No. 08-628

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 2008

IN RE GENERAL ELECTRIC, INC.,
Debtor

SILVERMAN, INC.,
Petitioner,

-v.-

GENERAL ELECTRIC, INC.,
Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRTEENTH CIRCUIT

BRIEF FOR THE RESPONDENT

Team Number R46
Counsel for the Respondent

QUESTIONS PRESENTED

I. WHETHER A CREDITOR'S VOTE AGAINST A CHAPTER 11 PLAN OF REORGANIZATION MAY BE DESIGNATED AS MADE IN BAD FAITH BECAUSE THE CREDITOR'S OWNERSHIP OF A TOTAL RETURN SWAP GAVE RISE TO AN ECONOMIC INTEREST IN THE REORGANIZATION PLAN THAT WAS THE EXACT OPPOSITE TO THAT OF THE OTHER MEMBERS OF ITS VOTING CLASS.

II. WHETHER SUBSTANTIVE CONSOLIDATION OF TWO DIFFERENT DEBTOR ESTATES MAY BE ORDERED TO FOSTER AN EQUITABLE DISTRIBUTION TO ALL CREDITORS AND IMPROVE THE LIKELIHOOD OF A SUCCESSFUL REORGANIZATION DESPITE A BONDHOLDER'S TOTAL RETURN SWAP AGREEMENT THAT IS ONLY PROFITABLE IF SUBSTANTIVE CONSOLIDATION IS DENIED.

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On April 22, 2008, the United States Bankruptcy Court for the District of Moot ruled in Respondent General Engine's favor as follows: (i) the court ordered substantive consolidation of the chapter 11 bankruptcies of General Holdings, Inc. ("Holdings") and its subsidiary General Engines, Inc. ("General"); (ii) the court designated Petitioner Silverman's vote on the reorganization plan as not in good faith under Bankruptcy Code § 1126(e); and (iii) the court confirmed the plan of reorganization for the consolidated debtors. (R. 10). The District Court affirmed the Bankruptcy Court without opinion. *Id.* The United States Court of Appeals for the Thirteenth Circuit affirmed the decision of the District Court on October 10, 2008 in Case No. 08-4080.

STATEMENT OF JURISDICTION

A formal statement of jurisdiction has been waived pursuant to Rule VIII of The Seventeenth Annual Chief Judge Conrad B. Duberstein Bankruptcy Moot Court Competition of March 2009.

STATUTORY PROVISIONS

The following statutory provisions are relevant to the facts of this case, and are set forth in the attached appendix: 11 U.S.C. § 1102 (2008), 11 U.S.C. § 1103 (2008), 11 U.S.C. § 1122(a) (2008), 11 U.S.C. § 1125(b) (2008), 11 U.S.C. § 1126 (2008), 11 U.S.C. § 1129(a)(7) (2008).

STATEMENT OF THE CASE

On April 1, 2007, parent company Holdings and its subsidiary General (collectively the "Debtors") filed for Chapter 11 bankruptcy protection in the Bankruptcy Court for the District of Moot. (R. 7). As a manufacturer of diesel engines for trucks and heavy equipment, the business supplies engines to the "Big Three" Detroit Automakers and has expanded its customer base to foreign auto companies and heavy equipment manufacturers. (R. 3). For almost sixty years, the company consisted of a single corporate entity until in 2001, the corporate structure was converted into the current parent-subsidiary. (R. 3-4). However, the separation of entities holds “no practical significance” beyond tax benefits, and the company essentially functions as a single business entity. *Id.*

In 2005, the Debtors decided to expand its manufacturing capacity while retiring debt and sought the assistance of an investment bank, Petitioner Silverman Sachs, Inc. (“Silverman”). (R. 5). On February 1, 2006, General issued 100,000 shares of zero coupon senior unsecured bonds with a ten year term and par value of $100,000,000 (the “Bonds”). *Id.* The Bonds were issued in $1,000 par value denominations at a price of $550 and reasonably required a guarantee from Holdings since Silverman relied solely on the businesses’ consolidated financial statements and did not determine the actual solvency of each company. *Id.* Silverman later decided to purchase 60,000 shares of the Bonds for $33,000,000. *Id.*

In 2007, a manufacturing defect causing fires in General’s small truck engines forced a recall. (R. 6). This defect resulted in personal injury and property damage to several consumer purchasers leaving General with mounting personal injury claims. (R. 6, 9). Consequently, General lost one of its primary supply contracts. (R. 6, 7). As a result, the Debtors developed severe cash flow problems and eventually filed for Chapter 11 protection. (R. 7). The Debtors’ declining economic situation had little impact on Silverman, notwithstanding the large amount of Bonds held by Silverman. (R. 5, 6). Silverman was protected from fluctuations in Bond value because it entered into a total return swap (“TRS”) agreement with Short-Term Capital Management (“STCM”) in 2006. (R. 5).

Silverman's position as a counterparty to the swap placed it in a unique position during the reorganization process. (R. 8). Silverman contracted to receive annual LIBOR payments based on the notional amount of $33,000,000, and Silverman would pay STCM any annual increase in Bond value whereas STCM would conversely pay for any decrease in value. (R. 6). On February 1, 2007, the swap agreement resulted in a net payment to STCM of $524,700 since LIBOR was 5.41% and the Bond value was $588.50. *Id.* For February 1, 2008, the Bonds decreased in value to $121 per share while LIBOR dropped to 3.82% forcing STCM to pay Silverman $29,310,600, an amount representing almost 90% Silverman's original investment. (R. 7). The next day, on February 2, 2008, Silverman sold 26,000 Bonds and retained 34% of General's bond debt, leaving Silverman with slightly more than one-third of the unsecured claims eligible to vote in Holding's reorganization. (R. 7).

Silverman lacks the typical creditor incentive to seek a greater distribution in bankruptcy because it can only gain financially if the Bond value further decreases due to the nature of its TRS agreement. *Id.* Therefore, Silverman has no economic incentive to vote for any plan that increases the value of the Bonds from $121. (R. 8, 9). Accordingly, Silverman rejected the proposed Plan of Reorganization that would pay bondholders $220 per Bond, which would have forced Silverman to pay $5,940,000 before consideration of the LIBOR payment. *Id.*

However, the proposed Plan of Reorganization based upon substantive consolidation presented several benefits including: (1) elimination of inter-corporate claims; (2) reduction of expense and effort required to untangle the finances of the Debtors; (3) elimination of creditors' duplicate claims into a single claim against the consolidated entity; and (4) increased distributions to General's unsecured creditors holding trade debt and large personal injury claims. (R. 10). However, as Silverman's CEO Steven Shi noted, Silverman wanted to block confirmation of the plan to avoid payment to STCM and possibly obtain further additional payments should the Bond value decrease. (R. 10).

The Honorable Thomas S. Bailey, Bankruptcy Judge for the District of Moot, ruled against Silverman's objection to plan confirmation and granted substantive consolidation, designated Silverman's claim and confirmed the proposed plan. *Id*. Silverman timely appealed and the Honorable Pete Buenger, United States District Judge for the District of Moot, affirmed without opinion. *Id.* On October 10, 2008, the Court of Appeals for the Thirteenth Circuit affirmed the decision of the District Court. Silverman appealed the Thirteenth Circuit's decision and filed a petition for Writ of Certiorari. On December 12, 2008, the Supreme Court of the United States granted Certiorari.

SUMMARY OF THE ARGUMENT

The lower courts were correct in holding that Silverman's vote in the bankruptcy reorganization was not cast in good faith, as required by 11 U.S.C. § 1126(e). Creditors such as Silverman should not be disqualified from casting a vote in bankruptcy reorganization when there is an ulterior motive that is contrary to the interests of other creditors in the reorganization. In this case, Silverman's TRS agreement with STCM created a situation where Silverman benefitted from a *failure* of the reorganization plan, whereas all other creditors in the same class would benefit from the *success* of the plan. Although Silverman may be acting in its own self-interest, Silverman had an ulterior motive that should result in the disqualification of its vote under § 1126(e).

