

Third Circuit Protects Lender Expectations Regarding Corporate Separateness in Lending to a Group of Affiliated Companies

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The Third Circuit's recent decision in *In re Owens Corning* offers comfort to lenders who have relied upon the separate existence and credit of affiliated parties in a financing. An important lesson from the court's decision is that credit underwriting and loan terms should evidence the lenders' reliance on the separateness of guarantors from the related borrowers.

Many lenders are concerned about the potential impact on a financing transaction of a future bankruptcy of a borrower, including the risk that in the bankruptcy the creditors of some members of an affiliated group of companies may try to reach the assets of more creditworthy members of the group (even without a direct claim on those assets). This is particularly true where the financing is a securitization or other structured financing relying on the bankruptcy remoteness of a borrower, a financing that relies on structural subordination, or a financing relying on the financial strength of one party to provide credit support for the financial risks associated with lending to a related party.

The "tool" that creditors use to attempt to reach the assets of creditworthy parties to the detriment of the lender is the argument that the legal separateness of affiliated entities should be ignored and instead the entities should be "substantively consolidated" – *i.e.*, treated as a single entity with all of their assets available to satisfy all creditor claims (effectively eliminating structural subordination, intercompany guarantees and other lender protections). Whether the bankruptcy court orders a "substantive consolidation" turns on factors such as the extent to which the entities involved followed appropriate corporate formalities, the extent of commingling of those entities' assets, the expectations of creditors and the relative harm and benefits to creditors.

The recent case of *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), offers comfort to lenders who have relied upon the separate existence and credit of affiliated parties in a financing.

In *Owens Corning*, a syndicate of lenders had provided a \$2 billion unsecured credit facility to Owens Corning and certain of its subsidiaries, and obtained guarantees of certain other Owens Corning subsidiaries. The guarantees gave the lenders direct claims against the guarantors' assets for repayment of the loan.

Owens Corning and seventeen of its subsidiaries subsequently filed for bankruptcy under Chapter 11 of the Bankruptcy Code. Their proposed plan of reorganization included a provision "deeming" that a consolidation of the debtors

had occurred. A significant impact of this deemed consolidation would have been that all intercompany guarantees (including the guarantees made for the benefit of the lenders) would be eliminated, effectively diluting the claims of the lenders and permitting all creditors to be paid from the combined assets of all entities (rather than the normal case of non-guaranteed obligations being paid only by the entity liable on the obligation). The lower court granted the plan proponents' request to substantively consolidate the entities over the objection of the lenders and other parties.

On appeal, the Third Circuit held that the deemed substantive consolidation was not appropriate. The court began by agreeing with earlier decisions stating that substantive consolidation should be used sparingly. However, the Third Circuit did not expressly adopt either of the prevailing tests used by courts to determine when substantive consolidation is appropriate, and articulated a standard that may make it even more difficult for creditors seeking to impose that remedy. The court held that the assets and liabilities of entities should be substantively consolidated only if (i) before the bankruptcy case is filed the entities disregarded separateness so significantly that their creditors relied on the "breakdown of entity borders" and treated them as one legal entity or (ii) after the bankruptcy case is filed their assets and liabilities are "so scrambled that separating them is prohibitive and hurts all creditors." Applying this test, the Third Circuit found that substantive consolidation did not fit the facts of the *Owens Corning* case, and that the deemed consolidation sought in the plan of reorganization was inconsistent with all the principles that courts should consider when deciding a substantive consolidation request. In the court's view the lenders "did the 'deal world' equivalent of 'Lending 101'" and, relying on the separateness of the entities, structured their financing to achieve structural seniority (*i.e.*, obtain direct claims against the guarantors and their assets) that other creditors of Owens Corning did not have. The court rejected arguments that the lenders had not in fact been relying on the separateness of the entities because the lenders did not obtain separate financial statements or legal opinions that substantive consolidation was not likely. The court also found that (other than some sloppy bookkeeping) the entities were in fact maintained as separate and distinct legal entities so that the "prohibitive unscrambling" standard had not been met. The court determined that substantive consolidation was particularly inappropriate under the circumstances because the plan proponents were utilizing substantive consolidation as an offensive weapon to achieve leverage in the plan negotiation process rather than its appropriate use of remedying identifiable harms.

In part, the Third Circuit was persuaded that the lenders had in fact been relying on the separateness of the guarantors. The court's opinion specifically noted that the lenders had required the guarantees from the inception of their discussion of the financing (and would not have made the loans without the "credit enhancement" provided by the guarantees, given Owens Corning's poor credit rating and growing asbestos liability), and that the loan documents contained covenants intended to protect the legal separateness and the financial

strength of the guarantors (such as limitations on merger of subsidiaries into the parent, mergers among the subsidiaries that would adversely impact the guaranty or transactions with the parent that would result in losses to a subsidiary).

Lenders who have relied upon the separateness of affiliated entities in underwriting and documenting a financing should take comfort in the Third Circuit's approach to substantive consolidation, particularly where the proponents of substantive consolidation are utilizing the doctrine solely as a sword to disenfranchise lenders (as was the case in *Owens Corning*). One important lesson for lenders from the Third Circuit's decision is that documenting at the outset of the transaction the importance of the legal and financial separateness of the affiliated companies will significantly strengthen the lender's position if other creditors seek substantive consolidation.