The Banks Win: In *Owens Corning* the Third Circuit Rejects Expansion of Substantive Consolidation Doctrine

In a win for the bank lenders to *Owens Corning*, on August 15, 2005 the United States Court of Appeals for the Third Circuit rejected the lower courts' expansion of the doctrine of substantive consolidation and established the first Third Circuit precedent in the area. This opinion will govern substantive consolidation issues in all pending and future bankruptcy cases in Delaware, New Jersey and Pennsylvania and is likely to have a profound effect in all other bankruptcy courts.

Background

Owens Corning is an asbestos bankruptcy involving disputes between trade and bondholder creditors, future asbestos claimants and bank creditors. Substantially all creditors were unsecured (including the banks), but the trade and bondholders had claims against only some of the entities in the corporate family. The banks, however, had obtained guarantees from all major subsidiaries of *Owens Corning*, giving the banks structural seniority over the holding company bondholders and the asbestos claimants. After more than two years in bankruptcy, the asbestos claimants, the trade and bondholder creditors (represented by the creditors committee) and the debtor joined forces to propose a plan of reorganization in which all creditors would share pro rata in the assets of the consolidated group. The practical effect of this proposed deemed consolidation would be to eliminate the structural advantage to the banks from their subsidiary guarantees, thus increasing recoveries to holding company bondholders and the asbestos claimants, at the expense of the banks.

The lower court had ruled last year, in what was seen as a radical expansion of substantive consolidation doctrine, that the cases should be consolidated because there was "substantial identity" among the debtor companies and because consolidation would simplify and expedite the bankruptcy case. The lower court cited the fact that the banks had not insisted on stand-alone financials for the subsidiaries as evidence that the banks had not truly relied on the subsidiary guarantees. In rejecting the lower court's rationale and decision, the Third Circuit clarified the permissible grounds for substantive consolidation and rejected the use of substantive consolidation as an offensive weapon to advantage one creditor group at the expense of another.

The Third Circuit's decision set forth some basic principles on substantive consolidation:

- The strong presumption is that corporate structures should generally be respected.
- Mere administrative convenience is not enough to justify substantive consolidation.
- Substantive consolidation must be used as a matter of last resort and not as a substitute for seeking other potentially more suitable remedies (fraudulent conveyance actions, equitable subordination and veil-piercing claims).
- Courts must be extremely wary of substantive consolidation claims brought by creditors who are seeking advantage over other creditor groups.

Likely Practical Impact

This decision will be an important factor in every case that potentially involves parent-subsidiary issues and different creditors at different levels of the capital structure. Among other things:

- This decision will be seen as generally reducing the chances of substantive consolidation and should facilitate the giving of legal opinions regarding substantive consolidation. This is likely to be seen by the market as strengthening structured-finance transactions.
- Banks are likely to focus on the facts cited by the court in the *Owens Corning* decision, some of which may not be present in the more typical case involving substantive consolidation. *Owens Corning* was a very large multinational corporation with sophisticated internal legal and accounting systems in place for all its subsidiaries. In contrast, middle-market companies may fail to observe corporate formalities and maintain separate books of account after a financing closes. Consequently, to assure the applicability of the approach in *Owens Corning*, banks may impose more burdensome requirements on borrowers to assure the separate existence of their subsidiaries.
- This decision should reduce the hold-up value of holders of notes issued at the parent company level. The threat of the type of substantive consolidation challenge that was encouraged by the lower court decision in the *Owens Corning* case should now recede.
- On the other hand, in situations where creditors are trying to effectuate a consensual plan, the *Owens Corning* decision may give the dissenting bondholder or other creditor some additional leverage to oppose the plan by objecting to substantive consolidation.
- This decision removes what many saw as a major disincentive for large companies to file for bankruptcy in Delaware.