Global Insolvency Practice Course 2019/2020 : Short Technical Paper

**Analyse whether substantive consolidation is ever appropriate in a multi-entity, multi-jurisdictional restructuring/insolvency? Include in your answer a critical analysis of why it is better / worse than an entity-focused insolvency / restructuring.**

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**Introduction**

The basic principal of company law in most jurisdictions around the world is that each company should be treated individually, as entities with a legal personality that enter into obligations, form their own contracts and attach liability to themselves rather than the human agents directing them or the shareholders who own them[[1]](#footnote-1). Furthermore, unless a contract specifically provides that two or more companies are jointly and severally liable for a debt, privy of contract (again, a doctrine which can be found in most jurisdictions[[2]](#footnote-2)) dictates that only the entity which entered into the obligation is liable in respect of it.

This has a profound effect on corporate insolvency law, which focusses on individual companies, rather than a consolidated group structure, even where an entire group of companies falls into an insolvency process. When a company becomes insolvent, the stakeholders in that insolvency are those who are owed money or a right of performance by that company and unless there are contractual documents or legislation which allows for other companies within the group structure to meet the liability of the company, creditors will have no recourse to other group entities in respect of that particular obligation.

According to Professor Roy Goode in his book *Principles of Corporate Insolvency Law[[3]](#footnote-3)*, "[w]*hat insolvency law here[[4]](#footnote-4) and overseas has so far singularly failed to accommodate is the management of enterprise groups[[5]](#footnote-5) where one or more, or possibly all, members of the group have become insolvent. …*[W]*hen it comes to insolvency the distinct legal personality of each individual company within the group is respected, with separate proceedings for each company, yet the insolvency of one member of the group may threaten the viability of previously solvent members and where the group activity is integrated a co-ordination of the management of the group as a whole may be highly desirable*."[[6]](#footnote-6)

However, Professor Goode goes on to admit that achieving procedural consolidation of groups of companies is very difficult, especially when the group may comprise companies incorporated in different parts of the world, with different insolvency processes and different rules for the treatment of creditors. In terms of substantive consolidation, where the assets and liabilities of group companies are pooled, Professor Goode states that "*this interferes with the existing rights of creditors, in particular creditors of a group member having substantial assets who can legitimately argue that they dealt with that member and should not have their position impaired by consolidation of assets and liabilities with less well-placed members of the group.*"[[7]](#footnote-7)

This short paper looks at the advantages and disadvantages of multi-national substantive consolidation compared to an entity by entity insolvency process. It also looks at some examples of courts around the world developing their own jurisprudence to provide flexible solutions to the problems which this issue raises. It concludes by arguing that substantive consolidation is expedient in the right situations, and if often used informally in group re-organisations in any event.

**Discussion and Analysis**

First, it is necessary to distinguish substantive consolidation from procedural or administrative consolidation and also from the administration of one insolvent estate which has assets in different jurisdictions around the world. In respect of the latter, the UNCITRAL Model Law[[8]](#footnote-8) and the willingness of courts and insolvency office holders in different jurisdictions to cooperate with each other has led to the successful administration of a single insolvency estate by different courts. In respect of the former, procedural consolidation is simply an administrative process which "*maintains the separation of the assets and liabilities of the different group members, but subjects all members of the group to a joint administration*."[[9]](#footnote-9)

Substantive consolidation achieves the merging of the assets and liabilities of different members of the group into one pooled estate by disregarding "*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*."[[10]](#footnote-10)

There are several questions that arise out of this each is dealt with in turn:

1. How does substantive consolidation interact with commercial and business consolidations in relation to the initial structuring of the group?
2. How does substantive consolidation affect the creditor base of each group company?
3. What jurisdictions permit substantive consolidation?
4. What is the test that the courts apply when allowing substantive consolidation and what balances need to be struck?

*Business Considerations*

When a group of companies is structured by its overall management and controllers, it is structured in that particular way for a reason. For example, a group may have different trading entities in different locations around the world so that creditors from those particular jurisdictions will have recourse only to the local group company. There may be tax considerations or regulatory reasons as to why a particular company is incorporated in that jurisdiction. This is especially the case in the author's home jurisdiction of Guernsey where many companies are established for tax and regulatory reasons, even though they are often operating overseas.

