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Legislative Guide on Insolvency Law

Part three: Treatment of enterprise groups in insolvency

Note by the Secretariat

Contents

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VI. Remedies

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

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

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

A. Extension of liability

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

5. Many laws recognize circumstances in which exceptions to the limited liability of corporate entities are available and one group member and relevant office holders

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

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

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

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

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

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

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

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

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

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

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

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

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

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

8. In a number of the examples where liability might be extended to the parent or other entity in control of an insolvent subsidiary, that liability may include the personal liability of the members of the board of directors of the parent or controlling entity (who may be described as de facto or shadow directors). While directors of an entity may generally owe certain duties to that entity, directors of a group member may be faced with balancing those duties against the overall commercial and financial interests of the group. Achieving the general interests of the group, for example, may require that the interests of individual members be sacrificed in certain circumstances. Some of the factors that might be relevant to determining whether directors of a controlling entity will be personally liable for the debts or actions of a controlled entity subject to insolvency proceedings include: whether there was active involvement in the management of the controlled entity; whether there was grievous negligence or fraud in the management of the insolvent entity; whether the parent's management could be in breach of duties of care and diligence or there was abuse of managerial power; or whether there was a direct relationship between the management of the controlled entity and its insolvency. In some jurisdictions, directors may also be found criminally liable. One of the principal difficulties with extending liability in such cases is proving the behaviour in question to show that the controlling entity was acting as a de facto or shadow director.

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

B. Contribution orders

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

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

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

13. Under one law that does provide for contribution orders, the court must take into account certain specified circumstances in considering whether to make an order. These include: the extent to which a related group member took part in the management of the group member in liquidation; the conduct of the related group member towards the creditors of the member in liquidation, although creditor reliance on the existence of a relationship between the group members is not sufficient grounds for making an order; the extent to which the circumstances giving rise to liquidation are attributable to the actions of the related group member; the conduct of a solvent group member after commencement of liquidation proceedings with respect to another group member, particularly if that conduct indirectly or directly affects the creditors of the group member subject to insolvency proceedings, such as with respect to failure to perform a contract; and such other matters as the court thinks fit.[1] Such an order might also 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.

C. Substantive consolidation

1. Introduction

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

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

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

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

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

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

18. The principal concerns with the availability of such orders, in addition to those associated with the fundamental issue of overturning the separate entity principle, include the potential unfairness caused to one creditor group when forced to share pari passu with creditors of a less solvent group member and whether the savings or benefits to the collective class of creditors outweighs incidental detriment to individual creditors. Some creditors might have relied on the separate assets or separate legal entity of a particular group member when trading with it, and should therefore not be denied a full payout because of their trading partner’s relationship with another group member of which they were unaware. Other creditors might have relied upon the assets of the whole group and it would be unfair if they were limited to recovery against the assets of a single group member.

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

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

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

2. Circumstances supporting consolidation

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

22. While these many factors remain relevant, some courts have begun to focus on a limited number and in particular on whether the affairs of the group members are so intermingled that separating assets and liabilities can only be achieved at extraordinary cost and expenditure of time or group members are engaged in fraudulent schemes or business activity that has no legitimate business purpose. The type of fraud contemplated is not fraud occurring in the daily operations of a company, but rather the total absence of a legitimate business purpose, which may relate to the reasons for which the company was formed or, once formed, the activities it undertakes. Examples of such fraud may include where the debtor transfers substantially all of its assets to a newly formed entity or to separate entities owned by itself for the purpose of preserving and conserving those assets for its own benefit and to hinder, delay and defraud its creditors. Fraudulent schemes also

include engagement in simulation, which may involve a contract that either does not express the true intent of the parties and has no effect between the parties or produces different effects between the parties than those expressed in the contract, i.e. sham contracts.

