

Special Report on the Preparation of Substantive Consolidation Opinions

*By the Committee on Structured Finance and the Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York**

I. INTRODUCTION

Structured finance is expected to continue to represent a substantial portion of the capital markets in the United States and internationally. The Committee on Structured Finance and the Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York (the “Association”), being the committees of the Association most interested in the legal issues involved in structured finance transactions, have written this Special Report on the preparation of substantive consolidation opinions. The purposes of the Special Report are (1) to review the process required to deliver a substantive consolidation opinion

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in structured finance transactions, (2) to urge that the parties involved and their lawyers take a fresh look at the opinions that are delivered in connection with the closings of these transactions, and (3) to provide a form that may be used by firms that are asked to render an opinion of this nature and do not have their own forms or that do have their own forms but may wish to take a different approach than they have used in the past. In particular, the Committees suggest that the substantive consolidation opinions be shortened and simplified. A form derived from the form ("1995 Model") appearing as Appendix D to the 1995 report titled *Structured Finance Techniques*¹ by the Committee on Bankruptcy and Corporate Reorganization of the Association follows this Special Report.

This Special Report also addresses the application of substantive consolidation to a limited liability company ("LLC"), which is often the entity of choice² for a "special purpose entity" ("SPE"),³ the typical subject of these opinions. A corporation, which is the entity discussed in the 1995 Model, is now rarely used for SPEs because of the flexibility available through the use of an LLC, especially under the Delaware Limited Liability Company Act.⁴

II. BACKGROUND

Structured finance involves the isolation, usually in an SPE, of income-producing assets from the risk of the bankruptcy of the organization that originates (the "Originator") or of the entity that services (the "Servicer")⁵ the assets.⁶ Two legal concepts are crucial to the isolation. The first is the transfer of the assets that are the subject of the transaction from the Originator to the SPE in a manner that will be recognized in any subsequent bankruptcy of the Originator or the SPE. This is usually accomplished through a "true sale" of the assets in which the ownership

1. Comm. on Bankr. & Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 595-606 (1995) [hereinafter "*Structured Finance Techniques*"].

2. Statutory trusts are also frequently used. See Delaware Statutory Trust Act, DEL. CODE ANN. tit. 12, §§ 3801-3863 (2007).

3. An SPE is sometimes referred to as a "special purpose vehicle" ("SPV").

4. DEL. CODE ANN. tit. 6, §§ 18-101 to 18-1109 (2005 & Supp. 2006).

5. The Servicer is frequently an affiliate of the Issuer.

6. See generally *Structured Financing Techniques*, *supra* note 1, at 528, 533; STEVEN L. SCHWARZ, *STRUCTURED FINANCE—A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (3d ed. 2007). The purpose of this Special Report is not to describe structured finance and its elements, which are ably set forth in these sources. Presuming an understanding of the basics, this Special Report addresses the role and utility of the delivery of substantive consolidation opinions in structured finance transactions. See *Structured Financing Techniques*, *supra* note 1, at 556. A provocative critique of the legal underpinnings of structured finance, including the role of legal opinions in the transactions, appears in Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553 (2008). The legal soundness of structured finance is defended in Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1672-83 (2004); see also William H. Widen, *Report to the American Bankruptcy Institute: Prevalence of Substantive Consolidation in Large Public Company Bankruptcy Cases from 2000 to 2005*, 16 AM. BANKR. INST. L. REV. 1, 8 (2008) ("[A] majority of large public company bankruptcy cases are substantive consolidation cases" in which the debtors are consolidated or "deemed consolidated" without a contest).

of the assets has been transferred from the Originator to the SPE in a manner such that the Originator does not retain any residual interest that will affect the ability of the SPE to realize on the assets, especially in the context of the bankruptcy⁷ of the Originator.⁸ The second is non-consolidation—that is, that the legal separateness of the SPE will be respected in the event of a bankruptcy of the Originator, Servicer, or other affiliated person so that a bankruptcy court will not draw the assets of the SPE back into the Originator's, Servicer's, or affiliate's bankruptcy case through the court's power of substantive consolidation.⁹

Another common feature of SPEs is bankruptcy remoteness which, although important for structured finance, is not a necessary part of substantive consolidation analysis. To achieve bankruptcy remoteness, the risk of a bankruptcy filing by or against the SPE is made unlikely by restricting the SPE's ability to incur indebtedness unrelated to the structured financing and limiting the ability of the affiliates of the SPE to cause it to file voluntarily for bankruptcy by requiring the consent of an independent person charged with considering the interests of the SPE's creditors in order to initiate a bankruptcy filing.¹⁰ An entity need not be bankruptcy remote—that is, subject to restrictions on incurring indebtedness and constrained from filing a voluntary bankruptcy case—in order to be legally distinct from and not subject to substantive consolidation with another entity. Bankruptcy remoteness, however, reduces the practical risks of consolidation by reducing the risk of the entity's bankruptcy from debt unrelated to the structured financing. It also reduces the threat of an opportunistic bankruptcy filing by the SPE at the instigation of the Originator or Servicer to frustrate enforcement of the rights of the parties to the structured financing.

A. THE DOCTRINE OF SUBSTANTIVE CONSOLIDATION

Substantive consolidation is a remedial doctrine, rarely invoked outside of bankruptcy,¹¹ whereby the assets and liabilities of two or more entities are combined,

7. The discussion in this Special Report and the accompanying form of opinion address entities that may become debtors in cases under the Bankruptcy Code and not depository institutions, insurance companies, or other entities that are subject to separate insolvency regimes.

8. See *Structured Financing Techniques*, *supra* note 1, at 542. Some more recent transactions are being structured to take advantage of the safe harbors in sections 555 to 562, sections 753 and 767, and elsewhere in the Bankruptcy Code, which were bolstered in Title IX of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 907, 119 Stat. 23, 170–83 (codified in scattered sections of 11 U.S.C.). See, e.g., *Caylon v. Am. Home Mortgage Corp. (In re Am. Home Mortgage, Inc.)*, 373 B.R. 503 (Bankr. D. Del. 2008) (repurchase agreements for mortgage loans).

9. See *Structured Financing Techniques*, *supra* note 1, at 558–59.

10. The fiduciary duties of the independent person and the efficacy of the provisions of the LLC agreement requiring the consent of an independent member or manager are beyond the scope of this Special Report. For those issues, see, for example, *In re Kingston Square Assocs.*, 214 B.R. 713, 720–23, 735–36 (Bankr. S.D.N.Y. 1997); TriBar Opinion Comm., *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. LAW. 717, 729 (1991) [hereinafter “TriBar Opinion Comm., *Opinions in the Bankruptcy Context*”].

