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The European Insolvency Regulation and Groups of Companies

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I. Introduction

The European Insolvency Regulation (EIR) has brought about a giant leap forward in the effective administration of insolvency proceedings in the European Union. Although over the previous quarter of a century some European countries (notably Germany and France) had started to become much more generous in giving effect to foreign insolvency proceedings, while others such as the United Kingdom had already traditionally been prepared to do so, the adoption of the Regulation for the first time ensured recognition of such proceedings throughout the whole European Union (with the exception of Denmark). Moreover, the Regulation provides for, among other things, rules determining the types of powers which a liquidator from another member state may exercise and rules dealing with the enforcement of court decisions in insolvency proceedings, including compositions. It also contains conflict of law rules with respect to a number of important insolvency issues. The Regulation has entailed the surrender by the member states of a substantial part of their sovereignty, because they have, to a large degree, accepted the powers of foreign liquidators and have only very limited grounds for refusing the enforcement of foreign court decisions (Articles 25(3) and 26 EIR). This is particularly true of cases in which the debtor does not have an establishment in the member state where the foreign insolvency proceedings are to be recognised or enforced, because, under the Regulation, it is not possible in such cases to open secondary proceedings in that member state.

Nonetheless, the Regulation cannot be the last step in this regard. One of its weaknesses is that it contains almost no rules harmonising the national insolvency laws of the member states. In a number of areas, such harmonisation would have been preferable, but attempts to achieve this turned out to be a bridge too far. Another weakness is that it deals solely with single companies and does not contain any provisions on how insolvencies that affect groups of companies should be dealt with[1]. Thus, for example, the provisions on coordination between main proceedings and secondary proceedings do not apply when separate establishments of an enterprise have been incorporated in the form of separate legal entities. The mere fact that the Regulation applies only to single companies has made insolvency practitioners sceptical as to its relevance, although by now it has become clear that such scepticism is not entirely justified, as there are many cases in which the Regulation appears to be applicable. Nevertheless, the absence of any provisions on groups can cause severe problems.

In particular, problems arise when the assets owned by separate companies or the activities conducted in separate companies are connected in such a way that splitting up the sales process would cause a considerable loss of value to the assets. A typical example of this was provided by the bankruptcy of KPNQwest nv. The KPNQwest group owned cables in Europe and across the Atlantic Ocean, the main ones being in the form of rings. For example, one ring ran through Germany, France, Belgium and The Netherlands, connecting major cities in these countries. However, the part of the ring that was situated in Germany was owned by a German subsidiary, the part of the ring situated in France by a French subsidiary, and so forth. When the Dutch parent company, KPNQwest nv, went into bankruptcy many of the subsidiaries had to enter insolvency proceedings as well. Interestingly, the KPNQwest nv bankruptcy was one of the first to fall under the scope of the Regulation since it was adjudicated on 31 May 2002, the date on which the Regulation entered into force. However, the trustees of the Dutch bankruptcy did not hold any powers with respect to bankrupt subsidiaries in other member states, and it proved to be very difficult to coordinate the sale of the rings. As it turned out, the KPNQwest group disintegrated and it is likely that the proceeds of the sale of the assets were much lower that they would have been if the enterprise had been sold as a whole. Similar problems arise in groups of companies that own contingent intellectual property rights. This

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1 See also the Virgós Schmit report §76.

applies in particular with respect to groups that own assets in the research and development sector. Often, a patent in itself is not worth that much, but may have a significantly higher value in connection with other patents or licences owned elsewhere in the group. Here again, the opening of separate insolvency proceedings with respect to different companies and the appointment of separate trustees for each one may lead to the disintegration of the business, to the detriment of the creditors of all the companies.

II. Concentration of centres of main interests

Pursuant to Article 3(1) of the Regulation, main proceedings can be opened with respect to a company by the courts of a member state within the territory of which the company's centre of main interests is situated. In the English case of *Crisscross Telecommunications Group*, the High Court decided that although the Crisscross subsidiaries were incorporated in different countries, the centre of main interests for all the companies was situated in England, and that therefore, with respect to all the companies, main proceedings could be opened in England. A similar decision was taken by the English High Court in the *Daisytek* case. Interestingly, in the *Crisscross* case it was not the parent company but one of the subsidiaries that was incorporated in England, whereas the actual headquarters of the group were indeed located in London. A similar example is provided by the *Cirio Del Monte* case. Here, the Italian court decided that two Italian companies and a Dutch subsidiary all had their centre of main interests in Rome.

