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RESTRUCTURING AND INSOLVENCY

Restructuring and insolvency in the United States: overview

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FORMS OF SECURITY

1. What are the most common forms of security granted over immovable and movable property? What formalities must the security documents, the secured creditor or the debtor comply with? What is the effect of non-compliance with these formalities?

Immovable property

Common forms of security and formalities. Immovable property in the US is known as real property. Real property is generally comprised of land and whatever is built on or affixed to it (often referred to as fixtures). State law governs forms of security in real property.

The principal and most common form of security interest granted over real property is a mortgage. A mortgage is an agreement between the creditor (mortgagee) and the debtor (mortgagor) that grants the creditor a lien and the right to foreclose on the real property if the debtor defaults on the underlying obligation. Foreclosure is typically but not always achieved through judicial action. Parties can agree in advance for a non-judicial foreclosure.

Another method of granting security in real property is through a deed of trust. A deed of trust involves three parties:

- The creditor (beneficiary).
- The debtor (trustor).
- A third-party trustee.

Under a deed of trust, the debtor retains equitable title in the real property, while the trustee retains legal title. If the debtor defaults on the underlying obligation, the trustee can foreclose for the benefit of the creditor. Whether a mortgage or a deed of trust is used usually depends on the state where the real property is located as local state laws differ.

For either a mortgage or deed of trust to be valid and enforceable against third parties, it must be recorded in the local land registry where the real property is located. Valid mortgages and deeds of trust must generally include the following:

- The name of the secured party.
- The debtor's signature (which must often be witnessed or notarised under applicable state law).
- A legal description of the underlying real property.
- An adequate description of the various terms and conditions of the security interest.

Effects of non-compliance. If a mortgage or deed of trust is not recorded, or lacks any of the essential elements mentioned above or otherwise fails to comply with state law, it may be unenforceable against the debtor's other creditors or subsequent purchasers of the real property. In addition, in a bankruptcy proceeding, under the "strong-arm" provisions of sections 544 and 548 of the Bankruptcy Code and other applicable law, a bankruptcy trustee or debtor-in-possession may be able to avoid a defective mortgage or deed of trust and recover the real property for the benefit of the debtor's estate and other creditors.

Regardless of any defects in a mortgage or security interest in real property, under relevant state law, a legally defective mortgage can still be enforceable under certain legal doctrines, including:

- Equitable mortgage.
- Equitable subrogation.
- Constructive notice.
- Substantial compliance.

The court with jurisdiction determines the validity and/or effectiveness of any challenged security interest in real property.

Movable property

Common forms of security and formalities. Moveable property in the US is commonly known as personal property. Personal property includes physical assets such as inventory and equipment, as well as bank accounts, intellectual property, and any other type of intangible assets.

As with real property, state law governs security interests in personal property. All 50 of the US states (and the Commonwealth of Puerto Rico) have adopted Article 9 of the Uniform Commercial Code, which governs the methods by which a security interest can be taken in personal property.

Under Article 9, a security interest in personal property is created and becomes enforceable against the property upon "attachment". Attachment occurs when the following apply (*UCC § 9-203*):

- The debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party.
- Value has been given.
- Either:
  - the debtor has authenticated a security agreement that adequately describes the property; or
  - the secured creditor has possession or control over the property.

In addition, for a creditor to have priority over third parties, the security interest must be "perfected". The method by which a secured party perfects its interest is largely determined by the type of property serving as collateral. In most instances, perfection is accomplished by either:

- The filing and recording of a financing statement (Form UCC-1) with the appropriate governmental authority.
- Taking possession or control of the property.

Where a filing is required, in most instances, a financing statement must include (*UCC §§ 9-503, 9-504*):

- The name of the debtor.
- The name of the secured party.
- An adequate description of the collateral.

The location where a financing statement is filed depends on the type of property serving as collateral and relevant state law. Financing statements for most types of personal property are typically filed with the secretary of state in the state where the debtor is located, regardless of whether the underlying property is located in another state. For property governed by certificates of title, such as motor-vehicles, perfection is typically accomplished by a secured creditor noting its interest on the certificate of title rather than filing a financing statement.

Effects of non-compliance. If a security interest is not properly perfected, the secured creditor can still enforce its security interest against a debtor, but the unperfected lien may not have priority over any subsequently perfected interests of third parties. In addition, in a bankruptcy proceeding, a trustee or debtor-in-possession can avoid an unperfected security interest to the benefit of unsecured creditors (*11 USC §§ 544 and 547*).

CREDITOR AND CONTRIBUTORY RANKING

2. Where do creditors and contributories rank on a debtor's insolvency?

The priority of creditors' claims and interests in a debtor's estate are set out in the Bankruptcy Code. Under the Bankruptcy Code, the priority of allowed claims and interests is, in descending order:

- Secured claims.
- Administrative expenses and priority claims.
- General unsecured claims.
- Subordinated claims.
- Equity interests.

In certain circumstances, where creditors agree to a different treatment, a Chapter 11 plan of re-organisation can modify the strict priority rules of the Bankruptcy Code. Moreover, creditors are free to contract for different treatment in relation to one another.

Secured claims

Allowed claims secured by valid and unavoidable liens are typically paid first. State law determines the priority of competing liens against the same collateral. A secured claim is limited to the value of a secured creditor's collateral (*11 USC § 506*). Any excess proceeds from a cash sale of the collateral are used to pay lower ranking claims. To the extent that the value of collateral is not sufficient to satisfy the amount secured by a properly perfected lien, the deficiency amount becomes a general unsecured claim and might not be paid in full, if at all, if there is not enough money in the debtor's estate to satisfy all unsecured claims.

