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From the Bankruptcy Courts: Consolidation in Bankruptcy Reorganization of Multitiered Corporations-Chemical v. Kheel, Revisited

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CONSOLIDATION IN BANKRUPTCY REORGANIZATION OF MULTITIERED CORPORATIONS —*CHEMICAL V. KHEEL,* REVISITED

Even though Thomas Wolfe's sagacious advice was that you can't go home again, nevertheless the bankruptcy bar may benefit by another visit to the case of *Chemical Bank New York Trust Co. v. Kheel*[1] to explore whether current bankruptcy cases have not eroded the stringent principle of substantive consolidation in reorganization cases set forth in that 1966 landmark decision.[2]

Joint Administration and Substantive Consolidation

At the outset, a distinction should be made between the joint administration of separate reorganization cases and substantive consolidation. In many situations involving related debtors in Chapter 11 cases, such as a general partner and a partnership entity or a parent corporation and its subsidiaries, it will be convenient to have a joint handling of purely administrative matters to expedite the cases without affecting substantive rights of creditors. For example, a single trustee or examiner may be appointed for two or more related cases. Such a joint administration is not as drastic as the substantive consolidation of related cases resulting in the treatment of two or more corporations as one entity.[3]

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1 369 F.2d 845 (2d Cir. 1966).

2 We make this revisit with some trepidation because counsel having revisited the case of Constance v. Harvey, 215 F.2d 571 (2d Cir. 1954), *cert. denied* 348 U.S. 913 (1955), in the appeal of *Volper v. Conti,* 132 F. Supp. 205 (E.D.N.Y.), *aff'd* 229 F.2d 317 (2d Cir. 1956), challenging the concept of the *Constance* case, was rebuffed by the court of appeals. There the Second Circuit held that the strong-arm clause of Section 70(c) of the former Bankruptcy Act stretched so far as to invalidate a security interest which was perfected more than four months before bankruptcy. Some exhilaration was experienced, however, when the Supreme Court several years later in Lewis v. Manufacturers Nat'l Bank of Detroit, 364 U.S. 603 (1961), reversed the holding in the *Constance* case, with a concurring opinion by the judge who wrote the *Constance* opinion, then elevated to the Supreme Court, frankly admitting the error of his prior opinion. This gives us some encouragement for a revisit to the *Chemical* case to see if it remains viable.

3 For a discussion on the difference between substantive consolidation and joint administration, see Weintraub & Resnick, *Bankruptcy Law Manual* ¶ 8.16.

We retrace our steps then, to the *Chemical* case where the trustee of several corporations in the shipbuilding trade, all of which were in separate Chapter X proceedings, sought substantive consolidation of the cases. Chemical Bank New York Trust Company, as trustee for the bondholders of one of the affiliated corporations (Seatrade Corporation), opposed the consolidation. Chemical's resistance to consolidation was not difficult to understand; it had a mortgage on a vessel of the Seatrade Corporation, the validity of which was under attack. Presumably, if this mortgage were set aside, Chemical would be an unsecured creditor sharing with other unsecured creditors of all the entities which would be disadvantageous to it because of the potential for a higher return if Seatrade Corporation's case were not consolidated with the other cases.

The Inconsolable Plaintiff

As a preliminary question the *Chemical* court considered whether consolidation of assets and liabilities should "not await the court's action on a plan of liquidation and be submitted as part of such a plan." [4] Although the court of appeals considered this to be the normal procedure where feasible, it conceded that there were some cases where the "exigencies of the situation" [5] necessitated consolidation in a separate proceeding rather than considering it in connection with a plan.

Chemical's argument in opposition to consolidation was that the court had no power to merge the assets and liabilities of the affiliated corporations in reorganization as to the bondholders represented by Chemical "absent a showing that it [Chemical] knowingly dealt with the group as a unit and relied on the group for payment." [6] Chemical based its argument on the Second Circuit decision in *Soviero v. Franklin National Bank of Long Island,*[7] in which the court pierced the veil of corporate separateness and ordered substantive consolidation of parent and affiliates upon finding a unity of interest and ownership among the affiliated corporations. In *Soviero,* the creditors dealt with the debtor and its affiliates as one unit.

