Can You SubCon Your Way into a Setoff? An Analysis of *In re Garden Ridge Corp.*

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Editor's Note: *For another article on setoff rights, see page 32.*

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The Third Circuit's recent opinion in *Garden Ridge Corp.*[2] may raise concerns about whether substantive consolidation of affiliated debtors' estates can retroactively create setoff rights that previously did not exist due to a lack of mutuality. The creditor in *Garden Ridge* sought to set off its obligation to one debtor through the use of its claim against another debtor by arguing that substantive consolidation of the debtors' estates created the necessary mutuality of obligations.

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The Third Circuit affirmed the lower courts' denial of the creditor's non-mutual setoff on the grounds that substantive consolidation did not retroactively create mutuality and did not wipe out the debtors' defenses preserved in their plan of reorganization. The court noted in *dicta* that had its decision in *Owens Corning*,[3] which set a new standard for substantive consolidation, been precedent prior to the substantive consolidation of the Garden Ridge entities, "the Bankruptcy Court might have considered other factors in determining the appropriateness" of the setoff claim and the debtor's mutuality defense.[4] This *dicta* and the fact that one panel member dissented (thereby making the decision "non-precendential" under the Third Circuit's procedural rules) may leave open the question of whether a substantive consolidation order under *Owens Corning* could permit creditors to exercise setoff rights against debtors' estates, even if, prior to substantive consolidation, the setoff could not have been exercised because of a lack of mutuality of obligations. Upon examination of the relevant case law and *Owens Corning*, however, it seems that the answer would be "no," and thus, the *Garden Ridge* decision denying the setoff would stand, even if substantive consolidation had been ordered in that case under the *Owens Corning* standard.

Bankruptcy Code Preserves Existing Setoff Rights without Creating New Ones

Generally, the right of setoff "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"[5] In bankruptcy, this right of setoff is valuable because it permits a creditor to receive a dollar-for-dollar credit on its debt up to the full amount the debtor owes it. Absent such setoff right, the creditor would be obligated to pay in full and receive only a fraction of the amount owed to it, known colloquially as a payment in "bankruptcy dollars." Section 553 of the Bankruptcy Code preserves a right of setoff as it existed under nonbankruptcy applicable law as of the petition date. At the same time, however, because a setoff effectively deprives the debtor's estate of receivables, § 553 requires the satisfaction of additional criteria prior to the exercise of any setoff. Importantly, nothing in the Code *creates* a setoff right that would not otherwise exist.[6]

Among the additional restrictions imposed by § 553 is that the debts sought to be offset be *mutual*, pre-petition debts.[7] Pre-petition obligations may not be set off against obligations that arise post-petition.[8] Debts are considered "mutual" only if they are "due to and from the same persons in the same capacity."[9] "[E]ach party must own [its] claim in [its] own right severally, with the right to collect [against the other] in [its] own name."[10] As a general matter, with respect to affiliates, courts do not permit "two entities, even if related, [to] aggregate their debts and claims for setoff purposes."[11] In other words, in the bankruptcy context, if creditor A owes debtor B, but is owed an obligation from debtor C, creditor A does not have a right of setoff and must pay B in full, while only receiving bankruptcy dollars from debtor C. This is true even if B and C are co-debtors and/or affiliates.

Substantive Consolidation and Its Effect on Setoff Rights

The creditor in *Garden Ridge*, which argued that substantive consolidation created its setoff right, was not the first creditor to make such an argument.[12] Using the example above, creditor A may argue that, by virtue of the substantive consolidation of B's and C's estates, mutuality exists for purposes of its right of setoff, and consequently, its obligation to B is reduced by the offsetting obligation owed to it by C. Substantive consolidation is not provided for by the Bankruptcy Code but rather is an equitable construct that "[t]reats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph [in]to claims against the consolidated survivor."[13]

Generally, substantive consolidation, unlike piercing the corporate veil (which punishes shareholders) or equitable subordination (which punishes bad-acting creditors), goes in a different direction: It does not remedy past wrongs but rather "affects distribution to innocent creditors."[14] "It brings all the assets of a group of entities into a single survivor...and merges liabilities as well."[15] The effect

