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Treatment of enterprise groups in insolvency

Note by the Secretariat

II. The onset of insolvency: domestic issues (*continued*)

D. Avoidance proceedings

1. Contents of legislative provisions

Avoidable transactions

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

Elements of avoidance and defences

(15) The insolvency law may specify the manner in which the elements referred to in recommendation 97 of the Legislative Guide would apply to avoidance of

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

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transactions in the context of insolvency proceedings with respect to two or more members of an enterprise group.[1]

2. Notes on recommendations

1. At its thirty-third session, the Working Group approved the substance of draft recommendations (14) and (15) as a basis for future deliberations and suggested that recommendation (15) should more clearly indicate the connection with recommendation 97 of the Legislative Guide. The elements of recommendation 97 are therefore included in a footnote. The Working Group may wish to consider whether that reference is sufficient.

E. Substantive consolidation

1. Purpose of legislative provisions

[The purpose of provisions on substantive consolidation is:

(a) To ensure respect, as a basic principle, for the separate legal identity of each member of an enterprise group;

(b) To provide legislative authority for substantive consolidation; and

(c) To specify the very limited the circumstances in which substantive consolidation is available as a remedy; and

(d) To specify the objective standards and procedures upon which substantive consolidation should be based to ensure transparency.]

2. Contents of legislative provisions

Separate legal identity in enterprise groups

(16) The insolvency law should respect the separate legal identity of each member of an enterprise group[, except as provided in recommendation 17].

Substantive consolidation

(17) The insolvency law may specify that the court may order insolvency proceedings with respect to two or more members of an enterprise group to proceed together as if they were proceedings with respect to a single entity[, pooling the assets and liabilities of those members to create a single insolvency estate], but only in the following limited circumstances:

(a) Where the court is satisfied that there was such an intermingling of assets of the enterprise group members that [it is impossible to identify the ownership of individual assets][the ownership of individual assets cannot be identified without undue expense or delay]; or

(b) Where two or more members of an enterprise group are engaged in simulation, fraudulent schemes or activity with no legitimate business purpose and

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[1] 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.

the court is satisfied that substantive consolidation is essential to rectify that scheme or activity; or

[(c) Where the court is satisfied that the enterprise group presented itself as a single enterprise or otherwise behaved in a manner that encouraged third parties [to deal with it as a single enterprise][to believe they were dealing with a single enterprise] [and blurred the legal boundaries between group members].]

3. Notes on recommendations

2. To better explain the draft recommendations on substantive consolidation, the approach of the Legislative Guide has been adopted and a purpose clause introduced. The Working Group may wish to consider the purposes to be included in that clause.

3. At its thirty-third session, the Working Group approved the substance of draft recommendation (16),[2] noting that the principle it reflected should apply as a general rule. On that basis, the cross-reference to draft recommendations (17) might not be required, and it is therefore included in square brackets for further consideration. The deletion of that qualification suggests that the draft recommendation could form part of a general introduction to this work.

4. To better explain the purpose of the draft recommendations on substantive consolidation, a topic not addressed in the Legislative Guide, the approach of the Legislative Guide has been adopted and a purpose clause introduced. The Working Group may wish to consider the purposes to be included in this clause.

Substantive consolidation

5. Draft recommendation (17) has been revised in accordance with decisions taken by the Working Group at its thirty-third session.[3] Following a suggestion that the chapeau of the draft recommendation should include confirmation that the result of substantive consolidation is a single insolvency proceeding concerning a single insolvency estate, that wording has been included in the chapeau, as well as in the explanation of substantive consolidation in the glossary. Further explanation concerning substantive consolidation could be included in the commentary.

Intermingling of assets

6. Paragraph (a) applies to intermingling of assets among members of the group, without specifying that those members must be subject to insolvency proceedings. Accordingly, the intermingled assets may relate to insolvent members as well as to solvent and apparently solvent members,[4] in accordance with a suggestion made in the Working Group.

