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LEGAL ISSUES

3d Circuit Raises the Bar on Grants of Substantive Consolidation

Decision Reverses Ruling in *Owens Corning*

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It still may be too early to gauge the ultimate legacy that the 3d U.S. Circuit Court of Appeal's reversal of a trial court's grant of substantive consolidation in the *Owens Corning* bankruptcy case will have on reorganizations, securitizations, and business transactions in general. However, in propounding a new standard, the 3d Circuit raised the evidentiary bar necessary to establish a *prima facie* showing that substantive consolidation is warranted.

The appellate court issued its much-anticipated decision in *Owens Corning* in August 2005. Rather than relying on the standards articulated in previous cases on the issue, the 3d Circuit rejected outright the two leading substantive consolidation tests and instead adopted its own standard — one that expressly narrowed the scope and application of substantive consolidation, a remedy that has been used increasingly in recent years, particularly in complex bankruptcy cases involving multinational corporations.[1]

The opinion already has been touted in subsequent court decisions as a basis for denying substantive consolidation, particularly when other remedies exist — albeit costly and more time-consuming ones — such as potential claims for fraudulent conveyance or potential remedies of equitable subordination. It is still unclear, however, whether the 3d Circuit's new and more rigorous standard will reverse the liberal trend that has made substantive consolidation an often-used remedy in complex bankruptcy cases involving massive, multi-structured conglomerates.

In reversing the lower court ruling in *Owens Corning*, the 3d Circuit found no evidence of a pre-petition disregard of the separate corporate identities of the Owens Corning companies. Indeed, the court held that opponents of substantive consolidation had relied on this corporate separateness in extending credit to Owens Corning and obtaining guarantees from its related subsidiaries and affiliates. The appellate court further found no evidence that the debtors' accounts were so hopelessly entangled as to make disentanglement impossible.

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 of these entities 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).

Substantive consolidation was explicitly recognized by the U.S. Supreme Court as early as 1941. *See Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941). Historically and today, the Bankruptcy Court's power to order substantive consolidation is derived from its equity powers, as expressed in current Section 105 of the Bankruptcy Code. Although not codified by the Bankruptcy Reform Act of 1978,[2] courts continue to recognize the validity of substantive consolidation and have ordered it many times since the Bankruptcy Code was enacted. See *In re Owens Corning*, 419 F.3d 195, 208-09, n14 (3d Cir. 2005), *cert. denied sub nom. Official Representatives of the Bondholders and Trade Creditors v. Credit Suisse First Boston*, 126 S.Ct. 1910 (2006) (surveying cases discussing the authority to grant substantive consolidation).

No single uniform test exists to determine when substantive consolidation should be granted. Ultimately, however, "most courts have slipstreamed behind two rationales — those of the [2d] Circuit [as articulated in *Union Sav. Bank v. Augie/Restivo Banking Co., Ltd. (In re Augie/Restivo Banking Co., Ltd.)*, 860 F.2d 515 (2d Cir. 1988)] and the D.C. Circuit [as articulated in *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.)*, 810 F.2d 270 (D.C. Cir. 1987)]." *In re Owens Corning*, 419 F.3d at 207.

The decision has been cited subsequently to support the denial of substantive consolidation and indeed appears to be achieving that which it sought to accomplish — the reversal of the liberal trend in favor of substantive consolidation.

To reach a determination on the issue of substantive consolidation under the *Augie/Restivo* test, courts examine whether (i) prepetition, creditors dealt with the entities proposed to be consolidated as a single economic unit and did not rely on their separate identity in extending credit, or (ii) the affairs of the debtors are so entangled that consolidation will benefit all creditors. *Id.* at 207-08 (quoting *In re Augie/Restivo Banking Co., Ltd.*, 860 F.2d at 518).

The *Auto-Train* test, while similar, seeks to determine whether a substantial identity exists between the parties sought to be consolidated and holds that consolidation is warranted, in spite of creditor reliance on separateness, when the demonstrated benefits of consolidation heavily outweigh the harm. *Id.* at 208 (quoting *In re Auto-Train Corp.*, 810 F.2d at 276). Under either set of tests, courts examine various factors, including 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.

Prior to the appeal to the 3d Circuit, the *Auto-Train* test was applied by the trial court in *Owens Corning* to decide the issue of substantive consolidation.

Owens Corning Decision

In the *Owens Corning* bankruptcy case, proponents of substantive consolidation sought to combine the assets of, and claims against, Owens Corning and all of 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 loaned Owens Corning about $1.3 billion, opposed substantive consolidation. If it were granted, guarantees given to the banks by certain "substantial" Owens Corning subsidiaries would be "washed away" in the consolidation, leaving them on an equal footing with the rest of Owens Corning's unsecured creditors.

Prior to the new standard articulated by the 3d Circuit in its August 2005 decision, the trial court held that, despite the potential harm to the banks, substantive consolidation of the Owens Corning organization best served the interests of all parties. 316 B.R. 168 (Bankr. D. Del. 2004).

