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Analysis

Problems at an Overseas Subsidiary – Could You End Up in Court?

Nick Hood



Nick Hood
Senior Business Adviser
Opus Advisory Group

Biography

Nick Hood is the Senior Business Adviser at the Opus Advisory Group (https://www.opusllp.com), the largest independent advisory, restructuring and insolvency firm in the UK.

Nick was a licensed Insolvency Practitioner, working in the business rescue market for 25 years. He is a committed internationalist, having created the largest global network of independent business rescue firms and having also worked overseas in Canada, Milan and Bahrain.

In his earlier career and after qualifying as a Chartered Accountant in 1970, Nick held senior executive positions in major companies in the construction, engineering and media sectors, as well as working for a boutique investment bank.

Nick's thought leadership and opinion blogs for Opus can be found at https://opusllp.com/resources/.

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Abstract

Closing down a struggling or failed overseas operation can prove far more complicated, costly and time-consuming than UK parent companies might expect. Beyond the immediate financial consequences, there may be a host of outstanding obligations to resolve, from employment disputes, tax liabilities and creditor claims to regulatory requirements, contractual commitments and local reporting rules. Differences in legal systems, business practices and cultural expectations can make the process even more challenging, particularly when head office lacks a clear understanding of the subsidiary's day-to-day affairs. Failure to manage the closure correctly can expose the parent company to unexpected liabilities, reputational damage and prolonged legal disputes. In the most serious cases, UK parent companies and their executives may even find themselves on the wrong side of the law in the jurisdiction concerned, warns the author of this article.

Introduction

Multinational groups are not all corporate giants with sophisticated oversight and control of their international operations. Relatively modest UK businesses set up overseas subsidiaries to operate in other markets around the world.

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Key characteristics of many of these cross-border arrangements include:

- minimal administrative resources in the foreign businesses, often with key functions such as accounting and regulatory compliance outsourced to local professional firms.

- only one or at most two UK Directors on the local Board, with limited oversight of or involvement in the day-to-day running of the subsidiary.

- poor visibility of local finances available to the UK management and a tendency to deal with local financial pressures by sending money through an inter-company loan account, which is only reconciled with local accounting records on an intermittent basis.

These features are not limited to UK SME investments abroad, they can be found in quite large and apparently more sophisticated UK corporates. The problem is that, from a purely financial perspective, foreign subsidiaries are often considered too small to attract sufficient attention from central management or rigorous scrutiny from external auditors.

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What happens when things go wrong?

Eventually, the UK parent company will conclude that providing any more financial support for the struggling overseas subsidiary is untenable, either because it makes no commercial sense, its own finances are too stretched or in the worst-case scenario, it has been forced to file for insolvency in the UK.

The financial implications for the parent may involve writing off the inter-company loan balance and being obliged to meet liabilities of the subsidiary it had guaranteed. There may be outstanding debts for the supply of inventory, but whether the UK concept of retention of title will work to recover value in the jurisdiction concerned is an open question.

Generally, the assumption in this scenario is that the parent can walk away from its overseas involvement by instructing local professionals to put the entity into the appropriate insolvency process. It will hope that there is sufficient cash in the subsidiary to pay those professionals, but it may have to dip into its pocket to fund the corporate burial.

Unfortunately, achieving a swift and conclusive separation is rarely this simple and the complexities, risks and issues can extend well beyond financial considerations. Not only can there be additional financial costs, but UK parent companies and their executives can find themselves liable to civil or even criminal sanctions.



The logistics of closing down a foreign subsidiary

Understanding the closure process

Entry into a terminal procedure such as Liquidation or its local equivalent has different requirements in every jurisdiction, not least on the key issue of the choice of the insolvency office holder.

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For example, in most European civil law regimes this decision will be entirely at the discretion of a Court and attempts to influence the outcome can lead to some unfortunate consequences. In common law jurisdictions it is more likely to be the creditors who will have the final say and in other types of legal systems there could be something as unpredictable as some form of panel, which operates on an apparently random rota system.

