USING LEGAL ENTITIES TO CREATE PRIORITY

I. INTRODUCTION

A. In this outline we consider the use of separate legal entities or persons to create priority orderings between creditors. The use of separate entities to create priority between creditors is a separate and distinct financing technique. It does not rely on the creation of a **lien**, **mortgage** or **security interest** nor does it rely on a form of contract known as a **subordination agreement**. When we think of a legal person we may think of natural persons with legal capacity or we may think of non-natural or artificial legal persons such as corporations, partnerships, limited liability companies or business trusts. In this unit the focus is on artificial legal persons.

B. For purposes of this discussion, the central structural feature of a legal person is that a legal person has the capacity to own property. Property may consist of an ownership interest in real estate (such as a fee simple absolute) or it may consist of an ownership interest in personal property. Personal property includes physical objects, such as automobiles and equipment, as well as intangibles, such as accounts receivable, bank accounts, investment property (e.g. stocks, bonds and mutual funds) and intellectual property. Certain intangibles may be "represented" by physical objects such as stock certificates or passbooks.

C. In its simplest form, consider the ownership relation to be a function from property objects to owners (i.e. the function assigns each item of property to a unique owner). Thus, each item of property is related to a single "owner" and that owner is a legal person. NB: the ownership relation is not a function from owners to property objects because each owner may own multiple property objects. For now, we shall ignore ownership forms such as joint-tenancy.

D. A second critical structural feature is that creditors may have claims against legal entities. The claims of a creditor against a legal entity (known as a "debtor") must be satisfied by the assets (i.e. the property objects) owned by the debtor if the debtor does not pay the creditor. In the absence of a special legal relationship, such as provision of a guarantee by another legal person, a creditor must look solely to the assets owned by its debtor to satisfy its claim; the creditor may not look to the property objects owned by other legal persons for payment. The claim of a creditor against a debtor is known as an "**in personam**" claim. The claim of a creditor against a property object of a debtor is an "**in rem**" claim.

E. The third critical structural feature is that legal persons may "own" non-natural or artificial legal persons. This allows for the creation of complex or tiered ownership structures. A common example is a typical corporate holding company structure.

Legal persons known as "shareholders" may own shares of a parent corporation. The parent corporation may directly own shares of a subsidiary corporation; such a subsidiary is known as a **first tier** subsidiary. In turn, the subsidiary corporation may own shares of a "**second tier**" subsidiary.

II. PRIORITY ANALYSIS AND STRATEGY

A. Let us take as our paradigm case a parent corporation ("**Parent**") that owns three subsidiary corporations. Parent owns all the issued and outstanding shares of a first tier subsidiary ("**First Tier**"). In turn, First Tier owns all the issued and outstanding shares of a second tier subsidiary ("**Second Tier**"). In addition, Parent owns 80% of the issued and outstanding common shares of a third subsidiary ("**Majority Owned**"). Parent is a pure holding company and does not own any operating assets. First Tier is a wholesale distributor of widgets (i.e. it holds widgets in inventory for sale to retailers of widgets). Second Tier is a manufacturer of widgets. Second Tier sells widgets to First Tier and, sometimes, to unrelated third parties. Majority Owned owns various pieces of equipment that it leases to unrelated third parties.

B. In our paradigm case, Parent is the direct owner of two intangible assets: the shares of First Tier and the shares of Majority Owned. Parent is not the owner of the leasing equipment or the widgets. Similarly, Parent is not the owner of the manufacturing equipment used by Second Tier to make widgets. First Tier is the owner of widgets and other tangible property related to its wholesale business. Also, First Tier owns several kinds of intangible property: accounts receivable from its customers who purchase widgets on credit and the shares of Second Tier. First Tier does not own the manufacturing equipment used to make widgets nor does it own the leasing equipment. Second Tier owns the manufacturing equipment. The central idea operating in the paradigm case is that ownership of intangible property consisting of an equity interest in a legal person does not amount to an ownership interest in the property objects owned by that legal person. Another way of looking at the structure is that the ownership relationship stops at the equity interest. If the ownership relationship did not stop at the equity interest, then our model of ownership as a function from property objects to legal persons would break down. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); United States v. Wallach, 935 F.2d 444, 462 (2d Cir. 1991); Monterey Life Systems v. United States, 635 F.2d 821 (Ct. Cl. 1980); Kentucky Electric Power Co. v. Norton Coal Mining Co., 93 F.2d 923, 926 (6th Cir. 1938).

