United Nations A/CN.9/WG.V/WP.82/Add.2

General Assembly

Distr.: Limited
4 September 2008

Original: English

United Nations Commission on International Trade Law
Working Group V (Insolvency Law)
Thirty-fifth session
Vienna, 17-21 November 2008

Legislative Guide on Insolvency Law

Part three: Treatment of enterprise groups in insolvency

Note by the Secretariat

Contents

V.08-56446 (E)

V. Treatment of assets on commencement of insolvency proceedings

1. The manner in which the commencement of insolvency proceedings will affect the debtor and its assets are discussed in detail in the *Legislative Guide* (see part two, chap. I). In general, those effects would apply equally to commencement of insolvency proceedings against two or more enterprise group members. Some of the effects that might differ in the group context are discussed below, with respect to protection and preservation of the insolvency estate; post-commencement finance; avoidance; subordination; and remedies, including substantive consolidation orders.

A. Protection and preservation of the insolvency estate

2. The *Legislative Guide* notes (see part two, chap. II, para. 26) that many insolvency laws include a mechanism to protect the value of the insolvency estate that not only prevents creditors from commencing actions to enforce their rights through legal remedies during some or all of the period of insolvency proceedings, but also suspends actions already under way against the debtor. The provisions of the *Legislative Guide* relating to the application of that mechanism, referred to as a "stay", would apply generally in the case of insolvency proceedings against two or more enterprise group members (see recommendations 39-51).

3. One issue that might arise in the context of the insolvency of enterprise groups, but not in the case of individual debtors, is the extension of the stay to an enterprise group member that is not subject to the insolvency proceedings (where the insolvency law permits a group member that is not insolvent to be included in the proceedings, this issue will not arise). The issue may be of particular relevance to enterprise groups because of the interrelatedness of the business of the group. For example, when finance arranged on a group basis by way of cross-guarantees or cross-collateralization, the finance provided to one member might affect the liabilities of another, or actions affecting the assets of group members not subject to insolvency proceedings may also affect the assets and liabilities or the ability to continue their ordinary course of business of group members against which applications for commencement have been made or insolvency proceedings have commenced.

4. Extension of the stay might be sought in a number of situations, for example, to protect an intra-group guarantee that relies upon the assets of the solvent group member providing the guarantee; to restrain a lender seeking to enforce an agreement against a solvent group member, where that enforcement might affect the liability of a member subject to an application for insolvency proceedings; and to restrain enforcement of a security interest against assets of a solvent entity that are central to the business of the group, including the business of group members subject to an application for insolvency proceedings. Such extension of the stay has the potential to affect the business of the solvent member and the interests of its creditors, depending upon the nature of the solvent member and its function within the group structure. The day-to-day activities of a trading group member, for example, may be more adversely affected than those of a subsidiary established to hold certain assets or obligations.

5. In some jurisdictions, ordering insolvency-related relief against a solvent group member (not included in insolvency proceedings) might not be possible as it might conflict, for example, with the protection of property rights or raises issues of constitutional rights. Nevertheless, it might be possible to achieve the same effect if a court could order measures of protection in conjunction with the commencement of insolvency proceedings against other enterprise group members in certain cases, such as where there is an intra-group guarantee. The measures may be available at the courts' discretion, subject to such conditions as the court determines appropriate.

6. Such measures might be covered by recommendation 48 of the *Legislative Guide*, which provides for the court to grant relief in addition to any relief that might be applicable automatically on commencement of insolvency proceedings (such as that addressed in recommendation 46). As the footnote to recommendation 48 points out, that additional relief would depend upon the types of measures available in a particular jurisdiction and the measures that might be appropriate in a particular insolvency proceeding.

7. Measures might also be available on a provisional basis. Recommendation 39 of the *Legislative Guide* addresses provisional measures, specifying the types of relief that might be available "at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the debtor or the interests of creditors, between the time an application to commence insolvency proceedings is made and commencement of the proceedings".

8. Protection for the interests of the creditors, both secured and unsecured, of the solvent group member, might be found in the relevant provisions of the *Legislative Guide*; recommendation 51 for example specifically addresses the issue of protection of secured creditors and grounds for relief from the stay applicable on commencement and might be extended to secured creditors of the solvent group member. Other grounds for relief from the stay might relate to the financial situation of the solvent member and the continuing effect of the stay on its day-to-day operations and, potentially, its solvency.