7. Various alternatives are proposed for the relevant test with respect to identification of individual ownership of assets. In jurisdictions that include intermingling of assets as a basis for substantive consolidation, courts have adopted different approaches to the question of how difficult the process of disentanglement

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[2] A/CN.9/643, para. 62.
[3] Ibid., paras. 63-75.
[4] Ibid., para. 65.

must be before justifying substantive consolidation. Some have required that disentanglement must be impossible or have adopted a test related to costs. For example, that the expense of unscrambling would threaten any recovery by the creditors; that it would be so costly as to consume the assets of the estates; or that it would be prohibitively expensive.

8. The standard of "impossible to identify" could be very difficult to prove and may not be workable. While such identification might require the expenditure of a significant amount of resources (for example, all of the available assets), extended legal proceedings and considerable uncertainty for all parties, it may nevertheless not be "impossible". Such an outcome would, however, defeat the key goals of insolvency, including maximizing the value of the assets. In practice, courts faced with an "impossibility" standard may adopt the approach of interpreting the standard to mean "cannot be accomplished without undue expense and delay", where the court would balance expense and delay to determine what was in the best interests of the insolvency estate and the creditors. An alternative to the standard of "impossible to identify" might therefore be that individual ownership cannot be identified without undue cost or delay. The relevant tests and the practical issues related to them, such as the burden of proof, could be further discussed in the commentary. The Working Group may wish to consider which approach should be taken.

9. A further issue the Working Group may wish to consider with respect to intermingling of assets relates to the question of ownership. While it might be possible to identify the actual ownership of assets at the time of commencement of the insolvency proceedings, the key question might be whether assets had been converted and transferred among enterprise group members in a way that ignored a member's separate legal existence, thus defeating reasonable expectations upon which the member's creditors extended credit. Identifying ownership in those circumstances might involve unravelling a web of intra-group transactions. For that reason the Working Group may wish to consider whether it might be desirable to describe ownership for the purposes of paragraph (a), as "rightful" or "equitable".

Simulation, fraudulent schemes and activities with no legitimate business purpose

10. Paragraph (b) focuses on the use of group members for three particular types of activity – simulation, fraudulent schemes and those with no legitimate business purpose. As such, it focuses on the actual conduct of such activities through group members and would include entities established and used to conduct those schemes and activities, as well as entities established for legitimate purposes, but later used for those schemes and activities. At its thirty-third session the Working Group agreed that although it might be desirable give more definition to the type of fraud contemplated, it would be difficult to do so and that the current approach should be retained for further consideration.[5]

11. In addition to conduct of the specific schemes and activities, draft paragraph (b) requires the court to be satisfied that substantive consolidation of the relevant entities is essential to remedy the three types of activity; if another remedy is available to achieve that result, it should generally be adopted. Where the activity

[5] Ibid., para. 67.

referred to under paragraph (b) involved intermingling of assets within the scope of paragraph (a), substantive consolidation could be ordered under paragraph (a).

Where a group presents itself as a single entity

12. Paragraph (c) incorporates the ideas previously reflected in draft recommendation [18] of A/CN.9/WG.V/WP.78/Add.1 and focuses on behaviour of the enterprise group that has given creditors a deceptive appearance of unity, leading them to believe they were dealing with a single entity, rather than with different members of a group. The Working Group may wish to consider whether such behaviour should be limited to fraudulent behaviour, or might include situations where through, for example, incompetence or bad management, the same appearance of unity is conveyed.

13. Factors relevant to considering whether paragraph (c) is satisfied might include: how the group promoted its public image through advertising, marketing and correspondence generally; financial arrangements, such as payment of invoices to one group member by other group members or payment of invoices to a number of group members by one group member; commonality of directors and company secretaries between members of the group; the use of a single bank account for all members; treatment of creditors of one group member as if they were creditors of other group members or of the group more generally, so that creditors lost their connection with specific debtors; and confusion with respect to the treatment of employees, in particular with respect to the identity of the employing entity. While many of these factors are commonplace occurrences within an enterprise group, they would provide grounds for substantive consolidation only in limited circumstances where reasonable due diligence on the part of creditors would not have ascertained the identity of the entity with which they were dealing.

