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Treatment of corporate groups in insolvency

Note by the Secretariat*

[*I. Glossary and II. Introduction appear in A/CN.9/WG.V/WP.74; III. The onset of insolvency: domestic issues appears in A/CN.9/WG.V/WP.74/Add.1*]

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IV. International issues

A. Introduction

1. In the international context, the models that have been created to address cross-border insolvency issues have always stopped short of dealing satisfactorily with groups. When the United Kingdom's House of Lords sitting under the chairmanship of Lord Hoffmann considered whether the United Kingdom should subscribe to the European Convention on Insolvency Proceedings,[1] the committee commented on the failure of the convention to deal with groups of companies—the most common form of business model. When the convention became the European Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings (the EC Regulation), it still did not address the issue. When the text of what became the UNCITRAL Model Law on Cross-Border Insolvency was debated, groups were "a stage too far". Subsequently, when the UNCITRAL Legislative Guide on Insolvency Law was being developed, it was recognized that embarking upon a discussion of the topic of corporate groups could significantly hinder progress with the remainder of the Guide and it therefore contains only a limited introduction, and no recommendations, on the subject of groups.

2. A well-reported case that illustrates one of the key problems with respect to groups in the international context was KPN Quest, which failed the day the EC Regulation came into force, 31 May 2002. KPN Quest was a telecoms group that owned cables around Europe and to the US. The main cables were in rings: for the ring around Europe, the French part of the ring was owned by a French subsidiary; the German part by a German subsidiary, and so on. When the Dutch parent failed, many of the subsidiaries were obliged to file for the protection of the court in the jurisdictions in which they were incorporated. No one was able to coordinate the proceedings and it was effectively broken up. A discussion of other international cross-border cases would confirm the shortcomings of the existing system; there is often a clear tension between the traditional separate legal entity approach to corporate regulation and its implications for insolvency and the facilitation of insolvency proceedings against a group or part of a group in a cross-border situation in a manner that would enable the goal of maximizing value for the benefit of creditors to be achieved.

3. The discussion in document A/CN.9/WG.V/WP.74/Add.1 raises a number of questions with respect to treatment of corporate groups in the domestic context that might also be discussed in the cross-border context, both with respect to the commencement of proceedings against members of a corporate group located in different States and the administration of those proceedings. Jurisdictions may have different tests for what qualifies a debtor to apply for commencement of proceedings, as well as different types of proceedings. For example, not all jurisdictions have well-developed proceedings for reorganization and even amongst those that do there are differences. Some, for example, may provide a form of reorganization that permits the debtor to remain in control, while others do not. Some jurisdictions may facilitate reorganization by permitting various types of post-commencement finance, while others do not (discussed further below). Rules

[1] Opened for signature on 23 November 1995.

on the effects of commencement vary (e.g. the type of stay available and to whom it will apply), as do rules on powers of the insolvency representative with respect, for example, to avoidance of antecedent transactions and the rules on negotiation, approval and implementation of a plan of reorganization.

4. As already stated, few laws recognize the reality of the corporate group and provide comprehensive rules for their treatment in a domestic context, let alone in cross-border situations. Given the ubiquity of corporate groups in modern commerce, there has been a steady increase in recent years in the number of insolvencies involving multinational corporate groups. Problems encountered with the insolvency of corporate groups in the domestic context are multiplied many times when one or more debtors are part of a multinational group, but each is a separate legal entity located in a different jurisdiction, against which separate proceedings must be initiated. Having concurrent proceedings with respect to related companies taking place in different jurisdictions may not be conducive to achieving a global plan because of the many differences in insolvency laws and the procedures available, if any, for coordinating those different proceedings. The history of cross-border insolvency since the Maxwell case in 1991[2] underscores the problems encountered in managing numbers of parallel proceedings, and the need for the creative solutions that have been developed and adopted. The following discussion raises a number of issues specific to the treatment of corporate groups in the cross-border context.

