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Insolvency

Law and Practice – USA

Contributed by
Skadden, Arps, Slate,
Meagher & Flom
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Law and Practice

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Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates has approximately 1,700 attorneys on four continents, and serves clients in every major financial centre globally. Skadden brings in-depth knowledge of the markets in which it operates and numerous local law capabilities to multi-jurisdictional, cross-border and domestic legal matters. In both the US and internationally, Skadden provides representation, strategic advice, innovative and practical legal solutions, and litigation assistance to financially troubled public and private companies and their major lenders, creditors, investors and transaction counterparties. In the US, Skadden focuses on Chapter 11 and 15 proceedings, out-of-court restructurings and related litigations in a variety of situations including "prepackaged" and "prearranged" bankruptcies.

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1. Market Trends and Developments

1.1 The State of the Restructuring Market

Empirical data indicate a moderate decline in US Chapter 11 bankruptcy filings in 2017 versus 2016 - - although certain jurisdictions have experienced increased levels of business bankruptcy filings. According to legal technology service-provider Epiq's statistic service AACER, as of August 2017, year-to-date business bankruptcy filings in the United States (including both Chapter 11 and Chapter 7) between 2016 and 2017 had increased 0.6%, while total Chapter 11 filings dropped roughly 5%. Chapter 11 filings in Delaware declined by approximately 35%, while filings in New York have increased by 19%, and filings in Texas have increased by 21%. This increase in Texas filings is, in large part, a result of increased oil and gas industry sector bankruptcy filings.

Over the last few years there have been significant market changes in the energy, retail and healthcare industry sectors that have resulted in increased needs for financial restructurings.

Recent political and regulatory changes in the US may have impacts on restructuring markets in certain industries. For instance, the Trump administration has adopted a pro-pipeline stance that may improve the state of oilfield service and pipeline industries. Also, the Trump administration has expressed its intention to repeal or alter some provisions of the Dodd-Frank Act. The Act provides for the reorganisation of failing banks and other financial institutions. Repeal of amendment of the Dodd-Frank Act may change the restructuring landscape for financial institutions.

Perhaps most significant are expected reforms and changes to the US tax code. US tax-code changes and reforms may drive increased economic activity in some sectors, with implications for financial restructurings, and may result in repatriation into the US of very significant capital. US tax-code changes may alter the ways in which restructuring transactions are undertaken and implemented in particular industries or generally.

Energy
In early 2016, in the energy sector, oil prices plummeted to roughly USD30 per barrel causing liquidity problems for many oil and gas companies. Oil and gas companies in the exploration and production (E&P) space relied on reserve-based loans (RBLs) to fund their operations. E&P company-owned reserves that secure E&P companies' borrowings under RBLs are subject to periodic revaluations and redeterminations, usually twice a year (once in the autumn and once in the spring). In the redetermination process, a lender assigns a value to a company's reserves and adjusts the company's borrowing base accordingly. The spring 2016 round of redeterminations and reserve revaluations reflected declining oil prices, thereby reducing borrowing base availability and, thus, liquidity available to E&P companies and forcing many Chapter 11 bankruptcy filings. Numerous E&P companies used Chapter 11 to shrink their cost structures and address liquidity concerns in 2016 and 2017 (eg, Stone Energy, Halcon Resources, Bonanza Creek Energy, and Triangle USA Petroleum). Likewise, E&P adjacent industries (such as oilfield services, pipeline construction, and offshore drilling and services) also experienced sharp increases in bankruptcy filings.

More recently, oil prices have rebounded to over USD50 a barrel and E&P Chapter 11 filings have slowed. Increased oil prices may also reduce bankruptcy filings in E&P adjacent industries, such as pipeline construction and oilfield service. The oilfield service industry generally is likely to benefit from reorganised E&P companies that emerge from bankruptcy and undertake deferred maintenance and improvement projects. Pipeline construction also may increase with improved E&P business activity and recent US pro-pipeline policy changes. However, the global oversupply of oil may continue to pose challenges ahead for certain sectors in the industry. For example, the 2017 trend of offshore support-vessel bankruptcies (like those filed by Gulfmark Offshore, EMAS CHIYODA Subsea, and Tidewater) may continue.

Retail
In 2016 and 2017, the need for financial restructurings and bankruptcy reorganisations in the retail sector increased significantly, resulting in numerous high-profile retail Chapter 11 filings, including American Apparel, BCBG Maz Azria, Payless ShoeSource, rue21, Gymboree, Perfumania, and Toys R US. Several ongoing retail industry changes have driven the recent retail bankruptcies, including: increased online sales (including the Amazon effect), the success of discount chains, changing retail consumer demographics and preferences, and a decrease in retail mall traffic partially attributable to the continued success and expansion of online retailers. As noted in a recent AlixPartners North American Restructuring Experts survey, large national retail chain footprints entail cost structures that are difficult to rationalise. Even outside of bankruptcy, retailers have closed thousands of stores and laid off tens of thousands of workers to try to cut costs and compete with e-commerce.

Retail bankruptcies are not occurring in a vacuum. Adjacent inter-connected industry sectors such as commercial real estate have been and will continue to be impacted by large retail filings, particularly as large chainstore business footprints shrink and retail companies use the Bankruptcy Code to reject unwanted leases, leaving commercial property owners and managers with excess supply and dwindling demand for their properties.

Healthcare
Healthcare bankruptcy filings now account for a greater percentage of the total number of bankruptcy cases filed in the US in the past few years, even if the total number of healthcare filings has not increased. Also, the past few years have seen a noticeable increase in the number of healthcare mergers and acquisitions outside of bankruptcy. By at least one estimate, the number of US healthcare distressed M&A deals increased by over 85% from 2013-2014 to 2015-2016. A number of factors account for increased financial stress in the healthcare market, including a change from volume-based to value-based reimbursement schemes; payer-led demand for less costly outpatient (rather than inpatient) procedures; the increased need for equipment and technology investments; and heightened competition among competitors, particularly in rural hospitals and senior-assisted living facilities.

Uncertainty about the future of the Affordable Care Act ("ACA") (also known as "Obamacare") contributes to healthcare industry stress. Potential repeal of the ACA may cause rising financial stress in the healthcare sector. Uncertainties surrounding the ACA's future have caused some insurers to increase their premiums or exit ACA insurance exchanges. Uninsured patients may increase as healthcare insurance premiums increase and patients have fewer insurance options. A spike in uninsured patients may cause further financial pressures for healthcare providers.

1.2 Changes to the Restructuring and Insolvency Market
Recent judicial decisions and case law developments have implications for in-court and out-of-court restructurings and related strategies.

Structured Dismissals
Structured dismissals of Chapter 11 cases have been used to terminate Chapter 11 cases without the filing of a plan, with results that normally may be achieved only through a confirmed Chapter 11 plan. Structured dismissals require court approval and often have provisions for distributions of debtor assets and the granting of releases, among other things. A recent US Supreme Court decision limits what may

be accomplished with a structured dismissal of a Chapter 11 case. In Czyzewski v Jevic Holding Corp, 137 S. Ct. 973 (2017), the Supreme Court held that structured dismissals must not violate the Bankruptcy Code's provisions that establish statutory payment priorities among various classes and creditors (namely, the "absolute priority rule"). The Court noted that the Bankruptcy Code's priority system constitutes a basic underpinning of business bankruptcy law and compliance with the statutory priorities is fundamental to the Bankruptcy Code's operation. Id. at 983-84. The Court held that bankruptcy courts cannot approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme in the absence of consent of the affected parties, even in "rare cases".

Following the Supreme Court's pronouncements in Jevic, structured dismissals of Chapter 11 cases will be closely scrutinised. Jevic is also likely to result in closer scrutiny of priority-skipping creditor distributions in other contexts, such as when proposed settlements and sale agreements govern distributions of settlement or sale proceeds.

Bankruptcy Treatment of Fraud Claims
In 2016, in Husky Int'l Elecs., Inc v Ritz, 136 S. Ct. 1581 (2016), the US Supreme Court addressed the dischargeability of certain debts obtained by fraud. Section 523(a)(2)(A) provides that a debt for money, property or services obtained by false pretences, false misrepresentations or actual fraud is not dischargable in bankruptcy. In its Husky decision, the Supreme Court held that the term "actual fraud" in Bankruptcy Code section 523(a)(2)(A) does not require an affirmative false representation. It follows that some debts may be non-dischargeable as "actual fraud" damages, even if the debtor has not misrepresented anything to the creditor.

Indenture Amendments
The recent decision by the US Court of Appeals for the Second Circuit in Marblegate Asset Mgmt., LLC v Educ. Mgmt. Fin. Corp, 846 F.3d 1 (2d Cir. 2017), is likely to impact restructuring strategies, especially in the out-of-court debt restructuring context. In Marblegate, the Second Circuit addressed the contours of the Trust Indenture Act's ("TIA") prohibition on non-consensual changes to the terms of an indenture (ie, changes not agreed to by a holder of debt issued under an indenture) that would impair or affect "the right of any holder of any indenture security to receive payment of the principal and interest on such indenture security." The Second Circuit held that, while an issuer could not amend the purely economic terms of an indenture (principal, interest, maturity) without the consent of each holder of debt, the TIA did not prohibit amendments to guarantee provisions or covenants without this consent. Such permitted amendments, while not impacting strictly economic terms, may have strong implications for a holder's ability ultimately to collect payment. The Second Circuit's Marblegate decision should facilitate out-of-court restructurings, because it provides issuers and others seeking to amend indentures with significant leverage when negotiating restructuring terms that require debt indenture amendments.

Make-Wholes
Two recent bankruptcy court decisions highlight the importance of careful drafting of credit documents. In In re MPM Silicones, LLC, No 14-22503-RDD, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), aff'd, 531 B.R. 321 (S.D.N.Y. May 4, 2015), and aff'd in part, rev'd in part, --F.3d--, 2017 WL 4772248 (2017) ("Momentive") and In re Energy Future Holding Corp, 527 B.R. 178 (Bankr. D. Del 2015), aff'd, No 15-620 RGA, 2016 WL 627343 (2016), and rev'd, 842 F.3d 247 (2016) ("EFH"), bankruptcy courts denied lender claims for so-called "Make-Whole" premiums. Make-Whole premiums are fees payable to debt-holders, for the early repayment of a debt obligation, that compensate a lender for lost interest. In both Momentive and EFH, the bankruptcy courts held that terms of particular credit agreements providing for Make-Whole premiums were not enforceable because, in both cases, Chapter 11 bankruptcy filings automatically accelerated the underlying debt. As the debt would be accelerated at the time of payment in each case, and the provisions of the particular credit agreement documents made no mention of Make-Whole premiums being due and payable in that context, there was no "early repayment" of the accelerated debt and the lenders could not collect Make-Whole premiums. While the Court of Appeals for the Third Circuit overturned the bankruptcy court's decision in EFH, these cases illustrate the importance of considering a possible bankruptcy or insolvency when drafting credit documents. The recent cases also demonstrate the need for distressed investors to retain counsel to review credit documents closely before purchasing a debt position.

Third Party Releases
In October 2017, in In re Millennium Lab Holdings II, LLC, No 15-12284, 2017 WL 4417562 (Bankr. D. Del. Oct. 3, 2017), the United States Bankruptcy Court for the District of Delaware issued a significant ruling, on remand from an appeal, regarding the scope of the bankruptcy court's constitutional authority and power to approve, on a final basis, non-consensual third-party releases that are often critical terms of complex Chapter 11 plans. The Millennium court held that the bankruptcy court does have requisite constitutional adjudicatory authority to confirm a Chapter 11 plan containing non-consensual third-party releases. The bankruptcy court rejected appellants' argument for an expansive interpretation of the US Supreme Court's jurisdictional decision in Stern v Marshall, 564 US 462 (2011), that appellants argued should preclude bankruptcy courts from giving final approval to non-consensual third-party releases. Appellants' flawed reading of Stern, the bankruptcy court said, would "dramatically change the division of labour between

the bankruptcy and district courts" in a manner far beyond Stern's narrow holding. Although the Millennium decision is likely to be appealed, it should provide comfort that non-consensual third-party releases remain a potentially valuable tool in resolving complex Chapter 11 restructurings.

Cram-Down Interest

In October 2017, the Second Circuit Court of Appeals opinion in Momentive Performance Materials Inc v BOKF, N.A., No 15-1682 2017 WL 4772248 (2d Cir. Oct. 20, 2017), included a ruling on cram-down interest rates that is likely to have a pronounced impact on secured creditors of Chapter 11 debtor companies. The Bankruptcy Code provides that a Chapter 11 debtor may confirm a plan over the objection of a secured creditor by (1) allowing the secured creditor to retain its liens in its collateral and (2) providing the creditor with a stream of future payments with a present value equal to the amount of its secured claim. Because the stream of future payments will be paid over time, a debtor must pay interest (so-called "cram-down interest") on such payments, at a rate determined by the bankruptcy court. In practice, this approach to secured creditor cram-down has resulted in debtors effectively issuing to and imposing non-consensual debt on their secured creditors under a plan, debt that is (i) for the amount of the secured lenders' secured claim, (ii) secured by a lien in the secured lenders' collateral and (iii) paid interest at a cram-down interest rate.

In the wake of certain US Supreme Court precedents, some bankruptcy courts had determined secured creditor cram-down interest rates by adding a "risk adjustment" (typically between 1% and 3%) to a risk-neutral interest rate, such as the national prime rate or the Treasury Rate. This so-called "prime-plus" method, was the method adopted by the lower courts in Momentive. However, the Second Circuit held that, in Chapter 11 cases, when determining the appropriate cram-down interest rate, a bankruptcy court must first consider whether there is an "efficient market" for the replacement debt being issued by the debtor. If such a market exists, then the interest rate that would be borne by an efficient market serves as the appropriate cram-down interest rate. If no efficient market exists, then courts should apply the "prime-plus" method to determine the appropriate cram-down interest rate.

Practitioners and debtors should carefully consider the Momentive decision when formulating and proposing cram-down treatment of secured claims. Such terms of treatment should depend in part on capital markets analysis, whether an efficient market will be determined to exist for the replacement debt being issued by the debtor, and if so, what interest rate the market will bear for that replacement debt. Likewise, investors purchasing a position in a financially troubled company's secured debt should be aware of the same issues: whether an efficient market exists and the interest rate any such market would bear on replacement cram-down debt issued by the debtor.

2. Statutory Regimes Governing Restructurings, Reorganisations, Insolvencies and Liquidations

2.1 Overview of the Laws and Statutory Regimes

In the United States, business reorganisations and liquidations are undertaken under both state and federal law regimes. At the federal level, restructuring and insolvency and liquidations proceedings are governed largely by Title 11 of the United States Code (the "Bankruptcy Code"). Chapters 1, 3, and 5 of the Bankruptcy Code contain general rules, definitions, and eligibility requirements for bankruptcy cases. Those three chapters apply to federal bankruptcy cases under Chapter 7 and Chapter 11 of the Bankruptcy Code. As federal law, the Bankruptcy Code is supreme and pre-empts conflicting state laws that also may provide for business liquidations, receiverships and similar regimes.

Under state law, there are three general alternatives that a financially troubled business entity may use to wind up its affairs, including: (1) general assignments for the benefit of creditors (known as "ABCs"), (2) receiverships, and (3) statutory dissolution procedures. Particular state law alternatives to federal bankruptcy law are usually available only to entities organised within a particular state that do not have substantial assets located in multiple states.

2.2 Types of Voluntary and Involuntary Financial Restructuring, Reorganisation, Insolvency and Receivership

Federal Regimes

Under the Bankruptcy Code, with some exceptions (see below), there are two primary types of bankruptcy cases that apply to business entities: Chapter 7 liquidation cases and Chapter 11 reorganisation cases. Chapter 9 bankruptcy is used by municipalities who are eligible to file for bankruptcy under the Bankruptcy Code. There are also distinct Bankruptcy Code provisions that apply to railroad, family farmer, fishermen, and other businesses.

Chapter 7 liquidation cases are relatively straightforward. Commencing a case under Chapter 7 creates an "estate," comprised of all of the debtor company's property and rights. The Bankruptcy Code requires the appointment of a Chapter 7 bankruptcy trustee who is tasked with administering and promptly liquidating all property of the estate for the benefit of creditors in the order of their respective statutory payment priorities set by the Bankruptcy Code.

Chapter 11 business bankruptcy cases are most often used by companies seeking to reorganise their financial affairs and operations pursuant to a Chapter 11 reorganisation plan. Chapter 11 may also be used to liquidate a business pursuant to a Chapter 11 plan of liquidation.

In Chapter 11, a debtor company has an exclusive statutory time period to propose and seek creditor acceptances of a chapter plan to reorganise or liquidate its business. Eligible creditors may vote in their respective classes to accept or reject the plan. If the plan is accepted by requisite creditor votes and approved by the Bankruptcy Court, the plan becomes binding on all creditors and other parties in interest when the Chapter 11 plan becomes effective.

State Law Regimes

Several regimes exist under state common law and state statutory law to facilitate the liquidation or restructuring of failing businesses. The state law-based regimes described below are in addition to contractual arrangements, including out-of-court restructurings and "work-outs" with creditors, whereby a company agrees with certain of its creditors on new terms of repayment or other treatment of the company's existing indebtedness.

Assignments for the Benefit of Creditors

General assignments for the benefit of creditors ("ABCs") are available under and governed by common law or statute in all 50 states. Through an ABC, an entity assigns, by way of a deed or otherwise, all of its property to an assignee or receiver. The assignee or receiver, similar to a Chapter 7 trustee, administers the assigned assets for the benefit of the business entity's creditors. ABCs usually implement creditor distributions following state-law priorities that are similar to the distribution priorities among creditors in cases under Chapter 7 of the Bankruptcy Code. However, an ABC generally does not impose a bankruptcy-like automatic stay of the exercise of creditor rights and remedies -- and therefore does not prevent creditors from commencing an involuntary bankruptcy case or taking other actions or pursuing other remedies against the company. An ABC does not provide for assumption or rejection of executory contracts.

Receiverships

State law receivers and receiverships may be authorised and ordered by a state court. Receivership laws vary among the 50 states. Typically, a receivership is commenced by petition of a creditor that requests a court to order that the debtor company be placed into receivership. In receivership, the company and its properties are administered by a court-appointed receiver for the benefit of creditors. Court-appointed receivers generally have stronger and more flexible powers than assignees in ABCs, because the court ordering the receivership will tailor its receivership order and the authority of the receiver to the circumstances of the particular case.

Statutory Dissolutions. Under applicable state statutes, business entities (corporations, limited liability companies, and limited partnerships) may have options to dissolve, wind down their affairs in an orderly manner, liquidate or dispose of their assets, make distributions, and terminate their legal existence. State law statutes typically specify dissolution and wind-down notice requirements and procedures requiring that provision must be made for payment of creditors before any distributions may be made to equity holders. Because dissolutions and wind-downs may be undertaken with or without court supervision, and because the dissolved company or its directors may choose individuals or a firm that will manage the wind-down, dissolutions may be disfavoured by creditors, especially creditors in a complex corporate and organisational structure.

2.3 Obligation to Commence Formal Insolvency Proceedings

In the United States, companies (public or private) are not required to commence bankruptcy or liquidation proceedings when they become insolvent. However, state law fiduciary duties may require directors and officers to act in accordance with the best interest of the company, without self-dealing, to maximise enterprise value. Accordingly, fiduciary duties and practical business realities and a loss of liquidity may compel company directors to commence a bankruptcy or other proceedings that protect going concern business value for the benefit of residual stakeholders including creditors.

2.4 Procedural Options

In the United States a financially troubled company is not required to initiate bankruptcy or other insolvency proceedings. However, once a company, through its owners, members, directors, or managers determines that it is appropriate to commence bankruptcy or state law insolvency proceedings, the company is generally permitted to proceed as it deems appropriate, subject to eligibility requirements.

2.5 Liabilities, Penalties or Other Implications for Failing to Commence Proceedings

There are no mandatory legal requirements that owners, members, managers or directors of an insolvent entity initiate a bankruptcy or similar insolvency proceeding for the entity, and there are no formal penalties for not doing so. Companies and their directors and officers with fiduciary duties may face practical, legal and financial circumstances (including loss of business liquidity) that will lead them to commence a business bankruptcy at the appropriate juncture (instead of taking no action). As a practical matter, the failure to commence bankruptcy at the appropriate time can lead to issues with contract counterparties, loss of a company's access to liquidity and capital markets, loss of going concern value, and events of defaults under the company's credit facilities that may cause rapid business deterioration and losses. In some circumstances, directors and officers may face possible personal liability for their failure to conduct the business and preserve its value in a manner consistent with their legal and fiduciary duties under state and federal laws. However, unlike in other countries, there are no specific civil or criminal penalties in the U.S. for not commencing insolvency proceedings.

2.6 Ability of Creditors to Commence Insolvency Proceedings

In the United States, creditors may commence involuntary bankruptcy cases against a financially distressed company. Under Bankruptcy Code section 303, creditors may petition a bankruptcy court (through a process similar to filing a civil complaint) to initiate bankruptcy proceedings under chapter 7 or chapter 11 of the Bankruptcy Code against a debtor company. If a debtor has 12 or more creditors who hold noncontingent and undisputed claims, then an involuntary bankruptcy petition against the debtor must be filed by no less than three creditors holding in the aggregate noncontingent and undisputed unsecured claims totaling at least USD15,775. If the debtor has less than 12 such creditors, an involuntary bankruptcy petition may be filed by one or more creditors holding at least USD15,775 of such claims. However, in calculating the value of such claims, contingent claims, claims subject to a bona fide dispute as to liability or amount, and secured claims are excluded from the total figure. Secured creditors, however, may still join the petition for numerosity of creditors purposes.

Following the filing of an involuntary chapter 7 or 11 bankruptcy petition, the debtor subject to the involuntary petition may oppose and contest the involuntary petition. If the debtor opposes the petition, the bankruptcy court, after a trial, will grant the bankruptcy case relief requested in the petition only if the petitioning creditors show either that (i) the entity is generally unable to pay its debts as they become due (excluding debts subject to a bona fide dispute) or (ii) a custodian, receiver or trustee had been appointed to take charge of substantially all of the debtor's property within 120 days before the involuntary petition was filed. An involuntary chapter 7 or 11 case commences when an involuntary bankruptcy petition is granted by the bankruptcy court.

Involuntary bankruptcy petitions are uncommon. Most sophisticated creditors are wary of commencing involuntary bankruptcy proceedings against a company. There is risk that, if an involuntary bankruptcy petition is filed improperly, the petitioning creditors will be liable to the debtor company for costs and attorney's fees associated with defending the petition. Additionally, if the court finds that an involuntary bankruptcy petition was filed in bad faith, the court may hold petitioning creditors liable for (i) damages resulting from the bankruptcy petition and (ii) punitive damages.

Outside of a bankruptcy, under applicable state laws that vary from state to state, one or more creditors may request a state court to appoint a receiver for an insolvent entity. See G1.

2.7 Requirement for "Insolvency" to Commence Proceedings

A business entity need not be insolvent to qualify for and commence a case under chapter 11 of the Bankruptcy Code. Likewise, there is no formal insolvency requirement that applies to a company filing for chapter 7 protection. However, some level of financial distress generally is required to take advantage of the federal bankruptcy laws, and a bankruptcy case may be dismissed if it is filed in bad faith.

Typically, only insolvent business entities qualify for appointment of a state law receiver. Insolvency is not usually required for an ABC or state law dissolution. Legal "insolvency" may be defined in different ways under various state and federal laws and judicial decisions.

2.8 Specific Statutory Restructuring and Insolvency Regimes

Banks are not eligible to be debtors under the Bankruptcy Code. Instead, federal U.S. banking laws permit the Federal Deposit Insurance Commission to close a financially troubled bank and act with a high degree of autonomy as its receiver. In special circumstances with large-scale economic implications, the Dodd Frank Act authorises the FDIC to resolve the financial issues of a company that derives 85% of its earnings from financial activities.

Like banks, domestic U.S. insurance companies are not eligible to commence bankruptcy cases under the Bankruptcy Code. However, insurance companies may be placed into trusteeship or receivership and wound-down under applicable state laws. All states have enacted some form of model legislation designed to provide courts, trustees, and receivers with guidance on how to administer an insolvent insurance company.

In the U.S., broker-dealers are authorised to file for bankruptcy under chapter 7 of the Bankruptcy Code; however, their insolvencies tend to be governed by specialised federal securities laws, including the Securities Investor Protection Act ("SIPA"). Similar to the FDIC in the administration of an insolvent bank, the Securities Investor Protection Corporation (SPIC) enjoys a great deal of autonomy when administering an insolvent securities broker. Notable SIPA liquidation proceedings include those involving MF Global and Bernard L. Madoff Investment Securities.

Railroads, family farms and family fisheries are addressed by special provisions of the Bankruptcy Code. Title 12 of the Bankruptcy Code provides the statutory framework for the reorganisation of a family farm or family fishery. Chapter 12 is a hybrid between chapter 11 and chapter 13, and is geared towards reorganising personal businesses. A subchapter of chapter 11 deals with the reorganisation of a railroad, and permits a railroad liquidation in limited circumstances. Chapter 9 is limited to providing a bankruptcy process for qualifying municipalities.

3. Out-of-Court Restructurings and Consensual Workouts

3.1 Consensual and Other Out-of-Court Workouts and Restructurings

In the United States, companies in need of financial restructuring may pursue and complete a restructuring without commencing a chapter 11 bankruptcy case if the company has sufficient liquidity and time to negotiate and reach agreement with its financial creditors and other primary stakeholders. Out-of-court restructurings may be a good strategy for companies looking to restructure their balance sheets. Even if a company is unable to restructure entirely out of court, a company can save considerable time and money by reaching agreement on restructuring terms with key stakeholders prior to commencing a chapter 11 case to effectuate the restructuring.

In the United States, sophisticated creditors, debtors and restructuring professionals understand that a negotiated out-of-court financial restructuring, if possible, is preferable to possibly litigious and less certain in-court restructuring cases. Under the right circumstances, consensual out-of-court restructurings may provide the best results for a financially distressed company and its stakeholders. A consensual out-of-court restructuring or "workout" may deleverage a financially distressed company and resolve risks and uncertainties for its employees, customers, suppliers, and creditors if the out-of-court restructuring provides the company with sufficient liquidity and a healthy balance sheet.

Out-of-court restructurings can avoid the high costs, possible reputational stigma, uncertainties, and potential business disruptions that may arise or occur during a chapter 11 bankruptcy case. Even if a restructuring cannot be consummated entirely out of court, a pre-packaged bankruptcy case (known as a "pre-pack") or a pre-negotiated bankruptcy case may be used to bind dissenting minority creditors and dissenting equity holders.

Typically, out-of-court restructurings are the product of fluid and multi-faceted negotiations between and among a company and its primary stakeholders and their advisors. There are no strict frameworks or rules for out-of-court restructurings. The lack of a formal framework gives parties flexibility and freedom to negotiate multi-party agreements and creative solutions.

Sophisticated lenders, creditors and other stakeholders may be willing to work with a financially distressed company on a consensual restructuring of credit terms and loans. Lenders often require new business plans and projections from management as well as additional business and legal diligence before delving too far into restructuring negotiations. Lenders may benefit from an out-of-court restructuring by negotiating more favorable loan agreement terms, in exchange for financial concessions sought by the company. Some lenders and debt holders may use out-of-court restructurings as an opportunity to swap debt for equity in the company.

Not all financially distressed companies are good candidates for out-of-court restructurings and workouts. Companies considering out-of-court options need sufficient time and liquidity to maintain business operations during often lengthy negotiations leading to out-of-court restructuring agreements.

Outside of bankruptcy, companies generally are unable to bind minority dissenting creditors or dissenting equity holders to restructuring terms. A small minority of dissenting creditors may exert outsized leverage to stall or block an out-of-court restructuring. Out-of-court restructurings therefore must be almost entirely consensual.

An out-of-court restructuring is typically a strategic option for companies that seek solely to restructure funded debt on their balance sheets (a "balance sheet restructuring" as opposed to "operational restructuring"). Getting unanimous approval on restructuring terms from diverse and unorganized creditor constituencies is usually extremely difficult or impossible. For that reason, the rights of diverse general unsecured creditors, including contract counterparties, employees, trade creditors, and the like, are most often left unimpaired in an out-of-court restructuring. In addition, securities laws can complicate a restructuring process for companies with publically traded debt. It follows that balance sheet restructurings based on negotiated agreements with organized, sophisticated financial creditors predominate in out-of-court restructurings.

Even if a company has sufficient liquidity for extended negotiations and is otherwise a good candidate for an out-of-court restructuring, the threat or prospect of a possible chapter 11 filing can be a powerful negotiation tool or ultimate strategy. If a financially distressed company has developed the support of requisite majorities of creditors needed to confirm a feasible chapter 11 plan over the opposition of dissenting creditors, the company may convince dissenting creditors that its proposed out-of-court restructuring is better for them than the treatment they will receive under a chapter 11 plan. Creditors refusing to agree to out-of-court restructuring terms run the risk that a company will file a pre-packaged or pre-negotiated bankruptcy case, approve a plan over creditor dissents, and leave the dissenting creditors with plan treatment less favorable to them than would be the result in the out-of-court restructuring. In short, a company can use the threat of chapter 11 as a weapon to line up uncooperative dissenting creditors.

In the United States, financially distressed companies are not required to negotiate with creditors prior to filing a bankruptcy. A company's decision to commence a voluntary chapter case is its own to make. While directors and officers of an insolvent company are not required to commence a bankruptcy case, bankruptcy may be the best decision for them as company fiduciaries if it is the best or only means of preserving and maximizing the company's enterprise value.

3.2 Typical Consensual Restructuring and Workout Processes

There is no standard timeline or singular process for out-of-court restructurings. A company's unique circumstances, exigencies and creditor objectives drive the timing, developments and outcomes in an out-of-court restructuring. Strategies, processes, types of agreements and timelines depend heavily on the facts of each case.

Out-of-court restructuring negotiations often take many months to complete. The complexity of negotiations and number of parties involved may extend the timeline. Timelines may shorten if an announcement is made about the restructuring process that causes suppliers to tighten trade credit. Often, a distressed company and its advisors will simultaneously pursue out-of-court negotiations and prepare for and negotiate a pre-packaged or pre-negotiated bankruptcy case that will be commenced if out-of-court negotiations fail or a chapter 11 case is needed to bind dissenters.

While the timeline of a particular out-of-court restructuring may be fluid and unpredictable, the contours of the process and the types of agreements negotiated are often predictable. At the onset of restructuring talks, debt holders and lenders will assess the company's situation to determine whether a restructuring is feasible. Lenders, bondholders or other creditor groups may form ad hoc committees and employ their own legal and financial advisors (often paid for by the company) to evaluate the situation. Lenders and bondholders will conduct business and legal due diligence to review the company's business plans and projections, financial covenants, debt structure, liquidity, and assets to determine what, if any, restructuring options would be feasible.