The court of appeals rejected Chemical's argument that creditor reliance on the affiliated corporations as one unit was necessary for consolidation.

Piercing the Corporate Veil

In addition to *Soviero,* the court of appeals cited *Stone v. Eacho*[8] in which the Fourth Circuit permitted consolidation upon the equitable doctrine of subordinating a parent's claim against a subsidiary where the "subsidiary has been allowed to transact business as an independent corporation and credit has been extended to it as such on the faith of its ownership of the assets in its possession." [9] It was only a stone's throw away from that principle of equitable subordination to arrive at the equitable principle of piercing

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[4] Chemical Bank N.Y. Trust Co. v. Kheel, note 1 *supra,* at 847.

[5] *Id.*

[6] *Id.*

[7] 328 F.2d 446 (2d Cir. 1964).

[8] 127 F.2d 284 (4th Cir.), *rehearing denied* 128 F.2d 16, *cert. denied* 317 U.S. 635 (1942).

[9] *Id.* at 288.

the corporate veil and consolidating the companies. "Only by entirely ignoring the separate corporate entity of the Virginia corporation and consolidating the proceedings here with those of the parent corporation in New Jersey can all the creditors receive the equality of treatment which it is the purpose of the Bankruptcy Act to afford." [10]

Thus, the principle of piercing the corporate veil is enforced to preserve the bankruptcy doctrine that "bankruptcy is equality." The beneficial effect of consolidation is important to creditors in general, as well as debtors, because of the "equality" syndrome of distribution, and for the reorganization process since it has the effect of eliminating intercompany claims, combining assets of all debtors which become common assets, and eliminating duplicative claims and cross guaranties.

Rejecting Chemical's argument that consolidation must be based on the creditors' dealing with the debtor and its affiliates as one, the court of appeals pointed out that an additional factor present in the instant case, but not found in *Stone* or *Soviero*, was the woeful condition of the corporate records. A factor to be considered was "the expense and difficulty amounting to practical impossibility of reconstructing the financial records of the debtors to determine intercorporate claims, liabilities, and ownership of assets." [11]

Caveats in Chemical

It cannot be overemphasized, however, that the *Chemical* court announced an important caveat for consolidation: "The power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others." [12]

Despite this word of caution, however, the court ordered consolidation without a clear showing of creditor reliance on the related corporations as one entity. In the rare case such as this, "where the interrelationships are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all." [13]

Judge Friendly, in his concurring opinion, wrote that consolidation based on a confusion of books and records should not be permitted as to a creditor who relied on the credit and financial condition of one corporation only—"especially to a creditor who was ignorant of the loose manner in which corporate affairs were being conducted." [14] Tackling the *Stone* case, he pointed out that there consolidation was based on the fact that the subsidiary carried on " 'no separate corporate activity of any sort' " and, accordingly, "no creditor could possibly have done business with it [the subsidiary] in reliance on its credit—a demonstration not at all made in this case." [15] Judge Friendly agreed, however, that consolidation in

[10] *Id.*

[11] Chemical Bank N.Y. Trust Co. v. Kheel, note 1 *supra,* at 847.

[12] *Id.*

[13] *Id.*

[14] *Id.* at 848.

[15] *Id.*

Chemical was appropriate in view of insufficient proof that Chemical or the bondholders relied on the separate credit of Seatrade Corporation. Apparently, their main reliance was on the ship mortgage and the individual guarantors. Chemical was "required to come forward with at least something more" to indicate its reliance on Seatrade's financial condition as a single entity.[16]

Moreover, Judge Friendly agreed with the holding in *Stone* that if any creditors should prove reliance on the credit of one entity, they would be sufficiently protected by having their claims, unaffected by the consolidation, heard in the consolidated proceedings. In other words, allow consolidation if the circumstances warrant it, preserving such rights as any creditor had in reliance upon a particular entity. Such right would not defeat consolidation but could be asserted in the consolidated proceeding.

Relying on one member of the group of corporations or the unit as a whole should not be the test for consolidation *vel non*. It is difficult in this day and age to imagine, with organizations such as Dun & Bradstreet and the numerous credit and reporting services of the National Association of Credit Management, as well as a host of other independent credit services, that a bank, finance company, or merchandise supplier can possibly lack knowledge of a corporate structure. Knowledge or lack of knowledge should not be the criterion.

