UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF MISSISSIPPI

IN RE:

MOJAVE CP, LLC,	**CASE NO. 10-50223-NPO**
DEBTOR.	**CHAPTER 11**

IN RE:

COMPASS POINTE HOLDINGS, LLC,	**CASE NO. 10-50224-NPO**
DEBTOR.	**CHAPTER 11**

ORDER DENYING MOTIONS FOR SUBSTANTIVE CONSOLIDATION AND DIRECTING JOINT ADMINISTRATION OF CASES

On April 8, 2010, there came on for hearing (the "Hearing") the Motion for Substantive Consolidation (Case No. 10-50223-NPO, Dkt. No. 56) (the "Mojave Motion") filed in the bankruptcy case of Mojave, CP, LLC ("Mojave") and the Motion for Substantive Consolidation (Case No. 10-50224-NPO, Dkt. No. 55) (the "Compass Pointe Motion") filed in the bankruptcy case of Compass Pointe Holdings, LLC ("Compass Pointe") (Mojave and Compass Pointe, collectively referred to as the "Debtors") (Mojave Motion and Compass Pointe Motion, collectively referred to as the "Motions"). At the Hearing, David L. Lord represented the Debtors. Based on the pleadings and the arguments of counsel, the Court finds that the Motions should be denied. As an alternative form of relief, the Court further finds that the cases of Mojave and Compass Pointe should be jointly administered pursuant to Rule 1015(b) of the Federal Rules of Bankruptcy Procedure.

Jurisdiction

This Court has jurisdiction over the parties and the subject matter of this proceeding pursuant to 28 U.S.C. § 1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A). Notice of the Motions was proper under the circumstances.

Facts

In identical Motions, Mojave and Compass Pointe ask this Court to substantively consolidate their cases, with the Mojave case (Case No. 10-50223-NPO) surviving as the lead case.[1] As grounds for substantive consolidation, the Debtors cite the following facts in their Motions:

1. Mojave and Compass Pointe are closely related entities.

2. Mojave and Compass Pointe together purchased an apartment complex located in Pascagoula, Mississippi. Mojave is the holder of a 55% interest, and Compass Pointe is the holder of a 45% interest.

3. Mojave and Compass Pointe share in the "cash flow, expenses of operation, means and methods of operation, and management" of the apartment complex.

4. The substantive consolidation of these cases would ease their administration, reduce duplicate filings, and promote judicial economy.

There are no supporting documents attached to the Motions, and the Debtors did not offer any testimony at the Hearing augmenting any of the above facts. From the petitions filed by the Debtors, and from the schedules, statements and other documents filed by them pursuant to Rule 1007 of the Federal Rules of Bankruptcy Procedure, the following additional facts may be gleaned:

1. Mojave is a limited liability corporation whose street address is in Alamo, California, and whose principal place of business and principal assets are in Jackson County, Mississippi. (Amended Petition, Case No. 10-50223-NPO, Dkt. No. 28). Compass

[1] The Motions do not state specifically whether the parties intend to terminate Compass Pointe, but assumably Mojave would be the only surviving entity if the Court substantively consolidates their chapter 11 cases.

Pointe is a limited liability corporation whose street address is in Ocala, Florida, and whose principal place of business and principal assets are in Jackson County, Mississippi. (Amended Petition, Case No. 10-50224-NPO, Dkt. No. 29).

2. Mojave, in its "List of Equity Security Holders," identifies Steve Tovani as its equity security holder whose address is the same as the street address for Mojave. (Case No. 10-50223-NPO, Dkt. No. 35). Compass Pointe, in its "List of Equity Security Holders," identifies Tim Dodd as its equity security holder whose address is the same as the street address for Compass Pointe. (Case No. 10-50224-NPO, Dkt. No. 36).

3. The "List of Creditors Holding 20 Largest Unsecured Claims" filed by Mojave and Compass Pointe are identical. (Case No. 10-50223-NPO, Dkt. No. 4; Case No. 10-50224-NPO, Dkt. No. 4).

4. The "Monthly Operating Reports" ("MORS") filed by Mojave and Compass Pointe for the reporting periods of February, 2010, and March, 2010, are identical. (Case No. 10-50223-NPO, Dkt. Nos. 71, 87; Case No. 10-50224-NPO, Dkt. Nos. 70, 85).

In sum, Mojave and Compass Pointe are separate legal entities that together acquired an apartment complex in Pascagoula. The two corporations do not share the same owners, officers, or directors. Although Mojave holds a greater interest in the apartment complex, it is not the parent company of Compass Pointe. There is no evidence that the two corporations commingled funds to the disadvantage of creditors or that they engaged in undocumented inter-company transactions. Indeed, from the MORS, it appears that most, if not all, creditors transacted business solely with Mojave.

