United Nations

A/CN.9/WG.V/WP.63/Add.16

General Assembly

Distr.: Limited
20 December 2002*

Original: English

United Nations Commission on International Trade Law
Working Group V (Insolvency)
Twenty-eighth session
New York, 24-28 February 2003

Draft legislative guide on insolvency law

Note by the Secretariat

Contents

[The Glossary to the Guide appears in document A/CN.9/WG.V/WP.63/Add.1; Part One, Chapters I and II appear in document A/CN.9/WG.V/WP.63/Add.2; Part Two, Chapter II.A-B in documents A/CN.9/WG.V/WP.63/Add.3-4; Chapter III.A-F in documents A/CN.9/WG.V/WP.63/Add.5-9; Chapter IV.A-D in Add.10-11, Chapter V in Add.12, Chapter VI.A-C in Add.13-14, and Chapter VII.A-B in Add.15]

*This document was submitted late because of the need to complete both consultations on the document and the twenty-seventh session of the Working Group (9-13 December 2002).

V.02-60698 (E)

Part Two (continued)

IV. Participants and institutions

A. The debtor

6. Rights of review and appeal

[*This section would be inserted after para. 230 of A/CN.9/WG.V/WP.63/Add.11*]

Note to the Working Group: in view of the section that follows in respect of creditors, does the debtor have any rights to seek review of decisions made by the insolvency representative or creditors? Can the debtor seek to have the insolvency representative removed and replaced? Can the debtor appeal against decisions made by the court with respect to aspects of the insolvency process? If so, should the Guide address those matters?

Under one law, for example, the debtor has a residual interest in the estate and can qualify as an aggrieved person who may seek review by the court of actions or decisions of the insolvency representative (leave of the court is required for actions against the trustee for malicious prosecution or defamation), and may also seek removal of the insolvency representative.

C. Creditors

3. Rights of review and appeal

[*The following paragraphs may be inserted after para. 295, A/CN.9/WG.V/WP.63/Add.11*]

(a) Introduction

1. Creditors, collectively, hold the primary economic interest in an insolvent estate. This interest is generally protected by an insolvency representative, who administers the estate with a view to preserving and protecting its assets and value, ultimately for the benefit of creditors.

2. To ensure creditors have confidence in the protection of their interests, it is desirable that an insolvency law provide for the active involvement of creditors in the insolvency proceedings. As is evident from the discussion in chapter IV, the level of that involvement and the roles assigned respectively to creditors, the insolvency representative and the courts in the decision-making process vary considerably between jurisdictions. Most regimes, however, provide creditors, as the primary beneficiaries of the estate, with some ability to scrutinize both the administration of the estate and the conduct of the insolvency representative in performing its duties. Where decisions relating to administration of the estate are to be made by the courts, those decisions generally may be appealed to a higher court, although some insolvency laws do exempt certain decisions from appeal (e.g. the decision appointing the supervising judge or commencing the proceedings).

3. It should be noted, however, that in considering the extent of the powers to be given to creditors to object to acts or decisions of the insolvency representative

some level of disagreement is almost impossible to avoid, particularly as the insolvency representative will be required to act for the benefit of all creditors and to take action that individual creditors may not support or agree with. In the normal course of events, however, such dissatisfaction would not give the court cause to replace the insolvency representative or give the creditor grounds for an action against the insolvency representative.

(b) Review of acts and omissions of the insolvency representative

4. Where the insolvency law does provide creditors with the power to object to acts or decisions of the insolvency representative and where the insolvency representative does not agree with or accept such an objection, the course of action available to creditors and the applicable procedural and evidential requirements generally depend largely on the role assigned to creditors in a particular insolvency regime.

5. Where the regime provides for the actions or decisions of the insolvency representative to be supervised or approved by the general body of creditors or the creditor committee, a high level of creditor protection may ensue. Where that supervision or approval adds steps to the administration of the insolvency estate, however, it has the potential to affect the cost and efficiency of the administrative process. For these reasons an insolvency regime will need to balance the extent to which supervision or approval by creditors is required (including defining both the acts and decision that require approval and the procedure for obtaining that approval) against the independence of the insolvency representative and the desirability of speed and cost effectiveness in the conduct of the insolvency proceedings. Regimes vary in the balance reached between these possibly competing factors. Further relevant factors that may need to be taken into account include the extent to which the court plays a role in supervising the proceedings and the insolvency representative, and the manner in which the insolvency regime balances that role against the participation of creditors.

(c) Grounds for review

6. The grounds upon which creditors may question either the decisions or administration of an insolvency representative and the decisions that may be subject to such questioning should be expressly stated in an insolvency law. The grounds for creditor action under existing laws can be divided into two main categories.

