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Report of Working Group V (Insolvency Law) on the work of its thirty-third session (Vienna, 5-9 November 2007)

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I. Introduction

1. At its thirty-ninth session in 2006, the Commission agreed that the topic of the treatment of corporate groups in insolvency was sufficiently developed for referral to Working Group V (Insolvency Law) for consideration and that the Working Group should be given the flexibility to make appropriate recommendations to the Commission regarding the scope of its future work and the form it should take, depending upon the substance of the proposed solutions to the problems the Working Group would identify under that topic.

2. The Working Group agreed at its thirty-first session, held in Vienna from 11 to 15 December 2006, that the UNCITRAL Legislative Guide on Insolvency Law and the UNCITRAL Model Law on Cross Border Insolvency provided a sound basis for the unification of insolvency law, and that the current work was intended to complement those texts, not to replace them (see A/CN.9/618, para. 69). A possible method of work would entail the consideration of those provisions contained in existing texts that might be relevant in the context of corporate groups, the identification of those issues that required additional discussion and the preparation of additional recommendations. Other issues, although relevant to corporate groups, could be treated in the same manner as in the Legislative Guide and Model Law. It was also suggested that the possible outcome of that work might be in the form of legislative recommendations supported by a discussion of the underlying policy considerations (see A/CN.9/618, para. 70).

3. The Working Group continued its consideration of the treatment of corporate groups in insolvency at its thirty-second session held in New York from 14 to 18 May 2007, on the basis of notes by the Secretariat covering both domestic and international treatment of corporate groups (A/CN.9/WG.V/WP.76 and Add.1). For lack of time, the Working Group did not discuss the international treatment of corporate groups contained in document A/CN.9/WG.V/WP.76/Add.2.

II. Organization of the session

4. Working Group V (Insolvency Law), which was composed of all States members of the Commission, held its thirty-third session in Vienna from 5 to 9 November 2007. The session was attended by representatives of the following States members of the Working Group: Algeria, Australia, Austria, Belarus, Bolivia, Canada, China, Colombia, Czech Republic, France, Germany, Greece, Guatemala, Iran (Islamic Republic of), Italy, Latvia, Lebanon, Malaysia, Mexico, Nigeria, Norway, Poland, Republic of Korea, Russian Federation, Senegal, Spain, Switzerland, Thailand, Uganda, United Kingdom of Great Britain and Northern Ireland, United States of America, Venezuela (Bolivarian Republic of) and Zimbabwe.

5. The session was also attended by observers from the following States: Denmark, Dominican Republic, Indonesia, Iraq, Netherlands, Panama, Philippines, Portugal, Qatar, Slovakia, Slovenia, Tunisia and Turkey.

6. The session was also attended by observers from the following international organizations:

(a) **Organizations of the United Nations system**: the World Bank;

(b) **Intergovernmental organizations**: the European Commission (EC);

(c) **International non-governmental organizations invited by the Working Group**: American Bar Association (ABA), American Bar Foundation (ABF), Centre for International Legal Studies (CILS), Groupe de réflexion sur l'insolvabilité et sa prévention (GRIP 21), INSOL International (INSOL), International Bar Association (IBA), International Insolvency Institute (III), International Women's Insolvency & Restructuring Confederation (IWIRC) and the International Working Group on European Insolvency Law.

7. The Working Group elected the following officers:

Chairman: Mr. Wisit Wisitsora-At (Thailand)

Rapporteur: Ms. Shamni Arulanandam (Malaysia)

8. The Working Group had before it the following documents:

(a) Annotated provisional agenda (A/CN.9/WG.V/WP.77); and

(b) A note by the secretariat on the treatment of enterprise groups in insolvency (A/CN.9/WG.V/WP.78 and Add. 1).

9. The Working Group adopted the following agenda:

1. Opening of the session;
2. Election of officers;
3. Adoption of the agenda;
4. Consideration of the treatment of enterprise groups in insolvency;
5. Other business;
6. Adoption of the report.

III. Deliberations and decisions

10. The Working Group continued its discussion of the treatment of enterprise groups in insolvency on the basis of documents A/CN.9/WG.V/WP.78 and Add.1, and other documents referred to therein. The Working Group considered the glossary and draft recommendations 1-24 and requested the Secretariat to prepare a revised text on the basis of its deliberations and decisions. Following a preliminary discussion of the timing of its consideration of international issues relating to the treatment of enterprise groups in insolvency, the Working Group was of the view that it would be appropriate to consider those issues at an early stage of its next session. The deliberations and decisions of the Working Group are reflected below.

IV. Treatment of enterprise groups in insolvency

A. Glossary

11. The Working Group considered the terms set forth in paragraph 2 of document A/CN.9/WG.V/WP.78. Some concerns were expressed with respect to the domestic element of the definition of "domestic [commercial] [business] enterprise group", as no explanation was provided for "domestic". A further concern related to the relationship between the elements of capital and control and the need to give due consideration to control.

12. It was said that the explanation of "enterprise" contained in paragraph 2 (b), encompassed certain entities not previously included, such as trusts. However, another view suggested limiting the use of "enterprise" to refer only to entities with legal personality, thus excluding contractual arrangements, such as franchising and distribution agreements, and certain family-based entities.

13. With respect to the explanation of "capital" contained in paragraph 2 (c), it was suggested that the notion of "partnership interests" be included. Specific concern was expressed with the explanation of control as currently drafted in paragraph 2 (d) on the basis that certain types of secured credits might be included.

14. The Working Group agreed that the terms set forth in paragraph 2 provided a sound working basis for future deliberations.

