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Treatment of corporate groups in insolvency

Note by the Secretariat*

[*I. Glossary, II. Introduction appear in A/CN.9/WG.V/WP.74*]

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* This document was submitted late to enable finalization of consultations.

III. The onset of insolvency: domestic issues

1. Corporate groups may be structured in ways that minimize the threat of insolvency to one or more members of the group, by entering into cross-guarantees, indemnities and similar types of arrangements. Where problems do arise, a parent company may seek to avoid the insolvency of any of its group members in order to preserve its reputation and maintain its credit in commercial and financial spheres by providing additional finance and agreeing to subordinate intra-group claims to other external liabilities.

2. However, if the complexity of a corporate group's structure is disturbed by the onset of financial difficulty affecting one or more, or even all, of the members of a group that leads to insolvency, problems arise simply because the group is constituted by members that are each recognized as having a separate legal personality and existence. Since the great majority of domestic insolvency and corporate laws omit provision for the effective liquidation or restructuring of groups, even though group issues might be addressed outside the insolvency area in relation to accounting treatment, regulatory issues and taxation, the absence of legislative authority to the contrary or judicial discretion to intervene in insolvency means that each entity has to be separately considered and, if necessary, separately administered in insolvency. In certain situations, such as where the business activity of a company has been directed or controlled by a related company, the treatment of the group companies as separate legal personalities may operate unfairly. It may, for example, prevent access to the funds of one company for the payment of the debts or liabilities of a related debtor company (except where the debtor company is a shareholder or creditor of the related company), notwithstanding the close relationship between the companies and the fact that the related company may have taken part in the management of the debtor or acted like a director of the debtor and caused it to incur debts and liabilities. Furthermore, where the debtor company belongs to a group of companies, it may be difficult to untangle the specific circumstances of any particular case to determine which group company particular creditors dealt with or to establish the financial dealings between group companies.

3. Much of what already exists in domestic law regarding the insolvency of corporate groups concentrates on the circumstances in which it might be appropriate to consolidate insolvency estates. What is lacking is more comprehensive guidance on how corporate group insolvency should be considered and in particular, whether and in what circumstances corporate groups should be treated differently from the insolvency treatment of a single corporate entity.

A. Commencement

4. The standard to be met for commencement of insolvency proceedings is central to the design of an insolvency law. As the basis of insolvency proceedings, this standard is instrumental to identifying the debtors that can be brought within the protective and disciplinary mechanisms of the insolvency law and determining who may make an application for commencement, whether the debtor, creditors or other parties. The UNCITRAL Legislative Guide on Insolvency Law[1] notes that

[1] UNCITRAL Legislative Guide, part two, chapter I, section B, paras. 20-21.

commencement standards should be transparent, certain and flexible with respect to the types of proceedings available and the ease with which those proceedings can be accessed.

5. The appropriateness of the solutions recommended by the Legislative Guide should be examined for application to corporate groups. A first issue is the insolvency test to be applied and to whom it will apply in the group context. A second question relates to who can apply to commence insolvency proceedings in respect of members of a group or the group as a whole, and the factors that are relevant to that determination.

1. Commencement standard

6. Many insolvency laws require a debtor to be insolvent (however defined) for commencement of insolvency proceedings. On that basis, insolvency proceedings could generally only be commenced against those members of the group that satisfied the insolvency test. One issue of relevance to the question of whether or not a member of a corporate group satisfies the test of insolvency is how various liabilities such as intra-group indebtedness and potential liabilities under a cross-guarantee should be treated.

7. In some cases, where for example the structure of the group is diverse, involving unrelated businesses and assets, the insolvency of one or more members of the group may not affect other members or the group as a whole and the insolvent members can be administered separately. In other cases, however, the insolvency of one member of a group may cause financial distress in other members or in the group as a whole, because of the group’s integrated structure, with a high degree of interdependence and linked assets and debts between its different parts. In those cases, the ability to consider the group as a whole would facilitate development of an insolvency solution for the whole of the group and avoid piecemeal commencement of proceedings over time if and when additional members of the group became affected by the insolvency proceedings initiated against the originally insolvent members. It would also overcome the difficulties that might arise with respect to identifying the appropriate debtor within the corporate structure against which proceedings should be commenced.

8. This scenario raises one of the key issues in the treatment of groups of companies in insolvency, that is, the degree to which the corporate group is economically and organizationally integrated and more importantly, the extent to which a highly integrated group should be treated differently in insolvency to a group where individual members retain a high degree of independence. That treatment might suggest, for example, that insolvency proceedings could be extended to include group members who do not satisfy the commencement standard, because it is necessary for the greater good of the group as a whole that they be included in those proceedings. A related issue might be whether the court should have the discretion to join or consolidate applications to commence proceedings against more than one insolvent member of a group to facilitate the joint administration of those proceedings. Joint administration is discussed below.

