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Third Circuit Rejects Substantive Consolidation in *Owens Corning*

In October 2004, the U.S. District Court in Delaware ordered the substantive consolidation of the assets and liabilities of Owens Corning and a number of its subsidiaries in the *Owens Corning* bankruptcy case. A syndicate of lenders led by Credit Suisse estimated that the decision would reduce the recovery on their $2.0 billion loan by as much as $1.0 billion. Not surprisingly, the decision was promptly appealed by the lenders.

The United States Court of Appeals for the Third Circuit has now reversed the District Court's decision in an important and strongly-worded decision. The court replaced the District Court's legal test for consolidation with a much more demanding standard. The court emphasized in broadly cautionary language that consolidation should be ordered only in extraordinary circumstances in which other creditor remedies are inadequate. Even then, consolidation may not be appropriate given the profound impact that it can have on the expected recoveries of competing creditors. As a result of the decision, it will now be much more difficult for a proponent of consolidation to succeed.

Background

There are 13 federal judicial circuits in the United States, each with its own Circuit Court of Appeals. Each circuit has jurisdiction over one or more states or territories, with the exception of the Federal Circuit which has nationwide jurisdiction over various types of cases. The Third Circuit has jurisdiction in Delaware, New Jersey, Pennsylvania and the Virgin Islands. Although no federal circuit court is bound by decisions of another circuit, decisions made in one federal circuit are often persuasive in other circuits. Given its importance, the decision of the Court of Appeals will be the subject of debate beyond the Third Circuit. Several other Circuit Courts of Appeals have previously adopted tests for granting substantive consolidation, clustering around two basic approaches. The Third Circuit's test in *Owens Corning* is among the most favorable of any yet decided for opponents of substantive consolidation.

The Facts

In 1997, a group of lenders made a $2.0 billion unsecured loan to Owens Corning and several of its subsidiaries, as co-borrowers. The lenders obtained credit support in the form of unsecured guarantees from certain Owens Corning subsidiaries. The guarantees gave the lenders direct claims against the assets of the guarantors. As a result, the lenders obtained structural seniority over other creditors of Owens Corning that did not have direct claims against the guarantors, including unsecured bondholders, trade creditors and tort claimants in asbestos litigation against Owens Corning. This structural seniority would have been eliminated by substantive consolidation, which would have collapsed Owens Corning and the guarantors into a single entity. The result would have given the creditors of each Owens Corning entity a direct claim against the assets of all of the pre-consolidation entities including the guarantors' assets that had previously been available only to the lenders as a result of their guarantees.

Legal Standard in the District Court

The District Court held that a *prima facie* case for consolidation exists when the proponents of consolidation demonstrate that: (1) there is substantial identity between the entities to be consolidated, and (2) consolidation is necessary to avoid *some* harm or realize *some* benefit (emphasis added).

If a *prima facie* case is made out, the burden shifts to the opponents of consolidation to show that: (1) they relied on the separateness of the entities to be consolidated, and (2) they will be prejudiced by consolidation.

Legal Standard in the Court of Appeals

The Court of Appeals was highly critical of the standard adopted by the District Court, branding it as too imprecise to measure and too easy to satisfy. The Court of Appeals replaced it with a meaningfully more-exacting standard. The Court of Appeals' test differentiates between the period prior to the date of the bankruptcy filing and the period following the filing date.

With respect to the pre-petition period, a *prima facie* case for consolidation exists if the proponents of consolidation show that prior to the petition date the entities disregarded separateness so significantly that creditors relied on the breakdown of entity borders and treated them as one legal entity. Proponents who are creditors must also show that they actually and reasonably relied on the entities' alleged unity. Involuntary creditors (such as asbestos litigants) whose claims arose by operation of law, rather than as a result of a contractual relationship, are unlikely to receive consideration under this test since, in the court's view, by definition, such creditors do not rely on entity separateness or entity unity.

With respect to the post-petition period, a *prima facie* case for consolidation is established if the proponents of consolidation prove that the assets and liabilities of the entities are so scrambled that separating them is prohibitive and hurts *all* creditors. Under this standard, consolidation will not be ordered unless consolidation would increase *every* creditor's recovery.

