

## Summary

### Intra-group financing and enterprise group insolvency: *Problems, principles and solutions*

This book is about intra-group financing, enterprise groups and their interaction with insolvency law. It commences with three narratives that outline the rise and fall of large multinational corporations, namely Lehman Brothers, Nortel Networks and Oi Brazil. Leo Tolstoy famously wrote that “All happy families are alike; each unhappy family is unhappy in its own way” (Anna Karenina, 1878). In the same way, the three insolvency stories are distinct from each other. Yet they also share some notable similarities.

First, multinational firms usually exist as multi-layered structures, comprising dozens or even hundreds of legal entities. This internal complexity frequently results in the multiplicity of insolvency proceedings opened against group members in different countries and subject to different laws. Second, while the companies within the group are legally separate, the group itself might act as an integrated global enterprise. Such integration manifests in the way the group is managed, and in the degree of operational and financial interconnectedness. Preserving group synergies is often vital for maintaining and maximising overall group value. Third, within many groups, financial affairs are coordinated at the group level. It is common for group members to reallocate liquidity (e.g. intra-group loans or centralised cash management) and support each other in obtaining external financing (e.g. cross-guarantees, co-debtorship and provision of collateral). When the group is solvent and there is no default on obligations of its members, these transactions do not pose any problems. By contrast, in financial distress and insolvency, they could lead to protracted disputes and complicate the efficient administration and resolution of group insolvencies.

From early precursors of business groups, such as the Medici system of partnerships in the 15<sup>th</sup> and 16<sup>th</sup> centuries, and the European colonial trading empires of the 17<sup>th</sup> centuries (i.e. the Dutch and English East India Companies), to the emergence of the first modern groups of companies at the end of the 19<sup>th</sup> century, groups have come to occupy a dominant place in the societies’ economic and political life. Yet despite the fact that corporate conglomerates (and not single entities) are the prevailing form of many present-day enterprises, insolvency law has traditionally centred around single entities, and this entity bias largely persists. This conflict between the group economic and legal realities lies at the heart of our analysis.

Considering how diverse groups and their financial arrangements are, we adopt an approach that allows us to look beyond these differences – the principle-based approach. This methodology involves a study of rules and their assessment through the lens of legal principles, all aimed at the development of optimal policy choices. These choices should promote legal principles to the greatest extent. However, legal principles may and often do collide with each other. For example, the principle of protection of legitimate expectations and trust of contractual partners may collide with the principle of estate value preservation and maximisation. The question therefore is: *How should insolvency law be designed to best balance conflicting legal principles in the context of intra-group financing?* To answer this key question, we take interim steps and (i) introduce enterprise groups and their organisational and financial arrangements; (ii) identify legal principles at stake (or in conflict) in the context of intra-group financing and group insolvency; (iii) examine how legislators and courts in different countries decide cases where relevant legal principles are not aligned; and (iv) dissect and analyse the factors that could potentially influence the resolution of conflicts between these legal principles.

Before delving into the content of specific chapters in the book, it is essential to clarify its scope. First, the book is a study of insolvency law. This law is understood broadly to include various proceedings that aim to resolve corporate financial distress. This includes ‘traditional’ fully collective proceedings designed for the joint satisfaction of all creditors of the debtor company. It also encompasses proceedings that are not premised on or do not require full collectivity (e.g. Dutch WHOA schemes, English schemes of arrangement) and may be available in the absence of insolvency (e.g. US Chapter 11). Second, this book addresses contractual and other voluntary financial arrangements, such as group guarantees, co-debtorships, intra-group loans, and certain contract terms (i.e. intercompany ipso facto and cross-default clauses). Hence, non-contractual or involuntary situations are excluded. Third, our research question and approach necessitate a comprehensive inquiry into and comparison of different national legal systems, along with the ideas and solutions they have developed to tackle similar problems. The primary focus is on three jurisdictions: the USA, the UK and the Netherlands. Fourth, we examine and learn from the post-financial crisis regulation of banking groups. Although this regulation is specific to banks, it might aid us in finding answers to the problems discussed in different chapters of the book. Fifth, and finally, the book does not seek to investigate private international law issues, such as international jurisdiction, applicable law, and the recognition of foreign insolvency proceedings and insolvency-related judgments. It mainly deals with substantive law matters and balances various ‘substantive’ law principles.

This book is divided into 6 parts and 14 chapters.

PART I. 'INTRODUCTION' contains **Chapter 1**, which introduces the reader to the subject, aims and scope of this book. It also sets the scene by presenting three exemplary cases – insolvencies of Lehman Brothers, Nortel Networks and Oi Brazil. These cases vividly illustrate the problems and complexities created by intra-group financing in insolvency.

