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## Abandoning Bankruptcy Law's "Identity of Interest" Exception

*He said true things, but called them by wrong names.*

Robert Browning, *Bishop Blougram's Apology*

When a corporation files a petition for bankruptcy relief, the bankruptcy court will scrutinize any transfers it made immediately before the commencement of the case. In particular, the court will often avoid a fraudulent transfer,<sup>1</sup> such as a transfer for which the debtor corporation did not receive "reasonably equivalent value."<sup>2</sup>

1. The most comprehensive scholarly discussion of fraudulent conveyance law is found in Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977).

2. Two provisions of the 1978 Bankruptcy Reform Act, Pub. L. No. 95-598, § 101, 92 Stat. 2549 (codified at 11 U.S.C.A. §§ 101-1532b (West 1979)) [hereinafter cited as "new Act"], concern fraudulent transfers. § 548 provides:

Fraudulent transfers and obligations

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor —

(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted;

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(ii) was engaged in business, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

(b) The trustee of a partnership debtor may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, to a general partner in the debtor, if the debtor was insolvent on the date such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation.

(c) Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on any interest transferred, may retain any lien transferred, or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

(d)(1) For the purposes of this section, a transfer is made when such transfer becomes so far perfected that a bona fide purchaser from the debtor against whom such transfer could have been perfected cannot acquire an interest in the property transferred that is superior to the interest in such property of the transferee, but if such transfer is not so perfected before the commencement of the case, such transfer occurs immediately before the date of the filing of the petition.

(2) In this section —

(A) "value" means property, or satisfaction or securing a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor; and

(B) a commodity broker or forward contract merchant that receives a margin payment, as defined in section 761(15) of this title, takes for value.

This scrutiny protects the bankrupt's creditors from some injurious forms of fraud. Yet certain affiliated<sup>3</sup> corporations can avoid the laws against fraudulent transfer through a judicial transfer that this Note will call the "identity of interest" exception.

The exception for affiliated corporations sharing an identity of interest is a flawed concept that should be discarded. Although the exception sometimes leads to equitable results, its standards are so vague that it more frequently hinders justice. Courts often invoke it inappropriately but ignore it when its flexibility would be useful. More fundamentally, the exception treats bankrupt affiliates erratically, viewing them sometimes as one unit, at other times as distinct entities. Courts could more sensibly approach the problem by establishing standards for determining whether affiliates should be treated as separate companies or as a single unit. In fact, courts already have proven legal tools to do this in "novation" and "consolidation"; consistent, principled use of those doctrines would permit courts to abandon altogether the complicated and unjust identity of interest exception.

Section I of this Note discusses the goals and weaknesses of the identity of interest exception; Section II explains the advantages of consolidation and novation; and the final Section suggests a way to separate cases where novation is appropriate from those where consolidation is the preferred remedy.

## I. GOALS AND FAILINGS OF THE EXCEPTION

The goal of the identity of interest exception is laudable. Not all transfers without monetary consideration are fraudulent; many transfers between affiliated corporations are made without monetary consideration for good business reasons.<sup>4</sup> For example, when a do-

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11 U.S.C.A. § 548 (West 1979).

§ 544(b) provides:

The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is now allowable only under section 502(3) of this title.

These provisions replace the similar provisions in the "old Act." Bankruptcy Act of 1898, ch. 575, 52 Stat. 883. The old Act's § 67d required "fair consideration" rather than "reasonably equivalent value." The new language streamlines the old because "fair consideration" has frequently been defined in terms of "reasonably equivalent value." 4 W. COLLIER, BANKRUPTCY 15-19 (14th ed. 1978).

3. The new Act defines "affiliate" for the first time. 11 U.S.C.A. § 101(2) (West 1979). The Act finds affiliation when one entity has 20% ownership or control of another and controls substantially all the other firm's business.