Creditors and their advisors will require a company to provide confidential information relating to its cash flows and financial projections in order to accurately assess the company's prospects. During the initial phases of a workout, a company will seek agreements that protect its confidential information. Prior to disclosing sensitive business information to lenders or creditors, a company will negotiate a confidentiality agreement or non-disclosure agreement ("NDA") with such parties. If the company has issued any securities, it will want to negotiate a material non-public information ("MNPI") clause in the NDA agreement. The MNPI clause will prevent creditors who receive MNPI during negotiations from trading in the company's securities while negotiations are ongoing. Creditors may insist that a company agree to make disclosures of MNPI by future dates certain so that such creditors may then resume trading in the company's securities.

When negotiating out-of-court restructurings, companies often seek standstill agreements or waivers of credit agreement defaults from lenders. A standstill or forbearance is an agreement with lenders or other creditors that they will not for a specified time period exercise specified remedies otherwise available to them. Lenders may also agree to waive their rights to declare defaults and to exercise default remedies for expected company violations of specific financial covenants. A company may ask certain lenders to waive previous defaults on debt instruments while restructuring negotiations are taking place. In exchange for their agreements to waive and forebear, creditors often will receive fees and the company's agreement that it will pay the costs of lender advisors and counsel.

It is common for ad hoc creditor groups or steering committees to form during out-of-court restructuring negotiations. The agent for lenders under a secured credit facility may form a steering committee of lenders to help organize the lenders. Noteholders may organize ad hoc groups to represent them during restructuring negotiations. Sometimes, a single creditor will have purchased a large portion of outstanding debt and then negotiate directly with the company or play an outsized role in an ad hoc group or steering committee.

The formation of creditor steering committees and ad hoc groups helps a company structure an effective process for negotiating and reaching agreement on restructuring terms. Companies therefore often agree to pay legal and financial advisor fees incurred by organized ad hoc and steering committee groups. When hiring advisors, committees and ad hoc groups may sometimes rely on advisors that a leading member of the committee or group already has employed; or creditor groups and committees will interview numerous restructuring professionals before selecting advisors.

Prior to or during restructuring negotiations, competing creditor groups may negotiate and reach intercreditor agreements. Intercreditor agreements (and closely related subordination agreements) between two or more of a company's creditors may fix and order their competing rights to receive payments of cash or other property from a company, including proceeds of a sale of shared collateral, as well as determine timelines and details with respect to such creditor groups' respective abilities to exercise remedies.

Intercreditor agreements may govern junior-lien creditor rights in an out-of-court restructuring as well as bankruptcy proceedings. A senior secured creditor may seek a junior secured creditor's agreement to confirm that the senior creditor is entitled to payment in full on its senior claim before the junior-lien creditor is entitled to receive any payment. An intercreditor agreement may restrict a junior-lien creditor's rights in bankruptcy, such as by limiting the junior-lien creditor's ability to object to bankruptcy sales, preventing the junior creditor from objecting to debtor-in-possession financing, and controlling junior creditor voting rights in chapter 11 (though bankruptcy courts may not enforce voting restrictions). With some exceptions, intercreditor agreements are generally enforceable in cases under the Bankruptcy Code.

3.3 Injection of New Money

Out-of-court restructuring agreements may provide for an infusion of new liquidity for a company. Outside of bankruptcy, existing creditors and new lenders are free to grant new loans to a company on terms that are valid under applicable non-bankruptcy law and the company's existing debt documents. If a company has unencumbered collateral, it may pledge that collateral to existing lenders in exchange for new money loans. If substantially all of a company's assets already are encumbered by liens, existing lenders may offer new credit to a company under new loan agreements (novations) or amended terms of existing agreements. New money lenders may agree to the "take out" of existing debt owed to existing creditors using new loan proceeds. Negotiations between and among financial creditors typically influence and determine the terms of any new money credit extended to a company.

If a dissenting minority of creditors refuse to agree to out-of-court restructuring terms, the company may commence a pre-packaged or pre-negotiated chapter 11 bankruptcy case to bind the dissenters and obtain new money debtor-in-possession financing ("DIP Financing"). A bankruptcy court approved DIP Financing may be preferred or required by new lenders who are prepared to offer new credit to a financially distressed company. Bankruptcy Code section 364 authorises a chapter 11 debtor-in-possession to obtain DIP Financing. See **6.10 Availability of Priority New Money**.

3.4 Duties of Creditors to Each Other, or on the Company or Third Parties

A creditor's legal duties to a company are typically defined contractually by the terms of the agreement between the parties. Contracts or agreements may require a creditor to disclose to a company when the creditor has undertaken certain actions or when certain events have taken place. Creditors are also bound by laws in the applicable jurisdiction regarding, among other things, fraud, tortious interference with a business relationship, and the exercise of certain remedies including foreclosures.

Generally, creditors owe no fiduciary duties to each other or to the company, and are free to act in their own self-interest even if doing so disadvantages other creditors or the company. However, in rare cases, a creditor's misconduct may cause its claim to be "equitably subordinated" in bankruptcy. Equitable subordination means that, as a matter of equity, a court orders lower priority claims to recover ahead of a claim held by the creditor who has acted inequitably. A creditor does not risk having its claim equitably subordinated by simply pursuing its own self-interest to the detriment of others. Equitable subordination is appropriate only if a creditor's conduct has resulted in an inequitable injury to other parties.

More commonly in the case of creditor misconduct, and instead of equitably subordinating creditor's claims, a bankruptcy court may preclude ("designate") the creditor's ability to vote on a plan of reorganisation. Courts have deemed vote designation appropriate when a creditor has acted out of pure malice to disadvantage a debtor or other creditors, or when the creditor attempts to put a debtor company out of business.

Non-bankruptcy, state law fiduciary duties of a director or officer of a company in bankruptcy continue to apply during an out-of-court restructuring as well as after a company commences at chapter 11 case. In bankruptcy, trustee-like fiduciary duties may apply to directors and officers of the debtors, and the Bankruptcy Code imposes statutory duties and obligations on a debtor-in-possession and bankruptcy trustees. See L1. Duties owed to and by creditors are primarily contractual.

3.5 Consensual, Agreed Out-of-Court Financial Restructuring or Workout

Out-of-court financial restructurings are fundamentally consensual and contractual in nature. Accordingly, out-of-court restructurings are implemented without judicial intervention or approval, pursuant to the contractual terms of multi-party agreements between and among the company, significant creditors, and other key stakeholders.

Out-of-court financial restructuring agreements may take many forms, all dependent on the unique circumstances of the particular situation. For instance, existing financial obligations of the company may be modified, reduced, eliminated or refinanced; the company and its lenders may agree to issue new equity in return for the cancellation or modification of existing indebtedness; and new money lenders may provide new credit facilities.

A financial restructuring may require commencement of a pre-packaged or a pre-negotiated chapter 11 bankruptcy case in order to bind dissenting creditors to otherwise agreed terms of a restructuring. If there are creditors, equity holders or other parties who might refuse to accept out-of-court restructuring terms, the company may propose, negotiate and agree pre-bankruptcy to commence a 'back-up' pre-packaged or pre-negotiated bankruptcy case, if necessary, to implement and effectuate restructuring terms over minority dissenters.

In a pre-packaged bankruptcy case, the debtor company commences a chapter 11 case after drafting a plan of reorganisation, and soliciting (and receiving) votes of creditor acceptance of the plan. Unlike out-of-court restructurings that require unanimous or near-unanimous creditor support, a debtor does not need creditors to unanimously accept its chapter 11 plan. Instead, only a majority in number of voting holders of claims that hold 2/3 of the dollar amount of debt voted in a class are needed to confirm a bankruptcy plan. Pre-packaged chapter 11 cases usually result in predictable and quick bankruptcy restructurings, with a chapter 11 plan confirmed quickly, sometimes in less than a few weeks, because needed votes accepting the plan are obtained prior to commencement of bankruptcy.

Before commencing a pre-packaged bankruptcy case, the debtor company and its supporting creditors typically will execute a restructuring support agreement ("RSA"). An RSA is generally enforceable in bankruptcy and binds the debtor company and certain of its creditors to agreed terms of a bankruptcy restructuring. Creditors who are signatory to an RSA will agree to support the terms of the chapter 11 reorganisation plan contemplated by the RSA.

A pre-negotiated bankruptcy is similar to a pre-pack, except that there may not be complete agreement by all voting classes of creditors on the terms of the chapter 11 plan when the debtor files its bankruptcy petition. In a pre-negotiated bankruptcy, supporting parties may sign an RSA prior to the bankruptcy filing or shortly thereafter. However, in this context, creditor agreements to an RSA do not constitute votes of acceptance of a plan; instead a solicitation of votes requires bankruptcy court-approved solicitation and disclosure documents. Often, a debtor will not have a finalized RSA when it files a pre-negotiated bankruptcy. Although pre-negotiated bankruptcies may be speedy and last only a few months, the lack of complete restructuring agreements and an agreed chapter 11 plan at the time of filing creates additional risks and uncertainties.

4. Secured Creditor Rights and Remedies

4.1 Type of Liens/Security Taken by Secured Creditors

A secured creditor is a creditor that has a right to payment against a borrower-obligor-debtor that is secured by a lien on or security interest in debtor property (collateral). Such liens and security interests, which may be granted contractually, judicially or by operation of law, are secured creditor property interests in debtor property that is the collateral of a secured creditor.

Generally, non-bankruptcy law governs the priority, extent and enforceability of such liens and security interests, and how and when a secured creditor may enforce its right to payment against its collateral if the debtor obligor does not meet its payment obligation. The priority among secured creditors with liens on the same collateral usually depends upon the point in time when each creditor perfects its liens. Creditors who perfect their liens first typically have first priority rights over later-perfected secured creditors with respect to any proceeds of collateral that is subject to competing secured creditor liens.

Under the Bankruptcy Code, a claim is secured to the extent of the value of the secured creditor's interest in the estate's interest in collateral property. 11 U.S.C. § 506(a). Generally, outside of an insolvency process, secured creditors are able to enforce payment of an obligation by foreclosing on collateral. In bankruptcy, limits are placed on a secured creditor's ability to enforce its liens and security interests and recover on its collateral. In the event of bankruptcy, a secured creditor who has not perfected its liens or security interests before bankruptcy will be treated as an unsecured creditor in bankruptcy.

A creditor's security can take a variety of forms. For real property, mortgages are the standard type of security taken by secured creditors. Mortgage laws and remedies are governed by the law of the state where the real property is located. Under certain state laws, there are other types of security in real estate, such as land sale contracts and deeds of trust. For personal property (or "chattels"), Article 9 of the Uniform Commercial Code (the "UCC") governs the perfection and enforcement of security interests. The UCC is not itself enacted law (it is merely a set of standardised laws produced by an outside committee of experts), but all fifty states have enacted the UCC in some form. The goal of the UCC is to create a standard set of laws across the United States that deal with the securitisation of chattels. The UCC governs a wide variety of chattels, including share pledges, debt instruments, accounts, and other intangible types of property. Additionally, creditors may become secured with real property or chattels, pursuant to court judgments, mechanics liens, tax liens, or other types of liens that arise by operation of non-bankruptcy law.

Federal statutes covering trademarks, copyrights and patents include provisions for recording certain interests in intellectual property. Each recording system differs, and the rights protected in trademarks, copyrights and patents by proper recordation also differ.

4.2 Rights and Remedies for Secured Creditors

Generally, outside of bankruptcy, each state's laws govern the rights and remedies of secured creditors. Secured creditors with mortgage liens on real property collateral may, upon a default by the mortgagor, obtain a judgment in court, foreclose on the real property, and force a judicial sale of the property. In some jurisdictions, secured creditors may credit bid their secured claims at judicial sales of real property collateral. Alternatively, some jurisdictions allow for strict foreclosure in which a secured creditor takes ownership of the property in complete satisfaction of its debt without a judicial sale. Likewise, applicable state laws that generally are based on the UCC dictate the rights and remedies of a creditor with chattels as collateral.

Many states have their own insolvency regimes outside of federal bankruptcy law. The two most common state insolvency regimes are receiverships and assignments for the benefit of creditors ("ABCs"). See **2.2 Types of Voluntary and Involuntary Financial Restructuring, Reorganisation, Insolvency and Receivership, 7.1 Types of Statutory Voluntary and Involuntary Insolvency and Liquidation Proceedings**. Secured creditors may assert their secured claim rights in state law receivership proceedings and ABCs in accordance with applicable state law.

Under certain circumstances, secured creditors may join in filing an involuntary bankruptcy petition against a debtor to commence chapter 7 or chapter 11 proceedings under the Bankruptcy Code. Section 303 of the Bankruptcy Code fixes the requirements for an involuntary petition. See **2.6 Ability of Creditors to Commence Insolvency Proceedings.**

When a voluntary bankruptcy petition commences, or an order for relief has been granted on an involuntary bankruptcy petition, the Bankruptcy Code's section 362 "automatic stay" takes effect and automatically stays the commencement or continuation of all creditor actions, including secured creditor actions, to collect on a debt that the debtor owes a creditor. Absent a bankruptcy court order granting a secured creditor relief from the automatic stay, the secured creditor cannot exercise creditor remedies otherwise available to it under non-bankruptcy law. In short, bankruptcy constrains secured creditors from asserting their claims and enforcing their liens and security interests without further order of the bankruptcy court.

In chapter 7 liquidation cases, validly perfected secured creditors have paramount "adequate protection" rights under the Bankruptcy Code protecting their prepetition liens and security interests, and first priority rights to payment out of the proceeds of their collateral. This gives secured creditors strong leverage against chapter 7 trustees who as a practical matter usually cannot use collateral of secured creditors without their consent. However, a debtor or trustee may surcharge collateral for the necessary costs of preserving or disposing of collateral. 11 U.S.C. § 506(c).

In a chapter 11 reorganisation case, large secured creditors may have significant opportunity to influence the progress and outcome of a chapter 11 case and the terms of a plan of reorganisation. Senior secured funded debt creditors with paramount liens and adequate protection rights often may dictate or block debtor-in-possession financing terms, or provide such financing themselves, and require the debtor to meet case progress milestones as a condition to new financing and use of secured creditor cash collateral.

Confirmation of a chapter 11 plan requires that a secured creditor be paid in full before other creditors are paid, or it must consent to the plan or, alternatively, receive either its collateral, the proceeds from a sale of its collateral in which it will have the opportunity to credit bid its secured claim, or a new claim against the reorganized debtor that is secured by the same collateral that secures the creditor's prepetition secured claim. 11 U.S.C. § 1129(b)(2)(A).

4.3 The Typical Time-lines for Enforcing a Secured Claim and Lien/Security

Secured creditors may be entitled to relief from the automatic stay if, for instance, their liens and security interests are not adequately protected during a bankruptcy case. See **4.5 Special Procedural Protections and Rights for Secured Creditors.** Absent a judicial order modifying or granting relief from the section 362 automatic stay, the stay remains in effect until a bankruptcy case is closed or dismissed, thereby preventing a secured creditor's unilateral enforcement of its claims and liens against debtor property that is the secured creditor's collateral. The length of a bankruptcy case may vary from a few months (in a prenegotiated or prepackaged chapter 11 case) to years, depending on the case.

4.4 Special Procedures or Impediments That Apply to Foreign Secured Creditors

Similarly situated creditors in a case under the Bankruptcy Code are treated alike. Therefore, foreign secured creditors typically receive no greater or lesser rights, protections, or impediments than domestic U.S. secured creditors. As a practical matter, enforcement of the automatic stay against a foreign secured creditor that has no connections in the U.S. may be difficult.

4.5 Special Procedural Protections and Rights for Secured Creditors

Applicable state laws give secured creditors high priority rights to payment in state law receivership proceedings and ABCs. In chapter 7 and 11 cases under the Bankruptcy Code, secured creditors have the following rights, among others:

Adequate protection rights. Secured creditors are entitled to and may seek "adequate protection" of their liens and security interests in debtor property to protect against any diminution in value of their interests in collateral that might occur during a chapter 11 case with the passage of time or as a result of use of the collateral property or the imposition of postpetition financing liens on the property. Adequate protection can take many forms, including periodic cash payments to a secured creditor (usually in the amount of post-petition interest that would otherwise be payable), granting the secured creditor replacement liens on other debtor property, or other protections. The general purpose of adequate protection is to protect the value of a secured creditor's lien interest in debtor property, and to compensate the secured creditor for any reduction in value of its collateral after the commencement of a bankruptcy case. For instance, section 363(e) of the Bankruptcy Code provides that on request of a secured creditor, the bankruptcy court shall "prohibit or condition" any use, sale or lease of property "as is necessary to provide adequate protection" of the secured creditor's interest in such property. Also, section 363(c) prohibits debtor use of a secured creditor's "cash collateral" (i.e., cash, negotiable instruments, securities, deposit accounts, etc., of the debtor in which the secured creditor has a security interest) without the secured creditor's consent or a court order authorising such use. Section 364(d) provides that a bankruptcy court may authorise postpetition loans and financings that are secured by a senior or equal lien on property of the estate that is subject to a secured creditor's preexisting lien only if there is adequate protection of the preexisting lien.

Relief from Automatic Stay. Section 362(d) of the Bankruptcy Code gives secured creditors rights to seek a bankruptcy court order granting the secured creditor relief from the section 362 automatic stay to exercise remedies against secured creditor collateral. A bankruptcy court may lift or modify the automatic stay (i) "for cause", including "the lack of adequate protection" of the secured creditor's lien interest in debtor property; (ii) if the debtor "does not have an equity" in the property that is subject to the secured creditor's lien, and such property "is not necessary to an effective reorganisation;" or (iii) the filing of the bankruptcy petition "was part of a scheme to delay, hinder or defraud creditors" involving a transfer of the secured creditor's real property collateral.

Cram-Down Treatment Rights. A secured creditor that is not to be paid in full under the terms of a chapter 11 plan when it goes effective, and that does not vote to accept the chapter 11 plan, has enforceable rights to require that the plan proponent demonstrate that the proposed plan either (a) makes full payment on the allowed amount of the secured claim with deferred payments (with a market interest rate) equal to the present value of the secured claim, (b) sells the secured creditors' collateral free and clear of the secured creditor's liens, with a new lien attaching to the proceeds, at a sale which provides the secured creditor with an opportunity to credit bid or (c) provides the secured creditor with the "indubitable equivalent" of the allowed amount of its secured claim. 11 U.S.C. § 1129(b)(2)(A). The "indubitable equivalent" standard requires that the secured creditor receive the equivalent of the secured amount of its claim or the value of its collateral by, for example, cash payments being made to the secured creditor equal to the allowed amount of its claim, abandoning the collateral back to the secured creditor, or granting the secured creditor a substitute lien on collateral of the same or greater value.

5. Unsecured Creditor Rights, Remedies and Priorities

5.1 Differing Rights and Priorities Among Classes of Secured and Unsecured Creditors

A creditor is unsecured when it holds no interest (no lien or security interest) in a debtor's property against which the creditor may seek enforcement of the debtor's payment or performance obligations. Generally, outside bankruptcy, if a debtor fails to pay or perform or otherwise defaults on an unsecured obligation, an unsecured creditor seeking to collect the debt owed must commence a civil action and seek a court judgment awarding it monetary damages against the debtor. If the debtor enters bankruptcy, unsecured creditors may assert their unsecured claims only as permitted by the Bankruptcy Code and any applicable bankruptcy court order; are entitled to participate and be heard in the bankruptcy process; and may recover on their claims to the extent distributions are made to unsecured creditors.

Outside of bankruptcy, an unsecured creditor must file a lawsuit against a debtor who refuses to pay, to obtain a money judgment against the debtor for the debt owed. If the judgment amount is not paid by the debtor, the creditor may record its judgment in accordance with applicable non-bankruptcy law to obtain a judgment lien that, in turn, can be enforced against the debtor's property. A judgment lien creditor is a secured creditor to the extent its judgment lien attaches to debtor property. A bankruptcy filing by a debtor typically stays all creditor collection efforts and state law judgment enforcement activities.

Outside of bankruptcy, applicable state laws control the priority of payment rights of creditors, and such laws may vary across jurisdictions. Typically, secured creditors have priority over unsecured creditors.

In bankruptcy, the rights of particular unsecured creditors are generally determined by their place in the Bankruptcy Code's payment priority scheme. In a chapter 7 bankruptcy case, unsecured creditor rights to payments on their claims are dictated by the strict statutory priority scheme set by section 726 of the Bankruptcy Code. Various classes of creditor claims have descending priority over holders of stock or other equity ownership interests. In a chapter 11 case, creditor payment rights are set by the terms of a plan of reorganisation or liquidation confirmed by the bankruptcy court that are, in turn, governed by the Bankruptcy Code's priority scheme. The Bankruptcy Code's hierarchical creditor priority scheme, in descending order of priority, is as follows:

- secured claims
- administrative expense claims
- priority unsecured claims
- general unsecured claims
- subordinated claims

Secured creditors have first and most senior priority to payment in bankruptcy, to the extent of the value of their collateral. Creditors can be both secured and unsecured. If a secured creditor's claim (a right to payment) is greater than the value of its collateral (i.e., the claim is "undersecured"), then the creditor will have two separate claims: a secured claim equal to the value of the collateral and an unsecured claim for the "deficiency" in collateral value. 11 U.S.C. § 506(a). A perfected secured creditor's claim is entitled to first priority payment rights to the proceeds of its collateral, but has no priority rights to payment of proceeds of assets of the debtor's estate that are not subject to the secured creditor's lien.

An administrative expense claim has a payment priority junior to secured claims and senior to other unsecured claims. Administrative expense claims are, generally, claims for costs, expenses and other postpetition obligations incurred by a debtor's estate following the filing of a bankruptcy petition that constitute "actual and necessary" costs of preserving the estate. Administrative expenses include, among other things, postpetition ordinary course operating expenses, postpetition financing costs and repayment obligations, and bankruptcy professional fees. See **5.9 Priority Claims**.

A general unsecured claim is a debt or other obligation owed by the debtor that arose prior to the petition date that is not secured by a lien or security interest. The general rule is that all prepetition general unsecured claims are generally entitled to equivalent bankruptcy treatment and the same payment priority, but there are statutory exceptions to the rule.

Section 507 of the Bankruptcy Code provides enhanced statutory priority for certain types of prepetition unsecured claims that are entitled to payment in full before lower ranked general unsecured claims receive a distribution. For instance, certain types of unsecured tax claims and certain employee wage claims and employee benefit claims (up to certain dollar amounts) are entitled to statutory enhanced priority.

Section 510 of the Bankruptcy Code provides that particular claims may be subordinated to general unsecured claims. For instance, a contractual subordination agreement entered into between creditors before the bankruptcy case will generally continue to be enforceable during the bankruptcy case as between the creditor parties to the agreement. Section 510 also provides that claims for damages arising from the purchase or sale of securities are subordinated to all claims that are senior to or equal to the claim or interest represented by the security. Also, claims of creditors that engage in "inequitable" conduct may be subordinated to other claims by order of the bankruptcy court.

5.2 Unsecured Trade Creditors

Unsecured prepetition trade claims generally are entitled to no higher priority or better treatment than other general unsecured claims. However, in bankruptcy cases, Bankruptcy Code section 503(b)(9) grants administrative expense priority to claims of prepetition unsecured trade creditors arising out of their delivery of goods to the debtor within 20 days of a bankruptcy filing, up to the value of the goods delivered during that time period.

Trade creditors may also receive full or substantially full payment on their prepetition unsecured claims in bankruptcy if such trade creditors are determined by court order to be "critical vendors" of the debtor. Generally, critical vendors are those who provide unique goods or essential services to the debtor, and are irreplaceable vendors. Before a debtor or its bankruptcy trustee may pay prepetition claims of critical vendors, the debtor must obtain a bankruptcy court order authorising such payments. Motions seeking critical vendor payment orders typically are filed and granted early in a chapter 11 case.

Another way unsecured trade creditors may receive full or substantially full payment of their claims under a chapter 11 plan is if their claims qualify as "convenience class" claims under the plan. Typically, convenience class claims are a separately classified class of smaller unsecured claims that receive payment in full under a chapter 11 plan for ease of administration of the plan. Whether a particular chapter 11 plan includes a convenience class and the size range of claims in that class varies on a case-by-case basis.

Trade creditors who deliver goods and services during a bankruptcy case hold administrative expense priority claims that are usually paid by the debtor in the ordinary course of business during a chapter 11 case. Such claims are entitled to payment in full under a confirmed chapter 11 plan.

5.3 Rights and Remedies of Unsecured Creditors

Unsecured creditors have the right to file an involuntary bankruptcy petition commencing an involuntary chapter 7 or 11 case against a debtor if the requirements of Bankruptcy Code section 303 are met. See **2.6 Ability of Creditors to Commence Insolvency Proceedings** Upon commencement of a bankruptcy case, however, the "automatic stay" of section 362 of the Bankruptcy Code takes effect, preventing creditors from asserting their non-bankruptcy rights and remedies. See **6.2 Position of the Company During Procedures.**

Unsecured creditors and other parties-in-interest in a bankruptcy case may, in certain circumstances, move the bankruptcy court to dismiss a voluntary bankruptcy petition "for cause." Such cause may include unreasonable delays by the debtor, its failure to pay certain fees, or its failure to file schedules. Also, in some jurisdictions, creditors may seek dismissal of a bankruptcy case if it was filed in "bad faith" (relevant factors include a debtor's lack of truthfulness with the court, lack of efforts to pay back creditors, and improper management of the estate). Likewise, in some circumstances unsecured creditors may seek to convert a chapter 11 case to a chapter 7 liquidation case pursuant to section 1112(b) of the Bankruptcy Code.

After a bankruptcy case has been properly commenced, unsecured creditors have rights to assert their claims by filing proofs of claim in the manner and before deadlines set by the bankruptcy court and applicable provisions of the Bankruptcy Code and related rules. Individually, unsecured creditors are parties in interest in a bankruptcy case with standing to participate and be heard in the proceedings. Unsecured creditors may, among other things, file motions seeking judicial relief, object to motions filed by other parties, and object to confirmation of a proposed chapter 11 plan. Unless a chapter 11 plan provides for payment in full of unsecured creditor claims (or provides for no distribution to such creditors), unsecured creditors have the right to vote to accept or reject the plan.

In practice, most rank and file smaller unsecured creditors have little direct involvement in a chapter 11 case. The interests of general unsecured creditors are represented by an official committee of unsecured creditors whose members are selected and appointed by the U.S. Trustee to represent the class of unsecured creditors as a whole. The members of the official unsecured creditors' committee are usually the largest unsecured creditors.

An official committee of unsecured creditors appointed to act on behalf of the interests of all unsecured creditors owes fiduciary duties to all unsecured creditors, and is authorised to employ committee legal counsel and financial consultants. The official committee typically plays an active role in a chapter 11 case, has standing to be heard on all matters, and may take positions adverse to the debtor, secured creditors and other parties in interest, and may object to confirmation of a chapter 11 plan, if the official committee and its advisors believe the plan is not in the best interests of unsecured creditors. Official committees representing unsecured creditors negotiate and often litigate to obtain the best recovery to unsecured creditors possible under the circumstances. A bankruptcy court may give standing to an official committee to commence estate causes of action against third parties including lien avoidance actions against secured creditors.

5.4 Pre-Judgment Attachments

Prior to a bankruptcy filing, an unpaid unsecured creditor may proceed in state court to seek a pre-judgment attachment of debtor property. Pre-judgment attachments are governed by state laws that vary by jurisdiction. Pre-judgment attachments allow an unsecured creditor to simultaneously preserve its rights against debtor property at the same time the creditor proceeds with a civil action to obtain a monetary judgement against the debtor, so that the creditor can collect against the debtor's property on a judgment for unpaid amounts due and owing. Under many state laws, a pre-judgment attachment remedy is only available if the creditor shows that the debtor is attempting to evade the creditor's judgment by moving or hiding property. Once a bankruptcy case has been filed, the Bankruptcy Code's section 362 "automatic stay" prevents pre-judgment attachments and other judgment enforcement actions.

5.5 Typical Timeline for Enforcing an Unsecured Claim

The time it takes to enforce unsecured claims varies depending on particular circumstances, applicable state laws and whether (or not) debtor bankruptcy cases have commenced. Before commencement of bankruptcy and the concomitant imposition of the section 362 automatic stay of creditor collection actions, state law will govern creditor collection efforts. The length of time it takes a creditor to collect on a debt outside bankruptcy will generally depend on the time required to obtain and then file a judgment. Collection time frames may be longer if the creditor's claim is disputed.

In chapter 7 or 11 bankruptcy cases, unsecured creditors generally must wait for the conclusion of the bankruptcy case to be paid in whole, or in part, or not to be paid at all—depending on what assets (if any) are available for distribution to unsecured creditors. The duration of bankruptcy cases varies greatly from case to case. Usually, an unsecured creditor must file a proof of clam in the bankruptcy case before the court-ordered claims bar date in order to retain its right to collect any payment on account of its claim. In a chapter 11 case, if the debtor has scheduled a creditor's claim in the proper amount and not listed it as contingent, unliquidated, or disputed, the creditor will not need to file a proof of claim. In cases where a creditor files a proof of claim, the debtor in possession, trustee, plan administrator or other parties in interest may object to the creditor's claim during a claims reconciliation process. If an objection is filed, the unsecured creditor may be required to defend and substantiate its claim in a hearing before the bankruptcy court.

Bankruptcy court orders in chapter 11 cases may authorise earlier payment of certain types of prepetition unsecured claims. However, the general rule in chapter 11 is that general unsecured claims are treated and paid as provided by the terms of a confirmed chapter 11 plan of reorganisation or liquidation.

5.6 Bespoke Rights or Remedies for Landlords

A landlord-lessor's rights and remedies as a creditor against its tenant under a lease depend on whether the tenant-lessee has commenced bankruptcy. Outside of bankruptcy, when a lessee defaults and fails to pay amounts owed under a lease, the landlord may assert its claims for unpaid rent or other charges, and commence an eviction proceeding against the lessee, all in accordance with applicable state law.

Upon commencement of a lessee bankruptcy, the section 362 automatic stay will halt landlord eviction and collection actions against the lessee-debtor. However, the Bankruptcy Code generally requires a debtor to assume or reject its obligations under an unexpired lease within 120 days of the bankruptcy petition date. This deadline may be extended an additional 90 days by court order upon a showing of cause. If the bankruptcy court grants such an extension, the court may grant a further extension only upon prior written consent of the lessor.

In bankruptcy, a landlord-lessor's claim for unpaid prepetition rent is a general unsecured claim. However, the debtor may "assume" or "reject" lessor's lease pursuant to section 365 of the Bankruptcy Code. See **6.13 The Ability to Reject or Disclaim Contracts**. If the lease is assumed, the lessor's prepetition claim and all other claims of the lessor under the lease are entitled to administrative expense priority treatment and must be paid in full. If the debtor rejects its obligations under the lease, the lessor's prepetition claim remains a general unsecured claim and the lessor may file a claim for damages resulting from the rejection. Such a rejection damages claim is capped at the greater of the rent reserved by such lease for a year or 15% of the remaining lease term, not to exceed three years. 11 U.S.C. § 502(b)(6). Generally, any claim for rent payable during the pendency of the bankruptcy case when the debtor occupies the property is entitled to an administrative expense priority claim.