If the plan proponents establish a *prima facie* case under the pre-petition period test, an opposing creditor can defeat consolidation by showing that it would be adversely affected by consolidation and that it relied on the debtors' separate existence. The court raised, but decided not to answer, the question of whether the opposing creditor's objection would (1) completely defeat consolidation or (2) allow consolidation, but guarantee the objecting creditor the same recovery it would have received absent consolidation (*i.e.*, a deemed non-consolidation as to that creditor). The prospect of a deemed non-consolidation raises many questions, including how a court would or even could determine the amount the objecting creditor would recover if consolidation was not ordered. That amount depends on many factors, most notably, the terms of the plan of reorganization that would have been approved by creditors and confirmed by the bankruptcy court if consolidation was not ordered. However, at the time a motion for consolidation is made, it is possible (if not likely) that such a plan will not exist, even in draft form, or even have been proposed.

How the Standard Has Changed

The test adopted by the Third Circuit Court of Appeals makes consolidation much less likely than the District Court's test.

First, the Court of Appeals' test shifts the burden of proof to the proponent of consolidation on the issue of whether creditors relied on corporate separateness. To establish a *prima facie* case for consolidation, proponents of consolidation must show that creditors did not rely on organizational separateness but rather legal unity among all entities proposed to be consolidated. By contrast, the District Court had placed the burden of proof on an objecting creditor to prove its reliance on entity separateness to rebut a *prima facie* case for consolidation.

Second, Court of Appeals' post-petition test for consolidation requires hopeless entanglement of the debtors' affairs. By contrast, the District Court did not view entity entanglement as a necessary component, but instead merely evidence that consolidation would benefit creditors.

Third, the Court of Appeals' post-petition test requires *all* creditors to benefit from consolidation. By contrast, the District Court's test could have been satisfied if *some* creditors benefited, a standard, in the Court of Appeals' view, that will almost always be met. This test of benefiting *all* creditors is unlikely to be satisfied except in the unusual case where the cost of separating assets and liabilities of the various entities is so high that the net benefit of not being forced to incur that cost would increase every creditor's recovery. The court has moved from a test that is very easily satisfied to a test that will very rarely be met.

Fourth, the Court of Appeals' post-petition test requires that the benefit to creditors must be in the form of increased recovery for creditors. The District Court, on the other hand, had taken a broader view that the required benefits could include (1) expediting the successful completion of the bankruptcy, (2) administrative benefit to the court, (3) rendering moot legal challenges predicated on corporate separateness, or (4) avoiding the need to unravel the financial affairs of the debtors.

The Court of Appeals outlined five principles that provide the rationale for limiting consolidation:

(1) Corporate separateness is a long-established, foundational principal of corporate law, and courts should be mindful of the "cross-creep of liability" that would result from consolidation;

(2) Consolidation almost always addresses harms caused by debtors and their controlled affiliates. Harms caused by stockholders or creditors can be addressed by other

remedies, such as "piercing the corporate veil" (to address improper stockholder domination of an entity), fraudulent transfer rules (to address inappropriate transfers of assets) and equitable subordination (to address misconduct by a creditor that uses its position as a stockholder to the detriment of other creditors);

(3) Mere convenience and benefit in, or simplifying the administration of, the bankruptcy case should not be an important factor in deciding whether to consolidate;

(4) Consolidation is an "extreme" and "rough-justice" remedy. As a result, consolidation should be a rare remedy of last resort after considering and rejecting other remedies (such as the statutory remedies provided in the U.S. Bankruptcy Code); and

(5) Substantive consolidation may only be used defensively to remedy identifiable harms caused by entanglement of the affairs of various entities. It may not be used offensively (for instance with a primary goal of tactically disadvantaging a group of creditors in the plan process or altering creditor rights).