Administrative expenses and priority claims

Certain expenses and claims related to the administration of the bankruptcy case are given priority of payment before general unsecured creditors (*11 USC § 507(a)*). In corporate bankruptcies, they rank in the following order:

- Expenses relating to administration of the bankruptcy case, including post-petition trade debt and professional fees.
- Wages of up to US$12,850 earned within 180 days before the bankruptcy filing (*11 USC § 507(a)(4)*).
- Unsecured claims for contributions to employee benefit plans arising from services rendered within 180 days before the bankruptcy filing (*11 USC § 507(a)(5)*).
- Certain unsecured tax claims of government units (*11 USC § 507(a)(8)*).

Any wages and benefits exceeding the statutory limits become general unsecured claims.

If, subject to court approval, a debtor borrows new money during a Chapter 11 proceeding (debtor-in-possession financing (DIP financing)), the creditor typically receives a right of first recovery out of all assets, (that is, a "superpriority lien"), except where the creditor agrees to a recovery junior to existing liens. The priority of the DIP financing is usually set out in the court order approving the financing (DIP order) (*see Questions 6, 8 and 12*).

Although not technically senior in priority to secured claims, the Bankruptcy Code requires all administrative priority claims to be paid in full as a condition to confirming a plan of re-organisation, which makes administrative priority claims senior in practice.

Subordinated Claims. Claims can be subordinated either by an agreement of the parties (a valid subordination agreement) or by judicial means. For example, claims can be equitably subordinated on account of fraud or other bad acts.

UNPAID DEBTS AND RECOVERY

3. Can trade creditors use any mechanisms to secure unpaid debts? Are there any legal or practical limits on the operation of these mechanisms?

Apart from taking a security over inventory or other goods provided to a debtor, a trade creditor can obtain a statutory lien under applicable state law on both movable and immovable property to secure payment for services, labour or goods provided to the debtor. Some examples of state statutory liens include:

- An artisan's lien.
- Mechanic's lien.
- Carrier's lien.
- Warehouseman's lien.

The requirements for obtaining these types of liens vary by state. Statutory liens are generally recognised in a bankruptcy case if they are valid and properly perfected under applicable state law.

In addition, the Bankruptcy Code allows creditors to reclaim goods that were sold in the ordinary course of the seller's business to the debtor within the 45 days immediately before the bankruptcy filing, if the debtor was insolvent at the time (*11 USC § 546(c)*). In certain circumstances, suppliers can also assert a priority claim for the value of any goods sold to the debtor in the ordinary course of the debtor's business within the 20 days before the bankruptcy filing (*11 USC § 503(b)(9)*).

4. Can creditors invoke any procedures (other than the formal rescue or insolvency procedures described in *Questions 6* and *7*) to recover their debt? Is there a mandatory set-off of mutual debts on insolvency?

Creditors can (and often do) work together with a distressed company to restructure its debt outside of court. Out-of-court restructuring mechanisms include:

- Debt refinancing.
- Debt for equity swaps.

- Exchange offers.
- New capital infusions of debt or equity, such as rights offerings and second lien or convertible debt offerings.

In many instances, creditors agree to terms of a restructuring in the pre-petition period. The terms of such restructurings are often memorialised in a restructuring agreement, which is then effectuated under a bankruptcy filing.

Alternatively, creditors may decide to bring a collection action against a debtor in accordance with the loan documents and applicable state law. However, if the debtor files for bankruptcy, any pending collection action against the debtor is automatically stayed (*11 USC § 362(a)*). A creditor can request the court to lift the automatic stay, either (*11 USC § 362(d)(1)-(2)*):

- For cause, including lack of adequate protection.
- If the debtor does not have any equity in the property and the property is not necessary for an effective re-organisation.

In certain specific circumstances, creditors may exercise rights of set-off or recoupment. Set-off is a creditor's right to offset mutual debts between the debtor and the creditor. Outside of a bankruptcy, a creditor's right to set off is governed by its contractual rights and/or applicable state law. In a bankruptcy proceeding, a creditor's right to set-off is governed by 11 USC § 553. Under this section, the set-off of mutual debts is neither mandatory nor automatic. Debts need not arise out of the same transaction, but a pre-petition debt can only be set-off against another pre-petition debt. Recoupment, which is not governed by the Bankruptcy Code but is a state law remedy recognised by US bankruptcy courts, allows a creditor to withhold funds to offset debts arising out of the same transaction only. Claims arise out of the same transaction when both debts arise out of a single integrated contract or similar transaction.

STATE SUPPORT

5. Is state support for distressed businesses available?

State support for distressed businesses is rare, controversial and generally not available. However, in extraordinary situations, the US government has provided billions of dollars in loans and other financing to systemically important entities. For example, during the 2008 financial crisis, financing and other assistance was provided to General Motors, Chrysler Corporation and AIG.

RESCUE AND INSOLVENCY PROCEDURES

6. What are the main rescue/reorganisation procedures in your jurisdiction?

Chapter 11 re-organisation

Objective. The main re-organisation tool for most US businesses is Chapter 11. Chapter 11 of the Bankruptcy Code governs the re-organisation of corporate entities (other than banks, insurance companies, stockbrokers and commodity brokers) (*11 USC § 109*). The purpose of Chapter 11 is two-fold. On one hand, the automatic stay (*11 USC § 362(a)*) provides a "breathing space" so that a distressed entity can preserve its business as a going concern by preventing creditors from taking action against the debtor or the estate, and allowing the debtor to propose a plan of re-organisation. On the other hand, Chapter 11 is meant to maximise recovery for the debtor's creditors.