5.7 Special Procedures or Impediments or Protections That Apply to Foreign Creditors

Generally, in the United States similarly situated creditors are treated alike. In bankruptcy, foreign creditors, whether secured or unsecured, typically encounter no different or special legal protections or impediments than similarly situated domestic U.S. creditors. The treatment of a foreign creditor's claim depends on the type of its claim, not the foreign status of the creditor.

5.8 The Statutory Waterfall of Claims

A liquidation can occur either under chapter 7 or chapter 11 of the Bankruptcy Code, or in receivership, ABC or dissolution proceedings governed by state law. See **7 Statutory Insolvency and Liquidation Proceedings**. State laws that vary from state to state govern payment priority waterfalls in such state law proceedings.

Liquidation distributions in chapter 7 cases are governed by the statutory claims priority scheme set by section 726 of the Bankruptcy Code. In the event of a chapter 7 liquidation, claims are paid in descending order of priority, with the highest priority creditors receiving payment first. Generally, each higher priority class of claims must be paid in full before a junior class receives any payment or other distribution of value.

Under a chapter 11 plan of liquidation, the waterfall of distributions to creditors will be fixed by the terms of the confirmed plan and need not comply strictly with the section 726 priority scheme.

5.9 Priority Claims

Under the Bankruptcy Code, unsecured administrative expense claims are entitled to first priority in payment after secured creditor claims are paid out of the proceeds of their secured creditor collateral. A confirmed chapter 11 plan must provide for payment in full of administrative expense claims unless holders of such claims agree to different treatment. Such administrative expense claims are claims for "the actual, necessary costs of preserving the estate." Administrative priority expenses include postpetition operating expenses such as postpetition wages, taxes and amounts payable to trade creditors who have supplied goods and services during the bankruptcy case, bankruptcy court approved professional fees and, generally, amounts owing to lenders and other creditors who have extended new money financings or trade credit to a debtor during a bankruptcy case.

Lesser priority unsecured claims receive payment after administrative expense claims, but before general unsecured claims. Common priority claims under the Bankruptcy Code are certain employee wage claims up to certain dollar amounts incurred during the 180 days prior to the bankruptcy filing, certain employee benefit program contribution claims up to a capped dollar amount, and certain tax claims.

Applicable state laws govern the priority of administrative costs, expenses and fees incurred by receivers and assignees in state law receiverships and ABCs.

5.10 Priority Over Secured Creditor Claims

Generally, first priority, validly perfected secured claims are entitled to payment out of the proceeds of the collateral securing such claims before proceeds of such collateral may be used to pay any other claims of lesser priority. In chapter 11 cases, official unsecured creditors' committees typically investigate and scrutinize secured creditor claims, liens and security interests in hopes of finding that such liens and security interests have not been properly perfected or can be avoided with bankruptcy fraudulent transfer or preference avoidance actions. If so, secured creditors may lose their secured status and be treated as unsecured creditors instead. The result may be the same in state law receiverships and ABCs where applicable state laws may give receivers and assignees rights to avoid certain liens. See **7.1 Types of Statutory Voluntary and Involuntary Insolvency and Liquidation Proceedings.**

If a bankruptcy court, pursuant to section 364 of the Bankruptcy Code, authorizes a postpetition financing to be secured by senior postpetition liens on debtor property that is already subject to liens of a prepetition secured creditor, the postpetition "priming" liens approved by the bankruptcy court will entitle the postpetition lender to have its postpetition financing secured claims paid in full out of the proceeds of the collateral subject to the priming liens before the proceeds of such collateral may be used to pay the prepetition claims of the prepetition secured creditor that has junior prepetition liens on the same property.

6. Statutory Restructurings, Rehabilitations and Reorganisations

6.1 The Statutory Process for Reaching and Effectuating a Financial Restructuring/Reorganisation

A rehabilitative financial restructuring in the United States is achieved by confirmation of a chapter 11 plan of reorganisation in a chapter 11 case under the federal U.S. Bankruptcy Code. A chapter 11 case gives a financially distressed company the opportunity to continue operating as a going concern while restructuring its balance sheet, its operations, or both. A chapter 11 case proceeds under the judicial supervision of a U.S. bankruptcy court.

A primary function of a chapter 11 case and confirmed chapter 11 plan is to bind all creditors, equity interest holders and other parties in interest to the terms of the plan and its treatment of various classes of creditors and equity interest holders. A chapter 11 reorganisation case may be the best or only strategy for restructuring a company when dissenting creditors are unwilling to agree to out-of-court terms.

Often, when minority dissenting creditors make it difficult as impossible to accomplish a fully consensual out-of-court financial restructuring of a company, a "prepackaged" chapter 11 reorganisation plan will be negotiated, fully documented and accepted by the requisite creditor majorities whose votes are solicited and obtained before commencement of a chapter 11 case. After all required votes of acceptance of the prepackaged plan are obtained, the company files a voluntary chapter 11 petition to initiate its chapter 11 case and obtain bankruptcy court confirmation of the prepackaged plan, often within weeks or little more than a month following commencement of the chapter 11 case.

A prepackaged chapter 11 case strategy binds dissenters, reduces a company's time in chapter 11, avoids high costs, possible risks and uncertainties of a protracted chapter 11 case, and typically reassures business customers, vendors, employees and other stakeholders that the company's bankruptcy will result in a speedy financial restructuring that deleverages the company's balance sheet and improves its prospects for the benefit of all stakeholders.

"Prenegotiated" chapter 11 cases also may result from out-of-court restructuring negotiations. Prenegotiated cases typically implement pre-bankruptcy restructuring agreements, but solicitation of requisite votes of acceptance of the plan of reorganisation occurs after the chapter 11 case is commenced. A solicitation of creditor votes on a chapter 11 plan during (not before commencement of) a chapter 11 case may be required when rights of diverse, unorganised classes of creditors, including general unsecured creditors, will be impaired by the terms of a chapter 11 plan. In that circumstance, a broad, public solicitation of votes on a chapter 11 plan prior to bankruptcy usually is impracticable or impossible and likely to damage going concern business operations and values.

If pre-bankruptcy restructuring negotiations fail and significant creditors begin to exercise remedies against the company or its property, or if the financially distressed company lacks liquidity needed to operate its business and continue negotiations outside of bankruptcy, it may commence a "traditional" chapter 11 reorganisation case. In a traditional chapter 11 case, the debtor company operates its business and reorganises its financial affairs under bankruptcy court supervision and protection. In chapter 11, the company may obtain postpetition debtor-in-possession financing needed for continued business operations and to pay the high costs of a chapter 11 case; begins to restructure its business operations as need be; negotiates with creditors and formulates reorganisation plan terms during the chapter 11 case; proposes and solicits creditor acceptances of a reorganisation plan; and thereafter obtains bankruptcy court confirmation of its reorganisation plan. A traditional chapter 11 reorganisation process may take months or even years.

A financially distressed company may commence a chapter 11 case by filing a voluntary chapter 11 petition in a bankruptcy court, if the company has a domicile, place of business or property in the United States. There is no requirement that the company be insolvent, but some financial distress is required for a good faith filing. Permissible objectives include preserving a business as a going concern and maximising recoveries for creditors.

A voluntary chapter 11 petition may be dismissed as a bad faith filing if, for instance, the chapter 11 filing is determined to be an abuse of judicial process, merely a litigation tactic against another party, an effort to delay legitimate efforts by secured creditors to exercise their rights, or if the filing entity has no real prospect of reorganizing.

An involuntary bankruptcy petition may be filed against a company by its creditors if the requirements of section 303 of the Bankruptcy Code are satisfied. However, involuntary chapter 11 cases are very uncommon. If an involuntary petition is dismissed as improvidently filed, costs and damages may be awarded against the petitioning creditors, as well as punitive damages if the involuntary petition is determined to have been filed in bad faith. See **2.6 Ability of Creditors to Commence Insolvency Proceedings**.

In a chapter 11 case, payments or other distributions to creditors on account of their prepetition claims generally may be made only pursuant to the terms of a confirmed chapter 11 plan that meets Bankruptcy Code requirements.

A chapter 11 plan is, effectively, a multi-party contract that resolves claims against and liabilities of the debtor entity in a manner consistent with the requirements of the Bankruptcy Code. The terms of a confirmed chapter 11 plan are binding on all creditors, equity interest holders and other parties in interest. Chapter 11 plan terms are typically the product of extensive multi-party negotiations between and among the company, senior lenders and other secured creditors, an official committee representing unsecured creditors, and other significant parties in interest including those who might purchase assets, provide funding or otherwise participate in restructuring transactions contemplated by the plan.

Under section 1123 of the Bankruptcy Code, a plan must include, among other provisions, terms that: (i) designate and define classes of claims and equity interests, specify the treatment of each class, and provide for the same treatment for each claim or interest in a particular class unless the holder of a claim or interest agrees to less favorable treatment; and (ii) provide adequate means for implementation of the plan. Plan terms may impair or leave unimpaired any class of claims or interests; provide for the assumption, rejection or assignment of executory contracts and unexpired leases; provide for the sale of property and the distribution of sale proceeds; and modify the rights of holders of secured and unsecured claims.

The chapter 11 plan process is very flexible. While the form of most chapter 11 reorganisation plans is similar, the constellation of terms of a particular plan is unique and very case specific. How a company is reorganized to improve its financial condition, what treatments various creditors receive, what will be the capital structure of the reorganized company, and numerous other issues are highly negotiated. The terms of a confirmed chapter 11 plan, to the extent accepted by voting creditor classes, may provide for distributions of value and payments to classes of creditors and equity holders that vary from their respective rights and priorities under the statutory priority scheme under section 726 of the Bankruptcy Code that applies in chapter 7 liquidation cases. See **7.1 Types of Voluntary and Involuntary Insolvency and Liquidation Proceedings**.

Numerous types of chapter 11 plan-based transactions may be used to reorganize, restructure and delever financially distressed companies. For instance, chapter 11 reorganisation plans may provide for: a conversion of certain creditor claims into equity of the reorganized company; a new money investment by old equity holders giving them continued ownership and control of the reorganized company; a refinancing of prepetition funded debt in a manner that leaves unimpaired the claims of general unsecured creditors (rank and file trade creditors, commercial counterparties, employees, etc.); a third party equity investment under the plan giving the third party ownership of the reorganized company; and sales of the company, company assets, business lines or subsidiaries.

A chapter 11 plan may be confirmed consensually with votes of acceptance by all classes entitled to vote. Confirmation of a plan requires that it be accepted by requisite majorities of creditors voting in at least one impaired creditor class, meaning a class of creditors whose claims are impaired must vote as a class to accept the plan. A class of creditors accepts a plan if it receives votes of acceptance by holders of at least two thirds in amount of the claims in such class entitled to vote who actually vote on the plan, and by more than one half in number of claimholders in the class that actually vote.

If one or more impaired creditor classes vote to accept a plan, its confirmed terms will be binding on creditors in accepting classes, and also on all creditors and equity interest holders in non-accepting classes. A plan's terms can be "crammed down" on dissenting creditor and equity classes if the Bankruptcy Code's section 1129(b) cram-down requirements are met. See **6.4 Modification of Claim**.

A chapter 11 company, as a debtor-in-possession or "DIP", may file a chapter 11 plan at any time during its chapter 11 case. Typically, a plan confirmation process will take at least 60 days or longer after a proposed chapter 11 plan has been negotiated, documented and filed. A chapter 11 debtor has the exclusive right to propose a chapter 11 plan for the first 120 days of its chapter 11 case, and this exclusive period may be extended for up to a maximum of 18 months after the commencement of the chapter 11 case. After a non-prepackaged plan is filed and proposed in a chapter 11 case and before the plan proponent may solicit votes of acceptance of its plan, the proponent must obtain, on at least 28 days' notice, bankruptcy court approval of a disclosure statement that must provide "adequate information" to those entitled to vote on the plan about the chapter 11 case, the plan and their treatment under the plan. 11 U.S.C. § 1125. After bankruptcy court approval thereof, the disclosure statement may be used to solicit votes of acceptance of the proposed plan. A minimum of 28 days' notice must be given of the deadline to file objections to confirmation of a proposed chapter 11 plan, which deadline may occur shortly before a hearing during which the court will determine whether the plan satisfies all Bankruptcy Code confirmation requirements.

In a "prepackaged" chapter 11 case, the prepackaged plan is typically filed simultaneously with the voluntary petition commencing the debtor company's chapter 11 case. A prepackaged plan may be confirmed very quickly (within 30 days or less) because votes of acceptance of a prepackaged plan are solicited before the chapter 11 case.

A chapter 11 case is a transparent and open judicial process. Generally, court papers filed in the chapter 11 case, as well as schedules, statements of financial affairs and other required reports and information are all public. A chapter 11 company must file public motions seeking court approval of all sales and other transactions outside the ordinary course of business, and such motion papers will detail the proposed transactions. Upon a motion requesting confidential treatment of specific information, a bankruptcy court may enter an order "sealing" documents that contain sensitive commercial, private or other information. If there is an objection to a motion to seal, the bankruptcy court will consider the objection and decide the motion after a hearing. Parties in interest who demonstrate a legitimate reason for accessing sealed information typically may do so if they agree to sign confidentiality agreements.

A chapter 11 debtor files early in its case a statement of financial affairs and schedules of assets and liabilities listing debtor's properties, bank accounts, contracts and leases, litigations, and other information identifying pre-bankruptcy transactions and payments to creditors and insiders. The schedules include a listing of known creditors and their respective claims.

The schedules of claims prepared and filed by a debtor are the basis for chapter 11 claims recognition. Claims are defined broadly under the Bankruptcy Code. The schedules of claims indicate whether particular claims are liquidated or unliquidated, contingent and/or disputed. After a debtor files its schedules, as well as its statements of financial affairs, the court orders a deadline and procedure for creditors to file proofs of claim. Fed. R. Bankr. P. 3003(c). Usually the court-approved claims filing deadline (also known as a claims "bar date") is approximately 45–60 days following the publication and mailing of notice of the deadline to known creditors. Unless a particular claim has been scheduled by a debtor as undisputed, non-contingent and liquidated in amount, a creditor must timely file a proof of claim to preserve its claim. A timely proof of claim also must be filed by a creditor who disputes the scheduled amount of its claim or whose claim has not been scheduled. Untimely proofs of claim may be barred by the bankruptcy court's claims bar date order. A proof of claim is deemed filed for any claim that is scheduled as non-disputed, non-contingent, and liquidated. 11 U.S.C. § 1111(a).

After the proof of claim deadline, the debtor assesses filed claims and the claims register to classify claims for chapter 11 plan purposes. Claims of similar type are classified together in classes of "substantially similar" claims for chapter 11 plan treatment and voting purposes. 11 U.S.C. § 1122. When a class is unimpaired under the plan - - meaning the rights of holders of claims or equity interests in the class will not be changed or impaired by the plan - - such class is deemed to accept the plan and class members do not vote. Likewise, if a plan provides that a particular class retains no rights and receives no value, the class is deemed to have rejected the plan without any solicitation of votes of that class. Contingent, unliquidated and disputed claims may be estimated by the bankruptcy court for purposes of voting on and confirming a plan.

Filed claims are deemed allowed by the Bankruptcy Code unless and until objected to by a party in interest. 11 U.S.C. § 502(a). If an objection to a claim is filed, the bankruptcy court will enter an order allowing or disallowing the claim in whole or part after notice and an evidentiary hearing at which the claimant and objector may litigate the merits of the claim. 11 U.S.C. § 502(b). The claims allowance/disallowance process in chapter 11 cases (otherwise known as "claims reconciliation process") usually occurs following confirmation and consummation of a chapter 11 plan. Disputed larger claims may be contested and allowed, disallowed or estimated by the bankruptcy court prior to or during a plan confirmation process.

After votes have been solicited and obtained from classes entitled to vote on a plan, and the deadline for filing objections to confirmation of a chapter 11 plan has passed, the bankruptcy court holds an evidentiary hearing on confirmation of the plan. At the confirmation hearing, the plan proponent (most often the chapter 11 company) must show that required acceptances of the plan have been received and that the plan satisfies all of the requirements of the Bankruptcy Code, including that the plan contains all plan provisions required by section 1123(a) and meets the numerous section 1129 confirmation requirements, including cram-down requirements under section 1129(b) if relevant. See **6.12 Restructuring or Reorganisation Plan or Agreement Among Creditors**.

The bankruptcy court will consider and sustain or overrule confirmation objections. Plan proponents and objectors may use expert testimony to establish or challenge feasibility, valuations or other matters that are disputed plan confirmation issues. If the court decides to confirm a plan, it will enter an order with findings of fact and conclusions of law that all Bankruptcy Code confirmation requirements have been satisfied. Plan objectors sometimes appeal confirmation orders, but appeals may become moot if the appellant does not obtain a stay of the confirmation order before a plan is substantially consummated.

Following confirmation and consummation of a chapter 11 plan, the reorganised company must perform its obligations and effectuate the transactions the plan contemplates, including the plan's treatments of various classes of creditors and equity interests. 11 U.S.C. § 1142(a). A confirmation order typically discharges the pre-petition claims and liabilities of a debtor, and includes plan-based injunctions against post-confirmation actions by creditors and other parties in interest that are inconsistent with the confirmed plan.

Upon the effective date of the plan (which occurs when the plan is substantially consummated), the chapter 11 debtor emerges from bankruptcy as a "reorganised debtor." Payments to be made on the effective date and thereafter are made in accordance with the plan's terms. Chapter 11 cases may continue for purposes of making periodic distributions to creditors, reconciling and resolving disputed and unliquidated claims, adjudicating litigated matters, and otherwise resolving disputes concerning implantation of the plan.

6.2 Position of the Company During Procedures

Upon the filing of a voluntary chapter 11 petition by a debtor, the company automatically is authorised (without need for court approval) to proceed in bankruptcy as a "debtor-in-possession" (or "DIP") and may continue to operate its business. 11 U.S.C. § 1108. As a DIP, the chapter 11 company's internal governance and management continues under applicable non-bankruptcy law. The DIP company's incumbent managers, directors and officers continue to manage the company's business and properties, and perform the DIP's duties under the Bankruptcy Code.

No bankruptcy court approvals are required for ordinary course business transactions, including ordinary course property uses and sales, and the incurrence of ordinary course unsecured debt (such as trade credit). However, the use, lease or sale of property outside the ordinary course of business requires bankruptcy court approval. 11 U.S.C. § 363. See F7, F8, G2. If the chapter 11 company needs to obtain credit and incur debt outside the ordinary course of business, it may do so only with bankruptcy court approval. 11 U.S.C. § 364. See **6.10 Availability of Priority New Money**.

In circumstances typically involving fraud, dishonesty or gross mismanagement of the affairs of the debtor by its current management before or during the chapter 11 case, the bankruptcy court may appoint a chapter 11 trustee to displace the DIP and incumbent management, and to take control of the debtor's property and business. 11 U.S.C. § 1104(a). If a chapter 11 trustee has not been appointed, the court may appoint an "examiner" to investigate the debtor, its management and affairs as appropriate, and may grant an examiner expanded powers to perform chapter 11 duties that the court orders a DIP not to perform. 11 U.S.C. §§ 1104(c), 1106(b).

The Bankruptcy Code specifies the rights, functions and duties of a chapter 11 DIP company, including duties to: file a list of creditors, file schedules of assets and liabilities, current income and expenditures; file a statement of financial affairs; account for all of the company's property; examine proofs of claim and object to their allowance as appropriate; furnish information requested by parties in interest, unless the court orders otherwise; file a chapter 11 plan as soon as practicable; and file reports that the bankruptcy court orders. 11 U.S.C. §§ 521, 1107, 1108. Filed schedules and statements identify known creditors and whether their claims are liquidated, contingent or disputed; identify the company's contracts and leases; identify pre-bankruptcy transfers and payments to creditors, insiders and third parties; and provide other significant information about the debtor's financial and legal affairs.

During a chapter 11 case, the debtor company is protected by the "automatic stay" of section 362 of the Bankruptcy Code. The automatic stay applies very broadly in any chapter 11 or 7 bankruptcy case to protect a debtor and its properties against unilateral creditor actions and other interferences with estate property. The stay gives a chapter 11 debtor company an opportunity to stabilize its business and affairs, negotiate with creditors and other stakeholders, and formulate and propose a chapter 11 plan of reorganisation. Upon the filing of a chapter 11 petition, the section 362 stay applies globally, automatically and generally to all persons and entities to prohibit: the commencement or continuation of any action or proceeding against the debtor or estate property that seeks to collect or recover on, a claim against the debtor that arose before the commencement of the bankruptcy case; the enforcement of prepetition judgments against the debtor or estate property; any act to exercise control over or obtain possession of estate property, or to create, perfect or enforce any lien against estate property; the setoff of any prepetition debt owing to the debtor against any claim against the debtor; and the commencement or continuation of any proceeding concerning the debtor before the United States Tax Court. 11 U.S.C. § 362(a).

There are numerous statutory exceptions to the scope of the automatic stay. For instance, it does not stay the commencement or continuation of a criminal action or proceeding against the debtor, or certain other police, regulatory and governmental acts. 11 U.S.C. § 362(b).

Willful violations of the automatic stay may result in bankruptcy court sanctions, damages awards and punitive damages. However, relief from the automatic stay may be granted. On request of a party in interest, a bankruptcy court "shall grant relief from the stay" after notice and a hearing "for cause" in a variety of circumstances including, for instance, the lack of adequate protection of a creditor's interest in estate property; with respect to the stay of an act against estate property, if the debtor does not have equity in such property and it is not necessary for an effective reorganisation; and with respect to a stay of an act against real property of the estate, if the filing of a bankruptcy petition was part of a scheme to delay, hinder, or defraud creditors. 11 U.S.C. § 362(d).

6.3 The Roles of Creditors During Procedures

Upon the commencement of a case under the Bankruptcy Code, all creditors (secured and unsecured) are immediately subject to the section 362 automatic stay, which prevents creditors from taking any actions against the debtor or its property to recover on a prepetition claim, to commence or continue litigation to collect on a prepetition claim, to obtain property of the debtor's estate, to enforce a prepetition judgment, or to perfect or enforce prepetition liens and security interests. The Bankruptcy Code limits the exercise of individual creditor rights, and a confirmed chapter 11 plan may modify and extinguish creditor rights. Creditors may assert their claims by filing a "proof of claim" in the bankruptcy case, in the manner and before deadlines prescribed by court orders, and bankruptcy court rules.

Individual creditors and ad hoc or other creditor groups have standing to appear and be heard in a bankruptcy case, and a bankruptcy court may permit them to intervene generally or in any specific chapter 11 matter or proceeding. Creditors employing counsel may file motions seeking bankruptcy court relief from the automatic stay and other judicial relief, may file objections to motions filed by a chapter 11 debtor or others, and may object to confirmation of a chapter 11 plan. However, many individual creditors, especially general unsecured creditors, remain unorganized and individually do not play an active role in a chapter 11 case.

Similarly situated creditors under particular credit agreements or debt instruments including indentures may be represented by a common agent or indenture trustee who may act in a chapter 11 case in accordance with the terms of applicable credit agreements and indentures. Such agents and indenture trustees may take instructions from controlling creditors and "steering committees" or "ad hoc committees" of such creditors, and employ sophisticated counsel and financial advisors to represent particular creditor group interests. Bankruptcy Rule 2019 requires, with certain exceptions, that every group or committee of unaffiliated creditors acting in concert to advance their common interests in a chapter 11 case, and every entity representing multiple creditors, must filed verified statements making disclosures of certain information. Fed. R. Bankr. P. 2019.

The rights of unsecured creditors in a chapter 11 case usually are represented by an official committee of unsecured creditors. The Bankruptcy Code requires the United States trustee ("UST") to appoint an official committee of creditors holding unsecured claims "as soon as practicable" following the commencement of a chapter 11 case. The UST may appoint additional committees of creditors or equity security holders as the UST deems appropriate. 11 U.S.C. § 1102(a).

Ordinarily, the members of an official committee of unsecured creditors appointed by the UST are unsecured creditors willing to serve who hold the seven largest unsecured claims against the debtor, or are members of a committee organised by creditors before the chapter 11 case. 11 U.S.C. § 1102(b). In practice, the UST exercises discretion when selecting and appointing official committee members, will interview those who express interest in serving, and will also take into account views of the chapter 11 debtor about whether particular creditors should be appointed. On request of a party in interest, a bankruptcy court may order the UST to appoint additional official committees, and change or increase the membership of an official committee to assure adequate representation of creditors (or equity security holders).

An official committee in a chapter 11 case monitors developments in the chapter 11 case and acts as it deems appropriate to advance the interests of the creditors (or equity security holders) it represents. An official committee owes fiduciary duties to the class of creditors (equity security holders) it represents, and may be expected to provide information requested by class members and to recommend to them whether to accept (or not) a proposed plan. An official committee may employ attorneys, financial advisors and other professionals to assist the committee in its role, and fees, costs and expenses incurred by an official committee and its professionals are paid by the debtor's estate to the extent approved by the bankruptcy court.

Official chapter 11 committees typically play important, active roles in the chapter 11 process including in the plan formulation, negotiation and confirmation process, and many if not all other chapter 11 matters and proceedings. An official committee may consult with the DIP concerning the administration of the case; investigate the conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business, and any other matter relevant to the case or a plan; participate in the formulation of a plan; and perform such other services and take such other actions as are in the interest of those represented by the committee. An official committee often acts as an adversary of the DIP but also may be supportive of the DIP.

6.4 Modification of Claims

Creditors whose claims are impaired under a proposed chapter 11 plan may vote to reject a plan. However, unanimous creditor acceptances of a chapter 11 plan are not required. As long as the requisite voting majorities under the Bankruptcy Code are satisfied, the chapter 11 process is intended to permit confirmation of a chapter 11 plan over the opposition of dissenting creditors who do not vote on the plan or who vote to reject the plan, unless dissenting creditors show the plan is non-confirmable as a matter of law.

Absent a valid, sustainable legal objection to confirmability of a plan on grounds that it does not meet Bankruptcy Code confirmation requirements, dissenting creditors may be unable to block confirmation of a chapter 11 plan. If dissenting creditors show that a proposed plan does not satisfy mandatory Bankruptcy Code confirmation requirements, it will not be confirmed - - or may need to be modified to be confirmable. Each plan confirmation requirement of section 1129(a) of the Bankruptcy Code must be satisfied. See **6.12 Restructuring or Reorganisation Plan or Agreement Among Creditors**

When a class of creditors has voted as a class to accept a plan, its terms will be binding on all creditors within the class, including individual creditors who voted against the plan unless such dissenting creditors can show the plan does not provide that they will receive at least as much value on account of their claims as they would receive in a liquidation of the debtor in a chapter 7 case. If creditors make such a showing, the plan is not confirmable. 11 U.S.C. § 1129(a)(7)(A)(ii).

A chapter 11 plan may be confirmed over the dissent of entire non-accepting creditor classes as well. If one or more impaired creditor classes vote as a class to accept the plan, the plan's treatment of non-accepting creditor classes can be "crammed down" on such classes if the plan provides that each creditor in a non-accepting class receive at least as much value as it would receive in a hypothetical chapter 7 liquidation of the company and the plan (i) does not discriminate unfairly against non-accepting classes and (ii) is "fair and equitable" with respect to each such class. 11 U.S.C. § 1129(b) (providing cram-down requirements). Plan terms satisfy the "fair and equitable" standard and may be crammed-down on non-accepting unsecured creditor classes if no class junior to a non-accepting unsecured creditor class may receive any payment until the non-accepting class is paid in full, and no class senior to the non-accepting unsecured creditor class receives more than the allowed amount of their claims. 11 U.S.C. § 1129(b)(2)(B). Likewise, a plan may be confirmed and crammed-down over the dissent of a non-accepting secured creditor class if the plan either (a) makes full payment on the allowed amount of any secured claim in such class with deferred payments (with a market interest rate) equal to the present value of the secured claim, (b) sells the secured creditor's collateral free and clear of the secured creditor's liens, with a new lien attaching to the proceeds, at a sale which provides the secured creditor an opportunity to credit bid or (c) provides the secured creditor with the "indubitable equivalent" of the allowed amount of its secured claim. 11 U.S.C. § 1129(b)(2)(A). See **4.5 Special Procedural Protections and Rights for Secured Creditors**.

The Bankruptcy Code also provides for cram-down of non-accepting classes of equity interests. 11 U.S.C. § 1129(b)(2)(C).

6.5 Trading of Claims

Generally, claims of creditors may be freely traded and transferred during a chapter 11 case. However, various contractual and legal restrictions may limit trading in a chapter 11 company's debt and debt securities. See **15 Trading Debt and Debt Securities**.

Bankruptcy Rule 3001 provides that if a claim has been transferred before a proof of claim is filed, the buyer of the claim must file a proof of claim with the bankruptcy court. If the buyer purchases the claim after a proof of claim with respect to such claim has been filed, the buyer must file evidence of the transfer with the bankruptcy court. The seller will be given an opportunity to object, but as long as there are no objections and the claim was not transferred for security, the transfer will be valid. The court will substitute the buyer for the seller as the new owner of the claim in all bankruptcy court records. Fed. R. Bankr. P. 3001.

6.6 Using a Restructuring Procedure to Reorganise a Corporate Group
It is common for bankruptcy cases of affiliated business entities to be administered together as "jointly administered" cases before a single bankruptcy court and judge. Affiliated chapter 11 debtor companies are routinely represented by the same bankruptcy counsel and other advisors, and a single "joint chapter 11 plan" may be proposed by and confirmed to reorganise all the affiliated debtor entities. Intercompany claims may pose significant issues that must be decided and resolved in the chapter 11 plan process. See **14. Intercompany Issues**.

6.7 Restrictions on the Company's Use of or Sale of Its Assets During a Formal Restructuring Process
All of a chapter 11 debtor's legal and equitable interests in property as of the commencement of the chapter 11 case, wherever located and by whomever held, become property of the DIP's "estate." 11 U.S.C. § 541. Any use, sale or lease of estate property outside the ordinary course of business requires bankruptcy court approval. 11 U.S.C. § 363(b). If a use, sale or lease of property requires bankruptcy court approval, generally a court will grant approval if the use, sale or lease is shown to be a sound exercise of the chapter 11 company's business judgment that is in the best interest of its estate.

6.8 Asset Disposition and Related Procedures
A chapter 11 debtor may sell estate property in the ordinary course of business without bankruptcy court approval, but otherwise bankruptcy court approval of a sale is required. 11 U.S.C. 363(b). A court will generally defer to a DIP's business judgment and approve a sale of property if the sale process and procedures are reasonable, fair and used to maximise value for the estate. See **7.2 Distressed Disposals as Part Insolvency/Liquidation Proceedings**.