14. It was suggested at the Working Group's thirty-third session that some clarification might be required as to the time at which the behaviour referred to in paragraph (c) took place, as it might have changed over time and with respect to different creditors.[6] The Working Group may wish to consider whether that issue requires further discussion and should be addressed in the commentary.

15. To clarify the consequences of substantive consolidation, the Working Group may wish to consider whether an additional recommendation to that effect is required. That recommendation might indicate, for example, that an order for substantive consolidation creates a single consolidated entity; extinguishes each debt payable by a group member or members to any other group member or members; or extinguishes each claim that a group member or members has against any other group member or members and so forth.

4. Additional recommendations on substantive consolidation

(a) Contents of legislative provisions

Partial substantive consolidation

[(18) The insolvency law may specify that the court may exclude specified assets or claims from an order for substantive consolidation [may make an order for partial

[6] Ibid., para. 76.

substantive consolidation by excluding specified assets or claims from the consolidated assets].]

Application for substantive consolidation

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

Meetings of creditors

[(20) The insolvency law should specify that if a first meeting of creditors is to be convened within a specified period of time after commencement of insolvency proceedings and substantive consolidation is ordered, a single creditor meeting [for all creditors of the enterprise groups members subject to substantive consolidation] may be convened.]

Calculation of suspect period in substantive consolidation

[(21) 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 of the Legislative Guide should be calculated when substantive consolidation is ordered.

(a) 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 of the Legislative Guide;

(b) When substantive consolidation is ordered subsequent to commencement of insolvency proceedings, the specified date from which the suspect period is calculated retrospectively with respect to the enterprise group members included in the substantive consolidated may be:

(i) 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; or

(ii) A single 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 group member, in accordance with recommendation 89 of the Legislative Guide.]

Modification of an order for substantive consolidation

[(22) The insolvency law should specify that the court may modify an order for substantive consolidation, including partial substantive consolidation[, provided that any actions or decisions taken pursuant to the order for substantive consolidation are not affected by the order for modification].]

Treatment of security interests in substantive consolidation

[(23) The insolvency law should respect the rights and priorities of a creditor holding a security interest over an asset of a member of an enterprise group that is subject to an order for substantive consolidation, unless:

(a) The secured indebtedness is owed solely between members of the enterprise group and is eliminated on substantive consolidation; or

(b) The court determines the security was obtained by fraud.]

(b) Notes on recommendations

16. At its thirty-third session, the Working Group agreed that drafts of several additional recommendations should be prepared for future consideration.[7]

Partial substantive consolidation

17. Draft recommendation (18) addresses the possibility that an order for partial substantive consolidation may be made, where certain assets or claims would be excluded from the assets to be pooled. Consistent with draft recommendation (17), draft recommendation (18) is permissive, both with respect to what the insolvency law may stipulate and whether or not the court makes an order for partial substantive consolidation. The order for partial substantive consolidation might exclude, for example, secured creditors to the extent they relied on the encumbered assets to satisfy their claims or those assets whose ownership is undoubtedly clear. With respect to solvent group members, the order for substantive consolidation might include only the net equity (if any) of those solvent members, leaving their creditors unaffected. The manner in which the order might be partial could be explained in the commentary.

Application for substantive consolidation

18. Draft recommendation (19) reflects the agreement of the Working Group at its thirty-third session with respect to persons permitted to apply for substantive consolidation.[8] The time at which an application might be made was also discussed and a number of issues identified.[9] In particular, it was noted that while there should be sufficient flexibility for additional group members to be added over time, it would be difficult, once certain stages in the insolvency proceedings had been reached, such as a reorganisation plan had been approved or partial distributions made, to add further members. The Working Group may wish to consider whether a further recommendation is required or whether those issues should be addressed in the commentary.