The *Crisscross, Daisytek,* and *Cirio Del Monte* judgments achieved a better coordination of the insolvency proceedings in the respective groups, because all the proceedings were placed under the supervision of the same court and because the same liquidators were appointed for all the group companies. However, I do not think that similar decisions can provide a panacea for all group situations. This solution works only where the management and activities of the group are centralised in such a way that the centre of main interests of each of the companies can be considered to really be located at the group centre. There are, however, many groups for which this may not be the case and where each subsidiary has its centre of main interests in a different country; nevertheless it is quite possible that, in some of these cases, there is a sufficiently strong connection between the group companies' assets or enterprises to make it worthwhile to subject the companies in question to some kind of group regime as well. Furthermore, it seems that the term 'centre of a debtor's main interests' should be given a rather strict interpretation. In this regard, it should be noted that the last sentence of Article 3(1) of the Regulation contains a rebuttable presumption that the registered office shall be the centre of main interests.

There are several good reasons for interpreting the term strictly. First of all, as stated in paragraph 13 of the preamble to the Regulation, the centre of main interests should be ascertainable by third parties. I think that the rationale behind this is that third parties that enter into some kind of legal relationship with a company should be fairly certain about the insolvency regime that would apply to the main insolvency proceedings of that company if things went wrong. Secondly, where the term is interpreted more loosely this may create more cases where courts in two or more member states consider the centre of main interests to be located in that state's territory (overlapping claims). In light of Article 16 of the Regulation and paragraph 22 of the preamble, the decision by one court to open main proceedings would prevent the other court(s) from opening them. This may therefore generate a race to the respective courts in question. Moreover, the presence of overlapping claims undermines the principle of community trust which underlies the recognition of judgments opening insolvency proceedings in other member states. Thirdly, a loose interpretation of the term would make it easier to shift the centre of main interests from one member state to the other shortly before the opening of insolvency proceedings, and thus to engage in forum shopping. Although this would be a very interesting option for lawyers advising the debtor, I do not think it is really desirable.

Finally, if a court were to conclude that the centre of main interests of a subsidiary was located at the centre of main interests of the group and if that centre of main interests was located outside the EU, e.g. in the United States, this would mean that such court would not be able to open insolvency proceedings under the Regulation with respect to that subsidiary, even if the activities of that subsidiary itself take place only within the EU. This would therefore reduce the scope and effectiveness of the Regulation.

To summarise, tempting as it may be to 'loosen up' the interpretation of the term somewhat in order to enable courts to deem the centre of main interests of all the relevant companies of a group to be located at one place, I do not think that this is a very good solution, for the reasons discussed above. The solution may also not work very well because (i) it does not have the desired effect where a creditor obtains the opening of insolvency proceedings in the member state where the subsidiary is incorporated prior to the opening of insolvency proceedings in the member state where the group's centre is located, (ii) there are many cases where even a looser interpretation of the term would not result in the group's headquarters being considered to be the centre of main interests of all the relevant group companies, and (iii) it increases the risk of a court deciding that the Regulation is not

applicable to insolvency proceedings with respect to subsidiaries where the centre of main interests of the group in question has been deemed to be located outside the European Union.

In the absence of other solutions, it may prove enticing to courts to apply the solutions of the *Criss-cross, Daisytek,* and *Cirio Del Monte* cases in instances where it is not so clear that the centre of main interests of the respective subsidiaries is really located at the group's headquarters (if such headquarters are located within the European Union). In order to avoid such a development, it is all the more important to have some kind of rules in place dealing with the coordination of group insolvencies.

One possible objection against the interference of foreign courts or foreign liquidators with the affairs of subsidiaries might be based on the principle of sovereignty of the member state where the subsidiary is located. I do not think that such an argument would be very convincing. As discussed in the introductory paragraph of this article, the present Regulation already entails the surrender by the member states of a substantial part of their sovereignty, and I do not think that the extension, in some way, of the Regulation to subsidiaries would make much difference here. I do not think that it really makes a difference whether an international enterprise maintains its local establishments as mere branches of one legal entity or whether it incorporates them into separate subsidiaries. The choice between those two options is often determined only by such issues as tax consequences and accounting purposes and – to a lesser extent – limitation of the liability with respect to each of the separate entities[2]. Therefore, I think that seeking a solution for group insolvencies that is somewhat similar to the Regulation's present solution for local branches should not be impaired by sovereignty considerations.

