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First Impression:

Deft Use of Consolidation Doctrine Avoids Taxes

By Adam L. Rosen

IN CASES WHERE the debtor and principal parties in interest agree, a decision by the U.S. Bankruptcy Court for the Central District of California demonstrates how a flexible utilization of the consolidation doctrine can be adopted to accomplish corporate, tax and plan purposes. *In re Standard Brands Paint Co.*, 154 B.R. 563 (Bankr. C.D. Cal. 1993) (J. March).

In what appears to be a case of first impression, the court held that the estates of five Chapter 11 debtors may be substantively consolidated for the limited purposes of voting on, confirming and distributing under a consolidated plan of reorganization.

Substantive consolidation of separate estates for plan purposes is not novel and it is well-settled that bankruptcy courts may substantively consolidate estates under their equitable powers pursuant to Bankruptcy Code Sec. 105(a). (See, "Substantive Consolidation of Individual Estates OK," *The Bankruptcy Strategist*, Vol. IX, No. 9). What makes *Standard Brands* noteworthy is that, after confirmation of the consolidated plan, each of the debtors will revert back to its separate corporate identity. This is in stark contrast to the usual effects of consolidation, which sees the stock of some of the consolidated entities cancelled and the various entities combined into a single corporation.

In *Standard Brands*, the debtors sought substantive consolidation to avoid the negative tax effects that would result if intercompany debts were permanently cancelled, or if the corporations were merged into the parent debtor.

The debtors also requested that the consolidation include the following:

- creation of a single estate for all five debtors;
- treatment of all claims against the five debtors as claims against the consolidated estate;
- provision for the filing of a single plan of reorganization, treating all creditors as claimholders against a consolidated estate;
- resolution of intercompany claims by issuing intercompany dividends or capital contributions, thus eliminating intercompany debts;

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Dual Functions:

Ruling Raises Concerns Over Lease Assumptions

By Joel Lewittes

A RECENT decision of the U.S. Court of Appeals for the Second Circuit may raise serious concerns in its analysis of the contours of the bankruptcy court's authority to permit assumption or rejection of executory contracts when the bankruptcy court faces a mixture of administrative and adjudicatory functions. *Orion Pictures Corp. v. Showtime Networks, Inc.*, 4 F.3d 1095 (1993).

In 1986, Orion Pictures Corp., a motion picture producer and distributor, signed an agreement with Showtime Networks, Inc., a cable service that televises movies licensed from motion picture distributors. The agreement required Showtime to license all of the films distributed by Orion, regardless of box office appeal, provided that certain criteria were met relating to advertising and theatrical releases.

In particular, a "key-man" clause conditioned Showtime's performance on Orion's continued employment of at least two of four named executives in positions similar to those held by them at the time of the execution of the agreement. In October and November of 1991, Showtime informed Orion that certain management changes at Orion, beginning as early as April 1991, violated the "key-man" clause.

On Dec. 11, 1991, Orion filed its Chapter 11 petition.

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- elimination of duplicate claims filed by creditors against more than one debtor; and
- retention of stock by each of the separate corporations and no formal merger of the separate corporations, and continued observance of separate corporate existences.

Substantive consolidation is an equitable doctrine that permits a bankruptcy court in a case under any chapter of the Code to determine that it is, in certain instances, appropriate to pool the assets and liabilities of a debtor with those of other debtors or, in some cases, non-debtor entities. *See, e.g., Union Savings Bank v. Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988).

Two Tests

The court in *Standard Brands* concluded that, under the facts presented, substantive consolidation of the estates of the five debtors for the specified purposes was warranted. The court applied both the Second Circuit's test in *Augie/Restivo* and the test of the D.C. Circuit Court in *Drabkin v. Midland-Ross Corp. (In re Auto-Training Corp.)* 810 F.2d 270 (D.C. Cir. 1987) in reaching its conclusion. The Second Circuit test requires proof that either:

- the creditors dealt with the debtors as a single unit and did not rely on their separateness in extending credit, *or*
- the debtors' affairs were so entangled that consolidation was the only practical recourse.

The D.C. Circuit test requires proof that:

- a substantial identity exists between the entities to be consolidated;
- there is a need for consolidation; *and*
- if a creditor objects to the consolidation and shows it prejudicially relied on the separate credit of one entity, the benefits of consolidation heavily outweigh the harm to that creditor.

The *Standard Brands* court approved the substantive consolidation for the specified purposes based upon the perceived benefits and lack of harm to creditors. The court based its novel use of substantive consolidation on a limited basis on the fact that:

"Because substantive consolidation is an equitable 'doctrine,' the bankruptcy court has the power to modify substantive consolidation to meet the specific need of the case. [citing *In re Parkway Calabasas, Ltd.*, 89 B.R. 832, 837 (Bankr. C.D. Cal. 1988)]" 154 B.R. at 570. The court found that, without substantive consolidation, it would be prohibitively expensive and difficult for the debtors to confirm five separate plans and that substantive consolidation would speed the debtors' emergence from Chapter 11, a benefit all creditors and shareholders.

The court placed reliance on the fact that substantive consolidation would avoid many difficult issues and conflicts concerning classification and voting problems that would result from the classification of intercompany claims and deciding whether such claims should be equitably subordinated or avoided as preferential transfers or fraudulent conveyances.

In addition, the court opined, that separate counsel for each of the debtors might have to be employed for the purposes of claim objections and plan proceedings so that one or more of the debtors could object to one or more of the plans proposed by the other debtors. This, of course, would greatly increase the administrative costs in the case.

The Code does not specifically authorize substantive consolidation. Traditionally, bankruptcy courts have granted motions substantively consolidating estates based upon their equitable powers. The court in *Standard Brands* relied on Sec. 105(a), which provides that: "the Court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." Also, the court relied on the language contained in Sec. 1123(a)(5)(C), which provides, in pertinent part, that a Chapter 11 plan "shall provide adequate means for the plan's implementation such as — (C) merger or consolidation of the debtor with one or more person." (*See, also*, Code Sec. 302(b) regarding consolidation of joint estates.)

Key Facts

The court placed great weight on the fact that no party in interest objected to the debtors' motion requesting substantive consolidation and, based on that fact, the court inferred that there was a lack of harm to any party in interest. 154 B.R. at 572. The court noted that this was a large case in which all the major parties were represented by sophisticated law firms who had been active throughout the case. It is unclear whether the court in *Standard Brands* would have reached the same result if a committee or major creditor had objected to the substantive consolidation.

The opinion in *Standard Brands* is a pragmatic one that may be limited to its somewhat unique facts. It is unclear whether the case has much precedential value in cases seeking the same result over the objection of a creditor. ■

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