11. One of the rare non-bankruptcy cases in which it is invoked is *Nesbit v. Gears Unlimited, Inc.*, 347 F.3d 72, 86 (3d Cir. 2003) (applying principles of substantive consolidation to determine whether

and the pooled assets are used in the aggregate, to satisfy the claims of creditors of the consolidated entities. As most recently described in the U.S. Court of Appeals for the Third Circuit's opinion in *Owens Corning*,¹² substantive consolidation derives from the U.S. Supreme Court's decision in *Sampsel v. Imperial Paper & Color Corp.*,¹³ with its antecedents in the remedies of piercing the corporate veil, equitable subordination, recharacterization of claims, and fraudulent conveyance and the duty of a third party in possession of the property of a debtor to turn over the property to the representative of the estate.¹⁴

The modern statement of the doctrine appears in the opinions of the U.S. Courts of Appeals for the Third, Second, and District of Columbia Circuits in their decisions in *Owens Corning* (2005),¹⁵ *Augie/Restivo* (1988),¹⁶ and *Auto-Train* (1987).¹⁷ Those decisions should be contrasted with the numerous substantive consolidation decisions of bankruptcy courts and district courts that contain lists of factors to be analyzed by the courts.¹⁸ The court in *Owens Corning*, the most recent Court of Appeals decision, synthesizes the considerations relevant to a substantive consolidation analysis into two parts:

two affiliated companies should be considered a single employer for purposes of satisfying the fifteen-employee threshold for a discrimination claim under Title VII of the Civil Rights Act of 1964), *cert. denied*, 541 U.S. 959 (2004).

12. *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), *cert. denied sub nom.* *McMonagle Credit Suisse First Boston*, 547 U.S. 1123 (2006).

13. 313 U.S. 215 (1941).

14. *See Owens Corning*, 419 F.3d at 205–09. *See also* Seth D. Amers & Alan Kolod, *Substantive Consolidation: Getting Back to Basics*, 14 AM. BANKR. INST. L. REV. 1, 2–13 (2006); Timothy E. Graulich, *Substantive Consolidation—A Post-Modern Trend*, 14 AM. BANKR. INST. L. REV. 527, 531–39 (2006) [hereinafter Graulich, "Post-Modern Trend"].

15. *Owens Corning*, 419 F.3d at 210–12.

16. *Union Sav. Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515, 518 (2d Cir. 1988). The test articulated in *Augie/Restivo* focuses on two factors: (1) "whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit," and (2) "whether the affairs of the debtors are so entangled that consolidation will benefit all creditors." *Id.* at 518 (internal quotation marks omitted).

17. *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 276 (D.C. Cir. 1987). This decision was adopted by the Eleventh Circuit in *Eastgroup Properties v. Southern Motel Association, Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991), and *Reider v. FDIC (In re Reider)*, 31 F.3d 1102, 1107–08 (11th Cir. 1994), and by the Ninth Circuit in *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 765–66 (9th Cir. 2000). In the Eleventh Circuit, the proponent of substantive consolidation must show that (1) there is substantial identity between the entities to be consolidated, and (2) consolidation is necessary to avoid some harm or to realize some benefit. *Eastgroup Props.* 935 F.2d at 249. When this showing is made, a presumption arises that "creditors have not relied solely on the credit of one of the entities involved." *Id.* (internal quotation marks omitted). Once the proponent has made this prima facie case for consolidation, the burden shifts to an objecting creditor to show that (1) it has relied on the separate credit of one of the entities to be consolidated, and (2) it will be prejudiced by substantive consolidation. *Id.* Finally, if an objecting creditor has made this showing, "the court may order consolidation only if it determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm." *Id.* (internal quotation marks omitted).

18. *See, e.g., In re Vecco Constr. Indus., Inc.*, 4 B.R. 407, 410 (Bankr. E.D. Va. 1980) (seven factors); *Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940), *cited in In re Tureaud*, 45 B.R. 658, 662 (Bankr. N.D. Okla. 1985), *aff'd*, 59 B.R. 973 (N.D. Okla. 1986) (fifteen factors); *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 723, 764 (Bank. S.D.N.Y. 1992) (longer list of factors). A useful list of issues to be considered appears as Appendix C to *Structured Financing Techniques*, *supra* note 1, app. C, at 593–94.

- Whether the entities “disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity”; or
- Whether the entities’ “assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.”¹⁹

With respect to the first test, “proponents who are creditors must also show that, in their course of dealing, they actually and reasonably relied on debtors’ supposed unity. Creditor opponents of consolidation can nonetheless defeat a *prima facie* showing under the first rationale if they can prove they are adversely affected and actually relied on debtors’ separate existence.”²⁰

B. TYPICAL SUBSTANTIVE CONSOLIDATION ANALYSIS OF A STRUCTURED FINANCE TRANSACTION

Structured financings typically use an SPE that is either newly organized for the financing or that was created for multiple issuances or in connection with an earlier financing that is being refinanced.²¹ Several steps are taken to establish and maintain the separateness of the SPE. First, the permissible activities of the entity are limited to the transactions incident to the financing. This is accomplished through restrictions in its organic documents and through covenants in the financing documents.²² Second, “separateness covenants” are usually included in the organizational documents for the SPE and the transaction documents, requiring the SPE to comply with all necessary formalities to maintain its separate existence as a matter of entity law and to maintain proper accounting books and records so that its separate assets and liabilities may always be identified.²³ Compliance with these provisions on a continuing basis should be sufficient to establish the separateness of the SPE in the event of a bankruptcy of an affiliated person and avoid the consolidation of the assets of the SPE with an affiliated person in the bankruptcy. This is true because, if there is compliance with these provisions, it should never be the case that the assets and liabilities of the Originator or Servicer of the SPE become so scrambled that it is impossible to separate them or that the entities

19. *Owens Corning*, 419 F.3d at 211.

20. *Id.* at 212 (internal citation omitted).

21. See *Structured Financing Techniques*, *supra* note 1, at 555.

22. See *id.* Typically, there are reciprocal promises by the parties to the transaction not to file a bankruptcy petition against the SPE until the expiration of the applicable preference avoidance period after payment of all of the SPE’s obligations in connection with the transaction.

23. See *Structured Financing Techniques*, *supra* note 1, at 555. See also *id.* app. C, at 593–94 (“Issue List for Substantive Consolidation Analysis”); Graulich, *Post-Modern Trend*, *supra* note 14, at 550–51. Typical separateness covenants also require that all transactions with the Originator and its affiliates be on terms no less favorable to the SPE than transactions with an unaffiliated entity and that the SPE take steps to make sure those parties dealing with it are aware that they are dealing with an entity distinct from the Originator. The first group of covenants, while not strictly required for the substantive consolidation analysis, are helpful in minimizing the risk of other theories of liability arising from transactions between the SPE and the Originator or its affiliates such as fraudulent transfer of assets from the Originator to the SPE not for fair value or equitable subordination of the claims of the Originator against the SPE due to inequitable conduct by the Originator. See STANDARD & POOR’S, STRUCTURED FINANCE U.S. LEGAL CRITERIA 46–52 (2006).

have engaged in activities that disregard their separateness. In a typical structured finance transaction, it will also be true that an attack based on the first part of the *Owens Corning* test will fail because no creditors can have justifiably relied on the unity of the SPE with the Originator or Servicer and because the most significant creditor of the SPE—the party financing the transaction—will have explicitly relied on the separateness of the SPE and would not have extended the credit on the agreed-upon terms in the absence of the isolation of the assets in the SPE.

C. APPLICATION OF THE PRINCIPLES OF SUBSTANTIVE CONSOLIDATION TO AN LLC

While the standards for the application of the theory of substantive consolidation were originally developed in the corporate context, those standards have more recently been applied in the context of LLCs and partnerships and can be expected to be applied to LLCs. Applicable state laws under which such entities are formed establish the separateness of those entities from their members and partners with equivalent or greater specificity than do state laws applicable to corporations.

