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## Feature

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### Substantive Consolidation Might Redefine a Debtor

#### Impact on Predicate Creditors Under § 544(b)



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Section 544(b) allows a bankruptcy trustee to avoid “any transfer of an interest of the debtor in property ... that is voidable under applicable law by a creditor holding an unsecured claim.”<sup>1</sup> Section 544 allows a trustee to “stand in the shoes” of any unsecured creditor of a debtor’s bankruptcy estate and avoid any transfer that could have been avoided by that unsecured creditor under state law.<sup>2</sup> A crucial component of § 544(b) is that a trustee can only avoid a transfer if it constitutes “an interest of the debtor in property.”<sup>3</sup>

As a result, a trustee cannot avoid transfers of property that originated from nondebtor entities, even if these are controlled by the debtor. A common solution to this problem is that a trustee can seek substantive consolidation of the nondebtor entity that transferred the property and then argue that he/she has standing to avoid the transfer as having been made from the consolidated debtor. Although controversial, the doctrine of substantive consolidation has generally been accepted as a remedy available to trustees.<sup>4</sup>

While there is a developed body of case law addressing substantive consolidation as a remedy, there are few cases that examine its effect on the corporate form of the consolidated entities and the effect, if any, on a trustee’s standing to bring an action under § 544(b). Recent case law has shed light on this issue, specifically whether substantive

consolidation redefines the debtor in such a manner as to alter the unsecured creditor body that a trustee can use to assert derivative standing under § 544(b). This article will analyze recent cases on substantive consolidation and the future viability of it as a remedy.

#### Substantive Consolidation Denied

At least two courts have found that substantive consolidation may not be used to redefine the predicate creditor requirement contained in § 544(b). In *In re Bauman*,<sup>5</sup> a chapter 7 trustee sought to substantively consolidate the bankruptcy estate of a corporation wherein the debtor was the sole shareholder with the bankruptcy estate of the debtor. The trustee’s explicit purpose in seeking substantive consolidation was to preserve potential fraudulent-transfer actions involving assets owned by the corporation and not the debtor.

The U.S. Bankruptcy Court for the Central District of Illinois held that the chapter 7 trustee failed to establish even a *prima facie* case for substantive consolidation and explained that even if substantive consolidation was appropriate, it would not provide the trustee with the ability to pursue avoidance actions under §§ 544 and 548 in order to recover transfers of property of a nondebtor entity for the benefit of the debtor’s creditors.<sup>6</sup> The court stated that “substantive consolidation is not the ‘uber-remedy’ that the trustee believes it would be,” explaining that substantive consolidation does not merge the debtors themselves, but simply combines the assets of the bankruptcy estates for distributional purposes.<sup>7</sup> In addition, the court stressed

<sup>1</sup> 11 U.S.C. § 544(b).

<sup>2</sup> *Barclay v. MacKenzie* (In re AFI Holding Inc.), 525 F.3d 700, 703 (9th Cir. 2008).

<sup>3</sup> 11 U.S.C. § 544(b).

<sup>4</sup> See, e.g., *Alexander v. Compton* (In re Bonham), 229 F.3d 750 (9th Cir. 2000); *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005); *Reider v. Fed. Deposit Ins. Corp.* (In re Reider), 31 F.3d 1102 (11th Cir. 1994); *First Nat’l Bank of Barnesville v. Rafoth* (In re Baker & Getty Fin. Serv. Inc.), 974 F.2d 712 (6th Cir. 1992); *First Nat’l Bank of El Dorado v. Giller* (In re Giller), 962 F.2d 796 (8th Cir. 1992); *Union Sav. Bank v. Augie/Restivo Baking Co. Ltd.* (In re Augie/Restivo Baking Co. Ltd.), 860 F. 2d 515 (2d Cir. 1988); *Drabkin v. Midland-Ross Corp.* (In re Auto-Train Corp.), 810 F.2d 270 (D.C. Cir. 1987).

<sup>5</sup> *In re Bauman*, 535 B.R. 289 (Bankr. C.D. Ill. 2015).

<sup>6</sup> *Id.* at 299-302.