Applying the Consolidation Test

The Court of Appeals found that the facts in *Owens Corning* fell far short of those required to satisfy the court's test for consolidation. Although the court cited a number of factors supporting its holding, the court expressly disapproved of using a "check-list" of factors to determine whether affiliated entities should be consolidated. It stated that rote use of "check-lists" failed to take into account the need to look at each case on its merits. As a result, the factors discussed below should not be viewed as conclusive of the outcome in future cases. They do, however, consistently reflect the court's view of consolidation as a remedy of last resort to be used sparingly.

Pre-petition Test

The court found that the lenders relied on the corporate separateness of the members of the credit group for several reasons, two of which are particularly noteworthy:

(1) The willingness of the lenders to extend credit was premised on obtaining structural seniority, which, in turn, is premised on corporate separateness; and

(2) The credit agreement contained a series of covenants that limited the relationship between the members of the credit group, and "importantly" a sub-set of covenants intended to protect the corporate separateness of the credit group members. The court cited restrictions on mergers among the credit group members, and covenants requiring each credit group member to maintain its corporate existence, to keep separate books and records, to give lenders visitation rights to each credit group member and to allow lenders to discuss business matters with the management of each credit group member.

These findings suggest that it will be difficult for debtors and creditors to use consolidation to defeat structural seniority, and will make it relatively easy for lenders to better protect themselves against consolidation through the use of covenants in loan documents.

The court's conclusions are helpful to lenders not only in structuring future deals, but also in protecting existing deals from consolidation. This is because the covenant restrictions that the court cited as important are routinely included in the loan documents governing many types of lending arrangements. For instance, most, if not all, of these types of covenants would generally appear in the loan documents for a syndicated lending transaction.

Some lenders in the syndicated loan market responded to the District Court's decision by adding to their loan documents a diluted version of the types of corporate separateness covenants traditionally applicable to special purpose entities in securitizations and other structure finance transactions. Such corporate separateness covenants typically contain specific restrictions (such as a prohibition on commingling bank accounts and making payments to satisfy the liabilities of other credit group members). They also often contain catch-all language requiring the credit group members to conduct their affairs in a manner that will not cause their corporate existence to be ignored or their assets and liabilities to be substantively consolidated. Lenders may continue to insist on these types of specific corporate separateness covenants, in addition to the types of covenants mentioned by the Court of Appeals.

Post-petition Test

The court found no evidence of hopeless entanglement. There was no doubt as which of the Owens Corning entities held the material assets and which had the material liabilities. The parties had agreed that the financial statements of Owens Corning's subsidiaries were accurate in all material respects. Although the court stopped short of expressly establishing a test for what constitutes hopeless entanglement, it appears that a finding of hopeless entanglement is not warranted if the financial affairs of affiliated entities can be unraveled with material accuracy. Consolidation was not justified by the mere difficulties cited by the District Court in accounting with complete certainty and accuracy for interest payments on intercompany loans and royalty payments on intercompany intellectual property licenses. The court recognized that imperfection in accounting for intercompany transactions is "assuredly not atypical" in large, complex company structures. Holding debtors to a standard of perfection in documenting their intercompany dealings would increase the risk of consolidation for complex corporate families. The court's materiality analysis holds companies to a more realistic standard that should not unfairly prejudice large national and international businesses with complicated organizational structures, and is grounded in a pragmatic understanding of how corporate organizations operate. Some critics had charged that such pragmatism was notably absent from the District Court's analysis.

The court also rejected the argument that the lenders would actually benefit from consolidation because it would avoid the prohibitively expensive cost of untangling the affairs of the members of the Owens Corning corporate family. The court found it extremely unlikely that it would cost even close to 1% of the lenders asserted $1.6 billion claim to resolve the accounting for the intercompany interest and royalty payments.

Other Issues

The Court of Appeals concluded unequivocally that the facts in *Owens Corning* did not come close to satisfying the tests for consolidation. Yet, even if the facts had met those tests, the court indicated that it would have denied consolidation on another ground.

