# ENTITY VERSUS ENTERPRISE: DEALING WITH INSOLVENCY OF CORPORATE GROUPS

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***Editor's Notes:****Corporate laws, even now, remain anchored to the principle of 'separate legal entity', despite the fact that businesses these days are increasingly being viewed on 'enterprise' basis. In cases where the assets, resources, operations, of an enterprise are scattered across multiple entities, then this entity-focussed approach may not be as effective as expected to be in rescuing the ailing enterprise.*

*IBC too, explicitly excludes assets of a subsidiary from the liquidation estate, following the principle of separate corporate existence. However, experience shows that business activities may be integrated in a 'group' structure comprising of a web of holding, subsidiary, associate, investee companies, so much so, that picking one and leaving the other would defy the very objective of insolvency proceedings against an entity.*

*The article discusses why it is important to adopt a holistic approach and how the same can be achieved.*

Business today spans across entities, and, indeed, jurisdictions. Most large corporates have business and operations across multiple entities, within a jurisdiction, and often, across jurisdictions. There are some entities that house assets, some hold investments, some hold intellectual property, and many hold different business verticals. Thus, whether all the resources of an enterprise are housed into a single entity or not is a crucial corporate structure decision, taken based on vast and complex array of factors, including ease of control, ease and tax factors in exit, market valuations, ring-fencing of certain assets, financing of assets of different operating units on their own strength, etc.

Appropriately, accounting standards have moved from entity-based reporting to group-based reporting, in form of consolidated financial statements, which consolidate assets and liabilities of subsidiaries, joint ventures and associates. Securities regulators, in their natural tendency to be aligned to the way the capital markets perceive it, are also driven by group-based regulation.

However, as Justice Sabyasachi Mukharji[91] had to say, "The ghost of the case of *Aron Salomon v. A. Salomon & Co. Ltd.*, [1897] AC 22 at 27, 30, 31, still visits frequently the hounds of Company Law." Corporate laws are still primarily based on "legal entity" rather than "enterprise", and unsurprisingly, insolvency laws, in most global jurisdictions, are still anchored on the concept of legal entity. Enterprise insolvency or group insolvency is aspirational, and even as advances are made once in a while to move to group insolvencies, the move to a mandated insolvency of a corporate enterprise group remains largely a distant optimism.

It would be apt to quote from leading author *Goode on Principles of Corporate Insolvency Law*[92]:

**"Business, entity or group enterprise?**

[91] State of UP and others vs Renusagar Power Co and others, 1988 AIR 1737; 1988 SCR Supl. (1) 627;
[92] Fifth Edition, by Kristin Van Zwieten, pg. 29-30

### *Entity vs. Enterprise*

The subject of insolvency proceedings has always been, and continues to be, the particular corporate entity that has become insolvent, and this focus is accentuated by the reluctance of English law to pierce the corporate veil. What insolvency law here and overseas has so far singularly failed to accommodate is the management of enterprise groups where one or more, or possibly all, members of the group have become insolvent. Whereas the preparation and filing of group accounts has long been required, when it comes to insolvency the distinct legal personality of each individual company within the group is respected, with separate proceedings for each company, *yet the insolvency of one member of a group may threaten the viability of previously solvent members and where the group activity is integrated a co-ordination of the management of the group as a whole may be highly desirable.* This is particularly the case as regards multinational group of companies, *where the complexity is exacerbated by the variety of corporate structures and the possibility of concurrent proceedings in different jurisdictions governed by different laws*, . . ." [emphasis supplied]

This Paper discusses the need for recognising "enterprise" over an "entity", explores the legislations in several jurisdictions, various judicial interpretations and recognitions, and various authorities on the subject and seeks to answer how the enterprise approach can be given effect to.

Accordingly, the discussion has been sequenced as follows –

1. Relevance of enterprise approach in insolvency
2. Current discussions on enterprise approach
3. Approaches to Group Insolvency
4. Pre-requisites for Adopting Enterprise Approach
5. The Cross-Border Angle in Group Insolvency
6. Precedents in global jurisdictions and in India
7. Issues in group-based insolvency proceedings
8. Making groups insolvency work under current framework of the Code

## Relevance of Enterprise Approach in Insolvency

The relevance of the enterprise approach may be seen from two perspectives – the objective of insolvency or liquidation proceedings, and the complex, inter-connected nature of legal entities in corporate groups of the present day.

The objective of insolvency law is, primarily, rescue, by reorganisation or any other means, and if rescue does not work out, then liquidation and distribution of liquidation estate equitably. If the assets or operations of a corporate group are scattered across inter-connected entities, it is not possible to achieve a meaningful rescue without taking a group-focused approach. The idea of a rescue plan is to focus on enterprise value, and not be tunnel-visioned by the entity approach.

If the proceedings pertain to liquidation, there again, it is quite common to have assets, contracts, licenses, concessions and intangible assets scattered across entities. If the liquidator's reach is limited to only the assets in the entity, many of the assets may either be difficult to liquidate, or the objective of value maximisation will not be served.

The other perspective, highlighting the need for, and potentially, difficulties in, group-focused approach is the sheer complexity and expanse of entities in present-day large corporate groups. Various factors have led to proliferation of entities across jurisdictions. Foreign direct investment norms of most countries require a locally-incorporated entity – hence, as business moves to an offshore jurisdiction, there is a local vehicle. Then, owing to taxation preferences for certain originating jurisdictions, the investment is made to move from a different jurisdiction. Part of the complexity results from attempt to obscure the beneficial ownership; hence, the constant chase of accounting standards to identify "significant influence" and the tax domicile rules to trace the "place of effective management", and the efforts by companies to try and escape such rules, creates a completely new level of complexity. Complexity is a self-breeding phenomenon –so more leads to even more.

