Summary

Groups of companies and bankruptcy

Strong financial, organizational, economic and personal relations often exist between group companies. Nevertheless, the companies are sought to remain separate legal entities. Their independence comes to the foreground when one or more related entities are declared bankrupt. The bankrupt companies are then disconnected away from the group and are also isolated from each other. Their bankruptcies are dealt with separately. The separate treatment of the various bankruptcies has caused problems in the Dutch insolvency-practice. The various bonds between the companies are so tight that often (some of) their assets and liabilities have become intermingled. If, in such a case, the companies have less than perfect accounting practices, it will be impossible for the trustee to assign the different assets and liabilities to the estates of the respective companies. This problem is often worsened by the fact that creditors do not know which of the companies is their contracting party due to the strong bonds that exist between the companies. If one and the same trustee is appointed to oversee the various bankruptcy proceedings another problem can come up: the trustee can find it difficult to assign his costs to the different estates. In the Dutch insolvencypractice these problems have been tackled by consolidating the estates, thus consolidating all assets and liabilities into one estate, canceling the inter-company claims and making superfluous the assignment of costs to the individual estates.
Next to the aforementioned practical problems some dogmatic problems arise when the bankruptcies of interrelated companies are dealt with separately. When the companies are declared bankrupt, it often appears that the creditors of a single company find themselves in very different positions with regard to each other. Large creditors, for example banks, have frequently been able to bind all group companies for the repayment of a loan that has been given to one of them. They have approached the group as a whole, and can continue doing this even if some group companies are declared bankrupt. In theory, small creditors also have the possibility to approach the group as a whole, but in practice this works out differently. In order to achieve that all creditors can approach the group as a whole if some group companies are declared bankrupt, substantive consolidation can be considered, but in my opinion, only in cases where the creditors have been misled by the companies or the companies have abused any existing positions of dominance. And even then one has to be cautious, because substantive consolidation can have far-reaching, sometimes negative consequences for some

of the creditors involved. Moreover, substantive consolidation should not be ordered because breaking up the unity the companies represent towards banks is time-consuming due to the fact that the annulment of the transactions between the companies and the banks via fraudulent preference actions (*actio Pauliana*) is laborious.
Substantive consolidation is not a panacea; this remedy has its own draw - backs. Frequently not all creditors of the bankrupt companies will benefit from a substantive consolidation. The asset/liability ratio usually differs from one company to the next, as a result of which the creditors of the ‘richest’ company will be harmed by the substantive consolidation. Moreover, because substantive consolidation has been a reaction to problems arising in the Dutch insolvency practice, some aspects of this remedy have not been dealt with in case law nor by legislation. As such, this remedy is uncertain from a legal point of view. It is, for example, not yet clear who is competent to decide whether substantive con - solidation is just and under which circumstances the remedy can be invoked. It is

thus important to formulate a norm, that recognizes the benefits of consolidation, but also its drawbacks. This norm should then be codified in order to enhance certainty and equality amongst debtors and their creditors.
Who benefits from a substantive consolidation and who is harmed by it depends on the circumstances of each case. This leads me to believe that a strict norm, enumerating all the situations in which substantive consolidation will be just, is impossible to formulate. In my view substantive consolidation should be possible when (1) the estates of the debtors have *de facto* been (partly) pooled in such a way that only an arbitrary division of this one estate is possible, (2) the debtors have dealt with the creditors as if they were one entity, or (3) the separate handling of the bankrupt estates is unjust and inequitable, because the benefits of the substantive consolidation for the joint creditors heavily outweigh the harm that it will cause to some of those creditors. Especially, with regard to this third scenario it is important to clarify the consequences of a substantive consolidation in order to ensure the court has a good idea of what a decision to consolidate will entail. The court will then be better equipped to decide whether substantive consolidation will be just and equitable in a given situation. The prerequisite that the benefits must *heavily outweigh* the harm will counterbalance the objections that flow from (a) the fact that balancing pros and cons entails a value judgment, and (b) the circumstance that the different pros and cons are often difficult to quantify and value, which complicates the balancing-process.
The preceding paragraphs lead me to the conclusion that – in principle – the estates of interrelated debtors should be dealt with separately. Substantive consolidation should only be allowed if the joint creditors of the bankrupt companies will benefit from it and the interests of an individual creditor will not be disproportionably harmed by it.
At the same time substantive consolidation should not be presented as an *ultimum remedium*, meaning that substantive consolidation can only take place when it is shown that other, more common remedies like tort claims and fraudulent preference actions do not suffice. Also in cases where these remedies