The Thirteenth Circuit properly applied the liberal test for substantive consolidation as articulated in *Auto-Train*. First, the liberal test recognizes that corporate enterprises today are often operated with little regard for corporate separateness. Second, the liberal test is a more accurate interpretation of previous case law compared to the *Augie/Restivo* or *Owens Corning* tests. Third, a recent District Court case, affirmed by a non-binding Third Circuit opinion, demonstrates that the differences between the liberal test and the *Owens Corning* test might not be so disparate, at least under the first prong for both tests. Fourth, the liberal trend properly relies on the existence of a guarantee as a factor in support of substantive consolidation whereas the Third Circuit misplaced its emphasis on guarantees as a sign of structural priority. Finally, substantive consolidation is appropriate in this case even if the court adopts the Second or Third Circuit tests. Therefore, the Thirteenth Circuit properly affirmed the motion to substantively consolidate the Debtors, approve the proposed Plan of Reorganization, and designate Silverman's vote under § 1126(e).

ARGUMENT

I. SILVERMAN'S VOTE SHOULD BE DESIGNATED AS NOT IN GOOD FAITH UNDER SECTION 1126(e) AND DISQUALIFIED BECAUSE SILVERMAN'S OWNERSHIP OF AN EXTERNAL TRS AGREEMENT GAVE RISE TO AN ECONOMIC INTEREST IN THE REORGANIZATION PLAN THAT WAS THE EXACT OPPOSITE OF THE OTHER MEMBERS OF ITS VOTING CLASS.

The Chapter 11 reorganization process is dependent upon the existence of creditor democracy. Creditors are divided into classes on the basis of their common interests in the outcome of the plan. *See* 11 U.S.C. § 1122(a) ("...a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class."). Unsecured creditors are represented by an appointed committee in negotiations with the debtor and other parties over the Plan of Reorganization. (R. 11) (citing 11 U.S.C. §§ 1102 & 1103). The classification and voting process gives creditors who are similarly situated the opportunity to consider and vote on whether or not the plan should be approved. The Chapter 11 plan must be accompanied by a disclosure statement and each class is given an opportunity to vote, based on whether the class, as a group, determines it to be in their best interests to approve or reject the plan. *See* 11 U.S.C. § 1125(b). The voting requirements under § 1126 recognize that there may be dissenters in a class and allows approval by the class at large, so long as 50% of the creditors holding at least two thirds of the claims vote in favor of the plan. *See* 11 U.S.C. § 1126(c).

Creditor democracy is based on the fundamental concept that creditors within a class have unity of interest and that the vote will not be distorted by votes cast with ulterior motives. When a class member holds a large claim, particularly when that claim exceeds 33 1/3%, and the creditor's interest in the outcome of the plan is adverse to the other members of the class, the concept of creditor democracy is subverted. "[W]here the record contains evidence that the creditor has voted without regard to the treatment of its claim, but instead, to achieve some benefit or goal inconsistent with interests of the estate and its creditors, the Court must inquire into those motives in order to preserve the integrity of the Chapter 11 process." *In re Dune Deck Owners Corp.*, 175 B.R. 839, 845 (Bankr. S.D.N.Y. 1995). Section 1126(e) assures that votes not be counted when the vote is cast in bad faith due to the existence of factors that create motivations for that creditor that are in direct opposition to the other members of the class. "[I]f any creditor receives some special consideration peculiar to him, his vote is no longer disinterested and unbiased." *In re Featherworks*, 25 B.R. 634, 641 (Bankr. E.D.N.Y. 1982).

This is the perfect case for applying § 1126(e). The entire basis for class voting is that the participants have a unity of economic interests. The function of § 1126(e) assures that votes will not be counted when a member of the class has some ulterior motive that is in opposition to the economic interests of the other members of the class. "[W]hen the voting process is being used as a device with which to accomplish some ulterior purpose, out of keeping with the purpose of the reorganization process itself, and only incidentally related to the creditor's status *qua* creditor, *section 1126(e)* is rightly invoked." *In re Landing Assocs.*, 157 B.R. 791, 807 (Bankr. W.D. Tex. 1993).

The existence of the TRS agreement held by Silverman creates an economic incentive that is strikingly contrary to the other members of Silverman's class. If the plan increases the distribution to class members, the class members will see an increase in the amount of money they receive for their claims; however, Silverman will see a decrease in the value it receives. If the plan decreases the distribution to class members, Silverman will see an increase. [1]

A. Congress Intended To Protect the Integrity of the Chapter 11 Process by Disqualifying Votes Cast in Bad Faith When a Creditor's Economic Interest Is Substantially Different From That of the Others in its Class

Creditor democracy is the central core of the Chapter 11 reorganization process. Creditors are designated into classes according to their interests where they can vote to either accept or reject a plan in Chapter 11, where creditors having "substantially similar interests" are grouped into classes to vote. *See* 11 U.S.C. § 1122(a). Section 1126(e) is essential to sustaining the principle of credit democracy. As the Thirteenth Circuit correctly points out, although the right to vote is a fundamental right of creditors in Chapter 11, the right to vote is not absolute since § 1126(e) grants the Bankruptcy Court power to designate a vote that is not cast in good faith. (R. 12). That section provides:

> On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.

There is a long history in the Bankruptcy Code and in case law of recognizing the unity of creditor interests and of protecting them. "It is the duty of the court to choose the path most

[1] Using a constant LIBOR rate of 3.82%, for every increase of 25% in the value of the Bonds, Silverman must pay $6,989,400 to STCM under the TRS agreement. Using the same LIBOR rate, for every decrease of 25% in the value of the Bonds, however, STCM must pay Silverman $9,510,600.

advantageous to the remaining creditors," where the court is *urged* to "preserve the integrity of the reorganization process" since "the basic purpose of Chapter X is to procure a plan which will best serve the parties legitimately interested." *In re P-R Holding Corp.*, 147 F.2d 895, 898-99 (1945).[2]

Section 1126(e) developed from § 203 of Chapter X of the Bankruptcy Law, 11 U.S.C.A. § 603 and former Bankruptcy Rule 10-305. Section 203 provided:

> If the acceptance or failure to accept a plan by the holder of any claim or stock is not in good faith, in the light of irrespective of the time of acquisition therof, the judge may, after hearing upon notice, direct that such claim or stock be disqualified for the purpose of determining the requisite majority for the acceptance of a plan.

"Rule 10-305 was substantially similar." *In re Dune Deck*, 175 B.R. at 843. The Supreme Court interpreted § 203 to apply to creditors whose purpose was to obstruct a reorganization hoping that they would receive greater a distribution of bankruptcy assets. *Young v. Higbee Co.*, 324 U.S. 204, 211 (1945). "[Section 203's] purpose was to prevent creditors from participating who 'by the use of obstructive tactics and hold-up techniques exact for themselves undue advantages from the other stockholders who are cooperating.'" *Id*. n.10 (citing Hearings on Revision of the Bankruptcy Act before the Committee on the Judiciary of the House of Representatives, 75th Cong., 1st Sess. on H.R. 6439, Serial 9, pp. 180-82). Therefore, § 203's definition of creditors not acting in good faith was limited to obstruction and holding-up of the reorganization process by creditors.

Creditors have become more sophisticated in their participation and influence they have in a debtor's Chapter 11 reorganization, particularly in the exchange of claims prior to confirmation of a plan. *See* Andrew Africk, *How Much Influence Can Be Purchased in Good*

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[2] This recognition is not limited to reorganization, since Fed. R. Bankr. P. 2006, which applies to Chapter 7 matters, "is intended to prevent the 'perversion' of creditor democracy and 'frustration' of creditor control by deterring those whose interest is other than maximizing the return to unsecured creditors." 9-2006 Collier on Bankruptcy-15th Edition Rev. P 2006.RH (citing 1983 Advisory Committee Note to Fed. R. Bankr. P. 2006).

Faith under Section 1126?, 139 U. PA. L. REV. 1393 (1991). In light of these developments, Congress indicated an intent to supersede the more limited § 203 from the Bankruptcy Act by enacting the broader § 1126(e). *See In re Fed. Support Co.,* 859 F.2d 17, 19 (4th Cir. 1988) ("In the good faith inquiry. . . there is a broader rule of disqualification").

