United States

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The US Constitution grants the US Congress the exclusive power to establish uniform laws on bankruptcies. Currently, the Bankruptcy Reform Act of 1978, as amended and supplemented, provides the nation's bankruptcy law, covering liquidations and reorganisations for individuals, businesses and municipalities.

The dominant policies underlying the US Bankruptcy Code are to foster the equitable distribution of a debtor's assets to creditors and to rehabilitate and restructure the debtor's business to preserve jobs, pay creditors, preserve competition and produce a return for owners. The Bankruptcy Code fosters rehabilitation of a business whenever its value, as reorganised, equals or exceeds its liquidation value.

1. The legal framework and the effectiveness of court processes/legal remedies

1.1 Describe the nature and effectiveness of the following processes:

(a) Debt recovery remedies where the creditor has no security

Outside bankruptcy, the enforcement of remedies available to unsecured creditors is subject to the laws of different states. Generally, an unsecured creditor is required to initiate an action to obtain a judgment against the debtor. If a judgment is entered against the debtor, the creditor may obtain a judgment lien against the debtor's non-exempt assets by recording the judgment in appropriate jurisdictions. This lien is enforced by execution against the property of the debtor – usually by an appropriate law enforcement officer who takes control of and sells the property. Pre-judgment attachment and garnishment may also be available remedies, depending on the law of a particular state and constitutional parameters.

(b) The enforcement of security

Security interests in movables or personal property and their enforcement are governed by Article 9 of the Uniform Commercial Code, as adopted in each state. The principal type of security interest for real property is a real estate mortgage, the enforcement of which is governed by the laws of the state in which the real estate is located, although certain fixtures, proceeds and accounts related to the real estate may be personal property governed by Article 9 of the code. In most states, creditors can avail themselves of self-help repossession of personal property collateral under certain conditions and can foreclose security interests, in commercially reasonable manners, without judicial intervention.

(c) Corporate bankruptcy/liquidation processes

A business or person may file for voluntary relief under Chapter 11 of the

Bankruptcy Code, provided that the debtor has a place of business, residence or property in the United States. Neither balance-sheet insolvency nor inability to pay debts as they mature is a requirement. The efficacy of a bankruptcy in the United States is determined by whether the US courts have power to enforce the debtor's discharge against creditors. That, in turn, depends on whether the creditors have minimum contacts with the United States or whether foreign jurisdictions will grant comity to US bankruptcy law. A business debtor may also commence a case under Chapter 7 of the Bankruptcy Code which governs liquidation. Insolvency and inability to pay debts as they become due are not prerequisites for Chapter 7 relief.

Creditors may also commence an involuntary liquidation or reorganisation case against a debtor. If the debtor's creditors total 12 or more, a petition may be filed by at least three creditors holding undisputed, unsecured, non-contingent debt aggregating at least $13,475. If the debtor has fewer than 12 creditors, a petition may be filed by one creditor holding undisputed, unsecured, non-contingent debt aggregating at least $13,475. The petition must allege and the petitioners must prove that the debtor is not paying debts as they become due (except those subject to a *bona fide* dispute), or that a custodian was appointed within the preceding 120 days to take charge of all or substantially all the debtor's property, other than for lien enforcement purposes.

(d) Formal corporate rescue processes

Chapter 11 of the Bankruptcy Code allows a business to propose a reorganisation plan which will be binding on dissenting creditors as long as at least one class of impaired creditors votes to accept the plan by a majority of the votes and two-thirds of the value of the claims voted in that class.

(e) Informal corporate rescue processes

Out-of-court restructurings are possible and are sometimes accomplished by exchange offers whereby debt is exchanged for equity or for new debt with less onerous terms. Out-of-court restructurings cannot legally bind dissenting creditors, except insofar as certain features such as collateral for accepting creditors coerce dissenters to go along.

1.2 What are the formal processes to effect a liquidation of the company's assets?

A company that seeks to liquidate its assets may commence a case under Chapter 11 or Chapter 7 of the Bankruptcy Code. Insolvency or inability to pay debts is not a prerequisite. Liquidating through Chapter 11 enables the debtor and creditors to control the liquidation. The effect of commencing a Chapter 7 case is the appointment of a trustee who conducts the liquidation with minimal intervention by creditors. The trustee converts the assets of the business to cash and distributes such cash to creditors holding allowed claims in accordance with the hierarchy set out in the Bankruptcy Code.

