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Legislative Guide on Insolvency Law

Part three: Treatment of enterprise groups in insolvency

Note by the Secretariat

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I. Introduction

1. This note draws upon the material contained in documents A/CN.9/WG.V/WP.74 and Add.1 and 2; A/CN.9/WG.V/WP.76 and Add.1 and 2; A/CN.9/WG.V/WP.78 and Add.1; A/CN.9/WG.V/WP.80 and Add.1; the *UNCITRAL Legislative Guide on Insolvency Law* (the *Legislative Guide*); the UNCITRAL Model Law on Cross-Border Insolvency (the Model Law); and the Reports of Working Group V (Insolvency Law) on the work of its thirty-first to thirty-fourth sessions (A/CN.9/618, A/CN.9/622, A/CN.9/643 and A/CN.9/647 respectively). It includes a revision of the recommendations discussed at the thirty-fourth session of the Working Group (New York, 3-7 March 2008) together with a draft commentary prepared on the basis of material contained in previous working papers and comments and suggestions made by the Working Group in its previous sessions.

2. The following material addressing the issues particular to the treatment of enterprise groups in insolvency is presented as part three of the *Legislative Guide* and follows the structure of parts one and two of the *Legislative Guide*, that is, commentary discussing relevant issues followed by legislative recommendations. Where an approach different to that taken in the *Legislative Guide* might be required with respect to a particular issue in the context of enterprise groups or where the treatment of enterprise groups in insolvency raises issues additional to those addressed in parts one and two of the *Legislative Guide*, they are discussed in this part. Where the treatment of issues in the context of enterprise groups would be the same as discussed in parts one and two, they are not repeated in this part. The recommendations of parts one and two of the *Guide* are therefore applicable in the context of enterprise groups, unless indicated otherwise in this part. The Working Group may wish to consider how this material should be presented. If it should appear as part three to the *Legislative Guide*, appropriate changes to references and format would be required. References to “the *Legislative Guide*”, for example, would be deleted and appropriate references to the relevant paragraphs and recommendations of parts one and two included.

II. Glossary

1. Notes on terminology

3. Since terms may have fundamentally different meanings in different jurisdictions, the explanations of the following additional terms are included in this part to provide orientation to the reader and assist in ensuring that the concepts discussed are clear and widely understood. The notes on terminology and the terms and explanations set forth in the glossary to the *Legislative Guide* should also be consulted as they may be relevant to the issues discussed below.

2. Terms and explanations

(a) “Enterprise group”: two or more enterprises, that are interconnected by ownership or control.

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

(d) “Control”: the capacity to determine, directly or indirectly, the operating and financial policies of an enterprise.

(e) “Procedural coordination”: coordination of the administration of two or more insolvency proceedings in respect of enterprise group members. Each of those members, including its assets and liabilities, remains separate and distinct.²

(f) Substantive consolidation: [the combining of the assets and liabilities of two or more enterprise group members to create a single insolvency estate.]³

III. Enterprise groups: general features

A. Introduction

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

5. The business of corporations is increasingly conducted, both domestically and internationally, through “enterprise groups”. The term “enterprise group” covers a large number of different forms of economic organization based upon the single entity and for a working definition may be loosely described as two or more

¹ Consistent with the approach adopted in the *UNCITRAL Legislative Guide on Insolvency Law*, the focus is upon the conduct of economic activities by entities that would conform to the types of entities described as an “enterprise”. It is not intended to include consumers or other entities that would not be governed by an insolvency law pursuant to recommendations 8 and 9 of the *Legislative Guide*.

² See discussion below, in A/CN.9/WG.V/WP.82/Add.1, paras. 18-21.

³ For the effects of substantive consolidation and the treatment of security interests, see recommendations 18 and 19.

corporations that are linked together by some form of control (whether direct or indirect) or ownership (see below). The size and complexity of enterprise groups may not always be readily apparent, as the public image of many is that of a unitary organization operating under a single corporate identity.

6. Enterprise groups have been in existence for some time, emerging in some countries, according to commentators, at the end of the 19th and beginning of the 20th century through a process of internal expansion, which involved companies taking control of their own financial, technical or commercial capacities. These single entity enterprises then expanded externally to take legal or economic control of other corporations. Initially these other corporations may have been in the same market, but eventually the expansion encompassed corporations working in related fields and later in fields that were different or unrelated, whether by reference to a product or geographical location or both. One of the factors supporting this expansion, at least in some jurisdictions, was the legitimatization of ownership of the shares of one corporation by another corporation; a phenomenon originally prohibited in both common law and civil law systems.

