No. 08-628

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 2008

IN RE GENERAL ENGINES, INC.,
Debtor

SILVERMAN SACHS, INC.,
Petitioner,

-VERSUS-

GENERAL ENGINES, INC.,
Respondent.

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

BRIEF FOR PETITIONER

Team Number P3
Counsel for the Petitioner

QUESTIONS PRESENTED

I. WHETHER THE THIRTEENTH CIRCUIT ERRED IN FINDING THAT A CLAIM HOLDERS' VOTE AGAINST A CHAPTER 11 PLAN OF REORGANIZATION MAY BE DESIGNATED AS MADE IN BAD FAITH BECAUSE THE CLAIMANT HAS OBTAINED A TOTAL RETURN SWAP FOR THE DEBT THAT CAUSES ITS ECONOMIC INTEREST TO BE CONTRARY TO THAT OF THE CLASS OF CLAIMS IN WHICH IT VOTES.

II. WHETHER THE THIRTEENTH CIRCUIT ERRED IN FINDING THAT THE SUBSTANTIVE CONSOLIDATION OF TWO DIFFERENT DEBTOR ESTATES MAY BE ORDERED UPON A FINDING THAT THE BENEFIT TO THE ESTATES OF BOTH DEBTORS OUTWEIGHS THE HARM.

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OPINIONS BELOW

By order and decision dated April 22, 2008, the United States Bankruptcy Court for the District of Moot ordered the substantive consolidation of the Debtor's estates, designated the vote of Silverman Sachs, and confirmed the reorganization plan. R. 10. Silverman Sachs filed a timely appeal and the District Court affirmed the judgment of the Bankruptcy Court without opinion. R. 10. In an unreported decision, the United States Court of Appeals for the Thirteenth Circuit affirmed the judgment of the District court. R. 10. The opinion of the Thirteenth Circuit is included in the record. R. 2-22.

STATEMENT OF JURISDICTION

A formal statement of jurisdiction is waived pursuant to Rule VIII of the Seventeenth Annual Chief Judge Conrad B. Duberstein Bankruptcy Moot Court Competition.

STATUTORY PROVISIONS

The following federal statutes are relevant to the facts of the case and are set forth in the appendices: 11 U.S.C. § 101(53B), 11 U.S.C. § 105(a), 11 U.S.C. § 546(g), 11 U.S.C. § 562, 11 U.S.C. § 1123(a)(4), 11 U.S.C. § 1122(a), 11 U.S.C. § 1126(e), 18 U.S.C. §152(6).

STATEMENT OF THE CASE

This appeal involves the confirmation of a Chapter 11 reorganization plan of the two debtor entities: General Engines (hereinafter "General") and General Holdings (hereinafter "Holdings") and its major creditor Silverman Sachs (hereinafter "Creditor").

In 2001, General created a separate parent corporation. Holdings was incorporated in the State of Nevada, primarily for tax purposes. R. 3-4. Nevertheless, Holdings maintained and administratively staffed a small office in the Nevada. R. 3. As the parent, Holdings owned 100% of General's stock. R. 3. Holding held license to all intellectual property and employed General's senior management. R. 3. Holdings leased the use of the intellectual property and its management services to General for a price which was subsequently found to be above market rate. R. 4-5. Additionally, General maintained control of the same operations it had prior to the restructuring, although the entities used a centralized cash management system and had the same Board of Directors. R. 3. As a publically traded company, Holdings filed regular reports with the SEC disclosing General's separate existence, although their financial statements were consolidated. R. 4. Clearly, they filed separate state tax returns, while the federal tax returns were consolidated. R. 4.

In 2005, in order to retire debt and finance an expansion of its manufacturing capabilities, the entities sought financing from the Creditor. R. 5. To that end, after several months of negotiation, General issued $100 million unsecured bonds (hereinafter "Bonds"), guaranteed by both entities. R. 5. In addition to requiring the separate guarantees, the Creditor required "certifications and an opinion of counsel confirming the corporate status, good standing and authority of each entity to enter into the bond transaction." R. 5. However, it relied on the consolidated financial statements. R. 5. The Creditor purchased sixty percent of the Bonds and entered into a swap agreement with Short-Term Capital Management, LLC (hereinafter "STCM"). R. 5. (Subsequently, the Creditor sold Bonds, resulting in ownership of 34%.) A provision of

the Swap Agreement, among others, provided that when the value the Bonds increased from its previous valuation, the Creditor would be required to pay STCM and where the value went down, STCM would be required to pay the Creditor. R. 6.

General and Holdings filed Chapter 11 petitions which were jointly administered. R. 7. The Creditors' Committee and the Debtors proposed a reorganization plan which, when implemented would result in drastically less recovery for the Creditor due to the Swap Agreement provisions. R. 7-8. Additionally, the plan called for the substantive consolidation of the Debtor entities, and consequently diluted the Creditor's voting rights, and the Creditor's ability to block confirmation of the plan. R. 8-9. Following the Creditor's vote rejecting the plan, the proponents of the plan moved to "designate" the Creditor's vote, alleging bad faith. R. 9.

The bankruptcy court ordered, following a confirmation hearing, substantive consolidation of the entities, designated the Creditor and confirms the reorganization plan. R. 10.

