

IN THE UNITED STATES BANKRUPTCY COURT  
For the Southern District of Iowa

In the Matter of

RAYMOND N. KENKEL and  
EVELYN KENKEL,  
Debtors,

Case No. 86-832-W  
Chapter 7

MANAWA IMPLEMENT AND SERVICE,  
INC.,  
Debtor,

Case. No. 86-1021-W  
Chapter 11

RAYLIN AG, INC.,  
Debtor.

Case No. 86-3345-W  
Chapter 12

ORDER -- MOTION FOR SUBSTANTIVE CONSOLIDATION  
OF DEBTORS' ESTATES

On March 9, 1988, a hearing was held on motion for substantive consolidation of Debtors' estates. The following attorneys appeared on behalf of their respective clients: C. R. Hannan for the Chapter 11 Debtor, Manawa Implement and Service, Inc. (hereinafter "Manawa") and for the Chapter 12 Debtor, Raylyn Ag., Inc. (hereinafter "Raylyn Ag"); Douglas E. Quinn for INNK Land & Cattle Company (hereinafter "INNK"); Donald L. Swanson for State Bank and Trust (hereinafter "State Bank"); Jack E. Ruesch for Council Bluffs Savings Bank (hereinafter "Bank"); and Randy R. Ewing for the John Deere Company. At the conclusion of said hearing, the Court took the matter under advisement and ordered the parties to submit briefs by April 11, 1988. The Court considers the matter fully submitted.

This is a core proceeding pursuant to 28 U.S.C. §157(b) (2). The Court, upon review of the pleadings, arguments of counsel, and briefs, now enters its findings and conclusions pursuant to F.R. Bankr. p. 7052.

FINDINGS OF FACT

1. On March 26, 1986, the Kenkels filed a Chapter 7 petition.
2. On May 2, 1986, Manawa filed a Chapter 11 petition.
3. On December 22, 1986, Raylyn Ag filed a Chapter 12 petition.
4. On August 2, 1983, INNK commenced an action against the Kenkels for wrongfully withholding INNK's funds. Said action was commenced in the United States District Court for the District of Colorado, and was entitled INNK Land & Cattle Company, Plaintiff, v. Raymond N. Kenkel and Evelyn Kenkel, Defendants, Case No. 83-F-1375. Following trial, judgment was entered on November 27, 1985, for INNK and against the defendants in the amount of \$964,857.86, which represented the wrongfully withheld net proceeds from the sale of a parcel of Colorado real estate known as the Hart Ranch.

5. During the pendency of the foregoing litigation, the Kenkels transferred to Raylyn Ag a large portion of the funds which were wrongfully withheld from INNK. Specifically, on May 19, 1982, Evelyn Kenkel transferred \$397,715.00 to Raylyn Ag in exchange for one thousand shares

of additional stock. This transfer took place just one day after the Kenkels had received the wrongfully withheld funds.

6. The Kenkels thereafter began a series of gifts to their children through which their entire ownership interest in Raylyn Ag was divested. Said gifts began 9 days after INNK had filed suit to recover the wrongfully withheld sale proceeds. The gifts included:

a. On August 11, 1983, Raymond Kenkel gave to his three children 559 shares of Raylyn Ag stock, and 294 shares of Manawa stock.

b. On August 12, 1983, Evelyn Kenkel gave 600 shares of Raylyn stock to her 3 children.

c. On October 12, 1983, Raymond and Evelyn Kenkel filed a 1983 gift tax return showing gifts to their children of the remainder of their stock in Raylyn Ag and Manawa, consisting of a gift by Evelyn Kenkel of 721 shares of Raylyn Ag, and a gift by Raymond Kenkel of 306 shares of Manawa to Tom Kenkel. Said return further reflected that Raymond and Evelyn Kenkel forgave \$62,000.00 of indebtedness owed to them by Tom Kenkel.

d. In early 1983, Raymond Kenkel transferred the building and property of Manawa to Raylyn Ag, while Manawa transferred the surrounding property to its president, Tom Kenkel, at a substantial discount, thereby effectively transferring that property to the Kenkel children as well.

e. On March 31, 1984, Raylyn Ag declared a dividend of \$141,260.00 which forgave a purported note due to Raylyn Ag from the Kenkels.

7. In regard to the various inter-corporation transfers, transfers between the Kenkels and both corporations, and the transfer of various stock in both corporations to third parties, no litigation has been commenced by

the Trustee or by INNK to recover any of these assets from any third party.

8. Manawa, Raylyn Ag, and the Kenkels all maintained their own separate accounts.

9. Manawa is currently undergoing a Chapter 11 reorganization and has entered into an agreement with all of its creditors regarding its continued existence.

10. Raylyn Ag is facing motions to dismiss its Chapter 12 proceedings filed by Federal Land Bank of Omaha and Council Bluffs Savings Bank. The Chapter 12 Plan is on file and awaiting confirmation pending the outcome of the instant motion.

#### DISCUSSION

Substantive consolidation is the merger of separate entities into a single entity so that the assets and liabilities of the separate parties can be aggregated in order to effect a more equitable distribution of property among creditors. Matter of Baker & Getty Financial Services, Inc., 78 B.R. 139, 141 (Bankr. N.D. Ohio 1987). Since there is no statutory authority under the Bankruptcy Code allowing substantive consolidation, courts rely on their general powers of equity to substantively consolidate bankruptcy estates. Matter of Lewellyn, 26 B.R. 246, 250 (Bankr. S.D. Iowa 1982) (citations omitted).

