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Representing Multiple Debtors in
Administratively Consolidated Cases

by

Honorable Michael G. Williamson
United States Bankruptcy Court
Tampa, Florida

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I. Substantive Consolidation and Joint Administration

1. Substantive Consolidation and Joint Administration Distinguished

a) Generally

(i) Substantive consolidation and joint administration are two different concepts. While the word "consolidation" is often used loosely in the context of a first-day motion for procedural joint administration of affiliated debtors, joint administration does not consolidate the bankruptcy estates of the affiliated debtors.

(ii) In fact, Bankruptcy Rule 1015 which is titled, "Consolidation or Joint Administration of Cases Pending in Same Court," does not "deal with the [substantive] consolidation of cases involving two or more separate debtors." Advisory Committee Note to Rule 1015. Rather, it is solely done for the administrative convenience of the court and the parties.

(iii) The word "consolidation" appears in the title to Bankruptcy Rule 1015 solely with reference to two or more petitions pending in the same bankruptcy court against the same debtor. Under Bankruptcy Rule 1015(a), in such instances, the court may allow the administration of a unitary estate by consolidating the cases.

2. Substantive Consolidation

a) Authority for Substantive Consolidation

(i) The explicit statutory power of a court to order substantive consolidation appears in only two Code sections:

1. Section 302(b) provides that "after the commencement of a joint case, the court shall determine the extent, if any, to which the debtors' estates shall be consolidated." This provision is limited under subsection (a) to a joint petition involving an individual debtor and "such individual's spouse." Bankruptcy Code § 302(a).

2. Section 1123(a)(5)(C) provides that a plan shall "provide adequate means for the plan's implementation, such as…merger or consolidation of the debtor with one or more persons."

(ii) These sections do not directly authorize substantive consolidation of affiliated debtors. There is, however, substantial case law authority supporting a bankruptcy judge's power to substantively consolidate entities under appropriate circumstances.

1. The seminal case in this regard is the Supreme Court case of *Sampsell v. Imperial Paper & Color Corp*., 313 U.S. 215, 217 (1941). In *Sampsell* the debtor transferred substantially all of his assets to a newly formed corporation, all of the stock of which was owned by himself, his wife and their son. The referee found the corporation was a sham and a cloak devised by the debtor for the purpose of preserving and conserving his assets for the benefit of himself and his family; and that the corporation was formed for the purpose of hindering, delaying and defrauding his creditors. In affirming the referee's decision, the Supreme Court held that it was appropriate to "consolidate the estate" of the individual debtor and the corporation.

2. More recent cases base the bankruptcy court's authority to order substantive consolidation on general equitable powers as set forth in Bankruptcy Code § 105(a). Norton Bankruptcy Law and Practice 3d, § 21:4 at 21-13. *See also Eastgroup Properties v. Southern Motel Ass'n, Ltd.,* 935 F.2d 245, 246 (11th Cir. 1991)*; In re Murray Industries, Inc.,* 119 B.R. 820, 828 (Bankr. M.D. Fla. 1990); *Matter of Munford, Inc.,* 115 B.R. 390, 397 (Bankr. N.D. Ga. 1990).

b) Effect of Substantive Consolidation.

(i) Unlike joint administration, substantive consolidation can substantially impact the substantive rights of the creditors to the assets available for distribution. In this respect, substantive consolidation treats the various affiliates as if they were one for purposes of distribution in bankruptcy.

(ii) Substantive consolidation may result in the liabilities of the consolidated entities being satisfied from a common fund of assets. Inter-entity claims can be eliminated; duplicative claims filed against various debtors can be eliminated; and, in Chapter 11 cases, the creditors of two entities may be combined for purposes of voting on a plan of reorganization. Norton Bankruptcy Law and Practice 3d, § 21:3 at 21-11.

(iii) The effect of an order of substantive consolidation is to treat the various entities as if they had merged the assets and liabilities of the entities. As a result, a creditor's claims against separate affiliates are deemed to be claims against the entire consolidated estate, even if the some of the consolidated entities had nothing to do with the creditor.