These choices can also be influenced by strict rules on conflicts of interest, so that in one European country just taking initial general advice from a local insolvency practitioner would disbar them from being appointed. This means that in practice, a UK parent company looking to put its subsidiary into Liquidation there will be faced with using two different professionals and paying two sets of fees.

Putting together financial and other information

Most insolvency regimes require the submission of some level of financial and other information about the entity to be closed down before the insolvency procedure can be commenced. This may not have to be definitive data, but in many scenarios a UK parent can be faced with serious deficiencies with local books and records. In some cases, local executives or professional advisers may refuse to co-operate with putting together the required information, either at all or without extracting ransom payments from the parent.



Employee entitlements and rights

This can be a minefield in many jurisdictions. One UK parent company CEO was threatened with arrest by the authorities in China after closing down their local subsidiary and leaving local employees unpaid. In another country, this time in Europe, parent company executives can be held responsible personally for unpaid employee entitlements under certain circumstances.

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Regulatory compliance

Executives of UK companies are generally reassured that the consequences of regulatory non-compliance by or enforcement against their company are halted by the commencement of a formal insolvency procedure such as Liquidation. This is not true in every scenario, but it is a reasonable working assumption in most.

Contrast this with the situation faced by one UK group, which had gone into Administration. For a number of reasons, it was necessary to liquidate its subsidiary in a European country. Among various difficulties with this strategy was one entirely unexpected problem. The subsidiary had been set up 16 years earlier. It had prepared accounts each year, which were submitted to the tax authorities but had not also been filed as required at a particular commercial Court.

Not only could the Liquidation not commence until all the missing accounts had been filed, but the filing fees, fines and penalties for all sixteen years of non-compliance had to be paid (along with the professional fees to ensure proper compliance) and could not fall into the unsecured creditor pot. In addition, the legal regime involved the concept of a controlling individual (akin to the UK's Person with Significant Control) who could be held personally liable for these liabilities if the company did not settle them.

A wide range of regulatory non-compliance by a foreign subsidiary can cause difficulties, especially where tax returns and payments, whether for corporate taxes or employee deductions, are overdue.

Potential parent company or personal liability for unpaid debts

There is a widespread misconception that subsidiary company liabilities will stay contained within the legal entity and will not migrate to the parent company in the


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absence of any formal guarantee or pledge arrangements. Equally, the concept of limited liability, supposedly protects executives from personal liability.

In the UK there is a broad spectrum of scenarios in which creditors and other institutions can pierce the corporate veil and reach into other parts of groups to seek redress, or else in which individual Directors, other officers or even shareholders can be held personally responsible for corporate debts. Unfortunately, this is also true in many jurisdictions worldwide.

Subsidiary risk management

As with all risk, the best mitigation strategy is to make sure the potential downsides are identified before the financial or commercial crisis starts, which means taking local professional advice at the outset of direct involvement in a foreign market and developing contingency plans to limit exposure in the worst-case scenario of an insolvent closure.

Reviewing risk on a regular basis is also essential, as is taking action promptly as the local situation deteriorates. A planned closure will always have a better outcome than dealing with creditor enforcement and an insolvency process controlled by hostile stakeholders.

It should also be remembered that local professional advisers appropriate to the normal running of an overseas subsidiary may not necessarily have the skills and experience needed in an insolvency situation. This is especially true in less developed or mature jurisdictions, where insolvency and restructuring expertise can be spread very thin. Making use of UK advisers with deep international connections in this specialist field will usually pay dividends and help to deliver the most satisfactory outcome achievable.

Analysis

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Reference

1 Arial 7 - McGrath and another and others v Riddell and others [2008] UKHL21.

2 Other relevant countires including Bahamas, Bermuda, Cayman Islands, Hong Kong, Ireland, News Zealand, South Africa.

Reference

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Figure 1: Summary of Average House Price



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