7. In the first category are those laws under which creditors are given certain rights where the insolvency representative can be shown to have committed some wrong. That wrong may include actual wrongdoing, such as the misappropriation of funds or assets or obtaining creditors' approval by improper means; procedural errors, such as a failure to seek a necessary approval of creditors or a creditors committee, or to undertake another act required by law; or negligence by the insolvency representative in the performance of its duties. Some jurisdictions limit a creditor's right to challenge the insolvency representative to some, if not all, of these situations.

8. In the second category are those laws which provide, normally in addition to the grounds related to specific wrongdoing, that creditors can test (normally in the courts) any decision, act or omission of the insolvency representative which they

individually or collectively object to or disapprove of. The basis of a successful action will normally be grounds similar to those already mentioned above, but may also include proof that the decision, act or omission was contrary to the interests of creditors. To prevent unreasonable disruption of the administration of an estate, an insolvency law may adopt appropriate limitations such as adjusting the standard of proof to be met in order for the court to uphold the creditors' appeal or protecting certain aspects of an administration against appeal, e.g. excluding actions concerning commencement of insolvency proceedings.

(d) Review procedures

9. Procedural approaches to a creditor's objection to the administration of an estate are largely determined by the rules governing the duties of the insolvency representative and the active role, if any, of creditors in the administration. For example, in those laws which require the insolvency representative to gain the approval of creditors, or their representatives, before undertaking certain acts, direct involvement of creditors in the decision-making process will normally preclude the need for a review procedure with respect to those acts, apart from those situations where the insolvency representative has misled creditors.

10. Where acts of the insolvency representative are not subject to the prior approval of creditors, there may be a need for a formal review procedure.

11. That review procedure may take different forms. Some laws grant creditors, collectively, a review role in the case of a dispute between the insolvency representative and a creditor. Examples of laws which adopt this approach focus on giving creditors the power to require the insolvency representative to call a meeting of all creditors or the creditors committee to attempt to resolve the issue raised.

12. Most insolvency laws, however, require creditors to raise their objection through a court action. Some insolvency laws allow individual creditors to bring an action, while others require the objecting creditor or creditors to represent a certain number of creditors or percentage of the debt to have legal standing to proceed with the action, or even require the action to be brought by the creditors committee or the general body of creditors. Such requirements may depend upon the grounds of the objection raised.

13. Most laws provide the courts, in reviewing an insolvency administration and enforcing the substantive rights of creditors, a number of powers. At one level, a court may direct an insolvency representative to take, or refrain from taking, a particular action related to the creditor's objection. The court may also have powers to confirm, reverse or modify decisions of the insolvency representative or to remove the insolvency representative whether at the direct request of the objecting creditor or on the motion of the court (see Part two, chapter IV.B.9). Many insolvency laws provide that the insolvency representative is personally liable for damages intentionally or negligently caused to creditors through the performance of the insolvency representative's duties (see Part two, chapter IV.B.7). Some insolvency laws also provide that in those circumstances the court may impose a monetary penalty on the insolvency representative.

(e) Reorganization

14. In reorganization, the creditors may have, in addition to those discussed above which relate to the insolvency representative, remedies relating specifically to approval of the plan and its implementation. These are discussed in Part two, chapter V, A.8, 10, 13 and 14.

VI. Management of proceedings

D. Treatment of corporate groups in insolvency

[*The following paragraphs may be inserted after the recommendations following para. 441, A/CN.9/WG.V/WP.63/Add.14*]

1. Introduction

15. It is common practice for commercial ventures to operate through groups of companies and for each company in the group to have a separate legal personality. Where a company in a group structure becomes insolvent, treatment of that company as a separate legal personality raises a number of issues which are generally complex and may often be difficult to address. In certain situations, such as where the business activity of a company has been directed or controlled by a related company, the treatment of the group companies as separate legal personalities may operate unfairly. That treatment, for example, may prevent access to the funds of one company for the payment of the debts or liabilities of a related debtor company (except where the debtor company is a shareholder or creditor of the related company), notwithstanding the close relationship between the companies and the fact that the related company may have taken part in the management of the debtor or acted like a director of the debtor and caused it to incur debts and liabilities. Furthermore, where the debtor company belongs to a group of companies, it may be difficult to untangle the specific circumstances of any particular case to determine which group company particular creditors dealt with or to establish the financial dealings between group companies.

16. Two issues of specific concern in insolvency proceedings involving one of a group of companies are:

(a) Whether any other company in the group will be responsible for the external debts of the insolvent company (being all debts owed by the insolvent company except for those owed to related group companies, i.e. "intra-group debts"); and

(b) Treatment of intra-group debts (claims against the debtor company by related group companies).