(iv) Importantly, if the different consolidated affiliates had avoidance actions against each other, those will cease to exist upon substantive consolidation. *In re Auto-Train Corp., Inc.*, 810 F.2d 270, 276 (D.C. Cir. 1987).

c) Themes found in case law on substantive consolidation:

(i) First, disregard of corporate formalities and commingling of assets may indicate substantive consolidation is appropriate. This follows from the recognition that there is a substantial identity between the debtors, with one entity exercising ultimate control over the assets and the other entities operating as mere instrumentalities. *See, e.g*., *In re Reider*, 31 F.3d 1102, 1106 -1107 (11^{th} Cir. 1994).

(ii) Second, consideration of possible harm or injustice to the creditors is determinative of the propriety of ordering substantive consolidation. Harm or injustice to the creditors may result where unscrambling the affairs of the debtors would threaten the realization of assets. *Id*.

(iii) On the other hand, a creditor may demonstrate that if substantive consolidation is ordered, injustice would result in the form of a diminished share of the assets due to the creditor's reliance upon the separate credit and assets of one of the entities. The power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of that creditor’s interrelationship with others. *Id*.

3. Joint Administration

a) Generally.

(i) The larger the entity seeking relief, the greater likelihood that the entity is composed of numerous separate affiliated corporations. Each of these is legally a separate “person” for purposes of filing a case. 11 U.S.C. § 101(41).

(ii) While the Bankruptcy Code treats entities separately, they often have functionally operated as a combined interdependent group within a corporate family. As corporate families grow in size to achieve economies of scale, and to avoid duplication of services as between individual family members, numerous inter-affiliate transactions occur in the day-to-day conduct of the combined business operation. This often results in substantial amounts of inter-company debt. While, in many instances, the amount one debtor owes to another as a result of such dealings is undisputed or ultimately is not material -- in other instances, it is not. *See, e.g., In re Adelphia Communications Corp.,* 336 B.R. 610, 617 (Bankr. S.D.N.Y. 2006).

(iii) Thus, in multi-debtor cases, individual debtors frequently have obligations to each other. These inter-company debts arise for various reasons:

1. money lent;

2. funds or other assets having been transferred from one debtor to another;

3. by reason of one debtor having provided or obtained services for other debtors;

4. by reason of allocations of overhead or charges for shared facilities or other property.

(iv) Courts recognize that affiliated debtors need to be administered in a Chapter 11 case in a fashion that is consistent with the consolidated manner in which they conducted their business pre-petition. Importantly, Bankruptcy Rule 1015 specifically provides a mechanism to deal with such enterprises.

b) Rule 1015—

> (a) Cases involving same debtor. If two or more petitions are pending in the same court by or against the same debtor, the court may order consolidation of the cases. (b) Cases involving two or more related debtors. If a joint petition or two or more petitions are pending in the same court by or against (1) a husband and wife, or (2) a partnership and one or more of its general partners, or (3) two or more general partners, or (4) a debtor and an affiliate, the court may order a joint administration of the estates. Prior to entering an order the court shall give consideration to protecting creditors of different estates against potential conflicts of interest.

c) Manner of Joint Administration. By local rule or practice of the presiding court, orders of joint administration typically include provisions dealing with the following:

(i) Captions. The Court will typically designate a lead case and, depending on the number of debtors and similarities of their names, a listing of all debtors in the jointly administered case file.

(ii) Claims. The order may direct that proofs of claim shall indicate only the case name and number of the case in which the claim is asserted. A separate claims register is typically maintained for each case. Claims are filed only in the name and case number of the debtor against which the claim is asserted. A separate claim is filed in each jointly administered case in which a claim is asserted by a particular creditor.

(iii) Docket. A single case docket is maintained after the entry of the order for joint administration, under the case number of the case designated in the joint administration order as the "lead case."

(iv) Monthly Reports. The order should specify whether separate monthly reports are to be filed in each jointly administered case, or whether a consolidated monthly report is to be filed in the "lead case."