2. Persons permitted to apply

9. As a matter of general insolvency law, the Legislative Guide recommends that creditors and debtors should be permitted to make an application for commencement of insolvency proceedings. It does not specifically address the issue of commencement with respect to corporate groups[2] and the questions to be considered would include whether a parent company could apply to commence proceedings against one or more members of its group, whether one member is permitted to apply in respect of all other members, including the parent and whether the insolvency representative appointed in respect of one member of the group could apply with respect to another member, for example, could the insolvency representative of the parent apply for commencement of proceedings against a subsidiary?

10. In addition, are there any public policy elements that might suggest that some provision for the possible intervention of a regulatory body (such as a securities agency or corporate regulatory agency) might be appropriate? A related question concerns application for commencement by creditors. While there may be no reason to justify departure from the approach that recommends creditors be permitted to apply for commencement of both liquidation and reorganization in the case of a corporate group, the structure of a corporate group may make it particularly difficult for a creditor to identify the specific part of the group with which it dealt and provide the evidence necessary to satisfy the commencement standard.[3] In some cases, particularly where the group is loosely organized, the particular debtor may be easily identified. Where there is a high degree of integration, however, the answer may be less clear, especially where the creditor believed that it was dealing with the group as a single enterprise.

11. With respect to intervention by a regulatory or supervisory body, the Legislative Guide notes[4] that in addition to the right of the Government as a creditor to initiate insolvency proceedings, some countries provide an additional more broadly based power for government or other supervisory authorities to use the insolvency regime to shut down a business in circumstances where the authority is not necessarily a creditor but closure of the business is considered to be in the public interest. In that case, a demonstration of illiquidity is not always necessary, enabling the Government to terminate the operations of businesses that have been engaged in certain activities, generally of a fraudulent or criminal nature or involving serious breach of regulatory obligations or a combination of these. The Legislative Guide suggests that given the potential for such a power to be misused in circumstances unrelated to insolvency and for public interest grounds to be very broadly defined, it is highly desirable that such powers be available only in very limited circumstances and only as a last resort in the absence of appropriate remedies under other laws. These limited circumstances may include the use of insolvency powers in conjunction with enforcement of laws, such as laws relating to money-laundering or regulation of securities, where a demonstration of insolvency may not be required. The Legislative Guide recommendations do not specifically

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[2] UNCITRAL Legislative Guide, part two, chapter 1, paras. 20-79.

[3] UNCITRAL Legislative Guide, part two, chapter I, paras. 37-41 and 48-53, for a discussion of creditor application.

[4] UNCITRAL Legislative Guide, part two, chapter I, para. 42.

refer to regulatory authorities as being amongst those parties permitted to make an application for commencement of insolvency proceedings.[5]

12. As a general rule, insolvency laws respect the separate legal status of each member of a corporate group and a separate application for commencement of insolvency proceedings is required to be made for each insolvent entity. There are some limited exceptions, however, which allow a single application to be extended to other members of the group where, for example, all interested parties consent to the inclusion of more than one company (South Africa); or there is a relationship between the companies that is variously described, but involves, for example, a significant degree of interdependence or control; intermingling of assets; the fictitious nature of the group; unity of identity or other similar characteristics (South Africa, Spain, France, Argentina, Mexico, USA[6]) that need not necessarily arise from the legal relationship (such as holding company-subsidiary) between the companies. Such joint administration (sometimes also referred to as procedural or administrative consolidation) does not affect the substantive rights of each of those debtors or the liability of each member to its own creditors. Appointment of the same insolvency representative for each company would facilitate their joint administration.

B. Effects of commencement

13. The ways in which the commencement of insolvency proceedings will affect the debtor and its assets are discussed in detail with respect to debtors engaged in commercial activities in the UNCITRAL Legislative Guide on Insolvency Law (part two, chapter I). The Legislative Guide does not, however, discuss how those effects might or should differ in the case of the insolvency of one or more members of a corporate group. Some of the effects that might need to be considered in the group context include the following.

14. First, the appointment of the same insolvency representative in respect of each group member. While many insolvency laws do not address this question, there are some jurisdictions where this has become a practice (including Australia, England and Germany). This has also been achieved to a limited extent in some cross-border insolvency cases in the EU (discussed further below). If this could be achieved, it would facilitate coordinated resolution of the insolvencies of the relevant group members. As a safeguard against possible conflict, the insolvency representative could be required to give an undertaking or be subject to a practice rule or statutory obligation to seek direction from the court in the event a conflict arises. If appointment of the same insolvency representative were not possible, consideration might need to be given to what additional powers insolvency representatives might require to facilitate coordination of the different proceedings, including: sharing and disclosure of information; proposal and negotiation of coordinated reorganization plans (unless preparation of a single group plan was possible as discussed below); use of avoidance powers and so forth. A related question concerns whether an

[5] Recommendation 14 provides that: "The insolvency law should specify the persons permitted to make an application for commencement of insolvency proceedings, which should include the debtor and any of its creditors."