The Flora Mir Decision

Four years later we meet Judge Friendly again in the *Flora Mir* case,[17] but this time writing the unanimous opinion for the court of appeals which refused to consolidate one of twelve subsidiaries with the other eleven because it had substantial rights in a recovery of monies in a pending lawsuit not available to the others. Although citing the *Chemical* case with approval, the court found that total consolidation was not appropriate because it would result in unfair treatment of the creditors of Meadors, Inc., one of the group. Consolidation was allowed as to the affiliated debtors, excluding only Meadors, Inc., since the evidence indicated (1) a multitude of intercompany transactions, many without apparent business purpose; (2) the difficulty of disentangling them; and (3) the consideration by the trade of all the debtors as a group. It is to be noted that consolidation was rejected as to Meadors, Inc. but allowed as to the others even though financial statements of each of the debtors existed, thereby destroying the necessity for a showing of an inability to reconstruct the financial records of the debtors. It was not bothered by the fact that the books and records were in good condition "since the accountants in relatively short order had managed to come up with financial statements of each of the debtors." [18]

In *In re Continental Vending Machine Corp.*,[19] a plan of reorganization under former Chapter X of the Bankruptcy Act provided for a consolidation of the unsecured debt of a parent and its subsidiary but

[16] *Id.* at 849.

[17] *In re* Flora Mir Candy Corp., 432 F.2d 1060 (2d Cir. 1970).

[18] *Id.* at 1063.

[19] 517 F.2d 997 (2d Cir. 1975).

refused to elevate or improve the claims of secured creditors. The court held that such a plan was "fair and equitable" and, as indicated in Judge Anderson's dissent, relied on *Chemical* as a basis for consolidation: "Moreover, as noted by the court in *Kheel* and by the trustee in the instant case, consolidation was properly ordered in this case because it was virtually impossible to reconstruct intercorporate claims, transactions, liabilities and ownership of assets." [20]

In the *Gulfco* case,[21] the Tenth Circuit considered and vacated an interlocutory order of consolidation in a Chapter X case because of insufficient information as to the condition of the several affiliated corporations. Referring to the *Chemical* case, the court observed that *Chemical* "considered the difficulty of accounting as a factor. Unlike here, the interrelationships were so strong that great expense (in order to bring about an unscrambling) threatened any recovery." [22] The Tenth Circuit, however, was willing to go so far as to do without detailed certified audits, but remanded the case before it would order consolidation so that "there can be some accounting studies, comparisons and evaluations together with reports to the court." [23]

Chemical and Subsequent Lower Court Decisions

Lower courts have been careful to walk gingerly with the admonitions in the *Chemical* decision as to consolidation: (1) to be used sparingly because of the possibility of unfair treatment to specific creditors who have dealt solely with one debtor without knowledge of its relationship with others; and (2) to be used in rare cases where the "interrelationships of the group are hopelessly obscured" and time and expense to unscramble the financial picture of the group is so substantial as to threaten realization of any net assets for all creditors, so as to justify equity stepping in to "reach a rough approximation of justice to some rather than deny any to all." [24]

In the *Commercial Envelope Manufacturing Company*[25] case, the bankruptcy court stated in approving consolidation: "As in *Chemical Bank, supra*, the interrelationships are complex and in many instances obscured. . . . Furthermore, the court in *Chemical Bank, supra*, held that once the proponent of consolidation makes out a prima facie case, the burden shifts to the objectant to show that there was a reliance on separateness." [26] The bankruptcy judge noted the debtors' conviction "that the only way a meaningful Chapter XI plan can be presented to creditors is for the plan to be a single, unitary one affecting all of the debtors and all of their creditors." [27] Then again, "when all is said and done, there is a practicability to authorizing consolidation here." [28]

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[20] *Id.* at 1005.

[21] *In re* Gulfco Inv. Corp., 593 F.2d 921 (10th Cir. 1979).

[22] *Id.* at 930.

[23] *Id.*

[24] Chemical Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966).

[25] 3 B.C.D. 647 (S.D.N.Y. 1977) (Babitt, J.).

