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Filing for Bankruptcy and Untying the Knot? Not Without Strings Attached

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Introduction

Substantive consolidation is an equitable remedy used sparingly by bankruptcy courts to consolidate the bankruptcy estates of two debtors. Although it originated in the corporate context, consolidating the estates of two corporate entities or a corporate entity and an individual debtor, its application has extended to consumer bankruptcy. The consolidation of the bankruptcy estates of two debtor spouses has been addressed and recognized by the Second, Third, Fourth, Sixth, Eighth, and Eleventh Circuit Courts.[1]

Part I of this article briefly examines the authority legitimizing substantive consolidation. Part II analyzes the remedy's corporate origins and the differing approaches taken by the circuit courts. Part III explores its expansion into the consumer context, particularly debtor spouses, and the Eighth Circuit's decision in *Boellner v. Dowden*, which was the first time a circuit court affirmed an order substantively consolidating the separate estates of debtor spouses. This article concludes that debtors in the process of ending their marital relationship should take concrete

[1] *See Wornick v. Gaffney*, 544 F.3d 486 (2d Cir. 2008); *In re Brannon*, 476 F.3d 170 (3d Cir. 2007); *Bunker v. Peyton (In re Bunker)*, 312 F.3d 145 (4th Cir. 2002); *Fishell v. U.S. Tr. (In re Fishell)*, 111 F.3d 131 (6th Cir. 1997); *Boellner v. Dowden*, 612 Fed.Appx. 399 (8th Cir. 2015); *Reider v. Fed. Deposit Ins. Corp. (In re Reider)*, 31 F.3d 1102 (11th Cir. 1994).

steps to legalize that dissolution prior to filing for bankruptcy if they want to reduce the risk that their bankruptcy estates will be substantively consolidated.

I. Despite a lack of Statutory Authority, the Supreme Court has affirmed Substantive Consolidation's Use as an Equitable Remedy.

Substantive consolidation is not expressly provided for in title 11 of the United States Code (the "Bankruptcy Code"). Nevertheless, it is well established that a bankruptcy court has the authority to order substantive consolidation. Most courts justify substantive consolidation by relying on section 105 of the Bankruptcy Code, which states in relevant part that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[2] Some courts, however, rely on section 1123 of the Bankruptcy Code, which "explicitly permits implementation of plans of reorganization through 'merger or consolidation of the debtor with one or more persons.'"[3]

Sampsell v. Imperial Paper & Color Corp. signifies the first time that the Supreme Court gave substantive consolidation its approval when it affirmed a district court's order consolidating the estates of an individual debtor with the debtor's corporation.[4] In considering the propriety of substantive consolidation, the Court examined the individual debtor's motive for creating the corporation and their relationship.[5] The Court found that "in this case, the corporation is formed in order to continue the bankrupt's business, where the bankrupt remains in control, and where the effect of the transfer is to hinder, delay, or defraud his creditors."[6] In addition, the Court found that the relationship between the individual debtor and the corporation was so similar that

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[2] 11 U.S.C. § 105(a) (2012).

[3] COLLIER ON BANKRUPTCY, ¶ 105.09 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009), *available at* LEXIS, 2-105 Collier on Bankruptcy P 105.09 (citing 11 U.S.C. § 1123(a)(5)(C)).

[4] *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941); *see also In re Reider*, 31 F.3d at 1105 (noting that "[i]n 1940, the Supreme Court gave its tacit approval to this equitable power to substantively consolidate two estates").

[5] *Sampsell*, 313 U.S. at 218.