SUMMARY OF THE ARGUMENT

A plan confirmation vote made solely in accordance with one's economic self-interest under a total return swap agreement does not constitute the egregious bad faith sufficient to designate a claim under section 1126(e) of the United States Bankruptcy Code. When Silverman Sachs voted against confirmation to maximize its economic recovery, it did not engage in the obstructive and collusive conduct that section 1126(e) was designed to prohibit. Likewise, although Silverman stood to gain by opposing plan confirmation, any pecuniary recovery was not in exchange for its confirmation vote. In addition, since the Bankruptcy Code expressly provides for the existence of swap

agreements, any *per se* rule against these financial instruments stymies the reorganization process and conflicts with Congressional mandates. Consequently, given the existence of less draconian means to account for inner-creditor conflicts, the designation of Silverman's claim was inappropriate in this case.

Substantive consolidation is an equitable remedy that should be employed sparingly in order to avoid harm to creditor expectations and promote efficiency in the market. Courts that adhere to the liberal or modern approach towards substantive consolidation run counter to those goals, as the uncertainty inherent in ever changing standards breeds inefficiency and unpredictability. The liberal *Auto-Train* approach promoted by the Thirteenth Circuit should be rejected by this Court. Instead, this Court should adopt the more restrictive test announced in *In re Owens Corning.* Consequently, this Court should reverse the appellate court's order for substantive consolidation because the proponents are unable to establish that disregard for corporate separateness was so pervasive that creditors relied on them as a single entity and that the cost of untangling the entities assets and liabilities is so prohibitive that it would all creditors would be harmed without consolidation. Alternatively, this Court should reverse the order because, regardless of the test employed, substantive consolidation is inappropriate in this case.

ARGUMENT

I. THE THIRTEENTH CIRCUIT ERRED IN FINDING THAT A CLAIM HOLDER'S VOTE AGAINST A CHAPTER 11 PLAN OF REORGANIZATION MAY BE DESIGNATED AS MADE IN BAD FAITH BECAUSE THE CLAIMANT HAS OBTAINED A TOTAL RETURN SWAP FOR THE DEBT THAT CAUSES ITS ECONOMIC INTEREST TO BE CONTRARY TO THAT OF THE CLASS OF CLAIMS IN WHICH IT VOTES.

Silverman Sachs, Inc. (hereinafter "Silverman") exercised its franchise against plan confirmation in good faith and, though its economic interest are in conflict with other members of the creditor class, the Bankruptcy Code provides for less restrictive means to account for inner-creditor conflict. Under Chapter 11, democracy principles seek to harmonize the disparate interests of stakeholders. *In re DRW Property Co.*, 54 B.R. 489, 497 (Bankr. N.D. Tex. 1985). Since competing motivations are common, *In re Adelphia Commc'n Corp.*, 336 B.R. 610, 644 (Bankr. S.D.N.Y. 2006), principles of good faith and self-dealing are not mutually exclusive in bankruptcy. *In re Featherworks Corp.*, 36 B.R. 460, 462 (E.D.N.Y. 1984). To compensate for conflicts of interest, the Code provides for various remedial measures. *See* 11 U.S.C. §§ 1122(a), 1123(a)(4), 1126(e) (2008). However, given the fundamental right of creditor suffrage, claim designation is inappropriate in the absence of egregious wrongdoing. *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 293 (Bankr. W.D. Pa. 1990). In the instant case, Silverman cast its vote simply to maximize its return on investment. R. 10. Even assuming that Silverman's interests are antithetical to those of the unsecured creditor class, less drastic remedies such as claim classification and claim discrimination are available to address this conflict. As a result, Silverman acted in good faith when it voted against plan confirmation. Consequently, this Court should vacate the judgment of the Circuit Court.

A. The mere existence of a swap agreement is insufficient to constitute an ulterior motive since Silverman Sachs cast its vote solely in accordance with its economic self-interest.

1. By exercising its franchise to maximize economic recovery, Silverman Sachs did not engage in the type of egregious and obstructive conduct that Congress intended Section 1126(e) to prohibit.

Although the Bankruptcy Code left courts with the task of defining the term good faith, *In re Figter Ltd.*, 118 F.3d 635, 638 (9th Cir. 1997), the history of claim designation makes clear that only the most reprehensible conduct will result in creditor disenfranchisement. *In re Peter Thompson Assocs.*, 155 B.R. 20, 23 (Bankr. D.N.H. 1993). Under the predecessor statute to section 1126(e), this Court found that the Bankruptcy Act attributed bad faith primarily to those claimants who were "bought off" just prior to plan confirmation. *Young v. Higbee Co.*, 324 U.S. 204, 213 (1945). Similarly, though a court may impute bad faith to a creditor acting with an ulterior purpose, *In re Holly Knoll P'ship.*, 167 B.R. 381, 385 (Bankr. E.D. Pa. 1994), case law has limited such motives to "pure malice, 'strikes' and blackmail, and . . . [the destruction of] an enterprise in order to advance the interests of a competing business." *In re Federal Support Co.*, 859 F.2d 17, 19 (4th Cir. 1988). Accordingly, in *In re MacLeod Co.*, the court designated the votes of claimants who, while still employed by the debtor, founded a competing operation. *In re MacLeod Co.*, 63 B.R. 654, 655 (Bankr. S.D. Ohio 1986). Furthermore, courts may find attributes of bad faith when a claimant becomes a creditor voluntarily after the bankruptcy filing. *In re Pine Hill Collieries Co.*, 46 F. Supp. 669, 672 (E.D. Pa. 1942). Taken alone, however, enlightened self-interest is not sufficient to constitute bad faith under the Code. *In re 255 Park Plaza Assocs.*, 100 F.3d 1214, 1219 (4th Cir. 1996). Importantly, the law encourages creditors to maximize their economic