B. The onset of insolvency: domestic issues

1. Commencement of insolvency proceedings

15. The Working Group discussed the commencement of insolvency proceedings in enterprise groups in the domestic context on the basis of document A/CN.9/WG.V/WP.78, sub III.A.1, paras. 1-10.

Joint application for commencement

16. It was observed that the purpose of a joint application for insolvency proceedings was to facilitate coordinated consideration of the insolvency of enterprise group members from the outset. It was noted that joint application, while possibly ensuring procedural coordination, did not affect the individuality of insolvency proceedings with respect to each group member, based upon satisfaction of the applicable commencement standard for that member. Any recommendation on joint application should be in line with the relevant provisions of the UNCITRAL Legislative Guide on Insolvency Law.

Draft recommendation 1

17. It was suggested that draft recommendation 1 could, in addition to a single joint application, allow individual applications with a joint purpose to be made with respect to members of an enterprise group. It was noted that in practice the applications would often be distinct for each member for administrative or other similar reasons.

18. It was further suggested that draft recommendation 1 could include a requirement for the group member to indicate its position in a group, particularly where the insolvent member was the controlling entity.

19. With respect to involuntary filing of a joint application, it was suggested that the current text, requiring a contractual arrangement between the applying creditor and the concerned members of the group, might lead to other members of the group being excluded from the joint application.

20. The Working Group agreed that draft recommendation 1 should be revised to clarify the possibility of group members filing separate applications with a joint purpose.

Draft recommendation 2

21. It was suggested that draft recommendation 2 should require a creditor to give notice of its joint application for commencement to other creditors of the group. In reply, it was noted that that requirement might be overly difficult to satisfy in practice, especially where there was a large number of unknown creditors. It was added that such a requirement might have a negative impact on the commercial standing of solvent members of the group.

22. It was further suggested that, in the event procedural coordination was ordered when part or all of the relevant insolvency proceedings had already been commenced, notice of the application for procedural coordination should be given to the insolvency representatives of those relevant proceedings.

23. It was said that draft recommendation 2 introduced a duty for the creditor to give notice to the debtor when a joint application for commencement had been made. It was added that such a duty had already been mandated under recommendation 19 of the Legislative Guide for applications by creditors for commencement of insolvency proceedings. In light of the complementarity of the present text with the Legislative Guide, it was suggested that draft recommendation 2 should be deleted.

24. The Working Group agreed that draft recommendation 2 should be deleted.

2. Treatment of assets on commencement of insolvency proceedings

(a) Procedural coordination

Draft recommendation 3

25. It was suggested that draft recommendation 3 should be revised to take into account the different approaches of the various jurisdictions in granting courts the power to initiate the procedural coordination of insolvency proceedings.

Draft recommendation 4

26. The substance of draft recommendation 4 was generally acceptable.

Draft recommendation 5

27. It was agreed that draft recommendation 5 should specify that the insolvency representative should be permitted to file for procedural coordination, as the

representative often possessed the most relevant information for making such a decision. It was indicated that the drafting should make it clear that any of the subjects indicated in the existing draft of the recommendation may file an application for procedural coordination.

28. It was also suggested that the draft recommendation should be aligned with draft recommendation 4, in particular paragraph 4 (a), and include a reference to any member with respect to which an application for commencement had been made.

Draft recommendation 6

29. It was noted that, while procedural coordination entailed gathering multiple insolvency proceedings before one court, no indication of the criteria for determining or choosing the competent court had been provided in the draft text. In response, it was explained that a range of different criteria, such as priority of filing, size of indebtedness or centre of control, might be chosen to establish the prevailing competence of one court in the domestic setting. It was therefore suggested that the matter should be left to domestic procedural rules.

Draft recommendation 7

30. It was agreed that the word "affected" should be deleted from draft recommendation 7, and that the word "when" should be replaced by the word "if".

31. It was clarified that the duty of notice to all creditors under draft recommendation 7 may be satisfied with collective notification, such as by notice in a particular legal publication, when domestic legislation so permitted, for instance in case of a large number of creditors with very small claims.

Draft recommendation 8

32. Several suggestions were made with respect to the additional information that might be included as contemplated by draft recommendation 8, such as coordination of hearings, arrangements to be made with respect to lending arrangements and so forth. Explanation of that additional information might be included in commentary to this work.

33. In accordance with a suggestion made at its thirty-second session, the Working Group considered whether the possibility of modifying or reversing an order for procedural coordination should be included in the draft recommendations or in commentary to those draft recommendations. It was noted that the purpose of procedural coordination was to promote procedural convenience and cost efficiency. When circumstances changed, it might be useful to have the flexibility to adjust the initial order to take account of the current situation. That might be the case, for example, if reorganization was not successful and the individual members should be liquidated separately. After discussion, the Working Group agreed to include text on the reversal or modification of an order for procedural coordination and to provide further explanation in the commentary.

34. With respect to commencement of insolvency proceedings, the question was raised as to whether the commencement standard of recommendation 15 of the Legislative Guide was broad enough to encompass notions of imminent insolvency

that might be encountered in a group context. For example, it was pointed out that it might often be the case that the insolvency of several or many members of the group would lead inevitably to the insolvency of all members (the "domino effect"). The imminence of the insolvency might be judged by reference to the group situation. Therefore, it was suggested that the standard for commencement of insolvency proceedings in the Legislative Guide might need to be broadened to take into account circumstances arising from the enterprise group context. After discussion, it was agreed that additional considerations concerning imminent insolvency in a group context might be addressed in commentary to this work.

