

Supreme Court Declines to Consider Third Circuit's Ruling on Substantive Consolidation: What is its Impact on Non-Consolidation Opinions?

In re Owens Corning, 419 F.3d 195 (3d Cir. 2005),
cert. denied, --- S.Ct. ----, 2006 WL 1131887 (U.S.)

The principles used to analyze substantive consolidation in the Third Circuit are now clear. In *Owens Corning*, the United States Court of Appeals for the Third Circuit tackled the issue of when a bankruptcy court may order substantive consolidation (i.e., the merger of assets and liabilities of separate entities). The Circuit Court's decision had determined that, in the Third Circuit, the remedy of substantive consolidation is extraordinary that should be used sparingly. On May 1, 2006, the United States Supreme Court denied a petition for writ of certiorari filed with respect to the *Owens Corning* decision thereby solidifying the fact that, at least in the Third Circuit, substantive consolidation should only be used as a remedy of last resort.

Indeed, the Third Circuit stresses that principles, rather than "imprecise tests and rigid elements," (found in opinions in other circuits) should guide a court's decision to substantively consolidate debtor estates. The following principles have been identified by the Third Circuit:

1. Respect for Corporate Separateness: Respecting entity separateness is a fundamental ground rule. Absent compelling circumstances, a bankruptcy court should not use its equitable powers to substantively consolidate a debtor with another entity. Moreover, even if compelling circumstances exist, substantive consolidation should be only a possibility, not a given.

2. Necessity for Substantive Consolidation Almost Always Inflicted by Debtor. The harm to be corrected by substantive consolidation is almost always

caused by the debtor rather than the creditor who will actually be affected by the substantive consolidation.

3. Mere Benefit to the Estate Does Not Justify Substantive Consolidation. A court should not order substantive consolidation for the sole reason of convenience. Expediting or simplifying the case (i.e., post-petition accounting, claims administration) does not warrant substantive consolidation.

4. Substantive Consolidation is a Remedy of Last Resort. Because of the “profound” impact to creditors and their rights, substantive consolidation should be used sparingly and only after the bankruptcy court has considered and rejected other remedies available under the Bankruptcy Code.

5. Substantive Consolidation Should be Used Defensively Rather than Offensively. Substantive consolidation should only be used defensively to rectify harms caused by entangled affairs and commingled assets. It should not be used offensively to disadvantage creditors or alter creditors’ rights.

Using these principles as guideposts, the Third Circuit identified two circumstances that may warrant an order of substantive consolidation: (1) the debtor disregarded separateness so significantly prior to the bankruptcy filing that its creditors relied upon the breakdown of entity borders and treated the debtor and another as one legal entity, or (2) after the bankruptcy filing, the debtor’s assets and liabilities are so scrambled that separating them is prohibitive and will hurt all creditors.

The rationale behind the first circumstance is to protect the “prepetition expectations” of creditors who have been misled by debtor regarding the separateness of the debtor from another entity. A proponent of substantive consolidation will be able to

make a prima facie showing that the debtor's pre-petition conduct/affairs warrant substantive consolidation by demonstrating that (a) the proponent is a creditor of the debtor and (b) the proponent actually and reasonably relied upon the existence of unified entities. An opponent of substantive consolidation need only demonstrate that (a) it will be adversely affected by substantive consolidation and (b) it actually relied upon the debtor's separate existence in order to rebut a prima facie showing.

Practicality underlies the second circumstance of permitting substantive consolidation to occur when the debtor's assets and liabilities have been hopelessly commingled with those of another entity. Substantive consolidation may be considered when it will enhance the value of assets available to creditors and will benefit *all* of the debtor's creditors.

With all appeals now exhausted, the *Owens Corning* decision should prove comforting to lenders and those attorneys issuing non-consolidation opinions because, at least in the Third Circuit, substantive consolidation may not be granted over the objection of a lender who is able to demonstrate that it relied upon the separateness of distinct and independent legal entities during the borrowing process.

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