Third Circuit Raises the Bar for Substantive Consolidation

September/October 2005

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The substantive consolidation of two or more entities is an important tool available to a bankruptcy court overseeing the cases of related companies whose financial affairs are hopelessly entangled or whose separate corporate identities otherwise have been disregarded by those in control or the companies' creditors. In deciding whether to consolidate two or more estates, a court must conduct a factually intensive inquiry and carefully balance the competing concerns of all interested parties. In the December 2004 edition of the *Business Restructuring Review* (vol. 3, no. 7), we examined a ruling handed down by the Delaware district court overseeing the chapter 11 cases filed by Owens Corning and its subsidiaries. The outcome had dire ramifications for the companies' lenders — the court authorized the deemed consolidation of the debtors' estates, thereby invalidating guarantees issued to the lenders by the debtor subsidiaries. That decision recently was reversed by the Third Circuit Court of Appeals. In *In re Owens Corning*, the Third Circuit emphasized that substantive consolidation is a remedy that should be invoked sparingly and only under very narrowly defined circumstances.

Substantive Consolidation

The bankruptcy court is a court of "equity." Although the distinction between courts of equity and courts of law largely has become irrelevant in modern times, courts of equity traditionally have been empowered to grant a broader spectrum of relief in keeping with fundamental notions of fairness as opposed to principles of black-letter law. This means that a bankruptcy court can exercise its discretion to produce fair and just results "to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." The remedies available to a bankruptcy court in exercising this broad equitable mandate include the power to invalidate pre-bankruptcy transfers that are fraudulent or preferential, the ability to "pierce the corporate veil" if a subsidiary is nothing more than its parent's "alter ego," and the power to reorder the priority of claims or interests (*i.e.*, equitable subordination) in cases of misconduct.

A bankruptcy court also can treat the assets and liabilities of two or more separate but related entities as inhering to a single integrated bankruptcy estate. Employing this tool, courts, in effect, "pierce the corporate veil" to satisfy claims of the creditors of the consolidated entities from their common pool of assets. This remedy is referred to as "substantive consolidation."

The Bankruptcy Code does not expressly countenance substantive consolidation (although it recognizes that a chapter 11 plan may provide for the consolidation of a "debtor with one or more persons "as a means of implementation). Rather, substantive consolidation is "a product of judicial gloss." Courts consistently have found the authority for substantive consolidation in the bankruptcy court's general equitable powers as set forth in section 105(a) of the Bankruptcy Code, which authorizes the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." Some courts have expanded the reach of the remedy further to allow the consolidation of debtors with non-debtors. Nevertheless, because of the dangers of forcing creditors of one entity to share equally with creditors of a less solvent debtor, "substantive consolidation 'is no mere instrument of procedural convenience . . . but a measure vitally affecting substantive rights'" Accordingly, courts generally hold that it is to be used sparingly.

Different standards have been employed by courts to determine the propriety of substantive consolidation. All of them involve a fact-intensive examination and an analysis of consolidation's impact on creditors. For example, in *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, the Eleventh Circuit adopted, with some modifications, the standard enunciated by the District of Columbia Circuit in *In re Auto-Train Corp., Inc.* At the outset, the Eleventh Circuit emphasized that the overriding concern should be whether "consolidation yields benefits offsetting the harm it inflicts on objecting parties."

Under this standard, the proponent of substantive consolidation must demonstrate that (i) there is substantial identity between the entities to be consolidated and (ii) consolidation is necessary to avoid some harm or to realize some benefit. Factors that may be relevant in satisfying the first requirement include:

- the presence or absence of consolidated financial statements;
- any unity of interests and ownership between various corporate entities;
- the existence of parent and intercorporate guarantees on loans;
- the degree of difficulty in segregating and ascertaining individual assets and liabilities;
- the existence of transfers of assets without formal observance of corporate formalities;
- any commingling of assets and business functions;
- the profitability of consolidation at a single physical location;

- whether the parent owns the majority of the subsidiary's stock;
- whether the entities have common officers or directors;
- whether a subsidiary is grossly undercapitalized;
- whether a subsidiary transacts business solely with the parent; and
- whether both a subsidiary and the parent have disregarded the legal requirements of the subsidiary as a separate organization.

If the proponent is successful, a presumption arises "that creditors have not relied solely on the credit of one of the entities involved." The burden then shifts to any party opposing consolidation to show that it relied on the separate credit of one of the entities to be consolidated and that it will be prejudiced by consolidation. Finally, if an objecting creditor makes this showing, "the court may order consolidation only if it determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm."

