeding</u>. Debtor and targeted entities argued that the motion was procedurally defective – arguing that Federal Rule of Bankruptcy Procedure 7001 required an adversary proceeding be brought, rather than the committee seeking substantive consolidation by motion.

c. <u>Consolidation with non-debtors</u>. Debtor and targeted entities argued that the bankruptcy court's equitable powers under Code section 105(a) cannot be used to substantively consolidation a debtor and non-debtors. The court saw two sub-issues:

(1) Whether substantive consolidation under Code section 105(a) as requested would violate provisions of the Bankruptcy Code; and

(2) If so, what provision(s).

3. Held:

a. Standing. The committee satisfied the requirements of statutory standing under Code section 1109, which holds, "A party in interest, including the debtor, the trustee, *a creditors' committee*, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter." (Emphasis added). The court also held the committee had constitutional standing under Article III (interest in the outcome), noting, "[D]enial of substantive consolidation could have a negative impact on the distribution to unsecured creditors, while a grant of substantive consolidation might add more assets, and admittedly more liabilities, to the estate, which *could* increase distributions to creditors." *Archdiocese*, 553 B.R. at 698-99. Finally, the court concluded that the committee satisfied the prudential standing limitations, noting that "the committee seeks relief for its own interests, or more precisely, that of its constituency." *Id.* at 699. "The matter involves a particularized grievance for consolidating estates. Since substantive consolidation is not a statutory cause of action, the zone of interests test is not implicated here." *Id.*

b. Motion v. Adversary Proceeding. Fed. R. Bankr. P. 7001(1) requires an adversary proceeding be brought to recover money or property. However, the court held that substantive consolidation is not that nature of action as it is an equitable, judicial remedy, and not the type of express, statutory remedy covered by the recovery actions covered by Rule 7001(1), noting, "Substantive consolidation . . . is not tantamount to turnover." *Id*. at 699. The court noted that substantive consolidation is traditionally sought by motion. Additionally, the court observed that, under Fed. R. Bankr. P. 9104(c), the procedural rules are (and to the extent not may be ordered to be) the same in a contested matter as in an adversary proceeding.

c. Consolidation with non-debtors. Two sub-issues:

(1) First, the court recognized as a matter of "hornbook law" that section 105(a) cannot override explicit mandates of other sections of the Bankruptcy Code.

(2) Second, it held substantively consolidating a debtor with a non-debtor implicates Code section 303(a), which precludes involuntary bankruptcy cases from being commenced against eleemosynary non-debtors (such as churches, schools, and charitable organizations). In other words, it would not do via Code section 105(a) what it could not do under Code section 303(a). So, as the targeted entities were non-profit entities, the court lacked authority to substantively consolidate them with the debtor.

d. Adequacy of alleged facts (the motion). The court held that even if it had the authority to consolidate the non-debtor entities, the committee did not allege sufficient facts to support substantive consolidation. The court reviewed the Eighth Circuit's opinion in *Giller* and held that a court should not simply focus on interrelationship between the parties, but on the necessity of consolidation. *Id*. at 701. The court collected a list of situations in which consolidation might be appropriate from *Giller* and other courts. *Id*. at 701-702.

The committee alleged interrelationship as a result of the Archbishop exercising control over the targeted Catholic entities and properties. *Id*. at 702. The committee also alleged the liabilities were intertwined as a result of clergy sexual abuse claims asserted against the various entities. *Id*. However, the court held the allegations were insufficient, noting that the committee only identified specific facts with respect to a few of the entities, but otherwise generally grouped the remainder of the entities, which allegations did not meet the plausibility requirements under *Twombly*[6] and *Iqbal*.[7]

The court also held that even if the allegations satisfied the pleading standards, they did not show any reason why the interrelationship would require consolidation. *Id*. at 703. As the court emphasized, clearly, the Catholic Church is hierarchical in nature and authoritarian in its doctrinal matters. "But those characteristics are insufficient for a court to ignore its corporate legal structure.

[6] *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007).