(v) Ballots. Ballots are typically styled only in the case name and number of the member case for which the plan being voted on was filed.

II. Consideration of ethical issues in representing multiple debtors.

1. Generally

a) While the principals of the affiliated debtors may consider the joint enterprise to be one integrated business entity, the filing of the bankruptcy petition necessarily raises significant issues resulting from these inevitable inter-company relationships.

b) In this respect, the employment of counsel in a bankruptcy case is governed by Bankruptcy Code § 327, Fed. R. Bankr. P. 2014, and the applicable rules of professional conduct.

2. Section 327(a)

a) Bankruptcy Code § 327(a) specifies the qualification standards for professionals, including attorneys, who are employed in a bankruptcy case. This statute provides:

> [T]he trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested

persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

b) Section 327(a) imposes a two-pronged test for the employment of professionals. The professional:

   (i) must not hold or represent any interest adverse to the estate, and

   (ii) must be a “disinterested person.”

c) Section 327 is rooted in the congressional intention to hold professionals performing duties for the estate to strict fiduciary standards. The section's main policy objective is to assure that a professional employed in the case will devote undivided loyalty to the client. Conflicting loyalties produce inadequate representation, which threatens the interests of both the debtor and the creditors, and compromises the ability of the court to mete out justice in the case. Furthermore, what may be acceptable in a commercial setting, where all of the entities are solvent and creditors are being paid, is not acceptable when those entities are insolvent and there are concerns about intercompany transfers and the preference of one entity and its creditors at the expense of another. Because of these limitations, a chapter 11 debtor does not have an absolute right to counsel of its choice. *In re Wheatfield Business Park LLC*, 286 B.R. 412, 418 (Bankr. C.D. Cal. 2002).

d) Accordingly, a literal application of section 327(a) means that where a bankruptcy debtor is a creditor of a related debtor, it is presumptively improper for the same attorney (or law firm) to be general counsel for the related debtors. *Id*. Examples of cases dealing with this issues:

   (i) *In re Interwest Bus. Equip*., 23 F.3d 311, 316 (10th Cir. 1994) stating that separate counsel is required where intercompany debts placed each estate in a creditor/debtor relationship with another.

   (ii) *In re Lee*, 94 B.R. 172, 177 (Bankr. C.D. Cal. 1988), stating that absent appropriate consent, a law firm may not represent both a corporation and its sole shareholder in related chapter 11 cases.

   (iii) *Gill v. Sierra Pac. Constr. (In re Parkway Calabasas, Ltd*.), 89 B.R. 832, 835 (Bankr. C.D. Cal. 1988), which adopts a presumption that the same counsel should not be appointed for related Chapter 11 debtors where creditors have dealt with the debtors as an economic unit, *rev'd on other grounds*, Bankr. 9th Cir. 1990 (unpublished opinion), *rev'd*, 949 F.2d 1058 (9th Cir. 1991) (adopting bankruptcy court opinion).

3. Fed. R. Bankr. P. 2014.

a) Rule 2014 of the Federal Rules of Bankruptcy Procedure sets forth the application procedure for the employment of professionals. Rule 2014 requires an application to disclose, "to the best of the applicant's knowledge, all of the person's connections with the debtor, creditor, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." Furthermore, the application must be supplemented by a verified statement of the prospective professional that makes these disclosures.

b) The purpose of Rule 2014 is to assure that both the court and the parties in interest receive full disclosure of all actual or potential conflicts that might affect the professional's representation of a trustee, committee or debtor in possession. *See, e.g., In re Lee Way Holding Co*., 100 B.R. 950, 955 (Bankr. S.D. Ohio 1989).

