AUTHOR STATEMENT

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DECLARATION OF HONOUR

I declare that the paper, entitled "Never? Or Hardly Ever? Is Substantive Consolidation Ever Appropriate in a Multi-Entity, Multi-Jurisdictional Restructuring/Insolvency?" is my own work, that has been prepared independently and that all references to, or quotations from, the work of others are fully and correctly cited.

Signed: Rosalind Nicholson

9 February 2022

"What, never?"
"No, never!"
"What, *never?*"
"Well, hardly ever!"

Act I, *H.M.S. Pinafore*[1]

NEVER? OR HARDLY EVER? IS SUBSTANTIVE CONSOLIDATION EVER APPROPRIATE IN A MULTI-ENTITY, MULTI-JURISDICTIONAL RESTRUCTURING/INSOLVENCY?

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Introduction

This short paper looks at whether substantive consolidation is ever appropriate in a multi-entity, multi-jurisdictional restructuring/insolvency. In exploring the question, it first looks at the what, why and when of substantive consolidation in the domestic context: what substantive consolidation is, and what it is not, why substantive consolidation might be considered as an option and when the Courts have concluded that it is appropriate. It then looks at the question in the international, multijurisdictional context and the particular issues which arise there and concludes with a consideration of whether substantive consolidation is better or worse than an entity-focused insolvency/restructuring.

[1] *H.M.S. Pinafore; or, The Lass That Loved a Sailor,* libretto by W. S. Gilbert, music by Arthur Sullivan Capt. Corcoran

I. WHAT?

Part I of this paper looks at both terminology and substance: what is "substantive consolidation", properly so called, and how does it differ, if it does differ, from other concepts such as deemed substantive consolidation, pooling and "piercing the corporate veil".

Commentators looking at substantive consolidation do not always use the term consistently, something which is capable of causing a degree of confusion. In its strictest sense, substantive consolidation, a US term in its origins, merges the debtors involved into one entity for the purposes of the bankruptcy cases, effectively combining the assets and liabilities of each estate, and creating a single source from which the claims of all creditors will be satisfied[2]. The creditors of the previously distinct subsidiaries are creditors of a single debtor (Brasher 2006).

Used in this sense, substantive consolidation is akin to the merger of two corporations creating “a single debtor, a single estate with a common fund of assets and a single body of creditors” in the place of multiple debtors[3], “each with its own estate and body of creditors.”[4] (Singerman 2005). The debtor entities are consolidated such that: (1) liabilities and assets are combined; (2) liabilities of the combined entities are satisfied from the assets of the combined entities; (3) distribution priorities are combined; (4) intercompany obligations are eliminated; and, in a chapter 11 setting, (5) creditors are combined for purposes of voting to confirm a plan (Markell, 2017).

However, the term is also frequently used to describe the case where separate legal entities are *treated* "*as if they were merged* into a single [entity] left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased)[5]. The result is that claims of creditors against separate debtors morph to claims against the consolidated Survivor”[6] (emphasis added). In this sense, the term substantive consolidation is similar to "pooling", a term commonly used in England and Wales, and elsewhere in the Commonwealth to describe the case where the assets of separate debtors are pooled and their liabilities treated *as if* they

[2] *In the Matter of Stuery*, 94 B.R. 553 (Bankr. N.D. Ind. 1988).
[3] The scope of this short paper does not allow a consideration of the question whether substantive consolidation may be used where some of the entities within the enterprise are not insolvent.
[4] *In re Parkway Calabasas*, 89 B.R. 832, 836-37 (Bankr. C.D. Cal. 1988) Cited in (Singerman 2005)
[5] See eg (Harlang 2015)
[6] *In re Owens Corning*, 419 F.3d 195, 205 (3d Cir. 2005) quoting *Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.*), 402 F.3d 416, 423 (3d Cir. 2005)). Cited in (Markell 2017)

were incurred by a single entity (Amera 2006). This is the sense in which Uncitral defines the term[7].