1.3 What is the effect on debt collection and the enforcement of security of:

(a) An adjudication of corporate bankruptcy/liquidation?

Upon commencement of a bankruptcy case, an automatic stay is imposed instantaneously, which prohibits all entities from commencing or continuing actions against the debtor and property of the debtor's bankruptcy estate. Its scope is broad and includes the post-petition commencement or continuation of actions to collect pre-petition claims, self-help remedies and actions to foreclose liens against property of the estate. Actions to protect public health and safety and exercises of police power are not stayed.

A secured claim holder may request relief with the bankruptcy court, from the automatic stay, which may be granted for cause, including lack of adequate protection of the creditor's interest in the debtor's property. Adequate protection, if granted, is intended to protect a creditor from erosion in the value of its collateral security and may include the provision of additional or replacement collateral or periodic cash payments to compensate for any erosion in value.

Generally, unsecured claim holders are ineligible for relief from the automatic stay as they have no specific property interests in the debtor's property.

Unless a debtor's schedules list a creditor's claim as undisputed and not liquidated, a creditor must file a proof of claim before the court-imposed deadline to participate in a distribution of the debtor's estate. If no objection to the proof of claim is filed, the claim is allowed. If an objection is filed, a hearing may be held before the bankruptcy court to resolve the objection. Either party may appeal the outcome of the decision.

From the date on which a Chapter 11 plan becomes effective, holders of allowed claims will receive distributions on account of their claims

according to the confirmed plan. Distributions may be in the form of cash, debt, stock or other assets. All claims that have been filed or could have been filed against the debtor are discharged if their holders receive adequate notice. In a Chapter 7 case, final distributions to holders of allowed claims can be made only after all the assets of the estate have been converted to cash and all claims and essential litigation are processed and completed. No discharge is available to a Chapter 7 debtor which is not an individual.

(b) The commencement of a formal corporate rescue process?

The same acts prohibited at the outset of a formal liquidation are prohibited at the outset of a formal reorganisation. Relief from the automatic stay tends to be more difficult to obtain in reorganisation cases, where the assets are needed for operation of the business.

(c) The initiation of an informal corporate rescue process?

The enforcement and collection of debts outside Chapter 7 or Chapter 11 are governed by state law. No automatic stay arises outside bankruptcy cases. Rather, in individual situations courts may grant injunctions for limited purposes.

(d) The initiation of an insolvency or insolvency-related process under any special legislation?

Laws imposing receiverships for insurance companies or other financial institutions may incorporate stays or their equivalents.

1.4 Are insolvency procedures started in another jurisdiction in respect of a corporation incorporated in your jurisdiction recognised?

The United States is not a signatory to any treaty on international insolvency. Some states, but not all, have enacted a foreign judgment recognition statute which may permit recognition of a foreign money judgment.

US courts generally grant comity to foreign insolvency cases if they afford US creditors the equivalent of procedural and substantive due process. Foreign insolvency laws need not yield the same results as US law. Chapter 15 of the Bankruptcy Code incorporates the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency in order to provide effective mechanisms for dealing with cross-border insolvency cases. Chapter 15 includes provisions for:

- commencement of a US case ancillary to a foreign proceeding;
- recognition by US bankruptcy courts of foreign insolvency proceedings;
- cooperation with foreign courts; and
- protection of property located in the United States.

The bankruptcy court may also dismiss or suspend a domestic case in favour of a foreign proceeding.

1.5 In what circumstances would the directors or officers of a company in financial difficulties face potential personal liability for continuing to trade? In practice, are any such provisions actually enforced?

Corporate officers and directors owe duties of care, good faith and loyalty to shareholders. In some states they may also owe fiduciary duties to creditors when a business is close to insolvency. Liability of officers and directors may result from a breach of such fiduciary duties and those duties imposed under the federal securities laws and state law. There is personal liability of 'control persons' for non-payment by the debtor of certain types of trust fund obligations such as payroll taxes to the government. While officers and directors are not precluded by statute or jurisprudence from allowing the company to continue in business while insolvent, many states have criminal laws dealing with officers and directors who knowingly incur new debts which they know the debtor would not pay.

2. What are the advantages and disadvantages of triggering a formal procedure?

The advantages of filing for Chapter 11 relief include:

- the automatic stay against collection actions;
- the ability to reject burdensome leases and executory contracts; and
- the ability to impose a reorganisation plan accepted by a majority of creditors (by contrast, in an out-of-court restructuring the consent of all creditors is required).