There are numerous anecdotes of complicated entity structures of well-known global enterprises. Lehman, when it filed for bankruptcy, is known to have 8000 entities in 40 jurisdictions. The Italian dairy company Parmalat had several hundred legal entities in various countries in its enterprise group, when it collapsed. The group entity chart for the bankruptcy of Federal Mogul, when magnified sufficiently to make subsidiary names legible, fills the wall of a small office.

Yet another intuitive reason for group-focused approach is that very often, financing is extended by lenders at the holding company level, from where the funds are relegated down to an operating entity which may be several layers below. Sometimes, the structures also plays with cross-border jurisdictions, including what may appear to be round-tripping – a domestic holding entity, which has an offshore subsidiary, and a domestic step-down entity.

If the assets of the holding entity primarily include the shares of the subsidiaries, using the controlling block of the shares as the basis for disposal of the subsidiaries would have seemed to be the intuitive way to deal with the propagated group. However, this is far from easy in practice; the place where the assets and operations are housed is distanced from the holding entity through several layers, and with use of devices such as non-voting shares and warrants, the direct access of the holding vehicle to the place of real assets and operations may be insulated by these ingenious devices. It must be understood that the group structure was planned and scripted by skilled planners, when the entity was healthy, and the strategists had all the time to do a deft, skilfully insulated and ring-fenced structure.

## Current discussions on Enterprise Groups Approach

Current discussions about the relevance of group-focused insolvency approach have been going on in different forums, from academia, to multilateral policy groups such as UNCITRAL, to domestic lawmakers.

One of the earliest inspirations to have a coordinated, cross-border, group-focused approach was the insolvency of BCCI, in early 1990s. BCCI had its headquarters in Luxembourg, but business in 70 countries. On the application of the liquidator, the UK court ordered pooling of assets of the Luxembourg entity with BCCI Overseas[93].

[93] Nicholls V-C wrote:

> *"The pooling arrangements are not conditional upon acceptance by creditors ... I am satisfied that the affairs of BCCI SA and BCCI Overseas are so hopelessly intertwined that a pooling of their assets ... is the only sensible way to proceed. It would make no sense to spend vast sums of money and much time in trying to disentangle and unravel."*

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Maxwell Communications was yet another case, with the entity having assets in several countries had its main person disappear in an accident, leaving the group rudderless. The ensuing insolvency had the so-far unequalled experience of judicial cooperation in different countries. US court and UK court appointed a joint examiner and joint administrator, to undertake pooling of assets in different jurisdictions[94].

UNCITRAL had constituted a working group, Working Group V, to deal with insolvency law, and through its various sessions, the Working Group has been advancing its work on insolvency of enterprise groups. Since UNCITRAL is also focused on cross-border insolvency, the Working Group has also suggested model for cross border insolvency of enterprise groups.

The UNCITRAL Legislative Guide to Insolvency Law has dedicated a complete part, viz., Part 3, dealing with insolvency of enterprise groups. One of the focal points of UNCITRAL's work was cross-border judicial cooperation – therefore, UNCITRAL had group proceedings as its main theme, and not just an embellishment.

The EU Insolvency Regulation also applies in cases where there are insolvency proceedings in two or more EU member states. However, based on its structure, the EU regulation does not extend in case of a non-EU insolvency proceeding.

How does one define or recognise an "enterprise group"? Since UNCITRAL has done a lot of work on the issue, one may ideally borrow from its definition from the UNCITRAL Model law on Enterprise Groups Insolvency, where there are 3 relevant definitions:

- "**Enterprise group**" means two or more enterprises that are interconnected by control or significant ownership.
- "**Control**" means the capacity to determine, directly or indirectly, the operating and financial policies of an enterprise.
- Significant ownership has not been defined – however, it appears that the definition of accounting standards will be relevant here.

## Approaches to Group Insolvency

The essential objective of a group-focused approach is to swell the estate or undertaking of the entity under insolvency or liquidation, and therefore, the proponent of the group approach may look up, look down, or look laterally. "Looking up" means looking at the holding vehicles, or controlling entities, promoters or other investors who have contributed equity or similar resources to the entity in question. "Looking down" means looking at the subsidiaries, associates or ventures into which equity or resources

[94] Justice Hoffman commented:

> *"These parallel proceedings in the English and American courts have resulted in a high level of international cooperation and a significant degree of harmonization of the laws ofthe two countries. The affected parties agreed to the plan and the scheme despite differences in the two nations' bankruptcy laws. The distribution mechanism established by them - beyond addressing some ofthe most obvious substantive and procedural incongruities - allowed Maxwell's assets to be pooled together and sold as going concerns, maximizing the return to creditors...these accomplishments - which, we think, are attributable in large measure to the cooperation between the two courts overseeing the dual proceedings - are well worth preserving and advancing, This collaborative effort exemplifies the 'spirit of cooperation' with which tribunals, guided by comity, should approach cases touching the laws and interests ofmore than one country. "* In re Maxwell Communications Corp (93 F 3d 1036 2d Cir (1996))*"*

may have gone, directly or indirectly, from the entity in question. “Looking laterally” means looking at fellow subsidiaries, siblings or similar entities which have shared control or significant influence as that over the entity in question. The proponent may, indeed, look in all directions – look up, look down and look laterally, so as to look at the entire group.

