Substantive consolidation of affiliated debtors in bankruptcy: creditors beware!

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Creditors involved with a bankrupt debtor face many hurdles to obtain maximum recovery on their claims. Each bankruptcy case commences with its own unique set of issues: sometimes the bankruptcy filing is driven by the need for an operational restructuring, while others may be driven by the need to deleverage the balance sheet or to channel and avoid mounting mass tort liabilities. Paramount among a creditor's concerns is when its claim will be paid and how much it will receive. Should the creditor wait for a reorganisation plan to be confirmed and then for claims distribution to take place, or should the creditor sell its claim now? Creditors will consider many points when wrestling with these issues. In particular, they should not overlook the potentially significant impact that substantive consolidation may have on their recoveries. Indeed, creditors must consider substantive consolidation and its impact on their claims, not only upon the commencement of and during a debtor's bankruptcy case, but also prior to any bankruptcy filing, including at the time when the creditor initially makes a credit decision and during the pre-bankruptcy course of dealings between the creditor and the debtor.

What is substantive consolidation?

Substantive consolidation is a legal tool which may be used in a bankruptcy case to consolidate a debtor and one or more of its affiliated entities so that they are treated as a single entity. Substantive consolidation:

- eliminates inter-entity claims and guarantees of the debtor and its consolidated affiliates;
- treats all assets of the debtor and its consolidated affiliates as a common pool of assets; and
- treats the claims of creditors against the debtor and its consolidated affiliates as claims against the common assets of all the debtor and its consolidated affiliates.

This common pool of assets is drawn on to pay distributions to the creditors of all the consolidated entities. This will typically result in recoveries very different from what creditors would expect if their claims were maintained against only the separate debtor without consolidation. Due to the potentially significant impact on claims recovery, and because the actions of the debtor and the relationship between the creditor and the debtor prior to any bankruptcy filing will be relevant to the court's substantive consolidation decision, all creditors should be aware of the risk well before any bankruptcy filing by a debtor, and must consider it in making credit decisions. In addition, once a bankruptcy petition is filed by the debtor, creditors must include the potential for substantive consolidation as part of their active monitoring of the bankruptcy case.

Creation of a bankruptcy estate

Understanding substantive consolidation requires knowledge of the basics of a typical bankruptcy case filing. Commencement of a Chapter 11 case creates for the debtor an estate comprised of all the debtor's interests in property. The estate and the debtor's business will be administered by the debtor's management and professionals as the debtor in possession. The debtor in possession will use its assets to satisfy claims against its estate. In general, the debtor's assets are not available to satisfy claims asserted against other debtor entities, even if the separate entities are part of the same corporate family. In a bankruptcy case the court will generally respect the independent legal existence (or corporate separateness) of different legal entities. Thus, a financial institution which loaned money to a particular debtor must look only to its debtor for recovery and cannot recover that debt from any other entity (in the absence of a contractual basis to do so, such as a guarantee). The mere fact that other entities are affiliated (either as sister, parent or subsidiary companies) does not result in any change to the enforceability of a company's independent legal existence.

This respect for the independent legal existence of entities is a critical component of how the capital markets work. If a financial institution did not believe that it could rely on the assets of its debtor to satisfy its claim, changes would need to be made to how credit is extended and the security obtained for such credit. Indeed, if the lender does not believe reliance on the original debtor's balance sheet is sufficient to justify the lending decision, it may seek other protection, such as guarantees from the original debtor's affiliates or taking a secured position. This is common lending practice and the capital markets depend on the enforceability of such lending arrangements, which are typically enforceable in bankruptcy. Understanding the risk of substantive consolidation will assist creditors in making these decisions.