Assets may be sold at any time during a chapter 11 case, and chapter 11 plan terms may provide for sales and other dispositions of property. Proposed section 363 asset sales may be negotiated, documented and agreed to prior to bankruptcy, with the sale being subject to commencement of a chapter 11 case and bankruptcy court approval. A sale under section 363 of the Bankruptcy Code may be attractive to potential buyers because the bankruptcy court can approve the sale free and clear of all liens, claims and other interests, with such interests attaching to the sale proceeds instead. A secured creditor typically has rights to credit bid in a chapter 11 section 363 sale of property that secures the secured creditor's claim. See **7.2 Distressed Disposals as Part Insolvency/Liquidation Proceedings**.

6.9 Release of Secured Creditor Liens and Security Arrangements
In a chapter 11 case, a secured creditor may agree to release its liens on property of the estate that is sold in a chapter 11 case, in return for "adequate protection" of its lien interest by having the lien attach to the proceeds of the sale or other property. Section 363(f) of the Bankruptcy Code permits property to be sold free and clear of all liens, claims or interests. See **4.5 Special Procedural Protections and Rights for Secured Creditors**, **7.2 Distressed Disposals as Part Insolvency/Liquidation Proceedings**.

6.10 Availability of Priority New Money
In chapter 11, an operating company usually needs ordinary course trade credit from its vendors and suppliers. The Bankruptcy Code permits a DIP company to obtain unsecured credit and incur unsecured debt in the ordinary course of business without bankruptcy court approval, and those who extend such credit are entitled to administrative expense priority rights of repayment. 11 U.S.C. § 364(a).

A chapter 11 DIP company may also need significant additional borrowings of new money financings during the chapter 11 case. The Bankruptcy Code authorises the DIP to obtain, with bankruptcy court approval after notice and a hearing, unsecured or secured postpetition financing outside of the ordinary course of business ("DIP Financing"). DIP Financing may be secured by a lien on unencumbered estate property, a junior lien on already-encumbered property, or a "priming" lien that is senior or equal to existing liens on the debtor company's property. In any event, the bankruptcy court and debtor company must provide "adequate protection" to pre-existing secured lenders whose collateral and liens are subjected or subordinated to (primed by) new DIP Financing liens. 11 U.S.C. § 364(b)-(d).

The Bankruptcy Code permits a chapter 11 DIP company to use "cash collateral" (i.e., cash, cash equivalents and cash proceeds of debtor accounts receivable and other collateral property that is subject to preexisting liens and security interests) with the consent of all holders of liens on or security interests in the cash collateral, or absent consent, by order of the bankruptcy court if the order provides "adequate protection" of such liens and security interests. 11 U.S.C. § 363 (c), (e).

Proposed terms of DIP Financing and uses of cash collateral are often included in the terms of prepetition restructuring support agreements between a company and its senior creditors. Creditors and other parties in interest may object to proposed DIP Financing, but the Bankruptcy Code's provisions for DIP Financing permit a bankruptcy court to approve DIP Financing and non-consensual use of cash collateral over such objections. Senior-most prepetition secured lenders often provide DIP Financing needed by a chapter 11 company, and usually receive senior, priming DIP Financing liens and negotiated terms of "adequate protection." The repayment rights of secured superpriority DIP Financing lenders typically have the highest payment priority rights in a chapter 11 case.

6.11 Statutory Process for Determining the Value of Claims

The chapter 11 process may be used to establish and determine the allowed amount and value of creditor claims, whether secured or unsecured. Substantive non-bankruptcy law usually determines whether asserted claims are valid and allowable, and in what amounts, but unless a claim is secured, claims for post-petition interest are usually disallowed by the Bankruptcy Code. 11 U.S.C. § 506(b). In chapter 11 cases, the value and allowed amount of most claims are determined in an allowance/disallowance process (or "claims reconciliation process") often occurring after a chapter 11 plan is confirmed and consummated. See **6.1 The Statutory Process for Reaching and Effectuating a Financial Restructuring/Reorganisation**.

A bankruptcy court may determine the value of a claim secured by a lien on property in which the estate has an interest after a hearing on notice to the holder of the secured claim. Fed. R. Bankr. P. 3012. The secured value of a creditor's allowed claim is equal to "the value of such creditor's interest in the estate's interest" in collateral property. 11 U.S.C. § 506(a)(1). The valuation of a secured claim turns on the value of the estate's interest in the property that secures a creditor's claim, and whether the particular creditor's lien is senior or junior to other liens (if any) encumbering the collateral property. The valuation methods that apply in a Rule 3012 valuation will vary depending on the type of collateral property and whether the creditor's liens encumber isolated assets or, rather, substantially all of an operating business's assets when a going concern enterprise valuation may be needed. Valuation of a creditor's lien and secured claim may occur when, for instance, a creditor seeks adequate protection of the value of its lien in connection with DIP Financing, use of cash collateral, or a 363 Sale of property subject to creditor liens; when a secured creditor seeks to credit bid its secured claim in a 363 Sale; and when a secured creditor objects to its cram-down treatment under a proposed chapter 11 plan. Value is determined "in light of the purpose of the valuation and of the proposed disposition or use" of property subject to creditor liens. 11 U.S.C. § 506(a)(1). See **4.5 Special Procedural Protections and Rights for Secured Creditors, 6.4 Modification of Claims, 15 Trading Debt and Debt Securities**.

6.12 Restructuring or Reorganisation Plan or Agreement Among Creditors

Section 1129(a) of the Bankruptcy Code enumerates mandatory requirements that apply to confirmation of a chapter 11 plan for a business entity. The section 1129(a) confirmation requirements implicate other provisions of the Bankruptcy Code (for instance, section 1123(a)'s requirement of certain mandatory chapter 11 plan provisions). See **6.1 The Statutory Process for Reaching and Effectuating a Financial Restructuring/Reorganisation**. The burden is generally on a chapter 11 plan proponent to show that the following section 1129(a) requirements are satisfied:

- the plan must comply with all applicable provisions of the Bankruptcy Code, including provisions that govern the classification of claims and the required contents of a plan;
- the plan proponent must comply with applicable provisions of the Bankruptcy Code including, for instance, provisions governing disclosure statements and solicitations;
- the plan must be proposed in good faith and not by any means forbidden by law;
- any payments made by the plan proponent, the debtor or any person issuing securities or acquiring property under the plan must be approved by the court as reasonable;
- the identity and affiliations of any individuals who will serve as officers, directors or in other key positions following confirmation of the plan must be disclosed;
- if the debtor charges rates that are subject to government regulatory approvals, any rate change that applies post confirmation rate must be approved or subject to regulatory approval;
- as to any holder of a claim or interest in an impaired accepting class that did not vote to accept the plan, it must provide that such holder will receive or retain property of a value not less than the holder would receive if the debtor were liquidated in a chapter 7 case;
- if a creditor holding a secured claim has properly elected under section 1111(b)(2) to retain its lien and have its entire claim treated as a secured claim, the plan must provide that such creditor receives or retains property having a value as of the effective date of the plan not less than the value of the creditor's collateral;
- each class under the plan has accepted the plan or is unimpaired (but if this requirement is not satisfied, the plan may be confirmed by "cram-down" of any impaired non-accepting class if applicable requirements of section 1129(b) cram-down are satisfied);
- the plan must provide for payment in full in cash of the allowed amount administrative expense claims and certain other priority claims unless holders of such claims agree to different treatment, or the Bankruptcy Code permits payments over time to certain such claimants;
- one impaired class of claims must have voted as a class to accept the plan; and
- the plan must be feasible, i.e., confirmation of the plan is not likely to be followed by a liquidation of the reorganised company or need for further financial reorganisation beyond that proposed by the plan;
- all fees payable to the UST must be paid; and

- the plan must provide for the continuation and payment of all retiree benefits to the extent required by section 1114(e)(1)(b) or 1114(g) for the duration of time the debtor has obligated itself to provide such benefits.

Section 1129(b) provides the standards that must be met in the event the plan must "cram down" non-accepting impaired classes of creditors and equity interest holders. See **6.1 The Statutory Process for Reaching and Effectuating a Financial Restructuring/Reorganisation, 6.4 Modification of Claims**.

Any party in interest may object to a plan on feasibility grounds or a failure to meet other Bankruptcy Code requirements.

6.13 The Ability to Reject or Disclaim Contracts

Section 365 of the Bankruptcy Code generally allows a debtor or chapter 11 or 7 trustee, with bankruptcy court approval, to (i) assume particular executory contracts and unexpired leases, (ii) assume and assign such agreements to third parties and (iii) reject executory contracts and unexpired leases. An "executory contract" is not defined in the Bankruptcy Code, but is generally understood to be an agreement between a debtor and non-debtor as to which each party has unperformed remaining contractual obligations. If a contract is not executory, it cannot be assumed or rejected.

An executory contract or unexpired lease that is burdensome, unneeded or unprofitable for the estate may be rejected. A bankruptcy court typically defers to the debtor's (or trustee's) business judgment to approve a proposed rejection. Rejection of a contract or lease pursuant to section 365 of the Bankruptcy Code relieves a DIP (or trustee) of the debtor's contractual performance obligations, and is deemed to be a debtor breach of the rejected agreement as of the commencement of the bankruptcy case, giving the non-debtor party a general unsecured claim for rejection damages. The non-debtor party may file a proof of claim on account of its rejection damages, and the allowable amount of rejection damages is capped by the Bankruptcy Code for rejection of certain types of agreements.

If a particular executory contract or unexpired lease is on balance a useful asset to the estate because the contract or lease is cost-effective, needed by the business or otherwise valuable, the DIP (or trustee) may, with bankruptcy court approval, assume the debtor's obligations under the executory contract or lease. As commonly occurs in 363 Sales, some or all of a debtor's executory contracts or unexpired leases may be sold and assigned to a third party. Section 365 of the Bankruptcy Code generally makes unenforceable contractual anti-assignment terms of such contracts and leases. However, some types of agreements (including personal services contracts, contracts with the federal government, partnership agreements and various intellectual property licenses), may not be assigned or sold under section 365 of the Bankruptcy Code absent the consent of the non-debtor counterparty.

In order to assume (or assume and assign) an executory contract or unexpired lease, the debtor (or trustee) must show "adequate assurance of future performance" of the debtor's obligations under the assumed agreement, and must cure all monetary and non-monetary defaults under the assumed agreement. Upon assumption of an executory contract or unexpired lease, the debtor (or assignee of the debtor) assumes the debtor's contractual obligations under the assumed agreement and they become administrative liabilities of the estate. It is common for 363 Sale bidding procedures to establish a process to notify contract counter-parties of the possible assumption and assignment of their agreements, and applicable deadlines to object to proposed cure payment amounts and adequate assurance of future performance. Such objections may be heard by the bankruptcy court when it considers approval of the 363 Sale or, in some cases, following the 363 Sale as, for example, debtors and purchasers may establish special procedures for resolving discrete assumption/assignment issues following bankruptcy court approval of a 363 Sale.

6.14 The Release of Non-debtor Parties

The terms of a confirmed chapter 11 plan may release non-debtor parties from actual or potential liabilities owed by them to the chapter 11 debtor entity. Bankruptcy court's typically require showings that the released parties provided some consideration for the releases they receive. Such consideration may be monetary or other contributions to the debtor during the chapter 11 case or pursuant to the plan. For instance, chapter 11 plans may incorporate settlements between the debtor company and its estate on the one hand, and certain creditors, equity owners, actual or potential litigation defendants, or other persons who may be liable to the debtor or its estate, on the other. Plan-based settlement terms may include general releases of non-debtor parties from all known and unknown estate claims and causes of action that might be asserted against them by the debtor or reorganized debtor, in consideration of settlement payments by the released non-debtor parties, their complete or partial waiver of their claims against the debtor and reorganized debtor, and the non-debtor parties' agreement to waive any direct claims such non-debtor third parties might have or assert against "protected parties" that may be defined under a plan to include current and former officers, directors and employees of the debtor, official committee members, lenders to the chapter 11 company, and their respective officers, directors, agents, employees, advisors, etc. Chapter 11 plans routinely provide for general releases of possible estate claims and causes of action against officers and directors of a chapter 11 debtor company, in consideration of their services to the company during the chapter 11 case.

Chapter 11 plans may also propose and effectuate "non-consensual third party releases" on creditors of a debtor in consideration of the value they will receive under a plan, whereby creditors are deemed to release, upon consummation of the plan, any direct or derivative claims and causes of action that individual creditors might have or assert against non-debtor "protected parties" (including current and former officers, directors and employees of the debtor, official committee members, lenders to the chapter 11 company, plan funders and others who have made it possible for the plan to be confirmed, and their respective agents, employees, advisors, etc.). Such third party non-consensual releases under a plan are often objected to and not always approved by bankruptcy courts, but in cases where creditors are paid in full under a plan, courts are more likely to approve such non-consensual third party releases.

6.15 Creditors Rights of Set-off, Off-set or Netting

In chapter 11 cases, creditors may have rights to offset and reduce a prepetition obligation they owe to the debtor by the amount of a prepetition obligation owed by the debtor to the creditor. Such "setoff" rights and "recoupment" rights may be enforced to the extent permitted by non-bankruptcy law and the Bankruptcy Code. Generally, the section 362 automatic stay prevents a creditor from exercising any setoff rights unless the creditor obtains a bankruptcy court order modifying the automatic stay. In practice, setoff rights usually are determined and exercised in connection with the bankruptcy claims reconciliation process, which usually occurs following confirmation of a plan in chapter 11 cases.

Setoff. Section 553 of the Bankruptcy Code preserves a creditor's rights of set off to the extent those rights exist under non-bankruptcy law, which may be contract law. Setoff rights allow a creditor who both owes a debt to the debtor and is owed a debt from the debtor to offset these mutual claims. Setoff allows a creditor to avoid having to pay a debt to a debtor in full while simultaneously only recovering a pro rata share of the creditor's claims against the debtor. Section 506(a) provides that a creditor's allowed claim is secured to the extent the amount of the claim is subject to setoff under section 553.

There are five requirements under section 553 of the Bankruptcy Code for a creditor's claim to be eligible for setoff: (1) the creditor must hold a claim against the debtor that arose before the debtor commenced its chapter 11 case (i.e., a prepetition claim); (2) the creditor must owe a prepetition debt to the debtor; (3) the claims must be mutual; (4) the claims must be valid and enforceable; and (5) the claims must not be otherwise disqualified for set off under section 553 of the Bankruptcy Code.

The first section 553 requirement is met where the creditor's claim against the debtor arose before the date on which the debtor commenced its bankruptcy case (the "Petition Date"). While most debts can easily be identified as pre- or post-Petition Date claims, there are some instances when such classification is not obvious. Courts have developed a variety of tests to determine whether a claim is pre- or post-petition, and which test is applied depends on the jurisdiction in which the bankruptcy case is commenced. The tests consider whether the conduct that gave rise to the liability occurred pre-petition, whether the claim was the result of a pre-petition relationship between the debtor and creditor, and whether the liability was foreseeable based on prepetition conduct between the two parties.

The second section 553 setoff requirement is that the creditor must owe a prepetition debt to the debtor. This requirement is met when a debtor has a claim against a creditor that arose prior to the commencement of the debtor's bankruptcy case. The third section 553 requirement is that the claims to be offset are "mutual". Courts have adopted a narrow definition of mutuality for setoff purposes, requiring that the claims and debts to be offset must be owed between the same parties, but need not to have arisen from the same transaction. The fourth requirement under section 553 of the Bankruptcy Code is that the claims to be set off must be both valid and enforceable. This requires only that the claims at issue exist and are valid under either non-bankruptcy law or the Bankruptcy Code.

The fifth and final requirement for setoff under section 553 of the Bankruptcy Code is that the claims not be disqualified under that section. Section 553 disqualifies two types of claims: (i) "acquired claims," i.e., claims against a debtor that a creditor acquires from a different creditor during the debtor's bankruptcy or in the 90 day period prior to the bankruptcy; and (ii) "acquired debts," claims, i.e., claims against the debtor that arise out of new debt created, in order to obtain set off rights, during the debtor's bankruptcy or the 90 day period prior to the bankruptcy.

Recoupment. Recoupment, like setoff, allows one of two parties to reduce claims the other party asserts against it by offsetting its own claims against the other. There are important distinctions between setoff and recoupment. The most significant difference is that in order for claims to be eligible for recoupment, they must have arisen out of the same transaction. Also, mutuality of parties is not a requirement of recoupment.

Recoupment is an equitable defense that may be asserted by a defendant to reduce a plaintiff's claim amount. The critical recoupment issue is whether the obligations to be offset and reduced truly derive from the same transaction. Different jurisdictions require varying degrees of connection.

The Second and Third Circuits have adopted a strict test to determine whether or not opposing debt obligations derive from the same transaction. This "integrated transaction test" requires that "both debts... arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations." Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138, 146–47 (2d Cir. 2002).

6.16 Failure to Observe the Terms of an Agreed Restructuring Plan

Chapter 11 plans and confirmation orders usually include injunctions that prohibit creditors and other parties in interest from taking actions that are inconsistent with express plan terms. In the event a chapter 11 DIP company or another necessary party fails to perform any act necessary to consummate or implement the terms of a confirmed plan, the bankruptcy court may direct performance of such acts. 11 U.S.C. § 1142(b). Failure to comply with a court order may result in contempt of court sanctions, damages and penalties.

If a DIP is unable to effectuate substantial consummation of a confirmed plan, or by its acts or omissions is in "material default" with respect to a confirmed plan, or a confirmed plan is terminated due to the occurrence or non-occurrence of a condition specified in the plan, or the DIP fails to comply with a bankruptcy court order, a party may request the bankruptcy court to convert the chapter 11 case to a case under chapter 7. The court may convert the case, unless the court determines that the appointment of a chapter 11 trustee or examiner is in the best interests of creditors and the estate. 11 U.S.C. § 1112(b).

6.17 Receive or Retain Any Ownership or Other Property

Existing equity owners of a chapter 11 company may retain equity or receive distributions of value on account of their equity interests pursuant to the terms of a chapter 11 plan in several circumstances. The enterprise value of the debtor may be sufficient to pay creditor classes in full and/or provide other plan treatment that satisfies the Bankruptcy Code's cramdown standards for creditor classes. In some cases, a 363 Sale may result in sale proceeds in excess of amounts required to pay all creditors in full, in which case the plan will provide that holders of equity interests receive distributions of any available residual value. Alternatively, a plan may implement an agreement whereby senior secured creditors agree to "gift" some amount of value to holders of old equity interests that they are not otherwise entitled to receive, usually on the condition that equity classes vote to accept the plan.

Generally, however, equity interest holders do not retain ownership of their reorganised chapter 11 company if the company is insolvent. Most often, chapter 11 plans provide that old equity interests are cancelled without distributions to equity holders, but the facts and circumstances and economics of particular cases may permit better plan treatment of equity holders.

In some cases, existing equity interests may retain their ownership interests in exchange for making contributions of substantial and significant "new value" to the debtor's estate, even when one or more senior creditor classes are impaired and not paid in full under a plan. If a junior equity holder or equity class makes a substantial new money contribution to the estate to fund a reorganisation plan, it may provide for the junior equity holder or class to retain its old equity interests (or receive the newly issued equity of the reorganised company) in consideration of the new value contribution provided by the old equity holders. In any event, the consideration received by the old equity holder(s) on account of a new value contribution must be subject to a market test—i.e., be subject to higher and better third party offers for the new equity of the reorganised chapter 11 company.

7. Statutory Insolvency and Liquidation Proceedings

7.1 Types of Statutory Voluntary and Involuntary Insolvency and Liquidation Proceedings

Insolvent companies may be liquidated voluntarily or involuntarily under federal law pursuant to chapter 7 or chapter 11 of the Bankruptcy Code. Creditors may file involuntary bankruptcy petitions against a financially distressed company. See **2 Statutory Regimes Governing Restructurings, Reorganisations, Insolvencies and Liquidations** and **7 Statutory Insolvency and Liquidation Proceedings**.

Alternatively, an insolvent company may also be liquidated pursuant to varying laws of the fifty states that provide for (i) the appointment of receivers (ii) general assignments for the benefit of creditors and (iii) the dissolution of business entities.

In the United States, when a liquidation proceeding may be commenced by a company generally is in the company's discretion. The exceptions to this rule include commencement by creditors of an involuntary chapter 11 or chapter 7 case, or when a state court orders appointment of a receiver or dissolution of the insolvent entity.

In the United States, an insolvent company has no legal obligation to commence liquidation or other insolvency proceedings, but fiduciary duties of its officers, directors or managers may lead it to do so as the best means of preserving and maximizing the value of company assets for all stakeholders.

Chapter 11 Liquidation. A key advantage of a chapter 11 liquidation is that the chapter 11 company's existing managers and directors usually remain in control to oversee continued operations and the liquidation of the business as a going concern. Management continuity and knowledge may preserve and maximize going concern values when business assets are sold.

A company may commence a voluntary case under chapter 11 of the Bankruptcy Code by filing a voluntary petition for relief. An involuntary chapter 11 petition may be filed by the debtor's creditors if the requirements of section 303 of the Bankruptcy Code are satisfied. See B6. Upon the commencement of a chapter 11 case, the bankruptcy automatic stay prevents the continuation of legal proceedings and creditor enforcement actions against the debtor company. Also, information about a chapter 11 debtor company's assets, liabilities and financial affairs is made publicly available. There is a formal process for scheduling and filing creditor claims. See **6 Statutory Restructurings, Rehabilitations and Reorganisations**.

The timelines and duration of chapter 11 liquidations vary from case to case. While chapter 11 provides maximum flexibility for a liquidation, chapter 11 is the most expensive and often time-consuming type of liquidation proceeding. Distributions to creditors generally cannot be made until a chapter 11 plan of liquidation is proposed and confirmed by bankruptcy court, which may take many months or longer.

Confirmation of a liquidating chapter 11 plan requires satisfaction of all of the Bankruptcy Code's legal standards for confirmation of a chapter 11 plan. See **6.1The Statutory Process for Reaching and Effectuating a Financial Restructuring/Reorganisation**. The "feasibility" requirement requires a showing of sufficient funding to consummate the liquidating plan. Absent sufficient net sale proceeds or other funding required to pay secured and administrative expense claims in full and to fund a chapter 11 plan-based liquidation process, the legal standards for confirming a liquidating chapter 11 plan cannot be satisfied.

A business liquidation may be accomplished during a chapter 11 case through one or more asset sales outside the ordinary course of business pursuant to section 363 of the Bankruptcy Code (a "363 Sale"). See G2. 363 Sales require court approval and may be undertaken before a plan is proposed - - or a liquidating chapter 11 plan may itself provide terms for one or more 363 Sales of all or substantially all of the Debtor's assets. The time required to obtain bankruptcy court approval of a proposed 363 Sale (30 days or less) is significantly shorter than the time needed to confirm a chapter 11 plan. A speedy 363 Sale of an entire business as a going concern may be accomplished by negotiating and executing a purchase agreement prior to the commencement of a chapter 11 case, and then seeking bankruptcy court approval of the sale transaction, subject to higher and better offers, promptly after the chapter 11 case is commenced.

A liquidating chapter 11 plan may provide for, among other things: (i) one or more 363 Sales or other transactions whereby business assets including contracts and leases are sold and assigned; (ii) the rejection of unwanted contracts and leases pursuant to section 365 of the Bankruptcy Code; (iii) procedures to resolve disputed / unliquidated claims and establishment of appropriate reserves of sale proceeds for distribution after claims are allowed; (iv) releases for company management and others involved in the chapter 11 plan process; (v) the formation of a liquidating trust to hold and liquidate any remaining assets; (vi) the dissolution of the debtor entity; and (vii) an appropriate distribution of asset proceeds to creditors in accordance with plan terms and Bankruptcy Code requirements.

Chapter 11 plans of liquidation often establish a liquidating trust that takes title to and liquidates any remaining estate assets including litigation claims and causes of action against third parties. A liquidating trust operates under the supervision of a trustee (who may be any individual selected by the debtor and/or the official committee of unsecured creditors pursuant to the terms of the plan).

If all or substantially all of a debtor's assets are sold during a chapter 11 case pursuant to one or more 363 Sales, the chapter 11 debtor then has three options: (i) confirm a liquidating chapter 11 plan, (ii) convert the chapter 11 case to a case under chapter 7 or (iii) seek a dismissal of the chapter 11 case. Typically, a liquidating chapter 11 plan is preferred if such a plan is practicable.

A chapter 11 case may be converted to a chapter 7 liquidation case if a chapter 11 plan cannot be confirmed. The chapter 11 debtor may request such conversion voluntarily as a matter of right, or another party in interest may request conversion for "cause" pursuant to section 1112(b) of the Bankruptcy Code. "Cause" is defined under section 1112(b)(4) of the Bankruptcy Code to include, among other things: (i) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation; (ii) gross mismanagement of the estate; (iii) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by either the Bankruptcy Code or by order of the court; (iv) revocation of an order of confirmation under section 1144 of the Bankruptcy Code; (v) inability to effectuate substantial consummation of a confirmed plan; (vi) material default by the debtor with respect to a confirmed plan; and (vii) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan.

Instead of converting its chapter 11 case to a chapter 7 liquidation case when a liquidating plan cannot be confirmed or consummated, a chapter 11 debtor may seek a "structured dismissal" of its bankruptcy case: a court-ordered dismissal of the bankruptcy case combined with certain additional relief, such as court-approved distributions to certain creditors and releases for various parties. However, bankruptcy courts cannot approve structured dismissals that do not strictly adhere to the Bankruptcy Code's creditor payment priority scheme absent consent of affected parties. Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017).

Chapter 7 Liquidations. A chapter 7 case may be a viable alternative to chapter 11 when the going concern value of a debtor's business and properties has been lost. Chapter 7 may be preferable if liquidity needed to administer the high costs of chapter 11 or to continue or restart business operations is unavailable, or if incumbent management is untrustworthy, unreliable, uncooperative, or hostile. Administrative expenses are generally less in chapter 7 than in chapter 11.

Upon the commencement of a chapter 7 case, incumbent debtor management and directors are immediately replaced by an interim chapter 7 trustee appointed by the UST. 11 U.S.C. § 701(a). The interim trustee exercises complete control over the debtor's estate and properties in accordance with the Bankruptcy Code. The interim trustee will continue as trustee unless creditors holding undisputed, non-contingent unsecured claims elect a different permanent chapter 7 trustee of their own choosing. 11 U.S.C. § 702.

The Bankruptcy Code confers broad powers and duties on a chapter 7 trustee. A chapter 7 trustee must "investigate the financial affairs of the debtor" and liquidate and distribute the debtor's property "as expeditiously as possible." 11 U.S.C. § 704. The chapter 7 trustee may hire professionals, including attorneys and other advisors, to assist him in performing his duties; the chapter 7 trustee may exercise broad discovery powers to uncover potential causes of action by the estate against the debtor's former insiders or affiliates; the chapter 7 trustee may elect to waive the debtor's attorney-client privilege in order to aid such discovery; however, a chapter 7 trustee may only operate the debtor's business for a limited period of time, such as where the sale of the debtor's business as a going concern will maximise the value of the estate. 11 U.S.C. § 721.

Chapter 7 results in prompt liquidation (not reorganisation) of a debtor's business and assets under the supervision of the chapter 7 trustee. No plan of repayment or liquidation is required or permitted in a chapter 7 case. The chapter 7 trustee collects and sells the debtor's assets in one or more 363 Sales, and uses net proceeds (if any) to pay creditors in accordance with statutory priorities set by section 726 of the Bankruptcy Code. The statutory distribution priorities among various classes of creditors and equity interest holders is mandatory in chapter 7 liquidation cases. A chapter 7 trustee may make distributions to creditors without court approval of any formal distribution plan.

A chapter 7 liquidation may be faster than a chapter 11 liquidation, but typically does not preserve going concern value. Business operations usually cease before or upon commencement of a chapter 7 case. There may be uncertainty about who will be appointed to serve as the chapter 7 trustee; whether that trustee will cooperate reasonably and in a timely manner with creditors; and what litigation, if any, the chapter 7 trustee may commence against creditors or former owners, management, officers, directors and third parties.

In a chapter 7 case, schedules of assets and liabilities and statements of the company's financial affairs must be filed. If a chapter 7 trustee determines to operate the company for any period of time, monthly operating reports must be filed. A chapter 7 trustee has a general obligation to furnish information requested by interested parties in the case, unless the bankruptcy court orders otherwise. At the conclusion of a chapter 7 case, the chapter 7 trustee is required to file a final report and a final account of its administration of the estate.

Creditors may file proofs of claim in chapter 7 cases, but in "no asset" chapter 7 cases there is no need for creditors to file proofs of claim because there will be no distributions to creditors. Creditors may exercise setoff rights in chapter 7, subject to the automatic stay. Setoff rights are generally resolved before a creditor receives any distributions from the chapter 7 trustee. See **6.15 Creditors Rights of Set-off, Off-set or Netting**.

State Law Receiverships. An insolvent business may be liquidated in state law receivership proceedings under the supervision of a state court. For companies with significant or complicated assets across multiple jurisdictions, a chapter 7 or 11 case under federal law may be more practical. Commencement of a state law receivership proceeding does not preclude subsequent commencement of a bankruptcy case that may supersede and stay the receivership.

Under the laws of most states, state courts have authority to appoint receivers, either by statute or under their general equitable authority. A receivership proceeding is a flexible process. State law receivers typically have authority limited to liquidating a company's assets and distributing their proceeds, but receivers may sometimes be empowered to operate a business.

State law receivership proceedings may be commenced when a creditor or shareholder requests a state court to appoint a receiver. State receivership laws and procedures vary greatly from state to state. Delaware (a common state of incorporation for companies) has well-developed law governing insolvency-based receivership proceedings. Pursuant to Section 291 of Title 8 of the Delaware Code, any creditor or shareholder of an insolvent corporation may file a complaint seeking the appointment of a receiver, but the party seeking the appointment must prove that the corporation is insolvent. After the receiver is appointed, it has jurisdiction over all property of the insolvent entity, except for real property located outside of the state.

The mechanics of receivership proceedings, including procedures for filing claims and determining the priority of such claims, are governed by applicable state laws and state court rules. Assets are distributed by the receiver to claimants on a pro rata basis by order of priority. This process is generally similar to a federal bankruptcy case, though the payment of the fees of the receiver takes first priority. Generally, first-lien creditors have the highest priority of payment after payment of the receiver's administrative expenses. In Delaware, a receiver is entitled to "reasonable compensation" and the costs of court proceedings must be paid before corporate assets can be distributed to any creditors or shareholders. 8 Del.C. § 298.

After a receivership is commenced: (i) receivers file schedules of assets and liabilities; (ii) creditors may file claims (which the receiver may object to); (iii) notice is provided to creditors prior to a sale or other disposition of assets; and (iv) the receiver may pursue litigation on behalf of the insolvent entity. In a Delaware receivership proceeding, the receiver is required to make a report to the court of all of the insolvent company's inventory and assets, as well as their probable value. The receiver must also report the full amount and nature of the company's debts, and file schedules of the company's creditors and stockholders. Such reports must be filed annually, but the court, in its discretion, may require multiple reports over the course of the proceeding. 8 Del.C. § 294. At the conclusion of the receivership proceeding, the receiver is required to file a final report and a final account of the distribution of the company's assets.