[6] USA: Bankruptcy Rule 1015 explicitly contemplates joint administration.

insolvency representative appointed to the insolvency proceedings of a parent company should have any powers that might override those of insolvency representatives appointed in respect of subsidiaries?

15. Second, the manner in which potential conflicts (for example, because of cross-guarantees members of a group, inter-group debts, wrongdoing by one member of a group that affects another member) should be addressed.

16. Third, the need, in jurisdictions that permit management to remain in office (whether under supervision or not), for any further or special provisions in the case of a corporate group.

17. Fourth, the appropriateness of provisions relating to application of a stay or suspension in the case of a single debtor to the case of a corporate group.

18. Fifth, provisions applicable to use and disposal of assets of the affected group members once proceedings commence and whether any special provisions are required, particularly with respect to the use of cash.

19. Sixth, the need for special provisions with respect to post commencement finance for a corporate group (or some two or more of its members). This issue is of particular relevance in relation to corporate groups in an international setting (discussed in A/CN.9/WG.V/WP.74/Add.2). The Legislative Guide recognizes that the continued operation of the debtor's business after the commencement of insolvency proceedings is critical to reorganization and, to a lesser extent, liquidation where the business is to be sold as a going concern. To maintain its business activities, the debtor must have access to funds to enable it to continue to pay for crucial supplies of goods and services, including labour costs, insurance, rent, maintenance of contracts and other operating expenses, as well as costs associated with maintaining the value of assets. The Guide notes, however, that many jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority for its repayment in insolvency. The Legislative Guide[7] includes a number of recommendations aimed at promoting the availability of finance for continued operation or survival of the debtor's business, providing appropriate protection for the providers of post-commencement finance, as well as appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.

C. Usual or special types of proceedings

20. Many insolvency laws make liquidation and reorganization available as mechanisms to resolve a debtor's financial difficulties. In the context of a corporate group, are these mechanisms sufficient or is there a need for them to be adapted to meet the special needs of corporate group insolvency and, in addition, to provide for the possibility of applying other remedies or relief that are peculiar to a corporate group?

[7] UNCITRAL Legislative Guide, part two, chapter II, section D, para. 94, Purpose of legislative provisions preceding recommendation 63. Chapter II, section D is set forth in document A/CN.9/582/Add.5.

D. Reorganization of two or more members of a group

21. Where insolvency proceedings are commenced against two or more members of a group, irrespective of whether or not those proceedings can be jointly administered, there is a question of whether it will be possible to reorganize the debtors through a single reorganization plan. If such a course of action were to be possible, what provisions amending, or in addition to, those discussed in detail in the reorganization chapter of the Legislative Guide[8] might be required to address fundamental matters such as: parties competent to propose the plan or participate in its proposal; nature and content of a plan; safeguards concerning a plan; convening and conduct of creditors meetings in respect of a plan; claims of creditors; classification of classes of creditors; voting of creditors and approval of a plan; objections to approval of the plan (or confirmation where it is required); and implementation of a plan.

22. A single reorganization plan would need to take into account the different interests of the different groups of creditors. It would also need to achieve an appropriate balance between the rights of those different groups of creditors with respect to approval of the plan and ensure that rejection by the creditors of one subsidiary would not mean the plan could not go ahead, provided safeguards analogous to those included in recommendation 152 of the Legislative Guide were available. These safeguards might include that the benefits to be received under the plan are equal to or greater than the creditors would have received in liquidation and fair in relation to their position relative to creditors of other group members.

23. These issues generally are not addressed in insolvency laws, although it is suggested that in some jurisdictions applications for commencement by members of the group will be jointly administered as a matter of practice and negotiations will commonly lead to consensual plans of reorganization in which different entities are effectively treated as one, although the court never formally considers the issue of substantive consolidation (USA).

E. Remedies

24. Because of the nature of corporate groups and the way in which they operate, there may be, as noted above, a complex web of financial transactions between members of the group and creditors may have dealt with different members or even with the group as a single economic entity, rather than with individual members. Untangling the ownership of assets and liabilities and identifying the creditors of each member of the group may involve a complex and costly legal inquiry. However, because of adherence to the separate entity approach, creditors of each entity must in general look to that entity for payment of their debt, and it will generally become necessary, where insolvency proceedings have commenced against one or more of the members of that group, to untangle the ownership of assets and liabilities of the insolvent entities.