Conversely, Chapter 11 can lead to the imposition of a Chapter 11 trustee displacing

management in extreme circumstances, or to the imposition of a creditors' plan or change of control.

The Bankruptcy Code also allows a debtor to file a 'pre-packaged' Chapter 11 case, where the debtor negotiates a Chapter 11 plan, prepares a disclosure statement and solicits votes on its Chapter 11 plan, all before commencing the Chapter 11 case. In this way the debtor can obtain the benefits of both an out-of-court work-out and a Chapter 11 restructuring, and limit the time spent in Chapter 11. In a 'pre-negotiated' Chapter 11 case, the debtor files its Chapter 11 plan and disclosure statement on the Chapter 11 petition date.

3. What are the practical options for out-of-court restructuring?

Whether a debtor can successfully reorganise outside Chapter 11 depends on the size and composition of its creditor groups and their willingness to negotiate with each other. Out-of-court restructurings generally work better for companies with few operations and creditors, or in situations where a debtor needs to adjust its debt service requirements but its underlying business operations are sound. They are less feasible if it is economically necessary to restructure liabilities other than indebtedness for borrowed money.

4. What is the effect on the management of a company of:

4.1 An adjudication of corporate bankruptcy/liquidation?

In Chapter 11, management can be retained and may manage the reorganisation or liquidation, with the participation of a creditors' committee. In Chapter 7, a trustee is appointed immediately and controls the liquidation.

4.2 The commencement of corporate bankruptcy/liquidation?

When a company becomes a debtor under Chapter 11, whether voluntary or involuntary, it is immediately and automatically authorised to operate its business and manage its property as a debtor in possession under the Bankruptcy Code. Management will continue to run the business unless and until a Chapter 11 trustee is appointed for cause such as fraud or gross mismanagement, or unless such appointment is in the best interests of the debtor and creditors. As a debtor in possession, management is entitled to use, sell or lease most property (with the exception of a secured creditor's cash collateral) in the ordinary course of business. Bankruptcy court approval is required to engage in transactions outside the ordinary course of business.

If a company files for Chapter 7 relief, a trustee will be appointed but may be displaced by another trustee elected by unsecured claim holders. The trustee's role is to convert the debtor's assets to cash and to distribute cash to creditors holding allowed claims in accordance with the hierarchy set forth in the Bankruptcy Code.

4.3 The initiation of an informal corporate rescue process?

In an out-of-court restructuring, management remains in place unless replaced by the board of directors in accordance with the debtor's bylaws. Depending on the cause of the debtor's troubles, the debtor's lenders or vendors may make further credit conditional on the supplementation of or changes in management.

5. Parties in interest/key players

5.1 Who is responsible for the 'case management' control and administration of:

(a) A corporate bankruptcy/liquidation?

The US trustee (a division of the US Department of Justice) oversees the administration of a case, subject to orders of the bankruptcy court. The US trustee appoints one or more creditors' committees.

(b) A formal rescue?

Upon commencement of a Chapter 11 case, management, as the debtor in possession, is charged with operating the business. The Bankruptcy Code allows for the appointment of professionals who are not in conflict with the estate to assist the debtor in carrying out its duties and in preparing and formulating a Chapter 11 plan. The Bankruptcy Code also provides for the appointment of a statutory creditors' committee responsible for representing the interests of all the debtor's unsecured claim holders. The creditors' committee is also authorised to retain legal and financial advisers at the estate's expense to assist in the restructuring process. In a healthcare business bankruptcy, the Bankruptcy Code requires the

appointment of an ombudsman to monitor the quality of patient care and represent the interests of patients, unless the bankruptcy court determines that an ombudsman is not necessary to protect patients in that particular case.

In a Chapter 7 case a trustee is appointed to convert the assets of the debtor to cash and to distribute such cash to creditors holding allowed claims against the debtor in accordance with the hierarchy set forth in the Bankruptcy Code. The creditors' committee in a Chapter 7 case is not authorised to retain professionals at the estate's expense.

(c) An informal rescue?

Normally, the creditors being asked to make concessions negotiate a protocol with the debtor as to which creditor expenses the debtor will pay, who will negotiate and how much information and oversight creditors will receive.