could lead to an acceptable outcome, I would not always choose for them to be applied. Substantive consolidation can – depending on the circumstances of the case – lead to a more equitable result for the creditors of the different debtors than the aforementioned remedies. For instance when the benefits of substantive consolidation for the joint creditors heavily outweigh the harm it will cause to some of those creditors. This can happen when the debtors' estates are intermingled, but can still be separated and put in order by using fraudulent transfer or preference actions, which actions would consume most assets of the estates, thus minimizing the distribution to creditors. If in that situation the bankruptcies are substantively consolidated the estates need not be separated, which will save costs as a result of which creditors can receive a larger distribu - tion on their claims.
While substantive consolidation gradually receives approval in The Nether - lands, the question has been raised whether it should also be possible to extend a bankruptcy proceeding of a company to another company that has not yet been declared bankrupt. After extending the bankruptcy proceeding the two bankruptcies can be consolidated.[1] Introduction of this remedy could put an end to the tinkering with group companies that sometimes takes place on the eve of bankruptcy: every so often the 'healthy' companies are separated from the ones that are not doing well. This separation may take place at random, because the 'healthy' companies owe their status to the financial input of the companies that

are put in liquidation.[2] Nevertheless, extending bankruptcy proceedings has disadvantages as well. For instance, declaring thriving companies bankrupt should be prevented.[3]

Origin and background of substantive consolidation

To get a better view of the advantages and disadvantages of substantive consolidation, I analyzed the Dutch, American, French, New Zealand and Irish rules on the subject. In the United States and France the law on substantive consolidation is judge made. In New Zealand and Ireland the legislator intro - duced rules regarding this matter.[4] In the Netherlands the admissibility of sub - stantive consolidation is based on a single ruling of the *Hoge Raad*, that is the Dutch Supreme Court.[5]

It is remarkable that in the countries where the law on substantive consolida - tion is judge made the scope of its application has not been clearly defined. In the United States and France substantive consolidation can take place between

1 See amongst others Slagter 1988, p. 129-130; Winter 1993, p. 13-14 and Winter *TvI* 1995, p. 6-7.
2 Winter 1993, p. 14 and Winter 1995 *TvI*, p. 7.
3 Winter 1993, p. 14 and Winter 1995 *TvI*, p. 7.
4 Articles 271 and 272 CA 1993 (NZ) and article 141 CA 1990 (IE).
5 HR 25 September 1987, *NJ* 1988, 136, comments by G; *AA* 1988, p. 107, comments by PvS (Van Kempen en Begeer/Zilfa en DCW).

bankruptcies of different kinds of entities, and people as well. Moreover, not only bankruptcies can be substantively consolidated, but also reorganizations. At this point in time this also appears to be possible in The Netherlands. At the time of finishing this thesis in New Zealand and Ireland on the other hand, the scope of application is limited by law to related companies that are put in liquidation. In my opinion the New Zealand and Irish approach should not be followed in The Netherlands, because it would unjustly limit the scope of application of sub - stantive consolidation. After all, the problems that can be solved by this remedy do not only arise between related companies, but can also arise between a company and its director, between spouses, etc.

In the legal systems under review substantive consolidation appears to be a reaction on problems that come up while dealing with bankruptcies of related persons and companies. On the one hand there are reactions to improper or even fraudulent dealings by related debtors towards their creditors. On the other hand reactions entailing practical solutions to problems that stem from the interming - ling of assets and liabilities or activities. But the interests of the creditors are always at the heart of the decision to consolidate. The harm that was caused them by improper or fraudulent dealings by the debtor will be undone by the substantive consolidation, or an arbitrary allocation of assets and liabilities will be prevented.

As explained above, not every creditor will benefit from a substantive consolidation. This circumstance is not dealt with in detail in every legal system under review. In the United States it attracts quite a lot of attention from judges, and in New Zealand it is also noticed that substantive consolidation can cause harm to some of the creditors. In France however, only a couple of authors mention the possible harm substantive consolidation can entail for creditors.[6] In The Netherlands the awareness of this negative consequence is growing. Here substantive consolidation initially was a reaction to the intermingling of assets and liabilities by debtors. In that case it is impossible to determine whether one or the other creditor will be harmed by a substantive consolidation, because the debt-to-asset ratios of the different debtors are unascertainable. But the increasing attention for substantive consolidation has led some authors to observe that this

remedy can harm certain creditors.[7] In the other legal systems analyzed in this book, where this disadvantage is taken into account, the pros and cons of substantive consolidation are often weighed to determine whether the remedy is just and equitable in a given instance. The American balancing tests are good examples of this practice, but also the New Zealand provision on the subject provides the court with discretionary powers that allow it to take into account all relevant circumstances.