It should also be noted here that the concept of group insolvencies does not necessarily entail that all the companies of the group be 'thrown' together into one estate and that the assets as well as the liabilities be compounded. The point of departure should be that all group companies are dealt with as separate entities with separate assets and liabilities. There may, however, be situations where separate administration of the estates is not possible, e.g. where it is not possible to disentangle the liabilities or assets of the various group companies. This exception I will leave aside for the time being. It will be discussed in section IV.

One possible solution might be to include a provision in the Regulation stating that, with respect to groups of companies, the centre of main interests of the ultimate European parent company is deemed to be the centre of main interests of each of the subsidiaries. This solution would have several advantages. First of all, the risk of overlapping claims with respect to the centre of main interests, which was discussed above, would be greatly reduced. Secondly, in the event of group insolvency, the court of the centre of main interests would be able to safeguard the coordination of the main insolvency proceedings with respect to all the group companies and thirdly it safeguards the application of the Regulation when the ultimate group centre of main interests is located outside the European Union. However, I also see some drawbacks. First of all, for the creditors of a subsidiary, it would be more difficult to ascertain the subsidiary's centre of main interests. Contrary to the present situation, the mere location of the subsidiary's registered office would no longer suffice to establish with a fair degree of certainty the location of its centre of main interests, and hence the insolvency regime applicable to main proceedings. In order to determine the centre of main interests, the creditor would have to investigate the group structure. Secondly, the subsidiary's centre of main interests would have to be deemed to be located at the group centre, regardless of whether the parent company or other group companies enter into insolvency proceedings as well. This means that a 'foreign' insolvency regime would apply, even if the subsidiary was the only group company entering insolvency proceedings. The alternative, whereby the centre of main interests is only deemed to be located at the group's headquarters if other group companies also enter insolvency proceedings, is unattractive for various reasons, but I think that the most important one of them is that it would be impossible to determine beforehand which insolvency regime would apply to main proceedings with respect to the subsidiary in question. Thirdly, assuming that the criterion for being considered a 'subsidiary' is ownership by the parent of more than 50% of the shares, it would be very easy to shift the deemed centre of main interests by transferring the subsidiary's shares to another group of companies. Finally, I doubt whether this type of construction would actually result in the main insolvency proceedings having a full impact on the subsidiary. Usually the subsidiary will still have an establishment in its country of incorporation and all (or virtually all) the assets will be located in that country. The reason for this is that where an international enterprise is structured as a group of companies rather than as one company with

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2 For the sake of completeness, I would further like to mention that, also under the present provisions of the Regulation, if a company is incorporated in one member state this does not mean that the main proceedings have to be opened in that member state. The presumption in Article 3(1) that the registered office is the centre of main interests is a rebuttable one.

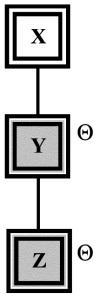
branches, a subsidiary in a particular country will often limit its activities, or at least its assets, to that country only. The opening of main proceedings, with respect to a subsidiary, in the country in which the group's headquarters are located will therefore often be followed by the opening of secondary proceedings in the member state in which the subsidiary is incorporated. Such secondary proceedings will then encompass virtually the whole of that subsidiary's estate. In such a case, the main proceedings will, with respect to the subsidiary, be largely limited to (i) coordination activities on the part of the liquidator (see Articles 29 *et seq.* of the Regulation) and (ii) certain extraterritorial effects which the secondary proceedings at the establishment in the state of incorporation cannot bring about.

III. Proposal with no shift of centre of main interests

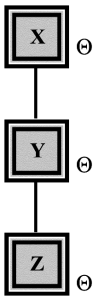
In view of the drawbacks of the above solution (shifting the subsidiary's centre of main interests), I will now suggest another, less drastic solution. In essence, my proposal is that if a subsidiary and its ultimate parent company both enter into insolvency proceedings the liquidator of the parent company be given powers similar to those that the liquidator in main proceedings has vis-à-vis secondary proceedings. The starting point should therefore be the application, in a more or less analogous fashion, of the provisions of Articles 27 *et seq.* of the Regulation. Below, I will first discuss some general principles and then address the analogous application of some of the Regulation's provisions.