In this sense, whilst the term is most usually applied, and most often defined as involving individual members of a corporate group[8], where "the assets of individual members of a corporate group are pooled and intragroup debts forgiven so that claims of third-party creditors may be satisfied from a single common source during a bankruptcy proceeding" (Widen 2007), it is not confined to the corporate context[9] or to the case where there is a multi-entity corporate group or enterprise.

In this short paper, save where otherwise indicated, the term "substantive consolidation" is taken to mean substantive consolidation in the strict sense: that is, where the separate entities are merged, intercompany liabilities extinguished and assets and liabilities pooled. It is also used to refer exclusively to a non-consensual and Court mandated consolidation. With the express and informed consent of all stakeholders[10], a general consolidation between entities is, of course, possible. A substantive consolidation, or an outcome to the same effect, is also possible via separate schemes of arrangement under English law, and elsewhere where similar legislation exists, with the consent of a majority in number representing 75% in value of the creditors of each of the entities to be consolidated and the sanction of the Court. However, none of these consensual arrangements form part of the consideration of this piece.

II. WHAT NOT?

Whilst substantive consolidation is similar to a piercing of the corporate veil, in that the separate legal personality of the constituent companies is dissolved or treated as dissolved, piercing the veil looks in only one direction (Brasher 2006)[11]: going behind the corporate form

[7] Uncitral defines substantive consolidation as a remedy which "permits the court, in insolvency proceedings involving two or more enterprise group members, to disregard the separate identity of each group member in appropriate circumstances and consolidate their assets and liabilities, treating them as though held and incurred by a single entity. The assets are thus treated as if they were part of a single estate for the general benefit of all creditors of the consolidated group members." (Uncitral 2012, 105)

[8] Though noting that the Uncitral definition of substantive consolidation refers only to "insolvency proceedings involving two or more enterprise group members"

[9] The corporate context is the context against which this paper is written. However, substantive consolidation is not confined to the purely corporate context. *In re Felix,* 572 B.R. 892 (Bankr. S.D. Ohio 2017) an Ohio bankruptcy Court made an order substantively consolidating limited liability companies with two individuals in their chapter 7 bankruptcy case. Cited Ferretti, T. M. (2018, June 8). "Jagged Little Pill": Substantive Consolidation in Health Care Insolvencies. *American Health Lawyers Association Weekly*.

[10] Including any in-the-money members

[11] And see also *In re Owens Corning*, Ibid. Note 6 supra. which also uses directional language in describing the effect of substantive pooling as against that of piercing the corporate veil

to attach liability to its immediate or ultimate beneficial owners. Substantive consolidation, by contrast, not only allows the creditors to look to the shareholders of an entity, but goes further and allows the consolidation not only of parent and subsidiary, but between affiliates at different levels within a group[12]. In this, substantive consolidation goes much further than piercing the corporate veil: and as such, has been described variously as *"the most dramatic and far-reaching exception to corporate separateness*" (Graulich 2006) and as an "*extreme remedy*" (Kothari and Bansal 2019), terms which are suggestive of the rarity with which the remedy is in practice prescribed.

It will be clear from the foregoing that substantive consolidation is not analogous to procedural consolidation. Procedural consolidation, where the proceedings in insolvency of different entities are coordinated, even if before different judicial or adjudicating authorities, has a long history having been approved in England and Wales at least as long ago as November 1893[13]. Procedural consolidation and administrative consolidation, where the same insolvency professional is appointed to administer the insolvent estates of two or more entities often makes practical and financial good sense where a number of entities within a corporate structure are insolvent and the subject of simultaneous insolvent administration (Kothari and Bansal 2019). It makes particular sense where, commonly for reasons to do with the place of incorporation rather than the place where the business has been done and liabilities incurred, the different entities are being administered in insolvency in different states within the same country[14] or region with cross jurisdictional assets and liabilities. Both procedural consolidation and administrative consolidation will often represent a material saving in legal and administrative costs, a reduction of delay, and a better outcome for creditors. However, procedural consolidation maintains the integrity of the separate corporate entities, their assets and liabilities in a way in which substantive consolidation does not.