[26] *Id.* at 650.

[27] *Id.* at 648.

[28] *Id.* at 651.

Following *Commercial Envelope*, another bankruptcy court in the case of *In re Vecco Construction Industries, Inc.*[29] also allowed consolidation. The court noted that the debtors' position was that consolidation was essential to ensure the development and implementation of a meaningful plan of arrangement. The interesting feature of the debtors' position was that they were not trying to prove the cases for consolidation based on the *Chemical* principles but upon the needs of the "economic benefit" to creditors as opposed to the "requirements enunciated in the earlier cases that each of the corporations have the identical creditors or that corporate formalities were so thinly veiled that creditors tended to rely upon the group for payment rather than a single corporation." [30]

Indeed, the court itself indicated a trend in the problems confronting the multitiered corporation:

> Due to the organizational make-up evidenced by the now common place multi-tiered corporations in existence today, substantive consolidation of a parent corporation and its subsidiaries has been increasingly utilized as a mechanism to deal with corporations coming within the purview of the Act.
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> The liberal trend in allowing consolidation of proceedings, as evidenced by recent case law, arises from the result of increased judicial recognition of the widespread use of interrelated corporate structures by subsidiary corporations operating under a parent entity's corporate umbrella for tax and business planning purposes.[31]

In addressing the issue of consolidation, the court in *Vecco Construction* delineated the "criteria which, when used as a yardstick, have assisted the courts in determining" [32] the propriety of consolidation. These elements were listed as follows: (1) the degree of difficulty in segregating and ascertaining individual assets and liabilities; (2) the presence or absence of consolidated financial statements; (3) the profitability of consolidation at a single physical location; (4) the commingling of assets and business functions; (5) the unity of interests and ownership between the various corporate entities; (6) the existence of parent and intercorporate guaranties on loans; (7) the transfer of assets without formal observance of corporate formalities.

The prevalence of the multitiered companies in reorganization cases is seen in *In re Interstate Stores, Inc.*[33] The two principal debtors were Interstate Stores, Inc. (Interstate), which operated a chain of department stores, and Toys "R" Us, Inc. (Toys), a subsidiary through which Interstate operated a chain of retail toy stores. The Chapter X trustee proposed a partial consolidation, namely consolidating Interstate with all its department store subsidiaries and Toys with all its toy shops. Creditors of Interstate, anticipating greater returns in a complete con-

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[29] 4 B.R. 407 (E.D. Va. 1980) (Bostetter, J.).

[30] *Id.* at 409.

[31] *Id.*

[32] *Id.* at 410.

[33] 15 C.B.C. 634 (S.D.N.Y. 1978) (Ryan, J.).

solidation with Toys, objected. In overruling their objection the court stated:

> Neither the Interstate general creditors nor the debenture holders did business with the Toys "R" Us debtors. They hold no obligations of those debtors nor do they hold any of their guarantees . . . complete consolidation is unjustified . . . and will obviously result in permitting those creditors . . . to resort to these assets in the first instance to the detriment of those creditors who hold the obligations of Toys "R" Us debtors. *In re Flora Mir, supra,* forbids such a result.[34]

Total consolidation of such separate and distinct entities in reorganization is not the general run of the mill case, but the partial consolidation of each principal, such as Interstate and Toys, is normal under these circumstances.

> The necessity for Courts to fashion this equitable remedy has become more frequent with the increasing appearance before the bankruptcy courts of large public parent companies with their multitiered subsidiaries. The *need* for some form of substantive consolidation is readily apparent in this case involving as it does a parent and 188 separate corporate debtors. Separate plans of reorganization would not be *feasible.* [Emphasis added.][35]

We emphasized two words, "need" and "feasible." Both should be the hallmarks of consolidation. However, the court in *Interstate Stores* issued the caveat of *Flora Mir* and *Chemical,* namely, "used sparingly." In an effort to reconcile this concept with the "needs" concept, it may be helpful to categorize the basis for the court's opinion. The uncontroverted evidence supported the proposed substantive consolidation of all Toy debtors in one group and the Interstate companies into another group. The facts which supported consolidation of the Toys group (without merging with Interstate) were: (1) operation of entities as a single unit; (2) different officers than Interstate; (3) trade creditors independent from Interstate; (4) issue of its own forms of purchase orders and financial statements; and (5) Toys' debtors operated as a single entity to the trade.

