From atomism to consolidation in group's insolvency

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From Atomism to Consolidation in Group’s Insolvency

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I. The Issue

It is well-known that more and more often – nowadays, we would even say as a matter of principle – the activity of any enterprise is not conducted through a single legal entity but through a more or less complex web of related corporations, each, formally, with its own assets and liabilities (i.e. with its “estate”). This is true in respect of “national” businesses but even more so in the presence of enterprises the components of which are spread out internationally, which, at a certain level and in a world of increasing globalisation, tends to be standard. The reasons thereof are manyfold and range from management ef-

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ficiency to tax planning, including national requirements or historical factors. In some cases, those reasons could be criticised, but usually they are perfectly reasonable, not to say even the result of a sound management of the business considered as a whole. It certainly occurs that the respective tax authorities are unsatisfied, but they have developed their own means to fight against inadequate inter-company pricing or hidden dividends and we believe that their concerns are already adequately taken care of.

As long as a group of companies – considered as a whole – is solvent, the fact that – and the manner in which – it is divided in several corporate entities is not an issue and is often ignored by third parties which are dealing with the group, or sometimes even by most of the group itself. If, however, one or more of the components of the group become insolvent, the problem arises as to why and whether each one of the related companies should actually be treated as a separate entity.

Indeed, independent of the fact that a legal entity is, or is not, part of a group of companies, in the event of its insolvency it is traditionally considered as a distinct body, solely liable for its debts and that answers therefore with (and only with) its owns assets. Adopting a rather schizophrenic approach, it is thus ignored that, during its lifetime, the company was only part of a larger economical entity and acted and was treated as such. This atomistic approach leads to a separate liquidation of the estate of each one of the various related companies, some of which may be bankrupt and others still solvent. Often a fierce battle then begins between the formerly unified estates. The arsenal at their disposal ranges from contractual, extra-contractual, tort, fraudulent conveyance (pauliana), mismanagement and hidden or fake dividend claims, including, in certain cases, extraordinary means such as “piercing the corporate veil” (“Durchgriff”) by which the creditors of one company try to reach the assets of another.

The limits and defects of such approach are well-known and quite often reached: considerable time, effort and, therefore, cost are spent on inter-company claims. Consequently, from an overall stand point, a substantial part of the assets available within the group are dilapidated instead of being divided among the group’s creditors. Moreover, quite often, the claims that one or more of the group’s companies could make towards third parties, in particular the group’s former insiders (such as its controlling shareholders and persons or companies related thereto), are not pursued – or in any event not successfully – because none of the estates, acting individually, have the necessary knowledge and/or resources, whereas, together, they could have been successful. Not seldom, the process last years, not to say decades, obviously to the

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2 Subject to very few exceptions, such as the well-known Italian rule according to which the sole shareholder of a limited by share company cannot in substance claim that such company has a limited liability (cf. § 2362 of the Italian Civil Code “(Unico azionista). In caso d’insolvenza della società, per le obbligazioni sociali sorte nel periodo in cui le azioni risultano essere appartenute ad una sola persona, questa risponde illimitatamente”).
satisfaction of the liquidators but certainly in a manner that is detrimental to the creditors as a whole. In extreme cases, the entire substance of the group is consummated without any possibility to actually reconstruct the estate of each single member of the group, as it ideally would – or should – have been.

Each practising lawyer is probably aware of many such cases. In recent years, one could cite the BCCI bankruptcy; some years ago, the Banco Ambrosiano case, both of which had international or even world-wide implications. In Switzerland, one could refer to cases such as Sasea, Omni Holding or Gatoil, which all also have an international dimension.

Faced with the aforesaid limits – or more accurately inefficiencies or even deficiencies – of the traditional atomistic approach, the parties involved in groups’ insolvencies have, with increasing frequency, tried to resort to the same standards as had been applied while the group was solvent, namely a consolidated approach. Significantly, this has been sometimes proposed not only by creditors, but also by the bankrupt companies themselves (i.e. by the debtors), by the trustees, and has in a few cases even been imposed by courts.

Consolidation is the combination of the assets and liabilities of two or more related legal entities into one entity. It is the translation in a liquidation (or reorganisation) prospective of what consolidation is from an accounting standpoint. It has been said that the result of consolidation is similar to that of a merger. Creditors of the various and separately incorporated entities become creditors of the consolidated group’s estate, sharing in the combined assets with all other group creditors. Joint claims against two or more pre-consolidated entities become, by confusion, one single claim against the consolidated estate. Intercompany obligations or claims disappear together with all down side costs and delays that inevitably exist when the atomistic approach is adopted.

Although consolidation has been referred to as a still “neglected corner of the law” and is certainly very much so in Switzerland, the issue is nothing really new. It raises both questions of internal (i.e. national) corporate and bankruptcy law, as well as problems of international law whenever – and, as has been seen, this is almost the rule – the group is trans-national. Therefore, we believe that a discussion of this issue is justified in today’s prospective, even though we will indirectly address it in a manner which relates, mainly, to national law. The international prospective will, however, not be ignored, not only because of the intrinsic trans-nationality of the matter, but also because we will analyse the US experience in this field and will also comment Swiss private international law relating thereto.

We will thus endeavour to address the problem by first exploring the experiences made in the United States of America (USA) (infra II) before an-

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3 Bank of Credit and Commerce International SA.
a lysing the Swiss status (infra III) and attempting to draw some general conclusions (infra IV).

II. The USA Approach

The aforesaid issue has been identified since decades in the USA where it has extensively occupied both the courts and authors. Having, quite obviously, been faced with many more cases than Switzerland (in a judicial environment which is also - traditionally - more concerned with finding equitable solutions rather than meeting the rigid requirements of sometimes inadequate statutes) a situation has arisen where the liquidation of groups of companies on a consolidated basis is, if not the rule, at least normal practice under certain conditions. We therefore believe that it is interesting to report on such USA experience. We will do so not only by summarising its current status, but also by synthetically recording its evolution. Indeed, since the issue at stake is exactly the same as that existing in Switzerland (and in all other European countries), we feel that it is enlightening to understand the manner in which US case law has evolved and refined itself in an attempt to offer the proper solutions to sometimes very different scenarios, and yet avoiding the excesses that oversimplified principles can easily lead to in this complex field.

As a general rule, bankruptcy law in the USA adopts the atomistic approach of legal entities in the event of their bankruptcy. In substance, regardless of the ownership structure of any legal (in most cases corporate) entities, their assets and liabilities are treated as distinct in respect of any other entity, even if related, i.e. even if part of the same group of companies. In a growing number of cases, bankruptcy courts have, however, adhered to the doctrine of consolidation. The issue often arises in cases where a parent corporation and its subsidiaries are involved, but is not limited to that elementary hypothesis.

Thus, what is referred to in the USA as “substantive consolidation in bankruptcy” has been defined as being the process by which the assets and liabilities of different entities are treated, for bankruptcy purposes, as belonging to a single enterprise. The consolidated assets create a single fund from which all the claims against the consolidated debtors are satisfied. Creditors of single entities before consolidation become joint creditors with all creditors of the consolidated debtors. As a matter of principle, these joint creditors share equally in the assets of the consolidated estate. Substantive consolidation also

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6 COLLIER on Bankruptcy 1100.06[1], at 1100-31 to -32 (L. King 15th ed. 1979).
7 For instance in a reorganisation plan, unless separate provisions are made, all creditors of the consolidated entities will be treated equally at distribution. TETELBAUM, The Multi-Tiered Corporate Bankruptcy and Substantive Consolidation - Do Creditors Lose Rights and Protection?, 89 COM. L.J. 285, 285 (1984).
eliminates inter company claims between the consolidated entities as well as
duplicative claims of third parties against the said debtors.

No express statutory rule exists (i.e. is codified) which empowers bankrupt-
cy courts to order substantive consolidation. Bankruptcy courts derive sub-
stantive consolidation powers from section 105 (a) of the US bankruptcy code
(the "Code"), which allows it to issue "any order, process or judgement that is
necessary or appropriate" to carry out the provisions of the Code. It is consid-
ered that this rule is a codification of the general "equity powers" traditionally
granted to anglo-american judges. It is unchallenged that these equity powers
enable a bankruptcy court to disregard separate corporate entities and there-
fore to order consolidation.