"Congress intentionally left 'good faith' undefined", where its definition would be developed by courts as cases arose. *Id*. The Thirteenth Circuit noted that "Congress chose the 'good faith' test set forth in the statute because it understood that no bright line test could address all situations, and it wanted to give the bankruptcy courts broad discretion to protect the voting process from abuse." (R. 14). Even though this section is broader than its predecessor, the primary purpose of it remains the same, to protect the integrity of the reorganization process through the disqualification of votes cast with an ulterior motive. But case law interpreting the predecessor § 203 is vital in this case since there is no indication in the legislative history or the Bankruptcy Code of intent to overrule or disregard it. *See John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs.,* 987 F.2d 154, 158 n.6 (3d Cir. 1993) (citing *Dewsnup v. Timm,* 502 U.S. 410, 417-18 (1992)) ("As the Supreme Court recently noted, pre-Code law provides an important interpretive tool when there are ambiguities or gaps in the Code and when Congress has not indicated in the Code itself or in the legislative history that it intended to alter the previously applicable law").

The key inquiry in finding bad faith under § 1126(e) in this case is whether "the creditor has an 'ulterior motive', such as to procure some collateral or competitive advantage that does not relate to its claim." (R. 12) (citing *In re Dune Deck,* 175 B.R. at 844).

B. Silverman Opposes the Plan Because It Seeks To Obtain an Economic Advantage That is the Exact Opposite of Others in its Class

Silverman initially had the proper motive of hedging its position with a TRS agreement to protect against fluctuations in Bond value. However, Silverman's vote would be in bad faith because it created a fundamentally different interest than that of the other creditors in its class when it decided to seek benefits from the external TRS agreement as opposed to maximizing its claim in the bankruptcy. It is well recognized by the courts that "the 'badges' of the requisite bad faith include creditor votes designed to. . . obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize." *In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) (citing *In re Dune Deck,* 175 B.R. at 845).

Under the reasoning in *Landing Associates,* Silverman's vote should be affirmed as cast in bad faith. In that case, the Court ruled that a creditor's vote should be found in bad faith when the creditor obtains incentives under an agreement with a third party upon the debtor's failure to reorganize. 157 B.R. at 809. The Court, "with more than little reluctance," did not disqualify the creditor's vote though the creditor was to obtain benefits under an external agreement upon the debtor's failed reorganization, because such agreement was monitored by the RTC and FDIC. *Id.* The Court reasoned that finding the creditor's motive as ulterior would go against the federal policy these institutions were designed to carry out, something that the Court felt was not within its power. *Id.* The Court "repelled by the creditor's conduct and motives, expressed concern that by designating the vote, it would undermine the federal policy under which the RTC induces lenders to administer the assets of failed banks." *In re Dune Deck,* 175 B.R. at 845 n.12 (discussing *In re Landing,* 157 B.R. at 809). No such federal policy concerns exist here since a

TRS is an over-the-counter derivative, thus, it is not monitored by the government at all. Therefore, under the reasoning of this Court, Silverman's vote should be disqualified.

1. Silverman's Conflict of Interest Is an Ulterior Motive Because It Seeks To Maximize Recovery as a Speculator, Not as Creditor, Giving Rise To a Motive That is the Exact Opposite to Others Within its Voting Class

We agree with the dissent that conflicts of interest are "a fact of life in Chapter 11 cases." (R. 17). However, the dissent fails to recognize that certain conflicts of interest taint the reorganization process, which § 1126(e) was designed to protect. "Section 1126(e) 'grants the bankruptcy court discretion to sanction any conduct that taints the voting process, whether it violates a specific provision or is in 'bad faith.'" *In re Adelphia*, 359 B.R. at 60 n.25 (Bankr. S.D.N.Y. 2006) (quoting *Century Glove, Inc., v. First Am. Bank*, 860 F.2d 94, 97 (3d Cir. 1988)). "The Court must ultimately decide whether the [creditor]'s vote is motivated by a legitimate concern over the treatment of its claim or the prospects for reorganization, or some other, unrelated reason which the law condemns." *In re Dune Deck*, 175 B.R. at 841. Such conflicts of interest require an examination of the motives of the creditors, so that they are not fundamentally different from that of the other creditors in the reorganization. "The [good faith] test is plainly to be sought in the motives of the holder of the claims." *In re Pine Hill Collieries Co.*, 46 F. Supp. 669, 671 (E.D. Pa. 1942).

In *P-R Holding*, the Second Court of Appeals examined what a creditor acting as creditor entails. "When the purchase is in aid of interest other than interest of a creditor, such purchases may amount of 'bad faith' under section 203." *In re P-R Holding Corp.*, 147 F.2d at 897; *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 289 (Bankr. W.D. Pa. 1990) ("Bankruptcy courts interpreting section 1126(e) have quoted this language with approval"). In that case, the Court found that a bidder for the debtor's property who purchased certificates for the purpose of assuring approval of the reorganization plan, which involved acceptance of the bidder's offer, was not in good faith since it amounted to an "aid of an interest other than an interest of a creditor." *In re P-R Holding Corp.*, 147 F.2d at 897. The Court agreed with the SEC that the purchase of the certificates by the bidder discriminated against the remaining owners of the certificates because this resulted in "an inequity among the creditors" which disfavored the remaining owners. *Id.* at 898. Our case is similar in that allowing Silverman to cast its vote discriminates against the other bondholders in its class, because like the bidder in *P-R Holding*, Silverman is acting in aid of an interest other than that of a creditor. The bidder in *P-R Holding* did not act with an interest of a creditor since it wanted to assure that its offer for the debtor's property was accepted, whereas Silverman is assuring it gets a large return under its external private agreement upon failure of the Debtors' reorganization.

2. <u>Silverman Has a Conflict of Interest With Members of its Own Voting Class, Not Just With Other Classes</u>

The Court in *Adelphia* further examined when a conflict of interest becomes bad faith. In that case, certain creditors of multiple interrelated debtors had a conflict of interest in that an increase in recovery on some of the creditors' claims resulted in a decrease in recovery of others', and vice versa. 359 B.R. at 58. The Court held that creditors which have competing claims in different interrelated debtors, and likewise in different classes of a single debtor, do not represent an ulterior motive. *Id*. at 64. But in our case, Silverman has created an interest that is the exact opposite of the others within its *own* voting class. This is where the difference lies.

The Court in *Adelphia* then discussed what conduct rises to an ulterior motive, including "creditor votes designed to. . . obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize." 359 B.R. at 57, 61, 63. Silverman seeks a benefit under the TRS agreement which is apart from recovery under the Debtor's reorganization. Silverman's conflict of interest with the other creditors in its class rises to the level of an ulterior motive. Silverman acted "in an interest other than a creditor" when it chose to maximize its investment under the TRS agreement as opposed to maximize its claim within the bankruptcy. The other creditors in Silverman's class should not have to suffer because Silverman wants to maximize its profit as a speculator under the TRS agreement upon the Debtors' failure to reorganize.

C. Silverman's Vote Is Based on an Ulterior Motive, More Than a Selfish Motive

Courts have made a distinction between selfish and ulterior motives, where voting in one's self-interest is not enough for bad faith. "Good faith voting and solicitation does not demand 'selfless disinterest.'" *In re Holly Knoll P'ship*, 167 B.R. at 385 (citing *In re Fed. Support Co.*, 859 F.2d at 19). "Good faith voting does not require, nor can it expect, a creditor to act with selfless disinterest." *In re Gilbert*, 104 B.R. 206, 216 (Bankr. W.D. Mo. 1989). Maximization of the creditor's economic position in a debtor's estate is consistent with Chapter 11 principles when acting as a creditor, where each voter has the right to judge the plan offered according to his own economic position and personal assessments. However, when a creditor's priority is to maximize its investment under a separate private agreement, like that of a TRS, such motive becomes more than selfishness. *See* Stephen J. Lebben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 422 (2007) ("In all cases we assume that creditors are motivated to take all available steps to maximize their recoveries in bankruptcy, at least when those steps have a positive net value" but this self-interest changes in the light of credit default swaps"). "Each creditor is expected to cast his vote in accordance with perception of his own self-interest, but he may not act with an ulterior or coercive purpose." *In re Fed. Support Co.*, 859 F.2d at 19.