4. Rules of Professional Conduct

   a) In addition to the requirements of § 327(a) and Rule 2014, the conduct of lawyers is governed by the applicable state rules of professional conduct. *Wilson v. Cumis Ins. Soc'y (In re Wilson)*, 250 B.R. 686, 689 (Bankr. E.D. Ark. 2000) (stating that the Texas lawyers in the case were subject to the rules of professional responsibility in Texas (because they were licensed there) and in Arkansas (pursuant to the local rules of the forum district)); *Captran Creditors Trust v. North Am. Title Ins. Agency (In re Captran Creditors Trust)*, 104 B.R. 442, 444 (Bankr. M.D. Fla. 1989) (citing local rule adopting the Florida Rules of Professional Conduct).

   b) It is typical for a court to have adopted a local rule requiring that an attorney appearing before the court, including those appearing *pro hac vice*, be familiar with, and be governed by, the Rules of Professional Conduct and other ethical limitations or requirements then governing the professional behavior of members of the legal profession in state court. *See, e.g.*, Bankr. M.D. Fla. Local Rule 2090-1.

   c) A typical provision contained in the codes of professional responsibility of most states is one prohibiting counsel from representing adverse interests unless the client gives informed written consent. Consent is required both for the representation of actual conflicting interests and potential conflicts of interest.

   d) The ABA Model Rules of Professional Conduct ("ABA Model Rules"), which are in force in most states define an actual conflict of interest as one that is "directly adverse" to another client or that is "materially limited" by the representation of another client. See ABA Model Rules R. 1.7.

5. Potential conflicts of interest come in enormously varying degrees. Some are quite likely to ripen into actual conflicts of interest. The likelihood of the development of other potential conflicts into actual conflicts may be very remote. Indeed, any lawyer with at least two clients has at least a remote potential conflict of interest: those two

6. Interplay of Bankruptcy Code § 327, Fed. R. Bankr. P. 2014, and the applicable rules of professional conduct.

   a) There is an important difference between the requirements of state rules and the apparent requirements of § 327(a). The state rules typically permit a client to consent to the prohibited conflicts of interest, and presume consent upon the written disclosure of a conflict covered by that provision. See ABA Model Rules R. 1.7(b)(4) (2002). Section 327(a), in contrast, has no explicit provision for waiver or consent to the representation of conflicting interests.

   b) Section 327(a) prohibits an attorney (or other professional) from representing a debtor in a chapter 11 case if the attorney has or represents an actual conflicting interest. This prohibition is absolute, and is not subject to waiver or consent. *Wheatfield* at 421.

   c) In addition, § 327 also prohibits an attorney from holding or representing a certain level of potential conflicts of interest. Employment may not be approved where a potential conflict creates a meaningful incentive to act contrary to the best interests of the estate and its various creditors. *Id*.

   d) Thus an actual conflict of interest creates a violation of § 327. A potential conflict of interest may also require the disqualification of a professional if, in the judgment of the court, the conflict is sufficiently important and there is a sufficient likelihood that it will ripen into an actual conflict. *See, e.g., In re Amdura*, 121 B.R. 862, 865-68 (Bankr. D. Colo. 1990) (potential conflict required disqualification because any viable chapter 11 plan would require bringing litigation against a bank that provided a substantial portion of the revenue of the law firm applying for appointment as counsel for debtor). As the First Circuit states in *Martin*, however, "[t]he naked existence of a potential for conflict of interest" does not prohibit employment under § 327(a). 817 F.2d at 182. "It is for the court to decide whether the attorney's proposed interest carries with it a sufficient threat of material adversity to warrant ... disqualification ...." *Id*.

7. Practical Solutions for Inter-Debtor Representation

   a) Although § 327 of the Bankruptcy Code and the disinterestedness standard apply to the retention of counsel, when analyzing disqualification, most courts focus on whether there is an actual "conflict of interest" that constitutes cause for removal. *See, generally, Inter-debtor and Inter-creditor Issues,* ABI Views from the Bench, 071005 American Bankruptcy Institute 143 (October 5, 2007) ("ABI Views") at 7 (citing *In re BH & P, Inc.*, 949 F. 2d 1300, 1311 (3d Cir. 1991); *In re Guy Apple Masonry Contractor, Inc.*, 45 B.R. 160, 166 (Bankr. D. Ariz. 1984) ("Conflicts of interest are not void, but voidable, as the facts may warrant. . . . The question is