The Second Circuit, in *In re Augie/Restivo Baking Co., Ltd.*, established a somewhat different standard for gauging the propriety of substantive consolidation. The court concluded that the various elements listed above, and others considered by the courts, are "merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors." With respect to the initial factor, the Court of Appeals explained that creditors who make loans on the basis of a particular borrower's financial status expect to be able to look to the assets of that borrower for repayment and that such expectations create significant equities. Addressing the second factor, the Second Circuit observed as follows:

> [E]ntanglement of the debtors' affairs involves cases in which there has been a commingling of two firms' assets and business functions. Resort to consolidation in such circumstances, however, should not be Pavlovian. Rather, substantive consolidation should be used only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets.

The *Augie/Restivo* test recently was adopted by the Ninth Circuit in *In re Bonham*. Other circuit and lower courts have adopted tests similar to the *Augie/Restivo* and *Eastgroup* standards. The Third Circuit took a hard look at the question for the first time in *Owens Corning*.

Substantive Consolidation in Owens Corning

Owens Corning and 17 of its wholly-owned subsidiaries, a major supplier of building and industrial materials based in Toledo, Ohio, sought chapter 11 protection in 2000 in an effort to manage skyrocketing asbestos litigation exposure. At the time that the companies filed for chapter 11, a consortium of more than 40 banks had loaned or committed to loan the parent company and five of its subsidiaries more than $2 billion in a series of revolving loans, competitive advance loans, swing line loans and letter of credit commitments under a master credit agreement that could be drawn on from time to time by the borrowers.

The parent guaranteed all loans made under the master credit agreement to either itself or its subsidiaries. Because the lenders refused to extend financing without subsidiary guarantees as a "credit enhancement," each major subsidiary (those with assets having a book value of $30 million or more) also guaranteed the loans. The credit agreement also contained provisions specifically designed to protect the separateness of the parent company and its subsidiaries, including an undertaking to maintain separate books and records in order to prepare separate financial statements and restrictions on mergers with affiliates.

Among the companies' other creditors at the time of the filing were bondholders, trade creditors and asbestos litigants. These and other creditor interests were represented during the case by an official unsecured creditors' committee, a committee or subcommittee representing bondholders and trade creditors, an official committee of asbestos claimants and a legal representative for future claimants.

In connection with their efforts to devise a plan of reorganization, the debtors sought a court order "deeming" their estates and the assets and liabilities of three non-debtor subsidiaries substantively consolidated. This meant that consolidation would be deemed to exist for purposes of valuing and satisfying creditor claims, plan voting and making distributions in respect of allowed claims. The chapter 11 plan, however, would "not result in the merger of or the transfer or commingling of any assets of the Debtors or Non-Debtor Subsidiaries, . . . [which would] continue to be owned by the respective Debtors or Non-Debtors." Moreover, "all guarantees of the Debtors of the obligations of any other Debtor [would] be deemed eliminated, so that any claim against any such Debtor and any guarantee thereof . . . will be deemed to be one obligation of the Debtors with respect to the consolidated estate."

Nearly all creditors, other than the banks, supported the request. According to the banks, the cross-guarantees elevated their claim for $1.6 billion outstanding under the credit agreement to a higher priority than other claims because it represented a direct claim against both the parent company and each of the subsidiary guarantors, whereas other creditors asserted direct claims only against the parent.

After conducting a four day evidentiary hearing, the judge of the district court (sitting in bankruptcy) granted the motion to consolidate the Owens Corning estates, observing that "I have no difficulty in concluding that there is indeed substantial identity between the parent debtor . . . and its wholly-owned subsidiaries." Each of the subsidiaries, the court explained, was controlled by a single committee, from central headquarters, without regard to the subsidiary structure. Among other things, this meant that the officers and directors of the subsidiaries did not establish business plans or budgets and did not appoint senior management except at the direction of the central committee. Subsidiaries were established for the convenience of the parent, principally for tax reasons. Also, the subsidiaries were entirely dependent on the parent for funding and capital, and the financial management of the entire enterprise was conducted in an integrated manner.

Substantive consolidation, the court emphasized, would greatly simplify and expedite the successful completion of the bankruptcy proceedings. More importantly, the court remarked, "it would be exceedingly difficult to untangle the financial affairs of the various entities," despite the considerable sums expended by the debtors to sort out the financial affairs of each individual entity.