25. Where this untangling can be effected, adherence to the separate entity principle operates to limit creditor recovery to the assets of the insolvent entity.

[8] UNCITRAL Legislative Guide, part two, chapter IV.

Where it cannot be untangled or reasons exist to treat the group as a single enterprise, some laws include remedies that allow the single entity approach to be set aside in specified circumstances. Historically, these remedies have been developed to overcome the perceived inefficiency and unfairness of the traditional separate entity approach in specific cases. These include, for example, extending liability for external debts to other, solvent members of the group, as well as to office holders and shareholders; contribution orders; pooling or (substantive) consolidation orders;[9] setting aside intra-group transactions; or subordinating intra-group lending. Because of the potential inequity caused to one creditor group when forced to share *pari passu* with creditors of another entity that may be less solvent, these remedies are not universally available, generally not comprehensive and apply only in restricted circumstances. Those remedies involving extension of liability may involve "piercing" or "lifting the corporate veil", by which shareholders, who are generally shielded from liability for the corporation's activities, can be held liable for certain activities. The other remedies discussed here do not, although in some circumstances the effect may appear to be similar.

1. Extension of liability

26. Extending the liability for external debts and, in some cases, the actions of the insolvent group member to solvent group members and relevant office holders is a remedy available to individual creditors on a case-by-case basis and depends upon the circumstances of that creditor's relationship with the debtor.

27. Many laws recognize circumstances in which exceptions to limited liability are available and related companies and relevant office holders could be found liable for the debts and actions of a group member. Some laws adopt a more prescriptive approach and the circumstances are strictly limited; other laws adopt a more expansive approach and courts are given broad discretion in evaluating the circumstances of a particular case on the basis of specific guidelines. In both cases, however, the basis for extending liability beyond the insolvent entity is the relationship between the insolvent and related group members in terms of both ownership and control. A further relevant factor may be the conduct of the related company to the creditors of the insolvent company.

28. Whilst there are different formulations of the circumstances in which liability might be extended, examples generally fall into the following categories, although it should be noted that not all laws reflect all of these categories and to some extent they may overlap:

(i) Exploitation or abuse by one member of the group (perhaps the parent) of its control over another member of the group, including operating a subsidiary continually at a loss in the interests of the controlling company (Argentina, Australia, South Africa, France, Brazil);

(ii) Fraudulent conduct by the dominant shareholder, which might include fraudulently siphoning off a subsidiary's assets or increasing its liabilities (France), or conducting the affairs of the subsidiary with an intent to defraud creditors (Liechtenstein);

[9] See glossary A/CN.9/WG.V/WP.74.

(iii) Operating a subsidiary as the parent company's agent, trustee or partner (Australia, UK);

(iv) Conducting the affairs of the group or of a subsidiary in such a way that some classes of creditors might be prejudiced (for example, incurring liabilities to employees of one group member) (Poland);

(v) Artificial fragmentation of a unitary enterprise into several entities for the purposes of insulating the single entity from potential liabilities; failure to follow the formalities of treating group members as separate legal entities, including disregarding the limited liability of subsidiaries (USA) or confusing personal and corporate assets; or where the corporate group structure is a mere sham or façade (UK, France), such as where the corporate form is used as a device to circumvent statutory or contractual obligations;

(vi) Inadequate capitalization of the company, so that it does not have an adequate capital basis for carrying out its operations (USA). This may apply at the time of establishment, or be the result of depletion of the capital by way of refunds to shareholders or if shareholders have drawn more than distributable profits;

(vii) Misrepresentation of the real nature of the corporate group, leading creditors to believe that they are dealing with a single enterprise, rather then with a member of a group;

(viii) Misfeasance, where any person, including another group member, can be required to compensate for any loss or damage to a company arising from fraud, breach of duty or other misfeasance, such as actions causing significant injury or environmental damage (USA, UK);

(ix) Wrongful trading, where directors, including shadow directors,[10] of a company have a duty to monitor, for example, whether the company can properly continue carrying on business in the light of its financial condition and are required to file for insolvency within a specified period once the company has become insolvent (France, UK, Russia). Permitting or directing a group member to incur debts when it is or is likely to become insolvent would fall into this category; and

(x) Failing to observe regulatory requirements, such as keeping regular accounting records of the subsidiary (France).

29. Generally, the mere incidence of control or domination of a subsidiary by a parent, or other form of close economic integration within a corporate group, is not regarded as sufficient reason to justify disregarding the separate legal personality of each group member and piercing the corporate veil.