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

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

B. Nature of enterprise groups

9. Enterprise group structures may be simple or highly complex, involving numbers of wholly or partly owned subsidiaries, operating subsidiaries, sub-subsidiaries, sub-holding companies, service companies, dormant companies, cross-directorships, equity ownership and so forth. They may also involve other

types of entity, such as special purpose entities (SPE),⁴ joint ventures,⁵ offshore trusts⁶ and partnerships.

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

11. The research literature on enterprise groups clearly shows that they can be based on different types of alliances such as bank relationships, interlocking board directorates, owner alliances, information sharing, joint ventures, and cartels. The research also shows that enterprise group structures vary across corporate governance systems. In some States, they are organized either vertically or horizontally and develop across industries. They generally include a bank, a parent or holding company⁷ (referred to as “parent company”) or a trading company, and a

⁴ Special purpose entities (SPE, also known as a “special purpose vehicle” or “bankruptcy-remote entity”) are created to fulfil narrow or temporary objectives, such as the acquisition and financing of specific assets, primarily to isolate financial risk or enhance tax efficiency. An SPE is typically a subsidiary owned almost entirely by the parent corporation; certain jurisdictions require that another investor own at least 3 per cent. Its asset and liability structure and legal status generally makes its obligations secure even if the parent becomes insolvent. The corporation establishing the SPE can accomplish its purpose without having to carry any of the associated assets or liabilities on its own balance sheet, thus they are “off-balance sheet.” SPEs may also be used for competitive reasons to ensure intellectual property, such as for the development of new technology, is owned by a separate entity that is not affected by pre-existing licence agreements.

⁵ A joint venture is often a contractual arrangement or partnership between two or more parties to pursue a joint business purpose. Such an arrangement may sometimes result in the formation of one or more legal entities that may involve both parties contributing equity, and sharing in the revenues, expenses, and control of the enterprise. The venture could be for one specific project only, or a continuing business relationship. Joint ventures are widely used in an international context, as some countries require foreign corporations to form joint ventures with a domestic partner in order to enter a market. This requirement often results in technology and managerial control being transferred to the domestic partner. Forming a joint venture might assist in spreading costs and risks; improving access to financial resources; providing economies of scale and advantages of size; and facilitating access to new technologies and customers or to innovative managerial practices. It may also serve competitive and strategic goals such as influencing structural evolution of an industry; pre-empting competition; creating stronger competitive units; and facilitating transfer of technology and skills, as well as diversification.

⁶ An offshore trust is a conventional trust that is formed under the laws of an offshore jurisdiction. They are similar in nature and effect to onshore trusts, involving a transfer of assets to a trustee to manage for the benefit of a person or class of persons. Offshore trusts may be formed for tax purposes or asset protection. In practice the effectiveness of such trusts may be limited if the insolvency law of the home jurisdiction of the person transferring the assets operates to set aside transfers to the trusts, and transactions entered into to defraud creditors.

⁷ A holding company or parent company is a company that directly or indirectly owns enough voting stock in another firm to control management and operations by influencing or electing its board of directors. The term may signify a company that does not produce goods or services itself, but whose purpose is to own shares of other companies (or own other companies outright).

diverse group of manufacturing firms. In contrast, in other States such groups are typically controlled by a single family or a small number of families and are uniformly vertically organized or have strong ties to the State, but not to particular families.

12. The degree of financial and decision-making autonomy in enterprise groups can vary considerably. In some groups, members may be active trading entities, with primary responsibility for their own business goals, activities and finances. In others, strategic and budgetary decisions may be centralized, with group members operating as divisions of a larger business and exercising little independent discretion within the cohesive economic unit. A parent company may exercise close control by allocating equity and loan capital to group members through a central group finance operation, deciding their operational and financial policies, setting performance targets, selecting directors and other key personnel, and continuously monitoring their activities. The power of the group may be centralized in the ultimate parent company or in a company further down the group chain, with the parent company owning the key group shares, but not having any direct productive or managerial role. The largest groups might have their own banks and perform the principal functions of a capital market. Group financing might involve intra-group lending between the parent company and subsidiaries, involving loans both from and to the parent company and the granting of cross-guarantees.⁸ Intra-group lending might be working capital or unpaid short-term debt such as unpaid dividends or credit in respect of intra-group trading; they may or may not involve the payment of interest.