Chapter 11 allows a debtor to:

- Preserve its business as a going concern and judicially adjust its debts by, among other things, reducing the amount owed or extending repayment terms.
- Implement an operational restructuring.

Corporate entities can also be sold, in whole or in part, or liquidated under Chapter 11, although Chapter 7 of the Bankruptcy Code also provides a means for business liquidations. In a Chapter 11 liquidation, the company's management often retains control, whereas in a Chapter 7 liquidation, a trustee is appointed.

Initiation. A voluntary Chapter 11 bankruptcy case is initiated by a debtor filing a petition for relief with a US bankruptcy court. A debtor is eligible to file for Chapter 11 if it is domiciled or has a place of business or property in the US (*11 USC § 109(a)*). Most courts examining eligibility to file in the US have held that the property requirement is a very low threshold to meet. For example, a very small amount of money in a US bank account or a retainer agreement with a US law firm is enough to constitute property for eligibility purposes.

A petition can either be:

- Voluntary, filed by the debtor.
- Involuntary, filed by its creditors.

If voluntary, the relief is automatic and the automatic stay immediately protects the debtor and its assets from creditor intervention (*11 USC § 362(a)*). In a voluntary filing, the debtor is automatically deemed a "debtor in possession" and the business continues to operate (*11 USC § 1101(1)*).

Substantive tests. A company does not need to be insolvent to seek Chapter 11 relief and there is no specific eligibility test or other requirement that a debtor's liabilities exceed its assets or that it is unable to pay its debts as they become due. In fact, many US companies have utilised bankruptcy to implement an operational restructuring while solvent. The fact that a debtor is paying its debts as they come due, however, is a defence to an involuntary filing. In addition, a Chapter 11 case can be dismissed on the request of an interested party for cause or bad faith. In making a determination whether to dismiss a bankruptcy case, bankruptcy courts typically examine whether the dismissal would be in the best interest of creditors and of the estate (*11 USC § 1112(4)*).

Consent and approvals. Although a debtor remains in control of its business, once a debtor files for Chapter 11, it is prohibited from taking certain actions without prior court approval. These actions include, among others:

- Incurring secured debt.
- Using cash collateral without consent.
- Paying pre-petition amounts.
- Transacting business outside the ordinary course of business.
- Paying employees for pre-petition services.

A debtor has an initial period of 120 days following the filing of its voluntary bankruptcy petition to propose a Chapter 11 plan, which can only be extended by the court for cause (*11 USC § 1121*). No other parties can file a plan during this period (often called the "exclusive period"). The bankruptcy court can extend this exclusive period for up to 18 months, if the debtor can provide sufficient cause for the court to do so (*11 USC § 1121(d)*). Interested parties can seek to terminate the debtor's exclusive period in order to file their own Chapter 11 plan, or file their own plan after the debtor's exclusive period expires. An interested party includes any creditor or equity holder.

Any proposed Chapter 11 plan must, among other things, divide eligible holders of claims and interests into classes (*11 USC § 1126*). Each class is comprised of substantially similar claims or interests. Administrative claims are typically not subject to classification.

An "impaired" claim or interest is one that is either not paid in full or that is altered in any way. Only classes of creditors or shareholders with claims or interests that are impaired and receiving a distribution under the plan can vote to accept or reject the plan. Classes that are unimpaired are deemed to accept the plan. Classes

not receiving any recovery are deemed to reject the plan. A class of claims is deemed to have accepted a plan if such plan has been accepted by creditors holding at least two-thirds in amount and more than one-half in number of the allowed claims in such class.

An attempt to confirm a plan where a class has rejected the plan is known as a "cramdown." To cramdown a plan on a rejecting class, at least one impaired class of creditors must have accepted the plan. In addition, for it to be confirmed, the plan must (*11 USC § 1129(b)*):

- Meet all requirements of § 1129 of the Bankruptcy Code.
- Not unfairly discriminate.
- Be fair and equitable.

These statutory elements only apply to each class of creditors as a whole and not to individual creditors. Therefore, if a class accepts a plan, but an individual creditor within the class rejects the plan, the court need not go through the above analysis.

In addition, even if all classes vote to accept a plan (a consensual plan), or a cramdown plan obtains the required support from an impaired class, a plan will not be confirmed by the bankruptcy court unless it meets all other applicable requirements under the Bankruptcy Code (*11 USC §§ 1126 and 1129*).

Supervision and control. During a bankruptcy proceeding, the bankruptcy court supervises the company's operations but is not involved in the day-to-day operations of the debtor. Instead, the debtor and its existing management remain in control as the debtor-in-possession. In rare circumstances, the bankruptcy court may appoint an examiner to investigate the affairs of the debtor or a trustee to take over management of the debtor's business. A court will appoint an examiner or a trustee upon a showing of cause, including fraud, dishonesty, incompetence or gross mismanagement of the debtor (*11 USC § 1104*). The Office of the US Trustee also has a supervisory role in Chapter 11 proceedings.

An official committee of unsecured creditors can also be appointed, which serves as an advocate for and owes a fiduciary duty to all general unsecured creditors (*11 USC §1102(a)(1)*). An official committee is charged with scrutinising the debtor's conduct and working to maximise unsecured creditors' recoveries.