4. In part, the possibility that distinct corporations could share common interests reflects modern business organization, which does not always encompass an entire enterprise. According to Professor Landers:

The owners of a business enterprise often choose to conduct their operations in the form of two or more separate corporations rather than as a single corporate entity. They may do so for a variety of reasons: to separate functions for administrative ease, to control

nee is on the verge of bankruptcy, the donor corporation may enjoy substantial benefits from merely postponing its affiliate's liquidation.<sup>5</sup> Or a fully solvent corporation may have a temporary cash flow problem, prompting the affiliated donor to offer aid to prevent disruptions in its market.<sup>6</sup> Even more commonly, two affiliates with identical management may toss assets back and forth carelessly, but without the intent usually required for fraud.<sup>7</sup> Courts have thus created an exception for affiliates that have an "identity of interest," presuming that such a close relationship ensures that business reasons really prompted the transfer.

But identity of interest is only poorly defined, and poor definition leads to unjust application. The unjustness of the identity of interest exception appears in three ways. First, the vagueness of the standard hinders planning by debtors. Second, the exception places unfair burdens on creditors, often forcing them to take inequitable and unforeseeable losses. Finally, the exception breaks up the unity of the fraudulent transfers doctrine. While these drawbacks might be acceptable if no alternative existed, they are hard to defend when the same benefits can be achieved without them.

Courts have not applied the identity of interest exception consistently. One court, for example, has applied the exception when a parent corporation paid one debt of a subsidiary that otherwise maintained its affairs separately.<sup>8</sup> But another court refused to apply it when two affiliates in the same business, both owned by the same individual, made several payments on behalf of each other.<sup>9</sup> A few intrepid judges have suggested imprecise standards like "overall pattern of operations that had existed over time"<sup>10</sup> but these are no more illuminating than the phrase "identity of interest." Neither

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many businesses with a minimal capital investment, to comply with various legal requirements, to minimize liability or to insulate certain assets for other activities, and, probably most important, to avoid the predations of the ubiquitous tax collector.

Landers, *A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975).

5. See, e.g., *Samuels v. Charles E. Fogg Co.*, 258 Mass. 402, 155 N.E. 429 (1927); *Nelson v. Poss*, 172 Minn. 149, 214 N.W. 787 (1927); *Ulicsnick v. Dalrymple*, 102 N.J. Eq. 136, 140 A. 19 (1928), *aff'd.*, 103 N.J. Eq. 407, 143 A. 920 (1928); *Farmers Exchange Bank v. Oneida Motor Truck Co.*, 202 Wis. 266, 232 N.W. 536 (1930); see generally Annot., 30 A.L.R.2d 1209 (1953).

6. See generally *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823 (5th Cir. 1959).

7. See generally *McNellis v. Raymond*, 287 F. Supp. 232 (N.D.N.Y. 1968), *rev'd on other grounds*, 420 F.2d 51 (2d Cir. 1970).

8. See *Mandel v. Scanlon*, 426 F. Supp. 519 (W.D. Pa. 1977).

9. See *Central Natl. Bank v. Coleman (In re B-F Bldg. Corp.)*, 312 F.2d 691 (6th Cir. 1963), discussed in note 20 *infra*.

10. *Hofler v. Marion Lumber Co.*, 233 F. Supp. 540, 542 (E.D.S.C. 1964). It should be noted that after pointing to this irrelevant factor, the court then went on to decide the case on the sound ground of novation.

debtors nor creditors can plan confidently in such a climate of uncertainty.<sup>11</sup>

The identity of interest exception also prevents just repayment of creditors. Consider this example: Albatross Associates pays a debt of its affiliate Blue Jay Brothers to Seagull Suppliers. Albatross receives nothing from Blue Jay for its payment, and shortly afterwards declares bankruptcy. If a court finds an identity of interest between Albatross and Blue Jay, the creditors of Albatross will not be able to avoid the payment to Seagull even though Albatross received no tangible value in exchange. On the other hand, Seagull may suffer unfairly if the court does not find an identity of interest, for then Albatross's creditors can recover the payment, even though Seagull thought it was dealing with the solvent affiliate, Blue Jay. In either case, Blue Jay retains the supplies delivered by Seagull, who might have to sue to recover them. Why involve Seagull in a lawsuit when the affiliates' own sloppy practices are to blame?