Under the Delaware LLC Act, for example, the assets of an LLC are not available to satisfy the liability of a member: “A limited liability company interest is personal property. A member has no interest in specific limited liability company property.”²⁴ Conversely, “the debts, obligations and liabilities of a limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the limited liability company, and no member . . . shall be obligated personally for any such debt, obligation or liability”²⁵ These state law provisions apply whether or not the member is in bankruptcy and mirror the long-established rules recognizing the distinction between the property of a corporation and that of its shareholders.²⁶

III. ROLE OF THE NON-CONSOLIDATION OPINION

Unlike the structuring steps, the delivery of a non-consolidation opinion at the closing of a transaction does not establish the separateness of the SPE.²⁷ Rather, the

24. DEL. CODE ANN. tit. 6, § 18-701 (2005); see also *id.* § 17-303(a) (limited partnerships).

25. *Id.* § 18-303. The same principles apply to limited partnership interests and beneficial interests in Delaware statutory trusts. See DEL. CODE ANN. tit. 6, § 17-701 (2005); DEL. CODE ANN. tit. 12, § 3805 (2007).

26. See *Bird v. Wilmington Soc. of Fine Arts*, 43 A.2d 476, 483 (Del. 1945) (“The owner of the shares of stock in a company is not the owner of the corporation’s property.” (internal quotation marks omitted)); *Sun Towers, Inc. v. Heckler*, 725 F.2d 315, 331 (5th Cir.) (“It is an elementary principle of corporate law that a corporation and its stockholders are separate entities and that the title to corporate property is vested in the corporation and not in the owners of the corporate stock.”), *cert. denied*, 469 U.S. 823 (1984); 11 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5100, at 88 (2003); *Gottfried v. Miller*, 104 U.S. 521, 528 (1881); *In re Fontana D’Oro Foods, Inc.*, 482 N.E.2d 1216, 1217 (N.Y. 1985); *DuPont v. DuPont*, 208 A.2d 509, 512 (Del. 1965).

27. See, e.g., *In re Owens Corning*, 419 F.3d 195, 213 n.24 (3d Cir. 2005) (dismissing the failure of the banks to have obtained a non-consolidation opinion at the closing of the loan as a factor relevant to the court’s analysis).

opinion serves the same function as the other opinions typically given by counsel for a borrower in a transaction, providing the recipient the opinion giver's professional judgment with regard to the legal issues the opinion addresses.²⁸ Thus, a non-consolidation opinion provides the recipient assurance that counsel for the Originator and the SPE (frequently the same firm) have considered the matters necessary to give the opinion. A key to the opinion is the recitation of the documents reviewed and the analysis of the particulars of the parties and the transaction in connection with the relevant separateness criteria. Little is added to the process by the inclusion in many opinions delivered today of the rote recitation of the development of the law of substantive consolidation and the laundry lists of the various "factors" often recited in court opinions, without considering which factors are relevant to the structure of the transaction under review.²⁹ The court in *Owens Corning* soundly criticizes the recitation of the factors as lacking the proper legal analysis and failing to "separate the important from the unimportant."³⁰ For example, SPEs are often wholly owned subsidiaries of the Originator and most of their assets are acquired from the Originator. The directors of the SPE are elected by the parent through its stock ownership, and officers of the SPE are designated by the parent through its control of the board of directors. This is equally true of most other subsidiary corporations and is not on its own a basis to ignore the separateness of the subsidiary.³¹ The court in *Owens Corning* similarly clarified the illogic of relying on the mere existence of intercompany guarantees as the basis for ignoring the separateness of the subsidiary. It is only because the subsidiary is separate that the parent must guarantee the obligations in order to incur liability to the third party.³² However, in delivering a non-consolidation opinion, the opinion giver must be mindful that this is an area in which the law has changed over time and may be subject to further changes, particularly in jurisdictions with no controlling precedent. In addition, other factors that are often included in the list of factors for substantive consolidation may be the bases for separate theories of liability; for example, failure to inform a counterparty that it is dealing with an independent entity may be the basis for agency liability.³³

Substantive consolidation opinions are always reasoned opinions in contrast to ordinary closing opinions addressing issues such as due execution and enforceability of agreements that customarily do not include any supporting legal analysis

28. DONALD W. GLAZER, SCOTT FITZGIBBON & STEVE O. WEISE, *GLAZER AND FITZGIBBON ON LEGAL OPINIONS* § 1.3.1, at 9–12 (3d ed. 2008) [hereinafter "GLAZER, FITZGIBBON & WEISE"]; ARTHUR N. FIELD & JEFFREY M. SMITH, *LEGAL OPINIONS IN BUSINESS TRANSACTIONS* § 1:3, at 1-6 to 1-8 (2d ed. 2007) [hereinafter "FIELD & SMITH"]. For a discussion of opinions addressing bankruptcy issues, see TriBar Opinion Comm., *Opinions in the Bankruptcy Context*, *supra* note 10.

29. See *Structured Financing Techniques*, *supra* note 1, app. D, at 598–99 n.9.

30. 419 F3d at 210–11.

31. *Id.*

32. *Id.* at 212–14.

33. See RESTATEMENT (THIRD) OF AGENCY § 6.02 (2006) (stating that the principal and, unless the counterparty otherwise agrees, the agent are both bound by a contract entered into by the agent as an agent for an undisclosed principal).

for the conclusions expressed. The opinion literature recognizes that opinion givers include legal analysis when they believe that the issue involves a difficult or uncertain question of professional judgment³⁴ indicating “a potential trouble spot to the opinion recipient.”³⁵ Legal analysis reflects “a determination by the opinion preparers that the opinion recipient should have the opportunity to obtain from its own counsel an assessment of the reasoning on which the opinion is based.”³⁶ Because the inclusion of reasoning conveys the necessary uncertainty of any substantive consolidation opinion and alerts the opinion recipient to the need to obtain the advice of its own counsel on the matters addressed, there is little utility to the inclusion of exhaustive and sometimes unfocused and unapplied analysis of the case law. At least between equally sophisticated parties to a private transaction, it should be sufficient, as the framework for analysis of the relevant facts, to cite the applicable court of appeals decisions and to note the profusion of cases in the jurisdictions having no controlling court of appeals authority.³⁷

IV. APPLICABLE LAW

Because the equitable remedy of substantive consolidation is a creature of U.S. bankruptcy law, a non-consolidation opinion can address only how a U.S. court exercising bankruptcy jurisdiction would apply the doctrine in a proceeding before that court.³⁸ Although SPEs are frequently organized under domestic law, many SPEs are organized under foreign laws because a foreign jurisdiction can provide favorable regulatory or tax characteristics. The foreign SPE may be a subsidiary of a domestic company or have other contacts with the United States. The substantive consolidation opinion may properly address, prior to the application of substantive consolidation to the facts of the case, the insolvency scheme that is likely to be applied to the SPE and the parties with which it might be consolidated. The principles of U.S. bankruptcy law applicable to the recognition of a foreign insolvency proceeding are found in part in the Model Law on Cross-Border Insolvency, which was adopted as chapter 15 of the Bankruptcy Code³⁹ as part of the 2005 amendments to the Bankruptcy Code. An entity may be a debtor

34. See Comm. on Legal Opinions, Section of Bus. Law, Am. Bar Ass'n, *Guidelines for the Preparation of Closing Opinions*, 57 BUS. LAW. 875, 879 (2002) (§ 3.5).

