

# Third Circuit Reverses Substantive Consolidation Decision in *Owens Corning* Bankruptcy Case

N. THEODORE ZINK

*Last year, in a controversial decision in the Owens Corning bankruptcy case, the District Court of Delaware substantively consolidated certain subsidiaries of Owens Corning into its bankruptcy estate. As a result, parties seeking to use guarantees to enhance their financings began to take extra precautions. Recently, the U.S. Court of Appeals for the Third Circuit reversed the district court decision. Here, a partner at Chadbourne & Parke LLP reviews the law of substantive consolidation, the district court's opinion and the Third Circuit's decision.*

**A** corporation is a recognized legal entity distinct from its owners and other affiliates. This separateness, a recognized feature of corporate law, is generally respected by courts. However, in a variety of contexts — most notably where the “piercing the corporate veil” and “alter ego” doctrines are applied — courts may conclude that the principle of corporate separateness should give way to right some wrong or to achieve some other benefit. In bankruptcy cases, substantive consolidation developed to overcome corporate separateness.

---

N. Theodore (Ted) Zink, a partner in the New York City office of Chadbourne & Parke LLP, has more than 16 years of experience in bankruptcy, workouts and creditors' rights. Mr. Zink has handled various bankruptcy situations, including the representation of debtors in prepackaged and conventional Chapter 11 cases, advisement of agent banks in the out-of-court restructuring of syndicated facilities, and representation of secured and unsecured lenders in Chapter 11 and cross-border insolvencies. He can be reached at [tzink@chadbourne.com](mailto:tzink@chadbourne.com). Associates Douglas E. Deutsch and Christy Rivera assisted in the preparation of this article.

---

Reprinted by permission. Copyright © 2005 ALEX eSOLUTIONS, INC. All rights reserved. No part of this journal may be reproduced in any form — by microfilm, xerography, or otherwise — or incorporated into any information retrieval system without the written permission of the copyright owner. Requests to reproduce material contained in this publication should be addressed to A.S. Pratt & Sons, 1725 K St., N.W., Suite 700, Washington D.C. 20006. For subscription information and customer service, call 1-800-572-2797.

A primary goal of the Bankruptcy Code is equality of distribution. The primary purpose of substantive consolidation is, likewise, to ensure the equitable treatment of all creditors. Substantive consolidation allows bankruptcy courts to combine the assets and liabilities of separate and distinct (but related) legal entities into a single pool and treat them as though they belong to a single entity. However, consolidation does not necessarily benefit all creditors. Different debtors are likely to have different asset/liability ratios, so substantive consolidation may disadvantage creditors holding claims against the financially stronger members of the consolidated group. Because of the potentially harsh redistributive result on innocent creditors, courts typically view substantive consolidation as a remedy to be granted “sparingly.”

## **THE OWENS CORNING BANKRUPTCY**

On Oct. 5, 2000, facing mounting asbestos litigation, Owens Corning and 17 of its wholly owned subsidiaries jointly filed petitions for Chapter 11 bankruptcy protection in the U.S. Bankruptcy Court in Wilmington, Del. The creditors in the case included, among others, asbestos claimants, bondholders and bank lenders under a \$1.6 billion bank credit line (the “banks”).

Several years after its bankruptcy filing, Owens Corning (together with asbestos claimants and others) proposed a reorganization plan predicated on obtaining substantive consolidation of 18 related debtor and non-debtor entities. The motion sought consolidation for Chapter 11 plan voting and distribution purposes only, thus preserving the corporate structure for all other purposes. The banks objected to the proposed consolidation.

At the crux of the consolidation issue was the undisputed fact that Owens Corning’s “Significant Subsidiaries” — those domestic subsidiaries having assets with an aggregate book value in excess of \$30 million — granted the banks guarantees at the time the credit line was entered in 1997. As a result of the guarantees, while asbestos claimants hold claims only against either Owens Corning or one other entity and holders of Owens Corning’s public debt hold claims only against Owens Corning, the banks potentially hold separate claims against each of the

guarantors in addition to their claims against Owens Corning. Accordingly, if the estates were substantively consolidated and the guarantees thereby nullified, the banks would be forced to share in the common pool of assets with asbestos claimants. In concrete financial terms, the banks believed they would lose more than \$1 billion in recoveries if the Owens Corning estates were substantively consolidated.

