Substantive Consolidation and the Owens-Corning Decision

Introduction

An October 5, 2004 ruling in the chapter 11 case of Owens-Corning suggests lenders should look again at an old issue, the substantive consolidation of affiliated entities. In Owens-Corning, the substantive consolidation of the holding company with its subsidiaries eliminated the structural seniority of bank lenders which had obtained guarantees from many of the subsidiaries to support credit provided to the holding company. Note holders, vendors and tort claimants whose claims ran to the holding company only became pari passu with the bank lenders in the assets of the subsidiaries by virtue of the consolidation of the subsidiaries and the holding company. Because an order of substantive consolidation can alter the terms on which credit was extended, lenders should consider the impact the Owens-Corning decision may have as they monitor outstanding obligations and consider the provisions in their form lending documents.

Remedies of substantive consolidation are “equitable,” not statutory. Whether it will be ordered in a particular case will turn on how the court chooses among and applies standards that have developed as judge made law, rather than through analysis of a statute. Historically, substantive consolidation has been reserved for cases where the financial affairs among affiliates are so entangled – whether by design or sloppy business practices – that accurate assessment of which entity is obligated to a particular creditor or group of creditors cannot be determined or could only be determined at undue cost.

Courts routinely state that substantive consolidation is to be granted “rarely.” Over time, a variety of standards or “tests” for when substantive consolidation should be ordered have been articulated. The court in Owens-Corning mentioned two of the most frequently cited formulations of the test. One of the tests asks two questions: whether (1) creditors dealt with the entities as a single economic unit and did not rely on their separate identities in extending credit, and (2) the affairs of the entities are so entangled that consolidation will benefit all creditors. This is the test applied in the Second Circuit (federal courts in New York, among other states) and the Ninth Circuit (federal courts in California, among other states). A second frequently cited test requires the party seeking substantive consolidation to...
establish that (1) there is a substantial identity between the entities to be consolidated, and (2) consolidation is necessary to avoid some harm or to realize some benefits. In this second test, if these two elements are established, the burden then shifts to parties opposing substantive consolidation to show that they (1) relied on the separate credit of one of the entities to be consolidated, and (2) will be prejudiced by substantive consolidation. This is the test applied in the D.C. Circuit and the Eleventh Circuit (federal courts in Florida among other states). While neither test inherently contradicts the other, there are subtle differences between the two and a court’s selection of one over the other may skew the likelihood that substantive consolidation will be ordered.

The Owens-Corning bankruptcy cases are pending in Delaware, which is in the Third Circuit. The Third Circuit has neither articulated its own test for substantive consolidation nor endorsed another circuit’s formulation. The Owens-Corning Court applied the second formulation to the exclusion of the first. The court did not explain why it chose the second test beyond noting that at a hearing held before another judge, “the parties seemed to agree” that the second test was the proper standard.

Summary of the Debt Structure in Owens-Corning

In 1997, a group of lenders (the Banks) made commitments in excess of $2 billion to Owens-Corning and five of its subsidiaries under a revolving credit agreement that included swing line, letter of credit and competitive advance loan facilities. Owens-Corning guaranteed the borrowings of the subsidiaries. The Banks also received guarantees from all of Owens-Corning’s subsidiaries with assets having a book value in excess of $30 million covering all borrowings under the credit agreement. The credit was unsecured – neither Owens-Corning nor any of its subsidiaries pledged assets as collateral for the Banks.

At the time Owens-Corning filed for bankruptcy, approximately $1.6 billion was outstanding under the credit agreement. Owens-Corning’s other principal obligations included the public debt claims of note holders, the trade claims of vendors, and personal injury claims related to asbestos exposure. While the Banks had direct claims against Owens-Corning and, by virtue of the guarantees, its subsidiaries, the other principal creditors had direct claims against the parent company, Owens-Corning, only. The other principal creditors’ interests in the subsidiaries’ assets were structurally junior to the Banks’ claims under the guarantees.

The Court’s Application of the Facts and the Law

The court had “no difficulty” in concluding that there was a “substantial identity” between Owens-Corning and the guarantor subsidiaries. To support its conclusion, the court noted that a single committee controlled all of the subsidiaries. The court did not explain why it chose the second test beyond noting that at a hearing held before another judge, “the parties seemed to agree” that the second test was the proper standard.