In my opinion, a weighing of interests should also be introduced in Dutch insolvency law. That is to say that substantive consolidation should be possible in

6 Due to the lack of Irish case law and literature on the subject remarks about Irish practices can not be made.

7 Amongst others: Josephus Jitta 1999, p. 105-106.

SUMMARY

The Netherlands if separate handling of the bankrupt estates is unjust and in - equitable, because the benefits of substantive consolidation for the joint creditors heavily outweigh the harm it will cause to some of them.

Grounds for substantive consolidation

In the United States, France, New Zealand, Ireland and The Netherlands several grounds for substantive consolidation of bankruptcies can be discerned. First, the presence of inextricably intermingled assets and liabilities, meaning that the assets and liabilities cannot be assigned to a specific estate. This circumstance justifies substantive consolidation, because any possible division will be arbitrary and unjustifiable towards the creditors of the debtors, the debtors themselves, as well as their shareholders. Furthermore, both the intermingling of *all* assets and liabilities and the intermingling of some, but not all assets or liabilities should provide sufficient grounds for substantive consolidation. Otherwise, the problem that an adequate basis for the division of the intermingled assets or liabilities cannot be found, will remain.

Another, broader definition of intermingling of assets and liabilities is used in France. There substantive consolidation based on the intermingling of assets and liabilities of the debtors is also possible if unusual financial relations exist between the debtors, such as the provision of services below their market value. In my opinion such traceable unusual financial relations should not be taken into account when determining whether substantive consolidation is just and equitable because the debtors have intermingled their assets and liabilities. If creditors are harmed by the presence of unusual financial relations these relations and the consequences thereof should be undone by other remedies such as fraudulent preference actions. Such actions ensure that only the unusual transactions that have harmed the creditors are annulled. Without an additional reason, substantive consolidation – a remedy that would not only undo the effects of the unusual transaction, but would also disproportionately harm some creditors – is not justified. Nevertheless, the decrease in costs that would take place because ac - tions against inter-company transactions would become unnecessary if sub - stantive consolidation were allowed, may be taken into account. The decrease in costs should be considered a benefit when determining whether the benefits of substantive consolidation for the joint creditors heavily outweigh the harm it will cause to some of them.

A second circumstance that is taken into account when determining whether substantive consolidation is just and equitable is the presence (or absence) of financial, economic, personal and organizational relations that often exist between group companies. While it is possible that companies are only related on a financial or personal level, in practice all the aforementioned relations usually exist simultaneously. However, it should be stressed that the various kinds of

relations tend to have a different influence on the decision to substantively consolidate bankruptcies.
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Financial relations between group companies play a part in the decisionmaking process in all legal systems under review. Sometimes in relation to the question whether the assets and liabilities of the debtors are intermingled, but mostly as a separate factor. The various financial relations between the debtors give different, and sometimes even mixed, signals. For example, some American and French judges hold that the existence of inter-corporate guarantees is an argument pro consolidation[8], while others – in my opinion correctly – hold that such guarantees proof that the companies are separate legal persons who have their own rights and responsibilities, and thus consolidation is not warranted just because inter-corporate guarantees exist.[9] In my view, financial relations between companies should be taken into account by the court that is considering substantive consolidation because a bankruptcy proceedings concentrates on the financial responsibilities of the debtor, but financial relations as such cannot justify a substantive consolidation.
Economic relations are also taken into account by courts confronted with a request for substantive consolidation, especially in the United States and New Zealand. At present, the existence of economic relations is not an important factor in the Netherlands. Here the focus lies on whether or not the assets and liabilities of the companies are intermingled. This is also true for France, where in the past several lower courts have substantively consolidated the bankruptcies and reorganizations of companies that *de facto* formed one entity with one under - taking[10], but the *Cour de cassation* has stuck to the rule that only intermingling of assets and liabilities or the existence of a fictitious company (*société fictive*) can give rise to substantive consolidation.
In my opinion the sole fact that economic relations exist between companies is insufficient reason to substantively consolidate their bankruptcies. These companies still are separate legal persons, that have separate rights and respons - ibi lities. They should pay their creditors out of their own assets. However, one should note that the existence of strong economic relations between companies
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8 See for example the American cases *In re Vecco Construction Industries Corp*., 4 B.R. 407, 410-411 (Bankr. E.D. Va. 1980) and *In re Richton International Corp*., 12 B.R. 555, 558 (Bankr. S.D. N.Y. 1981), and the French cases: Cass. com. 25 May 1993, nr. 91-10998 with regard to the fictitious company and Cass. com. 2 March 1999, nr. 95-14007 and Cass. com. 7 December 1999, nr. 97-14119 both with regard to the intermingling of assets and liabilities; the French cases are not published in the Bulletin des arrêts de la cour de cassation, but can be found on the internet: <http://www.legifrance.gouv.fr/>.
9 See for example the American cases *Union Sav. Bank v. Augie/Restivo Baking Co.*, 860 F.2d 515, 519 (2d Cir. 1988) and *In re Lease-a-fleet, Inc.*, 141 B.R. 869, 876 (Bankr. E.D. Pa. 1992). See also the following French case: CA Paris 16 January 1986 *Rev. soc.*, 1986, p. 445, comments by Calendini. And compare: CA Colmar 21 March 1972, *RtDCom.* 1973, p. 357-358, and CA Versailles 3 February 1994, *Bull. Joly* 1994, p. 535, 536: 'Considérant qu'il est exact également que les cautions accordées par la SCI BFL à la BNP (…) pour le prêt accordé à la SARL Floralies du Val'd'Oise et (…) pour le prêt accordé à la SARL FVO ne constituent qu'un indice secondaire de la confusion des patrimoines.'
10 For example: Trib. com. Paris 13 February 1986, *Gaz. Pal*. 1986, som., p. 220, comments by Marchi en CA Paris 20 March 1986, *Rev soc*. 1987, p. 98, comments by Guyon.

