CONSOLIDATION OF ASSETS: A CREDIT ENHANCEMENT TOOL IN CORPORATE INSOLVENCY PROCEEDINGS

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INTRODUCTION

The increasing surge of globalization in the recent decades has seen the international economic scenario being dominated by giant multinational corporate bodies. Together these corporate moguls have thought it prudent to have a uniform global regime favouring, if not absolutely then at least relatively, free trade. This approach has led to indubitable liberalization of the commercial market, thereby necessitating at least a modicum of uniformity and stability in the international regime of commercial laws. The need assumes all the more significance in light of events like major insolvency scams featuring multinational bodies like Enron that shook the faith people had in such corporations. It is in response to such requirement that certain hitherto unknown structural safeguards have been introduced, of which a certain corporate instrument by the name of the Doctrine of Substantive Asset Consolidation deserves special mention. The said doctrine, viewed as a promising credit enhancement implement with its roots embedded in the principle of equity, has since its emergence in the market proved to be extremely valuable in terms of its relative advantage in handling the intricate complexities of insolvency procedures and piercing veils to identify corporate fraud.

In the face of the changing dynamics of insolvency laws, structured finance has become the new mantra. The popularity of gigantic projects necessitates extensive investment, thereby leading to large-scale development that in turn is strengthened by new tools designed to enhance credit. A significant problem arises as a corollary to this situation wherein claims of several creditors come forth into existence against more than one debtor, but procedural complexity of corporate accounting renders it well-nigh impossible for the debtors to be separated.

The present research project reviews the virtues and vices of the concept of substantive asset consolidation, the said concept having been developed by the American judiciary as a remedy based on the principle of equity that seeks to simplify the intricacies of insolvency and asset liquidation.

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If one is to delve into the complex aspects of the American perception of the aforesaid concept, there appears to be no better starting point than the matter of In Re: Owens Corning, a Delaware Corporation Credit Suisse First Boston, as Agent for the Pre-petition Bank Lenders,[2] wherein the Third Circuit Court had provided the following definition of substantive asset consolidation: "Substantive consolidation, a construct of federal common law, emanates from equity. It treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor."

Although the judiciary had thus clarified their stance regarding the doctrine, it continued to attract more than a fair bit of academic criticism. Prior to this, the scholars had devised their own version of the doctrine, which exhibited both similarities as well as differences from the aforementioned judicial pronouncement.

According to them, "In place of two or more debtors, each with its own estate and body of creditors, substantive asset consolidation substitutes a single debtor, a single estate with a common fund of assets, and a single body of creditors. Assets and liabilities of each entity are pooled and inter-entity accounts and claims are eliminated. Creditors of the separate entities become creditors of the consolidated entity."[3] In course of this article, the author would like to critically analyze this particular concept of asset consolidation, its pros and cons and its application as a useful tool in the matters involving modern bankruptcy proceedings, along with examining the prevailing Indian scenario.

THE DOCTRINE OF SUBSTANTIVE ASSET CONSOLIDATION AND ITS USEFULNESS TO ENHANCE CREDIT

In the groves of academe, there has often been a prevailing opinion that the predecessor of the concept of substantive consolidation had made its presence known as early as 1789 in the form of a relief provided by the English chancery court that was exercising its powers of equity. Indeed, one can also say that the said decision had provided an ideal model format for the American judiciary in its attempt to develop the doctrine much later in the 20th century. Such attempts were usually much more pronounced in course of the matters involving 'piercing the corporate veil'.[4]

[2]419 F.3D 195

[3]Mary Elisabeth Kors, 'Altered Egos: Deciphering Substantive Consolidation', 59 U. PITT. L. REV. 381; the said definition has also been subsequently adopted by the judiciary during the Owens Corning proceedings.

[4]Seth D. Amera et al., 'Substantive Consolidation: Getting Back to Basics', 14 AM. BANKR. INST. L. REV.1.