With this in mind, before discussing in more detail the conditions under
which substantive consolidation can be implemented, we think it useful to
clarify the following peripheral, though important points:

(i) First of all substantive consolidation can be extended not only to other
bankrupt companies of the group, but also to bankrupt individuals. Indeed,
there is no restriction regarding the nature of the entity that may be
consolidated. Entities subject to consolidation have included individuals,
partnerships, corporations and their respective affiliates. The view is thus that what matters is rather the type of relationship that exists be-
tween the entities to be consolidated than the legal form of each such en-
tity.

One of the precedents usually referred to in that respect is in [re Steury](#) which concerned a husband and wife situation where both had filed separ-
ate bankruptcy petitions. Also, in [re 1438 Meridian Place](#), at the re-
quest of the debtor corporation's creditors, the court consolidated the
debtor with affiliated corporations (each operating separate real estate
properties) and the individual shareholders' estates on the ground that
all such entities were the alter ego of the shareholders. The court up-

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8 KHEEL, 369 F.2d at 847.
9 See AUGIE/RESTIVO, 860 F.2d n.1; PARKWAY CALABASAS, 89 Bankr. At 837 (noting that sub-
stantive consolidation is a creature of court-made law). The principle is well established
that "courts of bankruptcy are essentially courts of equity, and their proceedings inher-
ently proceedings in equity". Pepper v. Litton, 308 US 295, 304 (1939) (quoting Local
Loan Co. v. Hunt, 292 US 234, 240 (1934)); see also BERRY, Consolidation in Bankruptcy,
50 Am Bankr. L.I at 351 (1976) (advising that a challenge directed at the court's lack of
statutory authority is unlikely to succeed).
10 COLLIER ON BANKRUPTCY, 1100.06[1], at 1100-33.
11 COLLIER ON BANKRUPTCY, 1100.06[1], at 1100-33.
12 94 Bankr. 553 (Bankr. N.D. Ind. 1988); see also GILBERT, op. cit. 231–233.
13 COLLIER ON BANKRUPTCY, 1100.06[1], at 1100-33.
held that the debtor’s creditors, who could not comply with section 303 (b) of the Bankruptcy Code with respect to the non-debtor affiliates because they did not have a direct claim against them, nonetheless could bring them before the court where such affiliates were alleged to be alter egos of the debtor\textsuperscript{15}. The facts included a finding that “clear and manifest injustice” had been worked on the creditors\textsuperscript{16}. Indeed, under the circumstances, a different result would hardly have been equitable.

(ii) A further question is to know whether consolidation can be extended to non bankrupt (usually referred to as “non debtor”) entities (supposedly members of the same group). The problem in such case is that consolidation may threaten solvent entities; the latter indeed risk to be forced into liquidation through consolidation with one or more heavily insolvent related companies, thereby jeopardising their own creditors. The answer given by the bankruptcy courts is that consolidation of debtor and non bankrupt entities is possible, although it should occur only in unusual circumstances\textsuperscript{17}.

The precedent usually mentioned in that respect is Sampsell vs. Imperial Paper & Color Corp.\textsuperscript{18} where, however, the supreme court stated that the creditors of the non debtor (non bankrupt) company would be entitled to satisfy their claims out of the non debtor’s assets before any participation by the creditors of the bankrupt related company. This is therefore a case of consolidation limited to the net equity (if any) of the consolidated solvent company.

(iii) Not seldom courts are faced with cases where consolidation is believed to be the appropriate solution but where full consolidation appears to be excessive and therefore inequitable. As will be seen in the forthcoming analysis, bankruptcy courts have therefore, in various ways, accepted or unilaterally decided to order less than complete consolidation, for instance by limiting the substantive consolidation to unsecured creditors as opposed to secured ones\textsuperscript{19}. In this respect, as has been quite elegantly said, bankruptcy courts may indeed order partial substantive consolidations.

\textsuperscript{15} Id. at 95-96. Section 303(b) of the Code provides in pertinent part that: An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title (1) by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute, or an indenture trustee representing such a holder, if such claims aggregate at least $5,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims; 11 U.S.C. § 303 (1982 & Supp. IV 1986).

\textsuperscript{16} 15 Bankr. at 96.

\textsuperscript{17} COLLIER on Bankruptcy, 1100.06[3], at 1100-46. Cases consolidating debtors with non debtors include Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941), and in re Tureaud, 59 Bankr. 973 (Bankr. N.D. Okla. 1986).

\textsuperscript{18} 313 U.S. 215, 219 (1941).

\textsuperscript{19} See infra B.4 ad Continental Vending Machine Corp.
tion based on the view that "equity is not helpless to reach a rough approximation of justice to some, rather than deny any to all"²⁰.

(iv) Finally, it is probably useful to recall that (i) rule 1015 (b) of the bankruptcy rules allows bankruptcy judges to order the joint administration of the bankruptcies of different corporations belonging to the same group, which are pending before the same court, and that (ii) rule 2009 (a) allows for the appointment of a "single (i.e. common) trustee for the estates being jointly administered".

In this respect, it should be however underlined that, as recorded by the 1983 Advisory Committee Notes to bankruptcy rule 1015²¹, joint administration has to be distinguished from consolidation because "the propriety of consolidation depends on substantive considerations and affects the substantive rights of the creditors of the different estates", while joint administration has no substantive effect but merely simplifies the (parallel) liquidation process of several distinct legal entities²². Thus, the purpose of joint administration is only to make case administration easier and less costly; it has therefore been called "a creature of procedural convenience"²³, since it avoids the duplication of efforts that would result if cases involving related debtors where to proceed separately²⁴.

A. Conditions for granting substantive consolidation

In the absence of any statutory authority, courts must examine the facts of each case in order to determine whether consolidation may or may not be granted. This typical case law approach has lead to an important and sometimes quite unstructured – not to say contradictory – set of precedents, which courts and commentators periodically attempt to catalogue.

It is however believed that courts now frequently cite a list of seven prerequisites, deemed to be relevant to determine the appropriateness of consolidation²⁵:

(i) the presence or absence of consolidated financial statements;

²⁰ 369 F.2d 847 (2d Cir. 1966).
²² In re Parkway Calabasas Ltd., 89 Bankr. 832, 837 (Bankr. C.D. Cal. 1988) (the court discusses the distinction between joint administration and substantive consolidation); see also in re Richton Int’l Corp., 12 Bankr. 555, 557 (Bankr. S.D.N.Y. 1981).
²³ In re Steury, 94 Bankr. 553, 553 (Bankr. N.D. Ind. 1988).
²⁴ GILBERT J. STEPHEN, op. cit., 212.
(ii) the unity of interests and ownership between the various corporate entities;
(iii) the existence of parent and intercorporate guarantees or loans;
(iv) the degree of difficulty in segregating and ascertaining individual assets and liabilities;
(v) the transfer of assets without formal observance of corporate formalities;
(vi) the commingling of assets and business functions; and
(vii) the profitability of consolidation at a single physical location.

Although it is quite generally admitted that the presence of the foregoing factors is instrumental, their existence does not automatically lead to an order for consolidation. Indeed, because of the “equitable environment” in which the issue arises, courts consider that these factors should not be applied mechanically and that, depending on the circumstances, the presence or absence of certain of them may be ignored. They, therefore, have to be evaluated in the overall balance of interest which favour consolidation versus those which favour separation (atomism)26. As has been recently said in re Eagle-Pichler Industries Inc. “decisions on the subject are fact intensive, and decisions are made on a case-by-case basis”27.

B. Balance of interests test

Ascertaining whether certain factors exist is thus merely an initial step in the courts’ process of considering whether or not substantive consolidation should be applied. The second stage of the analysis is represented by a “balance test” where the interests (referred to as “equities”) favouring consolidation are balanced against the equities favouring continued debtor separateness28. In brief, the courts verify whether the benefits of consolidation outweigh the harm that consolidation would cause to creditors. In that process, it is usually considered that the party proposing consolidation bears the burden of the demonstration29.