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Feature

1 The views expressed in this article are those of the author only and not necessarily the views of the firm or its clients. The author acknowledges her colleague, Jennifer Nelsen, for her assistance with this article.
2 *In re Garden Ridge Corp.*, No. 09-1261, 2010 WL 2712145 (3d Cir. July 9, 2010).
3 *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005).
4 *In re Garden Ridge Corp.*, 2010 WL 2712145, at *2.
5 *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18 (1995) (internal quotations omitted).
6 *Id.*
7 *In re SemCrude LP*, 399 B.R. 388, 396 (Bankr. D. Del. 2008), *aff'd*, 428 B.R. 590 (D. Del. 2010); *Official Comm. of Unsecured Creditors v. Mfrs. & Traders Trust Co. (In re Bennett Funding Group Inc.)*, 212 B.R. 208, 212 (2d Cir. 1997).
8 *In re Lehman Bros. Holdings Inc.*, 404 B.R. 752, 757 (Bankr. S.D.N.Y. 2009).
9 *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 149 (2d Cir. 2002).
10 *SemCrude*, 399 B.R. at 396.
11 *In re KZK Livestock*, 221 B.R. 471, 480 (Bankr. C.D. Ill. 1998).
12 *See, e.g., U.S. v. Carey (In re Wade Cook Fin. Corp.)*, 375 B.R. 580 (9th Cir. B.A.P. 2007); *In re England Motor Co.*, 426 B.R. 178 (Bankr. N.D. Miss. 2010).
13 *Owens Corning*, 419 F.3d at 205 (internal quotation omitted).
14 *Id.* at 206.
15 *Id.*

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Expect maximum attendance at the presentation entitled "Commercial Real Estate: The Next Tsunami Approaches," where the audience will be mixed with hopeful bankruptcy professionals looking optimistically toward a busy few years, and those, like Scott, who are disheartened because of the stagnation. Expect to hear some audience member jeer "we've heard this before" and "we might as well have a panel about the coming wave of chapter 9 cases." That will be Scott.

Far and away the best committee panel will be "Bankruptcy Litigation/ International (joint): Litigation Issues in Cross-Border Cases." Scott will debut himself as the education director of ABI's Bankruptcy Litigation Committee from the back row of the room. Meanwhile, panelists will debate, among other topics, the proper venue for the bankruptcy cases of members of the EU, such as France and Great Britain, if their austerity measures prove not to be enough. We predict a bad "chunneling injunction" pun.

Last, but not least, attendees will laugh at comedian Frank Caliendo's impression of George W. Bush and what he believes the former president's response was to learning about the financial meltdown and the role collateralized debt obligations played: "I thought Seedy O's was the new breakfast cereal I tried during my second term that was like Cheerios but earthier. There is no way my cereal was responsible for the collapse of the financial markets." Then, the Indubies will rock the night away and provide a new take on the Prince classic "1999" by encouraging attendees to "party like its 2009." ■

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is that creditors, instead of looking only to that pool of assets "of the subsidiary with whom they dealt...now...share those assets with all creditors of all consolidated entities, raising the specter for some of a significant distribution diminution."[16]

Prior to *Garden Ridge*, the few courts that examined substantive consolidation's effect on setoff rights held uniformly that it does not transform previously non-mutual debts into mutual debts; substantive consolidation does not combine the debtors to create the requisite mutuality that creditor A would desire.[17] These cases held that substantive consolidation alone did not establish that the debtors were alter-egos or the "same entities" prior to the petition date—because a finding that the debtors were alter-egos requires different evidence under applicable state law, including a showing of fraud.[18]

Specifically, the Ninth Circuit Bankruptcy Appellate Panel in *U.S. v. Carey (In re Wade Cook Fin. Corp.)* held that "[s]ubstantive consolidation is a mechanism whereby the assets and liabilities of two or more related entities are pooled to create a single fund from which creditors of the combined estate may receive distributions."[19] While "substantive consolidation ignores the corporate form...of entities whose business and/or finances are so intertwined that it makes no sense to disentangle them," unlike corporate veil-piercing, it does not collapse legal entities and hold one entity responsible for the debts of another.[20] Accordingly, the court found that although they overlap, the evidence necessary to show substantive consolidation for purposes of distribution of the debtors' assets was insufficient to establish that the debtors were alter-egos because, under state law, alter-ego requires an additional showing of fraud or wrongdoing.[21]

More recently, the Bankruptcy Court for the Northern District of Mississippi in *In re England Motor Co.* also found that substantive consolidation cannot create mutuality for purposes of § 553.[22] The *England Motor* court found that even if debts *became* "mutual" by virtue of substantive consolidation, those debts "arose after the commencement of the bankruptcy cases" because they were created upon entry of the post-petition substantive-consolidation order.[23] Because § 553 requires that the offsetting debts arise *prior* to the petition date, the bankruptcy court must give the substantive-consolidation order retroactive effect, relief that the *England Motor* court was "loathe to provide."[24] Additionally, like *Wade Cook*, *England Motor* held that the purpose of substantive consolidation was, at bottom, to pool assets such that all creditors would receive their share of the pooled assets; it was "not to create or destroy defenses" so that a single creditor could "reap the benefits of setoff" (at the expense of other unsecured creditors).[25]