30. In a number of the examples where liability might be extended to the parent or other company in control of an insolvent subsidiary, that liability may include the personal liability of the members of the board of directors of the parent or controlling company (who may be described as de facto or shadow directors). While directors of a company may generally owe certain duties to that company, directors of a group company may be faced with balancing those duties against the overall

[10] Shadow or de facto directors: see glossary A/CN.9/WG.V/WP.74.

commercial and financial interests of the group. Achieving the general interests of the group, for example, may require that the interests of individual members be sacrificed in certain circumstances. Some of the factors that might be relevant to determining whether directors of a controlling company will be personally liable for the debts or actions of an insolvent controlled company include: whether there was active involvement in the management of the controlled entity; whether there was grievous negligence or fraud in the management of the insolvent company; whether the parent's management could be in breach of duties of care and diligence or there was abuse of managerial power; or whether there was a direct relationship between the management of the controlled entity and its insolvency. In some jurisdictions, directors may also be found criminally liable. One of the principal difficulties with extending liability in such cases is proving the behaviour in question to show that the controlling company was acting as a de facto or shadow director.

31. There are also laws that provide for parent companies to accept liability for debts of subsidiaries by contract, especially where the creditors involved are banks (Belgium, Netherlands), or voluntary cross-guarantees (Australia). Under other laws, which provide for various forms of integration of groups of companies (Germany, Portugal) the principal company can be jointly and severally liable to the creditors of the integrated companies, for liabilities arising both before and after the formalization of the integration.

2. Contribution orders

32. Another possible remedy in insolvency is the contribution order, by which a court can require a solvent group company to contribute specific funds to cover all or some of the debts of other group companies in liquidation. New Zealand introduced contribution orders into its Corporations Act in 1980.[11] The provisions specify that the companies should be "related" companies as defined.[12] Under that definition, the related company need not be the ultimate holding company of the group member in liquidation. The New Zealand provisions permit a liquidator, creditor or shareholder of a company in liquidation to make an application for a contribution order, although payment must be made to the liquidator, not to the applicant.

33. The New Zealand legislation provides that, in making a contribution order, the court must take into account certain specified circumstances. These include: the extent to which a related company took part in the management of the company in liquidation; the conduct of the related company towards the creditors of the company in liquidation, although creditor reliance on the existence of a relationship between the companies is not sufficient grounds for making an order; the extent to

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[11] New Zealand Companies Act, Sections 271-272.

[12] Companies Act 1993, section 2 (3) which defines the necessary relationship by reference to a holding/subsidiary relationship; direct or indirect ownership of more than half of the shares of the company, either by the other company, members of the other company or companies related to the other company; the businesses of the companies have been conducted in such a way that they cannot be separated; or both the insolvent company and the related company have one of these specified relationships with a third company.

which the circumstances giving rise to liquidation are attributable to the actions of the related company; and such other matters at the court thinks fit.[13]

34. Because of the problem of reconciling the interests of the two sets of unsecured creditors that have dealt with the two separate companies, the power to make a contribution order is not commonly exercised. Furthermore, the courts have taken the view that a full contribution order may be inappropriate if the effect is to threaten the solvency of the related company not already in liquidation. However, conduct of the solvent company after commencement of the liquidation of its related company might be relevant if it indirectly or directly affects the creditors of the related company, such as with respect to failure to perform a contract.

3. Substantive consolidation or pooling

35. A further type of remedy is that of substantive consolidation or pooling (referred to in this note as consolidation). As noted above, where joint administration occurs, the assets and liabilities of the debtors remain separate and distinct, with the substantive rights of claimants unaffected. Consolidation, however, permits the court in insolvency cases involving members of the same group to disregard the separate identity of the group members in appropriate circumstances and consolidate their assets and liabilities and treat them as though held and incurred by a single entity. This has the effect of creating a single estate for the general benefit of all creditors of all consolidated entities. Consolidation might extend to solvent companies belonging to the same group and to individuals, such as the controlling shareholder.

36. The availability of this type of order is not widespread and, where it is available, in general it is not widely used. Few jurisdictions provide statutory authority for consolidation orders.[14] Because of the absence of direct statutory authority or a prescribed standard for the circumstances in which such orders can be made, the courts of some jurisdictions have played a direct role in developing these orders and delimiting the circumstances in which they can be made. As is the case with contribution orders, these circumstances are very limited and tend to be those where there is a high degree of integration of the members of a corporate group and it would be difficult, if not impossible, to disentangle the assets and liabilities of the different entities.

