WorldCom, MCI And The Second Circuit’s Substantive Consolidation Doctrine: Asserting Creditors’ Rights In The Largest Bankruptcy Case In History – Part II

The Editor interviews Thomas Moers Mayer and Philip Bentley, Kramer Levin Nafddis & Frankel LLP. Part 1 of this interview, which appeared in the December issue, reviewed the background of the WorldCom bankruptcy and the positions taken by WorldCom and its various groups of creditors.

Editor: Would you recap for our readers the events leading up to the fight over substantive consolidation in WorldCom?

Mayer: The accounting fraud perpetrated by WorldCom prior to its bankruptcy is well known. Less well known is the drama that unfolded following the bankruptcy filing – a multi-billion dollar conflict between the creditors of WorldCom and those of its principal subsidiary, MCI. WorldCom was essentially a holding company. At the time of the bankruptcy, WorldCom owed $24 billion to bondholders and banks, but had few assets to pay those debts. MCI, in contrast, owed only $6 billion to bondholders and trade creditors, and it had more than enough assets to pay those debts in full. At least 90% of the operating value of the entire WorldCom enterprise was at MCI. In other words, most of the debt of the combined enterprise was at the parent level, and most of the value was at the subsidiary level. Not surprisingly, the MCI creditors believed that they should be paid in full before any value was given to the WorldCom creditors.

Editor: It was on this issue that the doctrine of substantive consolidation was invoked?

Bentley: Yes, WorldCom’s creditors invoked substantive consolidation to try to get around the usual rule that a subsidiary’s creditors must be paid in full before any value from the sub can be upstreamed to its corporate parent. Substantive consolidation permits the assets and debts of several related debtors to be pooled – that is, treated as if they were the assets and debts of a single entity – but only in very limited circumstances. In the Second Circuit, the Court of Appeals has ruled that substantive consolidation is permitted in only two circumstances. One is if no creditors relied on the separate identities of the various related companies. The other is if the financial affairs of the various companies are so hopelessly entangled that they cannot be separated. The MCI bondholders that Kramer Levin represented held debt that MCI had issued before it acquired MCI. So it was clear that people who bought this debt when it was issued relied on MCI’s separate identity. That served as an effective response to the first prong of the Second Circuit’s test. The main focus of the litigation, therefore, was on the second prong of the test: whether the financial affairs of WorldCom and MCI were so hopelessly entangled that they could not be pried apart.

Mayer: At the time that Kramer Levin first got involved in the case, in March of 2003, the holders of MCI senior debt were in the process of cutting their own deal with the WorldCom creditors. Their deal completely excluded our clients, the holders of MCI subordinated debt. Their settlement formed the basis for the plan that WorldCom filed in April. It called for the substantive consolidation of MCI and WorldCom, with the MCI seniors receiving 80 cents on the dollar and the MCI subordinated debt holders receiving nothing.

Bentley: We were left with no choice but to try to defeat WorldCom’s plan of reorganization through litigation. This was a tall order. WorldCom owned more than four hundred subsidiaries, and they were able to make a strong showing that the financial relations among these companies were extremely complex and probably impossible to disentangle. We therefore tried a different tack. We argued that, while it might be impossible to disentangle the finances of the four hundred different units, it was nevertheless possible to separate the finances of MCI as a whole from those of the rest of WorldCom. This exercise showed that MCI was solvent by a wide margin.

Editor: When did serious negotiations between your clients and WorldCom begin?

Mayer: The Debtors and the Committee wouldn’t even talk to us before the filing of the April 14th plan, and we had no substantive settlement discussions until late July and August. The parties were still very far from a deal by Labor Day, and negotiations continued while the parties were taking two or three depositions a day during the first week of September, with the trial less than a week away.

Editor: So people on the other side did not begin to take your clients’ position seriously until trial was around the corner?

Bentley: I think it is well known that WorldCom and its advisors took quite a hard line in these negotiations. They were formidable adversaries, and they gave little ground. We were fortunate in having clients who also had very stiff spines, and who were willing to take an equally strong line and to invest real money in a risky litigation. They were willing to stick it out to the end, and that eventually resulted in a very favorable outcome for them.

Mayer: The first real shot at a settlement came during a break in the deposition of one of our clients on Friday, September 4, three days before the start of the confirmation hearing on Monday. We thought we had a deal, but it fell apart on Saturday. On Sunday, Terry Savage of Lazard, the Debtors’ financial advisor, pulled me out of Paragon’s Sporting Goods to attend an evening meeting at Weil Gotshal, but negotiations broke down again at about 1 a.m.

Bentley: The confirmation hearing started the next day. After a few hours of preliminaries, the Debtors asked for a chambers’ conference. Judge Gonza-