[6] *Id.*

neither could claim to be "separate and insulated" from the other in the proceedings.[7] After reaching this conclusion, the Court affirmed the order consolidating the estates of the debtor and his corporation.[8] Since *Sampsell*, courts on all levels have recognized substantive consolidation's use as an appropriate remedy.[9]

II. Substantive Consolidation Originated in the Corporate Setting.

Following the Supreme Court's approval of substantive consolidation in *Sampsell*, courts began to substantively consolidate where there was fraud on the individual debtor's part in creating or using the corporation.[10] In these original cases, courts "applied essentially an alter ego or pierce the corporate veil test in assessing the propriety of substantive consolidation."[11] Eventually, courts substantively consolidated the bankruptcy estates of corporations and subsidiaries as well.[12] Regardless of the corporation/shareholder or corporation/corporation configuration, the circuit courts began to develop different tests to determine whether to order substantive consolidation.[13]

Currently, there is a lack of consensus among several of the circuits concerning the appropriate test to utilize in evaluating a motion for substantive consolidation.[14] One of two

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[7] *Id.*

[8] *Id.* at 221.

[9] *See, e.g., Cent. Tr. Co., Rochester, N.Y. v. Official Creditors' Com. Of Geiger Enter., Inc.*, 454 U.S. 354 (1982) (holding that a debtor corporation could not substantively consolidate the bankruptcy estate that it created under the 1898 version of the Bankruptcy Act with the bankruptcy estates it created for subsidiaries under the 1978 Bankruptcy Act).

[10] *In re Reider*, 31 F.3d at 1105.

[11] *Id.*

[12] *See* 2-105 COLLIER ON BANKRUPTCY, ¶ 105.09.

[13] *See id.* (stressing that "in substantive consolidation cases, the relationship between the legal entities as to which consolidation is sought is far more important than their form").

[14] *See In re Bonham*, 229 F.3d 750, 765 (9th Cir. 2000) (noting that "[n]o uniform guideline for determining when to order substantive consolidation has emerged"); *see also* 2-105 COLLIER ON BANKRUPTCY, ¶ 105.09 (providing that "substantive consolidation has received a variety of interpretations among the circuits. . .until the [Supreme] Court acts, the applicable test. . .will be determined by geography as much as by logic").

emerging tests has been adopted by circuit courts as they analyze this issue for the first time.[15] In *F.D.I.C. v. Colonial Realty Co.*, the Second Circuit made the decision to use the test previously developed in *In re Augie/Restivo Co., Ltd.,* that it had articulated for chapter 11 cases in a chapter 7 context as well.[16] Under this two-part factor-based test, a court must analyze "(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.'"[17] A court may order substantive consolidation if either factor can be established.[18]

In *In re Auto-Train Corp., Inc.*, the D.C. Circuit adopted a three-part burden-shifting test that has emerged as an alternative to the *Augie-Restivo* test.[19] The standard, referred to as the *Eastgroup* analysis by the Eleventh Circuit, imposes the initial burden on the proponent to "show not only a substantial identity between the entities to be consolidated, but also that consolidation is necessary to avoid some harm or realize some benefit."[20] If the proponent can make this showing, the burden shifts to the opposing party to establish "that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation."[21] If the opposing party fulfilled its burden, a motion for substantive consolidation may be granted if the court determines the "benefits of consolidation 'heavily' outweigh the harm."[22] Despite these two competing

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[15] *See In re Bonham*, 229 F.3d at 765.
[16] *F.D.I.C. v. Colonial Realty Co.*, 966 F.2d 57, 59 (2d Cir. 1992) (citing *In re Augie/Restivo Co., Ltd.*, 860 F.2d 515 (2d Cir. 1988)).
[17] *F.D.I.C.*, 966 F.2d at 61 (quoting *In re Augie/Restivo Co., Ltd.*, 860 F.2d at 518).
[18] *See In re Bonham*, 229 F.3d at 765.
[19] *See id.* (citing *In re Auto-Train Corp., Inc.*, 810 F.2d 270 (D.C. Cir. 1987)).
[20] *In re Auto-Train Corp., Inc.*, 810 F.2d at 276; *In re Reider*, 31 F.3d at 1107 (citing *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991)).
[21] *Id.*
[22] *Id.* (quoting *In re Continental Vending Mach. Corp.*, 517 F.2d 997, 1001 (2d Cir. 1975)).

standards, the circuit courts are undivided in holding that substantive consolidation is, essentially, a remedy of last resort.[23]

III. *In re Reider* and Subsequent Decisions Have Recognized the Power of Bankruptcy Courts to Substantively Consolidate the Estates of Debtor Spouses.