(b) Protection and preservation of the insolvency estate

35. The Working Group considered the issues discussed in paragraphs 20-24 of document A/CN.9/WG.V/WP.78, and in particular whether there were any circumstances, such as outlined in paragraph 23, in which a stay of proceedings in insolvency might be extended to a solvent member of an enterprise group. Some support was expressed in favour of a stay being available on a discretionary basis to protect the assets of a solvent member of the group, which could be used to finance insolvent members, provided the need for that stay was substantiated. Further clarification was required with respect to the question of whether a stay might be available to protect a group member from additional liability in situations such as those outlined in paragraph 23. After discussion, it was agreed that the issues could be explained in commentary to this work, without introducing a recommendation at this stage.

(c) Post commencement finance

36. The Working Group considered post-commencement finance on the basis of draft recommendations 9-13 of document A/CN.9/WG.V/WP.78.

Draft recommendations 9-11

37. As a preliminary issue, it was noted that draft recommendations 9-11 repeated key elements of the corresponding recommendations of the Legislative Guide, raising the question of how the current work of the Working Group related to the Legislative Guide and whether those recommendations relating to post-commencement finance would apply in the group context. It was confirmed that the goal of the current work was to complement the Legislative Guide by addressing issues that were particular to enterprise groups. Unless otherwise specified, it was suggested that the recommendations of the Legislative Guide generally would apply to enterprise groups. It was noted, for example, that recommendation 67 should apply to post-commencement finance in the group context. While repetition of the recommendations of the Legislative Guide might therefore not be required, draft recommendations 9-11 did serve to identify those recommendations of the Legislative Guide relevant to post-commencement finance and to place them in a group context. It was agreed that issues relating to drafting techniques might need to be reconsidered when the form of the current work of the Working Group, and in particular whether it was integrated with the Legislative Guide or constituted a stand-alone text, had become clearer.

38. The substance of draft recommendations 9-11 was generally found to be acceptable. As a matter of drafting, it was proposed that the words "subject to

insolvency proceedings" be added after the words "member of an enterprise group" in draft recommendation 11.

Draft recommendations 12 and 13

39. A number of issues common to both draft recommendations were discussed. A key question related to the provision of finance, whether by way of security or guarantee, by a solvent group member. It was observed that although the provision of finance by a solvent entity might cause prejudice to its creditors, it was not a matter of insolvency law, but rather one of the law regulating companies, which might require approval of shareholders or directors. However, it was also observed that even though it might be an issue of company law, a rule might be useful to ensure that post-commencement finance could be made available by a solvent entity in a group context in States where such lending might otherwise be *ultra vires*.

40. Where an insolvent member of the group provided finance, the concern was expressed that the transfer of assets might suggest substantive consolidation of the lender and borrower. In response it was pointed out that if the entities had been substantively consolidated, there would be no need to provide a security or guarantee.

41. With respect to the situations in which finance might be available, one view was that finance should be limited to cases of reorganization, and not be available in liquidation. In response, it was pointed out that that approach was too narrow, as very often the value of the debtor's estate was maximized through liquidation processes such as sale of the debtor's business as a going concern. It was noted in that regard that the Legislative Guide provided that post-commencement finance should be available for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the estate (recommendation 63). After discussion, it was agreed that the approach of the Legislative Guide should apply to the group context.

42. The question was raised as to the way in which the provision of finance by members of the group, i.e. intra-group lending and borrowing, should be treated in comparison to the provision of such finance by an entity external to the group, in terms of priority, avoidance, subordination and so forth. One solution proposed was that the question might be addressed in terms of incentives for providing post-commencement finance, as noted in draft recommendation 9. For example, intra-group lending might be given priority or legislative prohibitions on securing the assets of one group member for the benefit of another member could be relaxed in the group context.

43. To address concerns with respect to the provision of a security interest by a potentially solvent entity under draft recommendation 12, it was proposed that the draft recommendation be more closely aligned with draft recommendation 13 so that the entity providing the security interest should also be subject to insolvency proceedings. That proposal was supported.

44. The Working Group focused on the safeguards included in paragraphs (a) and (b) of draft recommendation 13. It was agreed that those paragraphs, with appropriate revision to reflect the context of provision of a security interest, as opposed to a guarantee, might also be included in draft recommendation 12. Different suggestions were made with respect to the substance of those paragraphs.

It was noted that where a single insolvency representative was appointed to the insolvency proceedings of a number of group members, the insolvency representative consenting to the finance might also be the insolvency representative of the receiving member, creating a conflict of interest. It was also noted that while paragraph (b) included a standard relating to the effect of the finance on creditors, paragraph (a) did not establish a basis for the insolvency representative's consent. To remedy that situation, it was proposed that the insolvency representative should also be required to satisfy the same standard as in paragraph (b).

45. With respect to paragraph (b), it was observed that the determination that creditors "will not" be adversely affected might be too difficult to achieve. Alternatives proposed were that the creditors "were not likely" to be adversely affected or that the court "was satisfied" that creditors would not be adversely affected. Some support was expressed in favour of adopting one of those approaches, although a different view was that neither would establish a sufficiently high standard. A different solution proposed that the focus should be upon demonstrating the benefit or the prospect of benefit to be derived from the provision of finance, rather than upon any adverse affect on creditors. It was noted in response that determining potential benefits in what was a highly risky situation, i.e. providing finance to an insolvent debtor, might be very difficult and might preclude such finance being provided. After discussion it was agreed that a formulation such as "the court was satisfied" could be adopted.