Meetings of creditors

19. Draft recommendation (20) relates to recommendation 128 of the Legislative Guide concerning convening of creditors meetings on commencement of proceedings. The draft recommendation provides that a single meeting may be

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[7] Ibid., paras. 81, 93, 108.
[8] Ibid., para. 82.
[9] Ibid., para. 84.

convened for all creditors of the group members included in the substantive consolidation. The principal purpose of a single meeting would be to save time and costs. Where creditors are required to vote, the insolvency law may specify that a resolution passed by creditors at a consolidated meeting may be regarded as having been passed by the creditors of each of the group members included in the substantive consolidation.

Calculation of suspect period in substantive consolidation

20. At its thirty-third session, the Working Group noted the particular difficulties that might arise with respect to avoidance and calculation of the suspect period when substantive consolidation has been ordered.[10] When substantive consolidation was ordered at the same time as commencement of insolvency proceedings with respect to those group members to be substantively consolidated, recommendation 89 of the Legislative Guide was sufficient. However, where substantive consolidation was ordered after commencement of insolvency proceedings and group members were added to the substantive consolidation at different times, difficult issues might arise, especially where the period of time between the application for or commencement of proceedings and the order for consolidation was long. It was also noted that if the date of the order for substantive consolidation was chosen as the relevant date for calculation of the suspect period, problems might arise with respect to transactions entered into by or between group members between that date and the date of application for or commencement of the insolvency proceedings, creating uncertainty for creditors and lenders. Draft recommendation (21) has been prepared for further consideration by the Working Group, as requested.

Modification of an order for substantive consolidation

21. Draft recommendation (22) reflects agreement at the thirty-third session of the Working Group that an order for substantive consolidation may be modified.[11] The draft recommendation includes a specific reference to an order for partial substantive consolidation. The recommendation does not indicate the ground for such modification, but the commentary could explain that such a modification might be appropriate where, for example, circumstances change, new information about the debtors becomes available after substantive consolidation, or material information was not made available at the time of the order for substantive consolidation. The words included in square brackets are also included in draft recommendation (8) above (see A/CN.9/WG.V/WP.80) on procedural coordination, to ensure acts and decisions taken pursuant to the order for substantive consolidation would be unaffected by modification of that order.

Treatment of security interests in substantive consolidation

22. At its thirty-third session, the Working Group agreed that recognizing and respecting security interests should be a key principle in substantive consolidation, although noting that there might be exceptions to that principle in certain limited

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[10] Ibid., paras. 89-93.

[11] Ibid., para. 88.

cases.[12] Draft recommendation (23) establishes the general principle and the two possible exceptions discussed by the Working Group.

Provision of notice of substantive consolidation

23. At its thirty-third session the Working Group discussed, but did not reach a conclusion on, the issue of provision of notice of an application for substantive consolidation.[13] The Working Group may wish to confirm that recommendations 19 (a), 22 and 23 of the Legislative Guide are sufficient for that purpose, or whether a draft recommendation along the lines of draft recommendation (6) above (see A/CN.9/WG.V/WP.80) concerning procedural coordination might be included. Under the recommendations of the Legislative Guide, group members affected by a creditor application for substantive consolidation would be notified of that application and parties in interest would be informed when, on an application by the insolvency representative of a group member, the court orders substantive consolidation.

24. Draft recommendation (7) above (see A/CN.9/WG.V/WP.80) addresses the information that, in addition to what is required under recommendation 25 of the Legislative Guide, should be included in the notice where procedural coordination is ordered. A similar approach might be desirable when substantive consolidation is ordered, to ensure creditors and other parties in interest are informed of the effect of the order for substantive consolidation. The Working Group may wish to consider whether a recommendation similar to recommendation (7) above should be included in the recommendations on substantive consolidation.

F. The insolvency representative

1. Purpose of legislative provisions

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

(a) To facilitate coordination of insolvency proceedings commenced with respect to two or more members of an enterprise group; 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.]