Finally, the greatest weakness of the exception for identity of interest is that it allows affiliated corporations sharing common objectives or concerns to escape the laws against fraudulent transfers. Thus, the exception shelters sloppy business practices, while failing to protect more careful affiliates. Moreover, creditors rely on the doctrine prohibiting fraudulent transfers to protect their interests. That doctrine forms an important part of bankruptcy law and needless exception to it raises needless problems.<sup>12</sup>

## II. AN ALTERNATIVE FOR BANKRUPT AFFILIATES

Rather than trying to except a category of affiliates from the laws against fraudulent transfer, courts should study the circumstances in which a questionable transfer was made. Sometimes the transfer can be redefined so that it satisfies the doctrine against fraudulent transfers. In such circumstances, a court can find a novation, exchanging the parties to a debt and replacing the bankrupt debtor with its solvent affiliate. When the affairs of two affiliates are so entangled that their accounts cannot be separated, courts should consider whether a transfer took place at all, or whether the two affiliates should really be treated as one corporation. Where appropriate, a court can "pierce the corporate veil"<sup>13</sup> to make a consolidation. The judg-

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11. Indeed, few could afford the internal review necessary to determine identity of interest. See Landers, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, 43 U. CHI. L. REV. 527, 540 (1976).

12. Cf. Clark, *supra* note 1, at 505 ("the law of fraudulent conveyances contains a few simple but potent moral principles governing the conduct of debtors toward their creditors").

13. "Piercing the corporate veil" has been described as "looking through or beyond the corporation to an individual or to another corporation for the purpose of ascertaining the real ownership or the real liability." Getman, *Vest Pocket Corporations*, 2 BROOKLYN L. REV. 45 (1933). On the other hand, it has also been described as "one of the law's least limpid metaphors." *Gartner v. Synder*, 607 F.2d 582, 586 (2d Cir. 1979) (Lumbard, J.). The balance of

ments necessary to find a novation or make a consolidation are not new; courts must make the same determinations in a variety of settings.<sup>14</sup> These concepts, moreover, can be applied without the tortured search for identity of interest.

### A. *Novation*

A novation occurs when the parties to an obligation substitute a new obligation between themselves or with a third party.<sup>15</sup> A novation of debtors is the substitution of a new debtor in place of the old. The creditor must consent to the release of the old debtor and the substitution of the new, but consent may be inferred from a course of conduct, such as accepting payment.<sup>16</sup> Thus, the criteria for a novation are simple and easily recognized.<sup>17</sup> Only the substitution is necessary; courts need not inquire into the relationship between the parties to the novation. Wholly unaffiliated parties may execute a novation. Identity of interest is therefore irrelevant to whether a novation has occurred.

The concept of novation solves many of the problems posed by the identity of interest exception. Consider again the affiliates Albatross and Blue Jay and the creditor Seagull. Albatross pays Blue Jay's debt to Seagull and then goes bankrupt. A court could find the following novation: Albatross assumed Blue Jay's obligation to pay Seagull and Blue Jay assumed a corresponding obligation to repay Albatross (thus satisfying the classic "reasonably equivalent value" test). The trustee for the creditors of Albatross can collect this account payable from Blue Jay like any other account payable. Seagull is not involved in a lawsuit at all. The court has not had to decide if an identity of interest exists, and the doctrine of fraudulent transfers stands intact.

Now, the trustees for the creditors of Albatross may not be satisfied when told that the account payable from Blue Jay may be col-

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this Note will therefore forsake the metaphor in favor of the more limpid term "consolidation."

14. See notes 15 & 22 *infra*.

15. BLACK'S LAW DICTIONARY 959 (5th ed. 1979). A novation may be effected in one of three ways: 1) by the substitution of a new obligation between the same parties to extinguish the old; 2) by the substitution of a new debtor in place of the old; or 3) by the substitution of a new creditor in place of the old. Courts have used novations since the early nineteenth century. See *Union Bank v. Stafford*, 53 U.S. (12 How.) 327 (1814); *John Wanamaker, Inc. v. Comfort*, 53 F.2d 751 (5th Cir. 1931), *cert. denied*, 285 U.S. 560 (1932); *City Natl. Bank v. Fuller*, 52 F.2d 870 (8th Cir. 1931); *Wheeler v. Wardell*, 173 Va. 168, 3 S.E.2d 377 (1939).

