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Moving towards a clearer framework for substantive consolidation in Brazilian court reorganisations

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Acknowledgement

INSOL International is very pleased to present a technical paper titled 'Moving towards a clearer framework for substantive consolidation in Brazilian court reorganisations' by Alex S. Hatanaka and Talitha Aguillar Leite of Mattos Filho, Brazil.

In most jurisdictions, the separate legal entity doctrine is still the most fundamental principle underpinning corporate law. This doctrine ensures that the corporate form will be respected, unless the entities have engaged in some form of misconduct or action with wrongful purpose.

In the realm of insolvency, in situations in which a legal entity-based approach may not do justice to a corporate group and its creditors, courts may be in a position to view the companies as a single, collapsed pool of assets and liabilities by ordering their substantive consolidation.

This paper examines the Brazilian approach to substantive consolidation and how this compares to that of the USA and the UK and the recommendations made in UNCITRAL's Legislative Guide on Insolvency Law, Part Three: Treatment of enterprise groups in insolvency. In the USA, the power to consolidate remains an equitable remedy, typically justified by reference to the broad powers afforded to the bankruptcy courts under the US Bankruptcy Code. In the UK, the separateness of the legal entity is and remains the cornerstone of English company law. Accordingly, even if the case involves a group of companies, the subject of insolvency proceedings remains the particular corporate entity that has become insolvent and there is an unwillingness to allow any remedy to consolidate assets and liabilities. For those jurisdictions in which consolidation or pooling is possible, the UNCITRAL Guide emphasises that the circumstances that would warrant a substantive consolidation order are very limited and the importance of ensuring fairness in the treatment of creditors of different corporate entities.

Brazilian bankruptcy law is silent as to whether two or more entities of the same corporate group may apply for substantive consolidation. Brazilian courts have, however, almost invariably authorised procedural consolidation and, to a lesser extent but still in a liberal manner, have allowed substantive consolidation. This paper reviews the different approaches adopted by Brazilian courts in recent landmark insolvency cases including OAS Group, Oi Group, Abengoa and most recently, Odebrecht. It highlights the need for creditors, when extending credit to a Brazilian group of companies, to review the risk of substantive consolidation and discusses whether the recently proposed Bill of Law No 6,229/2005 will provide parties in court reorganisations with an appropriate legal framework and a more certain and stable legal regime with respect to substantive consolidation.

INSOL International sincerely thanks Alex S. Hatanaka and Talitha Aguillar Leite for this detailed analysis of substantive consolidation in these jurisdictions and for providing our members with this very interesting and informative technical paper.

May 2020

Moving towards a clearer framework for substantive consolidation in Brazilian court reorganisations*

By Alex S Hatanaka and Talitha Aguillar Leite, Mattos Filho[1]

1. Introduction

This technical paper underscores the importance of careful examination of the substantive consolidation doctrine as it is applied to corporate groups in insolvency scenarios. It devotes special attention to the Brazilian experience.

In modern corporate reality, the activities of multinational businesses are typically organised as groups of companies rather than single independent companies. Some authors refer to these groups of companies as "enterprise groups".[2] Individual companies have become typical of small businesses and enterprise groups have emerged as the rule for more sophisticated businesses and are ubiquitous.

Commonly, groups of companies are spread out across multiple jurisdictions and thereby become subject to multiple laws and attract the attention of practitioners and scholars of private international law. As an anecdotal example, it is claimed that Lehman Brothers consisted of "some 8,000 entities in 40 countries"[3] at the time of its collapse.

Some Brazilian groups are examples of this reality. The very large $19 billion court reorganisation of the telecommunications group Oi included proceedings in Brazil, the US, the UK, the Netherlands and Portugal. The request for court reorganisation of the real estate group PDG Realty was filed jointly by 512 different legal entities.

The reasons underlying such structural complexity are wide-ranging and include globalisation, tax efficiency gains, management efficiencies, foreign direct investment rules, segregation of liabilities, access to international capital markets and antitrust considerations.

Despite the rise of groups of companies and their increasing complexity, the laws of some countries such as Brazil do not yet deal appropriately with insolvencies of groups of companies, nor do they adequately regulate how to efficiently administer cross-border insolvencies involving multiple legal entities.[4] As Mevorach points out, foreign elements

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* The views expressed in this paper are the views of the authors and not of INSOL International, London.

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2 According to the Glossary of the UNCITRAL Legislative Guide on Insolvency Law - Part three: Treatment of enterprise groups in insolvency (New York: United Nations, 2012, p 2), an "enterprise group" is defined as "two or more enterprises that are interconnected by control or significant ownership" and an "enterprise" as "any entity regardless of its legal form, that is engaged in economic activities and may be governed by the insolvency law". See regarding the concept, e.g., Miguens, Héctor José. "Corporate Groups and Liability Issues in Argentina, USA and UNCITRAL Recommendations" INSOL International Technical Paper Series, Issue No. 12, April 2010.

3 Miller, Harvey R.; and Horwitz, Maurice, "A better solution is needed for failed financial giants" The New York Times: Deal Book 9 October 2012. < https://dealbook.nytimes.com/2012/10/09/a-better-solution-is-needed-for-failed-financial-giants/>

4 In contrast to most national laws, the international accounting standards view businesses conducted by enterprise groups on a consolidated basis (IFRS 10 "requires an entity (the parent) that controls one or more other entities (subsidiaries) to present consolidated financial statements". In addition, it clarifies that "[c]onsolidated financial

involved in multinational enterprises in distress add further complexity to the issues typically embedded in a domestic insolvency.[5]

In most jurisdictions, the separate legal entity is still the most fundamental principle underpinning corporate law. The company's separateness doctrine ensures that the corporate form will be respected, unless the entities have engaged in some form of misconduct or action with wrongful purpose.[6]

In the realm of insolvency, in situations in which a legal entity-based approach may not do justice to the enterprise group and its creditors, courts may be in a position to view the companies as a single, collapsed pool of assets and liabilities by ordering their substantive consolidation. Simply put, substantive consolidation is "the effective merger of two or more legally distinct (albeit affiliated) entities into a single debtor with a common pool of assets and a common body of liabilities".[7]

The United Nations Commission on International Trade Law (UNCITRAL) uses similar wording to define substantive consolidation: "the treatment of the assets and liabilities of two or more enterprise group members as if they were part of a single insolvency estate".[8]

In an insolvent liquidation substantive consolidation scenario, the bankruptcy estates are consolidated into a single estate, that is, a common "hotchpot" congregating all cumulative assets and liabilities. The gathering of assets will be carried out by the pooling of assets of the different legal entities and the payment of the liabilities of the combined entities will be satisfied out of the pooled assets of the combined entities, pursuant to a combined ranking of distribution priorities.

In turn, in a reorganisation scenario, which is the focus of this paper, substantive consolidation means that the discussions relating to a potential restructuring will address the enterprise group as a whole, with the voting of a single plan for all legal entities by a single collapsed group of creditors of the different companies, pursuant to consolidated approval requirements. The group entities may be substantively consolidated on the basis of:

- a court order;
- the consensus of the relevant interested parties; or
- the approval of a reorganisation plan proposing the consolidation.

By doing so, inter-company obligations are wiped out (such as fraudulent conveyances or intra-group loans), and any otherwise lawful pre-petition bargaining for unequal treatment, such as corporate guaranties, becomes moot. As a result, the rights of the creditors are profoundly rebalanced according to how solvent each of the affiliates was in relation to the

statements are financial statements that present the assets, liabilities, equity, income, expenses and cash flows of a parent and its subsidiaries as those of a single economic entity"). Securities regulators in many jurisdictions require disclosures on a consolidated basis, and supervise the enterprise group rather than separate legal entities.

5 Mevorach, Irit, "Insolvency within Multinational Enterprise Groups" New York: Oxford University Press, 2009, p 1.

6 As Gower explains, "the fundamental attribute of corporate personality – from which all the other consequences flow – is that the corporation is a legal entity distinct from its members" (Davies, Paul L; and Worthington, Sarah, "Gower's Principles of Modern Company Law" Tenth Edition. London: Sweet & Maxwell, Thomson Reuters, 2016, p 29)

7 Kors, Mary Elisabeth, "Altered Egos: Deciphering Substantive Consolidation" In: 59 U Pitt L Rev 381 (1998), p 381.

8 UNCITRAL Legislative Guide on Insolvency Law - Part three: Treatment of enterprise groups in insolvency, New York: United Nations, 2012, p 2.

consolidated enterprise, as each of such companies will have a different debt-to-asset ratio.

In this regard, it is important to clarify that substantive consolidation is different to procedural consolidation, also known as procedural coordination.[9] Procedural consolidation is a narrower remedy and it implies multiple insolvency cases subject to joint administration by a single court and insolvency professionals. Procedural consolidation resolves some but not all of the challenges of efficiency in large bankruptcies; while the assets and liabilities of distinct entities are kept independent and intercompany claims are preserved, it does not affect the rights of creditors and plan voting and cram-down are still decided on the basis of each individual legal entity. As mentioned, substantive consolidation goes a step further – it is a more radical remedy.

