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UNCITRAL Legislative Guide on Insolvency Law

Part three: Treatment of enterprise groups in insolvency

Note by the Secretariat

1. This note sets forth the draft commentary and recommendations of part three of the UNCITRAL Legislative Guide on Insolvency Law. The commentary is a revised version of the text previously included in documents A/CN.9/WG.V/WP.82 and Addenda 1-3. The recommendations are based on the recommendations set forth in document A/CN.9/WG.V/WP.85 and Add.1 and revised on the basis of the Report of Working Group V on the work of its thirty-sixth session in May 2009 (A/CN.9/671).

2. A/CN.9/WG.V/WP.90 addresses the treatment of enterprise groups in the domestic context, while A/CN.9/WG.V/WP.90/Add.1 addresses the international context. A/CN.9/WG.V/WP.90/Add.2 is provided for the information and consideration of the Working Group. It includes some explanatory notes that are intended to explain revisions made to the draft recommendations, to facilitate discussion and to raise questions for consideration by the Working Group; it is not intended that the content of A/CN.9/WG.V/WP.90/Add.2 would form part of the text of part three of the Legislative Guide.

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UNCITRAL Legislative Guide on Insolvency Law

Part three: Treatment of enterprise groups in insolvency

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Introduction

UNCITRAL Legislative Guide on Insolvency Law

Part three: Treatment of enterprise groups in insolvency

1. Part three of the *Legislative Guide* focuses on the treatment of enterprise groups in insolvency. Where an approach different to that taken in part two might be required with respect to a particular issue as it affects an enterprise group or where the treatment of enterprise groups in insolvency raises issues additional to those discussed in part two, they are addressed in this part. Where the treatment of an issue in the context of an enterprise group is the same as discussed above, it is not repeated in this part. The substance of part two is therefore applicable to enterprise groups unless otherwise indicated in this part.

2. Chapter I addresses general features of enterprise groups. Chapter II deals with the insolvency of group members in a domestic context and proposes a number of recommendations to supplement the recommendations of part two, in so far as additional issues arise by virtue of the group context. Chapter III addresses the cross-border insolvency of enterprise groups, building upon the UNCITRAL Model Law on Cross-Border Insolvency, which is relevant to cross-border insolvency proceedings with respect to an individual group member, but does not address issues pertinent to the insolvency of different group members in different States.

Glossary

3. The following additional terms relate specifically to enterprise groups and should be read in conjunction with the terms and explanations included in the main glossary above.

(a) "Enterprise group": two or more enterprises that are interconnected by control or significant ownership;

(b) "Enterprise": any entity, regardless of its legal form, that is engaged in economic activities and may be governed by the insolvency law;[1]

(c) "Control": the capacity to determine, directly or indirectly, the operating and financial policies of an enterprise;

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[1] Consistent with the approach adopted with respect to individual debtors, the focus of this part is upon the conduct of economic activities by entities that would conform to the types of entities described as an "enterprise". It is not intended to include consumers or other entities of a specialized nature (e.g. banks and insurance companies) that would not be governed by insolvency law pursuant to recommendations 8 and 9 (see above, footnote 6 to recommendation 9). The special considerations arising from the insolvency of such debtors are not specifically addressed in the *Legislative Guide* (see above, part two, chap. I, paras. 1-11).

(d) "Procedural coordination": coordination of the administration of two or more insolvency proceedings in respect of enterprise group members. Each of those members, including its assets and liabilities, remains separate and distinct; [2]

(e) "Substantive consolidation": the treatment of the assets and liabilities of two or more enterprise group members as if they were part of a single insolvency estate.[3]

I. Enterprise groups: general features

A. Introduction

4. Most jurisdictions recognize the legal concept of "corporation", an entity which has a legal personality separate from the individuals comprising it, whether as owners, managers, or employees. As a legal or juristic person, a corporation is capable of enjoying and being subject to certain legal rights, duties and liabilities, such as the capacity to sue and be sued, to hold and transfer property, to sign contracts and to pay taxes. The corporation also enjoys the characteristic of perpetuity, in the sense that its existence continues, independent of its members at any given time and over time, and shareholders can transfer their shares without affecting the entity's corporate existence. Corporations may also have limited liability, whereby investors will only be liable for the amount they have intentionally put at risk in the enterprise, providing certainty and encouraging investment; without that limitation, investors would put their entire assets at risk for every business venture they entered into. A corporation depends on a legal process to obtain its legal persona and once formed, will be subject to the regulatory regime applying to entities so formed. That law generally will determine not only the requirements for formation, but also the consequences of formation, such as the powers and capacities of the company, the rights and duties of its members and the extent to which members may be liable for the company's debts. The corporate form can thus be seen as promoting certainty in the ordering of business affairs, as those dealing with a corporation know that they can rely upon its legal personality and the rights, duties and obligations that attach to it.

5. The business of corporations is increasingly conducted, both domestically and internationally, through "enterprise groups". The term "enterprise group" covers different forms of economic organization based upon the single entity and for a working definition may be loosely described as two or more corporations that are linked together by some form of control (whether direct or indirect) or ownership (see below). The size and complexity of enterprise groups may not always be readily apparent, as the public image of many is that of a unitary organization operating under a single corporate identity.

6. Enterprise groups have been in existence for some time, emerging in some countries, according to commentators, at the end of the 19th and beginning of the 20th centuries through a process of internal expansion, which involved companies

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[2] The concept of procedural coordination is explained in detail in the commentary, see below paras. 63-66.

[3] For the effects of substantive consolidation and the treatment of security interests, see below, recommendations 224 to 226 and the commentary at paras. 159-162.

taking control of their own financial, technical or commercial capacities. These single entity enterprises then expanded externally to take legal or economic control of other corporations. Initially these other corporations may have been in the same market, but eventually the expansion encompassed corporations working in related fields and later in fields that were different or unrelated, whether by reference to a product or geographical location or both. One of the factors supporting this expansion, at least in some jurisdictions, was the legitimatization of ownership of the shares of one corporation by another corporation; a phenomenon originally prohibited in both common law and civil law systems.

7. Throughout this expansion, corporations retained and continue to retain, their separate legal personality even though individual corporations are now probably the typical form of organization only for small private businesses. Enterprise groups are ubiquitous in both emerging and developed markets, with a common characteristic of operations across a large number of often-unrelated industries, often with family ownership in combination with varying degrees of participation by outside investors. The largest economic entities in the world include not only States, but also equal numbers of multinational enterprises. Major multinational groups may be responsible for significant percentages of Gross National Product worldwide and have annual growth rates and turnovers that exceed those of many States.

8. Despite the reality of the enterprise group, however, much of the legislation relating to corporations and particularly to their treatment in insolvency, deals with the single corporate entity. Despite the absence of legislation, judges in many countries, faced with issues that may be addressed by reference to a single enterprise rather than a single corporate entity,[4] have developed solutions to achieve results that better reflect the economic reality of modern business.

B. Nature of enterprise groups

9. Enterprise group structures may be simple or highly complex, involving numbers of wholly or partly owned subsidiaries, operating subsidiaries, sub-subsidiaries, sub-holding companies, service companies, dormant companies, cross directorships, equity ownership and so forth. They may also involve other types of entity, such as special purpose entities (SPE),[5] joint ventures,[6] offshore trusts[7] and partnerships.

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[4] Discussed further below, see E, paras. 34-42.

[5] Special purpose entities (SPE, also known as a "special purpose vehicle" or "bankruptcy-remote entity") are created to fulfil narrow or temporary objectives, such as the acquisition and financing of specific assets, primarily to isolate financial risk or enhance tax efficiency. An SPE is typically a subsidiary owned almost entirely by the parent corporation; certain jurisdictions require that another investor own at least 3 per cent. Its asset and liability structure and legal status generally makes its obligations secure even if the parent becomes insolvent. The corporation establishing the SPE can accomplish its purpose without having to carry any of the associated assets or liabilities on its own balance sheet, thus they are "off-balance sheet." SPEs may also be used for competitive reasons to ensure intellectual property, such as for the development of new technology, is owned by a separate entity that is not affected by pre-existing licence agreements.

[6] A joint venture is often a contractual arrangement or partnership between two or more parties to pursue a joint business purpose. Such an arrangement may sometimes result in the formation of

10. Enterprise groups may have a hierarchical or vertical structure, with succeeding layers of parent and controlled companies, which may be subsidiaries or other types of affiliated or related companies, operating at different points in a production or distribution process. They may also have a more horizontal structure, with many sibling group members, often with a high degree of cross-ownership, operating at the same level in that process. The businesses they conduct may be in a related field or in a diverse range of unrelated fields. It has been suggested that horizontal groups are more common in some parts of the world, such as Europe, while vertical groups are more common in others, such as the USA and Japan.

11. The research literature on enterprise groups clearly shows that they can be based on different types of alliances such as bank relationships, interlocking board directorates, owner alliances, information sharing, joint ventures, and cartels. The research also shows that enterprise group structures vary across corporate governance systems. In some States, they are organized either vertically or horizontally and develop across industries. They generally include a bank, a parent or holding company[8] (referred to as "parent company") or a trading company, and a diverse group of manufacturing firms. In contrast, in other States such groups are typically controlled by a single family or a small number of families and are uniformly vertically organized or have strong ties to the State, but not to particular families. Degrees of diversification also vary considerably, with some groups involving significant intra-group trading and other not.[9]

12. The degree of financial and decision-making autonomy in enterprise groups can vary considerably. In some groups, members may be active trading entities, with primary responsibility for their own business goals, activities and finances. In others, strategic and budgetary decisions may be centralized, with group members

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one or more legal entities that may involve both parties contributing equity, and sharing in the revenues, expenses, and control of the enterprise. The venture could be for one specific project only, or a continuing business relationship. Joint ventures are widely used in an international context, as some countries require foreign corporations to form joint ventures with a domestic partner in order to enter a market. This requirement often results in technology and managerial control being transferred to the domestic partner. Forming a joint venture might assist in spreading costs and risks; improving access to financial resources; providing economies of scale and advantages of size; and facilitating access to new technologies and customers or to innovative managerial practices. It may also serve competitive and strategic goals such as influencing structural evolution of an industry; pre-empting competition; creating stronger competitive units; and facilitating transfer of technology and skills, as well as diversification.

[7] An offshore trust is a conventional trust that is formed under the laws of an offshore jurisdiction. They are similar in nature and effect to onshore trusts, involving a transfer of assets to a trustee to manage for the benefit of a person or class of persons. Offshore trusts may be formed for tax purposes or asset protection. In practice the effectiveness of such trusts may be limited if the insolvency law of the home jurisdiction of the person transferring the assets operates to set aside transfers to the trusts, and transactions entered into to defraud creditors.

[8] A holding company or parent company is a company that directly or indirectly owns enough voting stock in another firm to control management and operations by influencing or electing its board of directors. The term may signify a company that does not produce goods or services itself, but whose purpose is to own shares of other companies (or own other companies outright).

[9] Some research suggests that groups in Chile, for example, are more divers than groups in South Korea, while groups in the Philippines are more vertically integrated than groups in India and far more involved in financial services than groups in Thailand. See T. Khanna and Y. Yafeh, Business Groups in Emerging Markets: Paragons or Parasites? Journal of Economic Literature, Vol. XLV (June 2007) pp331-372.

operating as divisions of a larger business and exercising little independent discretion within the cohesive economic unit. A parent company may exercise close control by allocating equity and loan capital to group members through a central group finance operation, deciding their operational and financial policies, setting performance targets, selecting directors and other key personnel, and continuously monitoring their activities. The power of the group may be centralized in the ultimate parent company or in a company further down the group chain, with the parent company owning the key group shares, but not having any direct productive or managerial role. The largest groups might have their own banks and perform the principal functions of a capital market. Group financing might involve intra-group lending between the parent company and subsidiaries, involving loans both from and to the parent company and the granting of cross-guarantees.[10] Intra-group lending might be working capital or unpaid short-term debt, such as unpaid dividends or credit in respect of intra-group trading; they may or may not involve the payment of interest.

13. In some States, family ties play an important connecting factor in enterprise groups and it may be the case, for example, that the more important family members and close associates of family members will sit on the board of the parent company of a group, with members of that board spread around the boards of group members so that there is a web of interlinked common directorships, enabling the family to maintain control over the group. For example, the chart of a large group in India shows a complex web of shared directorships between the board of the parent company and 45 other group members.[11]

14. In some countries, enterprise groups have enjoyed close ties to governments and government policies, such as those affecting access to credit and foreign currency and competition, which have significantly influenced the development of groups. Equally, there are examples where government policies have targeted the operations of enterprise groups, removing certain types of preferential treatment, such as access to capital.

15. The structure of many enterprise groups shows the dimension and potential complexity of the arrangements. They may involve many layers of different companies controlled to a greater or lesser extent by the level or levels above, in some cases involving hundreds if not thousands of different companies.[12]

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[10] In many countries a significant method of enterprise group capital raising is cross-guarantee financing, where each company within a group guarantees the performance of the others. Implementing cross-guarantee claims in liquidation has proved difficult in some jurisdictions and they have sometimes been set aside. In one jurisdiction, cross-guarantees may operate to reduce the regulatory burden on companies by bestowing accounting and auditing relief on companies that are party to the arrangement. The deed of cross-guarantee makes the group of companies that are party to that deed akin to a single legal entity in many respects and operates as a form of voluntary contribution or pooling in the event that one or more of the companies party to the deed goes into liquidation while the cross-guarantee is still operative. One advantage of this arrangement is that creditors and potential creditors can focus on the consolidated position for those entities, rather than on the individual financial statements of the wholly owned subsidiaries that are party to the deed.

[11] See Khanna and Yafeh, note 9.

