On June 16, 2009, the U.S. District Court for the District of Delaware handed down a decision in Schroeder v. New Century Liquidating Trust (In re New Century TRS Holdings Inc.)\(^1\) that could have an impact on the future use of substantive consolidation for purposes of confirming a chapter 11 plan. The District Court reversed a confirmed plan of liquidation on the basis that the three groupings into which the various debtors had been organized for purposes of distributions to creditors constituted a substantive consolidation, which was not warranted by the underlying circumstances.

Although the typical case of substantive consolidation calls for the merger of multiple entities into one, New Century involved a structure pursuant to which numerous debtors were consolidated into one of three debtor groups. Despite the fact that the consolidation was not a typical “many-into-one” structure, the District Court found that this “many-into-three” consolidation still constituted substantive consolidation and unfairly harmed certain creditors.

**An Equitable Remedy**

The Bankruptcy Code does not prescribe a standard governing the appropriateness of substantive consolidation. Instead, substantive consolidation is an equitable remedy, stemming from common law, under which the assets and liabilities of multiple debtors are treated from common law, under which the assets and liabilities of multiple debtors are treated as one indistinguishable entity. Courts generally caution that the practice should be used sparingly because it may adversely alter the expectations of those creditors who relied on a certain entity’s asset base by diluting such creditors’ ratable share of such debtor’s estate with the claims of creditors of less asset-rich debtors.

With the ‘New Century’ decision, the District Court reaffirmed the narrow use of the substantive consolidation doctrine, and may have narrowed it even further.

Courts in the U.S. Court of Appeals for the Third Circuit follow the standard established in In re Owens Corning\(^2\), when determining issues of substantive consolidation. In Owens Corning, the U.S. Court of Appeals for the Third Circuit held that substantive consolidation was only appropriate when (i) the parties consent; (ii) the prepetition period, the debtors disregarded their separateness to such an extent that creditors viewed them as one entity; or (iii) during the postpetition period, the debtors’ assets were so intertwined that separating the assets would be impossible or would hurt all creditors.\(^3\)

Courts in many districts use a multi-factor test to determine if substantive consolidation is appropriate. However, Owens Corning found that the use of a factor checklist may fail to give appropriate weight to the important factors over unimportant factors. The Third Circuit reasoned that the better approach is determining whether creditors deal with the entities as one or separate entities. Because substantive consolidation may have a negative impact on certain creditors, the Third Circuit warned that the remedy is extreme and imprecise, constituting “rough justice” that courts should use sparingly.\(^4\)

The Third Circuit based its approach on the Second Circuit’s test in In re Augie/Restivo Baking Co., Ltd.\(^5\) In Augie/Restivo, the Second Circuit found the two critical factors in evaluating the propriety of substantive consolidation are creditor reliance and financial entanglement.\(^6\)

The D.C. Circuit and the Eleventh Circuit have taken a slightly different stance on the issue, placing the emphasis on a balancing of the harms and benefits of consolidation, recognizing that creditor reliance plays a critical, but not solitary, role in the analysis.\(^8\) The D.C. Circuit requires that a party seeking to establish a prima facie case for substantive consolidation must demonstrate (i) a substantial identity among the entities sought to be consolidated and (ii) that consolidation is necessary to avoid harm or realize a benefit. In order to overcome this showing, a creditor must prove that it reasonably relied on the separateness

---

\(^1\) Schroeder v. New Century Liquidating Trust (In re New Century TRS Holdings Inc.)

\(^2\) In re Owens Corning

\(^3\) In re Owens Corning

\(^4\) In re Augie/Restivo Baking Co., Ltd.

\(^5\) In Augie/Restivo

\(^6\) In re Augie/Restivo

\(^7\) In re Augie/Restivo

\(^8\) In re Augie/Restivo

JOHN J. RAPISARDI is a partner in the financial restructuring department of Cadwalader, Wickersham & Taft and is an adjunct professor of law at Pace University School of Law. MICHAEL J. COHEN and EVA M. DE GRAUW, associates of the firm, assisted in the preparation of this article.
of the entities in its prepetition dealings.\textsuperscript{9} The Eleventh Circuit adopted the same approach.\textsuperscript{10}

**New Century in Bankruptcy**

New Century TRS Holdings Inc. and its affiliates were in the business of originating, servicing and purchasing mortgage loans. Following years of rapid growth, the business began to crumble in late 2006 due to its inability to obtain funding from warehouse lenders for its loan origination program. The business filed for bankruptcy protection in April 2007.