It is an advantage of modern day enterprise that companies can be established flexibly in many jurisdictions around the world and subverting that basic principle could well undermine this flexibility and commerciality. In the author's view, this is why substantive consolidation should not be conducted routinely or indeed without judicial oversight, even if there is legislation in place to allow for such consolidation to take place. It is also why formal substantive consolidation will only take place in a terminal insolvency regime such as a liquidation or bankruptcy where court supervision is part of the process and where distributions to creditors are made during or at the end of the matter.

*Creditors*

As noted in the quotation from Professor Goode in the introduction to this paper, pooling can have a profound effect on the rights of creditors compared to the economic benefit or shortfall that they would have encountered had the pooling not taken place[[11]](#footnote-11). To give a basic example, companies A, B and C are different companies within a group. They are all incorporated in different jurisdictions. A is the trading company of the group, but also has the largest creditor base. C's assets were recently transferred to A, but leaving behind one substantially large creditor. B hold a valuable piece of real estate but has no liquidity, and with a relatively small creditor base. Clearly, C's creditors would favour consolidation because if C went into an insolvency process by itself, they would only receive a small dividend from the estate. By contrast, B's creditors would object because they now stand to share the real estate asset with creditors of A and B. A's creditors might also object to sharing in A's estate with the creditors of B and C, but may also welcome swelling the assets by adding in the valuable piece of real estate.

There are also the rights of secured creditors, preferential creditors, shareholders and other key stakeholders such as employees to take into consideration. Each jurisdiction has its own law and indeed the nature of secured debt differs around the world. For example, England & Wales has the concept of a floating charge which is not found in most civil law jurisdictions around the world. UNCITRAL suggest[[12]](#footnote-12) excluding secured creditors from the consolidation process altogether, although this may give rise to problems depending on which assets are encumbered. Some jurisdictions given preferential status to the tax authorities, some do not. Some give preferential status to employees, some only give limited, or indeed no, status to employees. How a substantive consolidation deals with these issues is one which the courts would need to grapple with and mitigates, in the author's view, in favour of an entity by entity approach where there is a substantial difference in the way in which creditors of different group entities would be treated. The entity by entity approach would still need to depend on cooperation between different courts and office holders, with a willingness to work together to maximise assets held by entities within the group, especially when such group companies are inter-dependent on each other.

Whatever approach is taken, it is clear that prior to any court making an order to consolidate the insolvent estates, creditors of all estates will need to be notified and given the chance to make their own representations.

*Which Jurisdictions Permit Substantive Consolidation and What is the Test?*

At present, it is understood that the only legislative basis for a domestic substantive consolidation can be found in Germany[[13]](#footnote-13) which provides that parent companies or controlling entities are liable for the debts of their subsidiaries. This may amount to a form of consolidation, but only in respect of liabilities and not assets.

In the United States and the United Kingdom, substantive consolidation is a judge made solution based on the principles of equity. The one authority in England is the case of Re Bank of Credit and Commerce International SA (No 3)[[14]](#footnote-14), a decision ultimately of the Court of Appeal which approved the pooling of two of the BCCI companies in liquidation. In this case, the assets and liabilities in question were of two companies within the BCCI group, one incorporated in Luxembourg and one incorporated in England. The proposal to pool the assets and liabilities of the companies was challenged by the creditors' committee but preferred by the courts to the immeasurable problems that would have resulted had the estates not been pooled.

There is also case emanating from the Channel Islands in 2015 which is a more modern authority for the proposition that the assets of group companies from different jurisdictions can be pooled. In this case, the courts of both the islands of Jersey and Guernsey[[15]](#footnote-15) were willing to pool the assets of a Channel Islands wide group of companies known as Huelin-Renouf, which was the islands' main freight and shipping provider[[16]](#footnote-16). The group comprised a Jersey company and a Guernsey company, both in liquidation, and the proposal was to pool the assets and liabilities of both companies into the Jersey based estate. In the Guernsey case of Huelin-Renouf Shipping (Guernsey) Limited, the Court accepted that the statutory regime in Guernsey was such that it did not prevent the pooling from proceeding and also held that if that it would not have made the order had it not been satisfied that the Jersey court would accept that pooling formed part of Jersey law[[17]](#footnote-17). The Royal Court of Jersey subsequently determined that it would authorise the liquidators of the Jersey company to accept the assets and liabilities of the Guernsey company[[18]](#footnote-18). This was not a case where any party sought to challenge the arrangement proposed by the liquidators of the two companies. However, it is clear from the judgments that had there been any prospect of survival of one or more of the group companies (for example, if one of the companies was in an administration process, rather than liquidation), pooling would not have been an option.