5.2 Who is responsible for preparing the restructuring plan in a formal or informal rescue?

Under the Bankruptcy Code, the debtor has the exclusive right to propose a plan for the first 120 days of the case. The debtor then has another 60 days to have the plan accepted by creditors, during which time no other party in interest may file a plan. These deadlines are commonly referred to as the 'exclusive periods'. For cause these periods can be reduced or, within specified limits, extended. Once the debtor's exclusive period to file a plan terminates or upon the appointment of a trustee, any party in interest may file a plan. In informal rescues only the debtor can make an exchange offer, but this is normally the subject of negotiation.

5.3 Who are the key players? What are their roles and responsibilities?

The key players in formulating a plan are:

- the debtor and its retained professionals;
- each statutory committee of creditors (and sometimes shareholders); and
- secured creditors.

Under the Bankruptcy Code, acceptance of a plan by a class of creditors requires a majority vote in number and two-thirds in value of the claims of creditors that voted. If all impaired classes vote to accept the plan, the bankruptcy court will confirm the plan if:

- it finds it is feasible (ie, liquidation or further reorganisation is not necessary); and
- impaired classes will receive at least as much as they would in a Chapter 7 liquidation (the 'best interests of creditors' test).

If there is a dissenting class, the plan may be 'crammed down' on that class in accordance with the absolute priority rule, which requires the bankruptcy court to find that the plan is fair and equitable as to the dissenting class – meaning that if the dissenting class is not paid in full, no junior class can participate on account of its junior claim or interest unless it pays new value.

The debtor's role is to negotiate a plan that takes into account value, employee jobs and compliance with the Bankruptcy Code. The creditors' committee is supposed to negotiate the best plan for its entire constituency. Frequently, vendor creditors are more concerned about maintaining the debtor as a customer than in maximising value. Lenders are more prone to maximise value.

6. What financial information is available to creditors?

In the United States, publicly held companies are required to adhere to the disclosure requirements set forth in the federal and applicable state securities laws. The federal securities laws require publicly held companies to file quarterly and annual reports.

In a Chapter 7 or Chapter 11 case, creditors are entitled to find out why they have not been paid and to search for a debtor's assets to ensure nothing has been concealed. At or soon after the commencement of the Chapter 7 or Chapter 11 case, the debtor must file with the bankruptcy court comprehensive statements of assets, liabilities, executory contracts and financial transactions. In addition, the debtor must file an operating report every month. This report sets forth:

- a statement of operations;
- a current balance sheet;
- a statement of cash flows; and
- monthly disbursements.

Creditors may also request broader discovery and compel the debtor's management or any other person to submit to examination. Normally, bankruptcy courts allow statutory creditors' committees to make the most extensive examinations and debtors frequently cooperate with them without the need for court intervention.

7. Common questions

7.1 Funding and the priority given to new money

(a) If an insolvent corporation requires urgent working capital funding, what difficulties are likely to be encountered in the provision of such funding?

In the absence of additional security or consideration, outside bankruptcy, creditors may be reluctant to lend funds to an insolvent corporation. Even with additional security or consideration, creditors may still be reluctant to lend money to a company in financial distress outside of a bankruptcy case because the new loan will be subject to modification under any reorganisation plan. In such a situation, secured creditors may insist that the debtor commence a Chapter 11 case so that they can retain a court order that gives them statutory protections and priority in payment over most other creditors.

(b) Are lenders providing new money, or debtor-in-possession financing, given any statutory priority?

Unsecured credit extended post-bankruptcy is entitled to administrative expense priority. If that priority alone is insufficient to attract new financing, a trustee or debtor in possession may obtain post-bankruptcy financing in consideration of administrative priority over all other administrative expenses (a 'super-priority') and the granting of liens against unencumbered assets, a junior lien against assets subject to a prior lien and, if the existing liens are adequately protected, a lien senior to all existing liens. For instance, if the debtor needs to complete an office building already 90 per cent completed and, by borrowing $10 million, will create value of more than $10 million, the bankruptcy court may grant the new lender a lien senior to the pre-petition mortgage lien.

7.2 Ranking of creditors

In what order are creditors paid in a corporate bankruptcy/liquidation?

Claims are generally paid in the following order:

- administrative expense claims;
- priority claims;
- priority expense (for certain wages and benefits) claims;
- secured claims;
- unsecured claims; and
- ownership interests.

Notwithstanding the foregoing, secured claimants are entitled to payment from their collateral before that collateral is used to satisfy any other claims.

In a Chapter 11 case, the absolute priority rule ensures that a dissenting class of creditors is treated fairly. A plan cannot provide for compensation for junior classes unless the senior classes either accept the plan or are compensated in full.

