**Substantive Consolidation of Corporate Group**

**in Cross-border Insolvency**

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**1. Introduction**

A corporate group is a number of companies consisting of parent and subsidiary companies. Neither the EIR nor chapter 15 define a corporate group or stipulate an insolvency process for a corporate groups’ multiple entities across multiple jurisdictions.

Systemic failure can lead to corporate group failure. Three key features that distinguish the corporate group insolvency from a standard individual insolvency are: (1) each entity in the group has its own legal status, shareholders, creditors, and assets; (2) each entity may have a unique COMI and (3) coordination between the entities is difficult.[[1]](#footnote-1)

There are essential two major approaches to achieve insolvency resolution or liquidation in the whole corporate groups consisting of multiple entities across multiple jurisdictions—procedural consolidation and substantial consolidation. Procedural consolidation is where the proceedings of insolvency of different entities are coordinated in different jurisdictions where insolvency proceedings fall into main proceeding and secondary proceeding. Procedural consolidation allows a corporate group to have a common court filing, a single set of notices, a common administrator, and joint proceedings; however, the individual legal entities can retain their separate insolvency estates and create different reorganization plans.[[2]](#footnote-2)

While procedural consolidation has successfully been applied in several major insolvencies of cross-border entities, substantive consolidation, which aims to shatter the legal barriers between the entities and treat them as one, is rarely used. In essential, substantive consolidation disregards the separation of entities and pools the assets and liabilities of different legally independent entities into a common pool and handled by a unified authority. By combining all the assets and liabilities of multiple debtors, substantive consolidation fundamentally alters the value of creditor’s claims. Among other things, it is suggested that substantive consolidation will eliminated duplicate claims for the same indebtedness, intercompany claims and cross-corporate guarantees. [[3]](#footnote-3) The benefts of substantive consolidation exist mainly in two types of cases. A typical scenario in the first group is that the debtor group is functioning as one entity, and it is in line with creditors’ expectations at the time of making lending decisions to treat a group of companies as one entity; such practice will provide a quick solution to the given cases. Another type of cases is that the assets and liabilities of the debtor group are messily entangled together and very costly to untie; therefore, it is in the interest of creditors to treat the group as one entity.[[4]](#footnote-4)

There is a split of authority as to whether substantive consolidation is appropriate contrasted with entity-focused in insolvency. This article argues that substantive consolidation, even if not improper, is not better than entity-focused insolvency in respect of insolvencies involving cross-border corporate groups.

**2. Where the Question Arises**

A successful corporate group insolvency is said to accomplish several key goals: (1) maximization of enterprise-wide value, (2) clarity and predictability in applying the law, (3) treating similarly situated creditors equally, (4) procedural fairness, (5) protection of employment, and (6) respecting the separate legal status of entities.[[5]](#footnote-5)

Some scholars have formulated ideal frameworks in light of these goals or values. The ideal way would be through a single, centralized insolvency proceeding which provides oversight to ensure that these goals are pursued effectively. A single proceeding would minimize costs, expedite the proceedings, provide a single forum for comparison of relevant options, discourage individual parties-in-interest from taking action beneficial to them but suboptimal for the entire corporate group, and ensure cooperation among all the parties.[[6]](#footnote-6) In practice, substantive consolidation is only applied in extreme cases, including situations where one subsidiary’s veil needs to be lifted or where assets of one corporate group are tightly intertwined which makes it costly to divide them into respective companies

Just like the long lasting diametrically opposed approaches to cross-border insolvencies—universalism and territorialism, these two approaches have their reflection in the field of cross-border groups insolvencies: treating the entities of one corporate group as one entity or respecting the separate legal entities.

**3. Conceptualization of Corporate Groups**

UNCITRAL explains that the term “enterprise group” covers various forms of economic organizations that are treats a single entity but composed of two or more legal entities linked together by direct or indirect ownership.[[7]](#footnote-7) There are many different forms of enterprise groups or corporate groups. Structural flexibility benefits the corporate group by allowing for the allocation of risk and reduction of cost of capital through the leverage effect.