35. FIELD & SMITH, *supra* note 28, § 2.4, at 2-6 to 2-7.

36. GLAZER, FITZGIBBON & WEISE, *supra* note 28, § 3.3, at 110-14 (noting that substantive consolidation and other bankruptcy opinions typically are reasoned opinions); TriBar Opinion Comm., *Opinions in the Bankruptcy Context*, *supra* note 10, at 721 (“The use of a reasoned opinion is one method by which the opining counsel communicates uncertainties and limitations to the recipient, even if opining counsel is able to reach an unqualified conclusion.”).

37. The opinion should contain a focused discussion of potentially relevant cases or factors addressed to issues of concern in the specific transaction.

38. Other jurisdictions may have similar concepts, but those are not the subject of the substantive consolidation opinion by a U.S. lawyer.

39. See 11 U.S.C. §§ 1501-1532 (2006).

under U.S. bankruptcy law if it has its domicile,⁴⁰ a place of business, or assets in the United States.⁴¹ A foreign debtor entity that meets any of these criteria may be a debtor in a “plenary” bankruptcy case in the United States for the liquidation or reorganization of the debtor under chapter 7 or chapter 11 of the Bankruptcy Code.⁴² A foreign debtor in a case pending in another jurisdiction—typically, the jurisdiction in which the SPE is organized—may be a debtor in an ancillary case under chapter 15. The ancillary case may be brought by a “foreign representative” recognized by the foreign court.⁴³ The U.S. courts might give deference to a foreign insolvency proceeding as a matter of comity but cannot affirmatively assist the foreign proceeding unless it is recognized under chapter 15.⁴⁴ If the U.S. court declines to entertain a proceeding in the United States or transfers the assets to the foreign jurisdiction for distribution under such foreign jurisdiction’s laws,⁴⁵ the U.S. court will not need to reach the issue of substantive consolidation of the SPE with any other entity as a matter of U.S. bankruptcy law. No reported case has relied on the absence of substantive consolidation or a similar remedy as a basis to refuse recognition or comity to a foreign proceeding.⁴⁶

V. PERFORMING THE NECESSARY INVESTIGATION TO DELIVER THE SUBSTANTIVE CONSOLIDATION OPINION

An opinion giver often delivers a substantive consolidation opinion at the same time as the opinion giver delivers a standard closing opinion to the effect that the SPE is validly existing and in good standing and has duly authorized and executed the transaction documents. To give those opinions,⁴⁷ the opinion giver will first obtain certified copies of the organic documents of the SPE and a good standing certificate from the jurisdiction of organization. For a Delaware LLC, organic

40. Domicile includes jurisdiction of incorporation. *See, e.g.,* Underwood v. Hilliard (*In re* Rimsat, Ltd.), 98 F.3d 956, 960 (7th Cir. 1996) (citing *Bank of Augusta v. Earle*, 38 U.S. 519, 588 (1839) (holding a corporation “must dwell in the place of its creation”).

41. *See* 11 U.S.C. § 109(a) (2006); 28 U.S.C. § 1408 (2000) (venue of cases under title 11); 28 U.S.C. § 1410 (2000) (venue of cases ancillary to foreign proceedings).

42. The case may be brought by the foreign representative in certain circumstances. *See* 11 U.S.C. § 303(b)(4) (2006); *id.* § 1511.

43. *See* 11 U.S.C. § 1515 (2006); *but see In re* Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 389 B.R. 325, 331 (S.D.N.Y. 2008) (declining to recognize as a foreign main or foreign non-main proceeding a proceeding commenced in the Cayman Islands for limited liability companies organized under Cayman law where the assets and activities of the entities had no other substantial contacts with the Cayman Islands).

44. *See* *Argo Fund Ltd. v. Bd. of Dirs. of Telecom Arg., S.A. (In re* Bd. of Dirs. of Telecom Arg., S.A.), 528 F.3d 162, 171–72 (2d Cir. 2008); 11 U.S.C. § 1509(c) (2006).

45. *See* 11 U.S.C. § 1521(b) (2006).

46. This is because substantive consolidation is remedial. *See* *ABF Capital Mgmt. v. Kidder Peabody & Co. (In re* Granite Partners, L.P.), 210 B.R. 508, 517 (Bankr. S.D.N.Y. 1997); *In re* Ionica PLC, 241 B.R. 829, 836–37 (Bankr. S.D.N.Y. 1999). Although the precise remedy of substantive consolidation may not be available in a foreign jurisdiction, this does not warrant a U.S. court’s refusal to grant recognition or deny comity so long as the foreign law provides for other remedies for improper conduct. *See In re* Compañía de Alimentos Fargo, S.A., 376 B.R. 427, 438 (Bankr. S.D.N.Y. 2007).

47. The standard closing opinion is usually delivered in a document separate from the substantive consolidation opinion.

documents are the certificate of formation certified by the Secretary of State of the State of Delaware and the LLC agreement certified by an officer of the company.⁴⁸ These documents should contain the limitations on the purposes of the entity and the separateness covenants requiring that the entity take the steps necessary to establish and preserve its legal existence and operations separate from the Originator and the Servicer with regard to the assets that are sold or contributed to the SPE by the Originator, the Servicer, or their respective affiliates.⁴⁹ Importantly, the LLC agreement may regulate the rights of the members and managers of the LLC to vote in favor of the initiation of a bankruptcy case for the entity.⁵⁰ The LLC agreement may also grant rights (including, for example, the right to approve amendments to the agreement) to a person who is not a party to the LLC agreement.⁵¹ Similarly, the LLC agreement may appoint one or more managers who are not members.⁵² These provisions give lenders and other parties relying on the separateness covenants contained in the LLC agreement some power over any attempt to eliminate these protections. The SPE will usually be newly created, but, if not, the opinion giver will have to inquire whether the SPE has creditors for obligations not part of the financing and take those other obligations into consideration in formulating the opinion.

The opinion giver is also likely to be giving an opinion on the enforceability of the transaction documents as against the SPE, the Originator, and the Servicer. In order to do so, counsel will have examined the undertakings by the SPE in the transaction agreements to determine whether the provisions will be given effect by a court.⁵³ The focus of the enforceability opinion, after a discussion of the choice of law, is on the remedies that are provided in the event of a breach of the agreement.⁵⁴

The focus of the opinion giver's investigation for the purpose of the non-consolidation opinion will be different from the focus of the enforceability opinion and has two principal concerns. First, addressing the hopeless intermingling test, counsel should determine whether the terms of the parties' contracts or the parties' course of dealing will impair the ability to establish their legal separateness. For example, an agreement between the SPE and the Servicer or the Originator that the SPE will not maintain any separate bank accounts or that all bills for the activities of the SPE should be addressed to and paid directly by the Originator or

48. A Delaware LLC is formed by the filing of a certificate of formation with the Delaware Secretary of State and entering into an LLC agreement, sometimes referred to as an "operating agreement." See DEL. CODE ANN. tit. 6, § 18-201(a), (d) (2005). The LLC agreement may be entered into before or after the filing of the certificate of formation. For a comprehensive discussion of the delivery of opinions relating to LLCs, see TriBar Opinion Comm., *Third-Party "Closing" Opinions: Limited Liability Companies*, 61 BUS. LAW. 679 (2006), and GLAZER, FITZGIBBON & WEISE, *supra* note 28, §§ 19.1–19.6, at 671–97.