46. A related suggestion was that the requirements in paragraphs (a) and (b) should be cumulative. In response to that suggestion, it was observed that since different States adopted different approaches with respect to the level of involvement of courts in insolvency proceedings, as acknowledged in the Legislative Guide, draft recommendations 12 and 13 should not be too prescriptive and paragraphs (a) and (b) should be maintained as alternatives. For example, it was noted that the Legislative Guide recognized that not all States would require approval of the court with respect to confirmation of a reorganization plan (recommendations 152 and 153). After discussion, the prevailing view was that the more flexible approach of (a) or (b) should be adopted, with the possibility of including both if required by a State.

47. It was observed that paragraphs (a) and (b) did not address the rationale for, or identify criteria that could guide, the provision of finance, for example, to facilitate reorganization of the group of which the debtors were members or to maximize the value of that group. Such a requirement could be included in an additional subparagraph. That proposal received support.

48. The Working Group approved the substance of draft recommendations 12 and 13 with the revisions as agreed. The Working Group considered that the draft recommendations could be combined as they addressed provision of a security interest or guarantee in similar circumstances. It was noted, however, that the commentary should point to the different effect of each form of financing, particularly with respect to the consequences for creditors.

(d) Post-application financing

49. It was observed that once an application for insolvency proceedings was made, access to finance generally became more difficult. Moreover, post-commencement

finance was not available until after the commencement of insolvency proceedings. The lack of finance in the period of time between the application for and the commencement of insolvency proceedings could jeopardize the chances of economic recovery of the concerned entity. It was therefore suggested that the possibility of obtaining finance on a privileged basis should be extended to that period of time, possibly as a provisional measure as contemplated by recommendation 39 of the Legislative Guide.

50. In response, it was noted that while a delay between the application for and commencement of insolvency proceedings was normal, the unpredictability of the outcome of the application would prevent the benefits of an insolvency measure from extending to the pre-insolvency phase.

51. After a preliminary discussion, the Working Group decided to consider the matter further at a future session.

(e) Treatment of contracts

52. The Working Group considered recommendations 69-86 of the Legislative Guide, which address the treatment of contracts. It was pointed out that the treatment of contracts in the Legislative Guide was based on the assumption that the counterparty to the contract was solvent and that, as a basic concept, the focus was on whether continuation of a contract would be beneficial for the debtor. The first assumption might not always apply in the context of enterprise groups. The question of benefit might relate to the group as a whole in addition to the individual debtor.

53. It was noted that there were a number of intra-group contracts, such as distribution agreements, that might form the basis of the group (as explained in the term “control”). Consideration of those contracts might require parameters different from those adopted in the Legislative Guide. As a minimum, it was suggested that a group member should be prevented from opting out of the enterprise group by means of the provisions on treatment of contracts. In response, it was proposed that the balance of interests between the group and individual members needed further consideration, and could be explored in the commentary to the current work.

54. The Working Group decided to consider the matter further at a future session.

(f) Avoidance

55. It was recalled that, under the Legislative Guide provisions on avoidance, the members of an enterprise group would be considered to be related persons. Accordingly, transactions between them would be subject to avoidance, with the possible exception of those entities which were group members at the moment of the commencement of the proceedings, but not at the time the transaction to be avoided took place. A suggestion to reconsider the definition of “related person” in the Legislative Guide was not supported.

56. It was indicated that the treatment of avoidance in the enterprise group context should take into consideration the difference between, on the one hand, reorganization proceedings and sale of the entity as a going concern in liquidation proceedings and, on the other hand, piecemeal sale of the assets in liquidation. It was added that such a distinction might be reflected in considerations of the element of detriment, i.e. that of the group, individual debtors or creditors. A further issue in

the group context might relate to whether transactions were entered into in the ordinary course of business.

57. The Working Group approved the substance of draft recommendations 14 and 15 as a basis for future deliberations, noting that the language at the end of draft recommendation 15 might be made clearer by reference to recommendation 97 of the Legislative Guide.

(g) Set-off

58. It was observed that intra-group balancing of liabilities occurred regularly during insolvency proceedings of enterprise groups, and that the provisions of the Legislative Guide on set-off provided sufficient guidance to deal with them effectively. It was further added that reference should be made also to those provisions of the Legislative Guide dealing with netting and other set-off issues specific to financial contracts.

(h) Subordination

59. The Working Group had a preliminary discussion on the question of subordination, an issue that had been raised a number of times with respect to avoidance and set-off. It was indicated that certain jurisdictions had adopted a general rule on subordination of intra-group claims, the effect of which was to rank those claims below those of unsecured creditors. It was added that the adoption of such a rule would reflect a policy choice discouraging intra-group lending. It was further said that such a rule would be alternative to those on avoidance and set-off in the group context.

60. It was recalled that the Legislative Guide treated subordination in the context of the treatment of claims, but did not include any recommendations. After discussion, it was agreed that the Legislative Guide treatment was sufficient.

3. Remedies – substantive consolidation

61. The Working Group considered substantive consolidation on the basis of draft recommendations 16-18 of document A/CN.9/WG.V/WP.78/Add.1.

Draft recommendation 16

62. It was generally agreed that the principle of the separate legal identity of each member of an enterprise group should be upheld. Further, it was emphasized that that principle should be the general rule and substantive consolidation should be an exception, which would apply only in very limited circumstances where the interests of creditors so required. It was acknowledged that the opening words of draft recommendation 16 would apply to the Working Group's consideration of enterprise groups generally and, accordingly, the specific references to draft recommendations 17 and 18 might not be required. The Working Group approved the substance of draft recommendation 16.