Depending on what is being intended to be achieved, there may be various alternative approaches to achieve the group-focused results:

(i) Extension of liability and Contribution orders

(ii) Equitable subordination

(iii) Avoidance applications

(iv) Procedural consolidation

(v) Substantive consolidation

## Extension of Liability and Contribution Orders

Contribution order is a part of the “looking up” approach where the proponent of group approach seeks contributions from promoters or holding company to the equity of the entity in question. In that sense, this approach is breaching the concept of limited liability. Extension of liability is also, likewise, piercing the safety net of limited liability and extending the liability of the entity in question to other entities in the group, essentially those on whose implicit support the insolvent entity may have raised funding.

Insolvency jurisdiction does not routinely interfere with limited liability, which is the very foundation of corporate finance. Hence, a contribution order or extension of liability is generally based on circumstances where the insolvent entity has been misused by the group entities, almost under circumstances which may be either fraudulent or implying a mischief. Mostly, the order for fixing liability or ordering contribution from a group entity may in the nature of restoration of property or benefits that may have gone out of the insolvent entity. UNCITRAL Legislative Guide, Part 3 mentions as many as 9 illustrative circumstances[95] in which extension of liability order may be made; most of these seem to be falling in the realm of fraudulent trading.

A discussion on extension of liability must also include the provisions pertaining to directors’ liability for fraudulent or wrongful trading. Trading is regarded as wrongful, when the directors, being already aware that insolvency is unavoidable, continue to trade. Armed with benefit of limited liability, there is little at risk for the shareholders, but the creditors continue to see a depletion in value. In such cases, the directors are made responsible to make such contribution to the liquidation estate as the court/adjudicating authority may deem appropriate. The provisions of wrongful trading were inserted in the UK law specifically at the instance of Sir Kenneth Cork, and enacted as section 214 of the UK law, they came into the IBC as section 66 (2). Additionally, section 66 (1) deals with fraudulent trading; the section corresponds to section 213 of the UK law.

[95] page 56-57

## Equitable Subordination

Equitable subordination is used where a group entity is also a creditor. The proponent of group approach seeks to treat the claims of the group entities as substantive equity, and therefore, the subordinate these claims to the claims of external creditors.

The general approach in equitable subordination of third parties, as in case of contribution or extension of liability, is to undo an injury that would be done if the claim was treated based on its contractual status. In the case of *Enron Corp*., 333 B.R. 205, 222 (Bankr. S.D.N.Y. 2005), the US court put it thus: "Subordinating any amount of claim in excess of the established injury sustained would be punitive, and not consistent with the principles of equitable subordination nor permissible".[96]

In India, there is notable ruling of the NCLT, Allahabad Bench, wherein equitable subordination was ordered for claims of related parties.

## Avoidance Applications

Insolvency laws of most countries come with provisions to annul the impact of such transactions or trading that might have happened, either in anticipation of insolvency, or at undervalued or inadequate consideration, or with an intent of defrauding, etc. These proceedings may be with a clawback period, or in case of a deliberate mischief, without any statutory clawback period. The key element of avoidance provisions is unjust enrichment. As Goode puts it: "All..grounds of avoidance known to insolvency law involve the unjust enrichment of a particular party at the expense of other creditors, whether they are preferential creditors or ordinary unsecured creditors." Avoidance action is essentially to ensure the play of equity in the distributions to creditors, as the outward flight of resources or value by way of vulnerable transactions has presumably caused an inequitable loss to the liquidation estate.

IBC, 2016 lists several vulnerable transactions in case of corporate insolvency and liquidation – preferential transfers, undervalued transactions, fraudulent transactions, and extortionate credits. These are in addition to the provisions pertaining to fraudulent trading [sec 66 (1)] and wrongful trading [sec 66 (2)].

## Consolidation with the consent of Members/Creditors

Consolidation is an extreme step of treating different entitles as one – therefore, consolidating their assets and liabilities. Consolidation may be consensual – that is, done with the concurrence of at least an overwhelming majority of owners and creditors of the relevant entities, or may be non-consensual. This section deals with consensual consolidation.

Pooling or consolidation with the sanction of the members/creditors may be done, even during pendency of liquidation, by a scheme of arrangement, under sections 230-233 of the Companies Act, 2013. In corresponding provisions of laws of other countries, say, Australia, it has been held that there is no doubt that a scheme of arrangement may provide for pooling of assets and liabilities of different companies. *Dean-Willcocks v Soluble Solutions Hydroponics* (1997) 42 NSWLR 209.

[96] For a write up giving the evolution of the law on equitable subordination, see here: http://www.lawjournalnewsletters.com/sites/lawjournalnewsletters/2014/09/01/the-continuing-evolution-of-the-basis-for-equitable-subordination/?slreturn=20190206034956

In India, the NCLAT has held in *S C Sekaran vs Amit Gupta and others*, that a scheme under section 230 can be filed during insolvency or liquidation proceedings.

## Procedural consolidation

Procedural consolidation is actually not a consolidation – it is procedural coordination, such that while the different entities remain different, but their resolution or liquidation proceedings are put under a common procedure. Such consolidation may take various forms – common adjudicating authority, common administrator or insolvency professional, common committees of creditors, common agenda for action, etc. Procedural coordination saves time and costs, and all the more, ensures that diverse proceedings against different group entities do not result into divergent directions.