B. Jurisdiction to commence insolvency proceedings

5. The UNCITRAL Legislative Guide notes that a debtor must have a sufficient connection to a State to be subject to its insolvency laws. In many cases, no issue as to the applicability of the insolvency law will arise as the debtor will be a national or resident of the State and will conduct its economic activities in the State through a legal structure registered or incorporated in the State. However, where there is a question of the debtor's connection with a State, insolvency laws adopt different tests, including whether the debtor has its centre of main interests in the State, whether the debtor has an establishment in the State or whether it has assets in the State.

1. Centre of main interests (COMI)

6. The EC Regulation uses COMI to determine where "main" proceedings should be commenced within the EU. The UNCITRAL Model Law on Cross-Border Insolvency (the Model Law) also uses the concept of COMI, although somewhat differently to indicate those proceedings that could be recognized as constituting foreign "main" proceedings for the purposes of assistance. Importantly, the Model Law recognizes that the status of those proceedings as main proceedings may change and accordingly that the order for recognition may need to be modified or terminated.

[2] This case involved the United States and the United Kingdom. United States Bankruptcy Court for the Southern District of New York, Case No. 91 B 15741 (15 January 1992), and the High Court of Justice, Chancery Division, Companies Court, Case No. 0014001 of 1991 (31 December 1991).

7. Neither the UNCITRAL Model Law nor the EC Regulation define the term; recital 13 of the EC Regulation does however indicate that the term should correspond to "the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties". Article 16, paragraph 3, of the UNCITRAL Model Law and article 3 of the EC Regulation also provide that the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of main interests, unless it can be shown that the centre of main interests is elsewhere.

8. Much has been written about the concept of "centre of main interests" and how it is to be interpreted, particularly with respect to the EC Regulation. While the Regulation contains the presumption with respect to registered office, the weight to be given to that element and other factors to be taken into consideration in determining COMI have been the subject of a number of cases in the EU in recent years. It is not the purpose of this note to examine the development of that interpretation in detail; some of the cases involving consideration of COMI have been included in previous UNCITRAL documents (see A/CN.9/580, paras. 58-79 and A/CN.9/579, paras. 8-17).

9. In its May 2006 decision in the Eurofood IFSC Ltd case,[3] the European Court of Justice's principal conclusion was that the presumption that a company's COMI is in the Member State in which its registered office is situated can be rebutted only if objective factors ascertainable by third parties enable it to be established that the COMI is elsewhere. The Court did not consider what those factors might be, but noted that COMI could be in a location different to the registered office where, for example, the company was not carrying out business in the Member State in which its registered office was situated. In contrast, where a company was carrying out its business in the territory of the Member State in which it had its registered office, the mere fact that its economic choices were or could be controlled by a parent company in another Member State was not enough to rebut the presumption in article 3. The court emphasized that in the system established by the Regulation for determining the competence of the courts of the Member States, each debtor constituting a distinct legal entity is subject to its own court jurisdiction.

10. In cases decided before the ECJ decision, some of the factors considered sufficient to rebut the presumption have related to: the extent of a subsidiary's independence with respect to financial, management and policy decision-making; financial arrangements between parent and subsidiary, including capitalization, location of bank accounts and accountancy services; the division of responsibility with respect to provision of technical and legal documentation and signature of contracts; where design, marketing, pricing and delivery of products was conducted; and conduct of office functions. It remains to be seen how the relevance of, and weight attached to, those factors will be affected by the ECJ decision.

11. It has been suggested by one commentator that French cases decided before the ECJ decision indicated that some courts had been influenced by the fact that in many cases it was practical to bring together group insolvencies and to deal with

[3] C-341/04; available at http://eur-lex.europa.eu. Eurofood was registered in Ireland in 1997, with its registered office in Dublin. It is a wholly owned subsidiary of Parmalat SpA, a company registered in Italy, and its principal objective was the provision of financial facilities for the companies in the Parmalat group.

them in the country where proceedings concerning the parent company have commenced.[4] Cases cited involved French parent companies with subsidiaries in other Member States. This could also be said about the courts of a number of other jurisdictions in the EU where COMI has been applied, in appropriate cases, in a manner that resulted in the component parts of an insolvent group being administered in one country. Those cases have involved EU Member States, as well Member and non-Member States, such as Switzerland. It has been suggested that those cases achieved better results because of, for example, better coordination and the appointment of the same insolvency representative for all group members. The extent to which this can be achieved is, however, dependant upon the existence of factors supporting a determination that the COMI of all group members is in the same Member State. Those factors will not always exist and the insolvency of two or more group members may require proceedings to be commenced in different jurisdictions with respect to those different group members.