1. <u>Silverman Is Not "Largely Interested" in its Claim as a Creditor</u>

In *Pine Hill,* the Court held that a creditor who purchased securities for the purpose of defeating a plan did not cast its vote in bad faith because the creditor was "largely interested" in the debtor. *In re Pine Hill Collieries, Co.,* 46 F.Supp. 669, 672 (E.D. Pa. 1942). A "party, largely interested in the Debtor before his acquisition of controlling votes, who withholds consent to a plan primarily because he believes its consummation will be more injurious to his investment in the Debtor than liquidation, meets the standard of good faith." *Id.* at 671. The creditor in *Pine Hill* was significantly different from Silverman in that it not only was the largest creditor in the case, with mortgage bond and stock ownership in the debtor, but it operated the debtor under a management contract and a general sales agency contract. *Id.* at 670. The creditor even supported a previous proposed plan, which failed consummation due to the inability to obtain the consent of certain creditors. *Id.* Under this plan, the creditor was to continue as manager and sales agent of the debtor with an underwriting by the creditor of $125,000. *Id.*

No such interest in trying to help out the debtor exists in our case. The creditor in *Pine Hill* further differed from Silverman in that the creditor, through conferences held early on in the court's chambers, "at all times maintained the view that the proposed plan was not feasible and would in all probability result in an early sacrifice of the [debtor's] property to [a third company in the same field as the debtor and the creditor]," which was secured by the creditor through mortgage bonds. *Id.* at 672. The creditor's view was shared by other creditors holding the mortgage bonds, and the creditor even suggested modifications to the plan to which it would have consented. *Id*. The creditor's "primary motive" in rejecting the plan was "protection of its already large investment in the debtor." *Id.* Such a motive was selfish, but still that of a creditor who is interested in the reorganization process of the debtor. Thus, it was not ulterior like Silverman's motive of gaining an economic benefit from the failure of the Debtors.

2. Even if Silverman had a Permissible Selfish Motive To Protect its Claim, That Motive Became an Ulterior Motive When Silverman Decided to Maximize its Claim as a Speculator

Silverman initially acted appropriately by hedging the Bonds with a TRS giving it protection against fluctuation in Bond value. However, despite Silverman's original motives of hedging its position, Silverman created a fundamentally different interest than that of the others in its class. Silverman has shown no signs of maximizing its claim as *a creditor* like the creditors in *Pine Hill* and *Adelphia*. Silverman further shows a fundamentally different interest than that of the other creditors in its class when it sold 26,000 of its bonds upon learning of the proposed plan, significantly decreasing its claim against the Debtors, but kept just enough to maintain veto power in Holdings. Such behavior should amount to bad faith. "[I]t might be *improper*" when "a creditor, knowing it holds a *swing* vote in a class with many members, votes against the plan in order to exact some benefit for itself, as opposed to a benefit for the class." *In re Landing Assocs.,* 157 B.R. at 808 n.25. "Certainly there is 'bad faith' when those purchases result in a discrimination in favor of the creditors selling their interests." *In re P-R Holding Corp.*, 147 F.2d at 897. As the Thirteenth Circuit demonstrated through an example, even after a decrease in par value of the Bonds, Silverman would benefit with a significantly higher payment from STCM.[3]

[3] Assuming a further decrease in the bonds' value from $121 to $100, Silverman will have a loss of $714,000 in the value of the bonds it owns; however, the loss will be more than offset by a payment from STCM under the TRS agreement in the amount of $1,260,000, where Silverman's net economic change would be an increase of $546,000. (R. 8).

D. Requiring Wrongdoing for a Finding of Bad Faith Is Too Strict, But Even if Wrongdoing is Required, an Ulterior Motive Exists

There is no doubt that wrongdoing is enough for bad faith. "[P]ure malice, 'strikes', and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior." *In re Pine Hill Collieries Co.,* 46 F.Supp. at 671. However, some courts have required a showing of wrongdoing in order to meet bad faith. The "court should designate the votes of only those creditors or interest holders who were engaged in wrongdoing." *In re Allegheny Int'l, Inc.,* 118 B.R. at 293. But this is "far too strict a test to make *section 1126(e)* serve as the useful tool it was intended to be" since "[t]he entire bankruptcy process is permeated by equitable considerations." *In re Landing Assocs.,* 157 B.R. at 807.

Even if wrongdoing is required, an ulterior motive exists. The situation in our case is analogous to the actions of the creditor in *Allegheny*. In that case, the Court held that a creditor purchasing claims in order to take over and control the debtor was "in aid of an interest other than an interest as a creditor. . .", thus in bad faith. 118 B.R. at 288-89 (citing *In re P-R Holding,* 147 F.2d at 897)). The Court found that a creditor's purchase of 33.87% of claims in one class, just enough to block an affirmative vote in another class, added to the finding that the creditor's purpose was control and thus was in bad faith. *Id*. at 289-90. Although Silverman sold its claim instead of purchasing it, the motive and the outcome are the same. Both of these creditors disenfranchised the other creditors in their classes by manipulating their claim in a debtor. Both of these creditors had an ulterior motive, whether it was to take control of the debtor or to benefit from an external private agreement.

Further, requiring wrongdoing for bad faith is as extreme as holding that self-interest is enough for bad faith. "If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster." *In re Pine Colliers Co.*, 46 F. Supp. at 671. The fact that § 1126(e) was made broader than its predecessor shows Congress' intent to not be as restrictive as requiring wrongdoing would be.

II. SUBSTANTIVE CONSOLIDATION IS APPROPRIATE TO FOSTER AN EQUITABLE DISTRIBUTION TO ALL CREDITORS AND IMPROVE THE LIKELIHOOD OF A SUCCESSFUL REORGANIZATION DESPITE SILVERMAN'S TOTAL RETURN SWAP AGREEMENT THAT IS ONLY PROFITABLE IF SUBSTANTIVE CONSOLIDATION IS DENIED

Substantive Consolidation of General and Holdings is appropriate because the companies failed to honor the legal distinctions that existed between them as separate corporate entities. In such cases, substantive consolidation ensures that similarly situated creditors are treated equitably through an appropriate division of the debtor's assets by pooling the assets and liabilities of two or more related entities while eliminating inter-company claims,. *See Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 764 (9th Cir. 2000) (citations omitted). Thus, substantive consolidation facilitates the enterprise's true obligations to creditors after inter-company claims are netted, giving all creditors a truly equitable distribution in bankruptcy.

This Court has long recognized a bankruptcy court's broad authority to modify creditor-debtor relationships and has approved the use of substantive consolidation in bankruptcy proceedings. *See U.S. v. Energy Res. Co.*, 495 U.S. 545, 549 (1990) (citing *Pepper v. Litton*, 308 U.S. 295, 303-304 (1939)); *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) ("the power of the bankruptcy court to subordinate claims or adjudicate equities arising out of the relationship between several creditors is complete."). As a court of equity, a bankruptcy court must "sift through circumstances . . . to see that injustice or unfairness is not done in the administration of the bankruptcy estate." *Pepper*, 308 U.S. at 308-309.

Accordingly, equity demands that "*substance will not give way to form, that technical considerations will not prevent substantial justice from being done.*" *Id.* at 305 (emphasis added). On such grounds, substantive consolidation is appropriate in this case, inter alia, to: (1) enable the proper administration of the estates where a separate administration is unfeasible; (2) remedy debtor fraud or abuse; (3) promote the efficiency and reduced cost of reorganization; (4) avoid unnecessary litigation; and (5) prevent the possibility for separate plans that would require the obscure unraveling of inter-company claims and guarantees.

A. The Thirteenth Circuit Correctly Applied The Liberal Test To Determine the Propriety Of Substantive Consolidation

As the existence of interrelated corporations become more common in Chapter 11 reorganizations, some scholars believe that substantive consolidation represents the key doctrine in Chapter 11 cases today and argue that its increasing use represents a necessity dictated by current business practices. *See* William H. Widen, *Corporate Form and Substantive Consolidation*, 75 GEO. WASH. L. REV. 237 (2007). As a practical matter, if the use of substantive consolidation becomes more limited, the bargaining power of weaker parties is greatly reduced, and harm caused by debtors is less likely remedied. *Id.* at 246 (noting that this result would work against tort claimants and smaller creditors).