[12] A 1997 survey in Australia of the Top 500 listed companies showed that 89 per cent of those companies controlled other companies; the greater the market capitalization of a listed company,

16. A study based upon the 1979 accounts and reports of a number of large British-based multinationals, for example, had to be abandoned with respect to two of the largest groups, with 1,200 and 800 subsidiaries respectively, because of the impossibility of completing the task. Researchers noted that few people inside the group could have had a clear understanding of the precise legal relationships between all group members and that none of the groups studied appeared to have its own complete chart.[13] Similarly, the group charts of several Hong Kong property groups such as Carrian, which failed over 20 years ago, ran to several pages and a reader would have needed a good magnifying glass to identify the subsidiaries. The group chart of the Federal Mogul group, an automotive component supplier, when blown up to the point where you can read the names of all the subsidiaries, fills a wall of a small office. The group chart of Collins and Aikman, another automotive group, is printed in a book, with sub-sub-groups having the complexity of structure of many domestic enterprise groups.

17. The degree of integration of a group might be determined by reference to a number of factors, which might include the economic organization of the group (e.g., whether the administrative structure is arranged centrally or maintains the independence of the various members, whether subsidiaries depend on the enterprise group for financing or loan guarantees, whether personnel matters are handled centrally, the extent to which the parent makes key decisions on policy, operations and budget and the extent to which the businesses of the group are integrated vertically or horizontally); how the group manages its marketing (e.g., the importance of intra-group sales and purchases, the use of common trademarks, logos and advertising programmes and the provision of guarantees for the products); and the public image of the group (e.g., the extent to which the group presents itself as a single enterprise and the extent to which the activities of the constituent companies are described as operations of the group in external reports, such as those for shareholders, regulators and investors).

18. The legal structure of a group as a number of separate legal entities is not necessarily determinative of how the business of the group is managed. While each group member is a separate entity, management may be arranged in divisions along product lines and subsidiaries may have one or many product lines with the result that they fall across different divisions. In some cases, management may treat wholly owned subsidiaries as if they were branches of the parent company.

C. Reasons for conducting business through enterprise groups

19. Diverse factors shape the formation, operation and evolution of enterprise groups, ranging from legal and economic factors to societal, cultural, institutional and other norms. State leadership, inheritance customs, kinship structures (including

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the more companies it was likely to control (this ranged from an average of 72 controlled companies for those companies with the largest market capitalization to an average of 9 for the smallest); 90 per cent of controlled companies were wholly owned; the number of vertical subsidiary levels in an enterprise group ranged from 1 to 11, with an overall average of 3 to 4. In other countries the figures are much larger. Cited in Companies and Securities Advisory Committee (CASAC), Corporate Groups Final Report, 2000 (Australia), paragraph 1.2.

[13] Hadden, Inside Corporate Groups, 1984 International Journal of Sociology of Law, 12, 271-286, p273.

inter-generational considerations), ethnicity and national ideology, as well as the level of development of the legal (e.g., effectiveness of contract enforcement) and institutional framework supporting commercial activity may influence enterprise groups in different environments. Some studies suggest that group structures can make up for under-developed institutions, with consequent benefits for transaction costs.

20. The advantages of conducting business through an enterprise group structure may include reduction of commercial risk and maximization of financial returns, by enabling the group to diversify its activities into various types of businesses, each operated by a separate group company. One company may acquire another to expand and increase market power, at the same time preserving the acquired company and continuing to operate it as a separate entity to utilize its corporate name, goodwill and public image. Expansion may occur to acquire new, technical or management skills. Once formed, groups may continue to exist and proliferate because of the administrative costs associated with rationalizing and liquidating redundant subsidiaries.

21. A group structure may enable a group to attract capital to only part of its business without forfeiting overall control, by incorporating that part of the business as a separate subsidiary and allowing outside investors to acquire a minority shareholding in it. A group structure may enable a group to lower the risk of legal liability by confining high liability risks, such as environmental and consumer liability, to particular group members, thus isolating the remaining group assets from this potential liability. Better security for debt or project financing may be facilitated by moving specific assets into a separate member incorporated for that purpose, thus ensuring that the lender has a first priority over the whole or most of the new member's property. A separate group member may also be formed to undertake a particular project and obtain additional finance by means of charges over its own assets and undertaking or may be required for the purpose of holding a government license or concession. A group structure can simplify the partial sale of a business as it may be easier, and sometimes more tax effective, to transfer the shares of a group member to the purchaser, rather than sell discrete assets. A group may also be formed incidentally when a company acquires another company, which in turn might be a parent company for various other companies.

22. Meeting prudential or other statutory requirements may be easier where the companies subject to those regulatory requirements are separate group members. In the case of multinational groups, the domestic law of particular countries in which the group wishes to conduct business may require that local businesses be conducted through separate subsidiaries (sometimes subject to minimum local equity requirements) or impose other requirements or limitations, relating for example to employment and labour regulation. Arrangements not involving equity have been used for foreign expansion because of, for example, local obstacles to equity participation, the level of regulation imposed upon foreign investment operations and the relative cost advantages of those types of arrangement. Another relevant factor for multinational groups may be geographical imperatives, such as the need to acquire raw materials or to market products through a subsidiary established in a particular location. A related consideration of increasing importance that perhaps relates more to where parts of the groups structure are to be located than to the question of whether or not to organize a business through a group structure, is the

importance of local law on issues such as cost and simplicity of incorporation in the first instance, obligations of incorporated entities and treatment of the group in insolvency. Differences in law across jurisdictions can significantly complicate these issues.

23. Other key drivers for complicated group structures include fiscal considerations and their influence on the flow of money within groups. The incidence of tax is often cited as the reason for the formation of and subsequent growth of enterprise groups and many legal systems have traditionally given weight to the economic unity of related entities. While separate taxation of individual entities might be the underlying principle, it may be qualified to fulfil basic purposes such as protecting the revenue interests of governments and alleviating the tax burden that would otherwise result from the separate taxation of each group member.[14] Measures that take into account the connections between parent and subsidiary companies include tax exemptions for intra-group dividends; group relief; and measures aimed at combating tax evasion. Tax exemptions may be available, for example, on the dividends paid by a company to its resident corporate shareholders and for intra-group dividends where companies are linked by substantial ownership. Tax credits may be allowed for the foreign tax paid on the underlying profits of the subsidiary and for the foreign tax that is charged directly on a dividend. Group relief might be available where related companies can be treated as a single fiscal unit and file consolidated accounts. The losses of one subsidiary may be offset against the income of another or profits and losses may be pooled amongst group members.

24. As a result of the importance of fiscal considerations, inter-group pricing policies and national taxation rates and policies often determine the distribution of assets and liabilities within enterprise groups. Differential corporate tax rates across jurisdictions, as well as certain exceptions (such as reduced tax rates for profits from manufacturing activities or financial services income) applicable in some jurisdictions may make those jurisdictions more attractive than others that have higher tax rates and fewer or no exceptions. Nevertheless, tax authorities may have the right to revisit transfer-pricing structures aimed at locating profits in low taxation domiciles.

25. Choices such as between establishing a branch or a subsidiary might also be affected by fiscal regulation where, for example, repatriation of profits from a foreign subsidiary may be effected tax free by loan repayments to a parent company or may be tax free provided the parent owns a specified percentage (ranging from 5-20 per cent) of the foreign company's share capital; interest on funds borrowed to finance the acquisition of a subsidiary can be offset against their profits and as already noted, the subsidiaries profits and losses can be offset against each other in a consolidated tax return. Business activities have also been divided between two or more corporations to exploit tax allowances, limits imposed on the amounts of tax allowances or progressive rates of taxation. Other reasons might include: taking advantage of differences in accounting methods, taxable years, depreciation methods, inventory valuation methods and foreign tax credits; segregating activities that if combined in a single taxable entity, might be disadvantageous in fiscal terms; and taking advantage of favourable treatment for

[14] International Investment and Multinational Enterprises – Responsibility of parent companies and their subsidiaries, OECD, 1979.

certain activities (e.g., anticipated or potential sales, mergers, liquidations or intra-family gifts or bequests) that is available for some operations, but not for others.

26. Accounting requirements also have a role to play in determining the structure of enterprise groups. In some jurisdictions, certain devices such as "agent only" subsidiaries might be created to manage certain aspects of the business and enable the parent company to avoid submitting detailed trading accounts for that subsidiary, which is just an agent of the parent company that owns all of the relevant assets.

27. Many of these benefits of conducting business through an enterprise group may be illusory. Protection against devastating losses may fall away as a result of group financing agreements; intra-group trading; cross-guarantees; and letters of comfort [15] given to group auditors and the inclination of major creditors, and particularly bankers, to ensure that they have the indemnity of the top member in any group.

28. To avoid doubt, group structures are not required from the accounting point of view – accountants are just as happy with consolidating branches as groups of subsidiaries. It seems probable that the banking, commercial and legal sectors often fail to appreciate the accounting aspects of enterprise groups. The opportunities for misunderstanding will increase in the transition to new international financial reporting standards and as many groups change their consolidation approach from one that has regard for the substance of transactions, to one that requires legal form to prevail over substance. It was the "off-balance" accounting structures that made Enron, WorldCom and other failures possible and the need for clarity of financial statements is widely acknowledged.

D. Defining the "enterprise group" – ownership and control

29. Although the existence of enterprise groups and the importance of relationships between the group members are increasingly acknowledged, both in legislation and court decisions, there is no coherent body of rules that directly governs those relationships in a comprehensive manner. In jurisdictions where there is legislation that recognizes enterprise groups, it may not specifically deal with the regulation of such groups, by way of commercial or corporate legislation, but rather be contained in legislation on taxation, corporate accounting, competition and mergers or other issues; legislation addressing the treatment of enterprise groups in insolvency is rare. Furthermore, an analysis of legislation that does address aspects of enterprise groups reveals a diversity of approaches to the various issues associated with groups, not only between jurisdictions, but also on a comparison of the different legislation within a single jurisdiction. Thus different tests may apply to what constitutes a group for different purposes, although there may be common elements, and where those tests employ a particular concept, such as "control",

[15] A letter of comfort is generally provided by a parent company to persuade another entity to enter into a transaction with a subsidiary. It may include various types of undertaking, none of which would amount to a guarantee, which may include an undertaking to maintain its shareholding or other financial commitment to a subsidiary; using its influence to see that the subsidiary meets its obligation under a primary contract; or confirming that it is aware of a contract with the subsidiary, but without any express indication that it will assume any responsibility for the primary obligation.

definitions may be broader or narrower, depending upon the purpose of the legislation, as noted above.

30. While much legislation avoids specifically defining the term "enterprise group", several concepts are common to determining what relationships between companies will be sufficient to constitute them as an enterprise group for certain specific purposes, such as extending liability, accounting purposes, taxation and so on. These concepts are found both in legislation and in numerous court decisions on groups in various countries and generally include aspects of ownership and control or influence, both direct and indirect, although in some examples only direct ownership or control or influence is considered. The choice between the two concepts often reflects a balance between the desirability of certainty, which can be achieved by setting a prescribed level of ownership, and flexibility, which might be better achieved by referring to control and acknowledging the diverse economic realities of enterprise groups.

31. Some examples consider ownership by reference to a formal relationship between the companies, such as what constitutes a parent-subsidiary relationship. This may be determined by reference to a formal standard – the holding, whether directly or indirectly, of a specified percentage of capital or votes. Examples of those percentages vary from as little as 5 per cent to more than 80 per cent. Those laws specifying lower percentages generally consider additional factors such as the ones discussed below as indicators of control. In some examples, the percentages establish a rebuttable presumption as to ownership, while higher percentages establish a conclusive presumption.

32. Other examples of what constitutes an enterprise group adopt a more functional approach and focus on aspects of control, or controlling or decisive influence (referred to in this note as control), where "control" is often a defined term. The key elements of control include actual control or capacity to control, either directly or indirectly, financial and operating policy and decision-making. Where the definition includes capacity to control, it generally envisages a passive potential for control, rather than focusing upon control that is actively exercised. Control may be obtained by ownership of assets, or through rights or contracts that give the controlling party the capacity to control. What is important is not so much the strict legal form of the relationship, such as parent-subsidiary, between the entities, but rather the substance of that relationship.

33. Factors that might indicate the existence of control of one entity by another could include: the ability to dominate the composition of the board of directors or governing body of the second entity; the ability to appoint or remove all or a majority of the directors or governing members of the second entity; the ability to control the majority of the votes cast at a meeting of the board or governing body of the second entity; and the ability to cast or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the second entity, irrespective of whether that capacity arises through shares or options. Information that may be relevant to consideration of these factors might include: the group member's incorporation documents; details about the member's shareholding; information relating to substantive strategic decisions of the member; internal and external management agreements; details of bank accounts and their administration and authorized signatories; and information relating to employees.

E. Regulation of enterprise groups

34. Regulation of enterprise groups is generally based on one of two approaches or in some cases on a combination of the two: the separate entity approach (which is the traditional approach and by far the most prevalent) and the single enterprise approach.

35. The separate entity approach relies on several basic principles, foremost of which is the separate legal personality of each group company. It is also based upon the limited liability of shareholders of each group company and the duties of directors of each separate group entity to that entity.

36. The separate legal personality of a corporation generally means that it has its own rights and duties, irrespective of who controls it or owns it (i.e., whether it is wholly or partly owned by another company) and its participation in the activities of the enterprise group. The debts it incurs are its debts and the assets of the group generally cannot be pooled[16] to pay for these debts. Contracts entered into with external persons do not automatically involve the parent company or other group members. A parent company cannot take into account the undistributed profits of other group companies in determining its own profits. Limited liability of a corporation means that unlike in a partnership or sole proprietorship, enterprise group members have no liability for the group's debts and obligations, with the result that potential losses cannot exceed the amount contributed to the group member by purchasing shares.

37. The single enterprise approach, in comparison, relies upon the economic integration of enterprise group members, treating the group as a single economic unit that operates to further the interests of the group as a whole, or of the dominant corporate body, rather than of individual members. Borrowing may be conducted on a group basis, with group treasury arrangements being used to offset the credit and debit balances of each group member; group members may be permitted to operate at a loss, or be undercapitalized, as part of the overall group financial structure and strategy; assets and liabilities may be moved between group members in various ways; and intra-group loans, guarantees or other financial arrangements may be entered into on essentially preferential terms.