Substantive consolidation changes expectations

Substantively consolidating the estates of separate debtors will radically change the expectations of creditors, particularly if they have not considered the impact of this doctrine. For example, the lender making a credit decision, believing the debtor fully able to satisfy its debt after due diligence review of the debtor, may find that the assets of that debtor are greatly diluted as a result of being pooled with the assets of affiliated debtors and dissipated to satisfy obligations owing by those other debtors to other creditors. Alternatively, the lender may find that the guarantees of affiliates of the target debtor, which the lender obtained to mitigate its risk, are eliminated by a substantive consolidation order and are no longer available to satisfy the debt. Depending on many factors, including the claims against the other affiliates by other creditors (often completely unknown by the creditors of different debtors) and the pooling of assets, a creditor's recovery can be dramatically reduced. If the creditor had been aware of the possibility of substantive consolidation at the time it was making a credit decision, that creditor could try to protect against this risk by various means, including obtaining additional debt coverage (perhaps in the form of affiliate guarantees or secured first-lien positions on the assets of the debtor) or pricing the debt.

Substantive consolidation results in a restructuring and revaluing of the rights of creditors, which for some creditors will result in reduced recovery (while others may obtain increased recovery).

There are many different circumstances in which entities may be substantively consolidated and the likelihood of substantive consolidation does not depend on the type of legal entity that a particular debtor may be. Thus, for example, corporations may be substantively consolidated with other affiliated corporations, limited liability companies or limited partnerships. Further, in a typical Chapter 11 case where multiple related debtor entities have filed petitions, all Chapter 11 debtors may be consolidated into one estate or only certain Chapter 11 debtors may be consolidated. Chapter 11 debtors may also be substantively consolidated with affiliates that have not filed Chapter 11 cases. In addition, substantive consolidation may be retroactive to a certain date (potentially even to a date before the bankruptcy petition was filed), depending on the equities involved.

Substantive consolidation is typically part of the plan confirmation process

Substantive consolidation may be achieved by a motion to the bankruptcy court (typically filed by the debtor) requesting that the entities involved essentially be merged together. However, more typically substantive consolidation is requested as part of the Chapter 11 reorganisation plan.

Creditors should review both the proposed plan and the accompanying disclosure statement, as the disclosure statement will often detail the debtor's basis in support of substantive consolidation. This will help creditors to dissect the debtors' substantive consolidation case and make decisions on whether to object to it. In general, in order to be confirmed a Chapter 11 plan must be voted for by more than half the creditors holding at least two-thirds of the debt. For example, if the debtor is insolvent and stockholders are to receive no recovery on their equity interests, they will be deemed to have rejected the plan. In such cases, substantive consolidation may be ordered despite the deemed rejection by stockholders of the reorganisation plan. Once the Chapter 11 plan has become effective, the creditors holding allowed claims will be paid according to their claims, pursuant to the distribution procedures established by the plan.

Of course, creditors may object to and challenge substantive consolidation, and in many instances are well advised to do so to protect their recovery. Creditors which are actively monitoring the Chapter 11 case to protect their claims should become engaged in the negotiations over substantive consolidation with the debtor and other creditor constituencies as early as possible. Often negotiation over substantive consolidation will be part of the plan negotiations between the debtor and the official committee of unsecured creditors that is typically appointed in a large Chapter 11 case. Constituents of official statutory committees appointed in a bankruptcy case (eg, unsecured creditors) should take advantage of the recent amendments to the Bankruptcy Code, which place heightened duties on official committees to report to their constituents, and should actively enquire about substantive consolidation and its impact on claims. Typically courts view the lack of objections as consent to substantive consolidation.

Deemed substantive consolidation

A variant of substantive consolidation, referred to as 'deemed' substantive consolidation, has also been developed in Chapter 11 cases, although not without criticism by some courts. In a deemed substantive consolidation, assets and liabilities will be treated as if there were a true substantive consolidation and merger of the separate affiliated entities, and inter-company liabilities and guarantees would be eliminated, but all solely for purposes of the Chapter 11 plan confirmation and claims distribution process. Thus, creditors of each separate entity would be lumped together by class in order to vote on the plan and for distributions under the plan. There would be no actual consolidation or merger of the entities at all. Deemed substantive consolidation has become a widely used mechanism in the Chapter 11 plan process. When done consensually, deemed substantive consolidation can be extremely effective in distributing recoveries to creditors without the entity-based consolidation required in a traditional substantive consolidation. In the absence of consent by the creditors, the continued viability of deemed substantive consolidation in some jurisdictions is in doubt. Creditors holding claims that will be negatively affected by a deemed substantive consolidation should carefully consider the benefits that may be obtained by objecting to such treatment.