Draft recommendation 17 (a)

63. It was proposed that the chapeau of draft recommendation 17 be revised in order to confirm that the result of substantive consolidation was a single insolvency

proceeding concerning only one entity and to avoid any confusion with procedural coordination.

64. With respect to the alternatives in square brackets in the chapeau, the use of "may" was widely supported on the basis that it would better stress the exceptional nature of the remedy of substantive consolidation. It was also suggested that the words "but only" should be added after "single entity", in order to further emphasize that substantive consolidation would only apply in exceptional circumstances.

65. With respect to paragraph (a), it was proposed that the words "subject to insolvency proceedings" should be deleted, as the intermingling of assets in a group might also include solvent members and members apparently solvent, but actually insolvent because of the intermingling of assets.

66. Another suggestion was to replace the word "was" with the word "is", in order to indicate that the impossibility of identifying the ownership of individual assets should be ascertained after the commencement of insolvency proceedings. That suggestion was widely supported.

Draft recommendation 17 (b)

67. The view was expressed that paragraph (b) as drafted was too broad. To limit the scope, it was proposed that the words "and as a means of" be added after "for the purpose". In addition, it was suggested that the type of fraud contemplated was not sufficiently clear; it was not fraud occurring in the daily operations of a debtor, but rather total absence of a legitimate business purpose. Other explanations of what might be meant by fraud in that context were provided. After discussion, the general view was that defining fraud more specifically than set forth in paragraph (b) would prove difficult and the current approach should be retained for further consideration.

68. Reservations were expressed with respect to the intent of paragraph (b) as the creditors would not be privy to the fraudulent purposes contemplated and therefore should not bear the consequences of substantive consolidation. In addition, unless there was intermingling of assets, a situation covered by paragraph (a), it was difficult to understand what situations of harm to creditors paragraph (b) was intended to address. The view was also expressed that it was not necessary to adopt a remedy that departed from the primacy of the single entity principle in order to address fraud, as other remedies were available under the law of most States, such as extending liability within the group or avoiding individual transactions. In response, it was pointed out that different remedies varied in requirement and effect, and that some remedies involved time-consuming suits against individual debtors. In comparison, insolvency remedies provided a much faster solution. It was further pointed out that reliance upon individual remedies would inevitably mean that solvent members of the group were pursued individually, with the benefits provided by collective insolvency proceedings being lost.

69. It was observed that although the focus of paragraph (b) was upon the establishment of a particular structure for the purposes of fraud, it was also possible that an entity established for legitimate purposes could later be used for fraudulent purposes or simulation. Accordingly, paragraph (b) could focus upon entities "used" for such purposes to cover both situations. That proposal received support.

70. A further view was that requiring substantive consolidation to be "appropriate" for rectifying the fraudulent structure was too broad in light of the exceptional nature of the remedy and should be replaced by a requirement that substantive consolidation be "essential".

71. It was observed that the group members affected by substantive consolidation could include members that were affected by the insolvency of other members, members who satisfied a test of imminent insolvency as contemplated by the Legislative Guide and members that appeared to be solvent but on further investigation were not solvent because of intermingling of assets. A different view was that insolvency was not a prerequisite for substantive consolidation and a solvent entity might therefore be involved. In support of that view, it was noted that if substantive consolidation included only insolvent members of a group, few assets would be available for consolidation. For that reason, the focus of substantive consolidation should be the detriment caused to creditors and its remedy.

72. To address some of the concerns expressed, it was proposed that paragraph (b) should be deleted. Alternative proposals included: adding the substance of paragraph (b) to paragraph (a) and focusing on situations where there was intermingling of assets; adding the concept of detriment to creditors caused by fraud to paragraph (a); or addressing the issue of fraud in commentary to paragraph (a). In response, it was pointed out that many instances of fraud would not fall within the scope of paragraph (a) where the focus was on intermingling of assets and paragraph (b) should therefore be retained.

73. Another proposal with respect to the structure of the draft recommendations on substantive consolidation consisted of combining draft recommendations 16, 17 and 18, thus presenting draft recommendations 17 and 18 as rarely applicable exceptions to the general principle of respect for the separate legal identity of each member of an enterprise group.

74. After discussion, the Working Group agreed that paragraph (b) should be revised to reflect the views expressed.

75. It was suggested that the explanation contained in paragraphs 14-16 of document A/CN.9/WG.V/WP.78/Add.1 should emphasize recognition and respect for the rights of secured creditors in insolvency. It was also suggested that substantive consolidation and other remedies, such as extension of liability, should be discussed in commentary to the recommendations, clarifying the goals of each remedy and how each was different to the others.

Draft recommendation 18

76. The view was expressed that the discretion provided to the court in draft recommendation 18 was too broad, focusing on the subjective views of creditors rather than on the objective behaviour of the group that had led creditors to believe that they were dealing with a single entity, rather than with a member of an enterprise group. For that reason, it was proposed that the draft recommendation should focus on the conduct of the group and how it presented itself externally. An example was provided of a case in which substantive consolidation had been ordered when creditors had dealt with what appeared to be a single entity and were unaware of the identity of individual members with which they had dealt or even of the existence of a group. It was noted that that case was independent of the

existence of fraud. Focusing on the group's behaviour received some support, although concern was expressed as to the time at which that behaviour should be considered. It was pointed out that that behaviour might change over time and with respect to different creditors.