can contribute to the reliance of creditors on the existence of a single entity and the creditworthiness of this entity. This kind of reliance can be an argument in favor of substantive consolidation.
Furthermore, the economic relations between the companies can influence the reach of the substantive consolidation.[11] If group companies are active in various

branches of industry it is conceivable that, in bankruptcy, the estates of the companies in each branch will be pooled together resulting in different consolida - ted bankruptcies. Towards creditors this split up will be easier to explain than a full blown substantive consolidation of the bankruptcies of all group companies, because creditors often operate in a single branch of industry and do not realize their debtor is part of a much larger group that via different companies operates in various branches of industry.
Next to financial and economic relations, personal and organizational rela - tions often exist between group companies: every now and again a person sets up two or more companies of which he holds the shares and acts as a director. He coordinates the company policies of all companies and ensures that they are acted upon. Nevertheless, this does not mean that the companies act as one towards third parties and have not each got a separate corporate life and separate rights and responsibilities. Therefore it is not surprising that in the legal systems under review personal and organizational relations between companies hardly affect the answer to the question whether substantive consolidation is just and equitable.
In the United States and France the improper use of a company is sometimes thought of as sufficient grounds for substantive consolidation of the bankruptcies of the company and the person pulling the strings behind the corporate facade. As improper use of a company can be characterized setting up the company to circumvent non-competition clauses or defraud creditors. In the United States the use of so-called alter ego and instrumentality considerations in this context is heavily criticized. ‘Alter ego’ and ‘instrumentality’ are concepts thought to cover a lot of different circumstances that are not all relevant when looking for an answer to the question whether substantive consolidation is appropriate. It is especially troublesome that this tactic concentrates on the dealings of the person behind the company and not so much on the interests of the creditors of all companies involved, whereas their interests usually play a central part in bank - ruptcy proceedings.[12] This also holds true for the French tendency to substantive - ly consolidate the bankruptcies of a fictitious company and the person controlling it.
Usually substantive consolidation does not benefit the creditors of both the company and the person hiding behind it. In most cases the creditors of the person in charge will be disproportionately harmed by a substantive consolidation, which will in turn benefit some or all of the creditors of the company. This is the case,

11 With regard to the United States: *In re Interstate Stores, Inc.* 1978 Bankr. LEXIS 11 (Bankr. S.D. N.Y. 1978) and with regard to The Netherlands: the bankruptcies of Verzekerd Keur B.V. and several companies related to this company.
12 Compare: Kors *U.Pitt.L.Rev*. 1998, p. 440-441 and 445-446.

for example, if a lot of administrative claims are made against the estate of the company, which claims will – after the consolidation – rank higher than the unsecured creditors of both the company and the person in charge. In my view the interests of the joint creditors of the debtors should play a key part when deciding whether substantive consolidation is just and equitable. This leads me to conclude that in The Netherlands the legislator should not adhere to the rules regarding *vereenzelviging* (identification) – a remedy similar to substantive consolidation – when formulating a norm for substantive consolidation, because *vereenzelviging* (if used in a liability context) also concentrates on the dealings of the person behind the company who is pulling the strings. I prefer a weighing of interests to be made, which allows the court to take into account the specific circumstances of each case and the consequences a substantive consolidation would have for the creditors of the different debtors if it were to take place.

In the foregoing it is already explained that substantive consolidation has diffe - ring consequences for creditors. Some creditors will benefit from it, while others will be harmed by it, except that the determination that a creditor will benefit or be harmed cannot be made when the assets and liabilities of the debtors are inextricably intermingled.