The power to substantively consolidate must be used sparingly because it affects substantive rights and can

treat some creditors unfairly. Id. This unfairness can arise because separate debtors usually have different ratios of assets and liabilities, so the creditors of a debtor whose asset-to-liability ratio is higher than that of its affiliated debtor will lose to the extent the asset-to-liability ratio of the merged estates is lower. In re Snider Bros., Inc., 18 B.R. 230, 234 (Bankr. D. Mass. 1982). As a result, the Court must carefully scrutinize the evidence before consolidating estates. Lewellyn, 26 B.R. at 251.

Two different methods of analyzing facts under a substantive consolidation motion exists. The first is a "factual predicate" analysis set forth at 5 Collier on Bankruptcy, ¶1100.06 (15th Ed. 1988) (hereinafter "Collier"). The second is a "balancing of prejudice" analysis adopted by numerous courts. See Baker & Getty, supra; Lewellyn, supra; and Snider Bros., supra. The Court will analyze the evidence under each method.

#### Factual Predicate Analysis

Collier, supra, sets out four "factual predicates" that must be established to obtain an order for a substantive consolidation. These factual predicates include:

- (i) creditors of the affiliates dealt with such affiliates as an economic unit and did not rely on their separate identity in extending credit;
- (ii) assets of one entity have been transferred to another entity without fair consideration or with the intent to

hinder, delay, or to fraud creditors of the transferor and the transfer or transfers cannot be undone in a manner which would protect the rights of creditors of the transferor;

- (iii) the affairs of the affiliated entities are so entangled that it would be costly and time-consuming to deal with them separately; and
- (iv) the separate legal entities of affiliates have not been preserved and piercing the corporate veil of one or more affiliates is required to protect the rights of the creditors of a related affiliate.

Id. at 1100-33,34 (emphasis added).

Upon review of the evidence, the Court concludes that none of the four factual predicates exist for the following reasons. Concerning the first factual predicate regarding perceptions of creditors in extending credit, there is no showing that the creditors of either Raylyn Ag or the Kenkels viewed Manawa as a part of either of them in extending credit.

Concerning the second factual predicate regarding fraudulent conveyances, INNK contends all three estates should be consolidated because of allegedly fraudulent transfers by the Kenkels. Even assuming without deciding that the Kenkels' various transfers were fraudulent, the fact remains there is no evidence indicating the transfers cannot be undone. The only direct evidence on point was the testimony of Ms. Patricia A. Fitzgerald, bookkeeper for INNK, indicating that she had no knowledge of whether the transfers could be undone in a manner that would protect

the rights of creditors of the transferor. Further, it seems reasonable to assume the aggrieved parties could take. action to undo any transfer of stock or real estate that was improper.

Concerning the third factual predicate regarding entanglement of affairs, INNK contends the affairs and interrelationships of the affiliated entities are hopelessly obscured and entangled. However, the facts indicate otherwise because INNK has been able to trace and unscramble many of the transfers by the Kenkels. Exhibit 41 demonstrates that records were kept of the financial transactions of the various debtors and that tracing and unscrambling what happened is quite feasible.

Concerning the fourth factual predicate regarding separateness of entities, the facts indicate the three debtors are three separate entities. Manawa, Raylyn Ag, and the Kenkels all maintained their own separate accounts. There is no evidence of any co-mingling of assets or of any consolidated financial statement. Further, Exhibit 41 shows that all three debtors made an effort to distinguish among the separate entities in all transactions.

In conclusion, none of the four factual predicates necessary for a substantive consolidation order exists. Since INNK needed to establish all four but has failed to establish even one, INNK's motion for substantive

consolidation cannot be granted pursuant to a factual predicate analysis.

Balancing of Prejudice Analysis

Under a balancing of prejudice analysis, the Court should consolidate estates only if the benefits of consolidation outweigh the harm it would cause to creditors. In re DRW Property Co., 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985); Snider Bros., 18 B.R. at 234. In making this determination, the Snider Bros. Court stated:

While several courts have recently attempted to delineate what might be called 'the elements of consolidation' [citations omitted], ... the only real criteria is the economic prejudice of continued debtors' separateness versus the economic prejudice of consolidation. There is no one set of elements which, if established, will mandate consolidation in every case.

Id. at 224 (emphasis added). Finally, the party seeking consolidation has the burden of proving that any prejudice resulting from consolidation is outweighed by the greater prejudice resulting from the continued separation of the estates. DRW Property, 54 B.R. at 495.

In the case at bar, the prejudice to INNK resulting from the continued separation of the estates is that it will need to complete its tracing of transfers and then take appropriate steps to undo any improper transfers. However, INNK has already demonstrated it can trace the transfers. Thus, the prejudice to INNK is not severe. The prejudice to the creditors of the Kenkels, Manawa, and Raylyn Ag resulting from consolidation, on the other hand, is quite

severe and especially so for the Manawa creditors. Manawa is now a profitable entity and has reached agreement with its major creditors. It has completed a successful reorganization and will soon be paying its creditors. Consolidating all three estates could threaten Manawa's continued viability and Raylyn Ag's ability to create a workable plan. As a result, the Court concludes that INNK has not met its burden of proving that any prejudice resulting from consolidation is outweighed by a greater prejudice resulting from the continued separation of the estates.

CONCLUSION AND ORDER

WHEREFORE, based on the foregoing analysis, the Court concludes INNK has failed to establish any of the four factual predicates necessary in order to receive a substantive consolidation order.

FURTHER, the Court concludes that INNK has failed to meet its burden of proving that any prejudice resulting from consolidation is outweighed by the greater prejudice resulting from the continued separation of the estates.

IT IS ACCORDINGLY ORDERED that INNK's motion for substantive consolidation is denied.

Dated this 11<sup>th</sup> day of July, 1988.

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RUSSELL J. HILL  
U.S. BANKRUPTCY JUDGE