The Applications and Limitations of
Substantive Consolidation in Multi-entity, Multi-jurisdictional Insolvencies

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I. Introduction

This short paper analyses whether substantive consolidation is ever appropriate in a multi-entity, multi-jurisdictional restructuring / insolvency. The paper addresses the pros and cons of substantive consolidation, as compared to an entity-focused restructuring.

The business of corporations is increasingly conducted through complex groups of legally separate enterprises that are interconnected by common control or ownership. It has become more and more common for these "enterprise groups" to include entities domiciled across various jurisdictions. As enterprise groups have grown in size and multi-jurisdictional complexity, insolvency practitioners and legislators have developed frameworks to facilitate efficient administration of these complex restructurings.

The question of whether substantive consolidation is better or worse than an entity-focused insolvency depends entirely on how, and from whose perspective, one views the outcome of the different processes. Whether in the United States or abroad, the question of whether to substantively consolidate a group of entities during a bankruptcy or restructuring requires a fact intensive analysis. Depending on the circumstances, consolidation could benefit all creditors, it could benefit only one particular creditor, or it could benefit only the debtors. Other potential beneficiaries of consolidation are the court and the restructuring professionals handling the case, as substantive consolidation may lead to a more efficient restructuring process. In short, the answer to this question depends on the facts and circumstances of each particular case. The number of entities at issue, and any multi-jurisdictional considerations are just additional factors to be considered. Ultimately, enterprise group solutions can be achieved where parties are willing to work collectively and think creatively. But solutions should not be mandated or court ordered when creditors' rights are prejudiced.

II. Group Solutions in Insolvency Law

Various legal principals and practical tools are available to insolvency practitioners to achieve group focused solutions for insolvent enterprise groups. They include formal procedural consolidation or less formal mechanisms that allow for enhanced procedural coordination, including options to utilize the same insolvency practitioner, consolidate proceedings in the same court, or in certain jurisdictions, the ability to open special group coordination proceedings.[1] The

[1] Law to Facilitate the Management of Group Insolvencies, April 13, 2017, Federal Law Gazette Volume 2017 Part I No. 22, issued on April 21, 2017, p 866.

goal of these group solutions are to optimize realization of the debtors' assets on an entity-by-entity basis, while preserving individual creditor's property and contractual rights.

Substantive consolidation, i.e. the pooling of assets and liabilities of several companies into one single legal entity, is an entirely different type of group solution. It is often considered the most extreme. This paper focuses on the issue of substantive consolidation. While only available in certain jurisdictions, and applied differently in each, courts around the world agree that because of potential consequences to creditors, substantive consolidation should only be utilized where no creditors are harmed, or all creditors consent to their proposed treatment. The interests of a majority of creditors cannot trump the interests of individual creditors.

III. Substantive Consolidation in the United States

Under US law, substantive consolidation is an equitable remedy pursuant to which a bankruptcy court disregards the separate legal existence of a debtor, and pools the assets and liabilities of that debtor with one or more of its affiliates, such that the debtors' estates are treated as one consolidated entity for purposes of the bankruptcy proceedings. In substantive consolidation, "[t]he intercompany claims of the debtor companies are eliminated, the assets of all debtors are treated as common assets and claims of outside creditors against any of the debtors are treated as against the common fund."[2]

The US Bankruptcy Code does not provide any statutory authorization for substantive consolidation. Instead, substantive consolidation under the Bankruptcy Code is a judicially created doctrine arising from the general equitable powers granted to Bankruptcy Courts by virtue of Section 105(a) of the Bankruptcy Code.[3] Given that the power to order substantive consolidation derives from the equity jurisdiction of the Bankruptcy Court, decisions are made on a case-by-case basis and typically reflect a fact intensive analysis by the Bankruptcy Court of the particular factual circumstances relevant not only to how the debtor operated vis a vis its affiliates, but also to how the debtors presented themselves to and transacted business with their creditors. A court's inquiry will require a thorough examination of the structures of the entities proposed to be consolidated, and their intercompany respective creditor and third party relationships. Since substantive consolidation is an equitable remedy, the Bankruptcy Court also will examine the

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[2] In re Augie/Restivo Baking Co. Ltd., 860 F.2d 515, 518 (2d Cir. 1988).
[3] 11 U.S.C. § 105.

impact consolidation would have upon each of the debtors' creditors, if consolidated. The Bankruptcy Court will closely scrutinize whether any particular creditor or group of creditors would be unfairly prejudiced by substantive consolidation.