interest pursuant to a plan of reorganization. *In re Adelphia Commc'n Corp.*, 359 B.R. 54, 64 (Bankr. S.D.N.Y. 2006). Consequently, section 1126(e) does not require a claimant to vote out of an altruistic desire to promote the successful reorganization of the debtor. *In re Marin Town Center*, 142 B.R. 374, 379 (N.D. Cal. 1992). Instead, "a creditor is entitled to engage in self-dealing . . . to get the best deal it can . . . out of the reorganization process." 155 B.R. at 22. Since selfishness to some is enlightened self-interest to others, *In re A.D.W., Inc.*, 90 B.R. 645, 650-51 (Bankr. D.N.J. 1988), the pursuit of economic gain does not constitute bad faith. *In re Landing Assocs*., 157 B.R. 791, 803 (Bankr. W.D. Tex. 1993). As a result, the Code presumes that creditors will cast their votes "in accordance with [their own] perception[s] of . . . self-interest," 859 F.2d at 19, and such motivations are not sufficient to disqualify a creditor's claim. 157 B.R. at 803.

In the instant case, Silverman acted merely to optimize the return on its investment in the Debtor. R. 10. Although Silverman voted against plan confirmation, it did so not in spite of General Engines (hereinafter "General"), but in accordance with its rational, economic self-interest. R. 10. Both the record and the Debtor fail to contend that Silverman cast its vote with even the slightest degree of malice. Moreover, unlike the claimants of *In re MacLeod Co.*, Silverman does not seek to destroy the debtor to promote a competing business. R. 10. In addition, because Silverman entered into the swap agreement before the Debtor's bankruptcy filing, R. 6, the vote of Silverman was not the result of a financial blackmail. Significantly, confirmation of the plan results in a substantial financial loss to Silverman. R. 10. Accordingly, because Silverman did not become a creditor voluntarily after the bankruptcy filing, R. 6, Silverman voted merely to

advance is own economic self-interest. As a result, Silverman cast its vote against plan confirmation in good faith and without an impermissible ulterior motive.

2. Silverman Sachs' prospective recovery under the swap agreement is not in exchange for its action or forbearance in the plan confirmation vote.

To give content to section 1126(e), courts look to bankruptcy crimes. *In re Featherworks Corp.*, 25 B.R. 634, 641 (Bankr. E.D.N.Y. 1982), *aff'd*, 36 B.R. 460 (E.D.N.Y. 1984). Under the relevant bribery statute, a person commits a crime when he or she "knowingly and fraudulently . . . receives, or attempts to obtain any . . . property . . . for acting or forbearing to act in any case under title 11." 18 U.S.C § 152(6) (2008). Accordingly, to sustain a conviction under section 152(6), a party must receive a benefit in exchange for some action or inaction in relation to a bankruptcy case. 1 COLLIER ON BANKRUPTCY ¶ 7.02(6)(a) (2008). Because a party must act with "intent to deceive," the agreement must be kept private to satisfy criminal intent. *Id*. For example, in *In re Featherworks Corp.*, the court both designated the claims of a creditor and found reasonable grounds for a section 152(6) violation when the claimant received a substantial side-payment in exchange for a confirmation vote. 25 B.R. at 641. Similarly, though this Court did not address criminal conduct in *Young*, it did make clear that the primary purpose of section 1126(e) was to prevent the buying and selling of creditors' votes. 324 U.S. at 213. Consequently, in the context of claim designation, section 1126(e) should be linked with its relevant criminal statute. 25 B.R. at 641.

Here, there is no indication that Silverman satisfied the elements of the relevant bankruptcy crime. Although Silverman stood to gain by voting against confirmation of the proposed plan, it exercised its franchise solely in accordance with its economic self-

interest. R. 10. Any pecuniary recovery under the swap agreement was not in exchange for Silverman's vote, but rather derived from the value of General's bonds. R. 6-7. In addition, Silverman made no secret of the existence of the swap agreement and was forthright with the Bankruptcy Court regarding its potential recovery. R. 10. Unlike the claimants in *In re Featherworks*, a total return swap agreement entered into prior to a bankruptcy filing does not rise to the level of a bribe. Furthermore, as opposed to the issue facing this Court in *Young*, STCM did not attempt to buy the vote of Silverman for the purpose of confirming a more favorable plan. Indeed, when Silverman cast its vote, it did so in a manner contrary to the economic interest of STCM. Consequently, since Silverman's conduct does not rise to the level of egregious wrongdoing associated with criminal activity, Silverman did not act with the purpose of promoting a nefarious ulterior motive.