For the purposes of this article, I define a parent company as a company that (i) has its centre of main interests in a member state, and (ii) has a majority of the shareholders' voting rights in the subsidiary[3]. This definition of course needs refinement. For one thing it is a matter for discussion whether the definition should be based on ownership, control or the existence of a connection between the assets or businesses of the companies in question. The present definition is therefore only a working one. I also define a sister company as a company that is neither a parent nor a subsidiary of the subsidiary, but one that shares a parent company with the subsidiary.

Under my proposal, the liquidator of the parent company would have the powers to be described below at his disposal, unless the parent company itself has a parent company which also has entered into insolvency proceedings. Thus, in the situation



Y and Z have entered into insolvency proceedings, Y's liquidator would have these powers with respect to Z's insolvency proceedings, whereas in the situation



where X, Y, and Z have entered into insolvency proceedings, X's liquidator would have these powers with respect to both Y and Z, but Y's liquidator would not.

It is also conceivable that there could be both main proceedings as well as secondary ones with respect to Z (although, as may appear from the above, I think this will only happen in exceptional cases because in group structures the activities and assets of the subsidiary are usually limited to one member state). In such a case and with respect to the secondary proceedings, there could then be a collision between the powers of the liquidator in Z's main proceedings and those of X's liquidator. Here, the general rule should be that where X's liquidator has these powers with respect to Z's main and secondary proceedings, this should exclude similar powers being held by the liquidator in Z's main proceedings with respect to the secondary proceedings.

The solution I am proposing has the advantage of being similar to the present rules in the Regulation dealing with the relationship between main and secondary proceedings. I think that it therefore stands a better chance of acceptance as an amendment to the Regulation than a solution which would bring about a greater deviation therefrom.

An obvious disadvantage of this solution, however, is that it does not result in the insolvency proceedings of the group companies being administered by one

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3 *Cf.* Article 1(1)(a) of the Seventh Directive on Article 54(3)(g) of the EC Treaty (83/349/EC).

liquidator or set of liquidators, whereas this could occur under the first solution (under which the centre of main interests is deemed to be located at the group's headquarters). However and as discussed above, in such a scenario even if the same liquidators were appointed in all the main proceedings, their powers would effectively be reduced to powers of coordination in the event that a subsidiary or its creditors sought secondary proceedings in the subsidiary's member state of incorporation (where, in most cases, it would have an establishment).

I will now address a number of provisions of the Regulation, indicating where and to what extent these provisions should apply to group scenarios. In this regard, please note that what is stated in relation to the parent company's insolvency proceedings and its liquidator applies *only* to the *main* proceedings of the parent company and the liquidator in such proceedings. However, for brevity's sake I will in most cases simply use the terms 'the parent company's insolvency proceedings' and 'the parent company's liquidator'.

Article 3

There is no need for special provisions with respect to Articles 3(1) and (2), since the subsidiary can enter into main proceedings in the member state where its centre of main interests is located and territorial proceedings in other member states where it has an establishment. With regard to Article 3(3), there is no need to provide that any main proceedings with respect to the subsidiary that are opened after the opening of the parent company's main proceedings can only be winding up proceedings. On the contrary, it may be useful to have a subsidiary enter into reorganisation proceedings. However, where a subsidiary's reorganisation proceedings may interfere with the interests involved in the reorganisation or winding up of the whole group, the parent company's liquidator should be entitled to ask the court that opened the subsidiary's reorganisation proceedings to convert them into winding-up proceedings (*cf*. Article 37).

Article 20

Since the subsidiaries' estates will be treated as separate entities, there is no need to have special rules for group insolvencies dealing with the subject matter of Article 20. However, this is not the case where the group is dealt with as one estate (see below section IV).