Here again, the court’s decision depends on the facts. The hypotheses are numerous and it is almost impossible – and probably not appropriate – to go

26 In re DRW Property Co. 82, 54 Bankr. at 495.
28 In re Donut Queen, Ltd., 41 Bankr. at 709 (citations omitted).
29 In re Donut Queen, Ltd., 41 Bankr. at 709; Holywell Corp. v. Bank of N.Y., 59 Bankr. 340, 347-48 (S.D. Fla. 1986), aff’d sub nom. Holywell Corp. v. Smith, 843 F.2d 503 (11th Cir. 1988), cert. denied, 109 S. Ct. 133 (1988) (burden of demonstrating greater prejudice to creditors if consolidation were denied than would be suffered by debtors though imposition was sustained).
any further than stating the principle of the balancing of interests test. It has, however, been suggested that the variety of cases can be categorised in four types of situation in which bankruptcy courts usually find persuasive in holding substantive consolidation appropriate.\(^{30}\)

1. Corporate instrumentality cases

\(i\) General conditions

Although this opinion is challenged by some authors\(^{31}\), it appears that one of the standard category of cases in which substantive consolidation is granted is that where a subsidiary or affiliate has been formed for the purpose of delaying, hindering or defrauding creditors. This is nothing more than the "piercing the corporate veil" approach, which corresponds to what is called "Durchgriff" in Switzerland, and which is a well-known and generally applied theory in USA corporate law.

Indeed, when initially (in the early forties) analysing whether substantive consolidation of a parent and subsidiary was appropriate in bankruptcy cases, courts adopted the classical piercing the corporate veil approach that had been developed for instance in the "Deep Rock case"\(^{32}\). In the latter, courts indeed applied the so-called "alter ego" or "instrumentality" analysis to determine whether or not separate corporate entities should be disregarded and the parent and subsidiary therefore treated as one entity, i.e. consolidated. In this context in Fish v. East, a decision rendered in 1940\(^{33}\), the court of appeals set forth the following ten factors for deciding whether a subsidiary is a mere instrumentality of its parent:\(^{34}\):

(i) the parent owns all or a majority of the capital stock of the subsidiary;
(ii) there are common directors and officers;
(iii) the parent corporation finances the subsidiary;
(iv) the parent corporation is responsible for incorporation of the subsidiary;
(v) the subsidiary has grossly inadequate capital;
(vi) the parent company pays the salaries or expenses or losses of the subsidiary;
(vii) the subsidiary has no independent business from the parent;
(viii) the subsidiary is commonly referred to as a subsidiary or as a department or a division of the parent;


\(^{31}\) For instance GILBERT, op. cit., 218.

\(^{32}\) Taylor v. Standard & Elec. Co; 306 U.S. 307 (1939) and Fish vs. East, infra.

\(^{33}\) 114 E.2d 177 (10th Cir. 1940).

\(^{34}\) Id. 191.
(ix) directors and executive officers of the subsidiary do not act independently but take direction from the parent; and
(x) the formal legal requirements of the subsidiary, as a separate and independent corporation, are not observed.

Progressively, however, bankruptcy’s courts (the nature of which is federal) reluctantly referred to the “piercing the corporate veil” doctrine which is considered a question of company law (for which the state courts have jurisdiction). Nonetheless, as some commentators have pointed out, in this first category of cases substantive consolidation of bankrupt companies is fundamentally based on the same grounds as piercing the corporate veil in an ordinary corporate context.35

(ii) Recent cases

It is interesting to consider the way the aforesaid principles have been applied in recent years in a bankruptcy setting: in re Gulfco Investment Corp.36 the court stated that “where a corporation is a mere instrumentality or alter ego of the bankrupt corporation, with no independent existence of its own, equity would favour disregarding the separate corporate entities. It is, of course, proper to disregard a separate legal entity when such action is necessary to avoid fraud or injustice.”37 Although in the opinion of the trial court the ten factors highlighted in Fish vs. East were present to a “considerable degree”, the court of appeals held that, for other reasons, consolidation was not appropriate.38 Indeed, the strong factual difference in Gulfco was the absence of a scope to organise the corporate subsidiaries so as to hinder and delay creditors fraudulently.39

In re Tureaud40, the evidence supported consolidating corporate affiliates controlled by an individual debtor. The affiliates in Tureaud were clearly organised to hinder and delay judgement creditors, and property transfers were for the sole purpose of placing them beyond the reach of creditors. According to the court’s factual findings, a more egregious set of circumstances could hardly be found: Tureaud transferred assets by and among his wholly-owned corporations with total disregard for their separate nature; he used their assets as his own; he operated the corporations as one economic unit; there existed cross guarantees and asset pledges; payments of operational expenses were made without regard to the source of funds or documentation of payment; and

36 593 F.2d 921 (10th Cir. 1979).
37 Id. at 928.
38 Id. at 928-29.
39 Id. at 928.
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funds and property of the corporations were used by Tureaud and his family for personal benefit and enjoyment.

Similarly, in re Stop & Go of America, Inc., ample evidence supported the court’s conclusion that a shell corporation, formed to hold and own legal title to a franchise, was a deliberate scheme to protect the franchise seller’s interest in a manner likely to result in fraud on creditors; the shell corporation had no stationery, telephone, office, bank account, employees, expenses, or income. The trustee sought to consolidate the shell corporation with a bankrupt debtor that was the sole licensee of the franchise. The problem stemmed from the non-disclosure of the debtor’s relationship as licensee rather than owner of the franchise. But for consolidation, the debtor’s creditors would have been deprived of the most significant asset which they had been led to believe was held by the debtor corporation. The court’s order to consolidate, which had the effect of blocking the franchise seller’s claim to the shell corporation’s asset, is one of the clearest examples of the proper functioning of this equitable doctrine.

2. Cases where creditors rely on the group as a whole

In a second category of cases, courts have decided in favour of substantive consolidation when creditors have brought evidence that they, in good faith, relied on the assets and on the credit of the group as a whole, or on the credit of a parent company when dealing with its subsidiary.

This rule was probably pioneered in Stone v. Eacho where the court allowed substantive consolidation in a case involving a bankrupt New Jersey parent company, Tiptop Tailors, with one of its stores separately incorporated in Virginia. The court allowed consolidation based on findings that the subsidiary was not treated as a separate entity and that the subsidiary’s creditors dealt with the parent and with its subsidiary as if they were the same entity. The court therefore held that, from the creditors’ point of view, both companies appeared as being the same “enterprise”, and confirmed that it would accordingly look beyond nominal corporate forms and treat the assets and liabilities of the subsidiary as those of the parent.

The focus on creditors’ reliance appears again in Soviero vs. Franklin National Bank of Long Island where the court affirmed an order consolidating Raphan Carpet Corp. and 13 of its affiliates. Here again, the triggering factor was that creditors had dealt with Raphan and its affiliates as a single enterprise and that the group could not demonstrate reliance on any single affili-
In Soviero, the bankruptcy court made clear findings of commingling of assets and functions of the corporate entities affiliated with the bankrupt debtor and a flagrant disregard of corporate formalities, including: the same shareholders and directors, no corporate minutes, no working capital in subsidiaries, arbitrary allocation of inventory and expenses, and parent guarantees of subsidiary obligations. Moreover, creditors were advised that the bankrupt was a "consolidated enterprise" and were provided with consolidated financial statements listing assets of the affiliated companies as those of the bankrupt without any distinction.48

Invoking the conditions of the "instrumentality" doctrine, a secured creditor of one of the Raphan affiliates objected to substantive consolidation on the ground that consolidation is proper only when it can be shown that a subsidiary was organised to hinder, delay, or defraud creditors,49 a condition which was not fulfilled in Soviero. The court, however, found unity of interest and ownership common to all entities and stated that, considering the circumstances, adherence to the theory of separate corporations would be unfair to creditors.50 Thus, the court did not permit consolidation simply because of the commingling of assets and of the disregard for corporate formalities. Rather, the court recognised that, absent consolidation, an injustice to creditors would occur.51 It is incidentally interesting to note that, in justifying its decision the court stressed that when consolidation is otherwise proper, creditors that knew or should have known of the unity of interests and operations within the enterprise may be precluded from subsequently claiming prejudice from consolidation.52