The Northern District of New York addressed a similar argument in *In re Sentinel Products*, but there, the substantive consolidation plan provided that "for purposes of determining the availability of the right of Set-Off...the Debtors shall be treated as one entity so that...debts due to any of the Debtors may be set off against the debts of any of the Debtors."[26] The court found that this waiver operated only as to allowed claims subject to the plan.[27] Because the creditor's claim was considered outside the context of the consolidated plan, the court held that the debtors would "continue to maintain their separate corporate existences" and setoff would not be allowed.[28]

Do Garden Ridge, Owens Corning Change the Prevailing View?

Consistent with the above decisions, the lower courts in *Garden Ridge* held that substantive consolidation did not create mutuality for purposes of setoff.[29] The creditor, an employee with a claim against Garden Ridge Management Inc. (GRM), owed a debt to GRM's affiliate, Garden Ridge LP (GRLP). GRM and its affiliates were substantively consolidated in 2005 upon

16 *Id.*

17 *Wade Cook*, 375 B.R. at 598 (substantive consolidation does not permit setoff); *England Motor*, 426 B.R. at 188 (same); *cf. Packaging Indus. Group Inc. v. Danielson Mfg. Co. Inc. (In re Sentinel Prods. Corp., PI Inc.)*, 192 B.R. 41, 44, n.3 (N.D.N.Y. 1996) (plan's waiver of setoff rights operates only as to allowed claims).

18 *See, e.g., Wade Cook*, 375 B.R. at 598.

19 *Id.*

20 *Id.*

21 *Id.* at 599-600 (reversing, to determine whether entities were alter-egos).

22 *England Motor*, 426 B.R. at 187-88.

23 *Id.* at 188 (emphasis in original).

24 *Id.* (citing *Murray Indus. Inc. v. Dep't of Revenue (In re Murray Indus. Inc.)*, 125 B.R. 314, 317 (Bankr. M.D. Fla. 1991) ("It would certainly be a violation of due process if the order of substantive consolidation would operate to destroy defenses and rights which existed prior to the entry of the order of substantive consolidation.")).

25 426 B.R. at 188.

26 *Sentinel Prods.*, 192 B.R. at 46.

27 *Id.* at 46-47.

28 *Id.* at 47.

29 *In re Garden Ridge Corp.*, 338 B.R. 627, 641 (Bankr. D. Del. 2006); *Ferguson v. Garden Ridge Corp. (In re Garden Ridge Corp.)*, 399 B.R. 135, 140 (D. Del. 2008).

a finding that the "debtors, in effect, functioned as a single entity."[30] The creditor sought to set off his GRLP debt with his claim against GRM, contending that even if the debtors "were separate entities when he transacted with them... substantive consolidation effectively merged the entities, thereby creating mutuality for setoff purposes."[31]

The Third Circuit affirmed the lower courts' holding that because the creditor owed GRLP and was owed by GRM, mutuality was lacking and would only be satisfied if the two debtor entities "had disregarded their entity separateness,"[32] but, as stated, the court held that the bankruptcy court did not decide that question when it confirmed the consolidated plan "because the then-prevailing standard for substantive consolidation did not require such a finding."[33] The court, however, suggested that under its decision in *Owens Corning*, "which held that substantive consolidation is appropriate when debtors disregard their entity separateness," perhaps mutuality would have been created by the substantive consolidation order, but "it does not operate as an *ex post facto* finding that the Garden Ridge entities disregarded the entity separation."[34] The facts showed the opposite—that the creditor did not believe GRM and GRLP were alter egos *when he transacted with them* because he understood the separateness of the entities.[35] As an additional matter, the Third Circuit held that the plan permitted the debtors to retain "all legal and equitable defenses," and because the creditor's claim was live at the time, the debtors must have understood this provision to preserve their defense to setoff on the basis of a lack of mutuality. Accordingly, "substantive consolidation should not defeat the mutuality defense preserved here."[36]