49. The limitations should appear in the LLC agreement.

50. See DEL. CODE ANN. tit. 6, § 18-302 (2005 & Supp. 2006) (members); *id.* § 18-404 (managers).

51. See DEL. CODE ANN. tit. 12, § 18-302(e) (2007).

52. See *id.* § 18-101(10).

53. See GLAZER, FITZGIBBON & WEISE, *supra* note 28, § 9.6, at 289–94.

54. See *id.*; FIELD & SMITH, *supra* note 28, §§ 6:1–6:10, at 6-1 to 6-10.

the Servicer may well be enforceable against the SPE, Originator, and Servicer as a matter of contract law, but operating the SPE in that fashion could create some risk of substantive consolidation and potentially expose the Servicer or Originator to the liabilities of the SPE under other theories of liability. The cash flow from the assets that are held by the SPE will be a particular concern. The opinion giver will be especially interested in whether under the transaction documents the cash flow from the securitized assets is identified as belonging to the SPE and is to be promptly and properly segregated from the funds of any other affiliated entity. The failure to do so would raise the practical risk that the funds may become directly subject to the claims of creditors of the affiliated persons and create the risk that the affairs of the SPE and the affiliated persons will become so hopelessly intermingled as to provide a legal basis for substantive consolidation. The opinion giver will also take into account the treatment of intercompany accounts. It is typical for affiliated companies not to settle the transactions between them in cash but to create intercompany accounts that record intercompany financial transactions. The existence of these accounts creates two risks: that the accounts may become subject to dispute as to whether they should be treated as claims or capital contributions,⁵⁵ and that it may become difficult to substantiate and explain entries in the accounts with the passage of time and the accumulation of entries.⁵⁶

The second key element of the substantive consolidation analysis is whether the parties to the structured finance transaction, on the one hand, and other creditors of the SPE, the Originator, and Servicer, on the other hand, relied on the legal separateness of the SPE or justifiably perceived the SPE as a part of the Originator, the Servicer, or other affiliated party. The SPE, the Originator, the Servicer, and their respective affiliates should make third parties aware that the assets of the SPE belong to the SPE and not to the Originator or Servicer. The presentation of the SPE's assets and liabilities in financial statements made available to third parties is very important with respect to this point, as are the terms of the transaction documents. An additional fact that may be relevant is the manner in which the SPE presents itself to its counterparties in its business forms and communications, which can bolster or undercut the appearance of legal separateness.

Both separateness and reliance can involve facts that must be established independently from the terms of the documents and are not limited to the state of affairs as of the time that the opinion is given. If the SPE is not newly organized, it will be necessary for the opinion giver to establish the SPE's prior activities in order to determine that the SPE has maintained its separateness. The opinion giver must also establish that the transaction has been structured so as to provide that the SPE will maintain its separateness. As a predicate to the continued validity of the analysis, assumptions must be made with respect to the facts as they will

55. There is also the risk that the transactions themselves violate the separateness covenants in the transaction documents.

56. See, e.g., *In re Adelphia Commc'ns Corp.*, 368 B.R. 140, 150–53 (Bankr. S.D.N.Y. 2007) (detailing the debtor's efforts to create reliable financials to account for affiliate transfers, and noting that the debtor could not create reliable financials on an unconsolidated basis).

exist at the time that substantive consolidation is tested. Like facts that are necessary to other opinions, the facts necessary for a substantive consolidation analysis are expressly assumed, with the consent of the opinion recipients, or established based on certificates⁵⁷ of officers of the transaction parties and by reliance on the representations and warranties in the transaction documents.⁵⁸ Customarily, officers of the SPE, Originator, and Servicer execute certificates in which they certify to the activities of the parties up to the date of the opinions. In giving the opinion, the opinion giver will assume the future compliance by the parties with the terms of the transaction documents. If the SPE is otherwise subject to consolidation in the financial statements of the Originator or Servicer, it is good practice to require footnote disclosure of the separate assets and liabilities of the SPE in the consolidated financial statements as well as to require the preparation and delivery of separate financial statements for the SPE to demonstrate its separate assets and liabilities to parties dealing with it.

Because of the importance historically placed on the existence of guarantees by affiliates,⁵⁹ the opinion should explicitly address that factor but may conclude that the existence of guarantees does not impair the ability of the opinion giver to opine that the companies would not be consolidated.

VI. CONCLUSION

Structured finance continues to represent a substantial portion of the capital markets in the United States and abroad. Lenders and rating agencies will continue to seek comfort on the non-consolidation issue through the receipt of non-consolidation opinions. The process of generating and reviewing the opinions can be simplified and rationalized through a sharper focus on the elements of the analysis required to deliver the opinion and the level of detail required to appear in the opinion.

Recognizing that the use of a reasoned opinion, as all substantive consolidation opinions are, is sufficient to alert the opinion recipient of uncertainty in the analysis and the need for the recipient to consult its own counsel, it is the view of the Committees that substantive consolidation opinions can be condensed while still achieving their purpose. The form that follows this Special Report is an example of a suggested condensed opinion. The form provides assurance to the opinion recipient that the necessary steps have been taken to establish the separateness

57. For a discussion of the role of certificates, see GLAZER, FITZGIBBON & WEISE, *supra* note 28, §§ 4.2.3.7–4.2.3.9, at 145–47; FIELD & SMITH, *supra* note 28, §§ 5:10–5:14, at 5-12 to 5-16.

58. Like any other assumption in a certificate, although the opinion giver does not take responsibility for the facts assumed or contained in a certificate, the opinion giver may not rely on those facts if the opinion preparer knows them to be untrue or reliance is otherwise unreasonable under the circumstances. See TriBar Opinion Comm., *Third-Party “Closing” Opinions*, 53 BUS. LAW. 593, 610, 615 (1998) (§§ 2.1.4, 2.3); GLAZER, FITZGIBBON & WEISE, *supra* note 28, §§ 4.2.3, 4.3.4, at 129–47, 155–57; FIELD & SMITH, *supra* note 28, § 5:16, at 5-19 to 5-20.

59. The rating agencies consider the extent of guarantees in determining the rating for a transaction.

of the SPE while at the same time reducing the transaction expenses inherent in generating and reviewing a substantive consolidation opinion containing more detail than necessary. Avoiding unnecessary legal analysis in the opinion should have the effect of focusing the opinion preparers and the opinion recipient on the analysis of the factors needed to structure the specific transaction to achieve separateness.

FORM OF SUBSTANTIVE CONSOLIDATION OPINION

[Date]

[Addressees]

Ladies and Gentlemen:

We have acted as special counsel to [____], a [limited liability company] organized under the laws of [____] (the “Company”), in connection with the issuance by the Company of [Notes] [describe the transaction],¹ as more fully described below.

The Company has been formed to (i) issue the Notes pursuant to [insert description of registration or exemption] and (ii) [insert relevant description]. The Company is a wholly owned special purpose subsidiary of [____], a corporation organized under the laws of the State of [____] (“Parent”). Parent has provided to the Company capitalization in the amount of \$[____] million in cash in exchange for 100% of the [limited liability membership interests in] [beneficial interests in] the Company’s equity.

