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SARE'S AND SPE'S IN BANKRUPTCY

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**SINGLE ASSET REAL ESTATE
BANKRUPTCIES**

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Single Asset Real Estate Bankruptcies

I. Background

In 1994, Congress amended Title 11 of the United States Code (the “Bankruptcy Code”) to provide particularized treatment for debtors within the gamut of “single asset real estate” (“SARE”) entities. The purpose of adding a provision for SARE was “to put additional responsibility on a single asset real estate debtor and prevent a perceived abuse of the bankruptcy process on the part of these ventures.” *In re 652 West 160th LLC*, 330 B.R. 455, 460 (Bankr. S.D. N.Y. 2005) (citing S.Rep. No. 168, 103d Cong., 1st Sess. (1993)). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) significantly expanded the scope of SARE cases by subsequently removing the four million dollar secured debt cap component of the definition of SARE. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-08, 119 Stat. 23 (2005).

To qualify as SARE under the Bankruptcy Code after enacting BAPCPA, a debtor must own only:

real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

11 U.S.C. § 101(51B). In other words, the debtor’s sole source of income is generated from the sale and divestment of a single real property asset.

The most common SARE case is a dispute between a debtor with a single piece of real estate as its only asset, and one creditor with a secured claim on the asset. On each voluntary petition, debtors may check a box under the nature of business indicating “Single Asset Real Estate as defined in 11 U.S.C. § 101(51B).” However, in many cases debtors do not indicate that the debtor is a SARE entity on the voluntary petition. In the event the debtor files for relief and leaves that box unchecked, a party in interest may raise the question of whether the debtor is a SARE entity, and the courts must determine the issue.

II. The Test for SARE

Applying the Section 101(51B) definition of SARE under BAPCPA, the U.S. Court of Appeals for the Fifth Circuit expounded the appropriate test to determine whether a debtor is a SARE entity. See *In re Scotia Pacific Co.*, 508 F.3d 214, 220 (5th Cir. 2007). The Fifth Circuit described a three pronged test requiring proof of the following elements: “(1) the debtor must have

real property constituting a single property or project (other than residential property with fewer than 4 residential units), (2) which generates substantially all of the gross income of a debtor, and (3) on which no substantial business is conducted other than the business of operating the real property and activities incidental thereto.” *Id.* (focusing primarily on the third prong of the analysis and discussing the debtor’s business and corporate structure). The court was clear that these are mandatory elements, rather than mere factors for consideration. *See id.*

A. Real Property Constituting a Single Property or Project

The first inquiry is whether the debtor’s real property is a single property or project. Clearly, where a debtor’s real property consists of a single parcel of real estate, other than residential property with fewer than four residential units, the first element is satisfied.

The practical problem of classifying a debtor’s real property as SARE arises where the debtor owns multiple parcels of land. To classify multiple parcels of land as SARE, the property must be “linked together in some fashion in a common plan or scheme involving their use.” *In re McGreals*, 201 B.R. 736, 742 (Bankr. E.D. Pa. 1996); *see also In re Webb Mtn. LLC*, 2008 WL 656271 (Bankr. E.D. Tenn. March 6, 2008) (applying the three pronged test from *In re Scotia Pacific Co.*, and determining the debtor’s five parcels constituted SARE because the debtor had not yet developed the parcels and was not conducting any active business on the property).

B. Real Property Generating Substantially All of the Gross Income of a Debtor

Generally, the second determination regarding gross income is derived from a straightforward comparison of the revenue generated from the sale of the debtor’s real property to the revenue generated from the operation of the real property. In cases where the debtor’s primary source of income is derived from the sale of the real property, the debtor will satisfy this second element of the SARE analysis. *See Kara Homes v. National City Bank (In re Kara Homes, Inc.)*, 363 B.R. 399, 404-05 (Bankr. D.N.J. 2007) (holding the debtor received “substantially all of their income through the sale of real property.”). *Compare In re CGE Shattuck LLC*, Ch. 11 Case No. 99-12287 JMD, 1999 WL 33457789, at *7 (Bankr. D.N.H. 1999) (stating the debtor is not a SARE entity where “a significant percentage of the debtor’s revenues are derived from golf pro shop operations and other non-real property sources.”). In practice, courts have a tendency blend their discussions of the second SARE element with the third SARE element.

C. Real Property on which No Substantial Business is Conducted Other Than the Operating of the Real Property and Activities Incidental Thereto.

As a general rule, debtors operating hotels, resorts, golf courses or marinas are not SARE entities. *See Centofante v. CBJ Dev. Inc. (In re CBJ Dev. Inc.)*, 202 B.R. 467, 473 (B.A.P. 9th Cir. 1996) (holding that hotels are not SARE entities because the hotel “gift shop, restaurant, bar and the bus tours launched from the [h]otel parking lot are all business other than the business of operating the property.”); *In re Whispering Pines Estate, Inc.*, 341 B.R. 134 (Bankr. D.N.H. 2006) (determining operating a hotel is sufficiently active to constitute a business other than the business

of operating the real property); *In re Prairie Hills Golf & Ski Club*, 255 B.R. 228 (Bankr. D. Neb. 2000) (explaining a debtor is not a SARE entity where the debtor builds and sells residences, constructs roads to residences, golf and ski areas, removes snow from golf and ski areas, sells liquor in the clubhouse, and leases golf and ski areas to third parties); *In re Larry Goodwin Golf, Inc.*, 219 B.R. 391 (Bankr. M.D.N.C. 1997) (holding operation of a golf course, golf cart rentals, pool, concessions and undeveloped property for sale constitute substantial business, rather than retaining the real property solely for income); *In re Kkemko Inc.*, 181 B.R. 47 (Bankr. S.D. Ohio 1995) (holding that a marina is not SARE because the marina sold both concessions and gas, and stored, repaired and winterized boats); *In re Vail Plaza Dev., LLC*, Ch. 11 Case No. 08-26920 HRT (Bankr. D. Colo. June 5, 2009) (concluding the debtor was not a SARE entity because of the debtor's involvement in the hotel operations and ongoing sale of parking spaces in a separate development); *In re Club Golf Ptnrs. LP*, Ch. 11 Case No. 07-40096 BTR, 2007 WL 1176010 (Bankr. E.D. Tex. 2007) (holding the debtor's golf course was not SARE because the debtor sold memberships and merchandise in its pro shop, charged fees to use the golf course, golf carts, the driving range, the tennis courts and the clubhouse for special events, and sold food and beverages in the clubhouse restaurant); *In re CGE Shattuck LLC*, 1999 WL 33457789 (determining that real property is not SARE when a substantial percentage of revenues are derived from a golf pro shop and golf related services). In summary, these types constitute substantial business outside the scope simply operating real property, and are considered activities that are not "incidental" from operating the real property.

Notably, one exception to the general rule is when a debtor owns SARE with only a passive investment in an operating resort or hotel. *See Kara Homes*, 363 B.R. 399. *Kara Homes* primarily involved an uncompleted real estate development project, and the court went to great lengths to distinguish cases involving real estate development from cases involving operating debtors with multiple revenue streams. *See id.* at 405-06. Moreover, the court cited with approval the "palpably clear" analysis that debtors operating marinas, golf resorts, ski resorts, and hotels cannot be included in the definition of SARE. *See id.*; *see also In re Scotia Pacific Co.*, 508 F.3d at 221-23. Thus, only if the debtor has no active role in the management of the operating resort or hotel can the debtor qualify as a SARE entity.

III. The Application of 11 U.S.C. § 362(d)(3) to SARE

Where all SARE statutory elements are satisfied, SARE cases receive an expedited reorganization through the automatic stay provisions of Section 362(d)(3) of the Bankruptcy Code. "SARE debtors are carved out and subjected to stringent requirements in § 362(d)(3) which expedite the time for SARE debtors to file a plan of reorganization or commence making monthly payments, failing which the automatic stay is promptly lifted." *In re Scotia Pacific Co.*, 508 F.3d at 225. The legislative intention of Section 362(d)(3) "was to terminate the stay when the debtor neither proposes a viable plan nor makes payments to the secured party." 3 Collier on Bankruptcy ¶ 362.07[5] (15th ed.2005) (citing *NationsBank, N.A. v. LDN Corp. (In re LDN Corp.)*, 191 B.R. 320, 326-27 (Bankr. E.D. Va.1996)). Therefore, this statute allows a single creditor to impose an acceleration of the relief from stay process, unless the debtor fulfills certain requirements.