38. While many countries follow the separate entity approach, there are some countries that recognize exceptions to strict application of that approach and others that have introduced, either by legislation or through the courts, a single enterprise approach that applies to certain situations.

39. Some of the circumstances in which strict application of the separate entity approach has been overridden may include: consolidation of enterprise group accounts for a company and any controlled entity; related person transactions (where a public company is otherwise prohibited from giving any financial benefit, including intra-group loans, guarantees, indemnities, releases of debt or asset transfers, to a related company unless that transaction is approved by shareholders or is otherwise exempt); cross-shareholding (where group members are generally prohibited from acquiring, or taking a security over, the shares of any controlling member or issuing or transferring their shares to any controlled member); and

[16] See below, paras. 143-172 for a discussion of substantive consolidation.

insolvent trading (where a parent company which ought to suspect the insolvency of a subsidiary can be made liable for the debts of that subsidiary incurred when it was insolvent).

40. A few countries have established various categories of enterprise groups that can operate as a single enterprise, in exchange for enhanced protection of creditors and minority shareholders. In one,[17] enterprise group structures involving public companies are divided into three categories: (a) integrated groups; (b) contract groups; and (c) de facto groups, to which a set of harmonized single enterprise principles dealing with corporate governance and liability applies:

(a) Integrated groups are based upon a vote, by a specified proportion of shareholders of the parent company, which in turn owns a specified proportion of the shares of the subsidiary, to approve the complete integration of the subsidiary. The parent company will have unlimited power to direct the subsidiary, in return for the parent company being jointly and severally liable for the debts and obligations of the subsidiary;

(b) Contract groups can be formed by a specified proportion of shareholders of each of two companies entering into a contract that grants one company (the parent) the right to direct the other company, provided the directions are consistent with the interest of the parent company or the group as a whole. In return for giving the parent company the right of control, minority shareholders and creditors are given enhanced protection; and

(c) De facto groups are those where one company exercises, either directly or indirectly, a dominant influence over another company. Although not created by any formal arrangement, there must nevertheless be systematic involvement by the parent in the affairs of the controlled company.

41. In one country[18] where single enterprise principles have been introduced into corporate legislation, directors of wholly or partly owned subsidiaries may act in the interests of the parent company rather than their subsidiary company; there are provisions for streamlined group mergers; and legislation also permits contribution and pooling orders.

42. In another country,[19] commercial regulatory laws affecting enterprise groups increasingly use single enterprise principles to ensure that the policy underlying specific commercial legislation cannot be undermined or avoided by the use of enterprise groups. The courts have assisted in this development, selectively introducing the single enterprise concept to achieve the underlying policies of the legislation. The concept has been applied to insolvency law to avoid specified intra-group transactions, to support intra-group guarantees and in limited cases, to achieve substantive consolidation. The courts also have the power to alter the priority of claims in the liquidation of a group entity, either by treating some intra-group loans to that entity as equity rather than debt, or by subordinating intra-group loans to that entity to the claims of its external creditors.

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[17] Germany.
[18] New Zealand.
[19] USA.

II. Addressing the insolvency of groups: domestic issues

A. Introduction

43. Enterprise groups may be structured in ways that minimize the threat of insolvency to one or more group members, by entering into cross-guarantees, indemnities and similar types of arrangements. Where problems do arise, a parent or controlling group member may seek to avoid the insolvency of other 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 external liabilities.

44. However, if the complexity of an enterprise group's structure is disturbed by the onset of financial difficulty affecting one or more, or even all of the group members 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, as noted above, the great majority of domestic insolvency and corporate laws do not address the insolvency of enterprise 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 group members is closely integrated, that approach may not always achieve the best result for the individual debtor or for the business of the group as a whole, unless the multiple, parallel proceedings can be closely coordinated.

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

46. A second key issue in the treatment of enterprise groups in insolvency is the degree to which the group is economically and organizationally integrated and how that level of integration might affect treatment of the group in insolvency and in particular, the extent to which a highly integrated group should be treated differently to a group where individual members retain a high degree of independence. In some cases, where for example the structure of a group is diverse, involving unrelated businesses and assets, the insolvency of one or more group members 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 group member 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 circumstances, it might often be the case that the insolvency of several or many group members would lead inevitably to the insolvency of all members (the "domino effect") and there may be some advantage in judging the imminence of the insolvency by reference to the group situation as a whole or coordinating that consideration with respect to multiple members.

B. Application and commencement

47. General considerations with respect to application for and commencement of insolvency proceedings are discussed above in part two, chapters I and II. Since those chapters apply equally to individual enterprise group members, they should be considered in conjunction with the additional issues specific to enterprise groups discussed below.

1. Joint application for commencement

(a) Background

48. As a general rule, insolvency laws respect the separate legal status of each enterprise group member and a separate application for commencement of insolvency proceedings is required to be made for each of those members that satisfy the standard for commencement of insolvency proceedings and are covered by the insolvency law (see recommendation 10). There are some limited exceptions that allow a single application to be extended to other group members where, for example, all interested parties consent to the inclusion of more than one group member; the insolvency of one group member has the potential to affect other group members; the parties to the application are closely economically integrated, such as by intermingling of assets or a specified degree of control or ownership; or consideration of the group as a single entity has special legal relevance, especially in the context of reorganization plans.

49. The recommendations of the *Legislative Guide* concerning application for and commencement of insolvency proceedings would apply to debtors that are enterprise group members in the same manner as they apply to debtors that are individual commercial enterprises. Recommendations 15 and 16 establish the standards for debtor and creditor applications for commencement of insolvency proceedings and form the basis upon which an application could be made for each group member that satisfied those standards, including imminent insolvency in the case of an application by a debtor. In the enterprise group context, the insolvency of a parent or controlling group member may affect the financial stability of a subsidiary or controlled member or the insolvency of a number of such members might affect the solvency of others, so that insolvency is imminent more widely across the group. That situation is likely to be covered by the terms of recommendation 15 if, at the time of the application with respect to the insolvent group members, it could be said of the other group members that they would be unable to pay their debts as they mature.

(b) Purpose of a joint application

50. Permitting those group members that satisfy the commencement standard to make a joint application for commencement of insolvency proceedings would facilitate the coordinated consideration of those applications by the court, without affecting the separate identity of the applicants or removing the need for each one to individually satisfy the applicable commencement standard. It would also alert the court to the existence of a group, particularly if the application were to be accompanied by information substantiating the existence of the group and the relationship between the debtors and, where proceedings subsequently commenced

on the basis of that joint application, would have the advantage of establishing a common commencement date for relevant group members.

51. Such a joint application might include, where permitted under the law and feasible in the circumstances, a single application covering all group members that satisfy the commencement standard or parallel applications made at the same time in respect of each of those members. The latter approach may be appropriate where the group members are not located in the same domestic jurisdiction and different courts have competence (as discussed below) or where other circumstances of the case, such as that there is a significant number of proceedings to be coordinated, suggest that a single application would not be practical. In both cases, the insolvency law should facilitate the court undertaking a coordinated consideration of whether the commencement standards with respect to the individual group members are satisfied, taking into account the group context where relevant.

(c) Joint application and procedural coordination distinguished

52. The making of a joint application for commencement of insolvency proceedings should be distinguished from what is referred to below as procedural coordination. The purpose of permitting a joint application is to facilitate coordination of commencement considerations and potentially reduce costs. Commencement of multiple proceedings on the basis of a joint application should also facilitate coordination of those proceedings; the commencement date, and any other dates calculated by reference to that date, such as those relating to the suspect period, would be the same for each member. Permitting a joint application is not intended to predetermine how, if the proceedings commence, they will be administered and, in particular, whether they will be subject to procedural coordination. Nevertheless, a joint application for commencement might include an application for procedural coordination, as noted below, and might facilitate the court taking a decision on procedural coordination.

(d) Including a solvent group member in a joint application

53. A question that is often discussed in the group context is whether a solvent group member can be included in an application for commencement of insolvency proceedings with respect to other group members and if so, in what circumstances. Where a group member appears to be solvent, but further investigation shows insolvency to be imminent, inclusion of that member in the application would be covered by recommendation 15 of the *Legislative Guide*, as noted above.

54. Where the question is not one of imminent insolvency and the group member is clearly solvent, different approaches may be taken. Where a group is closely integrated, an insolvency law may permit an application for commencement to include group members that do not satisfy the commencement standard, on the basis that it is desirable in the interests of the group as a whole that those members be included in the proceedings. Factors relevant to determining whether the necessary degree of integration exists might include: the relationship between the group members that is variously described, but involves, for example, a significant degree of interdependence or control; intermingling of assets; unity of identity, reliance on management and financial support or other similar factors that need not necessarily arise from the legal relationship (such as parent-subsidiary) between the group

members. A further situation in which including a solvent group member in a joint application might be appropriate is where the existence of a "group" is fictitious.

55. Such an approach may facilitate development of an insolvency solution for the whole group, avoiding piecemeal commencement of proceedings over time, if and when additional group members became affected by the insolvency proceedings initiated against the originally insolvent members. It could also facilitate the preparation of a comprehensive reorganization plan, addressing the assets of both solvent and insolvent group members.

56. One of the problems with including a solvent group member, however, is that the insolvency law will generally only cover those entities properly regarded as satisfying the standard for commencement of insolvency proceedings. A solvent group member may, however, be voluntarily included in a reorganization plan, where a commercial decision is taken by that member that it should participate in the plan (see below, para. 184).

57. A joint application for commencement might also be permitted where all interested group members consent to the inclusion of one or more other members, whether they are insolvent or not, or all parties in interest, including creditors, so consent. An insolvency law might also consider whether a group member not involved at the time of commencement of insolvency proceedings against other group members might later be joined in those proceedings if it is subsequently affected by those proceedings or it is determined that its joinder would be in the interests of the group as a whole.

(e) Persons permitted to make a joint application

58. Consistent with the approach of recommendation 14 of the *Legislative Guide*, an insolvency law may permit a joint application to be made by two or more enterprise group members that satisfy the commencement standard of the insolvency law. It might also be made by any creditor with respect to the group members of which it is a creditor. Permitting a creditor to make an application with respect to group members of which it is not a creditor would be inconsistent with the commencement standard of recommendation 14.

(f) Competent courts

59. A joint application for commencement with respect to two or more enterprise group members may raise issues of jurisdiction, even in the domestic context, if those group members are located in different places with different courts potentially being competent to consider the application. This may occur, for example, in respect of a group operating nationally in States where jurisdiction for insolvency matters lies with courts in different places or applications for commencement may be made in different courts. Some laws may allow a joint application for commencement to be handled by a single court. Although that approach is desirable, it will ultimately be a question of whether domestic law permits joint applications involving different debtors (albeit members of the same group) in different jurisdictions or courts to be treated in such a way. Various criteria might be relevant to determining the appropriate court for handling such an application. It might, for example, be the court with competence to administer insolvency proceedings with respect to the parent or controlling member of a group, where that member is included in the

application. Other criteria, such as the size of indebtedness of the various group members or the centre of control of the group might also be chosen to establish the prevailing competence of one court in the domestic setting. Creditors of different group members might also be located in different places, raising issues of representation and the location in which creditor committees would meet or be constituted.

60. The fees payable and other associated procedural issues arising out of a joint application for commencement may need to be addressed.

61. Although the issue of which court is competent to consider a joint application for commencement where the subject group members are located in different domestic jurisdictions might be addressed by law other than the insolvency law, it is desirable that the approach of recommendation 13 of the *Legislative Guide* be followed. This would require the insolvency law to clearly indicate or include a reference to the relevant law that establishes the court with jurisdiction over such an application. Adoption of that approach should make it clear to all relevant parties where and how such an application can be pursued.

(g) Notice of application

62. The recommendations of the *Legislative Guide* with respect to notification of an application for commencement of insolvency proceedings would apply to a joint application. A joint application by a creditor should be notified to the group members that are the subject of the application in accordance with recommendation 19 (a). Where group members make a joint application, notice would not be required until proceedings commenced on the basis of that application, in accordance with recommendation 22.

Recommendations 199-201

Purpose of legislative provisions

The purpose of provisions on joint application [20] for commencement of insolvency proceedings with respect to two or more enterprise group members is:

(a) To facilitate coordinated consideration of an application for commencement of insolvency proceedings with respect to those enterprise group members;

(b) To enable the court to obtain information concerning the enterprise group that would facilitate determination of whether commencement of insolvency proceedings with respect to those group members should be ordered;

(c) To facilitate efficiency and reduce the costs associated with commencement of those insolvency proceedings; and

(d) To provide a mechanism [21] for the court to assess whether procedural coordination of those insolvency proceedings would be appropriate.

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[20] A joint application for commencement does not affect the legal identity of each group member included in the application; each member remains separate and distinct.

[21] A joint application is not a pre-requisite for procedural coordination, but may facilitate the court's consideration of whether an order for procedural coordination should be made.

Contents of legislative provisions

Joint application for commencement of insolvency proceedings

199. The insolvency law may specify that a joint application for commencement of insolvency proceedings may be made with respect to two or more enterprise group members, each of which satisfies the applicable commencement standard.[22]

Persons permitted to apply

200. The insolvency law should specify that a joint application may be made by:

(a) Two or more enterprise group members, each of which satisfies the applicable commencement standard in recommendation 15; or

(b) A creditor, provided it is a creditor of each group member that is to be included in the joint application.

Competent courts

201. For the purposes of recommendation 13, the words "commencement and conduct of insolvency proceedings, including matters arising in the course of those proceedings" include a joint application for commencement of insolvency proceedings with respect to two or more enterprise group members.[23]

2. Procedural coordination

(a) Purpose of procedural coordination

63. Procedural coordination is intended to promote procedural convenience and cost-efficiency and may facilitate comprehensive information being obtained on the business operations of the group members subject to the insolvency proceedings; assist the valuation of assets and the identification of creditors and others with legally recognized interests; and avoid duplication of effort. Procedural coordination refers to what may in practice be varying degrees of coordination with respect to the administration of multiple insolvency proceedings commenced with respect to two or more enterprise group members involving, possibly, one or more courts. Although administered in a coordinated manner, the assets and liabilities of each group member involved in the procedural coordination remain separate and distinct, thus preserving the integrity of the individual enterprises of the group and the substantive rights of claimants. Accordingly, the effect of procedural coordination is limited to administrative aspects of the proceedings and does not touch upon substantive issues. The scope of an order for procedural coordination would generally be determined by the court in each case.