The duration of a receivership proceeding varies depending on factual circumstances and applicable procedures. A court may use its equitable authority and judicial discretion to order a stay of litigation against an insolvent company in receivership. Delaware receivers (much like a debtor in a federal bankruptcy case) may reject executory contracts. The procedures for rejecting executory contracts are not prescribed by statute, and may be determined by the court exercising jurisdiction over the receivership proceeding. Typically, there are no special rules or procedures governing creditor setoff rights in receivership proceedings.

Assignments for the Benefit of Creditors ("ABCs"). In an ABC, a debtor company (as "assignor") executes an agreement with an experienced individual or entity fiduciary (the "assignee") providing for the general assignment of all assets of the debtor to the assignee as a trustee for the benefit of the debtor's creditors. An ABC functions much like a chapter 7 liquidation under the Bankruptcy Code, but is subject to the laws of the state in which the assignment is made. Each state has statutes that govern ABCs in its jurisdiction, but common law rules usually inform practice. ABCs may be either court supervised, or proceed without judicial supervision, depending on the law of the applicable state.

The assignment of all of a debtor's assets creates an estate including the assets and any proceeds thereof. The transfer of assets is subject to any and all creditor claims and preexisting valid liens and security interests encumbering the assets. The assignee as a fiduciary for creditors acquires all right, title and interest in the assigned assets for purposes of liquidating the assets and making distributions to creditors in order of their respective state law priorities.

An ABC does not result in an automatic stay of creditor actions, but applicable state laws may give an assignee the rights of a perfected lien creditor that are superior to the rights of unperfected security interest holders. Such state law lien creditor rights give an assignee (i) rights to avoid unperfected security interests and transfers that are avoidable as fraudulent or preferential under state law and (ii) rights to payment of assignee administrative fees, costs and expenses before the assignee makes distributions to creditors.

In addition to collecting assigned assets and taking control of the assignor's books and records, the assignee provides notice to creditors of the ABC and their opportunity to file claims with the assignee.

Dissolutions. State law dissolutions permit a business entity to wind-up its affairs, liquidate or dispose of its assets, pay its liabilities and claims, and conclude its existence. Dissolution and wind-up procedures vary from state to state and for differing forms of business entities. There is no stay of legal proceedings or creditor enforcement actions upon the commencement of a dissolution under state law.

Corporate dissolutions are typically commenced voluntarily by shareholder vote. In some circumstances, a corporation may also be dissolved involuntarily by court order. A corporation need not be insolvent to be dissolved. In a voluntary corporate dissolution, the board of directors adopts a dissolution resolution including a plan of liquidation that outlines the steps to be taken to dissolve the corporation and wind up its affairs. The dissolution resolution is subject to shareholder approval.

In Delaware, after the dissolution is approved by shareholders, a certificate of dissolution is filed with the Secretary of State where the corporation was formed. The corporation is dissolved upon the filing of the certificate and continues to exist only for purposes of winding down its affairs. A winding down process includes: (i) prosecuting and defending or settling to conclusion all civil, criminal, or administrative suits; (ii) disposing of the corporation's property; (iii) paying or making adequate provision for payment of the corporation's actual, disputed, contingent and foreseeable liabilities; and (iv) distributing remaining corporate assets (if any) to stockholders.

In a state law dissolution, the corporation may provide notice of the dissolution to all of its known creditors, and may also publish a notice of dissolution in a local newspaper to ensure all potential creditors are given notice of the dissolution. The notice usually will set a deadline by which creditors must alert the corporation of their claims in order to receive payment before any distributions are made to shareholders. Under Delaware law, providing notice to creditors is optional, though providing such notice and following other optional statutory dissolution and claims reconciliation procedures may provide directors with protection against personal liability to creditors. If no notice to creditors is provided and certain optional statutory procedures are not followed, directors may be liable to claimants for not making reasonable provision for liabilities.

Although some states, such as Delaware, do not permit a shareholder to file a lawsuit to involuntarily dissolve a corporation, a state's attorney general is generally able to file a lawsuit to request revocation or forfeiture of the corporation's charter if there has been an abuse of corporate power. If a corporation is dissolved as a result of such a court order, the liquidation plan will be prepared by a court-ordered trustee or receiver and may be subject to court approval.

The duration of a state law dissolution and wind-down process varies depending on factual circumstances and applicable state law and procedures. In a Delaware corporate dissolution, the corporation must continue to exist for three years following the filing of the certificate of dissolution (or such longer period as may be ordered by the Court of Chancery, up to ten years) to allow for the corporate wind-down process. The wind-down process includes paying or making adequate provision for all of the corporation's liabilities and distributing remaining assets (if any) to shareholders after all liabilities are paid in full or reserved for. Once the winding up process is completed and all distributions are made, the corporation's dissolution is complete.

A dissolution process under state law typically is overseen by a corporation's board of directors. In Delaware, directors have the statutory right and duty to wind up the affairs of their dissolved corporation. The Court of Chancery is unlikely to interfere with this right except upon a showing of good cause. Upon application and a good cause showing by any creditor, stockholder or director of a dissolved corporation, the Court may appoint one or more directors to be trustees, or appoint one or more persons to be receivers, of the dissolved corporation.

In a corporate dissolution, the corporation generally must abide by the terms of its existing contracts, including any termination rights. A company in a state law dissolution proceeding does not have a unilateral or statutory right to reject contacts. Creditors are not entitled to any special information rights. Creditors may exercise setoff rights in accordance with applicable state laws and any relevant contractual agreements between the creditor and the company. No special setoff rules apply during the dissolution process.

Non-corporate business entities (such as limited liability companies) also may be dissolved as permitted by applicable state laws.

7.2 Distressed Disposals as Part Insolvency/ Liquidation Proceedings

The manner in which business assets are sold, or otherwise disposed of in a liquidation– and who has authority to make such dispositions – depends on the type of liquidation proceeding.

Dispositions in Receiverships. In a receivership under state law, the court-appointed receiver generally has exclusive authority to negotiate and execute any sale of the company's assets, which must then be reported to the court. State law receiverships may allow for certain "free and clear" sale transactions. For example, in a Delaware receivership, the receiver may sell property free and clear of all liens, provided that the lien is disputed and the property subject to the lien is deteriorating in value. 8 Del.C. § 297.

Dispositions in an ABC. In an ABC, the designated assignee takes title to all of the assignor company's assets for the benefit of its creditors. The ABC assignee exercises its discretion, often informed by professional advice, about how best to liquidate assets and maximise their value. An assignee may, for instance, sell assets by auction process, in a going concern sale, in bulk, in lots or on an item-by-item basis, or to a single buyer of all the assets as an operating business. Asset sales by an ABC assignee must comply with applicable laws, and will be subject to the liens of secured creditors. Usually, applicable state law does not permit an assignee to sell "free and clear" of liens, so secured creditor consent to such free and clear sales must be obtained. If the ABC is court-supervised, a sale, especially of assets subject to liens, may require court approval.

Dispositions in Dissolutions. In state law dissolutions, the persons authorised by the company's directors to administer the dissolution and wind-up of the company's affairs will negotiate and consummate asset sales and dispositions in accordance with the company's plan of dissolution and liquidation. No judicial approval is required unless the dissolution has been ordered by a court or is subject to judicial supervision. No "free and clear" asset sales are available in connection with a sale of assets in a corporate dissolution, and no special credit bidding rules apply.

Bankruptcy Abandonment of Property. Under section 554 of the Bankruptcy Code, with the approval of the bankruptcy court, a chapter 11 debtor-in-possession (DIP), or a chapter 11 or chapter 7 trustee, may abandon property that is burdensome or of inconsequential value. Section 725 of the Bankruptcy Code permits a chapter 7 trustee, with bankruptcy court approval, to abandon property subject to a lien even if creditor's secured claim is greater than the value of the collateral.

363 Sales in Bankruptcy Cases. In chapter 11 and chapter 7 cases, the debtor-in-possession or bankruptcy trustee, as applicable, is authorised to sell assets outside the ordinary course of business with bankruptcy court approval pursuant to 363 Sales. The minimum time to obtain bankruptcy court approval of a proposed 363 Sale is approximately 30 days, which timeline includes notice to parties in interest and an evidentiary hearing on objections, if any. Section 363 Sales often include the sale and assignment to a purchaser of particular executory contracts and unexpired leases if the purchaser wants to assume the debtor's rights and obligations under such contracts and leases. See **6.13 The Ability to Reject or Disclaim Contracts.**

A bankruptcy court will approve the use or sale of debtor property outside the ordinary course of business as long as it is a sound exercise of the debtor's / trustee's business judgment and in the best interests of the debtor's estate. In deciding whether to approve a sale or use of debtor property, a court may consider numerous factors: (i) the proportionate value of the assets to be sold compared to the value of the debtor's estate as a whole; (ii) the amount of time elapsed since the commencement of the bankruptcy case; (iii) the likelihood that a chapter 11 plan of reorganisation will be proposed and confirmed in the near future; (iv) the effect of the proposed disposition on future plans of reorganisation; (v) the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property; (vi) which of the alternatives of use, sale or lease the proposal envisions; and (vii) whether the assets to be sold are increasing or decreasing in value.

Section 363 of the Bankruptcy Code permits both public and private sale transactions. Bankruptcy courts generally favour a public auction process to ensure that a sale transaction is fair and market-tested. A bankruptcy court-approved 363 Sale process may be very flexible and usually is tailored to maximise value in the particular facts and circumstances of the particular case.

Debtors and bankruptcy trustees often seek advance bankruptcy court approval of bidding procedures that will apply to a particular 363 Sale. Bidding procedures may include: (i) "qualified" bidder requirements, including execution of a confidentiality agreement, statement of bona fide interest and written evidence of available cash or financing for the transaction; (ii) procedures for conducting due diligence, including a time period during which due diligence must be completed, a confidential data room process and procedures for requesting additional information; (iii) requirements for "qualified" bids, including the deadline for submitting bids, required cash deposits and form of purchase agreement; (iv) auction rules, including the auction time and place, overbid and minimum bidding requirements, allowance of "credit bids" and the involvement/attendance of interested parties; and (v) parameters for determining the successful bid, including selection timing and criteria and any required consultations with the official creditors committee and other key parties in interest.

In many 363 Sales, a potential purchaser is selected as the "stalking horse" bidder. Its initial "stalking horse bid" sets a floor value for the sale, and assures that the debtor has a sale transaction to consummate before further efforts are undertaken to seek a higher bid. It is common for a secured creditor to be the stalking horse bidder when its collateral is being sold. A secured creditor credit bid is its offer to acquire property using, at least in part, the allowed amount of the secured creditor's claim for the collateral property being sold. Credit bidding rights give a secured creditor some control over a sale process of collateral property, to ensure the collateral is being sold for the highest price. A secured creditor may credit bid purchase price up to the allowed amount of its claim that is secured by the collateral being sold, without having to pay cash purchase price. If the secured creditor is the successful bidder, the creditor's claim is reduced by the amount of its credit bid. A secured creditor may bid for assets with both a credit bid and cash purchase price bids.

A stalking horse bidder usually receives bidder protections in exchange for its agreement to make an initial firm bid, and to compensate it for its due diligence costs and accepting the risk of being outbid. Common bidder protections include a break-up fee, which typically ranges from 1-4% of the value of the stalking horse bid, plus an expense reimbursement, both of which are payable in accordance with the negotiated terms of bidder protections, usually in the event a transaction is consummated with an alternative buyer. A limited "no shop" period may protect a stalking horse bidder between the time its purchase agreement is executed and when the bankruptcy court approves bidder protections. Bidder protections are not immediately enforceable upon execution of a stalking horse purchase agreement. Bankruptcy court approval of bidding procedures and bidder protections usually is sought simultaneously.

An expeditious 363 Sale may be accomplished by negotiating and executing a purchase agreement with a stalking horse bidder prior to commencement of a chapter 11 case, and then seeking bankruptcy court approval of the transaction promptly after a chapter 11 case is commenced. An officer of the debtor company will execute the sale agreement before bankruptcy, but the company's obligations will remain subject to bankruptcy court approval of the agreement.

Section 363(k) of the Bankruptcy Code specifically permits a secured creditor that is a prospective asset buyer to credit (or "credit bid") as purchase price the amount of any claims it may have that are secured by the property being purchased. The right to credit bid, however, is not absolute, and the Bankruptcy Code permits the bankruptcy court "for cause" to deny a purchaser the right to credit bid. A credit bid might be disallowed if it would chill bidding for the debtor's assets, or when the validity of the bidder's asserted secured claim is in dispute at the time of the proposed 363 Sale. Unsecured creditors are not able to credit bid because their claims are not secured by the property being sold.

Parties in interest in a bankruptcy case may object to a proposed 363 Sale, so there is a risk that a proposed sale may not be approved by the bankruptcy court. Under section 363(m) of the Bankruptcy Code, a sale of debtor property to a good faith purchaser generally cannot be unwound after the sale closes, even if the bankruptcy court's approval of the sale is overturned on appeal. Section 363(m) provides comfort to purchasers with respect to the finality of their sale.

Section 363 sales often are viewed favourably by potential purchasers because: (i) 363 Sales generally are quicker and less expensive than the complex process needed to confirm a chapter 11 plan; (ii) purchasers have the ability to select specific assets they wish to purchase and the liabilities they are willing to assume; (iii) assets generally can be sold "free and clear" of all liens, claims, interests and encumbrances if the requirements of section 363(f) of the Bankruptcy Code are satisfied; (iv) bankruptcy court approval of a 363 Sale and "good faith" findings by the bankruptcy court under section 363(m) will insulate the sale from future attack; and (v) the waiting period for U.S. anti-trust approval may be shortened to fifteen (15) days.

In a 363 Sale, a purchaser may acquire assets "free and clear" of all liens, claims, interests and other encumbrances on the assets. A "free and clear" sale is permitted as long as one of five conditions in section 363(f) of the Bankruptcy Code is satisfied: (i) applicable non-bankruptcy law would permit a sale of such property free of the interest; (ii) consent of the non-debtor party holding the interest; (iii) the interest is a lien and the sale price is greater than the aggregate value of all liens on the property being sold; (iv) the interest is in bona fide dispute; or (v) the entity asserting an interest in the assets could be compelled in a legal or equitable proceeding to accept a money satisfaction of such interest. Whether one or more of the section 363(f) conditions is satisfied with respect to particular interests or liabilities often may be disputed. Whether section 363(f) permits a 363 Sale free and clear of all successor liability claims is not clear. For example, some government agencies have challenged 363 Sales to the extent they would eliminate purchaser successor liability for environmental liabilities.

Undisclosed and unauthorised agreements among potential bidders and collusive bidding arrangements may be illegal or even criminal. Under section 363(n) of the Bankruptcy Code, such agreements are grounds to avoid a 363 Sale or recover additional consideration from the purchaser.

7.3 Implications of Failure to Observe the Terms of an Agreed or Statutory Plan

The consequences for a company or creditor failing to comply with the terms of a confirmed chapter 11 plan are described in **6.16 Failure to Observe the Terms of an Agreed Restructuring Plan** above.

7.4 Investment or Loan of Priority New Money

In both chapter 11 and chapter 7 cases, new money may be loaned to a debtor-in-possession, chapter 11 trustee or chapter 7 trustee pursuant to section 364 of the Bankruptcy Code. See **6.10 Availability of Priority New Money.**

Usually, there are no special rules or restrictions that apply to possible new money financings in state law receiverships, ABCs and dissolutions that would prohibit receivers, assignees or others in charge of a state law liquidation from borrowing or accepting funds that might be needed to complete a liquidation process.

In some circumstances, equity owners of an insolvent company might be willing to advance, as secured loans or otherwise, funds sufficient to accomplish an orderly liquidation process that avoids an unwanted bankruptcy case.

7.5 Insolvency Proceedings to Liquidate a Corporate Group on a Combined Basis

In chapter 11 and chapter 7 cases under the Bankruptcy Code, joint administration of multiple bankruptcy cases commenced by affiliated business group entities is permitted. Bankruptcy Rule 1015 permits the joint administration of bankruptcy cases of a debtor entity and any of its affiliates that commence cases under the Bankruptcy Code.

Jointly administered chapter 11 cases are commonly used to reorganise or liquidate complex multi-entity businesses.

7.6 Organisation of Creditors

In a chapter 11 case, an official committee of unsecured creditors is appointed by the UST. See **6.3 The Roles of Creditors During Procedures**. Additional unsecured creditors committees may be appointed when divergent classes of unsecured creditors need representation in the case. Likewise, an official equity committee may be appointed if it appears equity interest holders may be entitled to recoveries in the circumstances of a particular case. The fees and expenses of any official committees are paid by the debtor's estate, to the extent approved by the bankruptcy court. The official committee of unsecured creditors usually plays an important and adversarial role against the debtor and secured creditors in a liquidation case as the committee seeks to maximise recoveries for unsecured creditors.

In a chapter 7 case, the role of an official creditors' committee is more limited than an official chapter 11 creditors' committee because a chapter 7 creditors' committee is (i) not authorised to take any substantive action without first consulting with the chapter 7 trustee and (ii) not entitled to have any professional fees and expenses paid by the debtor's estate. In a chapter 7 case, the members of an official committee of unsecured creditors are elected by a vote of creditors that are entitled to vote to select the chapter 7 trustee under section 702(a) of the Bankruptcy Code. The official committee of unsecured creditors in a chapter 7 case may have between three (3) and eleven (11) members, all of whom must hold an allowable unsecured claim against the debtor. 11 U.S.C. § 705.

There are no official committees of creditors in a state law receivership, ABC or corporate dissolution proceedings. However, sophisticated or larger creditors may organise informally on an ad hoc basis to act and negotiate with receivers and others responsible for the liquidation of business assets.

7.7 Conditions Applied to the Use of or Sale of Its Assets

In chapter 11 and chapter 7 bankruptcy liquidation cases, a chapter 11 debtor-in-possession, or a chapter 11 or 7 trustee, may use estate property in the ordinary course of business without court approval. However, any use or sale of estate property outside the ordinary course of business requires bankruptcy court approval after notice and opportunity for a hearing. 11 U.S.C. § 363(b).

In state law receivership, ABC and dissolution proceedings, whether judicial approval of a use or sale of assets is required -- or whether any other condition (including secured creditor consent to use or sell secured creditor collateral) applies -- will depend on the particular state laws that apply and whether a proceeding is subject to judicial supervision.

8. International/Cross-border Issues and Processes

8.1 Recognition or Other Relief in Connection with Foreign Restructuring or Insolvency Proceedings

Foreign, non-U.S. companies that meet the eligibility requirements set forth in the Bankruptcy Code may commence plenary chapter 11 or chapter 7 bankruptcy cases in U.S. bankruptcy courts. Many foreign business entities commence chapter 11 proceedings in the U.S. by showing that they conduct business or hold property located in the U.S. If a company commences a plenary insolvency proceeding outside the U.S., the Bankruptcy Code also provides procedures for the foreign proceeding to be recognised in U.S. bankruptcy courts and affords the non-U.S. debtor certain rights and protections.

Eligible non-U.S. insolvency proceedings are recognised in the U.S. through chapter 15 of the Bankruptcy Code. Chapter 15 provides for the commencement of an ancillary U.S. bankruptcy case to assist a foreign court in a foreign insolvency proceeding. Chapter 15 is based on the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency. Over 40 nations or territories have adopted legislation based on this model law, which, at its core, is premised on international comity. Much like a chapter 11 case, a chapter 15 bankruptcy case serves both protective and facilitative functions. A chapter 15 bankruptcy case, commenced in a U.S. bankruptcy court by or for a foreign non-U.S. debtor that has commenced foreign insolvency proceedings outside the U.S., serves to protect the non-U.S. debtor by allowing it to stay both actions against its assets in the U.S. and litigation pending against it in U.S. courts. A chapter 15 case also facilitates a foreign debtor's restructuring efforts by allowing it to administer, sell or transfer property within the jurisdiction of the U.S. and take other actions in furtherance of its restructuring, such as assuming or rejecting executory contracts and unexpired leases, obtaining credit, or settling claims and disputes.

By filing a petition under chapter 15 of the Bankruptcy Code, a "foreign representative" petitions a U.S. bankruptcy court for recognition of a "foreign proceeding." A "foreign representative" is a representative, authorised in a foreign proceeding, to administer the reorganisation or liquidation of the foreign debtor's assets or affairs, or to act in a chapter 15 case as a representative of such foreign proceeding. 11 U.S.C. § 101 (24). A "foreign proceeding" is a "collective" judicial or administrative proceeding in a foreign country under the supervision of a non-U.S. court and laws relating to insolvency or adjustment of its debt, for the purpose of reorganisation or liquidation of the debtor. In order to be eligible to seek recognition under chapter 15, a non-U.S. entity must meet the U.S. Bankruptcy Code's eligibility requirements: it must either be domiciled, conduct business, or hold property in the U.S. As a practical matter, the most certain way for a non-U.S. entity to establish its eligibility to commence a case under chapter 15 of the Bankruptcy Code is to establish that the entity holds property located in the U.S.

Upon the filing of a chapter 15 petition, the bankruptcy court will hold a hearing to consider entering an order of recognition of the foreign proceeding, either as a foreign "main" proceeding or as a foreign "nonmain" proceeding. The distinction between "main" and "nonmain" is crucial. If the foreign proceeding is recognised as a main proceeding, because the foreign proceeding is in the country where the debtor's center of main interests is located, the U.S. automatic stay goes into effect and much of the core relief available to a chapter 15 debtor is granted automatically. On the other hand, if a chapter 15 proceeding is recognised as a foreign nonmain proceeding (i.e., the center of main interests of the foreign debtor is located in a third country), all relief requested in the chapter 15 case is left to the discretion of the U.S. bankruptcy court.

For a foreign proceeding to be recognised as a main proceeding, the debtor's "establishment" (i.e., a place of operation from which the debtor conducts non-transitory economic activity) in the country of the foreign proceeding must be the debtor's centre of main interest. It is a rebuttable presumption that the debtor's centre of main interest is the country of the debtor's registered office. However, the presumption may be rebutted using evidence of the location of the debtor's headquarters, its management, its primary assets, or the creditors most likely to be affected by the case. In making the centre of main interest determination, a U.S. bankruptcy court may also consider which foreign jurisdiction's laws will apply to most disputes between the debtor and its creditors.

8.2 Protocols or Other Arrangements with Foreign Courts
One of the policies underlying chapter 15 is to encourage cooperation between U.S. courts and their non-U.S. counterparts. To effectuate this policy, and to facilitate coordination and communication between courts, U.S. courts have employed a number of procedures with varying degrees of formality in chapter 15, chapter 11 and other cases as well. A bankruptcy court may appoint a person or entity to act at the direction of the court, or can enter into a cross-border protocol or cross-border agreement with a non-U.S. court. Protocols and agreements clarify and allocate the responsibilities of the relevant U.S. and foreign courts over certain issues, and establish methods by which the courts will communicate. Less formal arrangements include communication of information and developments by methods considered appropriate by the bankruptcy court, including statements made on the record at the relevant proceedings by the parties in interest.

8.3 Rules, Standards and Guidelines to Determine the Paramountcy of Law
Debtors in chapter 15 cases will often seek to allocate and clarify the scope of authority of the various courts' in the chapter 15 and plenary cases, sometimes through a cross-border protocol. Generally, U.S. courts will respect the decisions and procedures of foreign jurisdictions and tribunals so long as they are not "manifestly contrary to the public policy of the United States." 11 U.S.C. § 1506. This public policy exception to the recognition of foreign decisions has been interpreted narrowly and generally will only apply in exceptional circumstances.

While chapter 15 serves important facilitative and protective functions, it was not designed to reconcile the differences between the insolvency regimes of various nations. In the Hanjin chapter 15 case, Case No. 16-27041 (Bankr. D.N.J.), a large multinational shipping conglomerate filed a plenary proceeding in South Korea and a chapter 15 proceeding in New Jersey in 2016. A conflict of law issue arose when certain U.S. creditors of Hanjin sought to exercise rights over Hanjin's vessels based on U.S. maritime liens. The U.S. creditors argued that, under U.S. maritime law, they held valid secured claims against Hanjin's vessels, and as such, they should either be allowed to exercise their rights against the vessels, or be provided some form of security. The creditors argued that, should the vessels return to South Korea and be administered under the South Korean bankruptcy, the U.S. creditor rights would be diminished or extinguished as South Korean law did not recognize their maritime liens. The Hanjin bankruptcy court entered an order which denied the creditors' request for security and forbade the creditors from taking actions against Hanjin's vessels. The Hanjin bankruptcy court held that, because Hanjin had filed for insolvency protection in South Korea, the South Korean court was the appropriate forum for determination of the creditors' claims. Additionally, the bankruptcy court found that allowing Hanjin's ships to remain in U.S. waters without the threat of arrest would facilitate Hanjin's rehabilitation.

The Hanjin case demonstrates the importance of a creditor understanding the rights and remedies available to it under various insolvency regimes when dealing with a large multinational business entity. A debtor's decision to file a plenary proceeding in a certain jurisdiction may operate to alter the rights of U.S. creditors, even if the debtor also files an ancillary proceeding, such as a chapter 15 case.

8.4 Foreign Creditors
Under the Bankruptcy Code, debtors and U.S. bankruptcy courts cannot discriminate against non-U.S. creditors. Non-

U.S. creditors have the same rights to participate in and commence cases under the Bankruptcy Code. To exercise such rights, non-U.S. creditors may retain local counsel to participate in U.S. proceedings, to help ensure that non-U.S. creditor interests and rights against the debtor and in the debtor's property are protected and advanced. Non-U.S. creditors and other parties with significant claims against or interests in a debtor in a U.S. bankruptcy should consider retaining local counsel in the U.S.

In chapter 15 and chapter 11 bankruptcies, some of the debtor's largest creditors can be corporate parents or affiliates. Such parents and affiliates should closely monitor the debtor's bankruptcy filings. The claims of parents and affiliates are often treated as general unsecured claims against the debtor and, as such, may be subject to substantial or total impairment in a bankruptcy case. See N. Impaired treatment of intercompany claims and receivables may create solvency issues for parents and affiliates that could lead to potential "trading while insolvent" liability in certain non-U.S. jurisdictions. As such, parents and affiliates of entities in the zone of insolvency should closely monitor both their own and their affiliates' solvency positions and consider appropriate strategic options for minimizing liability exposure.

9. Trustees/Receivers/Statutory Officers

9.1 Types of Statutory Officers Appointed in Proceedings

Federal laws and various state statutes provide for and require the appointment of individuals or entities to function in executive, supervisory, fiduciary or representative roles in connection with bankruptcy, insolvency and similar proceedings governed by federal or state laws.

Under federal bankruptcy law, when a chapter 7 liquidation of a company is commenced, the Bankruptcy Code requires the appointment of a chapter 7 trustee. An initial chapter 7 trustee is appointed from a panel of trustees who have been qualified by the United States Trustee to serve as such. Creditors may subsequently elect a different person to serve as chapter 7 trustee. The chapter 7 trustee replaces the debtor company's incumbent management and board, controls its properties, administers the case and liquidates the chapter 7 estate assets. See **7.1 Statutory Insolvency and Liquidation Proceedings**.

In a business reorganisation or liquidation case under chapter 11, the Bankruptcy Code authorises the debtor company to continue to operate its business and manage its properties and affairs as a "debtor-in-possession." As a debtor-in-possession ("DIP"), the chapter 11 company is managed by its incumbent managers, officers and directors who have been appointed and serve in accordance with non-bankruptcy state business entity governance laws. Such managers, officers and directors owe fiduciary duties prescribed under applicable state and federal law. The DIP assumes statutory bankruptcy duties and obligations set by the Bankruptcy Code. See **12 Duties and Personal Liability of Directors and Officers of Financially Troubled Companies.**

In a chapter 11 case, in circumstances of fraud, dishonesty, incompetence or gross mismanagement, the DIP and its incumbent management may be replaced by court order with a chapter 11 trustee, if the court determines that appointment of a chapter 11 trustee is in the interests of creditors. The court may also appoint an independent examiner to inquire into specific matters involving the debtor and its affairs.

The United States Trustee ("UST") plays an important role in cases under the Bankruptcy Code. The UST is an official in the U.S. Department of Justice who acts as a governmental watchdog appointed to oversee all federal bankruptcy cases.

The Bankruptcy Code provides for appointment of a statutory committee of unsecured creditors whose role is to act in the best interests of unsecured creditors. A bankruptcy court may authorise other official committees, including equity committees in certain circumstances. However, the Bankruptcy Code does not authorise official committees of secured creditors.

Often a DIP company employs a chief restructuring officer or "CRO" to assist incumbent management. A CRO is not mentioned in or required by the Bankruptcy Code. See **12.3 Chief Restructuring Officers**.

Outside of bankruptcy cases under the Bankruptcy Code, various federal and state law-based insolvency proceedings, including receiverships, assignments for the benefit of creditors ("ABCs"), and state law dissolutions, involve statutory officers who are appointed judicially or otherwise. For instance, a receiver is appointed in state court receiverships; in ABCs, an assignee is appointed; for banks in receivership, the Federal Deposit Insurance Corporation is appointed as receiver for the failed bank; and various state laws govern who may be duly authorized to administer the wind down of dissolved business entities and insolvent insurance companies.

9.2 Statutory Roles, Rights and Responsibilities of Officers

Bankruptcy Court Judges. Federal bankruptcy court judges preside over business reorganisation and liquidation cases under the U.S. Bankruptcy Code. Bankruptcy courts are units of the federal court system, and they exercise subject matter jurisdiction over bankruptcy cases. Bankruptcy judges play the paramount official role in bankruptcy cases. Among other things, they: approve all debtor-company transactions that are outside the ordinary course of business; issue orders authorising the employment of professionals and deciding numerous contested matters that arise in a bankruptcy case; adjudicate litigated issues including claims objections; and ultimately decide whether proposed chapter 11 plans of liquidation or reorganisation may be confirmed in compliance with the Bankruptcy Code.

DIP. In a chapter 11 case, a "debtor-in-possession" company remains in possession of its assets, manages its properties and continues to run its business. The DIP has statutory duties under the Bankruptcy Code, and its officers, directors and managers owe fiduciary duties under applicable state and federal laws. See **12 Duties and Personal Liability of Directors and Officers of Financially Troubled Companies**.

United States Trustee. The UST oversees bankruptcy cases as a governmental 'watchdog' in chapter 7 and 11 cases. Among other things, the UST reviews and scrutinises professional employment and fee applications; appoints members of official committees; and reviews, comments on, and sometimes objects to bankruptcy motions filed by other parties in interest if the UST views such motions and the relief they seek as inconsistent with the Bankruptcy Code, other federal law or public policy. The UST reviews the schedules and statements of financial affairs prepared and filed by the DIP in its bankruptcy case; interviews the DIP; and gathers financial and other information from the debtors' management team.