1. Courts Are Split On the Standard To Apply For Substantive Consolidation

Three leading tests have currently emerged to determine the propriety of substantive consolidation: (1) the *Auto-Train* test; (2) the *Augie/Restivo* test; and (3) the *Owens Corning* test. *See Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.)*, 810 F.2d 270 (D.C. Cir. 1987); *Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)*, 860 F.2d 515

(2d Cir. 1988); *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005). The lack of uniformity among courts applying substantive consolidation is problematic not only for courts to reconcile but could also lead to disparate results or even forum shopping. *See* Widen, *supra*.

The D.C. Circuit Court of Appeals developed the liberal balancing test that compares the benefits of consolidation with the harm it may bring to objecting parties, stating that "[t]he proponent must show not only a substantial identity between the entities to be consolidated, but also that consolidation is necessary to avoid some harm or to realize some benefit." *See Eastgroup Props. v. Southern Motel Ass'n*, 935 F.2d 251, 259 (11th Cir. 1991) (citing 810 F.2d 270; *In re Giller*, 962 F.2d 796, 799 (8th Cir. 1992) (variation of the Auto-Train test that considers (1) necessity of consolidation due to debtor's interrelationships; (2) whether benefits outweigh harms; (3) prejudice resulting from non-consolidation). This test utilizes factors similar to veil piercing as a means of establishing whether a substantial identity exists between entities.[4]

The Second Circuit's *Augie/Restivo* test is "similar but not identical" to the modern test although the basis for both tests are predicated on a similar set of cases. Seth D. Amera & Alan Kolod, *Substantive Consolidation: Getting Back to Basics*, 14 AM. BANKR. INST. L. REV. 1, 24 (2006) (noting that the Auto-Train test is basically a faithful summarization of Second Circuit precedents). The Second Circuit adopted a two part test requiring that (1) creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (2) the debtor's affairs were so entangled that consolidation would benefit all creditors. *In re*

[4] *See, e.g., Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940) (considering multiple factors including: (1) the parent corporation's majority interest in the subsidiary, (2) the existence of common officers and directors, (3) the subsidiary's capitalization and asset holdings, and (4) the lack of legal formalism between the entities); *In re Vecco Constr. Indus*., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980) (applying factors including the commingling of assets and liabilities, consolidation of financial statements, the existence of inter-corporate guarantees on loans, and the transfer of assets lacking formal observance of corporate formalities).

Augie/Restivo, 860 F.2d at 518; *See also In re Bonham*, 229 F.3d 750 (adopting the *Augie/Restivo* test as "more grounded in substantive consolidation and economic theory").

At odds with the liberal test is the Third Circuit's decision to effectively limit the availability of substantive consolidation. *See In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005). The Third Circuit in effect chose form over substance by articulating that absent compelling circumstances, courts will respect entity separateness. *Id.* at 211. The *Owens Corning* decision, which supports the *Augie/Restivo* test, required that a proponent of substantive consolidation prove "(i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, *or* (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors." *Id.* at 210-11 ("[W]e favor essentially that of *Augie/Revisto*."). An objecting creditor can overcome a prima facie showing of substantive consolidation by demonstrating a reliance on the separateness of entities and any adverse effects consolidation can have on that creditor.

2. <u>The Liberal Test Recognizes The Interrelatedness of Corporate Structure Despite the Creation of Formally Separate Entities</u>

In today's business world, corporate enterprises are often operated without regard for corporate separateness. Widen, *supra*, at 259. Traditionally, the notion that substantive consolidation should be applied with judicial restraint and sparing use. However the liberal test has its "genesis in increased judicial recognition of widespread use of interrelated corporate structure by subsidiary corporations operating under a parent entity's corporate umbrella for tax and business purposes." *Eastgroup Props.*, 935 F.2d at 248-49; *See, e.g., In re Auto-Train,* 810 F.2d at 276 (noting that substantive consolidation significantly affects distributions to creditors). The reality is that in substantive consolidation cases, the relevance of the relationship between the legal entities greatly outweighs their form. *See* 2-105 COLLIER ON BANKRUPTCY ¶

105.09[1][c] (15th ed. rev. 2008); William H. Widen, *Report to the American Bankruptcy Institute: Prevalence of Substantive Consolidation in Large Public Companies From 2000 to 2005*, 16 AM. BANKR. INST. L. REV. 1 (2007) (noting that of the 315 cases reviewed, 178, representing 56.5% of the cases, were classified as substantive consolidation cases or "deemed" substantive consolidation cases).

Contrary to the dissent's belief that formal bright line rules are necessary to preserve predictability (R. 19), this area of law is based on equitable principles and should not be confined to a predetermined set of rules because the issue of substantive consolidation is idiosyncratic and fact specific to each case. *See In re Augie/Restivo,* 860 F.2d at 518. Appropriately, substantive consolidation jurisprudence has noted a shift in emphasis from traditional alter ego factors towards the impact on unsecured creditors. *Helena Chem. Co. v. Circle Land & Cattle Corp. (In re Circle Land & Cattle Corp.),* 213 B.R. 870, 876 (Bankr. D. Kan. 1997). Thus, the liberal test is therefore more apt to prevent inequities from arising during the reorganization process by providing courts with greater discretion to grant substantive consolidation. *See In re Standard Brands Paint Co.*, 154 B.R. 563, 568 (Bankr. C.D. Cal. 1993) (citing *In re Snider Bros.*, 18 B.R. 230 (Bankr. D. Mass. 1982) (noting that the emphasis has shifted from justifying substantive consolidation on traditional grounds towards a cost/benefit analysis).

3. <u>The Liberal Test Remains True to the Fundamentals and Principles of Substantive Consolidation As Established Through Prior Case Law</u>

Although the dissent in the Thirteenth Circuit noted that the liberal test sets a "low bar" for consolidation (R. 20), proponents of the liberal test offer that *Auto-Train* is the only test that "remains true to the fundamentals upon which it is based and strikes the requisite balance." Amera, *supra,* at 36-38 (noting that the liberal test is only improper if interpreted to mean that an innocent creditor's rights may be upset for the benefit of other creditors). This contention is based partly on the notion that the *Auto-Train* test shifts the burden to the objecting creditor asserting reliance on separate credit once a proponent makes a prima facie case for substantive consolidation. Conversely, by placing the burden on the proponent to prove creditor reliance on unity, *Augie/Restivo* and its chief supporter, *Owens Corning*, effectively limit the applicability of substantive consolidation without proper justification.

The *Augie/Restivo* test inexplicably places the burden on the proponent to show that creditors relied on corporate unity before a prima facie case can be made. *Id.* at 27 (noting that *Augie/Restivo* is easier to apply but unlike *Auto-Train*, fails to apply burden shifting consistent with the concurrence in *Chem. Bank v. Kheel (Matter of Seatrade Corp.)*, 369 F.2d 845, 848-49 (2d Cir. 1966)). None of the cases that *Augie/Restivo* relies upon indicate a proponent must show that creditors relied on the entities as a single economic unit. Amera, *supra*, at 29; *See In re Bonham*, 229 F.2d 750 (9th Cir. 2000) (adopting *Augie/Restivo* but placing the burden on objecting creditors to demonstrate a reliance on separate credit to overcome a prima facie case for substantive consolidation).

Furthermore, the second prong of the *Augie/Resitvo* test also misplaced its emphasis on hopeless entanglement under *Kheel*. *See* Amera, *supra*, at 36-38; (under *Kheel*, hopeless entanglement is merely a factor favoring substantive consolidation only after the court determined substantive consolidation was justified under an instrumentality analysis). Therefore, the more liberal *Auto-Train* test is not a new formulation that relaxes the standard for substantive consolidation but a faithful interpretation of prior cases and should be utilized in this case.