As to the Interstate group, it had (1) common management and centralized accounting; (2) parent guaranties for obligations; (3) a single "buying" corporation which did the purchasing; (4) receipts which were centralized in one "payment" corporation; and (5) "most importantly, it would not be possible to ascertain which debtor is the obligor with respect to the debt owed to any particular trade creditor since the accounting for such transactions was, in effect, done on a consolidated basis. In the language of *Continental* and *Chemical Bank,* the relationship of these debtors is 'hopelessly obscured.' These are the classic factors supporting substantive consolidation."[36]

Following his own opinion in the *Interstate* case, the bankruptcy judge in *In re E.C. Ernst, Inc.*[37] came to a

[34] *Id.* at 642.

[35] *Id.* at 640-41.

[36] *Id.* at 642.

[37] Index No. 78-B-2139 (S.D.N.Y. May 12, 1981) (Ryan, J.).

practical and sound application of the doctrine of substantive consolidation. The court cited *Chemical* as authority for piercing the corporate veil and allowing substantive consolidation "when a corporation is used as the instrumentality of another." [38] Other factors considered in ordering substantive consolidation were (1) the necessity to merge all assets and liabilities so that a feasible plan of reorganization could be proposed; and (2) the debtors' ability to propose a plan depended upon the pledge of the assets and credit of all the debtors. The judge noted that "[w]hile the fact that intercompany transactions are hopelessly obscured is a consideration in permitting substantive consolidation [citing *Chemical*], the availability of separate financial statements does not preclude a bankruptcy court from granting substantive consolidation [citing *Flora Mir*]." [39]

Conclusion

Consolidation of debtors in reorganization has become a necessity for the multitier corporation for the almost universal truism in the business world that the whole controls all of its parts. Top management controls the subsidiaries which for the most part are divisions of the parent. Some of the controlling features are common directors, contributions to central office overhead, and utilization of common funds where necessary to ease the crisis of the unit most in distress. Moreover, the parent usually borrows the funds necessary for operations and generally arranges for cross-collateralization of assets and cross guaranties.

Since the bankruptcy court is a court of equity, it has the power to consolidate cases which necessitate a piercing of the corporate veil. First and foremost in considering consolidation, the court should find that the subsidiary was merely an instrumentality or division of the parent. If we adopt this sound principle, it really makes an insignificant difference whether the books and records are in a confused state of affairs or whether they are kept in such perfect condition as to be able to distinguish the assets and liabilities of each.

Thus, we come back to the beginning, *Stone v. Eacho*: "It is recognized in principle that the fiction of corporate entity may be disregarded where one corporation is so organized and controlled and its affairs are so conducted that it is, in fact, a mere instrumentality or adjunct of another corporation. . . ." [40]

We must recognize that the multitiered corporation, generally a public company employing the services of certified public accountants, will generally be keeping books and records from which the financial condition of the parent and its subsidiaries or affiliates will be clearly indicated. In such cases, consolidation should not be denied where the corporate veil can be pierced by a showing of sufficient yardsticks as to warrant consolidation as set forth in the *Vecco* case. Nor can we ignore from inclusion in these yardsticks the precept of

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[38] *Id.*
[39] *Id.*

[40] 127 F.2d 284, 289 (4th Cir. 1942), quoting from Trustees Sys. Co. of Pa. v. Payne, 65 F.2d 103, 107 (3d Cir. 1933).

Interstate Stores, to consider "the need for some form of substantive consolidation," and that "[s]eparate plans of reorganization would not be feasible." Thus, as in *Ernst*, the parent may be the sole provider of cash or profits for the creditors of nonoperating companies. A plan of reorganization in such a case may not be considered feasible which does not take into consideration the utilization of property of a non-operating facility which has been sold. In sum, the utilization of the assets and potential of all affiliated corporations may be needed to pay the creditors of all the entities, equally if possible, in order to accomplish a successful reorganization in certain cases.

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—*The Wall Street Journal*
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