37. The principal concerns with the availability of such orders, in addition to those associated with the fundamental issue of overturning the separate entity principle, include the potential unfairness caused to one creditor group when forced to share *pari passu* with creditors of another entity that may be less solvent and whether the savings or benefits to the collective class of creditors outweighs incidental detriment to individual creditors. An additional issue is the extent to which the availability of consolidation would enable stronger, larger creditors to take advantage of assets that do not and should not properly be available to them. Other considerations include the likelihood that making a consolidation order will encourage creditors who disagree with such an order to seek review of the order, thus prolonging the insolvency proceedings, and the damage likely to be inflicted upon certainty and foreseeability of legal security. Inter-company claims disappear as a result of

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[13] New Zealand Companies Act, Section 272 (1).

[14] See New Zealand Corporations Act 1980, s272.

consolidation and creditors that have security interests in those claims will lose their rights. These concerns have led some commentators to suggest that consolidation should only be available where creditors agree or if not, under careful court control.[15]

38. In those jurisdictions where the courts have played a role in developing consolidation orders, they have identified a number of elements considered to be relevant to determining whether or not substantive consolidation is warranted. In each case it is a question of balancing the various elements; no single element is necessarily conclusive and all of the elements do not need to be present. The elements include: the presence or absence of consolidated financial statements; the unity of interests and ownership between the entities; the degree of difficulty in segregating individual assets and liabilities; sharing of overhead, management, accounting and other related expenses among different entities; existence of inter-entity loans and cross-guarantees on loans; the extent to which assets were transferred or funds shifted from one entity to another without observing proper formalities; adequacy of capital; commingling of assets or business operations; common directors or officers; common business location; fraudulent dealings with creditors; and whether consolidation would facilitate a reorganization or is in the interests of creditors. While these many factors remain relevant, some courts have started to focus on two factors in particular, namely, whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, and whether the affairs of the entities are so entangled that consolidation will benefit all creditors.

39. In some jurisdictions where there is no specific legislative authority for consolidation (Australia), voluntary consolidation may nevertheless be facilitated by provisions of the law addressing, for example, group cross-guarantee arrangements; schemes of arrangement; and arrangements between creditors and companies being liquidated or about to be liquidated. It may also be possible for courts to make consolidation orders on a consent basis (Canada). In a recent US case involving an application for consolidation by the parent, creditors of the subsidiary, which was in a much better financial situation, objected to the consolidation. A settlement was agreed whereby those creditors of the subsidiary who objected were promised a substantially greater payout then other unsecured creditors of the parent,[16] thus departing from the strict policy of equal distribution. The possibility of providing such an exception to the principle of *pari passu* with respect to consolidation orders has been noted elsewhere.[17]

40. In jurisdictions permitting consolidation orders relatively few have been made. In New Zealand's leading case,[18] the court took into account the intermingled corporate group management practices, which included combined board meetings of

[15] Peter, H., Insolvency in a Group of Companies, Substantive and Procedural Consolidation: When and How? In Challenges of Insolvency Law in the 21st Century, eds. H. Peter, N. Jeandin, J. Kilborn, Schulthess 2006, p. 206.

[16] WorldCom and MCI—Skeel, D. A., Groups of Companies: Substantive Consolidation in the U.S., in Challenges of Insolvency Law in the 21st Century, eds. H. Peter, N. Jeandin, J. Kilborn, Schulthess 2006, p. 232.

[17] Law Reform Commission of Australia, Report No. 45, General Insolvency Inquiry 1988, para. 856.

[18] *Re Dalhoff and King Holdings Ltd* (1991) 5 NZCLC 66,959.

the various group companies; the use of a single bank account for all the group companies and the policy of using whichever group company was convenient for the various business operations undertaken. In addition to those practices, management had encouraged creditors to treat the corporate group as a single entity, which created confusion among the creditors as to which of the entities they were dealing with and otherwise blurred the legal boundaries of the group companies. The court also concluded that given those arrangements, the liquidity of each group company affected that of the others. A further factor was that the only way to determine the status of various intra-group debts, if a consolidation order were not made, would be through separate legal proceedings, which would invariably increase the cost and length of the liquidation and thereby deplete the funds otherwise available for creditors.

41. The New Zealand court also considered the competing interests of creditors and shareholders and concluded that in insolvency the rights of creditors outweighed those of shareholders, supporting the making of the consolidation order. Moreover, without a consolidation order, the shareholders of some corporate group members would receive a return at the expense of creditors of other group members. The competing interests of shareholders of the different group companies were also to be considered, and in particular the interests of those who were shareholders of some of the companies but not of others.