B. Substantive Consolidation Is Appropriate Under The Liberal Test As Articulated In Auto-Train

1. General and Holdings Are Mere Instrumentalities of a Single Enterprise Necessitating the Use of Substantive Consolidation To Provide An Equitable Distribution To Creditors

Applying the *Auto-Train* test, this case satisfies the standard for substantive consolidation. For almost sixty years, the Debtors conducted business as a single corporate entity until Holdings and General split in 2001 just eight years ago. (R. 3). As Judge Fleming noted, the establishment of the legal entities had "no practical significance" apart from Holdings except to reduce tax liability for the entire enterprise evidenced by Holding's incorporation in the tax friendly state of Nevada. (R. 4). Furthermore, Holdings holds just a single office manned by one service employee. (R. 3-4). All business activities take place at General's Office in Moot, and federal tax returns were filed on a consolidated basis. (R. 3-4).

General represents Holdings' only business relationship, and all activities were conducted in an "integrated manner." (R. 4). The enterprise's unity of the interest is further established by a centralized cash management system and the use of consolidated financial statements. (R. 4-5). In essence, although Holding's SEC disclosures indicated that General was a separate entity (R. 4), the corporations were merely legal technicalities lacking any formal substance. *See Soviero v. Franklin Nat'l Bank,* 328 F.2d 446, 448 (2d Cir. 1964) (approving substantive consolidation where subsidiaries were mere instrumentalities of the debtor in order to prevent injustice to the debtor's creditors.)

Substantive consolidation is also necessary here to prevent injustice to General's unsecured creditors who would otherwise be left with an inequitable distribution due to questionable inter-company transactions. As the parent company, Holdings owns 100% of General's stock and provides General the use of Holding's intellectual property and management services at unjustified costs that are substantially higher than market rates. (R. 3-5). The companies also transferred intellectual property assets from General to Holdings without any payment raising litigious issues of fraudulent transfer. (R. 5). Consolidation would realize the benefit of canceling these potential inter-company claims and avoid the expense of costly litigation between the parties. The foregoing discussion demonstrates that substantive consolidation is appropriate where General and Holdings carried on as a single business not only in corporate and financial dealings but also in their dealings with the public.

2. <u>Silverman's Reliance on the Guarantee, Separate State Tax Returns, Certifications, and Opinion of Counsel Are Insufficient To Establish That Silverman Relied on Separate Credit Or That Silverman's Claim Would be Prejudiced Through Substantive Consolidation</u>

Silverman carries a heavy burden in demonstrating that it relied on separate credit in purchasing the bonds from General and that it will be prejudiced through substantive consolidation. *See Eastgroup Props.*, 935 F.2d at 249. However, Silverman may point to the guarantee, the existence of separate state tax returns, certifications, and reliance on opinion of counsel (R. 4-5) as a demonstration of separate reliance.

With respect to the state tax returns, Silverman's reliance on separateness is unpersuasive where separate state tax returns were done solely to secure tax benefits. *See In re American See In re Am. HomePatient*, 298 B.R. 152, 166 (Bankr. M.D. Tenn. 2003) (stating that the use of separate state tax returns does not demonstrate a reliance on separateness and presents no obstacle to substantive consolidation); *Eastgroup Props.*, 935 F.2d at 252 (noting that reliance is not demonstrated simply because the entities held themselves out to the public and their creditors as separate corporations).

Courts have also overwhelmingly adopted the stance that guarantees are not indicative of a creditor's reliance on the separateness of entities.[5] Not only have courts found that a guarantee fails to support a creditor's assertion of separate reliance, some courts have even found that a guarantee demonstrates that the creditor recognized the entities as alter-egos. See *In re Manzey Land & Cattle Co.*, 17 B.R. 332, 337 (Bankr. D.S.D. 1982) (substantive consolidation granted where the court held that inter-company guarantees indicated that the creditor recognized the debtors as alter-egos).

Although certifications were also issued, Silverman never requested any information about the separate financial condition of each enterprise. (R. 5). The reliance on consolidated financial statements coupled with Silverman's failure to uncover each entity's individual financial status places in doubt that the certifications and the guarantee demonstrate Silverman's reliance on separateness. *See In re Vecco Constr. Indus.*, 4 B.R. 407, 410 (Bankr. E.D. Va. 1980) (consolidated statements are an express factor supporting substantive consolidation.) Therefore, General submits that Silverman's guarantee is ineffectual to assert a claim of separate reliance as Silverman failed to take clear action demonstrating a reliance on separateness where the entities carried on as a single business.

As to the opinion of counsel, its use is generally excluded from the scope of bankruptcy. *See* The Tribar Opinion Committee, *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. LAW. 717 (1991). "Except in rare

[5] *See, e.g., Soviero v. Franklin Nat'l Bank,* 328 F.2d 446, 448 (2d Cir. 1964) (substantive consolidation granted despite guarantees given to purchasers); *FDIC v. Hogan (Matter of Gulfo Inv. Corp.)*, 593 F.2d 921, 927-28 (10th Cir. 1979) (noting that substantive consolidation would eliminate guarantees because a creditor is only entitled to only one claim out of the same transaction); *Eastgroup Props.*, 935 F.2d at 249 (noting that guarantees represent a factor listed by *In re Vecco Constr. Inds.*, 4 B.R. 407, 410 (Bankr. E.D Va. 1980); *In re Afflilated Foods, Inc.* 249 B.R. 770, 784 (Bankr. W.D. Mo. 2000) (adopting the liberal test as applied in *In re Giller* to determine that inter-company guarantees was a supporting factor in granting substantive consolidation); Chem. Bank, 369 F.2d at 848 (granting substantive consolidation despite guarantee of one of the debtor entities).

instances, lawyers resist giving substantive consolidation opinions in the case of a pre-existing corporation because of the virtual impossibility of isolating the present and historical facts to be considered." *Id.* Even were the opinion of counsel in this case directly addressing consolidation, the Tribar Opinion Committee noted that a non-consolidation letter would be subject to:

> discretionary, equitable judgment . . . in the context of the congressional goal of promoting reorganizations, with respect to the interplay of facts, circumstances, relationships, and other considerations, some of which may exist at the time the opinion is rendered and some of which may arise in the future.

Id. Thus, an opinion is at best speculative and not determinative on the issue of substantive consolidation. Based on the preceding discussion, Silverman implausibly relied on separate credit in purchasing the Bonds, and consequently would not be prejudiced through substantive consolidation.

3. <u>Even if Silverman Relied on Separate Credit, Substantive Consolidation is Appropriate to Improve the Efficiency and Cost of Reorganization While Properly Resolving Conflicts To Benefit the Majority of Creditors</u>

Assuming Silverman proves it relied on General's separate credit and would be prejudiced by consolidation through the elimination of duplicate claims, substantive consolidation is still justified. Granting substantive consolidation would allow a plan confirmation without the need for cramdown, which could not be done in this case without violating the absolute priority rule. (R. 9). This will enable the debtors' emergence from bankruptcy at a critical time to assist in the revival of the American Auto Industry. It will also reduce any uncertainty or delay in requiring separate plans and thus improve cost and efficiency. To force General and Holdings to proceed as separate entities would disrupt the odds of a successful reorganization due to substantial administrative and litigation costs paid by the estates at the expense of distributions to both debtors' creditors.

In addition, since General transferred assets and cash to Holdings prior to bankruptcy, General's unsecured creditors, including any tort claimants and bondholders, are left in the unenviable position of realizing any net assets while Holding's creditors receive a windfall. As such, the misuse of corporate form unjustly harms General's creditors who would otherwise receive an equitable distribution were the entities consolidated. Furthermore, consolidation is justified since General is likely undercapitalized and lacks funds to even pursue litigation and carry the costs of administration.

Absent consolidation, Silverman has already indicated that its best interest requires that this reorganization fail because only then would Silverman realize a lower payout on its share of Bonds to capitalize on the TRS agreement. Without consolidation, Silverman would foreseeably threaten to veto every single good faith plan and/or employ separate counsel and creditors' committees to leverage bargaining power equal to the "increased cost and disruption that granting such a request would create." Widen, *Corporate Form and Substantive Consolidation, supra,* at 282 (noting that in the Adelphia reorganization, a creditor tactically requested that each debtor be independently represented in an administrative consolidation). This would throw the entire reorganization process into a tailspin and drain the estates' assets until distribution for all other creditors are wiped out while Silverman enjoys the benefit of the total return swap. Such a result would ignore the very principles under the Bankruptcy Act protecting the equitable treatment of all creditors. Thus, substantive consolidation represents the only appropriate remedy to benefit debtors, their shareholders and all the debtors' creditors.