PART II. 'ENTERPRISE GROUPS: THEIR LIFE AND DEATH' provides an overview of corporate groups. **Chapter 2** develops a descriptive account of groups, their common characteristics, and types. It shares historical insights regarding the emergence of modern multinational enterprises and explores one of the most important concepts in company and insolvency law – limited liability. Our goal is to identify the key economic and legal prerequisites for, as well as the facilitators of, the formation of groups. **Chapter 3** describes how insolvency law tackles financial distress within enterprise groups and traces its evolution over time. The Global Financial Crisis of 2008 and the rise of the so-called rescue culture facilitated this evolution and prompted the adoption of group-minded solutions and tools. The aim of this chapter is both to highlight this progress and demonstrate the limitations of a single enterprise approach.

PART III. 'PRINCIPLES OF INSOLVENCY LAW AND HOW TO BALANCE THEM' establishes a theoretical foundation or methodology for the analysis of intra-group financial arrangements and enterprise group insolvency. **Chapter 4** introduces the principle-based approach, defines a legal principle, and identifies the most relevant legal principles in the context of enterprise group insolvency. **Chapter 5** builds up a conceptual framework embraced for investigating conflicts between these legal principles. The objective of this chapter is to discuss the 'benchmarks' that can be employed to resolve such conflicts. For this purpose, we explore: (i) the notion of fairness, (ii) the relative weight of legal principles, and (iii) meta-principles or fundamental standards, which help resolve conflicts between legal principles, including the meta-principles of proportionality. We conclude that the categories of fairness and weight do not appear to be workable or reliable benchmarks. In contrast, proportionality is universal and can be applied to determine a balanced outcome when legal principles clash in an individual case.

PART IV. 'INTRA-GROUP FINANCING AND INSOLVENCY: TRANSACTIONS AND PROBLEMS' stands as one of the core parts of the book, providing a foundation for evaluation and normative suggestions. It has a dual purpose. First, it describes financial arrangements common within groups of companies. They include, inter alia, cross-guarantees, co-debtorship, intra-group loans, and centralised cash management. Second, it analyses the benefits of intra-group financing for enterprise groups and highlights the problems that such financing and the legal regimes applicable to it can create for efficient group insolvency and restructuring.

**Chapter 6** examines a financial arrangement found in most enterprise groups: cross-guarantees. The purpose of this chapter is threefold. First, it delves into the reasons for entering into cross-guarantees and similar liability arrangements, and covers some law & economics explanations, including the agency cost of debt, the impact on firms' access to finance, and levels of risk-taking (i.e. *ex-ante* effects). Second, it highlights and explains how cross-guarantees give rise to various rights and obligations between a principal debtor, a guarantor (or co-guarantors) and a creditor – a configuration we refer to as the 'triangle of rights and liabilities'. The existence and enforceability of these rights and liabilities have direct consequences on the efficiency of restructuring proceedings. Third, it uncovers the problems and challenges that cross-guarantees pose in insolvency (i.e. *ex-post* effects). In the context of insolvency, intra-group guarantees can lead to value destruction due to the simultaneous enforcement of the same debt across the entire group. In this chapter, I identify a specific problem referred to as the 'ricochet problem'. It arises if the guarantor's right to claim compensation from the principal debtor (e.g. through *regres* or an indemnity claim) is not affected by the restructuring proceedings, such as the case in English schemes of arrangement. Filing a ricochet claim by the guarantor against the principal debtor for the full amount could undermine the effectiveness of the restructuring in the first place.

**Chapter 7** logically follows the preceding chapter and examines the mechanisms involving the re-allocation of liquidity within an enterprise group. This occurs after financing has been acquired from third parties and is subsequently 'transported' from one group entity to another. This financing can take the form of a single intra-group loan or an on-going re-distribution of funds by way of centralised cash management or cash pooling. The key question here is whether the claims of insiders, such as group members, are and should be subordinated in insolvency. No signs of consensus seem to appear on this divisive issue, either in academic literature or in law. This chapter summarises the arguments in favour and against subordination of insider loans and highlights the most serious critique of subordination related to underinvestment. The latter occurs when economically viable firms are liquidated instead of being rescued.

**Chapter 8** focuses on transaction avoidance in insolvency. It raises the question of whether a certain transaction, such a group guarantee, is avoidable in insolvency and whether 'group considerations' play a role in this decision. Based on a comparative analysis, it concludes that in all three jurisdictions cross-guarantees present substantial problems for transaction avoidance law. This is because these transactions are often driven by group considerations or group interest and may not entail clear and direct benefits to guarantors. The chapter puts together the difficulties of *ex-post* substantive review and points out that legal uncertainty is inherent in the assessment of transactions involving group members.

**Chapter 9** explores contractual clauses commonly found in financial transactions – clauses that provide creditors with special termination, amendment, or acceleration rights. These are called ipso facto and cross-default clauses. The chapter (i) explains the rationale and operation of ipso facto and cross-default clauses, (ii) highlights their alarming traits and effects on early crisis responses and the resolution of financial distress within enterprise groups, and (iii) discusses how different jurisdictions, including the UK, the USA and the Netherlands, grapple with these contractual provisions in pursuit of a balance between protecting freedom of contract and party autonomy, on the one hand, and ensuring value preservation and efficient restructuring of viable enterprises, on the other hand.