The [Certificate of Formation of the Company dated [____] (the “Certificate of Formation”) and the Company’s Limited Liability Company Agreement dated [____] (the “Limited Liability Company Agreement”)] limit the Company’s activities to the above activities and certain related activities. [Describe the actual operations of the Company.]

You have requested, and the Company has requested that we provide you with, an opinion as to whether, in the event that Parent² were to become a debtor in a case under title 11 of the U.S. Code, 11 U.S.C. §§ 101–1532 (the “Bankruptcy Code”), a U.S. court exercising jurisdiction over such case under the Bankruptcy Code (a “bankruptcy court”) would order the substantive consolidation of the assets and liabilities of the Company with those of Parent.

In arriving at the opinion expressed below, we have examined copies of the following:

1. [Certificate of Formation];
2. [Limited Liability Company Agreement];
3. [Transaction documents]

As to facts material to the opinion hereinafter expressed, we have, with your permission, relied upon statements or certificates³ of the Company, Parent, public officials, and [others] and have assumed that such statements and the certifications contained in such certificates are accurate in all respects material to this opinion.

1. As emphasized in the Special Report, the key to the proper preparation of the opinion is an analysis of the relevant terms of the transaction and an application of the relevant law to those facts.

2. An opinion may also be sought as to other affiliated companies including ultimate parent companies and other originators or servicers of the assets transferred to the Company.

3. The certificates should be carefully drafted to reflect the structure of the transaction that is the subject of the opinion and contain matters within the knowledge of the officer executing the certificate.

While we are not aware of any inaccuracies in such statements and certifications, we have not made any independent inquiry with regard to their accuracy.

[Applicable law discussion if SPE is organized under the laws of jurisdiction outside the United States.^{4]}

SUBSTANTIVE CONSOLIDATION UNDER THE BANKRUPTCY CODE

The general principle is well established that the legal separateness of corporate entities will presumptively be recognized. Substantive consolidation is a judicially created doctrine that runs counter to this well-established principle. Under the doctrine of substantive consolidation, a bankruptcy court may, if appropriate circumstances are determined to exist, consolidate the assets and liabilities of different entities by merging the assets and liabilities of the entities and treating the related entities as a consolidated entity for purposes of distribution in a bankruptcy case. Some courts have held that substantive consolidation can be used with similar effect to extend a debtor's bankruptcy proceeding to include in the debtor's estate the assets of a related entity that is not a debtor in a case under the Bankruptcy Code.⁵ In addition, some courts have held that a court can consolidate estates as to certain unsecured claims (e.g., trade claims) even if it is not consolidating as to all unsecured claims.⁶

The modern statement of the doctrine is found in the opinions of the U.S. Courts of Appeals for the Third, Second, and District of Columbia Circuits in their decisions in *Owens Corning*,⁷ *Augie/Restivo*,⁸ and *Auto-Train*,⁹ respectively. Under the Third Circuit test stated in *Owens Corning*, the proponent seeking substantive consolidation must establish either (i) the entities pre-petition "disregarded [their] separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity," or (ii) post-petition the "assets and liabilities [of the entities] are so scrambled that separating them is prohibitive and hurts all creditors."¹⁰ The Second Circuit's formulation in *Augie/Restivo*¹¹ (adopted by the Ninth Circuit)¹² is (1) "whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit," or (2) "whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."¹³ Under the District of Columbia Circuit test as

4. As discussed in the Special Report, where appropriate the opinion may discuss whether the special purpose entity will be subject to a plenary bankruptcy case in the United States, recognizing that substantive consolidation is a doctrine of U.S. bankruptcy law. Other relevant jurisdictions may have doctrines with a similar effect, which might be addressed in a separate opinion from counsel from that jurisdiction.

5. See, e.g., *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 765 (9th Cir. 2000).

6. See, e.g., *In re Cont'l Vending Mach. Corp.*, 527 F.2d 997, 1000-02 (2d Cir. 1975).

7. *In re Owens Corning*, 419 F.3d 195, 205-09 (3d Cir. 2005), cert. denied sub nom. *McMonagle Credit Suisse First Boston*, 547 U.S. 1123 (2006).

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

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

10. *Owens Corning*, 419 F.3d at 211.

11. See *Augie/Restivo Baking Co.*, 860 F.2d at 518.

12. See *Alexander*, 229 F.3d at 766.

13. *Augie/Restivo Baking Co.*, 860 F.2d at 518 (internal quotation marks omitted).

stated in *Auto-Train*¹⁴ (also followed by the Eighth¹⁵ and Eleventh¹⁶ Circuits), the proponent of consolidation must make a prima facie case demonstrating (1) that “there is substantial identity between the entities to be consolidated,” and (2) “that consolidation is necessary to avoid some harm or to realize some benefit.”¹⁷ Once the proponent for consolidation has made this showing, the burden shifts to an objecting creditor to show that (1) it has relied on the separate credit of one of the entities to be consolidated, and (2) it will be prejudiced by substantive consolidation.¹⁸ Although the D.C. Circuit’s test—to establish a prima facie case by requiring only that consolidation avoid some harm or realize some benefit—states a less severe standard than the tests adopted by the Second and Third Circuits, those courts following the *Auto-Train* test will substantively consolidate only in the absence of actual reliance by a creditor on the separateness of the entities which is prejudiced by consolidation unless the benefits of substantive consolidation “heavily outweigh” the harm to the objecting creditor harmed by consolidation.¹⁹ The Courts of Appeals’ decisions uniformly deny consolidation if separate assets and liabilities of the entities can be identified and there is reliance by a significant creditor on the separateness of the entities.²⁰

In circuits where there is no controlling Court of Appeals authority, the courts may rely on an analysis based upon lists of factors. Two sets of substantive consolidation factors are often cited. One list of factors taken from the older alter ego veil piercing cases is collected in the Tenth Circuit’s opinion in *Fish v. East*.²¹

14. See *Auto-Train*, 810 F.2d at 276.

15. See *First Nat’l Bank of El Dorado v. Giller (In re Giller)*, 962 F.2d 796, 799 (8th Cir. 1992).

16. *Eastgroup Props. v. S. Motel Ass’n, Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991).

17. *Auto-Train*, 810 F.2d at 276.

18. *Id.*

19. See *Eastgroup Props.*, 935 F.2d at 249. This “modern trend” was explicitly rejected in *Owens Corning*, 419 F.3d at 207.

20. See *Owens Corning*, 419 F.3d at 212; *Augie/Restivo Baking Co.*, 860 F.2d at 520 (“Where, as in the instant case, creditors . . . knowingly made loans to separate entities and no irremediable commingling of assets has occurred, a creditor cannot be made to sacrifice the priority of its claims against its debtor by fiat based on the bankruptcy court’s speculation that it knows the creditor’s interests better than does the creditor itself.”).