Notably in the United States these differing consequences resulted in a cautious use of the remedy, although they have not resulted in a rule proclaiming substantive consolidation unlawful if one or more of the creditors would be harmed by it. Sometimes some creditors have to make a sacrifice in support of larger concerns and goals. In my opinion this view is correct. Substantive consolidation should be possible when its benefits for the joint creditors of the debtors heavily outweigh the harm it will cause to some of those creditors.

A creditor that is harmed by the substantive consolidation should not expect any compensation for the harm caused. I do not recommend partial or conditional substantive consolidation as a means to compensate the harmed creditor, because of its complexity and the practical problems involved. The creditor may initiate proceedings against the trustee arguing that the trustee is liable because he committed a wrongful act by instigating the substantive consolidation, but he does not stand a fair chance, for the court has already decided that, under the relevant circumstances, substantive consolidation is appropriate.

Frequently the harmed creditor will be a creditor of the ‘richest’ debtor involved, arguing that he relied on the creditworthiness of his debtor. As rightly pointed out by some American courts, but different from the French practice on this point, a court cannot ignore this argument. If a creditor is able to proof reliance on the creditworthiness of his debtor, the harm a substantive con - solidation would cause him must be taken into account when weighing the pros and cons of that substantive consolidation.

On the other hand it is also possible that creditors have relied on the credit - worthiness of the joint debtors. Although, in my expectation, this will rarely happen. For example, the creditor who knows his debtor is or was related to other companies that together form a group, and who has relied on the strong bonds

between the debtor and these companies, does not fall into this category.[13] This creditor was aware of the companies having separate legal personalities and independent legal rights. If he believed the creditworthiness of his debtor was insufficient, he should have negotiated inter-corporate guarantees. In cases where reliance on the creditworthiness of the joint debtors nevertheless does happen, it is a strong argument in favor of substantive consolidation.

In case some creditors have relied on the creditworthiness of the group while others have relied on the creditworthiness of their specific debtor, the reliancearguments should be translated into pros and cons of the proposed substantive consolidation and taken in to account when the aforementioned weighing of interests takes place.

A substantive consolidation can also adversely affect shareholders. This is the case if they would have received a distribution would the bankruptcies have been treated separately, which distribution due to the substantive consolidation shifts to the creditors of an entity related to their company. Hence, the interests of the shareholders conflict with the interests of the creditors.

In my opinion, in The Netherlands, the interests of the creditors should prevail in cases like this. The purpose of bankruptcy proceedings in The Netherlands is serving the interests of the joint creditors of a debtor.[14] Other interests can be taken into account, but they cannot prevail. Although this rule evolved in nonconsolidated

bankruptcies, it should also apply in consolidated cases. I consider it just for a shareholder to be bearing a bigger risk than a creditor, because he supplied risk-bearing capital and he has rights that allow him to interfere in the company policy when the company is heading towards bankruptcy. This last point is especially true in the context of a group of companies where the shareholder is often an insider who holds the majority of the shares, and thus the majority of the voting rights.

Sometimes the negative effects of a substantive consolidation will be (partially) neutralized by its positive effects. Especially the simplification of the adminis - tration of the bankruptcy proceedings (combined reporting, organizing only one meeting in order to verify claims, etc.) can diminish costs and allow higher distributions to creditors. In the United States, and sometimes also in New Zea - land, it is furthermore noted that substantive consolidation can enhance the reorganization process. In reorganization proceedings substantive consolidation will also simplify the administration which allows a speedier and less costly re - organization to take place. In the Netherlands comparable arguments can be formulated in bankruptcy cases where a settlement can be reached between the debtors and their creditors: only one settlement agreement will have to be drafted and submitted to a vote by the creditors, because substantive consolidation entails treating the debtors as if there is only one debtor with one estate. If the creditors

13 Compare: article 272(3) CA 1993 (NZ) and article 141(5) CA 1990 (IE).

14 Van der Feltz, I, p. 27, Explanatory memorandum and p. 339, Explanatory memorandum with regard to article 20 *Faillissementswet*.

accept the proposed settlement, the court sanctions the settlement agreement, and its judgment becomes absolute, all bankruptcies will end, article 161 *Faillissementswet*.

Procedure

Keeping in mind the differing and far-reaching consequences substantive consolidation can have for the parties involved, it is important that a decision substantively consolidating two or more bankruptcies is carefully made. In my opinion this entails that the decision has to be made by the court, an independent and impartial authority, after hearing the interested parties. This corresponds with the decision-making process in the foreign legal systems under review. Other persons involved in the bankruptcy proceeding, for example the trustee or the examining judge (*rechter-commissaris*), are less equipped to decide on sub - stantive consolidation. These persons are not fully independent and might appear to be partial.