b) Most disqualification cases involve one of two types of actual conflicts: (a) where a conflict of interest suggests that counsel will not be a zealous advocate; or (b) where the attorney could potentially use privileged information gained through prior representation of a client's adversary against such former client. *Id.* *See also*, *In re Vebeliunas*, 231 B.R. 181, 195 (Bankr. S.D.N.Y. 1999); *Bd. of Educ. of City of N.Y. v. Nyquist*, 590 F.2d 1241, 1246 (2d Cir. 1979) (applying New York Code of Professional Responsibility)).

c) Accordingly, notwithstanding the fact that counsel would seemingly be conflicted under a literal interpretation of any of these standards, Courts have generally focused on the following factors when considering whether to disqualify counsel:

(i) Whether single counsel in jointly-administered, multi-debtor cases will result in greater efficiency and cost savings. *Id.* (citing *In re Global Marine, Inc.*, 108 B.R. 998, 1004 (Bankr. S.D. Tex. 1987) (extent of interrelationship among debtors requires that only one group of attorneys handle debtors' matters to avoid needless waste of time and expense); *In re BH & P*, 949 F.2d at 1310 (recognizing that a single representative of the estate "is often able to maximize the return to jointly administered estates through increased economy and efficiency"); *In re Star Broad., Inc.*, 81 B.R. 835, 844 (Bankr. D.N.J. 1988) (commenting that "it would be unreasonable and unnecessarily cumbersome to always require different counsel in related chapter 11 cases.")).

(ii) Whether disqualification will result in added expense to the estates. *Id.* (citing *BH & P*, 949 F.2d at 1310).

(iii) Whether disqualification will result in delay. *Id.* (citing *In re Mulberry Phosphates*, 142 B.R. 997, 999 (Bankr. M.D. Fla. 1992) (removing counsel would be detrimental to the estate and could delay confirmation, especially because counsel "is intimately familiar with the affairs of the Debtors and disqualifying them at this point would severely prejudice not only the Debtors but also the creditors involved.")).

(iv) Whether other constituents in the bankruptcy case support or oppose a pending disqualification motion. *Id.* (citing *Mulberry Phosphates*, 142 B.R. at 999 (noting that position of creditors' committee and bank group in opposing the motion was "important and persuasive" and "weighs heavily" in favor of denying the creditor's request)); and

(v) Whether the relief sought is for tactical purposes to secure a perceived litigation advantage. *Id.* (citing *Tese-Milner v. Beeler (In re Hampton Hotel Investors, L.P.)*, 289 B.R. 563, 583 (Bankr. S.D.N.Y. 2003)); *see also* *Universal City Studios, Inc. v. Reimerdes*, 98 F. Supp. 2d 449, 455 (S.D.N.Y.

d) As noted in Judge Gerber's decision disqualifying Adelphia's counsel from representing the debtors in the inter-debtor litigation, “the presence of intercompany claims between debtors represented by the same counsel does not automatically warrant the disqualification of that counsel.” *Adelphia Communications Corp*., 336 B.R. at 672-73. Rather, as discussed more fully below, courts have taken a “wait and see” approach to determine whether and to what extent disqualification may be appropriate. *Id*. at 673.

8. Dealing with the Close Cases

a) While most inter-debtor situations are not controversial, and counsel will be routinely retained to represent the various debtors without objection, there is the occasional case where legitimate concerns are expressed in connection with the multiple representation of debtors.

b) Courts have taken different approaches in dealing with these situations.

(i) *Wait and See Approach*. As noted by the Court in *In re Global Marine*, 108 B.R. at 1004:

> [T]he mere existence of the intercompany claim . . . does not at this point elevate the situation to one of an actual conflict of interest requiring the disqualification of [counsel]. . . . Should the conflict . . . become open and ongoing as opposed to dormant, the problem may at such time be resolved by among others, the appointment of special counsel . . . . To act at this time in a preemptive manner would only result in the interruption of the orderly administration of these Debtors' bankruptcy proceedings and cause them to incur unnecessary expense.