64. Multiple proceedings may be streamlined in various ways through an order for procedural coordination, facilitating sharing of information to obtain a more

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[22] See above, recommendation 15, which addresses debtor applications and recommendation 16, which addresses creditor applications for commencement.

[23] Recommendation 13 provides: The insolvency law should clearly indicate (or include a reference to the relevant law that establishes) the court that has jurisdiction over the commencement and conduct of insolvency proceedings, including matters arising in the course of those proceedings. The criteria that might be relevant to determining the competent court are discussed in the commentary, see above, para. 59.

comprehensive picture of the situation of the various debtors; combining of hearings and meetings, including joint meetings of creditors; preparation of a single list of creditors and other parties in interest for the provision of notice and coordination of the provision of notice; establishment of joint deadlines; agreement on a joint claims procedure and coordinated sale of assets; coordination of avoidance proceedings; and the holding of single creditor meetings or coordination among creditor committees. Streamlining may also be facilitated by the appointment of a single or the same insolvency representative to administer the insolvency proceedings or by ensuring coordination between insolvency representatives where two or more are appointed (see below, paras. 173-177). It may also involve cooperation between two or more courts or, when permitted by domestic law, administration of the multiple proceedings concerning group members in a single court.

65. Where two or more courts are involved, cooperation between them might include, for example, coordinating the holding of hearings, including joint hearings, and sharing and disclosure of information. As noted below with respect to cross-border cooperation (see part three, chap. III, paras. ...), joint or coordinated hearings may significantly promote the efficiency of parallel insolvency proceedings involving members of an enterprise group by bringing relevant stakeholders together at the same time to discuss and resolve outstanding issues or potential conflicts, thus avoiding protracted negotiations and resulting time delays. Such hearings would generally involve two or more courts holding hearings at the same time with provision for simultaneous communication so that parties can at least hear and preferably see the proceedings in each court. These hearings may be relatively more convenient to organize in a domestic setting, as they would not generally involve the challenges posed by different languages, time zones, laws, procedures and judicial traditions that may occur in the cross-border context. However, as in the international context, the conduct of such hearings might require the use of common procedures and agreement, for example, as to how filing of documents and submission of information is to be handled between different courts.

66. Various factors might be relevant to considering whether procedural coordination is appropriate in a particular case. These may relate, for example, to information substantiating the existence of the group and identifying the linkages between group members, including the position in the group of each member covered by the application, particularly where one of them was the controlling group member or parent. Although the provision of such detail might be onerous in cases where creditors are permitted to apply for procedural coordination, the essence of the application is that the debtors are group members and the court would generally need to be satisfied as to that relationship when determining whether proceedings should commence and procedural coordination be ordered.

(b) Creditor participation

67. With respect to creditor participation, the interests of creditors of the different group members have the potential to diverge and it is unlikely that those interests could be represented in a single committee. It may be, however, that in cases of procedural coordination involving many group members, establishing a separate committee for the creditors of each member might prove to be extremely costly and inefficient for administration of the proceedings. For that reason, the courts in some

States have the discretion not to establish a creditor committee for each separate entity in appropriate circumstances. Accordingly, the general principle may be that it is desirable that the insolvency law permit a single creditor committee to be established in suitable cases.

(c) Timing of application

68. Since the benefits to be derived from procedural coordination may be apparent at the time an application for commencement is made or may arise after proceedings have commenced, it is desirable that an insolvency law adopt a flexible approach to the timing of an application for procedural coordination. An application might therefore be made at the same time as an application for commencement of proceedings or at any subsequent time. However, since the goal of procedural coordination is to coordinate the administration of multiple proceedings, the feasibility of making an order at a late stage of the proceedings would be limited, in practice, by the usefulness of so doing. In other words, there may be little advantage in seeking to coordinate proceedings that are almost completed. The same approach might apply to adding group members to an existing order for procedural coordination where those additional members became insolvent at a later time.

69. An insolvency law might adopt the approach of stipulating a time limit for applying for procedural coordination to provide a degree of certainty. However, as is generally the case with any consideration of the need for a time limit, the advantages of establishing such a limit must be weighed against the potential disadvantages of inflexibility and the need to ensure that the time limit is properly observed.

(d) Persons permitted to apply

70. It is desirable that procedural coordination be as widely available as possible and that the court be given the discretion to consider whether coordination of the various proceedings would advantage their administration. The court may consider whether to order procedural coordination on its own initiative, particularly to address situations it is determined that procedurally coordinating the proceedings would be in the best interests of the enterprise group and facilitate administration, but no application for procedural coordination is forthcoming from a party authorized to do so. The court might also order procedural coordination in response to an application from authorized parties, such as any group member subject to insolvency proceedings, the insolvency representative of a member, who would generally possess the information most relevant for making such an application, or a creditor.

71. In the case of creditors, the eligibility limitation that applies with respect to an application for commencement of insolvency proceedings should not necessarily apply. Where the application for procedural coordination is made at the time of the application for commencement, the issue of commencement might be treated separately from that of procedural coordination. Similarly, once proceedings have commenced, there is no reason to limit the ability to apply for procedural coordination to those creditors who are creditors of the members to be coordinated – the decision to order procedural coordination should not be conditioned upon the status of the creditor applying.

(e) Competent courts

72. Procedural coordination may also raise the issues of jurisdiction noted above with respect to joint applications for commencement (see above, paras. 59-61), where different domestic courts have competence over the various group members subject to insolvency proceedings. In jurisdictions where those issues arise, they would generally be determined by reference to domestic procedural law. In some States, different proceedings may be consolidated or transferred to a single court, for example, the court with competence to administer insolvency proceedings with respect to the parent of a group. A range of other criteria, such as priority of filing, size of indebtedness or centre of control, might also be chosen to establish the prevailing competence of one court in the domestic setting. A key element of consolidating or transferring proceedings to a single court would be establishing communication between the courts involved prior to that transfer. Creditors of different group members might also be located in different places, raising issues of representation and the location in which creditor committees would meet or be constituted.

73. Although these issues might be addressed by law other than the insolvency law, it is desirable, as noted above with respect to joint applications (see para. 61), that the approach of recommendation 13 be followed. That would require the insolvency law to clearly indicate or include a reference to the relevant law that establishes the court with jurisdiction over an application for procedural coordination.

(f) Notice with respect to procedural coordination

74. An application for procedural coordination may be subject to the same requirements for giving of notice as an application for commencement of proceedings under the *Legislative Guide* (see recommendations 19, 22-24). When made at the same time as the application for commencement of proceedings, only an application for procedural coordination by creditors would require notice to be given to the relevant debtors, consistent with recommendation 19.

75. An application made at that time by group members should not require creditors to be notified, consistent with recommendations 23-24, but relevant information, such as the content or implications of the order, could be included with the notice of commencement of proceedings.

76. When an application for procedural coordination is made subsequent to commencement of proceedings, it may be appropriate to provide notice to creditors, notwithstanding that procedural coordination does not affect the substantive rights of creditors. The provision of notice may be particularly important where the law makes provision, as noted above, for cases commenced in different jurisdictions to be transferred to, or administered by, a single court and that transfer may affect procedural aspects of the proceedings of interest to creditors, such as the location of meetings of a creditor committee or the place for submission of claims.

77. Provision of notice to all creditors may be satisfied with collective notification, such as by notice in a particular legal publication, when domestic legislation so permits and when appropriate, for instance, in the case of a large number of creditors with very small claims. In addition to the information required by the recommendations above addressing provision of notice on commencement of proceedings (recommendation 25), notice of an order for procedural coordination

might include the terms of the order and information relevant to, for example, coordination of hearings and meetings, and arrangements to be made with respect to lending.

(g) Modifying or terminating an order for procedural coordination

78. Given that the purpose of procedural coordination is to promote administrative convenience and cost-efficiency, an insolvency law may include provisions relating to modification or reversal of an order to accommodate changed circumstances. That approach might be appropriate when, for example, a coordinated reorganization is not successful and the individual members should be liquidated separately. Reversal of an order, although rarely required, should be possible as the initial order is not intended to affect substantive rights. As a safeguard, the insolvency law could provide that reversal or modification would be possible, provided it was without prejudice to actions already taken or rights affected by the initial order.

Recommendations 202-210

Purpose of legislative provisions

The purpose of provisions on procedural coordination of insolvency proceedings with respect to two or more enterprise group members is:

(a) To facilitate coordination of the administration of those insolvency proceedings, while respecting the separate legal identity of each group member; and

(b) To promote cost-efficiency and a better return to creditors.

Contents of legislative provisions

Procedural coordination of two or more insolvency proceedings

202. The insolvency law should specify that the administration of insolvency proceedings with respect to two or more enterprise group members may be coordinated for procedural purposes.

203. The insolvency law should specify that, at the request of a person permitted to make an application under recommendation 206 or on its own initiative, the court[24] may order procedural coordination.

204. Procedural coordination may involve, for example, joint provision of notice; coordination of procedures for submission and verification of claims; appointment of a single or the same insolvency representative; coordination of avoidance proceedings; cooperation between the courts, including coordination of hearings; and cooperation between insolvency representatives, including information sharing and coordination of negotiations. The scope and extent of the procedural coordination [in each case] should be specified by the court.

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[24] Coordination might involve different courts competent with respect to different group members or a single court that is competent with respect to a number of different insolvency proceedings concerning members of the same group. Accordingly, an order for procedural coordination may require action by more than one court.

Application for procedural coordination

– *Timing of application*

205. The insolvency law should specify that an application for procedural coordination may be made at the time of an application for commencement of insolvency proceedings or at any subsequent time.[25]

Persons permitted to apply

206. The insolvency law should specify that an application for procedural coordination may be made by:

(a) An enterprise group member that is subject to an application for commencement of insolvency proceedings or subject to insolvency proceedings;

(b) The insolvency representative of an enterprise group member; or

(c) A creditor [26] of an enterprise group member that is subject to an application for commencement of insolvency proceedings or subject to insolvency proceedings.

Coordinating consideration of an application

207. The insolvency law should specify that the court[27] may take appropriate steps to coordinate with any other competent court consideration of an application for procedural coordination of insolvency proceedings concerning two or more enterprise group members. Those steps might involve, for example, coordinated proceedings; joint hearings; sharing and disclosure of information.

Modification or termination of an order for procedural coordination

208. The insolvency law should specify that an order for procedural coordination may be modified or terminated, provided that any actions or decisions already taken pursuant to the order should not be affected by the modification or termination. Where more than one court is involved in ordering procedural coordination, those courts may take appropriate steps to coordinate modification or termination of the procedural coordination.

Competent courts

209. For the purposes of recommendation 13, the words "commencement and conduct of insolvency proceedings, including matters arising in the course of those proceedings" include applications and orders for procedural coordination of insolvency proceedings with respect to two or more enterprise group members.[28]

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[25] The impracticability of ordering procedural coordination at an advanced stage of the insolvency proceedings is discussed in the commentary; see above, paras.68-69.

[26] To be eligible to make an application for procedural coordination, a creditor does not have to be a creditor of all the group members in respect of which it is seeking procedural coordination.

[27] See note 23 above.

[28] The criteria that might be relevant to determining the competent court are discussed in the commentary, see above, para.59 and note 23.

Notice of procedural coordination

210. The insolvency law should establish requirements for giving notice with respect to applications and orders for procedural coordination and modification or termination of procedural coordination, including the scope and extent of the order; to whom notice should be given; the party responsible for giving notice; and the content of the notice.

C. Treatment of assets on commencement of insolvency proceedings

79. The manner in which the commencement of insolvency proceedings affects the debtor and its assets is discussed in detail above (see part two, chap. II). 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.

1. Protection and preservation of the insolvency estate

(a) Application of the stay to a solvent group member

80. As noted above (see part two, chap. II, para. 26), 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 recommendations 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).

81. 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 is 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 with respect to which applications for commencement have been made or insolvency proceedings have commenced.

82. Extension of the stay to include the solvent member 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 from seeking to enforce an agreement against a solvent group member, where that enforcement might affect the liability of another member subject to an application for insolvency proceedings; and to restrain enforcement of a security

interest against assets of a solvent member that are central to the business of the group, including the business of group members subject to an application for insolvency proceedings. Extension of the stay in these cases 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 group member established to hold certain assets or obligations.

83. In some States, ordering insolvency-related relief with respect to a solvent group member (not included in insolvency proceedings) might not be possible as it would 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 with respect to 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.

84. These measures might be covered by recommendation 48, which provides for the court to grant relief in addition to any relief that might be applicable automatically on commencement of insolvency proceedings (as 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.

85. Measures might also be available on a provisional basis. Recommendation 39 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".

86. Protection for the interests of the creditors, both secured and unsecured, of the solvent group member, might also be found in the relevant recommendations above. 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.

87. Where a secured creditor is a member of the same enterprise group as the debtor or debtors, a different approach to the question of protection might be required, especially where the insolvency law permits substantive consolidation or subordination of related person claims (see below, paras.121-126).

(b) Post-application finance

88. The discussion on post-commencement finance in part two, chapter II 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.

89. The same need for finance also occurs in the period between the time an application for commencement of insolvency proceedings is made and commencement of those proceedings (referred to as post-application finance). When an enterprise group member becomes insolvent and makes an application for commencement of insolvency proceedings, that application often triggers an event of default under existing loan agreements, entitling the lender to discontinue advancing funds under those agreements. Where an insolvency law does not provide for automatic commencement of insolvency proceedings upon application, it can often take a period of several months between the making of an application and the commencement of the proceedings, during which time, the courts must make an independent evaluation as to whether the debtors subject to the application meet the statutory criteria to commence proceedings. However, if the group member is to continue as a going concern while this determination is being made, it must be able to continue to conduct its business, pay its employees, pay its suppliers and generally continue its day-to-day activities. The availability or lack of financing during this interim period can determine or significantly influence whether reorganization will ultimately be a viable option or whether liquidation will be required.