2. Presence of assets and establishment

12. These two tests are discussed in the UNCITRAL Legislative Guide.[5] In the UNCITRAL Model Law and the EC Regulation, which both define the term "establishment" although slightly differently, proceedings commenced where a debtor has an establishment are secondary or non-main proceedings; in the case of the Regulation, those proceedings are restricted to liquidation of those assets of the debtor situated in that State. The Model Law does not accord recognition to proceedings commenced on the basis of presence of assets, but acknowledges that there might be a need in some cases to commence local proceedings to deal with such assets, provided the debtor is already involved in main proceedings elsewhere (article 28).

C. Conflict of laws

13. The UNCITRAL Legislative Guide on Insolvency Law addresses some of the issues of conflict of laws that arise where insolvency proceedings involve parties or assets located in different States, noting that while insolvency proceedings may typically be governed by the law of the State in which those proceedings are commenced, many States have adopted exceptions to the application of that law.

14. Difficult problems of conflict of laws also arise with respect to multinational enterprises. One issue, for example, is that of parent company responsibility. The responsibility of a parent for a subsidiary might be determined by the law of the country in which the subsidiary is incorporated. That approach might not reflect the unity of the group as a whole as it would place creditors of the subsidiaries in unequal situations depending upon the location of the subsidiary. If, however, responsibility were to be based upon the rules of the jurisdiction of registration of the parent, that would lead to an extension of jurisdiction that might not be acceptable to other jurisdictions. This issue may be resolved to some extent where the parent voluntarily assumes the financial obligations of foreign subsidiaries, but not otherwise. The Working Group may wish to consider the extent to which

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[4] Jean-Luc Vallens, Eurofenix, Summer 2006, pp. 10-11.

[5] UNCITRAL Legislative Guide, part two, chapter I, paras. 15-18.

conflict of laws issues should be addressed in future work on corporate groups and the steps that might be taken in that regard.

D. Provision of post-commencement finance

15. A/CN.9/WG.V/WP.74/Add.1 refers to the recognition in the Legislative Guide of the need to facilitate post-commencement finance in the domestic context. It also notes that many jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority for its repayment in insolvency. Some of the structural impediments to providing new money include: lack of statutory authority; personal liability of an insolvency representative or directors or officers of the debtor for incurring the debts that such financing would entail; application of avoidance provisions to financing transactions; problems associated with providing priority to post-commencement finance; and a preference for liquidation over reorganization that makes the issue of such finance difficult to address.[6] The existence of these structural impediments with respect to domestic insolvency makes the availability and protection of post-commencement finance in cross-border insolvencies most uncertain. Differences exist between jurisdictions with respect to the priority accorded to post-commencement finance, as well as with respect to the provision of security for post-commencement finance. There are questions of applicable law, and of the use of post-commencement finance within corporate groups. For example, could post-commencement finance obtained by one insolvent corporate group member be used by another member of the same corporate group and if so, under what circumstances and conditions? Could a non-debtor member of a corporate group borrow money post-commencement and permit an insolvent group member to use those funds? In a number of cross-border insolvency cases, issues associated with post-commencement finance have been addressed in cross-border protocols.[7]

16. The recommendations of the Legislative Guide may not be sufficient to address post-commencement finance in the cross-border insolvency context. Some of the issues relevant to further consideration might include the following.

