Substantive Consolidation and Non-consolidation Opinions


By **Kathryn Borgeson**
Special Counsel | Financial Restructuring


By **Peter Dodson**
Senior Counsel | Financial Restructuring

Substantive consolidation is an equitable remedy pursuant to which a bankruptcy court disregards the separate legal existence of a debtor, and pools the assets and liabilities of the debtor with one or more of its affiliates, in order to make distributions to creditors under a plan of reorganization or liquidation.

The Bankruptcy Code does not contain specific authorization for substantive consolidation. Instead, a bankruptcy court's authority to substantively consolidate affiliated entities is derived from its general equitable powers.

When affiliated entities are substantively consolidated, intercompany claims among those entities are eliminated, the assets of the consolidated entities are pooled, and the claims of creditors against each entity are treated as against the common pool of assets. Substantive consolidation typically benefits one entity's creditors at the expense of another entity's creditors because each of the entities being consolidated has a different debt-to-asset ratio.

Lenders in structured finance transactions often require their Borrowers to be Special Purpose Entities ("SPEs") to isolate the assets that are being financed, and the cash flow from those assets, from outside factors, such as the performance of other assets or the financial condition of the SPE's affiliates. Substantive consolidation of an SPE with one or more of its affiliates defeats the isolation of the SPE's assets, pulling them into a common distribution pool.

How it Works

To provide comfort as to the Lender's interest in the assets being financed, and the cash flow from those assets, the Lender in a structured finance transaction often requires a non-consolidation opinion to be delivered by the SPE's counsel at closing.

A non-consolidation opinion states that if one or more parent entities of the SPE files for bankruptcy, the bankruptcy court would respect the separate legal existence of the SPE and would not order the substantive consolidation of the assets and liabilities of the SPE with those of one or more of its parent entities, guarantors or affiliated managers (such as an affiliated property manager).

The opinion confirms that the SPE structure required by the Lender will be respected in bankruptcy, and that the SPE's assets will remain isolated and will not be pulled into a common distribution pool with those of the SPE's affiliates.

Because the Bankruptcy Code does not contain prescribed standards for substantive consolidation, judicially developed standards control. Bankruptcy courts have developed multiple, complicated and occasionally conflicting tests for determining whether an SPE should be substantively consolidated with one or more of its parent entities. However, four important categories of factors have emerged:

(1) Record keeping: the SPE should have separately identifiable assets and liabilities, and separate accounting records and financial statements.

(2) Operational issues: the SPE should be adequately capitalized and economically independent from its equityholders.

(3) Intercompany transactions: the SPE's transactions with affiliates should be on arm's length and commercially reasonable terms, and guarantees of the SPE's obligations by affiliates and other credit support by affiliates should be limited.

(4) Benefits and harms: whether the benefits of substantive consolidation outweigh the prejudice to creditors that results from substantive consolidation.

Essentially, courts are looking to see whether the SPE's assets and liabilities can be separated from those of its affiliates, and whether the SPE can conduct its business as a standalone entity. Courts also look to whether substantive consolidation would cause injustice to creditors who relied on the separate credit and existence of the SPE. Substantive consolidation may result where an SPE's assets and liabilities are "hopelessly entangled" with those of its affiliates or where an SPE has to rely on its affiliates to conduct its business.

Practice Tips

The affiliates of the SPE that are included in the non-consolidation opinion are referred to as the non-consolidation opinion "pairings."

- The rule of thumb, and the requirement in rated deals, is to pair the SPE against any equity owner (or group of affiliated equity owners) that owns 49% or more of the equity interests in the SPE, plus any guarantor and any affiliated manager (collectively, the "Related Entities").
- The non-consolidation opinion will have the SPE on one "side" of the opinion, and the Related Entities on the other. Other deal-required SPEs, such as operating lessees or general partners of a limited partnership SPE, should be included on the SPE side of the non-consolidation opinion, paired against the Related Entities. No non-consolidation opinion is necessary between deal-required SPEs.

- In real estate transactions with both a mortgage loan and a mezzanine loan, the mezzanine borrower is not a deal-required SPE for purposes of the mortgage loan because it has separate debt that needs to be isolated from the debt of the mortgage borrower. Instead, the mezzanine borrower, as an equity owner of the mortgage borrower, should be included as a Related Entity in the mortgage non-consolidation opinion.