90. As noted above (part two, chap. II, para. 96), in the absence of enabling or clarifying treatment in the insolvency law, the provision of finance in this period before commencement of the insolvency proceedings may raise difficult questions relating to the application of avoidance powers and the liability of both the lender and the debtor. 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.

91. The existence of a provision under the insolvency law enabling finance to be obtained for the period of time between the making of an application and the commencement of the proceedings would provide the necessary authorization and give any existing or new lender the assurance and incentive necessary to provide additional financing to cover that period.

92. Recommendation 39 permits the court to order provisional measures to preserve the assets of the debtor prior to the commencement of insolvency proceedings, where those measures are needed to protect those assets and the interests of creditors. Since those measures could include authorizing post-application, the provision of that finance should therefore be regarded as being within the purview of recommendation 39.

2. Use and disposal of assets

93. It is noted above (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.

94. 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, which addresses the use of third-party owned assets in the possession of the debtor, may be sufficient.

95. 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 in possession of those assets is included in the insolvency proceedings or the provisions of a group reorganization plan should cover the assets (see below, para. 184, for a discussion of the inclusion of a solvent group member in a reorganization plan). Where the solvent group member is not included in the proceedings, the question will be whether those assets can be used to support 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.

3. Post-commencement finance

(a) The need for post-commencement finance

96. The discussion on post-commencement finance above in part two, chapter II (see paras. 94-95) 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. It is also noted, 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.

97. Post-commencement finance may be even more important in the group context than it is in the context of individual insolvency 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. 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 issues may include: balancing the interests of individual enterprise group members with what is required for the reorganization of the group as a whole; provision of post-commencement finance by solvent group members, especially in cases where issues of control might arise (such as where that solvent member is 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 other 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.

98. Recommendations 63-68 aim to promote the availability of finance for continued operation or survival of the debtor's business and ensure appropriate protection for the providers of post-commencement finance, as well as for other parties whose rights may be affected by the provision of post-commencement finance. In the enterprise group context, these recommendations would apply to post-commencement finance provided by both lenders external to the group and solvent members of the group.

(b) Sources of post-commencement finance in a group context

99. As noted above in part two, chapter II (see para. 99), post-commencement finance is likely to come from a limited number of sources. In the enterprise group context, that might include sources both external and internal to the group, where internal sources might include both solvent group members and group members already subject to insolvency proceedings. While some of the incentives for providing post-commencement finance might be the same for internal and external lenders, internal lenders may have the added inducement of their own survival where they are to be part of a reorganization.

(i) Provision of post-commencement finance by a solvent group member

100. 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 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, particularly where it is closely integrated with or reliant upon insolvent members for ongoing business activity. Different types of solvent entities, such as special purpose entities with few liabilities and valuable assets, might be involved in different ways in the insolvency of other group members, such as granting a guarantee or security interest to insolvent group members to help obtain new finance.

101. However, use of the assets of a solvent group member in that way, especially where that solvent member is likely to become, or subsequently becomes, insolvent, raises a number of questions. While the solvent entity might 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 ultimately may be regulated by the insolvency law. Questions may arise, for example, as to: whether a solvent group member would be entitled to the priority provided by recommendation 64 if it provided funding to an insolvent group member; whether the claim arising from that transaction would be subject to special treatment because the transaction occurred between related parties pursuant to recommendation 184; or whether such a transaction might be considered a preferential transaction in any subsequent insolvency of the member providing the finance. Under some laws, providing such finance may be prohibited as constituting a transfer of the assets of a solvent entity to an insolvent entity to the detriment of the creditors and shareholders of the solvent entity.

102. 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 external finance providers, could participate on a contractual basis. While there might be situations in which that approach would be appropriate, the requirement for post-commencement finance at any early stage of the insolvency proceedings – in reorganization proceedings, before a plan could be negotiated and, in cases such as liquidation on a going concern basis, where there would be no reorganization plan – suggests it is likely to be of limited application.

103. Recommendation 63 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 its authorization (by the court or by creditors). Those requirements remain relevant in the context of enterprise groups and for the avoidance of doubt, recommendation 63 should be interpreted as applying to a group member subject to insolvency proceedings that obtains post-commencement finance from either an external lender or a solvent member of the same group. What recommendation 63 does not address is a group member subject to insolvency proceedings providing post-commencement finance directly to another group member or facilitating its provision by way of security interest or guarantee.

(ii) Provision of post-commencement finance by an insolvent group member

104. Provision of post-commencement finance by one group member subject to insolvency proceedings to another such member is not directly addressed elsewhere in the *Guide*. Some of the general prohibitions 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 (see above, para. 96). The policy rationale for these prohibitions is likely to be even more evident when both the lender and the borrower are not only insolvent and subject to insolvency proceedings, but also members of the same enterprise group. The group context may also raise concerns with respect to the duties and obligations of the insolvency representative, when the insolvency representative of one insolvent

group member seeks to facilitate the provision of post-commencement finance to another insolvent group member.

105. 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 or to provide support for its provision, there may be circumstances, albeit potentially limited, where it would be both possible, and desirable, particularly when the interests of the enterprise group are 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 group members, it is desirable that it be balanced against the prospect that preservation of going concern value by the continued operation of the business will ultimately provide benefit to those creditors. A balance might also be desirable between sacrificing one group member for the benefit of other members and achieving a better overall result for all members. Although potentially difficult to achieve, the goal might be fair apportionment of any harm that arises 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 involved in the post-commencement finance.

Conflict of interest

106. The provision of finance in the group context raises issues concerning possible prejudice and conflict of interest that are not relevant in the case of a single debtor. A conflict of interest might arise, for example, in balancing the interests of the group as a whole against the potentially different interests of the lender and the receiver of post-commencement finance, particularly 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 in several ways in the insolvency law, such as by requiring court or creditor approval of the post-commencement finance or by appointing one or more additional insolvency representatives to ensure the interests of the creditors of the different group members are protected (see below, paras. 173-178). The appointment might be to address that specific conflict or on more general terms for the duration of the proceedings.

107. There is also the question of whether an insolvent group member might, as part of the financing arrangements of the enterprise group as a whole, be requested to guarantee finance provided to a solvent group member. Since the provision of that guarantee is likely to constitute a disposal of the assets of the insolvent group member, it would probably be covered by the recommendations addressing that issue (see recommendations 52-62).

(iii) Priority for post-commencement finance

108. Recommendation 64 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 those circumstances, it might be necessary to consider whether the level of priority accorded by recommendation 64 would be appropriate. One view might be that that level of priority provides appropriate incentive for the provision of finance and affords appropriate protection to the creditors of the provider. Another view might be that because of the related person 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), suggest the desirability of according a lower priority 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.

(iv) Security for post-commencement finance

109. Recommendations 65-67 address issues relating to the granting of security for post-commencement finance and generally would be applicable in the enterprise group context. A group member subject to insolvency proceedings may grant a security interest of the type referred to in recommendation 65 to secure post-commencement finance it has obtained for its own use. That situation is covered by recommendations 65-67. A group member subject to insolvency proceedings may also grant a security interest of the type referred to in recommendation 65 to secure repayment of post-commencement finance provided to another group member subject to insolvency proceedings. In the latter situation, 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 when the provision of the 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.

110. To parallel the requirements of recommendation 63 with respect to the receiving group member, it might be desirable to require the insolvency representative of the providing group member to determine that the provision of the post-commencement finance is necessary for the continued operation or survival of the business of that group member or the preservation or enhancement of the value of its estate. An additional requirement might be that any harm to creditors of the providing group member must be offset by the benefit to be derived from the granting of the security interest.

111. Consistent with recommendation 63, the insolvency law might also require the court to authorize or creditors of the providing group member to consent to the post-commencement finance. 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 advantages and disadvantages of the different considerations with respect to authorization that would also apply in

the group context are discussed above (see part two, chap. II, paras. 105-106). 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.

112. 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.

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

113. 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 elsewhere in the *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 with respect to the determinations to be made by the insolvency representative and the possible authorization by the court or consent of creditors.

[Recommendations from A/CN.9/671, para. 95]

Recommendations 211-216

Purpose of legislative provisions

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

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

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

(c) To ensure appropriate protection for the providers and receivers 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 the benefit and detriment associated with the provision of post-commencement finance among all group members involved.

Contents of legislative provisions[29]

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

[211. 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) Grant a security interest over its assets for post-commencement finance provided to another enterprise group member subject to insolvency proceedings; and

(c) Provide a guarantee or other assurance of repayment for post-commencement finance provided to another enterprise group member subject to insolvency proceedings.]

[212. The insolvency law should specify that post-commencement finance may be [provided] [advanced or facilitated] in accordance with recommendation 211, where the insolvency representative of the group member advancing finance, granting a security interest or providing a guarantee or other assurance:

(a) Determines it to be necessary for the continued operation or survival of the business of that enterprise group member;

(b) Determines it to be necessary for the preservation or enhancement of the value of the estate of that enterprise group member; and

(c) Determines [in accordance with the insolvency law] that any harm to creditors is offset by the benefit to be derived from advancing finance, granting a security interest or providing a guarantee or other assurance.]

[213. The insolvency law may require the court to authorize or creditors to consent to the provision of post-commencement finance in accordance with recommendations 211 and 212.]

Post-commencement finance obtained by a group member subject to insolvency proceedings from another group member subject to insolvency proceedings

[214. The insolvency law should specify that in accordance with recommendation 63, post-commencement finance may be obtained from an enterprise group member subject to insolvency proceedings by another group member subject to insolvency proceedings where the insolvency representative of the receiving group member determines it to be necessary for the continued operation or survival of the business of that group member or the preservation or enhancement of the value of the estate. The insolvency law may require the court to authorize or creditors to consent to the obtaining of that post-commencement finance.]

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[29] Recommendations 211 to 216 were revised at the 36th session of the Working Group, but not considered for lack of time. Accordingly, they are included here in square brackets.

Priority for post-commencement finance

[215. The insolvency law should specify the priority that applies to post-commencement finance provided by one enterprise group member subject to insolvency proceedings to another group member that is subject to insolvency proceedings.]

Security for post-commencement finance

[216. The insolvency law should specify that recommendations 65, 66 and 67 apply to the granting of a security interest in accordance with recommendation 211(b).]

4. Avoidance proceedings

(a) Nature of enterprise group transactions

114. Recommendations 87-99 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 because of the group structure and the different relationships that group members may have vis-à-vis each other. 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 an enterprise group, where the benefits and detriments of transactions might be more widely assigned. Those transactions, for example, contracts entered into for purposes of transfer pricing[30] may involve terms and conditions that are different to those included in similar contracts entered into by unrelated commercial parties on usual commercial terms. Similarly, some legitimate transactions occurring within an enterprise group may not be commercially viable outside the group context if the benefits and detriments were to be analysed on normal commercial grounds.

115. Intra-group transactions may represent trading between group members; channelling of profits upwards from one group member to a controlling group member; 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 some group members into the financing group member. Although this might not always be in the best interests of the individual group members, some laws permit

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[30] 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.

directors of wholly owned group members, for example, to act in that manner, provided it is in the best interests of the controlling group member.

(b) Avoidance criteria in the enterprise group context

116. 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, on the basis that they are normal "ordinary course" business transactions or subject them to particular scrutiny and a greater likelihood of avoidance because of the relationship between transacting parties as group members and the provisions of the insolvency law applicable to related person transactions. "Related person" is defined 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 (glossary, para. (jj)). While in some cases, 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, the mere existence of the enterprise group may not always provide sufficient justification to treat all intra-group transactions as transactions between related persons that should be subject to avoidance, as noted above (part two, chap. V, para. 48).

117. 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. Other transactions may not be so clearly within the scope of that recommendation 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 be transactions that are intra-group transactions because they cannot be conducted in other ways or because they result from the manner in which the group is structured. In some situations, for example, finance may only be available on an intra-group basis and there would be no justification to treat such a transaction more strictly than if it involved an external lender. Similarly, a group may involve centralized cash flow and transfers of cash, as noted above, that would not occur where there was no group.

118. 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. For these reasons, it is desirable that an insolvency law consider those issues in the group context and include group-related 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.

119. Recommendation 97 addresses the elements to be proven to avoid a particular transaction and defences to avoidance. It may be appropriate to consider how those elements 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. Some laws, for example, 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 that, as noted above, 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. Such a transaction might nevertheless be subjected to special scrutiny (in much the same way as is recommended for claims by related persons in recommendation 184, an approach followed by some laws that also permit 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.

120. 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 217-218

Purpose of legislative provisions

The purpose of avoidance provisions as among enterprise group members is [to provide, in addition to the considerations set forth in recommendations 87-99, that the insolvency law may permit the court to take into account that the transaction took place in the context of an enterprise group and establish the specific circumstances that may be considered by the court.]

Contents of legislative provisions

Avoidable transactions

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

Elements of avoidance and defences

218. The insolvency law should specify the manner in which the elements referred to in recommendation 97 would apply to avoidance of transactions in the enterprise group context.[31]

5. Subordination

121. It is noted above (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.

(a) Related person claims

122. 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.

123. As explained, the term "related person" would include enterprise group members. However, the mere fact of a special relationship with the debtor, including, in the group context, membership of the same enterprise group, may not be sufficient in all cases to justify special treatment of a creditor's claim. In some cases, those 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.

124. 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) are identified in part two, chapter V, para. 48. In the group context, additional considerations might include, as between a parent and a controlled group member: the parent's participation in the management of the group member; 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 group member.

125. 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

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[31] 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.

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.

126. 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 also have the effect of discouraging intra-group lending.

(b) Treatment of equity

127. 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 (see above, part two, chap. V, para. 76). 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.

128. Few insolvency laws specifically address subordination of equity claims in the enterprise group context. One law that does allows 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.

129. Subordination is discussed above in the context of treatment of claims and priorities, but the *Guide* 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).[32]

[32] See also the UNCITRAL Legislative Guide on Secured Transactions.

