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Third Circuit Court of Appeals Adopts Objective Test for Substantive Consolidation

Ronit J. Berkovich

In *In re Owens Corning*, the United States Court of Appeals for the Third Circuit overturned an order of a Philadelphia district judge presiding over a District of Delaware case granting the debtors' motion to substantively consolidate the bankruptcy estates of Owens Corning ("OCD") and 17 of its debtor and nondebtor subsidiaries. In its decision, the Third Circuit deduced from numerous accepted bankruptcy principles and statutes a test for substantive consolidation similar to the test adopted by the United States Court of Appeals for the Second Circuit. The court explicitly rejected the "liberal trend" asserted by other courts, including the United States Court of Appeals for the Eleventh Circuit and bankruptcy courts in Virginia and Florida.

Substantive Consolidation

The equitable doctrine of substantive consolidation permits a court in a bankruptcy case to disregard the separateness of one or more related legal entities and to consolidate and pool their assets and liabilities and treat them as though held and incurred by one entity. In effect, substantive consolidation creates a single estate for the benefit of all creditors of all the consolidated entities and combines such creditors into one creditor body. In addition, substantive consolidation eliminates intercompany liabilities of the consolidated entities and nullifies guarantees of one entity's debts of another.

Notably, some courts consolidate entities while providing certain priorities to creditors otherwise prejudiced by the consolidation. The appellate court did not opine on those situations.

A court's power to order substantive consolidation in a bankruptcy case is not expressly authorized by the Bankruptcy Code (except in the case of spouses). Instead, it arises under a bankruptcy court's general equitable powers under section 105(a) of the Bankruptcy Code, which provides in relevant part that a "court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." Generally, courts make the substantive consolidation determination on a case-by-case basis after reviewing the relevant facts and applying standards set forth in the case law.

The effects of substantive consolidation on creditor rights and distributions can be substantial. Because different legal entities are likely to have different debt-to-asset ratios, substantive consolidation generally prejudices some creditors (those of the more solvent entity) and benefits others (those of the less solvent entity). As a result

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of this drastic effect, as well as the doctrine's overlooking of corporate form and imposition of results not otherwise attainable absent satisfaction of requirements for fraudulent transfers (a transfer that may be unwound if made with the intent to hinder or defraud a creditor or for inadequate consideration at a time when the debtor was insolvent or became insolvent because of the transfer), equitable subordination (a doctrine that allows courts in certain situations to modify the normal priorities established by the Bankruptcy Code to avoid injustice in the distribution of the debtor's assets), or plan confirmation, courts have consistently cautioned that substantive consolidation is difficult to achieve and should be used only sparingly.

Tests for Substantive Consolidation

Though all courts appear to accept that under some circumstances substantive consolidation may be appropriate, there is no one accepted test for applying substantive consolidation. Rather, different courts have formulated their own tests for determining whether to substantively consolidate two or more legal entities, or have applied the same test differently.

The test cited with approval by most courts, but sometimes applied differently, is the objective and predictable test developed by the Second Circuit and most recently applied by it in *Union Sav. Bank v. Augie/Restivo Baking Co.* (*In re Augie/Restivo*). In *Augie/Restivo*, the Second Circuit summarized its prior holdings and held that substantive consolidation is appropriate only when (i) creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, or (ii) the affairs of the entities are so entangled that consolidation will benefit *all* creditors.

On the other end of the spectrum, the Eleventh Circuit (in *Eastgroup Props. v. S. Motel Assoc., Ltd.*) adopted a two-part test that it later applied differently in *Reider v. FDIC* (*In re Reider*). Under *Eastgroup* (which cites with approval the Second Circuit decisions), the proponent of substantive consolidation first must demonstrate (i) there is substantial identity between the entities to be consolidated and (ii) consolidation is necessary to avoid some harm or realize some benefit. Once the *prima facie* case has been made, the burden shifts to an objecting creditor to demonstrate that (i) it relied on the separate credit of one of the entities and (ii) it will be prejudiced by substantive consolidation. If this showing is made, the court may still order substantive consolidation if it determines that the demonstrated benefits of substantive consolidation heavily outweigh the harm.

The Eleventh Circuit's *Eastgroup* opinion is the most liberal test for granting substantive consolidation. In its subsequent decision in *Reider*, however, while purporting to adopt and apply the *Eastgroup* test, the Eleventh Circuit scaled back the potential far-reaching effect of *Eastgroup* by stating the requirements for substantive consolidation in strong language reminiscent of the *Augie/Restivo* standard, particularly that there must be entanglement or reliance.

Asserting a "liberal" trend first articulated in an uncontested decision on a substantive consolidation motion that satisfied the Second Circuit test, certain

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lower courts have adopted subjective standards for substantive consolidation. These courts generally go through a checklist of factors with little guidance on how courts should weigh those factors in making an ultimate determination of whether substantive consolidation is appropriate. Almost all the cases ordering substantive consolidation on a multi-factor approach, however, fall under one or more of the following categories: substantive consolidation was unopposed, the court found no creditor would be prejudiced by substantive consolidation, the court found the entities or persons to be substantively consolidated were mere shells or alter egos of each other and/or were established for a nefarious purpose, and/or the facts would satisfy the strict *Augie/Restivo* standards. The few cases that do not fall under one of those categories depart from the normally strict standards, but still require proof of substantial identity or hopeless commingling.

The other Courts of Appeal have not adopted a consistent test. The United States Court of Appeals for the Ninth Circuit adopted the *Augie/Restivo* test; the United States Court of Appeals for the Eighth Circuit adopted a test considering the necessity, benefits, and prejudice of substantive consolidation; and the United States Court of Appeals for the First Circuit has utilized a multi-factor approach. In *Nesbit v. Gears Unlimited, Inc.*, a title VII case, the Third Circuit summarized the positions taken by the different circuits.

Factual Background

In *Owens Corning*, several years prior to OCD's chapter 11 filing, a syndicate of banks provided a $2 billion

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Second Circuit Upholds Priorities Established Under Subordination Agreement and Rejects Appeal of Nondebtor Releases Under Doctrine of Equitable Mootness

Craig E. Johnson

In *In re Metromedia Fiber Network, Inc.*, the United States Court of Appeals for the Second Circuit addressed three key issues in the bankruptcy arena. First, the court decided that a subordinated creditor could not use a standard "X" clause in a subordination agreement to circumvent the priority of payment established through that agreement. Second, the court affirmed the district court's order approving confirmation of the debtor's plan of reorganization based on the doctrine of equitable mootness but ruled that the bankruptcy court erred in approving the nondebtor releases contained in the debtor's plan of reorganization.