3. <u>A confirmation vote motivated by a total return swap is not cast in bad faith *per se*, when the financial instrument merely hedges against economic risk while providing liquidity to the debt markets.</u>

Today, "credit derivates are no longer an exotic corner of the bond market but . . . [are] now . . . a market in [their] own right." Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 405 (2007)(quoting T. Bowler & J. Tierney, *Credit Derivatives and Structured Credit: A Survey of Products, Applications and Market Issues* (1999)(available at http://www.fornet.co.kr.bbs/aca208/145overview.pdf). Although some may dispute the overall benefits of these financial instruments, *Silverman Sachs, Inc., v. General Engines, Inc.*, No. 08-4080 (13th Cir. Oct. 10, 2008), derivative contracts serve an important function by allowing creditors to hedge against various forms of economic risk. Gregory

Gennady Plotko, *The Impact of Credit Default Swaps on the Chapter 11 Process*, 18 J. BANKR. L. & PRACT. 1, Art. 1 (2009). Akin to bespoke lender insurance, David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1024 (2007), total return swaps enable a creditor to convert high-risk debt into more conservative forms of investment. *Aon Fin. Prods., Inc. v. Societe Generale*, 476 F.3d 90, 96 (2nd 2007), Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 155 (2007). In particular, a total return swap provides liquidity to the debt markets and reduces a debtor's borrowing costs. *Id* at. 155-56. As one of the "most important" financial instruments, 18 J. BANKR. L. & PRACT. 1, Art. 1, the Bankruptcy Code expressly provides for the use of derivative agreements. *See* 11 U.S.C. § 101(53B) (2008) (defining a swap agreement), 11 U.S.C. § 546(g) (2008) (limiting avoiding powers under a swap agreement), 11 U.S.C. § 562 (2008) (timing of damages in connection with a swap agreement). Accordingly, since courts should interpret the Code in a manner to avoid conflicts among its provisions, *United States v. Ron Pair Enters.*, 489 U.S. 235, 245-47 (1989), votes cast in accordance with a swap agreement should not constitute bad faith.

In the instant case, this Court should not interfere with Congressional prerogatives by expanding the definition of good faith under section 1126(e). From the perspective of Silverman, the swap agreement enabled it to hedge against a default by the Debtor. R. 6. Given the precarious financial situation of General prior to the bankruptcy filing, the derivative contract was an efficient means to slice and spread Silverman's risk. R. 6-7. Just as the Code does not attribute bad faith to the purchase of an insurance policy, this Court should avoid a too exacting good faith standard in the realm of derivative

agreements. In addition, since the Code expressly contemplates the use of swap agreements, to penalize a creditor for using them is antithetical to Congressional objectives. Consequently, voting pursuant to a credit derivative should not constitute bad faith *per se*.

B. The United States Bankruptcy Code expressly contemplates other, less draconian means to account for the irreconcilable economic conflict between Silverman Sachs and the remaining unsecured creditor class.

1. Pursuant to Section 1123(a)(4), a plan can treat Silverman Sachs less favorably than other claimants within the unsecured creditor class.

Because a creditor's right to vote on a plan of reorganization is "fundamental," claim designation constitutes a draconian remedy to resolve inner-creditor conflicts. 359 B.R. at 61. Likewise, too narrow a definition of good faith under section 1126(e) may turn confirmation hearings into a trial on creditor motives. 155 B.R. at 23. Accordingly, Chapter 11 incorporates various democratic mechanisms to oversee a debtor's reorganization. 54 B.R. at 497. Consequently, claim designation is not the sole or even the most appropriate means to address claimants' conflicts of interest. 359 B.R. at 57. For example, section 1123(a)(4) of the Code provides that "a plan shall . . . provide the same treatment for each claim . . . of a particular class, unless the holder of a particular claim . . . agrees to a less favorable treatment." 11 U.S.C. § 1123(a)(4) (2008). By implication, therefore, a reorganization plan may provide for disparate treatment of claimholders within the same class. *In re Dow Corning Corp.*, 255 B.R. 455, 497-98 (E.D. Mich. 2000).

In the instant case, claim discrimination would enable Silverman to realize its economic objectives as well as provide additional funds to the remaining members of the

unsecured creditor class. Under the swap agreement, Silverman stands to benefit as its bondholdings decline in value. R. 7-8. Although Silverman's interests are somewhat skewed when compared to those of General's other unsecured creditors, section 1123(a)(4) provides an equitable solution to this seemingly irreconcilable conflict. Accordingly, Silverman did not cast its vote against confirmation in an effort to destroy the Debtor, but merely in response to the inequity of the reorganization plan as proposed. Moreover, other unsecured creditors stand to benefit as Silverman's recovery diminishes. Given that a modified plan of reorganization would satisfy the interests of Silverman as well as the remaining members of the unsecured creditor class, designation of Silverman's vote was too drastic a remedy when additional negotiation would have sufficed. Therefore, Silverman did not cast its vote in bad faith.

