EDITORIAL

Practical Difficulties in Handling Group Insolvencies[1]

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In the second half of the 20th century there was an explosion in the use of multiple companies within a single economic business concern. Driven by the forces of globalization, not just one or two subsidiaries but tens, hundreds or, in some cases such as Enron, thousands of companies locked together legally in a series of subgroup shareholdings and economically though complex funding arrangements. It would be a mistake to assume that these are created to avoid transparency (although the major frauds that hit the headlines do indeed involve complex group structures). There are many sound business reasons why trading through subsidiaries is appropriate including:

- National requirements, e.g. in order to hold real estate;
- Requirements of regulators, e.g. utilities and financial sectors;
- The demands of the capital markets requiring special purpose vehicles for fund raising;
- To maximize tax efficiencies and access to government grants and other funding;
- To hold employment contracts for local workers;
- And of course to ring-fence high-risk businesses, although this is rarely the dominant factor when creating multiple entity structures.

This paper will then consider some of the real practical difficulties that arise and why current insolvency law and practice is not always conducive to a successful outcome. There are many possible solutions to these problems but it is the author's preference to avoid extensive rewriting of basic insolvency law and therefore this paper concludes with some suggestions that focus on practice at least as much as on the law itself.

Unfortunately national laws in Europe have not kept pace with developments. Most laws remain based around the concept of a single trader or entrepreneur and although the definition will now include legal as well as natural persons they are not geared towards businesses made up of more than one entity. Indeed many laws will allow for the definition of legal person to include a branch of an overseas company, thus adding to the possible conflict and permutations of law. When one then considers the lack of harmonization of laws or even agreement on best practices between countries, it is little wonder that, when faced with an international group in financial difficulties, the problems of finding the best outcome for the stakeholders can never be underestimated.

Issues faced by advisors to international groups

It is well known that all the countries of Europe have different insolvency laws. But this is only part of the problem for the practitioner. Indeed the practitioner is part of the problem!

In most parts of Europe, insolvency practitioners are appointed by a court. These courts tend to be very local and for the most part appoint local lawyers to act. As a result the practitioners are rarely appointed to cases outside their immediate locality and therefore it is not uncommon for two companies in the same group but in different parts of the same country to have different insolvency practitioners appointed.

An unfortunate side-effect of this is that the local cases are too small in number and varied in size and industry so that insolvency practitioners cannot build experience, expertise or resources.

Only in the UK and similar systems have practitioners been able to build large practices based on an ability to take on cases across the country. It is not a co-incidence that it is in these countries that the creditors play a crucial part in the selection of the practitioner to handle the case. This is not a role of the court in these systems.

The UK has a licensing system supported by a monitoring unit to ensure that practitioners look after the interest of all stakeholders and not just the creditors that appointed them. However this licensing

Notes

1 This article is based on the text of a paper presented at the conference on financing and refinancing of companies facing insolvency hosted by the University of Geneva and the Centre de Droit Bancair et Financier, 17/18 September 2004.

brings its own problems, for it is therefore impossible for an experienced German or French or other non-British practitioner to accept a UK appointment over a UK company in order to consolidate the administration of a group.

An early issue that arises in any group insolvency is to understand the economic dynamics of the business. It is not simply good enough to draw up schedule showing legal ownership. Frequently there will be intercompany balances, relationships that are quite different from the ownership chart. Often these can involve companies that have connections through a common holding company many generations higher up the tree.

These balances may have arisen through the use of funds raised through an SPV and might even be supported by direct security or pledges or be bound by cross-guarantee arrangements. Alternatively other intragroup balances may arise through intercompany trading, and may include retention of title ('RoT') claims, lease-purchase or other terms. Rarely are RoT claims deliberately inserted into intercompany trading terms but are merely a by-product of the standard terms of trading of the vendor company.

A very common feature is the use of a single company to act as group treasurer that will daily or weekly sweep funds from all the companies, so that earnings from monies on deposit can be maximized or set-off applied to reduce group short-term borrowing costs.

All the above features were found in the Enron insolvency, where almost 3000 companies produced over 180 000 transactions that netted down to over 20 000 intercompany balances.

In these circumstances it can often be quite difficult to determine exactly which companies in the group are insolvent. The problem is compounded by the very different definitions of the state of insolvency to be found in different countries. Germany, for instance, has a strict balance sheet test whereas others have a cash flow test. Spain in its new law has for the first time included both balance sheet and cash flow tests but continues to seek an objective view on the point of technical insolvency, whereas the UK adopts a more subjective position requiring the directors to file if there is no reasonable prospect of avoiding insolvency.

One technique which was used during the Enron insolvency was the buying and selling of intercompany debt at levels driven by formulae in order to reduce the complexities and create some order. Interestingly this process was also used to escape technical insolvency in some instances as well as create arbitrage between jurisdictions that allowed debt set-off and those that did not.

Having determined which companies have to file for insolvency there remains the important question as to how to maximize the value of the assets.

Consider the problem of Daisytek/ISA group. The European group sold computer supplies (printer cartridges, cables, peripherals etc) through subsidiaries in UK, Germany, France and Italy, all owned by a UK holding company that was itself owned by a larger worldwide group headquartered in the US.