In both England & Wales and the Channel Islands, the test for substantive consolidation is the same. Indeed the Channel Islands cases followed the test adopted by the English Court of Appeal in BCCI as being one where the evidence needs to show that the affairs of the companies' estates sought to be pooled are "*so hopelessly intertwined that a pooling of their assets, with a distributing 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 in trying to disentangle and unrave*l."[[19]](#footnote-19)

So there is a three-fold test:

1. The companies must be in liquidation (i.e. a terminal process, where the assets are distributed to creditors);
2. The affairs of the companies must be completely (and hopelessly) intermingled; and
3. The costs of untangling the affairs would outweigh the benefit of pooling the assets together.

In the Huelin-Renouf case, it was clear from the evidence that creditors thought that they were dealing with "Huelin-Renouf" without any thought as to whether it was the Jersey or the Guernsey company, and the way in which the group kept its accounts reflected that fact. However, it is also clear from both the BCCI and Huelin-Renouf decisions that a decision of one court will very much depend on the decision of the corresponding court and that the legal test for consolidation (which may differ from jurisdiction to jurisdiction) must be met in both jurisdictions. In other words, it cannot be the case that one jurisdiction's court can impose a pooling arrangement on the other. Principles of comity and private international conflict of laws must always outweigh all other considerations.

In the United States, there is no legislation providing for the pooling of assets of group entities. It appears[[20]](#footnote-20) that the US courts will exercise their equitable jurisdiction to combine the assets and liabilities of separate and distinct but related legal entities into a single pool and treat them as though they belonged to a single entity – for example in the case of Eastgroup Properties v Southern Motel Assoc Ltd[[21]](#footnote-21), which adopted the substantive consolidation test set out in the case of Re Auto-Train Corp, Inc[[22]](#footnote-22). In order for the US courts to agree to substantive consolidation, the following must be established:

1. A substantial identity between the entities to be consolidated; and
2. That consolidation is necessary to avoid some harm, or to realise some benefits.[[23]](#footnote-23) In analysing this test, it is clear from the authorities that "*protection of the possible realisation of any recovery for the majority of unsecured creditors outweighs the potential harm to any particular creditor*"[[24]](#footnote-24).

The US courts have gone further than the UK courts in setting out a number of non-exhaustive factors to consider whether or not there is a case for consolidation. These are as follows[[25]](#footnote-25):

* Unity of interest and ownership between the debtors;
* Presence or absence of consolidated business or financial records;
* Existence of parent and incorporate guarantees on loans;
* Existence of transfers of funds or assets from one company to another without observing corporate or other legal formalities;
* Commingling of assets and business functions;
* Degree of difficulty in segregating and ascertaining individual assets and liabilities; and
* Profitability of consolidation at a single location.

It is suggested that these factors would likely be adopted by courts in the British/British-centric jurisdictions, being sensible factors that ultimately add up to the test set out by the English courts in the BCCI case. The point is whether consolidation would prejudice creditors as a whole and it is clear that if the consolidation has already, in practice, taken place prior to the insolvency such that creditors would have been ignorant as to which entity they were really dealing with, then the courts are more than likely going to order substantive consolidation in order to achieve a practical reality and the best result for the entire creditor body.

An application to pool the assets of related companies with intermingled assets may prove to be difficult if, for example, there were outstanding claims which could be brought by the liquidator, or even by the company in liquidation, against directors or third parties. It is not clear how the law would treat assets recovered as part of a wrongful trading action brought by a liquidator of one estate and whether those assets could be used for the benefit of other estates within the group. English law certainly treats wrongful trading recoveries as part of the estate available to unsecured creditors (as opposed to secured creditors)[[26]](#footnote-26) and it is certainly arguable that the fruits of those types of actions should only be available to creditors of that particular company.