2. <u>Even assuming that its claim is substantially similar, the Bankruptcy Code does not require that the plan place Silverman Sachs in a class with the Debtor's other unsecured creditors.</u>

Under section 1122(a) of the Code, "a plan may place a claim . . . in a particular class only if such claim or interest is substantially similar to the other claims . . . of such class." 11 U.S.C. § 1122(a) (2008). Although the Code expressly prohibits a plan from classifying dissimilar claims together, *In re U.S. Truck Co.*, 800 F.2d 581, 585 (6th Cir. 1986), "bankruptcy court[s] . . . [have] . . . substantial discretion to place similar claims in different classes." *In re Dow Corning Corp.*, 280 F.3d 648, 661 (6th Cir. 2002). While Congress provided proponents of reorganization plans with the ability to classify general unsecured claims separately, 7 COLLIER ON BANKRUPTCY ¶ 122.03(1)(a) (2008), it expressly rejected a provision to designate claims solely due to conflicts of interest. *In re Dune Deck Owners Corp.*, 175 B.R. 839, 845 (Bankr. S.D.N.Y. 1995). Consequently,

in the absence of a legislative mandate, an inner-claimant conflict is insufficient to constitute the disenfranchisement of a creditor. *In re Adelphia Commc'n Corp.*, 359 B.R. 54, 64-65 (Bankr. S.D.N.Y 2006).

Here, Silverman's interest in the Debtor is in conflict with that of the unsecured creditor class. R. 10. Accordingly, claim classification, not claim designation, should be the appropriate remedy. Akin to claim discrimination under section 1123(a)(4), the reclassification of Silverman's claim would address the inner-creditor conflict. Consequently, designation of Silverman's vote was too extreme a remedy.

II. THE THIRTEENTH CIRCUIT ERRED IN FINDING THAT THE SUBSTANTIVE CONSOLIDATION OF TWO DIFFERENT DEBTOR ESTATES MAY BE ORDERED UPON A FINDING THAT THE BENEFIT TO THE ESTATES OF BOTH DEBTORS OUTWEIGHS THE HARM.

The power to order the equitable remedy of substantive consolidation, although never expressly codified, has been recognized for over a half century. *See Sampsell v. Imperial Paper & Color Corp.,* 313 U.S. 215, 219. (1941); *see also* 11 U.S.C. §105(a). Virtually every circuit court has since exercised this power, resulting in a variety of tests and rationales. *See generally In re Owens Corning,* 419 F.3d 195, 206-209 (3d Cir. 2005), *cert denied,* 547 U.S. 1123 (2006) Courts, however, remain uniform in their agreement that such a drastic remedy should be used "sparingly." *Chemical Bank New York Trust Co. v. Kheel,* 369 F.2d 845, 847 (2d Cir. 1966); *see also In re Bonham,* 229 F.3d 750, 767 (9th Cir. 2000). However, the modern balancing test advocated by the Thirteenth Circuit results in inequitable and unpredictable results. *See In re Auto-Train Corp., Inc.,* 810 F2d 270, 276 (D.C. Cir. 1987); *Eastgroup Props. v. Southern Motel Ass'n, Ltd.,* 935 F.2d 245, 249 (11th Cir. 1991). Timothy E. Graulich, *Substantive Consolidation - A Post-Modern Trend*, 14 Am. Bankr. Inst. L. Rev. 527, 565-566. (2006).

Therefore, this Court should reject the modern approach and adopt the Third Circuit's test announced in *Owens Corning.* Under the *Owens Corning* test substantive consolidation is not warranted, and accordingly this Court should reverse the Thirteenth Circuit's decision. In any event, substantive consolidation is not an appropriate remedy under any test, thus the decision should be reversed.

A. The "liberal" trend runs counter to the equitable doctrine of substantive consolidation, resulting in inefficiency and unpredictability, and therefore this Court should adopt the more restrictive test promulgated by the Third Circuit.

1. The equitable doctrine of substantive consolidation should be used sparingly as to not harm creditor reliance enabling efficiency in the market.

Substantive consolidation is an equitable remedy that should be used "sparingly," although it is "part of the warp and woof of the fabric of the bankruptcy process. *Kheel,* 369 F.2d at 847; *In re Commercial Envelope Co.,* 14 C.B.C. 191, 192 (Bankr. S.D.N.Y. 1977). Traditionally, substantive consolidation was used only where "necessary to *avoid* fraud or injustice." *In re Gulfco Inv. Corp.,* 593 F.2d 921, 928 (10th Cir. 1979) (emphasis added). However, the goal of "avoid[ing] the expense [and] difficulty" associated with unraveling debtor estates has also been used to justify substantive consolidation. *In re Auto-Train Corp., Inc.* 810 F.2d 270, 276 (D.C. Cir. 1987). Nevertheless, the only rationale for substantive consolidation remains "the equitable treatment of *all* creditors" (emphasis added). *In re Augie/Restivo Baking Co., Ltd.* 860 F.2d 515, 518 (2d Cir. 1988). The trepidation surrounding substantive consolidation orders is primarily because it "is a measure vitally affecting substantive rights." *In re Flora Mir Candy Corp.,* 432 F.2d 1060, 1062 (2d Cir. 1970). Substantive consolidation pools the assets and liabilities of legally separate entities, extinguishing inter-entity claims, thus regarding the entities as a

single economic unit. *In re Owens,* 419 F.3d at 205; *see also In re Augie/Restivo,* 860 F.2d at 518. In effect, creditors' claims "morph into claims against the consolidated survivor," *In re Genesis Health Ventures, Inc.,* 402 F.3d 416, 423 (3d Cir. 2005), which may lead to unfair treatment of those creditors. *Kheel,* 369 F.2d at 847 (Concerned primarily with the unfair treatment of creditors who dealt with a single debtor and were unaware of the interrelationship with other debtors). Consequently, there is a significant risk, due to the revaluing, that creditors will recover considerably less. *In re Owens,* 419 F.3d at 205; *In re Auto-Train Corp., Inc.* 810 F.2d at 276.