42. The competing interests of secured and unsecured creditors also need to be considered, and in particular whether the rights of secured creditors should remain unaffected by such an order. The Legislative Guide on Insolvency Law discusses the position of secured creditors in insolvency proceedings and adopts the approach that while as a general principle that the effectiveness and priority of a security interest should be recognized and the economic value of the encumbered assets should be preserved in insolvency proceedings, an insolvency law may modify the rights of secured creditors in order to implement business and economic policies, subject to appropriate safeguards.[19]

43. Individual creditors may also be affected by the court treating as invalid any charges, guarantees or other intra-group securities between the companies in liquidation. The New Zealand court in *Re Dalhoff* ruled that an external creditor could not enforce an intra-group guarantee that depended on retaining the separate identity of the group companies in liquidation; that creditor would be treated as an unsecured creditor unless the court considered that it should retain some priority right over other creditors.[20]

44. Consolidation orders may also have taxation implications, where for example, taxation rules rely upon identification of the specific source of any returns to shareholders made after distributions to creditors (Australia).

4. Partial substantive consolidation or pooling

45. Courts in some jurisdictions that permit consolidation (NZ), can make a limited order by exempting the claims of specific unsecured creditors and satisfying

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[19] Annex I of the UNCITRAL Legislative Guide sets forth the sections of the Guide addressing the treatment of secured creditors in insolvency proceedings.

[20] See note 18.

them from the particular assets of one of the companies in liquidation where it would be equitable to do so. Partial consolidation might be achieved by: extending the order to only unsecured creditors on the basis that secured creditors have relied upon the single entity principle; extending the order to cover only net equity of the solvent group companies, thus not affecting the rights of the creditors of those solvent entities; making the parent company liable only for the negative net equity of the insolvent group member, thus not affecting that members assets; and limiting the consolidation to those assets and liabilities that are intermingled and excepting those assets whose ownership is clear.[21]

5. Avoidance

46. As the UNCITRAL Legislative Guide on Insolvency Law notes,[22] many insolvency laws include provisions which apply retroactively from a particular date (such as the date of application for, or commencement of, insolvency proceedings) for a specified period of time (often referred to as the suspect period) and are designed to overturn those past transactions to which the insolvent debtor was a party or which involved the debtor's assets where they have certain effects, such as reducing the net worth of the debtor or upsetting the principle of equal sharing between creditors of the same rank. The types of transactions to which such provisions apply generally include: transactions intended to defeat, hinder or delay creditors; undervalued transactions; preferential transactions; and transactions with related persons. The Legislative Guide notes the difficulties of proving subjective elements of avoidance requirements, such as the intention of the debtor when entering into the transaction and the subjective knowledge of the counterparty. Such elements would be even more difficult to prove in the corporate group context.

47. Those provisions and the types of transactions to which they apply are relevant in the context of the insolvency of one or more members of a corporate group. In that context, they may affect intra-group financial transactions, such as loans, asset transfers and guarantees, as well as third party mortgages or guarantees provided to external lenders. In some jurisdictions (Australia), payments by a company to a creditor of a related company and a guarantee or mortgage given by one group company to support a loan by an outside party to another group company, may be subject to avoidance if the benefits accruing to the guarantor or mortgagor are outweighed by the detriment incurred by entering into the transaction. Intra-group transactions that might involve a director of one group company breaching their fiduciary duties and the other group company having actual or constructive knowledge of that fact, such as loans, asset transfers or third party mortgages given by a company prior to its liquidation but without any direct or indirect benefit, may also be subject to avoidance.

48. The question to be considered with respect to those types of transactions is how they should be treated in insolvency of corporate groups. For example, should the avoidance provisions applicable in the context of a debtor that is a separate corporate entity apply in the context of corporate groups or is there a need for more extensive provisions that include different categories of transactions? In addition, would a relevant criterion in respect of group transactions be whether the

[21] H. Peter, note 16, p. 208.

[22] UNCITRAL Legislative Guide, part two, chapter II, section F, para. 150.

transaction conveyed advantages to the parent company that would not normally be granted between unrelated business entities?

6. Subordination

49. In some cases where consolidation might be inappropriate, other remedies such as subordination might be considered. One example might be where insiders (typically the controlling shareholder or a person related to that shareholder) have behaved in a manner that suggests they may not deserve priority relative to external creditors acting in good faith.

50. Some laws provide for subordination of related company debt to that of outside creditors (Spain, Germany, USA). Under the corporate law of one jurisdiction (USA), courts may review intra-group financial arrangements to determine whether particular funds given to a group company should be treated as an equity contribution (thus enabling subordination to creditors' claims), rather than an intra-group loan, or whether debts owed by a group member in liquidation under any intra-group lending arrangement should be subordinated to the rights of external creditors of that group member. For example, a parent company which is the secured creditor of a controlled company in liquidation may have its claims subordinated to those of unrelated unsecured creditors or even minority shareholders of the controlled company, based upon factors such as: the level of capitalization of the controlled company; the parent company's participation in the management of the controlled company; whether the parent company has sought to manipulate intra-group transactions to its own advantage at the expense of external creditors; or whether the parent company has otherwise behaved unfairly, to the detriment of creditors and shareholders of the controlled company.