Relevant Legal Principles

"X" Clauses

Debt may be subordinated to other debt by law or by agreement (typically, an indenture in the case of publicly issued subordinated debt). A subordination agreement between two creditors, one of whose debt is to be subordinated to the other's, generally provides that the senior creditor will receive payment in full from the debtor before the subordinated creditor receives anything. In general, under a subordination agreement, the occurrence of materially adverse events caused or directed by the borrower, such as a payment default, the commencement of a bankruptcy case, or another similar "triggering event," requires any further payments or other distributions that otherwise would be made to the holders of the subordinated debt to be paid to the holders of debt that is specifically designated as "senior." The Bankruptcy Code recognizes the validity of subordination provisions and, therefore, a plan of reorganization must preserve subordination rights unless the senior debtholders agree to different treatment.

In most indentures, however, a standard provision, commonly referred to as an "X" clause (*i.e.*, the "exception" to subordination), allows subordinated debtholders to retain securities in the reorganized debtor if such securities are subordinate to the securities received by the senior debtholders. The inclusion of "X" clauses became standard practice after the publication in 1971 of the Commentaries on the Model Debenture Indenture Provisions (the "Commentaries") by the American Bar Foundation. The rationale for this exception is that, by preserving the subordination, the "X" clause does not adversely affect the rights of senior debtholders, even though such holders have not been repaid in full in cash.

Nondebtor Releases

Upon confirmation of a plan of reorganization, a debtor generally is discharged from liability on claims that

arose before confirmation. Once confirmed, a plan is generally binding on all creditors, including those who voted against the plan. The discharge obtained after confirmation is for the benefit of the debtor and, consistent with that concept, section 524(e) of the Bankruptcy Code provides that a "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." While section 524(e) does not, on its face, authorize releases of nondebtor parties, a growing body of case law holds that it does not expressly preclude such releases either.

Under nondebtor releases, the debtor may seek to obtain releases for its principals, directors and officers, guarantors, financiers of its plan, and other third parties to protect them from claims related to the debtor that may be asserted against them after confirmation. Such releases may relate either to claims held by the debtor against third parties or to claims held by third parties against some other entities connected with the debtor.

Courts have split on the question of whether Bankruptcy Code section 524(e) precludes the confirmation of a plan containing a nondebtor release. The United States Courts of Appeal for the Ninth and Tenth Circuits have held that, without exception, section 524(e) prohibits nondebtor releases and permanent injunctions. The United States Court of Appeals for the Seventh Circuit, rejecting the notion that a release of nondebtors is impermissible under any circumstances, has concluded that such a release is within the power of the bankruptcy court as long as the affected creditors consent. Accordingly, it has held that a nondebtor release is binding only on those creditors who have voted to accept the plan. The majority of circuit courts, including the United States Courts of Appeal for the First, Second, Fourth, Sixth, Eleventh, and District of Columbia Circuits, that, directly or indirectly, have considered the issue have adopted a more flexible approach. They have held that bankruptcy courts have the authority to confirm plans of reorganization or settlements containing nondebtor releases. However, they have outlined specific requirements that must be satisfied before such plans can be confirmed. The United States Court of Appeals for the Fifth Circuit has also listed specific circumstances where temporary injunctions against a nondebtor may be appropriate but declined to approve a permanent injunction against a nondebtor. The United States Court of Appeals for the Third Circuit, in reversing a lower court order approving release provisions, declined to establish a blanket rule prohibiting all nonconsensual nondebtor releases and permanent injunctions of actions against nondebtor parties.

Despite having approved nondebtor releases in the past, the Second Circuit mentioned a reluctance to approve nondebtor releases.

Equitable Mootness

After a chapter 11 plan of reorganization is confirmed, a party in interest may appeal the confirmation. If the appellant fails to seek a stay of confirmation, the plan may be consummated before the appeal is heard. At that point, a debtor may move to dismiss the appeal under the doctrine of "equitable mootness." This doctrine relies on the public policy favoring finality of bankruptcy reorganization and provides that a substantially consummated plan usually should not be overturned on appeal. This reluctance to "unscramble the egg" creates a tension, however, between the public policy against upsetting a confirmed plan, on the one hand, and the due process right of creditors to appeal a judgment on the merits, on the other.

Equitable mootness is a doctrine peculiar to the context of appeal of a chapter 11 plan. Unlike "constitutional" mootness, it does not require a showing that there no longer is a live controversy or that no effective relief can be fashioned. Instead, the plan proponent need only show that the plan was "substantially consummated"; that is, the proposed transfer of property under the plan has occurred, the reorganized entity has assumed management of the reorganized business or the property dealt with under the plan, and distributions to creditors under the plan have commenced. An appellant's failure to exhaust all possible efforts to seek a stay pending appeal also weighs in favor of dismissing an appeal of confirmation.

The doctrine of equitable mootness depends heavily on the reliance by creditors and investors on the finality of the confirmation order and the harm that could be done by unjustifiably upsetting their expectations. Undercutting this reliance would make it more difficult for debtors to obtain financing necessary to exit from bankruptcy successfully. A competing consideration, however, is that creditors' legitimate expectations of being allowed to pursue their

right of appeal should not be upset if the court can fashion limited relief on appeal that would not effectively destroy the reorganization.

Factual and Procedural Background

In *Metromedia*, before commencing its chapter 11 case, the debtor, AboveNet, Inc., f/k/a Metromedia Fiber Network, Inc., and its subsidiaries (collectively, "Metromedia"), issued various notes pursuant to an indenture agreement that subordinated the rights of the holders of those notes (the "Subordinated Noteholders") to the rights of certain other creditors (the "Senior Noteholders"). An "X" clause in the subordination agreement allowed the Subordinated Noteholders to keep, in the case of a reorganization of Metromedia, securities issued by the reorganized Metromedia that are junior or otherwise subordinate to the securities issued to the Senior Noteholders.

Under Metromedia's plan of reorganization, the Subordinated Noteholders were to receive a combination of cash, common stock in the reorganized Metromedia, and warrants to purchase additional common stock. Nonetheless, the terms of the subordination agreement dictated that the entire distribution to be made to the Subordinated Noteholders was to be reallocated to the Senior Noteholders. Two Subordinated Noteholders objected to Metromedia's plan of reorganization and argued that the "X" clause, although requiring the reallocation of the cash and stock, allowed them to keep the warrants.

The objecting Subordinated Noteholders also argued that certain nondebtor releases provided under the plan of reorganization including one to a cer-

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Section 365 Applies Only to "True Leases" and Not to Secured Loans Which Purport To Be Leases

Lauren Sierchio

The United States Court of Appeals for the Seventh Circuit, in *United Airlines, Inc. v. HSBC Bank USA, N.A.*, held that for purposes of section 365 of the Bankruptcy Code, courts must look to substance over form and distinguish a "true lease" from a secured loan because section 365 applies only to "true leases." In addition, the Seventh Circuit found that courts must turn to state law for guidance on what aspects of a transaction distinguish "true leases" from secured loans. In applying California law, the Seventh Circuit determined that the debtor was a party to an agreement the substance of which was a secured loan and, accordingly, not subject to the mandates of section 365 of the Bankruptcy Code.