A. In In re Reider, *Eleventh Circuit is the first Court of Appeals to Expand Substantive Consolidation into the Consumer Context.*

Prior to making the decision to expand substantive consolidation into the consumer context in *In re Reider*, the Eleventh Circuit examined the relevant provisions of the Bankruptcy Code with respect to the joint administration of spouses' bankruptcy estates.[24] Following this examination, the court then evaluated the different substantive consolidation tests used to determine which was most applicable.[25] Section 302(a) of the Bankruptcy Code states "[a] joint case. . .is commenced by the filing with the bankruptcy court of a single petition. . .by an individual that may be a debtor. . .and such individual's spouse."[26] If the court orders joint administration after considering the best interests of the parties, the spouses' bankruptcy estates will be jointly administered, but joint administration does not automatically equate to consolidation.[27] Joint administration is for the sake of judicial efficiency while consolidation actually affects the rights of the creditors, debtors, and trustee.[28]

Following the court's order of joint administration, Section 302(b) provides "the court shall determine the extent, if any, to which the debtors' estates should be consolidated."[29] In *In*

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[23] *See In re Owens Corning*, 419 F.3d 195, 210 (3d Cir. 2005) (noting "there appears nearly unanimous consensus that it is a remedy to be used 'sparingly'" (citation omitted)).
[24] *In re Reider*, 31 F.3d at 1105.
[25] *Id.*
[26] 11 U.S.C. § 302(a) (2012).
[27] *See* 2-302 COLLIER ON BANKRUPTCY, ¶ 302.01.
[28] *See In re McCulley*, 150 B.R. 358 (Bankr. M.D. Pa. 1993) (providing that "[a]bsent a Court Order to consolidate, joint administration has absolutely no impact on the legal rights and obligations of the Debtor, Creditors, or the Trustee").
[29] 11 U.S.C. §302(b) (2012).

re Reider, the debtor spouses filed for joint administration of their bankruptcy estates, but opposed consolidation.[30] Despite this opposition, one of their creditors argued that their estates should be consolidated because "the case had been filed as joint," "the trustee had intermingled the funds," "the debtors had not [] set out a breakdown of the separate assets and liabilities, and "the assets and liabilities of the two debtors were so intermingled that they could not be separated."[31] The bankruptcy court agreed with the creditor and issued an order consolidating the debtor spouses' estates, which was affirmed by the district court.[32] On appeal, the Eleventh Circuit concluded that a modified version of the *Eastgroup* formulation, its own adaptation of the D.C. Circuit's burden-shifting approach, was be the most appropriate test to apply.[33] The court articulated the test as a two-prong analysis, "a court must determine: (1) whether there is a substantial identity between the assets, liabilities, and handling of financial affairs between the debtor spouses; and (2) whether harm will result from permitting or denying consolidation."[34] Upon application of this test to the facts, the Eleventh Circuit reversed, finding that the bankruptcy court accorded too much weight to the debtors' joint filing and listing of assets.[35] Despite not affirming the order of consolidation, the court's commentary reflected the possibility of substantively consolidating debtor spouses' estates.

