City of London Law Society Submission

UNCITRAL Legislative guide on insolvency law consultation

Part three: Treatment of enterprise groups in insolvency

1. INTRODUCTION

1.1 The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

1.2 The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the Consultation Paper has been prepared by the CLLS Insolvency Law Committee.

2. PURPOSE OF SUBMISSION

2.1 In this submission, we comment on aspects of the draft commentary (***Commentary***) and recommendations of part three of the UNCITRAL Legislative Guide on Insolvency Law (the ***Model Rules***) which:

(a) infringe generally recognised basic tenets of creditor protection; or

(b) might be unworkable or inappropriately complex/open to abuse.

2.2 We recognise that there are wide divergences in the insolvency laws of the legal systems in various jurisdictions. Jurisdictions will tend to be described as either debtor-orientated or creditor-orientated and it is not possible to adopt a strict "one size fits all" approach in devising a model insolvency law.

2.3 However, certain principles should be universally respected and this submission focuses on such principles. We have not commented on the general processes/methods of research adopted by UNCITRAL.

2.4 Paragraph 3 sets out general issues which cut across all Recommendations and specific issues are set out in paragraphs 4 onwards.

3. OVERVIEW

Nature and definition of the "enterprise group"

3.1 Whilst many jurisdictions do not recognise "enterprise groups", many countries have specific legislation which defines group relationships by reference to control or influence, capital participation, voting rights, participation in financial policy and decision-making, determination of composition of the board etc.

3.2 The Model Rules set out a definition of "Enterprise Group" in the Glossary (paragraph 4 of the Commentary): "*Two or more enterprises that are interconnected by control or significant ownership"*. Control is defined as: "*the capacity to determine, directly or indirectly, the operating and financial policies of an enterprise*".

3.3 The meaning of such definitions is not entirely clear. Whilst the Model Rules should not set out a definitive definition of 'enterprise group', we feel that it would be helpful to set out an exhaustive list of factors without which an 'enterprise group' could not be said to exist in order to contain the scope of application of the Model Rules.

3.4 For instance, the Model Rules should apply only if one or more factors of the following factors are present:

(a) Legal control: ability of one entity to control or exert influence directly or indirectly over another through voting rights, capital participation, determination of the board/governing body, ownership of assets, contractual arrangements etc; or

(b) De Facto control: influence of one entity on another entity in the absence of any formal arrangement.

4. EFFECT OF INSOLVENCY PROCEEDINGS ON SOLVENT GROUP MEMBER

Recommendations 199-201- Joint application for commencement of insolvency proceedings (not procedural coordination)

4.1 Whilst we see the justification in allowing a group member whose insolvency is imminent to be included in an application for commencement of insolvency proceedings (pursuant to Recommendation 15, Part two of the Model Rules[1]), we are not supportive of an insolvency law which would permit an application for commencement of insolvency proceedings to include group members that do not satisfy the commencement standard in Recommendation 15 (paragraph 12 of the Commentary).

4.2 We believe that this would undermine the basic policy that the insolvency law, which is aimed at protecting and managing an insolvent debtor's estate, is applicable to distressed debtors only, not wholly solvent debtors.

Recommendation 39/48 - Application of stay to a solvent group member?

4.3 We are not supportive of an interpretation of Recommendation 39 and 48 as allowing an application of stay to a solvent group member (even with an exclusion for secured creditors) (paragraph 40 of the Commentary). This would be an abusive interference in the rights of creditors in relation to that legal entity.

4.4 We do not support either the view that it may be appropriate to include assets of a solvent group member in the insolvency proceedings of another member (paragraph 54 of the Commentary).

5. POST COMMENCEMENT FINANCE

Recommendations 211-216

5.1 Recommendation 211 is drafted broadly to allow an enterprise group member subject to insolvency proceedings to (i) advance post-commencement finance to other group

[1] Recommendation 15: "*The insolvency law should specify that insolvency proceedings can be commenced on the application of a debtor if the debtor can show either that:*

*(i) It is **or will be generally** unable to pay its debts as they mature; or*

(ii) Its liabilities exceed the value of its assets."

members subject to insolvency proceedings and (ii) to grant a security interest over its assets (or provide a guarantee) for post-commencement finance provided to another enterprise group member. The broad wording would therefore allow both intra-group financing and external financing provided to one group member and secured over the assets of another group member.