Having concluded that the proponents of consolidation established a *prima facie* case, the court then examined whether the banks proved that they relied on the separate credit of the subsidiaries. It ruled that they did not, remarking that "[t]here can be no doubt that the Banks relied on the overall credit of the entire Owens Corning enterprise." According to the court, the evidence showed that each bank's loan commitment was to the entire enterprise, and the decision as to whether funds would be borrowed by the parent or one or more subsidiaries was made by the borrowers, not the banks. In obtaining guarantees from the major subsidiaries, the court emphasized, the banks knew only that each guarantor had assets with a book value greater than $30 million — they had no information regarding the debts of the guarantor subsidiaries. The very existence of the cross-guarantees, the court explained, was a reason to substantively consolidate the estates because "[a]ny guarantor held liable on its guarantee would have a right of indemnification against whichever entity or entities borrowed the money . . . . [and] [i]t would be extremely difficult to sort out the inter-subsidiary claims." Moreover, the court observed that the claims based upon the guarantees were not as clear cut as the banks maintained and had in fact been challenged by the debtor and various creditor groups as fraudulent conveyances.

Finally, in ruling that substantive consolidation of the debtors' estates was a "virtual necessity," the district court did not rule out the possibility that some portion of the banks' claim (based upon the cross-guarantees) ultimately might enjoy a higher priority than other unsecured creditors of the consolidated estates. The court, however, stated that this issue was more properly joined in connection with a "fair and equitable" analysis undertaken as part of confirmation of a chapter 11 plan of reorganization.

The Third Circuit Reverses

The banks appealed the district court's decision to the Third Circuit Court of Appeals, which reversed. After examining the historical provenance of the remedy and noting that it had never before directly considered its character and scope, the Third Circuit embarked upon its analysis with the observation that "there appears to be nearly unanimous consent that it is a remedy to be used 'sparingly.'" With this admonition as a prelude, the court considered what standards should govern invocation of the remedy. It opted for an "open ended, equitable inquiry" rather than the factor-based analysis employed by many courts. According to the court, "[t]oo often the factors in a check list fail to separate the unimportant from the important, or even to set out a standard to make the attempt." The factor-based approach, the court explained, "often results in rote following of a form containing factors where courts tally up and spit out a score without an eye on the principles that give the rationale for substantive consolidation (and why, as a result, it should so seldom be in play)."

The Third Circuit articulated these principles as follows:

- limiting the cross-creep of liability by respecting entity separateness as a fundamental ground rule informing the general expectations of state law, the Bankruptcy Code and commercial markets;

- the harms substantive consolidation addresses are nearly always caused by debtors (and entities they control) who disregard separateness;

- mere benefit to case administration is not a harm justifying consolidation;

- because consolidation is extreme (in that it may profoundly affect creditor rights and recoveries) and imprecise, this "rough justice" remedy should be "rare and, in any event, one of last resort after considering and rejecting" other available remedies; and

- although consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used offensively, such as,

> for example, to disadvantage tactically a group of creditors in the plan process.

Based upon these principles, the Third Circuit ruled that, absent consent, a proponent of substantive consolidation must prove either that: (i) pre-bankruptcy, the entities to be consolidated "disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity"; or (ii) after filing for bankruptcy, the entities' assets and liabilities "are so scrambled that separating them is prohibitive and hurts all creditors."

Addressing the first scenario, the Court of Appeals explained that a *prima facie* case for it typically exists when, based upon pre-bankruptcy dealings, a proponent can prove corporate disregard "creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity." Proponents of consolidation who are creditors, the Third Circuit added, also must prove that "they actually and reasonably relied on debtors' supposed unity" in their pre-bankruptcy dealings. Even so, the court emphasized, creditor opponents of substantive consolidation can defeat a *prima facie* showing under the first scenario "if they can prove they are adversely affected and actually relied on debtors' separate existence."

Having laid the ground rules, the Court of Appeals applied them to Owens Corning. First, the court examined the record and found lacking any evidence that the corporate separateness of the entities to be deemed consolidated was disregarded. The facts indicated that Owens Corning and the banks negotiated the lending transaction premised on the separateness of each of the affiliated companies, leading the Third Circuit to fault the district court's conclusion that "substantial identity" existed between parent and subsidiaries. It also characterized as "overly simplistic" the argument that the banks intended to ignore the separateness of the entities because they failed to obtain independent financial statements for each of the entities at the time of the financing. According to the court, "[w]e cannot conceive of a justification for imposing the rule that a creditor must obtain financial statements from a debtor in order to rely reasonably on the separateness of that debtor." Creditors, the Third Circuit added, "are free to employ whatever metrics they believe appropriate in deciding whether to extend credit free of court oversight."