4. The Appointment of a Single Creditors' Committee and Joint Debtors' Counsel Does Preclude the Use of Substantive Consolidation as an Equitable Remedy

Courts are split on whether administratively consolidated cases may be appropriately administered by a single creditors' committee and debtors' counsel.[6] However, in our case, because the Debtors operated as a single entity, conflicts of interest are doubtful since counsel for the estates represents a unified interest for an entire enterprise. It makes sense for a single firm to represent the debtors since the firm is in the best position to resolve and handle the interrelated issues between the estates where the corporations acted as one. Similarly, the creditors' committee represents a single body of an entire enterprise's creditors, not separate creditors for each entity.

This is not a case where counsel for the estate and committee seek substantive consolidation to secure payment on fees at the expense of creditors. *See Gill v. Sierra Constr., Inc. (In re Parkway Calabasas Ltd.)*, 89 B.R. 832, 835 (Bankr. C.D. Cal. 1988). Requiring duplicate counsel here would result in unnecessary expense where the entities are essentially an integrated company. Furthermore, even if separate creditors' committees and debtors' counsel are required, the additional benefits of substantive consolidation justify its use in this case. Therefore, substantive consolidation provides benefits which substantially outweigh the harm.

C. Even If This Court Adopts The Second Or Third Circuit Tests, Substantive Consolidation Is Appropriate In This Case Under Those Tests

The Third Circuit wanted to avoid a factor based approach where "courts tally up and spit out a score without an eye on principles." *In re Owens Corning,* 419 F.3d at 210; *In re Eagle-*

[6] *See In re Parkway Calabasas*, 89 B.R. 832, 835-836 (C.D. Cal. 1988) (noting in dicta that the appointment of a single counsel and/or creditors' committee may be improper in certain motions for substantive consolidation where questions arise as to the professional's commitment to each estate); In re White Motor Credit Corp., 18 B.R. 720, 722 (Bankr. N.D. Ohio 1980) (holding that separate committees are required in jointly administered bankruptcy case); contra *In re BH&P, Inc.*, 949 F.2d 1300, 1310, 1313 (3rd Cir. 1991) (expressly overruling the logic in *Parkway Calabasas* holding that conflicts should be determined on a case-by-case basis).

Picher Indus., 192 B.R. 903, 905 (Bankr. S.D. Oh. 1996) (noting that cases are often so fact specific that the traditional lists of factors courts use in determining substantive consolidation is of "limited use"). Additionally, the utilization of substantive consolidation is further encapsulated in quintessential principles that the Third Circuit deems necessary for its implementation.[7] Because the *Owens Corning* test is essentially a stricter variation of the *Augie/Restivo* test, the following analysis will show that substantive consolidation should be granted under *Owens Corning* and would therefore also satisfy the *Augie/Restivo* test.

1. <u>Silverman Recognized the Debtors' Interrelatedness And Did Not Rely on The Guarantee for Structural Priority But in Fact Bargained for Substantive Consolidation</u>

With respect to the first prong, the lack of respect for corporate formalism and acts of fraud by the Debtors represent a stark contrast from the facts in *Owens Corning*. 419 F.3d at 212 (court found no bad faith by any parties to the transactions.) In this case, the actions by the Debtors violated the "very ground rules . . . put in place" that, in the absence of bad faith, would have required a court to respect entity separateness. *Id.* at 212-213. Thus, a closer examination of the facts is required to determine whether creditors relied on the breakdown of borders and treated the enterprise as a single entity.

While the lenders in *Owens Corning* knew a "great deal about [the] subsidiaries," Silverman reasonably knew a great deal about the Debtors' individual finances because the investment bank would have uncovered such information when it arranged additional financing for the Debtors. *Id.* at 213. However, whereas the creditors in *Owens Corning* discovered the separate nature of the entities, Silverman would have learned that General and Holdings

[7] *In re Owens Corning*, 419 F.3d at 210 (noting that (1) courts will respect entity separateness absent compelling circumstances; (2) harms addressed by consolidation are those caused by debtors; (3) mere benefit to the administration of a case is not cause for substantive consolidation; (4) designating substantive consolidation as a remedy of last resort; (5) justifying the use of consolidation only for defensive purposes).

essentially functioned as a single entity and had a significantly interrelated structure. *Id.* While "[c]reditors are free to employ whatever metrics they believe appropriate in deciding whether to extend credit free of court oversight," Silverman's credit decision could not have been made in reliance on the existence of separateness where it likely uncovered that the Debtors functioned as a single entity. *Id.* at 213-214.

In addition, "lending syndicates simply do not rely on naked guarantees" when seeking structural priority. William H. Widen, *Corporate Form and Substantive Consolidation, supra,* at 274. Professor Widen asserts that in fact, lenders employ guarantees for defensive purposes to ensure that its priority is not subordinated by a subsidiary creditor. *Id.* at 274. This allows a lender to comfortably rely on consolidated statements and treat the enterprise as a single entity. *Id.* (noting that testimony from actual lending representatives in Owens Corning suggest the guarantees were required to prevent structural subordination).

For lenders to use a guarantee in an offensive manner, it would bargain for more than a mere guarantee. Lenders also require a "change in control" default in the loan agreement, typically required in securitization transactions. *Id.* at 275. However, even if a lender holds a default agreement, loan agreements do not prevent a parent entity from subsuming subsidiaries through liquidation, dissolution, or the formation of a general partnership. *Id.* at 276. From this perspective, the guarantee in Owens Corning did not represent the equivalent of "Lending 101." 410 F.3d at 212. While the dissent notes that credit must remain accessible in the markets (R. 19), the Owens Corning decision arguably goes too far by giving lender's an unanticipated windfall in bankruptcy that is likely to reduce a company's incentive to borrow funds.

Silverman's guarantee is even more favorable as evidence that it bargained for substantive consolidation when compared to *Owens Corning*. This is not a case where the lender tendered a loan to an entity facing substantial debt and tort liability, requiring a guarantee from an unencumbered and solvent affiliate that would protect its investment. 410 F.3d at 213. Silverman entered into a transaction one year before there was any concern that the Debtors would face potential tort liability due to defective engine fires. (R. 19). Without more, Silverman's guarantee merely protects its position against other similarly situated creditors and should not prevent the application of substantive consolidation.

2. <u>The Difference Between the Liberal Test And the Owens Corning Test Might Not Be so Disparate, at least under the First Prong of Both Tests</u>

Since *Owens Corning* was decided, the Third Circuit has upheld an order for substantive consolidation under that test in a case that first granted substantive consolidation under the modern test days before *Owens Corning* was decided. *Lisanti v. Lubetkin (In re Lisanti Foods, Inc.),* 04-3868 (JCL), 2006 US Dist. Lexis 76844 (D.N.J. October 11, 2006), *aff'd, In re Lisanti Foods Inc.,* No. 05-3912, 2007 WL 2212720 (3d Cir. Aug. 2, 2007). In *Lisanti*, the District Court applied the *Morfesis* test, a variation of *Auto-Train*, and held substantive consolidation appropriate under the modern test. A substantial identity was established because the debtor entities had the same management and shareholders, did business under similar names, conducted inter-company transfers that lacked the requisite formalities, and failed to charge each other for services. *Lisanti,* 2006 US Dist. Lexis at *23. As to the second prong under the modern test, consolidation was justified on grounds that the benefits of consolidation resulted in the elimination of professional fees and the efficiency of administration. *Id.*

The District Court upheld the bankruptcy court's ruling and determined that the substantial identity analysis satisfied the first prong of the *Owens Corning* test, noting that creditor proponents must also demonstrate that their reliance on the debtor's unity was reasonable. *Id.* Specifically, creditors dealt with the debtors as a single entity and extended credit on that basis. Creditors' reliance was justified because the debtor corporations held the same officers, directors, and shareholders, performed accounting and business functions from one central location, and used similar names and methods of operation. *Id.* at 27-28. Thus, the difference between the various tests, at least under the first prong, may not be as great as once assumed.

