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# Alert

## Ninth Circuit Limits Substantive Consolidation

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"[A] party moving for substantive consolidation must provide notice of the motion to the *creditors* of a putative consolidated non-debtor," held the U.S. Court of Appeals for the Ninth Circuit on Sept. 9, 2019. *In re Mihranian*, 2019 WL 4252115 (9th Cir. Sept. 9, 2019) (emphasis added). Affirming the lower courts' denial of a Chapter 7 trustee's motion to consolidate substantively the debtor's estate "with the estates of various non-debtors," the Ninth Circuit stressed that the trustee had given "no such notice" and that he had "failed to adequately research and serve Non-debtors' creditors." *Id.*, at *3. According to the court, it had "not [previously] determined whether a party moving for substantive consolidation must give notice of the motion to *creditors* of a putative consolidated non-debtor," but "[s]everal considerations support such a notice requirement." *Id.* at *2 (emphasis added).

**Relevance and Context**

"Substantive consolidation" is an equitable remedy. It "treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities …. The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor." *In re Genesis Health Ventures, Inc.*, 402 F.3d 416, 423 (3d Cir. 2005).

Substantive consolidation differs from "procedural" or administrative consolidation. Procedural consolidation merely allows a court to administer related cases (e.g., a corporate parent and affiliates) together, with each entity treated separately.

The Bankruptcy Code ("Code") says nothing about substantive consolidation. Equitable principles, though, apply. Accordingly, key decisions under the former Bankruptcy Act are still applicable. *See In re Bonham*, 229 F.3d 750, 765 (9th Cir. 2000) ("… the equitable power [of substantive consolidation] undoubtedly survived enactment of the Bankruptcy Code.").

The most persuasive analysis of substantive consolidation was articulated by the Third Circuit. *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2007) (Ambro, J.). In that court's view, separate entities should be consolidated only if "(i) [pre-bankruptcy] they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) [post-bankruptcy] their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors." *Id.* at 211. The Third Circuit thus rejected the mechanical application of "prefixed factors," used by some courts, to ascertain entity separateness. *Id.* at 210. Instead, the Third Circuit ordered an "intentionally open-ended, equitable inquiry" governed by the following principles: (1) entity separateness must be respected as a "fundamental ground rule" of limited liability, absent compelling circumstances calling equity … into play; (2) substantive consolidation should only be used to redress harms caused by debtors, not creditors (who are subject to other remedies such as fraudulent transfer avoidance and equitable subordination); (3) administrative convenience cannot justify this remedy; (4) the "rough

justice" wrought by substantive consolidation should be "rare and, in any event, one of last resort after considering and rejecting other remedies" that more precisely redress the harm at issue; and (5) substantive consolidation cannot be used "offensively," i.e., as a tactic to disadvantage a creditor group or alter creditors' rights, but may be used "defensively to remedy the identifiable harms caused by entangled affairs …." *Id.* at 210-211.

The Third Circuit then summarized the equitable nature of the substantive consolidation remedy. "Substantive consolidation at its core is equity. Its exercise must lead to an equitable result. Communizing assets of affiliated companies to one survivor to feed all creditors of all companies may to some be equal (and hence equitable). But it is hardly so for those creditors who have lawfully bargained prepetition for unequal treatment by obtaining guarantees of separate entities." *Id.* at 216, citing *Chemical Bank New York Trust Co., v. Kheel*, 369 F.2d 845, 848 (2d Cir. 1966) (Friendly, J., concurring) ("equality among creditors who have lawfully bargained for different treatment is not equity but its opposite ….").

**Facts**

The trustee in the *Mihranian* case initially sued the debtor's ex-wife, his two sons and the office manager of his medical business for purportedly having received fraudulent transfers. While his suit was pending, he moved for substantive consolidation of the non-debtors' assets with those of the debtor's estate. As the Ninth Circuit said, the trustee "sought the same relief — recovery of Debtor's assets that allegedly were kept from judgment creditors through fraudulent transfers — in both" the fraudulent transfer suits and the substantive consolidation motion. The bankruptcy court eventually dismissed the fraudulent transfer actions because the trustee was unable to "establish that Debtor was the initial transferor ... and those dismissals were upheld on appeal." 2019 WL 4252115 at *1.

The bankruptcy court later denied the trustee's substantive consolidation motion because the trustee failed to prove that the debtors' assets "were entangled with Non-Debtors' assets to such an extent as would justify substantive consolidation." The Bankruptcy Appellate Panel affirmed because the trustee "failed to serve the [substantive consolidation] Motion on Non-Debtors' creditors." On appeal to the Ninth Circuit, the trustee argued that he was not required to give notice "and that, even if such notice is required, he provided the requisite notice." *Id.* at *1.

**The Ninth Circuit**

"The sole aim of substantive consolidation is 'fairness to all creditors,'" said the Ninth Circuit. According to the court, case law in the circuit "supports extending a notice requirement" to the non-debtor's creditors. *Id.* at *2. Other courts addressing the issue have also required notice. Some lower courts may have permitted substantive consolidation without separate notice, but "that approach is the 'minority view.'" *Id.*

*Fairness.* "[N]otice and an opportunity to be heard must be given to creditors of the putative consolidated parties — whose claims would be equitably distributed under the consolidation order — and not just to the consolidated parties themselves," held the court. As a matter of fairness, the bankruptcy court should hear "from any objecting creditor before issuing its decision on consolidation [to] ensure that the consolidation truly is fair to all affected creditors." *Id.* at *3. Indeed, reasoned the court, substantive consolidation affects "the substantive rights of the creditors of the different estates." *Id.*, citing *In re Bonham*, 229 F.3d 750, 762 (9th Cir. 2000).

*Presumption of No Reliance on Separate Credit of Putative Consolidated Entities*. Substantive consolidation, as a matter of law, is warranted when "creditors dealt with the debtor and non-debtors as a single economic unit." *Id.* Because an objecting creditor has the burden of proving "that it did *not* rely on the separate credit of the putative consolidated entities," that creditor "must be given notice … and an opportunity to be heard in order to meet its burden of overcoming the presumption." *Id.*

*Lack of Notice and Research.* The trustee here only gave notice to the putative non-debtors themselves, not their creditors. Nor did the trustee "adequately research" the creditors of the non-debtors. His "knowledge of some creditors was several years old"; he never asked whether one non-debtor had any creditors; and he never made any attempt to discover the creditors of two other non-debtors.

**Comment**

Logic and fairness drove the Ninth Circuit's sensible decision. The trustee's inconsistent strategy was obvious. When his fraudulent transfer claims based on separate entities were about to fail, he resorted to a desperate substantive consolidation motion, one based on a lack of separateness.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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