PART V. 'GROUP SENSITIVE INSOLVENCY LAW: TOOLS AND SOLUTIONS' analyses potential solutions to the problems created by or connected to intra-group financing in insolvency, as outlined in Part IV. It scrutinises various legal tools that have emerged in response to the economic realities of enterprise groups and the patterns of their failures. Such tools include third-party releases, the extension of enforcement stays to non-debtor entities within the group, and the suspension or unenforceability of certain contractual clauses. These tools embrace the so-called 'extension effect'. The 'extension effect' can be seen when certain safeguards or benefits of insolvency law (e.g. a stay) apply to legal entities that are not subject to insolvency proceedings.

The aim of this part is to formulate recommendations or suggestions on how the law can address the challenges of intra-group financing and group insolvencies in a principled, balanced, and proportionate way. Different financial arrangements and unique problems related to them require different solutions. This is why there is no single answer to the main research question, but in fact many answers. These answers are provided in the concluding sections of Chapters 10, 11, 12 and 13. Some of them will be mentioned below.

**Chapter 10** discusses group debt deleveraging and debt adjustment by means of third-party releases. The latter present a group-mindful tool, allowing the restructuring of obligations of third parties (e.g. group guarantors, co-debtors, collateral providers) via a single proceeding. Third-party releases have recently attracted heightened attention due to their use in high-profile bankruptcies dealing with mass tort claims, exemplified by cases like Purdue Pharma. This chapter does not touch upon tort cases, instead focusing on transactions related to the attraction of funds by corporate groups. It examines the scope and requirements for releasing third parties (non-debtors) under the laws of the UK, the USA and the Netherlands, and concludes with a summary of main findings and a proposal of elements or considerations, which may guide the design and application of rules on third-party releases. Among these considerations are, for example,

the nature of the release (voluntary vs. involuntary) and the existence of a recourse claim (e.g. indemnity or *regres*), which can be filed by the third party, potentially undermining restructuring efforts. While the economic benefits of third-party releases are clear, it is crucial to use them proportionately and ensure that the rights of creditors are adequately protected (i.e. the 'group best-interest-of-creditors' test).

**Chapter 11** focuses on the rules concerning insolvency enforcement stays in the UK, the USA and the Netherlands. It explores whether law permits their extension to non-debtor parties (e.g. group guarantors or co-debtors) who are not themselves subject to insolvency or restructuring proceedings. It makes suggestions on when a group-wide extension of an enforcement stay might be desirable and under what conditions. Extending an insolvency stay may be warranted when an enterprise group is integrated, and the released group member plays an integral and necessary role in the anchor debtor's restructuring or future operations. It may also be justified when the debtor's restructuring plan envisages a third-party release. That said, the extension of a stay to non-debtor parties should be accompanied by adequate protections to prevent potential abuse. This means that the extended stay should be lifted if its continuation harms the creditor.

**Chapter 12** is devoted to rescue financing, and specifically to intra-group rescue financing. It is common for struggling companies to find themselves in dire need of cash. Failure to obtain financing may trigger cross-defaults, cause a breakup of commercial ties with critical suppliers, complicating negotiations with creditors and disrupting potential reorganisation. In a group scenario, intra-group financing is further coloured with transaction avoidance and statutory subordination risks, as discussed in the previous chapters. This chapter analyses two strategies that can supplement *ex-post* judicial review: (i) *ex-ante* authorisation of a transaction (so called 'safe harbour'), and (ii) pre-emptive financial arrangements prevalent in banking groups. It concludes with an overview of main findings and suggestions. For example, it contends that a properly structured safe harbour framework for the approval of intra-group rescue financing can be a valuable tool in the group restructuring toolbox. Yet the efficiency of a safe harbour regime will depend on its ability to adequately address group financial distress.

**Chapter 13** questions whether the constraints placed by insolvency law on freedom of contract – particularly those concerning the enforceability of ipso facto and cross-default clauses – should be applicable to intercompany ipso facto and cross-default clauses. The purpose of this chapter is twofold. First, it seeks to probe whether law, as adopted in the relevant jurisdictions, allows for extending its protective rules to contracts concluded by debtor's affiliates. Second, from a normative perspective, it examines and makes suggestions on whether and under what circumstances such an extension would be desirable and proportionate. For instance, it is argued that a

group-level extension of insolvency law safeguards may be warranted when the enterprise group is highly integrated, leading to a correlation between the fates and financial positions of group entities. Conversely, extending an ipso facto ban may be less proportionate if a group is decentralised and the insolvency risks of its entities are not correlated.

Part VI. 'Conclusion' comprises the final **Chapter 14**. This chapter summarises the key findings of the book and concludes with some high-level observations and thoughts. It identifies a number of general considerations or factors that tend to play a role in deciding whether a group-mindful approach should be adopted. Without claiming to have discovered all relevant factors, it highlights those which transpire throughout the entire book. These factors include: (i) group integration and interdependence, (ii) the financial situation of non-debtor group entities, (iii) the purpose and nature of the procedure, and (iv) the prevalence of public interest. It is hoped that this book and its findings will contribute to a better understanding of enterprise groups, intra-group financing, and their intersection with insolvency law.