Protection from creditors. The filing of a bankruptcy petition (other than under Chapter 15) triggers an automatic stay, which prevents any creditor or party in interest from taking certain actions against the debtor or property of the estate (*11 USC § 362*). Any action taken in violation of the stay is void, and any wilful violation of the automatic stay subjects the offender to actual damages, including costs and attorneys' fees and punitive damages under appropriate circumstances (*11 USC § 362(k)*). The stay lasts for the duration of the bankruptcy case unless the court lifts the stay on request of an interested party for cause, including lack of adequate protection (*11 USC § 362(d)*). If the stay is lifted, it is only lifted as to the specific party who requested the relief and their respective collateral.

While the stay is in effect, creditors cannot, among other things:

- Collect debt.
- Enforce liens.
- Foreclose on collateral.
- Improve or attempt to improve the position they were in before the bankruptcy filing.

The filing of a bankruptcy petition also serves to make certain contract terms unenforceable. Such provisions are known as "*ipso facto*" clauses and they are unenforceable under section 365(e) of the Bankruptcy Code. *Ipso facto* clauses are contractual or non-bankruptcy law provisions under which the bankruptcy or financial condition of the debtor is treated as a default permitting the non-debtor counterparty to terminate the contract. If the contract can be validly terminated for other reasons, the counterparty must first seek relief from the stay. Certain financial contracts, including commodity and derivative contracts, are exempt from the termination provisions of the automatic stay under certain "safe harbour" provisions, which include *11 USC §§ 546(e), 559, 560, 561*. Creditors can exercise set-off rights and enforce existing contractual termination rights for agreements covered by these provisions.

Length of procedure. There is no limit to the length of a Chapter 11 case. Typically, Chapter 11 cases can last anywhere from one to five years, depending on the complexity of the case and whether or not the case was pre-negotiated with the major creditors before filing. In situations where plans are negotiated before a filing, the length of the case can be much shorter, but the negotiations leading up to the filing of such cases can still take many months.

Conclusion. A Chapter 11 case concludes on one of the following events:

- Completion of a confirmed Chapter 11 plan (although certain matters, such as claims reconciliation can continue for a protracted period of time post-emergence, resulting in the case remaining "open" often for years post-emergence).
- Conversion of the Chapter 11 case to a Chapter 7 case (*11 USC §§ 348 and 1112*) (*see Question 7, Chapter 7 liquidation*).
- Dismissal for cause (*11 USC §§ 349 and 1112(b)*).

Cases can also terminate under a structured dismissal following a sale of substantially all of the debtor's assets. A structured dismissal generally involves a dismissal conditioned on certain principles agreed in advance by stakeholders and later approved by the bankruptcy court, as distinguished from an unconditional dismissal under section 1112(b) of the Bankruptcy Code.

7. What are the main insolvency procedures in your jurisdiction?

Chapter 7 liquidation

Objective. Chapter 7 of the Bankruptcy Code provides for the liquidation of non-exempt assets of either a distressed entity or an individual to pay creditors. A Chapter 7 trustee is appointed when an individual or entity files for Chapter 7, or a Chapter 11 case is converted to Chapter 7. The Chapter 7 trustee is primarily responsible for selling the debtor's non-exempt assets and distributing the proceeds to creditors according to the priority established under the Bankruptcy Code. A trustee is also charged with investigating the financial affairs of the debtor and pursuing available causes of action to maximise recoveries for creditors.

Initiation. As with a Chapter 11 proceeding, a Chapter 7 case is initiated by filing a bankruptcy petition. Similarly, as with a Chapter 11 case, a Chapter 7 case can be either voluntary or involuntary.

Substantive tests. A business entity can commence a Chapter 7 proceeding regardless of whether or not it is insolvent. Individuals filing for Chapter 7 protection must satisfy a means test to be eligible for Chapter 7 relief (*11 USC § 707(b)*). The means test is a specific formula provided by the Bankruptcy Code to ensure that only those who truly cannot pay their debts file under this Chapter. Individuals with higher income-to-debt ratios who do not pass the Chapter 7 means test must instead file under Chapter 11 or 13.

Supervision and control. As with all other chapters under the Bankruptcy Code, Chapter 7 is a court-supervised process. However, the primary difference from a Chapter 11 case is that the Chapter 7 trustee is responsible for collecting all non-exempt assets of the estate, liquidating those assets and subsequently distributing the proceeds to creditors.

Protection from creditors. The automatic stay operates in the same manner to protect debtors under Chapter 7, Chapter 11 and Chapter 13 of the Bankruptcy Code. See *Question 6*.

Length of procedure. As the purpose of a Chapter 7 case is the liquidation of an asset, rather than the re-organisation of a business, Chapter 7 cases typically conclude within a few months to a year unless there are complicated assets involved or complex litigation issues.

Conclusion. At the end of a Chapter 7 case, the trustee files a final report that accounts for the disposition of assets and certifies that the estate has been fully administered. Interested parties and the US Trustee have 30 days to object to this report (*Fed R Bankr P 5009*). If no objection is filed, the estate is presumed to have been fully administered, and the bankruptcy court then discharges the trustee and closes the case.

STAKEHOLDERS' ROLES

8. Which stakeholders have the most significant role in the outcome of a restructuring or insolvency procedure? Can stakeholders or commercial/policy issues influence the outcome of the procedure?

Debtor-in-possession (DIP)

In a Chapter 11 case, the debtor automatically becomes a "debtor in possession" and its existing management continues to operate the business (*11 USC § 1101(1)*). The debtor is responsible for making all business decisions and proposing a Chapter 11 plan during the exclusive period. The debtor must seek bankruptcy court approval for all transactions outside the ordinary course of its business, and is prohibited from taking certain other actions absent prior court approval (*see Question 6, Chapter 11 re-organisation*).

