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Marking the Boundaries of Secured and Undersecured in Multi-Debtor Chapter 11 Cases: Collecting Postpetition Interest Under 506(b) of the Bankruptcy Code

BRAD B. ERENS AND DAVID A. HALL

The U.S. Bankruptcy Court for the Southern District of New York recently considered whether in a multi-debtor Chapter 11 proceeding, a secured lender must be oversecured in respect of collateral held in each individual Chapter 11 estate in order to collect postpetition interest and fees under Section 506(b) "from that entity" or whether collateral should be aggregated across all debtors for purposes of making the 506(b) determination. The authors explain the case and its implications.

Bankruptcy can be unfriendly terrain for a creditor seeking to recover on a claim against a distressed entity. This is the case even for purportedly secured institutional lenders. Indeed, risks for secured lenders abound in bankruptcy. Such risks can include:

Brad B. Erens is a partner in the Business Restructuring and Reorganization practice at Jones Day. David A. Hall is an associate in the Banking and Finance practice at the firm. Resident in the firm's Chicago office, the authors may be contacted at bberens@jonesday.com and dahall@jonesday.com, respectively.

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- avoidance of a lien;
- disallowance of a claim;
- bifurcation of a claim into a secured claim and an unsecured claim under Section 506(a) of the Bankruptcy Code; and
- equitable subordination of a claim to the claims of other creditors under Section 510(c).

Other risks include the potential that certain rights set forth in credit documents may be unenforceable in whole or in part in bankruptcy even though such rights are fully enforceable under non-bankruptcy law. For instance, credit documents commonly provide for a default rate of interest and obligate the borrower to pay the lender's fees and expenses in connection with enforcing its rights and remedies. The filing of a bankruptcy petition generally terminates the right of any creditor — secured or unsecured — to collect postpetition interest on a prepetition claim, thus significantly impairing a common and material term of most secured lending transactions.[1]

Section 506(b) of the Bankruptcy Code provides an exception to that general rule for secured creditors, however, providing that —

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.[2]

Thus, a secured lender can collect interest on its claim as well as reasonable fees, costs and charges provided in any underlying loan documents to the extent that the lender is over-secured. Determining the amount of interest allowed under Section 506(b) as part of a secured claim has given rise to myriad issues (*e.g.*, the proper date for valuing collateral, the proper valuation method and whether default interest may be included in the calculation).

In *Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (In re Residential Capital, LLC)*[3] ("*ResCap*"), the U.S. Bankruptcy Court for the

Southern District of New York recently considered whether in a multi-debtor Chapter 11 proceeding, a secured lender must be oversecured in respect of collateral held in each individual Chapter 11 estate in order to collect post-petition interest and fees under Section 506(b) "from that entity" or whether collateral should be aggregated across all debtors for purposes of making the 506(b) determination.

LENDING STRUCTURES AND THE INTERPLAY IN CHAPTER 11

Resolution of this issue is complicated by today's business realities. In a simpler world, a single lender would make a single loan to a single borrower secured by that borrower's assets. Upon a bankruptcy filing by the borrower, determining whether the lender was oversecured for purposes of Section 506(b) would be relatively straightforward.

But the current world of finance is not simple. In many cases, a "secured lender" is actually a syndicate of lenders that provides a variety of financing to or for the benefit of multiple borrowers (and guarantors) comprising a complex domestic or international corporate enterprise. These borrowers and guarantors often pledge their collective assets to the syndicate under a security agreement and related loan documentation. Under customary financing transaction documents, an administrative agent working on behalf of the lender syndicate has broad recourse during and following an event of default to seek recovery from any and all borrowers and guarantors, and against any collateral in which the syndicate holds a perfected security interest. The agent is generally not limited in the manner or source of recovery on the debt, and is not required to marshal assets or to pursue primary obligors prior to seeking recovery from guarantors. In other words, liability on a typical commercial loan is joint and several among the borrowers and guarantors, and all pledged collateral is fair game in the manner and order chosen by the lenders.

Things become more complicated following a bankruptcy filing by members of a corporate group, which in some cases may run into the hundreds of debtors. Every entity within a corporate group may be liable on debts that are to be restructured in a series of related Chapter 11 filings. In the context of secured loans, the obligations involved will likely include both the loans

and any related guarantees.