The third edition of the highly regarded comparative overview of corporate law "*The Anatomy of Corporate Law*" has been updated to add a reference to the application of substantive consolidation in Brazil in the extract below:

> "In the U.S., the doctrine of 'substantive consolidation' gives bankruptcy courts the power to put assets and liabilities of two related corporations into a single pool. *Brazilian courts also have – and very liberally employ – this power*. Like the French "action en confusion de patrimoine", this is a means to respond to debtor opportunism taking the form of concealing assets in different corporate boxes, or of shunting assets around within a group. However, the doctrine makes the creditors of one corporate entity better off at the expense of those of the other and, therefore, is most appropriate where all creditors have been deceived as to the location of assets, or where the creditors that are made worse off acted collusively with the debtor".[10]

This paper examines whether the Brazilian approach to substantive consolidation has aligned with that of the US, the UK and UNCITRAL. It reviews the approach adopted by Brazilian courts in some landmark insolvency cases and discusses whether the current (lack of) legislation in Brazil and, more interestingly, the proposed Bill of Law No 6,229/2005 (referred to in 4.3.3 below), as it stands to date, is appropriate to handle the intricacies of substantive consolidation.

2. Substantive consolidation in the USA and the UK[11]

2.1 United States of America

The US Bankruptcy Code provides no statutory authority for substantive consolidation. The power to consolidate remains an equitable remedy, a construct of fairness and equity, typically justified by reference to the broad powers afforded to the bankruptcy courts under Section 105(a) of the US Bankruptcy Code.[12]

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9 "Procedural coordination" is defined by UNCITRAL as the "treatment of the assets and liabilities of two or more enterprise group members as if they were part of a single insolvency estate" (UNCITRAL Legislative Guide on Insolvency Law - Part three: Treatment of enterprise groups in insolvency, New York: United Nations, 2012, p 2).

10 Kraakman, Reinier; Armour, John; Davies, Paul; Enriques, Luca; Hansmann, Henry; Hertig, Gerard; Hopt, Klaus; Kanda, Hideki; Pargendler, Mariana; Ringe, Wolf-Georg; and Rock, Edward, "The Anatomy of Corporate Law" 3rd edition, Oxford University Press, 2017, p 133, (emphasis added).

11 The authors are licensed only to practice Brazilian law and, therefore, have prepared this section based on the review of the texts and materials referred to in the paper, with the purpose of supporting the comparative analysis to Brazilian law and practice.

12 11 USC §105(a). In addition, §1123(a)(5)(C) of the Bankruptcy Code authorises that reorganisation plans include the "merger or consolidation of the debtor with one or more persons" as a means of implementation. In turn, Fed R Bankr P 1015(b) provides for procedural consolidation, authorising bankruptcy courts to direct cases involving affiliated debtors to be jointly administered.

Some authors argue that the jurisprudential origins of the doctrine can be traced back to decisions dating as early as 1941,[13] preceding the passing of the Bankruptcy Code in 1978. These judicial opinions draw their historical roots from the doctrines of "veil-piercing", "alter ego" and "instrumentality".

The Third Circuit of the US Court of Appeals, which is responsible for Delaware, New Jersey and Pennsylvania, elegantly explained the meaning of substantive consolidation as follows:

> "Substantive consolidation treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor. Because its effect radically rearranges legal boundaries, assets and liabilities, substantive consolidation is typically a sparingly used remedy for debtors' conduct that blurs separateness so significantly that either the debtors' assets are so scrambled that unscrambling them is cost, time and energy prohibitive or creditors already perceive the debtors as simply a single unit and deal with them so".[14]

As a result of the absence of legal authority, the US courts have developed different tests to determine whether substantive consolidation should be ordered or not. Despite some inconsistency, an analysis of the case law shows that the decisions tend to be heavily factually dependent and invariably include an in-depth analysis of the impact of the consolidation on creditors' rights and expectations.

2.1.1 Owens Corning[15]

In the *Owens Corning* case, the Third Circuit approved a "deemed" consolidation of eighteen debtors and three non-debtor affiliates under a reorganisation plan and laid down the following disjunctive two-pronged test:

> "…[i]n our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors. Proponents of substantive consolidation have the burden of showing one or the other rationale for consolidation".[16]

2.1.2 Eastgroup[17]

In the *Eastgroup* case, the Eleventh Circuit of the US Court of Appeals elaborated on a test previously adopted by the DC Circuit in the precedent setting *In re Auto-Train Corp*

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13 In *Sampsell v Imperial Paper & Color Corp*, 313 US 215 (1941), the US Supreme Court authorised the pooling of assets of a non-debtor with a debtor in bankruptcy, in light of fraudulent transference of assets. Some authors, however, such as Baird, understand that *Sampsell* does not provide support for substantive consolidation, as it relies entirely on the fraudulent conveyance theory (Baird, Douglas G "Substantive Consolidation Today", Boston College Law Review, Volume 47 (2005), p 19).

14 *Genesis Health Ventures, Inc v Stapleton (In Re Genesis Health Ventures, Inc)* 402 F 3d 416, 423 (3d Cir 2005).

15 *In Re Owens Corning*, 419 F 3d 195 (3d Cir 2005).

16 *Ibid*, 211-2.

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

case,[18] establishing an important balancing test. First, "the proponent of substantive consolidation must show that (1) there is substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or to realize some benefit". With this, a presumption arises that "creditors have not relied solely on the credit of one of the entities involved," and thus "the burden shifts to an objecting creditor to show that (1) it has relied on the separate credit of one of the entities to be consolidated; and (2) it will be prejudiced by substantive consolidation".[19]

2.1.3 In re Augie / Restivo Baking Co Ltd[20]

In another influential precedent, the Second Circuit of the US Court of Appeals analysed several past decisions and concluded:

> "[a]n examination of those cases, however, reveals that these considerations are merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit' (…); or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors (…)".[21]

The Ninth Circuit followed the Second Circuit and adopted the *Augie / Restivo* two-prong test.[22] In practice, *Augie / Restivo* and *Eastgroup* are two of the most frequently used tests.[23]

2.1.4 Other approaches

Notwithstanding the two tests referenced above, Kors has highlighted the lack of consistency among the approaches of the different Circuits of the US Court of Appeals.[24] The Fourth, Fifth and Seventh Circuits had not adopted a standard of their own at that time. The First Circuit had adopted a different test from those, consisting of five factors set out in *Pension Benefit Guaranty Corp v Ouimet Corp.*[25] The Eighth Circuit considered a three-prong test established in *In Re Giller.*[26]

2.1.5 Core principles stemming from case-law

Notwithstanding the inconsistencies, there are three core principles at the heart of the substantive consolidation discussion in the US as set out below.

(i) Courts focus on whether there is "substantial identity" among the entities, that is, where a group of companies operates as a single integrated enterprise – as a

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18 *Drabkin v Midland-Ross Corp* (*In re Auto-Train Corp*) 810 F 2d 270 (DC Cir 1987).

19 *Supra,* note 17.

20 *Union Savings Bank v Augie / Restivo Baking Co, Ltd (In re Augie / Restivo Baking Co, Ltd)*, 860 F 2d 515, 518 (2d Cir 1988).

21 *Ibid,* 518 (citations and case law references omitted).

22 *In re Bonham*, 229 F 3d 750, 766 (9th Cir 2000).

23 Sprayregen, James H M; Friedland, Jonathan P; and Gettleman, Jeffrey W, "The Sum and Substance of Substantive Consolidation", Annual Survey of Bankruptcy Law 1 (2005 ed); p 5.

24 Kors, Mary Elisabeth, *supra* note 7, p 381 *et seq*.

25 "Some of the facts a court will look for in deciding whether to grant a substantive consolidation include the parent owning a majority of the subsidiary's stock, the entities having common officers or directors, the subsidiary being grossly undercapitalised, the subsidiary transacting business solely with the parent, and both entities disregarding the legal requirements of the subsidiary as a separate corporation" (711 F 2d 1085, 1093).

26 "Factors to consider when deciding whether substantive consolidation is appropriate include 1) the necessity of consolidation due to the interrelationship among the debtors; 2) whether the benefits of consolidation outweigh the harm to creditors; and 3) prejudice resulting from not consolidating the debtors" (962 F 2d 796).

functional whole – and creditors and remaining stakeholders viewed the group as a single business enterprise, with subsidiaries that do not have an independent existence from the parent.[27]

(ii) A group of companies may disregard the formalities of the separation of the legal entities so significantly as to cause its assets and liabilities to become "hopelessly entangled".[28] In this scenario, it may be necessary to support substantive consolidation, as unscrambling them may be cost-prohibitive and excessively time-consuming.

(iii) It is key to understand how creditors viewed the companies and to search for a solution that respects the principle of equal treatment of creditors, including treating differently creditors that have bargained for different rights. If a creditor or creditors relied on the separation to extend credit or otherwise do business with the debtor and, for that purpose, legitimately bargained for guaranties, security or other contractual advantage, then an application for an order of substantial consolidation may not be appropriate. One example would be where institutional lenders secured a syndicated loan with cross-guaranties from other entities in the borrower's group.

In situations of deliberate misrepresentation or failure to follow corporate formalities or intermingling of assets and liabilities, the actions of "veil piercing", "alter ego" and fraudulent conveyance are available independently of the insolvency proceedings. These doctrines may also be used to partially satisfy requirements to allow substantive consolidation.