C. Consider the position of a lender to Second Tier as compared to a lender to First Tier. The lender to Second Tier will have a claim on the manufacturing assets and no claim on the widgets or the shares of Second Tier. The lender to First Tier will have a

claim on the widgets and the shares of Second Tier. The claim on the shares of Second Tier represent a claim with a value equal to the residual or net value of the manufacturing assets after payment of the lender to Second Tier. Seen in this way, the tiered entity structure gives the lender to Second Tier a prior claim on the value of the manufacturing assets owned by Second Tier. The lender to First Tier may look only to the residual value of these assets indirectly by virtue of First Tier's stock ownership in Second Tier. Similarly, a lender to Parent would have an even more indirect interest in the residual value of this manufacturing equipment. The residual value of Parent in these manufacturing assets also would be subject to the prior claim of lender to First Tier. Of course, a lender to Parent will also be able to look to the residual value represented by the shares of Majority Owned. A lender to Majority Owned would have a prior claim on the leasing equipment assets (but no claim to the residual value represented by the shares of First Tier owned by Parent). Note that Parent only has a claim to the residual value represented by 80% of the net value of the leasing equipment owned by Majority Owned. To make this calculation first you must know the value of the leasing equipment. Then you must subtract the amount owed to the lender (think about principal, accrued but unpaid interest and other fees). This calculation gives you the value of 100% of the shares. After making the subtraction, then you multiply the result by 80% to reflect Parent's ownership percentage.

D. Consideration of the paradigm case reveals a structuring strategy that might be followed by a consolidated family of companies. If we ignore Majority Owned for the moment, consider the result if First Tier contributed all its operating assets to Second Tier. In such a structure, there would be three possible borrowers: Parent, First Tier and Second Tier. A lender to Second Tier would be closest to the operating assets and would be paid first out of those assets. A lender to First Tier would only have a residual claim to the value of these assets based on its share ownership of Second Tier. In effect, the lender to First Tier would have a second priority claim. A lender to Parent would have a third priority claim to the value of these assets, behind the lenders to First Tier and Second Tier. Notice that the priority structure reflected in this arrangement is achieved without the creation of any lien, mortgage or security interest. It simply requires that three different lenders each make a decision to lend at a different level of the corporate structure.

E. Notice that this type of priority structure can be altered by actions taken by Parent and its subsidiaries (which Parent controls). First, Parent might cause Second Tier to **transfer assets** or **dividend assets** to either Parent or First Tier. A lender to Second Tier who relied on the location of assets when making a loan might be frustrated if its priority ranking were to be destroyed by asset transfers or dividends. Second, if Parent caused Second Tier to provide **guaranties** to lenders to Parent and First Tier,

the structural priority created by the corporate structure would be lost. A lender to Second Tier might protect itself to some degree by obtaining **covenants** that prohibited asset transfers or dividends by Second Tier. Also, the lender to Second Tier might restrict the obligations that Second Tier might incur by obtaining a covenant prohibiting guaranties and the incurrence of other **indebtedness** by Second Tier. A covenant that prohibits an action is generally known as a **negative covenant**.

F. Notice also that the priority structure reflected in the corporate structure might be destroyed by another common form of corporate transaction-the **merger**. If Second Tier were to merge into First Tier and if First Tier were to merge into parent, a single legal person would result. Parent, as the surviving entity in this series of mergers, would become the owner of all the property objects in the consolidated corporate family. Parent would become the successor obligor on all the indebtedness of First Tier and Second Tier. All the lenders would have **pari passu** claims against the assets of Parent in case of a default. Accordingly, a lender to Second Tier (or, for that matter, First Tier) might negotiate for covenants prohibiting mergers and similar corporate transactions in order to preserve the priority created by the corporate structure.