(ii) *Appointment of Trustee*. Presumably, an independent trustee with no prior ties to management may be in a position to deal with potential conflicts more objectively than debtor’s counsel who presumably was chosen by one group of insiders as opposed to another. This alternative is usually not attractive, however, because of other reasons:

1. The standard under § 1104 for appointment of a trustee is very high. Not only is the appointment of a chapter 11 trustee an “extraordinary remedy,” “a party seeking appointment of a trustee has the burden of showing by clear and convincing evidence, cause under section 1104(a)(1) or the need for a trustee under section 1104(a)(2).” It has been suggested that while the term “cause” is not limited to “fraud, dishonesty, incompetence, or

2. The appointment of a chapter 11 trustee could act as an event of default under certain material post-petition arrangements, such as asset purchase agreements or debtor-in-possession financing arrangements, which would threaten to destroy any prospects of rehabilitation for the debtors.

3. The appointment of a chapter 11 trustee could severely delay the case and the debtors' emergence from chapter 11.

4. Moreover, any appointment of an independent party might require the appointment of an independent party for each of the debtors' estates, as well as a bevy of independent professionals to advise each of the independent parties.

(iii) Appointment of Other Independent Fiduciaries

1. Responsible Officers. While some may take issue with appointing a responsible officer in lieu of a trustee, it is an often-used practical solution to debtor conflicts or allegations of inappropriate conduct by management. Such an approach may also be useful if the multi-debtor conflicts are significant.

2. Delegation to Creditors' Committees and Individual Creditors. Courts at times delegate litigation in which debtor's counsel may have a conflict to an active creditor willing to undertake the case on behalf of the estate. The grounds typically needed for such a delegation are where (1) the committee or creditor presented a colorable claim for relief that on appropriate proof would support a recovery, and (2) the trustee or debtor-in-possession unjustifiably failed to bring suit or abused its discretion in not bringing suit. *Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes (In re STN Enters., Inc*.), 779 F.2d 901 (2d Cir. 1985).

(iv) *Substantive Consolidation.*

1. Of course, if the court substantively consolidates the estates of the various debtors, the inter-debtor conflicts are removed. The related companies' liabilities are combined, eliminating intercompany claims, and creating a larger pool of creditors to vote on a single plan of reorganization.

2. In considering whether substantive consolidation is appropriate, courts have considered the following non-exclusive list of factors:

    a) the presence or absence of consolidated financial statements;

b) the unity of interests and ownership between various corporate entities;

c) the existence of parent and intercorporate guarantees on loans;

d) the degree of difficulty in segregating and ascertaining individual assets and liabilities;

e) the existence of transfers of assets without formal observance of corporate formalities;

f) the commingling of assets and business functions; and

g) the profitability of consolidation at a single physical location.

Nesbit v. Gears Unlimited, Inc., 347 F.3d 72, 86, n. 7 (3d Cir. 2003) (citing *In re Vecco Constr. Industr., Inc*., 4 B.R. 407 (Bankr. E.D. Va. 1980); *In re Mortgage Inv. Co. of El Paso, Tex*., 111 B.R. 604, 610 (Bankr. W.D. Tex. 1990); *Holywell Corp. v. Bank of N.Y*., 59 B.R. 340, 347 (S.D. Fla. 1986); *In re Donut Queen, Ltd*., 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984) (all applying the *Vecco* seven-factor test).

III. Cash Management Systems

1. Generally

a) In multi-debtor cases, it is typical that all of the debtors' affiliates, parents and subsidiaries run a consolidated financial system, which includes a central cash management system operated for the benefit of all of the related companies.

b) These accounts, which are also known as concentration accounts, are essentially a single centralized bank account, usually held in the parent corporation's name. All of the proceeds and all of the debts of the parent corporation and the subsidiary corporations are maintained and distributed out of this one large account.

c) Courts have held that the use of a consolidated cash management system is an appropriate business practice and does not, by itself, constitute cause to pierce the corporate veil, provided that all funds are subject to strict accounting. *See, e.g., In re Hillsborough Holdings Corp.*, 176 B.R. 223, 253 (Bankr. M.D. Fla. 1994). In this situation, consolidation of cash is not equivalent to commingling in disregard of the corporate form.