Although affiliated, each company would file its own Chapter 11 petition, creating a separate bankruptcy estate for each entity consisting of each debtor's property "wherever located and by whomever held."[4] Multi-debtor Chapter 11 cases are typically consolidated for administrative purposes — meaning that the related cases are presided over by the same judge under a single consolidated case number. Relief from the bankruptcy court is typically, but not always, sought on behalf of all of the debtors collectively. The filing and resolution of claims and the allocation of assets, however, is generally done on an estate-by-estate or debtor-by-debtor basis, absent "substantive consolidation" of the debtor entities.

An equitable remedy, substantive consolidation effectively collapses the assets and liabilities of all of the separate debtor entities for purposes of administering claims —

> It 'treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor.… Consolidation restructures (and thus revalues) rights of creditors and for certain creditors this may result in significantly less recovery.[5]

Courts have applied the doctrine of substantive consolidation sparingly "[b]ecause its effect radically rearranges legal boundaries, assets and liabilities."[6] It is used "in situations where 'the debtors' assets are so scrambled that unscrambling them is cost, time and energy prohibitive or creditors already perceive the debtors as simply a single unit and deal with them so.'"[7]

Absent substantive consolidation, a creditor must look to the specific debtor or debtors against whom the debt is owing for recovery and cannot look to the consolidated assets of the debtors collectively. Thus, as a general matter, a creditor with a claim against a particular debtor should have those rights it had prior to the bankruptcy, and those rights cannot be enlarged or reduced in Chapter 11. In particular, a creditor cannot access for recovery the assets of a debtor against whom it has no claim. Conversely, however, an unsecured creditor with a prepetition claim recoverable from multiple debtor

entities may recover on that same claim from each such liable debtor up to the amount of the prepetition claim amount.

In some instances, such as in the case of trade vendors who may do business only with a sub-set of the debtors, the filing of claims against specific debtors in their respective Chapter 11 cases will not be complicated, and claim administration will be straightforward. The task is much more difficult, however, in the context of a credit facility, where many, if not all, of the debtors have joint and several liability on the debt. Many questions may arise including:

- How claims are divided and paid amongst the debtors;
- How value is assigned to the collateral in the individual estates;
- The value given to guarantees by debtor entities; and
- The proper way to determine if a creditor is secured, unsecured or under-secured for purposes of recovering from a debtor's estate.

THE *RESCAP* DECISION

The latter question was recently considered by the bankruptcy court in *ResCap* in connection with confirmation of the debtors' Chapter 11 plan. The specific issue addressed by the court was whether certain junior secured noteholders ("JSNs") were oversecured for purposes of Section 506(b).

The JSNs asserted secured claims against Residential Capital, LLC ("Res-Cap") and certain of its affiliates (as borrowers and guarantors), all of which filed for Chapter 11 protection in the Southern District of New York on May 14, 2012. The face amount of the claims was $2.222 billion, consisting of $2.120 billion in unpaid principal as of the petition date and $101 million in unpaid interest (the "JSN Claims"). The JSN Claims arose from a series of 9.625 percent Junior Secured Guaranteed Notes due 2015 (the "Notes") issued in June 2008. To secure the Notes, the JSNs were granted liens on or security interests in —

- assets and property of ResCap and certain of the guarantors and obligors under the Notes;

- certain equity interests, promissory notes and other debt instruments, certain deposit and security accounts and related assets;
- Financial Assets, as defined in Article 8 of the Uniform Commercial Code; and
- certain deposit accounts and related assets.

During the Chapter 11 cases, both the official committee of unsecured creditors (the "Committee") and the debtors began investigating the JSN Claims and, in particular, whether the claims were actually secured. Ultimately, both the Committee and the debtors (collectively, the "Plaintiffs") filed adversary proceedings challenging the validity of the claims and the liens securing them. The complaint, as later amended, sought, among other things, a declaration that the "JSNs are undersecured because they are not oversecured at any individual Debtor entity."[8] The JSNs filed counterclaims seeking, among other things, a declaration from the bankruptcy court that the JSNs were in fact oversecured and, thus, entitled to postpetition interest, default interest, fees and expenses.[9]

At trial, the bankruptcy court framed the inquiry regarding the allowance of postpetition interest as follows:

