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WHAT IS A "SUBSTANTIVE NONCONSOLIDATION OPINION," AND WHY DOES MY CLIENT NEED ONE?

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If you regularly represent commercial borrowers, you may already be familiar with the concept of a "substantive nonconsolidation opinion." If you've haven't yet had a lender require one of these opinions from your borrowing client, get ready, you will very likely soon have a client requesting that you produce one so that his commercial real estate transaction may close on time. Aside from delving deeper into bankruptcy case law than you ever thought you would go, like most lawyers, you probably wish to avoid giving a legal opinion that may put your firm and your legal liability carrier on the hook for the actions of your client, the work of other lawyers and often, third parties. Notwithstanding these aversions, the biggest obstacle for most lawyers in properly advising their clients is simply that they are unfamiliar with what it means to give a "substantive nonconsolidation opinion." The good news is that while this article may not make you an expert on bankruptcy law or the bankruptcy court's equitable powers of "substantive consolidation," it will arm you with enough knowledge to speak competently and intelligently about this matter with your client and lender's counsel.

The Roots of "Substantive Consolidation"

Nowhere in the United States Bankruptcy Code will you find mention of the concept of "substantive consolidation." "Substantive consolidation" is a remedy judicially borne out of each bankruptcy court's equitable powers as provided under Section 105(a) of the Bankruptcy Code. The concept is very simple. Where two or more entities, at least one of which is in bankruptcy, appear entwined enough to be considered as one entity (particularly in the minds of creditors), the bankruptcy courts may join the assets and liabilities of those entities into one bankruptcy proceeding.

Birth of the Substantive Nonconsolidation Opinion

Securities offered through the commercial mortgage-backed securities ("CMBS") market, wherein commercial loans are pooled and securitized, have historically yielded positive returns while proving to be relatively safe investments for the institutional investors that tend to purchase them. At the same time, greater numbers of lenders are placing loans into the CMBS stream. In so doing, lenders are able to free up capital and reduce risk to themselves by passing it through to investors on the secondary markets.

While traditional, non-recourse, single party loans have generally raised little concern, the increased occurrence over the last several years of having multiple borrowers, tenancy-in-common structures, and a host of affiliated service providers involved in a single transaction has given commercial lenders, rating agencies and those investors purchasing CMBS securities pause to consider the true risk of their mortgage securities. This concern has forced lenders, spurred by the demand of the rating agencies, to require opinions from borrower's counsel, which warrant that if one of the associated entities on a transaction files for bankruptcy protection or is forced into an involuntary bankruptcy, the assets of the borrowing entity will not be substantively consolidated with the bankrupt entity. Out of this arose the substantive nonconsolidation opinion. The clear concern for the investors buying interests in these loans from the CMBS market is that if the assets collateralizing their notes become part of a consolidated bankruptcy estate, despite their security interests,



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they will inevitably fight with the rights of other creditors, administrative fees claimants, and possible efforts by the borrowing entity to continue to use the property as part of the reorganization process. More immediately, however, the investors worry that the substantive consolidation of one of their mortgagors with a bankrupt entity will delay the timely payments due under that particular note. These efforts unquestionably diminish the value and potential return of the commercial mortgage-backed securities. Consequently, the investors heavily depend on the rating agencies to properly evaluate the risk on these types of investments.

The substantive nonconsolidation opinion, which is typically offered by counsel for the borrower and is drafted for the benefit of a particular lender, tells the lender and the rating agencies that the organization of the borrowing entities and structure of the transaction in question do not lend themselves to a ruling for substantive consolidation by a bankruptcy judge. The three main rating agencies, Moody's Investors Service, Standard & Poor's Ratings Service and Fitch IBCA, Inc. use the substantive nonconsolidation opinion as a guidepost to evaluate the level of risk versus security on a particular loan. With the opinion in place, the rating agencies will then rate the securities, thereby permitting the lenders to securitize their debt on the CMBS market.

Elements of a Substantive Nonconsolidation Opinion

A substantive nonconsolidation opinion generally consists of ten main elements: (1) a description of the organizational structure of the borrowers and their associated entities; (2) a description of the transaction, including loan specifics; (3) the purpose of the opinion, including the entity pairings required by the lender; (4) a listing of the documents examined by the law firm giving the opinion; (5) assumptions taken by the law firm giving the opinion; (6) a discussion of the applicable bankruptcy case law; (7) application of the case law to the current organizations and transaction, including the law firm's conclusions; (8) the opinions of the law firm regarding the potential for substantive consolidation; (9) any qualifications to the opinions expressed by the law firm; (10) and exhibits to the opinion, including plat descriptions of the property, and certificates by the borrowers and associated entities.

The lender requesting a substantive nonconsolidation opinion will generally also require that each of borrowing entities be set up as single purpose entities ("SPEs"), whose activities are limited to acquiring, owning, managing and otherwise dealing with the securing property, and whose articles of organization and/or operating agreements will not be amended for as long as the loan is outstanding. Often the lender will require that specific language be included in the borrowing entities' operating agreements, and may require that this language be duplicated as an exhibit to the opinion.