Especially in the case of In re Reider[5], the judiciary had held that the insolvent entity with which consolidation was sought to be carried out was a sort of 'alter ego' or an 'instrumentality' of the target affiliate –the relief obviously bears close similarity with substantive consolidation. During that particular period, this 'alter ego' test was usually applied to determine the suitability of whether a matter should be subjected to turnover proceedings. The normal practice for the courts was to appoint a receiver for the subsidiary or to require the subsidiary to turn over its assets to the holding company's bankruptcy trustee for the purpose of administering the assets for the benefits of the creditors of the holding company.[6] A prominent example of such practice was the court's decision to uphold the turnover of a subsidiary's assets on the ground that the subsidiary was an 'instrumentality' of the parent company, as was done in Fish v East.[7] However, on the said occasion the judiciary had refrained from providing any fixed guideline to determine whether a body is such an instrumentality, instead holding such determination to be 'primarily a question of fact and degree'. However, certain determinative circumstances had been laid down as indicators of whether a corporation can be termed the alter-ego of another. The judiciary further sought to justify turnover on the line of equity, stating that a "corporate entity may be disregarded where not to do so will defeat public convenience, justify wrong or protect fraud."[8] A similar decision was taken in Taylor v Standard Gas & Electric Co.[9], where the US Supreme Court rejected the claim of a corporate house against its insolvent subsidiary on the ground of the instrumentality theory. In the Fish case, on appeal, the court had found sufficient reasons to grant the parent company's claim for turnover, but nothing substantial was said regarding the quandary as to whether the creditors of the subsidiary should be denied priority to its assets in course of said turnover. It was only in a subsequent decision in In re Tip Top Tailors, Inc.[10], that the Fourth Circuit Court of Appeals chose to approve the consolidation of the subsidiary into the parent corporation and also held that the creditors of the parent company and the subsidiary should have a pro rata share in the combined asset pool in the absence of any evidence of the creditors of the subsidiary having placed any reliance upon its sole credit. The chronology of events would thus suggest the alter ego doctrine as the legitimate predecessor of the consolidation principle.

[5]31 F 3d, at 1105

[6]See Elvin Latty, *Subsidiaries and Affiliated Corporations* 2 (1936). See also Frederick Powell, *Parent and Subsidiary Corporations: Liability of a Parent Corporation for the Obligations of its Subsidiary* (1931).

[7]114 F.2d 177 (10th Cir 1940).

[8]ibid at p. 182; such fraud may also include by implication fraudulent transfers between the corporate bodies.

[9]306 US 307 [1939]

[10]127 F.2d 284 (4th Cir.), cert. denied, 317 US 635 [1942]

However, it took several more decades for the US judiciary to consider the latter doctrine more favourably in comparison with the former. In FDIC v Colonial Reality Co.[11], the Second Circuit Court of Appeals distinguished between the facets of the two aforementioned tenets, holding in the process that the purpose of piercing the corporate veil is to create an exception to the limited liability enjoyed by a company, while substantive consolidation seeks to ensure equitable handling of all creditors. Several landmark decisions had followed, including Soviero v Franklin National Bank of Long Island[12], Chemical Bank New York Trust Co. v Kheel [13], Flora Mir Candy Corp. v R.S. Dickson & Co.[14] and James Talcott, Inc. v Wharton[15], each contributing towards the development of the consolidation doctrine. The precise term 'substantive consolidation' was first pronounced in 1997 by Roy Babitt, J., in his opinion in In re Commercial Envelope Manufacturing Co. –"substantial consolidation, as will be seen, is now part of the warp and woof of the fabric of the bankruptcy process involving related debtors, though to be used sparingly".[16] What the term essentially means is that in a case of debt recovery, the claims against a number of entities are to be clubbed into one, so that the combined paying power can be utilized to satisfy the collective liability.