Specifically, 11 U.S.C. § 362(d)(3) provides in part:

(d) On request of a party in interest and after notice and a hearing, *the court shall grant relief from the stay* provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay -

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, *unless*, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later -

(A) the *debtor has filed a plan of reorganization* that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the *debtor has commenced monthly payments* that -

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien; and

(ii) are in an amount equal to interest at the then applicable non default contract rate of interest on the value of the creditor's interest in the real estate.

11 U.S.C. § 362(d)(3)(A)-(B) (emphasis added). Relief from stay under Section 362(d)(3) is only available to a creditor with a lien on SARE, as defined in 11 U.S.C. § 101(51B).

In Chapter 11 cases, 11 U.S.C. § 362(d)(3) must be read in conjunction with 11 U.S.C. § 1121. Section 1121(b) provides an initial exclusivity period for the debtor to file a plan, stating "only the debtor may file a plan until after 120 days after the date of the order for relief in this chapter." In contrast, Chapter 11 SARE cases applying 11 U.S.C. § 362(d)(3) entitle secured creditors to relief from stay within ninety days after the date of the order for relief. Thus, the debtor in a SARE case becomes subject to a fast-tracked ninety day deadline to file a plan, rather than the one hundred and twenty days provided in Section 1121(b).

To resolve this conflicting time period for SARE entities to file a plan, debtors may Subsections (A) and (B) to Section 362(d)(3) of the Bankruptcy Code allow debtors to prevent the creditor from imposing the expedited relief from stay. To shield itself from this automatic stay provision, the debtor "must either file a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time or make monthly payments in an amount equal to interest

at current fair market rate on the value of [the property] within 90 days after the entry of the order for relief.” *In re Cambridge Woodbridge Apartments, LLC*, 292 B.R. 832, 839 (Bankr. N.D. Ohio 2003). The statute provides a safe harbor for debtors in Section 362(d)(3)(A) for those debtors that file a Chapter 11 plan that has a reasonable possibility of being confirmed within a reasonable time. *See In re 652 West 160th LLC*, 330 B.R. at 462.

Alternatively, even if this exception is inapplicable, Section 362(d)(3)(B) “excepts from the requirement of commencement of interest payments secured creditors whose debt is secured by a judgment lien or an unmatured statutory lien.” *See In re 652 West 160th LLC*, 330 B.R. at 462 (citing *In re Syed*, 238 B.R. 133, 139 (Bankr. N.D. Ill.1999)). For example, the U.S. Bankruptcy Court for the Northern District of Ohio held that a mortgagee could not utilize Section § 362(d)(3) to obtain relief from the automatic stay to exercise its rights in an 180-unit apartment complex that was the debtor’s sole asset, where the debtor had been making adequate monthly protection payments to the mortgagee since filing for Chapter 11 relief. *See In re Cambridge Woodbridge*, 292 B.R. at 839-40.

BANKRUPTCY “PROOF” ENTITIES GO “POOF” IN BANKRUPTCY – SPECIAL
PURPOSE ENTITIES ARE NOT SO SPECIAL ANYMORE

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I. THE PURPOSE OF SPECIAL PURPOSE ENTITIES

- A. Isolation of collateral from the claims of other creditors
- B. Easier, quicker and less expensive financing
- C. Better vehicle for securitization
- D. Prevent entity from filing bankruptcy
- E. Easier, quicker access to collateral for the lender

II. THE NATURE AND ELEMENTS OF AN SPE

- A. Limited purposes and limited business
- B. Sole ownership of collateral
- C. Restrictions on governance and decision-making
- D. Independent Director(s)
- E. Restrictions on amendments to organizational documents
- F. Non-consolidation opinions of counsel

III. USE OF THE SPE IN REAL ESTATE DEVELOPMENT AND FINANCING

- A. Ownership of separate real estate assets
- B. Unique Lender or group of Lenders
- C. Separate cash flow

D. Common ownership of related SPEs by parent entity – pyramid or tiered ownership structures

IV. PRACTICAL REALITIES

- A. Common management of related SPEs by parent’s managers
- B. Centralized, albeit separate, recordkeeping
- C. Commingled cash and inter-entity debits and credits
- D. Consolidated tax returns
- E. Consolidated financial statements
- F. Knowledge of lenders

V. WHEN THE ENTERPRISE IS IN FINANCIAL DISTRESS

- A. Some SPEs in the enterprise are solvent, while others are not
- B. Some SPEs have positive cash flow, while others have negative cash flow or no cash flow
- C. Commingled cash becomes impossible to trace from one SPE to another
- D. Common management expenses are allocated to all SPEs and their parent entities in some equitable or rational manner – cash flow; asset value; amount of debt; equally
 - 1. Insurance under blanket policies
 - 2. Common recordkeeping and accounting expenses
 - 3. Common tax preparation expenses
 - 4. Leasing, selling and security services
 - 5. Common professional expenses

VI. THE BANKRUPTCY SENERIO

- A. Parent replaces independent director with a “friendly” director who votes to cause the SPE to file Ch 11, or simply files Bankruptcy for the SPE in disregard of corporate governance documents
- B. Parent, all intermediate tier entities and all SPE file Ch 11 are in one bankruptcy venue
- C. First Day Motions

1. Joint Administration
2. Retention of common professionals
3. Retention of existing cash management systems and consolidated bank accounts
4. Use of Cash Collateral from all entities to support post-petition operating and administrative expenses of the "enterprise" of entities, including payment of salaries to common management team members
5. Payment of pre-petition wages of employees, including management
6. No substantive consolidation

D. Expected "Day 2" Motions and activities to follow shortly after the case is filed, and usually within the first 90 days

1. Extension of the period under § 362(d)(3) for filing a plan or commencing payments to lenders
2. Non-payment of pre-petition and/or post-petition real estate tax liabilities outside of a plan
3. Consolidated plan of reorganization for all entities

VII. THE LENDER'S ARGUMENTS

A. Motion to Dismiss Separate SPEs

1. Bad Faith Filing
2. Lack of proper authorization or authority

B. Relief from Stay

1. No equity in insolvent SPEs
2. No prospects for a successful reorganization of insolvent SPEs

C. No adequate protection from use of excess cash flow from solvent SPEs

D. No relief without Substantive Consolidation

VIII. THE DEVELOPER-DEBTOR'S ARGUMENTS

A. Lender had knowledge of the common enterprise at the time of the loan and has waived arguments of "separateness" by acquiescence

B. Value and success of each SPE, both solvent and insolvent, is tied to the success of the entire enterprise

C. No single SPE has the internal management and structure to operate on its own

D. The overall "enterprise" is solvent, even if certain SPEs are not, and the going concern value of the entire enterprise, including the equity in solvent SPEs, is adequate protection for the use of cash collateral from certain SPEs to support that enterprise

E. Organizational documents of the SPE can be amended

F. Directors of the SPE have a fiduciary duty to protect the best interests of "the entity," which may include filing Ch 11 for the entity if it is part of an overall enterprise, even if the entity itself is not insolvent

G. Directors of a solvent SPE owe a duty to the owners of the SPE, and not to the creditors of the SPE

H. Lender lacks "standing" to challenge a violation of corporate governance documents

IX. THE DECISIONS OF THE COURTS

A. *In re General Growth Props., Inc.*, Case No. 09-11977-ALG, (Bankr. S.D.N.Y. August 11, 2009), *Memorandum Opinion Regarding Motions to Dismiss*, copy attached as Exhibit "B."

1. Motions to dismiss certain SPE debtors by Lenders to those SPEs, on primary grounds of "bad faith" and ineligibility to file.

2. Multi-tiered corporate structure, but GGP and its affiliates were the owners of the SPEs, which, in turn, owned specific real estate assets.

3. "Nationwide, integrated approach to the development, operation and management of its properties, with centralized leasing, marketing, management, cash management, property maintenance and construction management.