Official committee of unsecured creditors

In a Chapter 11 case, the US Trustee typically appoints an official committee of unsecured creditors, which is typically composed of the largest unsecured creditors willing to serve on the committee. The creditors' committee owes fiduciary duties to the body of the debtor's general unsecured creditors and works to maximise unsecured creditors' recoveries (*11 USC § 1102*). Among other things, creditors' committees:

- Monitor the debtor's operations.
- Consult with the debtor on major business decisions.
- Participate in negotiating the Chapter 11 plan.
- **Advisors**

The Bankruptcy Code authorises both the debtor in possession and creditors' committee to hire professionals, including attorneys, accountants, investment bankers and other agents to assist them to carry out their roles (*11 USC §§ 327 and 1103*).

Secured creditors

A Chapter 11 debtor requires the consent of its secured creditor, or the bankruptcy court's authority, to use such secured creditor's cash collateral. To be permitted to use a secured creditor's cash collateral during a Chapter 11 case, the debtor must provide the secured creditor with adequate protection (*11 USC § 363(e)*). With respect to non-cash collateral, a secured creditor can also request adequate protection of its interests. The purpose of adequate protection is to compensate the secured creditor for any diminution in the value of its collateral resulting from the debtor's use or sale of the same or imposition of the automatic stay (*11 USC § 361*). Adequate protection ensures that the secured creditor does not receive less than it would have received had the collateral been surrendered or liquidated immediately.

DIP lenders

Even if a debtor provides adequate protection and is able to use cash collateral, it may still require additional financing in the course of its bankruptcy proceeding. DIP financing can be provided to allow the debtor to continue to operate its business and confirm a Chapter 11 plan. The rights of DIP lenders are set out in the DIP order. DIP orders are often heavily negotiated by the debtor, the DIP lenders and the creditors' committee (if one has been appointed). In addition to setting out the rights of DIP lenders, DIP orders frequently contain milestones and other covenants designed to allow the creditors to establish some control over the bankruptcy proceedings. See *Question 12*.

Ad hoc groups and committees

Creditors holding similar claims or interests often join together to promote a shared interest or to achieve a common goal, such as increased recovery for their claims. These groups are commonly referred to as ad hoc groups or ad hoc committees. Such groups may be comprised of secured or unsecured creditors or even equity holders. Benefits available to a creditor that joins an ad hoc group include:

- The ability to exercise more influence than it could exert acting independently.
- Co-ordination among a creditor group can often reduce professional fees and other expenses.

Conversely, ad hoc group members are subject to certain disclosure requirements under US bankruptcy and securities laws because they often receive material non-public information, which can temporarily limit a member's ability to trade.

US Trustee

The Office of the US Trustee is not an economic stakeholder. However, it plays an important role in Chapter 11 cases (*see Question 6, Chapter 11 re-organisation*).

LIABILITY

9. Can a director, partner, parent entity (domestic or foreign) or other party be held liable for an insolvent debtor's debts?

Directors and officers

In the absence of fraud or some other crime, a director or officer is not generally held liable for an insolvent debtor's debts. Unlike many other jurisdictions, the US does not have a concept of wrongful trading. However, depending on the applicable state law, a director or officer can potentially be held directly liable for:

- Payroll and certain other taxes.
- Wages (in certain states) and Worker Adjustment and Retraining Notification Act (WARN Act) damages for breaches of a federal law requiring certain employers to provide 60 days' advance notice of a plant closure or mass lay-off to certain parties.

In addition, a director or officer can be liable for breaching fiduciary duties and similar causes of action under corporate law. Any action for a breach of fiduciary duties would be an action for damages rather than liability for a debtor's debts. Such actions are rarely brought and even more rarely successful.

Partners

Subject to applicable state law, a general partner is typically liable for the debts of a partnership. In Chapter 7 proceedings, the Chapter 7 trustee will have a claim against a general partner if:

- There is insufficient estate property to pay all allowed claims against the partnership in full.
- The general partner is personally liable for that deficiency under state law.

While a general partner is typically liable for the debts of the partnership, a limited partner who does not exercise control over the

partnership is not generally held liable for the debts of the partnership. Instead, in the absence of fraud or other wrongdoing, only the capital contributed by the limited partner can be used to pay the partnership's debts under applicable state law.

Parent entity (domestic or foreign)

Under most circumstances, a parent corporation is not held liable for the debts of a subsidiary. However, a parent entity can be held liable for the debts of an insolvent subsidiary under certain common law principles, including:

- Alter ego.
- Piercing the corporate veil.
- Single business enterprise.
- Agency.

These principles generally apply if the parent has disregarded corporate formalities and has actively participated in, or exercised control over, the subsidiary's operations so that the subsidiary is effectively a mere instrument of its parent.

A parent entity can also be liable under:

- State corporate and creditors' rights laws.
- Federal bankruptcy laws for fraudulent or preferential transfers of subsidiary assets (*see Question 10*).

Both of these types of liability are rare. More common are instances where a parent entity has guaranteed the debt of a subsidiary or affiliate. If the subsidiary files for bankruptcy and the parent guarantor is not a debtor, third parties can pursue and recover on the guarantee, as the automatic stay only prevents actions against the debtor subsidiary.

Where two affiliates are both debtors, the bankruptcy estates, as well as their assets and liabilities, remain separate unless the entities are substantively consolidated. However, for the convenience of both the court and the parties, bankruptcy cases are typically jointly administered so that the same court docket applies to both cases.