> [w]hether under section 506 of the Bankruptcy Code, the [JSNs] may recover postpetition interest and other fees, costs, or charges under the Indenture (a) only to the extent they are oversecured by assets at a single Debtor entity without reference to collateral at other Debtor entities; (b) to the extent they are oversecured with reference to all collateral held by any Debtor, collectively; and/or (c) to the extent that the Debtors collectively have sufficient assets to pay the [JSNs] claims in full and/or any particular Debtor is solvent.[10]

The court held that whether the JSNs were oversecured should be determined with reference to the collective collateral held by all of the debtors in the aggregate. The court expressly rejected the notion that, in order to collect postpetition interest under Section 506(b), the JSNs would have to be oversecured with respect to each individual debtor.[11]

The court concluded that Section 506(b) permits an oversecured creditor

to collect postpetition interest "to the extent that its allowed secured claim is secured by property the value of which…is greater than the amount of such claim."[12] Section 502(a)(1), the court explained, "establishes the rule governing the calculation of secured claims[, providing]…that a creditor's claim is secured 'to the extent of the value of such creditor's interest in the estate's interest in [the securing] property.'"[13]

The Plaintiffs argued that "it is necessary to examine the value of a specific 'estate's interest' under section 506(a) to determine whether the secured creditor is entitled to postpetition interest with respect to its claim against that particular debtor under section 506(b)."[14] The court recognized that this argument is premised on the logic of substantive consolidation, where a court, absent substantive consolidation, "will not pool the assets of multiple debtors to satisfy their liabilities."[15]

However, the court rejected this argument, It wrote that "aggregating collateral for purposes of determining whether a secured creditor is oversecured and entitled to postpetition interest and fees does not run afoul of this rule" because the secured creditor is not accessing collateral for payment of a claim from an entity against which it has no secured claim. The court concluded that "[t]he secured creditor by definition has a superior right to the value of the collateral; junior creditors have no right to share on a parity with the secured creditor."[16]

The court found unpersuasive certain decisions cited by the Plaintiffs[17] that involved aggregating collateral between debtor and non-debtor entities. For example, in *DeNofa*, a secured lender sought a ruling from the bankruptcy court that it was oversecured for purposes of Section 506(b) after taking into account not only assets of the debtor, but also of non-debtor entities that had pledged collateral to secure the lender's claims. The lender in *DeNofa* argued that Section 506(b), *unlike* Section 506(a) of the Bankruptcy Code, simply refers to a claim that is "secured by property the value of which…is greater than the amount of such claim" when determining whether postpetition interest and fees are appropriate. According to the lender, because there is no express requirement in 506(b) that property securing the claim be property in which the estate or the debtor has an interest, the court, under Section 506(b), should consider not only the debtor's collateral, but also collateral pledged by non-debtor entities.

The *DeNofa* court rejected this argument, holding that 506(b) permits postpetition interest only where an "allowed secured claim is secured by property" valued at more than the value of the "allowed secured claim." An "allowed secured claim," the court explained, is defined in Section 506(a) as "property in which the estate has an interest … to the extent of the value of such creditor's interest in the estate's interest in such property[.]" Thus, the court concluded, that non-debtor collateral cannot be included for purposes of making a 506(b) determination.

The *ResCap* court found *DeNafo* to be factually distinguishable because the issue in that case involved aggregating debtor and non-debtor assets for purposes of Section 506(b), whereas "the question presented here does not involve property that does not form part of the secured creditor's collateral; only collateral pledged to the secured creditor will be used to pay postpetition interest."[18] Rather, the *ResCap* court wrote, "the question is whether property subject to the JSN's liens, held across multiple debtors, can be aggregated for the purposes of making the JSNs oversecured." [19]

Noting the lack of "on point" case law, the court cited two opinions in support of its ruling. In the first, *In re SW Hotel Venture, LLC*,[20] the court rejected an argument similar to the Plaintiffs' argument in *ResCap*, holding that "the determination of [a secured creditor's] status as an oversecured (or undersecured) creditor must be made aggregating the collateral of all the Debtors." In *In re Revolution Dairy, LLC*,[21] the court reached the same conclusion, expressly rejecting the debtors' argument that collateral must be considered separately for purposes of determining the secured creditors' entitlement to postpetition interest. According to the court, "[t]he argument is clearly inconsistent with the code and cannot withstand scrutiny."