1. Authorization of post-commencement finance

17. The Legislative Guide refers to authorization by the court or consent by creditors (rec. 63) and in the domestic context it is clear which court and which creditors are relevant. In the insolvency of a corporate group, however, where the parent and subsidiaries may be located in different jurisdictions and thus be subject to different insolvency proceedings and different legal regimes, and finance may be required for one or more of those subsidiaries, several questions arise. Can the parent obtain finance in its own jurisdiction and provide it to the subsidiary in another jurisdiction? In that case, would court approval or creditor consent be

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[6] For a comparative summary and matrix of the treatment of post-commencement finance in 54 jurisdictions see International insolvency Institute (http://www.iiiglobal.org); see also *Financing in Insolvency Proceedings*, INSOL 2006, which covers 12 countries: Australia, Brazil, Canada, Germany, Hong Kong, India, Japan, Netherlands, Poland, South Africa, UK and USA.

[7] See *Digest of Financing Provisions from Cross-Border Insolvency Protocols*, International Insolvency Institute (http://www.iiiglobal.org).

required in the parent's jurisdiction or that of the subsidiary or perhaps both? Can one court approve post-commencement finance that will have effects in the other jurisdiction? Will both jurisdictions recognize orders made in the other affecting the provision of post-commencement finance in this situation?

18. The Legislative Guide notes that different laws require different types of authorization for different types of debt. For example, unsecured debt incurred by the insolvency representative in the ordinary course of business may not require authorization, while the same debt incurred outside the ordinary course will require authorization. Debt requiring security or priority will generally require authorization by the court and in some cases consent by creditors, especially where priority for post-commencement finance ranks ahead of existing priorities. In the cross-border context, should the requirement for authorization depend on the terms of the post-commencement finance?

19. The Legislative Guide also refers to post-commencement finance being obtained by the insolvency representative. In the type of scenario noted above, would it be the insolvency representative of the parent or the subsidiary? In addition, are there personal liability implications for the insolvency representative or for officers and directors of the parent or subsidiary?

2. Priority for post-commencement finance

20. The Legislative Guide recommends that an insolvency law should establish the priority to be accorded to post-commencement finance and that it should rank ahead of those claims of unsecured creditors with an administrative priority. In the cross-border context, which claims of which creditors will that priority refer to? How is the question of authorization affected by differences in the priority that may be afforded between the two jurisdictions?

3. Security for post-commencement finance

21. The Legislative Guide also refers to the provision of a security interest for post-commencement finance on unencumbered assets or already encumbered assets provided it does not have priority over existing creditors. It also recommends the procedure to be followed in order to provide a priority senior to that of existing secured creditors. Could the court of one jurisdiction approve post-commencement finance that involved encumbering property in another jurisdiction? Where existing secured creditors objected to the encumbrance of that property, could the court nevertheless approve the provision of a security interest and if so, under what circumstances?

4. Conversion of proceedings

22. Where reorganization proceedings are converted to liquidation, questions may arise as to whether the priority accorded to post-commencement finance in the reorganization will be recognized in a subsequent liquidation. The Legislative Guide recommends that it should be so recognized, but how would that issue be addressed in a cross-border situation?

E. Recognition of foreign proceedings

23. Outside those States to which the EC Regulation applies, achieving a coordinated result for the insolvency of one or more members of a corporate group located in different States depends upon whether foreign proceedings can be recognized and whether parties involved in the various proceedings can cooperate and coordinate with each other. In those States that have adopted the UNCITRAL Model Law on Cross-Border Insolvency,[8] the answer should be relatively straightforward; proceedings commenced where the debtor has its COMI could be recognized as foreign main proceedings [art. 17], while proceedings commenced where the debtor has an establishment could be recognized as non-main proceedings. Once recognition has been ordered, specified assistance to the foreign proceedings comes into effect and the courts and insolvency representatives associated with the various proceedings are authorized to cooperate and communicate with each other. Where the Model Law has not been adopted, however, reference must be had to national laws, many of which do not contain provisions equivalent to those provided in the Model Law with respect to recognition, assistance, cooperation or coordination.[9] Because of the absence of such provisions, achieving a coordinated result can be time-consuming, costly and, in some cases, impossible.