In re Richton International Corp.,53 the court made strong recourse to the creditor reliance theory upheld in Soviero. The court noted: the debtors operated as a single business entity; significant operational and policy decisions regarding the debtors were made and implemented by the parent of the debtor corporations; funds were shifted between the debtors to provide for operating

47 See 5 Collier on Bankruptcy, 1100.06[2], at 1100-38 (stating that "Soviero underscores the theme of creditor reliance articulated in Stone v. Eacho and this theme is of critical importance in subsequent cases"). Subordinate facts in Soviero also compelled consolidation. The president and secretary of Raphan where the sole directors and shareholders of the affiliates. Raphan maintained accounting records for the affiliates at its principal place of business, creditors were issued consolidated financial information, Raphan signed all of the affiliates' leases, and the proceeds from sales by the affiliates were deposited into Raphan's account. Stationery and advertising referred to the affiliates as "branches", not separate corporations. See Soviero, 328 F.2d at 447-48.
48 Id. at 447.
49 See Soviero, 328 F.2d at 448.
50 Id.
52 See id. at 235.
expenses; the debtors filed consolidated federal tax returns; and there were extensive cross corporate guarantees of bank and trade obligations. "What is present in this case is a situation akin to what was found by the court in the Soviero case, that many creditors dealt with [the debtor corporations] as one entity." Significantly, the court stated that no evidence was presented to indicate creditor reliance on the separate credit of any subsidiary. Also, it determined that consolidation would yield "an equitable treatment of creditors without any undue prejudice to any particular group."55.

This being said, it probably has to be admitted that the differences between "instrumentality cases" (supra point 1) and "creditors reliance cases" (the present point 2) are not always clear cut. A recent example is in re Eagle-Picher Industries Inc.56 where, in March 1996, a bankruptcy court ordered consolidation without making completely clear on which basis this was done, having found, however, that the group was fundamentally run as a single entity without paying any particular regard to its corporate subdivisions. The interesting aspect is that this was apparently not done to defraud creditors; it rather seems that the court considered that "no reasonable creditor of Hillsdale [corporate subsidiary] could believe that it was not dealing with EPI [the parent company] when it dealt with Hillsdale."

The aforesaid precedents should not lead to believe that consolidation is granted automatically, or at least easily in cases of this nature. Indeed, there is a series of cases in which consolidation has been denied. For instance in Anaconda Building Materials Co. vs. Newland57, the creditors of the debtor home-building corporation sought to consolidate the assets of four subsidiary corporations formed to acquire mortgages from the parent by issuing debentures to investors and using proceeds to purchase the mortgages. The parent assumed no obligation for indebtedness of the subsidiaries, and each had a separate executive officer, its own offices, books, bank account, and personnel. However, the parent held all the outstanding stock of each subsidiary, there were some common officers and directors, and there was some evidence that the subsidiaries were minimally capitalised. In addition, the principal executive officer of the parent was also the executive and administrative officer of each subsidiary, dominating all of them. The court held that "circumstances of this kind, considered separately or together, are insufficient to warrant dilution of the assets of an insolvent subsidiary corporation for the benefit of the creditors of the parent corporation and to the detriment of the blameless creditors of the subsidiary"58. Thus, the bondholder creditors of the subsidiary were not sub-

54 Id. at 558.
55 SARGENT PATRICK C., op. cit. 1230. Id. at 558-59.
57 336 F.2d 625 (9th Cir. 1964).
58 Id. at 629 (footnote omitted).
jected to the “injustice” of consolidation, which would have benefited the parent company creditors who apparently were not relying on the credit of the consolidated enterprise.

Similarly, in re Augie / Restivo Baking Co.\textsuperscript{59} the court denied consolidation, upholding that the course of dealing and expectations of the parties did not justify it. Hence, the findings were that the relevant creditor had extended credits to a group debtor based on that debtor’s finances alone. The basis of the court’s denial thus stemmed from recognition of lenders’ well identified expectations when extending credits to a specific entity\textsuperscript{60}. It should be noted here that this non consolidating approach can be beneficial and/or detrimental to the creditors, or more accurately to those creditors which are in favour of consolidating, depending on whether or not the company of which they are formally creditors is, or is not, in a worse financial position (i.e. has a worse debt to equity ratio) than the other companies of the group. In any event, in Augie, the court recognised that “the sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors”\textsuperscript{61}, and not therefore to favour a creditor that had never relied on the group as a whole.

Finally, one could mention the well-known case in re Flora Mir Candy Corp.\textsuperscript{62}. Such case addressed consolidation within the context of one parent company (Flora Mir) and 12 subsidiaries and affiliated, where it was not the creditors but rather the debtors that had moved for consolidation. The court recognised that, because of the particular circumstances, consolidation would be unfair to the creditors, even though most of them had treated the debtors as one single entity. The interest of this case is that if (i) the creditors did indeed rely on the fact that the group was a single economical entity but that (ii) the result of consolidating the liquidation or all companies of the group would be unfair to such creditors; then the interest balancing test should lead the court to deny the consolidation \textit{in casu} desired by the debtors.

3. Cases in which it is practically impossible or unreasonable to “unscramble” respective estates

\textit{Chemical Bank New York Trust Co. vs. Khee}\textsuperscript{63} introduced a new justification for substantive consolidation. In essence, the court determined that consolid-

\textsuperscript{59} 860 F.2d 515 (2d Cir. 1988).
\textsuperscript{60} Id. at 518-19. “Lenders structure their loans according to expectations regarding that borrower and do not anticipate either having the assets of a more sound company available ... or having the creditors of a less sound debtor compete for the borrower’s assets”. Id. The court recognised that interest rates and loan terms are based on these expectations. “Fulfilling those expectations is therefore important to the efficiency of credit markets”. Id. at 519. Substantive consolidation would undermine such efficiency when creditors rely on the credit of specific entities. Id.
\textsuperscript{61} 860 F.2d 515, 518 (2d Cir. 1988) (citations omitted).
\textsuperscript{62} 432 F.2d 1060 (2d Cir. 1970).
\textsuperscript{63} 369 F.2d 845 (2d Cir. 1966).
tion could be granted in cases in which the interrelationships between the various entities forming the group were so hopelessly obscured that the time and expense necessary to unscramble them would exceed the benefits that would accrue from the hypothetically disentangled records. The test is difficult to meet: indeed, before allowing consolidation, the court sets rigorous standards in which it compares expenses and difficulty to unscramble with the practical impossibility of restructuring the financial record. Consolidation was granted in the Kheel case because of the extraordinary circumstances involved; in brief, one individual (Kulukundis) controlling eight shipping companies where the individual had been shifting funds from one corporation to the other, making intercorporate loans, settling the various companies’ obligations without any regard to the source of funds, making withdrawals and payments from and to corporate accounts without record keeping, etc. 64.

The intermingling and intertwining of corporate accounts was also extremely blatant in re 1438 Meridian Place, N.W., Inc. 65. The court found that eight corporate entities owned by the individual debtor kept no identifiable accounting records to segregate income and expenses; neither the court nor the creditors could intelligently sort out or separate the financial affairs of the corporations; and it was “clearly impossible to reconcile the income and expenses as they relate to the operations and management” of the properties 66. The court’s holding was also based on a finding that consolidation would not prejudice secured or unsecured creditors 67.