Where the creditor harmed is one who negotiated for and extended credit based on the separateness of the entities, any harm is unjust. *See generally In re Augie/Restivo,* 860 F.2d at 518-519. The Second Circuit recognized the vital interest in protecting creditors' agreements, both in the individual case and in terms of the efficiency of the market. *Id.* In discussing the equitable virtues of creditors' lending based on their expectations, Judge Winters explained that "expectations are central to the calculation of interest rates and other terms of loans, and fulfilling those expectation is therefore important to the efficiency of the credit markets." *Id.* Allowing courts to impose substantive consolidation without regard for creditor expectations would create a "race among creditors…to claim their pound of flesh." *In re Auto-Train,* 810 F.2d at 277. Additionally, there would an unwillingness on the part of lenders to extend credit. *Id.* Therefore, any utilitarian benefit received by virtue of expediency and efficiency, is belied by the efficiency that is lost where creditors are no longer confident that their agreements will be honored and the subsequent negative effects on the market. *See* (R. 15-16). Furthermore, granting consolidation that harms such creditors is contrary to

equity principles at the heart of the doctrine, as "[e]quity among creditors who have lawfully for different treatment is not equity but its opposite…" *Kheel,* 369 F.2d at 848 (Friendly, J. concurring

2. The liberal trend towards substantive consolidation creates unpredictability.

In re Vecco rationalized its adoption of the "liberal trend" towards substantive consolidation by the pointing to the increasingly complex modern corporate structure. 4 B.R. 407, 409 (Bankr. E.D. Va. 1980). The court followed its announcement by stressing the need to remain vigilant in employing the remedy sparingly. *Id.* at 410 (citing *In re Continental Vending Machine Corp.,* 517 F.2d 997, 1001 (2d Cir. 1975). However, *In re Vecco* and its progeny have made "substantive consolidation the rule, rather than the sparingly used exception." Graulich, *supra* at 529; *See, e.g. In re Richton International Corp.,* 12 B.R. 555 (Bankr. S.D.N.Y. 1981); *In re F.A. Potts & Co., Inc.,* 23 B.R. 569 (Bankr. E.D. Pa. 1982). The problems of the modern approach stem from the ill-defined standards culled from various factor lists and the inherent unpredictability that goes along with unclear standards. The resulting modern balancing test, based on the seven *Vecco* factors, becomes nothing more than a checklist that "fail[s] to separate the unimportant from the important." *In re Vecco,* at 4 B.R. 410; *In re Owens Corning,* 419 F.3d at 210; Sabin, Willett, *The Doctrine of Robin Hood - A Note on "Substantive Consolidation,"* 4 DEPAUL Bus. & COM. L.J. 87, 102-103 (2005). In rejecting the checklist approach, the Third Circuit recognized that the perfunctory check-off system would result in courts "miss[ing] the forest through the trees," and may "lead a court to lose sight of why" the substantive consolidation doctrine exists. *In re Owens Corning,* 419 F.3d at 210-211. It follows from the fluid and overlapping nature of the factors, that predictability becomes

virtually impossible. By way of example, the Second Circuit found that evidence of inter-corporate guarantees were strong evidence in support of creditor reliance on the separateness of the debtor entities, whereas the same factor had traditionally been viewed as support for the contention that the creditor regarded the debtors as a single entity. *See generally In re Augie/Resitvo* 860 F.2d at 518-519. As a result, debtors and creditors are unable to develop a rational plan with regards to bankruptcy proceedings. Therefore the liberal trend again proves to be a hindrance to efficiency.

3. This Court should adopt the Third Circuit's test for substantive consolidation because it promotes equity, efficiency and predictability.

The *Auto-Train* approach to substantive consolidation cases epitomizes the concerns discussed above, and therefore should be rejected by this court. The D.C. Circuit held that the elements necessary to grant substantive consolidation are met if the proponents establish that: (1) there is a substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or to realize some benefits. *In re Auto-Train,* 810 F.2d at 276. The application of this test, however, results in an over -application of the remedy and "allows a threshold not sufficiently egregious and too imprecise for easy measure." *In re Owens Corning,* 419 F.3d at 210.

This Court should adopt the Third Circuit's test announced in *In re Owens Corning* because it created a clear standard which provides for predictability and efficieny lacking from the *Auto-Train* approach. The Third Circuit's test in *Owens Corning* essentially adopts the Second Circuit's test in *In re Augie/Restivo.* The Second Circuit announced a two-prong test after reviewing the various factors that courts have considered. *In re Augie/Resitivo,* 860 F.2d at 518. However, the Third Circuit's standard is more restrictive, resulting in a clear understanding that substantive consolidation will

no longer be the answer to all chapter 11 problems. Graulich, *supra* at 563-564. Accordingly, this approach should be adopted.