51. In one jurisdiction that does not have legislative provisions permitting subordination (UK), the courts may in limited cases postpone the prior rights of intra-group creditors to those of unsecured external creditors, under the principles of unjust enrichment.[23] In another jurisdiction (Australia), a creditor group company may voluntarily agree to subordinate its claims to those of external creditors.[24]

F. Issues for consideration—domestic treatment of corporate groups in insolvency

52. The foregoing discussion indicates those aspects of the treatment of corporate groups in insolvency that are addressed by laws affecting domestic insolvency; it is clear that most attention has focussed upon the circumstances in which the separate corporate entity approach can be reconsidered once insolvency proceedings have commenced. Few laws specifically address issues such as the commencement of those proceedings against one or more members of a corporate group or the effects of such commencement. While it may be possible to draw the conclusion, therefore, that the manner in which corporate insolvency laws address those issues in the

[23] A legal doctrine stating that if a person receives money or other property through no effort of his own, at the expense of another, the recipient should return the property to the rightful owner, even if the property was not obtained illegally. Most courts will order that the property be returned if the party who has suffered the loss brings a lawsuit.

[24] Australia: Corporations Law, s563C.

context of individual corporations is appropriate to the insolvency of one or more members of a corporate group, it is suggested that that may not always be the case.

53. The Working Group may also wish to consider what future work might be undertaken on the treatment of corporate groups in insolvency in light of the following possibilities. In considering those possibilities, the Working Group may wish to adopt a working assumption that any proposals or recommendations are not intended to interfere with the high incidence and increasing sophistication of corporate group structures, nor interfere in or create uncertainty for the multitude of commercial transactions that are entered into with corporate groups (often regardless of the absence or presence of legislation directed at the possible insolvency of or within a group). The prospect or possibility that work on corporate groups could propel corporate groups toward sanctuary in a "safe haven" should be avoided.

54. The Working Group may wish to consider the following issues:

(a) The scope of future work and, in particular, how the term "corporate group" could be defined for that purpose;

(b) Access to insolvency proceedings in the event of the insolvency or one or more members of a corporate group, which might include consideration of:

(i) The circumstances under which it would be appropriate for proceedings to be commenced against all or part of a corporate group and the commencement standard that should apply, in particular to members of the group that may not satisfy that standard but should be included in the proceedings for other reasons;

(ii) The person competent to make an application for commencement;

(iii) The effects of commencement and the extent to which they should differ from those discussed in the UNCITRAL Legislative Guide, for example, with respect to use and disposal of assets;

(c) What relief should be available in insolvency proceedings against a corporate group, including:

(i) Procedural relief, such as whether the same insolvency representative could be appointed to each insolvent group member or the extent to which it would be appropriate for insolvency estates to be jointly administered;

(ii) Substantive relief, such as the extent to which formal relief, protections and remedies would be available against solvent members of a corporate group; the extent to which the limited liability protection of separate entities may be waived; the extent to which two or more members of a group may be liable for the external debts of one of them; the extent to which it would be appropriate to facilitate substantive consolidation of assets and liabilities of group companies, contribution orders and subordination of claims; and

(iii) Other forms of relief that might be appropriate in group situations;

(d) Cooperation between courts and insolvency representatives in a group situation, particular where different insolvency representatives are appointed to different members of the group;

(e) Other issues particular to corporate groups that might require special provisions, such as:

(i) The powers of an insolvency representative appointed in the insolvency of a parent company of a group and the extent to which, for example, that insolvency representative could steer the actions to be taken by the (insolvent) subsidiary;

(ii) Whether provisions additional to the recommendations of the UNCITRAL Legislative Guide on Insolvency Law are required with respect to the provision of post-commencement finance in the corporate group context;

(iii) The extent to which the recommendations on avoidance provisions UNCITRAL Legislative Guide on Insolvency Law should apply in the context of corporate groups and whether there is a need for more extensive provisions that include different categories of transactions, including those between members of the group;

(iv) The extent to which special provisions may be needed in the case of corporate groups where management is permitted to remain in office; and

(v) Whether provisions additional to the recommendations of the UNCITRAL Legislative Guide on Insolvency Law are required with respect to reorganization of corporate groups, in particular with respect to negotiation, approval and implementation of a reorganization plan.

[*IV. International issues appears in A/CN.9/WG.V/WP.74/Add.2*]