16. See *Oakland County v. Allen*, 295 Mich. 61, 294 N.W. 98 (1940); *Chicago Blvd. Land Co. v. Nutten*, 268 Mich. 541, 256 N.W. 541 (1934); *Fidelity Ins. Trust & Safe Deposit Co. v. Shenandoah Valley R.R.*, 86 Va. 1, 9 S.E. 759 (1889). Unfortunately, the cases have not delineated how explicit a "specific act" must be to be tantamount to an express declaration. See *City Natl. Bank v. Fuller*, 52 F.2d 870 (8th Cir. 1931); *Travis v. Central Sur. & Ins. Corp.*, 117 F.2d 595 (5th Cir. 1941).

17. See generally cases collected at 61 A.L.R.2d 755 (1958).

lected like any other account payable. Blue Jay may be bankrupt itself.<sup>18</sup> Then the trustees would still want to pursue Seagull. Under such circumstances, pure novation analysis still gives a fairer result than a broad identity of interest exception. The proper inquiry should be: *At the time of the alleged novation* (when Albatross paid Seagull), was Blue Jay's promise to repay Albatross "reasonably equivalent value"? If so, then the novation should be upheld as non-fraudulent despite Blue Jay's subsequent misfortune, and Seagull should remain immune from attack. If, on the other hand, Blue Jay was insolvent when Albatross paid Seagull, then its promissory note was of questionable worth—less than reasonably equivalent value—and Albatross's payment to Seagull should be avoided. Once more, the presence or absence of an identity of interest between Albatross and Blue Jay is irrelevant.

The cases most often cited as establishing the identity of interest exception have recognized the value of a novation analysis. Indeed, the most frequently cited case actually looked for a novation without ever referring to identity of interest.<sup>19</sup> Some courts, however, looking at the close relationship involved, used the term "identity of interest" to buttress their novation analysis,<sup>20</sup> and others lapsed into making it a flawed independent standard.<sup>21</sup> By doing away with the

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18. The insolvency of the party accepting the others' debt does not affect the status of the novation. *See Riber v. Morris*, 279 Mich. 344, 272 N.W. 700 (1937).

19. *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*, 109 F.2d 924 (2d Cir. 1940). *See text at notes 28-29 infra.*

20. *See, e.g., Hofer v. Marion Lumber Co.*, 233 F. Supp. 540, 542 (E.D.S.C. 1964), which unnecessarily emphasized the overall pattern of operations of the affiliates over time; *Mandel v. Scanlon*, 426 F. Supp. 519, 524 (W.D. Pa. 1977), which also overemphasized a "history of business dealings" between a parent corporation and its subsidiary.

*See also Central Natl. Bank v. Coleman (In re B-F Bldg. Corp.)*, 312 F.2d 691 (6th Cir. 1963). In *B-F Bldg. Corp.*, Baird was president and controlling shareholder of two firms, B-F Building Corp. and Baird-Foerst Corp. Baird-Foerst borrowed \$10,000 from the bank in exchange for an unsecured note. Baird-Foerst then gave the funds to B-F, receiving no consideration in return. Later, when both B-F and Baird-Foerst were on the verge of bankruptcy, B-F gave the bank a promissory note for \$10,000, secured by its land. In return, the bank relinquished Baird-Foerst's earlier promissory note. The court upheld the contention of the creditors' trustee that the last-minute substitution of a fully secured note for an "unsecured and probably worthless" note was a fraudulent transfer. That assessment was probably accurate, but one is left to wonder what could possibly present a more compelling case for "identity of interest." More precisely, one should wonder whether the case offered an appropriate setting for a consolidation. *See text at notes 22-24 infra.*

21. In *Klein v. Tabatchnick*, 418 F. Supp. 1368 (S.D.N.Y. 1976), Tabatchnick and Emmer were the principal shareholders in JNT, a small brokerage firm. Using securities furnished by Joseph Taub as collateral, Tabatchnick borrowed \$50,000 from a bank. In turn, Tabatchnick lent the \$50,000 to JNT for its operations. When Taub asked for his securities back, Emmer offered some of his own securities as replacement collateral. In return, Tabatchnick gave Emmer certain JNT securities. When JNT went bankrupt, the trustees for JNT's creditors argued that the delivery of JNT securities to Emmer was a fraudulent transfer. The court searched for an identity of interest and found none, since "[t]here is no evidence of any comingling of Tabatchnick's and JNT's assets or business affairs, or of the existence of common debts . . .

exception and looking instead at the parties' true understanding of the transaction, courts can avoid repeating these unjust results.