B. Prepetition disregard for corporate separateness did not exist and the debtor entities' assets and liabilities are not so commingled that unraveling them is there is prohibitive, nor does it harm all creditors, and therefore, substantive consolidation is not an appropriate remedy.

This Court should reverse the Thirteenth Circuit's decision, ordering substantive consolidation because the proponents cannot show, as they must, that:

> (1) prepetition [the debtors'] disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity; or
>
> (2) postpetition [the debtors'] assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.

In re Owens Corning, 419 F.3d at 211.

1. The debtors' indifference to corporate separateness was not so significant as to lead their creditors' to treat them as a single legal entity and in any event, the Creditor's reliance on the separate guarantees should be honored.

In determining whether a *prima facie* case has been established with respect to the first element, the court must, based on the parties pre-petition dealings, consider whether "corporate disregard creat[ed] contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity." *Id.* To overcome a prima facie case, creditors must prove "they are adversely affected and actually relied on debtors' separate existence." *Id.* Here, there is no doubt that the Creditors relied on the debtors' separateness and, in any event the debtors did not act in a way that would lead creditors to believe they were a single entity.

Owens Corning Delaware, ("OCD") the corporate parent and its seventeen subsidiaries filed for chapter 11 reorganization in 2000 after having entered into an a

credit agreement with the creditor-bank for $2 billion. *Id.* at 201- 202. The loan was premised on the understanding that the agreement would include separate guarantees from the subsidiaries and ultimately contained provisions that "expressly [] limit[ed] the ways in which OCD could deal with its subsidiaries…[and] contained provisions designed to protect the separateness of OCD and its subsidiaries." *Id.* OCD's reorganization plan provided for substantive consolidation, substantially decreasing the value to the creditor-bank, and accordingly they objected. *Id.* at 202. Finding that no prepetition disregard was present, the Third Circuit relied on the negotiated guarantees as substantial evidence of creditor reliance. *Id.* at 210, 212-213 ("If an objecting creditor relied on the separateness of the entities, consolidation cannot be justified *vis-à-vis* the claims of that creditor."). The decision further reasoned that because the creditor-bank was aware of particularized information regarding the subsidiaries, including their assets and liabilities, they were fully aware of the "separate financial makeup of the subsidiaries." *Id.* at 213.

In the instant case, the Creditor required Holdings to guarantee the bonds thus establishing that there were no misconceptions about the separateness of the entities. R.5.; *In re Owen Corning,* 419 F.3d at 213; *see also In re Augie/Restivo,* 860 F.2d at 518 (for the proposition that guarantees are strong evidence of creditor reliance on separate debtor entities). Furthermore, the Creditor required, among other things, certification "authori[zing] *each* entity to enter into the bond transaction," establishing a thorough knowledge of the Debtors' corporate separateness. R.5. Although they did rely on the Debtors' consolidated financial statements, the court in *Owens Corning* found that it was immaterial that the creditor-bank reviewed only consolidated financial statements and

further refused to establish a rule requiring creditors to obtain individual financial statements. 419 F.3d at 213. Additionally, there is little, if any, evidence suggesting that creditors could be generally mislead. Even in light of their consolidated financial statements, Holdings, as a publicly traded company, made regular SEC filings disclosing General's separate existence. R. 4.

2. The debtor entities' assets and liabilities are not so commingled that their separation is prohibitive nor harms all creditors.

The Third Circuit's decision, drawing on decades of precedent, effectively establishes the standard that should be applied to determine whether commingling justifies consolidation. Accordingly, consolidation is justified only where the unraveling of the assets and liabilities "will reduce the recovery of *every* creditor." *In re Owens Corning,* 419 F.3d at 214. In other words, *every* creditor must benefit in a way that makes assets available, rather than shifting that benefit to one group to the detriment of another creditor. *Id.* By definition, efforts to unravel must be so prohibitive "as to threaten the realization of any net assets for all creditors." *Kheel* 369 F.2d at 845. Additionally, given that substantive consolidation will always result in some increased efficiency and/or lowered costs, "[m]ere…administrative benefit to the Court falls far short" of the benefit benchmark. Moreover, "hopeless commingling" does not result from the "impossibility of perfection" or the probability that mistakes will be made when unraveling the entities assets and liabilities. *Id.* Accordingly, the court held that there was "no meaningful evidence postpetition of hopeless commingling" of the assets and liabilities. *Id.* 419 F.3d 214. Each subsidiary observed corporate formalities, had a specific reason for existing, and maintained separate and accurate -- albeit "sloppy"-- business records and documented intercompany transactions. *Id.* at 214, 200.

Furthermore outside auditors, after examining the subsidiaries' books, were able to eliminate most financial discrepancies. *Id.* at 200.