In my opinion creditor and shareholder approval is not a requirement for substantive consolidation. If it were a requirement, the decision-making process would be lengthy and difficult, and would often result in a refusal to consolidate where consolidation would benefit the joint creditors of the debtors. After all, a substantive consolidation will usually harm a number of creditors and/or share - holders, who would probably therefore vote against a substantive consolidation.

As the Dutch lack a specialized insolvency court entrusted with handling large and difficult bankruptcies, the court with jurisdiction should be the court that has started the first of all bankruptcy proceedings involved. This rule is clear and practicable. Each debtor, the trustee in one of the bankruptcies, and the creditor committee should be able to petition the court for substantive consolidation, because they are best informed about the relations between the bankrupt debtors. The petitioner(s) should file a reasoned petition with the court. The petition may be filed until the trustee in one of the bankruptcies has sent a written notice to the creditors (a) informing them that the lists of provisionally allowed and disputed

claims have been deposited at the clerk's office and (b) reminding them of the meeting at which their claims will be verified, see article 115 *Faillissementswet*. Limiting the possibility to petition the court for a substantive consolidation in this way is efficient.
The petitioners and other interested parties should be allowed to challenge a decision ordering substantive consolidation or refusing this remedy. For practical reasons a parallel should be drawn between this situation and the situation where interested parties challenge a decision declaring a (legal) person bankrupt. Ergo, the possibilities for disputing such a decision laid down in article 8 *Faillissementswet* and further should be applied analogously.
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Consequences

Substantive consolidation entails the joining of two or more estates into one for the purpose of the bankruptcy proceeding. In the United States, France and The Netherlands the joining of the estates is the point of departure. In New Zealand and Ireland this is also possible, but the legislator has taken a different point of departure. He has chosen an approach whereby the court, on a case-by case basis, decides the extent of the substantive consolidation. In these countries partial consolidation is therefore possible. But partial substantive consolidation is also possible in the United States. Partial substantive consolidation can be defined, in short, as a substantive consolidation that does not affect all creditors; some creditors will be in a position similar to the one they would have been in had the substantive consolidation not been ordered. In my opinion partial substantive consolidation should not be possible in The Netherlands. This means the remedy of substantive consolidation will be less flexible, but also less complicated and more practical.
Substantive consolidation does not, in my opinion, abrogate the legal per - sonality of the debtor companies involved. Substantive consolidation entails treating the companies *as if* they were one bankrupt debtor. In reality the companies still exist as separate legal entities although the consolidated bank - ruptcy proceeding will usually result in the dissolution of each of the companies involved, see article 2:19 Dutch Civil Code, and 16 and 173 *Faillissementswet*.
The fact that the debtors are treated as if they were one in my view entails the appointment of a single trustee. The decision to substantively consolidate their bankruptcies has put an end to the conflicts of interest between the creditors of the various debtors and between the debtors themselves. After this decision the remaining conflicts are similar to the ones detectable in non-consolidated bankruptcy proceedings. Whether two or more trustees should be appointed, depends on the magnitude and the complexity of the consolidated proceeding.
In none of the legal systems under review a substantive consolidation has consequences for the distributional hierarchy between creditors. This hierarchy will then apply between all the creditors of the debtors involved. Although it must be pointed out that some security rights are affected by the consolidation. In that regard a distinction has to be made between a real security, which allows a creditor to recoup its claim from the proceeds of a certain asset of the debtor, and a personal guarantee, which means a third party has guaranteed the payment to be made by the debtor.[15]
Security rights that fall into the first category, for example a mortgage right (*hypotheekrecht*) or a right of lien (*pandrecht*), are, in principle, not affected by a substantive consolidation unless the creditor finds its security in an asset that disappears due to the consolidation, such as an inter-company claim. Intercompany claims are eliminated by a substantive consolidation because otherwise

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15 About the difference between these types of security rights: Snijders & Rank-Berenschot 2007, p. 406, nr. 482.