THE THEORETICAL BACKGROUND OF SUBSTANTIVE ASSET CONSOLIDATION

From 1978 onwards, substantive consolidation began to be endowed with quite a liberal reception, with the Bankrupt Reform Act having wrought significant changes in the insolvency litigation scenario. The judiciary observed that the aforesaid trend had its "genes in the 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 purposes."[17] Subsequently, there have appeared two different tests viz. the Auto-Train Test and the Augie/Restivo Test, devised by the U.S. Court of Appeals for the District of Columbia Circuit and the Second Circuit respectively, so as to guide the bankruptcy courts in the application of the Doctrine of Substantive Consolidation.

[11]966 F.2d 57, (2nd Cir. 1992)

[12]328 F.2d 446 (2nd Cir. 1992)

[13]369 F.2d 845 (2nd Cir. 1966)

[14]432 F. 2d 1060 (2nd Cir. 1970)

[15]517 F. 2d 997 (2nd Cir. 1975), cert. denied, 424 US 913 (1976)

[16]3BANKR. CT. DEC. (CRR) 647, at p. 648; also see J. Maxwell Tucker, 'Development: Grupo Mexicano and the Death of Substantive Consolidation (c)', 8 AM. BANKR. INST. L. REV., 427.

[17]*Eastgroup Properties v Southern Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991) at p. 248.

Auto-Train Test

The Auto-Train Test[18] lays down the following criteria for qualifying for substantive asset consolidation:

(a) a substantial identity has to exist between the entities to be consolidated;

(b) necessity of consolidation to avoid some harm or to realize some benefit must be proven; and

(c) if a creditor objects and demonstrates his reliance on the separate credit of one of the entities and that the consolidation will result in undue prejudice to him, then under such circumstances, consolidation can only be allowed if the demonstrated benefits of consolidation heavily outweigh the harm.

Augie/Restivo Test

As per the Augie/Restivo Test[19], the proponent of consolidation must be able to establish either of the following two grounds:

(a) That the creditors dealt with the entities as a single unit rather than relying on their separate identity while extending credit; or

(b) That the affairs of the corporate entities are so closely enmeshed that any attempt to separate them involves extreme difficulty and/or prohibitive asset-consumption and thus consolidation stands to act in the benefit of all the creditors involved.

Having said that, even if a proponent succeeds in establishing either of the aforesaid grounds, the judiciary has the discretionary power to approve or reject consolidation based on whether the resulting benefit outweighs the resulting harm. However, in the absence of any express statutory authority in this respect,[20] the application in practice consists of a sort of synthesis of all such available tests, with the court wielding powers like that of a 'court of equity'.[21] However the validity of the premise of such power has subsequently been challenged by statutory developments and the decision in Grupo

[18]See *Drabkin v Midland-Ross Corp. (In re Auto-Train Corp.)* 810 F.2d 270 (D.C. Cir. 1987); an almost similar test was laid down in *First National Bank of El Dorado v Giller* 962 F.2d 796 (8th Cir. 1992)

[19]See *In re Augie/Restivo Baking Co.* 860 F.2d at 518 (issuing two-factor test for substantive consolidation consideration). The test was further reaffirmed in *FDIC v Colonial Reality Co.* 966 F.2d 57 (2nd Cir. 1992)

[20]Such absence has been remarked upon in FED. R. Bankr. P. 1015 Advisory Committee's note (1983).

[21]See *Local Loan Co. v Hunt* 292 US 234 (1934) and *James Talcott, Inc. v Wharton* 517 F.2d 997 (2nd Cir. 1975).

Mexicano case[22]. Yet in spite of lack of statutory support, substantive asset consolidation has emerged in the corporate scenario as an effective instrumentality for debt management, enjoying blessings of equity, so to speak.

