# Do You Blur the Lines Between Your Separate Companies? The Courts Might Too.

Is your business divided into separate entities? It isn't an uncommon practice. Business owners often establish separate legal entities to manage different aspects of their business. One reason for doing so is to prevent the assets of one entity from being used to satisfy the debts of another entity.

This can be effective, but an owner's failure to treat the entities as truly separate can hurt in litigation. If an owner does not act as though the entities are separate, then the courts may also treat the separate legal entities as if they were one, with all of the combined assets of the merged entities being available to satisfy creditors of all entities. This remedy is called "substantive consolidation", and it was recently utilized by the US Bankruptcy Court for the District of Massachusetts in the case of *In re. Cameron Construction & Roofing Co., Inc.*

In this case, one individual was the majority owner of two limited liability companies. One LLC ("LLC A") was responsible for the day-to-day operations of a roofing business, while the second LLC ("LLC B") owned the real estate occupied by the business (and had substantial assets compared to LLC A). Even though the two LLCs followed the basic corporate formalities of filing separate tax returns and annual reports, the court granted the remedy of substantive consolidation based on the following, non-exhaustive, list of factors:

- There was common ownership of the two LLCs and intermingled assets.
- The two LLCs failed to perform other corporate formalities, such as corporate record keeping or payment of distributions.
- LLC B engaged in business outside the scope of the purpose stated in its Operating Agreement and Certificate of Organization. In particular, it permitted its employees to do work for LLC A and never invoiced LLC A for the services it provided.
- There was no written lease between LLC A and LLC B for the space utilized by LLC A, and LLC A paid higher than market rent to LLC B for the space.
- LLC A was thinly capitalized.
- The capital structure of the two entities was unfair to LLC A, as LLC A made a 10% capital contribution to LLC B but only owned 1% of the equity in LLC B.
- Any harm caused by allowing substantive consolidation was outweighed by the benefits to the creditors of LLC A.

**Conclusion**

How can you prevent your business entities from being substantively consolidated? Merely following basic corporate formalities is not sufficient to avoid the remedy of substantive consolidation. Business owners must avoid making the mistakes highlighted above and should always treat separate entities as truly separate.

All business owners who own multiple business entities should review their policies and procedures to ensure that their entities are consistently operated as separate and distinct in all respects. If you have questions regarding the structure of your business, need assistance to untangle your business entities, or have any other questions on this topic, please contact Colin Coleman at cac@psh.com or Brian Reilly at bjr@psh.com.

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