D. Remedies

130. Because of the nature of enterprise groups and the way in which they operate, there may be a complex web of financial transactions between group members, and creditors may have dealt with different members or even with the group as a single economic entity, rather than with members individually. Disentangling the ownership of assets and liabilities and identifying the creditors of each group member may involve a complex and costly legal inquiry. However, because adherence to the separate entity approach means that each group member is only liable to its own creditors, it may become necessary, when insolvency proceedings have commenced with respect to one or more of the group members, to disentangle the ownership of their assets and liabilities.

131. When this disentangling can be effected, adherence to the separate entity principle operates to limit creditor recovery to the assets of the specific group member of which they were a creditor. Where it cannot be affected or other specified reasons exist to treat the group as a single enterprise, some laws include remedies that allow the single entity approach to be set aside. Historically, these remedies have been developed to overcome the perceived inefficiency and unfairness of the traditional separate entity approach in specific group cases. In addition to setting aside intra-group transactions or subordinating intra-group lending, the remedies may include: the extension of liability for external debts to solvent group members, as well as to office holders and shareholders; contribution orders; and pooling or substantive consolidation orders. Some of these remedies require findings of fault to be made, while others rely upon the establishment of certain facts with respect to the operations of the enterprise group. In some cases, particularly where misfeasance of management is involved, other remedies might more appropriately be employed, such as removing the offending directors and limiting management participation in reorganization.

132. Because of the potential inequity that may result when one group member is forced to share assets and liabilities with other group members that may be less solvent, remedies setting aside the single entity approach 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”, which may result in shareholders, who are generally shielded from liability for the enterprise’s activities, being held liable for certain activities. The remedies discussed below do not involve lifting the corporate veil, although in some circumstances the effect may appear to be similar.

1. Extension of liability

133. Extending the liability for external debts and, in some cases, the actions of the group members subject to insolvency proceedings to solvent group members and relevant office holders is a remedy available under some laws to individual creditors on a case-by-case basis and depends upon the circumstances of that creditor’s relationship with the debtor.

134. Many laws recognize circumstances in which exceptions to the limited liability of corporate entities are available and one group member and relevant office holders could be found liable for the debts and actions of another group member. Some laws

adopt a prescriptive approach and the circumstances are strictly limited; other laws adopt a more expansive approach, giving the courts 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 group member is the relationship between that group member and related group members in terms of both ownership and control. A further relevant factor may be the conduct of the related group member vis-à-vis the creditors of the member subject to insolvency proceedings.

135. 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:

(a) Exploitation or abuse by one group member (perhaps the parent) of its control over another group member, including operating that group member continually at a loss in the interests of the controlling group member;

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

(c) Operating a group member as the parent or controlling group member's agent, trustee or partner;

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

(e) 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 group members or confusing personal and corporate assets; or where the enterprise group structure is a mere sham or facade, such as where the corporate form is used as a device to circumvent statutory or contractual obligations;

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

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

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

(i) Wrongful trading, where directors, including shadow directors of a group member have a duty to monitor, for example, whether that group member can properly continue carrying on business in the light of its financial condition and are required to apply for insolvency within a specified period once it has become

insolvent. Permitting or directing a group member to incur debts when it is or is likely to become insolvent would fall into this category; and

(j) Failing to observe regulatory requirements, such as keeping regular accounting records of a subsidiary or controlled group member.

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

137. In a number of the examples where liability might be extended to the controlling group member, that liability may include the personal liability of the members of the board of directors of the controlling group member (who may be described as de facto or shadow directors). While directors of an individual group member may generally owe certain duties to that group member, they may be faced with balancing those duties against the overall 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 group member will be personally liable for the debts or actions of a controlled group member subject to insolvency proceedings include: whether there was active involvement in the management of the controlled group member; whether there was grievous negligence or fraud in the management of the insolvent group member; whether the management of the controlling group member 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 group member 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 group member was acting as a de facto or shadow director.

138. There are also laws that provide for controlling group member or parents to accept liability for debts of controlled group members or subsidiaries by contract, especially where the creditors involved are banks, or by entering into voluntary cross-guarantees. Under other laws, which provide for various forms of integration of enterprise groups, the principal group member can be jointly and severally liable to the creditors of the integrated group members, for liabilities arising both before and after the formalization of the integration.

2. Contribution orders

139. A contribution order is an order by which a court can require a solvent group member to contribute specific funds to cover all or some of the debts of other group members subject to insolvency proceedings. Although contribution orders are not widely available under insolvency laws, a few jurisdictions have adopted or are considering adopting these measures, generally only in liquidation proceedings.

140. A number of the issues noted below may not require specific provisions to be included in the insolvency law, as remedies may already exist under other laws, such as those addressing liability and wrongful trading.

141. Under those laws that do permit contribution orders, the problem, as noted above, of reconciling the interests of the two sets of unsecured creditors that have dealt with the two separate group members, has meant that the power to make a contribution order is not commonly exercised. Courts have also taken the view that a full contribution order may be inappropriate if the effect is to threaten the solvency of the group member not already in liquidation, although it might be possible to order a partial contribution that is limited to certain assets, such as the balance remaining after meeting bona fide obligations.

142. Under one law that does provide for contribution orders, the court must take into account certain specified circumstances in considering whether to make an order. These include: the extent to which a related group member took part in the management of the group member in liquidation; the conduct of the related group member towards the creditors of the member in liquidation, although creditor reliance on the existence of a relationship between the group members is not sufficient grounds for making an order; the extent to which the circumstances giving rise to liquidation are attributable to the actions of the related group member; the conduct of a solvent group member after commencement of liquidation proceedings with respect to another group member, particularly if that conduct indirectly or directly affects the creditors of the group member subject to insolvency proceedings, such as with respect to failure to perform a contract; and such other matters as the court thinks fit.[33] Such an order might also be possible, for example, in cases when the subsidiary or controlled group member had incurred significant liability for personal injury or the parent or controlling group member had permitted the subsidiary or controlled group member to continue trading whilst insolvent.

3. Substantive consolidation

(a) Introduction

143. As noted above, when procedural coordination is ordered, the assets and liabilities of the debtors remain separate and distinct, with the substantive rights of claimants unaffected. Substantive consolidation, on the other hand, permits the court, in insolvency proceedings involving two or more enterprise group members, to disregard the separate identity of each group member in appropriate circumstances and consolidate their assets and liabilities, treating them as though held and incurred by a single entity. The assets are thus treated as if they were part of a single estate for the general benefit of all creditors of the consolidated group members. Few jurisdictions provide statutory authority for consolidation orders and in those where the remedy is available, it is not widely used. A principal concern is that consolidation overturns the principle of the separate legal identity of each group member, which is often used to structure an enterprise group to respond to various business considerations, serving different purposes and having important implications, in terms for example of taxation law, corporate law and corporate governance rules. If the courts routinely agreed to substantive consolidation, many of the benefits to be derived from the flexibility of enterprise structure could be undermined.

144. Notwithstanding the absence of direct statutory authority or a prescribed standard for the circumstances in which substantive consolidation orders can be

[33] New Zealand Companies Act 1993, Sections 271 (1) (a) and 272 (1).

made, the courts of some jurisdictions have played a direct role in developing these orders and delimiting the appropriate circumstances. This practice reflects increased judicial recognition of the widespread use of interrelated corporate structures for taxation and business purposes. The circumstances that would support a consolidation order are, nevertheless, very limited and tend to be those where a high degree of integration of the group members, through control or ownership, would make it difficult, if not impossible, without expending significant time and resources, to disentangle the assets and liabilities of the different group members.

145. Consolidation is typically discussed in the context of liquidation and the legislation that authorizes it does so only in that context. There are, however, legislative proposals that would permit consolidation in the context of various types of reorganization. In jurisdictions without specific legislation, consolidation orders may be available in both liquidation and reorganization, where such an order would, for example, assist the reorganization of the group. While typically requiring a court order, consolidation may also be possible on the basis of consensus of the relevant interested parties. Some commentators suggest that consolidation by consensus frequently occurs in cases involving enterprise groups, and often in situations where the courts would generally uphold creditor objections to consolidation if a formal application were to be made. It may also be possible by way of a reorganization plan. Some laws permit a plan to include proposals for a debtor to be consolidated with other group members, whether insolvent or solvent, which could be implemented with creditor approval.

146. Consolidation might be appropriate where it leads to greater return of value for creditors, either because of the structural relationship between the group members and their conduct of business and financial relationships or because of the value of assets common to the whole group, such as intellectual property in both a process conducted across numerous group members and the product of that process. A further ground might be where there is no real separation between the group members, and the group structure is being maintained solely for dishonest or fraudulent purposes.

147. 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 a less solvent group member and whether the savings or benefits to the collective class of creditors outweighs incidental detriment to individual creditors. Some creditors might have relied on the separate assets or separate legal entity of a particular group member when trading with it, and should therefore not be denied a full payout because of their trading partner's relationship with another group member of which they were unaware. Other creditors might have relied upon the assets of the whole group and it would be unfair if they were limited to recovery against the assets of a single group member.

148. Because it involves pooling the assets of different group members, consolidation may not lead to increased recovery for each creditor, but rather operate to level the recoveries across all creditors, increasing the amount distributed to some at the expense of others. Additionally, the availability of consolidation may enable stronger, larger creditors to take advantage of assets that should not be available to them; encourage creditors who disagree with such an order to seek its review, thus prolonging the insolvency proceedings; and damage the certainty and

enforceability of security interests (where intra-group claims disappear as a result of consolidation, creditors that have security interests in those claims would lose their rights).

149. Consolidation would generally involve the group members subject to insolvency proceedings, but in some cases and as permitted by some insolvency laws, might extend to an apparently solvent group member. This might occur when the affairs of that member were so closely intermingled with those of other group members that it would be beneficial to include it in the consolidation, when further investigation showed it to be actually insolvent because of the intermingling of assets or where the legal entity is a sham or involves a fraudulent scheme. Where the solvent group member is to be included, the creditors of that group member may have particular concerns and a limited approach might be taken so that the consolidation order extended only to the net equity of the solvent group member in order to protect the rights of those creditors, although this would be difficult in cases of intermingling or fraud.

(b) Circumstances supporting consolidation

150. A number of elements have been identified as relevant to determining whether or not substantive consolidation is warranted, both in the legislation that authorizes consolidation orders and in those cases where the courts have played a role in developing those orders. In each case, it is a question of balancing the various elements to reach a just and equitable decision; no single element is necessarily conclusive and all of the elements do not need to be present in any given case. Those elements have included: the presence of consolidated financial statements for the group; the use of a single bank account for all group members; the unity of interests and ownership between the group members; the degree of difficulty in segregating individual assets and liabilities; sharing of overhead, management, accounting and other related expenses among different group members; the existence of intra-group loans and cross-guarantees on loans; the extent to which assets were transferred or funds moved from one member to another as a matter of convenience without observing proper formalities; adequacy of capital; commingling of assets or business operations; appointment of common directors or officers and the holding of combined board meetings; a common business location; fraudulent dealings with creditors; the practice of encouraging creditors to treat the group as a single entity, creating confusion among creditors as to which of the group members they were dealing with and otherwise blurring the legal boundaries of the group members; and whether consolidation would facilitate a reorganization or is in the interests of creditors.

151. While these many factors remain relevant, some courts have begun to focus on a limited number and in particular on whether the affairs of the group members are so intermingled that separating assets and liabilities can only be achieved at extraordinary cost and expenditure of time or group members are engaged in fraudulent schemes or business activity that has no legitimate business purpose. With respect to the first ground, the degree of intermingling required is hard to quantify and has been variously described by different courts as involving a degree of intermingling that was hopeless or a practical impossibility to disentangle; that would require such time and expense to disentangle the interrelationships between the group members and the ownership of assets that it would be disproportionate to

the result, or was so substantial that it would threaten the realization of any net assets for the creditors; or that the allocation of assets and liabilities between the relevant members was essentially arbitrary and without economic reality. In reaching a decision that the degree of intermingling in a particular case justifies substantive consolidation, the courts have looked at various factors, including the manner in which the group members operated and related to each other, including with respect to management and financial matters; the sufficiency of record keeping of the individual group members; the observance of proper corporate formalities; the manner in which funds and assets were transferred between the various members; and other similar factors concerning group operations.

152. The type of fraud contemplated is not fraud occurring in the daily operations of a company, but rather the total absence of a legitimate business purpose, which may relate either to the reasons for which the company was formed or, once formed, the activities it undertakes (see above, para. 135(e)). Examples of such fraud may include transfers by a debtor of substantially all of its assets to a newly formed entity or to self-owned separate entities for the purpose of preserving and conserving those assets for its own benefit and to hinder, delay and defraud its creditors, simulation[34] or Ponzi[35] and other such fraudulent schemes.

(c) Applications for substantive consolidation

(i) Persons permitted to apply

153. An insolvency law should address the question of who may apply for substantive consolidation and at what time. With respect to the parties permitted to apply, it would seem appropriate to follow the approach of recommendation 14 concerning the parties permitted to apply for commencement of insolvency proceedings. In the group context, that would include a group member and a creditor of any such group member. In addition, it would be appropriate to permit applications by the insolvency representative of any group member, since in many instances, it will be the insolvency representative or representatives appointed to administer group members that will have the most complete information on group members and are therefore in the best position to assess the appropriateness or desirability of substantive consolidation.

154. Although in some States it might be possible for the court to act on its own initiative to order substantive consolidation, the serious impact of such an order requires that a fair and equitable process be followed and that parties in interest have the opportunity to be heard and to object to such an order, in accordance with recommendations 137-138. For that reason, and since the *Legislative Guide* generally adopts the approach that courts do not act on their own initiative in insolvency matters, it may be appropriate to follow that approach in the case of substantive consolidation.

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[34] Simulation may involve contracts that either do not express the true intent of the parties and have no effect between the parties or produce different effects between the parties than those expressed in the contracts, i.e. sham contracts.

