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Using Substantive Consolidation and Similar Remedies to Consolidate the Bankruptcy Estate

WEDNESDAY, JUNE 3, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Use of Substantive Consolidation in Bankruptcy Proceedings

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June 3, 2020

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Driving progress
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Substantive Consolidation: What is it?

- **A court-made doctrine and equitable remedy in bankruptcy, which originated with Bankruptcy Act of 1898**
- **Substantive Consolidation permits a bankruptcy court to combine the assets and liabilities of separate—but related—legal entities into one and treat them as a single entity**
- **The entities can be other debtor affiliates, or even potentially non-debtor affiliates**
- **The consolidated assets create a single fund from which all claims against the consolidated debtors are satisfied**
- **The merged companies' inter-company claims are extinguished, and the creditors of the consolidated entities are combined for purposes of voting on plans of reorganization**

Note: Substantive consolidation is not to be confused with procedural consolidation or joint administration

Substantive Consolidation: Legal Authority?

What is the legal authority that provides for Substantive Consolidation?

- **Bankruptcy Courts cite "Federal common law" and/or Section 105(a) of the Bankruptcy Code (i.e. the "Catch-All Provision")**
  - "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. 105(a)

- **Comparable to piercing the corporate veil or "mere instrumentality"/"alter-ego" doctrines under state law**

Does Substantive Consolidation Help or Harm Creditors?

It depends . . .

- **Substantive Consolidation is a hotly contested issue, as it can have severe impacts on debtors and creditors alike**
- **Substantive consolidation can cut through separate corporate structures and create a larger asset pool for distribution if certain complexities are overcome**
- **However, often creditors of one debtor entity will benefit at the expense of creditors of another entity**

Does Substantive Consolidation Help or Harm Creditors?

- **Typically, creditors of a poor estate are likely to seek consolidation to benefit from the pooling of assets with a more solvent related entity**
- **Substantive consolidation also may be sought when related estates have accounting practices that make them difficult to separate**
- **"While the remedy of substantive consolidation is more widely used to consolidate debtor estates already in bankruptcy, its scope has been held to reach non-debtor entities, under the appropriate circumstances"**
  - *Dominion Fin. Corp. v. Morfesis (In re Morfesis)*, 270 B.R. 28, 31 (Bankr. D.N.J. 2001)

Consolidating Non-Debtors with Debtors

- **Majority of Courts**
  - Permit consolidation of a non-debtor entity with a debtor entity
- **Minority of Courts**
  - Cite lack of jurisdiction over non-debtor in a bankruptcy action
  - Will not consolidate non-debtor entities with debtor entities
- **Burden of Proof**: Higher for substantively consolidating a debtor entity with a non-debtor entity (where permitted)

When Will a Court Allow Substantive Consolidation?

- **Courts have not developed a clear legal standard governing when the doctrine is to be applied, the analysis is highly fact-specific**
- **There are divergent views among the circuits regarding the standard for when/how often substantive consolidation should be employed**
- **The Third Circuit has noted that there is "nearly unanimous consensus" that it should be used "sparingly"**
  - *In re Owens Corning*, 419 F.3d 195, 209 (3d Cir. 2005)
  - *See also Wells Fargo Bank v. Sommers (In re Amco Ins.)*, 444 F.3d 690, 696 n.5 (5th Cir. 2006) and *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 767 (9th Cir. 2000)
- **But other courts, like the Eleventh Circuit, have noted a more "liberal" trend of allowing substantive consolidation, ostensibly due to the rise in "mega-corporations" with many subsidiaries**
  - *See Eastgroup Properties v. Southern Motel Assocs., Ltd.*, 935 F.2d 245, 248–49 (11th Cir. 1991)

What is the Standard for Substantive Consolidation?

- **Varies by jurisdiction, but there are three main tests from the Second, Third, and D.C. Circuits**
- **Second Circuit: *Augie/Restivo (1988)***
  - (i) if creditors dealt with entities as a single economic unit
  - (ii) if debtor affairs are so entangled that consolidation will benefit creditors
  - Focuses on creditors
- **Third Circuit: *Owens Corning (2005)***
  - (i) if creditors relied on entity sameness
  - (ii) are postpetition assets are so scrambled as to make separation prohibitive, harm creditors
  - Judge Ambro (lender-friendly jurist)
- ***D.C. Circuit: Auto-Train (1987)***
  - (i) substantial identity exists
  - (ii) necessary to avoid harm or realize benefit
  - Focuses on debtor entities

What Factors Will Courts Consider?

- **Prior to *Owens Corning*, courts developed two principal tests to determine if estates of two or more related debtors should be substantively consolidated: (1) Traditional Multi-Factor or Elements Test and (2) Balancing Test**
- **The Traditional Multi-Factor or Elements Test:**
  - This is the more traditional test, where courts consider a number of elements, which vary from court to court
  - Commonly considered elements include, among others: the presence or absence of consolidated financial statements, the unity of interests and ownership between the various corporate entities, and commingling of assets and business functions
- **The Balancing Test:**
  - The more modern test, which asks whether 'the economic prejudice of continued debtor separateness' outweighs 'the economic prejudice of consolidation.'
  - *See, e.g.*, *Eastgroup Props. v. Southern Motel Assocs., Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991)

Where do Courts Stand Today?