4. Slim solvency of overall Enterprise - \$29B of assets v. \$27B of liabilities.

5. Typical SPE structures: restriction in their loan documents and operating agreements that require them to maintain separate existence and limit debt; prohibitions on consolidation, liquidation, mergers, asset sales, amendments and other "separateness covenants;" and retention of independent directors;

6. Some of the SPE loans were guaranteed by other GGP entities.

7. Many loans were financed by commercial mortgage-backed securities ("CMBS").

8. As to “bad faith” court applies *both* the objective futility and subjective bad faith tests.

9. Debtor that is not in financial distress not prohibited from filing bankruptcy

10. Court looks at “enterprise concept” in assessing bad faith, especially in light of lenders’ knowledge of the workings of the enterprise and the potential benefits and detriments from such a structure.

11. Independent directors have fiduciary duties to shareholders as well as to creditors, especially if the entities are solvent.

12. Debtor need not prove confirmability of a plan in order to file a petition.

13. Organizational documents did not prohibit the rights of the shareholder to appoint different independent directors to the Board.

B. *In re Meruelo Maddux Properties, Inc.*, Case No. 09-13356-KT, Docket No. 832, U.S.Bk. Ct., So. Dist. CA, Nov. 5, 2009, pgs 3-5, *Notice of Rulings on Certain Objections to Debtors’ Motion for Final Order(s) Authorizing Use of Cash Collateral and Use of Debtors’ Cash Management System and on Related Relief from Stay Motions*, copy attached as Exhibit “C.”

1. SPE’s articles limited operations to single property

2. SPE’s articles also prohibited change in legal structure, modification of articles without lender consent if modification would adversely affect debtor’s ability to perform its obligations, commingling of funds of SPE with other entities, and becoming obligated on any debts other than that of the lender.

3. Court finds that SPE’s articles “were drafted to protect the Lender from just what happened in this case, and more.”

4. Lender argues that Court cannot authorize actions of the SPE in violation of its corporate authority.

5. Debtor argues (1) no violence to articles if Court authorized the actions, (2) SPE could amend its articles, and (3) restrictive provisions can be altered through a plan.

6. Court concludes: (1) articles can be amended to remove the restrictions upon which Lender relies, (2) Lender has no vote on a proposal to amend the articles, (3) “the primary purpose of adequate protection is to preserve [the SPE’s] ability to perform its obligations in connection with the [Lender’s] loan,” (4) Lender has simple breach of contract claim, (5) Lender is not a shareholder, director or officer of the SPE, (6) if Lender was a third party beneficiary then it could be vulnerable to lender liability claims for improper interference with, or control over, the business of the SPE, (7) Lender lacks standing to “insert itself into the

internal corporate affairs of the SPE,” and (8) adequate protection addresses the Lender’s concerns which is the real harm that the Lender fears.

C. Extended Stay Inc., et al, In re (Bank of America, N.A., et al. v. Lightstone Holdings, LLC, et al.), 52 BCD 47 (Bankr. S.D.N.Y. 2009), copy attached as Exhibit “E.”

1. Non-recourse loans to debtor were guaranteed by principals who only had liability on their guaranties if the debtor committed certain acts, such as filing bankruptcy.
2. Guarantors caused debtors to file bankruptcy
3. Lenders sued the guarantors under the “bad boy” provisions of the guaranties, as well as for breach of implied covenant of good faith, tortious interference with contract and breach of fiduciary duty.
4. Guarantors removed pending state court suits to the bankruptcy court where the debtor’s case was pending.
5. Court remands cases to state court for lack of jurisdiction, finding simple contract dispute between non-debtor entities.

X. THE FIX ?

A. Create covenants that require separate recordkeeping, separate management, segregation of cash, separate bank accounts and use of entity assets solely to pay entity debts, and require periodic certifications of compliance from management.

B. Define who can be the “independent director,” with the qualifications such that the only qualified person is someone associated with the credit community. – Note: this does not relieve the director from his/her fiduciary duties but it may make it more difficult to replace the independent director with an owner-developer friendly person immediately prior to bankruptcy.

C. Require normal bankruptcy proof provisions, i.e. no authority to file BK without unanimous affirmative vote of all directors, no filing without 30-60 days prior notice to secured lender, and opportunity to structure transaction outside of bankruptcy, retention of independent attorneys and other professionals to advise the SPE, other than those who represent the owner, and inability to amend the organizational documents of the entity in such as way as to change these provisions.

D. Consider guaranties from individual principals with “bad boy” provisions that trigger liability only if the entity files BK, or commits other “bad acts.”

Exhibit A
(Sample Non-Consolidation Opinion)

Re: Partial Assumption of \$XXXXXXX Loan from XXXXXXXXXXXXXXXX Corp., a New York corporation, and its successors and assigns, to XXXXXXXXXXXXXXXXXXXX, LLC and XXXXXXXXXXXXXXXX, LLC, each a Delaware limited liability company, as tenants-in-common, as subsequently partially assumed by XXXXXXXXXXXXXXXX, LLC, a Delaware limited liability company, secured by the multi-family real estate project commonly known as XXXXXXXX Apartments located in XXXXXXXXXXXXXXXXXXXX – Nonconsolidation Opinion.

Ladies and Gentlemen:

We have acted as special counsel to XXXXXXXXXXXXXXXX, a Delaware limited liability company (“*New TIC Borrower*”), in connection with the assumption of a mortgage loan (the “*Loan*”) in the original principal amount of \$XXXXXXXXXXXXXXXXXX made by XXXXXXXXXXXXXXXXXXXXXXXXXXXX, a New York corporation (“*Original Lender*”), succeeded in interest by XXXXXXXXXXXXXXXXXXXX, successor-by-merger to XXXXXXXXXXXXXXXX, as Trustee for the registered holders of XXXXXXXXXXXXXXXX Commercial Mortgage Pass Through Certificates (“*Noteholder*”), whose servicer is XXXXXXXXXXXXXXXX. (“*Servicer*”), which Loan was made to XXXXXXXXXXXXXXXX, LLC, a Delaware limited liability company (“*H*”), and COTTONWOOD S, LLC, a Delaware limited liability company (“*S*”), as tenants-in-common (collectively, “*Original Borrower*”).

XI. OPINION REQUESTED

You have requested that our opinion as to whether, under present reported decisional authority and statutes applicable to federal bankruptcy cases effective as of the date of this opinion, if XXXXXXXXXXXXXXXX and YYYYYYYYYYYYYY, as Trustees of X&Y TRUST created under Declaration of Trust dated XXXXXX, 1996, and any amendments thereto (the “*Trust*”) were to become a debtors in a case under the Bankruptcy Code (as defined below), a federal court exercising federal jurisdiction, exercising reasonable judgment after full consideration of all relevant factors and applicable law, would order the substantive consolidation of the assets and liabilities of New TIC Borrower with those of the Trust.

XII. FACTUAL ASSUMPTIONS

In rendering the opinions herein, we have assumed, without verifying the accuracy of such assumptions or the accuracy of the underlying facts set forth in this section, the following factual assumptions which are supported by the Transaction Documents and the Factual Assumption Documents identified on Exhibit “A” hereto which we have reviewed. We have further assumed that these facts are accurate as of the date of this opinion and will continue to be

accurate in all material respects at any relevant time hereafter. Nothing in the assumed facts set forth below will limit or qualify any opinion we may give in a separate opinion letter dated the date hereof and relating to the Transaction described herein. Certain capitalized terms used but not defined herein are defined on Exhibit A hereto.

A. General Description of Transaction

Pursuant to (i) that certain Assumption Agreement by and between S, Original Lender and XXXXXXXXXXXXXXXX, LLC, a Delaware limited liability company ("**Original TIC Borrower**"), dated XXXXXXXX, 2006, recorded on XXXXXXXXXXXX, 2006 as Entry No. 00000000, in Book 00000, beginning at Page 0000 in the Recorder's Office, Original TIC Borrower owns a 7.73216% tenant-in-common ownership interest (the "**TIC Interest**") in certain real property commonly known as XXX Apartments located in XXXXXXXXXXXX as more particularly described in the Security Instrument (the "**Property**"), and (ii) certain other assumption agreements by and between S, Original Lender and the parties as identified on Schedule 1 attached to the Assumption and Release Agreement (as defined on Exhibit A hereto) (collectively, the "**Other TIC Borrowers**"), the Other TIC Borrowers collectively own a 92.26784% tenant-in-common ownership interest in the Property.