The Bankruptcy Code provides different treatment for leases and secured loans despite the fact that the two transactions share similar economic features. The characterization of the transaction under the Bankruptcy Code as either a "lease" or a secured financing may be of critical importance to both parties to the agreement.

Treatment of a "True Lease" Under the Bankruptcy Code

Under the Bankruptcy Code, if the debtor is a party to a true lease, the lessor's title to the leased property will remain valid, and the lease will be treated as an executory contract; that is, the debtor will be required either to assume or reject the lease in its bankruptcy case pursuant to section 365 of the Bankruptcy Code. In addition, the Bankruptcy Code requires the debtor to continue to perform its obligations under a lease of personal property or commercial real property until the debtor assumes or rejects the lease.

If the debtor assumes a lease, the debtor must cure all defaults under the lease (including any unpaid amounts), provide adequate assurance of future performance, and thereafter perform all its obligations under the lease. Moreover, after a lease has been assumed, the debtor's obligations under the lease generally are entitled to administrative expense priority; that is, priority over all other unsecured claims filed against the debtor.

The Bankruptcy Code permits the debtor to assign a lease it has assumed even if the contract provisions specifically prohibit assignment. Moreover, contract provisions that terminate a lease upon insolvency or the filing of bankruptcy are unenforceable under the Bankruptcy Code. If the lease was terminated before the bankruptcy filing, however, the debtor may not assume it.

If the debtor rejects (*i.e.*, breaches) the lease, the nondebtor party is entitled to repossess its property and recover damages arising from the rejection. These damages are calculated in the same manner as they would be under

nonbankruptcy law (although real property lease damages are capped by the Bankruptcy Code), but are deemed to arise prepetition (before the commencement of the bankruptcy case). The claim for such damages is treated under the debtor's plan of reorganization in the same manner as other prepetition, general unsecured claims and is entitled to payment in bankruptcy dollars on a pro rata basis with other unsecured claims.

Treatment of Secured Financings Under the Bankruptcy Code

A "financing" lease is, in substance, a conditional sale or financing of the "leased" property, and the rental payments are, in substance, the payment of principal and interest on a loan secured by the leased property or, ultimately, the purchase price for the "leased" property. Unlike a true lease, which a debtor is required to assume or reject, a debtor is prohibited under the Bankruptcy Code from assuming or assigning a financing agreement. In addition, in contrast to the Bankruptcy Code requirement that the debtor perform its obligations under a lease of personal property or commercial real property until the debtor assumes or rejects the lease, the debtor is under no obligation to continue making payments to a creditor/lessor under a financing agreement after the debtor's bankruptcy filing unless the creditor is secured and the court finds that payments of some amount are necessary to adequately protect the creditor's interest in its collateral.

Under a "disguised" financing agreement, the "lessor" is essentially a seller or lender and does not own the property. Instead, the lessor may be deemed to have a security interest in the property and is treated for bankruptcy law purposes as a creditor with either a secured or unsecured claim that may be dealt with in the debtor's bankruptcy case. Such a claim will be treated as secured or unsecured depending upon whether (i) the creditor's security interest is properly perfected and (ii) if it is, the value of the creditor's collateral. Under section 506(a) of the Bankruptcy Code, a secured lender has a secured claim to the extent of the value of its interest in the collateral and an unsecured claim for any deficiency. Under certain circumstances, a secured creditor may have grounds to seek relief from the automatic stay to foreclose on its collateral.

Given that the Bankruptcy Code fails to discuss which economic features of a transaction have what consequences, the Seventh Circuit concluded it must turn to state law to supply the definitions.

Factual Background

During the 1990s, United Airlines, Inc. ("United") entered into complex transactions to obtain financing to build or improve facilities at four major airports including: San Francisco, Los Angeles, Denver, and New York's John F. Kennedy. In short form, these transactions generally consisted of a public entity issuing bonds that paid interest exempt from federal taxation because of the issuer's status as a unit of state government. The proceeds of the bond issuance were turned over to United in exchange for United's promise to retire the bonds over a specified period and reimburse administrative costs. In addition, for each airport, United and the issuer entered into a lease giving the issuer the right to evict United from the occupied facilities upon United's failure to pay amounts due.

At issue in this appeal was the San Francisco transaction. In 1997, the California Statewide Communities Development Authority (the "CSCDA") issued $155 million in bonds and the funds realized from the issuance were provided to United. United used the proceeds of the bonds to improve facilities at the San Francisco airport but not at its maintenance base. The transaction was formulated through four documents including, among others, a sublease and a leaseback. United subleased to the CSCDA 20 acres of a 128-acre maintenance base at the airport (that United leases from the airport) for a term of 36 years, for a total rent of $1.

Under the leaseback, the CSCDA leased the 20 acres back to United for rents equal to the interest payments on the bonds, plus an administrative fee, with a balloon payment of $155 million in 2033 to retire the principal, the option to postpone final payment (and extend the sublease) for five years, or the option to prepay, in which case the sublease and the leaseback would terminate. In addition, the leaseback included a "hell or high water" clause providing that United must pay the rent under the lease regardless of whether its lease with the airport ends before 2033, the property is submerged in an earthquake, or some other physical or legal

event deprives United of the use or benefits of the maintenance base.

When United filed a petition for relief under chapter 11 of the Bankruptcy Code in 2002, it took the position that the San Francisco transaction and the other three transactions were not "leases" for purposes of section 365 of the Bankruptcy Code. Instead, United asserted that these transactions were, in substance, secured loans so that it could continue using the airport facilities while only currently paying a fraction of the amounts otherwise called for under the agreements.

The bankruptcy court held that although the word lease is not defined anywhere in the Bankruptcy Code, the term in section 365 includes "true leases" but not transactions where the form is that of a lease but the substance is that of a secured financing. Applying this holding, the bankruptcy court determined that the transactions involving the San Francisco, Los Angeles, and New York airports were secured loans and the transaction involving the Denver airport was a true lease. Accordingly, United had to cure any defaults and resume full payments on the Denver transaction but was entitled to reduce payments on the other transactions and treat the difference as unsecured debt.

On appeal, the district court held in four separate opinions that all four transactions were "true leases" by applying the applicable state law to determine whether each transaction had the characteristics of a true lease or a secured financing. United appealed all four decisions. The Seventh Circuit addressed the San Francisco transaction and held in abeyance the other appeals, pending the outcome in the San Francisco matter.