9. Where a secured creditor is at the same time another member of the same enterprise group, a different approach to the question of protection might be required, especially where the insolvency law permits consolidation or subordination of related person claims (see below).

B. Use and disposal of assets

10. The *Legislative Guide* notes (see part two, chap. II, para. 74) that, although as a general principle it is desirable that an insolvency law not interfere unduly with the ownership rights of third parties or the interests of secured creditors, the conduct of insolvency proceedings will often require assets of the insolvency estate, and assets in the possession of the debtor being used in the debtor's business, to continue to be used or disposed of (including by way of encumbrance) in order to enable the goal of the particular proceedings to be realized.

11. Where insolvency proceedings concern two or more enterprise group members, issues may arise with regard to the use of assets belonging to a group member not subject to insolvency proceedings to support ongoing operations of

those members subject to such proceedings, pending resolution of the proceedings. Where those assets are in the possession of one of the group members subject to insolvency proceedings, recommendation 54 of the *Legislative Guide*, which addresses the use of third-party owned assets in the possession of the debtor, may be sufficient.

12. Where those assets are not in the possession of any of the group members subject to insolvency proceedings, recommendation 54 generally will not apply. There may be circumstances, however, where the solvent group member is included in the insolvency proceedings and the provisions of a group reorganization plan would cover the assets. Where the solvent group member is not included in the proceedings, the question will be whether those assets can be used to support those group members subject to insolvency proceedings and if so, the conditions to which that use would be subject. The use of those assets might raise questions of avoidance, particularly where the supporting member subsequently became insolvent, and also raises concerns for creditors of that member.

C. Post-commencement finance

13. 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. Of those laws that do address post-commencement finance, very few, if any, specifically address the issue in the context of enterprise groups.

14. Recommendations 63-68 of the *Legislative Guide* aim to promote the availability of finance for continued operation or survival of the debtor's business and provide 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.

15. Post-commencement finance may be even more important in the group context than it is in the context of individual proceedings. If there are no ongoing funds there is very little prospect of reorganizing an insolvent enterprise group or selling all or parts of it as a going concern and the economic impact of that failure is likely to be much greater, especially in large groups, than it would be in the case of an individual debtor. The reasons for promoting the availability of post-commencement finance in the group context are therefore similar to the case of the individual debtor, although a number of issues different to those relating to the individual debtor are likely to arise. These may include: balancing the interests of individual enterprise group members with what is required for the reorganization of the group as a whole; the provision of post-commencement finance by solvent group members, especially in cases where issues of control might arise, such as where that

solvent member was controlled by the insolvent parent of the group; treatment of transactions that are essentially between related parties (see glossary, para. (jj)); provision of finance by group members subject to insolvency proceedings; the possibility of conflict of interest between the needs of the different debtors with respect to ongoing finance where a single insolvency representative is appointed to several group members; and the desirability of maintaining, in insolvency proceedings, the financing structure that the group had before the onset of insolvency, especially where that structure involved pledging all of the assets of the group for finance that was channelled through a centralized group entity with treasury functions.

1. Provision of post-commencement finance by a solvent group member

16. As noted above, one of the questions with respect to post-commencement finance in the enterprise group context is whether the assets of a solvent group member can be used, such as by provision of a security interest or guarantee, to obtain financing for an insolvent member from an external source or to fund the insolvent member directly and, if so, the implications for the recommendations of the *Legislative Guide* concerning priority and security. A solvent group member might have an interest in the financial stability of the parent, other group members or the group as a whole in order to ensure its own financial stability and the continuation of its business. Different types of solvent entities, such as special purpose entities with few liabilities and valuable assets, could be involved in granting a guarantee or security interest.

17. However, use of the assets of a solvent group member as a basis for obtaining finance for an insolvent member raises a number of questions, especially where that solvent member is likely to become, or subsequently becomes, insolvent. While the solvent entity would provide that finance on its own authority under relevant company law in a commercial context and not under the insolvency law, the consequences of that provision of finance may be regulated by the insolvency law. A question may arise, for example, as to whether a solvent subsidiary group member would be entitled to the priority provided under recommendation 64 of the *Legislative Guide* if it provided funding to an insolvent group member; whether the claim arising from that transaction would be subject to special treatment because the transactions occurred between related parties under recommendation 184; or whether such a transaction might be considered a preferential transaction in any subsequent insolvency of the member providing that finance. Under some laws, providing such finance may constitute a transfer of the assets of that solvent entity to the insolvent entity to the detriment of the creditors and shareholders of the solvent entity and thus be prohibited.