<sup>7</sup> *Id.* at 301-02.

that substantive consolidation does not have the retroactive effect of converting property owned by a nondebtor entity into property owned by the debtor as of the pre-petition date of the transfer.

Similarly, the U.S. Bankruptcy Court for the District of Minnesota in *In re Petters Co. Inc.*<sup>8</sup> held that substantive consolidation of bankruptcy estates has no effect on a trustee's standing to bring an action under § 544, and that a trustee has the same standing as to any specific transfer he/she had prior to consolidation. *Petters Co.* involved a massive Ponzi scheme that was perpetrated by the principal of the debtor. The debtor and various entities associated with the Ponzi scheme filed chapter 11 cases and were substantively consolidated.

In *Petters Co.*, the chapter 11 trustee argued that the effect of substantive consolidation was a complete merger of the debtor/entities into a new single legal entity. The trustee posited that this allows him to satisfy the predicate creditor requirement of § 544(b) by using the standing of a pre-petition creditor of any one of the debtor-entities to avoid a pre-petition transfer made by a different debtor-entity. The court rejected the trustee's merger argument for three primary reasons.

First, the argument does not acknowledge the separate pre-petition existence of the entities and the estates created upon filing for bankruptcy. Second, the order for consolidation only altered the structure of the bankruptcy estate and not the status of the debtor/entities under nonbankruptcy law. Third, the underlying substantive law remains the same; thus, the trustee's standing must "be anchored in the actual history of the transferor/debtor, and substantive consolidation does not and could not remake that history."<sup>9</sup> In reaching this conclusion, the court described substantive consolidation as a remedy that is only effective within a bankruptcy case and the administration of the estate that "cannot reach with legal effect back in time before the date on which a case was commenced."<sup>10</sup>

## **Krohn: Substantive Consolidation Permitted**

The bankruptcy court for the District of Nevada addressed this issue in *Krohn v. GY Property Holdings LLC*<sup>11</sup> and — in contrast to *Bauman* and *Petters* — found that substantive consolidation might have the effect of redefining the debtor, such that the pool of qualifying predicate creditors for avoidance actions under § 544(b) is increased.<sup>12</sup> The dispute before the court centered on a chapter 7 trustee's effort to avoid transfers from nondebtor entities that were made several years before the petition date pursuant to § 544(b). The trustee sought to overcome issues relating to her standing by seeking to substantively consolidate the nondebtor transferors with the debtor's bankruptcy estate *nunc pro tunc* to the petition date.

The defendants argued that substantive consolidation does not redefine a debtor such that the trustee could assert derivative standing on behalf of an unsecured cred-

itor of the debtor to avoid a transfer from a nondebtor entity. In other words, the trustee would have to identify a separate predicate creditor for each nondebtor entity notwithstanding substantive consolidation, and she could not create qualifying predicate creditors where none existed prior to consolidation.

The trustee argued that such an argument would undermine the rationale courts have used to allow substantive consolidation and would permit debtors to insulate money by transferring funds to shell companies with impunity. The trustee also noted that she should be allowed to choose any creditor of the consolidated entities if substantive consolidation was permitted because such a remedy would have the effect of combining the assets and liabilities of the companies at issue.

The issue was presented in the context of competing motions for partial summary judgment. The bankruptcy court reviewed the remedy of substantive consolidation and its effect on entities following consolidation. The bankruptcy court distinguished *Bauman* and *Petters Co.*, and relied on the Ninth Circuit's seminal decision in *Bonham* in holding that substantive consolidation would expand the body of unsecured creditors through which the trustee could assert derivative standing. The bankruptcy court noted that while the Ninth Circuit in *Bonham* did not address the exact issue that was the subject of the cross-motions for summary judgment, it has approved the use of substantive consolidation for the express purpose of preserving avoidance claims:

*Bonham* stands in stark contrast to the limited, administrative effect attributed to substantive consolidation by the courts in *Bauman* and *Petters Company*. Instead, it solidly supports the Trustee's argument that substantive consolidation [might], in appropriate cases, be used to define the bankruptcy debtor to include nondebtor entities used as mere instrumentalities. Just as courts [might] substantively consolidate entities while still preserving their post-confirmation identities, so may they disregard the separate existence of mere instrumentalities. *Bonham* dramatically demonstrates that, in such instances, the result is to merge the entities into a single bankruptcy estate for all purposes, circumscribed as it [might] be by the order of consolidation, after giving full consideration to the facts and circumstances of that case.