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Charges of Aiding and Abetting Breach of Fiduciary Duty and Fraudulent Conveyance Dismissed Against Lender

Christopher M. Lopez

In *Sharp International Corp. v. State Street Bank and Trust Company*, the United States Court of Appeals for the Second Circuit affirmed the district court's dismissal of a claim against a lender for aiding and abetting a breach of fiduciary duty by a borrower by failing to disclose its knowledge of the fraudulent activities of a company to another creditor. The court also affirmed the dismissal of the claims against the lender for constructive and fraudulent conveyances finding that there was neither an inference of bad faith by the lender nor was there an allegation of actual fraud for the transfer the debtor sought to avoid.

Requirements for Pleading Aiding and Abetting a Breach of Fiduciary Duty and Fraudulent Conveyance

New York law requires a plaintiff to plead three elements to establish a claim for aiding and abetting a breach of a fiduciary duty: (i) a breach of fiduciary obligations, of which the aider and abettor had actual knowledge; (ii) the defendant knowingly induced or participated in the breach; and (iii) the plaintiff suffered damages as a result of the breach.

With reference to fraudulent transfers, certain provisions of the Bankruptcy Code grant to the trustee or debtor in possession specific authority under federal bankruptcy law or applicable state law to avoid (unwind) certain transfers of property or interests in property made by the debtor before the bankruptcy petition was filed. The New York Uniform Fraudulent Conveyance Act deems a transfer as constructively fraudulent if it is made without fair consideration and either: (i) the transferor is insolvent or will become insolvent by the transfer in question; (ii) the transferor is engaged in or is about to engage in a business transaction for which its remaining property constitutes unreasonably small capital; or (iii) the transferor believes that it will incur debt beyond its ability to pay. To be for fair consideration, (i) the recipient of the debtor's property must either (a) convey property in exchange or (b) discharge an antecedent debt in exchange, (ii) the exchange must be for equivalent value, and (iii) the exchange must be made in good faith.

To prove actual fraud, a creditor must show intent by the transferor to hinder, delay, or defraud. Courts often look to badges (or indicia) of fraud to demonstrate actual fraudulent intent including: (i) a close relationship between the parties; (ii) a transfer outside the usual course of business; (iii) retention by the transferor of the property; and (iv) inadequate consideration for the transfer.

Background

Prior to 1997 to October 1999, the controlling shareholders of Sharp International Corp. ("Sharp"), a New York corporation in the business of importing and selling watches, clocks, pens and pencils,

began to falsely report sales, inventory, and accounts receivable, and invent customers in order to report fictitious revenue and facilitate the borrowing of large sums of money which the shareholders diverted for their personal benefit. During this period of fraudulent activity, a lender (the "Lender") approved a $20 million line of credit to Sharp and Sharp also issued $17.5 million of subordinated notes to a group of investors (the "Noteholders"). In 1998, the Lender suspected Sharp was engaging in fraud and launched an internal investigation focused on the company, including conducting due diligence to verify the existence of Sharp's purported customers and requesting certain financial documents and audits, which Sharp refused to provide. Sharp alleged that as a result of the Lender's suspicions of fraud, the Lender arranged for Sharp to repay the Lender's loans from the proceeds of new loans obtained from unsuspecting lenders, such as the Noteholders. In March 1999, the Noteholders purchased an additional $25 million in subordinated notes from Sharp ($10 million more than Sharp owed the Lender). At this time, the Lender did not give any warnings or blow any whistles on Sharp and gave its consent to the new indebtedness. Sharp paid $12.25 million from the new proceeds to the Lender and the controlling shareholders gave personal promissory notes for the remaining $2.75 million owed to the Lender. Shortly thereafter, Sharp's accountants refused to issue an audit opinion on behalf of the company and in September 1999, the Noteholders commenced an involuntary chapter 11 bankruptcy proceeding against Sharp.

In May 2001, Sharp, through its trustee in bankruptcy, commenced a proceeding against the Lender in the bankruptcy court and alleged that the Lender aided and abetted Sharp in breaching its fiduciary duty to the Noteholders by not disclosing Sharp's fraud. Sharp further alleged that the Lender received a fraudulent conveyance by accepting the $12.25 million in proceeds of the loans obtained from the Noteholders. The bankruptcy court dismissed Sharp's complaint on the basis that Sharp failed to properly allege a claim against the Lender upon which relief could be granted. Regarding the aiding and abetting claims, the bankruptcy court held that Sharp failed to plead that the Lender had actual knowledge of Sharp's shareholders looting the company or that the Lender participated in or induced any fraud (the first prong of the three-part test described above). As to the constructive fraudulent conveyance claim, the bankruptcy court held that Sharp failed to allege that the Lender's receipt of the payment from Sharp in satisfaction of the loan was not in "good faith." The bankruptcy court dismissed the intentional fraudulent conveyance claim due to Sharp's failure to allege badges of fraud. The district court affirmed the bankruptcy court's decision, but on a different basis. The district court held that, while Sharp adequately alleged the Lender's knowledge of the fraud, Sharp did not properly plead the second prong of the test, that the Lender participated in or induced the fraud. Sharp filed an appeal to the Second Circuit.

> [T]he court noted that a failure to act is only considered aiding and abetting when a defendant owes a fiduciary duty to the plaintiff.

The Second Circuit's Decision

Aiding and Abetting a Breach of Fiduciary Duty

On appeal, the Second Circuit affirmed the holdings from the lower courts. The court began its analysis of the aiding and abetting claim by noting that the bankruptcy court and the district court agreed that Sharp failed to allege that the Lender knowingly induced Sharp's shareholders to commit fraud or had participated in the breach committed by the shareholders. The court noted that "inducement" was not defined under New York law, but is commonly understood to mean a person who provided "substantial assistance" to the primary violator. According to the court, substantial assistance exists when an aider and abettor affirmatively assists, helps conceal, or fails to act when required to do so, thereby allowing the breach to occur. However, the court noted that a failure to act is only considered aiding and abetting when a defendant owes a fiduciary duty to the plaintiff. The court considered Sharp's allegations against the Lender, which included: (i) the Lender's demand that Sharp obtain new debt to retire the Lender's debt; (ii) concealing knowledge of the fraud; (iii) electing not to foreclose on the loan; (iv) avoiding the new lenders' attempts to discuss Sharp's credit; and (v) providing consent to Sharp for the Note-

holders' purchase of $25 million in new notes. The court concluded "that the complaint says no more than that [the Lender] relied on its own wits and resources to extricate itself from peril, without warning persons it had no duty to warn." The court found that the Lender's actions or inaction did not constitute inducement to commit fraud because the Lender had no duty under New York law to inform existing Sharp creditors of the fraud nor did they constitute substantial assistance. The court further concluded that the Lender's desire to have its loans repaid and its giving of consent to the new debt did not affirmatively assist the fraud. According to the court, the Lender became aware of the fraud through research that could have been conducted by any other lender.

