

## CREDITOR FOILED IN SUBSTANTIVE CONSOLIDATION AND ABSOLUTE PRIORITY OBJECTIONS TO DIP FINANCING:

### *In re THE BABCOCK AND WILCOX COMPANY*

In *In re The Babcock and Wilcox Co.*, 250 F.3d 955 (5<sup>th</sup> Cir. 2001), the Fifth Circuit reviewed the bankruptcy court's entry of a debtor-in-possession ("DIP") financing order that an objector claimed substantively consolidated the bankruptcy of Diamond Power ("Diamond"), a Babcock and Wilcox affiliate, with the bankruptcies of several other Babcock and Wilcox affiliates. The objector, Bergemann, also claimed the DIP order violated the absolute priority rule. The bankruptcy court denied Bergemann's objections, and the Fifth Circuit affirmed.

All of the Babcock and Wilcox entities filed a motion seeking authorization for post-petition financing from Citicorp North America. Citicorp agreed to provide a \$300 million line of credit available to all the debtors. In exchange, Citicorp received a security interest in all of the debtors' assets (including Diamond). Thus, any funds one debtor borrowed under the line of credit would result in a claim against the assets of all the debtors. The DIP financing order also accorded Citicorp superpriority administrative expense status against all the debtors.

The debtors amended the agreement to address the circumstance where Diamond had drawn relatively little from the line of credit but, because of the lien on its assets and Citicorp's superpriority status, paid more than its share to satisfy Citicorp's claim. The amended DIP order provided that if Diamond made payments to Citicorp in excess of funds received by Diamond under the line of credit, Diamond would have a claim against all the other debtors, subordinate only to Citicorp's claim.

Bergemann had a \$52 million pending patent infringement suit against Diamond. Bergemann argued that the DIP order amounted to improper *de facto* substantive consolidation and violated the absolute priority rule. Bergemann was specifically concerned that Citicorp's claim against all the debtors might disproportionately deplete Diamond's assets, leaving little or nothing to pay Bergemann's patent infringement claim. He also objected because his claim was subordinated to the DIP Lender's claim.

Bankruptcy courts use substantive consolidation to cumulate all of the assets and debts of multiple entities where they actually operate as a single en-

- ADMIRALTY & MARITIME
- ANTITRUST & TRADE REGULATION
- AVIATION
- APPELLATE LITIGATION
- BANKING, RESTRUCTURING &  
CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL  
LITIGATION
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, &  
EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH &  
DISABILITY INSURANCE
- LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION,  
TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY &  
E-COMMERCE
- INTERNATIONAL
- LABOR RELATIONS &  
EMPLOYMENT
- MEDICAL PROFESSIONAL &  
HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT &  
FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE,  
DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL,  
FEDERAL AND STATE)
- TELECOMMUNICATIONS &  
UTILITIES
- TRUSTS, ESATES &  
PERSONAL PLANNING
- VENTURE CAPITAL &  
EMERGING COMPANIES

### Bankruptcy, Restructuring, and Creditors-Debtors Rights

www.joneswalker.com  
bankruptcy@joneswalker.com

- ADMIRALTY & MARITIME
- ANTITRUST & TRADE REGULATION
- AVIATION
- APPELLATE LITIGATION
- BANKING, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL LITIGATION
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH & DISABILITY INSURANCE
- LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY & E-COMMERCE
- INTERNATIONAL
- LABOR RELATIONS & EMPLOYMENT
- MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES

terprise. But to substantively consolidate two or more estates, bankruptcy courts must make specific findings similar to an alter ego analysis and address the effect of the consolidation on creditors. Bergemann claimed that the court failed to examine the substantive consolidation factors before entering a DIP order that he argued functioned as a *de facto* substantive consolidation by allowing all debtors to borrow on the line of credit and by allowing Citicorp to have claims against all debtors regardless of their respective draws on the line of credit.