[7] *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

The typical substantive consolidation is reserved for situations where the finances of two or more debtors are so confusingly intertwined that it is impossible to separate them. Nothing of the sort is alleged here." *Id*. The court also held that the allegations did not show interrelationship among the entities collectively, versus interrelationship from each entity to the debtor. Among other conclusions, the court also emphasized that the committee failed to allege the benefits of consolidation outweighed the harm, recognizing that creditors of non-debtors who do not face sexual abuse claims could have their claims significantly diluted. *Id*. at 704.

4. Appeals. The Committee appealed the decision to the District Court, which affirmed the Bankruptcy Court's ruling on substantially the same grounds in *Official Comm. of Unsecured Creditors v. Archdiocese of Saint Paul & Minneapolis*, 562 B.R. 755, 764 (D. Minn. 2016). The Committee then appealed that decision to the Eighth Circuit in Case No. 17-1079. As of the date of publication of these materials, no opinion has been issued in that case. However, it poses an opportunity for the Eighth Circuit to weigh in on whether substantive consolidation may be used against entities which would not be subject to involuntary bankruptcy proceedings.

C. *Opportunity Fin., LLC v. Kelley*, 822 F.3d 451 (8th Cir. 2016).

1. Background. This is one of many cases and appeals resulting from a Ponzi scheme perpetuated by Thomas Petters through Petters Company, Inc. ("PCI"). After the discovery of the scheme, the trustee/receiver for PCI filed separate chapter 11

bankruptcies on behalf of PCI and eight associated special purpose entities ("SPE")[8]. The trustee sought to substantively consolidate the bankruptcies, which the bankruptcy court granted in *In re Petters Co., Inc.*, 506 B.R. 784 (Bankr. D. Minn. 2013). The Lenders to the SPEs appealed the consolidation, but their appeals were denied by the district court for lack of standing.

a. Structure and relationship of the entities. The original bankruptcy order provides the following facts. PCI functioned as an "ostensibly-operating enterprise and as a holding company for all but one of the remaining [special purpose entity ("SPE")] Debtors," with Tom Petters as its sole shareholder. *In re Petters*, 506 B.R. at 789. The SPEs served as vehicles for execution of lending and security transactions with particular "investors." *Id.* These investors were lenders that provided financing for PCI on a sustained basis. *Id*. Each SPE[9] was identified to a particular lender, meaning each had only one creditor (or group of related creditors). *Id.*

b. Bankruptcy Court's substantive consolidation. The trustee sought to consolidate the eight SPEs and PCI. Each creditor of each SPE objected to

[8] SPEs refers to special purpose entities (also sometimes referred to as special purpose vehicles) which are subsidiary companies with legal status and asset/liability structures designed to provide financial risk isolation for each entity, and protection for each entity's lenders, should the parent company go into bankruptcy.

[9] Because these entities were expressly designed to separate the lenders from the ultimate borrower (PCI) in order to provide a "good faith" defense to avoidance actions, the bankruptcy court noted that each could also be described as a "bankruptcy-remote entity." *In re Petters Co., Inc.*, 506 B.R. at 802.

consolidating their SPE with any other debtor. *Id.* at 791. The court ultimately consolidated the debtors for all purposes, substantive and administrative. *Id.* at 854.[10]

c. The Appeal. The Lenders appealed the substantive consolidation to the district court, which dismissed the appeal, holding the Lenders did not have standing to appeal the consolidation because they were not "persons aggrieved." *Opportunity Fin., LLC v. Kelley*, 822 F.3d 451, 455 (8th Cir. 2016). The Lenders appealed that decision to the Eighth Circuit in *Opportunity Finance*.

2. Arguments. The Lenders argued that (1) the trustee was estopped from objecting to their standing because he expressly stated in his certification motion that the district court had jurisdiction to hear the appeals and (2) regardless, they were persons aggrieved. *Id.* at 455-56.

3. Held.

a. Estoppel. The court held that the trustee's statement that the district court had jurisdiction under 28 U.S.C. §§ 158(a) and 1334 was not clearly inconsistent with his later position that the Lenders are not parties aggrieved. *Id.* at 456. "The cited statutes address the finality of bankruptcy court judgments, orders, and decrees. There is nothing clearly inconsistent with arguing that, based on the finality of the bankruptcy court's order, the district court has jurisdiction

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[10] The Bankruptcy Court's decision provides an extensive analysis of circuit court jurisprudence on substantive consolidation, and specifically on the Eighth Circuit's test in *Giller*. *See In re Petters Co., Inc.*, 506 B.R. at 797-801. It also presents a lengthy analysis of *Giller's* substantive consolidation factors as applied to the underlying facts in the Ponzi scheme. *Id.* at 803-52.

over the appeal, and later arguing, because the Lenders did not have standing to appeal, that the appeal should be dismissed." *Id.* (citation omitted).

b. Persons Aggrieved. The court held that the Lenders were not "persons aggrieved" and, therefore, they did not have standing to challenge the substantive consolidation.