In a bankruptcy proceeding, either a debtor or a creditor may file an application for substantive consolidation. The written decisions addressing such requests reflect judicial recognition that substantive consolidation is an extraordinary remedy, which affects substantive rights. Bankruptcy Courts have found that "because every entity is likely to have a different debt-to-asset ratio, consolidation almost invariably redistributes wealth among creditors of the various entities. . . This problem is compounded by the fact that liabilities of consolidated entities *inter se* are extinguished by the consolidation."[4] As a result, Bankruptcy Courts have characterized substantive consolidation a remedy "that should be used "sparingly."[5]

The United States Supreme Court has long recognized the equitable doctrine of substantive consolidation. In *Sampsell v. Imperial Paper & Color Corp.*, the Supreme Court substantively consolidated the bankruptcy estate of an individual bankrupt with a nondebtor corporation using veil-piercing-type theories.[6] In the years since the *Sampsell* decision, Bankruptcy Courts have ordered substantive consolidation where the proponent thereof has demonstrated either (i) a substantial harm to be avoided or (ii) a substantial benefit to be effected generally which, under the circumstances and considering whether the rights of third parties would be unduly prejudiced thereby, it is equitable to avoid or effect. Circumstances where substantive consolidation has been effected include situations where it was proved that one or more entities was a "mere instrumentality" or "alter ego" of another entity. This has occurred in a variety of different fact patterns.

Through the *Eastgroup Properties* case, the United States Court of Appeals for the Eleventh Circuit identified a variety of factors, many focused on the balancing of the harms, that courts should consider when deciding whether to substantively consolidate entities.[7] Those factors include:(1) the degree of difficulty in segregating and ascertaining individual assets and liability, (2) the presence or absence of consolidated financial statements, (3) the economic benefits of consolidation at a single physical location, (4) the commingling of assets and business

[4] *Drabkin v. Midland Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 276 (D.C. Cir. 1987).
[5] *In re ADPT DFW Holdings, LLC*, 2017 Bankr. LEXIS 3326, at *12 (Bankr. N.D. Tex. Sep. 29, 2017).
[6] 313 U.S. 215, 218-19 (1941).
[7] 935 F.2d 245 (11th Cir. 1991).

functions, (5) the unity of interests and ownership between the various corporate entities, (6) the existence of parent and inter-corporate guarantees on indebtedness, (7) the transfer of assets without formal observance of corporate formalities,(8) the ownership by the parent of a majority of the stock of the subsidiary, (9) common identities of officers or directors, (10) the gross undercapitalization of the subsidiary, (11) transaction of business by the subsidiary solely with the parent and (12) disregard by both entities of the legal requirements of the subsidiary as a separate organization.[8] These factors have been subsumed in later case law, where courts of appeal have crafted tests to determine when substantive consolidation may be appropriate.

For instance, in *In re Augie/Restivo Baking Co., Ltd.*, the United States Court of Appeals for the Second Circuit enunciated a two factor test in order to disregard the separate identity of two corporations and issue an order of substantive consolidation.[9] The presence of either factor is a sufficient basis to order substantive consolidation. First, creditors of those corporations must have "dealt with the entities as a single economic unit and . . . '[must not have relied] on their separate identity in extending credit'."[10] Second, the "affairs of the debtors must be so entangled that consolidation will benefit all creditors. . . ."[11] The court added that to "resort to consolidation based upon entanglement" should not be "Pavlovian" and "should be used only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets."[12] The court noted that this test represents a distillation of numerous factors cited by federal courts in different jurisdictions, but other courts have, at various times, focused on one or the other of these two essential elements.