17. Insolvency laws provide different responses to these issues. Some laws adopt a prescriptive approach which strictly limits the circumstances in which group companies can be treated as other than separate legal personalities, in other words, the circumstances in which a related company can be responsible for the debts of an insolvent group member. Other laws adopt a more expansive approach and give courts broad discretion to evaluate the circumstances of a particular case on the basis of specific guidelines. The range of possible results in the latter case is

broader than under those laws adopting a prescriptive approach. In either case, however, it is common for insolvency laws to address these issues of intra-group liability based upon the relationship between the insolvent and related group companies in terms of both shareholding and management control. One possible advantage of addressing these issues in an insolvency law is to provide an incentive for corporate groups to continuously monitor the activities of companies within the group, and take early action in the case of financial distress of a member of that group. Treating companies as other than separate legal entities however, may undermine the capacity of business, investors and creditors to quarantine, and make choices about, risk (which may be particularly important where the group includes a company with special requirements for risk management, such as a financial institution); it may introduce significant uncertainty that affects the cost of credit, particularly when the decision about responsibility for group debts is made by a court after the event of insolvency; and it may involve accounting complexities concerning the manner in which liabilities are treated within the group.

2. Group responsibility for external debts

18. Insolvency regimes look to a number of different circumstances or factors in the assessment of whether a related or group company should bear responsibility for the external debts of an insolvent member of the group.

19. It is common to many jurisdictions for the related company to bear responsibility for the debt where it has given a guarantee in respect of its subsidiaries. Similarly, many regimes infer responsibility to compensate for any loss or damage in cases of fraud in intra-group transactions. Further solutions may be prescribed by other areas of law. In some circumstances, for example, the law may treat the insolvent company as an agent of the related company, which would permit third parties to enforce their rights directly against the related company as a principal.

20. Where the insolvency law grants the courts a wide discretion to determine the liability of one or more group companies for the debts of other group companies, subject to certain guidelines, those guidelines may include the following considerations: the extent to which management, the business and the finances of the companies are intermingled; the conduct of the related company towards the creditors of the insolvent company; the expectation of those creditors that they were dealing with one economic entity rather than two or more group companies; and, the extent to which the insolvency is attributable to the actions of the related group company. Based on these considerations, a court may decide on the degree to which a corporate group has operated as a single enterprise and, in some jurisdictions, may order that the assets and liabilities of the companies be consolidated or pooled,[1] particularly where that order would assist in a reorganization of the corporate group, or that a related company contribute financially to the insolvent estate, provided that contribution would not affect the solvency of the contributing company. Contribution payments would generally be made to the insolvency representative administering the insolvent estate for the benefit of the estate as a whole.

[1] A decision that a corporate group has operated as one economic entity will give rise to application of other provisions of the insolvency law, for example, the duty of directors to prevent insolvent trading. Some laws also allow, in limited circumstances, companies to voluntarily pool assets and liabilities.

21. One further and important consideration in insolvency laws that allow such measures is the effect of those measures on creditors. These regimes, in seeking to ensure fairness to creditors as a whole, must reconcile the interests of two (or more) sets of creditors who have dealt with two (or more) separate corporate entities. These collective interests will conflict if the total assets of the combined companies are insufficient to meet all claims. In such a case, creditors of a group company with a significant asset base would have their assets diminished by the claims of creditors of another group company with a low asset base. One approach to this issue is to consider whether the savings to creditors collectively would outweigh the incidental detriment to individual creditors. In the situation where both companies are insolvent, some laws take into account whether the withholding of a consolidation decision, ensuring separate insolvency proceedings, would increase the cost and length of proceedings and deplete funds which would otherwise be available for creditors, as well as allowing the shareholders of some corporate group companies to receive a return at the expense of creditors in other group companies.[2]

22. The common principle of all regimes with laws of this type is that, for a consolidation order to be granted, the court must be satisfied that creditors would suffer a greater prejudice in the absence of consolidation than the insolvent companies and objecting creditors would from its imposition. In the interests of fairness, some jurisdictions allow for partial consolidation by exempting the claims of specific creditors and satisfying these claims from particular assets (excluded from the consolidation order) of one of the insolvent companies. The difficulties imposed by this reconciliation exercise have resulted in such orders being infrequently made in those countries where they are available.

23. It should be noted that insolvency laws providing for consolidation do not affect the rights of secured creditors, other than possibly the holders of intra-group securities (where the secured creditor is a group company).

3. Intra-group debts

24. Intra-group debts may be dealt with in a number of ways. As discussed above (see Part two, chapter III.E), intra-group transactions may be subject to avoidance actions. Under some insolvency laws that provide for consolidation, intra-group obligations are terminated by the consolidation order. Other approaches involve classifying intra-group transactions differently from similar transactions conducted between unrelated parties (e.g. a debt may be treated as an equity contribution rather than as an intra-group loan) with the consequence that the intra-group obligation will rank lower in priority than the same obligation between unrelated parties.

[2] Some laws require creditors, as well as assets and liabilities, of each relevant group company to be separately identified before any distribution can be made.