Creditors' Committee. An official committee of unsecured creditors in a chapter 11 case, once appointed by the UST, employs attorneys, accountants and financial advisors to assist the committee as it monitors developments in the chapter 11 case and acts as it deems appropriate to advance the interests of unsecured creditors. (In some cases, an official committee of equity security holders may be appointed if recoveries to equity holders appear likely.) An official creditors' committee and owes fiduciary duties to the class of creditors it represents. See **6.3 The Roles of Creditors During Procedures.** Creditors' committee expenses, including attorney and other advisor fees, are paid by the debtor's estate to the extent approved by the bankruptcy court. A creditors' committee may consult with the DIP concerning the administration of the case; investigate the conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business, and any other matter relevant to the case or a plan; participate in the formulation of a plan; and perform such other services and take such other actions as are in the interest of unsecured creditors. An official creditors' committee often acts as an adversary of the DIP but also may be supportive of the DIP. An official creditors' committee in a chapter 7 case functions differently. See **7.6 Organisation of Creditors**.

Trustee. In chapter 7 liquidation cases, a trustee displaces the debtor company's existing management and liquidates the assets of the company's estate and distributes the proceeds to creditors. A chapter 7 trustee collects estate property, investigates the financial affairs of the debtor, litigates to judgment or settles debtor litigation claims against third parties, and may object to claims filed by creditors. A chapter 7 trustee has the right to employ, with bankruptcy court approval, attorneys and other professionals.

In a chapter 11 bankruptcy case, a chapter 11 trustee may be appointed to replace the DIP in cases of management fraud, dishonesty, incompetence, or gross negligence, or if such appointment is in the interest of creditors. When a chapter 11 trustee is appointed, it takes on the roles and responsibilities of the DIP; displaces incumbent management; controls the debtors' properties and estate; is responsible for managing the debtor company's business affairs; will operate the business of the debtor company while it is in bankruptcy; and files all reports and other pleadings, including a plan of reorganisation or liquidation. A chapter 11 trustee has the right to employ, with bankruptcy court approval, attorneys and other professionals.

Examiner. An examiner may be appointed in a chapter 11 case to investigate specific matters related to the debtor as ordered by the bankruptcy court. For instance, an examiner may investigate questionable pre-bankruptcy transactions, possible debtor litigation claims against third parties, and allegations of fraud, dishonestly, incompetence, misconduct, mismanagement, or irregularity in the management of the debtor by current or former management. An examiner reports its findings to the bankruptcy court, and may employ professionals to assist in its duties.

Assignee. In a state law ABC, the assignee is the person appointed to act as a fiduciary for creditors. The assignee, acting like a chapter 7 bankruptcy trustee, liquidates the debtor's assets and distributes the proceeds to creditors in accordance with their respective priorities under applicable state law.

Receiver. In a state law receivership, a receiver is appointed by a state court, most often to liquidate an insolvent business when a creditor or shareholder successfully requests a receivership. Typically, insolvency must be shown by the party requesting a receivership. In some cases, the court exercising jusrisdiction over the receiver may deem it best for the receiver to continue to operate the company's business and at a later time turn it back to the stockholders and officers as a going concern. The receiver's authority is governed by applicable state law and orders of the court.

FDIC, as receiver. In an FDIC receivership, the FDIC acts as a receiver for a failed bank. The FDIC's authority and role are governed by federal banking law, specifically the Federal Deposit Insurance Act. The FDIC, as receiver, assumes the task of selling/collecting assets of a failed bank and settling its debts, including claims for deposits in excess of the insured limit.

9.3 Selection of Statutory Officers

United States Trustee. The United States Trustee is a federal official appointed by the President as an official in the U.S. Department of Justice.

Creditors' Committee. Bankruptcy Code section 1102 gives the UST authority to appoint members of an unsecured creditors' committee in chapter 11 cases. Members often consist of the seven largest unsecured creditors willing to serve. Members of an official creditors committee in a chapter 7 case are selected differently. See **6.3 The Roles of Creditors During Procedures, 7.6 Organisation of Creditors**.

Trustee. In liquidation cases, an initial interim chapter 7 trustee is appointed by the UST at the outset of the case. The interim trustee appointed upon the commencement of a chapter 7 case is selected from a panel of pre-qualified trustees in the district where the case is filed, and the interim trustee often remains the chapter 7 trustee for the entirety of the case. However, the Bankruptcy Code allows creditors to elect a different trustee at the statutory section 341 meeting of creditors required by the Bankruptcy Code.

If a trustee is ordered in a chapter 11 case, the UST typically selects and appoints the chapter 11 trustee in consultation with key parties in interest, subject to final court approval.

Examiner. The appointment of an examiner is permitted by Bankruptcy Code section 1104. In chapter 11 cases, appointment of an examiner may be ordered by the bankruptcy court, after notice and a hearing, upon the request of a party in interest or the UST. If an examiner is ordered, the UST selects and appoints the examiner in consultation with key parties in interest, subject to final court approval.

9.4 Interaction of Statutory Officers with Company Management

DIP Officers and Directors. A debtor-in-possession company's managers, officers and directors are selected, appointed and serve in accordance with applicable non-bankruptcy laws that apply to the internal governance of the DIP as a corporation, limited liability company, etc.

Trustee. In a chapter 7 or chapter 11 case, when a trustee is appointed, the trustee displaces incumbent managers, directors and officers by taking ultimate control of the company and its properties, rights, business affairs and operations. Subject to bankruptcy court approval, a chapter 7 or 11 trustee employs attorneys, accountants, financial advisors and other professionals of her choosing.

Receiver. In a state law receivership of an insolvent entity, the receiver takes control of the company and its business, most often to liquidate and distribute assets, but appointment of a receiver does not terminate the company's existence, and the receiver may permit officers and managers to remain in place, subject to the receiver's ultimate control.

Assignee. In an ABC, the assignee takes ownership of all of the company's assets for the benefit of its creditors and functions like a chapter 7 trustee to liquidate the business. The company and it's officers and directors have no continuing role in the ABC process.

CRO. While neither a statutory officer nor specifically contemplated by the Bankruptcy Code, a chief restructuring officer or "CRO" may be employed by a debtor company to assist its management on bankruptcy restructuring issues. See 12.3. Generally, CROs have professional restructuring and industry experience, giving them credibility with the debtor's various constituencies. A CRO may be retained as a senior officer of the debtor management team, and in some cases may report directly to the DIP's board of directors (rather than other senior officers). A CRO may have duties to communicate with senior lenders and other key stakeholders on non-privileged issues. Creditors often support the debtor-company's selection and employment of a CRO to bring industry and restructuring experience to the bankruptcy case. Senior creditors may sometimes influence the selection of a particular CRO. CROs are generally retained with bankruptcy court approval under Bankruptcy Code section 327 or 363. UST protocols for retention of CROs apply in many areas of the country.

9.5 Restrictions on Serving as a Statutory Officer

Creditors' Committee Members. Generally, in chapter 11 cases, an official unsecured creditors' committee consists of unsecured creditors, willing to serve, that hold the largest unsecured claims against the debtor. In practice, the UST selects who will serve as members of the committee and the UST has discretion to select various types of unsecured creditors who need not be among the seven largest. See **6.3The Roles of Creditors During Procedures.** In chapter 7 cases, official creditor committee members are selected differently and must be creditors who hold allowable unsecured claims against the debtor. 11 U.S.C. § 705. See **7.6 Organisation of Creditors**.

Trustee. An individual may serve as a chapter 11 trustee upon appointment and application of the U.S. Trustee and approval of the court. In addition, creditors may elect a trustee if they so choose but chapter 11 trustee elections are rare. In the absence of their election, the U.S. Trustee selects the chapter 11 trustee, subject to final court approval. The Bankruptcy Code requires that the U.S. Trustee consult with the parties in interest and that the appointed individual be disinterested. To qualify as disinterested, an individual: (i) cannot be a creditor, equity security holder, or an insider; (ii) is not and was not a director, officer, or employee of the debtor within 2 years before the date of the filing of the petition; and (iii) does not have an interest materially adverse to the interests of the estate, creditors, equity security holders.

In a chapter 7, the U.S. Trustee's office appoints an interim trustee from a standing panel of trustees in the district the case is filed. In order to serve on the panel, federal regulations require that the panel member must: (i) possess integrity and good moral character; (ii) be physically and mentally able to perform the required duties; (iii) be courteous and accessible to all parties with reasonable inquiries about the case to which they are assigned; (iv) be free of prejudices against any group which would interfere with their ability to be unbiased in the case; (v) cannot be related to any employee of the Executive Office for United States Trustees of the Department of Justice or of the Office of the United States Trustee for the district which the individual is applying; (vi) be willing to serve as required by the United States Trustee; and (vii) submit the appropriate application. If the creditors do not elect a successor chapter 7 trustee, the interim trustee becomes the permanent trustee.

Examiner. The Bankruptcy Code is silent on the required qualifications to serve as an examiner but some courts assess whether the examiner is disinterested (as defined under the Bankruptcy Code), impartial, and can engage in a meaningful review of the books, records, and transactions of the debtor.

Assignee. Applicable state law governs an ABC and the rules and requirements that apply to selection of an assignee may differ significantly from state to state. These requirements may be found either in a state statute, under common law, or both. In practice, ABC assignees are experienced professional fiduciaries.

Receivers. State law receivers are appointed by state courts. The rules and requirements that apply to selection of a receiver may vary from state to state, and the court that appoints a receiver usually exercises its discretion when making the selection.

FDIC, as receiver. In an FDIC receivership, the FDIC acts as a receiver for a failed bank. The FDIC's authority and role are governed by federal banking law, specifically the Federal Deposit Insurance Act.

The retention and compensation of restructuring professionals is regulated by the Bankruptcy Code and the bankruptcy court, with oversight from the UST.

The trustee in a chapter 7 case, or a chapter 11 trustee if appointed, may be a lawyer, accountant, other restructuring professional. Subject to court approval, restructuring professionals may also serve in officer roles (such as chief financial officer, etc.).

It is common for a restructuring industry professional to be retained and employed as a CRO. If the CRO or other professional has served as an officer of the debtor company prior to bankruptcy, special protocols may apply to such professional's retention and employment during the bankruptcy case. See **12.3 Chief Restructuring Officers**.

10. Advisors and Their Roles

10.1 Types of Professional Advisors

In the United States, any sizeable out-of-court business restructuring or in-court bankruptcy case will involve numerous restructuring professionals who advise and assist the financially distressed company, its major stakeholders and other parties in interest on strategic, legal, financial, operational and administrative restructuring issues, tasks and decision-making. Professionals include attorneys, accountants, financial advisors, investment bankers, and others. A company may also employ a specialised business consultant, a chief restructuring officer or others with industry-specific expertise or general experience in operational restructurings to help run the company while it is undergoing an out-of-court or formal bankruptcy process. In large chapter 11 cases, claims agents are employed to assist with bankruptcy case administration. Public relations firms may be employed as well.

Restructuring professionals provide a company and its board of directors and senior management with expert advice needed to make informed strategic and other decisions that satisfy fiduciary standards. In bankruptcy, such decisions will be scrutinised by other parties in interest.

Creditors typically employ their own professional advisors, including attorneys, financial advisors, business consultants and investment bankers, to aid creditor constituencies in analysing and resolving restructuring issues. In some bankruptcy cases, an examiner may be appointed to investigate and report on specific matters. Examiners and bankruptcy trustees may retain professional advisors.

Professionals may be employed by any party in interest in an out-of-court restructuring or bankruptcy case. In bankruptcy, who employs a professional determines whether the bankruptcy court must approve the employment and how the professional is paid.

An advisor who is hired by a debtor or an official committee in a chapter 11 case may seek payment from the debtor's estate by filing a fee application. The Bankruptcy Code details a non-exhaustive list of factors that a bankruptcy court may consider in awarding fees to professionals employed by the debtor or an official committee. While any party in interest may object to a professional fee application, the U.S. trustee typically plays a significant role in screening fee applications and ensuring compliance with the Bankruptcy Code and other applicable professional compensation rules. The bankruptcy court may raise its own concerns about particular fee applications. In larger chapter 11 cases, a fee examiner may be appointed by the court to monitor and report to the court on professional fees.

When and how often a court-approved chapter 11 professional must make fee applications and be paid depends on a bankruptcy court's local rules and the orders entered in a particular case. Interim professional fee applications are made and approved periodically in large cases, ensuring that professionals are paid regularly subject to bankruptcy court approval. Professional fees and expenses approved by a bankruptcy court are granted administrative expense priority, meaning they must be paid ahead of general unsecured creditor claims.

Individual creditors, lenders, unofficial ad hoc creditor committees, equity holders and other significant parties in interest may employ legal, financial and other professionals. While the employment of professionals by individual parties does not require bankruptcy court approval, those parties usually must also pay the fees and expenses of their retained professionals. However, court-approved bankruptcy financings in a chapter 11 case – "DIP Loans" – almost always provide that the professional fees and expenses of the DIP lender and of secured lenders are to be paid by the debtor's estate. Additionally, in some circumstances, creditors who make a "substantial contribution" to the success of a chapter 11 case may seek court-approved payment by the debtor's estate of their professional fees.

10.2 Authorisations Required for Professional Advisors

The Bankruptcy Code requires that a debtor, an official creditors' committee, bankruptcy trustees and certain other parties must obtain bankruptcy court approval to retain particular professionals, and such professionals must satisfy statutory requirements. When a debtor company retains an attorney to represent and advise the company as its bankruptcy counsel, the Bankruptcy Code requires that the attorney meet certain requirements and disclose any potential conflicts.

Section 327 of the Bankruptcy Code governs employment of restructuring professionals and includes the requirement that an employed professional be a "disinterested person" (as defined in section 101(14) of the Bankruptcy Code) and not hold an interest adverse to the estate. In order to be disinterested under the Bankruptcy Code, an attorney or other professional advisor must not be an equity securityholder, director, officer or employee of the debtor. While the Bankruptcy Code does not expressly define "adverse interest," the "no adverse interest" requirement has been applied by many courts to mean, at a minimum, that a professional cannot simultaneously represent a creditor and the debtor in the chapter 11 case (just as an attorney cannot represent a plaintiff and a defendant on opposing sides of the same lawsuit).

Bankruptcy court approval of an application to employ a particular professional is an all-important requirement if that professional is to be retained and compensated in a bankruptcy case with payments from the debtor's estate. A professional retention application must include a declaration from the proposed professional disclosing its connections with the debtor and all other parties in interest. The required disclosures allow the bankruptcy court to assess whether a prospective professional has any conflicts that might be disqualifying.

A debtor may retain special counsel to handle matters in its bankruptcy case that might pose a potential conflict for the debtor's primary restructuring counsel. Employment of such special conflicts counsel is common in large, complex chapter 11 cases where the hundreds or thousands of creditors and other parties in interest make it difficult for any single law firm to be entirely free of conflicts or potential conflicts.

A chapter 11 debtor company almost always employs "ordinary course" professionals – i.e., non-restructuring professionals who do not advise on core restructuring matters. Ordinary course professionals typically have been pre-bankruptcy advisors to the debtor; they provide advice and representation on ordinary course, non-bankruptcy matters. Debtors retain and compensate their ordinary course professionals with streamlined applications and procedures routinely approved by bankruptcy courts.

Professional advisors owe duties to the party or constituency they advise and represent. For example, professionals employed by an official committee of unsecured creditors owe professional duties to the committee. The committee, in turn, owes fiduciary duties to the class of creditors it represents.

Applicable non-bankruptcy rules of professional conduct govern professionals. Professional duties and other standards of professional conduct are enforced by courts. Given the statutory duties and obligations of a debtor in possession, its restructuring professionals must act in a manner consistent with such duties and obligations.

10.3 Roles Typically Played by the Various Professional Advisors

Attorneys assist, advise and represent a company in out-of-court restructurings and in in-court bankruptcy cases. In both of those circumstances the company's attorneys provide advice on strategic alternatives and represent the company in the negotiation and the documentation of restructuring transactions and agreements.

In the event a chapter 11 bankruptcy case is commenced, counsel prepares and files bankruptcy petitions and motions seeking court orders required under the Bankruptcy Code and/or to operate the business of the company and effectuate the restructuring. Debtor's counsel advises the chapter 11 company and its board on their bankruptcy duties and obligations; advises on strategic case issues including formulation of a chapter 11 plan and transactions; negotiates with lenders, creditors, and other parties in interest; represents the company in litigation and settlement discussions; and, generally, works with other debtor professionals to coordinate numerous matters that impact the outcome of the chapter 11 case.

A chapter 11 company's other professionals (including investment bankers and financial and business advisors) work with management and bankruptcy counsel as a team to advance the company's chapter 11 goals and objectives as determined by the company's board and senior management.

Restructuring professionals retained by lenders, creditors' committees, owners and other parties in interest provide advice and assist in numerous matters and negotiations, and in adversarial and litigated matters. Accountants, auctioneers, investment bankers and other financial and business advisors provide non-legal assistance to those who retain them. Each professional plays a unique role in a chapter 11 case, and in matters leading to a chapter 11 plan of reorganisation or liquidation.

Typically, an investment banker plays a primary role in evaluating the company's capital structure and how it might be transformed by a chapter 11 plan. The debtor's investment banker might market the debtor's assets or the company as a whole for a possible sale or other restructuring transaction. In addition to providing strategic financial advice, investment bankers assist in negotiations and help reconfigure existing credit agreements and procure possible new financing sources. Investment bankers assist in the identification and development of possible financial transactions and plan alternatives, and provide valuations as needed.

Accountants and financial advisors are often heavily involved in the preparation of operating reports, schedules, and/or determining whether certain financial statements or other disclosures require auditing. Professional financial advisors and business consultants assist in the formulation of business plans, may advise on operations, liquidity and financial metrics, and typically prepare the liquidation analysis needed to confirm a chapter 11 plan.

Other professionals may handle routine chapter 11 administrative responsibilities. In a chapter 11 case, a debtor hires a claims agent to coordinate proofs of claim, the giving of notices and other administrative matters in the chapter 11 case. As with claims agents, other professionals employed by a chapter 11 company may help coordinate bankruptcy-related administrative responsibilities so that the chapter 11 process does not unduly burden or interfere with company management and ordinary course business operations.

11. Mediations/Arbitrations

11.1 Use of Arbitration/Mediation in Restructuring/Insolvency Matters

Arbitrations and mediations, sometimes referred to as "alternative dispute resolution" ("ADR"), are sometimes agreed to in commercial and other transaction agreements, and in disputed matters generally as an alternative to litigation. Arbitration may be employed when the parties previously have agreed to arbitrate their disputes under an agreement incorporating an enforceable arbitration clause. In the financial restructuring and insolvency context, mediations are routinely ordered by bankruptcy courts to resolve disputes arising in bankruptcy proceedings. Alternative dispute resolution is not typically involved in U.S. restructurings absent commencement of formal chapter 11 bankruptcy proceedings.

Generally, bankruptcy judges and parties to chapter 11 cases appear to be making increased use of mediations to resolve disputes that otherwise may cause delays, protracted expensive litigation and uncertain outcomes. The trend toward greater use of court-ordered mediations in chapter 11 cases is likely to continue given the general public policy favouring alternative dispute resolution.

11.2 Parties' Attitude to Arbitration/Mediation

It is common for parties to agree to mediate their disputes in complex chapter 11 bankruptcy cases. Bankruptcy court-ordered mediations tend to focus on resolving disputes about how a chapter 11 plan of reorganisation should be structured, and what plan treatments and recoveries for various stakeholders should be. Mediation may be employed at the suggestion (or by compulsion) of a bankruptcy judge, pursuant to local rules adopted under the Alternative Dispute Resolution Act.

Certain types of chapter 11 cases, such as mass tort cases, appear to more frequently involve plan mediation. For example, the Catholic archdiocese bankruptcy cases have employed mediations in order to resolve the competing demands of tort claimants who were victims of sex abuse to facilitate the debtor emerging from bankruptcy with a realistic capital structure. See, e.g., In re Archdiocese of Portland, Oregon, Case No. 04-37154 (Bankr. D. Ore. 2004); In re Archdiocese of Milwaukee, Case No. 11-20059 (Bankr. E.D. Wis. 2011); In re Archdiocese of St. Paul and Minneapolis, Case No. 15-30125 (Bankr. D. Minn. 2015).

Chapter 11 plan mediations have been used where creditors perceive that management may be under a conflict of interest. In In re Cengage Learning Inc., Case No. 13-44108 (Bankr. E.D.N.Y.), a sitting bankruptcy judge was appointed as mediator. The mediation process led to a consensual chapter 11 plan of reorganisation instead of litigation filed by shareholders and creditors who attacked a pre-bankruptcy leveraged buyout. Creditors had argued that the debtor's management, appointed by the equity sponsor whose actions were under review, could not be trusted to conduct an independent investigation and assert claims against the sponsor.

Bankruptcy mediation has been used to resolve otherwise intractable inter-creditor disputes. In one of the largest recent U.S. bankruptcy cases, In re SunEdison, Inc., Case No. 16-10992 (Bankr. S.D.N.Y.), unsecured creditors had commenced lawsuits seeking to avoid various secured creditor liens and claims, and had objected to a plan-based allocation of value proposed by the debtors. The bankruptcy court appointed another sitting bankruptcy judge to serve as plan mediator and ordered the parties to mediate their disputes. After several weeks of mediation, the parties reached a global settlement of all their claims and counter-claims, resulting in an overwhelmingly consensual plan of reorganisation.

Bankruptcy judges have entered orders authorising and/or directing parties to participate in mediation to resolve complex disputes in other large complex chapter 11 cases. Such orders typically include provisions protecting the confidentiality of the mediation process, allocating the costs of the mediation, requiring a mediator to file a report regarding the mediation, and requiring a principal with settlement authority to attend all mediation sessions.

Mediations or arbitrations may be used in chapter 11 cases to resolve discrete disputes or an entire class of disputes. In a discrete dispute, one or more of the parties may ask the court to compel mediation or arbitration, or the parties may stipulate to mediation or arbitration. This occurs when a particular creditor's claim has been objected to, and the parties prefer to avoid unnecessary litigation in favor of a less expensive mediation or arbitration process.

When an entire class of claims is disputed, a debtor may file a motion with the bankruptcy court seeking the court's approval of systematic mandatory mediation or arbitration procedures that would apply generally in the bankruptcy case. Such procedures often provide that, prior to a bankruptcy court trial on a particular dispute, the parties are required to participate in a mediation process. For example, in In re Eagle Bus Manufacturing, Case No. 90-00985 (Bankr. S.D. Tex.), a voluntary ADR procedure was ordered to give personal injury tort claimants an option of mediating their dispute, or liquidating their claims through litigation. If the ADR option was chosen, a claimant was required to fill out a form confirming its loss. Thereafter, the debtors were required to confirm or deny liability, or make a settlement offer within 30 days. To the extent the debtors denied liability, the claim would go to mediation. In the event that a dispute was not resolved in mediation within 60 days, the claimant could opt for binding arbitration or file a motion for relief from the automatic stay to liquidate its claim in a non-bankruptcy forum. Using ADR, more than 95% of over 3,200 pre-petition tort claims were resolved.

11.3 Mandatory Arbitration or Mediation

A bankruptcy court may order mandatory arbitration in a bankruptcy case only when a prepetition contract contains a mandatory arbitration provision. While bankruptcy courts have the power to order mandatory mediation of disputes generally, it is unusual for a bankruptcy court to order parties to participate in mediation if they express an unwillingness to do so.

11.4 Pre-insolvency Agreements to Arbitrate

Generally, pre-bankruptcy agreements to arbitrate are enforceable in bankruptcy. When deciding whether to enforce an arbitration clause in a prepetition contract between a debtor and a non-debtor, the bankruptcy court will first seek to determine whether the dispute to be arbitrated is a "core" matter in the bankruptcy case or a "non-core" matter. A contract dispute is "core" if either (i) it is unique to or uniquely affected by the bankruptcy proceedings or (ii) it directly affects a core bankruptcy function.

If the dispute is "core," a bankruptcy court need not honour a pre-insolvency arbitration clause. For example, a bankruptcy court has core jurisdiction to make "determinations as to the dischargeability of particular debts." A creditor might move to refer the question of dischargeability to arbitration, but if arbitration of that dispute would jeopardise the Bankruptcy Code's dischargeability policy, then a bankruptcy court may refuse to honour the arbitration clause, and instead decide the matter itself.

If the dispute is "non-core," an arbitration clause in a prepetition agreement generally will be enforced by a bankruptcy court and will be referred to arbitration. For example, a breach of contract claim between a debtor and a contract counterparty is a "non-core" dispute. If it is subject to a mandatory arbitration agreement in the contract, the dispute should be referred to arbitration in accordance with the terms of the prepetition contract.

11.5 Statutes That Govern Arbitrations and Mediations

Alternative dispute resolution is recognised and enforced by federal statutes and procedural rules governing the operation of the United States judiciary. The Federal Arbitration Act, 9 U.S.C. § 1 et seq., applies in both bankruptcy and non-bankruptcy contexts. It provides that federal courts will honour arbitration agreements between parties to a dispute, and limits judicial review of arbitral decisions. The Alternative Dispute Resolution Act, 28 U.S.C. § 651, requires courts to adopt local rules authorising the use of mediation and arbitration in civil actions.

Many Federal courts, including bankruptcy courts acting pursuant to the Alternative Dispute Resolution Act, have adopted rules that facilitate mediations and arbitrations. Judicial rules may specify default mediation procedures, but courts and parties are typically free to consensually decide upon different procedures.

For example, the United States Bankruptcy Court for the Southern District of New York has adopted its Local Rule 9019-1 providing procedures for mediations and arbitrations in bankruptcy cases. The rule provides that matters may be assigned to mediation by court order or by stipulation of counsel, and that mediation may apply to any dispute that may arise in a bankruptcy case. The procedures also require that party representatives attending a mediation must have complete authority to negotiate all disputed amounts and issues, and that the mediator may control all procedural aspects of the mediation. The procedures provide that statements made during mediation shall not be divulged by the parties or the mediator to the bankruptcy court or any third party. The local rule permits referrals to arbitration only to the extent that (i) the disputed issue does not arise in an adversary proceeding, (ii) the issue arises in an adversary proceeding where the amount in controversy is less than USD150,000 or (iii) the court retains jurisdiction to decide the adversary proceeding.

11.6 Appointment of Arbitrators/Mediators

In bankruptcy mediations, the mediator usually is selected by mutual agreement of the parties to the mediation and then appointed by the bankruptcy court. Parties may engage in a "strike and rank" process to select a mediator, or may simply reach mutual agreement, or follow a recommendation from the bankruptcy judge.

When mandatory arbitration is required by prepetition contracts, the process for choosing and appointing the arbitrator usually is set forth in, and governed by, the prepetition contract. Commonly, an arbitration provision may provide for three arbitrators, one each selected by the parties to the dispute, with the third arbitrator selected by the two arbitrators selected by the parties. Parties may elect to have their arbitration administered by an arbitral institution; may administer the arbitration on their own; or may opt for a hybrid approach where an arbitral institution is designated as the appointing authority for the arbitral tribunal in the event the parties fail to reach agreement on a tribunal. Depending on the applicable arbitration rules adopted by the parties, the parties may "nominate" arbitrators, but only the applicable arbitral institution is empowered to "appoint" the arbitrators.

Parties may agree upon and bankruptcy courts in their discretion may select and appoint mediators of their own choosing. However, arbitration and mediation rules adopted by Federal district and bankruptcy courts often provide for a standing list of qualified mediators that parties may select from. For example, Local Rule 9019-1 of the United States Bankruptcy Court for the Southern District of New York provides for the establishment of a register of qualified mediators. Various professional organisations and arbitral institutions also maintain lists of qualified arbitrators. Such organisations or institutions may have differing rules or requirements that qualified arbitrators must satisfy. The American Arbitration Association, a leading provider of alternative dispute resolution services, maintains a national roster of individuals qualified to serve as arbitrators.

Private contracts with arbitration agreements may restrict or place qualifications on who may be selected as an arbitrator to decide disputes under a contract.

12. Duties and Personal Liability of Directors and Officers of Financially Troubled Companies

12.1 The Duties of Officers and Directors of a Financially Distressed or Insolvent Company

In the United States, state and federal laws, statutes and judicial decisions impose duties on officers, directors and managers of business entities. Such duties generally apply whether or not a company is financially troubled. Failure to satisfy such duties may result in personal liability.

At the federal level, non-bankruptcy statutes (such as Sarbanes-Oxley and the Dodd-Frank Act) impose duties that may be implicated when a company, especially a publically traded company, experiences financial distress or bankruptcy. Federal court decisions applying the federal statutes inform the potential duties and liabilities that may apply in particular circumstances. Such non-bankruptcy federal statutory duties and liabilities are outside the scope of this commentary.

Federal court decisions indicate that trustee-like duties may apply to officers, directors and managers when a corporation is in bankruptcy. For instance, in Pepper v. Litton, 308 U.S. 295, 307 (1939), the United States Supreme Court stated that, in bankruptcy, the "standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation - - creditors as well as shareholders." In CFTC v. Weintraub, 471 U.S. 343 (1985), the Supreme Court said, "... bankruptcy causes fundamental changes in the nature of corporate relationships. One of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors.... [T]he debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession. Indeed, the willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'" Id. at 355.

State laws (statutory and decisional) generally provide for potential duties and liabilities, including fiduciary duties, of officers, directors and managers of corporations and other business entities, that may apply whether or not a company is financially troubled or in bankruptcy. As to which state's fiduciary laws apply to officers and directors in a particular case, the "internal affairs doctrine" generally governs: it is a conflicts of laws principle which recognises that only one state should have the authority to regulate a corporation's internal affairs - - matters particular to the relationships among or between the corporation and its current officers, directors and shareholders - - because, otherwise a corporation could be faced with conflicting demands.

The variety of numerous state law legal standards and judicial decisions addressing fiduciary duties cannot be canvassed in this commentary, but the law of the state of Delaware is informative and will be described here because a majority of publicly-traded corporations in the United States are formed under Delaware law. Courts elsewhere sometimes look to Delaware law and judicial decisions when applying and interpreting their non-Delaware corporate fiduciary laws.

Generally, officers, directors and managers of a financially distressed or bankrupt firm who seek to fulfill their fiduciary duties should act with due care in an informed manner and with the benefit of professional advice after considering all reasonable alternatives, to maximise the value of the company for the benefit of its residual beneficiaries - - rather than focusing on who might have legal standing to assert a claim for breach of fiduciary duties.

Fiduciary Duties of Directors and Officers of Delaware Corporations

The Delaware General Corporate Law ("DGCL") states that, unless otherwise provided by law or in the company's Certificate of Incorporation, "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors." In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders. Directors owe both a duty of loyalty and a duty of care.

Delaware corporations shall also have officers as described in the corporate bylaws or in a resolution of the board of directors. Officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty. An officer's fiduciary duties are the same as those of directors.