2.1.6 Latest discussions

In more recent case law, the discussion has shifted to more specific aspects of substantive consolidation. Courts have, for example, shown clear reluctance to employ substantive consolidation in insolvent liquidation proceedings in order to include assets of non-debtors, except in cases of fraudulent conveyances.[29]

In other case law, an innovative solution was used to unlock a Chapter 11 court reorganisation in *Republic Airways Holding*.[30] The debtors submitted a Chapter 11 plan providing for substantive consolidation and all creditors but one came to agree to the proposed consolidation. The debtors and the official creditors' committee amended the plan such that the sole opposing creditor could decide whether substantive consolidation would apply to its claim or not. As a result, substantive consolidation was applied to the debtors with respect to all creditors, but one. Despite the continuing objection from the

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27 In this regard, it is interesting to review the seven factors listed in the case of *In re Vecco Const Industries, Inc* (4 B R 407 (Bankr ED Va 1980), 410): "First, the degree of difficulty in segregating and ascertaining individual assets and liability. Second, the presence or absence of consolidated financial statements. Third, the profitability of consolidation at a single physical location. Fourth, the commingling of assets and business functions. Fifth, the unity of interests and ownership between the various corporate entities. Sixth, the existence of parent and inter-corporate guarantees on loans. Seventh, the transfer of assets without formal observance of corporate formalities".

28 In reviewing groups that are "hopelessly entangled," some court decisions, such as *Eastgroup*, use a balancing test whereby the court determines whether the demonstrated benefits of substantive consolidation "heavily" outweigh the harm. The time and expense necessary to attempt to untangle the combined assets and liabilities must be substantial enough to threaten to leave every creditor worse off (*In Re Owens Corning*, 419 F 3d 195 (3d Cir 2005), 211).

29 See (a) *Spradlin v Beads and Steeds Inns, LLC (In Re: Matthew Lowell Howland and Meagan Larae Howland)*(6th Cir 2017); (b) *The Official Committee of Unsecured Creditors v The Archdiocese of Saint Paul and Minneapolis*, No 17-1079 (8th Cir 2018); and (c) *Audette v Kasemir (In re Concepts Am, Inc.)*, Case No 14 B 34232 (Bankr ND Ill. Mar 1, 2018).

30 *In re Republic Airways Holdings, Inc*, 565 BR 710 (Bankr SDNY April 10, 2017), *aff'd*, 2018 US Dist LEXIS 52148 (SDNY March 28, 2018).

single creditor to the solution given to the case, the court confirmed the plan as well as the "partial" substantive consolidation, using the *Augie / Restivo* two-prong disjunctive test.

2.1.7 The future of substantive consolidation

Although the courts have warned that substantive consolidation is supposed to be a narrow and exceptional instrument to be used only under compelling circumstances, in practice it has become a relatively common remedy in large bankruptcy cases.[31] Graulich contends that the US courts have been gradually adopting a modern, "liberal" approach to the doctrine, using overly relaxed standards for its application and he calls for a return to the original standard of careful and sparing use.[32]

As Baird highlighted, the *WorldCom* reorganisation has shown how the pressures to ensure a speedy reorganisation can be overwhelming.[33] However, Baird predicts an "uncertain future of substantive consolidation".[34] He emphasises that the Supreme Court has yet to rule on a case endorsing, or declining to endorse, the substantive consolidation doctrine. Moreover, the lack of clear statutory authority in the US Bankruptcy Code may threaten the very existence of the doctrine.

While Baird concedes that a bankruptcy judge may have some discretion to fill the interstices, he cautions against broader application, quoting Judge Posner:

> "[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be".[35]

2.2 United Kingdom

Since *Salomon v Salomon and Co*,[36] the separateness of the legal entity is and remains the cornerstone of English company law. Accordingly, even if the case involves a group of companies, the subject of insolvency proceedings remains the particular corporate entity that has become insolvent. This focus is heightened by the reluctance of English courts to lift the corporate veil.[37]

English law has rules to hold one company liable for the debts and liabilities of another company in the group, even where it has not given a guarantee. Such rules are based on agency, piercing the corporate veil and "alter ego" doctrines, but are rarely invoked with success.[38] As Goode explains, "there are special situations in which the court is willing to pierce the corporate veil, as where the company has been created and used as an engine

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31 Widen, William H, "Report to the American Bankruptcy Institute: prevalence of substantive consolidation in large public company bankruptcies from 2000 to 2005", ABI Law Review, vol 16: 1.

32 Graulich, Timothy, "Substantive Consolidation – A post modern trend", ABI Law Review, vol 14: 528.

33 Baird, s*upra,* note 13, 2005, p 10, making reference to the case *In re WorldCom,* 2003 WL 23861928, at 37.

34 *Ibid,* p 15.

35 *Ibid,* p 21. Citation of Judge Posner (*In re Chi, Milwaukee, St Paul & Pac RR*, 791 F 2d 524, 528 (7th Cir 1986).

36 [1897] AC 22.

37 Goode, Roy, "Principles of Corporate Insolvency Law", Fourth Edition, Student Edition, London: Sweet & Maxwell, 2011, p 23.

38 *Ibid,* p 789. In a similar fashion, Mevorach mentions that "[a]lthough the 'wrongful trading' statutory remedy (s 214 of the English Insolvency Act 1986) can potentially be used to impose group liability (applying the concept of 'shadow director' in s 214(7)), English courts are essentially reluctant to develop a 'group enterprise law' and tend to adhere to the entity doctrine (as expressed in *Adams* v. *Cape Industries plc* [1990] B.C.L.C. 479). However, particular transactions among group members that may be regarded as 'vulnerable' can be attacked using the avoidance provisions such as s 238 of English Insolvency Act 1986 (transactions at an undervalue) or s 239 (preferences) and the concept of 'connected persons' incorporated therein" (Mevorach, Irit, s*upra*, note 5, p 192).

of fraud; but such cases are exceptional, and it is extremely difficult to persuade an English court to look behind the veil of incorporation".[39]

Outside these doctrines there are no clear rules on the liability of the parent company for the companies within its group[40] and, in particular, no statutory authority for substantive consolidation in insolvency proceedings.

In fact, the traditional approach remains strongly rooted, despite the clear acknowledgement by some legal scholars that there is a "disjuncture between the law's vision of the limited liability company and the reality of commercial life. The law does not hold parent companies liable for subsidiaries because it treats companies as juristic persons with separate corporate personality. The reality is that groups operate as economically and managerially cohesive operations, often with high levels of unity".[41]

It is only symptomatic of the scarcity of decisions that most materials on the subject discuss the case of *BCCI*,[42] in which English courts exceptionally accepted a petition to consolidate assets in the insolvent liquidation of several companies of the group, in light of severe intermingling of assets.[43] Another rare English case on the subject, as referenced by Mevorach,[44] was *Exchange Securities & Commodities Ltd* (In Liquidation),[45] in which the liquidator proposed a scheme under Section 425 of the Companies Act 1985 that included the pooling of all assets and the distribution of proceeds to creditors according to percentages agreed with them. Neither case, however, involved a rescue procedure.[46]

Likewise, in relation to the regulation of cross-border insolvencies, there has been an unwillingness to allow any remedy to consolidate assets and liabilities, except in circumstances of radical intermingling of assets. Instead, the focus has been on the procedural coordination in an effort to efficiently administer cross-border insolvencies of groups of companies. Cases such as MG Rover, Daisytek and Maxwell Communications are repeatedly cited as evidence that it is indeed possible to coordinate complex cross-border insolvencies and, particularly, that there will be reasonable compliance with the

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39 Goode, Roy, *supra* note 37, p 107. In the same sense, see Davies and Worthington, *supra* note 6, pp 197-206.

40 As Gower points out, "British law does in fact apply the doctrine of limited liability to intra-group shareholders as much as to extra-group shareholders and, as we say in the previous chapter, the courts will not pierce the veil within a group of companies simply on the grounds that the group constitutes a single economic entity." (Davies and Worthington, *supra* note 6, p 228). See also Davies, Paul L *Introduction to Company Law*. Oxford: Oxford University Press, 2002, p 104.

41 Finch, Vanessa; and Milman, David, "Corporate Insolvency Law: Perspectives and Principles" Third Edition, Cambridge University Press, 2017, pp 496-7.

42 Re *Bank of Credit and Commerce International SA - BCCI* (No. 3) [1993] BCLC 1490. Cited by Goode, Roy, *supra* note 37, 2011, p 24 and Mevorach, Irit, "Appropriate Treatment of Corporate Groups in Insolvency: A Universal View", European Business Organization Law Review, 8: 179-194 (2007), p 187.

43 Roy Goode explains that, under English laws, substantive consolidation "is infrequent and is generally confined to situations in which the assets and liabilities of the different companies are so intermingled that there is no sensible alternative to consolidation" (Goode, *surpa* note 37, p 789).

44 Mevorach, *supra* note 42, p 187.

45 [1987] BCLC 425.

46 In the UK, a rescue procedure is understood as "a major intervention necessary to avert eventual failure of the company" (Belcher, Alice, "Corporate Rescue" Sweet & Maxwell, 1997, p 12). Rescue may involve informal mechanisms or formal processes. As Vanessa Finch and David Milman explain, "[i]nformal actions do not demand any resort to statutory insolvency procedures but are contractually based. They are usually instituted by directors or creditors and they may involve the use of professional help: where, for instance, a 'company doctor' or firm of accountants is appointed (usually on a creditor's insistence) to investigate the company's affairs and to make recommendations. (...) Alternatively, under the 'London Approach', co-ordination of a creditors' agreement in accordance with informal guidelines may be achieved with the Bank of England acting as an honest broker in making efforts to persuade reluctant parties to pursue such informal settlements. Formal arrangements under which rescues may be attempted are provided for in the Insolvency Act 1986 and include company voluntary arrangements (CVA), receiverships and administrative receiverships and administration" (*supra* note 41, p 207).

