



Substantive Consolidation Rejected by Third Circuit in Chapter 11 Cases of Owens Corning and its Subsidiaries

Last week in *In re Owens Corning*¹ the Third Circuit Court of Appeals reversed a Delaware District Court judge's ruling that granted the motion made by Owens Corning ("OC") and its subsidiaries for substantive consolidation in OC's Chapter 11 cases. In doing so, the Court surveyed the current state of the law of substantive consolidation and articulated the principles that should be considered by courts addressing requests for substantive consolidation. The result is a new two-prong test for substantive consolidation in the Third Circuit (which includes the Chapter 11-intensive District of Delaware).

Background

As described by the Third Circuit, OC and its subsidiaries operated as a multinational organization, with each subsidiary existing as a separate entity for a specific reason – such as for limited liability, tax benefits or regulatory reasons. Each subsidiary observed corporate formalities and maintained separate books and records, with regularly documented intercompany transactions.

In June of 1997, a syndicate of banks (the "Banks") extended a \$2 billion unsecured loan to OC and certain of its subsidiaries (the "OC Borrowers"). One condition of the loan was that the Banks obtain guarantees from present or future domestic OC subsidiaries having assets with an aggregate book value in excess of \$30 million (the "OC Guarantors"). As a result of the subsidiary guarantees, the Banks held direct claims against the OC Guarantors for payment defaults by the OC Borrowers. The Third Circuit found that the Banks clearly demonstrated that they would not have extended the original loan without the subsidiary guarantees. Moreover, the Third Circuit observed that the Credit Agreement governing this loan contained express limitations on the ways in which OC could deal with its subsidiaries, each limitation generally aimed at protecting the separateness of the subsidiaries, and required the subsidiaries themselves to preserve their separateness.

In October of 2000, OC and seventeen of its subsidiaries (the "Debtors") filed for reorganization under Chapter 11 of the Bankruptcy Code, in large part to seek protection from a mounting docket of asbestos claims. In October of 2004, the Delaware District Court granted a motion to consolidate the assets and liabilities of the OC Borrowers and the OC Guarantors in anticipation of the plan of reorganization.² The consolidation approved by the District Court would have had a dramatic impact on the recovery to the Banks, who absent consolidation would have looked to the OC Guarantors (including Fibreboard Corporation) that had no asbestos exposure to obtain recovery. The Banks appealed that decision claiming that the District Court incorrectly granted the substantive consolidation motion due to (i) a misunderstanding of the reasons behind and the standards required for substantive consolidation and (ii) a lack of factual findings to support such an extraordinary remedy.

Substantive Consolidation

Substantive consolidation is an equitable remedy that is to be used sparingly. The Third Circuit previously defined substantive consolidation as "treat[ing] 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 into claims against the consolidated survivor."³

In this case, the Debtor's plan of reorganization (the "Plan") included a more specific type of substantive consolidation – a "deemed consolidation." In essence, the Plan said that "consolidation is deemed to exist for purposes of valuing and satisfying creditor claims, voting for or against the Plan, and making distributions for allowed claims under it," yet "the Plan would not result in the merger of or the transfer or commingling of any assets," which will continue to be owned as they were

¹ *Credit Suisse First Boston v. Owens Corning (In re Owens Corning)*, ___ F.3d ___, 2005 WL 1939796 (3d Cir. August 15, 2005).

² This District Court decision was the subject of our October 2004 Client Publication.

³ *Id.* at *7 (quoting *Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.)*, 402 F.3d 416, 423 (3d Cir. 2005)).

before substantive consolidation.⁴ The Plan further provided that on the effective date, “all guarantees of the Debtors of the obligations of any other Debtor will be deemed eliminated”⁵ and the separate obligations of the subsidiary Debtors arising from the guarantees under the Credit Agreement will be eliminated. The practical result was that, although the entities would remain separate following the Debtors’ emergence from bankruptcy, the assets and liabilities of OC’s separate entities would be merged for purposes of the Plan, which would have the effect of eliminating the Bank’s subsidiary guarantees.

Principles of Substantive Consolidation

The Third Circuit surveyed existing substantive consolidation case law across jurisdictions. From the case law the Court extracted the following five basic substantive consolidation principles: (i) courts should respect entity separateness absent compelling circumstances that call equity into play, and then only possibly allow substantive consolidation, (ii) actions of debtors, and not of creditors, are required to cause the types of harms for which substantive consolidation is a remedy, (iii) the mere benefit to case administration is not a sufficient basis for allowing substantive consolidation, (iv) substantive consolidation should be rare and a remedy of last resort after considering and rejecting other available remedies and (v) substantive consolidation may not be used offensively, such as to tactically disadvantage certain creditors or to alter creditor rights.