Another example is in re Vecco Construction Industries 68, where the court noted the extensive intercompany activities, the failure to segregate the accounts receivable and disbursements, the transfers and commingling of assets and funds of the related companies, and the operation as a single entity. It was not difficult for the court to grant consolidation upon the debtors’ request because no creditor objected. The court adopted the debtors’ statement that

64 Ibidem, 845 a 847: “The debtor corporations are all owned or controlled by the former shipping magnate, Manuel E. Kulukundis. The Referee found that the debtor corporations were operated as a single unit with little or no attention paid to the formalities usually observed in independent corporations, that the officers and directors of all, so far as ascertainable, were substantially the same and acted as figureheads for Kulukundis, that funds were shifted back and forth between the corporations in an extremely complex pattern and in effect pooled together, loans were made back and forth, borrowings made by some to pay obligations of others, freight due to some pledged or used to pay liabilities and expenses of others, and withdrawals and payments made from and to corporate accounts by Kulukundis personally not sufficiently recorded on the books.”


66 Id. at 93–94.

67 Id. at 97.

creditors would be treated fairly and that consolidation would result in maximum savings in administrative expenses.

The thrust of this category of "consolidation cases" is that although inequities may be involved in the consolidation, they are outweighed by practical considerations such as accounting difficulties and expense, which may occur where interrelationships of corporate groups are highly complex or untraceable. As was said by the court in Chemical Bank New York Trust Co. vs. Kheel, "Evidence of these facts and others, such as dispersal of key personnel since most of the transactions occurred, support the Referee's conclusion that auditing of the corporations' financial condition and especially the inter-company relationships would entail great expenditure of time and expenses without assurance that a fair reflection of the conditions of the debtor corporations would in the end be possible (...) Moreover, we have here an additional factor not present in Soviero or Stone vs. Eacho., the expense and difficulty amounting to practical impossibility of reconstructing the financial records of the debtors to determine inter-corporate claims, liabilities and ownership of assets". Because however consolidation is such a drastic measure affecting substantive rights, the practical considerations must "heavily outweigh" the inequities involved.

4. Case where consolidation is part of a reorganisation plan

The fourth category is represented by cases where consolidation is achieved by an express proposal in a reorganisation plan. This is, in substance, the case in which consolidation is proposed in order to facilitate or expedite the process. Such type of proposal is increasingly included in the reorganisation of

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69 Id. at 412.
70 369 F.2d 847 (2d Cir. 1966), 847.
71 In re Continental Vending Mach. Corp., 517 F.2d 997, 1001 (2d Cir. 1975), cert. denied sub nom. James Talcott, Inc. v. Wharton, 424 U.S. 913 (1976). In this respect, it is worth reminding that, in an opinion that is considered fundamental, in the aforesaid Chemical Bank New York Trust Co. vs. Kheel case, judge Friendly wrote an opinion in which he was sharing the result but not its grounds and affirmed (p. 848): "I cannot agree that a practice of handling the business of a group of corporations so as to impede or even prevent completely accurate ascertainment of their respective assets and liabilities in their subsequent bankruptcy justifies failure to make every reasonable endeavour to reach the best possible approximation in order to do justice to a creditor who has relied on the credit of one - especially to a creditor who was ignorant of the loose manner in which corporate affairs were being conducted. Equality among creditors who have lawfully bargained for different treatment is not equity but its opposite, and the argument for equality has a specially hollow ring when made by the United States [NB: in casu the claiming creditor] whose priority over other creditors will necessarily be enhanced by having the assets of all these corporations thrown into a hotchpot".
72 See B. Weintrob/A. Resnick, 8.16, at 8-77; see, e.g. in re Apex Oil Co., 101 Bakr. 92, 94 (Bankr. E.D. Mo. 1989).
interconnected corporations due to the fact that it is more and more seldom that “sole” companies are involved in such plans, and increasingly frequent that they regard groups of companies as a whole. In the USA, the basic principle is that reorganisation plans have to be approved by the creditors. If all creditors adhere to a plan proposing substantive consolidation, the court must approve it. In the absence of unanimous approval, courts must make an independent determination as to whether consolidation is appropriate. In such case, they can approve the plan even though some debtors do expressly oppose it, such decision to be taken, however, within the limits of the compulsory rules of the bankruptcy code. The said rules include the obligation to equally treat creditors who are in the same situation. It has, however, been considered that a creditor originally having a claim against a more solvent company may be entitled to a more favourable treatment under the plan than a creditor with a claim against a less solvent entity, notwithstanding that, a priori, the two claims have equal rights and priorities.

Such a plan was for instance upheld by the court as being fair and equitable to the creditors in re Continental Vending Machine Corp. The interest of this case is, however, also that the plan provided for a consolidation which was limited to the unsecured creditors of a parent company and its subsidiary, and which did not apply to the secured claims thereof. It is therefore another example of “limited (partial) substantive consolidation” as opposed to “full substantive consolidation”. The grounds for not extending the benefits of the consolidation to the secured creditor is that he had obtained exactly what he had bargained for. Indeed, by negotiating separate security agreements with both the parent and the affiliate company, the creditor “certainly did not deal with corporations in a mistaken belief that the two were one”.

C. Equitable subordination

As has been seen, in some instances bankruptcy courts do not grant full or even only limited substantive consolidation, mainly because it is believed that this would not be equitable towards creditors that have relied on the solvency or at least on the assets of a given member of a group of companies as opposed to the group as a whole. In such case, bankruptcy courts sometimes apply an alternative equitable relief, namely the subordination of some claims (usually those of insiders or controlling parties of the group) in respect of other claims (usually of those individuals or entities that are “outside” the group).

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73 Both may be general unsecured claims. Id. 90.10[5], at 90-185 n.37; see also in re Interstate Stores, Inc., 15; COLLIER, Bankr. Cas. (MB) 634, 642-43 (Bankr. S.D.N.Y. 1978).
75 Continental Vending, 517 F.2d at 1002. See GILBERT, op. cit., 226 and 227.
76 GILBERT, ibidem, 277.
Thus, it is important to see at the outset that substantive consolidation and subordination are two different (equitable) answers to the same type of concern. As Clark stated: “Equitable subordination and piercing the corporate veil are, in large part, modes of overcoming the extraneous limitations of historically received fraudulent conveyance law” and “may be seen as applications of the same notions of securing the moral obligations of debtors to creditors ...”

As a matter of principle, the relative priority of claims established by the Bankruptcy Code dictates that similar claims should be treated similarly and that all unsecured claims rank pari passu in the absence of consensual subordination pursuant to section 510 (a) of the Code. However, certain conduct amounting to fraud or undue influence by a particular claim holder might warrant that established guidelines for the payment of claims be altered to compensate for such conduct.

Accordingly, the doctrine of equitable subordination allows the courts to subordinate the claims of creditors whose wrongful acts either harm the debtor’s other creditors or provide the claimant with an unfair advantage with respect thereto. Thus, the remedy of equitable subordination involves the subordination of the claims of certain creditors – and of any interest given to secure them – to the claims of unsecured creditors. The subordinated claim is not invalid, but payment of the claim is postponed until other creditors are paid in full. As the court stated in a well-known case: “equitable subordination exemplifies the underlying premise of bankruptcy policy, which is an equitable balancing of the interests of all affected parties in a bankruptcy case.”

The doctrine applies to both secured and unsecured claims and all or part of a claim may be subordinated. Also, application of the doctrine does not always result in the subordination of one claim to another; a claim may simply be realigned to establish parity with other claims.

As has already been suggested, the remedy of subordination, like substantive consolidation, derives from principles of equity. However, equitable subordination, in contrast to substantive consolidation, is directly based on the provisions of the Bankruptcy Code, 11 U.S.C. § 510 (c) (1), which permit the court to alter the priority of otherwise allowable claims on the basis of principles of equitable subordination and state law. Most subordination cases refer

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78 Ibidem, 505.
80 In re Pepper v. Litton, 308 U.S. 295, 310 (1939).
82 Id. at 1351.
83 See in re W.T. Grant Co., 699 F.2d 599, 604 n.7, cert. denied, 464 U.S. 822 (1983) (equitable subordination is a compensatory rather than punitive remedy such that placing junior debt on parity with senior debt may be sufficient).
to Pepper vs. Litton\textsuperscript{84}, which first enunciated the power of the bankruptcy courts to subordinate a claim on the basis of principles of equity.