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This position decisively influenced the contents of the letter dated 27 May 2010, submitted by the City of London Law Society (CLLS) to UNCITRAL, in response to the consultation on the UNCITRAL Legislative Guide on Insolvency Law – Part Three: Treatment of enterprise groups in insolvency. The CLLS submission makes a fierce case for very prudent use of the substantive consolidation doctrine. The letter informs, moreover, that "[t]here is no general principle of English insolvency law which gives an English court the power, whether or not based on the application of equitable principles, to treat the assets and liabilities of one entity as though they were assets and liabilities of another entity for the purposes of a liquidation or administration of one of those entities".

As a result of this more traditional position, UK law seems to be poles apart from the discussion in Brazil, where courts have been adopting a very "liberal approach" to substantive consolidation as mentioned by Kraakman, *et al*.[47]

3. Substantive consolidation and the UNCITRAL Legislative Guide on Insolvency Law

In 2005 UNCITRAL published its Legislative Guide on Insolvency Law (the Guide),[48] a valuable legislative guide for the purpose of fostering and encouraging the adoption of effective domestic legislation on corporate insolvency.

The section of the Guide on "Treatment of Groups in Insolvency" expresses concern that a departure from the legal entity separateness principle may undermine the capacity of creditors and other stakeholders to make informed decisions on risks and, consequently, may introduce uncertainty and elevate the cost of credit.

Nonetheless, the Guide recommends that a court take the following factors into consideration when determining whether a group of companies has operated as a single enterprise and an order for consolidation or pooling should be granted:

> "the extent to which management, the business and the finances of the companies are intermingled; the conduct of the related company towards the creditors of the insolvent company; the expectation of creditors that they were dealing with one economic entity rather than two or more group companies; and the extent to which the insolvency is attributable to the actions of the related group company".[49]

These factors are ostensibly close to those discussed in the US court precedents on substantive consolidation referred to in 2.1 above.

For those jurisdictions in which consolidation or pooling is possible, the UNCITRAL guide emphasises the importance of ensuring fairness in the treatment of creditors of different corporate entities, highlighting that creditors of a company with a significant asset base will have their assets diminished by the claims of creditors of another company with a lower asset base.

It then proposes the application of a balancing test, similar to those in *Eastgroup* and *Owens Corning*, suggesting that the court must be satisfied that "creditors would suffer a

47 *Supra* note 10.

48 UNCITRAL Legislative Guide on Insolvency Law, New York: United Nations Publications, 2005 (accessed on 29 Aug 2019: https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf).

49 *Ibid* p 278.

greater prejudice in the absence of consolidation than the insolvent companies and objecting creditors would from its imposition".[50]

Although the Guide discusses the treatment of groups for purposes of recommendations for domestic legislation, it was really in 2012 with the publication of Part Three of the Guide that the debate regarding enterprise groups deepened further.[51] Part Three discusses substantive consolidation in depth and, in line with the US and UK experiences, highlights that the circumstances that would warrant a substantive consolidation order are very limited.

Part Three of the UNCITRAL Guide acknowledges that substantive consolidation is more prominently discussed in the context of insolvent liquidations, but notes that "there are, however, legislative proposals that would permit substantive consolidation in the context of various types of reorganisations".[52]

UNCITRAL recommends that the group members, a creditor of any such group member and any insolvency professional (trustee, receiver or judicial administrator) representing a group member, should be able to apply for substantive consolidation in insolvent liquidations. It does, however, opine that courts should not have powers to act on their own initiative to order substantive consolidation.

In terms of timing of the application for consolidation, the Guide recommends that laws allow for the application for substantive consolidation to be filed at the outset of proceedings, but with flexibility to be presented at any subsequent time; provided, however, that, when ruling on this subsequent time application, courts should give consideration to the progress of the proceedings and the decisions already made by that time. The Guide also cautions on the importance of balancing the rights and expectations of the different stakeholders, including the priority creditors, the secured creditors and the owners or shareholders (emphasising the absolute priority rule which is adopted in many countries).

Insofar as reorganisations are concerned, the Guide discusses co-ordinated reorganisation plans, under the same consolidated procedure, but it recommends that approval of a co-ordinated reorganisation plan be made on a member-by-member basis, using voting requirements determined in accordance with each member of the group, rather than a consolidated list of creditors prepared for a substantively consolidated group. Therefore, it recommends the non-consolidation approach as a general rule, arguing that "it would not be desirable to consider approval on a group basis and allow the majority of creditors of the majority of members to compel the approval of a plan for all members".[53]

4. Substantive consolidation in Brazil

Federal Law 11,101, dated 9 February 2005, known as the Brazilian Bankruptcy Law, governs the insolvency remedies available in Brazil: judicial reorganisation (*recuperação judicial*), prepackaged reorganisation (*recuperação extrajudicial*) and liquidation (*falência*).

The Brazilian Bankruptcy Law was passed fifteen years ago and, during this period, some large and complex Brazilian groups, including, for example, OGX Petróleo e Gás SA, Sete

50 *Ibid,* p 278.

51 UNCITRAL Legislative Guide on Insolvency Law, Part Three: Treatment of enterprise groups in insolvency. New York: United Nations Publications, 2012. (accessed on 29 Sep 2019: https://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part3-ebook-E.pdf).

52 *Ibid*, p 60.

53 *Ibid*, p 80.

Brasil Participações SA, Oi SA, OAS SA and Odebrecht SA have made use of the judicial reorganisation mechanism to pursue a restructuring and overcome distress. In fact, from 2006 to 2013 the number of companies that filed for judicial reorganisation increased dramatically from 156 to 690. Then in 2018, this number nearly doubled to 1,215.[54]

The increasing number of filings and the experience of administering and resolving large, complex cases led to the discussion in courts, by practitioners and by scholars, of several new and controversial issues, including the substantive consolidation of groups.[55]

Despite the lack of statutory authority, some groups of companies began to apply jointly to Brazilian courts for orders for judicial reorganisation. A study of 2016 concluded that, during the period between September 2013 and October 2015, almost 90% of the judicial reorganisation requests filed with the Specialised Bankruptcy Courts of the State of São Paulo were made by groups of companies applying for substantive consolidation.[56]

4.1 Procedural consolidation

Brazilian Bankruptcy Law is silent on the possibility of procedural consolidation. Nonetheless, Section 113 of the Brazilian Civil Procedural Code[57] provides for the possibility of multiple claimants litigating jointly in the same lawsuit, provided the cause of action or claims are common or related and the parties jointly share the rights and obligations under dispute.[58]

It is understood by scholars[59] that this general legal provision can be used to allow procedural consolidation in insolvency proceedings such that several companies of the same group can jointly apply for judicial reorganisation. The reorganisation will be administered jointly for efficiency purposes, but each company will present its own reorganisation plan and creditors of each company will vote on each reorganisation plan separately.

It is important to point out that a procedural consolidation of several companies of the same group is distinct from substantive consolidation of such companies. In practice, however, procedural consolidation often leads to substantive consolidation in Brazilian insolvency proceedings.

54 Available at: https://www.serasaexperian.com.br/amplie-seus-conhecimentos/indicadores-economicos.

55 Article 265 of the Brazilian Corporate Law provides for the possibility of a corporate group to be formalised by means of a written agreement providing for the combination of resources and efforts to achieve their goals, or to participate in common activities or undertakings. Nonetheless, formally constituted corporate groups are very unusual, and "de facto" corporate groups are the rule in Brazil.

56 Cerezetti, Sheila Christina Neder; and Souza Júnior, Francisco Satiro de, "A silenciosa 'consolidação' da consolidação substancial" Revista do Advogado No 131, Vol 36, São Paulo, 2016, pp 216-223.

57 Law 13,105, dated 16 March 2015.

58 Sacramone, Marcelo Barbosa. "Comentários à lei de recuperação de empresas e falência". São Paulo: Saraiva Educação, 2018, pp 197/198.

59 Cerezetti, Sheila C Neder, "Grupos de Sociedades e Recuperação Judicial: o Indispensável Encontro entre Direitos Societário, Processual e Concursal" Yarshell, Flavio Luiz; and Pereira, Guilherme Setoguti J, *Processo Societário – Volume II*. São Paulo: Quartier Latin, 2015, pp 735-789, p 752; and Santos, Paulo Penalva. "A Consolidação Substancial na Recuperação Judicial: a Problemática do Plano Único" Salomão, Luis Felipe; and Santos, Paulo Penalva, "Recuperação Judicial, Extrajudicial e Falência: Teoria e Prática". 3ª ed, Rio de Janeiro: Forense, 2017, pp 371-395, p 383.

4.2 Relevant Brazilian cases discussing substantive consolidation

4.2.1 Rede Energia Group[60]

Rede Energia Group is arguably the first relevant case in which debtors approved a plan with substantive consolidation. In this 2012 case, Rede Energia SA, two of its subsidiaries and two of its shareholders jointly filed for judicial reorganisation, in which each company presented separate lists of creditors and indicated their individual indebtedness.