3. Persons permitted to apply and timing of an application

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

24. Although in some States it might be possible for the court to act on its own initiative to order substantive consolidation, the serious impact of such an order requires that a fair and equitable process be followed and that parties in interest have the opportunity to be heard and to object to such an order. Accordingly, it is desirable that courts not have the power to act on their own initiative. It should be noted that the *Legislative Guide* generally does not provide for courts to act on their own initiative in insolvency matters of that gravity.

25. Since the factors supporting substantive consolidation might not always be apparent or certain at the time insolvency proceedings commence, it is desirable that an insolvency law adopt a flexible approach to the timing of an application for substantive consolidation. An application might be made at the same time as an application for commencement of proceedings or at any subsequent time, although the possibility of applying for substantive consolidation might be limited, in practice, by the state reached in administration of the proceedings, particularly for example, with respect to implementation of a reorganization plan. When substantive consolidation is ordered subsequent to commencement of proceedings, certain matters may already have been resolved, such as submission and admission of claims or certain decisions taken and acted upon with respect to individual group members. It is desirable that the order consolidate the separate proceedings already in progress and preserve existing rights. Claims already admitted against a group member, for example, might therefore be treated as claims admitted against the consolidated estate.

26. The same approach might apply to adding group members to an existing substantive consolidation. As the administration proceeds, it may become apparent that additional group members should be included, provided the grounds for the initial order are satisfied with respect to those members. If the consolidation order is made with the consent of the creditors, or if creditors are given the opportunity to object to a proposed order, the addition of another group member at a later stage of the proceedings has the potential to vary the pool of assets from what was originally agreed or notified to creditors. In that situation, it is desirable that creditors have a further opportunity to consent or object to the addition to the consolidation. Where

substantive consolidation is ordered subsequent to a partial distribution to creditors, the introduction of a hotchpot rule might be desirable. This would ensure that a creditor who has received a partial distribution in respect of its claim against the single group member may not receive payment for the same claim in the consolidated proceedings so long as the payment of the other creditors of the same class is proportionately less than the partial distribution the creditor has already received.

4. Competing interests in consolidation

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

(a) Owners and equity holders

28. Many insolvency laws adopt the general rule that the rights of creditors outweigh those of owners and equity holders, with owners and equity holders being ranked after all other claims in the order of priority for distribution. Often this results in owners and equity holders not receiving a distribution. In the enterprise group context, the shareholders of some group members with many assets and few liabilities may receive a return, while the creditors of other group members with fewer assets and more liabilities may not. If the general approach of ranking shareholders behind unsecured creditors were to be extended in consolidation to the group as a whole, all creditors could be paid before the shareholders of any group member received a distribution.

(b) Secured creditors

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

30. Questions arising with respect to consolidation might include: whether a security interest over some or all of the assets of one group member could extend to include assets of another group member where a consolidation order was made or whether that security interest should be limited to the defined pool of assets upon which the secured creditor had originally relied; whether secured creditors with insufficient security could make a claim against the pooled assets as unsecured creditors; and whether internal secured creditors (i.e. creditors that are at the same time group members) should be treated differently to external secured creditors. In this respect, it might be useful to consider devising different solutions for security interests encumbering specific assets and security interests encumbering the whole

estate. To allow a secured creditor's security interest to be extended to the consolidated assets upon consolidation, could improve that creditor's position at the expense of other creditors.

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

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

(c) Priority creditors

33. Similar questions arise with respect to the treatment of priority creditors. Practically, they might benefit or lose from the pooling of the group's assets in the same way as other unsecured creditors. Where priorities, such as those for employee benefits or tax, are based on the single entity principle, a question arises as to how they should be treated across the group, especially where they interact with each other. For example, employees of a group member that has many assets and few liabilities will potentially compete with those of a group member in the opposite situation, with few assets and many liabilities, if there is consolidation. While priority creditors generally might obtain a better result at the expense of unsecured creditors without priority, the different groups of those priority creditors might have to adjust any expectations arising out of their priority position with respect to the assets of a single entity.