### B. Consolidations

Novation can often explain inter-affiliate transfers that would otherwise complicate bankruptcy proceedings. But novation can only account for simple transfers; where affiliates had many dealings, novation is inadequate to untangle them. In such tangled situations, courts still need not resort to searching for identity of interest; they can consolidate the accounts of the affiliates. Consolidation allows the court to treat the affiliates in law as they are already treating themselves in fact: as one entity. It provides the same advantages for debtors and creditors as novation and, like novation, it is well-established and easily applied.<sup>22</sup> Again, although identity of interest might be a good reason to consolidate accounts, it is hardly a prerequisite for consolidation.

Consider once more the case of Albatross and Blue Jay. But now assume that they purchase supplies not only from Seagull but also from companies Tern, Ugly Duckling, Vulture, and Wren. Neither Albatross nor Blue Jay keeps accurate records and they rarely know which company has ordered or received which supplies. Each pays for supplies out of cash on hand, regardless of who ordered them, and it is impossible to tell who paid for what. When Albatross goes bankrupt, its creditors want to recover the payments made on behalf of Blue Jay for which Albatross received no value. Neither identity of interest nor novation will treat this situation correctly: the fairest

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Nor is there any indication that JNT had some obligation to fulfill with respect to the arrangement between Tabatchnick and Emmer." 418 F. Supp. at 1372-73.

Apparently, the court did not see that Tabatchnick was acting purely as JNT's intermediary in his borrowing. Novation theory would more equitably and accurately have handled the situation: JNT furnished securities to Emmer in exchange for Emmer's agreement to give Tabatchnick collateral. Since Tabatchnick used that collateral solely for a loan to JNT, JNT's transfer to Emmer was hardly fraudulent. It was directly in exchange for the continuance of the Tabatchnick loan. The court's focus on the term "identity of interest" distracted it from a more accurate analysis.

Similarly, the court in *Older v. Winslow* (*In re Winslow Plumbing, Heating & Contracting*), 424 F. Supp. 910 (D. Conn. 1976), sought but did not find an identity of interest. The Winslows sold all the stock of a solvent Winslow P.H. & C. to the Nutmeg Co. To sweeten the deal, the Winslows agreed to convey some of their land in Vermont to Winslow P.H. & C. before they consummated the sale to Nutmeg. Unfortunately, Winslow P.H. & C. went bankrupt before Nutmeg finished its payments to the Winslows. The Winslows bought back their stock in Winslow P.H. & C. and then transferred the Vermont land back to themselves. The trustee for Winslow P.H. & C.'s creditors challenged the retransfer of the land as fraudulent. The court found no identity of interest between Winslow P.H. & C. and Nutmeg and therefore avoided the transfer. 424 F. Supp. at 915.

22. See e.g., *Pepper v. Litton*, 308 U.S. 295 (1939); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939); *Chemical Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966); *Soviero v. Franklin Natl. Bank*, 328 F.2d 446 (2d Cir. 1964); *Stone v. Eacho*, 127 F.2d 284 (4th Cir.), cert. denied, 317 U.S. 635 (1942); *Commerce Trust Co. v. Woodbury*, 77 F.2d 478 (8th Cir. 1935).



result will come from combining the accounts to the benefit of both companies' creditors. Under the identity of interest analysis, courts would wrestle to determine for which payments Blue Jay had received adequate consideration. Dozens or even hundreds of payments, often poorly recorded, would complicate this task, and some creditors would suffer. If the court could find novations, it could protect creditors, but the intermingled accounts might not allow the necessary isolation of disputed transfers.

The court is not helpless, however. It could consolidate the accounts of Albatross and Blue Jay to hold that they should be treated as one entity, Federated Flock. Given the affiliates' extensive intermingling, this technique gives the closest possible approximation to what actually existed. Such a consolidation will produce one of three situations:

1) Blue Jay's financial strength will pull Albatross out of bankruptcy. If a consolidated Federated Flock would be solvent, then Albatross's petition for bankruptcy should be withdrawn, since Albatross would never have filed for bankruptcy if it had legally merged with a strong Blue Jay. All creditors are fully paid.