The procedural coordination may involve coordination among different judicial or adjudicating bodies as well. As we have noted elsewhere, one of the landmark examples of judicial coordination was the insolvency of BCCI. Cross-border judicial coordination, with the jurisdiction of the "center of main interests" (COMI) taking the main role, is key theme of UNCITRAL recommendations.

In procedural coordination or consolidation, the assets and liabilities of different entities remain distinct – there is no pooling of thereof.

Procedural consolidation shall also be distinguished from joint application for commencement of proceedings against entities fulfilling commencement standards.

## Substantive Consolidation

Substantive consolidation is perhaps the most radical remedy for group insolvency, seeking to pool the assets and liabilities of a group of entities. Highlighting the rare success of substantive consolidation in insolvency proceedings, *Goode* says: "(Treating a group as a single economic enterprise for insolvency purposes) is not easy to achieve, even if limited to procedural consolidation, which would treat the member of the group as one for the purpose of administration, while keeping the assets and liabilities separate. It is harder still, in policy terms, to effect substantive consolidation, involving the pooling of assets and liabilities, for this interferes with the existing rights of creditors, in particular creditors of a group member having substantial assets who can legitimately argue that they dealt with that member and should not have their position impaired by consolidation of assets and liabilities with less well-placed members of the group… It is only infrequently that English courts will be willing to pierce the corporate veil. It is rarer still to consolidate assets and liabilities."[97] US courts are far more receptive to the use of such powers, but in the USA as well, courts have called it "rough justice"[98].

The acceptability of an appeal for substantive consolidation continues to oscillate over time. However, as corporates become increasingly driven by group level governance, courts cannot be insulated from the reality, and where appropriate, courts may be open to use the power to consolidate.

To quote from UNCITRAL Legislative Guide, vol 3:

[97] Goode on *Principles of Corporate Insolvency Law*, Fifth edition, page 30

[98] In *Owens Corning*, 419 F.3d 195 (3d Cir. 2005)it was stated: "Indeed, because substantive consolidation is extreme (it may affect profoundly creditors' rights and recoveries) and imprecise, this "rough justice" remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies (for example, the possibility of more precise remedies conferred by the Bankruptcy Code)".

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Notwithstanding the absence of direct statutory authority or a prescribed standard for the circumstances in which substantive consolidation orders can be made, the courts of some jurisdictions have played a direct role in developing these orders and delimiting the appropriate circumstances. While this practice may reflect increased judicial recognition of the widespread use of interrelated corporate structures for taxation and business purposes, the circumstances that would support a substantive consolidation order are, nevertheless, very limited. They include situations where there is a high degree of integration of the operations and affairs of group members, through control or ownership, that would make it very difficult, if not impossible, to disentangle the assets and liabilities of the different group members in order to identify, for example, ownership of assets and the creditors of each group member, without significant expenditures of time and resources that would ultimately hurt all creditors.[99]

Before proceeding further, the elusive difference between commonly used phrase "lifting or piercing the corporate veil" and "substantial consolidation" needs to be noted. Lifting or piercing of corporate veil, another substantive power of courts, is used in variety of circumstances to eliminate the veil of incorporation and treat a company and its owners, or a company and its owned entities, as one. There has been a long line of rulings where English courts have used this power, and recently, the UK Supreme court opted for a so-called principled approach for such lifting, piercing, or side-stepping[100]. There is usually no intent of consolidation of liabilities in case of lifting or piercing of corporate veil, as that would not have been the intent in most cases.

On the other hand, in substantive consolidation, there will be pooling of assets as well as liabilities. Therefore, both the assets and liabilities get consolidated, and inter-company balances between the group entities get eliminated. This is the same process that happens in accounting consolidation[101]. While the liquidation estate gets merged into a larger pool, the priorities of creditors who may have made loans to different entities in the group may not be disturbed – this may be appropriately dealt with by the adjudicating body. After all, the idea of substantive consolidation is to benefit the creditors generally, without causing detriment to any.

## Cross Border angle in Group Insolvency

The issue of insolvency of enterprise groups is most relevant for larger corporates, many of whom have global presence. Hence, in most such group insolvency matters, there are cross borders issues.

UNCITRAL 53rd session is reportedly working on a legislative draft of cross border insolvency of enterprise groups.

The draft legislative provisions on facilitating the cross-border insolvency of enterprise groups framed by UNCITRAL[102] talk about development of a "group insolvency solution" for the whole or part of an enterprise group and cross-border recognition and implementation of that solution in multiple States. The objective is protection and maximization of the overall combined value of the operations and assets of enterprise group members affected by insolvency **and** of the enterprise group as a whole.

A "group insolvency solution" has been defined to mean a set of proposals developed in a "planning proceeding" for the reorganization, sale, or liquidation of some or all of the operations or assets of one or

[99] https://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part3-ebook-E.pdf, p. 60

[100] *Prest v Petrodel Resources Ltd* [2013] 2 AC 415

[101] Lord Denning's often cited quote on lifting/piercing of corporate veil was inspired by preparation of group accounts - DHN Food Ltd vs Tower Hamlet [1976] 1 WLR 852

[102] https://undocs.org/en/A/CN.9/WG.V/WP.158,

more enterprise group members, with the goal of preserving or enhancing the overall combined value of the group members involved.