G. Keep in mind that a covenant is merely a contract. Prohibiting asset transfers, dividends, incurrence of indebtedness (including guaranties) and mergers by a negative covenant does not prevent these actions from occurring. The covenant merely gives the beneficiary of the covenant a breach of contract action. The breach of covenant may permit the lender to **accelerate** the maturity of its debt. This means that the lender can ask for its money back. If, however, the debtor does not pay the accelerated maturity, the lender will need to sue for payment. The presence of an accelerated claim may cause the debtor to file for bankruptcy. There is no assurance that, in a bankruptcy proceeding, the court will restore the structure to the status quo prior to the covenant violation. Elsewhere we will consider the doctrine of **equitable subordination**. Briefly, equitable subordination is a doctrine that might permit the debt of one creditor to be subordinated to the debt of another creditor based on bad actions taken by the first creditor. For example, if a creditor knowingly induced the debtor to violate a covenant in order to improve its position vis-à-vis another creditor who benefited from the covenant, the second creditor may argue to the court that the claim of the bad creditor should be subordinated to its claim.

H. One of the primary techniques used in **structured financing** and **asset securitization** transactions is to create what is known as a **special purpose vehicle** or **SPV**. Typically, the SPV acquires assets and borrows money. The lender satisfies itself that the assets of the SPV are adequate to service and repay its loan. It relies on the separateness of the SPV from the other members of the corporate group to give it priority over different lenders to other members of the group and to give it certain

other benefits. Thus, a lender may rely on the existing corporate structure of a consolidated group in making a loan or it may recommend changes in the corporate structure, such as creation of an SPV and the transfer of assets to the SPV, as a condition to extending credit. In either case, consideration of corporate structure and the priority that it creates is essential in formulating a lending strategy.

SPV's go by various names. Sometimes they are referred to as **special purpose corporations** or **SPC's**. Other times they are referred to as **bankruptcy remote subsidiaries**.

III. SUBSTANTIVE CONSOLIDATION

A. A debtor that relies upon corporate structure to create a priority structure also must be concerned about the doctrine of **substantive consolidation**. Substantive consolidation is an equitable doctrine pursuant to which a court can order that the separate corporate or other entity forms be ignored, the inter-company obligations of the consolidated entities cancelled and the property objects of the consolidated entities pooled. Following the substantive consolidation, the pooled assets are used to satisfy the third party creditors of the consolidated entities. Neither the Bankruptcy Code nor the Bankruptcy rules expressly authorize a bankruptcy court to order substantive consolidation. Nevertheless, many courts have held that Section 105(a) of the Bankruptcy Code authorizes such an order as part of the court's general equity powers.

B. In considering whether or not to order substantive consolidation a court will consider a variety of factors including: the presence or absence of separate financial statements for each entity, the difficulty of separating the financial affairs of each entity, whether the entities observed corporate or other entity formalities, whether the entities use the same or different names, whether the entities commingle cash receipts in the same bank accounts, whether creditors were urged to rely on the separate credit of certain of the entities and did in fact so rely, whether the entities were adequately capitalized for the business conducted by each, whether particular creditors or, in the case of majority owned subsidiaries, equity holders will be prejudiced by the substantive consolidation, etc. In class presentations, one or more students will be asked to examine certain cases that discuss substantive consolidation and these factors will be analyzed in greater depth. In re Augie/Restivo Baking Company, Ltd., 860 F.2d 515 (2d Cir. 1988); Chemical Bank New York Trust Company v. Kheel, 369 F.2d 845 (2d Cir. 1966); Fish v. East, 114 F.2d 177 (10th Cir. 1940).