4. Analysis re: "Persons Aggrieved" holding.

a. The "persons aggrieved" doctrine "limits standing to persons with a financial stake in the bankruptcy court's order, meaning they were directly and adversely affected pecuniarily by the order." *Id.* at 458 (citation omitted). The Lenders argued they were "persons aggrieved" because the substantive consolidation "(1) diminished their property by increasing [the trustee's] potential recovery against them and decreasing the value of their contingent claims, and (2) impaired their rights by precluding potential affirmative defenses in the avoidance actions." *Id.*

b. The court first held that any pecuniary harm to the Lenders was several steps removed and so it was not a "direct" pecuniary impact. In order for them to suffer pecuniary harm, (i) the trustee would have to prevail in the avoidance actions, (ii) the Lenders would have to pay the judgment in full, and then (iii) the Lenders would have to file a valid proof of claim against the consolidated estate. *Id.* The court emphasized that this "possibility of harm does not satisfy the persons aggrieved standard." *Id.*

c. The court next considered whether the impact on the Lenders' avoidance action defense would satisfy the persons aggrieved standard. The Lenders argued that the consolidation transformed two groups of Lenders into initial transferees of PCI rather than subsequent transferees, eliminating the good faith defense otherwise available in avoidance actions under Code section 550(b)(1). *Id.* The court held, "Generally, a bankruptcy court order allowing litigation to proceed against an adversary defendant does not make that defendant a party aggrieved," even if the litigation has already commenced and the possibility of liability is more than theoretical, as was the case here. *Id.* at 458-59 (citation omitted). Further, according to the court, the "Lenders' citation of a Bankruptcy Code provision whose application may be altered by the bankruptcy court's order does not change the fact that the Lenders' interest in avoiding liability is antithetical to the primary purposes of the Bankruptcy Code." *Id.* at 459. Additionally, it emphasized that even if the Lenders' interests were arguably protected by the Bankruptcy Code, they still suffered only indirect harm. *Id.*

d. The court noted the persons aggrieved doctrine was designed to "prevent bankruptcies from being needlessly prolonged by parties whose interests are not central to the process." *Id.* at 460. Allowing the Lenders to appeal the substantive consolidation "would completely undermine the rationale behind [the] standard and bring bankruptcy proceedings to a grinding halt." *Id.* (citation omitted).

5. Dissent. Circuit Judge Bye dissented in the opinion, noting that "the corporate structure of the Ponzi scheme—and, derivatively, the structure of the bankruptcy proceedings—gave [two Lenders] two significant defenses to potentially escape billions of dollars of liability in the Trustee's avoidance actions." *Id.* at 461 (Bye, C.J., dissenting). However, with substantive consolidation, there were no SPEs separating these two Lenders from PCI, resulting in the loss of their two defenses to the avoidance actions ((1) the good faith defense, and (2) a defense that the trustee didn't have standing because there were now multiple creditors on whose behalf he could act). *Id.* Because this defense-stripping action impaired the parties' rights, rather than simply allowing litigation to go forward, the dissent argued the Lenders were "persons aggrieved" with standing to appeal. *Id.* at 462-63.