Constructive Fraudulent Conveyance

The court further affirmed the dismissal of Sharp's allegation that a payment to the Lender in partial satisfaction of Sharp's obligations under the loan constituted a constructive fraudulent conveyance under the New York Fraudulent Conveyance Act. Sharp alleged that the repayment of the Lender's loan was not for "fair consideration" because the Lender did not receive the payment in good faith. The court noted that the concept of "good faith" was an elusive concept under New York constructive fraudulent conveyance law because the intent of the transferor or transferee was irrelevant. Accordingly, the court affirmed the dismissal of Sharp's claim and, citing to case law in the Second Circuit, noted that bad faith does not overcome a general principle that satisfying an antecedent debt constitutes fair consideration for a transfer of property. The court noted that the only exception to this proposition were payments satisfying antecedent debts of insiders and concluded that generally, a preference between creditors does not constitute bad faith. The court also concluded that it did not matter if the preferred creditor knew whether the debtor was insolvent.

The court also rejected Sharp's argument that this situation involved more than a preference and the Lender acted in bad faith because it knew that the funds used to repay the loan were fraudulently obtained from the Noteholders. The court concluded "that a lack of good faith 'does not ordinarily refer to the transferee's knowledge of the source of the debtor's monies which the debtor obtained at the expense of other creditors.'" The court further noted that the Lender's loan was made in good faith prior to the alleged fraudulent transfer. As such, the court did not believe there were grounds to "collapse" the loan into other bad faith acts. According to the court, the Lender's knowledge of the shareholder's fraud, without more, does not lead to the conclusion that the Lender received the $12.25 million in bad faith.

Intentional Fraudulent Conveyance

Finally, the court affirmed the dismissal of Sharp's intentional fraudulent conveyance claim because Sharp failed to allege fraud with respect to the transfer it sought to void. Sharp alleged that its $12.25 million payment to the Lender was voidable as an intentional fraudulent conveyance. To prove actual fraud, Sharp had the burden to prove that the Lender actually intended to hinder, delay, or defraud present or future creditors or show badges of fraud to establish actual fraudulent intent. Sharp alleged that the district court improperly focused on the badges of fraud aspect instead of the undisputed evidence of actual fraud committed by Sharp's controlling shareholders. The court concluded that Sharp failed to allege fraud for the $12.25 million payment because the fraud alleged in Sharp's complaint referred to the manner in which Sharp obtained the funding from the Noteholders, and not Sharp's $12.25 million payment to the Lender. The court held that the $12.25 million payment was at most a preference between creditors and did not prove that the Lender intended to delay, hinder, or defraud present or future creditors. Accordingly, the court held that Sharp failed to plead that the Lender committed an intentional fraudulent conveyance.

Conclusion

The Second Circuit's holding in *Sharp* affirms that absent the existence of a fiduciary duty, lenders have no duty to disclose to other creditors actual knowledge of any fraudulent activity by a troubled company. Instead, a lender has a right to protect its interests, even if the results of that is to the detriment of another creditor. Furthermore, a non-insider's knowledge of a fraud does not overcome the general presumption that the payment of an antecedent debt does not constitute bad faith. Accordingly, in the Second Circuit, a debtor may not assert a fraudulent conveyance action against a creditor solely based on the creditor's knowledge of fraudulent activity.

Sharp Int'l Corp. v. State Street Bank & Trust Co. (*In re Sharp Int'l Corp. & Sharp Sales Corp.*), 403 F.3d 43 (2d Cir. 2005).

Section 365 Applies Only To "True Leases"

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The Seventh Circuit's Decision

There were two questions before the Seventh Circuit in this case. First, whether section 365 uses form or substance to distinguish leases from secured credit. And second, what attributes constitute a lease as opposed to a secured loan. In order to make this second determination, the Seventh Circuit analyzed and applied California state law.

In citing several appellate court cases, the Seventh Circuit noted that all courts considering the issue agree that only a "true lease" counts as a "lease" under section 365. Before offering a definition of a "true lease," the Seventh Circuit defended the rationale behind the well-established principle that section 365 applies only to "true leases." Observing that the Bankruptcy Code specifies different treatment for secured loans as compared with leases, the court stated "it is unlikely that the Code makes big economic effects turn on the parties' choice of language rather than the substance of their transaction; why bother to distinguish transactions if these distinctions can be obliterated at the drafter's will?"

The Seventh Circuit believed that understanding the difference between "financial distress," a situation in which an entity cannot meet its debts as they come due, but has a positive cash flow from current operations, and "economic distress," a situation in which a firm has a negative cash flow, is instrumental in distinguishing the way leases and secured loans are intended to be treated under the Bankruptcy Code. The court suggested that the Bankruptcy Code effectively treats the date on which a bankruptcy begins as the creation of a new firm, free of the debts of its predecessors. In other words, "the new firm must cover all new expenses, while debt attributable to former operations is adjusted." Leases for airplanes and business premises, for example, are classified as new expenses pursuant to the requirements for assumption of leases under section 365. In contrast, the Bankruptcy Code treats secured loans as old expenses to be adjusted in order to manage financial distress.

> As the court stated "[r]eversion without additional payment is the UCC's *per se* rule for identifying secured credit."

So what happens when you have a lease that provides "rent" that represents the cost of funds for capital assets or past operations? The court concluded that such a lease has the quality of debt "and to require such obligations to be assumed under section 365 would permit financial distress from past operations to shut down a firm that has a positive cash flow from current operations." The court summarized the differences between the two transactions stating that a lease which is dominated by a consumption component is often a "true lease," whereas a lease in which the underlying asset serves as a security for an extension of credit is treated as a security agreement governed by Article 9 of the Uniform Commercial Code (the "UCC"). The Seventh Circuit summed up the UCC's *per se* rule for distinguishing "true leases" and secured loans as "[i]f the lessee has an option to acquire ownership at the end of the term for no or a nominal payment, then the transaction must be treated as secured credit."

The Seventh Circuit found that the drafters of the Bankruptcy Code could not have intended the term "lease" in section 365 to incorporate any transaction in the form of a lease when the text of the Code mandates different treatments for leases and secured debt (*i.e.*, leases for current consumption have to be paid in full while secured debt may be adjusted to reduce financial distress).

To determine the contours for a "true lease" under section 365, the Seventh Circuit examined California state law. Given that the Bankruptcy Code fails to discuss which economic features of a transaction have what consequences, the Seventh Circuit concluded it must turn to state law to supply the definitions. The court observed that a state law that defined a lease by form as opposed to substance would conflict with the Bankruptcy Code, "because it would disrupt the federal system of separating financial distress from economic distress."

California has enacted the UCC, and therefore, adopted the UCC's functional approach to separating leases from secured credit with respect to personal property. The Seventh Circuit disagreed with the district court's conclusion that California allows form to con-

trol, and concluded that California also takes a substance over form approach with respect to real property based on a review of California state law cases.