18. Some of the difficulties associated with provision of finance by a solvent group member might be solved if addressed in the context of a reorganization plan, in which the solvent group member, as well as finance providers, could participate on a contractual basis. However, while there might be situations where that approach could be appropriate, the requirement for post-commencement finance at any early stage of the insolvency proceedings and before a plan could be negotiated and in cases such as liquidation on a going concern basis, where there would not be a reorganization plan, suggests it would be of limited application.

19. Recommendation 63 of the *Legislative Guide* establishes the basis for obtaining post-commencement finance (that the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the estate) and how it might be authorized (by the court or by creditors). Those requirements remain relevant in the context of enterprise groups, and for the avoidance of doubt, it might be made clear that, in the enterprise group context, recommendation 63 should be interpreted as applying to the provision of post-commencement finance to a group member subject to insolvency proceedings by both an external lender and a solvent group member.

2. Provision of post-commencement finance by an insolvent group member

20. Provision of post-commencement finance by one group member subject to insolvency proceedings to another such member is not directly addressed by the *Legislative Guide*. Some of the difficulties under existing laws associated with insolvent entities borrowing and lending funds may need to be further considered to facilitate provision of post-commencement finance in that situation. Under some insolvency laws, for example, the provision of such finance is likely to raise issues of liability of both the provider of finance and the debtor being financed. As the *Legislative Guide* notes (see part two, chap. II, para. 96), some insolvency laws provide, for example, that where a lender advances funds to an insolvent debtor in the period before commencement of proceedings, the lender may be responsible for any increase in the liabilities of other creditors or the advance may be subject to avoidance in any ensuing insolvency proceedings as a preferential transaction. In other examples, the insolvency representative is required to borrow the money, potentially involving personal liability for repayment.

21. While it may generally be expected that a group member subject to insolvency proceedings would not have the ability to provide post-commencement finance to another such member, there may be circumstances where it would be both possible, and desirable, particularly when the group is considered as a whole. To the extent that the provision of such finance has an impact on the rights of existing creditors, both secured and unsecured, of both members, it must be balanced against the prospect that preservation of going concern value by continued operation of the business will ultimately provide benefit to those creditors. A balance should also be achieved between sacrificing one group member for the benefit of other members and achieving a better overall result for all members. Although difficult to achieve, the goal should be fair apportionment of the harm that might arise from such post-commencement finance in the short term with a view to the long term gain, rather than the sacrifice of one member (and its creditors) for the benefit of others.

22. For the avoidance of doubt, it should be made clear that, in the enterprise group context, recommendation 63 should be interpreted as applying, in addition to the circumstances noted above, to the provision of post-commencement finance by a group member subject to insolvency proceedings to another such member.

(a) Conflict of interest

23. The provision of such finance also raises issues concerning possible prejudice and conflict of interest that do not arise in the context of a single debtor. A conflict of interest might arise, for example, where a single insolvency representative is

appointed to the insolvency proceedings of a number of group members. For example, the insolvency representative of the member providing the finance might also be the insolvency representative of the receiving member. That situation might be addressed by the appointment of an additional insolvency representative (discussed below, see A/CN.9/WP.82/Add.3, paras. 42-46), whether to address that specific conflict or more generally, to achieve a better balance between the interests of the creditors of the different group members.

(b) Priority for post-commencement finance

24. Recommendation 64 of the *Legislative Guide* specifies the need to establish the priority to be accorded to post-commencement finance and the level of that priority, i.e. ahead of ordinary unsecured creditors, including those with administrative priority. While priority generally provides an important incentive for the provision of such financing, the inducement required in the group context is perhaps slightly different than in the situation of the individual debtor. The particular interest of the group member providing finance may relate more to the insolvency outcome for the group as a whole (including that member), than to commercial considerations of profit or short-term gains. In such circumstances, it might be necessary to consider whether the level of priority recommended by the *Legislative Guide* would be appropriate. One view might be that the same priority would be appropriate as there must be incentives for the provision of finance and such a priority would afford greater protection to the creditors of the provider. Another view might be that because of the related party nature of the transaction and the group context (including the finance provider's self-interest in the outcome of the insolvency proceedings for the group as a whole), a lower priority should be accorded to protect the interests of creditors more generally and achieve a balance between the interests of the finance provider's creditors and those of the group member receiving the finance. Whichever approach is adopted, it is desirable that the insolvency law accord priority to such lending and specify the appropriate level.