Discussion

There is no specific authority in the Bankruptcy Code for the "substantive consolidation" of the assets and liabilities of related entities. Substantive consolidation derives from the bankruptcy court's general equitable powers set forth in 11 U.S.C. §105(a)[2] and in chapter 11 cases in

[2] Section 105(a) authorizes the Court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. 11 U.S.C. § 105. Unless otherwise noted, all references to statutory sections and to the Bankruptcy Code are to the United States Bankruptcy Code found at Title 11 of the United States Code.

§ 1123(a)(5)(C).[3] See S.I. Acquisition, Inc. v. Eastway Delivery Serv., Inc. (In re S.I. Acquisition, Inc.), 817 F.2d 1142, 1145 n.2 (5th Cir. 1987). The purpose of substantive consolidation is "to ensure the equitable treatment of all creditors." In re Murray Indus., 119 B.R. 820, 830 (Bankr. M.D. Fla. 1990). To achieve this result, substantive consolidation treats separate legal entities as if they were merged into a single survivor left with all the assets and liabilities of both entities. Chem. Bank New York Trust Co. v. Kheel (In re Seatrade Corp.), 369 F.2d 845, 847 (2d Cir. 1966). Accordingly, the liabilities of both entities are satisfied from the common pool of assets created by consolidation. Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co.), 250 F.3d 955, 958-59 n.5 (5th Cir. 2001). Inter-company liabilities of the consolidated entities disappear. Id. Also, in chapter 11 cases, substantive consolidation combines creditors of the consolidated entities for purposes of voting on reorganization plans. Id. at 959. Clearly, substantive consolidation is no mere procedural devise but affects the substantive rights of the parties. For example, sharing assets with all other creditors of a consolidated survivor in almost all instances will reduce the recovery of those creditors who transacted business solely with the entity having significantly greater funds. Murray Indus., 119 B.R. at 829-30. In this way, the concept of substantive consolidation is not unlike piercing the "corporate veil" of an entity under state law to allow a creditor to reach assets of another related corporate entity. See generally Mary Elisabeth Kors, Altered Egos: Deciphering Substantive Consolidation, 59 U. Pitt. L. Rev. 381-451 (1997-1998).

The Fifth Circuit Court of Appeals has acknowledged that bankruptcy courts have the authority to order substantive consolidation but has not yet addressed the standard that bankruptcy

[3] Section 1123(a)(5)(C) provides: "[A] plan [of reorganization] shall . . . provide adequate means for the plan's implementation, such as . . . merger or consolidation of the debtor with one or more persons. . . ."

courts should employ in determining when to apply the remedy. See Wells Fargo Bank v. Sommers (In re Amco Insur.), 444 F.3d 690, 696 (5th Cir. 2006) ("[W]e decline to address . . . the proper standard for and application of substantive consolidation."). However, because of the real possibility that some creditors will suffer prejudice, the Fifth Circuit has described substantive consolidation as an "extreme and unusual remedy." Scotia Pacific Co. v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.), 584 F.3d 229, 249 (5th Cir. 2009) (citation omitted). In the absence of any guidelines from the Fifth Circuit, this Court considers helpful a sampling of the various tests applied by those Circuit Courts that have delineated the factors to be considered.

The First Circuit Court of Appeals in Pension Benefit Guaranty Corp. v. Ouimet, 711 F.2d 1085, 1093 (1st Cir. 1983), has adopted the following five-factor test:

1. The parent owns a majority of the subsidiary's stock.

2. The entities have common officers or directors.

3. The subsidiary is grossly undercapitalized.

4. The subsidiary transacts business solely with the parent.

5. Both entities disregard the legal requirements of the subsidiary as a separate corporation.

Ouimet, 711 F.2d at 1093. The presence of any or all of these factors weighs in favor of substantive consolidation. The Second and Ninth Circuits use the two-pronged inquiry announced in the landmark case of Union Savings Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.), 860 F.2d 515 (2d Cir.1988). That inquiry requires consideration of two critical factors:

1. Whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or

2. Whether the affairs of the debtor are so entangled that consolidation will benefit all creditors.

Augie/Restivo, 860 F.2d at 518; Alexander v. Compton (In re Bonham), 229 F.3d 750, 766 (9th Cir. 2000) (describing approach of Second Circuit as more grounded in economic theory and as more easily applied). The Third Circuit adopted its own test in In re Owens Corning, 419 F.3d 195 (3d Cir. 2005), holding that a proponent of substantive consolidation must show either that prepetition creditors treated the entities as "one legal entity," or that post-petition, the assets and liabilities of the entities are "so scrambled that separating them is prohibitive and hurts all creditors." Id. at 211.