77. It was proposed that the chapeau of draft recommendation 18 should be aligned more closely with draft recommendation 17, with "should" being substituted for "may". It was also proposed that draft recommendation 18 could be added to draft recommendation 17. The Working Group did not propose any further examples for inclusion in the draft recommendation.

78. After discussion, the Working Group agreed that draft recommendation 18 should focus on the behaviour of the group as a single entity. The Secretariat was requested to prepare drafting suggestions combining draft recommendations 17 and 18.

Additional questions on substantive consolidation

79. The Working Group discussed additional questions on substantive consolidation on the basis of document A/CN.9/WG.V/WP.78/Add.1, paras. 23 and 24.

(i) Treatment of competing interests

Security interests

80. The Working Group agreed that recognizing and respecting security interests should be a key principle in substantive consolidation. It was added that there might be exceptions to that principle in certain limited cases. In that respect, it was suggested that intra-group securities might be cancelled or subordinated to unsecured claims, and that security interests created to pursue fraudulent schemes should be subject to avoidance or otherwise disposed of.

(ii) Partial substantive consolidation

81. Support was expressed for retaining the possibility of ordering a partial substantive consolidation that might exclude certain assets.

(iii) Persons permitted to apply for substantive consolidation

82. It was indicated that since the insolvency representative would often be in the best position to apply for substantive consolidation, it should be permitted to apply. Creditors too might possess relevant information and therefore should also be permitted to apply.

83. There was general agreement that the courts should not be permitted to order substantive consolidation on their own initiative. The serious impact of substantive consolidation required a fair and equitable process to be followed. It was noted that in some States, courts could not act on their own initiative. It was recalled that the Legislative Guide did not generally provide for courts to act on their own initiative in insolvency matters of that gravity.

(iv) Time of application and for inclusion of additional group members

84. It was indicated that no time limits should be included with respect to the possibility of applying for substantive consolidation, as the existence of the various entities to be consolidated might be discovered at different moments and even after lengthy investigation. Preventing those entities from being consolidated because of time limits would be unfair. It was added that the same principle should apply to the inclusion of additional group members in the substantive consolidation. It was noted that, in practice, limits to the possibility of applying for substantive consolidation might arise from the state of the insolvency proceedings, and, in particular, from the execution of a reorganization plan. The introduction of a hotchpot rule might be needed if substantive consolidation were to be ordered after a partial distribution of assets.

(v) Notice of application

85. It was indicated that notice of application for substantive consolidation should be given to insolvency representatives, if the entities to be consolidated were insolvent, and to the appropriate representatives of solvent enterprise group members. Notice should be given in an effective and timely manner in the form determined by domestic law. Support was also expressed for notifying creditors of the concerned entities of the application, in light of the impact that substantive consolidation might have on their claims. However, the view was also expressed that providing notice of an application for substantive consolidation to the creditors of a solvent entity might significantly affect the commercial standing of that entity. It was added that the matter should be dealt with in line with recommendations 22 and 23 of the Legislative Guide, which did not mandate notification of the application for commencement of insolvency proceedings to the creditors of the concerned entity. In response, it was noted that equal treatment should be provided with respect to notice to creditors of solvent and insolvent entities.

(vi) Competent court

86. The Working Group discussed the issues relating to the court competent to order substantive consolidation and other related measures.

87. It was recalled that where jurisdiction for insolvency matters fell under the competence of special courts or, in certain cases, of administrative authorities, the same bodies would be competent for matters relating to substantive consolidation. It was added that, in the event of a conflict of competence, a number of criteria to allocate jurisdiction would be available, such as priority, location of the parent company or the centre of main interests, and that the choice of that criterion should be left to domestic law. That approach was in line with the one adopted in recommendation 13 of the Legislative Guide.

(vii) Varying an order for substantive consolidation

88. The Working Group agreed that the possibility of varying an order for substantive consolidation should be included.

(viii) Effect of consolidation on calculation of the suspect period

89. Where substantive consolidation was ordered at the same time as commencement of insolvency proceedings with respect to relevant members of a group, the Working Group agreed that the provisions of the Legislative Guide on calculation of the suspect period would apply.

90. Where substantive consolidation was ordered after the commencement of proceedings or where group members were added to a substantive consolidation at different times, it was acknowledged that difficult issues arose with respect to the choice of the date from which the suspect period would be calculated, particularly when the period of time between application for or commencement of those proceedings and substantive consolidation was long.

91. Criteria proposed for calculation of the suspect period included: (a) taking the earliest date of application for or commencement of insolvency proceedings with respect to those members to be consolidated; (b) allowing the court to determine the most appropriate date in the substantive consolidation order; or (c) preserving a date for each group member calculated by reference to the Legislative Guide.

92. It was observed that choice of the date of substantive consolidation for calculation of the suspect period would 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. The need to provide certainty for lenders and other third parties was stressed. A longer suspect period might be desirable in case of fraud or intermingling of assets.

93. After discussion, it was agreed that alternatives based upon options (a) and (c) above should be prepared for future consideration.

(ix) Contribution orders

94. It was proposed that the Working Group might consider the issue of contribution orders. Such an order might be possible, for example, in cases when the subsidiary had incurred significant liability for personal injury or the parent had permitted the subsidiary to continue trading whilst insolvent. In response, it was suggested that those issues could be addressed by remedies already available under other law, such as liability and wrongful trading. Accordingly, it was felt that such a remedy might not be required.

4. Participants

(a) Appointment of an insolvency representative

95. The Working Group considered the appointment of a single insolvency representative on the basis of draft recommendations 19-20 of document A/CN.9/WG.V/WP.78/Add.1.