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Substantive Consolidation Case Law

In the days of old, substantive consolidation was generally granted only when two or more entities entangled themselves to the extent that a court might pierce their corporate veils under an “alter ego” type analysis. Various inquiries were used by each court to gauge whether purportedly separate entities were in fact alter egos of one another, and while the presence of no one factor was conclusive, the combination of several factors usually meant a finding in favor of substantive consolidation. These “tests” included whether the following conditions existed:

- (1) One entity owned all or a majority of the capital stock of the subsidiary;
- (2) There were common directors and officers;
- (3) One entity financed another;
- (4) One entity was responsible for incorporation of the other;
- (5) The subsequently incorporated company had a grossly inadequate capital;
- (6) One entity paid the salaries or expenses or losses of the other entity;
- (7) The entities had no independent business from each other;
- (8) One entity was commonly referred to as a subsidiary or as a department or a division of the other entity;
- (9) Directors and executive officers of one entity did not act independently but took direction from another entity;
- (10) The formal legal requirements of each entity as separate and independent corporations were not observed;
- (11) The presence or absence of consolidated financial statements;
- (12) The unity of interests and ownership between the various corporate entities;
- (13) The existence of parent and inter-corporate guarantees on loans;
- (14) The degree of difficulty in segregating and ascertaining individual assets and liabilities;
- (15) The transfer of assets without formal observance of corporate formalities;
- (16) The commingling of assets and business functions; and
- (17) The profitability of consolidation at a single physical location.

See *Fish v. East*, 114 F.2d 177 (10th Cir. 1940), and *In re Vecco Constr. Indus., Inc.*, 4 B.R. 407, 410 (Bankr. E.D. Va. 1980). Once the courts had answers to these questions, they would determine on a case-by-case basis whether under a “balancing of the equities” approach, substantive consolidation was warranted. While today’s courts tend not to use these “alter ego” considerations as the guiding principal by which to order or not order substantive consolidation, courts still decide substantive consolidation on a case-by-case basis, and the “alter-ego” analysis continues to play an important role in the courts’ decision-making processes.

Today, courts use two “modern” tests to establish whether substantive consolidation is appropriate. The first of these tests is called the “Auto-Train” test, as developed by the D.C. Circuit Court in *Drabkin v. Midland-Ross Corp.* (In re: Auto Train Corp.), 810 F.2d 270 (1987), and adopted and modified by the Eleventh Circuit in *Eastgroup Properties v. Southern Motel Ass’n. Ltd.*, 935 F.2d 245 (1991). The Auto-Train test includes three criteria, all of which are required for the court to order substantive consolidation. These elements are:



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- (1) The proponent must show a substantial identity between the entities to be consolidated; and
- (2) The proponent must show that consolidation is necessary to avoid some harm or to realize some benefit; and
- (3) If a creditor objects and demonstrates that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation, then the court may order consolidation only if it determines that the demonstrated benefits of consolidation "heavily" outweigh the harm.

The second of the "modern" tests was created by the Second Circuit Court of Appeals in the case of *Union Sav. Bank v. Augie/Restivo Baking Co.* (In re: *Augie/Restivo Baking Co.*), 860 F.2d 515 (1988). The Second Circuit's test requires one of two conditions be present for a court to order substantive consolidation. These conditions are:

- (1) The creditors dealt with the entities as a single unit and did not rely on the entities' separate identity in extending credit; or
- (2) The affairs of the debtors are so entangled that consolidation will benefit all creditors because untangling the affairs is either impossible or so costly as to consume other assets.

While these cases form the backbone of substantive consolidation case law, this is a growing area of law with many fact specific court rulings. Practitioners in this area should carefully review all of the case law before opining as to whether the facts and circumstances of their transaction are susceptible to substantive consolidation.

Transactions Which Trigger Substantive Nonconsolidation Opinions

Any loan in which the lender will subsequently package the loan with others and sell it through the CMBS market is a candidate for requiring a substantive nonconsolidation opinion. Typically, the rating agencies will require the lender to obtain a substantive nonconsolidation opinion where the size of the loan in question equals a specific percentage of the pool of loans. Alternatively, the rating agencies may require an opinion where the loan amount meets or exceeds \$8-15 million.

Types of Substantive Nonconsolidation Opinions and Entity Pairings

Despite the fact that the substantive nonconsolidation opinions are mandated by the rating agencies, each lender, via its outside counsel, generally has its own requirements and opinion nuances. Furthermore, the type of substantive nonconsolidation opinion will depend upon the forms of the entities involved (i.e. corporations, limited partnerships, limited liability companies, etc.) and their inter-relationships to each other. Often the key to how a substantive nonconsolidation opinion is structured, and whether one is required at all, depends on who owns or controls the SPE borrowers in a deal. Each pairing of entities is in essence a separate legal opinion stating that the assets of the borrower should not be substantively consolidated with that particular affiliated insolvent entity.

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Thus, for example, where the borrower is a corporate SPE, the lender will require an opinion that pairs any fifty percent equity owner with the corporation. Where the borrower is a limited liability company ("LLC") SPE, the lender will require an opinion that pairs any non-SPE member with the LLC. For any SPE member of the LLC, the lender will additionally require that the opinion state that the SPE member will not be substantively consolidated with the parent of such SPE member. With a borrower who is a limited partnership ("LP") SPE, on the other hand, the lender will require an opinion that pairs any limited partner holding fifty percent or greater interests in the profits and losses of the LP SPE with the LP SPE. Any general partner of the LP SPE, who itself is not an SPE, will also be paired to the borrowing LP SPE. Most rating agencies will also require that with a LP SPE there must be at least one general partner that is a SPE. Consequently, the rating agencies through the lender will also require that the substantive nonconsolidation opinion pair the general partner SPE with its owners, members or partners.

Conclusion

Substantive nonconsolidation opinions have become a necessary part of commercial borrowing over the last several years, with no sign of a slow down in the near future. Whether your client is involved in real estate transactions, real estate syndication, or even such activities as timberland purchasing, rental car agency borrowing, timeshare development or the franchising of establishments, you may be called upon to deliver or have a third party deliver a substantive nonconsolidation opinion. The aforementioned backdrop, at the very least, should provide you enough basic information to steer your client and his project in the right direction.