The District of Columbia and Eleventh Circuits employ a three-part, burden-shifting analysis that was first announced in Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987), as part of an inquiry to ensure that substantive consolidation yields more benefits than harm. Id.; Eastgroup Props. v. S. Motel Assocs., Ltd., 935 F.2d 245, 249 (11th Cir. 1991). The focus of that analysis is the "substantial identity" of the entities. The debtor establishes a *prima facie* case by showing that there is a substantial identity between the entities and consolidation is necessary to avoid some harm or realize some benefit. Auto-Train, 810 F.2d at 276. If the debtor establishes a *prima facie* case, a presumption arises that creditors have not relied solely on the credit of one of the entities involved. Id. A creditor may rebut this presumption by establishing that it relied on the separate credit of a debtor and will be prejudiced by substantive consolidation. Even if a creditor is successful in carrying this burden, the court may still order substantive consolidation if it determines that the benefits of consolidation "heavily" outweigh the harm. Id.

In determining whether substantive consolidation is appropriate, our sister bankruptcy court in Texas has relied upon a non-determinative list of factors first announced in In re Vecco Construction Industries, Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980). Mostly, these factors are

examples of information that show a "substantial identity" between the entities sought to be consolidated and include:

1. The degree of difficulty in segregating and ascertaining individual assets and liabilities.

2. The presence or absence of consolidated financial statements.

3. The profitability of consolidation at a single physical location.

4. The commingling of assets and business functions.

5. The unity of interests and ownership between various corporate entities.

6. The existence of parent and inter-corporate guarantees on loans.

7. The transfer of assets without formal observance of corporate formalities.

Vecco, 4 B.R. at 409; In re Mortgage Inv. Co., 111 B.R. 604, 610 (Bankr. W.D. Tex. 1990) (applying Vecco factors). The more Vecco factors that are present, the stronger the case for substantive consolidation.

What all of the above tests reveal is that no uniform guidelines exist for conducting the substantive consolidation inquiry. Instead, the inquiry requires a highly fact-specific analysis to determine whether substantive consolidation would effectuate the goal of fairness to all creditors. These tests also show that consolidation is based typically on the conclusion that the entities are "alter egos" or that one entity is the "mere instrumentality" of the other.

At the Hearing, counsel for the Debtors provided the Court with a copy of Raymond Professional Group, Inc. v. William A. Pope Co. (In re Raymond Professional Group, Inc.), 421 B.R. 891 (Bankr. N.D. Ill. 2009), in support of the Motions. In that case, however, the bankruptcy court did not reach the issue of substantive consolidation because the attorney who requested the remedy had a conflict of interest that resulted in his disqualification. Indeed, the court in Raymond

Professional questioned whether substantive consolidation is permitted at all under the Bankruptcy Code. Therefore, Raymond Professional does not appear to be instructive.

Here, the particular facts cited by Mojave and Compass Pointe in the Motions and the additional facts gleaned from the pleadings do not establish a *prima facie* case for substantial consolidation under any of the standards described in the above discussion. Mojave and Compass Pointe are separate legal entities, owned by separate individuals. Moreover, the Debtors presented no evidence that they hopelessly commingled funds, that they disregarded corporate formalities, or that creditors viewed them as one indistinguishable entity. There is simply no indication that creditors would suffer harm if these estates remain separate. Mere cost-savings in the administration of the cases is insufficient reason in itself to justify such a drastic remedy. Owens Corning, 419 F.3d at 211.

Despite the absence of evidence supporting substantive consolidation, the facts outlined in the Motions demonstrate that Mojave and Compass Pointe fall within the definition of "affiliates" under § 101(2),[4] thus allowing for the joint administration or administrative consolidation of their cases under Rule 1015(b) of the Federal Rules of Bankruptcy Procedure. That Rule provides:

> If a joint petition or two or more petitions are pending in the same court by or against . . . 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.

Fed. R. Bankr. P. 1015(b). The primary function of joint administration is to promote procedural convenience and cost efficiencies, which will remedy the concerns raised in the Motions without affecting the substantive rights of any creditors or other interested parties. In re McKenzie Energy

[4] "The term 'affiliate' means . . . entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement." 11 U.S.C. § 101(2)(D).

Corp., 228 B.R. 854, 874 (Bankr. S.D. Tex. 1998).

Conclusion

In conclusion, the Debtors have not shown that substantive consolidation is warranted and, therefore, the Motions should be denied. As an alternative to substantive consolidation, the Court finds that joint administration of the cases of Mojave and Compass Pointe will avoid unnecessary costs and will simplify and expedite the completion of these cases for the benefit of the Court, creditors, and other parties-in-interest.

IT IS, THEREFORE, ORDERED that the Motions hereby are denied.

IT IS FURTHER ORDERED that the respective cases of Mojave and Compass Pointe shall be jointly administered for procedural purposes only, and all pleadings shall be filed in the lead case of Mojave (Case No. 10-50223-NPO).

IT IS FURTHER ORDERED that the joint administration of these cases will not alter the filing of proofs of claim or distribution of assets. Any proofs of claim filed by a claimant shall be filed in the particular case in which the claimant asserts a claim. This Order is not, and shall not be construed, as a substantive consolidation of the respective estates.

SO ORDERED.

Neil P. Olack
United States Bankruptcy Judge
Dated: April 28, 2010