It is usual that equitable subordination is ordered in three types of situations:

(i) fraud, illegality or breach of fiduciary duty;
(ii) under-capitalisation;
(iii) utilisation of the debtor as "mere instrumentality" or "alter ego"\textsuperscript{85}.

Generally speaking, however, in most cases subordination is based on abuse of control by an insider. If the insider creditor obtains a claim on an arm's length basis, that claim is valid and enforceable on the same terms as other claims. If, on the other hand, the insider obtains its claim based on an abuse of its status of insider, and this claim harms other creditors, the insider will be subordinated to other claims. Courts have, however, not limited subordination to insiders. Subordination of a claim of outside creditors can thus be envisaged and is likely to depend on clear fraud, such as intentional or reckless misrepresentation to other creditors. "If the claimant is not an insider or fiduciary, however, the trustee must prove more egregious conduct such as fraud, spoilation or overreaching and prove it with particularity"\textsuperscript{86}.

III. The Swiss Status

A. The current Swiss status

1. Atomism remains the principle

The basic approach in Switzerland remains that of "atomism". This has been constantly reaffirmed by our supreme court, for instance in its decision BGE 105 III 112: "Or l'identité juridique est seule déterminante dans les voies d'exécution forcée"\textsuperscript{87}. This is and remains the principle. However, since years Switzerland has been faced, both from a national and international stand point, with the same inequitable and, in any event, unsatisfactory results which have originated in the USA the policy of substantive consolidation, extensively discussed in our previous chapter.

\textsuperscript{84} Lobell and Applegat, Lending to a troubled company - special considerations: fraudulent transfers, substantive consolidation, subordinated debt treatment; developing theories of lender liability and equitable subordination, 733 PRI/Corp 175 ss, 350.

\textsuperscript{85} The specific leading precedent in that respect being Pepper vs. Litton.

\textsuperscript{86} In re N & D Properties, Inc., 799 F.2d 726, 731 (11th Cir. 1986).

\textsuperscript{87} See also von Büren Roland, Der Konzern, Schweizerisches Privatrecht, VIII/6, 1997, 443 and Peter Henry/Birchler Francesca, Liquidation des groupes de sociétés et consolidation - Enseignements de la pratique récente, SZW 1995, 122.
There is no statutory authority, under Swiss law, which expressly foresees the application of substantive consolidation in cases of insolvency of several related (or unrelated) corporate entities (or individuals). It can even be said that, as such, the problem of substantive consolidation has hardly been addressed or even identified by the Swiss courts and authors.

Traditionally, the cases in which the rigorous application of the atomistic approach produced totally unfair results have been tempered by the application of the “piercing the corporate veil theory” (referred to as “Durchgriff” or “théorie de la transparence” in Switzerland), for instance where the debtor was found to be grossly under-capitalised. As we have stressed, if the roots of the Durchgriff theory are probably the same as those of substantive consolidation, such remedy is, however, in its very essence limited to a bi-lateral approach (the creditors of one company reaching the assets of another) and does, therefore, traditionally not generate a real consolidation effect (in the absence of reciprocity, i.e. the creditors of such latter company having no access to the assets of the former one). Thus, the Durchgriff theory, at least in its traditional form, does not procure a satisfactory solution to more global concerns and is accordingly, as such, not an appropriate basis to order consolidation.

2. The – though timid and uncertain – exceptions
Since the late eighties, in the light of the USA experience, some authors have been suggesting that consolidation and subordination could be appropriate solutions to supersede the limits of the atomistic approach. Ruedin has, for his part, proposed to include in a possible Swiss group of company statute a principle whereby the claims of inside creditors would automatically be subordinated (postponed) to those of external creditors. Thereafter, several authors have also advocated in favour of subordination. However, almost 20 years later no such law is in force or even foreseen. Even worse, the Swiss bankruptcy code has been recently revised without any particular attention.

90 RUEDIN ROLAND, Propositions pour un droit suisse des groupes de sociétés, SAG 1982, 102 ss, 111.
91 See VON BÜREN ROLAND, ibidem, 448-449 and the several authors mentioned by him; see also SCHÜPBACH HENRY-ROBERT, Droit et action révocatoire, Helbing & Lichtenhahn, Bâle et Francfort sur le Main, 1997, art. 288, no. 94, 208-209.
having been paid to the peculiarities of groups of companies. As a matter of fact, neither a proposed “Konzern-pauliana” nor any provision regarding subordination or consolidation has been inserted, notwithstanding the proposals made in that sense92.

The absence of any statutory provision has, however, not totally hindered recourse to consolidation and subordination. Subordination has indeed been ordered in some (yet exceptional) cases93. On the other hand, more and more often Swiss courts have been faced with the substantive consolidation issue. To our knowledge, the first case is that of the liquidation of Banque de Crédit International, a small international banking group which became insolvent in 1974. Its main offices were in Geneva and it had subsidiaries and related companies in Zurich, London, Luxembourg, Nassau and Vaduz. In the absence of opposition by any of the creditors, the trustees proposed a plan which foresaw the consolidated liquidation of all entities. Such plan was approved by the Court of appeal of Geneva on March 19, 197694.

Slightly later, the same Court of appeal of Geneva, in its decision dated November 23, 1978, this time refused to approve the consolidated liquidation of Banque Leclerc & Cie and of its several related entities, including a number of Panama companies. The reason for such decision was that, in this case, some creditors were against consolidation because this would have diluted the liquidation dividends they would otherwise have received since “their” debtors were proportionally more solvent than the other members of the group. In the absence of statutory authority, the Court of appeal of Geneva, acting in its capacity of monitoring body in banking reorganisation matters (“concordats”) deemed that it could not approve a liquidation scheme which was not expressly foreseen by a statutory provision95.

In a matter which appears to us to have some significance, the Swiss supreme court, in a decision rendered in 198696 in the Banque Commerciale SA matter, took its distance with regard to the Geneva Leclerc case. In the former, the Swiss supreme court was also faced with a proposal made by the trustees of a Swiss insolvent bank (NB: not of the group as a whole) which was not in strict compliance with the provisions of the Swiss bankruptcy code. As in the Leclerc case, the issue was therefore to establish whether such proposal could be approved or not. Interestingly the court stated that the principles of

92 Peter Henry, L’action révocatoire dans les groupes de sociétés, SAG 1989, 15.
93 See those mentioned by von Büren Roland, ibidem, 448-449, in particular the decision rendered by the High Court of the Canton Vaud on November 18, 1981.
the bankruptcy code do suffer exceptions and that one of these could be
granted when the proposed scheme aimed at simplifying the liquidation pro-
cess and at limiting its costs "Il n’est pas contraire aux principes fondamentaux
de la réalisation forcée de préférer le principe de l’économie à celui de l’éga-
lité"\textsuperscript{97}. This appears to us as being nothing else than the rational adopted by
the US courts for justifying the category of cases referred to above as “cases
in which it is practically impossible or unreasonable to ‘unscramble’ respective
estates”\textsuperscript{98}. It is a substantial evolution which, had it existed in 1978, would
probably have led the Geneva appeal court to approve the consolidated liq-
uidation of the Banque Leclerc group. In other words, we would suggest that,
faced with a petition for the consolidated liquidation of a group of companies,
this precedent should today, as a matter of principle and if the relevant condi-
tions are met, allow it to be approved by Swiss bankruptcy courts, even when
opposed by certain creditors. In such prospective, the criteria that the Swiss
courts should apply to decide in favour of or against consolidation are (i) the
complexity and costs benefit of the proposed consolidation and (ii) the ben-
efits that would derive to the creditors in a consolidation scenario as opposed
to an atomistic liquidation\textsuperscript{99}.