III. WHY?

Given the extreme[15] nature of the remedy, the next enquiry, logically, would be why substantive consolidation ever arises for consideration? The first factor, the background, if you

[12] *In re Owens Corning* Note 6 supra "Each of these remedies has subtle differences.. "Piercing the corporate veil" makes shareholders liable for corporate wrongs…Substantive consolidation goes in a direction different (and in most cases further) than any of these remedies; it is not limited to shareholders, it affects distribution to innocent creditors, and it mandates more than the return of specific assets to the predecessor owner. It brings all the assets of a group of entities into a single survivor. Indeed, it merges liabilities as well. "

[13] By Vaughan Williams J in *Re Abbott* reported at [1894] 1 QB 442

[14] For example, in Brazil see (Stefan Sax 2018)

[15] The word used by (Kothari and Bansal 2019)

will, is the increasing use of multi-entity interrelated corporate structures for business, strategic, and taxation purposes, in both emerging and developed markets[16]. This trend obviously multiplies the occasions on which the affairs of corporate groups fall to be considered and inevitably, the occasions on which a corporate member or members of such a group finds itself facing insolvency. However, that factor alone is plainly not enough. Although some commentators have questioned whether the rule in *Salomon v Salomon*[17], the doctrine of separate corporate personality, should apply where the protection which it allows is not that of the ultimate investor from the debts of the enterprise, but the protection of corporate tiers of an enterprise group, and of a corporate parent from liability for the obligations of its subsidiaries[18], the doctrine of separate corporate personality generally continues to be considered critical, even in the modern environment[19].

The starting point in the search for the answer to this question, "why?", is to bear in mind that substantive consolidation is a *remedy*, and, at least in its origin, an equitable remedy[20] applied by the Court where the application of strict legal principles would serve perpetuate a wrong. The answer to the "why?" therefore lies in an examination of the wrongs for which substantive consolidation may provide a remedy.

Analysed in that way, in terms of the wrong for which substantive consolidation may be a remedy, it will be apparent that something more is required than the existence of a tiered corporate structure, even one where there is a high degree of integration of the operations and affairs of the members of the group through ownership or control[21], or the existence of intra-group loans and cross-guarantees on loans (a function of modern lending practices), or of consolidated financial statements for the group[22]. Nor, the cases show, is it sufficient simply that substantive consolidation may achieve a better result for the individual debtor or for the

[16] (Uncitral 2012)
[17] *Aron Salomon (Pauper) v A. Salomon And Company, Limited* [1897] AC 22.
[18] (Blumberg 1986) , amongst others.
[19] For example, see (Lipton 2018) and see also (The World Bank Group 2016) C16.3. Armour, Hansmann and Kraakman describe limited liability as one of the five 'core structural characteristics of the business corporation': (Armour and Hansmann 2009) 1, 5.
[20] See (Archbold 9th Edition 1842) page 456 and *Re Kriegel, Waring & Co; Ex Parte Trotm*an (1893) 68 LT 588
[21] (Uncitral 2012) para 106
[22] Factors listed, amongst others, in (Uncitral 2012) as having been identified as relevant to determining whether or not substantive consolidation is warranted, both in the legislation that authorizes substantive consolidation orders and in those cases where the courts have played a role in their development ((Uncitral 2012) para. 112) albeit with the caveat that no single element is necessarily conclusive. Uncitral itself, in paragraph 98 of the Guide, agrees that, generally, the mere incidence of control or domination of a group member by another group member, or other form of close economic integration within an enterprise group, is not regarded as sufficient reason to justify disregarding the separate legal personality of each group member and piercing the corporate veil.

group collectively or for creditors. Rather, what is required is something which goes beyond mere incidentals to the existence and operations of a corporate group and which, left unaddressed, and strict legal principles applied, would result in an injury to the interests of the creditors, or some group of creditors, which it is unconscionable to permit.

Although not always expressed in precisely these terms, there is support to be drawn for this approach in the cases, to which we now turn in asking when the Courts have considered substantive consolidation appropriate.