This could therefore be an argument against substantive consolidation if creditors of one group entity see an opportunity to reap the benefits of a successful wrongful trading action brought by the liquidators of another group entity. In the author's view, and bearing in mind that the courts, certainly in the common law world, appear to have a fairly wide discretion as to whether substantive consolidation should take place, courts should be very cautious to accede to an application for substantive consolidation where it is clear that one group of creditors are seeking to take that sort of position.

The UNCITRAL recommendations[[27]](#footnote-27) provide for unity where that is possible, but exclusions of certain types of assets (such as the fruits of certain claims) where necessary. This is sensibhle, because it may be that substantive consolidation is desirable notwithstanding the existence of such claims and clearly a balance has to be struck between pooling on the one hand and not allowing certain creditors to be disadvantaged on the other.

**Conclusions**

It has been argued[[28]](#footnote-28), correctly in the author's view, that in practice many Chapter 11 reorganisations and English schemes of arrangement already deal with multiple international estates at the same time as part of the proposed restructuring and that this amounts to a quasi-substantive consolidation. There is often no formal consideration of the merits of substantive consolidation, but the courts, when considering the restructuring of a group of companies, will often deal with the assets and liabilities together, albeit ensuring that the corporate veil is not pierced, but the re-organisation will often amount to a result which is similar, if not the same, to the consequence of a substantive consolidation in a liquidation. So even where a court is not willing, or is unable, to order a substantive consolidation, it could still approve a restructuring proposal through a US Chapter 11 process or an English scheme of arrangement that treats a group as if the assets and liabilities were to be pooled in order to give the best result to creditors.

In conclusion, therefore, whilst an element of caution and judicial oversight must play a significant role in any application for substantive consolidation[[29]](#footnote-29) and whilst there will also be safeguards to ensure that creditors of any given group entity are not materially prejudiced, the courts should be encouraged to look at the best result for creditors as a whole and substantive consolidation will often be the solution that achieves that result.

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* Warner, Professor Ray*, Note about Substantive Consolidation* (undated)
* UNCITRAL Model Law on Cross Border Insolvency (1997) and the guide to enactment and interpretation (2014)
* UNCITRAL Legislative Guide on Insolvency Law, Part Three: Treatment of enterprise groups in insolvency (43rd session, A/C 9/686, July 2010)

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*England & Wales:*

* Produce Marketing Consortium Limited [1989] 5 BCC 569

Tweddle v Atkinson (1861) 1 B & S 393; 121 ER 762

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*Bailiwick of Guernsey:*

* Huelin-Renouf Shipping (Guernsey) Limited [2015] GRC 46 (Deputy Bailiff McMahon)

*Bailiwick of Jersey:*

* Huelin-Renouf Shipping Limited [2015] JRC 206 (Deputy Bailiff Le Cocq)

*United States of America:*

Vecco Construction Industries, Inc 4 B R 407, 409 (Bankr ED Va, 1980)

Fishell v United States Trustee (In re Fishell), No 95-1637, 1997 WL 188458 at \*3 (6th circuit, Apr 16, 1997)

* Re Providence Financial Investment Inc and Providence Fixed Income Fund LLC (case 16-20516-AJC and 16-20517-AJC, 2018) – motion for substantive consolidation filed on 16 April 2018 by the bankruptcy trustee Maria Yip by her attorneys in the United States Bankruptcy Court, Southern District of Florida, Miami Division

Re Auto-Train Corp, Inc 810 F.2d 270 (D.C. Cir 1997)

Eastgroup Properties v Southern Motel Assoc Ltd 935 F.2d 245, 248 (11th Cir, 1991)

