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The ABC's of Substantive Consolidation

By John B. Berringer and Dennis J. Artese

The phenomenon of mega-bankruptcy cases of huge corporations with multiple businesses and scores, if not hundreds, of constituent legal entities as subsidiaries is a recent development. While not all large, multi-national corporations have subsidiary issuers or guarantors of funded debt, a great many of them do, and most all of them have separate trade creditors for many separate legal entities. Thus, it has been widely reported that substantive consolidation is a hotly contested issue in the Enron, Worldcom, K-Mart, and Owens Corning mega-bankruptcy cases, among others.

Part one of this two-part series discusses generally the availability of substantive consolidation for related debtor and non-debtor entities, as well as their creditors. Part two will focus on the legal standards, burdens and key factors courts apply in determining whether substantive consolidation is proper in a given bankruptcy case.

What Is It?

Substantive consolidation is an equitable remedy which permits a bankruptcy court to ignore corporate distinctions, combine the assets and liabilities of separate and distinct — but related — legal entities into a single pool and treat them as though they belong to a single entity. 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.

"The primary purpose of substantive consolidation is to ensure the equitable treatment of all creditors.'" *Bonham v. Compton (In re Bonham)*, 229 F.3d 750, 764 (9th Cir. 2000) (citations omitted). This does not mean, however, that substantive consolidation is improper if it would cause any harm to a creditor. Indeed, the law of substantive consolidation recognizes that there will always be some measure of harm because "consolidation almost invariably redistributes wealth among the creditors of the various enti-

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Advancing the Creditors' Plan: Hostile Takeovers in Chapter 11

By Mark D. Silverschotz

Creditors wishing to play an active role in the restructuring of a Chapter 11 debtor often are faced with a series of impediments. Management may be incompetent or corrupt. Almost certainly it will be entrenched and many aspects of Chapter 11 that serve to protect a debtor must be overcome.

Accordingly, to disentangle an estate from the clutches of inadequate management, creditors must be aggressive when seeking to advance their vision of how the reorganization process ought to unfold.

There are three points in the typical Chapter 11 case where creditor impact may be maximized, and where resolution of disputes in one manner or another may have controlling influence over the case's disposition. These events are:

- Debtor-in-possession ("DIP") financing motions
- Key employee retention program ("KERP") approval motions
- Motions to extend (or terminate) exclusivity.

Recently, in the Sleepmaster Chapter 11 case in Wilmington, Delaware, Anderson Kill represented the Official Creditors' Committee and successfully took control of the case by terminating the debtor's exclusive right to file a plan and thereafter proposing and confirming a creditors' committee plan pursuant to which the debtor's assets were sold to its largest competitor.

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DIP Financing Motions

The most common objections to a DIP facility will include opposition to any terms purporting to prematurely validate liens, provide excessive fees, and impose improper rates or other terms. However, to establish that the committee intends to be active in the reorganization process, special focus should be brought upon terms in the DIP that serve to entrench management. For example, many DIP facilities have onerous "change in control" clauses that treat the replacement of senior management as an "event of default."

Similarly, while it may be reasonable for a DIP facility to provide that the appointment of a trustee constitutes an event of default, the committee might argue that a loan approved by the bankruptcy court ought to allow for continuance of the lending arrangement for thirty days so the trustee either can obtain financing from another source, or negotiate appropriate terms with the existing DIP lender. Such an objection will establish the tone of the case, make the bankruptcy judge aware of the view of the committee respecting management, and avoid the expense and dislocation associated with litigating the appointment of a trustee at the outset of a case.

In Sleepmaster, the Committee focused upon the fees being generated by the DIP, and questioned the need for the facility at such high cost. Indeed, the amount of the fees, and management's willingness to pay them, became a mantra that counsel employed to establish a theme for the case.

KERP Approval Motions

KERP programs have been extremely controversial. Some commentators have suggested that they be banned outright from Chapter 11 cases. The theoretical benefit of a KERP—the necessity and value associated with maintaining managerial stability during the outset of a case by providing incentives for management continuity—is speculative in most cases, and an absurd concept in many others. Where

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ties." *Auto-Train Corp. v. Midland-Ross Corp. (In re Auto-Train)*, 810 F.2d 270, 276 (D.C. Cir. 1987). This almost necessarily results because "[t]he creditor of a debtor whose asset-to-liability ratio is higher than that of its affiliated debtor will receive a proportionately smaller satisfaction of its claim because the asset-to-liability ratio of the merged estates will be lower." J. Stephen Gilbert, *Note: Substantive Consolidation In Bankruptcy: A Primer*, 43 VAND. L. REV. 207 (Jan. 1990).

Do Bankruptcy Courts Have The Power To Grant It?

Substantive consolidation was explicitly recognized by the Supreme Court as early as 1941. *See Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941). Historically and today, the bankruptcy court's power to order substantive consolidation is derived from its equity powers as expressed in Section 105 of the Bankruptcy Code. Although not codified by the Bankruptcy Reform Act of 1978, courts continue to recognize its validity and have ordered substantive consolidation subsequent to the enactment of the Bankruptcy Code.

Nevertheless, opponents of substantive consolidation still argue that orders of substantive consolidation are beyond the equity powers of the bankruptcy court. For this they rely on the Supreme Court's decision in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999). There, the Supreme Court held that a district court lacked the inherent equitable power to enjoin a debtor from transferring its unencumbered assets before the complaining creditor obtained a judgment. *See id*. at 333. The Supreme Court found that in the absence of a specific statute expanding the district court's jurisdiction, it had no equitable powers beyond those exercised by the High Court of Chancery in England at the time of the adoption of the Constitution and the Judiciary Act in 1789. Thus, opponents of substantive consolidation argue that bankruptcy courts lack the equitable power to issue orders of substantive consolidation because there is no statutory or historical basis for such an order.