Draft recommendation 19

96. It was proposed that the last words of draft recommendation 19 “to conduct that procedural coordination” were unnecessary and could be deleted. It was noted that use of the word “against” with respect to insolvency proceedings suggested

involuntary proceedings and should be avoided. A suggestion to substitute "may" with "should" was not supported on the basis that it might cause problems in States with more than one domestic jurisdiction. The Secretariat was requested to prepare a revised draft of draft recommendation 19.

97. A further suggestion was that an additional draft recommendation could be included before draft recommendation 19 to the effect that coordination of two or more proceedings could be achieved by appointment of a single insolvency representative or other means of coordination. It was also suggested that the commentary should address situations where the debtor remained in possession and no insolvency representative was appointed.

98. With respect to the second sentence of paragraph 25 of document A/CN.9/WG.V/WP.78/Add.1, it was proposed that the words "would ensure" be revised.

Draft recommendation 20

99. The Working Group approved the substance of draft recommendation 20.

(b) Coordination of multiple proceedings with respect to members of an enterprise group

100. The Working Group discussed the coordination of multiple proceedings with respect to members of an enterprise group on the basis of draft recommendations 21-23 of document A/CN.9/WG.V/WP.78/Add.1.

Draft recommendation 21

101. It was explained that draft recommendation 21 dealt with coordination of insolvency proceedings in general, while draft recommendation 22 dealt with coordination of insolvency proceedings in the context of procedural coordination. Accordingly, the two draft recommendations should reflect different levels of coordination of proceedings. In that regard, it was suggested that in draft recommendation 21 the word "establish" should replace the word "facilitate".

102. It was noted that in certain jurisdictions, courts, rather than insolvency representatives, would have the authority to coordinate insolvency proceedings, and that that should be reflected in draft recommendations 21-23.

103. The possibility of one insolvency representative, such as the representative of the parent company, taking a leading role in the coordination of the proceedings relating to members of an enterprise group was noted. While such a leading role might reflect the economic reality of the enterprise group, it was agreed that equality under the law of all insolvency representatives should be preserved. It was noted that coordination under the leadership of one insolvency representative may nevertheless be achieved on a voluntary basis, to the extent possible under applicable law. Accordingly, that possibility should be added to the forms of cooperation permitted under draft recommendation 23.

104. Since insolvency representatives might be reluctant to engage in coordination of proceedings before an order for procedural coordination was entered into, it was proposed that draft recommendation 21 should be permissive rather than prescriptive.

Draft recommendation 22

105. It was noted that since in certain jurisdictions the judicial order for procedural coordination would indicate the related measures required for coordination, reference to the terms of the judicial order should be inserted in draft recommendation 22.

Draft recommendation 23

106. It was said that certain forms of cooperation listed in draft recommendation 23, such as cooperation on issues relating to the exercise of powers and allocation of responsibilities between insolvency representatives, coordination on the use and disposition of assets, use of avoidance powers and so forth, were regulated by the law in a number of jurisdictions, and therefore could not be disposed of by the insolvency representatives. Accordingly, it was suggested that the words "to the extent permitted by law" be inserted in the draft recommendation.

(c) Creditors

107. The Working Group discussed the participation of creditors on the basis of document A/CN.9/WG.V/WP.78/Add.1, para. 35.

108. It was noted that there was a significant difference between the treatment of creditor participation in substantive consolidation and procedural coordination. It was suggested that where substantive consolidation was ordered, a single creditors meeting could be convened for all creditors of the consolidated entity and a single creditor committee could be established. In contrast, in procedural coordination, the interests of creditors diverged and could not be represented in a single committee. It was noted, however, that in cases of procedural coordination involving many group members, providing a separate committee for the creditors of each member might prove to be extremely costly and inefficient for administration of the proceedings. Accordingly, in some States, the courts might have the discretion not to establish a creditor committee for each separate entity. After discussion, the Working Group agreed that as a general principle a single committee was not appropriate in procedural coordination.

109. With respect to intra-group creditors, it was observed that those creditors would be considered related persons under recommendation 131 of the Legislative Guide, leading to their disqualification from participation in a creditor committee. A further concern related to the treatment of intra-group claims and the effect on intra-group creditors. If the rights of intra-group creditors were affected, such as by the subordination of intra-group claims, those relying on the assets of those creditors would in turn be affected.

110. It was agreed that recommendation 137-138 of the Legislative Guide should apply in the group context to external and intra-group creditors in the same manner.

5. Reorganization plan

111. The Working Group considered draft recommendation 24 and paragraph 42 of document A/CN.9/WG.V/WP.78/Add.1.

Draft recommendation 24

112. The Working Group agreed that the provisions of the Legislative Guide with respect to reorganization plans would apply in the enterprise group context.

113. Support was expressed in favour of adopting "should" with respect to paragraph (a) and "may" with respect to paragraph (b).

114. It was proposed that paragraph (a) should clarify that it contemplated the filing of a single reorganization plan in each of the proceedings concerning group members covered by the plan. That plan would be voted upon by the creditors of each group member, in accordance with the voting requirements applicable to a plan for a single debtor. Approval of such a plan would be considered on a member-by-member basis and would require agreement of the creditors of each entity; it would not be possible 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 the benefits to be derived from such approval. Those issues would be covered by recommendations 143 and 144 of the Legislative Guide concerning content of the plan and the accompanying disclosure statement. Additional details that might relevantly be disclosed in the group context included details with respect to group operations and functioning of the group as such. However, caution should be exercised in providing information relating to a solvent group member covered by the reorganization plan.