A little over a year later, in July 2008, over the objections from a small number of creditors, the bankruptcy court confirmed the debtors' liquidation plan. The liquidation plan categorized the debtors' creditors into three groups and provided for the distribution of the assets of the debtors in each group to the creditors of the debtors in each group. During the plan confirmation proceeding, certain creditors objected to the confirmation of the plan because it provided for substantive consolidation in violation of *Owens Corning* and provided for disparate treatment of claims within the same class. The bankruptcy court overruled the objections and entered an order confirming the plan of liquidation.

**District Court Decision**

The objecting creditors immediately filed an appeal with the District Court and requested a stay of the liquidation proceeding pending the appeal. The stay was denied, however, and upon confirmation of the plan by the Bankruptcy Court, a few claims were settled and certain minor distributions were made. Notwithstanding the progress made in the debtors' liquidation, the District Court found the appeal was not equitably moot because reversal of the confirmation order would pose little harm to the parties involved.

- **Debtor grouping structure held improper.** Although the *New Century* plan did not effect the typical consolidation model of consolidating multiple debtors into one entity, the District Court found substantive consolidation did take place by pairing 16 debtors into three groupings. The "rough justice" described in *Owens Corning* is the increased competition among creditors for a consolidated pool of assets in addition to a re-valued claim that is less precise than if the creditors were dealing with the debtors individually. Due to the manner in which the debtors were grouped, the

District Court found that such "rough justice" existed and thus the debtors had substantively consolidated.

In addition, the District Court found that the non-cancellation of inter-debtor liabilities and the fact that the grouping of the debtors was achieved through compromise settlement was insufficient to negate a finding of substantive consolidation. The District Court reinforced the main concern expressed in *Owens Corning*, which was the effect consolidation would have on creditors, and found that the facts surrounding the liquidation plan in *New Century* were insufficient to lessen the negative impact on the creditors. As such, *New Century* did not fall into the narrow scope for substantive consolidation under *Owens Corning*.

- **Disparate treatment within a class of claims.** The District Court went on to consider whether the liquidation plan effected the disparate treatment of creditors in the same class. Section 1123(a)(4) of the Bankruptcy Code requires that to be confirmable a plan must "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest."\textsuperscript{11}

The District Court found that the holders of a claim in one class agreed to a higher distribution in that class in exchange for no distribution in another class for which they hold claims. Although those creditors consented, the creditors in the same class for which the consenting creditors are receiving a higher distribution did not consent. As there is a limited pool to draw from, the District Court found that the non-consenting creditors are disadvantaged by the larger distribution the consenting creditors would receive from the same class.

**Further Limitations**

The *New Century* decision initially seems to have an impact on the finality of a confirmation order. However, the District Court discussed at length the effect a reversal of the confirmation order would have on the finality of confirmation orders in general. As this was a plan of liquidation, the District Court found the same complexity did not exist in unraveling a liquidation as there would be with a plan of reorganization. The District Court found that very few creditors would be impacted by a reversal of the confirmation in comparison to the impact refusing a reversal would have on the objecting creditors.

The *New Century* decision will likely have a significant impact on the doctrine of substantive consolidation. *Owens Corning* established that substantive consolidation is a practice that should be used sparingly because the effect on creditors could potentially be harsh and extreme.

With the *New Century* decision, the District Court reaffirmed this narrow use of the substantive consolidation doctrine, and may have narrowed it even further. The *New Century* court found an improperly effected substantive consolidation because 16 debtors were grouped into three categories, and not simply consolidated into one. In addition, the liquidation plan was already in the process of being executed. However, the District Court determined that the treatment of the objecting creditors outweighed any compelling reason the debtors may have had for consolidating their entities into three groups. Because the Second Circuit and Third Circuit take a similar approach to substantive consolidation, it is likely that this decision may also resonate with courts in the Second Circuit.

**Conclusion**

Whether the *New Century* decision will have an impact on the doctrine of substantive consolidation remains to be seen. As *Owens Corning* had already found the doctrine should be utilized sparingly, the *New Century* decision may simply work to reinforce that principle. However, the use of substantive consolidation in the confirmation of a plan is a common practice in corporate bankruptcies and this decision is likely to stir up new attention to this issue in prospective cases.

---

\* Reprinted with permission from the July 2, 2009 edition of the NEW YORK LAW JOURNAL © 2009. ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-01-10-04