No universal standards

No single legal standard is applied universally by all federal courts to decide substantive consolidation issues. The US Supreme Court has not ruled on the issue and the Bankruptcy Code does not provide specific statutory guidance. Rather, the doctrine of substantive consolidation continues to evolve in the various federal circuits throughout the United States. As such, parties should consult legal counsel to address the specifics of their local jurisdiction to make final determinations on the risk or likelihood of substantive consolidation in a particular case. Indeed, the lack of a universal standard for substantive consolidation makes this a very difficult area of the law for parties to predict whether estates will be consolidated. Moreover, even in jurisdictions where the circuit courts have established a standard to follow, the application of such standards is often heavily dependent on the facts, making it difficult to rely on previous cases as solid support for subsequent decisions.

Despite the lack of a universal standard, several standards have been articulated in certain key jurisdictions and certain evidentiary concepts are common among the majority of these standards. Understanding the types of facts and circumstances considered by the courts in substantive consolidation decisions can prove invaluable to a creditor making a credit decision with a particular debtor before a bankruptcy case or protecting its claim after a bankruptcy filing.

The diverging views on how these standards

should be applied further complicate matters. For example, some cases have suggested that there is a liberal trend towards allowing substantive consolidation. According to the liberal trend, due to the significant use of complex and interrelated corporate family structures employing subsidiaries which operate under a corporate parent for tax and other business purposes, parties should expect that substantive consolidation is a real possibility in a bankruptcy case. These jurisdictions are more likely to find substantive consolidation appropriate in certain circumstances. Other significant jurisdictions regard substantive consolidation as a last-resort remedy which should be used sparingly. This approach appears to give greater respect to the fundamental principle of independent legal existence of separate entities and the expectations of the credit markets.

Key legal standards

Among the most significant legal standards for substantive consolidation are those developed and applied in the Second and Third Circuits (the *Augie/Restivo* and the *Owens Corning* standards) and adopted by courts in other jurisdictions. These standards are well reasoned and come from two important jurisdictions for corporate bankruptcy cases as they include the bankruptcy courts in New York and Delaware, where many leading Chapter 11 cases have been filed. In addition, the DC Circuit's *Auto-Train* standard takes a slightly different approach from substantive consolidation, but is also significant as several other courts have adopted it.

The Second Circuit's *Augie/Restivo* standard is a test of two critical factors, whereby satisfaction of either prong justifies substantive consolidation. The test examines whether:

- creditors dealt with the debtors as a single economic unit and "did not rely on their separate identity in extending credit"; or
- the affairs of the debtors are so entangled that consolidation will benefit all creditors.

The *Owens Corning* standard in the Third Circuit considers whether:

- prior to filing the bankruptcy case, the entities disregarded their corporate separateness so significantly that their creditors relied on that disregard and treated the entities as one legal entity; or
- after the bankruptcy filing, the assets and liabilities of the entities are so mixed up that it would be prohibitive to separate them and harmful to all creditors.

Therefore, a *prima facie* case in support of substantive consolidation may be made where the parties' pre-petition dealings established disregard of corporate boundaries, thus giving creditors contractual expectations that they were dealing with the debtors as one entity. After the petition, the court considers how mixed up the debtor entities' assets and liabilities are and the relative harm or benefit to creditors that would result from substantively consolidating the estates.

Pursuant to the *Auto-Train* standard, a *prima facie* case for substantive consolidation is established where:

- there is a substantial identity between the entities to be consolidated; and
- consolidating the entities is necessary to avoid harm or realise some benefit.