- **Many recent lower court decisions continue to rely on the standards articulated in *Auto-Train, Augie/Restivo Baking Co.* and *Owens Corning***
- **One court has noted that the *Augie/Restivo Baking Co.* and *Owens Corning* standards differ very little:**
  - "[T]he tests seem essentially the same—only the Third Circuit seems slightly more stringent in its wording." *In re ADPT DFW Holdings, LLC*, 574 B.R. 87, 98 (Bankr. N.D. Tex. 2017)
- **But the analysis remains very fact intensive**
  - In *ADPT DFW Holdings,* court cited to both Owens Corning and *Augie/Restivo Baking Co.* and conducted analysis under both the Multi-Factor and Balancing test
  - Still, the court turned to case-specific facts in its analysis: "the case at bar involves 140 Debtors . . . While there is no magic number that should necessarily change the legal analysis, surely all reasonable minds must recognize that having 140 related debtors in bankruptcy together is rare and creates unique challenges . . ."

Where do Courts Stand Today?

- **Lower courts applying the standard of *Augie/Restivo Baking Co.* have granted substantive consolidation**
  - *See, e.g., In re Republic Airways Holdings Inc.,* 565 B.R. 710 (Bankr. S.D.N.Y. 2017) (applying *Augie/Restivo*), aff'd, 582 B.R. 278 (S.D.N.Y. 2018)
- **While those applying the *Owens Corning* standard have typically rejected substantive consolidation, and courts often cite the decision's limiting language**
  - *See, e.g., In re Howland*, 674 F. App'x 482, 488 (6th Cir. 2017) ("Substantive consolidation is an 'extreme' measure, only to be used 'sparingly,' especially when consolidating a non-debtor entity" citing *Owens Corning*, 419 F.3d at 208-09, 211))
  - *See also Official Comm. of Unsecured Creditors of HH Liquidation, LLC v. Comvest Grp. Holdings, LLC (In re HH Liquidation, LLC),* 590 B.R. 211, 261(Bankr. D. Del. 2018)

Non-consolidation Opinions: View at 10,000 feet

- **A Non-consolidation Opinion explains the law concerning substantive consolidation in bankruptcy *and* provides assurance that a pertinent party to the transaction would likely not be consolidated with another party**
- **Required in a variety of transactions**
  - Particularly when a transaction involves a single-purpose entity ("SPE") or "special purpose vehicle" ("SPV")

Non-consolidation Opinions: Who Writes?

Bankruptcy lawyers

Issue opinion

Resolve questions about:

- "Entity separateness"
- Whether transaction is at "arms' length"
- "Value" (less common)

Why bankruptcy lawyers?

Substantive consolidation only exists in bankruptcy court

Bottom Line

- **The substantive consolidation analysis is very fact-based and rarely, or "sparingly" used in most jurisdictions**
- **Look to your jurisdiction for the legal standard that courts have employed when considering substantive consolidation**
- **Think through how substantive consolidation could impact your position relative to other creditors, and potentially seek a Non-consolidation opinion**

Alter Ego and Piercing the Corporate Veil

- **Substantive consolidation is similar to the state law remedy of piercing the corporate veil based on a finding that an entity is an alter ego**
- **Piercing the corporate veil, however, is not a prerequisite to the application of the bankruptcy law remedy of substantive consolidation**
- **There are sometimes parallel analyses, for example, first prong of the D.C. Circuit's test for substantive consolidation requires the movant to show "a substantial identity between the entities to be consolidated"**
  - *See In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 618 (Bankr. Del. 2001)

Alter Ego and Veil-Piercing in Bankruptcy

- **11 U.S.C. 541 defines "property of the estate" as "all legal and equitable interests of the debtor in property as of the commencement of the case"**
- **The U.S. Supreme Court held in *Butner* that "[p]roperty interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding"**
  - *Butner v. United States*, 440 U.S. 48, 55 (1979)
- **The challenge with alter ego claims is in determining whether a cause of action belongs to the estate or the creditor(s), ultimately, who can bring the cause of action will depend on each state's law on alter ego**

Alter Ego and Veil-Piercing in Bankruptcy

- **For example, under Texas law the remedy of alter ego "appears to be available to all creditors of the corporation so long as the requisite melding of the corporation and its control entity are established"**
  - *S.I. Acquisition, Inc. v. Eastway Delivery Serv., Inc. (In re S.I. Acquisition, Inc.)*, 817 F.2d 1142, 1152(5th Cir. 1987)
- **Because the alter ego claim could be asserted by any or all of the creditors without regard to the facts of their particular situation, the trustee was the proper entity to bring the action**
- **But this varies based on how each state treats the alter ego doctrine**
  - The Ninth Circuit, interpreting California law, allowed a single creditor to pursue an alter ego claim
  - *See Ahcom, Ltd. v. Smeding*, 623 F.3d 1248 (9th Cir. 2010)

Best Practices

- **How can debtors protect themselves?**
  - Maintain corporate separateness: management, books & records, offices, employees, etc.
  - Adequately capitalize all subsidiaries
  - Observe corporate formalities: establish Board of Directors, keep minutes of meetings, etc.
- **How can creditors protect their interests?**
  - Think through how substantive consolidation will impact your priority
  - Evaluate the financial situation of each subsidiary
  - Seek a non-consolidation opinion from experienced counsel