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

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

⁸ In many countries a significant method of enterprise group capital raising is cross-guarantee financing, where each company within a group guarantees the performance of the others. Implementing cross-guarantee claims in liquidation has proved difficult in some jurisdictions and they have sometimes been set aside. In one jurisdiction, cross-guarantees may operate to reduce the regulatory burden on companies by bestowing accounting and auditing relief on companies that are party to the arrangement. The deed of cross-guarantee makes the group of companies that are party to that deed akin to a single legal entity in many respects and operates as a form of voluntary contribution or pooling in the event that one or more of the companies party to the deed goes into liquidation while the cross-guarantee is still operative. One advantage of this arrangement is that creditors and potential creditors can focus on the consolidated position for those entities, rather than on the individual financial statements of the wholly owned subsidiaries that are party to the deed.

operations of enterprise groups, removing certain type of preferential treatment, such as access to capital.

15. The structure of many enterprise groups shows the dimension and potential complexity of the arrangements. A 1997 survey in Australia of the Top 500 listed companies showed that 89 per cent of those companies controlled other companies; the greater the market capitalization of a listed company, the more companies it was likely to control (this ranged from an average of 72 controlled companies for those companies with the largest market capitalization to an average of 9 for the smallest); 90 per cent of controlled companies were wholly owned; the number of vertical subsidiary levels in an enterprise group ranged from 1 to 11, with an overall average of 3 to 4.⁹ In other countries the figures are much larger. A study based upon the 1979 accounts and reports of a number of large British-based multinationals had to be abandoned with respect to two of the largest groups, with 1,200 and 800 subsidiaries respectively, because of the impossibility of completing the task. Researchers noted that few people inside the group could have had a clear understanding of the precise legal relationships between all group members and that none of the groups studied appeared to have its own complete chart. Similarly, the group charts of several Hong Kong property groups such as Carrion, which failed over 20 years ago, ran to several pages and a reader would have needed a good magnifying glass to identify the subsidiaries. The group chart of the Federal Mogul group, an automotive component supplier, when blown up to the point where you can read the names of all the subsidiaries, fills a wall of a small office. The group chart of Collins and Aikman, another automotive group, is printed in a book, with sub-sub-groups having the complexity of structure of many domestic enterprise groups.

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

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

⁹ Cited in Companies and Securities Advisory Committee (CASAC), Corporate Groups Final Report, 2000 (Australia), paragraph 1.2.

C. Reasons for conducting business through enterprise groups

18. Diverse factors shape the formation, operation and evolution of enterprise groups, ranging from legal and economic factors to societal, cultural, institutional and other norms. State leadership, inheritance customs, kinship structures (including inter-generational considerations), ethnicity and national ideology, as well as the level of development of the legal (e.g., effectiveness of contract enforcement) and institutional framework supporting commercial activity may influence enterprise groups in different environments. Some studies suggest that group structures can make up for under-developed institutions, with consequent benefits for transaction costs.

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

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

21. Meeting prudential or other statutory requirements may be easier where the companies subject to those regulatory requirements are separate group members. In the case of multinational groups, the domestic law of particular countries in which the group wishes to conduct business may require that local businesses be conducted through separate subsidiaries (sometimes subject to minimum local equity requirements) or impose other requirements or limitations, relating for example to employment and labour regulation. Arrangements not involving equity have been used for foreign expansion because of, for example, local obstacles to equity participation, the level of regulation imposed upon foreign investment operations and the relative cost advantages of those types of arrangement. Another relevant

factor for multinational groups may be geographical imperatives, such as the need to acquire raw materials or to market products through a subsidiary established in a particular location. A related consideration of increasing importance that perhaps relates more to where parts of the groups structure are to be located than to the question of whether or not to organize a business through a group structure, is the importance of local law on issues such as cost and simplicity of incorporation in the first instance, obligations of incorporations and treatment of the group in insolvency. Differences in law across different jurisdictions can significantly complicate these issues.

22. Other key drivers for complicated group structures include fiscal considerations and their influence on the flow of money within groups. The incidence of tax is often cited as the reason for the formation of and subsequent growth of enterprise groups and many legal systems have traditionally given weight to the economic unity of related entities. While separate taxation of individual entities might be the underlying principle, it may be qualified to fulfil basic purposes such as protecting the revenue interests of governments and alleviating the tax burden that would otherwise result from the separate taxation of each group member.¹⁰ Measures that take into account the connections between parent and subsidiary companies include tax exemptions for intra-group dividends; group relief; and measures aimed at combating tax evasion. Tax exemptions may be available, for example, on the dividends paid by a company to its resident corporate shareholders and for intra-group dividends where companies are linked by substantial ownership. Tax credits may be allowed for the foreign tax paid on the underlying profits of the subsidiary and for the foreign tax that is charged directly on a dividend. Group relief might be available where related companies can be treated as a single fiscal unit and file consolidated accounts. Losses of one subsidiary may be offset against the income of another or profits and losses may be pooled amongst group members.

