

# BANKER & TRADESMAN

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## LAW of the LAND

## A New Risk For Real Estate In Bankruptcy Cases

### Substantive Consolidation Comes To Massachusetts

BY CHRISTOPHER R. VACCARO  
SPECIAL TO BANKER & TRADESMAN

The term “substantive consolidation” is unfamiliar to most, but after a recent bankruptcy court decision in Massachusetts, it may become a household phrase when the next economic downturn inevitably arrives.



CHRIS VACCARO

Described briefly, substantive consolidation is a legal device used by federal bankruptcy courts, usually at the urging of bankruptcy trustees, where assets of affiliated businesses are consolidated

into a single bankrupt estate for distribution to creditors. Bankruptcy courts infrequently employ substantive consolidation, and have refrained from using it in Massachusetts to draw assets of non-bankrupt affiliates into bankrupt estates. That changed last December, in *Lassman v. Cameron Construction LLC*.

Wilfred Cameron owned a corporation engaged in the roofing business. He also owned a separate limited liability company that held real estate in Attleboro, where his roofing business operated. The roofing business and the real estate company were distinct entities that filed separate annual reports and tax returns and paid their own employees. This structure, well-known in

the business community, is designed to insulate real estate companies from liabilities of operating companies, and vice versa.

The roofing business fell upon hard times after Cameron passed away. His survivors placed the roofing businesses into bankruptcy, probably assuming that the real estate company would be safe from the roofing business’s dissatisfied creditors. However, the survivors were unprepared for Donald Lassman, the bankruptcy trustee for the roofing business, who saw flaws in the entities’ corporate structures that might lead the bankruptcy court to consolidate the real estate company’s building into the roofing business’s bankrupt estate.

### Determining The Number Of Entities

The trustee found evidence that the roofing business and real estate company operated as a single entity. For example, the roofing business sporadically paid above-market rent to the real estate company, without a written lease. The roofing business was thinly capitalized. Both entities lacked records of stockholder and member meetings and votes. The real estate company’s employees (whose worker’s compensation insurance costs were lower) often worked for the roofing business. These factors suggested that the assets and businesses of the two entities were

intermingled and intertwined.

Without specifically invoking the substantive consolidation doctrine, the trustee asked the bankruptcy court to disregard the legal separateness of the real estate company and allow distribution of its property to the roofing business’s creditors. The real estate company objected, arguing that its affiliation with the roofing business was standard practice, and that common ownership of distinct corporate entities, by itself, is insufficient for courts to disregard their separateness in the absence of fraudulent purposes.

The bankruptcy court realized that the trustee, in effect, sought substantive consolidation of the assets of the bankrupt roofing business and the non-bankrupt real estate company. The court acknowledged that substantive consolidation of affiliated bankrupt debtors was widely accepted, but uncommon among bankrupt debtors and their non-bankrupt affiliates. However, the court saw a trend toward greater judicial acceptance of substantive consolidation between debtors and their non-debtor affiliates, as bankruptcy judges gain better understanding of inter-related corporate structures.

The court cited the analysis of the District of Columbia bankruptcy court, holding that substantive consolidation requires that: there be substantial identity between entities to be consolidated; consolidation be necessary to avoid harm or

realize benefits; and the benefits of consolidation outweigh the harms. The court found sufficient evidence to consolidate the assets of the real estate company and the bankrupt roofing business, despite the late Mr. Cameron's superficial efforts to separate the two entities. The court ruled in the trustee's favor, and the real estate company's property was combined with the roofing business's meager assets

for distribution to the roofing business's creditors.

Bankruptcy attorney Jesse Redlener, who successfully represented the trustee, notes that "the real estate company and the debtor maintained the window-dressing of separate entities, bank accounts, employees and corporate purpose; however, the judge recognized that behind the curtain, the business operations of these

entities were one and the same." Considering the bankruptcy court's willingness to accommodate the bankruptcy trustee in this situation, more cases of substantive consolidation can be expected in future bankruptcies. ■

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*Christopher R. Vaccaro is a partner at Dalton & Finegold in Andover. His email address is cvaccaro@dflp.com.*