(c) Security for post-commencement finance

25. Recommendations 65-67 of the *Legislative Guide* address issues relating to the granting of security for post-commencement finance and would be generally applicable in the enterprise group context. The granting of a security interest of the type referred to in recommendation 65 by one group member subject to insolvency proceedings for repayment of post-commencement finance provided to another such member may be distinguished from the same financing transaction between an external lender and an individual debtor. In the group context, the group member is granting the security over its unencumbered assets but is not directly receiving the benefit of the post-commencement finance and is potentially diminishing the pool of assets available to its creditors. It may, however, derive an indirect benefit in the group context when the provision of finance facilitates a better solution for the insolvency of the group as a whole and, as noted above, any short-term detriment is offset by the long-term gain for creditors, including its own creditors. The member receiving the finance is deriving a direct benefit, but increasing its indebtedness to the potential detriment of its creditors, although they should also benefit in the longer term.

26. To achieve a balance between the interests of the finance provider's creditors and those of the group member receiving the finance, it may be desirable to require, with respect to recommendation 65, that creditors should consent to the grant of such a security interest or that the harm to creditors must be offset by the benefit to be derived from the granting of the security interest. The question of harm or benefit is linked to the determination of the necessity of post-commencement finance and its authorization pursuant to recommendation 63 and it is therefore desirable that the parties responsible under that recommendation are also responsible for making the determination as to harm. Consistent with recommendation 63, that could be the insolvency representative, with the possibility of requiring authorization also from creditors or the court.

27. Given that new finance may be required on a fairly urgent basis to ensure the continuity of the business, it is desirable that the number of authorizations required be kept to a minimum. The *Legislative Guide* (see part two, chap. II, paras. 105-106) discusses the advantages and disadvantages of the different considerations with respect to authorization that would also apply in the group context. It may be added that since the issues to be determined are likely to be more complex in that context, involving as they do a larger number of parties and complex interrelationships, it is most likely to be the insolvency representatives of the relevant group members that will be in the best position to assess the impact of the proposed financing arrangement, in much the same way as they are with respect to determining the need for new finance under recommendation 63. If the involvement of the courts or creditors is considered desirable, however, it should be borne in mind that issues of delay may be encountered where there are a large number of creditors to be consulted or where the court does not have the ability to make speedy decisions.

28. Where it is considered desirable to accord a security interest granted to secure new finance a priority ahead of an existing security interest over the same asset, as contemplated by recommendation 66, the safeguards applicable under that recommendation and recommendation 67 would apply in the group context.

(d) Guarantee or other assurance of repayment for post-commencement finance

29. The granting of a guarantee by one group member for payment of new finance to another is not a situation that arises in the case of an individual debtor and is therefore not addressed in the *Legislative Guide*. However, since the considerations that arise are similar to those discussed above with respect to the granting of a security interest, it may be appropriate to adopt the same approach, that is, to require the consent of creditors or a determination that the potential harm will be offset by the benefit to be derived.

Recommendations

Purpose of legislative provisions

The purpose of provisions on post-commencement finance for enterprise groups is:

(a) To facilitate finance to be obtained for the continued operation or survival of the business of the enterprise group members subject to insolvency proceedings or the preservation or enhancement of the value of the assets of the estates of those members;

(b) To facilitate the provision of finance by enterprise group members, including members subject to insolvency proceedings;

(c) To ensure appropriate protection for the providers of post-commencement finance and for those parties whose rights may be affected by the provision of that finance; and

(d) To advance the objective of fair apportionment of benefit and detriment among all group members.