The 3d Circuit reversed the trial court's decision, finding that the lower court had granted the motion for substantive consolidation improperly. In so doing, the 3d Circuit propounded a new standard for substantive consolidation, which — unlike standards adopted by other courts in the past — shied away from using a set of "prefixed factors" to direct the analysis of the issue. *In re Owens Corning*, 419 F.3d at 210. Instead, the 3d Circuit approached the substantive consolidation inquiry guided by principles that it identified as giving a rationale to the remedy:

1. Courts should respect the separateness of corporate entities absent compelling circumstances to do otherwise.
2. Substantive consolidation was created to remedy harm caused by the debtors that disregarded their corporate separateness (as opposed to harm caused by creditors, which can be remedied through the various avoidance provisions of the Bankruptcy Code).
3. Mere benefit to the administration of the estate (*i.e.*, making post-petition accounting more convenient) is not a "harm" for which the remedy of substantive consolidation should be invoked.
4. Substantive consolidation is an extreme, imprecise remedy that should be rarely invoked and, in any event, is a remedy of "last resort."
5. Substantive consolidation may be used defensively to remedy the harms of entangled affairs, but it may not be used offensively (*i.e.*, for the primary purpose of altering creditor rights in the plan process). *Id.* at 211.

Guided by these principles, the 3d Circuit announced that its new standard would require a proponent of substantive consolidation 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) post-petition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors." *Id.*

To establish a *prima facie* case under the first rationale of the 3d Circuit's new standard:

> Proponents who are creditors must also show that, in their prepetition course of

> dealing, they actually and reasonably relied on debtors' supposed unity. Creditor opponents of consolidation can nonetheless defeat a *prima facie* showing … if they can prove they are adversely affected and actually relied on debtors' separate existence. *Id.* at 212.

Under the second rationale of the new standard, nothing short of hopeless commingling of the individual entities' assets and liabilities is sufficient to warrant a grant of substantive consolidation. *Id.* at 214. Thus, commingling justifies substantive consolidation "only when separately accounting for the assets and liabilities of the distinct entities will 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." *Id.* (emphasis in original). Additionally, the impossibility of perfection in untangling the affairs of the debtors does not constitute a sufficient basis to warrant the grant of substantive consolidation. *Id.* at 214-15.

Applying the newly articulated standard to the *Owens Corning* case, the 3d Circuit rejected the trial court's conclusion of substantial identity between Owens Corning and its subsidiaries. *Id.* at 214. The appellate court noted that the case did not warrant substantive consolidation under the first rationale (requiring a prepetition disregard of corporate separateness) because the existence of the subsidiary guarantees obtained by the banks to secure Owens Corning's loan demonstrated that the entities' corporate separateness was recognized pre-petition. *Id.* at 213.

The court also found substantive consolidation unwarranted under the second rationale (requiring hopeless commingling of the separate entities' assets and liabilities in order to grant substantive consolidation). *Id.* at 214. The 3d Circuit found no evidence of hopeless entanglement or that "the cost of untangling [the debtors' affairs would be] so high relative to the [debtors'] assets that the banks, among other creditors, [would] benefit from consolidation." *Id.* at 215.

Notably, the 3d Circuit also rejected outright two established aspects of substantive consolidation. First, the court eliminated the use of "deemed" consolidations (*i.e.*, consolidations that do not effectuate an actual merger of the related companies under applicable state corporate law but deem them consolidated for the limited purpose of voting on, and determining distributions under, a plan of reorganization). *Id.* at 216.

Second, the appellate court prohibited the use of substantive consolidation to alter contractual rights and thus change the relative positions of the various groups of creditors in the plan negotiation process. *Id.* at 212-213, 216. Rather, the 3d Circuit cautioned that substantive consolidation should not be used as a "free pass" to spare the proponent of the remedy from pursuing harder-to-prove alternative claims and remedies such as veil piercing, fraudulent transfer and conveyance claims, and equitable subordination. *Id.* at 206, 214.

The 3d Circuit's decision, by its own words, attempted to raise the bar on establishing a *prima facie* showing for substantive consolidation and sought to effectuate a shift away from what previously had been described as the "liberal" trend in favor of reliance upon and use of substantive consolidation in bankruptcy restructurings and reorganizations. See *id.* at 209, 210.

Aftermath

Few decisions have dealt with the issue of substantive consolidation directly since the 3d Circuit's articulation of the new standard in *Owens Corning*. While it may be too soon to determine the full impact of the decision, the few opinions issued since the 3d Circuit's pronouncements in *Owens Corning* are instructive as to the future viability of substantive consolidation as a remedy in bankruptcy cases.

The decision has been cited subsequently to support the denial of substantive consolidation and indeed appears to be achieving that which it sought to accomplish — the reversal of the liberal trend in favor of substantive consolidation. Indeed, courts in the 5th Circuit, the 2d Circuit, and within the 3d Circuit all have supported their refusal to grant substantive consolidation on, among other things, the 3d Circuit's pronouncement in *Owens Corning* that substantive consolidation is a drastic remedy that is to be used rarely.