5. Notification of creditors

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

35. The potential impact of consolidation on creditor rights suggests that affected creditors should have the right to be notified of any order for consolidation made at the time of commencement and have the right to appeal, consistent with recommendation 138. One issue to be considered is whether a single objection would be sufficient to prevent consolidation from occurring. It may be possible, for

example, to provide objecting creditors who will be significantly disadvantaged by the consolidation relative to other creditors with a greater level of return than other unsecured creditors, thus departing from the strict policy of equal distribution. It may also be possible to exclude specific groups of creditors with certain types of contracts, for example limited recourse project financing arrangements entered into with clearly identified group members at arm's length commercial terms.

36. Where the application is made by creditors after proceedings have commenced, it might be desirable for notice of the application to be given to insolvency representatives of the entities to be consolidated. Notice should be given in an effective and timely manner in the form determined by domestic law.

6. Effect of an order for substantive consolidation

37. The insolvency law should establish the effects of an order for substantive consolidation. These would include: the establishment of a single consolidated insolvency estate; the extinguishment of intra-group claims; claims against the individual group members to be consolidated will be treated as claims against the consolidated estate; priorities established against the individual group members should be recognized as priorities against the consolidated estate; and a single meeting of creditors may be convened for all consolidated group members. Concerning liquidation value for the purposes of recommendation 152 (b) of the *Legislative Guide*, that value in substantive consolidation would be the liquidation value of the consolidated entity, and not the liquidation value of the individual members before substantive consolidation.

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

7. Modification of an order

39. Although, given the substantive effect of an order for substantive consolidation, modification of that order might not always be possible or desirable, there may be cases where circumstantial changes or new information that becomes available indicate the desirability of modifying the original order. Any such modification should be subject to the condition that any actions or decision taken pursuant to the initial order should be unaffected by the order for modification.

8. Partial substantive consolidation

40. Some laws make provision for what may be termed "partial substantive consolidation", that is, a limited order for substantive consolidation that excludes certain assets or claims from the consolidation. Consolidation might be limited, for example, to those assets and liabilities that are intermingled, excluding those assets whose ownership is clear. Another approach excludes certain assets from substantive consolidation if otherwise creditors would be unfairly prejudiced.

9. Competent court

41. The issues discussed above (see A/CN.9/WG.V/WP.82/Add.1, paras. 15-16 and 23-24) with respect to both joint applications and procedural coordination would apply also to substantive consolidation.

Recommendations

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 enterprise group member;

(b) To provide legislative authority for substantive consolidation;

(c) To specify the very limited 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 and predictability.

Contents of legislative provisions

Separate legal identity in enterprise groups

16. The insolvency law should respect the separate legal identities of enterprise group members. Exceptions to that general principle should be limited to the grounds set forth in recommendation 17.

Substantive consolidation

17. The insolvency law may specify that the court may order substantive consolidation of insolvency proceedings with respect to two or more enterprise group members in the following circumstances:

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

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

Application for substantive consolidation

18. The insolvency law should specify:

(a) The persons permitted to make an application for substantive consolidation, which may include an enterprise group member, the insolvency representative of any enterprise group member or a creditor of any such group member;

(b) That an application for substantive consolidation may be made at the time of an application for commencement of insolvency proceedings with respect to two or more enterprise group members or at any subsequent time.

Effect of an order for substantive consolidation

19. The insolvency law should specify that an order for substantive consolidation should have the following effects:

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

(b) Claims against group members included in the order are treated as claims against the single consolidated estate;

(c) Priorities established in the individual insolvency proceedings should be recognized in the substantive consolidation [notwithstanding the effect of the substantive consolidation]; and

(d) A single meeting of creditors may be convened for all consolidated group members.

Treatment of security interests in substantive consolidation

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

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

(b) The court determines the security was obtained by fraud in which the creditor participated; or

(c) The transaction granting the security is subject to avoidance in accordance with recommendation 88 of the *Legislative Guide*.

Partial substantive consolidation

21. The insolvency law may specify that the court may exclude specified assets or claims from an order for substantive consolidation.