Under this standard, once a *prima facie* case is established a creditor can object to substantive consolidation on the grounds that it relied on the separate credit of one of the entities and that it would be prejudiced by consolidation. Nonetheless, the court may order substantive consolidation if the benefits of consolidating outweigh the harm. This standard has been criticised by some courts as providing too easy a mechanism to override the general principles of corporate separateness inherent in the credit markets.

Factors to consider

Creditors and financial institutions considering pre-bankruptcy credit decisions face a difficult path when considering the risk of substantive consolidation in the event that the debtor were to file a bankruptcy case. Initially, it is difficult to predict where a debtor may file a bankruptcy case, as appropriate venues may include the jurisdiction where the debtor has a principal place of business, as well as jurisdictions where its affiliates reside. In addition, the different legal standards are applied in varying ways by various courts. However, the risk of significantly reduced recoveries in bankruptcy as a result of substantive consolidation compels analysis of the substantive consolidation risk as part of the credit decision process. Fortunately, many of the categories of fact that the courts may consider can be analysed. Such facts include the following:

- Do the entities have consolidated financial statements and do the individual entities maintain individual financial statements?
- Is there common ownership among the various entities? Does the parent corporation own all or a majority of the capital stock of the subsidiaries?
- Are there common officers and directors among the various entities in the corporate family? Is there evidence that the officers and directors of certain entities in the corporate family are not acting independently in the interests of such entities, but rather take direction from parent or other related entities?
- Does the parent entity finance the subsidiary entities?
- Do the affiliates or subsidiary entities have grossly inadequate capital?
- Do the subsidiary or affiliate entities have no business other than with the parent or other affiliates, or no assets except those conveyed to them by the parent or other affiliates?
- Have creditors relied on the separate credit of individual entities?
- Do the entities in the corporate family hold themselves out as separate legal entities or do they trade as a single entity? Are subsidiaries referred to as such or as mere departments or divisions of the parent?
- Are there guarantees on loans of one or more entities by affiliates in the corporate family?
- Are the assets and liabilities of the individual entities capable of being segregated and ascertained? If so, how difficult will it be to do so?
- Were assets transferred between related entities and if so were corporate formalities observed in doing so?
- Were assets and business functions commingled among the various entities in the corporate family?
- Would consolidating at a physical location be profitable?
- Would substantive consolidation make plan confirmation and consummation more likely than not?

Substantive consolidation and creditor recovery

Predicting whether a bankruptcy court may order substantive consolidation of related entities is a difficult task. That task is even more difficult if a creditor is trying to decide before the debtor has filed a bankruptcy case and would likely require consideration of each of the substantive consolidation standards that may be available. Indeed, even where the applicable legal standard is determined with certainty, given the many competing interests in a Chapter 11 case, the equities involved in the case and the various facts that will be presented to the court, it is hard to predict the outcome with any certainty. Nonetheless, it is helpful to consider a hypothetical example.

In this simplified example there is a corporate family of debtors with a parent and four subsidiaries. All the entities are Chapter 11 debtors in affiliated bankruptcy cases. Virtually the entire claims body against Sub D and a significant portion of claims against Sub A relate to guarantees of payment given by them on the debt of the parent to the banks that provided pre-petition unsecured financing of $2 billion to the parent. The banks did not obtain guarantees from Subs B and C. Table 1 illustrates the significant difference that a

Table 1

Debtor	Assets	Claims	Multiple recovery (%, with substantive consolidation)	Single recovery (%, with substantive consolidation)
Parent	$1.5 billion	$2.5 billion	60%	–
Sub A	$500 million	$2.05 million	24%	–
Sub B	$10 million	$1 million	100%	–
Sub C	$100 million	$3 billion	3%	–
Sub D	$400 million	$2.3 billion	17%	–
Totals	$2.51 billion	(with substantive consolidation) $5.85 billion		43%

substantive consolidation order may have on the recoveries of the various creditors.