Substantive consolidation is an equitable remedy that allows the bankruptcy court to permit the assets and liabilities of affiliated debtors to be treated as a single pool. Similar to the "alter ego" and "piercing of the corporate veil" doctrines, substantive consolidation permits the court to disregard the separate nature of two or more corporate entities. Although substantive consolidation is not codified in the Bankruptcy Code, it has been recognised by most bankruptcy courts. Whether or not a court decides to honour the request to substantively consolidate two or more debtors depends on the facts and circumstances of each case. Generally, there must be a strong relationship between the debtors, combined with additional factors such as the commingling of separate assets and similar liabilities. Developed case law critical of substantial consolidation has rendered substantial consolidation an exceptional and rare remedy.

There are also "control group" state and federal liability statutes that hold a parent liable for certain claims against its subsidiaries. These include certain environmental, pension, labour and tax claims, including claims in bankruptcy.

SETTING ASIDE TRANSACTIONS

10. Can an insolvent debtor's pre-insolvency transactions be set aside? If so, who can challenge these transactions, when and in what circumstances? Are third parties' rights affected?

An insolvent debtor's pre-bankruptcy transactions can be avoided or set-aside by the trustee or debtor-in-possession through an adversary proceeding. Adversary proceedings are lawsuits that take place within the debtor's bankruptcy proceeding and are governed by Part VII of the Federal Rules of Bankruptcy Procedure. The two primary types of adversary proceedings that relate to the avoidance of pre-petition transfers are preference and fraudulent transfer actions.

The bankruptcy rules regarding preferences and fraudulent transfers are set out in sections 547 and 548 of the Bankruptcy Code, respectively. An adversary proceeding can also seek to avoid a pre-petition transfer under similar state laws. A trustee or debtor-in-possession also has the strong-arm power to avoid unperfected security interests for the benefit of other creditors.

Preferences

A preferential transfer is a transfer of the debtor's property (*11 USC § 547*):

- To, or for the benefit of, a creditor.
- On account of an antecedent debt owed by the debtor before the transfer was made.
- Made while the debtor was insolvent.
- Made on or within 90 days before the date of the filing of the bankruptcy petition.

The 90-day time period is expanded to one year if the creditor is an "insider" as defined by the Bankruptcy Code (*11 USC § 101(31)*). The debtor is automatically presumed to be insolvent during the 90 days before bankruptcy, but the transferee may present evidence to rebut that presumption.

If these requirements are met, and an exception does not apply, a pre-petition transfer of property will be avoided for the benefit of other creditors as a preference. Two main exceptions where an otherwise preferential transfer will not be avoided include where (*11 USC § 547(c)*):

- The transaction was in the ordinary course of the debtor's business.
- The debtor received new value in exchange for the transfer.

Fraudulent transfers

A fraudulent transfer under the Bankruptcy Code is a transfer that was made within two years before the bankruptcy filing if either the (*11 USC § 548(a)(1)*):

- Transfer was made by the debtor with the actual intent to hinder, delay or defraud its creditors.
- Debtor received less than reasonably equivalent value for the transaction at a time when the debtor was insolvent.

However, a subsequent good faith purchaser for value retains a lien or an interest in the collateral despite the above (*11 USC § 548(c)*). Good faith is not defined in the Bankruptcy Code, but courts have generally held that good faith in this context means that the purchaser had no knowledge of the fraud.

State law

A debtor can also use applicable state law to avoid certain transfers under similar legal principles (*11 USC § 544(b)*). This is particularly important with respect to fraudulent transfers as most states have a two to six-year "look-back" period, which often exceeds the two-year look-back period available under the Bankruptcy Code.

CARRYING ON BUSINESS DURING INSOLVENCY

11. In what circumstances can a debtor continue to carry on business during rescue or insolvency proceedings? In particular, who has the authority to supervise or carry on

the debtor's business during the process and what restrictions apply?

A Chapter 11 debtor is automatically authorised to continue operating and managing its business without court approval (*see Question 6, Chapter 11 re-organisation*). Existing management ordinarily remains in place throughout the bankruptcy proceeding. In rare cases involving fraud or gross mismanagement, a Chapter 11 trustee may be appointed to replace the debtor's management (*see Question 6, Chapter 11 re-organisation*). Conversely, in Chapter 7 cases, a trustee is always appointed (*see Question 7, Chapter 7 liquidation*).

In all Chapter 11 cases, the bankruptcy court supervises the debtor, and the US Trustee and the creditors' committee, if appointed, monitor the Chapter 11 debtor (*see Question 8*). The conduct of the debtor's business is subject to certain constraints under the Bankruptcy Code (*see Question 6, Chapter 11 re-organisation*).

363 sales and the use, sale or lease of property

The debtor can generally use, sell or lease its property in the ordinary course of business without special authorisation from the bankruptcy court. However, the bankruptcy court must approve the sale of property outside the ordinary course of business under section 363(b) of the Bankruptcy Code. This is necessary when the debtor wants to either sell substantially all of its assets or particular pieces of property that the debtor would not normally sell within the ordinary course of its business. Such sales are commonly referred to as "363 sales" after the name of the applicable bankruptcy provision.

In a typical 363 sale, the debtor executes a formal asset purchase agreement with an initial proposed purchaser, known as the "stalking horse bidder." The stalking horse bidder usually sets the floor for the minimum purchase price for the asset(s) which will be subject to higher and better offers at a subsequent auction.

After an asset purchase agreement is executed, the debtor files a motion for the court to approve certain bid procedures to be used at a subsequent auction, which also contains a deadline for other interested buyers to submit competing bids. The outcome of the auction is subject to court approval before which parties can still object to the sale. However, once the court enters a final sale order that approves the sale, the order governs and is final (subject to the applicable appeal period).