The question then arises: Did *Owens Corning* change the substantive-consolidation standard such that it could create mutuality for purposes of setoff? In reviewing the case, it does not seem that even a determination thereunder would be sufficient to retroactively create mutuality of obligations under § 553. Prior to *Owens Corning*, the two prevailing tests for substantive consolidation originated from *Union Savings Bank v. Augie/Restivo Baking Co. Ltd. (In re Augie/Restivo Baking Co. Ltd.)*[37] and *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp. Inc.)*.[38] Generally, *Augie/Restivo* considered two critical factors for substantive consolidation: "(i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[39] The *Auto-Train* court required the "substantial identity" of the entities and allowed consolidation despite reliance on separateness when "the demonstrated benefits of consolidation 'heavily' outweigh the harm."[40]

Owens Corning held that a higher burden must be met for substantive consolidation, requiring proof that (i) prior to the petition date the debtor entities disregarded separateness "so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) post-petition, their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[41] To establish substantive consolidation under the first option requires showing that creditors dealt with the debtors prepetition as "one indistinguishable entity."[42] Such an allegation can be defeated if creditors relied on corporate separateness, such as the existence of corporate guarantees from affiliate or parent debtors.[43] The second option requires showing "hopeless commingling" of post-petition assets and is only justified to benefit "every creditor;" benefit to a few creditors or to facilitate distribution (as was permitted under *Auto-Train*) is insufficient.[44]

Despite *Garden Ridge*'s suggestion that *Owens Corning* could have altered the creditor's situation, the court failed to consider several other aspects of *Owens Corning*. First, substantive consolidation under the second *Owens Corning* test, the post-petition commingling of assets, is irrelevant to the pre-petition identities of the debtors and, therefore, should not lead to a finding of pre-petition "oneness" of the debtor entities for purposes of creating mutuality for a setoff right. Second, even satisfaction of the first prong, which requires that "in their pre-petition course of dealing, [creditors] actually and reasonably relied on the debtor's supposed unity,"[45] might be insufficient to establish that the debtors were alter-egos. As *Wade Cook* noted, to create mutuality for setoff, one must determine that the debtors were *alter-egos* under state law, which requires evidence of intentional fraud.[46] The finding of pre-petition disregard of separateness in *Owens Corning* addresses the "scenario [in which]...creditors have been misled by debtors' actions (*regardless of whether those actions were intentional or inadvertent*) and thus perceived incorrectly (and relied upon this perception) that multiple entities were one."[47] Inadvertence or incorrect perception by the creditor may be sufficient for substantive consolidation, but it is insufficient to establish that the debtor entities were alter-egos under state law for purposes of setoff.

England Motors is instructive because its holding is applicable regardless of the standard that a bankruptcy court may use in ordering substantive consolidation. The fact remains that such order must be entered post-petition and should not have retroactive effect. To permit the substantive-consolidation order to retroactively create mutuality would alter creditors' rights (certainly setoff creditors' rights) to the detriment of other creditors and allowing a creditor a setoff effectively elevates it to secured status at the expense of other creditors that may merit distributions from the debtors' estates. This could lead to using substantive consolidation "offensively" to "alter creditors rights," or elevate non-mutual setoff creditors (creditor A in the above example) to secured status. Such use of substantive consolidation to the benefit of one category of creditors is precisely one of the items that *Owens Corning* cautioned against in establishing its new criteria for substantive consolidation. "While substantive consolidation may be used defensively to remedy the identifiable harms caused by entangling affairs, it may not be used offensively (... having a primary purpose to disadvantage tactically a group of creditors...or to alter creditor rights)."[48] Despite the *dicta* in *Garden Ridge*, creating retroactive setoff rights through substantive consolidation could be inconsistent with the true principles behind *Owens Corning* and the substantive-consolidation standard mandated therein. ■

30 *Garden Ridge*, 2010 WL 2712145, at *1 (citing to record).
31 *Id.*
32 *Id.* at *2.
33 *Id.*
34 *Id.* (citing *Owens Corning*, 419 F.3d at 211).
35 *Id.*
36 *Id.*

37 *Union Savings Bank v. Augie/Restivo Baking Co. Ltd. (In re Augie/Restivo Baking Co. Ltd.)*, 860 F.2d 515 (2d Cir. 1988).
38 *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp. Inc.)*, 810 F.2d 270 (D.C. Cir. 1987).
39 *Augie/Restivo*, 860 F.2d at 518 (citations omitted).
40 *Auto-Train*, 810 F.2d at 276 (citation omitted).
41 *Owens Corning*, 419 F.3d at 211.
42 *Id.* at 212.
43 *Id.*
44 *Id.* at 214.

45 *Owens Corning*, 419 F.3d at 212.
46 *In re Wade Cook*, 375 B.R. at 599.
47 *Owens Corning*, 419 F.3d 211 n.19 (emphasis added).
48 *Id.* at 211.