Upon scrutiny, it is clear that upon substantive consolidation certain creditors will improve their recoveries and others will suffer. If substantive consolidation is ordered, all the assets are pooled together to be used to pay the claims of all the entities. Further, the guarantee claims of the banks against Sub A and Sub D would be wiped out by the substantive consolidation order. Thus, in the absence of substantive consolidation the banks would have received a full recovery on their claims if the guarantees were respected and the payments were made from the parent and the Sub A and Sub D guarantors (based on a recovery of 60 per cent from the parent, 24 per cent from Sub A and 17 per cent from Sub D). However, if substantive consolidation were ordered, the banks' recovery would be less than half of the full amount of their claim, based on a single recovery of 43 per cent. Additionally, with substantive consolidation, the creditors of Sub C would seem to achieve a windfall, increasing their recoveries from 3 per cent to 43 per cent, and the creditors of Sub B would lose their full recovery and receive the same 43 per cent recovery as the other consolidated creditors.

Given the many constituencies involved in a Chapter 11 case, such a result may be obtained consensually as part of the plan or reorganisation negotiation process. For example, such a consensual negotiated result may be achieved because the banks believe there are problems with their claims that could result in sustainable challenges to the claims. Alternatively, perhaps there is concern that the claims nominally placed at Sub-C level may in fact be properly asserted against the parent or the entire corporate family. However, there may be particular circumstances ie, where the banks did everything right to protect their claims) in which the banks decide to protect their claims and litigate over the issue of substantive consolidation.

The Owens Corning *decision*

The decision of the Third Circuit Court of Appeals in *Owens Corning* is a good example of how the courts will protect the legitimate rights of creditors which did everything correctly to protect their interests from substantive consolidation.

The debtors sought the substantive consolidation of Owens Corning of Delaware, along with certain wholly owned subsidiaries, some of which had also filed for protection under the Bankruptcy Code. Owens Corning and its subsidiaries comprised a multinational corporate family made up of corporations and limited liability companies. The different entities had different purposes, including:

- limiting exposure from mass tort asbestos liabilities;
- tax benefits; and
- various regulatory and operational purposes.

These subsidiaries were each separate legal entities which observed corporate formalities, such as:

- maintaining separate books and records;
- documenting inter-company transactions; and
- having separate business purposes for their existence.

Prior to Owens Corning seeking bankruptcy protection, it sought to acquire a separate entity. When Owens Corning was trying to raise financing for the transaction it had a poor credit rating and was facing growing asbestos liabilities. Therefore, the banks requested guarantees from the subsidiaries, giving the banks direct claims against the subsidiaries. Such guarantees were part of the loan term sheets and were required for the banks to extend the loan. When the $2 billion loan closed, the loan documents provided for the subsidiary guarantees, which were absolute and unconditional, and each of which was a guarantee of payment and not merely of collection. This distinction meant that upon the default of the primary obligor, the banks could proceed against the guarantors directly and immediately without first having to obtain a judgment against the primary obligor and then collect on that judgment to determine any shortfall. The loan documents also provided that the guarantees of the subsidiaries could not be released without payment of the debt or written consent by the banks. Further, the banks included various provisions in the loan documents limiting how the primary obligor could deal with its subsidiaries. Transactions with the subsidiaries and the parent that would result in a loss to the subsidiary could not be entered into, and the loan documents had provisions designed to maintain the corporate separateness of the subsidiaries and the parent. Such provisions included agreements to:

- maintain the entities as separate entities;
- keep separate books and records;
- prepare separate financial statements; and
- prohibit inter-company mergers.