IV. WHEN?

So when have the Courts[23] thought it appropriate to order substantive consolidation? The general answer to this question appears to be "rarely". In the US, *"there appears to be nearly unanimous consensus that it is a remedy to be used "'sparingly."*[24]. Even in China, where there is a statutory basis for substantive consolidation, the Supreme Court of the Peoples Republic ("SPC") has directed that substantive consolidation should only be used in exceptional circumstances[25].

It is worth emphasising in undertaking this part of the enquiry that as an equitable remedy, there is no checklist of factors which the Courts tick off in turn in determining whether an order for substantive consolidation is or is not appropriate in the particular case, each factor having similar weight[26]. Rather, the Courts adopt a principled approach, identifying the harm for which an order of substantive consolidation may supply a remedy[27], and determining whether the exercise of the equitable jurisdiction will in the particular circumstances of the case lead to an equitable result[28].

The cases suggest that there are two principal[29] circumstances where the Court will consider making a substantive consolidation order. Both require that there are two or more affiliated

[23] It is beyond the scope if this short paper to conduct an exhaustive review of all decisions made on this subject. However, a review of the secondary materials listed in the bibliography and of the cases referred to, does support the propositions which this paper suggests.
[24] *In re Owens Corning*, Ibid. Note 6 supra.; see also *In re Augie/Restivo Baking Co. Ltd*., 860 F.2d 515 518 (2d Cir. 1988)
[25] 2018 SPC Meeting Minutes referred to in (Nuo Ji 2021)
[26] See *In re Owens Corning* Ibid. Note 6 supra
[27] Mere benefit to the administration of the case therefore not qualifying as a "harm" for this purpose – *Re Owens Corning* Ibid. Note 6 supra
[28] *In re Owens Corning* Ibid. Note 6 supra
[29] As an equitable remedy, the cases in which it may be applied are not closed and there may be other circumstances where the Court considers that the remedy is justified. The two cases identified here are the two identified in *Owens Corning* but support for the identification these two cases as those in which

entities whose affairs have been intermingled. However, it is not sufficient merely that the enterprises share common control or ownership, nor even that the same people have the capacity ultimately to determine the operating and financial policies of an enterprise[30]. These factors merely define the nature of a group. What the cases show is that there needs to have been an intermingling of the assets and liabilities of the separate entities to such a degree that the estates have become so blended that it is impracticable on insolvency to separate them[31]. Impracticability in this context contemplates not merely that the task is a difficult one but that the estates would be substantially dissipated if an attempt were made to proceed with the several liquidations separately[32]. Such commingling will commonly have been a result of a failure on the part of the separate enterprises, or those controlling them, themselves to have treated the entities as separate, or distinguished them as such in their dealings with creditors and others: in effect, the separate enterprises have been operated, whether as a result of a lack of care, deliberately or as part of a scheme of fraud, as if they were a single business unit[33]: as the Court neatly put it in Re Owens Corning[34] "*corporate disregard as a fault, may lead to corporate disregard as a remedy*". In such circumstances, too, it is possible to see that equity might in some conditions require that the separate enterprises be treated as one in the context of the liquidation of their affairs and this is the second of the cases where the authorities suggest substantive consolidation may in an appropriate case be a remedy[35].

To be added to these two cases, perhaps, is that where the separate entities have been used as part of a fraudulent scheme or activity with no business purpose[36] or to deceive creditors[37]

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an order will be considered is also available from wider authority, including the English and Scottish authorities cited below.

[30] The definition of an "Enterprise Group" suggested in the Model Law on Enterprise Group Insolvency with Guide to Enactment (2019) (Uncitral 2019)

[31] *Re Bulwer; Ex Parte Sheppard* (1833) Mon and B 415. *Re Kriegel, Waring & Co; Ex Parte Trotman* Note 20 supra.; *Taylor v Morris* [1993] BCLC 1343*; Bank of Credit and Commerce International SA* (No 3) [1993] BCLC 1490 approving *Re Bank of Credit and Commerce International SA (No 3)* [1993] BCLC 106.