Article 27

It should remain a prerequisite for the opening of main proceedings with respect to a subsidiary that the subsidiary in question be insolvent. Therefore, with respect to subsidiaries, there is no need for a rule similar to that of Article 27, which provides that the opening of secondary proceedings does not require the insolvency of the debtor being examined. Furthermore, the main proceedings of the subsidiary should not need to be winding up proceedings, nor should they be limited to the territory of one member state, although in practice the assets of the relevant subsidiary will often be situated in only one member state.

Article 29

The liquidator in the parent company's insolvency proceedings should have the right to request the opening of insolvency proceedings with respect to the subsidiary.

Article 30

There is no need for a provision such as that of Article 30, since the opening of main insolvency proceedings with respect to a subsidiary should be decided on its own merits.

Article 31

The obligation under paragraph (1) to communicate information should also apply in the relationship between the insolvency proceedings of the parent company and those of its subsidiary. However, the information to be provided by the parent company's liquidator should be limited to information which is relevant to the subsidiary's insolvency proceedings. There should not be an obligation on the part of the parent company's liquidator to inform the subsidiary's liquidator of the progress made in lodging and verifying claims at parent level. The obligation to provide information to the parent company's liquidator should not exclude the obligation on the part of the liquidator of one subsidiary to provide information to the liquidator of another subsidiary.

The obligation to cooperate set out in paragraph (2) should also apply in the relationship between the liquidator(s) of the parent company (whether in main or territorial proceedings) on the one hand and the liquidator(s) of the subsidiary on the other. This duty should not exclude the obligation on the part of the liquidators in different insolvency proceedings of the subsidiary to cooperate with each other.

The obligation under paragraph (3) to provide an opportunity to submit proposals on the liquidation or use of assets should apply in the relationship between the liquidator(s) of the subsidiary (whether in main or territorial proceedings) on the one hand and the liquidator of the parent company in the main proceedings on the other. This obligation should exclude the obligation on the part of the liquidator in the subsidiary's territorial proceedings to provide such an

opportunity to the liquidator in the subsidiary's main proceedings.

Article 32

With respect to the subsidiary's proceedings, there is no need to give the parent company's liquidator the rights provided for in Article 32, except that he should be entitled to attend the subsidiary's creditor meetings and to speak and make proposals at such meetings.

Article 33

The liquidator in the parent company's insolvency proceedings should have the right to request the court which opened the subsidiary's insolvency proceedings to (i) stay the process of liquidation in whole or in part, or (ii) stay the process of reorganisation in whole or in part, in the interests of the group's creditors as a whole. The parent company's liquidator should also have the right to request that court to take any other measures with respect to the subsidiary's insolvency proceedings which he considers to be in the interests of the group's creditors as a whole, e.g. an order for the sale of certain assets. There are many instances where it is in the overall interests of the creditors that assets of different companies be sold together, under one contract, to the same buyer.

A request by the parent company's liquidator should be rejected only if granting it would manifestly be against the interests of the group's creditors as a whole. Continuing measures, if any, should be terminated either at the request of the parent company's liquidator or if the court deems them no longer to be in the interests of the group's creditors.

Article 34

Since the point of departure is that a coordinated sale or refinancing may yield a better result for the group's creditors as a whole, the parent company's liquidator should have primary control over offering a plan to be voted on by the creditors. Therefore, he should have the right to (i) propose a plan with respect to a subsidiary (*cf.* Article 34(1)) and (ii) request the court in the subsidiary's main proceedings to suspend any right to propose a plan with respect to that subsidiary. The right under (ii) should be linked to the prospect of a group plan in which the subsidiary will be included. If such a prospect no longer exists, the suspension should be lifted.

The centrepiece of the group provisions should be the possibility of proposing a plan covering the parent company and one or more subsidiaries. I think that it is preferable that such a plan be provided for, in detail, in the Regulation rather than applying the national law of the member state where the main proceedings of the parent company have been opened.