[35] A fraudulent investment operation that pays returns to separate investors from their own money or money paid by subsequent investors, rather than from any actual profit earned.

(ii) Timing of an application

155. Since the factors supporting substantive consolidation might not always be apparent or certain at the time insolvency proceedings commence, it is desirable that an insolvency law adopt a flexible approach to the issue of timing, allowing an application to be made at the same time as an application for commencement of proceedings or at any subsequent time. It should be noted, however, that the possibility of applying for substantive consolidation subsequent to commencement might be limited, in practice, by the state reached in administration of the proceedings, particularly for example, with respect to implementation of a reorganization plan. Certain key matters may already have been resolved, such as sale or disposal of assets or submission and admission of claims, or certain decisions taken and acted upon with respect to individual group members, creating practical difficulties with consolidating partly administered proceedings. In this situation, it is desirable that the order take account of the status of administration, consolidating the separate proceedings already in progress and preserving existing rights. Claims already admitted against a group member, for example, might therefore be treated as claims admitted against the consolidated estate.

156. The same approach might apply to adding group members to an existing substantive consolidation. As the administration of various enterprise group members proceeds, it may become apparent that additional group members should be included because the grounds for the initial order are also satisfied with respect to those members. If the consolidation order was made with the consent of the creditors, or if creditors were given the opportunity to object to a proposed order, the addition of another group member at a later stage of the proceedings has the potential to vary the pool of assets from that originally agreed or notified to creditors. In that situation, it is desirable that creditors have a further opportunity to consent or object to the addition to the consolidation. Where substantive consolidation is ordered subsequent to a partial distribution to creditors, the introduction of a hotchpot rule might be desirable. This would help to ensure that a creditor who has received a partial distribution in respect of its claim against the single group member may not receive payment for the same claim in the consolidated proceedings, so long as the payment of the other creditors of the same class is proportionately less than the partial distribution the creditor has already received.

(d) Competing interests in consolidation

157. In addition to the competing interests of the creditors of the different group members, the interests of other stakeholders may warrant consideration in the context of consolidation, including those of creditors vis-à-vis shareholders; of the shareholders of the different group members, in particular those who are shareholders of some of the members but not of others; and of secured and priority creditors of different consolidated group members.

(i) Owners and equity holders

158. Many insolvency laws adopt the general rule that the rights of creditors outweigh those of owners and equity holders, with owners and equity holders being ranked after all other claims in the order of priority for distribution. Often this results in owners and equity holders not receiving a distribution (see part two,

chap. V, para, 76 and recommendation 189). In the enterprise group context, the shareholders of some group members with many assets and few liabilities may receive a return, while the creditors of other group members with fewer assets and more liabilities may not. If the general approach of ranking shareholders behind unsecured creditors were to be extended in consolidation to the group as a whole, all creditors could be paid before the shareholders of any group member received a distribution.

(ii) Secured creditors

159. The position of secured creditors in insolvency proceedings is discussed throughout the *Legislative Guide* (see Annex I for relevant references) and the approach adopted that, as a general principle, the effectiveness and priority of a valid security interest should be recognized and the economic value of the encumbered assets should be preserved in insolvency proceedings. That approach will also apply to the treatment of secured creditors in the enterprise group context. It is also recognized that an insolvency law may nevertheless affect the rights of secured creditors in order to implement business and economic policies, subject to appropriate safeguards (see part two, chap. II, para. 59).

160. Questions arising with respect to consolidation might include: whether a security interest over some or all of the assets of one group member could extend to include assets of another group member where a consolidation order was made or whether that security interest should be limited to the defined pool of assets upon which the secured creditor had originally relied; whether secured creditors with insufficient security could make a claim against the pooled assets as unsecured creditors; and whether internal secured creditors (i.e. creditors that are at the same time group members) should be treated differently to external secured creditors. Security interests over the whole of a debtor's estate would generally crystallize on the commencement of insolvency proceedings and the issue of that interest expanding to cover the pooled assets should not arise. To allow any secured creditor's security interest to be extended or expanded as the result of an order for substantive consolidation would improve that creditor's position at the expense of other creditors and amount to an unjust benefit or windfall, which is generally undesirable. The same point could be made with respect to employee claims.

161. One solution with respect to the treatment of external secured creditors might be to exclude them from the process of consolidation, thus achieving what might be termed a partial or limited consolidation. Individual secured creditors that relied upon the separate identity of group members, such as where they relied upon an intra-group guarantee, might require special consideration. Where encumbered assets are required for reorganization, a different solution might be possible, such as allowing the court to adjust the consolidation order to make specific provision for such assets or requiring the consent of the affected secured creditor. A secured creditor could surrender its security interest following consolidation, and the debt would become payable by all of the consolidated entities.

162. The interests of internal secured creditors might also need to be considered. Under some laws, those internal security interests might be extinguished, leaving the creditors with an unsecured claim, or those claims might be modified or subordinated.

(iii) Priority creditors

163. Similar questions arise with respect to the treatment of priority creditors. Practically, they might benefit or lose from the pooling of the group's assets in the same way as other unsecured creditors. Where priorities, such as those for employee benefits or tax, are based on the single entity principle, the treatment of those priorities across the group may need to be considered, especially where they interact with each other. For example, employees of a group member that has many assets and few liabilities will potentially compete with those of a group member in the opposite situation, with few assets and many liabilities, if there is consolidation. While priority creditors generally might obtain a better result at the expense of unsecured creditors without priority, the different groups of those priority creditors might have to adjust any expectations they may have as a result of their priority position with respect to the assets of a single entity. Where there is intermingling of assets so that it is not possible to determine who owns what assets, it may be very difficult to determine how much might be available to settle the claims of priority creditors. Accordingly, although it is desirable that the priorities established under the insolvency law with respect to each individual debtor be recognized where that debtor is subject to substantive consolidation, it might not always be possible to give them full effect.

(e) Notification of creditors

164. An application for substantive consolidation may be subject to the same requirements for giving notice as an application for commencement of proceedings.[36] When made at the same time as the application for commencement of proceedings, only an application for substantive consolidation by creditors would require notice to be given to the relevant debtors, consistent with recommendation 19. An application by group members made at the same time as the application for commencement would not require creditors to be notified under recommendations 22 and 23, which do not mandate notification of an application for commencement of insolvency proceedings to the creditors of the concerned entity.

165. The potential impact of substantive consolidation on creditor rights suggests that affected creditors should have the right to be notified of any order for consolidation made at the time of commencement and have the right to appeal, consistent with recommendation 138. One issue to be considered is whether a single objection would be sufficient to prevent consolidation from occurring. It may be possible, for example, to provide objecting creditors who will be significantly disadvantaged by the consolidation relative to other creditors with a greater level of return than other unsecured creditors, thus departing from the strict policy of equal distribution. It may also be possible to exclude specific groups of creditors with certain types of contracts, for example, limited recourse project financing arrangements entered into with clearly identified group members at arm's length commercial terms.

166. Where the application is made by creditors after proceedings have commenced, it might be desirable for notice of the application to be given to insolvency

[36] See above, part two, chap. I, para. 64-71and recommendations 19 (a), 22-25.

representatives of the entities to be consolidated. Notice should be given in an effective and timely manner in the form determined by domestic law.

(f) Effect of an order for substantive consolidation

167. The insolvency law should establish the effects of an order for substantive consolidation. These might include: the treatment of assets and liabilities of the consolidated group members as if they were part of a single insolvency estate; the extinguishment of intra-group claims; treatment of claims against the individual group members to be consolidated as claims against the consolidated estate; recognition of priorities established against the individual group members as priorities against the consolidated estate (to the extent possible, given the difficulty noted above); and the convening of a single meeting for creditors of all consolidated group members. Concerning liquidation value for the purposes of recommendation 152 (b), that value in substantive consolidation would be the liquidation value of the consolidated estate, and not the liquidation value of the individual members before substantive consolidation. An order for substantive consolidation might also combine the creditors for the purposes of voting on any reorganization plan for the consolidated group members. Intra-group claims would generally disappear on consolidation on the basis that since the claim and the obligation to pay belong or are owed by the same insolvency estate, they effectively cancel each other out.

168. Where substantive consolidation is ordered after the commencement of proceedings or where group members are added to a substantive consolidation at different times, the choice of the date from which the suspect period for the purposes of avoidance (see recommendation 89) would be calculated may need to be considered to provide certainty for lenders and other third parties. The issue may become more important as the period of time between an application for or commencement of individual insolvency proceedings and the order for substantive consolidation increases. Choosing the date of the order for substantive consolidation for calculation of the suspect period for avoidance purposes may create problems with respect to transactions entered into between the date of application for or commencement of insolvency proceedings for individual group members and the date of the substantive consolidation. One approach might be to calculate that date in accordance with recommendation 89. Another approach may be to establish a common date by reference to the earliest date on which there was an application for commencement or commencement of insolvency proceedings with respect to those group members to be consolidated. In either case, it is desirable that the date be specified in the insolvency law to ensure transparency and predictability.

(g) Modification of an order

169. Although modification of an order for substantive consolidation might not always be possible or desirable, given the substantive effect of that order, there may be cases where circumstantial changes or the availability of new information indicate the desirability of modifying the original order. Any such modification should be subject to the condition that any actions or decision taken pursuant to the initial order should be unaffected by the order for modification. Those actions or decisions, whether taken by the court or the insolvency representative, may include

sales of assets and provision of finance to group members, provided they were taken in good faith.

(h) Exclusions from an order for substantive consolidation

170. Some laws make provision for what may be termed an order for partial or limited substantive consolidation, that is, an order for substantive consolidation that excludes certain assets or claims.

171. These exclusions will be rare, given the assumption in favour of substantive consolidation where the requirement for intermingling is met. Consolidation might be limited, for example, to unsecured creditors, thereby excluding external secured creditors, who might be free to enforce their security interests (unless those security interests depend upon the separate identity of the group members to be consolidated), or to only those assets and liabilities that are intermingled, thus exempting those assets whose ownership might be clear. Claims associated with any such excluded assets would go with the asset. Another approach excludes certain assets from substantive consolidation if otherwise creditors would be unfairly prejudiced, although this ground is unlikely to be relevant in cases of intermingling or fraud.

(i) Competent court

172. The issues discussed above with respect to both joint applications and procedural coordination would apply also with respect to the court competent to order substantive consolidation (see above, paras. 59-61 and recommendation 209).

Recommendations 219-232

Purpose of legislative provisions

The purpose of provisions on substantive consolidation is:

(a) To provide legislative authority for substantive consolidation, while respecting the basic principle of the separate legal identity of each enterprise group member;

(b) To specify the very limited circumstances in which the remedy of substantive consolidation may be available in order to ensure transparency and predictability; and

(c) To specify the effect of an order for substantive consolidation, including the treatment of security interests.

Contents of legislative provisions

Exceptions to the principle of separate legal identity

219. The insolvency law should respect the separate legal identity of each enterprise group member. Exceptions to that general principle should be limited to the grounds set forth in recommendation 220.

Circumstances in which substantive consolidation may be available

220. The insolvency law may specify that, at the request of persons permitted to make an application under recommendation 223, the court may order substantive consolidation with respect to two or more enterprise group members [in the following limited circumstances]:

(a) Where the court is satisfied that the assets or liabilities of the enterprise group members are intermingled to such an extent that the ownership of assets and responsibility for liabilities cannot be identified without disproportionate expense or delay; or

(b) Where the enterprise group members are engaged in a fraudulent scheme or activity with no legitimate business purpose and the court is satisfied that substantive consolidation is essential to rectify that scheme or activity.

Exclusions from substantive consolidation

221. The insolvency law may permit the court to exclude specified assets and claims from an order for substantive consolidation.

Application for substantive consolidation

– *Timing of application*

222. The insolvency law should specify that an application for substantive consolidation may be made at the time of an application for commencement of insolvency proceedings with respect to enterprise group members or at any subsequent time,[37] provided the conditions of recommendation 220 are satisfied.

– *Persons permitted to apply*

223. The insolvency law should specify the persons permitted to make an application for substantive consolidation, which may include an enterprise group member, the insolvency representative of an enterprise group member or a creditor of any such group member.

Effect of an order for substantive consolidation

224. The insolvency law should specify that an order for substantive consolidation has the following effects:[38]

(a) The assets and liabilities of the consolidated group members are treated as if they were part of a single insolvency estate;

(b) Claims and debts between group members included in the order are extinguished; and

(c) Claims against group members included in the order are treated as claims against the [single] [consolidated] insolvency estate.

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[37] The impracticability of ordering substantive consolidation at an advanced stage of the insolvency proceedings is discussed in the commentary, see above, paras. 155-156.

[38] The effect on security interests is addressed in recommendation226.

225. [The insolvency law should specify that a creditor holding a security interest over an asset of an enterprise group member or a labour claim against that enterprise group member cannot [improve][enhance] the value, ranking or priority of their security interest or claim as a result of an order for substantive consolidation affecting that enterprise group member.]

Treatment of security interests in substantive consolidation

226. The insolvency law should specify that the rights and priorities of a creditor holding a security interest over an asset of an enterprise group member subject to an order for substantive consolidation should, as far as possible, be respected in substantive consolidation, unless:

(a) The secured indebtedness is owed solely between enterprise group members and is extinguished by an order for substantive consolidation;

(b) It is determined that the security interest was obtained by fraud in which the creditor participated; or

(c) The transaction granting the security interest is subject to avoidance in accordance with recommendations 87, 88 and 217.

Recognition of priorities in substantive consolidation

227. The insolvency law should specify that the priorities established under insolvency law and applicable to individual enterprise group members prior to an order for substantive consolidation should, as far as possible, be recognized in substantive consolidation.

Meetings of creditors

228. The insolvency law should specify that, to the extent a meeting of creditors is required by the law to be held subsequent to an order for substantive consolidation, creditors of all consolidated group members are eligible to attend.

Calculation of suspect period in substantive consolidation

229. (1) The insolvency law should specify the date from which the suspect period with respect to avoidance of transactions of the type referred to in recommendation 87 should be calculated when substantive consolidation is ordered.