1. Halsbury's Laws of England, Volume 15 (2016), Companies, Paragraph 1(1).1 [↑](#footnote-ref-1)
2. Modern law generally derives from the English case of Tweddle v Atkinson (1861) 1 B & S 393; 121 ER 762 where Crompton J said: "*It would be a monstrous proposition to say that a person was a party to the contract for the purpose of suing upon it for his own advantage, and not a party to it for the purpose of being sued*". [↑](#footnote-ref-2)
3. 5th edition, Sweet & Maxwell [↑](#footnote-ref-3)
4. Being England [↑](#footnote-ref-4)
5. Defined by UNCITRAL Working Group V (Insolvency Law) as "*two or more legal entities (group members) that are linked together by some form of control (whether direct or indirect) or ownership*" (A/CN, 9WG.V/WP92.2010, para 2). [↑](#footnote-ref-5)
6. Goode, paragraph 1-29 [↑](#footnote-ref-6)
7. *Ibid* [↑](#footnote-ref-7)
8. Which has been the basis for, for example, Chapter 15 of the United States Bankruptcy Code, the European Union Insolvency Regulation and the Cross Border Insolvency Regulations in the United Kingdom [↑](#footnote-ref-8)
9. *Goode,* chapter 16-10 [↑](#footnote-ref-9)
10. UNCITRAL Legislative Guide on Insolvency Law, Part Three: Treatment of enterprise groups in insolvency, para 105 [↑](#footnote-ref-10)
11. This analysis assumes that assets of an insolvent estate are distributed *pari passu* to unsecured creditors and that all unsecured creditors rank and abate equally. [↑](#footnote-ref-11)
12. UNCITRAL Legislative Guide on Insolvency Law, Part Three: Treatment of enterprise groups in insolvency, para 123 [↑](#footnote-ref-12)
13. The *Konzernrecht*, codified in the Stock Corporations Act 1965 [↑](#footnote-ref-13)
14. [1993] BCLC 106 (first instance); [1993] BCLC 1490 (Court of Appeal) [↑](#footnote-ref-14)
15. Which are completely separate jurisdictions, independent of each other. [↑](#footnote-ref-15)
16. The author's firm, Ogier, acted for the joint liquidators in both islands and the author appeared as Guernsey Advocate for the liquidators before the Royal Court of Guernsey. [↑](#footnote-ref-16)
17. Relying on two Jersey cases called Re Corebits Services Limited and Re Zoombits (in liquidation) [2011] JRC 166 and Re Royco Investments Company Limited [1994] JLR 236 where the assets of sister Jersey companies had been pooled. [↑](#footnote-ref-17)
18. Huelin-Renouf Shipping (in liquidation) [2015] JRC 206 [↑](#footnote-ref-18)
19. Re BCCI (No 3) [1993] BCLC 106, at 111 per Sir Donald Nicholls V-C whose decision was upheld on appeal [↑](#footnote-ref-19)
20. As the author is not a US lawyer, much of this part of my short paper relies on arguments made (in a case that the author was involved in as Guernsey counsel for the liquidators) on a motion by the US bankruptcy trustee of a related entity to substantively consolidate the Florida and Guernsey companies within a group of companies used as a vehicle to perpetrate a Ponzi scheme across the US and UK – see Re Providence Financial Investment Inc and Providence Fixed Income Fund LLC (case 16-20516-AJC and 16-20517-AJC), United States Bankruptcy Court, Southern District of Florida, Miami Division. The motion was opposed by the Guernsey liquidators of the Providence Guernsey fund and was subsequently withdrawn on terms. [↑](#footnote-ref-20)
21. 935 F.2d 245, 248 (11th Cir, 1991) [↑](#footnote-ref-21)
22. 810 F.2d 270 (D.C. Cir 1997) [↑](#footnote-ref-22)
23. *Ibid*, at 276. [↑](#footnote-ref-23)
24. Fishell v United States Trustee (In re Fishell), No 95-1637, 1997 WL 188458 at \*3 (6th circuit, Apr 16, 1997) [↑](#footnote-ref-24)
25. Vecco Construction Industries, Inc 4 B R 407, 409 (Bankr ED Va, 1980) [↑](#footnote-ref-25)
26. Produce Marketing Consortium Limited [1989] 5 BCC 569 at 598 [↑](#footnote-ref-26)
27. UNCITRAL Legislative Guide on Insolvency Law, Part Three: Treatment of enterprise groups in insolvency, page 71-74 [↑](#footnote-ref-27)
28. In an unreferenced paper provided by Professor Ray Warner entitled "*Note about Substantive Consolidation*" as part of the GPIC Module A materials. [↑](#footnote-ref-28)
29. As advocated in the UNCITRAL recommendations cited above. [↑](#footnote-ref-29)