According to the court, the parent company established subsidiaries, primarily for tax reasons. The parent company funded the subsidiaries operations and provided their capital. Subsidiaries repaid intercompany borrowings without interest. No subsidiary controlled its own finances.

The court found the second prong of the test it opted to use – whether substantive consolidation would provide “some benefit,” satisfied in two ways. Substantive consolidation would “greatly simplify and expedite” the completion of the bankruptcy proceeding and would make the “exceedingly difficult” task of untangling the financial affairs of the various debtor entities unnecessary.
Once the court made these findings, the burden then shifted to the Banks to prove that they had relied on the separate credit of the guarantors. Pointing to several reasons, the court concluded the Banks failed in their proof. The court viewed the multi-borrower and multi-guarantor structure of the Banks’ debt as an extension of credit to the entire enterprise. The court found it telling that the Banks required information only on the book value of each guarantor’s assets without inquiring as to that guarantor’s liabilities in requiring and taking the guarantees. The court also relied on its finding of fact that the financial reporting provided to the Banks was done on a consolidated basis.

After it concluded substantive consolidation was appropriate and necessary, the court observed “[t]he real issue is whether the Banks are entitled to participate, pari passu, with other unsecured creditors, or whether the Banks’ claim is entitled to priority, in whole or in part, over the claims of other unsecured creditors...the parties may come to a realization that the existence of the subsidiary guarantees does not warrant treating the Banks as if their claim was secured, and thus superior to the claims of all other unsecured creditors; but that the existence of the subsidiary guarantees might warrant treating the Banks’ claim as if it were partially secured.” The court ordered the parties to meet for the purpose of agreeing on a plan of reorganization. It appears an agreement was not reached. The Banks have appealed the decision.

Will the Owens-Corning Decision Become a Watershed?

In gauging the impact the Owens-Corning decision may have in subsequent bankruptcy cases, lenders should be aware of the context in which the case was decided. There were a number of factors present in Owens-Corning that make it unlike most bankruptcy cases.

The substantive consolidation issue was tried before a district court judge, not a bankruptcy judge. The judge who heard the evidence was removed from the case on motion of several of the Banks. The district judge who rendered the decision was his replacement. The ruling was based on the second judge’s review of the transcripts and documents admitted into evidence during a four day trial he did not attend.

The debt structure in Owens-Corning was not typical of most bankruptcy cases. The Banks were unsecured. Tort claims for personal injury related to asbestos constituted a major portion of the debt. The company joined with the tort claimants and the commercial creditors in supporting substantive consolidation. This alliance is noteworthy as the company’s records and employees are usually the primary sources for much of the evidence necessary to address the legal standard.

The court’s observation in its conclusion, which is quoted above, suggests the court wanted to encourage the Banks and the other principal creditors to divide, in some negotiated fashion, the economic difference between enforcing and eliminating the Banks’ structural seniority. Potential litigants and courts may, in the future, read this as diminishing the forcefulness of the decision.

Planning Ahead

What should lenders do in the wake of Owens-Corning? The decision did not purport to change the standards that must be met for substantive consolidation. Owens-Corning is, however, the first decision to substantively consolidate a major company over the objections of a significant creditor group. Whether future decisions will adhere to the rule that substantive consolidation is a remedy to be rarely granted remains to be seen. Lenders should not be surprised to see an increase in the instances in which substantive consolidation is sought to undermine the structural seniority one group of unsecured creditors enjoys over others in a multi-tiered enterprise. In such instances, lenders should expect to see litigants offer Owens-Corning as support for the notion that there is a “substantial identity” between entities when the
parent controls the operations, management and financing of the subsidiary. Lenders should also expect that litigants will argue Owens-Corning means that simply showing it would be difficult and expensive to untangle the obligations among affiliates and that joining them would expedite the bankruptcy process is sufficient for substantive consolidation.

What can lenders do to decrease the risk of harm to their credit through substantive consolidation? A valid and perfected security interest on each of the assets of the borrowers and credit support parties is the best defense. Substantive consolidation does not strip liens. There are of course situations where, for business reasons, lenders may not require collateral for the credit. Where the credit must be unsecured, lenders should consider protective measures early in the credit process. Due diligence files should show the lender evaluated the cash flow and balance sheet of each entity liable directly or indirectly for the borrowing. Covenants in the credit agreement should be drafted so that the borrowers and any credit support parties promise to remain sufficiently independent in their operations, management and financing from one another. Representations and warranties might be tailored to demonstrate that the lenders received initial and ongoing assurances.