The plan should take into account that the creditors of the various subsidiaries in question and the parent company's creditors may have very different positions. Moreover, it should not be possible for the creditors of one subsidiary to sink the whole plan by voting against it, if the benefits they are to receive under the plan (i) are greater than what they would have received if the subsidiary was completely wound up and (ii) are fair in relation to the benefits to be received by creditors of the other group companies involved in the plan, taking into account the relative strength of their respective positions. I think a plan that is somewhat similar to an American Chapter 11 plan or a German *Insolvenzplan* might be most suitable here. Lastly, I think the following should apply:

- The proceedings with regard to the plan take place in the court which opened the proceedings with respect to the parent company.
- The plan may be proposed by either the parent company or its liquidator.
- The creditors are divided into classes. Creditors of different companies should be placed in different classes. Creditors with different ranking in respect of the assets of a particular company should also be put in different classes.
- In the event that more than one company is liable for a debt, the creditor concerned should be placed in only one class and should count only once.
- The creditors vote by class, whereby each class determines whether it accepts the plan. Acceptance may require a qualified majority, e.g. two thirds.
- The court may apply 'cram-down' provisions if one or more classes have rejected the plan, provided (i) a certain majority of all creditors has accepted the plan and (ii) the benefits which the creditors of the class(es) that rejected the plan are to receive under it (a) are more than what they would have received if the company in question was completely wound up and (b) are fair in relation to the benefits which the creditors of the other classes are to receive, taking into account the relative strength of their respective positions.
- If the plan has been accepted, the court confirms the plan unless (i) its acceptance has been obtained by dishonest means or (ii) there are creditors that are to receive less under the plan than they would have received if the relevant company had been wound up and such creditors oppose the confirmation of the plan.
- If the plan is rejected or its confirmation refused, no new group plan can be submitted.

Article 35

There is no need for a provision such as that of Article 35 dealing with surplus assets remaining in secondary proceedings.

Article 36

Article 36 currently provides for cases where territorial proceedings were opened prior to the main proceedings. It states that Articles 31 to 35 shall apply to such proceedings in so far as possible. There is no need for a similar provision with respect to the relationship between the insolvency proceedings of subsidiaries and parent companies, because the rules discussed above with respect to this relationship should apply irrespective of whether the subsidiary's proceedings were opened prior or subsequently to those of the parent company.

Article 37

The parent company's liquidator should have the power to request the court that has opened reorganisation proceedings with respect to the subsidiary to convert these into winding up proceedings.

Article 38

The parent company's liquidator should be entitled to request the opening of insolvency proceedings with respect to a subsidiary (see Article 29). He should also have the power to request the taking of any conservatory measures provided for under the national law of the subsidiary's insolvency proceedings for the period between the request for opening of the insolvency proceedings and the judgment opening those proceedings.

In my opinion, the above should also apply with respect to sister companies. However, here the question arises as to which of the liquidators should have the powers of the liquidator in the main proceedings of the parent company. My suggestion is that this be the liquidator of the sister company whose assets are assumed to be the most valuable.

IV. Substantive consolidation

There may be circumstances where the only way in which it is possible to administer the insolvency proceedings of two or more debtors is by treating their respective estates as one aggregate estate. One such situation is where the debtors are intertwined to such an extent that it is impossible to determine which assets belong to which debtor. Another is where there have been transactions between the debtors or where one debtor has provided services to the other, but where the bookkeeping in respect of these transactions or services has been inadequate and it is no longer possible to determine, with sufficient accuracy and at acceptable cost, the inter-company claims. Furthermore, such cases often involve transactions that constitute fraudulent conveyance, making it even more difficult to determine the interrelationship between the debtors. Where, for reasons such as the above, it may simply not be possible to disentangle the debtors sufficiently, the only solution is to deal with the debtors' respective estates as one aggregate estate. Thus, all assets are pooled and the claims of the creditors of the consolidated debtors treated as claims against a single entity.

The joining of estates has had quite some attention in United States case law and literature and is known there as 'substantive consolidation', a term which I shall adopt here. Although in this article I shall not digress into a thorough analysis of US bankruptcy law, it may be useful to take into account some of the elements which play a role in US practice.

The US Bankruptcy Code does not contain any provisions on substantive consolidation, except for Section 302 (b), which concerns the consolidation of the estates of spouses. Substantive consolidation with respect to companies is a matter of case law.