Applying *Lisanti*, this case meets the criteria for substantive consolidation. A substantial identity exists because the Debtors have the same management and shareholders, did business under similar names, conducted inter-company transfers that lacked the requisite formalities, and failed to properly charge each other for services. (R. 4-5). Silverman's reliance is assumed because the corporations held the same officers, directors, and shareholders, performed accounting and business functions from one central location, and used similar names and a centralized operation. (R. at 4-5). Thus, the first prong of the Owens Corning test is satisfied, and substantive consolidation should be granted.

3. <u>The Economic Costs of Unwinding the Financial Entanglement Between General and Holdings Is Unjustifiable Where Such an Accounting Could Lead To a Net Zero Distribution For All Creditors</u>

The Third Circuit explained that substantive consolidation is appropriate under the second prong only where a separate accounting reduces every creditor's recovery. 410 F.3d at 214 . Under such an application, neither the shifting of assets to benefit one group at another's expense or an administrative benefit to the court will satisfy the test under the second prong. *Id*. As such, hopeless commingling is necessary to justify that substantive consolidation results in the equitable treatment of all creditors' best interest. *See Augie/Restivo,* 860 F.2d at 519 (citing *Kheel,* 369 F.2d at 847). Furthermore, substantive consolidation is not appropriate under this prong solely on grounds that consolidation might sustain the viability of reorganization. 860 F.2d at 521.

Under this stringent standard, substantive consolidation is still appropriate in this case. This is not a case of speculation where the Thirteenth Circuit believes creditors would be better served by consolidation or where plan proponents threaten consolidation as a weapon to nullify Silverman's veto power or reduce its bargaining power. *Id.* at 520. Unlike the entities that respected corporate formality in *Owens Corning*, the Debtors failed to honor separate legal status and caused the harm arising in this case. General and Holdings are separate only in technical form; General presented material evidence supporting the allegation of fraudulent transfers between the companies. (R. 4). The evidence suggests that not only did Holdings overcharge General for both management and license fees, General also transferred proprietary assets to Holding without return consideration. (R. 4); *c.f. Owens Corning,* 410 F.3d at 214 ("Indeed, there is no question which entity owns which principal assets and has which material liabilities").

Even had Silverman relied on separate credit in extending the loan, the costs of untangling the corporations threaten to jeopardize the net distribution of assets to creditors, thus harming all creditors. While fraudulent conveyance actions are available to remedy the situation without resorting to a consolidation, that is unrealistic because the imposing costs of employing additional legal and accounting firms would rob creditors of any remaining distributions regardless of its propriety. The separate administration of estates would also result in classification and voting problems as a consequence of classifying inter-debtor claims. Depending on the exact level of interchangeability between the entities, the time and expense incurred may drain the entire asset pool of both estates when considering the imminent and staggering litigation costs of multiple fraudulent transfer proceedings and subsequent subordination claims.

The Third Circuit's concerns over deemed consolidations are inapposite to this case because substantive consolidation is not being used as an offensive ploy or merely as a benefit to only certain creditors. Because the debtors in Owens Corning respected corporate formalism, the cost to substantively consolidate those entities would have been greater than the cost of a separate administration. Assuming substantive consolidation is denied in this case, a single plan for the debtors is unlikely, meaning separate plans would be required. To confirm separate plans, the debtors would have to perform liquidation and reorganization analysis that pass the best interest test for each case to ensure that the claimant would receive an amount not less than what that holder would receive under Chapter 7. 11 U.S.C. § 1129(a)(7); *See In re Standard Brands Paint Co.*, 154 B.R. 563. This is problematic due to the excessive costs of projecting these calculations. Furthermore, separate counsel would need to be retained for claim objections and plan proceedings, effectively erasing any hope of an equitable distribution for creditors. Therefore, substantive consolidation is essential to maximize distributions to all creditors.

CONCLUSION

For the foregoing reasons, respondent respectfully requests that this Court affirm the decision of the United States Court of Appeals for the Thirteenth Circuit.

Respectfully Submitted,

Dated: February 2, 2009

Counsel for Respondent

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing Brief for the Respondent was mailed by Federal Express, to Counsel for the Petitioner on February 2, 2009.

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§ 1102. Creditors' and equity security holders' committees

(a)(1) Except as provided in paragraph (3), as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate.

(2) On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States trustee shall appoint any such committee.

(3) On request of a party in interest in a case in which the debtor is a small business debtor and for cause, the court may order that a committee of creditors not be appointed.

(4) On request of a party in interest and after notice and a hearing, the court may order the United States trustee to change the membership of a committee appointed under this subsection, if the court determines that the change is necessary to ensure adequate representation of creditors or equity security holders. The court may order the United States trustee to increase the number of members of a committee to include a creditor that is a small business concern (as described in section 3(a)(1) of the Small Business Act), if the court determines that the creditor holds claims (of the kind represented by the committee) the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large.

(b)(1) A committee of creditors appointed under subsection (a) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee, or of the members of a committee organized by creditors before the commencement of the case under this chapter, if such committee was fairly chosen and is representative of the different kinds of claims to be represented.

(2) A committee of equity security holders appointed under subsection (a)(2) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest amounts of equity securities of the debtor of the kinds represented on such committee.

(3) A committee appointed under subsection (a) shall--

(A) provide access to information for creditors who--

(i) hold claims of the kind represented by that committee; and

(ii) are not appointed to the committee;

(B) solicit and receive comments from the creditors described in subparagraph (A); and

(C) be subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

§ 1103. Powers and duties of committees

(a) At a scheduled meeting of a committee appointed under section 1102 of this title, at which a majority of the members of such committee are present, and with the court's approval, such committee may select and authorize the employment by such committee of one or more attorneys, accountants, or other agents, to represent or perform services for such committee.

(b) An attorney or accountant employed to represent a committee appointed under section 1102 of this title may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case. Representation of one or more creditors of the same class as represented by the committee shall not per se constitute the representation of an adverse interest.

(c) A committee appointed under section 1102 of this title may--

(1) consult with the trustee or debtor in possession concerning the administration of the case;

(2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;

(3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;

(4) request the appointment of a trustee or examiner under section 1104 of this title; and

(5) perform such other services as are in the interest of those represented.

(d) As soon as practicable after the appointment of a committee under section 1102 of this title, the trustee shall meet with such committee to transact such business as may be necessary and proper.

§ 1122. Classification of claims or interests

(a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.

§ 1125. Postpetition disclosure and solicitation

(b) An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information. The court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets.

§ 1126. Acceptance of plan

(a) The holder of a claim or interest allowed under section 502 of this title may accept or reject a plan. If the United States is a creditor or equity security holder, the Secretary of the Treasury may accept or reject the plan on behalf of the United States.

(b) For the purposes of subsections (c) and (d) of this section, a holder of a claim or interest that has accepted or rejected the plan before the commencement of the case under this title is deemed to have accepted or rejected such plan, as the case may be, if--

(1) the solicitation of such acceptance or rejection was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation; or

(2) if there is not any such law, rule, or regulation, such acceptance or rejection was solicited after disclosure to such holder of adequate information, as defined in section 1125(a) of this title.

(c) A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.

(d) A class of interests has accepted a plan if such plan has been accepted by holders of such interests, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount of the allowed interests of such class held by holders of such interests, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.

(e) On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.

(f) Notwithstanding any other provision of this section, a class that is not impaired under a plan, and each holder of a claim or interest of such class, are conclusively presumed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required.

(g) Notwithstanding any other provision of this section, a class is deemed not to have accepted a plan if such plan provides that the claims or interests of such class do not entitle the holders of such claims or interests to receive or retain any property under the plan on account of such claims or interests.

§ 1129. Confirmation of plan

(a) The court shall confirm a plan only if all of the following requirements are met:

(7) With respect to each impaired class of claims or interests--

(A) each holder of a claim or interest of such class--

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; or

(B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.