Finally, it seems that substantive consolidation is, in any event, possible if
no interested party opposes it. This would obviously also apply in non-banking
cases which are less subject to the monitoring of Swiss courts or administra-
tive authorities. In that respect, in a recent paper we reported on the limited sub-
stantive consolidation of the so called “Kettler group” which included eight re-
lated Swiss companies, all bankrupt. The problem lay in the fact that each of
the estates (which were administered by separate trustees) had already re-
covered funds that no one intended to consolidate. The issue regarded rather
other assets of the group which undoubtedly belonged to it when considered
as a whole, but which had no clear paternity due, precisely, to the (fraudulent)
manner in which the group had been managed. Instead of entering into
lengthy and costly litigation between the various estates in order to establish
such paternity, they agreed to move jointly to recover the said assets, in par-
ticular by taking action against the former managers and insiders of the group.
An agreement to that effect was entered into, which, in substance, resulted in
a form of substantive consolidation the peculiarity of which was that it was
limited to part of the group’s assets (those recovered jointly as opposed to
those that had already been recovered on a separate – atomistic – basis)\textsuperscript{100}.

97 “It is not contrary to the fundamental principles of bankruptcy law to prefer the cost saving
principle to that of equality [of treatment]”; ibidem, consid. 2(f) ab initio.
98 See above II.B.3.
99 For more details about this case, see Peter Henry/Birchiller Francesca, Liquidation des
groupes de sociétés et consolidation – Enseignements de la pratique récente, op. cit.,
125–127.
100 Ibidem, 124–125.
B. The possible Swiss status

The conclusion of our analysis of the current status of consolidation in Switzerland is therefore essentially that, lacking of any statutory authority, it is a very seldom applied relief and that when it is, at least for the time being, it is upheld only if none of the creditors oppose (which corresponds, in substance, to some of what we have called the "cases where consolidation is part of a reorganisation plan" in the USA\textsuperscript{101}). We will now endeavour to understand whether, under existing Swiss law, it really is not possible to impose the consolidated liquidation of a group even in the presence of objecting parties.

We see four grounds on which this could be done.

1. The Banque Commerciale SA consequences

We would first of all like to recall that the actual implications of the decision rendered by the Swiss supreme court in the Banque Commerciale SA case are, at least in our mind, that consolidation could be granted under certain conditions, even though this would, strictly speaking, breach the fundamental principle of autonomy of corporations. We refer in that respect to the comments that we have just made in relation to such case\textsuperscript{102}. In our attempt to draw comparisons with the US approach, we believe that this Swiss precedent corresponds, in substance, to that category of cases identified in the USA as being those "in which it is practically impossible or unreasonable to 'unscramble' respective estates"\textsuperscript{103}.

2. A generalisation of the "Durchgriff" doctrine

As has already been pointed out, consolidation and Durchgriff fundamentally have the same roots and, as the US experience shows, some of the cases in which consolidation is granted are cases in which, in a corporate law scenario, the "corporate veil" would be "lifted" or "pierced". This being admitted, we would take one more step and suggest that substantive consolidation is nothing else than a generalisation of the "Durchgriff" doctrine; in fact, it can be equiparated to a multi-lateral - as opposed to bi-lateral - application of the same theory.

The piercing of the corporate veil theory has, since decades, been perfectly acknowledged and applied in Switzerland even though such relief lacks any specific legal basis. Indeed, in the absence of any express statutory provision, the "Durchgriff" is deemed to derive from art. 2, second paragraph of the Swiss civil code (CCS) which broadly states that "Jedermann hat in der

\textsuperscript{101} See above II.B.4.
\textsuperscript{102} See above III.A.2.
\textsuperscript{103} See above II.B.3.
Ausübung seiner Rechte und in der Erfüllung seiner Pflichten nach Treu und Glauben zu handeln. Der offenbare Missbrauch eines Rechtes findet keinen Rechtsschutz104, which is, in our mind, nothing else than the Swiss translation of the general equity rule which ultimately presides in the USA.  

If clause 2, paragraph 2 CCS is sufficient legal grounds for the Durchgriff, and since consolidation is (at least in certain cases) based on the same equitable concerns as the Durchgriff and is nothing else than a generalisation thereof, therefore art. 2, paragraph 2 CCS should also be sufficient statutory authority to grant substantive consolidation105. Based on the aforesaid, consolidation could be ordered in all cases in which Durchgriff is, for instance where subsidiaries are under-capitalised or where the existence of separate legal entities has been totally ignored during the life of the group and the companies (debtors) pretend to be separate entities when they become insolvent. This would correspond to what we have called the “corporate instrumentality cases” in the USA106.

3. Reliance on the group as a whole (“Konzernvertrauen”)

In a decision rendered in 1994107, the Swiss supreme court innovated by, in essence, establishing a new source of “obligation” within groups of companies: a “liability basis” deriving from what is referred to as a “Konzernvertrauen”, i.e. a liability which is the result of the impression created by the group that it would be answerable as a whole (with all its assets). As is known, this impression is often deliberately given and even cultivated by groups of companies.

Even though the grounds of this new doctrine remain somewhat uncertain, considering the lack of any serious alternative in an environment where equitable solutions often blatantly need to be found, the Konzernvertrauen principle has raised an intense interest and has already been frequently cited by both authors and courts108.

In our mind, this new doctrine is fundamentally and closely related to that of “instrumentality” and, not surprisingly, its legal basis is found, according to

104 “All parties have to act in good faith in the use of their rights and compliance with their obligations. The obvious abuse of a right is not protected by law”.

105 Peter Henry/Birchiler Francesca, Liquidation des groupes de sociétés et consolidation – Enseignements de la pratique récente, SZW 1995, 130.

106 See above II.B.1.

107 Decision rendered by the Swiss Federal Tribunal on November 15, 1994, Wiburu Holding AG vs. Swissair Beteiligungen AG, ATF 120 II 331 = JT 1995 I 359.

our supreme court, in the aforementioned clause 2, paragraph 2 CCS. This should suffice, at least at this level of analysis, to suggest that, in cases where the group presents itself as a whole, the “Konzernvertrauen doctrine” could also be generalised and allow substantive consolidation, in the same manner and for the same reasons that what has just been suggested with regard to the Durchgriff doctrine.\textsuperscript{109} This would correspond to what we have called the “cases where creditors rely on the group as a whole” in the USA\textsuperscript{110}.

4. The groups considered as partnerships

Finally, in a paper that was just published\textsuperscript{111}, we advanced a new theory according to which groups of companies, at least in certain cases, implicitly constitute partnerships\textsuperscript{112}. The consequence thereof is that each member of the partnership – i.e. of the group – would be jointly and severally liable on all its assets for the debts of all the members of the group as a whole (and for the losses thereof), which leads to nothing else than substantive consolidation. Should this – somewhat provocative – theory be considered as founded, it would probably offer the best, or at least the clearest, legal basis for consolidation. Incidentally, it would indeed be the direct consequence of an existing Swiss statute and would also allow for an order to consolidate in the presence of opposition of creditors (even of a majority of them), and even without any proposal in that sense by the debtors or by the trustees.

C. Trans-national consolidation

Because groups of companies are more and more often international, the question not seldom arises as to how a hypothetically possible consolidation scheme can actually be applied not only in one of the countries in which the group is located (supposedly that of the parent company) but also in other countries where corporations or assets of the group are situated. This issue opens a new and very broad set of problems which would require an in-depth and multinational analysis. We will limit our comments to the question as to how Switzerland would react in the presence of a substantive consolidation scheme decided abroad, which concerns a group that owns assets in Switzerland.

\textsuperscript{109} In respect of the Konzernvertrauen as allowing substantive consolidation, see Peter Henry/Birchler Francesca, Liquidation des groupes de sociétés et consolidation – Enseignements de la pratique récente, op. cit., 129–130.

\textsuperscript{110} See above II.B.2

\textsuperscript{111} Peter Henry/Birchler Francesca, Les groupes de sociétés sont des sociétés simples, SZW 1998, 113 ss.

\textsuperscript{112} As defined in clause 530, paragraph 1 of the Swiss Code of Obligation.
We believe that two cases should be distinguished: that where one or more entities which are part of the group are incorporated in Switzerland, and that where only assets belonging to foreign corporations are located in Switzerland. In the first hypothesis, in our mind the trans-national character of the group has no specificity and the general principles that we have previously outlined should apply. For the sake of clarity, this would mean, for instance, that the “Konzernvertrauen” or the “partnership” theories could be proposed to achieve consolidation, the only problem being whether Swiss law – as opposed to foreign law – would apply (to the merit).