The proponents in the present case cannot satisfy their burden of showing that the cost of untangling the Debtor entities is so prohibitively high as to harm every creditor. The evidence presented at the confirmation hearing to show the difficulty and expense of untangling the entities consisted mainly of claims regarding allegedly fraudulent and mispriced upstreaming of assets. R.4. Although the Bankruptcy Court, explicitly found that unraveling was "not impossible," it refused to determine the non-consolidated payouts. R.10. However, a court should at least attempt to ascertain an approximation of the expense especially, whereas here, the creditor relied on the separate entities. *Kheel,* 369 F.2d at 848 (Friendly, J., concurring). Here, given the testimony regarding the difference between the prices charged for the license and management services and their market value, coupled with individualized state tax returns and SEC filings, unraveling is possible. R. 5. Moreover, there is no evidence suggesting that the Debtors bookkeeping was inaccurate or, like in *Owens Corning,* even "sloppy." *In re Owens Corning,* 419 F.3d at 200. Surely where the elimination of financial discrepancies in a corporation consisting of seventeen subsidiaries and "sloppy" bookkeeping is possible, then it is also possible in the present case. Additionally, given that consolidation based on commingling should be utilized only as a last resort, alternative remedies such as veil-piercing and fraudulent conveyance should be explored. *See In re Owens,* 419 F.3d at 205-206; Graulich, *supra*, at 531-537.

CONCLUSION

For all the foregoing reasons, the judgment of the United States Circuit Court for the Thirteenth Circuit designating the petitioner's plan confirmation vote as cast in bad faith and ordering the substantive consolidation of the respondent's separate entities should be reversed.

Respectfully Submitted,

Counsel for Petitioner

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing Brief for Petitioner was mailed by certified mail, return receipt requested, to Counsel for Respondent on February 3, 2009.

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APPENDIX A

11 U.S.C. § 101(53B) (2008)

§ 101. Definitions

(53B) The term “swap agreement”--

(A) means--

(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is--

(I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;

(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange, precious metals, or other commodity agreement;

(III) a currency swap, option, future, or forward agreement;

(IV) an equity index or equity swap, option, future, or forward agreement;

(V) a debt index or debt swap, option, future, or forward agreement;

(VI) a total return, credit spread or credit swap, option, future, or forward agreement;

(VII) a commodity index or a commodity swap, option, future, or forward agreement;

(VIII) a weather swap, option, future, or forward agreement;

(IX) an emissions swap, option, future, or forward agreement; or

(X) an inflation swap, option, future, or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that--

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic

consequence, or economic or financial indices or measures of economic or financial risk or value;

(iii) any combination of agreements or transactions referred to in this subparagraph;

(iv) any option to enter into an agreement or transaction referred to in this subparagraph;

(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), together with all supplements to any such master agreement, and without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this paragraph, except that the master agreement shall be considered to be a swap agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), (iii), or (iv); or

(vi) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v), including any guarantee or reimbursement obligation by or to a swap participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with and

(B) is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule, including the Gramm-Leach-Bliley Act, the Legal Certainty for Bank Products Act of 2000, the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934) and the Commodity Exchange Act.

APPENDIX B

11 U.S.C. § 105(a) (2008)

§105. Power of court

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

APPENDIX C

11 U.S.C. § 546(g) (2008)

§546. Limitations on avoiding powers

(g) Notwithstanding sections 544, 545, 547, 548(a)(1)(B) and 548(b) of this title, the trustee may not avoid a transfer, made by or to (or for the benefit of) a swap participant or financial participant, under or in connection with any swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

APPENDIX D

11 U.S.C. § 562 (2008)

§562. Timing of damage measurement in connection with swap agreements, securities contracts, forward contracts, commodity contracts, repurchase agreements, and master netting agreements.

(a) If the trustee rejects a swap agreement, securities contract (as defined in section 741), forward contract, commodity contract (as defined in section 761), repurchase agreement, or master netting agreement pursuant to section 365(a), or if a forward contract merchant, stockbroker, financial institution, securities clearing agency, repo participant, financial participant, master netting agreement participant, or swap participant liquidates, terminates, or accelerates such contract or agreement, damages shall be measured as of the earlier of--

(1) the date of such rejection; or

(2) the date or dates of such liquidation, termination, or acceleration.

(b) If there are not any commercially reasonable determinants of value as of any date referred to in paragraph (1) or (2) of subsection (a), damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value.

(c) For the purposes of subsection (b), if damages are not measured as of the date or dates of rejection, liquidation, termination, or acceleration, and the forward contract merchant, stockbroker, financial institution, securities clearing agency, repo participant, financial participant, master netting agreement participant, or swap participant or the trustee objects to the timing of the measurement of damages--

(1) the trustee, in the case of an objection by a forward contract merchant, stockbroker, financial institution, securities clearing agency, repo participant, financial participant, master netting agreement participant, or swap participant; or

(2) the forward contract merchant, stockbroker, financial institution, securities clearing agency, repo participant, financial participant, master netting agreement participant, or swap participant, in the case of an objection by the trustee,

has the burden of proving that there were no commercially reasonable determinants of value as of such date or dates.

APPENDIX E

11 U.S.C. § 1123(a)(4) (2008)

§1123. Contents of plan

(a) Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . .

(4) 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 . . . .

APPENDIX F

11 U.S.C. § 1122(a) (2008)

§ 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.

APPENDIX G

11 U.S.C. § 1126(e) (2008)

§1126. Acceptance of 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.

APPENDIX H

18 U.S.C. §152(6)

§152. Concealment of assets; false oaths and claims; bribery

A person who---

(6) knowingly and fraudulently gives, offers, receives, or attempts to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof for acting or forbearing to act in any case under title 11 . . .

shall be fined under this title, imprisoned not more than 5 years, or both.