The 2nd Specialised Bankruptcy Court of São Paulo authorised the joint request for judicial reorganisation of all entities on the basis that they were:

> "in fact organised as a corporate group, with a common controlling company and credit inter-dependence, as loans exist between the companies that comprise the group, and cross-corporate guaranties to honor obligations to third parties. Moreover, the plan is based on the joint cash flow of the companies, in such a way to find an effective means of reorganisation".

At that point, the Court did not decide on the merits of the substantive consolidation. It limited its ruling to granting the joint request for procedural consolidation, backed by the substantial identity and interdependence arguments.

Some of the Group's bondholders appealed the decision, opposing the procedural consolidation and arguing that the separateness of the legal entities should be preserved and each company should have to file a separate judicial reorganisation proceeding. While a decision on such appeal was pending in the Court of Appeals of the State of São Paulo, Rede Energia Group submitted a single judicial reorganisation plan for all of the Group companies and such plan was voted on and approved in the general meeting of creditors. Despite the fact that there was no prior express decision by the Court allowing for substantive consolidation, the voting took place pursuant to a single list of creditors of all companies substantively consolidated and such procedure was subsequently confirmed by the 2nd Specialised Bankruptcy Court of São Paulo.

Rede Energia Group and the bondholders entered into a settlement agreement and accordingly the appeal by the bondholders did not come before the Court for a final decision and was dismissed without any analysis of its merits. The settlement agreement contained non-public information and has not been disclosed by the parties.

The Rede Energia Group case is noteworthy because the creditors' approval of a plan with substantive consolidation was unprecedented in a large case. However, it did not generate a thorough analysis of the requirements for substantive consolidation as it was proposed by the debtors without a prompt challenge by the creditors and was analysed and approved in the general creditors' meeting and not before the Court.

4.2.2 Schahin Group[61]

In 2015, Schahin Engenharia SA, its Brazilian holding companies and fifteen non-Brazilian companies jointly filed for judicial reorganisation, arguing that all debtors had the same decision-making centre, consolidated cash accounts and a single commercial strategy.

The 2nd Specialised Bankruptcy Court of São Paulo admitted the judicial reorganisation proceeding of the Schahin Group companies under procedural consolidation, accepting

60 Case-file number 0067341-20.2012.8.26.0100, filed with the 2nd Reorganisation and Bankruptcy Court of São Paulo.
61 Case-file number 1037133-31.2015.8.26.0100, filed with the 2nd Reorganisation and Bankruptcy Court of São Paulo.

the substantial identity and cohesive group argument. The Court's decision, however, emphasised that the joinder of the proceedings would not necessarily result in substantive consolidation. As a result, Schahin Group presented separate lists of creditors, indicating the indebtedness of each entity separately.

Some creditors presented objections to the submission of a single plan for all entities and, as a result, the substantive consolidation discussion was reviewed by the Court on the day before the general creditors' meeting.

The Court authorised the substantive consolidation of Schahin Group, allowing the presentation of a single judicial reorganisation plan and voting based on a consolidated list of creditors. The Court's decision was based on its findings that the companies had not respected their legal separateness, had intermingled their assets and liabilities, had a cross-ownership structure across the companies, had given cross-guaranties among Schahin's companies and had used a common cash account.

A syndicate of banks holding large claims against Schahin Group filed an interlocutory appeal against the substantive consolidation order, but the appeal was rejected by the Court of Appeals of the State of São Paulo. The Court adopted the reasoning of the 2nd Specialised Bankruptcy Court of São Paulo and characterised the position of the creditors challenging the result as self-serving and lacking legal support.

4.2.3 OAS Group[62]

OAS SA, the holding company of OAS Group, and nine companies in its economic group, including three non-Brazilian companies, jointly filed for judicial reorganisation. At first, each reorganising entity of the OAS Group presented a separate list of creditors.

Later on, OAS Group presented a single judicial reorganisation plan, citing their cross-corporate guaranties, commingling of their assets, their use of a common workforce and common creditors across the companies. The group argued that substantive consolidation was necessary in view of the inter-dependence among the companies. In line with such approach, OAS Group filed a unitary list of creditors, and the judicial reorganisation plan was approved based on a consolidated quorum of creditors at the general meeting of creditors.

When confirming the approval of the judicial reorganisation plan, the 1st Specialised Bankruptcy Court of São Paulo authorised the substantive consolidation of OAS Group entities on the grounds that all companies operated systemically and all entities were part of the same economic group.

A creditor appealed this decision, but the Court of Appeals of the State of São Paulo dismissed the appeal, concluding that OAS entities were all part of a corporate group, with commingling of rights and obligations, and thus there would be "no reasonable justification for the presentation of separate plans".[63] The decision of the Court of Appeals analyses the fact that the companies under substantive consolidation were highly integrated and performed coordinated activities in infrastructure projects, and therefore the creditors could not argue they were not aware of such integration and interconnection among the debtors. The decision mentions, moreover, that the different companies followed the same common goals, they shared premises and headquarters (except for the offshore holdings

62 Case-file number 1030812-77.2015.8.26.0100, filed with the 1st Reorganisation and Bankruptcy Court of São Paulo.

63 Interlocutory Appeal (*Agravo de Instrumento*) 2084379-15.2015.8.26.0000, Court of Appeals of the State of Sao Paulo, 2nd Corporate Law Specialised Chamber, Reporting Judge Carlos Alberto Garbi, majority of votes, date 31 August 2015, p 30.

created to raise finance), businesses were carried out in bundled fashion, and several contracts had guaranties granted by the parent or other companies of the group.

4.2.4 Oi Group[64]

The complex Oi Group judicial reorganisation was a very large group insolvency, involving indebtedness of approximately R$ 65 billion, around US$19 billion at the time of filing. Oi SA, Telemar Norte Leste SA and five other subsidiaries, including four non-Brazilian companies, jointly filed for judicial reorganisation.

In June 2016, when authorising the processing of the judicial reorganisation, the 7th Specialised Corporate Court in Rio de Janeiro allowed the joint request and the procedural consolidation of the seven reorganising entities, based on the commingling of rights and obligations arising from the contracts entered into between the companies of Oi Group and third parties. In this respect, the Court considered that:

> "in order to verify the existence of this phenomenon [economic groups], it is necessary to examine three fundamental points, namely: individual contribution with efforts or resources, activities to achieve a common end, and profit sharing. In this respect, the business companies that are requesting relief do comply with the requirements above".[65]

The substantive consolidation was ordered in August 2017, after the 7th Specialised Corporate Court in Rio de Janeiro analysed the structure of Oi Group and concluded that the companies were interdependent, due to cross-guaranties granted by Oi Group companies, the issuance of bonds by the non-Brazilian subsidiaries guaranteed by Oi SA and intercompany loan agreements entered into by Oi SA, Telemar Norte Leste SA and Oi Móvel SA. The court concluded that the reorganisation was only viable on a group basis, as a result of the level of interlacing of the businesses and companies. In addition, the 7th Specialised Corporate Court in Rio de Janeiro permitted the presentation of a consolidated reorganisation plan and a unified list of creditors.

Several creditors appealed this decision, and the Court of Appeals of the State of Rio de Janeiro ordered the creditors to vote on Oi Group's substantive consolidation proposal in the general meeting of creditors. If consolidation were rejected, then seven different creditors' meetings would need to be held in order to vote on the plan separately.

The proposal for substantive consolidation was approved by the majority of the creditors and was subsequently confirmed by the 7th Specialised Corporate Court in Rio de Janeiro. It is noteworthy that the voting on the substantive consolidation took place on a consolidated basis, in that creditors voted whether to approve the consolidation or not, and their votes were counted as if Oi Group was a single entity. The contradiction of such approach was that creditors of entities with a better debt-to-asset ratio were diluted by the vote of creditors with a slimmer debt-to-asset ratio in the decision as to whether to consolidate or not.

4.2.5 UTC[66]

UTC Participações SA, UTC Engenharia SA and 12 other affiliates jointly filed for judicial reorganisation. Analysing the application, the 2nd Specialised Bankruptcy Court of São

64 Case-file number 0203711- 65.2016.8.19.0001, filed with the 7th Corporate Court of Rio de Janeiro.
65 Decision on the Case-file number 0203711- 65.2016.8.19.0001, by the 7th Corporate Court of Rio de Janeiro, p 89.507.
66 Case-file number 1069420-76.2017.8.26.0100, filed with the 2nd Reorganisation and Bankruptcy Court of São Paulo.

Paulo authorised procedural consolidation and, although the UTC group filed a consolidated judicial reorganisation plan for all 14 companies, segregated lists of creditors were presented for each of the entities.

Several creditors objected, contending that the decision issued by the 2nd Specialised Bankruptcy Court of São Paulo allowed for procedural consolidation, but not for substantive consolidation. Hence, creditors voted on the substantive consolidation in the general meeting of creditors, with separate voting with respect to each debtor. The result of the voting was that substantive consolidation was authorised by the majority of creditors of all entities.

In this case, only one unsecured creditor, Patri Sete, voted against the substantive consolidation. In addition, Patri Sete claimed that certain debenture holders should not have the right to vote with respect to the substantive consolidation of two of the companies.

The 2nd Specialised Bankruptcy Court of São Paulo disregarded Patri Sete's vote against the substantive consolidation, on the ground that the vote was abusive and only served the creditor's own interest while unduly harming the other creditors. The court granted the substantive consolidation for all companies of the UTC Group.