New Substantive Consolidation Test

After describing the principles of substantive consolidation, the Third Circuit created its own articulation of a substantive consolidation test. The two-prong test for substantive consolidation in the Third Circuit, absent consent of the parties, is that with respect to the entities for whom substantive consolidation is sought:

- (i) prepetition they 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.⁶

The first prong of the test is intended to protect creditors’ prepetition expectations. A *prima facie* case for substantive consolidation under this prong “typically exists when, based on the parties’ prepetition dealings, a proponent proves corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one

indistinguishable entity.”⁷ A creditor wishing to obtain substantive consolidation must also show that “in their prepetition course of dealing, they actually and reasonably relied on debtors’ supposed unity.”⁸ On the other hand, creditors wishing to defeat a *prima facie* substantive consolidation claim must prove “they are adversely affected and actually relied on debtors’ separate existence.”⁹ Interestingly, the Court did not decide whether such a showing by an objecting creditor defeats substantive consolidation for all parties or just for the objecting creditor.

The second prong of the test looks to the practicality concerns that arise when the assets and liabilities of the subject entities are “hopelessly commingled.”¹⁰ The Court made clear that “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” and *not* when “the affairs of the two companies are so entangled that consolidation *will be beneficial*,”¹¹ as was the standard of the District Court. Administrative benefit to the court or shifting benefit from some creditors to others is not enough to justify substantive consolidation.

Court’s Analysis

Applying the new two-prong test above to the facts of the OC bankruptcy, the Court held that substantive consolidation should not be granted. Further, the Court found that a “deemed consolidation,” as was proposed in the Plan, “cuts against the grain of all the principles”¹² because it would be inconsistent for a court to find a fatal lack of separateness and then allow the structure to remain in place following substantive consolidation.

The Third Circuit held that the facts did not support the first prong of the test because (i) the Banks required the subsidiary guarantees, (ii) OC structured its affairs to maintain the separateness of its subsidiaries and (iii) the parties to the loan agreed that the subsidiary guarantees were meant to create structural seniority in the event of a payment default. The Banks’ decision not to obtain independent financial statements from each OC Guarantor was not found in itself to show that the Banks made their credit decision in reliance of the breakdown of entity borders such that the entities would be treated as one. The Banks did obtain other detailed information about the OC Guarantors, including information about their assets and debt.

⁴ *Id.* at *4.

⁵ *Id.*

⁶ *Id.* at *13.

⁷ *Id.* at *14.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* at *13.

¹¹ *Id.* at *16.

¹² *Id.* at *14.

The facts also did not support the second prong of the test according to the Third Circuit, which found that there was not meaningful evidence presented to demonstrate hopeless commingling of assets and liabilities. Even though there will likely be some imperfection and inaccuracies in untangling the affairs of the entities, this alone is not a justification for ordering substantive consolidation. As the Court noted, imperfection in intercompany accounting is not atypical in large, complex company structures. The cost of untangling affiliate entities is also not sufficient justification for granting substantive consolidation. In this case, the Court believed that costs involved in untangling the OC entities were but a fraction of the amount owed to the Banks.

Commentary

The two principal tests for substantive consolidation prior to the Third Circuit's *Owens Corning* decision were the Second Circuit's standard in *In re Augie/Restivo* and the D.C. Circuit's standard in *In re Auto-Train*.¹³ In *In re Augie/Restivo*, the Second Circuit stated that substantive consolidation has "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"¹⁴

¹³ *Id.* at *9.

¹⁴ *Union Sav. Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515, 518 (2d Cir. 1988) (internal quotation marks and citations omitted).

The D.C. Circuit's opinion in *In re Auto-Train* instead required "not only substantial identity between the entities to be consolidated, but also that consolidation is necessary to avoid some harm or to realize some benefit," ultimately stating that even if a creditor makes a showing that it relied on the separate credit of one of the entities and consolidation will prejudice the creditor, consolidation may only be ordered if the court "determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm."¹⁵

The new Third Circuit test, particularly when viewed in the context of the five guiding principles announced by the Court, appears to increase the burden on parties seeking substantive consolidation within that circuit. It remains an open point as to whether courts outside of the Third Circuit will adopt the Third Circuit's reasoning.

* * * * *

Shearman & Sterling LLP represents Credit Suisse First Boston, agent for the Banks, in certain matters in connection with the Owens Corning Chapter 11 cases. Shearman & Sterling LLP did not participate in, and played no role in connection with, any of the proceedings regarding the substantive consolidation of Owens Corning and its affiliates.

¹⁵ *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 276 (D.C. Cir. 1987) (citation omitted).

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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