Cash collateral

The debtor cannot use cash collateral without court authorisation, unless the secured creditor consents. If the debtor does not have creditor consent, it must provide the secured party with adequate protection (*see Question 8, Secured creditors*). Common forms of adequate protection are interest payments or replacement liens on other unencumbered property.

Executory contracts and leases

Section 365 of the Bankruptcy Code provides that a debtor can assume (accept) or reject the obligations under its executory contracts and leases. A contract is typically deemed "executory" if both parties have material performance obligations remaining, such as unexpired supply agreements. However, certain types of contracts, such as contracts to make a loan or provide other financial accommodations, cannot be assumed or assigned (*11 USC § 365(e)(2)*).

A debtor will likely move to assume an executory contract or lease that has favourable terms or that would be difficult or impossible to replace. To assume an executory contract or lease, a debtor must "cure" any outstanding obligations (that is, pay in full) and provide adequate assurance to the counterparty that it can perform future obligations under the contract or lease (*11 USC § 365(b)*). The debtor can also assign an executory contract or lease regardless of any anti-assignment provision contained in that agreement. The debtor can also reject an executory contract or lease containing onerous terms. Rejection constitutes a breach as of the bankruptcy filing date. Damages arising out of the breach are deemed to be a general unsecured, pre-petition claim.

ADDITIONAL FINANCE

12. Can a debtor that is subject to insolvency proceedings obtain additional finance both as a legal and as a practical matter (for example, debtor-in-possession financing or equivalent)? Is special priority given to the repayment of this finance?

A Chapter 11 debtor can continue to obtain unsecured credit and incur unsecured debt, such as trade debt, in the ordinary course of business unless the bankruptcy court orders otherwise. Post-petition credit obtained in this manner has priority over all pre-petition unsecured claims (*see Question 2*).

A Chapter 11 debtor also can obtain debtor-in-possession (DIP) financing, with court approval (*see Question 2* and *Question 8, DIP creditors*). The DIP order sets out the priority to be given to the DIP financing, which may include granting to the DIP lenders:

- A super-priority claim over all other administrative expenses.
- A lien on unencumbered property of the estate.
- A junior lien on property that is already subject to a lien.
- In special circumstances, an equal or senior (priming) lien on property that is already subject to a lien.

In addition to DIP financing during a bankruptcy proceeding, a Chapter 11 debtor may also need to obtain exit financing to:

- Make the payments required under the Bankruptcy Code and the plan of re-organisation.
- Provide funds to support the re-organised debtor's business operations following plan confirmation.

Rights offerings are a common form of exit financing. In a bankruptcy rights offering, creditors or equity holders are offered the right to purchase shares in the re-organised company, sometimes at a significant discount. Each participant is generally offered the right to purchase its pro rata share of the equity available under the offering, which is the same percentage that its current holdings in the pre-petition entity represent. Rights offerings are usually backstopped for a fee by a third party that agrees to purchase any unsubscribed shares to ensure that the re-organised debtor's capital needs are met or that the debtor receives the minimum amount necessary to fund a plan and its business in the future.

MULTINATIONAL CASES

13. What are the rules that govern a local court's recognition of concurrent foreign restructuring or insolvency procedures for a local debtor? Are there any international treaties or EU legislation governing this situation? What are the procedures for foreign creditors to submit claims in a local restructuring or insolvency process?

Recognition

In 2005, the US adopted the UNCITRAL Model Law on Cross-Border Insolvency 1997 with modifications (UNCITRAL Model Insolvency Law) in the form of Chapter 15 of the Bankruptcy Code. Chapter 15 enables a foreign representative to seek recognition in the US of a foreign insolvency proceeding. Chapter 15 applies where (*11 USC § 1501*):

- A foreign court or foreign representative seeks assistance in the US with a foreign proceeding;

- A US court or party in interest in a US proceeding seeks assistance in a foreign court in connection with a US proceeding;
- A foreign proceeding and a US proceeding are pending concurrently with respect to the same debtor; or
- Creditors or other interested persons in a foreign country request the commencement of, or participation in, a US bankruptcy proceeding.

The bankruptcy court will grant recognition of a foreign proceeding as long as the relief would not be manifestly contrary to US public policy (*11 USC § 1506*). The main benefits of Chapter 15 are to:

- Have the effect of the automatic stay apply to the debtor's US assets.
- Commence litigation against US parties.
- Stay pending US proceedings.

Only an entity that resides, has domicile or has a place of business or property in the US can be a Chapter 15 debtor (*11 USC § 109(a)*). Generally, this is a low threshold to meet and courts have held that a small amount of money in a US bank account or a retainer paid to a US law firm is enough to satisfy the eligibility requirement.

The foreign representative of the debtor must file a Chapter 15 petition for recognition of the foreign proceeding with the bankruptcy court (*11 USC § 1504, 1509(a) and 1515*). The bankruptcy court can grant provisional relief from the Chapter 15 petition being filed until the court rules on the petition, if such relief is urgently needed to protect the assets of the debtor or the interests of creditors (*11 USC §1519*). That relief can include recognition of the automatic stay.

Upon recognition, the foreign representative has full access to the US bankruptcy court. The US bankruptcy court typically grants comity and recognises and enforces all foreign court judgments made in foreign proceedings as long as they are not contrary to US public policy. If recognition is denied, the foreign representative's access to US courts is limited to its right to sue the debtor to collect or recover a claim against, or an account receivable of, the debtor (*11 USC § 1509(f)*).

International treaties

The US has not entered into any special insolvency treaties and is not subject to any multinational regimes of the type that exist in the EU. Chapter 15 reflects the adoption of the UNCITRAL Model Insolvency Law into US law.