VI. Recent cases/issues in the 10th Circuit.

A. *In re Castle Arch Real Estate Inv. Co., LLC*, 2013 WL 492369, at *16-17 (Bankr. D. Utah Feb. 8, 2013).

1. Summary of 10th Circuit Substantive Consolidation standards. The *Castle Arch* court summarized the 10th Circuit's substantive consolidation law as follows:

> The [*Fish v. East*, 114 F.2d 177 (10th Cir.1940)/ *Federal Deposit Insurance Corp. v. Hogan (In re Gulfco Investments Corp.)*, 593 F.2d 921, 928 (10th Cir. 1979)] criteria can be reduced into two general components: (1) the extent to which the entity to be substantively consolidated was managed or controlled by the debtor, and (2) whether the entity to be substantively consolidated had an economic existence independent from the Debtor. (citing *In re Horsley*, 2001 WL 1682013 *4 (Bankr. Utah 2001).
> Finally, as recognized by numerous courts, the degree of difficulty and expense involved with segregating and ascertaining individual assets and liabilities of each of the entities is particularly relevant. (citing *Horsley*). Thus, substantive consolidation is proper where

the assets of the entities in question are "hopelessly co-mingled," (citing *Gulfco*) or where difficult accounting problems caused by inter-company debt are "so strong that the great expense (in order to bring about an unscrambling) threaten[s] recovery.

B. *In re Circle Land & Cattle Corp*., 213 B.R. 870 (Bankr. D. Kan. 1997).

1. Background. An oversecured creditor (Helena Chemical Company – "Helena") of the corporate chapter 11 debtor ("Circle Land & Cattle") sought substantive consolidation of a non-debtor corporation (Custom Agri-Services, Inc. – "Custom"). Custom moved under 12(b)(6) to dismiss the complaint for failure to state a claim. *In re Circle Land & Cattle Corp*., 213 B.R. at872. The stockholders of Custom were also stockholders in Circle Land & Cattle, and were the children of the President of Circle Land & Cattle. The allegations showed some overlapping of the operations of the two entities. Helena alleged that the family used Custom to divert income from Circle for their personal benefit rather than paying Helena, among other allegations. Helena sought an order that Custom was the alter ego of Circle Land & Cattle, and substantive consolidation of Custom as a bankruptcy debtor.

2. Alter Ego Law vs. Substantive Consolidation. The court distinguished between these two doctrines, noting that Helena's complaint confused state corporate law and federal bankruptcy law with respect to the two: "Substantive consolidation should not be confused with either the corporate law concept of piercing the corporate veil or the bankruptcy law concept of joint administration. Unlike piercing the corporate veil, substantive consolidation does not seek to hold shareholders liable for acts of their incorporated entity." *Id.* at 874 (citing 1 David G. Epstein et al., Bankruptcy 26 (1992)). The court emphasized that the remedy of substantive consolidation should be sparingly

granted, relying on a commentator who concluded, "Better, we think, to ask are any creditors going to be hurt by this consolidation and, if the answer to that is yes (or more properly, if the one seeking consolidation cannot prove the opposite), consolidation should be denied in almost every case." *Id*. at 875-76 (citing 3 David G. Epstein, et al., Bankruptcy, § 11-41 at 190 (1992)).

3. Held. The court made two alternative holdings. The first on the basis of failure to state a claim, and the second on the basis of consolidating a non-debtor.

a. Failure to State a Claim – Substantive Consolidation. The court held that the complaint failed to state a claim for substantive consolidation, noting that although economic entanglement of the entities is relevant to the analysis, "an applicant must allege more than the piercing-of-the-veil factors to state a claim for substantive consolidation." *Id*. at 876. The focus has shifted from alter-ego factors to the effect on general unsecure creditors of the entities. *Id*. According to the court, an applicant must allege equitable grounds for consolidation, such as: "that general creditors have dealt with the entities as a single economic unit to their detriment; that a necessity exists for consolidation to protect creditors; that a harm to the creditors could be avoided by the remedy; or that the benefits of consolidation outweigh any resulting harm to general creditors of the entities." *Id*. The complaint did not provide any allegations with respect to the existence of any general unsecured creditors, and they were not notified to the suit to consolidate. Additionally, Helena was an oversecured creditor, and could not "itself satisfy the need or harm elements of substantive consolidation." *Id*.

Additionally, the court held the complaint lacked allegations that general creditors dealt with the entities as a single economic unit; or that consolidation was necessary to avoid a particular harm or realize a particular benefit for the general creditors. *Id*.

b. Consolidating a Non-Debtor/Subject-matter Jurisdiction. The court also held that since Helena was not a creditor of Custom, it could not initiate or join an involuntary petition against Custom, and since Custom meets the definition of a farmer under Code section 101(2), Code section 303(a) excepts it from being placed in involuntary bankruptcy. *Id*. The court reviewed decisions allowing non-debtor consolidation under Code section 105(a) in disregard of section 303's requirements, noting that, in effect, the courts used Code section 105 as a grant of subject matter jurisdiction. *Id*. The court agreed with the reasoning of other collected cases that consolidation of a non-debtor is contrary to the Code limitations for involuntary bankruptcy petitions, and dismissed the complaint. *Id*. at 877.