[32] *Re Kriegel, Waring & Co; Ex Parte Trotman* Ibid. Note 31 supra. *In re Augie/Restivo Baking Co., Ltd.*, Ibid. Note 24 supra.

[33] (Harlang 2015)

[34] 419 F.3d 195, 205 (3d Cir. 2005)

[35] *In James Talcott, Inc. v. Wharton (In re Continental Vending Machine Corp.)* 517 F.2d 997 (2d Cir. 1975). "The power to consolidate is one arising out of equity, enabling a bankruptcy court to disregard separate corporate entities, to pierce their corporate veils in the usual metaphor, in order to reach assets for the satisfaction of debts of a related corporation. While it does not require that the creditors knowingly deal with the corporations as a unit, *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966), it should nevertheless be "used sparingly" because of the possibility of unfair treatment of creditors who have dealt solely with the corporation having a surplus as opposed to those who have dealt with the related entities with deficiencies."

[36] As posited by the World Bank Group as one of the two cases where substantive consolidation would be justified (The World Bank Group 2016)

[37] This is one of the circumstances in which Uncitral, in its Legislative Guide to Insolvency Law Part Three: Treatment of Enterprise Groups in Insolvency proposes that provision for substantive consolidation should be made. See also (Renssen 2017)

However, the exercise of an equitable jurisdiction requires a balancing of factors and, even where there has been a significant intermingling of affairs and a myriad of intercorporate transactions[38] require untangling, where substantive consolidation would prejudice, unfairly, a creditor or group of creditors, the Court may decline to make such an order[39]. This last factor perhaps explains the rarity with which substantive consolidation orders are made. It also explains why the Court will not, ipso facto, treat a resolution of creditors as determinative of the question where the interests of others may be negatively affected[40]. In balancing the equities, the Court will look to balance the benefits that substantive consolidation would bring against the harms it would cause[41] and see that the potential harm to creditors which may result from substantive consolidation is balanced against the harm which will occur in its absence (Singerman 2005).

V. BETTER?

This analysis suggests that, where substantive consolidation is ordered it will be ordered because the outcome is, in the broadest sense, "better" than the alternative, that is, a restructuring/insolvency on an entity by entity basis.

Some commentators now suggest that "entity law" in the process of erosion[42] and that "[*L]imited liability has been carried unthinkingly beyond the original objective of insulating the ultimate investor from the debts of the enterprise. Limited liability now enables a corporate group organized in tiers of companies to insulate each corporate tier of the group, and thus, achieve layers of insulation for the parent corporation from liability for the obligations of its numerous subsidiaries. In light of recent environmental disasters of worldwide dimensions, re-examination of the traditional doctrine of limited liability as applied to corporate groups has emerged as an issue of major importance* (Blumberg 1986). It is beyond the scope of this short paper, sadly, to debate the continuing merits of the limited liability model as against an enterprise group model in general although it is clear that the Courts in England and Wales and the USA (and, it seems, Australia[43]) continue to respect the doctrine of separate corporate

[38] *Re Flora Mir Candy Corp* 432 F.2d 1060 (2nd Cir. 1970) cited in (Singerman 2005)
[39] *In Re Continental Vending Machine Corp*. 517 F.2d 997; *In re Flora Mir Candy Corp* Ibid.Note 38 supra.
[40] *Re Higton; ex parte Strutt* (1821) 1 Gl and J 29; *Re Hope; Ex parte Part* (1832) 2 Deac and Ch 1; *Re Trix Ltd; Re Ewart Holdings Ltd* [1970] 3 All ER 397
[41] *Re Bonham*, 229 F.3d 750 (9th Cir. 2000) at 765
[42] *PI Blumberg et al. Eds Blumberg on corporate groups Vol I, 2005, s3.02* cited in (Vette January 2011)
[43] See (Scott Atkins 2021)

personality as the "fundamental ground rule"[44]. Rather, in practice, the better question is not whether substantive consolidation is better or worse in a general sense, but whether it is better or worse, in a comparative sense, in the specific circumstances of the particular case.