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 5th U.S. Circuit Court of Appeals reversed the U.S. District Court 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 granted when alternative remedies such as the alter ego doctrine and fraudulent conveyance claims otherwise may be available.

Likewise, New York District Courts, which are bound by the 2d Circuit's *Augie/Restivo* test, nevertheless have used the *Owens Corning* test as support for their refusal to grant substantive consolidation. In fact, one New York Bankruptcy Court, in *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 based upon the *Augie/Restivo* test.

That court denied substantive consolidation because (i) there was 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 was not sufficient to warrant substantive consolidation. *Id.* at **4, 5. Similarly, 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 Bankruptcy Court for the Southern District of New York relied on the *Owens Corning* decision to deny substantive consolidation when alternative remedies were available to be pursued.

Additionally, 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), applying the 3d Circuit's standard, the District Court affirmed the denial of substantive consolidation sought by the appellant in the case on grounds that the remedy is one that should scarcely be invoked.

The holdings of these cases imply a possible shift or reversal of the liberal trend in favor of substantive consolidation. Cases reaching the opposite result are few and far between, and no court to date has been bold enough to directly challenge the 3d Circuit's test. Indeed, rather than rejecting the test outright as non-binding, a Florida Bankruptcy Court, in *In re Winn-Dixie Stores, Inc.*, 356 B.R. 239, 252 (Bankr. M.D. Fla. 2006), instead held the *Owens Corning* standard inapplicable and distinguished its case upon

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the facts. That court held the 3d Circuit's standard inapplicable because the *Winn-Dixie* case did not involve deemed consolidations and, in any event, framed the issue before it not as one of substantive consolidation but of whether to approve an agreement reached between the parties. *Id.* at 252.

On the other hand, the District Court of New Jersey in *Lisanti v. Lubetkin (In re Lisanti),* Civ. No. 04-3868, 2006 WL 2927619, at *1 (D.N.J. Oct. 11, 2006), applying the new 3d Circuit standard, denied appellants' motion for reconsideration of its order upholding the Bankruptcy Court's grant of substantive consolidation. In *In re Lisanti*, the District Court issued its decision affirming the grant of substantive consolidation one week before the 3d Circuit published its newly articulated standard in the *Owens Corning* case. *Id.* at *7.

On reconsideration, the appellants argued that substantive consolidation was no longer warranted in light of the 3d Circuit's new standard. *Id.* at *8. The District Court disagreed. While the District Court recognized that "outright reversal…or remand to the bankruptcy court may indeed be warranted in many cases pending on appeal that were decided under the pre-*Owens Corning* law," *Lisanti* was not one of those cases because ample evidence existed supporting the grant of substantive consolidation under the first prong of the new 3d Circuit standard. *Id.*

Indeed, the court found "substantial" evidence in the record demonstrating that creditors viewed the debtors as a single entity when extending credit. *Id.* Specifically, "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." *Id.*

The outcome of *Lisanti* raises a number of issues in light of the other post-*Owens Corning* decisions denying substantive consolidation. Will *Lisanti* be the only case since *Owens Corning* that presents evidence that, under the 3d Circuit's new standard, justifies the grant of substantive consolidation? Or does *Lisanti* represent a rare instance in which substantial record evidence was presented that warranted substantive consolidation even under the *Owens Corning* standard? For the time being, these issues remain unresolved.

Widespread Impact

The long-term implications of the 3d Circuit's new standard are still unclear. It appears, however, that the standard has received early deference and respect nationwide and, at least for the time being, is being used by the majority of courts addressing the issue of substantive consolidation to deny the remedy. With the one exception of *Lisanti*, all indications point to an apparent trend away from substantive consolidation. The *Owens Corning* decision thus effectively has called into question the viability of substantive consolidation as a Chapter 11 remedy.

[1] See, *e.g.*, the bankruptcy cases of *In re Enron Corp.*, U.S. Bankruptcy Court for the Southern District of New York, Case No. 01-16034, Confirmation Order (Docket No. 19759) and Modified Fifth Amended Plan (Docket No. 19477), and *In re Woldcom, Inc.*, U.S. Bankruptcy Court for the Southern District of New York, Case. No. 02-13533, Modified Second Amended Plan (Docket No. 9525) and Confirmation Order (Docket No. 9686), in which substantive consolidation disputes played a critical role in the reorganization process.

[2] There is a passing reference to substantive consolidation in the marital context. See 11 U.S.C. Section 302(b) (authorizing a bankruptcy court to determine the extent, if any, to which the estates of a husband and wife are to be consolidated upon the commencement of a joint bankruptcy case).

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Anderson Kill & Olick, P.C. represented the interests of bondholders and trade creditors in supporting substantive consolidation on the Owens Corning bankruptcy case.

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