This argument was explicitly rejected, however, in *In re Stone & Webster, Inc.*, 286 B.R. 532 (Bankr. D. Del. 2002). The *Stone & Webster* Court distinguished *Grupo Mexicano*, noting that it had "nothing to do with substantive consolidation" and also cited language from Justice Scalia's majority opinion suggesting that bankruptcy law provides a court with authority to grant remedies not administered by courts of equity in 1789. But the court

did not rely on these and other articulated reasons in rejecting the *Grupo Mexicano* argument. Instead, it concluded that a bankruptcy court's power to issue orders of substantive consolidation is derived from Bankruptcy Code Section 1123(a)(5)(c), which provides, in relevant part: "[n]otwithstanding any otherwise applicable non-bankruptcy law, a plan shall. . .(5) provide adequate means for the plan's implementation such as. . .(c) *merger or consolidation of the debtor with one or more persons*. . . ." 11 U.S.C.A. § 1123(a)(5)(c) (emphasis added). Because the court determined that it had a statutory basis for issuing orders of substantive consolidation, it was irrelevant whether courts of equity in 1789 administered remedies equivalent to substantive consolidation. *See also In re G-I Holdings, Inc.*, 2001 WL1598178, at *7 (Bankr. D.N.J. Apr. 6, 2001) (denying preliminary injunction motion to order substantive consolidation, but rejecting the *Grupo Mexicano* argument); *In re Bonham*, 229 F.3d 750 (9th Cir. 2000) (ordering substantive consolidation subsequent to *Grupo Mexicano*); *In re Perimian Producers Drilling, Inc.*, 263 B.R. 510, 515-16 (W.D. Tex. 2000) (rejecting argument that bankruptcy court did not have jurisdiction to order substantive consolidation).

Conclusion

Although creditors on the losing side of a substantive consolidation of the assets and liabilities of related debtors can be expected to continue challenging the power of a bankruptcy court to employ such a remedy, the great weight of authority on that issue supports the proponents of substantive consolidation. ■

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a committee seeks wholesale replacement of management, the KERP motion presents an opportunity to identify for the court a history of the plagues visited upon the estate by existing management. Generally, courts are disinclined to listen to tales of managerial incompetence; it is a common denominator of many Chapter 11 cases. But, in the case of KERP motions, demonstrable incompetence is highly relevant.

In Sleepmaster, the Committee was able to express its concerns respecting management and limit the scope of the benefits obtained by them. The court was reminded that the committee was dissatisfied with management's performance and the foundation was laid for more significant confrontations that lie ahead.

Exclusivity Extension Motions

Termination of a Debtor's exclusive right to file a plan is often the turning point of a Chapter 11 case. In Sleepmaster, utilizing the positions it had staked out throughout the case, the Committee was able to obtain termination of the Debtor's exclusive right to file a Chapter 11 plan. Thereafter, the Committee commenced negotiations with the Debtor's largest competitor, and the terms of a sale were agreed upon. The Committee then proposed a plan, obtained approval of a disclosure statement, and sought confirmation of the plan. After solicitation of votes, virtually all creditors voted to accept the treatment proposed to them under the Committee's plan, and the plan was confirmed.

Conclusion

In any Chapter 11 case, a Committee must decide as soon as possible whether or not to "ride out the storm" with existing management. Old management often cannot properly operate the debtor's business and must be removed. Accordingly, termination of exclusivity and the successful proposal of a committee plan may provide the best recovery to unsecured creditors in Chapter 11 cases with unsatisfactory management. Sleepmaster provided an example of how that strategy can benefit unsecured creditors. ■

Upcoming Events

J. Andrew Rahl

November 14, 2003

J. Andrew Rahl, Jr., Chair of the Bankruptcy & Restructuring Group at Anderson Kill & Olick, will speak on a panel with Bruce Ferguson of Summit Investment Partners on "Bad Behavior: A Source for Returns" at the 5th Annual Distressed Debt Investing Forum in Las, Vegas, Nevada.

December 1 - 2, 2003

Distressed Investing 2003 Conference
Plaza Hotel • New York, New York

Jordan Siev

J. Andrew Rahl, Jr. will also co-chair the Distressed Investing 2003 Conference sponsored by Renaissance American Management & Beard Group and will also speak on a panel with bankruptcy lawyers from five other law firms on "substantive consolidation and struggle among the classes" in connection with the conference. Anderson Kill & Olick will host a wine tasting event at the conference on Monday evening, December 1st at the Plaza Hotel in New York City. For more information, please email ahenderson@renaissanceamerican.com, dial (800) 726-2524 or visit http://www.renaissanceamerican.com.

Jordan Siev, a senior shareholder at Anderson Kill & Olick, P.C., will also speak on another panel on "Investment Opportunity through Creditor Litigation."

Andrea Pincus

December 4-6, 2003

Public Companies and Claims Trading Committee Program "Do Bondholders Have Any Rights Prior to a Payment Default?"
La Quinta Resort & Club • La Quinta, California

Andrea Pincus, Deputy Chair of the Bankruptcy & Restructuring Group of Anderson Kill & Olick, is scheduled to speak at the American Bankruptcy Institute's 2003 Winter Leadership Conference (Committee Educational Session).

To register for any of these conferences, or for more information, please visit us at www.andersonkill.com.

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