Articles

Third Circuit Reverses Owens Corning: Substantive Consolidation as a Shield, Not a Sword,

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The Third Circuit Court of Appeals has upheld the integrity of entity forms and commercial lending structures by reversing the Delaware bankruptcy court's order for substantive consolidation in the *Owens Corning* bankruptcy case. The circuit court established a set of principles for evaluating the appropriateness of substantive consolidation grounded on the fundamental rule of limiting the cross-creep of liability by respecting entity separateness. In a strongly-worded decision limiting application of this doctrine, the court stated: "If an objecting creditor relied on the separateness of the entities, consolidation cannot be justified *vis-à-vis* the claims of that creditor."[1]

BACKGROUND

The facts of the case are straightforward. Owens Corning and its subsidiaries comprise a multinational corporate group, with subsidiaries created and utilized for a variety of corporate, tax, and regulatory purposes. In 1997, Owens Corning sought and obtained a $2 billion loan from a group of banks in order to acquire Fibreboard Corporation. One of the banks' conditions to making the loan was obtaining guarantees from each existing and future subsidiary having assets with a book value in excess of $30 million; the credit agreement contained specific limitations on Owens Corning's dealing with its subsidiaries and requirements designed to protect their respective separateness.

Within three years, Owens Corning was facing mounting asbestos litigation and filed for reorganization with 17 of its subsidiaries. The debtors and certain unsecured creditors proposed a reorganization plan that included substantive consolidation of all debtors, together with three non-debtors. The plan, however, did not consolidate and pool together all the assets and liability of the entities; rather it proposed a "deemed consolidation" having the primary purpose of eliminating the separate subsidiary guarantees to the banks.

In support of its order, the bankruptcy court had concluded that:

a. There was substantial identity between Owens Corning and its subsidiaries;

b. The banks did not rely on the separate credit of the subsidiaries;

c. Consolidation would simplify and expedite completion of the reorganizaiton; and

d. It would be exceedingly difficult to untangle the financial affairs of the various entities.[2]

THE APPELLATE RULING

While these circumstances often have been cited by courts in support of consolidation, the court of appeals found the bankruptcy court's conclusions to be incorrect and unsubstantiated, and failed to adhere to the theoretical justification for the severe remedy of consolidation. Testimony indicated that the parties intended to treat the entities separately and that the banks had assessed the value of the guarantees in part from the entities' separateness; moreover, the very existence of the guarantees demonstrated an assumption of separateness. The court of appeals rejected the contention that the banks' failure to require independent financial statements for each subsidiary or even a legal opinion concerning substantive consolidation demonstrated non-reliance. The court also found no meaningful evidence of hopeless commingling of assets and liabilities. On this point, the court of appeals dismissed the idea that commingling of assets will justify consolidation when affairs of the companies are so entangled that consolidation will be "beneficial"; rather, only when separately accounting for the entities' assets and liabilities will reduce recovery for *every* creditor; mere benefit to some creditors or administrative benefit to the court falls short.[3] Imperfections and inaccuracies in sophisticated intercompany accounting systems are not uncommon, and do not justify an expanded substantive consolidation option for complex corporate groups in bankruptcy.

The court of appeals, disagreeing with the idea of a liberal or modern trend toward the increased use of substantive consolidation, articulated its view of the principles to be advanced in applying the doctrine:

1. Limiting the cross-creep of liability by respecting entity separateness is a fundamental ground rule;

2. The harms consolidation addresses are usually those caused by the debtors who disregard separateness; harms caused by creditors are generally remedied by provisions in the Bankruptcy Code;

3. Mere benefit to administering the bankruptcy case is not sufficient;

4. The extreme and imprecise remedy of consolidation should be rare and one of last resort; and

5. Consolidation may be used defensively to remedy identifiable harms caused by entanglement, but not offensively.[4]

CONCLUSION

In sum, a proponent of consolidation in the Third Circuit must show that (1) prepetition, the entities disregarded separateness so significantly that their creditors relied on this failure and treated the entities as one, or (2) postpetition, their assets and liabilities are so entangled that separating them is prohibitive and will hurt all creditors.[5] The court found no meaningful evidence supporting either of the foregoing tests for consolidation. The court favored the analytical approach of the Second Circuit in *In Re Augie/Restivo Baking Co., Ltd.,*[6] based on creditor reliance or excessive entanglement; and avoided the more lenient model followed by the District of Columbia Circuit in *In re Auto-Train Corp.*[7] based on "substantial identity" and a weighing of the benefits versus the harm of consolidation (which could override creditor reliance).

Significantly, the court's ruling signals greater respect for complex corporate structures and lending arrangements, and an unwillingness to disregard entities and business relationships in bankruptcy absent extreme circumstances. Moreover, the ruling gives greater support to the line of cases holding that intercorporate guarantees demonstrate recognition of the separateness of entities (weighing against consolidation), rather than reliance on the enterprise as a group (supporting consolidation). Although the decision is precedential for the Third Circuit only, creditors should find comfort in the court's instruction that attempts to use consolidation as a sword to deprive one group of creditors their rights, while granting a windfall to other creditors, will not be tolerated. Substantive consolidation, an extreme remedy affecting vital creditors' rights, will be permitted in the Third Circuit only as a last-resort remedy, and sparingly so. This is good news for commercial lenders as well as the securitization and structured finance markets.

Notes:

1. *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005).

2. *In re Owens Corning*, 316 B.R. 168, 171-172 (Bank. D.Del. 2004).

3. *Owen* at 214 (emphasis in original).

4. *Id*. at 211. The court cited with disapproval the assertion by the Eleventh Circuit of a modern or liberal trend toward allowing consolidation in *Eastgroup Properties v. Southern Motel Ass'n, Ltd*., 935 F.2d 245, 248 (11th Cir. 1991); *see* 419 F.3d at 209 fn. 15.

5. *Id* at 211.

6. *In re Augie/Restivo*, 860 F.2d 515 (2d Cir. 1988). After a detailed history and analysis of substantive consolidation, the Ninth Circuit adopted a test based on the Second Circuit's *Augie/Restivo* decision. *See In re Bonham*, 229 F.3d 750 (9th Cir. 2000). For a recent case denying consolidation in a structured finance situation, *see In re Central European Industrial Dev. Co LLC*, 288 B.R. 572, 576 (Bankr. N.D.Cal. 2003) ("Debtors infer that the corporate structure insisted upon by Lehman

somehow amounts to an attempt to create a 'bankruptcy-remote' entity, an evil they would cure by substantive consolidation. Their theory is unavailing…Debtors have cited no law that would be violated by such a corporate structure.")

7. *In re Auto-Train*, 810 F.2d 270 (D.C. Cir. 1987). The Eleventh Circuit and Eighth Circuit follow an approach similar to the D.C. Circuit *Auto-Train* decision, *see Eastgroup Props. v. Southern Motel Ass'n, Ltd.*, 935 F.2d 245 (11th Cir. 1991); *in re Giller*, 962 F.2d 796 (8th Cir. 1992).