the claim, which is part of the consolidated estate, would have to be paid out of that estate. The elimination of inter-company claims entails the elimination of a lien on that claim, see article 3:81(2)(a) of the Dutch Civil Code. The holder of the lien will thus be harmed by the substantive consolidation. Despite being alert in the past, this creditor finds it security right eliminated. In my opinion this circumstance justifies granting the creditor a privilege, meaning his claim – for the amount of the eliminated inter-company claim – must be paid out of the assets of the combined estates in priority to other creditors. The rank of this priority right needs to be determined by the court in order to ensure that the creditor will not be disproportionately prejudiced or favored by the substantive consolidation.
Because substantive consolidation entails dealing with the debtors as if there was only one debtor, and thus one estate, any inter-corporate guarantees between the debtors in the consolidated bankruptcies are frozen. If personal guarantees were to come into effect this fictitious entity would guarantee its own debts, which does not offer any additional security to creditors: as a result of the substantive consolidation creditors can already recoup from the assets of the combined estate.
Personal guarantees obtained from third parties for the payment of debts of one of the debtors will, on the other hand, come into effect. In my opinion, the following should even be accepted: If a creditor has obtained a guarantee from a third party, D, entailing that D will pay all outstanding debts of debtor A to the creditor in the event debtor A does not pay them, D will, as a result of the substantive consolidation of the bankruptcies of A and B, have to pay all out - standing debts of A and B to the creditor. After all, as a result of the sub stantive consolidation A has *de facto* become responsible for the payment of B's debts. A's assets will be used not only for the payment of its own debts, but also for the payment of B's debts. If D wants to prevent this extended liability he will have to guarantee the payment of A's debts up to the moment of its bankruptcy.
Regarding priority rights a distinction has to be made between priority rights that extend over all assets of the debtor (so-called: *algemene voorrechten*), and priority rights that rest on a specific asset (so-called: *bijzondere voorrechten*). In The Netherlands and France the last mentioned priority rights are rightly considered to keep on resting on the specific asset involved if substantive consolidation takes place. The legislator has deliberately attached priority rights to certain creditor claims. Substantive consolidation cannot subvert that decision. Additional protection for the creditors with claims mentioned in the articles 3:283-287 of the Dutch Civil Code is a political choice, which may only be amended by the legislator.
In the United States and France the first mentioned category of priority rights is thought to extend over all assets in the combined estate in case of a substantive consolidation. I would recommend implementing this practice in The Nether - lands. The joint liability resulting from the substantive consolidation entails that both bankrupts are *de facto* debtors of the privileged creditor. A priority right that is attached to a creditor's claim therefore extends over the assets of both debtors, that is to say all assets in the combined estate. This reasoning is also in keeping
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with article 3:278(2) of the Dutch Civil Code, were it is held that *algemene voorrechten* extend over all assets of a debtor: due to the substantive con - solidation the assets of the different debtors are treated as if they belonged to a

single debtor.
The possibility of substantive consolidation has raised the question whether a creditor who owes a debt to one of the companies involved therein can setoff this debt against a claim he has against another of those companies. In other words, is a setoff possible when strictly speaking the debts are not mutual? In the United States and New Zealand this is sometimes possible. In France the *Cour de cassation* has explicitly sanctioned such a setoff.[16] And in my view the Dutch legislator should also permit such a setoff. This kind of setoff is justified because the bankruptcies of the different debtors are treated as if there was only one bankruptcy; a single bankrupt entity. The assets and liabilities of the different debtors are treated as if they belonged to only one debtor. The debt as well as the claim of the aforementioned creditor thus fall into a single estate at the moment of the setoff, meaning that the requirement of article 6:127(3) of the Dutch Civil Code is fulfilled.
In the Netherlands, as in France, specific rules exist on director liability regarding directors of bankrupt companies.[17] If a director has mismanaged a company, he can – depending on the circumstances – be held liable for the shortage of funds available to pay the creditors. If the bankruptcy of a company is substantively consolidated with the bankruptcy of another company the question comes up whether a director of one of the companies can be held liable for the *combined* shortage of funds. In France the *Cour de cassation* has answered this question in the negative in a case involving substantive consolidation based on the intermingling of assets and liabilities.[18] But some French authors have argued that in cases involving substantive consolidation based on the existence of a fictitious company, the question should be answered in the affirmative.[19]
If in The Netherlands a trustee in a consolidated proceeding holds a director liable for the shortage of funds, liability for the combined shortage of funds is the most desirable option. Due to the substantive consolidation there *de facto* exists only one estate and thus one shortage of funds. A different approach would entail extra work for the trustee. He would have to determine what would have been the separate shortages of funds in each estate that would have existed had the bankruptcies been treated separately. This would be a Herculean task, especially if, due to the substantive consolidation, fraudulent preference actions regarding

16 Cass. com. 9 May 1995, *Bull. civ.* IV, p. 117, nr. 130; *D.* 1996, jur., p. 322, comments by Loiseau.
17 See with regard to The Netherlands: article 2:138/248 BW and with regard to France: article L651-2 C. com.
18 Cass. com. 23 May 2000, *D.* 2000, AJ, p. 299, comments by Lienhard; *D.* 2002, som., p. 78, comments by Derrida.
19 See for example Pétel, comments following Cass. com. 23 May 2000, *JCP-E* 2000, chron., p. 1567, nr. 13, with regard to the directors of the controlling entity.