2. U.S. Trustee Guidelines

a) When a company files for bankruptcy, the debtor company must comply with certain administrative guidelines promulgated by the Office of the United States Trustee (the "U.S. Trustee Guidelines"). Most notably, for purposes of this article, are the guidelines relating to the debtor's banking and investment policies.

b) The U.S. Trustee Guidelines require that upon commencement of a bankruptcy case, the debtor must immediately close all of its bank accounts and establish new bank accounts as debtor in possession. The filing date is the line of demarcation between the company prepetition and the newly established bankruptcy estate that is created upon the commencement of the bankruptcy case.

c) The debtor also must notify the Office of the U.S. Trustee of each financial institution that will be holding estate funds and provide the U.S. Trustee with access to information regarding these accounts. The debtor must open the account under its name and identify itself on the account as debtor in possession. All checks must contain the words "Debtor in Possession" along with the company name.

3. Practical Considerations[1]

a) The U.S. Trustee Guidelines can be burdensome and disruptive to a debtor's business operations. It is, therefore, routine in many large cases for the debtor to ask the bankruptcy court to permit it to continue to use its current cash management system. Generally, the debtor will argue that it has been using the current system for a number of years and that it is similar to those systems commonly employed by companies of comparable structure. *Id*.

b) The debtor will point to numerous essential benefits resulting from its existing cash management system. These include:

(i) the ability to control and monitor corporate funds,

(ii) maintaining cash flow availability to the various entities on an as-needed basis,

(iii) the reduction of the expenses that would otherwise be incurred by maintaining separate accounting systems, and

(iv) the ability to account for all cash flow events on a consolidated basis. *Id*.

c) As a practical matter, the sudden interruption in the debtor's financial operations that would result from switching cash accounting systems at a critical time in the debtor's financial life would have a devastating effect on the ability of the debtor to reorganize. *Id*.

d) Another practical consideration is expense and the effect on goodwill that may result from new checks that include the legend "Debtor in Possession" on each check. *Id*.

[1] See, generally, Brad B. Erens, Scott J. Friedman, Kelly M. Mayerfeld, *Bankrupt Subsidiaries: The Challenges To The Parent Of Legal Separation*, 25 Emory Bankr. Dev. J. 65 (2008).

4. Cash Management Motion[2]

   a) Generally,

      (i) In cases involving affiliated debtors, the debtors will file motions to maintain the debtor's existing cash management system.

      (ii) These motions address the enormous practical problems that would result if the debtor were required to close all of its bank accounts and establish a new cash management system. The confusion and disruption that may occur could substantially impair the debtor's reorganization prospects.

   b) Contents:

      (i) The debtor will need to file a cash management motion that includes the following information:

         1. A description of the debtor's existing cash management system in reasonable detail, including a listing and description of all bank accounts (including account numbers).

         2. An explanation of how cash receipts and disbursements are traced through the company's cash management system.

         3. Details on how such transactions are reflected in the company's books and records, the controls established on disbursements, and how excess cash is held during the day and overnight.

5. Preserving Inter-Estate Claims

   a) Inter-Estate Claims can take several forms:

      (i) Debts owed by one estate to the other arising from pre-petition dealings.

      (ii) Unliquidated claims for services provided by one affiliate to another.

      (iii) Preferential payments made by an affiliate to another within a year of bankruptcy.

      (iv) Fraudulent conveyances in the form of transfers for which no consideration is given.

      (v) Post-petition administrative claims resulting from inter-company cash and service transactions.

   b) Disclosure Issues

[2] Jay M. Goffman and Grenville R. Day, *First Day Motions And Orders In Large Chapter 11 Cases: (Critical Vendor, DIP Financing and Cash Management Issues)*, 12 J. Bankr. L. & Prac. 6 (West 2003).