Contents of legislative provisions

Provision of post-commencement finance by a group member subject to insolvency proceedings

10. The insolvency law should permit an enterprise group member subject to insolvency proceedings to:

(a) Advance post-commencement finance to other enterprise group members subject to insolvency proceedings;

(b) Pledge its assets as security for post-commencement finance provided to other enterprise group members subject to insolvency proceedings; and

(c) Provide a guarantee or other assurance of repayment for post-commencement finance obtained by other enterprise group members subject to insolvency proceedings,

provided the insolvency representative of the member advancing finance, pledging assets or providing a guarantee determines it to be necessary for the continued operation or survival of the business of that enterprise group member or for the preservation or enhancement of the value of the estate of that enterprise group member. The insolvency law may require the court to authorize or creditors of the lending, pledging or guaranteeing group member to consent.

Priority for post-commencement finance

11. The insolvency law may specify the priority that should apply to post-commencement finance provided by one enterprise group member subject to insolvency proceedings to another group member that is also subject to insolvency proceedings. Where the priority is not specified by the insolvency law, the court should be authorized to determine that priority.

Security for post-commencement finance

12. The insolvency law should specify that a security interest of the type referred to in recommendation 65 of the *Legislative Guide* may also be granted by an enterprise group member subject to insolvency proceedings for repayment of post-commencement finance provided to another group member that is also subject to insolvency proceedings, provided creditors consent or a determination is made in accordance with the insolvency law that any harm to creditors is offset by the benefit to be derived from the granting of the security interest.[1]

[1] Recommendations 66-67 of the *Legislative Guide* set forth the safeguards to apply to the

Guarantee or other assurance for repayment of post-commencement finance

13. The insolvency law should specify that an enterprise group member subject to insolvency proceedings may guarantee or provide other assurance of repayment for post-commencement finance obtained by another group member subject to insolvency proceedings, provided creditors consent or a determination is made in accordance with the insolvency law that harm to creditors is offset by the benefit to be derived from the provision of the guarantee or other assurance of repayment.

D. Avoidance proceedings

30. Recommendations 87-99 of the *Legislative Guide* relating to avoidance would generally apply to avoidance of transactions in the context of an enterprise group, although additional considerations may apply to transactions between group members. A significant expenditure of time and money may be required to disentangle the layers of intra-group transactions in order to determine which, if any, are subject to avoidance. Some transactions that might appear to be preferential or undervalued as between the immediate parties might be considered differently when viewed in the broader context of a closely integrated group, where the benefits and detriments of transactions might be more widely assigned. Those transactions may involve different terms and conditions than the same contracts entered into by unrelated commercial parties on usual commercial terms, for example, contracts entered into for purposes of transfer pricing.[2] Similarly, some legitimate transactions occurring within a group may not be commercially viable outside the group context if the benefits and detriments were analysed on normal commercial grounds.

31. Intra-group transactions may represent trading between group members; channelling of profits upwards from the subsidiary to the parent; loans from one member to another to support continued trading by the borrowing member; asset transfers and guarantees between group members; payments by one group member to a creditor of a related group member; a guarantee or mortgage given by one group member to support a loan by an outside party to another group member; or a range of other transactions. A group may have the practice of putting all available money and assets in the group to the best commercial use in the interests of the group as a whole, as opposed to the benefit of the group member to which they belong. This might include sweeping cash from subsidiaries into the financing group member. Although this might not always be in the best interests of the subsidiary, some laws permit directors of wholly owned subsidiaries, for example, to act in that manner, provided it is in the best interests of the parent.

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granting of a security interest to secure post-commencement finance. Those safeguards would apply to the granting of a security interest in the enterprise group context.

[2] Transfer pricing refers to the pricing of goods and services within a multi-divisional organization. Goods from the production division may be sold to the marketing division, or goods from a parent company may be sold to a foreign subsidiary. The choice of the transfer prices affects the division of the total profit among the parts of the company. It can be advantageous to choose them so that, in terms of bookkeeping, most of the profit is made in a country with low taxes.

32. Some of the transactions occurring in the group context may be clearly identified as falling within the categories of transactions subject to avoidance under recommendation 87 of the *Legislative Guide*. Other transactions may not be so clearly within the scope of recommendation 87 and may raise issues concerning the extent to which the group was operated as a single enterprise or the assets and liabilities of group members were closely intermingled, thus potentially affecting the nature of the transactions between members and between members and external creditors. There may also be transactions that are not covered by the terms of avoidance provisions. Some insolvency laws, for example, provide for avoidance of preferential payments to a debtor's own creditors, but not to the creditors of a related group member, unless the payment is made, for example, pursuant to a guarantee. It is desirable that an insolvency law includes these factors as matters to be taken into account in determining whether a particular transaction between group members would be subject to avoidance under recommendation 87.