The United States Court of Appeals for the Third Circuit articulated a similar test with additional nuance in *In re Owens Corning*.[13] There, a lender made a series of loans to several of the debtors, which loans were guaranteed by the debtor's parent company, and various subsidiaries. The proponents of the plan (including the debtors) sought substantive consolidation of the bankruptcy estates in order to reduce the debtors' collective liability to the lenders. On appeal, the Third Circuit Court of Appeals did not find any evidence of prepetition disregard of separateness by the lenders. Rather, the court noted that the loan was negotiated, and the

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[8] *Id.* at 249-50.
[9] *Union Savings Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.)*, 860 F.2d 515, 518-19 (2d Cir. 1988).
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] 419 F.3d 195, 211 (3d Cir. 2005).

guarantees were provided, in reliance on the separateness of the debtors from each other. Further, the Third Circuit was not persuaded by arguments that the failure of the lenders to obtain independent financial statements for each of the debtors during the loan negotiation process or to monitor the debtors independently evidenced the intention of the lenders to treat the debtors as a single economic unit, particularly in light of the fact that the lenders had investigated the financial status of each of the guarantors. The court noted that it could "not conceive of a justification for imposing the rule that a creditor must obtain financial statements from a debtor in order to rely reasonably on the separateness of that debtor. Creditors are free to employ whatever metrics they believe appropriate in deciding whether to extend credit free of court oversight."[14] As a result, the Third Circuit found that the proponent of consolidation must show that "(i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[15]

Although the trend in caselaw is to use substantive consolidation sparingly, there are two relatively recent cases in which substantive consolidation was justified, in part, because it would help facilitate an efficient reorganization. In *In re Gyro-Trac (USA), Inc.*, the Court approved substantive consolidation of three entities based, in part, on the fact that the proposed plan would merge the three entities into one and avoid the cost of three separate reorganizations.[16] The Court's ruling was also premised on the fact that the case included shared creditors, the commingling of assets, intercompany loans and transfers of assets among entities. The Court found substantive consolidation was warranted because consolidation would not prejudice distributions to creditors, it would facilitate implementation of the debtor's proposed plan and would allowed to the creditors to be paid more efficiently. In *In re Bashas Inc.*, the Bankruptcy Court approved substantive consolidation in spite of an absence of hopeless entanglement, commingling, improper intercompany transfers, or poorly maintained books and records.[17] Instead, substantive consolidation was requested out of convenience to facilitate a reorganization plan. While the result would appear at odds with other caselaw, the court made clear that substantive consolidation would not prejudice any creditor. Since the proposed reorganization plan in *Bashas* would pay all creditors in full, the principals supporting the tests articulated in *Owens Corning* and *Augie/Restivo* were preserved. *Gyro-Trac* and *Bashas* are examples of

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[14] Id. at 214.
[15] Id. at 211.
[16] 441 B.R. 470 (Bankr. D.S.C. 2010).
[17] 437 B.R. 874 (Bankr. D. Ariz. 2010).

cases where substantive consolidation proved to be a useful tool that streamlined the reorganization process to the benefit of all creditors.

IV. A Summary of Enterprise Group Insolvency Laws

Several laws have emerged in the last ten years aimed at managing and coordinating efficient administration of large, possibly cross-border, corporate groups. They include the European Union's Bank Recovery and Resolution Directive (2014) (the "BRRD"), the European Union's European Insolvency Regulation Recast (2015) (the "EIR Recast") and the United Nations Commission on International Trade Law's Model Law on Enterprise Group Insolvency (2019) (the "Model Law").[18] Each of these laws is focused on preserving group synergies in order to preserve enterprise value for the benefit of creditor. The laws provide various strategies for dealing with corporate groups in financial distress, and promote inter group cooperation and communication.