Applying California law to the present case, the Seventh Circuit reversed the decision of the district court and determined that the transaction between United and the CSCDA was not a "true lease" in substance. The Seventh Circuit pointed to multiple characteristics of the transaction that indicated its substance was a secured loan. First, the "rent" is measured not by the market value of the 20 acres within the maintenance base but rather by the interest payments on the funds United borrowed from the CSCDA. The court further determined that the "hell or high water" clause also reinforced a lack of connection between the maintenance base's value and United's obligations to the CSCDA.

Second, the court noted that at the end of the lease, the CSCDA will have no remaining interest in the leased property. As the court stated "[r]eversion without additional payment is the UCC's per se rule for identifying secured credit." The CSCDA challenged this argument, reasoning that United will not own anything at the end of the lease but rather, will continue to be the airport's tenant. The Seventh Circuit was not persuaded by this line of reasoning and suggested that the full tenancy interest reverting to United is enough to imply a secured loan.

Third, the court noted that the transaction provides for a balloon payment to retire the principal. This, the court concluded, was a feature often found in secured credit arrangements but not in leases.

Lastly, the court found it important that if United prepays the obligations, the lease and the sublease would terminate immediately. This, the court determined, indicates the transaction is a secured loan because in a true lease situation, "prepayment would secure the tenant's right to occupy the property for an additional period." Taking all of the above factors into consideration, the Seventh Circuit reversed the judgment of the distinct court and found the transaction between United and the CSCDA to not be a "true lease." Instead, the court concluded that United used an asset (its interest in the maintenance base) to secure a financing and it agreed to pay "rent" equal to the price of the financing rather than the value of the "leased" premises.

Conclusion

In *United Airlines*, the Seventh Circuit cements the principle that section 365 only applies to "true leases." Accordingly, parties should be aware that at least in the Seventh Circuit, courts will not allow form to govern over substance or the circumvention of the underlying policies of the Bankruptcy Code through the mere manipulation of the structure of an overall transaction or the language of a contract. Although an agreement may be drafted as a lease, unless the agreement is actually a "true lease," the economic advantages of being treated as a lessor versus a secured lender under the Bankruptcy Code will not be available.

United Airlines, Inc. v. HSBC Bank USA, N.A., 2005 U.S. App. LEXIS 15240 (7th Cir. July 26, 2005).

Legislative Update

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 To Become Effective

With certain enumerated exceptions set forth in the bill which have already taken effect, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") will take effect on October 17, 2005 and will apply only to cases commenced under the Bankruptcy Code on or after that date. Interim rules and forms for the Act have been established but it appears that permanent rules for the Act will not take effect until a later time. While the full impact of the Act will not be known until after it takes effect on October 17, 2005, it is believed that many of the provisions are expected to have a major impact. A detailed summary of the key provisions of the bill is set forth in the Special Edition of the *Bankruptcy Bulletin* from April 2005.

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, 109th Cong. (2005).

Second Circuit Upholds Priorities and Rejects Appeal

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tain trust (the "Trust") were not authorized by the Bankruptcy Code. These releases permanently enjoined creditors from suing the Trust and the various other nondebtors. In exchange for the releases and 10.8% of the common stock in the reorganized Metromedia, the Trust would forgive approximately $150 million in unsecured claims against Metromedia, convert $15.7 million in senior secured claims to equity in the reorganized Metromedia, invest approximately $12.1 million in the reorganized Metromedia, and purchase up to $25 million of unsold common stock in the reorganized Metromedia.

Despite the two Subordinated Noteholders' objections to the reallocation of the warrants and the nondebtor releases, the bankruptcy court confirmed Metromedia's plan of reorganization, and the district court affirmed the confirmation order. The objecting Subordinated Noteholders proceeded to appeal to the Second Circuit the confirmation order on two grounds. First, they challenged the reallocation to other creditors of stock warrants that were initially allocated to them under Metromedia's plan. Without contesting that cash and stock allocated to appellants were properly reallocated to those creditors under the terms of the subordination agreement, the objecting Subordinated Noteholders argued that they were allowed to keep the warrants by virtue of the "X" clause. Second, they contended that the releases in Metromedia's plan were unauthorized by the Bankruptcy Code, at least on the findings made by the bankruptcy court.

The Second Circuit's Decision

"X" Clause and Subordination

In *Metromedia*, the Second Circuit first addressed the challenge to the reallocation of stock warrants from the Subordinated Noteholders to the Senior Noteholders under the subordination agreement. The "X" clause exempted from subordination "securities of [MFN] as reorganized or readjusted, or securities of [MFN] or any other Person provided for by a plan of reorganization or readjustment, junior, or the payment of which is otherwise subordinate, . . . with respect to the Notes, to the payment of all Senior Indebtedness." The objecting Subordinated Noteholders argued that under the "X" clause, the warrants were exempt from subordination. To interpret this clause, the Second Circuit sought guidance from the Commentaries and case law. After conferring with these sources, the Second Circuit held that, generally, an "X" clause allows a subordinated noteholder to "retain its securities only if the securities given to the senior noteholder have higher priority to future distributions and dividends (up to the full amount of the senior notes)." In this way, the "X" clause provides a two-fold benefit. First, it allows senior noteholders to enjoy unimpaired the priority to payment that they hold under the notes. Second, it also assures that the junior creditor remains fully subordinated without requiring it to yield assets that are not required for full payment of the senior creditor, with the attendant delay, friction, and transaction costs. According to the court, the Subordinated Noteholders could keep the stock warrants only if by doing so, they did not impair the priority of the Senior Noteholders established by the subordination agreement.

Applying this understanding of "X" clauses to the facts in *Metromedia*, the Second Circuit found that the Senior Noteholders had not received full payment for their debt under Metromedia's plan of reorganization and, therefore, if the Subordinated Noteholders were permitted to retain their warrants, the Subordinated Noteholders would be able to buy the same class of common stock allocated to the Senior Noteholders, giving the Subordinated Noteholders equal priority to any future distribution and impairing the seniority of the Senior Noteholders, contrary to the priorities established by the subordination agreement. For these reasons, the court upheld the bankruptcy court and district court decisions and refused to allow the objecting Subordinated Noteholders to retain their warrants and maintained the priority created by the subordination agreement.