21. 114 F.2d 177, 191 (10th Cir. 1940). The list is as follows:

- (1) The parent corporation owns all or a majority of the capital stock of the subsidiary.
- (2) The parent and subsidiary corporations have common directors or officers.
- (3) The parent corporation finances the subsidiary.
- (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.
- (5) The subsidiary has grossly inadequate capital.
- (6) The parent corporation pays the salaries or expenses or losses of the subsidiary.
- (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.
- (8) In the papers of the parent corporation, and in the statements of its officers, “the subsidiary” is referred to as such or as a department or division.
- (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation.
- (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

Id. at 191. See also *Eastgroup Props.*, 935 F.2d at 249–50; *In re Tureaud*, 45 B.R. 658, 662 (Bankr. N.D. Okla. 1985), *aff’d*, 59 B.R. 973 (N.D. Okla. 1986); *FDIC v. Hogan (In re Gulfo Inv. Corp.)*, 593

The second commonly cited list of factors appears in *In re Vecco Construction Industries, Inc.*²²

The presence or absence of some or all of these “elements” does not necessarily lead to a determination that substantive consolidation is or is not appropriate.²³ Indeed, many of the “elements” are present in most bankruptcy cases involving affiliated companies or a holding company structure but do not necessarily lead to substantive consolidation. The Third Circuit and other courts have noted that some of these factors, particularly the “consolidation of financial statements,” “difficulty of separating assets,” “commingling of assets,” and “profitability to all creditors,” may be more important than others.²⁴

We also note that courts in several cases have considered a factor articulated in 1942 in *Stone v. Eacho*—i.e., whether “by . . . ignoring the separate corporate entity of the [subsidiaries] and consolidating the proceeding . . . with those of the parent corporation . . . all the creditors receive that equality of treatment which it is the purpose of the bankruptcy act to afford.”²⁵ Arguably, these cases reflect “the courts’ recognition of the increasingly widespread existence in the business world of parent

F2d 921, 928–29 (10th Cir. 1979). For a similar, but somewhat longer, list, see *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 723, 764 (Bankr. S.D.N.Y. 1992) (citing cases). See also *First Nat’l Bank of El Dorado v. Giller (In re Giller)*, 962 F.2d 796, 798–99 (8th Cir. 1992); *In re Affiliated Foods, Inc.*, 249 B.R. 770, 776–84 (Bankr. W.D. Mo. 2000); *In re Apex Oil Co.*, 118 B.R. 683, 692–93 (Bankr. E.D. Mo. 1990) (relying, in part, on such factors, but also considering fairness of substantive consolidation to creditors).

22. 4 B.R. 407, 410 (Bankr. E.D. Va. 1986). The factors in this case are

- (1) “the degree of difficulty in segregating and ascertaining individual assets and liabilities”;
- (2) “the presence or absence of consolidated financial statements”;
- (3) “the profitability of consolidation at a single physical location”;
- (4) “the commingling of assets and business functions”;
- (5) “the unity of interests and ownership between the various corporate entities”;
- (6) “the existence of parent or inter-corporate guarantees on loans”; and
- (7) “the transfer of assets without formal observance of corporate formalities.”

Id. at 410.

23. See *In re Donut Queen, Ltd.*, 41 B.R. 706, 709–10 (Bankr. E.D.N.Y. 1984) (noting that criteria should not be mechanically applied in determining consolidation; rather, factors should be evaluated within the larger context of balancing the prejudice resulting from the proposed order of consolidation with the prejudice alleged by the creditor from the debtor’s separateness); see also *Drexel Burnham*, 138 B.R. at 764–65 (noting that consolidation factors must be “evaluated within the larger context of balancing the prejudice resulting from the proposed consolidation against the effect of preserving separate debtor entities”).

24. See *Owens Corning*, 419 F.3d at 210–11; see also *Morse Operations, Inc. v. Robins Le-Cocq, Inc. (In re Lease-A-Fleet, Inc.)*, 141 B.R. 869, 877 (Bankr. E.D. Pa. 1992) (noting that “the more important factors” have not been alleged or asserted “with any degree of particularity”); *R2 Invs., LDC v. World Access, Inc. (In re World Access, Inc.)*, 301 B.R. 217, 276 (Bankr. N.D. Ill. 2003). Conversely, the courts in *Augie/Restivo Baking Co.*, 860 F.2d at 519, and *Owens Corning*, 419 F.3d at 212, point to explicit guarantees as indicia of separateness.

25. 127 F.2d 284, 288 (4th Cir.), cert. denied, 317 U.S. 635 (1942); see also *In re Richton Int’l Corp.*, 12 B.R. 555, 558 (Bankr. S.D.N.Y. 1981) (considering, as a key factor, that consolidation “will yield an equitable treatment of creditors without any undue prejudice to any particular group”); *In re Manzey Land & Cattle Co.*, 17 B.R. 332, 338 (Bankr. D.S.D. 1982); *In re Food Fair, Inc.*, 10 B.R. 123, 127 (Bankr. S.D.N.Y. 1981).

and subsidiary corporations with interrelated corporate structures and functions”²⁶ and suggest that, in the absence of harm or prejudice to any particular group, a court would be less focused on traditional concerns with actual or constructive blameworthy behavior. There are bankruptcy court decisions in which courts have ordered substantive consolidation where consolidation would enhance the debtors’ chances of successful reorganization.²⁷ It is important, however, to note that the courts in these cases have emphasized the absence of any harm or prejudice to any particular group or have concluded, after considering the equities, that any harm or prejudice is outweighed by the benefits of substantive consolidation.²⁸

The U.S. Courts of Appeals for the Second Circuit and the Third Circuit, however, have ruled that merely furthering the reorganization effort is not, in the absence of the more traditional factors, enough to warrant substantive consolidation.²⁹

Given that the power to order substantive consolidation derives from the equity jurisdiction of the bankruptcy courts, the issue is determined on a case-by-case basis and the decisions reflect the courts’ analysis of the particular factual circumstances presented. A court’s inquiry involves an examination of the organizational structures of the entities proposed to be consolidated, their relationships with each other, and their relationships with their respective creditors and other third parties. In particular, the court will consider the impact upon the creditors of each entity if consolidation were to be ordered and whether such parties would be unfairly prejudiced or treated more equitably by substantive consolidation.

APPLICABILITY TO LIMITED LIABILITY COMPANIES

While substantive consolidation was originally developed in the corporate context, the standards have more recently been applied in the context of partnerships and limited liability companies. Courts have ordered substantive consolidation of a general partnership with its general partners,³⁰ a corporation with

26. *In re F. A. Potts & Co., Inc.*, 23 B.R. 569, 571 (Bankr. E.D. Pa. 1982); see also *Eastgroup Props.*, 935 F.2d at 248–49 (noting a “modern” or “liberal” trend toward allowing substantive consolidation in “recognition of the widespread use of interrelated corporate structures by subsidiary corporations operating under a parent entity’s corporate umbrella” (quoting *In re Murray Indus., Inc.*, 119 B.R. 820, 828–29 (Bankr. M.D. Fla. 1990))); *Richton Int’l*, 12 B.R. at 555; *Vecco Constr. Indus.*, 4 B.R. at 409; *In re Interstate Stores, Inc.*, 1 B.R. 755, 758 (Bankr. S.D.N.Y. 1980); Seth D. Amera & Alan Kolod, *Substantive Consolidation: Getting Back to Basics*, 14 AM. BANKR. INST. L. REV. 1, 38–39 (2006); but see *Owens Corning*, 419 F.3d at 209 n.15 (“[T]hus we disagree with the assertion of a ‘liberal trend’ toward increased use of substantive consolidation.”).