Alter Ego Model

The Alter Ego model has been developed on the basis of the premise that there may exist a relationship between two corporate entities so that one can be identified with the other so as to make one liable to contribute towards discharge of the liabilities of the other. This model is a traditional one that has successfully withstood the tests of time and is still popular among the judiciary of different regimes in terms of its application for the purpose of consolidation of assets.[23] According to a portion of the judiciary, piercing the corporate veil and substantive consolidation share certain similar characteristics and the relating laws overlap each other to a certain extent, thereby rendering it quite difficult for somebody to distinguish between the two doctrines as such. For the purposes of 'alter ego analysis', courts have been known to have directly applied the piercing precedent at times and to have solely relied on substantive consolidation precedents during the remaining matters.[24] It is beyond doubt that the very rationale behind the action of consolidation lies inherent in the fact that the entities involved are 'alter egos' of one another or that one of them is a 'mere instrumentality' of another.[25] The test can thus only be applied by the judiciary on occasions wherein a connection has been established between the entities so as to deem one the alter ego of another.

Balancing Test

A successful application of the doctrine of substantive asset consolidation, although serving the interests of the creditors involved, may well prove detrimental to the interests of some of the parties concerned. It is then that the concept of the balancing test comes into play as a sort of overarching guiding principle –it involves an attempt by the judiciary to balance the harm suffered by one of the parties against the benefit accruing

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[22]*Sampsell v Imperial Paper & Color Corp.* 313 US 215 (1941)

[23]For illustrations of the successful application of the Alter Ego model, see *First National Bank v Giller (In re Giller)* 962 F.2d 796 (8th Cir. 1992), *FDIC v Hogan (In re Gulfco. Inv. Corp.)* 593 F. 2d 921 (10th Cir. 1979), *James Talcott, Inc. v Wharton (In re Continental Vending Mach. Corp.)* 517 F. 2d 997 (2nd Cir. 1975)

[24]*In re.Cooper*, 147 B.R. at 683, wherein it was said *"There is a substantial overlap between the grounds for and the remedies of piercing the corporate veil and substantive consolidation"*; *Gainesville P.H. Properties*, 106 B.R. at 309, where both piercing and consolidation precedents had been cited.

[25]*In re Tito Castro Constr., Inc.*, 14 B.R. 569 at 571 (Bankr. D.P.R. 1981)

to the rest of them. Most of the decisions regarding substantive consolidations have included a consideration of the said test, albeit to varying degrees.[26] Since the test is generally applied before the consolidation takes place, courts usually measure the desirability of the harm suffered in the absence of the consolidation against the harm suffered in the event such consolidation takes place.[27]

It is true that the balancing test brings a much-needed uniformity in deciding the appropriateness of the matter under consideration for application of the consolidation doctrine, but in reality a lot remains to be achieved to dispel the uncertainty surrounding the applicability of the doctrine, since such ambiguity weaken creditor confidence and deters the principle and objectives of credit enhancement.

SUBSTANTIVE ASSET CONSOLIDATION: A CRITICAL ANALYSIS

As has already been mentioned hereinabove, the Doctrine of Substantive Asset Consolidation has had a long and eventful history as a legal instrument. One must remember that the doctrine owes its origins substantially to the existing principles of disregarding the independent corporate personality and piercing the corporate veil. The benefits of application of the doctrine that must logically have motivated the judiciary to adopt the same are as follows:

(a) Avoiding the extremely high costs of disentangling the financial affairs of the related entities;

(b) Protecting the expectations of creditors who relied on the collective credit of the entities;

(c) Redressing the misappropriation of the assets of one entity for the benefit of another entity;

(d) Recognizing the control, and operational interdependence existing between the companies involved, which have made them 'alter egos' of one another.

The aforementioned factors seem to indicate that the doctrine of asset consolidation stands against the very basic tenets of the company law regime that recognizes separate corporate personalities of individual corporate entities. The main allegation that is levelled against the doctrine is that whether the necessity to repay the accumulated debt is sufficient to justify the theory's general disregard for the separate corporate persona. As opposed to such objections, in circumstances where disentanglement of

[26]See *Fishell v United States Trustee (In re Fishell)*, No. 95-1637, 1997 WL 188458, (6th Cir. Apr. 16, 1997)