The Court of Appeals next examined whether there was any evidence of hopeless commingling of the debtors' assets and liabilities post-bankruptcy. It found none. The Third Circuit ruled that the lower court mistakenly concluded that commingled assets warrant consolidation when the affairs of the companies are so entangled that consolidation "will be beneficial":

> As we have explained, commingling justifies 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. Moreover, the benefit to creditors should be from cost savings that make assets available rather than from the shifting of assets to benefit one group of creditors at the expense of another. Mere benefit to some creditors, or administrative benefit to the Court, falls far short. The District Court's test not only fails to adhere to the theoretical justification for "hopeless commingling" consolidation — that no creditor's rights will be impaired — but also suffers from the infirmity that it will almost always be met. That is, substantive consolidation will nearly always produce some benefit to some in the form of simplification and/or avoidance of costs. Among other things, following such a path misapprehends the degree of harm required to order substantive consolidation.

According to the Third Circuit, although the debtors' intercompany accounting was assuredly imperfect, "perfection is not the standard in the substantive consolidation context." The court expressed confidence that a court could properly order and oversee an accounting process designed to sort out any inaccuracies in the debtors' intercompany books.

The Third Circuit also ruled that other considerations "counsel strongly against consolidation." Among these were the debtors' misuse of the remedy "offensively to achieve advantage over one group in the plan negotiation process" and their reliance on consolidation as a "free pass" to avoid prosecuting threatened fraudulent transfer claims, "that are liberally brandished to scare yet are hard to show." Finally, the court was highly critical of the proposed "deemed consolidation" structure, characterizing it as "perhaps the flaw most fatal" to the bid for substantive consolidation. In effect, the Third Circuit remarked, the plan proponents "seek to remake substantive consolidation not as a remedy, but rather a stratagem to 'deem' separate resources reallocated to [Owens Corning] to strip the Banks of rights under the Bankruptcy Code, favor other creditors, and yet trump possible Plan objections by the Banks." Finding such a scheme untenable, the court concluded that the "nearly perfect storm" needed to invoke substantive consolidation was absent.

Analysis

Substantive consolidation of affiliated debtors' estates in a negotiated plan of reorganization as a means of simplifying a complicated corporate structure is not uncommon, particularly as corporate structures increasingly are driven by tax considerations that may cease to become viable once an affiliated network of companies files for bankruptcy. *Owens Corning* is unusual because it involves a request for consolidation by the debtors outside of a plan of reorganization over the objection of a significant creditor group. More commonly, the creditors of an asset poor debtor whose affiliates also have filed for bankruptcy seek substantive consolidation of the related debtors' estates as a means of enhancing their recoveries.

To the extent that a "liberal trend" has developed toward the increased use of substantive consolidation, the Third Circuit flatly rejected it. Even so, its conclusion that consolidation was unjustified in *Owens Corning* likely was driven by the perception that the facts of the case rose to the level of a clear abuse of the remedy. It is unclear whether the standard for consolidation articulated by the Third Circuit differs in any meaningful sense from the standards traditionally applied by other courts. In fact, the Third Circuit's standard appears to consider the same factors as the traditional standards, but it uses those factors as guidelines rather than a rote checklist of indiscretions to be tallied.

The ruling, however, can be interpreted to allow a single creditor, provided it demonstrates reasonable reliance on corporate separateness, to defeat consolidation (at least with respect to its claim) even where the remaining creditors do not object and consolidation clearly would benefit the estates and the vast majority of creditors. To this extent, the Third Circuit's formulation of the standard would appear to raise the bar for achieving consolidation by placing more emphasis on the absence of prejudice to any single objecting creditor than the "balance of harm versus benefit" analysis that figures prominently in the *Augie/Restivo* and *Auto-Train* approaches.

Owens Corning sends a clear message that non-consensual consolidation rarely is appropriate and should be authorized only after meticulous fact-finding demonstrates that the remedy is justified. It also indicates that chapter 11 plans proposing "deemed consolidation" have little chance of being confirmed in a cram-down scenario in the Third Circuit if the remedy is a strategy devised to disadvantage a creditor or group of creditors.

In re Owens Corning, 2005 WL 1939796 (3d Cir. Aug. 15, 2005), *reversing* 316 B.R. 168 (Bankr. D. Del. 2004).

Drabkin v. Midland-Ross Corp. (In re Autotrain Corp., Inc.), 810 F.2d 270 (D.C. Cir. 1987).

Eastgroup Properties v. Southern Motel Assoc., Ltd., 935 F.2d 245 (11th Cir. 1991).

In re Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir. 1988).

In re Bonham, 229 F.3d 750 (9th Cir. 2000).