Nondebtor Releases

The Second Circuit next addressed the issue of whether Metromedia was justified in granting the Trust and other nondebtors releases under its plan of reorganization. Despite having approved nondebtor releases in the past, the Second Circuit mentioned a reluctance to approve nondebtor releases. The Second Circuit held that such releases are *only* appropriate in "rare" cases and should only be approved upon a finding that truly unusual circumstances render the releases important to the success of the plan of reorganization. According to the court, there is no explicit authority in the Bankruptcy Code supporting nondebtor releases (outside asbestos cases), and such releases lend themselves to abuse by permitting nondebtors to shield themselves from liability to third parties. The Sec-

ond Circuit clarified that "a nondebtor release is not adequately supported by consideration simply because the nondebtor contributed something to the reorganization. . . ." Courts that have approved nondebtor releases in the past have done so when the estate has received substantial consideration or in unique circumstances. The Second Circuit concluded that the bankruptcy court's findings were insufficient on whether the releases were important to the success of the plan of reorganization because the sole finding by the bankruptcy court was that the nondebtor made a "material contribution" and there was no finding or evidence presented that the releases were important or necessary to the debtor's plan of reorganization. According to the court, a bankruptcy court should make factual findings to support the authorization of nondebtor releases.

Notwithstanding the Second Circuit's opinion on nondebtor releases, it held that the objecting Subordinated Noteholders' appeal of the nondebtor releases was equitably moot, because Metromedia's plan of reorganization had been "substantially consummated," including the issuance of substantially all of reorganized Metromedia's stock, the full receipt of the consideration from the Trust, the cash distributions, and entry into a host of contracts, leases, and other arrangements as part of the reorganized Metromedia's day-to-day operations. The Second Circuit determined that the releases were a significant aspect of the plan and that the bargain struck by Metromedia and the Trust might have been different absent the releases. As a result, it would be inequitable to try to unravel the plan. The Second Circuit held that "[i]t appears that all these things have been done, and that none of the completed transactions can be undone without violence to the overall arrangements. In any event, we cannot predict what will happen if this settlement is in any part altered." Moreover, the Second Circuit found that neither of the objecting Subordinated Noteholders sought a stay of confirmation or an expedited review of the appeal, which the court determined also weighed against appellants in their efforts to reverse an order of confirmation. The court suggested that parties in such circumstances should seek a stay even if it may seem unlikely that a court will grant a stay. For these reasons, the Second Circuit concluded the appeal was equitably moot.

The Second Circuit clarified that "a nondebtor release is not adequately supported by consideration simply because the nondebtor contributed something to the reorganization. . . ." Courts that have approved nondebtor releases in the past have done so when the estate has received substantial consideration or in unique circumstances.

Conclusion

In the context of analyzing an "X" clause, the Second Circuit found that such clauses will allow a subordinated noteholder to retain its securities only if the securities given to the senior creditors have higher priority to future distributions and do not impair that priority. This finding will provide comfort to senior creditors who seek to employ subordination agreements to establish priority of payment. The holding in *Metromedia* does not discard the use of "X" clauses altogether as the court acknowledged that they serve to reduce transaction costs under a subordination agreement. Nonetheless, such "X" clauses will not be found to nullify the priorities embodied in the subordination agreement.

In addition, in *Metromedia*, the Second Circuit signaled what may be a reluctance by the court to approve nondebtor releases absent unusual circumstances. The Second Circuit applied a strict standard and held that, unless the debtor can demonstrate unique circumstances where the releases are important to the success of the plan, such releases will not be approved. Creditors should keep in mind, however, that at least in the Second Circuit, if a stay of confirmation is not sought or obtained, a court may still confirm a plan of reorganization containing nondebtor releases if the plan has been substantially consummated at the time of appeal based on the doctrine of equitable mootness.

In re Metromedia Fiber Network, Inc., No. 04-2112-BK, 2005 WL 1693838 (2d Cir. July 21, 2005).

Objective Test for Substantive Consolidation

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loan to OCD. As a condition to the loan, the banks required that a guarantee be provided by all OCD's domestic subsidiaries having assets with an aggregate book value in excess of $30 million. To enhance the value of these guarantees, the credit agreement contained explicit provisions requiring the subsidiaries to maintain their separateness from OCD, including limiting the ways OCD could deal with the subsidiaries.

After filing chapter 11 petitions, OCD and seventeen of its debtor and nondebtor subsidiaries proposed a chapter 11 plan providing for the "deemed" substantive consolidation of the debtors and three nondebtor subsidiaries. Under the proposed plan, consolidation would be deemed to exist for purposes of allowing and satisfying creditor claims, voting for or against the plan, and making distributions on claims, but the plan would not effect an actual consolidation or merger of the legal entities. As a result of the deemed consolidation, however, the guarantees provided by the subsidiaries under the credit agreement would be eliminated, and the "deemed" consolidated entities would only be liable for a single obligation to the banks on the underlying claim. The banks objected to the proposed substantive consolidation. It could result in a diminution of their distribution of approximately $2 billion.

Procedural History

After withdrawing the reference from the bankruptcy court, the district court granted the debtors' motion for substantive consolidation and overruled the banks' objection. The court applied its interpretation of the test utilized by the District of Columbia Circuit in *Drabkin v. Midland-Ross Corp.* (*In re Auto-Train Corp.*). The court first held there was substantial identity between the entities being consolidated. In support of its determination, the court pointed to certain factors common in large multi-entity companies, such as: all the subsidiaries were controlled by a single committee from a central headquarters, the subsidiaries were established for the convenience of the parent company, and the subsidiaries were dependent on the parent company for funding and capital. The court also ruled it would be "exceedingly difficult" to untangle the financial affairs of the various entities.

> The court also criticized the multi-factor approach, noting that the factors in a checklist often fail to separate the unimportant from the important or even establish a standard by which to apply them.

After noting the proponents of substantive consolidation had established a *prima facie* case under the *Auto-Train* test, the court further held that, despite the existence of the guarantees, the banks relied on the overall credit of the entire enterprise, as opposed to that of any or all of the individual subsidiaries. The court even held that the very existence of the guarantees supported substantive consolidation, as the interdebtor indemnification claims would be difficult to sort out. The court concluded that under the *Auto-Train* standard, substantive consolidation was appropriate. The banks filed an appeal with the Third Circuit.

Third Circuit Adopts Objective Test for Substantive Consolidation

After a detailed discussion of the history of substantive consolidation and the varying standards therefor, the Third Circuit stated explicitly that it favored the *Augie/Restivo* approach. According to the court, one prong of *Auto-Train*'s standard, namely that substantive consolidation is necessary to avoid some harm or realize some benefit, is too imprecise for easy measure and thus presents too low a bar. The court also favored the *Augie/Restivo* approach because another prong of the *Auto-Train* standard would allow for substantive consolidation to be justified even if an objecting creditor proves it relied on the separate credit of one entity. The court also criticized the multi-factor approach, noting that the factors in a checklist often fail to separate the unimportant from the important or even establish a standard by which to apply them.

The Third Circuit then set forth five principles critical to substantive consolidation. First, to conform to the expectations of state law, the Bankruptcy Code, and the market, entity separateness should be respected absent compelling circumstances. Second, the harms addressed by substantive consolidation are those caused by debtors, while harms caused by creditors can be remedied by other provisions of the Bankruptcy Code

(*i.e.*, equitable subordination and fraudulent transfers). Third, substantive consolidation should not be used merely to benefit administration of a case. Fourth, because substantive consolidation is an extreme and imprecise remedy, it should be used rarely, only as a last resort. Finally, while substantive consolidation may be used defensively to remedy identifiable harms caused by entangled affairs, it may not be used offensively, such as tactically against a particular creditor group to deprive it of a dispositive vote in a subsidiary's chapter 11 plan.