[27]*Eastgroup Properties* 935 F.2d 249

the assets and liabilities of various entities involves prohibitive expenditure and other difficulties, substantive consolidation may significantly increase creditor recoveries, thereby satisfying a primary aim of insolvency law, viz. to enhance the assets of the debtor's estates. There are other benefits of consolidation too, such as decreasing the cost of administering insolvency proceedings, confirming a plan for reorganization, increasing the possibility of reorganization by a significant margin, reducing the cost of debt management etc. Moreover, where a creditor has in good faith relied upon the collective credit of the legal entities involved, protecting such reliance succeeds in enhancing economic efficiency as well as reflecting the equitable face of the otherwise procedural and strict corporate law, something that is not undesirable by any standard whatsoever.

At the other end of the spectrum lies the reasoning that misappropriation and alter ego justifications may not be sufficient for asset consolidation; the same results can be achieved by the law regarding fraudulent transfer, may be to a higher degree of success, resulting in recovery of the money alleged to have been misappropriated. To achieve the same result, some argue, is not worth disregarding the fundamental principles of corporate law such as independent corporate persona.

However, the researcher would herein like to submit a counter argument to such allegations. Law relating to fraudulent transfer concentrates on penalizing intentional misbehavior by shareholders and is of not much relevance to provide a remedy to the debtors. The concept of asset consolidation is indeed useful in today's corporate scenario, when as a result of substantial intra-company investments, the costs of disentanglement might be a disincentive, as a result of which, it might result in loss of resources for the creditors to recover from. The most important benefit of this doctrine is the role played by it in dissuading corporate sharks from creating smaller subsidiaries with the sole purpose of funding themselves, without sharing the associated liabilities, in a clear attempt to confuse the creditors. Such role assumes all the more significance in the light of the present complex structure of subsidiary and off-balance sheet funding with a huge number of dummy corporations in between; the judiciary needs all the help it can get to declare full or partial asset consolidation in order to derive the best recovery from the pooled assets for the creditors. If such consolidation happens in an out of court settlement, then all the creditors get to draw security interest pari pasu. Thus despite all of its alleged shortcomings, the Doctrine of Substantive Asset Consolidation seems to be here to stay as a rather useful corporate instrument.

SUBSTANTIVE CONSOLIDATION IN THE INDIAN SCENARIO

A perusal of Indian corporate law jurisprudence will reveal that there does not exist any specific statutory provision providing for substantive consolidation of assets in

relation to corporate insolvency. However, the author would like to submit herein that such absence is far from being a deliberate omission; rather it is an inevitable reflection of the unorganized nature of the insolvency law regime in India. Indian company law is yet to boast of a specific insolvency code, with every conceivable corporate scenario, ranging from incorporation to winding up of a body corporate being governed by the all-encompassing provisions of a single piece of legislation viz. the Companies Act, 1956. However, in light of the economic boom that the nation is experiencing at present, the time now seems ripe for the legislators to codify the insolvency laws of the land into a specific composite code. Regarding the application of the doctrine of substantial asset consolidation within the Indian insolvency regime, it is further submitted that since the judiciary has time and again applied the seal of recognition to the concept of piercing the corporate veil, there appears to be no room for a presumption to the effect that the principles of disregarding the independent existence of a body corporate are matters alien to the Indian courts.[28] From an equitable perspective, lack of legislative provisions cannot in reality prevent the judiciary from digressing from the application of the literal meaning of strict positive law in the interests of justice. Indeed, a brief glance through the Indian jurisprudence will yield numerous precedents to bear testimony to such judicial activism.

