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Insolvency law

Possible future work in the area of insolvency law

Addendum

Treatment of corporate groups in insolvency

The following extract from the UNCITRAL Legislative Guide on Insolvency Law is provided, for ease of reference, in support of the proposal contained in document A/CN.9/582/Add.1.

UNCITRAL Legislative Guide on Insolvency Law
Part two, chapter V

C. Treatment of corporate groups in insolvency

1. Introduction

82. 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 that 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.

83. Three issues of specific concern in insolvency proceedings involving one of a group of companies are:

(a) The responsibility of any other company in the group 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");

(b) The treatment of intra-group debts (claims against the debtor company by related group companies); and

(c) Commencement of insolvency proceedings by a group company against a related group company.

84. Reflecting the complexity of this topic, the discussion that follows is intended only as a brief introduction to some of these issues. Insolvency laws provide different responses to these and other issues, which may be distinguished by the extent to which a law allows the veil of incorporation to be lifted. Some laws adopt a prescriptive approach, which strictly limits the circumstances in which group companies can be treated as other than separate legal personalities and the corporate veil lifted or, in other words, the circumstances in which a related company can be responsible for the debts of an insolvency 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 on the basis of 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, in particular when the decision about responsibility for group debts is made by a court after the event of insolvency; and involve accounting complexities concerning the manner in which liabilities are treated within the group.

85. Although a variety of approaches are taken to these very complex issues, it is important that an insolvency regime address matters concerning corporate groups in sufficient procedural detail to provide certainty for all parties concerned in commercial transactions with corporate groups. Alternatives to direct regulation of corporate groups in insolvency would include providing sufficient definition in other parts of the insolvency law to allow application of these provisions to

corporate groups, such as the use of avoidance or subordination provisions with respect to related parties.

2. Group responsibility for external debts

86. 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.

87. It is common in 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.

88. 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 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, in particular 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.

89. 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 withholding a consolidation decision, ensuring separate insolvency proceedings, would increase the cost and length of proceedings and deplete funds that would otherwise be available for creditors and result in benefiting the equity holders of some corporate group companies who receive a return at the expense of creditors in other group companies.

90. 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 those 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 States where they are available.

91. 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

92. Intra-group debts may be dealt with in a number of ways. Under some insolvency laws, intra-group transactions may be subject to avoidance proceedings. 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.