The expression "planning proceeding" has been defined in the context of COMI (centre of main interests) – a planning proceeding is an insolvency proceeding commenced in respect of an enterprise group member **at its centre of main interests**, provided that following conditions are fulfilled – (i) one or more enterprise group members are "participating" in such proceeding for the purpose of developing and implementing a group insolvency solution, (ii) the subject enterprise group member is a necessary and integral part of that group insolvency solution, and (iii) a group representative has been appointed (who can be a person or a body, including interim one, authorised to act as a representative of a planning proceeding.

Note that "participation" refers only to the right to appear, make written submissions and be heard in that proceeding on matters affecting the other enterprise group member's interests and to take part in the development and implementation of a group insolvency solution. Such participation is voluntary and subject to the prohibition, if any, imposed by the court if the other enterprise group members has its COMI in another jurisdiction.

Once the conditions as above are met, and the proceeding becomes a planning proceeding, the group representative is authorised to –

(i) seek **relief** (refer Article 13)in this State to support the development and implementation of a group insolvency solution;

(ii) act in a foreign State and seek **recognition** of the planning proceeding (by way of an application, refer Article 14) and **relief** (provisional or otherwise, refer Articles 15,17) to support the development and implementation of the group insolvency solution;

(iii) **participate** in a foreign proceeding relating to an enterprise group member participating or not participating in the planning proceeding.

"Relief" as used in the articles above, generally refer to moratorium provisions, imposing stay on execution against assets of the enterprise group member, suspending the right to transfer, encumber the assets, staying commencement of isolated actions, etc. Relief under Article 13 (available to a planning proceeding) may be granted by the court on the request made by the group representative. Such relief may not be granted in respect of assets/operations (located in the State) of a **participating** enterprise group member, **not subject to insolvency proceedings**. Also, where the assets/operations (located in the State) **belong to an enterprise group member having COMI in another State**, the relief can only be granted to the extent **not interfering with the administration of insolvency proceedings taking place in that State**. Similarly, relief may be refused under Articles 15, and 17 (dealing with provisional relief/relief which may be granted on application for recognition of or actual recognition of a foreign planning proceeding), if the relief would interfere with the administration of an insolvency proceeding taking place in the COMI of an enterprise group member participating in the planning proceeding.

As indicated, once a planning proceeding is recognised, the group representative may "participate" in any proceeding under the insolvency law of the enacting State concerning enterprise group members that are participating in the planning proceeding.

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Presently, the insolvency jurisdiction of English Courts is derived from EU Insolvency Regulation[103], the UNCITRAL Model law on Cross-Border Insolvency (as imbibed in the Cross-Border Insolvency Regulations, 2006[104]), and in general the Insolvency Act, 1986.

Chapter V of the EU Regulations deals with insolvency proceedings of members of a group of companies (which, by definition means a parent undertaking and all of its subsidiaries). The EU Regulation makes provisions for cases where insolvency proceedings falling within the scope of the Regulation are opened in relation to two or more members of a group of companies in more than one Member State. These provisions are however for the most part focused on enhancing co-ordination between the proceedings; **they stop short of consolidation, either substantive or procedural** – see *Goode*[105]. The EU regulations facilitate "group coordination proceedings" (refer Article 61), however, the same is voluntary the insolvency practitioner has been given the right to object to their participation in the proceedings within a specified time period. In order to open group coordination proceedings, the court must be satisfied that the opening of such proceedings is appropriate to facilitate the effective administration of the insolvency proceedings relating to the different group members, no creditor of any group member expected to participate in the proceedings is likely to be financially disadvantaged by the inclusion of that member in such proceedings; and the group coordinator fulfils the requirements laid down under the regulations. Interestingly, the "group coordination plan", that is, "a plan that identifies, describes and recommends a comprehensive set of measures appropriate to an integrated approach to the resolution of the group members' insolvencies", shall **not include recommendations as to any consolidation of proceedings or insolvency estates**.

Precedents in Global Jurisdictions and in India

*In re Owens Corning*, 419 F.3d 195, 210 (3d Cir. 2005), the United States Court of Appeal, Third Circuit, discussed "subtle differences" among various remedies –

> ""Piercing the corporate veil" makes shareholders liable for corporate wrongs. Equitable subordination places bad-acting creditors behind other creditors when distributions are made. Turnover and fraudulent transfer bring back to the transferor debtor assets improperly transferred to another (often an affiliate). **Substantive consolidation goes in a direction different (and in most cases further) than any of these remedies**; it is not limited to shareholders, it affects distribution to innocent creditors, and it mandates more than the return of specific assets to the predecessor owner. **It brings all the assets of a group of entities into a single survivor. Indeed, it merges liabilities as well.** "The result," to repeat, "is that claims of creditors against separate debtors morph to claims against the consolidated survivor." *In re Genesis Health Ventures, 402 F.3d at 423*. The bad news for certain creditors is that, instead of looking to assets of the subsidiary with whom they dealt, they now must share those assets with all creditors of all consolidated entities, raising the specter for some of a significant distribution diminution."

As to substantive consolidation, the US Court noted, "Substantive consolidation, a construct of federal common law, emanates from equity. It "treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated

[103] Regulation (EU) 2015/848, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32015R0848
[104] https://www.legislation.gov.uk/uksi/2006/1030/contents/made

[105] Pg. 31.

survivor." *Genesis Health Ventures, Inc. v. Stapleton* (In re Genesis Health Ventures, Inc.), 402 F.3d 416, 423 (3d Cir.2005).