The *ResCap* court noted that its ruling would clearly give the JSNs the benefit of their bargain, and that to rule otherwise would "ignore the reality of [the debtors'] business arrangement with the JSNs, in favor of formulaic adherence to fictional corporate separateness."[22] The court also emphasized that its ruling would in no way frustrate the expectations of the other parties in interest in the Chapter 11 cases because the liens of the JSNs were known, or could have been known, by all such entities when they determined to do business with the debtors.[23]

ANALYSIS

The *ResCap* court considered its reasoning and conclusions to be straightforward. Nevertheless, the issue is hardly settled, leaving a great degree of uncertainty and risk for secured lenders in the Chapter 11 context.

For example, consider a situation where a syndicate of lenders extends credit under a facility to multiple borrowers within a corporate structure, each of which is authorized to borrow and to pledge collateral in support of the loan, and each of which is fully liable for the debt. Arguably, the syndicate has a claim in each borrower's Chapter 11 case for the full amount of the facility, plus interest, all of which is secured to the extent of the value of the collateral pledged by each obligor as security. A court could conclude in this circumstance that, whether a lender group is oversecured for purposes of Section 506(b), should be determined on an estate-by-estate basis. Such a conclusion could be based, to a certain degree, on the same principles that underlie the substantive consolidation doctrine (*i.e,* that claim administration and resolution is conducted in each Chapter 11 case separately absent a formal consolidation of the Chapter 11 debtors' estates).

The court in *ResCap* brushed aside this argument, finding that "aggregating collateral for purposes of determining whether a secured creditor is oversecured and entitled to postpetition interest and fees does not run afoul of" the substantive consolidation principle because "[n]o debtor in a multi-debtor case will be required to pay a secured creditor more than the value of the secured creditors' collateral."[24] Instead, the court explained, "[t]he secured creditor by definition has a superior right to the value of the collateral; junior creditors have no right to share on parity with the secured creditor."[25]

While this may be an accurate characterization of the debtors' "collectively," it would appear that, by aggregating collateral among all Chapter 11 estates, the court's ruling may increase the likelihood that a secured creditor is entitled to postpetition interest and fees under Section 506(b), which may not be the case on an individual basis, thus reducing recoveries for unsecured creditors. This approach is more consistent with what would happen outside of bankruptcy, where fully-secured lenders are entitled to a complete recovery, including fees and interest, from their collateral before unsecured creditors or junior secured creditors are entitled to any recovery.

Sections 506(a) and 506(b), however, make the distinction between over-

secured and undersecured claims and their respective treatment in bankruptcy. An undersecured creditor holds both a secured and an unsecured claim, and is not entitled to postpetition interest. By contrast, an oversecured creditor is entitled to postpetition interest as part of its allowed secured claim. Therefore, in enacting Sections 506(a) and 506(b), Congress clearly did not intend, with respect to postpetition interest and fees, that the results for secured creditors in bankruptcy should mimic the results outside of bankruptcy.

The *ResCap* court also noted that its ruling reflects the broader "workings of the business world at large," and in particular, the regular practice whereby a borrower is permitted to move assets among subsidiaries and to create subsidiaries, so long as liens remain attached to the assets as they shift.[26] This kind of flexibility, the court explained, is necessary to enable corporations to "employ varying corporate structures in order to avail themselves of tax benefits, limit their liability, and comply with a multiplicity of regulatory requirements." [27]

According to the court, a rule in bankruptcy that a secured lender is entitled to collect postpetition interest and fees only if the lender is oversecured with respect to collateral owned by each individual debtor could have a significant impact on lending transactions involving large corporate enterprises with multiple debtor borrowers:

> [C]redit agreements and indentures might begin to prohibit corporate families from employing the type of complex subsidiary and affiliate structures that are currently commonplace and borrowers will be required to hold all collateral at a single entity. Absent these precautions, lenders would be less willing to extend credit…or would charge higher interest rates to compensate for the possibility that their contractual rights to postpetition interest, fees, costs and charges will not be honored in bankruptcy. Id. There may be some truth to these business realities and the argument would be that, as a result, a strict interpretation of section 506(b) of the Bankruptcy Code would be unworkable in the context of a large corporate enterprise with multiple debtor-borrowers. Nevertheless, as noted, an unsecured creditor with a prepetition claim recoverable from multiple debtors is typically permitted to recover on that claim from each debtor entity up to the full amount of the claim.[28]

Although the law on this issue remains unsettled, practitioners can structure transactions to minimize the risks associated with collecting postpetition interest in bankruptcy. Many larger business enterprises are structured with one or more holding companies at the head of the corporate structure, with a series of operating subsidiaries beneath. Instead of structuring the facility with multiple borrowers, the facility could have just one — the holding company — which would pledge as collateral all of its assets (and most notably, its equity interests in the underlying corporate family). The other members of the corporate family would be guarantors of the loan. The holding company, in turn, would then lend to the operating companies below in the corporate structure to fund operations, with the loans documented in intercompany notes secured by the operating companies' assets. Thus, the assets pledged by the holding company would include the intercompany notes and the corresponding pledges of assets.