2) A bankrupt Albatross will be consolidated with an also-bankrupt Blue Jay. Here, consolidation would merely allow a more equitable distribution to the affiliate's creditors. For example, without consolidation, Albatross's unsecured creditors might recover 10% of their debts while Blue Jay's creditors recovered 70%. If the two firms were effectively operating as one, Albatross's and Blue Jay's creditors should receive the same percentage of the amount owed them.

3) Albatross's bankruptcy will pull a solvent Blue Jay into bankruptcy. Consolidation would have the same effect as if the two firms had voluntarily merged before bankruptcy. It might make the creditors of Blue Jay lose some money, but this result is not unfair. Albatross's creditors were actually subsidizing Blue Jay's creditors; and it would be more unfair to force one group of creditors to take a greater loss when the two affiliates were actually operating as one business. In reality, the joint business Federated Flock was bankrupt, and all its creditors should be treated equally.

Some cases dealing with complex transfers between affiliates have recognized that consolidation ultimately underlies the identity of interest analysis.<sup>23</sup> But the term "identity of interest" has assumed a life of its own, and courts have followed it to the wrong result.<sup>24</sup>

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23. See *McNellis v. Raymond*, 287 F. Supp. 232 (N.D.N.Y. 1968), *revd. on other grounds*, 420 F.2d 51 (2d Cir. 1970), discussed in text at notes 26-27 *infra*.

24. In *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823 (5th Cir. 1959), Gray was the proprietor of W.A. Gray Construction Co. and was also president and sole shareholder of the incorporated Twin City Construction Co. Twin City's creditors sued Pioneer Bank & Trust to recover three payments from Twin City to the bank. In one, Gray had borrowed \$50,000 from the bank and deposited it in Twin City's account in exchange for \$49,500 worth of Twin City

Modern courts should realize that consolidation is the more precise and easily applied remedy to regulate bankrupt affiliates and should restore it to the center of their analyses.

### III. DISTINGUISHING NOVATION FROM CONSOLIDATION

Novation and consolidation can solve many of the problems posed by the bankruptcy of affiliates while avoiding the difficulties of the identity of interest exception. Nevertheless, courts must decide which doctrine — novation or consolidation — to apply. This decision is important: in many cases finding a novation will be difficult or impossible, but if consolidation is used too widely, it will needlessly disturb both debtors and creditors. In fact, however, the choice is not usually difficult and where the decision is a close one, generally accepted accounting principles (GAAP)<sup>25</sup> will readily point the court in the right direction.

Usually, courts can easily determine whether the interest transferred by an affiliate merits simple novation treatment or the more extreme medicine of consolidation. In *McNellis v. Raymond*,<sup>26</sup> for example, the court applied the identity of interest exception in circumstances that cried out for consolidation. Donald Potter had brokered real estate through Potter Real Estate Company. His father was the 98% owner, president, and treasurer of Potter Securities Corporation and also consulted for the real estate company. The Potters operated the two businesses as one unit, drawing the formal distinction only for tax and licensing purposes. Thus, Potter Securities often purchased property for Potter Real Estate without any consideration. Over a four-year period, Isadore Raymond lent Potter Securities over \$500,000, fully aware of the two firms' integration. During that time, Potter Real Estate slowly repaid the allegedly usurious loans. The trustee in bankruptcy for Donald Potter's creditors sued to avoid the payments as fraudulent transfers of Potter Real Estate funds.<sup>27</sup> Clearly, the court did not need to worry about an identity of interest in that case. It could have ordered a consolidation of the two firms by virtue of the pervasive intermingling of corporate assets. The words of the Second Circuit in *Chemical Bank*

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stock. When Gray's venture fell through, he had Twin City repay the bank \$50,125. The trustee challenged this payment as being without fair consideration. 270 F.2d at 831. The court held that there was such a degree of identity and comingling of affairs between Twin City and Gray that the corporation and its sole stockholder could not be regarded as separate legal entities, insofar as the \$50,000 loan was concerned. 270 F.2d at 831. But after noting that "there was no proof of actual intent to defraud creditors of Twin City," the court rejected the trustee's claim. 270 F.2d at 831. Yet that analysis did not consider the years of intermingling between the affiliates; consolidation would have meted out more complete justice.

