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The Precarious Status of Substantive Consolidation as a Bankruptcy Remedy

By J. Andrew Rahl, Jr., John B. Berringer and Luma S. Al-Shibib

The continued viability of substantive consolidation, a remedy that had gained increasing popularity in recent years—particularly in complex bankruptcy cases involving multinational corporations, like Enron and Worldcom—was called into doubt by the August 2005 decision of the Third Circuit Court of Appeals in the *Owens Corning* bankruptcy case.[1] In that decision, the Third Circuit promulgated a new, more stringent standard for the award of substantive consolidation, expressly narrowing its scope and application.

The Third Circuit's opinion has been invoked in subsequent court decisions as a basis for denying substantive consolidation, particularly when other remedies exist—albeit costly and more timely ones—such as potential claims for fraudulent conveyance or potential remedies of equitable subordination. It is still unclear, however, whether the Third Circuit's standard will reverse the liberal trend that has made substantive consolidation an often-used remedy in complex bankruptcy cases involving multi-tiered conglomerates.

What Is Substantive Consolidation?

Substantive consolidation is an equitable remedy that permits a bankruptcy court to ignore corporate distinctions, combine the assets and liabilities of separate and distinct—but related—legal entities into a single pool, and treat them as though they belong to a single entity. The consolidated assets create a single fund from which all claims against the consolidated debtors are satisfied; the merged companies' inter-company claims are extinguished; and the creditors of the consolidated entities are combined for purposes of voting on plans of reorganization. "The primary purpose of substantive consolidation 'is to ensure the equitable treatment of all creditors.'" *Bonham v. Compton (In re Bonham)*, 229 F.3d 750, 764 (9th Cir. 2000) (citations omitted).

No uniform test exists to determine when this remedy should be granted; most courts examine a checklist of various factors to determine whether a substantial identity or single economic identity existed among the debtors, including, but not limited to: the existence of a unity of interests and ownership, the degree of difficulty in segregating individual assets and liabilities, the observance of corporate formalities, and the commingling of business functions.

Owens Corning Decision

In *Owens Corning*, the proponents of substantive consolidation sought to combine the assets of, and claims against, Owens Corning and its subsidiaries and affiliated entities into a single pot in which all creditors of the consolidated entity would share. A consortium of bank creditors, which had loaned Owens Corning approximately $1.3 billion, opposed substantive consolidation because, if granted, guarantees given to the banks by certain "substantial" Owens Corning subsidiaries would be "washed away" in the consolidation, leaving the banks on an equal footing with the rest of Owens Corning's unsecured creditors. The trial court held that despite the potential harm to the banks, substantive consolidation best served the interests of all parties. 316 B.R. 168 (Bankr. D. Del. 2004).

The Third Circuit reversed, finding the grant of substantive consolidation improper and, instead, propounded a new standard requiring

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"Substantive Consolidation continued from p1

a proponent of the remedy to prove that: "(i) prepetition [the debtors and their affiliates] . . . disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."

To establish a *prima facie* case under the first rationale, proponents must show that "in their prepetition course of dealing, they actually and reasonably relied on debtors' supposed unity." Conversely, a creditor can defeat a *prima facie* showing by demonstrating actual reliance on the debtors' separate existence and harm it would suffer if substantive consolidation was granted.

The consequence of the Third Circuit's formulation is that it renders the first rationale virtually impossible to sustain: nothing short of hopeless commingling of the individual entities' assets and liabilities will suffice to warrant substantive consolidation. As to the second rationale, commingling justifies substantive consolidation only when an attempt to unscramble assets would "reduce the recovery of *every* creditor—that is, when every creditor will benefit from the consolidation. … Mere benefit to some creditors, or administrative benefit to the Court, falls far short." The impossibility of perfection in untangling the affairs of the debtors does not constitute a sufficient basis to warrant the grant of substantive consolidation.