## THE DISTRICT COURT'S RULING

In last fall's ruling, Judge Fullam applied the *Auto-Train* test — a decision from the U.S. Court of Appeals for the District of Columbia Circuit and one of the leading cases on substantive consolidation — to the facts presented in the *Owens Corning* case and found that substantive consolidation was warranted. That test requires a proponent of substantive consolidation to demonstrate: (a) substantial identity among the entities to be consolidated; and (b) substantive consolidation is necessary to avoid some harm or realize some benefit. If this showing is made, a presumption arises that creditors have not relied solely on the credit of one of the entities involved, thus shifting the burden to the party opposed to consolidation to show that: (1) it has relied on the separate credit of one of the entities to be consolidated; and (2) it will be prejudiced by substantive consolidation.

Concluding with “no difficulty” that there was indeed substantial identity between Owens Corning and its subsidiaries, Judge Fullam conducted the harm/benefit analysis and noted that substantive consolidation would “greatly simplify and expedite the successful completion of the entire bankruptcy proceeding.” Moreover, absent consolidation, the District Court judge observed, it would be “exceedingly difficult to untangle the financial affairs of various entities.”

Having found that a *prima facie* case for substantive consolidation was demonstrated, Judge Fullam shifted the burden to the banks to prove: (1) reliance on the separate credit of the individual guarantors; and (2) that they would be prejudiced by substantive consolidation. In finding that the banks did not rely on the separate credit of any of the subsidiary guarantors, the judge noted that separate financial information

for the guarantors was not provided to the banks and only those subsidiaries with assets of \$30 million or more were required to provide guarantees, with no regard given to other debt obligations.

For these reasons, Judge Fullam found that the banks had not met their burden and granted the motion for substantive consolidation. According to the judge, substantive consolidation should be permitted, because not only did it allow “obvious advantages. . . [it was] a virtual necessity.”

## THE COURT OF APPEALS’ REVERSAL

In reversing Judge Fullam’s decision, the U.S. Court of Appeals for the Third Circuit began its analysis by rejecting the *Auto-Train* framework used by Judge Fullam and turning instead to the more stringent substantive consolidation test created by the U.S. Court of Appeals for the Second Circuit in the *Augie/Restivo* case. The Third Circuit held that with respect to those entities for whom substantive consolidation is sought, consolidation proponents must demonstrate that: (1) prepetition these entities disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity; or (2) postpetition these entities’ assets and liabilities are so scrambled that separating them is so cost-prohibitive as to adversely affect the recovery of all creditors.

The Third Circuit also reviewed several “principles” that it suggested substantive consolidation seeks to advance. Focusing on the severity of substantive consolidation as a remedy, the Third Circuit stated that a “fundamental ground rule” is to limit the cross-creep of liability by “respecting entity separateness.” It directed courts to “respect entity separateness absent compelling circumstances calling equity (and even then only possibly substantive consolidation) into play.” Again recognizing the harshness of this solution, the Third Circuit referred to substantive consolidation as a “rough justice” remedy to be viewed as “one of last resort after considering and rejecting other remedies.” The Third Circuit also announced that substantive consolidation should typically address harms caused by the debtors (and not

harm caused by the creditors) and that mere benefit to the case is not sufficient to invoke substantive consolidation.