Procedures for foreign creditors

Foreign creditors have the same rights as US creditors and no formal distinction is made based on their status as a foreign creditor. Foreign creditors are also subject to the automatic stay, although the practical effect of this depends on whether the foreign creditor:

- Has submitted to jurisdiction in the US, either expressly or by doing business or having assets in the US.
- Seeks any recovery or relief in the US bankruptcy case.

REFORM

14. Are there any proposals for reform?

Proposed amendments to the Federal Rules of Bankruptcy Procedure, which govern bankruptcy court procedures, are made every two to three years. Typically, a proposed rule change is considered by an advisory committee and published for public comment. Ultimately, after comments are considered and incorporated, the proposed amendments must be approved by the Judicial Conference, Congress and the US Supreme Court. Only after the Supreme Court's approval do the amendments become actual law.

The last major amendment to the Bankruptcy Code took place in 2005 and is known as the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). This legislative act made significant changes to the Bankruptcy Code that primarily deal with consumers. BAPCPA ultimately makes it harder for some consumers to file for bankruptcy. For example, for a presumption of abuse not to arise, consumer debtors must now pass the means test (*see Question 7, Chapter 7 liquidation*).

In addition, the American Bankruptcy Institute (ABI), a private organisation of insolvency professionals, released a report and recommendations for broader Chapter 11 reform in December 2014. The ABI reforms have not yet been presented to Congress. It will likely take several years before any new bankruptcy laws based on these suggested reforms are enacted.

On 30 June 2016, the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) was enacted to address Puerto Rico's financial crisis. Modelled after Chapter 9 of the Bankruptcy Code, PROMESA establishes procedures and requirements for Puerto Rico to restructure its debt.

ONLINE RESOURCES

Legal Information Institute

W *www.law.cornell.edu/ucc*

Description. The Legal Information Institute's website is hosted by Cornell University Law School and contains up-to-date versions of the Bankruptcy Code and the Uniform Commercial Code, as well as related rules, statutes, and legislative history.

United States Court

W *www.uscourts.gov/FederalCourts/Bankruptcy.aspx*

Description. The website is maintained by the Administrative Office of the US Courts. It provides an overview of the US bankruptcy laws and the bankruptcy system in the US, as well as information about the judicial branch of the US Government.

Practical Law **Contributor profiles**

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Areas of practice. Restructuring and insolvency; private equity; corporate governance.

Recent transactions

- Select lender representations: Energy XXI (counsel to second lien lenders); 21st Century Oncology (counsel to bank group); Gymboree Corp. (counsel to agent for first lien lenders); Quicksilver Resources, Inc. (counsel to ad hoc group of second lien lenders); Midstates Petroleum Co. (counsel to ad hoc group of second and third lien creditors); Pacific Drilling (counsel to first lien agent); Verso Corp. (counsel to second lien lenders); Molycorp (counsel to secured lenders); Genco Shipping & Trading Ltd. (counsel to secured creditors); New Page Corp.,(counsel to first lien lenders); Cengage Learning, Inc. (counsel to first lien lenders); Magnetation LLC (counsel to ad hoc committee of noteholders and DIP lenders).
- Select company and estate representations: PA Outer Harbor, Inc.; Icicle Seafoods; Virgin America, Inc.
- Select committee representations: M & G Chemicals; TK Holdings Inc.; Alpha Natural Resources, Inc.; Lehman Brothers Holding, Inc.; Eastman Kodak Company; Arcapita Bank; Great Atlantic and Pacific Tea Company, Inc.; Fleming Companies; Winn-Dixie Stores, Inc.; Enron Corp.
- Select Ad Hoc Unsecured Noteholder Representations: iHeart; National Resource Partners; Gulfmark Offshore; Ultra Resources; Affinion Group Inc.; Nortel Networks, Inc.; Tronox, Inc.; GEO Homebuilding.
- Select international restructurings: Boart Longyear (counsel to foreign representative in chapter 15); Fruit of the Loom, Ltd (counsel to Cayman Islands' company in bankruptcy proceedings in the Caymans and US); Sino-Forest Corp. (counsel to foreign representative in chapter 15); Vitro Packaging de Mexico, SA de CV (counsel to company in cross-border restructuring and in chapter 15 case).

Professional associations/memberships. American College of Bankruptcy; International Insolvency Institute; National Bankruptcy Conference.

Publications

- Co-author of Collier on Bankruptcy, the preeminent treatise in bankruptcy law.
- Recently co-authored a chapter *Evaluating strategic debt buybacks: How to pursue effective de-leveraging strategies* in Navigating Today's Environment: The Directors' and Officers' Guide to Restructuring.
- Frequent speaker at conferences sponsored by the American Bankruptcy Institute and the National Conference of Bankruptcy Judges.

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Areas of practice. Restructuring and insolvency.

Recent transactions

- Zais VII, in the first CDO to be restructured under Chapter 11.
- Lehman Brothers, the largest bankruptcy in US history.
- Washington Mutual, the largest bank failure in US history; Charter Communications.
- Mirant Corporation, one of the largest energy industry bankruptcies in US history.
- Adelphia Communications, large and complex inter-creditor dispute.
- Global Safety Textiles in their precedent setting cross-border Chapter 11 restructuring.
- Centaur Gaming, owner and operator of Hoosier Park in Indiana.
- Heartland Automotive, the largest independent franchisee and operator of Jiffy Lube quick-lube service centres in the US.
- Communications Dynamics Inc. one of the leading suppliers of construction, maintenance, and rebuild products to the cable industry.