In applying this standard to *Owens Corning*, the Third Circuit rejected the trial court's finding of substantial identity between Owens Corning and its subsidiaries. Instead, it decided that substantive consolidation, under the "significantly-disregarded-separateness" rationale, was not warranted because the existence of subsidiary guarantees on the banks' loan demonstrated that the entities' corporate separateness was recognized prepetition. Neither was the remedy justified under the second rationale since there existed no evidence of hopeless entanglement.

Also, the Third Circuit rejected outright two established corollaries of substantive consolidation. First, it eliminated the use of "deemed" consolidations (*i.e.*, those which effectuate no actual merger but merely deem entities consolidated for the limited purpose of voting on, and determining distributions under, a plan of reorganization). Second, the use of substantive consolidation to alter contractual rights and change the relative positions of various groups of creditors in the plan negotiation process was prohibited. The circuit court cautioned that substantive consolidation should not be used as a "free pass" to spare the proponent of the remedy from pursuing harder-to-prove alternatives such as fraudulent transfer claims, and veil piercing and equitable subordination remedies.

The Third Circuit's decision sought to raise the bar on establishing a *prima facie* showing for substantive consolidation and to effectuate a shift away from the "liberal" trend in favor of reliance upon, and utilization of, substantive consolidation in bankruptcy reorganizations.

Aftermath: Decisions Issued Since the Third Circuit's New Standard

Since the Third Circuit's articulation of its new standard, only a few decisions have addressed the issue of substantive consolidation. For example, in *Wells Fargo Bank of Texas, N.A. v. Sommers (In re Amco Ins.)*, 444 F.3d 690, 697 (5th Cir. 2006), the court reversed the grant of substantive consolidation, in part, because as articulated in *Owens Corning*, the remedy rarely should be granted, granted only as a last resort, and not when alternative remedies such as the alter ego doctrine and fraudulent conveyance claims otherwise may be available.

In New York, where federal courts are bound by the less restrictive *Augie/Restivo* test (propounded in *Union Sav. Bank v. Augie/Restivo Banking Co., Ltd. (In re Augie/Restivo Banking Co., Ltd.)* 860 F.2d 515 (2d Cir. 1988)), *Owens Corning* has been cited recently as authority for the denial of substantive consolidation. In *Official Committee of Unsecured Creditors v. American Tower Corp. (In re Verestar, Inc.)*, 343 B.R. 444, 462 (Bankr. S.D.N.Y. 2006), the court, relying on *Owens Corning*, denied substantive consolidation because alternative remedies were available. Similarly, *In re Reserve Capital Corp.*, Nos. 03-60071-78, 2007 WL 880600, at *4 (Bankr. N.D.N.Y. Mar. 21, 2007), adopted the *Owens Corning* standard on the rationale that it

was an implementation of the *Augie/Restivo* test. Denying substantive consolidation, the bankruptcy court found (i) no evidence of prepetition dealings with the entities as a single unit, and (ii) the additional delay in case administration and creditor distributions caused by the need to untangle the entities' commingled affairs insufficient to warrant substantive consolidation.

Likewise, in *Steiert v. Guiliano, Miller & Co., L.L.C. (In re Macrophage, Inc.)*, No. Civ. 06-3793-94, 2007 WL 708926, at *6 (D.N.J. Mar. 2, 2007) a district court within the Third Circuit, citing *Owens Corning*, affirmed the denial of substantive consolidation on grounds that the remedy is one that rarely should be invoked.

The holdings of these cases imply a possible reversal of the liberal trend. Academics, however, who are not bound by *Owens Corning* as precedent, have been critical of the decision. Of these the harshest criticism has come from Professor William Widen, who formerly had been a corporate partner at a major New York law firm. Characterizing the Third Circuit's understanding of lending practices as "imperfect," Professor Widen opined that:

> Before the Third Circuit's decision in *Owens Corning* … no sophisticated lending syndicate ever relied on a mere covenant prohibiting merger, consolidation, or dissolution to create priority when the syndicate itself employed a web of guarantees. The reason for nonreliance on such covenants is simple: the market believed that the presence of intercompany guarantees virtually assured that imposition of substantive consolidation would be proper for any companies forming part of an intercompany guarantee web (and no competent counsel would have opined otherwise). In *Owens Corning*, rather than a *bona fide* case of reliance on asset partitions, we have a case of simple good fortune for the lenders: the asset partitions and guarantees happened to remain in place until the bankruptcy filing, and the continued presence of the guarantee structure afforded them a priority. William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 237, 279 (2007).