Calculation of suspect period in substantive consolidation

22. 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 may be:

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

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

Modification of an order for substantive consolidation

23. 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.

Competent court

24. The insolvency law should indicate that for the purposes of applying recommendation 13 of the *Legislative Guide* to enterprise groups, the words "commencement and conduct of insolvency proceedings, including matters arising in the course of those proceedings" include applications and orders for substantive consolidation.

Notice

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

VII. Participants

A. Appointment of an insolvency representative

1. Coordination of proceedings

42. The *Legislative Guide* discusses a number of issues relating to the appointment and role of the insolvency representative and recommendations 115-125 would generally apply in the group context. When multiple proceedings commence with respect to group members, an order for procedural coordination may be made, or it

may not. In either case, coordination of those proceedings may be facilitated if the insolvency law were to include specific provisions promoting coordination and indicating how it might be achieved, along the lines of article 27 of the Model Law. That approach could be adopted with respect to coordination between the different courts involved in administering proceedings for different group members or between different insolvency representatives appointed to those proceedings. Where insolvency representatives are appointed, their obligations under the *Legislative Guide* (specifically, recommendations 111, 116-117, and 120) might be extended to include: sharing and disclosure of information; approval or implementation of agreements with respect to division of the exercise of powers and allocation of responsibilities between insolvency representatives; cooperation on use and disposal of assets; proposal and negotiation of coordinated reorganization plans (unless preparation of a single group plan is possible as discussed below); coordination of the use of avoidance powers; obtaining of post-commencement finance; coordination of the submission and admission of claims and distributions to creditors. The insolvency law could also address timely resolution of disputes between the different insolvency representatives appointed.

43. Where a number of insolvency representatives are appointed to the different proceedings, the insolvency law may permit one of them, for example, the representative of the parent company, to take a leading role in the coordination of the proceedings relating to group members. While such a leading role might reflect the economic reality of the enterprise group, equality under the law of all insolvency representatives should be preserved. Coordination under the leadership of one insolvency representative may also be achieved on a voluntary basis, to the extent possible under applicable law.

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

2. Appointment of a single insolvency representative

45. Coordination of multiple proceedings might be facilitated by the appointment of a single insolvency representative. In practice, it might be possible to appoint one insolvency representative to administer multiple proceedings or it might be necessary to appoint the same insolvency representative to each of the proceedings to be coordinated, depending upon procedural requirements. Such an appointment would ensure coordination of the administration of the various group members, reduce related costs and facilitate the gathering of information on the group as a whole. While many insolvency laws do not address this question, there are some jurisdictions where appointment of a single insolvency representative in the group context has become a practice. This has also been achieved to a limited extent in some cross-border insolvency cases.

46. Where a single insolvency representative is appointed to administer a group involving multiple debtors with complex financial and business relationships and different groups of creditors, conflicts may arise, for example, with respect to cross-guarantees, intra-group debts, post-commencement finance or the wrongdoing

by one group member with respect to another group member. As a safeguard against possible conflicts, the insolvency representative could be required to provide an undertaking or be subject to a practice rule or statutory obligation to seek direction from the court. Additionally, the insolvency law could provide for the appointment of one or more further insolvency representatives to administer the entities in conflict. That appointment might relate to the specific area of conflict, with the appointment being limited to its resolution, or be an appointment for the duration of the proceedings. The obligation of disclosure contained in recommendations 116 and 117 of the *Legislative Guide* may be relevant to conflict situations arising in a group context.

3. Debtor in possession

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

Recommendations

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 enterprise group members; and

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

Contents of legislative provisions

Appointment of a single insolvency representative

26. 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 enterprise group members, [a single] [the same] insolvency representative may be appointed.