Patri Sete appealed the decision, and this appeal is currently pending with the Court of Appeals of the State of São Paulo. Meanwhile both the judicial administrator and the public prosecutor's office have expressed their opposition to the appeal.

4.2.6 Abengoa[67]

Abengoa Construção Brasil Ltda, Abengoa Concessões Brasil Holding SA and Abengoa Greenfield Brasil Holding SA jointly filed for judicial reorganisation, presenting a consolidated list of creditors, alleging (i) commingling of rights, assets and obligations; (ii) shared liabilities; and (iii) the same officers and creditors of the companies. The 5th Corporate Court of Rio de Janeiro Judicial authorised the procedural consolidation, but it ordered the presentation of individualised lists of creditors by the debtor companies.

With respect to the reorganisation plan, the 5th Corporate Court of Rio de Janeiro Judicial, based on the principle of company preservation, authorised the procedural consolidation of the companies and expressly permitted the debtors to decide on the best structure to present the judicial reorganisation plan (either consolidated or individualised by debtor, as long as segregated lists of creditors were presented).

Several creditors appealed this decision, and the Court of Appeals of Rio de Janeiro confirmed the possibility of presentation of a consolidated judicial reorganisation plan. It ordered, however, that if a single creditor objected to the consolidated plan, then the substantive consolidation would not be authorised and each company's creditors would have to vote on the plan on a separate basis. Abengoa Group filed an appeal with the Superior Court of Justice, the higher court that decides on Federal Law violations, and this appeal is pending trial.

Despite the fact that the debtors presented a consolidated reorganisation plan, the plan was voted on separately by each company's creditors, and segregated lists of creditors were presented for each company. The judicial reorganisation plan was approved by all

[67] Case-file number 0029741-24.2016.8.19.0001, filed with the 5th Corporate Court of Rio de Janeiro.

separate general creditors' meetings, and these approvals were subsequently confirmed by the 5th Specialised Corporate Law Court of Rio de Janeiro.

4.2.7 Odebrecht[68]

Odebrecht SA and 19 other affiliates jointly filed for judicial reorganisation. The accompanying list of creditors identified the creditors of each of the reorganising entities of the Odebrecht Group, separately. Odebrecht Group applied for substantive consolidation, alleging that the companies were interdependent, arguing they have (i) the same decision-making centre; (ii) common management; (iii) consolidated cash flow and accounts; and (iv) shared liabilities and assets.

When ruling on the admissibility of the judicial reorganisation, the 1st Specialised Bankruptcy Court of São Paulo ordered creditors to vote on the proposal for substantive consolidation in the general meeting of creditors. However, the Court determined the voting to be held by the majority of creditors of the Odebrecht Group on a consolidated basis, without any separation between the creditors of each different legal entity.

In view of that, a bank filed an interlocutory appeal against the decision, stating that the voting should be cast separately, respecting the individual creditor-debtor relations. The arguments of the appeal were accepted by the Court of Appeals of the State of São Paulo and, as a result, creditors voted on the substantive consolidation in the general meeting of creditors separately by entity.

At the creditors' meeting, Odebrecht Group presented a "master" consolidated plan that would be applicable to the entities whose creditors approved the substantive consolidation, and six other "individual" reorganisation plans[69] for the entities whose creditors were expected to reject the substantive consolidation.

Creditors of Odebrecht SA and five other entities[70] approved the substantive consolidation and, subsequently, approved the consolidated plan. As expected, the creditors of the six entities with separate reorganisation plans did not approve the substantive consolidation and each of them voted and approved the corresponding plan, separately.

The voting on substantive consolidation and reorganisation plans for the eight remaining entities of Odebrecht Group was adjourned and the meeting will reconvene in May 2020.

4.3 Analysis of the requirements for substantive consolidation in Brazil

Most scholars of Brazilian Bankruptcy law suggest, in line with other countries, that, given the lack of express legal authority, an order for substantive consolidation should be granted only in exceptional circumstances.[71] These scholars argue that the prevailing rule should be respect for the independence of each company of a corporate group and the autonomy of their assets and liabilities, which means that separate reorganisation plans,

68 Case-file number 1057756-77.2019.8.26.0100, filed with the 1st Reorganisation and Bankruptcy Court of São Paulo.

69 Odebrecht Energia SA, OP Gestão de Propriedades SA, OPI AA, OSP Investimentos SA, Odebrecht Serviços e Participações SA and ODB International Corporation.

70 Kieppe Participações e Administração Ltda, ODBINV SA, Odebrecht Energia Investimentos SA, Edifício Odebrecht RJ SA and Odebrecht Properties Investimentos SA.

71 Cerezetti, Sheila C. Neder, *supra* note 59, p. 764-68; Sacramone, Marcelo Barbosa. *supra* note 58, p. 201; Santos, Paulo Penalva, *supra*, note 59, p. 395; Scalzilli, João Pedro; Spinelli, Luis Felipe; and Tellechea, Rodrigo. "Recuperação de empresas e falência: teoria e prática na Lei n. 11.101/2005". 2nd ed., São Paulo: Almedina, 2017, p. 283; and Aires, Antonio; Xavier, Celso and Fontana, Maria Isabel. "Recuperação Judicial e Falência de Grupo Econômico". In: Elias, Luis Vasco. "10 Anos da Lei de Recuperação de Empresas e Falências: Reflexões sobre a Reestruturação Empresarial no Brasil". São Paulo: Quartier Latin, 2015, pp. 65-86, p. 68.

separate lists of creditors and separate voting requirements should be the rule. Some scholars argue, however, that under certain circumstances, the corporate veil ought to be lifted and substantive consolidation allowed in order to ensure the success of the judicial reorganisation proceeding[72] and to provide an equitable solution to creditors, debtors and other stakeholders affected by the distress situation.[73]

An interesting article by Cerezetti and Souza Júnior, based on empirical studies, suggests that in a large number of cases, parties involved in a court reorganisation do not devote sufficient attention to the substantive consolidation discussion, which, for practical reasons in order to simplify and expedite the process, is "silently" adopted and implicitly accepted by the parties, without further discussion or an express court decision.[74] By contrast, in complex and large cases, where creditors tend to be closely involved and focused on the development of the reorganisation proceedings, such silent acceptance of the substantive consolidation is not generally seen.

In practical terms, as in the *Abengoa* case described above, Brazilian courts have allowed both procedural consolidation and substantive consolidation in liberal fashion -- particularly in cases of judicial reorganisation of complex corporate groups.

4.3.1 Brazilian courts' approach to substantive consolidation

Brazilian courts have taken one of three approaches when making a determination as to substantive consolidation:

(i) The first approach is an analysis as to whether there is substantial identity among the entities of the group and a relevant disregard of the group entities for the corporate veil separateness.

(ii) In the second approach, courts call on an expert to prepare a preliminary report analysing the corporate, economic and financial structure of the companies that jointly filed for judicial reorganisation as well as the level of substantial identity and respect for the segregation of corporate entities. Based on the findings of this preliminary report, the courts decide whether to apply substantive consolidation.

(iii) More recently, a third approach has become common, whereby courts delegate to the creditors' meeting the decision as to whether the companies proposing court reorganisation should be substantively consolidated. Such referral is based on Article 35, I, item "f", of Brazilian Bankruptcy Law, which provides that "any matter that may affect the creditors' interests" may be resolved in the general creditors' meeting". The decisions of some courts, however, to require creditors to vote on a consolidated basis on the proposal for substantive consolidation would appear to contradict this principle. The *Oi* telecom case described above (paragraph 4.2.4) is an example. We submit that the initial creditor vote on a proposal for substantive consolidation should take place separately among only the creditors of a single legal entity in the group, following the approach of the *Odebrecht* case (paragraph 4.2.7).

In sum, Brazilian courts have been ordering substantive consolidation without consistency, reshuffling the bargain that creditors contractually fought for and, as a result, misaligning the expectations of creditors with the actual end result.

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72 Santos, Paulo Penalva. *supra*, note 59, p. 395.

73 Cerezetti, Sheila C Neder. "Grupos de Sociedades e Recuperação Judicial: o Indispensável Encontro entre Direitos Societário, Processual e Concursal". In: Yarshell, Flavio Luiz; and Pereira, Guilherme Setoguti J, *Processo Societário – Volume II*. São Paulo: Quartier Latin, 2015, pp 735-789, p 785.

74 Cerezetti, Sheila C Neder; and Souza Júnior, Francisco Satiro de, *supra* note 56, pp 216-223.

The most concerning impact of the liberal application of substantive consolidation is that the pool of assets and the liabilities that a single creditor expected a debtor to have is suddenly changed without the creditor's consent. When the creditor extended credit to the debtor it relied on the principle of legal entity separateness and calculated its risk *vis-à-vis* the debtor accordingly. That is, the creditor calculated that the debtor had a certain pool of assets to satisfy payment of its liabilities – that is, a certain debt-to-asset ratio. When substantive consolidation is applied to a group of debtor entities, this equation is changed without the creditor's consent and against its expectations. The debt-to-asset ratio of the consolidated group will most certainly be different. Some creditors may have negotiated parent, affiliate or third-party guaranties in order to have recourse to more than a single pool of assets for the payment of the obligation. The collapse of the companies into a single "hotchpot" renders these guaranties worthless and imposes an average debt-to-asset ratio on all creditors of the consolidated companies. It is a radical change to the credit risk analysis.