Under US case law, substantive consolidation may be allowed not only where the financial affairs and businesses of the debtors are commingled in such a way that they cannot be separated at acceptable cost[4], but also in cases where creditors of related entities have dealt with these entities as a single economic unit, and have not relied on their separate identities when extending credit[5]. For the purposes of European legislation, I would suggest that only the first type should, and must, lead to consolidation. Where the financial affairs and the businesses of the debtors are commingled to such an extent that they cannot be separated at acceptable cost, there is simply no other solution. For the sake of completeness, I would here like to mention that if debtor A has a definable set of assets but it is impossible to establish the size of debtor B's claim on debtor A for past services etc., substantive consolidation may only be necessary if the proceeds in debtor A's insolvency proceedings are sufficient to

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4 See Court of Appeals for the Second Circuit 2 December 1966 The Chemical Bank of New York Trust Co. / Kheel 369 F 2d 845.

5 See C.J. Tabb, *The law of bankruptcy,* 1997; Collier, *On bankruptcy* Chapter 105; Court of Appeals for the Second Circuit 24 February 1964, Soviero / The Franklin National bank of Long Island 328 F 2nd 446; Court of Appeals from the 2nd Circuit 24 October 1988, In re Augie / Restivo Baking Co 860 F.2d 515.

make a distribution to ordinary creditors such as debtor B.

With respect to the second type of case (i.e. where creditors have dealt with the debtors as a single economic unit), I do not see the necessity of substantive consolidation. Moreover, it often happens that some creditors will have dealt with the debtors as one economic unit, but others not. I think that in the second type of case it would be more appropriate to allow those creditors that were confused, or that were led to believe that the enterprises were liable as one entity, to institute separate claims against those of the debtors who can be held liable therefor; rather than to throw all the assets together.

Finally, I would like to add in this respect that it is conceivable that the main reason that the second type of case is eligible for substantive consolidation under US law is that, in the United States, substantive consolidation also opens the possibility of including all the assets and creditors in one single reorganisation plan. It makes sense to have such a plan where the companies acted as a single economic unit. However the proposals which I made in section III include the possibility of a group plan even in the absence of substantive consolidation. Therefore I think that, also for this reason, there is no need for substantive consolidation under European law if the companies acted as a single economic unit without there being any commingling of the assets or businesses.

The American courts profess to apply substantive consolidation only in exceptional cases because it has several undesirable effects[6], of which I here mention the following:

(i) Assuming that after substantive consolidation all ordinary creditors receive the same percentage in a distribution, the consolidation will almost always have prejudiced the creditors of one of the consolidated debtors in favour of those of another[7]. For example, if, in the absence of substantive consolidation, the ordinary creditors of debtor A would have received 60% of their claims and those of debtor B 20% of their claims, the creditors of debtor A will be worse off as a result of consolidation and the creditors of debtor B better off. The same would apply to preferred creditors with the same ranking (e.g. employees) if they do not receive full payment. I think that, generally speaking, where the estates are hopelessly entangled this argument does not hold, because if it is completely impossible to determine which assets belong to which company or to determine the magnitude of inter-company obligations, it will also be impossible to estimate with any degree of certainty the percentage distributions in each of the insolvency proceedings in the absence of substantive consolidation. However, the argument does carry weight where substantive consolidation is sought on the basis of the single economic unit scenario rather than the entanglement scenario. As stated earlier, in my proposal for the European context, I do not consider substantive consolidation to be necessary in the former scenario (single economic unit). Nonetheless, even when substantive consolidation is sought by reason of the commingling of assets and/or businesses, it may sometimes still be possible to determine that the position of the creditors in insolvency proceedings A would have been stronger than the position of the creditors in insolvency proceedings B. This can be the case, for example, when the debtors are largely intertwined but where it is still possible to determine that some of the assets definitely belong to only one of the debtors.

(ii) Inter-company claims disappear, whereas if it were not for the substantive consolidation, they would have led to an increase of the distribution to the creditors of the company holding such claims. Here again, it can be argued that in cases of complete entanglement it might not have been possible to determine the magnitude of the inter-company claims at all. However, there are also cases in which, in spite of the entanglement, a definite value could have been attributed to at least some inter-company claims.

(iii) Creditors that have security interests in inter-company claims lose these rights as a result of the substantive consolidation.

(iv) If two or more of the debtors are jointly and severally liable for a debt, the position of the creditor concerned will weaken if these debtors are substantively consolidated and if, as a result of such consolidation, the creditor can claim only once.