33. An issue that may need to be considered in the group context is whether the goal of avoidance provisions is to protect intra-group transactions in the interests of the group as a whole or subject them to particular scrutiny because of the relationship between group members. Transactions between group members might be covered by those provisions of an insolvency law dealing with transactions between related persons. The *Legislative Guide* defines "related person" to include enterprise group members such as a parent, subsidiary, partner or affiliate of the insolvent group member against which insolvency proceedings have commenced or a person, including a legal person, that is or has been in control of the debtor. Those transactions are often subject, under the insolvency law, to stricter avoidance rules than other transactions, in particular with regard to the length of suspect periods, as well as presumptions or shifted burdens of proof to facilitate avoidance proceedings and dispensing with requirements that the debtor was insolvent at the time of the transaction or was rendered insolvent as a result of the transaction. A stricter regime may be justified on the basis that these parties are more likely to be favoured and tend to have the earliest knowledge of when the debtor is, in fact, in financial difficulty.

34. Recommendation 97 addresses the elements to be proven to avoid a particular transaction and defences to avoidance and it may be appropriate to consider how they would apply in the group context and whether a different approach is required. One approach to the burden of proof in the case of transactions with related persons, for example, might be to provide that the requisite intent or bad faith is deemed or presumed to exist where certain types of transactions are undertaken within the suspect period and the counterparty to the transaction will have the burden of proving otherwise. In the context of enterprise groups, some laws have established a rebuttable presumption that certain transactions among group members and the shareholders of that group would be detrimental to creditors and therefore subject to avoidance. A different approach would be to acknowledge, as noted above, that transactions occurring within a group, although not always commercially viable if occurring outside the group context, are generally legitimate, especially when occurring within the limits of relevant applicable law and within the ordinary course of business of the group members concerned, but should nevertheless be subjected to special scrutiny (in much the same way as is recommended for claims by related persons in recommendation 184 of the *Legislative Guide*). Some laws also permit claims of the related group member to be subjected to special treatment and the

rights of related group members under intra-group debt arrangements to be deferred or subordinated to the rights of external creditors of the insolvent members.

35. Recommendation 93 makes limited provision for a creditor to commence an avoidance proceeding with the approval of the insolvency representative or leave of the court. In the group context, the level of integration of the group may have the potential to significantly affect the ability of creditors to identify the group member with which they dealt and thus provide the requisite information for commencing avoidance proceedings.

Recommendations

Purpose of legislative provisions

The purpose of avoidance provisions is:

(a) To reconstitute the integrity of the estate and ensure the equitable treatment of creditors;

(b) To provide certainty for third parties by establishing clear rules for the circumstances in which transactions occurring prior to the commencement of insolvency proceedings involving the debtors or the debtors' assets may be considered injurious and therefore subject to avoidance;

(c) To enable the commencement of proceedings to avoid those transactions; and

(d) To facilitate the recovery of money or assets from persons involved in transactions that have been avoided.

Contents of legislative provisions

Avoidable transactions

14. The insolvency law should specify that, in considering whether a transaction of the kind referred to in recommendation 87 (a), (b) or (c) of the *Legislative Guide* that took place between related persons in an enterprise group context should be avoided, the court may have regard to the circumstances of the enterprise group in which the transaction took place. Those circumstances may include: the degree of integration between the enterprise group members that are parties to the transaction; the purpose of the transaction; and whether the transaction granted advantages to the enterprise group members that would not normally be granted between unrelated parties.

Elements of avoidance and defences

15. The insolvency law may specify the manner in which the elements referred to in recommendation 97 of the *Legislative Guide* would apply to avoidance of transactions in the context of insolvency proceedings with respect to two or more enterprise group members.[3]

[3] That is, the elements to be proved in order to avoid a transaction, the burden of proof, specific defences to avoidance, and the application of special presumptions.

E. Subordination

36. The *Legislative Guide* notes (see part two, chap. V, para. 56) that subordination refers to a rearranging of creditor priorities in insolvency and does not relate to the validity or legality of the claim. Notwithstanding the validity of a claim, it might nevertheless be subordinated because of a voluntary agreement or a court order. Two types of claims that typically may be subordinated in insolvency are those of persons related to the debtor and of owners and equity holders of the debtor.