C. *In re Stewart*, No. 15-12215-JDL, 2017 WL 1740365, at *1 (Bankr. W.D. Okla. May 3, 2017).

1. Background.

a. Chapter 7, jointly administered cases of 2 debtors ("Debtors").

b. Plaintiff Creditor's adversary proceeding complaint sought to add 9 non-debtor entities "(Non-Debtors") relying on theory of substantive consolidation.

c. Debtors managed and had held an interest in Non-Debtors.

d. Chapter 7 trustee adversary proceeding sought fraudulent transfer recoveries from Non-Debtors.

e. Rather than seeking fraudulent transfer recovery or involuntary bankruptcy, Plaintiff Creditor's adversary proceeding sought to substantively consolidate the Non-Debtors into Debtor's chapter 7 estate.

2. Adversary Complaint/Motion to Dismiss. Motion to dismiss by Intervenor, a creditor of one Non-Debtors (which likely stood to have its recovery diluted if consolidation occurred) sought to be brought into Debtors' bankruptcy by substantive consolidation, issues considered:

a. Jurisdiction: Under Code section 105, could the bankruptcy court establish jurisdiction over non-debtor entities through substantive consolidation adversary proceeding?

b. Standing: Did Plaintiff Creditor, as non-creditor of Non-Debtors, have standing to force their assets into Debtors' bankruptcy estate in substantive consolidation adversary proceeding?

c. Adequacy of alleged facts (the complaint): Should Plaintiff Creditor's complaint for substantive consolidation be dismissed for failing to join Non-Debtors' creditors as indispensable parties, constituting denial of due process?

3. Held:

a. Jurisdiction – Substantive consolidation is not based on state law carrying a right to a jury trial, but is a creation of bankruptcy law. A proceeding for substantive consolidation is not a "Stern proceeding" and is subject to final disposition by the bankruptcy court without consent of the parties

b. Standing – An individual creditor does have standing to pursue a substantive consolidation. Although there is a split of authority, "[t]he majority of circuits, including the Tenth Circuit, recognize that bankruptcy courts have the authority to substantively consolidate bankruptcy cases pursuant to their general equitable powers." *Id.* at *6.

c. Adequacy of complaint – the court stated:

> It is imperative to remember, however [after reciting the standards recited in other decisions], that substantive consolidation is not totally dependent upon an alter ego theory where the debtor has intermingled control and assets of non-debtors. The overriding equitable consideration is that consolidation will *benefit all creditors*, both those of the current debtors and those to be forcibly made debtors.

Id. at *7 (emphasis in original).

d. Ruling on motion to dismiss – Plaintiff Creditor had plead sufficient facts to support substantive consolidation. But, once that was determined, the focus turns to equitable consideration of the consolidation on the general unsecured creditors of the Non-Debtors:

> [T]he Movant for consolidation must allege equitable grounds exist for consolidation to the benefit of *all* creditors, and the benefits of consolidation outweigh any resulting harm to general creditors of the entities.
>
> …

> [T]he focus of substantive consolidation should be on its effect on the general creditors of all the named defendant entities ….

Id. at *8 (emphasis in original).

e. Necessary parties. The issue of joinder of all creditors of Non-Debtors as parties-defendant in the adversary proceeding was reserved for later decision. The court observed that "some type of notice" would be required if the substantive consolidation claim proceeded, but that issue was premature until a complaint survived a motion to dismiss. *Id*. at *10.

VII. Conclusion.

Substantive consolidation appears to be widely accepted for related debtors and estates, although it can still be controversial, as reflected in the *Petters* cases. However, courts are split on the issue of whether consolidation is appropriate for non-debtor entities, particularly where those entities could not satisfy the standards for an involuntary bankruptcy. An apparent split between several bankruptcy courts may ultimately elevate the issue to higher court review.