The court was deeply troubled by the fact that the court ordered a "deemed" consolidation instead of an actual consolidation. In an actual consolidation, Owens Corning and its subsidiaries would morph into a single entity. As a result, Owens Corning would lose the benefits it had sought in setting up separate subsidiaries, including tax and other benefits, shielding other entities from litigation liability and regulatory compliance. In contrast, a deemed consolidation would preserve these benefits. The deemed consolidation would eliminate the guarantees under the credit agreement and the lenders' resulting structural seniority. Deemed consolidation would also diminish the value of the lenders' claims as creditors, weaken the lenders' voting rights on a plan of reorganization and reduce their ultimate recovery. In the court's view, the contemplated deemed consolidation for these limited purposes was nothing more than a ploy to disadvantage the lenders, while providing a windfall to other creditors. The court held that such an offensive use of substantive consolidation was fatal to the proposed consolidation.

It is worth emphasizing that the Court of Appeals' decision did not turn on its unwillingness to accept such a deemed consolidation. The court's holding is not limited to cases involving deemed consolidations. The decision applies equally to both deemed and actual consolidations. The outcome in *Owens Corning* would have been no different if the District Court had ordered an actual consolidation. The decision makes it clear, however, that deemed consolidations are doomed in the Third Circuit.

Analysis

The Court of Appeals' test for consolidation significantly raises the legal standard for consolidation. It also makes it clear that the factual bar to satisfying these tests is high, and will rarely be satisfied. The court was emphatic that consolidation is a remedy that should be used only in extraordinary circumstances. To avoid unwarranted consolidations, it raised both the legal standard and the facts that must be shown in justification.

The court was troubled by the fact that substantive consolidation is a departure from the foundational principal of corporate separateness on which corporate law is based, and on which commercial expectations are predicated. The court was concerned about upsetting both bargained-for contractual expectations of the parties and market expectations, noting that consolidation of the Owens Corning entities would "cause chaos in the marketplace." The court characterized (correctly) the structural seniority used by the lenders as "the "deal world" equivalent of "Lending 101." It noted (again correctly) that this type of lending occurs every business day. The court was clearly reluctant, in the absence of extraordinary circumstances, to defeat the lenders' contractual expectations, and to call into question the validity of a basic structuring technique on which market participants and the commercial markets rely to protect the interests of certain creditors against the claims of other creditors.

The decision provides much-needed guidance on when it is appropriate to order consolidation, but does not eliminate entirely the difficult task of predicting whether the tests for consolidation have been satisfied in a given case. First, the Court of Appeals' tests for consolidation are couched of necessity in somewhat general terms that are susceptible to inconsistent application and interpretation in future cases. One of the fundamental criticisms of substantive consolidation is that, by its nature as an equitable remedy, it lacks the specificity and detail of creditor remedies created by statute. Second, the court rejected a "check-list" approach to measure whether the tests have been met, instead advocating a case-by-case approach in which the relevant factors, and the relative weight to be given to those factors, are determined based on the facts presented.

Nonetheless, the uncertainty resulting from this general standard is mitigated by the court's mandate to make consolidation a remedy of last resort to be considered only after other creditor remedies have been reviewed and rejected. The commercial markets can take some comfort from the fact that, even if it remains difficult to quantify the risk of consolidation in a particular situation, the likelihood of consolidation has been reduced significantly.

Postscript

The proponents of consolidation have sought a rehearing of the decision *en banc* (*i.e.*, by the entire nine member panel of the Third Circuit). As is customary, the original decision was by a three member panel assigned to the case. *En banc* rehearings are rarely ordered. If a rehearing *en banc* is denied, or the decision is upheld or overturned by the full court, there is no further appeal as a matter of right. The only recourse is to apply to the U.S. Supreme Court for a writ of certiorari, which essentially is a decision by the Supreme Court to allow the parties to reargue the case before the Supreme Court. Such writs of certiorari are rarely granted and only on a limited basis where the Supreme Court decides that the issue of law is important and, for example, where there is an important difference between several of the Courts of Appeal.

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Rick Chung
212.969.3468 – rchung@proskauer.com

Neil Cummings
310.284.5628 – ncummings@proskauer.com

Michael E. Foreman
212.969.3218 – mforeman@proskauer.com

Martin S. Zohn
310.284.5648 – mzohn@proskauer.com

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