The Model Law, for instance, includes a preamble that describes its objective as promoting, among other things: (a) cooperation between courts and other competent authorities of this State and foreign States involved in those cases; (b) cooperation between insolvency representatives appointed in this State and foreign States in those cases; (c) development of a group insolvency solution for the whole or part of an enterprise group and recognition and implementation of that solution in multiple States; (d) fair and efficient administration of insolvencies concerning enterprise group members that protects the interests of all creditors of those enterprise group members and other interested persons, including the debtors; (e) protection and maximization of the overall combined value of the assets and operations of enterprise group members affected by insolvency and of the enterprise group as a whole; (f) facilitation of the rescue of financially troubled enterprise groups, thereby protecting investment and preserving employment; and (g) adequate protection of the interests of the creditors of each enterprise group member participating in a group insolvency solution and of other interested persons.[19] Neither the Model Law, nor the BRRD or the EIR Recast, however, provide express authorization for the substantive consolidation of an enterprise groups' assets and liabilities. In fact, substantive consolidation is expressly prohibited by the EIR Recast.[20]

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[18] The United Nations Commission on International Trade Law ("UNCITRAL") was established in 1966 to "further the progressive harmonization and modernization of the law of international trade" through the development of legislative and non-legislative instruments in several key areas of commercial law. Its 60 members are drawn from the member states of the United Nations.

[19] Model Law Part One, Part A, Chapter 1.

[20] EIR Recast, Art. 72(3) ("the plan referred to in point (b) of paragraph 1 shall not include recommendations as to any consolidation of proceedings or insolvency estates").

In addition to developing the Model Law, UNCITRAL has also published a legislative guide on insolvency law (the "Legislative Guide") aimed at informing and assisting insolvency law reform around the world. Part three of the Legislative Guide focuses on enterprise groups and addresses various mechanisms that can be used to streamline insolvency proceedings involving two or more members of the same enterprise group, including substantive consolidation.[21]

The Legislative Guide identifies several factors to be considered when assessing whether substantive consolidation is warranted. The factors are similar to those identified by courts in the United States and include, the presence of consolidated financial statements for the group; the use of a single bank account for all group members; the unity of interests and ownership between the group members; the degree of difficulty in segregating individual assets and liabilities; the sharing of overhead, management, accounting and other related expenses among different group members; the existence of intra-group loans and cross-guarantees on loans; the extent to which assets were transferred or funds moved from one member to another as a matter of convenience without observing proper formalities; the adequacy of capital; the commingling of assets or business operations; the appointment of common directors or officers and the holding of combined board meetings; a common business location; fraudulent dealings with creditors; the practice of encouraging creditors to treat the group as a single entity, creating confusion among creditors as to which of the group members they were dealing with and otherwise blurring the legal boundaries of the group members; and whether substantive consolidation would facilitate a reorganization or is in the interests of creditors.[22] The Legislative Guide directs that no one factor is dispositive, and instead submits that the various factors should be considered on a case by case basis in order to achieve a just and equitable result.[23]

One interesting topic addressed in the Legislative Guide, which is not similarly addressed under U.S. law, is the concept of partial or limited substantive consolidation. In these circumstances, the order for substantive consolidation expressly excludes certain assets or claims of creditors that would be unfairly prejudiced.[24] This type of partial group solution could be particularly useful in situations where particular creditors would benefit from substantive

[21] *See* United Nations Commission on International Trade Law, UNCITRAL Legislative Guide on Insolvency Law, Part Three, Chapter II paras. 105-137.
[22] *Id.* at 112.
[23] *Id.*
[24] *Id.* at 135.

consolidation, but others, such as secured creditors who relied upon the separate identity of group members, would be excluded from the process of substantive consolidation. It would protect the rights of secured creditors in complex financing transactions and securitizations, who only agreed to lend on the condition that their collateral assets were ring-fenced in special purpose entities that exist separate and apart from their corporate parent.