5.2 We can see justifications for post-commencement finance as a matter of theory. In the UK, this issue is subject to much debate. However, a strong body of opinion believes that, in the UK experience, there is no practical need for post application or post-commencement finance (whether for an individual debtor or an enterprise group) to be specifically provided for in the insolvency law, nor of an insolvency law which would allow post commencement finance to obtain priority over other debt.

5.3 In the UK experience, where the business of a company/group is fundamentally good, the lenders have provided the necessary liquidity to allow the company/group companies to continue as a going concern.

5.4 We believe that if the lenders are not prepared to provide the necessary funding without obtaining priority (see Recommendation 64) or security ranking ahead of other debt, this is likely to be a reflection on the state of the business and may result in artificially prolonging the life of a company, which would ultimately fail.

5.5 We do not support the view that an insolvent group member should be able to provide security or quasi-security for post-commencement finance provided to another insolvent group member (paragraph 72). The provider of security would thus be diminishing the pool of assets available to its unsecured creditors and it is more difficult to see any real benefit for its creditors which might arise from the provision of security.

5.6 We note also that the legitimacy of Debtor in Possession (DIP) Financing arrangements has recently been questioned in the US (*Clyde Bergemann, Inc. v Babcock & Wilcox Co. (In re Babcock & Wilcox Co., 250 F 3d 955 (5th Circuit 2001))*. In that case, a bank provided DIP financing to various group members (the debtors), secured by a first lien and super-priority claim against each debtor's estate, not only for all post-petition amounts borrowed by each debtor but also **for all amounts borrowed by all of the other debtors under the agreement**. This meant that all DIP debtors cross-collateralised each other's obligations. A creditor objected to this because it argued that the inter-debtor cross-collateralisation amounted to a de facto substantive consolidation of the debtors, without having satisfied the necessary conditions for substantive consolidation. The 5th Circuit Court of Appeals rejected this argument. However, there is a valid argument[2] that the DIP debtors' estates *were* being *partially* substantively consolidated and the DIP Financing bank was effectively lending to one large undifferentiated corporate group with full recourse against all assets of the group without regard to which particular debtor within the group actually borrowed funds. It is therefore arguable that such de facto substantive consolidation undermines the basic principles of separate legal personality.

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[2] *Bankruptcy Law Letter, 1 August 2001*.

6. SUBSTANTIVE CONSOLIDATION

Recommendations 219-231

6.1 Although we recognise that in certain very limited circumstances, substantive consolidation may be a useful tool, we would urge the Model Rules to restrict the conditions of availability of substantive consolidation to very limited circumstances.

6.2 It is common misconception that substantive consolidation is a tool widely used in the US. In fact, substantive consolidation is narrowly restricted and in fact US bankruptcy's courts' authority to order substantive consolidation has been questioned in *Re NM Holdings Company LLC*[3]. The modern statements of this US doctrine are found in a number of opinions of the US Courts of Appeal for the Third[4], Second[5] and District of Columbia Circuits[6]. The opinions of the various Circuits, whilst all worded slightly differently, share two essential components: (i) the assets and liabilities of the entities are so "scrambled", "entangled", or there is such "substantial identity" between the entities that it will "harm the creditors to treat them separately"; and that (ii) the creditors perceived or treated the entities as one entity/single economic unit and the creditors did not **rely on their separate identity or relied on their joint identity** on this (note that those courts following the *Auto-Train* line of authority will consolidate only in the absence of actual reliance by a creditor on the separateness of the entities). Where there is no controlling Court of Appeal authority, the courts tend to rely on a list of factors/elements to establish substantive consolidation.

6.3 Furthermore, in the US, substantive consolidation derives from the equity jurisdiction of the bankruptcy courts and the issues are determined on a case by case discretionary basis. We believe that for countries based on Roman law legal systems, which do not have a concept of equitable jurisdiction and where the courts are not used to adopting such discretionary approach, substantive consolidation could be misused if the Model Rules do not clearly restrict its application to very limited circumstances.

6.4 We think it is very important that creditors' rights in rem should not be affected by substantive consolidation. It is generally accepted that rights in rem/proprietary rights are inviolable rights which a legal system should strive to uphold. We believe that the current exclusion in Recommendation 225 should be more narrowly defined. The current wording in Recommendation 225 "*…should, as far as possible, be respected.*" should be replaced with wording to suggest that substantive consolidation should never affect rights in rem, other than in cases as set out in sub-paragraphs (a)-(c), which seem to be reasonable exceptions.