The bankruptcy court further stressed that substantive consolidation would not alter the statutory requirements of § 544(b) or applicable state law. Rather, it would simply define who is the "debtor."<sup>13</sup> The court made it clear that if the trustee was successful in achieving substantive consolidation, she might be permitted to bring nondebtor transferors

<sup>13</sup> A corollary to the principle that substantive consolidation only defines what is meant by the term "debtor" and does not alter state law in that a trustee might be limited in asserting derivative standing on an unsecured creditor if state law requires a creditor's claim to predate the transfer at issue. In such scenarios, a creditor that only has a claim against an entity that is substantively consolidated with a debtor should not be identified as the predicate creditor in an adversary proceeding seeking avoidance of a transfer of property from the debtor. The creditor of the nondebtor entity becomes a creditor of the debtor on the date that the entities are substantively consolidated, which would necessarily be after the date of the transfer at issue. The trustee in *GY Property Holdings* was not affected by such a fact because Nevada has adopted the Uniform Fraudulent Transfer Act, which allows a creditor to avoid a transfer "whether the creditor's claim arose before or after the transfer was made." N.R.S. § 112.180(1).

<sup>8</sup> *Kelley v. Opportunity Fin. LLC (In re Petters Co. Inc.)*, 550 B.R. 438, 456 (Bankr. D. Minn. 2016).

<sup>9</sup> *Id.* at 455.

<sup>10</sup> *Id.*

<sup>11</sup> Case Number 14-01075.

<sup>12</sup> The Houmand Law Firm, formerly Nelson & Houmand, PC, was counsel of record for the trustee and litigated this issue before the U.S. Bankruptcy Court for the District of Nevada. The authors were counsel for the trustee in the adversary proceeding that is the subject of this article.

into the debtor's estate for the express purpose of preserving the estate's avoidance actions.<sup>14</sup>

## Conclusion

While the issue of whether a trustee can expand the pool of qualifying unsecured creditors through substantive consolidation is still an open question, it might be a strategy worth considering for trustees administering estates that involve a multitude of transfers from separate, but related, entities to the debtor. **abi**

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<sup>14</sup> There might be an added benefit to substantively consolidating a nondebtor entity if the Internal Revenue Service (IRS) is a creditor of that nondebtor entity. This approach might allow a trustee to utilize a 10-year reach-back period under § 544(b) by asserting derivative standing on behalf of the IRS. In pursuing collection actions, the IRS is not limited to statutes of limitations as set forth in state fraudulent-transfer law. Rather, the IRS is subject to the 10-year statute of limitations set forth in the Internal Revenue Code. *See* 26 U.S.C. § 6502(a)(1); *see also, e.g., In re Behrends*, No. AP 14-1377 EEB, 2017 WL 4513071, at \*8 (Bankr. D. Colo. April 10, 2017); *In re CVAH Inc.*, 570 B.R. 816, 834 (Bankr. D. Idaho 2017); *Ebner v. Kaiser (In re Kaiser)*, 525 B.R. 697, 710 (Bankr. N.D. Ill. 2014); *Finkel v. Polichuk (In re Polichuk)*, No. 10-003 ELD, 2010 WL 4878789, at \*3 (Bankr. E.D. Pa. Nov. 23, 2010); *Alberts v. HCA Inc. (In re Greater Southeast Cmty. Hosp. Corp. I)*, 365 B.R. 293, 299-306 (Bankr. D.D.C. 2006); *Shearer v. Tepsic (In re Emergency Monitoring Techs. Inc.)*, 347 B.R. 17, 19 (Bankr. W.D. Pa. 2006); *Osherow v. Porras (In re Porras)*, 312 B.R. 81, 97 (Bankr. W.D. Tex. 2004). *But see Wagner v. Ultima Holmes Inc. (In re Vaughan Co.)*, 498 B.R. 297 (Bankr. D.N.M. 2013) (holding that bankruptcy trustee could not assert derivative standing on behalf of IRS).