In addition, such a collapse has very important consequences for the expected dynamics of the court reorganisation. For a decision on the reorganisation plan, the creditors are divided into four different groups:

(1) Class I: labour or occupational accident creditors;

(2) Class II: secured creditors (up to the value of the collateral);

(3) Class III: unsecured creditors and subordinated creditors; and

(4) Class IV: creditors defined by law as micro companies and small business companies.[75]

Each of the four classes must approve the reorganisation plan. Votes of creditors belonging to each of Classes I and IV will be cast according to the number of creditors voting – a headcount criterion without regard for the amount of the credit extended by each creditor. Votes of creditors belonging to each of Classes II and III will be cast not only by the number of creditors but also by the amount of credit represented by such creditors, with an approval requiring a majority of votes according to both criteria.

Shareholders of the debtors, companies controlled by the debtors and any affiliates where the debtors have more than 10% of the capital stock will be prevented from voting, even if there are intercompany claims.

A cram-down rule is also available under Brazilian law. The court can approve the reorganisation plan even if it was rejected by the general creditors' meeting, provided that, cumulatively, the following requirements are fulfilled:

(a) favourable votes of creditors holding more than half of the amount of credits attending the meeting, regardless of their class;

(b) approval by at least 2 classes of creditors or, if there were only 2 classes voting, by one of them; and

(c) favourable votes of at least one third of the creditors in the rejecting classes.

[75] Micro companies and small business companies are defined by law based on their yearly gross revenues. Micro companies currently have yearly gross revenues up to R$360,000. Small business companies have yearly gross revenues of at least R$360,000 but less than US$4,800,000.

With a few exceptions, decisions in a general creditors' meeting are made by vote of the majority of creditors attending the meeting, with votes cast based on the amount of credit held by the creditors. The exceptions are that general creditors' meetings follow different rules for voting on the reorganisation plan and for electing creditors' committee members.

Following the amalgamation of the companies in substantive consolidation, creditors of a certain class will vote along with creditors of the same class of all consolidated companies, which may create a scenario of sharp distortions when compared to the distinct voting scenario. This radical rebalance of the bargaining power among creditors will happen with respect to all decisions, including the reorganisation plan approval, assessment of risk of the potential cram-down decision by the judge and approval of any other matters by simple majority.

For example, a creditor that had a security lien, a mortgage or pledge over an asset and was the only secured creditor of a certain company of the group, would expect to have control of Class II and to have a strong leverage position to negotiate a reasonable recovery in case of distress. If a group of companies is consolidated, all Class II creditors will be grouped together and must vote on a consolidated basis, therefore diluting the creditor of our example. As a result, this creditor may in fact become a minority creditor.

This scenario of uncertainty could discourage investment. It casts into doubt the comfort that investors, financial institutions and financiers have in knowing that a certain set of rights will be available in the event that the debtor defaults and goes into a distress scenario and enforcement becomes necessary. If there is a reasonable risk that consolidation will dilute or render worthless some creditors' rights, then it is necessary to analyse the credit risk of the whole group and not only that of the single legal entity. That may make sense in cases where the economic group, pre-petition, presented itself to the market as a single unit – a consolidated group that exists, in practice, only as a single player. If the creditors and other stakeholders have relied upon the assets of the whole group – because the group in fact presents itself as a monolith – it would be unfair indeed if they were limited to recovery against the assets of a single group member.

This is not, however, the rule in the Brazilian market, as in most cases legal separateness protection is a concept that groups tend to seek out and preserve such that each legal entity is insulated from the liabilities of the group's other entities. A situation of entanglement of assets and liabilities among group members is atypical.[76] Also, groups tend not to admit to operating in such a manner because in an enforcement lawsuit such an admission could lead the court to order a piercing of the corporate veil, pooling of the assets and liabilities and, if the reorganisation plan is rejected, even a joint ruling of liquidation.[77]

4.3.2 Recommended due diligence

It is recommended, therefore, that when extending credit to a Brazilian group of companies, a creditor should analyse and perform due diligence on the risk of substantive consolidation, reviewing issues that would indicate its likelihood such as intermingling of

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76 The commingling of assets is one of the cases that authorise the lifting of corporate veil pursuant to Art 50 of the Civil Code.

77 The Superior Court of Justice has interpreted Art 50 of Civil Code to allow the "extension" of bankruptcy liquidations, in a case where abuse of legal personality – ie, commingling of assets and liabilities or misuse of the legal personality finality – has been proven (vg, RO-MS 12.872-SP (3rd Chamber, Justice Nancy Andrighi, j Jun 24 2002), RO-MS 16.105-GO (3rd Chamber, Justice Nancy Andrighi, j Aug 19 2003), REsp 228.357-SP (3rd Chamber, Justice Castro Filho, j Dec 19 2003), REsp 418.385-SP (4th Chamber, Justice Aldir Passarinho, j Jun 19 2007) and REsp 1.034.356-SP (Justice Marco Buzzi, j Aug 3 2017)).

assets and liabilities, cross-guaranties, a unified workforce and payment of obligations of several companies from a single cash account or cross-payments. The creditor may, for example, ask the company applying for credit to complete a written questionnaire that asks questions about these issues. If this analysis indicates a high likelihood of substantive consolidation, then the credit terms and conditions should be structured with due regard to the possibility that in an insolvency scenario the group may be viewed as a single entity. Also, if the creditor extends credit and the debtor later becomes insolvent, the creditor may argue that it relied upon the legal separateness of the debtor entity. It may offer as evidence of this reliance, the debtor's answers to the creditor's written questionnaire as well as other documentary evidence of due diligence performed by the creditor in evaluating the debtor as an individual credit risk. Creditors may also make use of covenants providing for the delivery of periodic reports on these separateness issues, and for the obligation to maintain the segregation of the companies.

In our view, Brazilian Courts have become indulgent in allowing substantive consolidation even in situations where most of the creditors have relied on the corporate autonomy of each legal entity and have bargained for guaranties and security interests based on each company's separate credit risk. Even more concerning is the possibility that a challenge to substantive consolidation by an individual creditor – on the ground that it relied on the separateness and lawfully bargained for guaranties – may be deemed by a court to be voting in abuse of right (see, for example, the *UTC* case referred to in 4.2.5 above). In practice, we have seen cases where the court deemed the vote to be abusive as a vote based on selfish, egoistic reasons.

4.3.3 Potential reform of the Brazilian bankruptcy law

Since 2018, a version of Bill of Law No 6,229/2005 (Bill of Law), prepared by Representative Hugo Leal, has been under discussion in Congress to propose significant changes to Brazilian Bankruptcy Law. Among these proposed changes are new Articles 69-G to 69-L, which address procedural consolidation and substantive consolidation.

The Bill of Law provides that procedural consolidation will be allowed. Specifically, proceedings for all relevant debtors will be conducted and administered by the court with jurisdiction over the main establishment of the debtors, along with a single judicial administrator. Each legal entity will remain independent, however, with its assets and liabilities segregated. The reorganisation measures to be taken may be described in separate plans or a single consolidated plan, but voting will take place independently in respect of each legal entity.

4.3.3.1 Proposed test for substantive consolidation

With respect to the proposed test for substantive consolidation, the Bill of Law contains the following provision:

> "Article 69-J. The court may, exceptionally, regardless of a creditors' meeting, authorise the substantive consolidation of assets and liabilities of debtors that are part of the same economic group that are under judicial reorganisation under substantive consolidation, when the interconnection and commingling of assets and liabilities are found, to an extent that it is not possible to identify each of its holders without dedicating excessive time and resources, cumulatively, with at least two of the following requirements:
>
> I – presence of cross-guaranties;
> II – relation of control or dependence;

III – partial or total identity of the shareholders; and
IV – action as a group in the market by the debtors.
Sole paragraph (*Parágrafo Unico*) – The application of the caput of this Article is subject to the demonstration of social and economic benefits that justify the substantive consolidation".

The Bill of Law provides in addition that, if substantive consolidation is allowed, assets and liabilities of the debtors will be treated as if they belonged to a single consolidated debtor. Intercompany loans, fraudulent conveyance claims and guaranties granted by companies subject to the substantive consolidation will be wiped out. As a consequence, the debtors may present a single unitary plan to be voted on by one sole general creditors' meeting, and the rejection of such unitary plan will result in the bankruptcy liquidation of all debtors.

4.3.3.2 Benefit of court control

It is a positive feature of the Bill of Law that it provides that the courts are competent to make the decision as to the substantive consolidation of the assets and liabilities of debtors that are part of the same economic group, rather than delegating such a decision to a creditors' meeting.

First, the general creditors' meeting should decide on the proposed reorganisation plan. It would not make sense to start the general creditors' meeting with the substantive consolidation decision and then suspend the meeting for presentation and analysis of the reorganisation plan.

Second, it eliminates the risk that some decisions on substantive consolidation may be taken by creditors already under a consolidated list, which would be a contradiction (as in the *Oi Telecom* case referred to in 4.2.4 above).

Third, even if votes are taken company by company, another problem that may arise is that several voting exercises may be necessary, as there may be multiple scenarios of consolidation. For example, where a group of six companies request substantive consolidation and the creditors of two of the debtor companies vote against the consolidation, creditors of the other four entities will need to vote again in order to decide on the consolidation of only four companies. This second vote is different and likely does not involve the companies with the best debt-to-asset ratios. This would be extremely cumbersome for very complex groups, for example, the judicial reorganisation of PDG Realty, which had 512 plaintiffs.