27. See *Manzey Land & Cattle*, 17 B.R. at 338; *F. A. Potts & Co.*, 23 B.R. at 573; *Murray Indus.*, 119 B.R. at 832; *In re Nite Lite Inns*, 17 B.R. 367, 372–73 (Bankr. S.D. Cal. 1982).

28. See *supra* note 27. See also *In re Silver*, No. 3-75-1710(D), 1976 U.S. Dist. LEXIS 17383, at *11 (Bankr. D. Minn. 1976).

29. In *Augie/Restivo*, the Second Circuit found that consolidation would unfairly prejudice the principal creditor of one of the debtors. 860 F.2d at 520. In *Owens Corning*, the Third Circuit stated, “Mere benefit to the administration of the case (for example, allowing a court to simplify a case by avoiding other issues or to make postpetition accounting more convenient) is hardly a harm calling substantive consolidation into play.” 419 F.3d at 211.

30. *FDIC v. Colonial Realty Co.*, 966 F.2d 57, 59–60 (2d Cir. 1992).

individuals,³¹ and individuals with corporations.³² Applicable state laws under which limited liability companies are formed establish the separateness of such entities from their members with equivalent or greater specificity than do state laws applicable to corporations.³³

We believe that a bankruptcy court considering the issue of substantive consolidation of a Delaware limited liability company with another entity would apply the general principles of substantive consolidation that have been developed in cases under the Bankruptcy Code, most of which address consolidating the assets and liabilities of one corporation with those of another corporation. Accordingly, we have relied, in our analysis, on the general body of substantive consolidation case law and believe that such law would be applicable to the court's determination as to whether to consolidate substantively the Company with Parent.

APPLICATION OF THE LEGAL PRINCIPLES TO THE PRESENT TRANSACTION

The question whether, and in what circumstances, a court would order substantive consolidation of the assets and liabilities of the Company with those of Parent cannot be answered in the abstract but must take into account the actual facts and circumstances of the operations and relations of those entities over time. In light of the lack of a detailed, clearly prescribed standard for determining the appropriateness of substantive consolidation under existing case law, and given the equitable basis for the remedy, any opinion regarding substantive consolidation must, of necessity, be a reasoned opinion based on the various "elements" and, to the extent applicable, the balancing test applied by some courts. The circumstances of the future operations of the Company on one hand and Parent on the other cannot be known today and, accordingly, in addition to assuming that the parties will comply in all material respects with, and not amend or change, the provisions of the agreements and instruments described in items 1 through 3 on the first page hereof, in each case to the extent material to this opinion, we have, with your permission, assumed for purposes of our opinion the representations and warranties in the transaction documents and the compliance by the Company, Parent, and other parties to the transaction documents with covenants in the transaction documents³⁴ [and requirements of the Certificate of Formation and Limited Liability Company Agreement] requiring the parties to maintain their separate identities and operations, again in each case to the extent material to this opinion.

We have further assumed with your permission [include here other assumptions about the future operations of the Company and conduct of the parties,

31. *Holywell Corp. v. Bank of N.Y.*, 59 B.R. 340, 348 (S.D. Fla. 1986), *vacated sub nom.* Miami Ctr. Ltd. P'ship v. Bank of N.Y., 838 F.2d 1547 (11th Cir.), *cert. denied*, 488 U.S. 823 (1988).

32. *In re Baker & Getty Fin. Servs., Inc.*, 78 B.R. 139, 142-43 (Bankr. N.D. Ohio 1987).

33. *See, e.g.*, DEL. CODE ANN. tit. 6, §§ 18-303, 18-701 (2005).

34. These covenants include any undertaking by Parent to cause the Company to comply.

such as assumptions about the future conduct of Parent, not contained in covenants in the transaction documents that are relied upon in rendering the opinion].

In connection with the opinion hereinafter expressed we have further [assumed, with your permission,]³⁵ that the capitalization of the Company is now and is expected to continue to be adequate in light of its contemplated business and obligations but do not assume the future solvency or adequate capitalization of the Company.

Compliance with the foregoing, and the absence of facts inconsistent therewith, will in our view be significant with respect to any effort to consolidate Parent substantively with the Company in the event Parent becomes a debtor in a case under the Bankruptcy Code.

Although there is a unity of ownership between Parent and the Company, this fact does not, of itself, establish any harm or prejudice to creditors of Parent. Further, the separate financial affairs of Parent and the Company, the absence of guarantees [except that the holders of the Notes are included among the beneficiaries of certain customary indemnification obligations of Parent under [describe the operative documents]],³⁶ and the fact that the Company has not undertaken to make loans to Parent should establish that the creditors of Parent did not rely upon the credit of the Company.

We also do not believe a showing could be made of sufficient administrative necessity or convenience for a court to consolidate substantively the Company and Parent. The Company's assets would be segregated and readily identifiable and intercompany transactions properly recorded so that they would not be so intermingled that a prohibitively costly "unscrambling" that could threaten reorganization would be required.

Under these circumstances, while there is no case litigated on the merits directly on point, it is our opinion that, in the event Parent were to become a debtor in a case under the Bankruptcy Code, a bankruptcy court would not substantively consolidate the Company and Parent. We note, however, that substantive consolidation is an equitable doctrine and that courts have accorded different degrees of importance to the factual elements before them in determining whether to exercise their equitable power to order substantive consolidation.

35. Alternative language: [relied upon a certificate of Parent to the effect].

36. [We note that there is a joint and several securities law indemnity in the [Purchase Agreement] from the Company and Parent. We understand this is conventional in similar circumstances, although as indicated above Parent is not an obligor on the Notes. This indemnity does not cover any obligation of the Company under the [Operative Documents] or otherwise and is not a guarantee of specific debt or a general guarantee of the obligations of another entity. We do not believe that under these circumstances such an indemnity would require an "unscrambling" that would mandate substantive consolidation or show a general reliance upon the credit of Parent]. [The transaction may involve other intercorporate debt, such as an intercorporate note from the Company to Parent that is part of the Company's capitalization and repaid when the Company has excess funds, the impact of which counsel will need to consider.]

We have assumed, with your permission, that a party in interest would timely present an objection to substantive consolidation and properly brief and argue such objection.³⁷

We express no opinion with respect to the consolidation, substantive or otherwise, of the assets and liabilities of the Company with those of Parent if such consolidation is incorporated in a plan of reorganization that is accepted by the creditors of the Company by the majorities required by Bankruptcy Code section 1126.

This opinion letter has been furnished to you solely in connection with this transaction and on the condition that the opinion expressed herein may not be published or otherwise communicated by you to any other party without our specific prior written approval in each instance. No one other than you may rely upon the opinion expressed herein. We undertake no duty to update this opinion for developments after the date hereof.

Very truly yours,

XXXX

37. See *In re* Buckhead Am. Corp., No. 91-978, 1992 Bankr. LEXIS 2506, at *4 (Bankr. D. Del. Aug. 13, 1992) (entering order substantively consolidating all eight debtors after all objections by creditors had been withdrawn); *In re* Standard Brands Paint Co., 154 B.R. 563, 571-72 (Bankr. C.D. Cal. 1993) (entering order substantively consolidating five debtors for voting and distribution purposes in the absence of any objection by creditors).