The Fifth Circuit rejected Bergemann's appeal. Despite recognition that Citicorp would have access to Diamond's assets in excess of the amount Diamond borrowed, the Fifth Circuit in effect found that Bergemann was adequately protected by Diamond's ability to file a claim against other bankrupt entities who had drawn even more on the line of credit. The Fifth Circuit found that no substantive consolidation occurred because the DIP order did not combine the assets or liabilities of the debtors and did not establish a common pool to pay all creditors claims. The order also did not extinguish inter-debtor claims or combine debtors' creditors for purposes of voting on a plan of reorganization. Absent substantive consolidation, the bankruptcy court did not need to analyze the consolidation factors.

Bergemann also argued that the super-priority lien status granted Citicorp violated the absolute priority rule. Under the rule, a junior creditor may not receive any value if the more senior creditors are not paid in full. Although the case does not explain Bergemann's argument, Bergemann must have believed that the DIP order allowed a junior creditor to receive value while simultaneously denying Bergemann full recovery. In rejecting Bergemann's argument, the Fifth Circuit agreed with a New York bankruptcy court that "[t]he absolute priority rule is a confirmation standard which does not apply to a pre-confirmation contested matter involving a debtor's request to obtain senior credit." *In re 495 Cent. Park Ave. Corp.*, 136 B.R. 626, 632 (Bankr. S.D.N.Y. 1992).

The Fifth Circuit also rejected the argument that the bankruptcy court had committed a *Braniff* error by attempting to perform a distribution outside the plan that could not be accomplished within a plan. *In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (5<sup>th</sup> Cir. 1983). The court found that, unlike *Braniff*, the DIP order did not "change the fundamental nature of the assets nor limit future reorganization options."

Although the Fifth Circuit found ample legal authority for affirming the denial of Bergemann's objections, the opinion suggests that the court also

### Bankruptcy, Restructuring, and Creditors-Debtors Rights

www.joneswalker.com  
bankruptcy@joneswalker.com

- ADMIRALTY & MARITIME
- ANTITRUST & TRADE REGULATION
- AVIATION
- APPELLATE LITIGATION
- BANKING, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL LITIGATION
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH & DISABILITY INSURANCE
- LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY & E-COMMERCE
- INTERNATIONAL
- LABOR RELATIONS & EMPLOYMENT
- MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES

looked to equitable considerations. The court discussed an affidavit submitted by Babcock and Wilcox, stating that the financing agreement was “critical to the continued vitality of each of the Debtors.” The court remarked that Bergemann was unable to refute this statement and that Bergemann had some protection through the ability of Diamond to bring claims against the other debtors. This discussion indicates that the court found the prejudice to Bergemann insufficient to overcome the benefit afforded the mass of other creditors.

**- Laura Leigh Blackston, Author, and Nan Roberts Eitel, Editor  
Partners, Bankruptcy, Restructuring & Creditors-Debtors Rights**

*Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:*

R. Patrick Vance  
Jones Walker  
201 St. Charles Ave., 49th Fl.  
New Orleans, LA 70170-5100  
ph. 504.582.8194  
fax 504.589.8194  
email pvance@joneswalker.com

### Bankruptcy, Restructuring, & Creditors-Debtors Rights Practice Group

BRAD J. AXELROD  
JEFFREY M. BAUDIER  
LAURA LEIGH BLACKSTON  
MATTHEW T. BROWN  
NAN ROBERTS EITEL  
ELIZABETH J. FUTRELL  
TARA RICHARD KEBODEAUX

ROBIN D. MCGUIRE  
R. LEWIS MCHENRY  
MICHAEL T. PERRY  
CARL D. ROSENBLUM  
GENEVIEVE HARTEL SALASSI  
CLAIBORNE P. TANNER  
R. PATRICK VANCE

To subscribe to other E\*Zines, visit [www.joneswalker.com/news/ezine.asp](http://www.joneswalker.com/news/ezine.asp)