Another commentator has criticized the Third Circuit's standard because:

> placing such a high burden on a proponent just to make a *prima facie* case enables any creditor to defeat consolidation in virtually any case, whether or not that creditor itself reasonably relied on separateness and regardless of the benefits consolidation may provide. If consensual consolidation is permitted (as it is by *Owens*), no purpose is served by effectively giving every single creditor a veto over consolidation without having to prove that it is being unjustly injured. Such a veto is inconsistent with the notion of bankruptcy as a collective remedy that deprives each individual creditor of the right to veto debtor action unless its demands are met and, instead, permits a debtor to act to maximize aggregate value so long as the economic value of individual rights is protected. Seth D. Amera *et al.*, *Substantive Consolidation: Getting Back to Basics*, 14 AM. BANKR. INS. L. REV. 1, 34 (2006).

There are also a few cases that, while not rejecting the Third Circuit's reasoning outright, have reached a result contrary to the *Owens Corning* decision. Indeed, a Florida court, in *In re Winn-Dixie Stores, Inc.*, 356 B.R. 239, 252 (Bankr. M.D. Fla. 2006) held the *Owens Corning* standard inapplicable and distinguished its case upon the facts, noting that its case did not involve a deemed consolidation (as *Owens Corning* had) and, in any event, framing the issue before it not as one of substantive consolidation but whether to approve an agreement reached between the parties.

On the other hand, the District Court of New Jersey in *Lubetkin v. Official Committee of Unsecured Creditors (In re Lisanti Foods, Inc.)*, Civ. No. 04-3868, 2006 WL 2927619, at *1 (D.N.J. Oct. 11, 2006), purported to apply the new Third Circuit standard in upholding the grant of substantive consolidation. After the district court affirmed confirmation of the debtor's plan, creditors of the debtor filed an appeal to the Third Circuit. However, when the Third Circuit issued its decision in *Owens Corning*, the appellants sought re-argument in the district court on the basis that substantive consolidation was no longer warranted in light of the Third Circuit's new standard. The district court, while acknowledging "the significant change in the law of substantive consolidation wrought by the Third Circuit's decision in *Owens Corning*," denied reargument. Of particular importance was the district court's determination that the facts—which were similar to those that the Third Circuit cited in *Owens Corning* as a basis for denying substantive consolidation—satisfied the first prong of the new standard. The district court found "substantial" evidence that creditors had viewed the debtors as a single entity when extending credit: "each of the creditors dealt with the debtors on a combined basis where the financial risk was predicated on the total of the three entities. [Creditors] did not render credit to each individual debtor, but rather [to the] combined entity."

Conclusion

The long-term implications of the Third Circuit's standard are unclear. On the one hand, the new standard has received substantial deference from other courts and generally has been invoked to deny substantive consolidation. To that extent, *Owens Corning* has effectively called into question the continued efficacy of substantive consolidation. Counteracting this trend are the *Lisanti Foods* court and the critical views of academic observers. So, for the time being, the future of substantive consolidation remains murky.

[1] *In re Owens Corning*, 419 F.3d 195, 212 (3d Cir. 2005), *cert. denied sub nom., McMonagle v. Credit Suisse First Boston*, 126 S. Ct. 1910 (2006).

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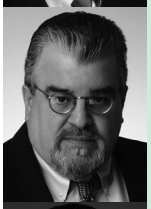

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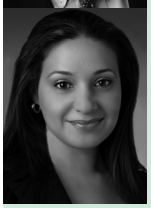

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Anderson Kill represented the interests of the bondholders and trade creditors in supporting substantive consolidation in the *Owens Corning* bankruptcy case.

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