Upon receipt of consent of Noteholder, Original TIC Borrower will transfer the TIC Interest to New TIC Borrower (the "**Transfer**") and New TIC Borrower will assume the Loan (the "**Assumption**") which is secured by the Property.

B. The Parties

New TIC Borrower was formed in Delaware in August 2009 and is a wholly-owned subsidiary of the Trust. New TIC Borrower was initially capitalized by the contribution of (i) cash and (ii) certain other valuable consideration by the Trust. New TIC Borrower was organized for the limited purpose of acquiring, owning and transferring the commercial real estate project (or an undivided interest therein as tenant in common with one or more other persons as entities) located at XXXXXXXXXXXXXXXXXXXX (the "**Project**"), and the operation and management of the Project and such activities as are necessary or incidental in connection therewith. The principal executive offices of New TIC Borrower are located at XXXXXXXXXXXXXXXXXXXX. New TIC Borrower is duly organized, in good standing and validly existing under the laws of the State of Delaware.

The Trust was formed in December 1996 pursuant to that certain Declaration of Trust dated XXXXXXXX 1996, and amendments thereto. The Trust was initially capitalized by the contribution of (i) cash and (ii) certain other valuable property. The Trust was organized for the benefit of those certain persons designated from time to time as beneficiaries thereto.

C. CORPORATE CONDUCT

1. Procedures Observed

The Trustees of the Trust and sole member of New TIC Borrower, have authorized the execution and delivery of the Transaction Documents (as defined on Exhibit A hereto). The parties to the Loan are entering into the Transaction Documents for the Transfer and Assumption

in reliance on the existence of New TIC Borrower as a legal entity separate, independent and distinct from the Trust. The formation and isolation of New TIC Borrower as an entity separate and distinct from the Trust and its respective Affiliates (excluding New TIC Borrower) is a necessary precondition to the willingness of the Noteholder to consent to the Transfer and Assumption. Such steps and indicia of New TIC Borrower's separate identity include, by way of example and without limitation, the following:

- (i) New TIC Borrower does and will maintain its own books of account and corporate records separate from those of the Trust;
- (ii) New TIC Borrower has paid and will pay its own operating expenses and liabilities from its own funds. New TIC Borrower will, in the future, pay its share of the expenses related to the Transactions;
- (iii) New TIC Borrower prepares, or will prepare, its separate financial statements, separate from the financials of the Trust;
- (iv) New TIC Borrower does and will maintain its assets in such a manner that it is not costly or difficult to segregate, ascertain or otherwise identify its individual assets from or as against those of the Trust;
- (v) New TIC Borrower does not and will not commingle or pool its funds or other assets with those of the Trust;
- (vi) New TIC Borrower does not and will not maintain any joint bank account or other depository account to which the Trust has independent access;
- (vii) New TIC Borrower does and will maintain an arm's length relationship with the Trust. New TIC Borrower is not, nor will be, nor holds or will hold itself out to be, responsible for the debts of the Trust nor the decisions or actions respecting the daily business and affairs of the Trust; and
- (viii) Each officer and member of New TIC Borrower shall discharge his or her fiduciary duties and obligations to New TIC Borrower in accordance with all applicable laws and the its Amended and Restated Limited Liability Company Agreement (the "Limited Liability Company Agreement").

2. Limited Activities

We have reviewed New TIC Borrower's Limited Liability Company Agreement which currently restricts New TIC Borrower, as a limited purpose entity, to activities related to the acquiring, owning and transferring the Project and the operation and management of the Project and such activities as are necessary or incidental in connection therewith. New TIC Borrower will not amend its Limited Liability Company Agreement in any manner which would affect such restriction on New TIC Borrower's activities.

3. Trustees and Sole Member

The Trustees of the Trust and the sole member of New TIC Borrower, have made a diligent analysis of the business and operations of New TIC Borrower, and each is reasonably confident that New TIC Borrower is as of the date of this opinion and going forward intends to: (i) be adequately capitalized to conduct its business and affairs as a going concern, considering the size, nature and intended purposes of its business; (ii) remain solvent; (iii) be able to pay its debts as they come due; and (iv) as a result, be able to survive as a stand-alone entity, independent of financial assistance of any Person not contemplated by the Transaction Documents. The Trustees of the Trust and the sole member of New TIC Borrower, do not anticipate as of the date of this opinion any need for New TIC Borrower to obtain advances or loans, other than the Loan. New TIC Borrower has analyzed its own business and operations and is reasonably confident that it is as of the date of this opinion and going forward intends to: (i) be adequately capitalized to conduct its business and affairs as a going concern; (ii) remain solvent; (iii) be able to pay its debts as they come due; and (iv) as a result, be able to survive as a stand-alone entity. There are no actions, suits or other proceedings (including matters relating to environmental liability) pending or threatened against or affecting the Trust, New TIC Borrower, or any of their respective properties, that if adversely determined, in the aggregate, may have a material adverse effect on the financial condition of the Trust or New TIC Borrower.

4. Conduct

None of the Trust nor New TIC Borrower has concealed or will conceal from any interested party any transfers contemplated by the Transaction Documents. None of the Trust nor New TIC Borrower has itself removed or concealed, and will not itself remove or conceal from creditors any of its respective assets and has not participated and will not participate in removing or concealing the assets of any other entity.

D. CAPITALIZATION OF PARTIES

Neither New TIC Borrower nor the Trust has been or is insolvent as of the date hereof (after giving effect to the Transaction), or has engaged, is engaged or is about to be engaged in a business for which the property owned by such party represents an unreasonably small capitalization. The capitalization of New TIC Borrower and the Trust is and has always been adequate in light of its proposed business and purpose as of the date hereof and such capitalization is sufficient to meet its reasonably anticipated liabilities. As of the date hereof, New TIC Borrower and the Trust are each able to pay their respective debts as they mature, and such parties do not intend to incur debts in the future that will be beyond their respective ability to pay as such debts mature.

E. OTHER ASSUMPTIONS

Please be advised that in rendering the opinions expressed below, with your understanding and consent, we have assumed, without any independent investigation, inquiry or verification, the following:

1. The accuracy of the factual statements of New TIC Borrower and the Trust made in the Factual Assumption Documents (as such term is defined in Exhibit A, attached hereto) as to factual matters.

2. The genuineness of the signatures not witnessed by us, the authenticity of documents submitted to us as originals, and the conformity to originals of documents submitted to us as copies.

3. Each document submitted to us for review is accurate and complete, each such document that is an original is authentic, each such document that is a copy conforms to an authentic original, and all signatures on each such document are genuine.

4. Each certificate submitted to us for review that has been issued by any governmental official, office, agency or other person concerning the property or status of any person or entity (such as certificates of corporate good standing, certificates concerning tax status, certificates concerning Uniform Commercial Code filings or certificates concerning title registration or ownership) is accurate, complete and authentic and all official public records (including their proper indexing and filing) are accurate and complete.

5. All of the Transaction Documents have been duly delivered by all of the respective parties thereto.

6. There are no oral or written statements or agreements that modify, amend, or vary, or purport to modify, amend, or vary, any of the terms of the Transaction Documents.

7. Each of the Transaction Documents is the legal, valid, binding and enforceable obligations of the parties thereto enforceable against that party in accordance with its terms, except as limited by bankruptcy, insolvency, or other similar laws of general application relating to or affecting the enforcement of creditors' rights generally and subject to general principles of equity.

8. With respect to the Trust:

(i) The Trust prepares, or will prepare, its separate financial statements, separate from the financials of New TIC Borrower;

(ii) The Trust does and will maintain its assets in such a manner that it is not costly or difficult to segregate, ascertain or otherwise identify its individual assets from or as against those of New TIC Borrower;

(iii) The Trust does not and will not commingle or pool its funds or other assets with those of New TIC Borrower;

(iv) The Trust does not and will not maintain any joint bank account or other depository account to which New TIC Borrower has independent access; and

(v) The Trust does and will maintain an arm's length relationship with New TIC Borrower.