There is, in many cases, a good case to be made that a consolidated treatment of a multi-national multi-entity group would indeed be better than several treatment on an entity by entity basis across jurisdictions. Sandeep Gopalan and Michael Guihot (Guihot 2016) give a number of examples including, most recently, Stanford International Bank, Lehman Brothers and Bear Sterns. However, many of the issues presented by the entity based model can be resolved, not by *substantive* consolidation, but by procedural or administrative consolidation: for example, administrative consolidation, which sees the same insolvency practitioner appointed across an enterprise is capable of resolving any information barriers across the different entities. It also, almost certainly, represents a significant saving in costs. Similarly, a joint appointment would potentially facilitate a sale or restructuring of a business in circumstances where assets are held by different entities across a group: for example, patents, licenses, databases, machinery, real estate[45].

Substantive consolidation, on the other hand, will be "better" in a particular case only in rare cases, those featuring what the Court in *Owens Corning* called "the nearly "perfect storm" needed to invoke it". In those cases, as identified above, then substantive consolidation will be "better" than an entity by entity approach: either because the entity based approach would require substantially all the available assets to be consumed in the attempt accurately to identify and attribute them and the liabilities or because the manner in which, pre-bankruptcy, the group has conducted its affairs means that an injustice would be perpetrated if, post-bankruptcy, the strict legal division of assets and liabilities were to be insisted upon.

VI. WHERE?

So far, this short paper has looked at substantive consolidation only in the domestic context, where the affiliated entities are situated within the same jurisdiction. It now turns to look at the cross-border and multi-national context.

Although court sanctioned "pooling" orders, where the assets and liabilities of two or more entitles are combined and inter-entity liabilities subordinated, discounted or written off, have

[44] (Kors 1998) cited and adopted in *In re Owens Corning* Note 6 supra.
[45] (Kokorin 2021)

historically been successfully implemented across borders, it is unsurprising, perhaps, given the rarity of substantive consolidation in the domestic context, that such orders are rarer still in the cross-border context. Indeed, it is a struggle to find a single example.

The added difficulties in the multi-jurisdictional context are obvious. Assets are likely to be in different countries; the claims of creditors, secured and unsecured, are likely to be governed by different laws; the entities themselves may be subject to different substantive and regulatory regimes which may affect creditor priorities; local courts may be required by local law to give priority to local creditors; the available forms of administration in insolvency may be different and may conflict; there may be wider – or narrower- or just different, clawback or transaction avoidance possibilities amongst the jurisdictions; creditors may have dealt with a particular entity because of its place of incorporation with the concomitant expectation of the regime under which it may be wound up. An attempt to consolidate may mean that there is a choice to be made of the location of the single insolvency administration: that choice may result in creditors not local to that jurisdiction having, or perceiving themselves to have, diminished involvement or representation in the winding up[46].

Accordingly, whilst the arguments in favour of a substantive consolidation in a multi-jurisdictional, multi-entity insolvency/restructuring will be the same as those in the domestic context, all these factors, and others similar, mean that the incidence of substantive consolidation across borders – at least in the absence of a global acceptance of universalism and legislation to match - will be very rare. Indeed, it is striking that whilst endorsing domestic legislation to provide for substantive consolidation in its Legislative Guide on Insolvency Law, Uncitral itself does not advocate for a cross-border model.

VII. CONCLUSION

So, is substantive consolidation ever appropriate in a multi-entity, multi-jurisdictional restructuring/insolvency? "Appropriate" is, of course, not the same as "desirable": it necessarily imports the question of practicality, and it is the practicalities associated with a cross-jurisdictional substantive consolidation which render it essentially impracticable, at least in the territorialist world in which we currently operate, for an order for substantive consolidation to be made. So, whilst, with Captain Corcoran's musical Crew in HMS Pinafore,

[46] (Mevorach 2005) Although this factor has, perhaps, been superseded by the experience of the Covid-19 Pandemic

we may hesitate before accept an absolute "Never", substantive consolidation is currently, if not a never, then certainly a "hardly ever".

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