6.5 Therefore, we would prefer substantive consolidation to be available only in restrictive circumstances where this is the only means of achieving a meaningful resolution of a group insolvency. However, we feel that it should not be triggered at the option of creditors or individual group members. The implications of substantive consolidation are so far-reaching that we believe only insolvency office-holders who are able to assess the effect of the insolvency proceedings on the company and other group members should have the right to make an application for substantive consolidation, and that this should be combined with a right for the creditors to object. It may also be appropriate in certain circumstances for a majority of creditors to have a right to make an application for substantive consolidation.

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3 *407 B.R. 232*

4 *Owens Corning 419 F.3d 195, 205-09 (3d Cir.2005)*

5 *In Re Augie/Restivo Baking Co. Ltd. 860 F.2d 515,518 (2d Circ. 1988)*

6 *In re Auto-Train Corp., Inc 810 F.2d 270, 276 (D.C. Cir. 1987)*

6.6 We would also note that the Model Rules do not currently deal with certain potential other negative consequences of substantive consolidation. For instance, substantive consolidation should not be used to get around defences or rights which were available to the debtor prior to the substantive consolidation. This issue was raised in the US Bankruptcy Court, N.D. Mississipi in *Re England Motor Company, Happy day Motors, Inc. and England Holdings, Inc., Debtors*[7] where a lender to a parent company argued that its debts (arising from deposits) to subsidiary companies should be set off against its loan to the parent company. Absent substantive consolidation, the lender would not have been able to argue set-off since the debtor company was different from the company to which it owed its liabilities and therefore the requisite mutuality did not exist. The lender argued that the debts became mutual when substantive consolidation occurred which had the effect of pooling the assets and liabilities of the separate entities. The court however rejected this argument on the basis that this would have meant that substantive consolidation had a retroactive effect by destroying defences and rights which existed prior to the entry of the order of substantive consolidation.

6.7 Therefore, the Model Rules should emphasise a purposive interpretation of substantive consolidation and should ensure that it does not result in certain creditors obtaining unfair advantages over others. This rationale is exemplified in the following description of substantive consolidation, in the sixth circuit case *First National Bank of Barnesville v Rafoth*[8] *"Substantive consolidation is employed in cases where the* ***interrelationships of the debtors are hopelessly obscured*** *and the time and expense necessary to unscramble them is so substantial as to threaten the realisation of any net assets for all the creditors…in any consolidated case, there is implicit in the Court's decision to consolidate the conclusion that the practical necessity of consolidation to protect the possible realization of any recovery for the majority of the unsecured creditors* ***far outweighs the prospective harm to any particular creditor."***

6.8 We understand that in certain jurisdictions there is a doctrine of substantive consolidation under which a bankruptcy court may, if appropriate circumstances are determined to exist, consolidate the assets and liabilities of different entities by merging their assets and liabilities and treating them as a consolidated entity for the purposes of bankruptcy proceedings.

6.9 There is no general principle of English insolvency law which gives an English court the power, whether or not based on the application of equitable principles, to treat the assets and liabilities of one entity as though they were assets and liabilities of another entity for the purposes of a liquidation or administration of one of those entities.

6.10 A liquidator of a company would have general powers under Schedule 4 to the Insolvency Act to make compromises or arrangements with creditors of that company with the sanction of the court. There is a precedent for a court sanctioned compromise or arrangement between companies in a group (each of which had commenced an insolvency proceeding) and their respective creditors effectively consolidating the affairs of the two companies and creating a pooling of assets and liabilities in and for the purpose of those liquidations. However, this does not provide any precedent for consolidating the affairs of a company in liquidation with those of a company not in liquidation. It is in our view in any event unlikely that the court would sanction any such compromise or arrangement unless the affairs of the companies concerned were so intermingled and confused that it could not be

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7 2010 WL 220152 (Bkrtcy.N.D.Miss.)

8 974 F.2d 712, 720 (6th Cir. 1992)

established which assets and liabilities should be attributed to which company or creditors, and such an arrangement was plainly in the interests of creditors of both companies.

7. CROSS-BORDER ISSUES

7.1 In terms of the cross-border insolvency regime for the enterprise group, the discussion appears to revolve around procedural coordination, which we support. It is clear from recent examples of global insolvencies that procedural co-ordination is not only useful but an essential aspect of insolvency law. In practice procedural co-ordination has been achieved by appointing the same administrators over different companies subject to insolvency proceedings (e.g. in the case of MG Rover, Eurotunnel etc…)

7.2 We note that the COMI of a group has not been defined but we do not believe that this is necessary since procedural co-ordination is concerned with insolvency proceedings on an entity by entity basis.