2. Contents of legislative provisions

Appointment of a single insolvency representative

(24) [19] The insolvency law should specify that, where the court determines [it to be in the best interests of the administration of the insolvency estates of two or more members of an enterprise group] a single insolvency representative may be appointed.

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[12] Ibid., para. 80.
[13] Ibid., para. 85.

Conflict of interest

(25) [20] The insolvency law should specify measures to address a conflict of interest that might arise between the estates of two or more members of an enterprise group where only one insolvency representative is appointed. Such measures may include the appointment of one or more additional insolvency representatives [for each estate with respect to which a conflict exists].

Cooperation between two or more insolvency representatives in a group context

(26) [21] The insolvency law may specify that where insolvency proceedings are commenced with respect to two or more members of an enterprise group, the insolvency representatives appointed to those proceedings should cooperate to the maximum extent possible.[14]

Cooperation between two or more insolvency representatives in procedural coordination

(27) [22] The insolvency law should specify that, where more than one insolvency representative is appointed in insolvency proceedings subject to procedural coordination, the insolvency representatives should cooperate to the maximum extent possible.

Forms of cooperation

(28) [23] To the extent permitted by law, cooperation to the maximum extent possible may 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 lead role;

(c) Coordination with respect to proposal and negotiation of reorganization plans; and

(d) Coordination with respect to administration and supervision of the debtors' affairs and continuation of its business, including post-commencement financing; safeguarding of assets; use and disposition of assets; use of avoidance powers; filing and approval of claims; and distributions to creditors.

3. Notes on recommendations

25. To better explain the draft recommendations on appointment of a single insolvency representative and the desirability of coordination of multiple proceedings commenced with respect to members of the same enterprise group, the approach of the Legislative Guide has been adopted and a purpose clause

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[14] 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.

introduced. The Working Group may wish to consider the purposes to be included in that clause.

26. Draft recommendation (24) (previously draft recommendation [19] of A/CN.9/WG.V/WP.78/Add.1) has been revised in accordance with a request by the Working Group at its thirty-third session.[15] It is not limited to cases where procedural coordination is ordered, referring instead to cases where the court determines it to be in the best interests of the administration of the relevant insolvency estates that a single insolvency representative be appointed.

27. Draft recommendation (25) (previously draft recommendation [20], A/CN.9/WG.V/WP.78/Add.1) has been revised to align it with draft recommendation (24) and remove the limitation to conflicts of interest that arise only in cases of procedural coordination. The Working Group approved the substance of draft recommendation (25) at its thirty-third session.[16]

28. Draft recommendation (26) (previously draft recommendation [21], A/CN.9/WG.V/WP.78/Add.1) has been revised to take account of concerns expressed at the thirty-third session of the Working Group.[17] Since different jurisdictions adopt different approaches to cooperation between insolvency representatives, whether in general or in respect of procedural coordination in particular, the draft recommendation adopts the permissive approach of "the insolvency law may". The goal of the recommendation is to encourage cooperation, in the interests of efficiency and cost effectiveness, as well as of achieving the best solution for the insolvent members of the group and other interested parties. The closing words in both draft recommendations (26) and (27) (previously draft recommendation [22], A/CN.9/WG.V/WP.78/Add.1) have been deleted to avoid confusion with the notion of procedural coordination. Draft recommendation (26) applies to any instance of insolvency proceedings with respect to two or more members of an enterprise group; draft recommendation (27) is specific to procedural coordination.

29. Draft recommendation (28) (previously draft recommendation [23], A/CN.9/WG.V/WP.78/Add.1) has been revised to make the forms of cooperation available to the insolvency representative subject to applicable domestic law, recognizing that some of the forms of cooperation listed might be regulated by law and could not therefore be disposed of by agreement between the insolvency representatives. Paragraph (b) has been revised to include the possibility that the insolvency representatives appointed to members of an enterprise group may agree between themselves that one of them should take a lead or coordinating role, in accordance with a suggestion made at the thirty-third session of the Working Group.[18]

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[15] A/CN.9/643, paras. 96-97.
[16] Ibid., para. 99.
[17] Ibid., paras. 101-104.
[18] Ibid., para. 103.