In the event of a bankruptcy filing by the holding company and the operating subsidiaries, the lender group would have its claim against the holding company, and its entitlement to postpetition interest would be determined on the basis of the value of the collateral held at the holding company level, which would include the intercompany notes. Under this scenario, there may be less of a chance that the lender group would find itself undersecured for purposes of Section 506(b). Nevertheless, this structure would not be without potential risk, including challenges to the enforceability of secured intercompany loans among the corporate entities, which would serve as the key piece of collateral in support of the loan.

Alternatively, in a facility with multiple borrowers, lenders could seek as part of any bankruptcy-related negotiations (*i.e.*, in connection with the use of cash collateral, a sale of assets or postpetition financing) a stipulation from the borrowers to the value of collateral held at each borrower entity. The parties could then stipulate to an amount for the lenders' claim against each entity in an amount sufficient to allow the lenders to accrue postpetition interest on each such claim. In fact, it is typical for postpetition financing orders and final cash collateral orders to contain broad stipulations to the amount of the lenders' claims and a statement that such claims are "oversecured." Such stipulations could simply take this concept a step further to avoid any doubt as to the oversecured nature of the lenders' claims against each debtor entity.

CONCLUSION

Bankruptcy presents various challenges for secured lenders, including the need to protect valuable rights negotiated in pre-bankruptcy financing transaction documents. The right to collect interest, especially default interest, and the right to be compensated for fees and costs associated with a credit, are key economic considerations for lenders. Such rights may be limited under Section 506(b) of the Bankruptcy Code. The *ResCap* decision enforces the right of a secured lender to collect postpetition interest by broadly interpreting what it means to be oversecured in a multi-debtor Chapter 11 case. However, due to the unsettled and largely untested nature of this question, a prudent lender may well consider structuring a credit facility to maximize the chances that its right to postpetition interest and fees is protected.

NOTES

[1] *See* 11 U.S.C. §502(b)(2).

[2] 11 U.S.C. §506(b).

[3] 501 B.R. 549 (Bankr. S.D.N.Y. 2013).

[4] 11 U.S.C. §541(a).

[5] *In re Owens Corning*, 419 F.3d 195, 205 (3d Cir, 2005) (internal citations omitted).

[6] *In re Reserve Capital Corp.*, No. 03-60071, 2007 BL 238199, *4 (Bankr, N.D.N.Y. Mar. 21, 2007) (citation and internal quotation marks omitted).

[7] *Id*. Although courts have examined a number of factors in determining whether substantive consolidation is appropriate, the two key inquiries are (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." *Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.),* 860 F.2d 515, 518 (2d Cir. 1988); *In re The Lodge at Big Sky, LLC*, 454 B.R. 138, 142 (Bankr. D. Mont. 2011). Stated slightly differently, "what must be proven…is that (i) prepetition [the debtors] 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." *Owens*

Corning, 419 F.3d at 212.
[8] *See* 501 B.R. at 559.
[9] *See id*.
[10] *Id*. at 561.
[11] *Id*. at 599.
[12] *Id*.
[13] *Id*.
[14] *Id*. at 598.
[15] *Id*.
[16] *Id*.
[17] *See Wornick v. Gaffney*, 544 F.3d 486 (2d Cir. 2008); *DeNofa v. Nat'l Loan Investors L.P.* (*In re DeNofa*), 124 F. App'x 729 (3d Cir. 2005).
[18] *Id*. at 599.
[19] *Id*. at 599.
[20] 460 B.R. 4, 26 (Bankr. D. Mass. 2011).
[21] Case No. 13-20770 (Bankr. D. Utah Apr. 29, 2013) [Docket No. 206].
[22] *Id*. at 601.
[23] *Id*.
[24] 501 B.R. at 598.
[25] *Id*.
[26] 501 B.R. at 601.
[27] *Id*.
[28] *Id*.