After the Eleventh Circuit's expansion of substantive consolidation into the consumer context, the Six, Fourth, Third, and Second circuits followed suit by recognizing its potential use.[36] In *In re Fishell*, the Sixth Circuit affirmed the district court's order affirming the

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[30] *In re Reider*, 31 F.3d at 1104.
[31] *Id.*
[32] *Id.*
[33] *Id.* at 1108 (citing *Eastgroup Properties v. Southern Motel Ass'n, Ltd.*, 935 F.2d 245 (11th Cir. 1991)).
[34] *In re Reider*, 31 F.3d at 1108.
[35] *Id.* at 1109 (holding that "the bankruptcy court erred by placing undue reliance upon the fact that the debtor spouses' estates had been jointly administered").
[36] *See supra* text accompanying note 1.

bankruptcy court's denial of substantive consolidation, concluding that the debtor spouses' motion was "an attempt by the debtors to wrest control of the distribution of 'their assets' from the Chapter 7 trustee and take a second bite at the reorganization apple."[37] The Fourth Circuit, in *In re Bunker*, did not disturb the bankruptcy court's order consolidating the estates of debtor spouses, finding that it was not pertinent to the issue on appeal.[38] Similarly, in *In re Brannon* and in *Wornick v. Gaffney*, substantive consolidation was not an issue on appeal, but the Third and Second Circuits, respectively, recognized its potential in the spousal context.[39]

B. Eighth Circuit is the most recent circuit court to consider the issue of substantive consolidation in the spousal context.

In *Boellner v. Dowden,*[40] the United States Court of Appeals for the Eighth Circuit held that it was within the discretion of the bankruptcy court to order substantive consolidation of spouses' bankruptcy estates when they file separate petitions for chapter 7 bankruptcy.[41] In doing so, it relied on the Eleventh Circuit's opinion in *In re Reider*.[42] However, in contrast to the Eleventh Circuit in *In re Reider* and most other substantive consolidation opinions, the *Boellner* court notably omitted a cautionary statement about substantive consolidation's sparing use.[43] This is particularly significant considering the court's arguable expansion of a bankruptcy court's

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[37] *In re Fishell*, 111 F.3d at 3 (6th Cir. 1997).

[38] *In re Bunker*, 312 F.3d at 148 (4th Cir. 2002) (concluding that "[t]he spouses may take the exemption nonwithstanding the joint administration or substantive consolidation of their individual bankruptcy estates").

[39] *In re Brannon*, 476 F.3d at N. 2 (3d Cir. 2007) (noting that "[t]he court may [] determine to substantively consolidate the cases. . .but that did not occur here"); *Wornick v. Gaffney*, 544 F.3d at 491 (2d Cir. 2008) (acknowledging that a joint petition by debtor spouses does not affect any legal rights unless consolidated).

[40] 612 Fed.Appx. 399 (8th Cir. 2015).

[41] *Id.* at 400.

[42] *Id.* at 401.

[43] *See, e.g., In re Reider*, 31 F.3d at 1109 (cautioning that [s]ubstantive consolidation should be invoked 'sparingly' where any creditor or debtor objects to its use" (citation omitted)); *see also* 2-105 COLLIER ON BANKRUPTCY, ¶ 105.09 (finding that "[i]n general, courts have adopted the view that 'power to consolidate should be used sparingly'" (citation omitted)).

power to consolidate bankruptcy estates. Furthermore, it became the first circuit court to actually affirm an order substantively consolidating the separate estates of debtor spouses.[44]

In contrast to the debtor spouses in previous cases, the debtor spouses in *Boellner* were living separately and filed separate petitions for chapter 7 bankruptcy.[45] In response to the separate petitions, the trustee filed a motion for joint administration and substantive consolidation, arguing that "allowing the Boellners to maintain separate bankruptcy estates would prejudice the creditors because the Boellners could then stack federal and state exemptions."[46] The debtor spouses opposed the trustee's motion, emphasizing that not only did they live separately, but also they had separate assets and liabilities.[47] The debtor spouses conceded that filing separate petitions permitted the debtor husband to claim federal exemptions for his annuities and IRAs under section 522(d) of the Bankruptcy Code while permitting the debtor wife to claim a state exemption for her house.[48] After determining that the benefits of consolidation outweighed the harm and that prejudice would result to creditors if separate bankruptcy estates were maintained, the bankruptcy court ordered joint administration and substantive consolidation.[49] The trustee removed the debtor spouses' appeal from the Bankruptcy Appellate Panel to the district court, which affirmed the order of the bankruptcy court and denied the debtors' motion for reconsideration.[50]