(2) When substantive consolidation is ordered at the same time as commencement of insolvency proceedings, the specified date from which the suspect period is calculated retrospectively should be determined in accordance with recommendation 89.

(3) When substantive consolidation is ordered subsequent to commencement of insolvency proceedings, the specified date from which the suspect period is calculated retrospectively may be:

(a) A different date for each enterprise group member included in the substantive consolidation, being either the date of application for or commencement of insolvency proceedings with respect to each such group member, in accordance with recommendation 89; or

(b) A common date for all enterprise group members included in the substantive consolidation, being the earliest of the dates of application for, or commencement of, insolvency proceedings with respect to those group members.

Modification of an order for substantive consolidation

230. The insolvency law should specify that an order for substantive consolidation may be modified, provided that any actions or decisions already taken pursuant to the order are not affected by the modification.[39]

Competent court

231. For the purposes of recommendation 13, the words "commencement and conduct of insolvency proceedings, including matters arising in the course of those proceedings" include an application or order for substantive consolidation, including modification of that order.[40]

Notice

232. The insolvency law should establish requirements for giving notice with respect to applications and orders for substantive consolidation and modification of substantive consolidation, including the parties to whom notice should be given; the party responsible for giving notice; and the content of the notice.

E. Participants

1. Appointment of an insolvency representative

(a) Coordination of proceedings

173. When multiple proceedings commence with respect to group members, an order for procedural coordination may or may not be made, but in either case, coordination of those proceedings may be facilitated if the insolvency law was to include specific provisions promoting coordination and indicating how it might be achieved, along the lines of article 27 of the Model Law. That approach could be adopted with respect to coordination between the different courts involved in administering proceedings for different group members and between the different insolvency representatives appointed in those proceedings. The appointment and role of the insolvency representative are discussed above (see part two, chap. III, paras. 36-74). The issues discussed, together with recommendations 115-125 would generally apply in the group context. The obligations of an insolvency representative under the *Legislative Guide* (specifically, recommendations 111, 116-117, and 120) might be extended in the group context to include various aspects of coordination, including: sharing and disclosure of information; approval or implementation of agreements with respect to division of the exercise of powers and allocation of responsibilities between insolvency representatives; cooperation on use and disposal of assets; proposal and negotiation of coordinated reorganization plans

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[39] It is not intended that use of the term "modification" would include termination of an order for substantive consolidation.

[40] The criteria that might be relevant to determining the competent court are discussed in the commentary, see above, paras. 59-61and note 23.

(unless preparation of a single group plan is possible as discussed below); coordination of the use of avoidance powers; obtaining of post-commencement finance; coordination of the submission and admission of claims; and distributions to creditors. The insolvency law could also address timely resolution of disputes between the different insolvency representatives appointed.

174. Where a number of insolvency representatives are appointed to the different proceedings concerning group members, the insolvency law may permit one of them to take a leading role in coordinating those proceedings. That representative could be, for example, the representative of the parent or controlling group member if it is subject to proceedings. While such a leading role might reflect the economic reality or structure of the enterprise group, equality under the law of all insolvency representatives should be preserved. Coordination under the leadership of one insolvency representative may also be achieved on a voluntary basis, to the extent possible under applicable law.

175. In certain jurisdictions, courts, rather than insolvency representatives, may have the principal authority to coordinate insolvency proceedings. When the insolvency law so provides, and different courts are involved in administering proceedings for different group members, it is desirable that the provisions concerning coordination of proceedings apply also to the courts and that they have powers along the lines of article 27 of the Model Law.

(b) Appointment of a single or the same insolvency representative

176. Coordination of multiple proceedings might also be facilitated by the appointment of a single or the same insolvency representative to administer the different group members subject to insolvency. In practice, it might be possible to appoint one insolvency representative to administer multiple proceedings or it might be necessary to appoint the same insolvency representative to each of the proceedings to be coordinated, depending upon procedural requirements and the number of courts involved. Although the administration of each of the group members would remain separate (as in the case of procedural coordination), such an appointment could help to ensure coordination of the administration of the various group members, reduce related costs and delays and facilitate the gathering of information on the group as a whole. With respect to the latter point, care might need to be exercised in how that information is treated, ensuring in particular that confidentiality requirements with respect to separate group members are observed. While many insolvency laws do not address the question of appointing a single insolvency representative, there are some jurisdictions where such an appointment in the group context has become a practice. This has also been achieved to a limited extent in some cross-border insolvency cases, where insolvency representatives from the same international firm have been appointed in the different jurisdictions.

177. Where a single or the same insolvency representative is appointed to administer several members of a group with complex financial and business relationships and different groups of creditors, there is the potential for loss of neutrality and independence. Conflicts of interest may arise, for example, with respect to cross guarantees, intra-group claims and debts, post-commencement finance, lodging and verification of claims; or the wrongdoing by one group member with respect to another group member. The obligation to disclose potential or existing conflicts of interest contained in recommendations 116 and 117 would be

relevant to the group context. As a safeguard against possible conflicts, the insolvency representative could be required to provide an undertaking or be subject to a practice rule or statutory obligation to seek direction from the court. Additionally, the insolvency law could provide for the appointment of one or more further insolvency representatives to administer the entities in conflict. That appointment might relate to the specific area of conflict, with the appointment being limited to its resolution, or be more general and for the duration of the proceedings.

(c) Debtor in possession

178. When the insolvency law permits the debtor to remain in possession of the business, and no insolvency representative is appointed, special consideration may be required to determine how multiple proceedings should be coordinated and the extent to which the obligations applicable to the insolvency representative, including any additional obligations referred to above, will apply to the debtor in possession (see above, part two, chap. III, paras. 16-18). To the extent that the debtor in possession performs the functions of an insolvency representative, consideration might also be given to how provisions of an insolvency law permitting the appointment of a single or the same insolvency representative or one of several insolvency representatives to take a lead role in coordinating proceedings might apply to the debtor in possession context.

Recommendations 233-237

Purpose of legislative provisions

The purpose of provisions on appointment of insolvency representatives in an enterprise group context is:

(a) To permit appointment of a single or the same insolvency representative to facilitate coordination of insolvency proceedings commenced with respect to two or more enterprise group members; and

(b) To encourage cooperation where two or more insolvency representatives are appointed, with a view to avoiding duplication of effort; facilitating gathering of information on the financial and business affairs of the enterprise group as a whole; and reducing costs.

Contents of legislative provisions

Appointment of a single or the same insolvency representative

233. The insolvency law should specify that, where it is determined to be in the best interests of the administration of the insolvency proceedings with respect to two or more enterprise group members, a single or the same insolvency representative may be appointed to administer those proceedings.[41]

[41] Although recommendation 118 addresses selection and appointment of the insolvency representative, it does not recommend appointment by any particular authority, but leaves it up to the insolvency law. Whichever mechanism is used with respect to domestic appointment would apply to recommendation 233.

Conflict of interest

234. The insolvency law should specify measures to address any conflict of interest that might arise when a single or the same insolvency representative is appointed to administer insolvency proceedings with respect to two or more enterprise group members. Such measures may include the appointment of one or more additional insolvency representatives.

Cooperation between two or more insolvency representatives in a group context

235. The insolvency law may specify that when different insolvency representatives are appointed to administer insolvency proceedings with respect to two or more enterprise group members, those insolvency representatives should cooperate with each other to the maximum extent possible.[42]

Cooperation between two or more insolvency representatives in procedural coordination

236. The insolvency law should specify that, when more than one insolvency representative is appointed to administer insolvency proceedings that are subject to procedural coordination, those insolvency representatives should cooperate with each other to the maximum extent possible.

Forms of cooperation [Cooperation to the maximum extent possible]

237. The insolvency law should specify that the cooperation to the maximum extent possible between insolvency representatives referred to in recommendations 235 and 236, should be implemented by any appropriate means, including:

(a) Sharing and disclosure of information;

(b) Approval or implementation of agreements with respect to division of the exercise of powers and allocation of responsibilities between insolvency representatives, including one insolvency representative taking a coordinating or leading role;

(c) Coordination with respect to administration and supervision of the affairs of the group members subject to insolvency proceedings, including day-to-day operations where the business is to be continued; post-commencement finance; safeguarding of assets; use and disposition of assets; use of avoidance powers; submission and admission of claims; and distributions to creditors; and

(d) Coordination with respect to proposal and negotiation of reorganization plans, communication with creditors and meetings of creditors.

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[42] In addition to the provisions of the insolvency law with respect to cooperation and coordination, the court generally may indicate measures to be taken to that end in the course of administration of the proceedings.

F. Reorganization of two or more enterprise group members

179. Recommendations 139-159 address issues specific to the preparation, proposal, content, approval and implementation of a reorganization plan. In general, those recommendations will be applicable in the context of an enterprise group.

1. Coordinated reorganization plans

180. When reorganization proceedings commence with respect to two or more enterprise group members, irrespective of whether or not those proceedings are to be procedurally coordinated, one issue not addressed elsewhere in the *Legislative Guide* is whether it will be possible to reorganize the debtors through a single reorganization plan covering several members or through coordinated, substantially similar plans or each member. Such plans have the potential to deliver savings across the group's insolvency proceedings, ensure a coordinated approach to the resolution of the group's financial difficulties, and maximize value for creditors. Although several insolvency laws permit the negotiation of a single reorganization plan, under some laws this approach is only possible where the proceedings are procedurally coordinated or substantively consolidated, while under other laws it would generally only be possible where the proceedings could be coordinated on a voluntary basis.

181. In practice, the concept of a single reorganization plan or coordinated plans would require the same or a similar reorganization plan to be prepared and approved in each of the proceedings concerning group members covered by the plan. Approval of such a plan would be considered on a member-by-member basis with the creditors of each group member voting in accordance with the voting requirements applicable to a plan for a single debtor; it would not be desirable to consider approval on a group basis and allow the majority of creditors of the majority of members to compel approval of a plan for all members. The process for preparation of the plan and solicitation of approval should take into account the need for all group members to approve the plan and it would accordingly need to address the benefits to be derived from such approval and the information required to obtain that approval. Those issues would be covered by recommendations 143 and 144 concerning content of the plan and the accompanying disclosure statement. Additional details that could relevantly be disclosed in the group context might include details with respect to group operations, the linkages between group members, the position in the group of each member covered by the plan and functioning of the group as such.

182. Such a reorganization plan or plans would need to take into account the different interests of the different groups of creditors, including the possibility that providing varying rates of return for the creditors of different group members might be desirable in certain circumstances. Achieving an appropriate balance between the rights of different groups of creditors with respect to approval of the plan, including appropriate majorities, both among the creditors of a single group member and between creditors of different group members is also desirable. Classification of claims and classes of creditors also needs to be considered, as does voting of creditors and approval of a plan, particularly when group members are creditors of each other and therefore "related persons". Calculation of applicable majorities in the group context may require consideration of how creditors with the same claim

against different group members should be counted for voting purposes, particularly where the claims may have different priorities. Some consideration may also need to be given to whether rejection by the creditors of one of several group members might prevent approval of the plan across the group and the consequences of that rejection. One approach might be based upon provisions applicable to the approval of a reorganization plan for a single debtor. Another approach might be to devise different majority requirements that are specifically designed to facilitate approval in the group context. Safeguards analogous to those in recommendation 152 could also be included, with an additional requirement that the plans should be fair as between the creditors of different group members.

183. In the group context, a related person includes a person who is or has been in a position of control of the debtor or a parent, subsidiary or affiliate of the debtor (see glossary, (jj)). Voting by related persons on approval of the plan is discussed above (see part two, chap. IV, para. 46) and it is noted that although some insolvency laws restrict the ability of related persons to vote in various ways, most insolvency laws do not specifically address the issue. It should be noted that where the insolvency law includes such restrictions, they might cause difficulty in some groups when a particular member has only creditors classified as related persons or a very limited number of creditors who are not related persons.

184. An insolvency law might also include provisions addressing the consequences of failure to approve such a reorganization plan as addressed by recommendation 158. One law, for example, provides that the consequence of failure to approve a plan is the liquidation of all insolvent group members. Where solvent members participated in the plan by consent, special provisions may be required to prevent undue advantages arising from that liquidation.

2. Inclusion of a solvent group member in a reorganization plan

185. Paragraphs 53-57 above discuss the possibility of including a solvent group member in an application for commencement of proceedings. It is noted that an apparently solvent member may, on further investigation, satisfy the commencement standard of imminent insolvency and thus be covered, for commencement purposes, by recommendation 15. That situation may not be uncommon in an enterprise group where the insolvency of some members leads almost inevitably to the insolvency of others. Where imminent insolvency is not an issue, however, a solvent group member generally could not participate in a reorganization plan for other members of the same group in insolvency proceedings under the insolvency law. There may, however, be circumstances in which different levels of participation by a solvent member in a reorganization plan might be both appropriate and feasible, on a voluntary basis. Such participation by solvent group members is, in fact, not unusual in practice. The solvent group member could thus aid the reorganization of other enterprise group members and would be contractually bound by the plan once it were approved and, where required, confirmed. The decision of a solvent group member to participate in a reorganization plan would be an ordinary business decision of that member, and the consent of creditors would not be necessary unless required by applicable company law. With respect to any disclosure statement accompanying a plan that included a solvent group member, caution would need to be exercised in disclosing information relating to that solvent group.

Recommendations 238-239

Purpose of legislative provisions

The purpose of provisions relating to reorganization plans in an enterprise group context is:

(a) To facilitate the coordinated rescue of the businesses of enterprise group members subject to the insolvency law, thereby preserving employment and, in appropriate cases, protecting investment; and

(b) To facilitate the negotiation and proposal of coordinated reorganization plans in insolvency proceedings with respect to two or more enterprise group members.

Contents of legislative provisions

Reorganization plan

238. The insolvency law should permit coordinated reorganization plans to be proposed in insolvency proceedings with respect to two or more enterprise group members.

239. The insolvency law should specify that an enterprise group member that is not subject to insolvency proceedings may voluntarily participate in a reorganization plan proposed for two or more enterprise group members subject to insolvency proceedings.