In the area of cross-border insolvency law, the newly released EU Regulation on insolvency proceedings recast (EIR recast) provides a definition of groups of companies by using control as a benchmark. Its definition is as follows: (13) ‘group of companies’ means a parent undertaking and all its subsidiary undertakings; (14) ‘parent undertaking’ means an undertaking which controls, either directly or indirectly, one or more subsidiary undertakings. An undertaking which prepares consolidated financial statements in accordance with Directive 2013/34/EU of the European Parliament and of the Council (1) shall be deemed to be a parent undertaking.[[8]](#footnote-8)

For the sense of insolvency, risk allocation and the structural flexibility can mitigate the likelihood of corporate group insolvency. If all or part of the entities of the group are insolvent, opening of separate proceedings with independent administrator leads to the disintegration of business and ultimately a decrease in the returns to the creditors.

However, there are problems which are impossible to overcome and unfair situations will arise if substantive consolidation is used to obtain fairness in favor of all creditors. Dismantling the pre-established legal separateness may not offer an effective solution while bringing other problems.

**4. Problems of Cross-border Substantive Consolidation**

**4.1 Problem One: COMI of Corporate Group**

At the first place, COMI, though well established in the world of cross-border insolvency, is a concept dependent of circumstances. The E.U. and the U.S. have different approaches to COMI. The E.U. focuses on formal registration, whereas the U.S. focuses on the head office test.[[9]](#footnote-9)

There is no concept such a corporate group COMI and each entities have its own COMI. Therefore, the double hindrances of COMI, COMI concept itself and lack of group COMI concept, make it too extremely difficult, if not impossible, to frame a unified rule for determining corporate group COMI. When people attempt to decide COMI of a corporate group, it is quite possible that they forget when the corporate group design the group structure, the designer had allocated different COMI to different entities. [[10]](#footnote-10)

EIR Article dictates that the COMI is the place of registration which is a rebuttable presumption. Corporate groups may strategically migrate their COMI for more advantageous insolvency law. However, there is no data to demonstrate whether creditors, particularly of the largest corporate groups, are truly confused as to with which member of the group they are dealing. That is to say, the creditors such as trading partners are not unaware of the COMI of the specific group member with which they are having business. Thus, when the insolvency courts attempt to regard the all the group members as a single entity and artificially identify a united COMI for this entity, they are not only distorting the original intent of the group but also misread the comprehension of the creditors at the time doing business with group members.

**4.2 Problem Two: Piercing Cross-border Corporate Veil**

Substantive consolidation disregards distinctions between parent companies, subsidiaries and affiliates that operate together as a corporate group. Furthermore, it will allow courts to dissolve and combine the assets and liabilities of all or a portion of the entities within a corporate family, so that all assets and liabilities are actually pooled together into a single entity. Though there are subtle differences between substantive consolidation and piercing corporate veil, for the purpose of insolvency, they are quite similar or share common rationale.

It is noteworthy that even under domestic law, piercing corporate veil is an exception of separate identity of legal persons. It is well-established that a company has independent legal status; the limited liability and legal personality are core features of companies which generate economic efficiency by lowering the costs of doing business. It is not advisable to dismantle the core ground of commercial law only for the purpose of convenience and facilitation of insolvency practice.

At the same time, it is extremely difficult to pierce the veils of foreign entities. For instance, choosing the appropriate governing law for deciding whether or not to pierce the veils will make the complex cross-border insolvency more complex.

One may argue that the rules in respect of piercing corporate veil share common features, such as (1) the shareholder dominated and controlled the corporation to such a degree that the corporation did not have an independent existence and shareholders were the alter egos of the corporation; (2) the corporate form was used fraudulently or for an improper purpose; and (3) this fraudulent or improper use of the corporate form caused injury to creditors.

However, even if the rules for piercing veils between insolvency proceeding jurisdiction and alter-ego entity jurisdiction are the same, which is doubtful, it is hard for the foreign court to recognize the insolvency court’s decision which denies the legal person identity of an enterprise which was registered in this foreign jurisdiction.

**4.3 Problem Three: Substantive Consolidation of Nondebtor Entities**

The biggest unfairness scenario arising from substantial consolidation is the consolidation of debtor entities and nondebtor entities. One can at first grant cast doubt on substantive consolidation by asking why a solvent legally separate entity shall be regarded as insolvent together with other legally separate entities. In the more difficult scenario, this question becomes more challenging when the solvent entities and insolvent entities are registered and have operation in various jurisdictions. Even they can be seen as members of the same corporate group, it is at odd that insolvency law announce they are regarded a single entity while company laws of different jurisdictions stipulate they are independent of each other in the sense of legal personality.