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

24. Choices such as between establishing a branch or a subsidiary might also be affected by fiscal regulation where, for example, repatriation of profits from a foreign subsidiary may be effected tax free by loan repayments to a parent company or may be tax free provided the parent owns a specified percentage (ranging from 5-20 per cent) of the foreign company's share capital; interest on funds borrowed to finance the acquisition of a subsidiary can be offset against their profits and as already noted, the subsidiaries profits and losses can be offset against each other in a consolidated tax return. Business activities have also been divided

¹⁰ International Investment and Multinational Enterprises – Responsibility of parent companies and their subsidiaries, OECD, 1979.

between two or more corporations to exploit tax allowances, limits imposed on the amounts of tax allowances or progressive rates of taxation. Other reasons might include: taking advantage of differences in accounting methods, taxable years, depreciation methods, inventory valuation methods and foreign tax credits; segregating activities that if combined in a single taxable entity, might be disadvantageous in fiscal terms; and taking advantage of favourable treatment for certain activities (e.g., anticipated or potential sales, mergers, liquidations or intra-family gifts or bequests) that is available for some operations, but not for others.

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

26. Many of these benefits of conducting business through an enterprise group may be illusory. Protection against devastating losses may fall away as a result of group financing agreements; intra-group trading; cross-guarantees; and letters of comfort¹¹ given to group auditors and the inclination of major creditors, and particularly bankers, to ensure that they have the indemnity of the top member in any group.

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

D. Defining the “enterprise group” – ownership and control

28. Although the existence of enterprise groups and the importance of relationships between the group members are increasingly acknowledged, both in legislation and court decisions, there is no coherent body of rules that directly governs those relationships in a comprehensive manner. In jurisdictions where there is legislation that recognizes enterprise groups, it may not specifically deal with the regulation of such groups, by way of commercial or corporate legislation, but rather be contained in legislation on taxation, corporate accounting, competition and mergers or other issues; legislation addressing the treatment of enterprise groups in

¹¹ A letter of comfort is generally provided by a parent company to persuade another entity to enter into a transaction with a subsidiary. It may include various types of undertaking, none of which would amount to a guarantee, which may include an undertaking to maintain its shareholding or other financial commitment to a subsidiary; using its influence to see that the subsidiary meets its obligation under a primary contract; or confirming that it is aware of a contract with the subsidiary, but without any express indication that it will assume any responsibility for the primary obligation.

insolvency is rare. Furthermore, an analysis of legislation that does address aspects of enterprise groups reveals a diversity of approaches to the various issues associated with groups, not only between jurisdictions, but also on a comparison of the different legislation within a single jurisdiction. Thus different tests may apply to what constitutes a group for different purposes, although there may be common elements, and where those tests employ a particular concept, such as “control”, definitions may be broader or narrower, depending upon the purpose of the legislation, as noted above.

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

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

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

32. Factors that might indicate the existence of control of one entity by another could include: the ability to dominate the composition of the board of directors or governing body of the second entity; the ability to appoint or remove all or a majority of the directors or governing members of the second entity; the ability to control the majority of the votes cast at a meeting of the board or governing body of the second entity; and the ability to cast or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the second entity, irrespective of whether that capacity arises through shares or options. Information that may be

relevant to consideration of these factors might include: the group member's incorporation documents; details about the member's shareholding; information relating to substantive strategic decisions of the member; internal and external management agreements; details of bank accounts and their administration and authorized signatories; and information relating to employees.

E. Regulation of enterprise groups

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

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

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

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

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

38. Some of the circumstances in which strict application of the separate entity approach has been overridden may include: consolidation of enterprise group accounts for a company and any controlled entity; related party transactions (where a public company is otherwise prohibited from giving any financial benefit,

including intra-group loans, guarantees, indemnities, releases of debt or asset transfers, to a related company unless that transaction is approved by shareholders or is otherwise exempt); cross-shareholding (where group members are generally prohibited from acquiring, or taking a security over, the shares of any controlling member or issuing or transferring their shares to any controlled member); and insolvent trading (where a parent company which ought to suspect the insolvency of a subsidiary can be made liable for the debts of that subsidiary incurred when it was insolvent).

39. A few countries have established various categories of enterprise groups that can operate as a single enterprise, in exchange for enhanced protection of creditors and minority shareholders. In one, enterprise group structures involving public companies are divided into 3 categories: (a) integrated groups; (b) contract groups; and (c) de facto groups, to which a set of harmonized single enterprise principles dealing with corporate governance and liability applies:

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

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

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

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

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

[A/CN.9/WG.V/WP.82/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.3 addresses remedies (extension of liability, contribution orders and substantive consolidation), participants (single insolvency representative) and reorganization plans and Add.4 addresses international issues.]