The UK trading company agreed all terms with the major suppliers (Hewlett Packard, Epson etc.) and allocated product among subsidiaries within a group-wide credit limit for each supplier.

It was also common practice for the companies to trade with each other when customer demand exceeded the local stockholdings. All suppliers and all group companies had retention of title clauses included in their terms of trading.

One of the most valuable of the assets was the customer list. This was maintained centrally in the UK but was accessible from any country on networked computers.

Meanwhile the UK holding company was responsible for negotiating credit lines with banks. These included a receivables discounting agreement with Eurosales factors (a Royal Bank of Scotland subsidiary) that was then implemented locally between the local trading subsidiary and the local subsidiary of the bank.

All employees held contracts with the local subsidiaries but all senior personnel were chosen by and reported to the head office in UK. Some had directors in common and indeed some board meetings were 'joint meetings' of the boards of several companies.

Some companies were solvent, others clearly insolvent, while some could be solvent if intercompany accounts were waived, reduced or subordinated

It is important to note that there is no suggestion of fraud in this case. These circumstances arose for genuine business reasons and indeed served the group well during the period when it was successful.

Against this background the author and colleagues at PricewaterhouseCoopers were able to create a limited administrative consolidation of the group using the European Union Insolvency Regulation (1346/200). The key was the argument that the centre of main interest for all the companies was in the UK. As a result it was possible to create parallel UK administration for each company with the same administrators for each insolvent company. The Italian company was kept out of insolvency by the joint agreement of the administrators of the German and UK companies (that is, the same persons acting in different capacities) to waive part of their intercompany accounts in return for immediate payment of the balance.

The move to create Europe-wide administrative consolidation of the Daisytek group has proved extremely controversial, with many local insolvency practitioners, commentators and even courts of the first instance arguing against such actions on the

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grounds of national sovereignty. In Germany, secondary proceedings were opened that produced significant difficulties. These include the inability to include the Germany business in a sale of the UK business which has delayed the realization of the assets, destroyed jobs and more than doubled the cost of the proceedings.

The EUIR was also used in the case of the German Parmalat companies, where administrative consolidation was possible using EUIR to maximize the efficiency of the process. We were able to not only consolidate the administration of the German and Italian companies but also that of the two German companies that, being based in different parts of the country, would otherwise almost certainly have had separate practitioners dealing with them.

In Parmalat, however, not all went smoothly in other countries. As featured previously in *International Corporate Rescue,* some large creditors of the Irish subsidiary have fought the use of an Italian process in Ireland all the way to the European court.

Possible solutions

It remains and should remain the sovereign right of a nation to determine its own priorities in the event of an insolvency. Nevertheless there is an urgent need to establish some standard and universally recognized protocols between courts and between practitioners that will enable a more efficient handling of groups of companies.

In the author's view, administrative consolidation should be sought in all group situations except for those subsidiaries for which a clear and unmanageable conflict of interest exists. Common for companies of the same group situated in the same location, there should be a move to widen this to international businesses. If the EUIR is applied in the manner seen in Daisytek, Parmalat, Criss Cross and other cases, then this can be partially achieved. However this is not without difficulties. The possibility of local secondary proceedings often opened for purely nationalistic reasons remains a serious impediment.

Furthermore the use of EUIR has opened up several difficulties for the restricted licensing and monitoring regime in the UK. There is limited monitoring of UK cases handled by non-UK practitioners using foreign proceedings and those UK cases handled by licensed practitioners operating outside the UK (such as the author!).

With or without the EUIR there must be clear operational protocols whenever different practitioners are involved in group insolvencies if inefficiencies are to be avoided. These do not have to be long and complex documents but should set out exactly who is going to be responsible for what. Clearly there is a clear benefit to all when the practitioners know and respect each other.

To supplement the EUIR and to ensure the proper protection of all stakeholders and police the conflict of interest issues, consideration should be given to an international licensing system for practitioners. Such a license would, if properly awarded and monitored, also foster a greater level of trust between practitioners in different countries than is currently to be found. This could be a special 'international' license so as not to inconvenience those practitioners whose case load remains strictly local. In a way, a group of companies is like a heavy lorry in its capacity to do damage to other users of the economic road. The drivers of such vehicles need a special licence beyond that needed to drive a car.

With the safeguards suggested above, it is the author's view that full substantive consolidation should not normally be necessary. A good practitioner should be able to keep the estates largely separate and be able to handle the attribution of value when specific assets are intermingled, for instance when a business belonging to more than one group company is sold to a single purchaser. The means of doing this can be by some combination of 'fair value' accounting, agreement with the beneficiaries (normally the creditors) and the direction of the court. Such partial substantive and consensual consolidations can be a useful additional tool in the practitioner's armoury.

However, full and automatic substantive consolidation would be a dangerous step. It would create a significant change between the pre and post filing contractual position and open up the possibility of stronger larger creditors taking advantage of assets that do not and should not properly belong to them. The courts should continue to be very reluctant to go down this path, unless there is clear evidence of no loss of benefit to any class of creditors.

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