The second hypothesis appears to be more peculiar. Indeed, under Swiss private international law (“SPIL”), the Swiss assets of a foreign bankrupt company are not directly accessible to the foreign bankruptcy’s trustees, but are the object of a so called “ancillary bankruptcy” in Switzerland.\(^{113}\) Such ancillary bankruptcy (also referred to as “mini bankruptcy”) is administered totally independently. Quite ironically one could say that this is a “molecular approach”, considering that, while we are wondering if consolidation is possible as opposed to atomism, we are faced here with a case in which the bankruptcy of one single corporation is the object of two separate bankruptcies!

In any event, the scope of the Swiss (SPIL) rules is to make sure that the Swiss creditors of the bankrupt company are adequately protected. The Swiss somewhat nationalistic answer to that concern is that the Swiss secured or privileged creditors will be paid as a matter of priority out of the ancillary bankruptcy’s assets and that only the balance, if any, will be transferred to the foreign bankruptcy estate. Not only: according to clause 173, paragraph 3 SPIL, such transfer takes place only after the competent Swiss court has reviewed whether the claims of the unsecured creditors domiciled in Switzerland have been fairly included in the liabilities (“schedule of debts”) of the foreign bankruptcy. Should the Swiss court find that this is not so (i.e. the Swiss creditors are not fairly treated), such unsecured Swiss creditors will have direct access to the balance of the liquidation of the Swiss ancillary bankruptcy (which will therefore not be transferred abroad).

It is in this context that, should the foreign bankruptcy propose (or be part of) a consolidated scheme, the Swiss judge will be called upon to check whether or not such scheme “fairly” (i.e. “equitably”, in French “équitablement”, in German “angemessen”, in Italian “adeguatemente”) treats the Swiss creditors.

An illustration of this type of situation is offered by the so called “Royco/Varia case”, which was the object of a decision of the court of first instance of Geneva dated November 16, 1989. The Royco/Varia group was composed of about 20 companies, the main ones being in the UK. Following a series of frauds, the UK companies of the group (8 out of 20) were placed in liquidation and the UK judge appointed one (common) trustee. Since several of those companies had assets in Switzerland, ancillary bankruptcies were opened in

\(^{113}\) See clauses 166 ss SPIL.
Geneva in accordance with the aforesaid SPIL. The UK trustee thereafter prepared a liquidation plan in which he recommended the pooling of all assets and liabilities of the group, i.e. substantive consolidation. To our knowledge, at the end of the ancillary bankruptcy liquidation proceeding, the Geneva court approved the transfer of the balance to the UK trustee notwithstanding the fact that a consolidation scheme had been proposed, thereby (indirectly) adhering thereto.

The conclusions to be drawn are, in our opinion, threefold:

(i) Consolidation of Swiss assets within the context of the liquidation of a foreign group is possible. This implies – and confirms – that it is not contrary to any imperative Swiss rule (in particular to any “ordre public” principle). This being so, one could hardly imagine why a purely national consolidation or a trans-national consolidation of foreign assets into those of a Swiss group could not be granted as well.

(ii) The approval of such consolidation scheme is subject to the review of the Swiss judge who will apply an equitable (rather than a rigidly “legal”) test. Accordingly, the Swiss bankruptcy judge has, at least in some cases, the equitable power to decide whether consolidation is, or is not, the appropriate solution.

(iii) Because clauses 166 ss SPIL provide that secured and privileged Swiss creditors will (always) be paid as a matter of priority out of the Swiss assets of an ancillary bankruptcy, in the event a foreign consolidation plan is approved by the Swiss judge the result will not be full, but only partial, substantive consolidation, since the Swiss secured or privileged creditors will not be affected by the consolidation scheme.

IV. Conclusion: A Tentative (Conceptual) Synthesis

The traditional “atomistic” approach often – or at least sometimes – is inappropriate when liquidating one or more entities which are part of a group of companies. Such traditional approach, indeed, not seldomly proves to be unfair – in the sense of “non equitable” – or impracticable for reasons of cost, time or administration. In such case, alternatives to the atomistic approach should be available.

A first attempt to overcome the intrinsic limits of the atomistic approach has historically been the “piercing the corporate veil” (“Durchgriff”) doctrine the prospective of which is however limited to only two separate entities, the creditors of one gaining access to the assets of the other (but not vice versa). The difference between such bi-lateral approach and consolidation is clear: in

114 See Peter Henry/Birchler Francesca, Liquidation des groupes de sociétés et consolidation – Enseignements de la pratique récente, SZW 1995, 127.
the former there is no real pooling of assets or, if any, only a limited and asymmetrical one, as if one entity would have jointly guaranteed the debts of the other (but, again, not the contrary). In addition, the Durchgriff approach can be applied – granted – only to each single creditor and on a case by case basis, depending on the circumstances surrounding each one’s relationship with the debtor. This relief thus belongs fundamentally to the same category as cases of fraudulent conveyance (actio pauliana) and suffers from the same limits.

Thus, a more radical solution is required. The most (?) convincing one seems to be the consolidation of the assets and liabilities of several – or all – entities belonging to the relevant group. In some cases, this can also extend to individuals, in particular to the estate of the controlling shareholder.

Cases in which consolidation can be granted generally includes findings of:

(i) hindrance or fraud on creditors;
(ii) creditors’ reliance on the group as a whole (i.e. on the group as a consolidated enterprise);
(iii) intermingling and intertwining of corporate estates and of their accounts;
(iv) facilitation of the reorganisation plan.

Clearly, the decision to consolidate affects the very substance of the rights of creditors and debtors, at least as traditionally viewed in consideration of the limited liability of corporations. Consolidation should therefore be reserved to extraordinary cases and granted only after careful analysis of the rights and interests of all involved parties. As U.S. case law has shown, consolidation may be in the debtors’ as well as in the creditors’ interest (or in some creditors’ interest); in both cases, this can prove unfair.

Should full substantive consolidation appear inappropriate or excessive, there exist less radical solutions which derive from the same concerns of equity, but allow the legitimate interest of other parties involved to be duly taken into account. Such solutions are, inter alia:

(i) _procedural (as opposed to substantive) consolidation_, where one or more of the following three (procedural) decisions is taken:
- the same court (forum) is declared to have jurisdiction so as to order and monitor the liquidation of the bankruptcy of all group companies;
- the joint administration of one or more of the affiliated companies;
- the appointment of a single trustee for the liquidation of all the estates which are jointly administered.

(ii) _partial substantive consolidation_ (as opposed to full substantive consolidation). In such case, consolidation will not extend to those assets or creditors in respect of which consolidation does not appear equitable. As the USA (and Swiss) case law illustrates:
- consolidation may extend only to unsecured creditors, as opposed to secured ones which have – by definition – relied on an atomistic view of the group;
– in case consolidation is extended to solvent companies of the group, consolidation might pertain only to the net (if any) equity of such non bankrupt related companies; in other words it will not affect the creditors of the solvent company;
– where part of the assets do clearly belong to some companies and others are totally scrambled, consolidation may be limited to the intermingled part of the group’s assets.

(iii) finally – but it is important to realise that we here remain in the same conceptual area of equitable concern – there are cases in which any form of consolidation appears inappropriate, but where, because of their behaviour, insiders (with respect to the group) clearly do not deserve to have priority and/or be treated equally in respect of outside good faith creditors. In such cases, substantive subordination of the claims of the “insiders” in respect of those of outsiders can be ordered. This can prove to be an appropriate relief in cases, for instance, of under-capitalisation of subsidiaries or where insiders have been more or less systematically siphoning (looting) the subsidiaries’ equity.

Some of the aforesaid remedies have (although timidly) already been applied in Switzerland on rather unclear grounds. We feel that they could perhaps be implemented, de lege lata, based on existing statutory provisions and on the equitable powers of our magistrates, should they choose to use them. This is evidently not to say, however, that some kind of express statutory rules should not be envisaged.