

## Client Alert

### District Court Decision Negates Bank Guarantees Granted by Fortune 500 Affiliates

In a controversial decision entered last month in the Owens Corning bankruptcy case, United States District Court Judge John P. Fullam, Sr. granted a motion to substantively consolidate certain subsidiaries of Owens Corning into its bankruptcy estate. In light of this decision, lenders taking guarantees from affiliates of their primary borrower should proceed with caution.

#### An Introduction to Substantive Consolidation

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.

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. But consolidation may not benefit all creditors. Because different debtors are likely to have different asset-liability ratios, substantive consolidation may disadvantage creditors holding claims against the financially stronger members of the consolidated group. As one court observed, “lenders structure their loans according to their expectations regarding that borrower and do not anticipate either having the assets of a more sound company available in the case of insolvency or having the creditors of a less sound debtor compete for the borrower’s assets.” Because of the potentially harsh redistributive result on innocent creditors, courts view substantive consolidation as an “extraordinary” remedy to be granted “sparingly.”

#### The Owens Corning Bankruptcy

On October 5, 2000, Owens Corning and 17 of its wholly-owned subsidiaries jointly filed petitions for chapter 11 bankruptcy protection in the United States Bankruptcy Court in Wilmington, Delaware. Owens Corning filed for protection to address what it claimed were “growing demands on cash flow resulting from multi-billion dollar asbestos liability.” 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 their bankruptcy filing, Owens Corning (together with asbestos claimants and others) moved for 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 motion.

At the crux of the consolidation issue is the undisputed fact that Owens Corning's "Significant Subsidiaries" — those domestic subsidiaries having assets with an aggregate book value in excess of \$30,000,000 — 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. The distinction has significant monetary implications for the Banks.

If the estates are not substantively consolidated, and the Banks' guarantees are not otherwise invalidated for reasons unrelated to consolidation, it appears that the Banks would be paid close to 100 cents on the dollar. If, however, the estates were substantively consolidated and the guarantees thereby nullified, the Banks would share in the common pool of assets with asbestos claimants. In concrete financial terms, the Banks believe they will lose more than \$1 billion in recoveries if substantive consolidation is upheld.

### The District Court's Ruling

Judge Fullam began his brief decision by noting that all parties seemed to agree that the proper standard to apply to this case was set forth in *Auto-Train*, one of the leading cases on substantive consolidation. 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, explained the court, 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. Having established the analytic framework, Judge Fullam examined the facts relevant to the required showing for substantive consolidation.

The court cited to evidence on the operational side of the business and concluded with "no difficulty" that there is indeed substantial identity among Owens Corning and its subsidiaries. Among other things, the Judge found that the subsidiaries were dependent on the parent for funding and capital, that financial management was controlled centrally, that subsidiary officers and directors did not establish business plans or budgets and that control of the group of companies was exercised on a product-line basis. With regard to the harm/benefit analysis, the court found that substantive consolidation would "greatly simplify and expedite the successful completion of the entire bankruptcy proceeding." Moreover, absent consolidation, noted the court, it would be "exceedingly difficult to untangle the financial affairs of the various entities."

Because the "substantial identity" and harm/benefit elements had been shown to his satisfaction, Judge Fullam found that a *prima facie* case for substantive consolidation had been demonstrated. Therefore, stated the court, *Auto-Train* requires a shifting of the burden to the Banks who must then prove (1) reliance on the separate credit of the individual guarantors and (2) that they will be prejudiced by substantive consolidation.

Judge Fullam found that the Banks did not rely on the separate credit of the subsidiary guarantors because (i) separate financial information for the guarantors was not provided to the Banks, and (ii) only those subsidiaries with assets of \$30 million or more were required to provide guarantees, with no regard given to their other debt obligations. The court further concluded that the Banks would not be prejudiced because the guarantees — subject to a stayed fraudulent avoidance action — were

not clearly valid in the first instance and, if the guarantees were allowed, would create other avoidable transfer claims and confusing inter-subsidiary claims. As such, Judge Fullam found it “unrealistic to suppose that the Banks would have an easier time collecting their claims if consolidation were denied.” Accordingly, the Banks had not met their burden and the motion for substantive consolidation was granted.

### The Settlement Option?

After finding for Owens Corning and the other proponents of substantive consolidation, Judge Fullam added an unusual note in the conclusion of his decision which suggested that this might not be the final word on the matter. Claiming not to be convinced that “this is an all or nothing issue,” the Judge stated that the best result would recognize a more equitable sharing among the Banks and the other creditors. All parties, accordingly, were advised to settle their issues and end their scorched earth litigation tactics. Whether these statements will move the parties toward the negotiating table is not at all clear.

### Analysis

While Judge Fullam stated he would adhere to the standards set forth in *Auto-Train*, the court demonstrated a willingness, not readily evident in other cases, to find that the elements for consolidation were present. This was born of necessity, at least as perceived by Judge Fullam. Without substantive consolidation, all creditors in the Owens Corning bankruptcy case, except the Banks, would likely receive cents on the dollar. Confirmation of a plan of reorganization under these facts would be difficult. In contrast, for Judge Fullam, a substantive consolidation order makes confirmation possible. So too does any other compromise Judge Fullam can broker on the substantive consolidation issues, as suggested in his unusual post-script references.

In any event, the case for expediency does not change the applicable legal requirements. Judge Fullam appears to have exhibited little restraint in granting relief that virtually all other courts view as “extraordinary.” Concerns with Judge Fullam’s opinion include the following:

- the court’s analysis ignores the fact that Owens Corning’s strict adherence to corporate formalities makes this case different from other reported substantive consolidation cases;
- the court’s “harm/benefit” analysis ignores the widely accepted view that the potential salutary effect of consolidation on plan confirmation, standing alone, does not justify the imposition of such an extraordinary remedy; and
- the court’s conclusion that a \$1 billion loss (an amount the court previously acknowledged would be addressed at a separate evidentiary hearing, if necessary) would not prejudice the Banks, seems without logical foundation.

Judge Fullam’s decision has been appealed and it is difficult to speculate as to the ultimate outcome. Nevertheless, the opinion is not likely to be adopted by bankruptcy courts sitting in other circuits, especially in those circuits where the courts have adopted a substantive consolidation test which is clearly distinguishable from *Auto-Train*. Pending final resolution of this decision at the appellate level, however, lenders who seek guarantees should take certain precautionary measures to minimize the risk of substantive consolidation in courts that may be persuaded to adopt the expedient approach used by the court in *Owens Corning*.

## Recommendations

In light of Judge Fullam's decision, lenders should consider the following options when considering making a loan supported by affiliate guarantees:

- requiring detailed non-consolidated financial information from each guarantor, both at the outset of the lending and on an ongoing basis during the extension of the loan;
- restricting guarantors' actions related to entity form and solvency (such as consolidation, merger, liquidation and borrowing);
- requiring that the guarantees be collateralized by guarantor assets; and
- generally attempting to treat the guarantor (via restrictions and otherwise) in the same manner as the primary borrower.

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## For Additional Information

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