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[44] *But see In re Bunker*, *supra*, (declining to review the bankruptcy court's order of substantive consolidation because it was not raised on appeal).
[45] *Boellner*, 616 Fed.Appx. at 400.
[46] *Id.*
[47] *Id.*
[48] *Id*. at 400-401; *see also* 11 USC §522(d) (2012); Ark. Const. art. IX, § 3.
[49] *Boellner*, 616 Fed.Appx. at 401.
[50] *Id.*

On appeal, the Eighth Circuit considered whether the bankruptcy court abused its discretion in ordering substantive consolidation of the debtor spouses' bankruptcy estates.[51] In its analysis, the Eighth Circuit articulated a definition, "[s]ubstantive consolidation of two bankruptcy estates 'means assets and liabilities of both debtors are pooled,'" and adopted the two-prong test established by the Eleventh Circuit in *In re Reider*.[52] The court concluded that the first prong, substantial identity, was fulfilled because the debtor wife owned the home while the debtor husband owned the household goods, and they both had jointly withdrawn funds from IRAs.[53] The court then concluded that the second prong, harm to creditors, was satisfied as well because if the debtor wife was permitted to claim a state exemption for her home and the debtor husband was permitted to claim federal exemptions for his annuities and IRAs, "their separate estates would have significantly less value than if their cases were substantively consolidated."[54] After determining that the two prongs of the *In re Reider* analysis were fulfilled, the court affirmed the order of substantive consolidation.[55]

Boellner represents the continued expansion of substantive consolidation into the non-corporate context. In doing so, the Eighth Circuit added legitimacy to the notion that the *In re Reider* standard is the appropriate one to use when substantive consolidation of the bankruptcy estates of debtor spouses is being evaluated – the only standard that has yet to be used by circuit courts in such a context. Furthermore, *Boellner* demonstrates that there continues to be a split among the circuit courts between the factor-based approach originally articulated by the Second Circuit and the D.C. Circuit's burden-shifting approach. Even though the Supreme Court has

[51] *Id.*
[52] *Id.* (quoting *In re N.S. Garrott & Sons*, 48 B.R. 13, 17 (Bankr. E.D. Ark. 1984)).
[53] *Boellner*, 616 Fed.Appx. at 401.
[54] *Id.*
[55] *Id.* at 402.

recognized the legitimacy of substantive consolidation as an equitable remedy, it has yet to indicate which method of analysis is preferable.[56] Regardless, it is questionable that when the Supreme Court gave its approval of the power of bankruptcy courts to substantively consolidate in *Sampsell* that it foresaw it being used to consolidate the estates of debtor spouses that were no longer living together and had filed for bankruptcy separately.

Conclusion

Debtors that are considering filing for bankruptcy and are living separately from their spouse should consider the affect of the *Boellner* decision, especially if they live in the Eighth Circuit. According to *Boellner*, a bankruptcy court may force consolidation in such a situation, which, in contrast to just joint administration, affects the rights of all those involved. It would be wise for a debtor to legalize their separation in some form, whether legal separation or divorce, thereby providing evidence for the court that there is no longer a "substantial identity" between the spouses. Moreover, it would also be helpful to ensure that the debtors' financial statements indicate that they have completely separate assets and liabilities. Most importantly, debtors should not try to manipulate the bankruptcy system in a way that potentially prejudices creditors, such as attempting to stack exemptions as the debtors did in *Boellner*.

[56] *See* 2-105 COLLIER ON BANKRUPTCY, ¶ 105.09 (observing that "[t]hese divergent views can be reconciled only by the Supreme Court").