In the U.S., though it is uncontroversial that the bankruptcy courts have authority approving substantive consolidation under Section 105(a) of the Bankruptcy Code which provides that a court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the Bankruptcy Code. However, because forcing creditors of one entity to share equally with creditors of a less solvent debtor is not appropriate in many circumstances, courts generally hold that substantive consolidation is to be used sparingly and have labeled it an extraordinary remedy.[[11]](#footnote-11)

In *In re Pearlman*, when ruling against substantive consolidation of debtors and nonbebtors, the Folorida bankruptcy court reasoned that allowing the substantive consolidation of debtors with nondebtor entities would circumvent “the procedures laid out in the Bankruptcy Code for involuntary bankruptcies. Section 303 provides strict requirements for when and how an unwilling party can be placed into bankruptcy. [F]orcing a non-debtor into bankruptcy via substantive consolidation,” the court observed, circumvents these strict requirements and is in contravention of" the Bankruptcy Code. The court concluded that it would be outside the scope of section 105’s grant of authority for a bankruptcy court to circumvent such statutory provisions.

**4.4 Problem Four: Practical Difficulty in Cross-border Enforcement**

Let us come back to the real world. The U.S. is the only jurisdiction which has explicit provisions via case law with respect to cross-border substantive consolidation. But U.S. courts have consolidated entities on limited occasions. In re Owens-Corning set the standard for substantive consolidation. However, it is a rare tool used only when the legal separateness of the entities was a mere formality. Under these circumstances, the assets and liabilities are intertwined so much that creditors recognized no borders between the entities and it does not benefit them to respect the separateness of the entities.[[12]](#footnote-12) Therefore, it seems that even in the U.S. substantive consolidation is an exception rather than a principle.

Enforcement of the U.S. judgments in foreign courts is another question. In rejecting the recognition of a U.S. judgment, the English Supreme Court noted that there was no basis in English law to enforce the foreign law upon third parties while emphasizing that the Model Law does not extend enforcing judgments on third parties *in personam*.[[13]](#footnote-13) In *Re Polly Peck International plc*, where the administrator requested substantive consolidation, the UK court showed reluctance to apply substantive consolidation and the court denied the argument that one Special Purpose Vehicle (SPV) subsidiary is just the façade of the given company and thereby should be substantively consolidated. The UK court insisted that using SPVs solely for the purpose of finance is common practice, even if creditors are harmed by group structures. There is no necessity to transplant the concept of substantive consolidation to UK case law.[[14]](#footnote-14)

Substantive consolidation is arguably a proceeding involving multiple third parties. Thus, it seems that it cannot find the existing legal ground in the English law and continental jurisdictions. The EIR Recast contains cooperation and communication duties for insolvency practitioners and courts involved in insolvency proceedings of group companies and the possibility to open group coordination proceedings in which a coordinator shall propose a group coordination plan setting out an integrated approach to the resolution of the group member’s insolvencies. However, it should be noted that this plan shall *not* include recommendations as to any consolidation of proceedings or insolvency estates though it is also argued that the EIR does not prohibit all forms of procedural consolidation.

**5. Conclusion**

To summarize, although substantive consolidation has theoretic advantages such as minimizing transaction and insolvency costs and practical applications within the U.S., generally it is not justifiably reasonable or advisable in the worldwide real-world cross-border insolvency. In contrast, if the concept and application of procedural consolidation are expanded and widely accepted by major economics and insolvency jurisdictions, the cross-border insolvency practice can be enhanced to a high level.

In fact, in most scenarios of transnational insolvencies, procedural consolidation, i.e. consolidating the procedural aspect of the insolvency rather than the actual entities, is not only the necessary but also sufficient mechanism to facilitate the insolvency process.

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7. See http://www.uncitral. org/pdf/english/texts/insolven/Leg-Guide-Insol-Part3-ebook-E.pdf. [↑](#footnote-ref-7)
8. EIR recast, Art. 2. [↑](#footnote-ref-8)
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