24. For those reasons, coordination and harmonization of international insolvency proceedings has been greatly facilitated in recent years by practices and procedures developed by insolvency professionals and courts, starting with individual cases and the need to address particular issues faced by the parties. Agreements or “protocols” have been negotiated by the parties and approved by the courts in the jurisdictions involved. Those cross-border insolvency protocols cover a number of issues, including, for example, settling a particular dispute arising from the different laws in concurrent cross-border proceedings, creating a legal framework for the general conduct of the case and coordinating the administration of an insolvent estate in one State with an administration in another State. Some examples of cross-border protocols are discussed in UNCITRAL document A/CN.9/580, paragraphs 18-48.

25. At its 39th session in 2006, the Commission decided that work to compile practical experience with respect to negotiating and using cross-border insolvency protocols should be undertaken by the Secretariat, initially through informal consultation with judges and insolvency practitioners.[10]

F. Cooperation between courts and office holders

26. Chapter IV is a key part of the legislative framework provided by the Model Law, filling the gaps found in many national laws by expressly empowering courts

[8] Adopted in British Virgin Islands, overseas territory of the United Kingdom of Great Britain and Northern Ireland (2005), Eritrea, Great Britain (2006), Japan (2000), Mexico (2000), Montenegro (2002), Poland (2003), Romania (2003), Serbia (2004), South Africa (2000) and United States of America (2005).

[9] For an analysis of the law of 39 jurisdictions, see “Cross-Border Insolvency: A Guide to Recognition and Enforcement”, INSOL International, 2003.

[10] See *Official Records of the General Assembly, Sixty-first session, Supplement No. 17* (A/61/17), para. 209.

to cooperate in the areas governed by the Model Law and to communicate directly with foreign counterparts. Notably, this is not restricted to the time after which a decision to recognize a foreign proceeding has been made, and it could therefore take place from the earliest point of contact. Authorization is also provided for cooperation between a court in the enacting State and a foreign representative, and between a person administering the insolvency proceeding in the enacting State and a foreign court or a foreign representative. Recognizing that the idea of cooperation might be unfamiliar to many judges and representatives, article 27 of the Model Law sets out possible means of cooperation. The analogous provision of the EC Regulation is article 31, which establishes a duty of cooperation and communication between, in the language of the Regulation, "liquidators", but does not address the same obligation as between courts or between courts and liquidators. The key to many cross-border insolvency cases involving groups of companies has been the ability and willingness of courts and insolvency representatives to cooperate and communicate to ensure coordination of main and non-main proceedings.

G. Where to from here?

27. In view of the current situation with respect to the insolvency of corporate groups internationally and in the absence of greater convergence of domestic insolvency laws, and in particular the rules addressing treatment of corporate groups, what can be done to facilitate the administration of cross-border insolvency cases, aside from promotion of the UNCITRAL Model Law, and is there a need for legislative provisions specifically addressing the insolvency of groups that might, for example, be added to the Model Law? The EC Regulation, which represents one mechanism that perhaps could be extended to specifically address questions relating to groups, applies directly to participating Member States to ensure that main proceedings commenced in one jurisdiction will be automatically recognized in other States, with certain specified effects. It entails a certain surrender of sovereignty within members States that facilitates its administration. Outside of an integrated regional group like the EU, however, a different approach may be required.

28. Consolidation and joint administration have been discussed above in the domestic context and may have application in cross-border cases. Other proposals are based upon establishing a concept of centre of main interests applicable to a corporate group that would facilitate group commencement and administration of insolvency proceedings.