Fourth, unlike a vote-taking procedure, the courts will be in a position to assess the situation and issue a technical, independent decision. This decision can take into account the possibility that the substantive consolidation would be unfair to certain groups of creditors that may not be in a position of gathering majority interests.

There may be an argument that the phrase "regardless of a creditors' meeting" in the Bill of Law could be interpreted as granting the Judge the power to determine the substantive consolidation, regardless of a meeting, but in addition to and not as a replacement for, the right of a creditors' meeting to do so. Some legal scholars take the position that general creditors' meetings ought to be able to resolve the issue.[78] For the reasons indicated above, however, we contend that it is more appropriate for the court to retain the power to

[78] Santos, Paulo Penalva, *supra* note 59 p 393-394; and Sacramone, Marcelo Barbosa, *supra* note 58, p 201.

disregard corporate veils, allowing for a unitary reorganisation plan and – potentially – dramatically rebalancing the rights at stake.

4.3.3.3 Policy choice – an "exceptional" remedy

The policy choice of the Bill of Law was to make clear that an order to treat different legal entities as one should be "exceptional", in line with the US approach of using such a mechanism only "sparingly". This very clear legislative command should make it more difficult for groups to obtain substantive consolidation based on unspecific arguments of, for example, the need to preserve the going-concern, or the need to make the reorganisation viable.

The Sole Paragraph of Article 69-J requires the "demonstration of social and economic benefits" that result from a potential substantive consolidation. This requirement is in addition to the other requirements, and it must not be used as a doorway to justify a wide application of substantive consolidation. An argument that substantive consolidation is necessary to make rescue possible, or to preserve the going-concern should not on its own be sufficient. The group of companies will need to make certain assertions akin to confessions of disregard for the corporate veil separateness. In other scenarios these types of confessions can lead to the lifting of the corporate veil – for example, enforcement actions by creditors (not subject to the court reorganisation), or a bankruptcy liquidation scenario.

4.3.3.4 Requirement for "interdependence"

In terms of the requirements, it is clear that the wording of the Bill of Law has drawn inspiration from US case law, by requiring the interconnection or commingling of assets and liabilities to an extent that identification of the relevant holder would be too burdensome and expensive. "Interconnection" would probably be better described as "interdependence", which is a word used in several court decisions to describe a situation where the reorganisation of one company is dependent on the reorganisation of other companies of the group – a situation more likely to happen in vertically integrated groups than in horizontally integrated groups.[79] In fact, the Brazilian proposed test requires a high level of substantive identity and a lack of due regard for corporate veil segregation. This test resembles the US analysis as to whether "debtors' assets are so scrambled that unscrambling them is cost, time and energy prohibitive" or if they are "hopelessly entangled".

On this point, the UNCITRAL Report, Part Three, describes this test:

> "The degree of intermingling required is hard to quantify and has been variously described by different courts as involving a degree of intermingling that was hopeless or a practical impossibility to disentangle; that would require such time and expense to disentangle the interrelationships between the group members and the ownership of assets that it would be disproportionate to the result; that was so substantial that it would threaten the realization of any net assets for the creditors; or that involved an allocation of assets and liabilities between the relevant members that was essentially arbitrary and without economic reality. In reaching a decision that the degree of intermingling in a particular case justified substantive consolidation, the courts have looked at various factors, including the manner in which the group members operated and related to each other, including with respect to

[79] This point is well explained by Sprayregen, Friedland and Gettleman, *supra* note 23, pp 21-28.

> management and financial matters; the sufficiency of record keeping of the individual group members; the observance of proper corporate formalities; the manner in which funds and assets were transferred between the various members; and other similar factors concerning group operations".[80]

4.3.3.5 *Inadequacy of the requirements of Article 69-J*

In addition to the intermingling of assets, the list of factors included in items I to IV of Article 69-J of the Brazilian Bill of Law is additional to the requirements in the *caput* of Article 69-J, but the list is visibly incomplete. The UNCITRAL Report, Part Three, points out the following factors to determine whether companies should be substantively consolidated:

> "the presence of consolidated financial statements for the group; the use of a single bank account for all group members; the unity of interests and ownership between the group members; the degree of difficulty in segregating individual assets and liabilities; the sharing of overhead, management, accounting and other related expenses among different group members; the existence of intra-group loans and cross-guaranties on loans; the extent to which assets were transferred or funds moved from one member to another as a matter of convenience without observing proper formalities; the adequacy of capital; the commingling of assets or business operations; the appointment of common directors or officers and the holding of combined board meetings; a common business location; fraudulent dealings with creditors; the practice of encouraging creditors to treat the group as a single entity, creating confusion among creditors as to which of the group members they were dealing with and otherwise blurring the legal boundaries of the group members; and whether substantive consolidation would facilitate a reorganisation or is in the interests of creditors".[81]

In addition, the factors "relation of control and / or dependence" (item II) and "partial or total identity of the shareholders" (item III) will be almost inevitably complied with under any circumstances, given that the discussion relates to a corporate group. In turn, the factor described in item IV is too vague when it calls for the companies to have acted "as a group" or jointly in the market.

Therefore, a choice by the legislature to say that the fulfilment of two factors out of four factors seems to be a narrow and inadequate approach, leaving many important considerations out of the debate. In fact, the factors list should be open-ended. It seems to us that no single factor should be conclusive, and not all of the factors of the UNCITRAL Report, Part Three, need to be present in a case to justify consolidation. The determination should be whether the courts are satisfied that prepetition the debtors materially disregarded the legal entities' veils of incorporation, blurring the lines of separation of the legal entities such that there was substantial identity of the companies. The test should not be whether a certain number of factors are found in each case.

4.3.3.6 *Creditors' right to challenge*

In addition, the Bill of Law does not include as a factor the creditors' perception with respect to the group – that is, whether the creditors perceived the debtors as a single unit

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80 UNCITRAL Legislative Guide on Insolvency Law, Part Three: Treatment of enterprise groups in insolvency, *supra* note 51, pp 62-63.

81 *Ibid*, p 62. In the US, a seven-factor laundry list can be found in the previously cited *Vecco* case (*In re Vecco Constr*, 4 BR 407, 410 (ED Va 1980)) *supra* note 25.

and dealt with them on such assumption. As pointed out in the *Owens Corning* case in the US, it is necessary to determine whether prepetition the debtors "disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity".

In order to allow creditors to defend their expectations, we suggest that creditors should have the right to successfully challenge the substantive consolidation if the creditor can show that "(1) it has relied on the separate credit of one of the entities to be consolidated; and (2) it will be prejudiced by substantive consolidation".[82]

The use of such a defence should not be viewed as abusive as a rule – just because the creditor is defending its own interest – unless specific circumstances of actual abuse, misuse of this right to challenge or fraud are demonstrated. Addressing this creditor concern is key to the development of the Brazilian financial and capital markets by fostering a strong investment environment and providing a stable framework for companies to raise financing.

5. Conclusion

Brazilian Bankruptcy Law is silent with respect to the possibility of two or more entities of the same corporate group jointly seeking the judicial reorganisation remedy by requesting procedural consolidation. More importantly, Brazilian Bankruptcy Law is silent as to whether such entities may apply for substantive consolidation. Nonetheless, Brazilian courts have almost invariably authorised procedural consolidation and, to a lesser extent but still in a liberal manner, have allowed substantive consolidation. Brazilian case law reveals that the courts' approaches to substantive consolidation have been inconsistent, and the analysis of the requirements for substantive consolidation has been less stringent than that of the US, the UK and that recommended by UNCITRAL.

The pending Bill of Law to amend the Brazilian Bankruptcy Law, pursuant to the draft prepared by Representative Hugo Leal, is an important step in the right direction. It includes long-needed provisions to address the matter. Representative Leal's draft makes clear that courts – as opposed to the general creditors' meeting – are competent to make such determinations and introduces more certainty with respect to the requirements for procedural consolidation and substantive consolidation.

Notwithstanding this progress, there is still room for improvement in Article 69-J of the Bill of Law. First, we submit that the list of factors that are required to be fulfilled for substantive consolidation should not be a closed list of four factors of which two must be fulfilled. It should be an open-ended list of factors that leads to the conclusion that there was substantial identity among the companies and that the lines of separation of the corporate entities had become obfuscated to such an extent that the creditors perceived the debtors as a monolith and a sole credit risk. More comprehensive lists of such factors can be found in the UNCITRAL Report, Part Three, and one should consider that items II and III of the Bill of Law's proposed factors list are almost inevitably complied with, whilst item IV is too vaguely worded.

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82 *Eastgroup Properties v Southern Motel Assoc, Ltd*, 935 F 2d 245 (11th Cir 1991). Articles 231, 232 and 233 of Brazilian Corporate law provide for explicit protection to debenture holders and creditors, in case their credit rights are affected by a merger of the debtor into other company (*incorporação*), a merger of equals (*fusão*) or a spin-off (*cisão*); all of which are situations where the debt-to-asset ratios are changed and therefore comparable to substantive consolidation from that perspective.

Finally, we also submit that the creditors should have the right to block the application for an order for substantive consolidation, as long as they prove that they relied on the separation of the legal entities to be substantively consolidated and that they will be prejudiced by such an order.

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