inter-company transactions are omitted. Determining the shortages of funds would require a trustee to guess the outcomes of such proceedings, which could result in arbitrary determinations of these shortages. In cases involving inter - mingling of assets and liabilities these determinations would not even be possible. To avoid excessive director liability the court may use its power to moderate the amount for which the director is held liable, see article 2:138/248(4) of the Dutch Civil Code.
An important procedural consequence of substantive consolidation is that one joint meeting must be held to verify the creditors' claims.[20] At that meeting the creditors of all debtors involved will be allowed to dispute the claims of the other creditors of these debtors. This is important, because due to the substantive consolidation of the bankruptcies of company A and company B, the amount of

the claim creditor X has against A will have a direct impact on the distribution to creditor Y, a creditor of B.
Before this verification process can start, creditors will have to file a proof of claim with the trustee. In my opinion a proof of claim filed with the trustee prior to the substantive consolidation-decision, should be considered a proof of claim filed in the consolidated bankruptcy proceeding. This procedure is efficient and does not harm an interested party. If, on the day substantive consolidation is ordered, in one or more of the bankruptcy proceedings involved the term for filing proofs of claim has not yet expired, the longest remaining term left for filing proofs of claim should apply to the creditors of all debtors involved. If this term is less than ten working days from the date a notice is published in the Dutch government gazette (*Nederlandse Staatscourant*) explaining that the de cision substantively consolidating the bankruptcies is in force, or if in all bankruptcy proceedings involved the term for filing proofs of claim has expired, this term should be automatically extended to 10 working days from the date the aforementioned notice is published in the Dutch government gazette. These rules are meant to establish equal treatment of creditors where a substantive con - solidation can have a positive effect on the distributions made to them. Creditors who did not file a proof of claim before the decision substantively consolidating the bankruptcies, will still have the opportunity to file a proof of claim and thus benefit from the substantive consolidation, just like the creditors who have already filed their proofs of claim.

Extension

In the United States and France it is not only possible to substantively consolidate insolvency proceedings, but it is also possible to extend a bankruptcy or reorganization proceeding to a related non-debtor, meaning a related person or

20 HR 25 September 1987, *NJ* 1988, 136, comments by G; *AA* 1988, p. 107, comments by PvS (Van Kempen en Begeer/Zilfa en DCW).

entity that is not yet involved in such a proceeding. The proceedings will then be substantively consolidated. In the United States, as in France, the non-debtor does not have to fulfill the requirements that normally apply when opening a bankruptcy or reorganization proceeding.
The aim of extension of such proceedings is to put a check on the improper use of corporate legal personality and the limited liability rule at the expense of creditors.
The extension-remedy has encountered a lot of criticism in the United States. Some Bankruptcy Courts refuse to apply the remedy on principle, mostly because extension would deprive the non-debtor of the protection he normally derives from the requirements for an involuntary proceeding, but there are also Bankruptcy Courts that allow extension as a remedy that optimally serves all interests involved in situations where the assets and liabilities of the debtor and the non-debtor are inextricably intermingled or – most frequent – one of them is the alter ego of the other.
In France the possibility to extend a bankruptcy or reorganization proceeding is hardly criticized. It is often used when the debtor and non-debtor have intermingled their assets and liabilities or one of them appears to be a fictitious company.
In The Netherlands the improper use of corporate legal personality and the limited liability rule at the expense of creditors can give rise to tort claims and director liability, see articles 6:162 and 2:138/248 of the Dutch Civil Code. If such claims are successful and paying up will render the non-debtor insolvent, he

can be declared bankrupt. Depending on the circumstances this bankruptcy procee ding can then be substantively consolidated with the proceeding of the already bankrupt company. Thus, the same result – creditors sharing the harm – is reached as would have been reached had extension of the bankruptcy pro - ceeding taken place. Depending on the circumstances a trustee can also petition the court for an involuntary proceeding against a company related to the debtor. If successful and once again depending on the circumstances, he can then request for a substantive consolidation of the various bankruptcies.
Looking at these possibilities for a Dutch trustee to undertake actions against persons who have interfered in the management of the bankrupt company, I am of the opinion that adding extension as an additional remedy is unnecessary; the added value of this remedy would be minimal. Furthermore, the argument that extension of a bankruptcy proceeding would deprive the non-debtor of the protection a debtor normally derives from the requirements for an involuntary proceeding holds true also for The Netherlands, see article 6(3) *Faillissementswet*. Moreover, alter ego and fictitious company-arguments that in the United States and France can give rise to an extension are not popular in The Nether - lands. At present only extraordinary circumstances justify the identification of two or more legal persons (*vereenzelviging*).[21]

21 HR 13 October 2000, *NJ* 2000, 698, comments by Ma (Rainbow).