Conflict of interest

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

Cooperation between two or more insolvency representatives in a group context

28. The insolvency law may specify that where insolvency proceedings are commenced with respect to two or more enterprise group members, the insolvency representatives appointed to those proceedings should cooperate to the maximum extent possible.[2]

Cooperation between two or more insolvency representatives in procedural coordination

29. The insolvency law should specify that, when 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

30. To the extent permitted by law, cooperation to the maximum extent possible may be implemented by any appropriate means, including:

(a) Sharing and disclosing 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 affairs of the group members subject to insolvency proceedings, including day-to-day operations where the business is to be continued; post-commencement financing; safeguarding of assets; use and disposition of assets; use of avoidance powers; submission and admission of claims; and distributions to creditors.

VIII. Reorganization of two or more enterprise group members

48. Recommendations 139-159 of the *Legislative Guide* address issues specific to the preparation, proposal, content, approval and implementation of a reorganization plan. In general, these recommendations will be applicable in the context of an

[2] 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.

enterprise group, although it may be desirable to consider whether, in the particular circumstances of enterprise groups, additional recommendations or further explanation of the application of existing recommendations are required.

1. Single reorganization plan

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

50. If an insolvency law were to permit a single reorganization plan to be prepared and approved with respect to several group members, consideration would need to be given to the application of a number of the provisions of the *Legislative Guide* relating to reorganization of a single debtor to the case of a group, in particular those relating to: coordination of the preparation of the plan, including the parties competent to propose the plan or participate in its proposal; nature and content of a plan and accompanying documentation; convening and conduct of creditors' meetings in respect of a plan; classification of claims and classes of creditors; voting of creditors and approval of a plan, particularly when group members are creditors of each other and therefore "related persons"; applicable safeguards; objections to approval of the plan (or confirmation where it is required); and implementation of a plan.

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

52. A single reorganization plan would need to take into account the different interests of the different groups of creditors, including the possibility that providing varying rates of return for the creditors of different group members might be desirable in certain circumstances. Achieving an appropriate balance between the rights of different groups of creditors with respect to approval of the plan, including

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

53. In the group context, a related person would include a person who is or has been in a position of control of the debtor or a parent, subsidiary or affiliate of the debtor. The *Legislative Guide* discusses voting by related persons on approval of the plan (see part two, chap. IV, para. 46) and notes that although some insolvency laws restrict their ability to vote in various ways, most insolvency laws do not specifically address the issue. The *Legislative Guide* does not recommend that the voting rights of related persons should be restricted, but where the insolvency law includes such restrictions they might cause difficulty when a group member has only creditors classified as related persons or a very limited number of creditors who are not related persons.

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

54. Although a solvent entity generally could not be included in a reorganization plan by order of the court, because it would not be subject to the insolvency law and not part of the insolvency proceedings there may be circumstances in which such an inclusion would be appropriate and, in fact, is not unusual in practice. A solvent entity could be included in a reorganization plan on a voluntary basis in order to aid the reorganization of other enterprise group members. The decision of a solvent group member to participate in a reorganization plan would be an ordinary business decision of that member, and the consent of creditors would not be necessary unless required by applicable company law. With respect to any disclosure statement accompanying a plan that includes a solvent group member, caution would need to be exercised in disclosing information relating to that solvent group.

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

Recommendations

Purpose of legislative provisions

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

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

(b) To facilitate the negotiation and approval of a single reorganization plan in insolvency proceedings with respect to two or more enterprise group members.

Contents of legislative provisions

Reorganization plan

31. The insolvency law should permit a single reorganization plan to be approved in insolvency proceedings with respect to two or more enterprise group members.

32. The insolvency law may provide that an enterprise group member that is not subject to insolvency proceedings may participate in a reorganization plan proposed for two or more enterprise group members subject to insolvency proceedings. This paragraph does not affect the rights of shareholders or creditors of that member.

[*A/CN.9/WG.V/WP.82 provides an introduction to enterprise groups; Add.1 addresses application and commencement of insolvency proceedings (joint applications and procedural coordination); Add.2 addresses treatment of assets on commencement of insolvency proceedings (protection and preservation of the insolvency estate, use and disposal of assets, post-commencement finance), avoidance, and subordination; Add.4 addresses international issues*.]