However, "Prior to substantive consolidation, other remedies for corporate disregard were (and remain) in place. For example, where a subsidiary is so dominated by its corporate parent as to be the parent's "alter ego," the "corporate veil" of the subsidiary can be ignored (or "pierced") under state law. Kors, supra, at 386-90 (citing as far back as I. Maurice Wormser, Piercing the Veil of Corporate Entity, 12 Colum. L.Rev. 496 (1912)). Or a court might mandate that the assets transferred to a corporate subsidiary be turned over to its parent's trustee in bankruptcy for wrongs such as fraudulent transfers, Kors, supra, at 391, in effect bringing back to the bankruptcy estate assets wrongfully conveyed to an affiliate. If a corporate parent is both a creditor of a subsidiary and so dominates the affairs of that entity as to prejudice unfairly its other creditors, a court may place payment priority to the parent below that of the other creditors, a remedy known as equitable subordination, which is now codified in § 510(c) of the Bankruptcy Code. See generally id. at 394-95."

US Bankruptcy Rule 1015 provides for order for joint administration of estates in cases involving two or more related persons, that is if a joint petition or two or more petitions are pending in the same court by or against a debtor and an affiliate. Notes to the said rule clarify that –

> "This rule does not deal with the consolidation of cases involving two or more separate debtors. Consolidation of the estates of separate debtors may sometimes be appropriate, as when the affairs of an individual and a corporation owned or controlled by that individual are so intermingled that the court cannot separate their assets and liabilities. Consolidation, as distinguished from joint administration, is neither authorized nor prohibited by this rule since **the propriety of consolidation depends on substantive considerations and affects the substantive rights of the creditors of the different estates**. For illustrations of the substantive consolidation of separate estates, see *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941). See also *Chemical Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966); Seligson & Mandell, Multi-Debtor Petition—Consolidation of Debtors and Due Process of Law, 73 Com.L.J. 341 (1968); Kennedy, Insolvency and the Corporate Veil in the United States in Proceedings of the 8th International Symposium on Comparative Law 232, 248–55 (1971)."

Different standards have been employed by courts to determine the propriety of substantive consolidation.

In *Union Savings Bank v. Augie/Restivo Baking Co., Ltd.* (In re Augie/Restivo Baking Co., Ltd.), 860 F.2d 515, 518 (2d Cir. 1988), concluded that the factual elements considered by the courts to determine whether equitable treatment will result from substantive consolidation are "merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, ... **or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."**

In *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991), the Eleventh Circuit adopted a modified version of the standard articulated by the District of Columbia Circuit in Drabkin v. Midland Ross Corp. (In re Auto-Train Corp., Inc.), 810 F.2d 270, 276 (D.C. Cir. 1987). According to this standard: (i) the proponent of consolidation must demonstrate that there is substantial identity between the entities to be consolidated and that consolidation is necessary to avoid some harm or to realize some benefit; and (ii) a creditor may object on the grounds that it relied on the entities' separate credit and will be prejudiced by consolidation, in which case the court can order consolidation only if it determines that the benefits of consolidation "heavily" outweigh the harm.

Also, in *In re Owens Corning(supra),* the court also discussed the principles which may be instrumental in assessing whether to order substantive consolidation, and encapsulated thus, “In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.”

The approach of Indian courts in matters of insolvency or winding up towards group insolvency is a largely unexplored territory. There is no noticeable trend where, in matters of winding up, courts have used consolidation, or even lifting or piercing of corporate veil, aggressively. There are matters where winding up may have been ordered under the so-called “just and equitable” power under the Companies Act, but that is more for reasons other than insolvency.

In *Life Insurance Corporation of India v. Escorts Ltd. & Ors.*, (1986) 1 SCC 264, the Supreme Court observed,

> “Generally and broadly speaking, the corporate veil may be lifted where a statute itself contemplates lifting the veil or fraud or improper conduct is intended to be prevented or a taxing statute or **a beneficient statute is ought to be evaded** or **where associated companies are inextricably connected as to be in reality, part of one concern**. It is **neither necessary nor desirable to enumerate the classes of cases where lifting the corporate veil is permissible**, since that must necessarily depend on the relevant statutory or other provisions, the object sought to be achieved, the impugned conduct, the involvement of the element of the public interest, and **the effect on the parties who may be affected**, etc.”

In *DHN Food Distributors Ltd. v. London Borough of Tower Hamlet* [(1976) 3 All ER 462] the Court of Appeal was dealing with three companies, out of which one was the holding company and the other two were its subsidiaries. After quoting the views of Prof. Gower that "there is **evidence of a general tendency to ignore the separate legal entities of various companies within a group, and to look instead at the economic entity of the whole group**" Lord Denning, M.R. has observed : "This group is virtually the same as a partnership in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point." (p. 467) In the same case, Goff, L.J. has said : "[T]his is **a case in which one is entitled to look at the realities of the situation and to pierce the corporate veil.**" (p.468) – see *New Horizons Ltd. v. Union of India*, (1995) 1 SCC 478.