Owens Corning and its subsidiaries filed for Chapter 11 protection due largely to extensive and growing asbestos liabilities. As part of the reorganisation plan process, the proponents of substantive consolidation sought to have a deemed consolidation, pursuant to which the Chapter 11 plan process would go forward as if the assets and liabilities of the separate entities were merged but in fact remaining separate, with the guarantees to the banks eliminated. Eliminating the guarantees would have significantly reduced the distribution to the banks while enhancing the distribution to other creditors. The Third Circuit viewed this as a ploy that would deprive one group of creditors, the banks, of their rights, while providing a windfall to other creditors, the holders of asbestos claims. The Third Circuit noted that such unravelling of pre-petition expectations and bargaining would create chaos in the marketplace.

The Third Circuit's decision, like other courts before it, emphasised that substantive consolidation is an extreme remedy that should be used only in compelling circumstances that call equity into play. The court spoke favourably of the Second Circuit's *Augie/Restivo* test, but was critical of the DC Circuit's *Auto-Train* test and any standard that would apply a checklist of factors in determining whether to consolidate. Instead, in formulating a standard and determining whether to consolidate, the Third Circuit emphasised five principles to be advanced:

- Limiting the cross-creep of liability by respecting entity separateness is a "fundamental ground rule". As a result, the general expectation of state law and of the Bankruptcy Code, and thus of commercial markets, is that courts respect entity separateness unless there are compelling circumstances calling equity (and even then only possibly substantive consolidation) into play.
- The harms addressed by substantive consolidation are nearly always those caused by debtors (and entities they control) that disregard separateness. Harms caused by creditors are typically remedied by provisions found in the Bankruptcy Code (eg, fraudulent transfer (§§ 548 and 544(b)(1)) and equitable subordination (§ 510(c))).
- Mere benefit to the administration of the case (eg, allowing a court to simplify a case by avoiding other issues or in order to make post-petition accounting more convenient) is hardly a harm calling substantive consolidation into play.
- As substantive consolidation is extreme (it may profoundly affect creditors' 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 remedies (eg, the possibility of more precise remedies conferred by the Bankruptcy Code).
- Although substantive consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used offensively (eg, with the primary purpose of tactically disadvantaging a group of creditors in the plan process or altering creditor rights).

Applying these five principles, the Third Circuit set forth the following two rationales for consolidating: "[W]hat must be proven [in the absence of consent] concerning the entities for whom a substantive consolidation is sought is that (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."

The court stated that the first rationale for consolidation in this disjunctive standard was intended to protect in bankruptcy the pre-petition expectations of those creditors. Consequently, a *prima facie* case for consolidation generally 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".

In applying this standard to the facts of the case, the Third Circuit noted that there was no pre-petition disregard of corporate separateness and no commingling of the debtors' assets and liabilities. The court also stated that "substantive consolidation should be used defensively to remedy identifiable harms, not offensively to achieve advantage over one group in the plan negotiation process". According to the court, what the banks did in structuring the pre-petition loan was the "'deal world' equivalent of 'Lending 101'", as they achieved structural seniority by obtaining a direct claim against the guarantors and their assets upon obtaining a judgment which the other creditors of Owens Corning did not have. Pre-bankruptcy, there was no evidence of disregard of the separateness of Owens Corning and its subsidiaries, or of any bad faith concerning any of the parties to the loan transaction. This kind of

lending occurs every business day and, according to the court, undoing this transaction would be a demanding task. Thus, the Third Circuit reversed the district court decision and held that no substantive consolidation was appropriate.

Conclusion

Substantive consolidation may have a significant impact on a creditor's recovery in a bankruptcy case. Creditors must be aware of the impact of substantive consolidation in their pre-bankruptcy dealings with debtors. If they do not account for substantive consolidation in making credit decisions, they could find that a full recovery on such claims in the absence of substantive consolidation will be reduced significantly. The legal standards for determining substantive consolidation vary across different federal judicial circuits, and even within those circuits the application of the standards depends on the facts and is tempered by notions of equity. When making a credit decision, sophisticated creditors will consider the various parameters of substantive consolidation and protect their investment appropriately with various credit enhancements. In many instances, such creditors would be well advised to consult legal counsel to help them navigate the stormy waters of substantive consolidation both outside and inside bankruptcy proceedings.

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