9. New TIC Borrower has not engaged in any business other than the Transfer and the Assumption.

Any factual assumption made above or elsewhere that is “based solely on” a Factual Assumption Document is based solely on such document and we have relied upon all factual matters set forth in such documents, without any independent inquiry or verification of the factual matters stated therein.

XIII. NON-CONSOLIDATION OPINION

You have requested our opinion as to whether, under present reported decisional authority and statutes applicable to federal bankruptcy cases effective as of the date of this opinion, if the Trust were to become a debtor in a case under the Bankruptcy Code, a federal court exercising federal jurisdiction, exercising reasonable judgment after full consideration of all relevant factors and applicable law, would order the substantive consolidation of the assets and liabilities of New TIC Borrower with those of any of the Trust.

1. AUTHORITY OF COURT TO ORDER SUBSTANTIVE CONSOLIDATION

The authority of a bankruptcy court to order substantive consolidation lies in its general equitable powers under section 105(a) of the Bankruptcy Code. In re Bonham, 229 F.3d 750, 764 (9th Cir. 2000). Although a bankruptcy court’s power of substantive consolidation derives from its general equity powers as expressed in Section 105, id., that section merely provides that the court may issue orders necessary to carry out the provisions of the Bankruptcy Code. There is no direct statutory or regulatory authority or prescribed standards for substantive consolidation. Instead, judicially developed standards control whether substantive consolidation should be granted in a given case.

The fluidity and uncertainty associated with such standards have been noted by several courts; it is best typified by the often-paraphrased comment “that as to substantive consolidation, precedents are of little value, thereby making each analysis on a case by case basis.” In re Crown Mach. & Welding, Inc., 100 B.R. 25, 27-28 (Bankr. D. Mont. 1989). This ad hoc approach has resulted in a lack of clear-cut standards, and the relevant factors, the weight to be attached to such factors and the significance of competing considerations offered by objectors to substantive consolidation remain largely unsettled. Although two broad themes have emerged from substantive consolidation case law, Bonham, 229 F.3d at 765, the results of these tests are not consistent:¹ the application of one test may very well yield a result different from that

¹ A third theme that has developed in the recent bankruptcy cases is the concept of joint administration of separate but related bankrupt debtors. While not formally resulting in the substantive consolidation of the assets and liabilities of a parent company and its affiliates or subsidiaries, the bankruptcy courts in the In re General Growth Properties, Inc., et al. and In re Meruelo Maddux Properties, Inc., authorized related, but separate, debtor entities to commingle their assets for the purposes of cash collateral use and providing adequate protection to their secured creditors. See In re General Growth Properties, Inc., No. 09-11977 (Bankr. S.D.N.Y., filed April 16, 2009) (Final Order Authorizing Debtors to (A) Obtain Postpetition Secured Financing Pursuant to Bankruptcy Code Sections 105(a), 362, and 364, (B) Use of Cash Collateral and Grant Adequate Protection Pursuant to Bankruptcy Code Sections 361 and 363 and (C) Repay in Full Amounts Owed Under Certain Prepetition Secured Loan Agreement, entered May 14,

achieved using another test. Accordingly, the analysis presented herein, as well as any other analysis of whether there is a substantial risk of substantive consolidation, is subject to the general qualification that, in any given instance, there can be no guaranty that a court, in exercising its discretionary equitable authority, will deny substantive consolidation.

2. MECHANICS OF SUBSTANTIVE CONSOLIDATION

The nature and impact of the substantive consolidation of affiliated corporate debtors' estates closely resembles a corporate merger in which the rights of shareholders and creditors of the merging entities are affected:

Substantive consolidation usually results in, inter alia, pooling the assets of, and claims against, the two entities; satisfying liabilities from the resultant common fund; eliminating inter-company claims; and combining the creditors of the two companies for purposes of voting on reorganization plans.

In re Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988).

Certain creditors face a harsh economic result associated with an involuntary combination of their debtor's estate with less solvent estates. For this reason, the Second Circuit noted that "[t]he power to consolidate should be used sparingly," Chemical Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966).² Another court concluded that virtually every request for substantive consolidation involves harm to creditors:

It must be recognized and affirmatively stated that substantive consolidation, in almost all instances, threatens to prejudice the rights of creditors. . . . This is so because separate debtors will almost always have different ratios of assets to liabilities. Thus, the creditors of a debtor whose asset-to-liability ratio is higher than that of its affiliated debtor must lose to the extent that the asset-to-liability ratio of the merged estates will be lower.

In re Snider Bros., Inc., 18 B.R. 230, 234 (Bankr. D. Mass. 1982).

At least some courts, however, feel that substantive consolidation may be more appropriate and justified in cases where the court is faced with more complex corporate

2009); In re Meruelo Maddux Properties, Inc., No. 09-13356 (Bankr. C.D.C.A., filed March 26, 2009) (Order Authorizing the Debtors' Use of Cash Collateral On An Interim Basis, entered April 27, 2009).

² Additionally, courts beyond the Second Circuit have consistently recognized that substantive consolidation should be used sparingly, as it is a measure that vitally affects creditors' substantive rights, and have exercised their discretion accordingly. In re Bonham, 229 F.3d at 767; In re DRW Property Co., 82, 54 B.R. 489, 494 (Bankr. N.D. Tex. 1985); In re Snider Bros., Inc., 18 B.R. 230, 234 (Bankr. D. Mass. 1982); Eastgroup Properties v. Southern Motel Assoc., Ltd., 935 F.2d 245, 248 (11th Cir. 1991); In re Steury, 94 B.R. 553, 554 (Bankr. N.D. Ind. 1988); In re Lease-A-Fleet, Inc., 141 B.R. 869, 872 (Bankr. E.D. Pa. 1992).

structures.³

Thus, courts have stated that substantive consolidation should be “used sparingly.” There is, however, a “modern” or “liberal” trend toward allowing substantive consolidation, which has its genesis 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.

Eastgroup Properties v. Southern Motel Assoc., Ltd., 935 F.2d 245, 248-49 (11th Cir. 1991) (citations omitted).

3. REPORTED DECISIONS

The reported decisions under the Bankruptcy Act and cases decided after the enactment of the Bankruptcy Code rely on one or several of the following theories or tests in determining whether substantive consolidation is warranted in a particular case. Historically, the analysis of substantive consolidation was rooted in the theory of piercing the corporate veil, in which factors are considered in making a determination as to whether one debtor is the alter-ego of the other. More recently “[t]wo ‘similar but not identical’ tests have been applied to assess whether substantive consolidation is proper . . .” Bonham, 229 F.3d at 765. The first of these tests is the presence or absence of certain “factors,” which factors tend to concentrate on the manner in which the debtors conducted business. The second approach is the application of a balancing test, in which the aforementioned “factors,” as well as the impact of consolidation on creditors, are taken into account.

a. Alter Ego or “Instrumentality” Theory. Certain cases indicate that courts may rely on the alter ego or “piercing the corporate veil” doctrine to analyze whether substantive consolidation is warranted.⁴ If two or more entities, purportedly separate, are not in fact separate, courts will consider piercing the corporate veil; but, this is a drastic result and is authorized only in the most extreme circumstances.⁵ The cases that rely on the alter ego doctrine, however, generally involve either an attempt to consolidate nondebtor affiliates⁶ or assertions of inequitable conduct or fraud on the part of affiliated debtors or their principals.⁷ Therefore, these cases are factually distinguishable from other substantive consolidation cases

³ Eastgroup Properties, 935 F.2d 245; In re Vecco Constr. Indus. Inc., 4 B.R. 407 (Bankr. E.D.Va. 1980); In re Murray Indus. Inc., 119 B.R. 820 (Bankr. M.D. Fla. 1990).

⁴ In re Tureaud, 45 B.R. 658 (Bankr. N.D. Okla. 1985), aff’d by, 59 B.R. 973 (Bankr. N.D. Okla. 1986); In re 1438 Meridian Place, 15 B.R. 89 (Bankr. D.C. 1981); In re Stop & Go of America, Inc., 49 B.R. 743 (Bankr. D. Mass. 1985); Matter of Baker & Getty Fin. Servs., Inc., 78 B.R. 139 (Bankr. N.D. Okla. 1987); see also In re S.I. Acquisition, Inc., 58 B.R. 454, 460 n.3 (Bankr. W.D. Tex. 1986), rev’d on other grounds, 817 F. 2d 1142 (5th Cir. 1987).