In the United States, the courts are able to address these problems by, for example, ordering that the creditors that are prejudiced by the substantive consolidation receive higher percentage distributions than other creditors with the same ranking. This type of measure has been held possible because substantive consolidation is considered an equitable remedy under s.105 (a) of the US Bankruptcy Code.

Notes

6 See Court of Appeals for the 2nd Circuit 24 October 1988, In re Augie / Restivo Baking Co 860 F.2d 515; Court of Appeals for the 2nd Circuit 28 October 1970, In re Flora Mir Candy Corp / R.S. Dickson & Co. 432 F 2nd 1060.

7 Court of Appeals for the 11th Circuit 11 July 1991, Eastgroup Properties / Southern Motel Assoc. Ltd, 935 F 2d 245.

When the option of substantive consolidation is provided for in the European Insolvency Regulation, and I think that with respect to commingled cases it must be included, the first questions to be answered are: (i) which court will supervise the consolidated proceedings? and (ii) which court will decide on the substantive consolidation? As to the first question, I think that the court supervising the parent company's main proceedings is the court that should supervise the consolidated proceedings. Under the proposal I put forward in section III, it is the parent company's liquidator who is entrusted with the interests of the group's creditors as a whole; therefore, the court supervising this liquidator should be the one to take into account the group interests here too. I find the second question more difficult to answer. Whether it is the parent company's creditors or those of the subsidiary that will be prejudiced in the absence of any counter measures being taken will differ from case to case. I therefore do not think that the protection of one group of creditors can be a determining factor in selecting which court has authority to decide whether the proceedings should be consolidated. Since, under my proposal, the subsidiary's main proceedings will have to cease to continue as such as a result of the consolidation, I think that the court supervising these proceedings should decide on the consolidation.

My proposal is therefore as follows: Either the liquidator in the parent company's main proceedings, the liquidator in the subsidiary's main proceedings or the creditors of either company may request the court in the subsidiary's main proceedings to order substantive consolidation of the insolvency proceedings of the parent and this subsidiary. If the request is granted, the subsidiary's main proceedings are converted into secondary proceedings with respect to the consolidated companies, and the parent company's main proceedings become main proceedings of the consolidated companies. However, if secondary proceedings with respect to the parent company have already been opened in the member state in which the subsidiary's main proceedings were also opened, these secondary proceedings are converted into secondary proceedings of the consolidated companies and the subsidiary's main proceedings terminated.

Earlier in this section, I discussed the negative effects consolidation might have on some of the creditors (lower percentage in the distribution, elimination of inter-company claims, loss of security interests and loss of favourable position due to multiple debtors). As mentioned, in the Unites States the courts can take measures to address these effects e.g. by ordering different treatment of the creditors. I think that, under the Regulation, similar powers should be given to the courts supervising the insolvency proceedings of consolidated companies. Such decisions should be recognised and given effect in any secondary proceedings with respect to the consolidated companies in question.

The above proposal on substantive consolidation refers to parents and subsidiaries; however, I think that what has been suggested in this regard should also apply where only sister companies but not the parent have entered into insolvency proceedings. Again, here I suggest that the sister company whose assets are assumed to be the most valuable be treated as the parent company.

V. Proposals

In summary, my proposals are the following:

1. The European Insolvency Regulation should provide for a group regime for cases in which a parent and one or more subsidiaries have entered into insolvency proceedings. Under this regime, the parent company's liquidator should have powers of coordination with respect to the subsidiary's proceedings as well as the power to effect the coordinated sale of the assets of the companies in question.
2. In the event that a group regime has been put into place, there should be the option of putting together a group reorganisation plan. The creditors of the group companies involved in the plan should be divided into separate classes for the purpose of voting on the plan. The court supervising the parent company's main proceedings should have the power to apply 'cram-down' provisions, provided (i) the creditors concerned receive more than they would have received if the company in question had been wound up, and (ii) those creditors are not treated unfairly vis-à-vis the other creditors, taking into account the relative strength of their respective positions.
3. For cases in which it is not possible to disentangle the assets or businesses of group companies that have entered into insolvency proceedings, there should be a mechanism for substantive consolidation. The decision on whether or not to consolidate the insolvency proceedings of the parent and subsidiary in question should be taken by the court supervising the subsidiary's main proceedings, while the court supervising the parent company's main proceedings should supervise the consolidated main proceedings.