In *Vodafone International Holdings BV v. Union of India*, (2012) 6 SCC 613, the Supreme Court observed –

> “The question is what is the nature of the "control" that a parent company has over its subsidiary. It is not suggested that a parent company never has control over the subsidiary. For example, **in a proper case of “lifting of corporate veil”, it would be proper to say that the parent company and the subsidiary form one entity.** But barring such cases, the legal position of any company incorporated abroad is that its powers, functions and responsibilities are governed by the law of its incorporation. No multinational company can operate in a foreign jurisdiction save by operating independently as a "good local citizen". A company is a separate legal persona and the fact that all its shares are owned by one person or by the parent company has nothing to do with its separate legal existence. If the owned company is wound up, the liquidator, and not its parent company,

> would get hold of the assets of the subsidiary. . . . Thus, even though a subsidiary may normally comply with the request of a parent company it is not just a puppet of the parent company. **The difference is between having power or having a persuasive position.** Though it may be advantageous for parent and subsidiary companies to work as a group, each subsidiary will look to see whether there are **separate commercial interests which should be guarded**. When there is a parent company with subsidiaries, is it or is it not the law that the parent company has the "power" over the subsidiary. It depends on the facts of each case."
>
> "Of course, *in many cases the courts do lift up a corner of the veil but that does not mean that they alter the legal position between the companies*. The directors of the subsidiary under their Articles are the managers of the companies. If new directors are appointed even at the request of the parent company and even if such directors were removable by the parent company, such directors of the subsidiary will owe their duty to their companies (subsidiaries). **They are not to be dictated by the parent company if it is not in the interests of those companies (subsidiaries**). The fact that the parent company exercises shareholder's influence on its subsidiaries cannot obliterate the decision-making power or authority of its (subsidiary's) directors. **They cannot be reduced to be puppets**. **The decisive criteria is whether the parent company's management has such steering interference with the subsidiary's core activities that subsidiary can no longer be regarded to perform those activities on the authority of its own executive directors**."

In fact, even for lifting or piercing of corporate veil, the courts have stressed that the same should be resorted to sparingly.

In *Walnut Packaging Private Limited vs The Sirpur Paper Mills Limited and another*, a contention was brought before the AP High Court that a subsidiary company had become unable to pay its debts, and in view of nexus between the holding and the subsidiary, the holding company should be made liable to pay for the debts of subsidiary. Several well-known Indian rulings on the concept of lifting and piercing of corporate veil were cited. The court held: "By reading these two judgments[106], it becomes clear that an iota of right or obligation related to public good is essential for ignoring the corporate principle and resort to extreme devise of lifting/piercing corporate veil. The principle is not available when ordering winding up of holding company for alleged default by its subsidiary." At another place, the court held: "The principle of lifting veil cannot be applied for ordering winding up of a holding company when creditor is unable to receive money from subsidiary company."

In *Meekin Transmission Limited vs State of UP and Others*, the matter pertained to recovery of tax dues from the directors where the company had gone into winding up following failure of revival proceedings before BIFR. The Allahabad High court has cited a whole lot of rulings, and at the end of the day, decided not to invoke the doctrine of lifting or piercing of corporate veil to extend the liability of company on the directors.

Thus, other than abusive use of the corporate façade, it is difficult to find precedents for substantive consolidation, or something close to the same, in Indian rulings.

[106] Kapila Hingorani vs State of Bihar [ https://indiankanoon.org/doc/1455798/ ] and Singer India Limited vs Chandra Mohan Ladha [ https://indiankanoon.org/doc/1134266/ ]

## Issues in Group-based Insolvency Proceedings

While majority of US courts have concluded that bankruptcy courts have the power to substantively consolidate debtor entities under section 105(a) of the US Bankruptcy Code, which provides that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the US Bankruptcy Code. However, because forcing the creditors of one entity to share equally with the creditors of a less solvent entity is not appropriate in many circumstances, courts generally hold that substantive consolidation is an "extraordinary remedy" that should be used sparingly.

The Legislative Guide on Insolvency Law discusses that 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:

(i) the extent to which management, the business and the finances of the companies are intermingled;

(ii) the conduct of the related company towards the creditors of the insolvent company;

(iii) the expectation of creditors that they were dealing with one economic entity rather than two or more group companies; and

(iv) 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.

Another crucial consideration in insolvency laws if the effect of such measures on creditors. The laws shall 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. On approach to reconcile as such is to consider whether the savings to creditors collectively would outweigh the incidental detriment to individual creditors.

As stated in the Guide, "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." However, it should be noted that insolvency laws providing for consolidation *do not affect the rights of secured creditors*, **other than** possibly the holders of intragroup securities.

In *Insolvency in a Group of Companies, Substantive and Procedural Consolidation: When and How?*, and *Substantive Consolidation: A Critical Examination*, the authors discuss and include the following circumstances under which substantive consolidation should be granted or factors under which substantive consolidation may be requested:

(i) there has been hindrance or fraud on creditors;

(ii) there has been good faith creditors' reliance on the group as a whole (i.e. on the group as a consolidated enterprise);

(iii) there has been intermingling of various corporate estates and of their accounts, if any;

(iv) there exists difficulty in separating subsidiaries' assets and liabilities;

(v) whole or part of the groups' companies have been grossly undercapitalised;

(vi) a consolidated approach would facilitate a reorganisation plan;

(vii) there are intercorporate loan guarantees or other forms of intercorporate financing;

(viii) general failure to observe corporate formality;

(ix) generally speaking, this would be in the interest of the creditors.

As discussed in *Eastgroup Properties v. Southern Motel Assoc., Ltd*., 935 F.2d 245 (11th Cir. 1991), in *In re Vecco Construction Industries, Inc.*, 4 B.R. 407 (Bankr. E.D. Va. 1980), the court outlined the following seven factors in making prima facie case for consolidation –

"(1) The presence or absence of consolidated financial statements.