C. For purposes of this discussion, it is sufficient to note that a substantive consolidation can adversely affect the **certainty of payment** expected by a lender

because it may result in assets being used to repay the debts of many lenders. In the absence of a substantive consolidation, the assets of a debtor might be used to satisfy one lender on a priority basis. This priority might make repayment more likely for the preferred lender. Application of substantive consolidation also may adversely affect the **timeliness of payment**. If substantive consolidation results in a non-bankrupt subsidiary being consolidated with another entity or entities that are debtors in a bankruptcy proceeding, then the assets of the non-debtor subsidiary will become subject to the **automatic stay**. The automatic stay will prevent the subsidiary from making current payments on its outstanding debt. Keep in mind that both lenders and rating agencies consider the timeliness of payment and the certainty of payment when evaluating the credit standing of a potential borrower. In class presentations, one or more students will be asked to analyze cases that consider whether a debtor in a bankruptcy proceeding may be substantively consolidated with a non-debtor. Compare In re Circle Land and Cattle Corp., 213 B.R. 870 (Bankr. D. Kan. 1997); In re Colfor, 1997 Bankr. LEXIS 1535 (N.D. Ohio 1997); In re R.H.N. Realty Corp., 84 B.R. 356 (S.D.N.Y. 1988); In re DRW Property Co., 54 B.R. 489 (N.D. Texas 1985); In re Alpha & Omega Realty, Inc., 36 B.R. 416 (D. Idaho 1984) with In re Creditors Serv. Corp., 195 B.R. 680 (Bankr. S.D. Ohio 1996).

D. The threat of substantive consolidation is a significant factor in evaluating the strength of an asset securitization transaction. Accordingly, rating agencies typically require that a law firm render a legal opinion to the effect that, in a properly presented case, a court would not order the substantive consolidation of the SPV with other identified entities in a consolidated corporate structure. The concern is that the assets owned by the SPV be isolated from the reach of other creditors. Only the lender to the SPV should have a direct claim on the assets of the SPV. A substantive consolidation, just like a violation of one or more of the negative covenants, might subject the assets of the SPV to the claims of multiple creditors. In addition, accountants require a legal opinion to confirm that assets have been isolated from the reach of other creditors in order to give a structured financing off balance sheet treatment.

E. Of course, all this corporate structure designed to give priority to a creditor class will be of little use if the SPV or other separate legal person does not, in fact, own the assets that the lenders in the class are relying upon. There is often great concern that a particular legal person may not own the assets relied upon by a lender. This concern particularly arises in a structured financing or asset securitization transaction in which assets, such as accounts receivable, are transferred by an entity like First Tier to a newly created SPV. We turn to this problem in the next section.

IV. TRUE SALE AND CAPITAL CONTRIBUTIONS

A. A transfer of assets to a subsidiary may be accomplished either by a sale or by a contribution of assets to the subsidiary. Comstock v. Group of Institutional Investors, 335 U.S. 211, 229 (1948). The rights of a transferee of property are subject to any applicable avoidance powers recognized under the Bankruptcy Code. Otherwise, the transferee's interest in property that is transferred prior to the filing of a bankruptcy petition is defined by non-bankruptcy law. Butner v. United States, 440 U.S. 48, 55 (1979).

B. A central question to be answered in many transactions is whether the transfer of assets constituted a **true sale** of the assets or instead should be characterized as a secured loan. Courts consider a variety of factors in making this determination including: compliance with applicable law to effect a transfer, the intention of the parties, and the allocation of risks and benefits associated with ownership. In re Bevill, Bressler & Schulman Asset Management Corp., 67 B.R. 557 (D.N.J. 1986); In re OMNE Partners II, 67 B.R. 793 (Bankr. D.N.H. 1986); Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979); In re Kassuba, 562 F.2d 511 (7th Cir. 1977).

C. In summary, a separate legal person or entity provides no benefit to a financier if the assets on which the financier is relying are not owned by the separate legal entity. In setting up a financing structure, often assets must be rearranged within a consolidated group of companies. These transfers must be considered complete transfers and not security interests to be effective. The matter is of significant importance and, accordingly, rating agencies often require the delivery of legal opinions that confirm certain transfers will be considered true sales by a court in a properly presented case.