7.3 Avoidance of antecedent transactions

Are there any legal provisions that might operate to invalidate the creation of security, the disposal of an asset or the payment of a creditor by a company in financial difficulties?

The Bankruptcy Code allows the debtor in possession or trustee to avoid preferences and fraudulent transfers. A transfer of an interest of the debtor in property (including a security interest) will be deemed a preference and avoided if it was granted on account of an antecedent debt and made within 90 days before the commencement of the bankruptcy case at a time when the debtor was insolvent, and its effect was to give the creditor a greater recovery than it would receive in a Chapter 7 liquidation case. There are various defences to a claim that a transaction was a preference – for example, if the transfer was made in the ordinary course of business or the recipient of the transfer later furnished new value. A security interest may be avoided if it is unperfected.

A fraudulent transfer of a debtor's property interest is either actually fraudulent or constructively fraudulent. An actually fraudulent transfer is made with the intent to hinder, delay or defraud creditors. A constructively fraudulent transfer is made for less than the reasonably equivalent value at a time when the debtor transferor:

- is insolvent;
- was made insolvent by the transfer;
- is about to engage in business with unreasonably small capital; or
- intends to incur debts beyond its ability to repay them.

If the transfer is made for the benefit of an insider under an employment contract, it may be constructively fraudulent if the transfer was made outside the ordinary course of business and the debtor received less than reasonably equivalent value in exchange.

The result of setting aside a voidable transfer is

to require the property or its value to be returned to the debtor's estate. Where a voidable preference is recovered, the creditor has an unsecured claim against the debtor's estate for the amount of the voidable preference.

7.4 'Cram-downs'

What is the position of both unsecured and secured creditors that vote against, do not agree with or do not consent to either a formal or an informal rescue plan?

In a Chapter 11 plan, claims are placed in classes comprised of substantially similar claims. Creditors then vote by class and the plan is accepted if a majority in number and two-thirds in value of the claims in that class vote in favour of the plan. The Bankruptcy Code, however, provides additional protections to creditors. Unless a creditor consents to lesser treatment, it must receive in a plan at least as much as it would receive in a liquidation (the 'best interests' test). The bankruptcy court must also find the plan feasible – which means it will not be quickly followed by liquidation or another reorganisation proceeding.

If a class rejects the plan, it may still be confirmed on the dissenting class if it is feasible, meets the best interests test and accords with the absolute priority rule. The absolute priority rule provides that a junior class may not be paid until a senior class has either accepted the plan or been paid in full.

Secured creditors can be compelled to accept certain treatment regardless of their votes:

- Their collateral can be sold and they can bid in or receive the proceeds;
- They can be given a new note in the amount of the value of their collateral (up to the amount they are owed) at a market interest rate secured by the collateral; or
- They can receive certain other treatment.

Unsecured creditors can be forced to take value in any form equal to at least what they would receive in a Chapter 7 case.

If a plan is not approved because it fails to meet the above requirements, the Chapter 11 case may be dismissed or converted to a liquidation case under Chapter 7 of the Bankruptcy Code. A debtor may also propose a liquidation plan under Chapter 11.

7.5 Creditor protection

What actions can creditors take if they are not satisfied with the conduct of either a formal rescue procedure or a corporate bankruptcy/liquidation?

Disgruntled creditors may move for the appointment of a Chapter 11 trustee or examiner. Under the Bankruptcy Code, a Chapter 11 trustee may be appointed for cause (including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case), if such appointment is in the interests of creditors, equity security holders, and other interests of the estate, or if grounds exist for the case to be converted to a Chapter 7 or dismissed but the bankruptcy court determines that appointment of a trustee is in the best interests of creditors and the estate. The Bankruptcy Code requires the US trustee to request the appointment of a trustee if reasonable grounds exist to suspect fraud, dishonesty or criminal conduct by the debtor's board of directors or senior executives in the management or public financial reporting of the debtor. As a trustee replaces current management, a trustee's appointment is reserved for rare cases where there is the extraordinary showing of cause mandated by the Bankruptcy Code.

A party in interest may also request the appointment of an examiner to investigate any appropriate concern. A court will order the appointment of an examiner if such appointment is in the interests of creditors, equity security holders or other interests of the estate, or if the debtor's fixed, liquidated, unsecured debts (other than debts for goods, services or taxes or debts owing to an insider) exceed $5 million. If an examiner is appointed, the bankruptcy court retains broad discretion to direct the scope of the examiner's investigation.