After establishing the framework for its review, the Third Circuit began its application to the facts of the case. It addressed the first prong of its analysis by asking whether there was disregard of corporate separateness. It found that there was no disregard as Owens Corning and the banks negotiated the original lending transaction premised on the separateness of all the Owens Corning subsidiaries. Owens Corning cannot, said the Third Circuit, create the ground rules on corporate structure one day and ignore them the next. Moreover, the Third Circuit found that the fact that the banks did not require a review of individual, internal credit metrics for each Owens Corning subsidiary was not determinative of the issue — as was found to be the case by Judge Fullam — as the banks premised their credit extension on facts they knew about the guarantor subsidiaries as a group. The banks knew, for example, that each guarantor subsidiary had assets of at least \$30 million, that collectively the guarantor subsidiaries had assets worth more than \$900 million, and that the guarantor subsidiaries had little or no debt. Accordingly, the Third Circuit believed that it was irrelevant that the banks did not receive independent financial statements for each entity.

The Third Circuit also found that it was irrelevant that the banks did not request a legal opinion from counsel that substantive consolidation was unlikely to occur were any of the borrowers subject to bankruptcy. (The Third Circuit noted such opinions are typically not given for entities in existence for any significant period of time before the proposed financing.) Acknowledging that this type of lending with subsidiary guarantees occurs in the ordinary course of business, the Third Circuit held that the banks' requirement of guarantees from certain subsidiaries was evidence that the banks relied on the separateness of the entities in granting the loan.

The Third Circuit then turned to the second prong of its analysis and addressed hopeless entanglement. As the Third Circuit had already established the high threshold that “commingling justifies consolidation only when separately accounting for the assets and liabilities of the distinct entities will reduce the recovery of every creditor,” the Third

Circuit easily found that hopeless entanglement did not exist here. The fact that intercompany interest and royalty payments were not perfectly accounted for, as argued by the proponents of substantive consolidation, did not yield a different conclusion where there was no question of which entity owns which principal assets and which entity is obligated under which principal liabilities. According to the Third Circuit, “imperfection in intercompany accounting is assuredly not atypical in large, complex company structures” and could be addressed by a lower court’s oversight of an appropriate accounting process.

Finally, the Third Circuit reviewed several of the principles that it had earlier set forth. The Third Circuit again noted that substantive consolidation was a defensive tool meant to remedy identifiable harms and should not be used offensively simply to achieve advantage over one group in the plan negotiation process, as the Third Circuit believed was clearly the purpose here. The Third Circuit also determined, without citation to a specific principle, that the “flaw most fatal” to substantive consolidation in this case was the fact that the substantive consolidation at issue was a “deemed” consolidation (i.e. a temporary consolidation for all parties other than the banks). The Third Circuit rhetorically asked: “If [the Owens Corning entities’] corporate and financial structure was such a sham before the filing of the motion to consolidate, then how is it that post the [p]lan’s effective date this structure stays largely undisturbed, with the [Owens Corning entities] reaping all the liability-limiting, tax and regulatory benefits achieved by forming subsidiaries in the first place?”

## ANALYSIS

Judge Fullam’s opinion seemed born of necessity — as the only way to get an Owens Corning plan confirmed — and not of thorough legal analysis. Judge Fullam had ignored the fact that Owens Corning strictly adhered to corporate formalities, that application of the harm/benefit analysis should have disregarded the potential salutary effect of consolidation, and that a \$1 billion loss to the banks was certainly prejudicial. The Third Circuit agreed.

Although the Third Circuit adopted a more stringent substantive consolidation test (the *Augie/Restivo* test) than the test adopted by Judge Fullam (the *Auto-Train* test), the specific test applied is less important than a thorough and thoughtful analysis that pays appropriate deference to the corporate form. The test applied by the Third Circuit and the general principles enunciated by that court are consistent with the overwhelming majority of reported decisions on substantive consolidation.

Lenders should draw comfort from the Third Circuit's opinion. Among other things, the Third Circuit validated the current-day practice of obtaining subsidiary guarantees in connection with lending arrangements and limited the due diligence that lenders need to be able to demonstrate to counter a request for substantive consolidation. For example, lenders need not obtain independent, nonconsolidated financial statements with respect to each guarantor to demonstrate they relied on the corporate separateness of entities so long as they can demonstrate that they received detailed information from the parent about these subsidiaries.