Unlike a director or officer of a corporation, a corporate entity owes no fiduciary duties to its stockholders.

Duty of Loyalty. The duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally. A classic example of conduct implicating the duty of loyalty is when a fiduciary either appears on both sides of a transaction or receives a personal benefit not shared by all shareholders. A director must remain independent in his or her decision making. Independence means that a director's decision is based on the merits of the subject before the board rather than extraneous considerations or influences.

The duty of loyalty includes, among other things, the duty to act in good faith. Violations of the duty to act in good faith include (1) so-called "subjective bad faith," that is, fiduciary conduct motivated by an actual intent to do harm; and (2) intentional dereliction of duty, a conscious disregard for one's responsibilities. Such conduct is "non-exculpable" and "non-indemnifiable."

Duty of Care. The duty of care requires that directors use that amount of care which ordinarily careful and prudent men would use in similar circumstances. It requires directors to consider all material information reasonably available in making business decisions and to reasonably inform themselves of alternatives. The greater the significance of the decision, the greater the requirement to source and consider alternatives. To be found liable for a breach of the duty of care, Delaware law requires that directors have acted with gross negligence. Delaware courts have stated that the definition of gross negligence used in Delaware corporate law jurisprudence is "extremely stringent" and "means reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." Due care in the decision-making context is "process" due care only. As discussed below, Delaware courts will apply enhanced scrutiny to the decisions of fiduciaries, including the substantive reasonableness of a fiduciary's decision.

Under Delaware law, a corporation may include a provision in its Certificate of Incorporation that exculpates its directors from monetary liability arising from a breach of the duty of care. This exculpation does not apply to officers of a corporation.

Standards of Review for Fiduciary Duty Claims Under Delaware Law

Depending on the allegations and the nature of the challenged fiduciary decision, claims for breach of fiduciary duty are analyzed under one of several different standards of review. Among them are (1) the business judgment rule; (2) "intermediate" scrutiny under the Delaware Supreme Court decisions in Unocal and Revlon; and (3) entire fairness.

Business Judgment Rule. The business judgment rule is a corollary common law precept to the fundamental statutory principle that the business affairs of a corporation are managed by or under the direction of the board of directors. The business judgment rule has been described as a presumption, a substantive rule of law and a procedural guide for litigants. As a presumption, the business judgment rule holds that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. As a substantive rule of law, the business judgment rule provides that there is no liability for an injury or loss to the corporation arising from corporate action when the directors, in authorising such action, proceeded in good faith and with appropriate care. As a procedural guide, the business judgement rule places the initial burden on the plaintiff to rebut the presumption of the business judgment rule. The plaintiff must prove by a preponderance of the evidence that the directors' decision involved a breach of fiduciary duty. If a plaintiff is successful, the burden then shifts to the defendants to prove the entire fairness of the transaction. It does not create per se liability. The Delaware Supreme Court has stated that the business judgment rule presumptions apply to both directors and officers.

If the business judgment rule presumptions are not rebutted, directors' business decisions will not be disturbed if they can be attributed to any rational business purpose. A plaintiff who fails to rebut the business judgment rule presumptions is not entitled to any remedy unless the transaction constitutes waste. A claim of waste will arise only in the rare case where directors irrationally squander or give away corporate assets.

Intermediate Scrutiny. Delaware law recognises an "intermediate standard of review," under which Delaware courts are instructed to undertake enhanced scrutiny to review the reasonableness of a board's decision to undertake certain corporate actions, if disputed. The reasonableness standard permits a reviewing court to address inequitable action even when directors may have subjectively believed that they were acting properly. Delaware courts have stated that reasonableness review does not "permit a reviewing court to freely substitute its own judgment for the directors" or provide "a license for law-trained courts to second-guess reasonable, but debatable, tactical choices that directors have made in good faith."

For instance, under Revlon, enhanced judicial scrutiny of the reasonableness of director decisions under an intermediate standard of review may be applied when a corporation's decision to undertake certain transactions is challenged:

[t]he directors of a corporation "have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders" … in at least the following three scenarios: (1) "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganisation involving a clear break-up of the company"; (2) "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company"; or (3) when approval of a transaction results in a "sale or change of control"

If director actions are challenged in these circumstances, Delaware courts are required "to examine whether a board's overall course of action was reasonable under the circumstances as a good faith attempt to secure the highest value reasonably attainable. There is no single blueprint that a board must follow to fulfill its duties, and a court applying enhanced scrutiny must decide whether the directors made a reasonable decision, not a perfect decision."

Entire Fairness. Under the "entire fairness" standard of judicial review, defendant directors must establish to the court's satisfaction that the challenged transaction was the product of both fair dealing and fair price. Fair dealing embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. Fair price relates to the economic and financial considerations of the proposed transaction, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.

Absent strict procedural requirements, in transactions where a controlling stockholder stands on both sides, there is a presumption that the transaction is reviewed under the entire fairness standard of review.

Exculpation and Indemnification for Directors and Officers Under Delaware Law
The DGCL includes two ways by which a corporation can shield directors from personal monetary liability for breaches of fiduciary duty: (1) an exculpation provision under Section 102(b)(7) of the DGCL; and (2) indemnification under Section 145 of the DGCL.

Section 102(b)(7). Under 8 Del. C. § 102(b)(7), a Delaware corporation can include in its Certificate of Incorporation, except as otherwise described, "[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director." Notably, Section 102(b)(7) precludes exculpating directors for, among other things, "any breach of the director's duty of loyalty to the corporation or its stockholders;" "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;" and "any transaction from which the director derived an improper personal benefit." Delaware courts have stated that Section 102(b)(7) "bars the recovery of monetary damages from directors for a successful shareholder claim that is based exclusively upon establishing a violation of the duty of care." Section 102(b)(7) does not apply to officers.

A Section 102(b)(7) provision can be asserted at the pleadings stage in support of a motion to dismiss for failure to state a claim. A plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board's conduct.

Section 145. Under 8 Del. C. § 145, a Delaware corporation is granted broad and flexible powers to indemnify a person "who was or is a party or is threatened to be made a party" to a proceeding "by reason of the fact that the person is or was a director [or] officer … of the corporation." This indemnification extends to both the costs of defending and certain types of liability incurred in such a lawsuit. The statute sets "two boundaries for indemnification":

The statute requires a corporation to indemnify a person who was made a party to a proceeding by reason of his service to the corporation and has achieved success on the merits or otherwise in that proceeding. At the other end of the spectrum, the statute prohibits a corporation from indemnifying a corporate official who was not successful in the underlying proceeding and has acted, essentially, in bad faith.

For any circumstance between the extremes of "success" and "bad faith," the DGCL leaves the corporation with the discretion to determine whether to indemnify its officer or director. Between the boundaries of "success" and "bad faith," a corporation may choose to undertake permissive indemnification of an officer or director.

In addition to indemnification, Section 145 also authorises corporations to advance to an officer or director the costs and expenses incurred in defending against a lawsuit subject to Section 145 so long as the corporation receives "an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorised in this section."

Fiduciary Duties of Managers of a Delaware Limited Liability Company
Managers and members of a Delaware limited liability company (an "LLC") have traditional fiduciary duties, but those duties may be modified or limited by the LLC agreement.

Until recently, the Delaware Limited Liability Company Act (the "Act") did not expressly impose fiduciary duties on managers or members of an LLC. Rather, Section 18-1101(c) of the Act has provided that "to the extent that, at law or in equity, a member or manager has duties (including fiduciary duties)," such duties may be expanded, restricted or eliminated by provisions in the LLC agreement; provided that the LLC agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

In 2013, however, the Delaware General Assembly amended the Act to make it clear that traditional fiduciary duties applied to members and managers of LLCs under the rules of law and equity relating to fiduciary duties. Accordingly, if an LLC agreement is silent regarding these matters, traditional fiduciary duties will be implied as a matter of Delaware law.

The two "cornerstone" fiduciary duties that would apply are the duty of care and the duty of loyalty. The duty of care requires managers to act with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances, and to act on an informed basis. In discharging the duty of care, a manager is entitled to rely in good faith on information, opinions, reports and statements presented by another manager, or by a member, officer or employee of the LLC, or any other person as to matters reasonably believed to be within such person's professional or expert competence.

The duty of loyalty requires managers to act in a manner the manager honestly believes to be in the best interests of the LLC and its members. The duty of loyalty requires managers to be both "disinterested" and "independent" and to refrain from conduct such as fraud, bad faith and self-dealing. In discharging this duty, managers also owe a duty of good faith and a duty of full and fair disclosure to the members. Under common law fiduciary duty principles, members, like stockholders of a Delaware corporation, generally do not owe fiduciary duties to the LLC or other members, other than in limited circumstances, such as where the member is a controlling member or is actively participating in decision making as a managing member.

Because of the ability to restrict, expand or eliminate fiduciary duties granted by the Act, parties to an LLC agreement are well advised to specify the extent, if any, of fiduciary duties of managers, members and other persons, and to include any presumptions of good faith, standards or review and/or the ability to rely on experts or reports to ease the burden of review. Notwithstanding whether or not fiduciary duties apply, as a matter of Delaware law, the implied contractual covenant of good faith and fair dealing inures to every contract, including every LLC agreement, and such covenant (and liability for a bad faith violation of such covenant) may not be eliminated. The implied covenant is rarely invoked by Delaware courts, however, and is reserved for situations where an LLC agreement is ambiguous or a gap-filler is required. Delaware courts will not apply the implied covenant to override express contractual provisions or to imply fiduciary duties when the LLC agreement expressly eliminates such duties.

12.2 Direct Fiduciary Breach Claims

Outside bankruptcy, the general rule is that directors do not owe creditors duties beyond the relevant contractual terms. As a result, even when a corporation is insolvent or in the "zone of insolvency," creditors do not have standing to bring direct claims for breach of fiduciary duty. However, creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties because the corporation's insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value. The fiduciary duties that creditors gain derivative standing to enforce are not special duties to creditors, but rather the fiduciary duties that directors owe to the corporation to maximise its value for the benefit of all residual claimants.

The Delaware Court of Chancery has stated that directors of an insolvent corporation "do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximise the firm's value." Notwithstanding a company's insolvency, directors continue to have the task of attempting to maximise the economic value of the firm. When directors make decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others.

To obtain standing to sue derivatively, a creditor need only establish that the corporation was insolvent at the time the lawsuit was filed, as shown by the balance sheet test or the cash flow test. The creditor does not need to show that the corporation was continuously insolvent through judgment or "irretrievably insolvent."

With respect to the rights of creditors outside bankruptcy, Delaware law is clear that managers of an LLC do not owe fiduciary duties to creditors of the LLC, even when the LLC is insolvent. The Delaware Supreme Court has held that creditors of a Delaware LLC have no standing to assert derivative claims against managers (including any claims of breach of fiduciary duties) on behalf of an LLC, even if the LLC is insolvent. A statutory right to bring derivative claims only exists in favour of a member or assignee of an LLC interest. Lenders and other counterparties contracting with an LLC typically seek contractual rights and remedies in lieu of standing to assert a derivative claim.

12.3 Chief Restructuring Officers

The appointment of a professional chief restructuring officer or "CRO" is common in large and complex chapter 11 cases in the United States. There is no express statutory basis in the Bankruptcy Code for appointing a CRO, but that has developed as a practical solution providing independent and professional assistance to incumbent management of financially troubled companies. See **9.4 Interaction of Statutory Officers with Company Management**.

A professional CRO may be employed by a company before bankruptcy, or with bankruptcy court approval, appointed after commencement of a bankruptcy case. A CRO may serve as a director, officer, or report to board members. Typical CRO functions include formulating a restructuring strategy, assisting in development of a plan of reorganisation or liquidation, and assisting management on restructuring tasks and maintaining ordinary course operations during a chapter 11 case. Appointment of a CRO may assuage creditor concerns about existing management and decrease the likelihood that parties in interest will seek appointment of an examiner or chapter 11 trustee. Lenders may condition availability of financing on the appointment of a CRO and lender access to the CRO during the restructuring process.

If the CRO is appointed or retained as a corporate officer or director, the CRO's fiduciary duties will be governed by applicable state and federal laws. If a CRO is retained as an independent consultant to the company or its directors, the scope of the CRO's fiduciary duties (if any) and to whom such duties are owed may be unclear. A CRO's pre-bankruptcy role as an advisor or officer of a financially troubled company will not automatically disqualify the CRO from serving as CRO of the company during its chapter 11 case.

Debtors generally retain CRO's under Bankruptcy Code section 363 (uses of estate property out of the ordinary course) or section 327(a) (employment of professional persons). Section 327(a) requires that an employed professional be a "disinterested person" (as defined in section 101(14) of the Bankruptcy Code) and not hold an interest adverse to the estate. What a CRO's duties will be during a particular bankruptcy case should be considered carefully when determining whether the CRO should be employed under section 363 or, alternatively, section 327(a) of the Bankruptcy Code. Retention as a professional under section 327(a) of the Bankruptcy Code will impose additional obligations on the CRO, such as court approval of payments to the CRO in connection with the bankruptcy case.

12.4 Shadow Directorship

The concept of "shadow directorship" is not recognised in American jurisprudence. Most analogous to a shadow director is a controlling stockholder who acts as the de facto leader or controller of the corporation. Delaware law may impose fiduciary duties upon controlling stockholders.

"Lender liability" is an umbrella term encompassing a variety of common law theories based on contract and tort as well claims under federal and state statutes. Lender liability causes of action are generally creatures of state law, and as a result, can vary from state to state, depending on the applicable law. A lender faces a variety of consequences if found liable, including possible equitable subordination or recharacterisation of its claims, and potential liability to both the borrower and third parties.

In some jurisdictions, lender liability causes of action may rise when a lender exercises excessive control over a borrower's affairs. The underlying theory of such an action is that, in effect, the lender is acting as an officer or director of the borrower and thereby owes the borrower, as well as the borrower's creditors and stockholders, fiduciary duties.

There is no settled definition of "control." The issue requires fact intensive inquiry. Courts generally consider a number of factors, including: (i) control over the company's voting stock, (ii) managerial control, including personnel decisions and decisions as to which creditors should be paid, (iii) whether the relationship between the company and lender was the result of an arms-length transaction, and (iv) whether the lender is the company's sole source of credit. Courts must balance between allowing a lender to reasonably protect its collateral and investment – e.g., right to monitor and place limits on additional borrowing – and imputing liability where the lender completely dominates the borrower's affairs. See National Westminster Bank USA v. Century Healthcare Corp., 885 F.Supp. 601, 603 (S.D.N.Y. 1995) ("A lender is not obligated to sit idly by and watch its financial security erode. The issue is whether a creditor may monitor the debtor's financial situation, make suggestions intended to improve it and take actions short of undue entanglement with the borrower's operations. There is nothing inherently wrong with a creditor carefully monitoring its debtor's financial situation or suggesting courses of action the debtor ought to follow to improve its financial situation.").

12.5 Owner/Shareholder Liability

Stockholders ordinarily face no personal liability for corporate debts or liability to creditors of a corporation, absent veil piercing or alter ego liability. However, in certain circumstances, Delaware law imposes fiduciary duties upon stockholders, who own majority interests or who exercise control over corporate business affairs, to act fairly with respect to other stockholders. See Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1113-14 (Del. 1994).

Controlling stockholders of insolvent corporations may face liability for standing on both sides of transactions that transfer value for the benefit of the controlling stockholders. Such transactions may constitute self-dealing, which is a breach of the fiduciary duty of loyalty. Transactions between a corporation and a controlling stockholder usually are subject to the higher "entire fairness" standard of judicial review because of the insider nature of such transactions.

13. Transfers/Transactions That May Be Set Aside

13.1 Grounds to Set Aside/Annul Transactions

Federal bankruptcy law provides statutory causes of action to avoid (i.e., set aside or unwind) certain transfers (including modifications of a debtor's legal rights, or its incurrence of obligations) made to or for the benefit of third parties, primarily: (i) fraudulent transfer avoidance actions under Bankruptcy Code section 548 and (ii) preferential transfer avoidance actions under Bankruptcy Code section 547.

Bankruptcy Code section 549 permits avoidance of certain post-petition transactions. Bankruptcy Code section 544 grants a trustee and chapter 11 debtor-in-possession the same rights to avoid a fraudulent transfer that a creditor would have under applicable state law.

Statutory actions to avoid fraudulent transfers and preferential transfers are known as "avoidance actions." While preference actions and fraudulent transfer actions both may result in avoidance of certain transactions (so that they may be set aside or unwound), the two types of actions serve different purposes. The law of fraudulent transfers and voidable preferences is complex as are judicial decisions applying and interpreting the statutes.

Preference actions under Bankruptcy Code section 547 avoid pre-bankruptcy transfers to or for the benefit of creditors that advantage or prefer such creditors over other creditors. The dual purposes of the section 547 preference actions are to (i) recover preferential transfers and preserve the value of a debtor's estate, and discourage preferential pre-bankruptcy transactions and payments to favored creditors and (ii) provide for equality of distribution of a debtor's assets among its creditors.

Fraudulent transfer actions permit recovery of transferred assets and the unwinding of transactions undertaken with an intent to delay, hinder, or defraud creditors, or that are otherwise determined to be constructively fraudulent based on the economics of the transfer. Fraudulent transfer causes of action avoid transactions that have unfairly or improperly depleted a debtor's assets.

Every state in the United States has its own fraudulent transfer law, the substance of which is nearly identical to the Bankruptcy Code section 548 fraudulent transfer statute. Many state fraudulent transfer laws have limitations and "look-back" periods longer than those provided for in the Bankruptcy Code. Most state laws are modeled after the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act, both of which provide that a transfer is avoidable if it is either actually fraudulent or constructively fraudulent.

Fraudulent Transfers/Fraudulent Conveyances. Fraudulent transfer actions under the Bankruptcy Code generally must be commenced before the later of two years after a bankruptcy case is commenced or one year after a trustee is appointed, if the trustee's appointment occurs before the expiration of the original two year period.

There are two types of transfers of debtor property that constitute a fraudulent transfer under Bankruptcy Code section 548. The first is a transfer made with actual intent to hinder, delay, or defraud creditors. The second is a constructively fraudulent transfer: a transfer (1) made in exchange for less than "reasonably equivalent value" and (2) at a time when the transferor was either insolvent, undercapitalized, or generally unable to pay its debts as they came due.

Transfers are defined broadly under Bankruptcy Code section 101(54). Fraudulent transfer causes of action are not limited to simple asset transfers; rather, almost any mode of disposing of or parting with property or an interest in a debtor is covered. The creation of a lien; retention of title as a security interest; modification of a debtor's legal rights; incurrence of obligations by a debtor; and the foreclosure of a debtor's equity of redemption all constitute transfers. Transfers may be avoided whether or not they are direct or indirect, absolute or conditional, voluntary or involuntary.

Courts have not provided a clear definition of the meaning of the phrase "reasonably equivalent value," a key concept in constructive fraudulent transfer litigation. Most courts have held that the determination of whether a debtor received less than reasonably equivalent value must be assessed based on all facts and circumstances, including whether a price paid is the product of arms'-length negotiations or a marketing process among unaffiliated parties. Value must be measured as of the date of the transaction, although in practice (i.e., in litigation) value is most often established by after-the-fact expert opinion testimony.

The definition of "insolvent" is also fluid. Under the Bankruptcy Code, a business entity is "insolvent" if its financial condition is such that "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." The phrase "unreasonably small capital" is not defined in the Bankruptcy Code, though courts have applied it to mean that the debtor does not have enough capital to operate its business, including sufficient cushion for unanticipated events.

The Bankruptcy Code provides some defenses and limitations to fraudulent transfer liability. Transferees who "take for value" and in "good faith" may have a defense to fraudulent transfer actions. The word "value" in this context is defined as "property, or satisfaction or securing of a present or antecedent debt of the debtor."

The Bankruptcy Code provides certain statutory safe harbors against fraudulent transfer liability with respect to certain otherwise-avoidable transfers. For example, a trustee is prohibited from avoiding a transfer that is a margin payment or a settlement payment made by or to (or for the benefit of) a financial institution or other entity identified in Bankruptcy Code section 546(e), unless such transfer was intentionally fraudulent. Courts have disagreed on how broadly the section 546(e) safe harbor applies.

Bankruptcy Code section 550 provides for the recovery of property transferred fraudulently or the recovery of its value. If a transfer of assets or sale proceeds is avoided as a fraudulent transfer, then the property transferred or its value may be recovered from "the initial transferee" of the transfer or the "entity for whose benefit such transfer was made." Also, the property transferred or its value may be recovered from "any immediate or mediate transferee" of such initial transferee. No recovery may be obtained from an immediate or mediate transferee "that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided."

Preferential Transfers. Preferential transfers may be avoided under Bankruptcy Code section 547, which provides that a debtor or trustee may avoid: (i) a transfer; (ii) of an interest of the debtor in property; (iii) to or for the benefit of a creditor; (iv) for or on account of an antecedent debt owed by the debtor before such transfer was made; (v) made while the debtor was insolvent; (vi) made on or within 90 days before the date of the filing of the petition; or between 90 days and one year before the filing of a petition, if the creditor was an insider at the time of the transfer; and (vii) that enables the creditor to receive more than he/she would get if the case were a case under chapter 7 of the Bankruptcy Code.

Affirmative defenses may be asserted against voidable preference liability. The most common affirmative defenses, each of which is fact-intensive, include: (i) the ordinary course of business defense, (ii) the subsequent new value defense and (iii) the contemporaneous exchange of value defense. The burden is on the transferee to prove all elements of a claimed defense by a preponderance of the evidence.

13.2 Look-back Period

Generally, fraudulent transfers may be avoided if they were made or incurred on or within two years before the commencement of a bankruptcy case. However, section 544 of the Bankruptcy Code permits a trustee or chapter 11 debtor-in-possession to rely on any applicable longer state law fraudulent transfer look-back (or "reach-back") periods. State law reach-back periods may be up to four or six years after the transfer was consummated. For transfers made to self-settled trusts or similar devices with the intent to hinder, delay, or defraud creditors, the Bankruptcy Code subjects such transfers to attack for 10 years.

Preference liability is imposed under section 547 of the Bankruptcy Code for any transfer of an interest of the debtor in property that was made on or within 90 days before the bankruptcy case, if the elements of section 547 are satisfied and the creditor-transferee has no defenses. The 90-day preference "reach-back" period is extended to one year prior to the bankruptcy case if the transferee at the time of the transfer was an insider of the debtor.

13.3 Claims to Set Aside or Annul Transactions

A bankruptcy trustee (or a debtor-in-possession in a chapter 11 case) has standing to assert fraudulent transfer and preference avoidance actions. A bankruptcy trustee's (or chapter 11 debtor-in-possession's) avoidance powers are exclusive during the bankruptcy case.

Creditors' committees and creditors may seek derivative standing to assert avoidance actions on behalf of the debtor's estate especially in cases where the debtor-in-possession may have a conflict. The bankruptcy court must order and authorise such derivative standing. The terms of a chapter 11 plan of reorganisation or liquidation may provide that the reorganised debtor or some other estate representative, such as a litigation trustee, may retain and assert avoidance actions following consummation of the Plan.

Fraudulent transfer and preference actions may be asserted in chapter 7 and chapter 11 business bankruptcy cases under the Bankruptcy Code. State law fraudulent transfer actions may be asserted by creditors outside federal bankruptcy proceedings, but cannot be commenced or continued by creditors after commencement of bankruptcy and imposition of the bankruptcy automatic stay.

14. Intercompany Issues

14.1 Intercompany Claims and Obligations

Generally, the commencement of an insolvency proceeding under the Bankruptcy Code does not alter the treatment of valid intercompany claims. Like all other claims against a debtor, claims of a parent, subsidiary or affiliate against a debtor (collectively, "Intercompany Claims") are entitled to pari passu treatment with claims of unaffiliated third party creditors having the same priority (i.e., secured, unsecured, subordinated, etc.) if the Intercompany Claims are valid.

While Intercompany Claims generally are entitled to pari passu treatment with other claims, they often are separately classified and afforded different treatment under chapter 11 plans of corporate debtors, particularly those with complex corporate structures. In many cases, there are no distributions under a chapter 11 plan on account of Intercompany Claims between and among debtors in the same corporate family who are reorganising in jointly administered bankruptcy cases. Instead, such claims are reinstated. The reinstatement of Intercompany Claims preserves a means for the reorganised corporate family to move cash between related entities on account of the repayment of Intercompany Claims after the company reorganises, which may be more efficient and cost-effective than transferring funds via dividends.

Complications may arise when distinct corporate entities within a corporate family have different assets and liabilities owed to third party creditors. Whether or not Intercompany Claims are recognised and respected may significantly impact the recoveries of third-party creditors. Creditors may insist that Intercompany Claims be taken into account when calculating the recoveries of third party creditors at different corporate entities. Even when Intercompany Claims are taken into account when calculating recoveries to third-party creditors, Intercompany Claims may still be reinstated as part of a chapter 11 plan so that they can be used by the reorganised company to efficiently transfer value within the reorganised corporate enterprise.

There are a number of grounds on which Intercompany Claims may be challenged during insolvency proceedings. The most common theories used to challenge Intercompany Claims are discussed below.

14.2 Offset, Set off or Reduction

In chapter 11 and 7 cases, Intercompany Claims, like all other claims against a debtor, are subject to setoff if the requirements of section 553 of the Bankruptcy Code are satisfied. Intercompany Claims may also be reduced under the doctrine of recoupment.

Section 553 of the Bankruptcy Code preserves a creditor's rights of set off to the extent those rights exist under non-bankruptcy law, which may be contract law. Setoff rights allow a creditor who both owes a debt to the debtor and is owed a debt from the debtor to offset these mutual claims. See **6.15 Creditors Rights of Set-off, Off-set or Netting**.

There are five requirements under section 553 of the Bankruptcy Code for a creditor's claim to be eligible for setoff: (1) the creditor must hold a claim against the debtor that arose before the debtor commenced its chapter 11 case (i.e., a pre-petition claim); (2) the creditor must owe a prepetition debt to the debtor; (3) the claims must be mutual; (4) the claims must be valid and enforceable; and (5) the claims must not be otherwise disqualified for set off under section 553 of the Bankruptcy Code.

Section 553's mutuality requirement is particularly relevant in the context of Intercompany Claims, because courts will not allow a "triangular setoff" of debt obligations among company affiliates. For example, courts have decided that a nondebtor subsidiary may not offset a debt it owes to the debtor against a debt that the debtor owes to a different subsidiary in the corporate family; and, additionally, that a debt owed by a creditor to a debtor's subsidiary may not be offset by a debt owed by the debtor to the creditor. Sometimes contract terms provide that affiliates are to be treated as the same entity for purposes of the mutuality requirement in a setoff context. Some courts will enforce such agreements, but other courts have ruled that private parties cannot contract out of the mutuality requirement of section 553 of the Bankruptcy Code.

Intercompany Claims may also be offset and reduced under the equitable doctrine of recoupment. Recoupment is an equitable defense that may be asserted by a defendant to reduce a plaintiff's claim amount. See **6.15 Creditors Rights of Set-off, Off-set or Netting**. In order for Intercompany Claims to be eligible for recoupment, they must have arisen out of the same transaction.

Intercompany Claims may be subject to recoupment when a company provides goods or services to one of its affiliates, creating a claim against the affiliate, and the affiliate counterclaims against the company asserting that the goods or services it received did not meet the required contractual standard. Such competing claims arise out of the same transaction and would permit recoupment, if a court agrees each claim is meritorious.

14.3 Priority Accorded Unsecured Intercompany Claims and Liabilities

Intercompany Claims generally are entitled to the same distribution priority as third party claims of the same priority. If an Intercompany Claim is secured by properly perfected liens and security interests, it generally will be entitled to treatment as a secured claim. If an Intercompany Claim is an unsecured claim, it generally will be entitled to equal treatment with all other general unsecured claims. If an Intercompany Claim is contractually subordinated to other claims, that subordination should be enforceable and respected under section 510(a) of the Bankruptcy Code.

14.4 Subordination to the Rights of Third Party Creditors

Intercompany Claims may have a direct and material impact on recoveries of third-party creditors of different debtor entities in a corporate family. Intercompany Claims therefore are subjected to intensive scrutiny during a bankruptcy case. Intercompany Claims may be challenged and disallowed, avoided, recharacterised or subordinated to the rights of third party creditors under several theories.

Recharacterisation. Intercompany Claims asserted by a parent or affiliate against an insolvent debtor subsidiary may be challenged and recharacterised as equity. Courts have found that "[t]he 'paradigmatic' recharacterisation case involves a situation where 'the same individuals or entities (or affiliates of such) control both the transferor and the transferee, and inferences can be drawn that funds were put into an enterprise with little or no expectation that they would be paid back along with other creditor claims.'" Adelphia Commc'ns Corp. v. Bank of America, Inc. (In re Adelphia Commc'ns Corp.), 365 B.R. 24, 74 (Bankr. S.D.N.Y. 2007), aff'd in part, 390 B.R. 64 (S.D.N.Y. 2008). Courts evaluate numerous factors when determining whether an Intercompany Claim should be recharacterised as equity:

- the names given to the certificates evidencing the indebtedness;
- the presence or absence of a fixed maturity date and schedule of payments;
- the presence or absence of a fixed rate of interest and interest payments;
- the source of repayments;
- the adequacy or inadequacy of capitalization;
- identity of interest between creditor and stockholder;
- the security, if any, for the advances;

- the corporation's ability to obtain financing from outside lending institutions;
- the extent to which the advances were subordinated to the claims of outside creditors;
- the extent to which the advance was used to acquire capital assets; and
- the presence or absence of a sinking fund to provide repayments.

No one factor is controlling and courts generally evaluate the particular circumstances of each case. If an Intercompany Claim is recharacterized as equity, it is likely that no value will be provided to the holder of the Intercompany Claim in a bankruptcy restructuring.

Equitable Subordination. Section 510(c) of the Bankruptcy Code allows for possible "equitable subordination" of claims, i.e., a judicial subordination of certain claims on equitable grounds that makes them lower in priority of payment to other claims. A general unsecured Intercompany Claim might be subordinated in right of payment to other general unsecured claims if (i) the claimant engaged in some type of inequitable conduct, (ii) the misconduct resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant and (iii) equitable subordination of the claim is not inconsistent with the other provisions of the Bankruptcy Code.

In order to demonstrate that a creditor has engaged in inequitable conduct justifying equitable subordination of its claims, it may be shown that the creditor perpetrated some sort of fraud, illegality, breach of fiduciary duty, or used the debtor as its own instrumentality or as an alter ego of the creditor. Inequitable undercapitalisation may be alleged when a parent has created a subsidiary and not provided it with sufficient funds to conduct its business. Allegations that an affiliate used the debtor as a mere instrumentality or alter ego might be made where the debtor is the subsidiary in a parent-subsidiary relationship. Claims for equitable subordination of Intercompany Claims may succeed when courts find that the party whose claim is to be subordinated is an insider, because the insider bears the burden of proving good faith and inherent fairness of the transaction that the debtor is seeking to subordinate.