(2) The unity of interests and ownership between various corporate entities.

(3) The existence of parent and intercorporate guarantees on loans.

(4) The degree of difficulty in segregating and ascertaining individual assets and liabilities.

(5) The existence of transfers of assets without formal observance of corporate formalities.

(6) The commingling of assets and business functions.

(7) The profitability of consolidation at a single physical location."

Additional factors that could be presented in some cases include – (1) the parent owning the majority of the subsidiary's stock; (2) the entities having common officers or directors; (3) the subsidiary being grossly undercapitalized; (4) the subsidiary transacting business solely with the parent; and (5) both entities disregarding the legal requirements of the subsidiary as a separate organization. The US Court, however, stressed that, "We stress, however, that we mention the specific factors set out in Vecco, Ouimet, and elsewhere only as examples of information that may be useful to courts charged with deciding whether there is a substantial identity between the entities to be consolidated and whether consolidation is necessary to avoid some harm or to realize some benefit. No single factor is likely to be determinative in the court's inquiry."

## Making group insolvency work under the current regime in India

In several Indian insolvencies and liquidations, the need for some sort of group approach has already been felt. Recently, in *Venugopal N. Dhoot v. State Bank of India & Ors*., CA 1022(PB)/2018, the National Company Law Tribunal, Principal Bench, New Delhi has set a precedent by consolidating corporate insolvency resolution process matters of group companies as one to be heard by the National Company Law Tribunal, Mumbai Bench.

### *Entity vs. Enterprise*

In many cases of liquidation as well, there are inter-connected investments and operations in different jurisdictions. In short, there is a clear necessity for adopting the enterprise approach.

The potential approaches to group insolvency may depend on the facts and the immediate objective. Some of the potential approaches and the circumstances in which these approaches may be relevant may be as follows:

| | |
|---|---|
| **During CIRP stage** | |
| **Initiation of CIRP proceedings against group entities** | If the intent is to have a resolution plan for the entire group; as a part of the plan, the resolution applicant may make a proposal for consolidated group. The RP may, based on propriety of the matter, hold group CoC meetings, or at least ensure better coordination among the CoCs. |
| **Appointment of common resolution professional** | If the intent is merely to avoid overlaps in different RPs. The entities may have different CoC meetings, but the presence of common RP will ensure better coordination. |
| **During liquidation stage** | |
| **Initiation of voluntary/compulsory liquidation against group entities by the liquidator of the parent** | If the intent of the liquidator is to get the proceeds from disposal of the assets of the group entities. The liabilities of the group entities will first be settled from the assets; net assets will be paid over to the holding entity. |
| **Change of management of group entities** | If the intent of the liquidator is to plug any loss of value due to management reasons, or otherwise, take the group entities under the control of the liquidator. |
| **Action against transfer of assets or business to group entities** | If the business/assets have been transferred to subsidiaries/group entities in recent past, and the liquidator considers such transfer as not being bonafide, the liquidator may try to clawback and reverse the impact of these transactions. |
| **Substantive consolidation** | If the intent of the liquidator is consolidate the assets and liabilities, and eliminate the distinction between legal entities altogether. |

## Substantive consolidation in India

The provision of the Code providing an apparent sanctity to the separation of legal entities is clear; section 36 (3) (a) provides that the shares of an Indian or foreign subsidiary shall be included in the liquidation estate. Section 36 (4) (d) provides that the assets of any such subsidiary shall be excluded from the liquidation estate. Therefore, the law makes it clear that the bounds of the liquidation estate will extend to the shares of the subsidiaries, but will not piece the same to reach out to the asset of the subsidiary.

The inspiration behind such explicit provision is difficult to understand. However, it could not have been intended to negate the substantive power of an Adjudicating Authority to traverse the legal entity, where the separation is artificial. In essence, the intent of the explicit provision in the Code can only be that there will not be adventurous expeditions trying to break the citadel of legal entities. Hence, the creditors of the holding entity may only and have a claim as to the shares of the holding entity. Therefore, it will require a demonstration of the artificiality of the legal entities, such that the assets may be regarded, in the true sense, to be the assets of the holding entity only. The true purport of this provision is simply to legislate what has been attained with series of rulings in the USA, such as *Owens Corning*.

The ability of the Adjudicating Authority to use the substance-over-form principle and question the separation of legal entities is not affected by this provision. In fact, in every jurisdiction, the exercise of equitable powers such as substantive consolidation is an exception to the separation of legal entity. The provisions of the Code are merely a statutory recognition of the separation of legal entity, which, in ordinary circumstances, is well understood. Under the US Bankruptcy Code, the power to order substantial consolidation has been said to emanate from a very broadly worded provision in section 105 (a) vesting the bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions". If substantive consolidation better carries the intent and provisions of the Code, the court is said to have that equitable power. In the Indian law, section 60 (5) (c ) of the Code empowers the Adjudicating Authority to entertain and dispose of "any question of law or facts, arising out of or in relation to the insolvency resolution or liquidation proceedings of the corporate debtor or corporate person under this Code."

Substantive consolidation is an equitable power; it will be futile to search for an equitable power in the statute. Reg 11 of the NCLT Regulations provides for inherent powers of the Tribunal to pass such orders as may be necessary to meet the ends of justice.