25. "Generally Accepted Accounting Principles" are the accounting concepts applied by the American Institute of Certified Public Accountants.

26. 287 F. Supp. 232 (N.D.N.Y. 1968), *revd. on other grounds*, 420 F.2d 51 (2d Cir. 1970).

27. 287 F. Supp. at 238-39.

*New York Trust Co. v. Kheel*<sup>28</sup> are instructive:

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 its interrelationship with others. Yet . . . where the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.<sup>29</sup>

At the other extreme are cases like *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*.<sup>30</sup> Ironically, *Barr & Creelman* is frequently cited as establishing the identity of interest exception, even though it never employed the term. Dolomite Marine Corporation had ordered shipbuilding materials from Barr & Creelman. The materials were delivered to Dolomite 3, a wholly owned subsidiary of Dolomite Marine, which used the materials to construct a ship and issued three checks, totaling \$6000, to Barr & Creelman. When Dolomite Marine and Dolomite 3 both filed for reorganization, the trustee for Dolomite 3's creditors attacked the \$6000 payment as fraudulent, since it was made to satisfy an obligation that had formally been incurred by Dolomite Marine. The court refrained from finding a novation, commenting that "the meager record does not afford means of determining whether such a novation actually occurred."<sup>31</sup> Yet novation is indeed the proper inquiry in such a case. If Dolomite 3 was paying Dolomite Marine's debt in exchange for Dolomite Marine's equity in the shipbuilding materials (as was almost certainly the case), the single transaction may be analyzed as a novation, without resort to either total consolidation or the cumbersome identity of interest inquiry.

Cases are not always so conveniently extreme. Some posing the problem treated in this Note will fall into a muddy grey area, where the affiliates at least arguably maintained separate identities, but also allowed their accounts to become substantially intertwined. The measure of any legal standard is how accurately and easily it draws a line through such a grey area. As we have seen, the identity of interest exception comes up short. Yet a relatively simple standard solves the dilemma and permits us to apply with confidence the elegantly simple tools of novation and consolidation. At present, bankrupt en-

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28. 369 F.2d 845 (2d Cir. 1966). Manuel Kulukundis owned or controlled eight shipping lines; he shifted funds back and forth among them in furtherance of his master business plan. All went bankrupt at the same time. Since "auditing of the corporations' financial condition and especially the inter-company relationships would entail great expenditure of time and expense without assurance [of] a fair reflection . . . of the debtor corporations," the court ordered all assets and liabilities consolidated. 369 F.2d at 846.

29. 369 F.2d at 847.

30. 109 F.2d 924 (2d Cir. 1940).

31. 109 F.2d at 926.

tities, including affiliates, are presumed to be distinct. This presumption should remain undisturbed since novation theory will precisely explain most transfers between affiliates. However, if the independent auditors appointed by the court find that the application of generally accepted accounting principles (GAAP) cannot accurately disentangle the affiliates' affairs, then the court should order consolidation.

This standard would give the accountants the burden of determining whether the affiliates' finances can be distinguished — appropriately so, since they are better able to make such a decision than judges. The standard is not expensive, since it requires little more work than the auditors must already perform. Moreover, the standard is far more precise than the identity of interest exception and therefore makes planning easier. Some uncertainty will always remain in the grey area, but reliance on GAAP leaves much less uncertainty than the identity analysis.

#### CONCLUSION

Bankruptcy cases involving inter-affiliate transfers are inherently difficult. Some judges in complex bankruptcy proceedings have tried to correlate law with apparent equity by using an identity of interest exception to the fraudulent transfers doctrine. However, the exception is itself inequitable, allowing two affiliated corporations to be united for some purposes and distinct for others. In the interest of consistency and fairness, the courts should refrain from applying the identity of interest exception to allegedly fraudulent transfers. Instead, they should rely on the less troublesome concepts of novation and consolidation to achieve just results.