The court then announced a test, similar to that of *Augie/Restivo,* but in a more precise fashion. Absent consent, to obtain substantive consolidation in the Third Circuit, a proponent must prove either (i) the entities proposed to be substantively consolidated prepetition disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one entity, *or* (ii) their assets and liabilities are so scrambled that separating them postpetition is prohibitive and hurts *all* creditors.

The court explained that the first scenario is meant to protect the prepetition expectations of creditors, particularly those who may have been misled by debtors' actions into an erroneous perception that the multiple entities were one. A proponent can make a *prima facie* case for the first rationale when it proves that, based on the parties' prepetition dealings, corporate disregard created expectations of creditors that they were dealing with debtors as one indistinguishable entity. A creditor proponent must also show that it actually and reasonably relied on the entities' supposed unity. A creditor opponent of substantive consolidation can defeat a *prima facie* showing by proving it would be adversely affected by substantive consolidation and it actually relied on the entities' separate existence.

The second scenario recognizes the practicality that when the entities' affairs are hopelessly commingled, all creditors are better off with substantive consolidation. In such a situation, substantive consolidation maximizes the value of assets available to all creditors, either because the entities cannot be unscrambled or because unscrambling would leave nothing for distribution.

Order Granting Substantive Consolidation of Owens Corning and its Subsidiaries is Reversed

The court concluded it was "apparent" that substantive consolidation was inappropriate under the facts before it.

Applying the prepetition test, the court found no evidence of prepetition disregard of the entities' separateness. To the contrary, the credit agreement at issue was premised on the separateness of OCD and its guarantor subsidiaries. Critical to the court's reasoning was that the very deal negotiated among the banks, OCD, and its guarantor subsidiaries - that with respect to the assets of the guarantor subsidiaries, the banks would be structurally senior to the other creditors of OCD - was being eliminated by substantive consolidation. The entire structure of the credit agreement contradicted the district court's ruling that there was substantial identity among the entities upon which the banks relied. The fact that the banks did not obtain separate financial statements for each subsidiary was not determinative, as the banks did obtain other information about the subsidiaries and the appellate court reasoned the banks' credit metrics were irrelevant. Rather, the fact that they demanded separate guarantees knowing they had value was dispositive.

Applying the postpetition test, the court found no meaningful evidence postpetition of hopeless commingling of the debtors' assets and liabilities. In fact, there was no question which entity owned which principal assets and owed which material liabilities. The court held that the fact that some creditors would benefit from the cost savings achieved by substantive consolidation was not relevant. Rather, all creditors must benefit from such cost savings to justify substantive consolidation. Similarly, the court was not concerned that it would be impossible to achieve perfect disentanglement of the entities' affairs. Perfection is not the standard, as a court could review the evidence and separate the assets and liabilities in a sufficient manner.

The court also noted how substantive consolidation in the case worked against the principles it believed govern the substantive consolidation inquiry, as set forth above. Substantive consolidation was not being used by the debtors as a last resort remedy, but as a tool of administrative convenience. Moreover, it was being used as an offensive tactical sword, not the defensive shield for which it was designed.

The most fatal flaw of the proposed consolidation in the Third Circuit's view, however, was that it was merely deemed, or, as the court described it, "a pretend consolidation for all but the Banks." The court found it incredible that the debtors argued, in support of substantive consolidation, that their corporate and financial

structure was a sham, yet they intended to leave this structure undisturbed after their emergence from bankruptcy to be able to reap all the liability-limiting, tax, and regulatory benefits the structure provided.

In the court's view, these circumstances demonstrated the sole purpose of the deemed consolidation was to strip the banks of their lawfully bargained for rights under the credit agreement and the Bankruptcy Code. This is not the equitable result the equitable doctrine of substantive consolidation was intended to achieve. Moreover, the deal negotiated prepetition by the banks and the debtors, an unsecured loan the credit of which is enhanced by subsidiary guarantees, is common in the business world. To undo this everyday lending arrangement would cause chaos in the marketplace. Accordingly, the court reversed the substantive consolidation order and remanded the case back to the district court.

Conclusion

The Third Circuit's opinion in *Owens Corning* will have a significant impact on chapter 11 cases. In the Third Circuit, which includes the states of Delaware, New Jersey, and Pennsylvania, it establishes an extremely objective standard for approving substantive consolidation. This improves predictability of results immeasurably. Even beyond the Third Circuit, however, the *Owens Corning* opinion will likely be influential in that its detailed and comprehensive analysis of the history and policy behind substantive consolidation provides strong support for its conclusion and admonition that, absent consent, substantive consolidation should only be granted as a last resort. Its dissection of the various standards used by courts in substantive consolidation decisions and rejection of the "liberal trend" cannot be ignored by any court deciding a contested substantive consolidation fight.

After *Owens Corning*, proponents of substantive consolidation in chapter 11 cases must make a very strong showing of prepetition reliance or postpetition entanglement, especially in the Third Circuit. Absent such a showing, practitioners will have to resort to distinguishing the facts of *Owens Corning*, particularly the "deemed" consolidation the court found so offensive.

The Third Circuit's opinion is a positive development in bankruptcy law. It sets forth a definitive test for approval of substantive consolidation. This clarity and objectivity in the law, which had previously been lacking in most circuits, will hopefully eliminate the tactical invocation of substantive consolidation to place distribution rights under a cloud for extended delays to induce creditors to forfeit rights for no valid legal reason. This may lead to a more expedient emergence from bankruptcy for some debtors, thus furthering a major goal of chapter 11.

In re Owens Corning, 2005 U.S. App. LEXIS 17150 (3d Cir. August 15, 2005).

Nesbit v. Gears Unlimited, Inc., 347 F.3d 72, 86 (3d Cir. 2003), *cert. denied*, 124 S.Ct. 1714 (2004).

Reider v. FDIC (*In re Reider*), 31 F.3d 1102, 1109 (11th Cir. 1994).

Eastgroup Props. v. S. Motel Assoc., Ltd., 935 F.2d 245, 248 (11th Cir. 1991).

Drabkin v. Midland-Ross Corp. (*In re Auto-Train Corp.*), 810 F.2d 270, 276 (D.C. Cir. 1987).

Union Sav. Bank v. Augie/Restivo Baking Co. (*In re Augie/Restivo Baking Co.*), 860 F.2d 515, 518 (2d Cir. 1988).

In re Owens Corning, 316 B.R. 168 (D. Del. 2004).

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