1. Centre of main interests of a corporate group

29. One solution for addressing the issues noted above with respect to the cross-border treatment of groups might be to establish a concept of "centre of main interests of a corporate group". This would be of particular relevance in cases where there was a high degree of integration between members of a corporate group and the group was run essentially as a single entity. The concept could be defined by reference to, for example, the issues discussed in the context of the COMI in the EU, such as how and where policy, management and financial decisions of the

group were made (which has been referred to as where the "head office functions"[11] of the group were carried out) and third party perceptions, particular those of creditors, concerning that location. The COMI would determine the jurisdiction in which main insolvency proceedings against a corporate group or one or more of its members should be commenced and the law that would apply to commencement and administration of the proceedings. Where the adoption of such an approach depended on close integration of the group, the requisite level of integration would need to be defined. Creditors would be required to investigate the connections of a company with which they dealt to ascertain whether or not it was part of a group. It may lead to main insolvency proceedings being commenced against an insolvent subsidiary at the location of the group COMI, irrespective of whether the parent or other subsidiaries registered at that location were also subject to insolvency and local proceedings might still be required at the place of incorporation of the insolvent subsidiary to deal with its business and assets.

30. A different approach could be to deem the COMI of the group to be that of the parent corporation, so that all subsidiaries would also have that COMI and jurisdiction for commencement of proceedings would not be related to place of incorporation or registered office.

2. Substantive consolidation

31. Where a group is closely integrated and assets and liabilities belonging to each group member cannot be easily identified, cross-border substantive consolidation might facilitate the administration of group proceedings. Consideration of this remedy in a cross-border case is, however, much more complex than in a domestic setting, since it raises issues of the insolvency law to apply; the extent to which courts could waive rules in a cross-border situation that would be applied in a domestic case; the avoidance rules to apply; negotiation, approval and implementation of a reorganization plan and so forth. Such consolidation in cross-border cases is not common. There are, however, examples of cases where the insolvency of a closely integrated group involving subsidiaries in different jurisdictions has been administered as if it were a single entity with the consent of creditors and the legality of the solution was never tested in the courts.[12] Some cases between Canada and the USA have involved a consolidated reorganization plan.

3. Joint administration

32. Another approach might be to adopt measures facilitating the broader use of joint administration. As noted above, few jurisdictions provide formally for joint administration of insolvency cases involving members of the same corporate group, although the practice does exists between some jurisdictions, for example, Canada

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[11] See Gabriel Moss, QC and Professor Dr. Christoph Paulus, The urgent need for reform—what and when? Current trends in European Rescue and the Impact of the European Insolvency Regulation, 15 July 2005.

[12] *Bramalea* involved a corporation headquartered in Canada, with operating subsidiaries in Canada and the USA, as well as a number of partnerships and joint venture arrangements, discussed in Ziegel, J, Corporate Groups and Crossborder Insolvencies: A Canada-United States Perspective, 7 Fordham J. Corp & Fin. L. 367. There are additional examples of such an approach being used in the EU.

and the United States.[13] Joint administration requires no formal decision with respect to a group's centre of main interests and would be facilitated by adoption of the UNCITRAL Model Law, to provide a legislative framework for cross-border cooperation and communication, and the use of cross-border protocols or other mechanisms to address procedural and administrative issues between the different jurisdictions.

H. Issues for consideration: international treatment of corporate groups

33. A/CN.9/WG.V/WP.74/Add.1 raises a number of issues for consideration by the Working Group with respect to the treatment of corporate groups in insolvency in a domestic context. In addition to those issues, the Working Group may also wish to consider the following issues as they apply to the international context:

(a) Definition or description of a "corporate group" and the ways in which it might differ from the domestic context;

(b) Access to insolvency proceedings and in particular the jurisdiction in which single proceedings for a corporate group might be commenced by reference, for example, to some concept of COMI for corporate groups;

(c) The relief available in international proceedings, including joint administration and consolidation; and

(d) Provisions additional to those contained in the UNCITRAL Legislative Guide on Insolvency Law that might be required with regard to post-commencement finance.

[13] US law provides for companies related to an original applicant (where the relationship is defined) to file in the same court provided the original applicant has its domicile, residence, principal place of business or principal assets in the district of that court. Once the application has been made, the court may make an order for joint administration of the estate (US: Bankruptcy Code, title 28, 1408).