⁵ Matter of Lewellyn, 26 B.R. 246, 252 (Bankr. Iowa 1982); Meridian Place, 15 B.R. at 96.

⁶ See Tureaud, 45 B.R. at 662; Meridian Place, 15 B.R. at 89; In re The Julien Co., 120 B.R. 930 (Bankr. W.D. Tenn. 1990).

⁷ See Baker & Getty, 78 B.R. 139; Stop & Go, 49 B.R. 743 (granting consolidation where fraudulent schemes or misleading information led creditors to believe entities were one).

based on the recent trend in affording greater significance to inter-creditor issues under the balancing test of Snider Bros., as adopted in cases such as Eastgroup Properties. These alter ego cases represent an independent means of accomplishing the effects of substantive consolidation by applying recognized remedies under non-bankruptcy law.

In applying the alter ego theory, the relevant issue to be decided by the court is whether one entity is a mere instrumentality of another entity or individual. "The remedy applies when there is such identity or unity between a corporation and an individual or another entity that all separateness between the parties has ceased and the failure to disregard the corporate form would not be unfair or unjust." In re Gainesville P-H Properties, Inc., 106 B.R. 304, 306 (Bankr. M.D. Fla. 1989), *aff'd sub nom. Eastgroup Properties*, 935 F.2d 245. As with the "factors" approach to substantive consolidation, the cases that depend primarily on the alter ego analog to substantive consolidation cite factors that are used to ascertain whether substantive consolidation is justified. The relevant factors in the alter ego analysis concern the lack of separateness between entities. The following factors are typically cited:

- (1) the parent corporation owns all or a majority of the capital stock of the subsidiary;
- (2) the parent and subsidiary have common officers and directors;
- (3) the parent finances the subsidiary;
- (4) the parent is responsible for incorporation of the subsidiary;
- (5) the subsidiary has grossly inadequate capital;
- (6) the parent pays salaries, expenses or losses of subsidiary;
- (7) the subsidiary has substantially no business except with parent;
- (8) the subsidiary has essentially no assets except for those conveyed by parent;
- (9) the parent refers to the subsidiary as department or division of parent;
- (10) directors or officers of the subsidiary do not act in interests of subsidiary, but take directions from parent;
- (11) formal legal requirements are not observed;
- (12) dominance of corporate entities by principal; and
- (13) commingling of funds of all entities.

Tureaud, 45 B.R. at 662, *aff'd*, 59 B.R. 973 (Bankr. N.D. Okla. 1986) (citing Fish v. East, 114 F.2d 177 (10th Cir. 1940) and In re Gulfco Inv. Corp., 593 F.2d 921 (10th Cir. 1979)).

As with the "factors" and balancing tests for substantive consolidation described herein, a court's determination as to whether it will allow disregard of the corporate entity is highly fact intensive. In Meridian Place, the court explained that "there is no magic formula or litmus paper

approach to reaching a determination of the propriety of the piercing of the corporate veil.” Generally, however, courts have considered the factors stated above, together with whether there is “an element of injustice or fundamental unfairness.”⁸ 15 B.R. at 96 n.10.

(i) “Factors” to be Considered. Cases decided under the Bankruptcy Act and shortly after the enactment of the Bankruptcy Code rely principally on a determination of whether certain factors are present in a particular case. This approach is related to but somewhat broader than the “instrumentality” rule, employed in the Fish v. East line of cases. For example, in Kheel, the court cited the following factors in its decision to grant substantive consolidation: (i) common ownership; (ii) operation of debtors as a single unit; (iii) little attention to corporate formalities; (iv) the fact that officers and directors were substantially the same; (v) the fact that officers and directors were mere figureheads; (vi) the shifting back and forth and/or pooling of funds of different entities; and (vii) the fact that withdrawals from the account of one entity were used to pay liabilities of the other and were not properly recorded. 369 F.2d at 846. Additionally, in Vecco, four debtor subsidiaries were consolidated, and the court relied on the following list of factors: (i) the degree of difficulty in segregating and ascertaining individual assets and liabilities; (ii) the presence or absence of consolidated financial statements; (iii) the profitability of consolidation at a single physical location; (iv) the commingling of assets and business functions; (v) the unity of interests and ownership concerning the various corporate entities; (vi) the existence of parent and inter-corporate guarantees on loans; and (vii) the transfer of assets without formal observance of corporate formalities. 4 B.R. at 410. Several courts have adopted the Vecco factors⁹ as well as additional factors that a court may consider relevant in a particular case.¹⁰ Regardless of which factors are

⁸ See In re Standard Brands Paint Co., 154 B.R. 563 (Bankr. C.D. Cal. 1993), where the court rejected the application of the “old alter ego/piercing the corporate veil” analysis to determine whether or not there was a “substantial identity” between the debtor and its subsidiaries, even though the debtor and the subsidiaries kept separate books and records and observed all corporate formalities thereby complying with such analysis, and instead held that case law was moving to a more “modern” approach by viewing “substantial identity” in more “functional terms.” Id., at 572-573. The court found that such approach was very similar to the “entanglement” prong of the Augie/Restivo test and held that there was a substantial identity between the debtor and such subsidiaries because the debtor and such subsidiaries operated as a single unit and because no creditor of the debtor or such subsidiaries objected to substantive consolidation. Id.

⁹ DRW Property, 54 B.R. 489; In re Gainesville P-H Properties, Inc., 106 B.R. 304 (Bankr. M.D. Fla. 1989) aff’d. sub nom. Eastgroup Properties v. Southern Motel Assoc., Ltd., 935 F.2d 245 (11th Cir. 1991); In re Baker & Getty Fin. Serv., Inc., 78 B.R. 139 (Bankr. N.D. Ohio 1987); In re Donut Queen, 41 B.R. 706 (Bankr. E.D.N.Y. 1984); In re Richton Int’l Corp., 12 B.R. 555 (Bankr. S.D.N.Y. 1981); In re Luth, 28 B.R. 564 (Bankr. D. Idaho 1983).

¹⁰ In re Apex Oil Co., 118 B.R. 683 (Bankr. E.D.Mo. 1990) (considering whether: (i) the assets and liabilities of debtors were inseparable, (ii) debtors’ businesses were mutually dependent, (iii) debtors had many of the same officers, directors and employees, (iv) certain transactions lacked arms-length formality, (v) financial statements were consolidated, (vi) debtors cross-guaranteed and cross-collateralized each other’s debts, and (vii) debtors filed consolidated tax returns and were severally liable thereunder) (reversed on other grounds); In re F.A. Potts and Co., 23 B.R. 569 (Bankr. E.D.Pa. 1982) (considering whether: (i) same directors and officers make decisions for both entities, (ii) operations were directed from one office, (iii) the subsidiary’s in-house accounting was performed by its parent, (iv) financial and tax statements were consolidated, and (v) funds were freely transferred between entities); Gainesville, 106 B.R. at 304 (considering the Vecco factors as well as whether: (i) debtors had common

used, a court employing this analysis tends to view that no single factor is dispositive of whether substantive consolidation is warranted and that, instead, the court must consider the factors in the context of each case.

The Second Circuit, in Augie/Restivo, reduced to two the laundry list of “critical factors” to be considered, namely, “whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . [or] whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.” 860 F.2d at 518 (citation omitted). The proponent of substantive consolidation has the burden of proving that one of the two critical factors is present. Id. The Second Circuit further affirmed the use of this test in F.D.I.C. v. Colonial Realty Co., 966 F.2d 57 (2d Cir. 1992), noting that analysis of the “two critical factors” set forth in Augie/Restivo is necessary “to ensure that consolidation yields benefits offsetting the harm it inflicts on objecting parties.” Id. at 61, citing In re Auto-Train Corp., 810 F.2d 270, 276 (D.C. Cir. 1987); see also In re 599 Consumer Electronics, Inc., 195 B.R. 244 (S.D.N.Y. 1996).