(i) Assuming the estates of the various debtors are not substantively consolidated during the chapter 11 case or under the plan, in order for a plan to be formulated that apportions the value of the combined enterprise equitably among the creditors of the various affiliates, an analysis must be undertaken to quantify the inter-estate claims referenced above.

(ii) This can be part of a liquidation analysis prepared for inclusion in the disclosure statement, and should be part of the proof needed to confirm the plan.

(iii)Based on this analysis, the plan may provide for separate classes of creditors for each of the affiliated debtors. While this can be included in one joint plan, creditors must be treated in a fashion that gives them generally what they would receive in a stand-alone case.

IV. "Creeping" DIP Financing Issues

1. Generally,

a) It is typical for operating business enterprises in chapter 11 to need post-petition financing. While such financing is available from third-party finance companies that specialize in debtor-in-possession or DIP financing, such financing is usually expensive in terms of up-front fees, unused facility fees, and interest rates. Accordingly, debtors-in-possession often turn to their pre-petition lender in seeking post-petition financing.

b) While these transactions are often routine, and do not create any significant issues, there are two circumstances that complicate post-petition lending in the context of a multi-debtor case. The first is where the value of the pre-petition collateral is less than the debt, such that the pre-petition lender is undersecured. The second arises in cases where there is not uniformity in the debt- to-collateral ratio among the various affiliated debtors. For example, one affiliate may only have a portion of its assets encumbered by the pre-petition loan, and another might have no equity in its assets. If these affiliates have separate unsecured creditor bodies, then in liquidation, the one with the more favorable debt-to-collateral ratio would be able to pay more to unsecured creditors.

2. Roll-Up of the Undersecured Prepetition Loan

a) Secured creditors often attempt to bootstrap their undersecured prepetition position into a fully secured loan through the vehicle of cross-collateralization, also known as a "roll-up" or "roll-over" financing.

b) This is a form of security arrangement whereby pre-petition debt is secured by post-petition collateral. For example, a lender in extending new credit may insist that loan payments be applied to pay off the undersecured pre-petition loan prior to paying off the post-petition DIP loan.

c) This form of DIP financing is generally viewed unfavorably by the courts. This is because such a provision may improve the collateral position of an undersecured lender before the court can determine the extent of the lender's pre-petition security, thereby elevating the entire amount of the pre-petition loan to fully secured status. They also may negatively affect the debtor's reorganization prospects because they will restrict the debtor's ability to cram down the secured creditor's claim through a plan of reorganization. *Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490, 1493 (11^{th} Cir. 1992).

3. *Saybrook*

a) In *Saybrook*, the United States Court of Appeals for the Eleventh Circuit ruled that cross-collateralization is not authorized by Bankruptcy Code § 364. *Id*. at 1496.

b) Accordingly, DIP financing from a pre-petition lender will invariably be scrutinized closely to ensure that it does not have the effect of elevating what was an undersecured pre-petition loan to a fully secured loan.

4. *Vanguard*

a) Another approach originally embraced by the often-cited case of *In re Vanguard Diversified, Inc*., 31 B.R. 364 (Bankr. E.D.N.Y. 1983) would approve a cross-collateralization provision if the debtor establishes the following:

  a) Absent the proposed financing, its business operations will not survive;

  b) It is unable to obtain alternative financing on acceptable terms;

  c) The proposed lender will not accede to less preferential terms; and

  d) The proposed financing is in the best interests of the general creditor body.

5. Multi-Debtor Cases

a) Complicated DIP financing structures often mask the possibility of a “creeping” cross- collateralization both in terms of pre- and post-petition collateral and in terms of encumbering otherwise free and clear assets of select affiliate debtors.

b) Unsecured creditors and the committees that represent them need to be vigilant to ensure that the position of certain classes of unsecured creditors is not eroded by the creep of the pre-petition loan onto otherwise unencumbered assets.