Equitable Disallowance. Equitable disallowance is a remedy that fully disallows a creditor's claim rather than merely subordinating it to claims of other creditors. There is no specific provision in the Bankruptcy Code that allows for equitable disallowance, and courts are split on the issue of whether they have authority to impose such a remedy against creditors. The lack of statutory authority in the Bankruptcy Code for equitable disallowance has led some courts to conclude that the Bankruptcy Code intentionally did not include equitable disallowance as a remedy. Other courts, however, have determined that equitable disallowance is authorised under a bankruptcy court's general equitable powers under section 105(a) of the Bankruptcy Code. Where equitable disallowance is a recognised remedy, allegations may focus on whether a fiduciary of the claimant entity acted on inside information for personal advantage to the detriment of shareholders or creditors. If so, the entity's claim may be disallowed on equitable grounds.

Fraudulent Transfer. Actual and constructive fraudulent transfer causes of action may be used to avoid certain transactions. See **13 Transfers/Transactions That May Be Set Aside**. Fraudulent transfer causes of action may be used to unwind or invalidate Intercompany Claims. Actual fraudulent transfers can arise in an Intercompany Claims context when a company transfers assets from a debtor to another entity in the corporate family in bad faith, in order to deplete the debtor's estate and provide creditors with smaller distributions.

Constructive fraudulent transfer actions may invalidate Intercompany Claims that are predicated on voidable intercompany transactions, such as historical internal restructurings. Companies therefore should be careful to document their intercompany transactions and the consideration exchanged, to better defend against future attempts to clawback value received from a subsidiary that may become a chapter 11 or 7 debtor in the future.

Preferences. Section 547 of the Bankruptcy Code may allow a debtor entity to avoid and recover a preferential intercompany transfer made to or for the benefit of its parent or other affiliate. See **13 Transfers/Transactions That May Be Set Aside**. Intercompany transactions and related Intercompany Claims arising within one year of a bankruptcy filing may be subject to avoidance under Bankruptcy Code section 547 if the statute's requirements are satisfied.

14.5 Liability of Parent Entities

Contractual relationships, including the terms of loan documents that obligate numerous entities comprising a company, may obligate a parent entity or affiliate for the liabilities of a related business entity. Even in the absence of contractual relationships, statutory "control group" liability may make a parent or affiliate liable for the claims against and liabilities of a subsidiary.

Commercial and financing agreements may contractually obligate a company for its affiliate's liabilities. A company may agree to be a guarantor of an affiliate's debts or other obligations, as when the company agrees to pay obligations owed to a third party should the affiliate become incapable of making payments. Intercompany guaranty and indemnification arrangements are commonplace, and are a frequent basis for creditors of a company to make claims against its parent. A parent may be directly liable for its subsidiary's debts where the parent company enters into a joint contract with the subsidiary and a third party and agrees to be jointly liable with its subsidiary. Many joint contracts will contain a clause that the insolvency of a party is a default under the contract: if the subsidiary becomes insolvent or fails to perform its duties, the parent can be held responsible for the remaining contractual liabilities.

"Control group" liability is statutory liability that makes a parent responsible for the liabilities of its subsidiaries. Some statutes make a parent responsible for its subsidiary's actions even where the parent has not taken any action beyond merely owning the subsidiary. A corporate parent may be liable under federal securities laws where the parent can exercise control over its subsidiary's corporate decisions regardless of whether the parent took action in furtherance of the subsidiary's violations. See 17 C.F.R. § 230.405. Under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), a parent will be liable for a subsidiary's environmental liabilities only if the parent has actively contributed to the event or decisions that created the subsidiary's environmental liability. See 42 U.S.C. § 9601. Other statutes make a parent liable for its subsidiary's liabilities if the parent either benefits from the subsidiary's actions or the parent and subsidiary operate as a single "control group" for purposes of the statute. See 29 C.F.R. § 4001.3 (Employee Retirement Income Security Act); see also 29 U.S.C. § 152 (National Labor Relations Act).

14.6 Precedents or Legal Doctrines That Allow Creditors to Ignore Legal Entity Decisions

Formal legal entity distinctions and legal separateness normally enforced may be ignored to make a parent (or affiliate) liable for the debts of a related but separate entity under several legal theories: (i) corporate veil-piercing / alter-ego liability; (ii) substantive consolidation; and (iii) agency theory.

Piercing the Corporate Veil. In the United States, companies in the same corporate family are treated as distinct legal entities, each with its own management and business affairs. A large company will form subsidiaries and affiliates to manage risk. Each entity generally is responsible only for its own liabilities. Generally, an entity's creditors may look to recover only from the entity with which the creditor does business. Corporate parents generally are treated as separate legal entities and are not liable for the debts of their subsidiaries.

U.S. courts sometimes allow creditors of an insolvent subsidiary to seek payment from the parent entity to recover on the subsidiary's debts, but only in very limited circumstances. Courts may grant this remedy, known as "piercing the corporate veil", when a parent and its subsidiary have not acted as distinct entities, and the two companies were operated as one. In such circumstances, equity may dictate that a parent should be responsible for claims against its subsidiary. Courts, however, are generally reluctant to pierce the corporate veil. A creditor must demonstrate that a parent exercised control above and beyond the level of control a parent usually exercises over a subsidiary. Usually, creditors seeking to pierce the corporate veil must demonstrate either that the subsidiary was the "alter ego" of the parent or, alternatively, that the subsidiary was acting as the parent company's agent.

"Alter Ego" Theory. To successfully assert subsidiary liabilities against a parent in an "alter ego" action, a creditor must show the parent dominated the subsidiary without regard for the subsidiary's separate legal identity, and equity dictates veil piercing to avoid an injustice to the creditor. The creditor must prove the parent was so in control of the subsidiary that there was no real distinction between the two entities. The inquiry is fact intensive, and courts will consider: (i) whether the parent is the sole stockholder of the subsidiary; (ii) the adequacy of the subsidiary's capital structure; (iii) whether the parent observed corporate formalities; (iv) whether personal and corporate funds were commingled such that the accounts were interchangeable; (v) whether the parent and subsidiary have the same officers and directors; (vi) whether the parent borrowed money from the subsidiary without documentation or on non-market terms, or engaged in other transactions with the subsidiary that were not at arms-length; (vii) whether the entities share the same books, employees, bank accounts, etc. No factor is determinative, and courts will assess all relevant circumstances.

If a creditor shows that a subsidiary was merely an alter ego of its parent, the creditor must then prove the parent's domination of its subsidiary resulted in harm or injury to the creditor. Courts differ on what kind of injury is required. In some jurisdictions, courts require a showing that parental control of its subsidiary was used to perpetrate a fraud against the creditor. In other jurisdictions, courts merely require a showing of general unfairness to the creditor that does not have to rise to the level of fraud.

"Agency" Theory. "Agency" theory provides that a parent is liable for the actions of its subsidiary where the subsidiary operated as the parent's agent. To pierce the corporate veil under this theory, a creditor must prove that (i) the parent company intended for the subsidiary to be its agent; (ii) the subsidiary agreed to act on behalf of the parent; and (iii) the parent had total control of the subsidiary. The creditor must show the subsidiary had either actual or apparent authority to act on its parent's behalf. Actual authority exists where the parent has expressly stated that the subsidiary is to act on the parent's behalf, or has implied to the subsidiary that it has authority to take steps to perform a task that the parent has expressly authorized. Apparent authority stems from a third party's belief that the parent gave the subsidiary authority and relied on that belief in transacting with the subsidiary.

If the creditor can demonstrate the subsidiary had either actual or apparent authority to act for the parent, then the creditor must show that the parent also had the requisite control of the subsidiary such that piercing the corporate veil is appropriate. A creditor generally must show that a parent somehow controlled or directed its subsidiary's affairs with respect to the cause of action the creditor has a claim from, or that caused the harm to the creditor.

Substantive Consolidation. Substantive consolidation is an equitable remedy that a bankruptcy court may order. The remedy combines all of the assets and liabilities of separate business entities into one pool for purposes of distributing value to creditors. Substantive consolidation is an available remedy only when one or more affiliated entities have commenced bankruptcy. While no Bankruptcy Code provision explicitly authorizes substantive consolidation, courts have found equitable authority to order it under sections 105(a) and section 1123(a)(5)(C) of the Bankruptcy Code, which allows for consolidation of the debtor with other persons in furtherance of implementing a plan.

When substantive consolidation is used to combine the assets and liabilities of a parent and its subsidiaries, the parent effectively becomes liable for the claims against its subsidiaries. Courts are generally hesitant to utilize substantive consolidation as a remedy because of its dramatic impact on the rights of the separate entities and their respective creditors. Usually, substantive consolidation is used to consolidate the assets of two related debtor entities. Under extraordinary circumstances, non-debtor affiliates may be substantively consolidated into the debtor's estate as well.

There is no universal substantive consolidation test. Substantive consolidation analysis requires highly fact-based inquiry. Courts generally focus on (i) how interrelated or commingled the entities were prior to the debtor's bankruptcy proceedings, (ii) the balance of interests of the creditors and other parties who will be impacted by the potential consolidation and (iii) how significant the impact would be to the bankruptcy estate should the entities be consolidated. The Second and Third Circuits have adopted the same "Augie/Restivo Test" for determining when substantive consolidation is appropriate. See In re Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir 1988). The two-pronged test for substantive consolidation requires showing that either (i) creditors dealt with the entities as a single economic unit and did not rely on their separate identities or (ii) the affairs of the debtors are so entangled that consolidation will benefit all creditors because the cost of separating the entities would be impossible or too costly.

14.7 Duties of Parent Companies

In the United States, a corporate parent may owe fiduciary duties to a financially troubled subsidiary under applicable state laws and judicial precedents. Courts have found fiduciary breaches where a parent entity uses its control of insolvent subsidiary assets to benefit the parent company, to the detriment of the insolvent subsidiary and its creditors. Creditors of an insolvent subsidiary corporation may have standing to assert derivative claims on behalf of their corporation against its parent for breaches of fiduciary duties owed to the subsidiary.

If an insolvent subsidiary's creditors assert derivative claims for breach of fiduciary duty against the insolvent subsidiary's directors and officers, the parent company might be found to have aided and abetted the subsidiary's directors' and officers' breaches of fiduciary duties owed to the subsidiary where the parent's management encouraged such breaches.

14.8 Ability of Parent Company to Retain Ownership/Control of Subsidiaries

State law corporate governance rules apply to the relationship between a parent company shareholder and its subsidiary. State law corporate law shareholder rights continue during a bankruptcy case. Shareholders generally retain their governance rights. However, courts in the United States have found that state law governance rights may be limited by courts under certain circumstances in a chapter 11 case. Courts have decided that shareholders retain their corporate governance rights to the extent that they do not exercise those rights in an abusive fashion, or in a manner intended to undermine the chapter 11 restructuring. Shareholders of a bankrupt corporation may hold meetings to elect new board members, but bankruptcy courts may enjoin shareholder meetings if it is clear that the purpose of electing a new slate of directors is to undermine what would otherwise be a successful reorganisation.

Following confirmation of a chapter 11 plan, company shareholders may lose their ownership of the corporation. Often in chapter 11 cases, there is not enough value to pay all creditors in full, and therefore no value may be retained by the company's old shareholders on account of their old stock, and it will be cancelled by the terms of a chapter 11 plan. Nevertheless, pursuant to a chapter 11 plan, shareholders may contribute new value under a chapter 11 reorganisation plan in return for reinstated or newly issued equity interests, thereby preserving an equity stake in, and perhaps equity control over, the reorganised company.

Where both a parent and its subsidiaries have entered bankruptcy, courts typically will allow the parent's equity interest in its subsidiaries to survive in order to preserve the overall corporate structure of the enterprise. Reinstating intercompany equity interests as part of a chapter 11 plan, if done for the sole purpose of preserving the debtors' corporate structure, is appropriate because maintaining the corporate structure avoids unnecessary costs of rebuilding the corporate organisation.

15. Trading Debt and Debt Securities

15.1 Limitations on Non-banks or Foreign Institutions

The buying and selling of a company's debt can have a significant impact on a company's restructuring efforts out-of-court or in a chapter 11 restructuring. It is important for a company to understand which entities hold its various forms of debt so that the company and its professionals can effectively formulate and negotiate a successful out-of-court restructuring or chapter 11 plan. On the creditor side, holders of corporate debt may have various obligations associated with owning or trading debt securities.

The United States has a robust regulatory regime that applies to different securities markets and various types of financial institutions. While there are no limitations on foreign institutions holding Commercial Loans or Debt Securities (as defined below) in the United States, various U.S. regulations may apply to foreign investors depending on the particular investment and type of security being purchased and/or traded. There also are regulations that limit the debt-issuer, such as transfer restrictions on unregistered Debt Securities, which can impact the terms of the instrument being traded. While there are no governmental restraints on foreign institutions holding Commercial Loans or Debt Securities in the United States, the lending instruments themselves can specify certain required characteristics that investors must have in order to own the securities. For example, some debt instruments may prohibit their transfer to certain institutions, competitors or other entities or organisations that the issuer does not want to be obliged to. Such requirements may preclude or limit foreign institutions from holding and/or trading a particular loan or bond.

A foreign entity generally will not be subject to United States tax liability for gains from trading U.S. Debt Securities if the foreign entity's gain is not related to business that the foreign entity conducts in the United States and if the foreign entity is a non-resident for tax purposes in the United States. However, in certain instances a foreign entity may be subject to a withholding tax on interest payments it receives on a Debt Security. Such tax implications are outside the scope of this commentary.

15.2 Debt Trading Practices

There are two broad categories of debt instruments that may be traded: (i) commercial loans, such as loans by a bank to a corporate borrower under revolving credit facilities ("Commercial Loans"); and (ii) debt securities, such as bonds, notes and debentures that can be traded either on the open market or in restricted environments ("Debt Securities").

Commercial Loans

Commercial Loans may be traded on the secondary market in the United States. The loan facility agent generally is responsible for recording all trading activity with respect to the particular loan. Customary documentation for transfers of Commercial Loans are form documents created by the U.S. Loan Syndications and Trading Association (LSTA). The LSTA is an entity that develops standards and procedures to facilitate trading Commercial Loans on the secondary market.

Commercial Loans may be traded on the secondary market in two main ways: by assignment and by participation. Generally, an assignment of a loan is a mechanism by which the original lender sells its stake in the original loan in whole or in part. The assignee then is considered a lender to the borrower. The assignee benefits from any guarantees and/or security associated with the Commercial Loan and assumes contractual privity with the borrower. The original lender, on the other hand, no longer has any rights or responsibilities and loses the benefit of any guarantees and security with respect to the portion of the Commercial Loan that was assigned. Generally, in the "term loan b" market (the market for syndicated credit agreements in which most institutional investors operate), lenders are able to assign loans without significant restrictions, though in some instances lenders do have to receive consent from borrowers to assign such a Commercial Loan.

Differently, in a participation, creditors sell their economic position in a Commercial Loan to another investor. In a participation, the original lender retains voting rights and its contractual status with the borrower, and sells merely its economic interest in the loan to a third party. Total return swaps and other synthetic instruments such as credit derivatives that trade economic interests in debt obligations are frequently traded in the United States.

Debt Securities

In the United States, Debt Securities are generally issued in global note form, meaning that one or more global notes are used to represent the entire issuance of a particular tranche of Debt Securities. A global note often contains the basic terms and conditions of the Debt Security. It is relatively uncommon for Debt Securities to contain provisions that prohibit transfers without the consent of the borrower.

Once an offering is complete, the global note is typically deposited with the Depository Trust Company (DTC) and registered in the name of DTC's nominee, Cede & Co. Once the global note is deposited with DTC, trades in the Debt Security represented by the global note may be settled electronically among DTC participants, which facilitates secondary market trading, either over-the-counter or through exchanges.

Buyers and sellers of such Debt Securities generally do not hold their interests in the global note directly. Instead, DTC has participants, usually brokers and financial institutions, which hold an investor's interest in a global note for the investor, leaving the investor with beneficial ownership of the security. Investors can transfer their beneficial ownership in the global note through DTC's system, such transfers being evidenced by routine securities trading confirmations.

For Debt Securities, guarantees and security often are held by an agent or trustee under the applicable indenture. When beneficial holders buy a Debt Security, they benefit from the guarantee and security associated with the applicable Debt Security that they have purchased. While routine or administrative matters relating to the Debt Security usually are handled by the indenture agent or trustee, material decisions (for instance those concerning waiver of an event of default or releasing collateral) often require the approval of a majority, supermajority or unanimous consent of the beneficial holders of a Debt Security.

15.3 Loan Market Guidelines

Commercial Loans. Courts in the United States generally have concluded that, unlike Debt Securities, Commercial Loans including loan participations and syndications are not considered "securities" and do not fall under the ambit of the U.S. Securities Exchange Act of 1934 (the "Exchange Act") or other federal securities law. When deciding whether an instrument is a security, courts typically assess whether the instrument was (i) intended to raise capital or finance a business's investments, and similarly if the buyer's motivation was primarily in earning a profit, or if instead the instrument was merely used in furtherance of a consumer purpose, such as purchasing goods, (ii) how broadly distributed the instrument was, (iii) whether the instrument was marketed as a security and whether reasonable investors perceived it as an investment, and (iv) whether the instrument is governed by a regulatory scheme outside of securities law. In unusual circumstances, such factors may weigh in favour of determining that a Commercial Loan is a security. However, it is most often the case that a Commercial Loan will not be deemed a security, and as such is not subject to the restrictions of Rule 10b-5 discussed below.

As Commercial Loans are not considered "securities" subject to SEC regulation, equality of information requirements and other anti-fraud/insider trading statutes generally do not apply to Commercial Loan transactions. Nor are Commercial Loans subject to equality of information requirements promulgated by organisations such as the LSTA. The LSTA is merely an entity that develops standards and procedures to facilitate trading in Commercial Loans on the secondary market. The LSTA serves a similar purpose as the Loan Market Association does in Europe and Asia. The LSTA does not have legal authority to regulate the market for Commercial Loans, and instead only issues guidance to entities trading Commercial Loans, and works with regulators to change regulatory policies.

Debt Securities. Generally, trading in Debt Securities is subject to U.S. federal securities laws. Debt Securities are "securities" that are regulated under the Exchange Act. Under the Exchange Act, the SEC has promulgated Rule 10b-5, which makes it illegal for any person, directly or indirectly:

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

A person is liable under Rule 10b-5 where he or she has made a statement, either written or oral, or has failed to disclose information where he or she had a duty to do so, that would impact a reasonable investor's decision on whether to buy or sell a security. Additionally, in order to be found liable, the person must have acted with reasonable intent to deceive, manipulate or defraud the investor. There is some question as to the applicability of Rule 10b-5 to Debt Securities, as some courts have found that issuers owe no fiduciary duties to holders of their Debt Securities, and without a fiduciary duty, there is no duty to disclose. However, caution should be exercised, as other courts may not be bound by these decisions and fraud claims could also be brought under common law and state law.

Rule 10b-5 also proscribes insider trading, where an investor makes a trade based on material non-public information. Generally this involves a corporate insider, for example an officer or a director of a company, breaching his or her fiduciary duties to the company or shareholders of that company by providing material non-public information to another person who proceeds to trade based on this inside information. The other common theory of insider trading that is prohibited by Rule 10b-5 is where a party who is not directly connected to the company misappropriates confidential or material non-public information in breach of a duty owed to the source of the information, and trades on the insider knowledge.

The SEC has argued that any party in possession of material non-public information should be either required to disclose that information or refrain from trading on it. Parties often attempt to contract around this requirement of equal access to information. A party in possession of material non-public information will sometimes attempt to have the counterparty in a transaction sign a "big boy" letter. In a "big boy" letter, the counterparty acknowledges that the other party to the transaction may have material non-public information that has not been disclosed to the counterparty, but the counterparty agrees to the transaction because it is a "big boy" and has decided to proceed anyway. "Big boy" letters are intended to protect the party holding the material non-public information from liability under anti-fraud statutes.

However, the extent to which a "big boy" letter protects a party holding material non-public information is unclear. The SEC has articulated that such letters do not shield a party trading on material non-public information from liability for insider trading. Further, Section 29(a) of the Exchange Act prohibits parties from contracting around or waiving compliance with any of its provisions. As such, "big boy" letters may not be enforceable, and do not provide absolute protection from SEC enforcement actions.

However, "big boy" letters can work to defeat 10b-5 claims in some instances. These letters often contain non-reliance provisions whereby the counterparty asserts that it did not rely on the statements of the party in possession of the inside information during the course of the transaction. As discussed above, one element of a 10b-5 claim is that the statement or omission would have had an impact on a reasonable investor's decision. While the letter itself may not be enforceable, the fact that a counterparty agreed to a non-reliance provision sometimes can be used to demonstrate that the reliance prong under Rule 10b-5 was not met. Without reliance, the 10b-5 claim may fail.

Institutional investors holding Debt Securities of a debtor have to operate with particular caution during restructuring negotiations. During such negotiations, investors may be provided with information about the debtor that is considered to be material non-public information. If this information is left undisclosed to certain investors, the investors may be unable to trade the relevant Debt Securities without potentially violating insider trading laws. Courts in the United States have taken a relatively aggressive stance for determining what information in the course of restructuring negotiations is considered to be material non-public information. In one case, the court found that the terms of settlement offers exchanged between a creditor and debtor could potentially constitute restricted information for insider trading purposes. In light of this decision, investors in the United States have become particularly careful about including "blowout" provisions in any non-disclosure agreements so as to require public disclosure of any information that could be considered material non-public information.

Entities that trade both Debt Securities and Commercial Loans frequently receive material non-public information in the course of becoming a lender in their Commercial Loans practice. If an entity trades both Debt Securities and Commercial Loans of the same borrower, that institution should take precautions to ensure that it has proper internal controls in place to ensure the institution does not trade Debt Securities on inside information that it has received in connection with its participation in a Commercial Loan.

15.4 Enforcement of Guidelines

While the rules governing trading in Commercial Loans and Debt Securities of a company do not change upon the issuer's commencement of bankruptcy, there are certain enhanced reporting requirements pertaining to debt trading that are triggered when a bankruptcy case is commenced.

First, Bankruptcy Rule 2019 requires that creditors and equity holders of a debtor who are acting in concert disclose the economic interests that they hold in the debtor. This rule effectively requires that members of ad hoc groups in the bankruptcy case disclose their economic interests, so that a bankruptcy judge, the debtor and other constituencies may determine the motivation of these groups and their members during the course of chapter 11 proceedings and negotiations.

Second, Bankruptcy Rule 3001 sets forth certain requirements that debt buyers and sellers must meet when transferring claims against a debtor. Generally, under Bankruptcy Rule 3001, when a buyer purchases a claim from a creditor, the buyer of the claim must file evidence of the transfer of the claim and if the transfer is not objected to, the buyer will replace the seller as the claim owner. Bankruptcy Rule 3001 was adopted to ease the administrative burden of understanding the ownership of claims after the commencement of a bankruptcy case. However, because Commercial Loans and Debt Securities are typically evidenced by a master proof of claim filed by the agent / trustee, Bankruptcy Rule 3001 generally does not apply to transfers of interests in Commercial Loans or Debt Securities.

16. The Importance of Valuations in the Restructuring & Insolvency Process

16.1 Role of Valuations in the Restructuring and Insolvency Market

Valuations are important to the resolution of numerous matters that may arise during particular chapter 11 cases. The importance of a valuation depends on its purpose in a particular proceeding or dispute. Different matters and disputes implicate differing legal standards and valuation needs. For instance, when a state law receiver is appointed, the party may need a valuation backed by evidence to show that the business entity, as to which a receivership is sought, is insolvent. Applicable state law will determine the proper insolvency tests. Also, creditors may seek to obtain derivative standing to pursue breach of fiduciary duty claims against a company's directors and officers when the company is insolvent. Valuation disputes may arise in this context.

In bankruptcy cases, valuations and related expert testimony may be required in varied contexts and litigations. Following are some bankruptcy matters and proceedings in which valuations may be determinative of outcomes.

Adequate Protection. Secured creditors are entitled to and may seek "adequate protection" of their lien interests in debtor property, to protect their interest in such collateral against any diminution in value that might occur during a chapter 11 case with the passage of time, or as a result of use of the property or the imposition of postpetition financing liens on the collateral property. Determining the value of secured creditor collateral as of the petition date, and whether the existing secured creditor has adequate protection by virtue of an equity cushion in its collateral, require valuation of the relevant collateral.

Appointment of Official Equity Committee. An official committee of equity holders may be appointed under section 1102(a)(2) of the Bankruptcy Code if, among other things, the debtor is solvent. The solvency determination, often disputed, may require valuations.

Determination of Secured Status of Claim. Section 506 of the Bankruptcy Code allows for the "bifurcation" of partially secured claims into secured and unsecured components. Valuations of collateral may be required to fix an undersecured creditor's secured and unsecured claim amounts. See **5.1 Differing Rights and Priorities Among Classes of Secured and Unsecured Creditors**.

Section 506(a) provides that, when bifurcating a claim into secured and unsecured components, "value shall be determined in light of the purposes of the valuation and proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use on a plan affecting such creditor's interest." Because the Bankruptcy Code provides little guidance on asset valuation methodologies for section 506 purposes, numerous valuation approaches may be used depending on the collateral at issue and its likely proposed disposition or use by a debtor. In any event, a bankruptcy court will look to all relevant evidence when assigning value to collateral for purposes of bifurcating a claim pursuant to section 506 of the Bankruptcy Code.

Fraudulent Transfer Litigation. Parties asserting constructive fraudulent transfer actions must prove that the debtor was insolvent at the time of or rendered insolvent as a result of the alleged fraudulent transfer. Proving insolvency usually requires a valuation of the debtor's assets and liabilities. Valuation methods may vary in this context, but often involve a balance sheet test using the value of the debtor's liabilities on the date of the transfer, and the "fair value" of its assets that typically is going concern value, unless the debtor is in extreme financial distress, in which case liquidation value may be more appropriate. In calculating insolvency in the constructive fraudulent transfer context, courts may consider contingent assets and liabilities, provided that the contingent assets and liabilities may be reasonably estimated and may be subject to adjustment in value for the nature of the contingency.

Preference Litigation. Preference actions under section 547 of the Bankruptcy Code permit the recipient of an alleged preference to rebut a presumption that the debtor was insolvent during the 90-day "preference period." The plaintiff must show that the transferee received more than it would have in a hypothetical chapter 7 liquidation of the debtor. Valuations are needed if the foregoing issues are disputed.

Confirmation of a Chapter 11 Plan. Disputed valuations may play a central role in a contested chapter 11 plan confirmation process. Often, the enterprise value of a reorganized company dictates which classes of creditors will be paid in full, in part or not at all. Enterprise valuation is needed to determine the value of new securities to be issued and distributed under a plan. Numerous other valuations may come into play in the confirmation process. A hypothetical liquidation analysis is needed to satisfy the "best interests of creditors" test set forth in section 1129(a)(7) of the Bankruptcy Code. It requires a proponent of a chapter 11 plan to demonstrate that, for a class of claims or interests, each holder of a claim or interest must either (i) vote to accept the plan or (ii) "receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain" in a hypothetical chapter 7 liquidation.

Disclosure Statements and "Adequate Information". Generally, before a debtor can solicit votes on a chapter 11 plan, it must transmit a written disclosure statement to holders of claims and interests that contains "adequate information." 11 U.S.C. § 1125. While the Bankruptcy Code states specifically that a court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets, a valuation often is included as part of a court-approved disclosure statement. The valuation methodology used will depend on the debtor's business and assets, but usually includes a discounted cash flow analysis based on the company's projected cash flows after implementation of the proposed restructuring.

16.2 Initiating Valuation

There is no hard and fast rule regarding who will initiate a valuation process in a U.S. insolvency proceeding. Numerous matters in a chapter 11 case may require some sort of valuation. While a chapter 11 company often initiates matters that will require its professionals to undertake or show valuations for specific purposes, such valuations may be disputed by adverse parties who employ their own professionals and experts to show differing values. Competing valuations and expert opinions may be put into evidence when the debtor seeks to satisfy its evidentiary burdens by showing going concern and liquidation values in connection with confirming a chapter 11 plan. In other scenarios, like fraudulent transfer litigation, it may be a creditor or creditor group that initiates a valuation. It is unusual for a bankruptcy court to require or order a valuation, although it is possible that a court-appointed examiner might undertake a valuation in the course of his or her investigation.

16.3 Jurisprudence Related to Valuations

Valuation jurisprudence is well-developed in the United States. Bankruptcy courts are very familiar with accepted valuation methodologies commonly used by investment bankers and similar professionals who provide valuation reports, opinions and testimony.

The particular circumstances of a chapter 11 case, the purpose for the valuation, the context in which a valuation dispute arises, the nature of a company's business and its assets, industry norms and the reliability and availability of business projections all may influence the types of valuations and methodologies that will be used by parties and relied upon by the bankruptcy court.

There are no court-appointed or pre-approved valuation experts that must be used in bankruptcy cases. Numerous investment banking and specialised professional financial advisory firms have developed expertise in providing valuations in the insolvency context. The selection of a particular professional firm or individual will depend on their experience with (i) the type of valuation required (e.g., going concern vs. liquidation), (ii) the property being valued (e.g., operating business, real estate, store inventory, intellectual property, etc.) and (iii) the relevant industry (e.g., telecommunications, manufacturing, mining, retail, etc.).

Generally, judicial or similar officers are not appointed by the bankruptcy court to render views on valuation. Typically, the parties to a dispute each select and retain their own valuation experts. It is ultimately up to the bankruptcy judge to weigh, evaluate, and determine the credibility of competing expert opinions and evidence of value when making valuation findings.

It is up to the professional advisors retained by various constituencies in a bankruptcy case (i.e., investment bankers or similar firms with valuation expertise) to determine the most appropriate valuation methodologies and theories to employ under the circumstances. Valuation methodologies that are commonly used include comparable company analysis, precedent transaction analysis and discounted cash flow analysis. Other valuation approaches can be used, including the capital asset pricing model, weighted average cost of capital, asset-based approaches, cost based approaches and estimates of past and future economic benefits. Appraisals from professional appraisers who have specific asset-type expertise may be used.

A company's directors and officers rarely, if ever, should undertake or commission valuations for their own purposes. Company fiduciaries should request and rely on the assistance of the company's professionals for valuation services and testimony, including advice about when and how valuations should be done. Undertaking or initiating valuations prematurely or unnecessarily, before it is entirely clear for what purposes a valuation is ultimately needed, may be counterproductive and pose litigation risk.

Market-testing is not required to meet any legal requirements in a U.S. bankruptcy proceeding. However, depending on the facts and circumstances of a particular case, market-testing may be an appropriate and effective means to blunt valuation disputes.

There are certain instances in U.S. insolvency proceedings where liquidation values are relevant as the sole value comparator. For instance, the "best interests of creditors test" under section 1129(a)(7) of the Bankruptcy Code requires liquidation value as the sole relevant measure of value.

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