It appears as if consideration employed in Augie/Restivo has emerged as one of the two principal competing methods for determining substantive consolidation. See Bonham, 229 F.3d at 766. The Ninth Circuit adopted the Augie/Restivo approach as more grounded in substantive consolidation and economic theory. Id. In so doing, it noted that

[t]he first factor, reliance on the separate credit of the entity, is based on the consideration that lenders “structure their loans according to their expectations regarding th[e] borrower and do not anticipate either having the assets of a more sound company available in the case of an insolvency or having the creditors of a less sound debtor compete for the borrower assets.” In re Augie/Restivo, 860 F.2d at 518-19. Consolidation under the second factor, entanglement of the debtor’s affairs, is justified only where “the time and expense necessary even to attempt to unscramble them [is] so substantial as to threaten the realization of any net assets for all the creditors” or where no accurate identification and allocation of assets is possible. [Citation omitted.]

Bonham, 229 F.3d at 766.

Irrespective of the application of Augie/Restivo, the laundry list of “factors” enumerated in Veeco, Kheel and others remain relevant as to whether substantive consolidation should be granted. In re Munford, Inc., the court adopted the Augie/Restivo test, but also considered the underlying factors that led the Augie/Restivo court to its two-part test:

[T]he two factors are admittedly a synthesis of the more specific factors which were popular with other courts that considered the

officers and directors, (ii) the subsidiary transacted business only with its parent, and (iii) both entities disregarded legal formalities of subsidiary as a separate corporation).

substantive consolidation question, and the Court feels comfortable in consulting with earlier decisions that discuss these specific factors. A corollary to this observation is that each Augie/Restivo factor involves multiple considerations, and as a result the adjudication of the consolidation issue is necessarily going to be fact intensive.

115 B.R. 390, 395 n.1 (Bankr. N.D. Ga. 1990).

Although the court in Bonham stated that the presence of either of the two “critical” Augie/Restivo factors was a sufficient basis for a court to order substantive consolidation, Bonham, 229 F.3d at 766, the bankruptcy court’s findings regarding a number of other “factors” provided the factual predicates to support the conclusion that creditors had not relied on the separate credit of the entity. Id. at 767, 768. In this regard, the court noted that (1) assets had been commingled, (2) there was no clear demarcation of affairs, (3) the names of the entities were often commingled, (4) there was a lack of independent financial statements, (5) a lack of separate corporate tax returns, (6) there was personal involvement of a single principal with the affairs of the entities, and (7) the debtors to be consolidated were not operated as separate entities. Furthermore, the entities for which substantive consolidation was sought were a part of a scheme to perpetuate a fraud. Id.

It is important to note that many of the stated factors are present in most bankruptcy cases involving affiliated debtors. For example, stock ownership, inter-affiliate transfers, incorporation caused by the parent, common directors and officers, the existence of inter-corporate claims, and consolidated financial statements or tax returns are all typical of most affiliated corporations. Accordingly, in a well argued case, such factors should be afforded less weight than the remaining ones in a court’s determination of whether substantive consolidation is appropriate. Additionally, many of the stated factors are easily verified and do not require detailed analysis; for example, consolidated financial statements and tax returns are either present or absent. Two factors, however, that are consistently discussed and accorded significance in the substantive consolidation debate are whether there will be difficulty in segregating assets and liabilities and the extent to which corporate formalities are observed.

(ii) *Segregation of Assets and Liabilities.* Poor or nonexistent record keeping of separate assets (particularly cash and other liquid assets), liabilities and inter-affiliate transactions, whether by design or otherwise, is one of the more common reasons for imposing substantive consolidation.¹¹ When the combination of affiliates’ assets, liabilities and business affairs are so “hopelessly entangled” such that segregation is either prohibitively expensive or impossible, courts exhibit little reluctance in granting substantive consolidation. Generally, the degree of entanglement will be a central question.

The Second Circuit recognized the benefits to be realized by all creditors upon substantive consolidation of estates whose financial affairs had not been segregated:

¹¹ See, e.g., *In re Adelphia Commc’ns Corp.*, 368 B.R. 140, 150-153 (Bankr. S.D.N.Y. 2007) (detailing the debtor’s efforts to create reliable financials to account for affiliate transfers, and noting that the debtor could not create reliable financials on an unconsolidated basis).

[I]n the rare case such as this, where the interrelationships of the group 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.

Kheel, 369 F.2d at 847 (emphasis added). The Second Circuit appears to have established a stringent standard for the degree to which the debtors' affairs need to be obscured before consolidation is appropriate. In reversing the lower court's substantive consolidation order, the Second Circuit held:

Resort to consolidation in such circumstances [involving commingling of assets and business functions], however, should not be Pavlovian. Rather, substantive consolidation should be used only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets. . . . Commingling, therefore, can justify substantive consolidation only where "the time and expense necessary even to attempt to unscramble them [is] so substantial as to threaten the realization of any net assets for all the creditors," . . . or where no accurate identification and allocation of assets is possible. In such circumstances, all creditors are better off with substantive consolidation.

Augie/Restivo, 860 F.2d at 519 (emphasis added; citations omitted).

In some instances, protection of creditors whose interests would be adversely and unfairly affected by consolidation predominates over financial entanglement concerns.¹² Other cases involving financial entanglement as one of the factors considered also illustrate some degree of variation in the proof required to demonstrate that substantive consolidation is warranted."¹³

¹² See In re Flora Mir Candy Corp., 432 F.2d 1060 (2d Cir. 1970) (finding unlikely that any showing of accounting difficulties would justify consolidation when claims of debentureholders of formerly independent entity, whose stock was subsequently transferred, would be extinguished or diluted); DRW Property, 54 B.R. 489 (considering the extent of financial entanglement, which would require \$2 million and 6 months to untangle, and refusing to order consolidation because the harm to creditors outweighed any benefits to the parties concerned); Snider Bros., 18 B.R. 230 (Bankr. D. Mass. 1982) (stating that financial entanglement of entities is a factor determining whether consolidation is warranted, but ultimately, court will consider whether harm to creditors is too great to order consolidation). But see In re I.R.C.C., 105 B.R. 237 (Bankr. S.D.N.Y. 1989) (evidence considered by court applying Augie/Restivo financial entanglement standard consisted primarily of representations by debtor's counsel and chapter 7 trustee of inadequate accounting practices, undocumented inter-affiliate loans, commingled bank accounts, common use of assets, cross-funding of expenses and consolidated tax returns).

¹³ Compare Vecco, 4 B.R. 407 (granting substantive consolidation without opposition when debtors had single operating account and consolidated financials, had made no attempt to segregate receivables,

(iii) *Observance of Corporate Formalities.* Substantive consolidation may also be ordered as a result of the debtors' failure to comply with corporate formalities in connection with inter-affiliate transfers and third party transactions, meetings of directors and shareholders, representations made to third parties regarding corporate entities, and any other formal conduct required by corporate law. The failure to consistently observe corporate formalities is typically given some evidentiary weight in reported cases, but usually is not dispositive unless such elements, together with other evidence, support a finding of fraudulent or inequitable conduct by the debtors or their principals. Generally, in such cases where fraudulent or inequitable conduct has occurred, the court will rely on the alter ego theory (see below) to justify substantive consolidation. For example, in Tureaud, the court found "an almost total disregard of the corporate fiction; the corporations are a sham-- functionally indistinguishable from each other with commingling of assets and business functions." 45 B.R. at 661. The court also found that directors and officers of the nondebtor affiliates, which were substantively consolidated with the debtor-principal, acted in the interest of their principal rather than independently. Some of the affiliates failed to file tax returns and others were suspended for failure to make requisite corporate filings. More significant evidence in Tureaud included the debtors' principals' fraudulent purposes for incorporation ("front to raise money for [principal's personal] purposes, and to hinder and delay judgment creditors" (Id. at 660)), and the affiliates' "hopelessly commingled" assets. Id. at 661.