1. Related person claims

37. In the enterprise group context, subordination of related person claims might mean, for example, that the rights of group members under intra-group arrangements could be deferred to the rights of external creditors of those group members subject to insolvency proceedings.

38. As noted above, the term "related person" as used in the *Legislative Guide* would include enterprise group members. However, the mere fact of a special relationship with the debtor, including, in the group context, being another member of the same group, may not be sufficient in all cases to justify special treatment of a creditor's claim. In some cases, these claims will be entirely transparent and should be treated in the same manner as similar claims made by creditors who are not related persons; in other cases they may give rise to suspicion and will deserve special attention. An insolvency law may need to include a mechanism to identify those types of conduct or situation in which claims will deserve additional attention. Similar considerations apply, as noted above, with respect to avoidance of transactions occurring between enterprise group members.

39. The *Legislative Guide* identifies a number of situations in which special treatment of a related person's claim might be justified (e.g. where the debtor is severely undercapitalized and where there is evidence of self-dealing). In the group context, additional considerations might include, as between a parent and a controlled subsidiary: the parent's participation in the management of the subsidiary; whether the parent has sought to manipulate intra-group transactions to its own advantage at the expense of external creditors; or whether the parent has otherwise behaved unfairly, to the detriment of creditors and shareholders of the controlled group member. Under some laws, the existence of those circumstances might result in the parent having its claims subordinated to those of unrelated unsecured creditors or even minority shareholders of the controlled company.

40. Some laws include other approaches to intra-group transactions such as permitting debts owed by a group member that borrowed funds under an intra-group lending arrangement to be involuntarily subordinated to the rights of external creditors of that borrowing member; permitting the court to review intra-group financial arrangements to determine whether particular funds given to a group member should be treated as an equity contribution rather than as a loan, where the law subordinates equity contributions to creditor claims (on treatment of equity, see below); and allowing voluntary subordination of intra-group claims to those of external creditors.

41. The practical result of a subordination order in an enterprise group context might be to reduce or effectively extinguish any repayment to those group members whose claims have been subordinated if the claims of secured and unsecured external creditors are large in relation to the funds available for distribution. In some cases this might threaten the viability of the subordinated group member and be detrimental not only to its own creditors, but also its shareholders and, in the case of reorganization, to the group as a whole. The adoption of a policy of subordinating such claims may have the effect of discouraging intra-group lending.

2. Treatment of equity

42. The *Legislative Guide* notes (see part two, chap. V, para. 76) that many insolvency laws distinguish between the claims of owners and equity holders that may arise from loans extended to the debtor or their ownership interest in the debtor. With respect to claims arising from equity interests, many insolvency laws adopt the general rule that the owners and equity holders of the business are not entitled to a distribution of the proceeds of assets until all other claims that are senior in priority have been fully repaid (including claims of interest accruing after commencement). As such, these parties will rarely receive any distribution in respect of their interest in the debtor. Where a distribution is made, it would generally be made in accordance with the ranking of shares specified in the company law and the corporate charter. Debt claims, such as those relating to loans, however, are not always subordinated.

43. Few insolvency laws specifically address subordination of equity claims in the enterprise group context. One law that does allow the courts to review intra-group financial arrangements to determine whether particular funds given to a group member subject to insolvency proceedings should be treated as an equity contribution, rather than as an intra-group loan, enabling it to be postponed behind creditors' claims. Those funds are likely to be treated as equity where the original debt to equity ratio was high before the funds were contributed and the funds would reduce the ratio; if the paid-up share capital was inadequate; if it is unlikely that an external creditor would have made a loan in the same circumstances; and if the terms on which the advance was made were not reasonable and there was no reasonable expectation of repayment.

44. The *Legislative Guide* discusses subordination in the context of treatment of claims and priorities, but does not recommend the subordination of any particular types of claims under the insolvency law, simply noting that subordinated claims would rank after claims of ordinary unsecured creditors (recommendation 189).

[*A/CN.9/WG.V/WP.82 provides an introduction to enterprise groups; Add.1 addresses application and commencement of insolvency proceedings (joint applications and procedural coordination); Add.3 addresses remedies (extension of liability, contribution orders and substantive consolidation), participants (single insolvency representative) and reorganization plans; and Add.4 addresses international issues.*]