115. A different scheme for voting was proposed that would allow the majority of creditors of the majority of group members to approve a plan, overriding the objections of the minority of group members. After discussion, that proposal was not supported and the Working Group agreed that the creditors of each member of the group covered by the plan should approve the plan in accordance with the voting requirements applicable to individual entities.

116. With respect to paragraph (b), it was proposed that the text should clarify what was intended by the words "include" and "with consent". It was noted that reorganization plans might be either a contract or a quasi-contract, which required court confirmation to become effective. With respect to consent, it was questioned whether that referred to the consent of creditors or of the relevant officers or owners of the group member in accordance with applicable company law. The prevailing view was that since the decision of a solvent entity to participate in a reorganization plan was an ordinary business decision of that entity, the consent of creditors was not necessary unless required by applicable company law. It was noted that insolvency law was not relevant to such consent.

117. Regarding the meaning of "include", it was pointed out that the solvent entity might provide financing or assets to the reorganization, the details of which would be included in relevant disclosure statements, or be merged with insolvent entities to form a new entity under the reorganization plan. In the latter instance, the effect on the creditors of the solvent entity would have to be disclosed and their rights clarified. After discussion, the Working Group approved the substance of paragraph (b) with the revisions proposed.

Additional questions on reorganization

118. The Working Group noted that the commentary might include material on a number of issues relating to reorganization, such as the situations in which variable rates of return might be justified for creditors of different group members and related person provisions might cause difficulty in reorganization, such as when a parent company had only creditors classified as related persons who were thereby disqualified from voting on a reorganization plan.

119. Concerning liquidation value for the purposes of recommendation 152 (b) of the Legislative Guide, the Working Group was of the view that in substantive consolidation that value would be the liquidation value of the consolidated entity, and not the liquidation value of the individual members before substantive consolidation.

120. With respect to failure of implementation of a reorganization plan it was agreed that recommendations 155-156 of the Legislative Guide were sufficient to address the matter in the enterprise group context.

6. Form of current work

121. The Working Group discussed the possible form of its work on enterprise groups in insolvency and its effects on structure and drafting style. It was generally agreed that the work should be in the form of a legislative guide for various reasons, including the complexity of the topic, the diversity of approaches to it and the connection to the Legislative Guide. The Working Group also considered whether the resulting text should be published as an addendum to the Legislative Guide or as a stand-alone work. Some views favoured a stand-alone publication for reasons of simplicity and ease of distribution, whereas others supported an addendum to the Legislative Guide because of the relationship between the two texts.

7. Glossary

122. Having completed its discussion of draft recommendations 1-24, the Working Group turned its attention to further consideration of the terms included in the glossary (see above, paras. 11-14).

123. It was agreed that the term “enterprise group” should be more generic and not limited to domestic situations. Further explanation concerning international aspects of a group might be added later. It was also agreed that the explanation of the term “enterprise” provided sufficient connection to business or commercial activity and the words “domestic”, “business” and “commercial” could therefore be deleted.

124. The Working Group approved the substance of the explanation of “enterprise”, with a clarification to be added that an enterprise was not intended to include consumers, consistent with the approach adopted in the Legislative Guide.

125. With respect to “capital”, it was proposed that the definition should distinguish between incorporated and unincorporated entities, both of which could be included in an “enterprise group”. It was indicated that “capital” could include assets in the context of an unincorporated entity and shareholding in the context of an incorporated entity. Similarly, control by contractual arrangement would only be relevant in the context of unincorporated entities. In response to a query with

respect to the inclusion of “credits”, it was suggested that that would be included in the notion of “debts”. A proposal to add a reference to “trust units” was supported.

126. It was suggested that since, in a number of States, groups could be formed by an agreement that did not involve capital, that concept might be included in the explanation of the term “control”. A question was raised as to whether control should be limited to contractual arrangements and exclude implied control. After discussion, the Working Group agreed that those issues should be further considered.

127. The Working Group agreed that the term “member of an enterprise group” needed to be clarified to ensure that the reference to eligibility under the insolvency law referred only to the scope of the insolvency law and the types of entities covered by it and not to satisfaction of the commencement standards of the insolvency law by a specific debtor.

128. A number of revisions were proposed with respect to “procedural coordination”. Firstly, it was generally agreed that the third and fourth sentences of the explanation should be included in commentary rather than forming part of the glossary. It was also agreed that the last words of the second sentence, commencing with “and the substantive rights” should be deleted. It was proposed that the explanation of procedural coordination should clarify that it involved coordination between courts, as well as insolvency representatives.

129. It was recalled that A/CN.9/WG.V/WP.74 proposed additional terms that might be relevant to the glossary. In particular, the attention of the Working Group was drawn to “substantive consolidation”. The Secretariat was requested to prepare a revision of the explanation of that term, taking into account the deliberations in the Working Group. The Secretariat was also requested to consider other terms from that working paper that might be appropriate for future consideration.

C. International issues

130. The Working Group had a preliminary discussion of the timing of its consideration of international issues relating to the treatment of enterprise groups in insolvency. It was agreed that resolving issues concerning the treatment of groups in insolvency in a domestic context was both a logical first step for the Working Group to take and a prerequisite for consideration of international issues. Having achieved substantial progress with respect to those domestic issues, the Working Group was of the view that it would be appropriate to consider international issues at an early stage of its next session. That consideration would be based upon document A/CN.9/WG.V/WP.76/Add.1 and should take into account issues of post-commencement and post-application finance, as well as cross-border protocols.