With regard to tests like the 'alter ego' or 'instrumentality' or 'similar corporate entity', one may refer to existing provisions like Section 5 of the Competition Act of 2002 that acknowledge such concepts, albeit in an indirect manner.[29] Therefore one can safely contend that the requirement for disregarding the independent corporate persona for the purposes of securing justice as well as preserving commercial interests have already become a part of the Indian legal scenario. Piercing of corporate veil has been supported time and again by the judiciary –certainly there is no dearth of precedent in that regard. Proceeding along the same line of logic, the concept can be effectively used when a company adopts a proceeding for voluntary winding up and the creditors look to recover their money. Under such circumstances, particularly when the corporate entities feel expedient to arrive at an out-of-court settlement, the concept of substantive asset consolidation could be utilized to ensure recovery for majority of the creditors.[30]

Nevertheless, despite the inherent benefits offered by the doctrine, practical

[28]See *Tata Engineering Locomotive Co. v State of Bihar* (1964) 1 Comp LJ 284 (SC), wherein the judiciary had observed, "*this is largely in the discretion of the court and depends upon the underlying social, economic and moral factors as they operate in and through the corporation.*"

[29]Section 5 of the Competition Act, 2002 deals with the conditions that need to be satisfied for the purpose of merger, or acquisition of one or more corporate enterprises.

[30]As per the usual practice in U.S. however, such settlements result in bigger corporate houses managing to get priority rights of recovery from assets.

considerations may impede the application of the same in the Indian corporate law regime. For example, the constrictions under which the official liquidator has to labor as per the provisions of the Companies Act make it rather difficult for efficient asset consolidation to take place. In fact, the author would like to go as far as suggesting that these rule-bound formalities governing Indian company law act as a serious hindrance in the context of bringing in innovative, equity-based principles into operation. Having said that, the Indian judiciary is endowed with considerable discretionary power to render justice on the common law ground of equity and proper exercise of such powers can effectively neutralize such adverse effects, especially when one thinks of the almost unlimited power wielded by the Supreme Court under Article 142 of the Constitution of India.[31] Under the aegis of legitimate exercise of judicial discretion by virtue of application of such overarching constitutional empowering provisions, the Doctrine of Substantive Asset Consolidation can not only be applied in India as an equity-based remedy, but such possibilities may also enhance the significance and acceptability of insolvency proceedings in the country. Such enhancement is likely to assume all the greater implication in future, because given the recent trend of multi-national and trans-national corporations establishing presence in the India, and its credit market turning global, the country's legal regime would soon be called upon to respond to global business needs in accordance with prevailing standards. Keeping in mind the efficacy of the doctrine under consideration, the nation's judiciary should now contemplate initiation of its use in the ongoing proceedings.

CONCLUSION

Thus in course of this article, the author has attempted to portray the varying nuances of the Doctrine of Substantive Asset Consolidation, having relied upon the hypothesis that despite its laches and loopholes, the doctrine, if used sparingly and with caution, can prove to be a great credit enhancer that has the potential to provide a tremendous boost to the confidence of the market and the creditors while ensuring greater transparency simultaneously. In the rapidly evolving economic order of present times, where mammoth volumes of capital are being invested by gigantic mega corporations, the risk of defrauding the creditors under the guise of insolvency proceedings is rampant. Under such circumstances, the normal rules of asset recovery may not suffice and the judiciary may have to look further for more efficacious relief. Substantive consolidation being a creation of expediency based on economic and equitable factors, the courts will

[31] Article 142 (1): *"The Supreme Court in the exercise of its jurisdiction may pass such decree or make such order as is necessary for doing complete justice in any case or mater pending before it, and any decree so passed or order so made shall be enforceable throughout the territory of India in such manners as may be prescribed by or under any law made by Parliament and, until provision in that behalf is so made, in such manner as the President may by order prescribe."*

not be bound in its application by strict procedural red-tapes otherwise prevalent in normal corporate litigation. At the other end of the spectrum, there lies the legitimacy of concerns regarding whether the doctrine will at all be in the best economic interests of the corporate houses given its affinity for deviation form the established principle of corporate independence on which hinges the modern corporate world. Having said that, however, judiciary can, as has often been witnessed in the past, be fine-tuned to overcome such barriers –the prevailing scenario in U.S. bears witness to the possibility of successful application of the doctrine in matters pertaining to corporate insolvency. It is a lesson that the Indian judiciary and the Indian market would do well to dwell upon, since it is a universal principle that time leaves those far behind who fail to match its pace.