Under the existing authorities, no conclusive determination can be reached based on the presence or absence of some or all of the "elements." In fact, the elements listed by the courts differ from case to case. In the end, such elements are often balanced against the potential prejudicial effect on creditors that consolidation will have. This is particularly true under the cases applying some form of balancing test as discussed below.

disbursements or income, had inaccurately allocated affiliate expenses through inter-company accounts, and had filed bankruptcy schedules on consolidated basis); In re Source Enterp., 392 B.R. 541, 552-54 (Bankr. S.D.N.Y. 2008) (upholding bankruptcy court's determination to substantially consolidate when creditors dealt with entities as a single economic unit, economic activity for both entities was maintained on one set of books, principals treated entities as one company, and all creditors would benefit from consolidation); Baker & Getty, 78 B.R. 139 (ordering substantive consolidation when corporate funds were commingled and used for principal's personal purposes, inadequate records of transfers were made, and corporate entities were alter ego of principal who admitted having engaged in Ponzi scheme to defraud investors), Tureaud, 45 B.R. 658 (Bankr. N.D. Okla. 1985), aff'd 59 B.R. 973 (Bankr. ND. Okla. 1986) (basing alter ego finding on majority of "elements" and fraud supported substantive consolidation of nondebtor entities in face of hopeless commingling of personal and corporate assets, numerous undocumented inter-corporate transfers, lack of distinction between inter-company transactions despite separateness of books and records, and impossibility of accurately tracing all transfers) with In re Ford, 54 B.R. 145 (Bankr. W.D. Mo. 1984) (finding evidence of commingled corporate and personal funds in corporate bank account, common use of funds, and common responsibility for loans insufficient for substantive consolidation; appropriate remedies for diversion of debtors' funds for nondebtor uses are avoidance actions) and In re Standard Brands Paint Co., 154 B.R. 563, 572-73 (Bankr. C.D. Cal. 1993), granting substantive consolidation even though the records of the debtor and its subsidiaries could be segregated because debtor and subsidiaries operated as a single unit, creditors did not rely on the separate identity when extending credit but rather dealt with the entities as a single unit, and there were "multiple interdebtor guarantees, and intercreditor debts" between the subsidiaries and the debtor).

b. Balancing Test.

An alternative test of substantive consolidation has given greater significance to a showing “that the demonstrated benefits of substantive consolidation outweigh the harm.” Eastgroup Properties, 935 F.2d at 249. The substantive consolidation “factors” or “elements” are considered in the balance but, to a certain extent, the impact of consolidation on creditors appears to be given a greater degree of significance than mere proof of such substantive consolidation “elements.”¹⁴ This balancing analysis shifts the focus from the manner in which affiliated debtors conducted business to the effect of substantive consolidation on creditors.¹⁵ The test has also been stated as follows: if the possibility of economic prejudice that would result from continued separateness outweighs the minimal prejudice that consolidation would cause, then substantive consolidation is warranted.¹⁶ In any event, the burden of proving that the benefit outweighs the harm clearly falls on the proponent of substantive consolidation. Reported decisions establish the fundamental premise that the prejudicial impact of the imposition of an equitable remedy must be taken into account. Judge Friendly’s concurring opinion in Kheel articulated this fundamental premise:

I cannot agree that a practice of handling the business of a group of corporations so as to impede or even prevent completely accurate ascertainment of their respective assets and liabilities in their subsequent bankruptcy justifies failure to make every reasonable endeavor to reach the best possible approximation in order to do justice to a creditor who had relied on the credit of one -- especially to a creditor who was ignorant of the loose manner in which corporate affairs were being conducted. Equality among creditors who have lawfully bargained for different treatment is not equity, but its opposite. . . .

369 F.2d at 848 (emphasis added). Other relatively early decisions echoed the concern for creditors prejudiced by substantive consolidation and identified considerations that would later appear in the Snider Bros. formulation of the balancing test.¹⁷

¹⁴ See, e.g., Snider Bros., 18 B.R. 230; DRW Property, 54 B.R. 489; In re Steury, 94 B.R. 553 (Bankr. N.D. Ind. 1988); In re Crown Mach. & Welding, Inc., 100 B.R. 25 (Bankr. D. Mont. 1989). But c.f. Gainesville, 106 B.R. 304 (relying on alter ego factors), aff’d sub nom. Eastgroup Properties v. Southern Motel Assoc., Ltd., 935 F.2d 245 (11th Cir. 1991).

¹⁵ The need to protect interests of creditors affected by substantive consolidation was underscored in Flora Mir Candy, 432 F.2d at 1063 (denying consolidation due to resulting unfair treatment of certain creditors).

¹⁶ DRW Property, 54 B.R. 489; Snider Bros., 18 B.R. 230; In re Donut Queen, 41 B.R. 706 (Bankr. E.D.N.Y. 1984); In re Lewellyn, 26 B.R. 246 (Bankr. S.D. Iowa 1982); In re Murray Indus. Inc., 119 B.R. 820 (Bankr. M.D. Fla. 1990).

¹⁷ See In re Richton Int’l Corp., 12 B.R. 555, 558 (Bankr. S.D.N.Y. 1981) (considering an additional element after analyzing the Vecco “elements”: “substantive consolidation. . . will yield an equitable treatment of creditors without any undue prejudice to any particular group”); In re Food Fair, Inc., 10 B.R. 123, 127 (Bankr. S.D.N.Y. 1981) (finding that equitable treatment without undue prejudice is key factor).

The court in Snider Bros. reviewed grounds for substantive consolidation, including the various formulations of the “factors” test appearing in prior decisions. The court’s synthesis of the appropriate test for substantive consolidation focused upon objecting creditors’ interests instead of “elements” that are largely attributable to the debtors’ pre-petition conduct:

A review of the case law reveals that equity has provided the remedy of consolidation in those instances where it has been shown that the possibility of economic prejudice which would result from continued separateness outweighed the minimal prejudice that consolidation would cause. While several courts have recently attempted to delineate what might be called “the elements of consolidation,” [citing Vecco and Food Fair], I find that the only real criterion is that which I have referred to, namely the economic prejudice of continued debtor separateness versus the economic prejudice of consolidation. There is no one set of elements, which, if established, will mandate consolidation in every instance. Moreover, the fact that corporate formalities may have been ignored, or that different debtors are associated in business in some way, does not by itself lead inevitably to the conclusion that it would be equitable to merge otherwise separate estates.

Snider Bros., 18 B.R. at 234 (emphasis added).

The court in Snider Bros. articulated the following balancing test principles: (a) the proponent must demonstrate a “necessity for consolidation, or a harm to be avoided by use of the equitable remedy of consolidation”; (b) supporting evidence must go beyond a mere showing of commingling or unity of interest and must demonstrate the harm caused thereby or prejudice without consolidation; (c) “elements” are only one factor in the proof of necessity; and (d) even if the proponent can demonstrate the necessity for consolidation, objecting creditors possess the defense that the benefits of consolidation do not counterbalance the harm to the objector. Id. at 238. Therefore, in applying the Snider Bros. test, a proponent of substantive consolidation who is successful on the issue of necessity must still demonstrate that the benefits of consolidation outweigh the prejudice to creditors. The objecting creditors are charged with the burden of proof on defenses to consolidation.

Many courts have adopted the balancing test formulated in Snider Bros., either expressly¹⁸ or implicitly,¹⁹ including the Eleventh Circuit in Eastgroup Properties:

¹⁸ See In re Auto-Train Corp., 810 F.2d at 276; In re F.A. Potts & Co., 23 B.R. 569, 572 (Bankr. E.D. Pa. 1982); Lewellyn, 26 B.R. at 251; In re Drexel Burnham Lambert Group Inc., 138 B.R. 723, 764-65 (S.D.N.Y. 1992); Donut Queen, 41 B.R. at 709; DRW Property, 54 B.R. at 495; In re Baker & Getty Fin. Serv., Inc., 78 B.R. at 143; Steury, 94 B.R. at 554.

¹⁹ See In re Luth, 28 B.R. at 567 (citing Snider Bros. test as another “element”); In re Helms, 48 B.R. 714, 717 (Bankr. D. Conn. 1985) (balancing interests is another important factor); In re N.S. Garrott & Sons, 48 B.R. 13, 18 (Bankr. E.D. Ark. 1984) (adopting Snider Bros. principles as important factors); In re Silver Falls Petroleum Corp., 55 B.R. 495, 498 (Bankr. S.D. Ohio 1985).