G. Reorganization

1. Contents of legislative provisions

Reorganization plan

(29) [24(a)] The insolvency law should, in addition to recommendations 139-159 of the Legislative Guide, permit a single reorganization plan [covering all relevant members of an enterprise group] to be approved [by the creditors of each member of an enterprise group subject to insolvency proceedings] [in insolvency proceedings with respect to two or more members of an enterprise group].

(30) [24(b)] The insolvency law may provide that a member of an enterprise group that is not subject to insolvency proceedings may participate in a reorganization plan proposed for two or more members of the enterprise group subject to insolvency proceedings. This paragraph [does not affect][is without prejudice to] the rights [under applicable corporate rules] of shareholders or creditors of that member.

2. Notes on recommendations

30. Draft recommendation (29) (previously draft recommendation [24](a), A/CN.9/WG.V/WP.78/Add.1) has been revised to clarify the issues raised by the Working Group at its thirty-third session[19] and includes possible additional or alternative text in square brackets that the Working Group may wish to consider. It was noted at the previous session that a single plan (in the sense of the same or a similar plan) would be proposed in each of the proceedings relating to group members covered by the plan and that the creditors of each member would vote on its approval separately, in accordance with the voting requirements applicable to individual debtors. It is not proposed that the plan would be approved on a group basis with creditors voting in classes across the group. The process for preparation and solicitation of its approval should take into account the desirability of approval by all relevant members and the benefits to be derived from such approval. Those issues are covered by recommendations 143-144 of the Legislative Guide concerning content of the plan and the accompanying disclosure statement. Additional details to be included in the disclosure statement might relate to group operations and the functioning of the group as such, as well as information concerning the participation in the reorganization of any solvent members of the enterprise group.

31. Draft recommendation (30) (previously draft recommendation [24](b), A/CN.9/WG.V/WP.78/Add.1) has been revised to clarify the role of insolvency law with respect to the participation of a solvent group member in a plan of reorganization for insolvent members of a group. The Working Group noted that the decision of a solvent group member to participate in the plan was an ordinary business decision for that entity to take in accordance with applicable law; it was not a matter for creditors of that entity (unless required under applicable law) or for regulation by the insolvency law. That participation by the solvent entity might include, for example, provision of financing or assets to the reorganization or merger with insolvent entities to form a new entity under the plan, the details of which, including the effects on creditors of the solvent entity, should be included in

[19] Ibid., paras. 113-117.

the relevant disclosure statements. The last sentence of the recommendation is intended to ensure that the participation of the solvent entity in the reorganization plan does not prejudice the rights of creditors or shareholders of the solvent member. The Working Group may wish to consider whether the rights of both creditors and shareholders should be limited to those under applicable corporate rules or should refer to those rights more generally.

32. The Working Group may wish to consider whether the additional information that might be required in the enterprise group context with respect to the disclosure statement under recommendation 143 of the Legislative Guide should be specified in a supplementary recommendation.

H. Issues to be further considered by the Working Group

33. The Working Group may wish to recall that at its thirty-third session it decided to further consider two issues at a future session: post-application financing and treatment of contracts.[20]

34. With respect to post-application finance, the Working Group may wish to consider whether the addition of a recommendation enabling a member of an enterprise group to seek and obtain financing between the application and commencement of insolvency proceedings might be included, subject to certain conditions. Those conditions might include: the debtor can demonstrate that, without such financing, it would be unable to continue operations; the lender has received notice of the application for commencement of insolvency proceedings and nevertheless consents to the terms of the post-application loan; and the court determines, for example, that the terms of the post-application finance are necessary, fair and in the best interests of creditors.

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[20] Ibid., paras. 49-51 and 52-54 respectively.