V. Substantive Consolidation Under Non-U.S. Law

Only a handful of jurisdictions around the world provide statutory authority for substantive consolidation. Like in the U.S., the insolvency laws of most European Union member states, such as Austria, Belgium, the United Kingdom, Germany, Greece, Hungary, Italy, Latvia, the Netherlands, Poland and Sweden do not allow for substantive consolidation of legal entities.[25] Jurisdictions that allow for substantive consolidation do so only in appropriate circumstances, where there is a high degree of integration of the operations and affairs of group member, through control or ownership, that would make it very difficult if not impossible, to disentangle the assets and liabilities of the different group members in order to identify ownership of assets and the creditors of each group member without significant expenditure of time and resources that would harm all creditors.[26]

Spanish law, for example, allows for substantive consolidation "when there is confusion of assets and it is not possible to separate the ownership of assets and liabilities without incurring an unjustified expense or delay."[27] Under French law, the "commenced proceedings may be extended to one or more other persons where their assets are intermingled with those of the debtor or where the legal entity is a sham."[28] In the United Kingdom, a group of companies may, be treated as one single company where their affairs "… are so hopelessly intertwined that a pooling of their assets, with a distribution enabling the like dividend to be paid to both companies' creditors, is the only sensible way to proceed. It would make no sense to spend vast sums of money and much time trying to disentangle and unravel."[29]

[25] Wessels and Madaus (2017), Rescue of Business in Insolvency Law, Instrument of the European Law Institute, pp 348–349.
[26] UNCITRAL Legislative Guide on Insolvency Law – Part Three ¶106.
[27] Art. 43 Spanish Insolvency Act.
[28] Code de Commerce, Art. L. 621-2.
[29] Bank of Credit and Commerce International SA (No 3) [1993] BCLC 1490 at 1502.

Courts in Brazil, on the other hand, seem to have lost focus on the distinctions between procedural versus substantive consolidation. In *Reorganization of Corporate Groups in Brazil: Substantive Consolidation and the Limited Liability Tale,* the author reviewed a number of bankruptcy cases in the State of São Paulo and determined that many cases ended up being de facto substantively consolidated because the judge failed to take necessary precautions that would preclude that result.[30] These cases resulted in assets and liabilities becoming mixed during the course of the bankruptcy proceeding, effectively eliminating the separateness of the legal entities, without notice to creditors, approval by creditors or an order of the court. This lax attitude towards substantive consolidation in Brazil is at odds with the fact intensive analysis undertaken in U.S. and E.U. courts. Given the manner in which creditor rights can be implicated as a mere by-product of an informally run proceeding rath than due to concerns of equitable outcomes and economic considerations, a vigilant, fact-intensive approach is more appropriate.

VI. Conclusion

Modern corporate groups are often strategically structured to address certain tax or corporate law concerns, or specifically to ring-fence assets into special purpose entities in order to accommodate specialty financing arrangements, such as securitization. The principal concern with substantive consolidation is that it disregards the separate legal identity of individual group members to the detriment of creditors who relied on, and contracted for the benefit of the entities' legal separateness. Most courts appear to agree that protecting creditor rights is paramount. Substantive consolidation should only be considered in situations where creditors' rights are not prejudiced.

Thought leaders should continue to develop group solutions to address and manage large, international enterprise group insolvencies. Laws and protocols that promote inter-jurisdictional communication and cooperation, and that use creative thinking to streamline complex multi-jurisdictional restructurings should continue to be developed. Absent certain circumstances, such as fraud or alter ego, or alternatively, absent consent of all parties, substantive consolidation should not be considered a viable group solution as it interferes with contracted for rights of creditors, and compromises principles of corporate separateness.

[30] Neder Cerezetti, Sheila, *Reorganization of Corporate Groups in Brazil: Substantive Consolidation and the Limited Liability Tale* (August 1, 2019).

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