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Insolvency 2021

USA: Law & Practice

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USA

Law and Practice

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CONTENTS

1. State of the Restructuring Market p.4
1.1 Market Trends and Changes p.4

2. Statutory Regimes Governing Restructurings, Reorganisations, Insolvencies and Liquidations p.5
2.1 Overview of Laws and Statutory Regimes p.5
2.2 Types of Voluntary and Involuntary Restructurings, Reorganisations, Insolvencies and Receivership p.5
2.3 Obligation to Commence Formal Insolvency Proceedings p.6
2.4 Commencing Involuntary Proceedings p.7
2.5 Requirement for Insolvency p.7
2.6 Specific Statutory Restructuring and Insolvency Regimes p.7

3. Out-of-Court Restructurings and Consensual Workouts p.8
3.1 Consensual and Other Out-of-Court Workouts and Restructurings p.8
3.2 Consensual Restructuring and Workout Processes p.9
3.3 New Money p.10
3.4 Duties on Creditors p.10
3.5 Out-of-Court Financial Restructuring or Workout p.11

4. Secured Creditor Rights, Remedies and Priorities p.11
4.1 Liens/Security p.11
4.2 Rights and Remedies p.12
4.3 Special Procedural Protections and Rights p.13

5. Unsecured Creditor Rights, Remedies and Priorities p.14
5.1 Differing Rights and Priorities p.14
5.2 Unsecured Trade Creditors p.15
5.3 Rights and Remedies for Unsecured Creditors p.15
5.4 Pre-judgment Attachments p.16
5.5 Priority Claims in Restructuring and Insolvency Proceedings p.16

6. Statutory Restructuring, Rehabilitation and Reorganisation Proceedings p.17
6.1 Statutory Process for a Financial Restructuring/Reorganisation p.17
6.2 Position of the Company p.20
6.3 Roles of Creditors p.21
6.4 Claims of Dissenting Creditors p.22
6.5 Trading of Claims against a Company p.23
6.6 Use of a Restructuring Procedure to Reorganise a Corporate Group p.23
6.7 Restrictions on a Company's Use of Its Assets p.23
6.8 Asset Disposition and Related Procedures p.23
6.9 Secured Creditor Liens and Security Arrangements p.23
6.10 Priority New Money p.23
6.11 Determining the Value of Claims and Creditors p.24
6.12 Restructuring or Reorganisation Agreement p.24
6.13 Non-debtor Parties p.25
6.14 Rights of Set-Off p.25
6.15 Failure to Observe the Terms of Agreements p.26
6.16 Existing Equity Owners p.26

7. Statutory Insolvency and Liquidation Proceedings p.26
7.1 Types of Voluntary/Involuntary Proceedings p.26
7.2 Distressed Disposals p.30
7.3 Organisation of Creditors or Committees p.33

8. International/Cross-Border Issues and Processes p.33
8.1 Recognition or Relief in Connection with Overseas Proceedings p.33
8.2 Co-ordination in Cross-Border Cases p.34
8.3 Rules, Standards and Guidelines p.34
8.4 Foreign Creditors p.35
8.5 Recognition and Enforcement of Foreign Judgments p.35

9. Trustees/Receivers/Statutory Officers p.35
9.1 Types of Statutory Officers p.35
9.2 Statutory Roles, Rights and Responsibilities of Officers p.36
9.3 Selection of Officers p.37

10. Duties and Personal Liability of Directors and Officers of Financially Troubled Companies p.38
10.1 Duties of Directors p.38
10.2 Direct Fiduciary Breach Claims p.42

11. Transfers/Transactions that May Be Set Aside p.43
11.1 Historical Transactions p.43
11.2 Look-Back Period p.44
11.3 Claims to Set Aside or Annul Transactions p.44

1. STATE OF THE RESTRUCTURING MARKET

1.1 Market Trends and Changes

Since the start of the COVID-19 pandemic, there has been a dramatic rise and fall in US restructuring activity. According to the UCLA-LoPucki Bankruptcy Research Database, 56 large public corporations filed for bankruptcy in 2020 - a number of filings not observed since the global financial crisis, and a 124% year-over-year increase. Although the health effects of the COVID-19 pandemic persisted into 2021, many of the economic effects did not. Through September 2021, the Bankruptcy Research Database reports a mere seven filings by large public corporations. At this rate, 2021 will have the lowest number of filings by large public corporations since 1998, which is as far back as the Bankruptcy Research Database presents the figures. The reduction in filings can largely be attributed to a combination of loose fiscal policy, expansionary monetary policy, and the prevalence of borrower-friendly debt instruments.

Government Support Measures during COVID-19

Governments globally increased expenditures to mitigate the financial harm of COVID-19. In the USA, the federal government has provided more than USD5 trillion in COVID-19 relief through a handful of legislative acts. In March 2020, the USA passed the CARES Act, providing nearly USD2 trillion in fiscal stimulus. And in March 2021, the US followed up with the American Rescue Plan, providing an additional USD1.9 trillion in economic relief.

Some provisions of the US fiscal stimulus indirectly supported companies by boosting the purchasing power of customers – such as the economic impact payments, expanded unemployment benefits, and enhanced tax credits. And other provisions provided more direct support to companies by funding grants and loans – such as the Main Street Lending Programme or the Paycheck Protection Programme.

In addition to the fiscal stimulus provided by the US government, companies also benefited from the US Federal Reserve's (the "Fed") monetary stimulus. In March 2020, the Fed twice lowered the federal funds rate; first lowering the rate by 0.50%, and second by lowering the rate by 1.00%. Since March 2000, the rate has remained at the historically low 0.00% to 0.25%.

The Fed also took the unusual step of bolstering the financial markets by announcing its intent to purchase corporate bonds and corporate bond ETFs as needed to stabilise the markets. After its announcement in March 2020, the Fed acquired nearly USD14 billion in corporate debt—USD8.6 billion in ETF holdings and USD5.1 billion in corporate bonds. In the summer of 2021, the Fed announced that it would sell off its corporate bond positions by year end.

A company-friendly market developed as a result of the fiscal and monetary stimulus. M3 Partners, a corporate advisory firm, reports that restructuring activity has slowed significantly in 2021, in part because leveraged loans and high yield issuances increased 37% in the first quarter of 2021 and 62% in the second quarter. And the Wall Street Journal reported this summer that for the first time on record, the yield on non-investment-grade bonds was less than the rate of inflation.

More Favourable Capital

Companies have not only had access to capital at unprecedented levels, they have had access to capital on more favorable terms. In 2019, only 74% of institutional loans contained covenant-lite terms. By the first half of 2021, covenant-lite loans accounted for 90% of institutional loans. Such loans reduce the likelihood of default

because their terms permit more flexibility regarding payments, collateral, and financial performance. Fitch Ratings reports that through July 2021, US high yield default volume totals a mere USD5.6 billion – down 90% compared with 2020's total of USD55.1 billion. And the year-to-date default rate of 0.4% is the lowest level recorded since 2007.

However, the prevalence of covenant-lite loans may be an indication that lenders are underpricing the risk of default. And if economic conditions change, there could be a wave of borrower defaults without the early warning signs that financial covenants traditionally provide.

For some companies, access to credit might merely delay filings. While the financial economy rebounded quickly from the COVID-19 pandemic, the real economy continues to suffer. Businesses are struggling with a snarled global supply chain (the Port of LA recently had a record backlog of 73 cargo ships), a shortage of labour (there were 10.4 million job openings in August 2021), and rising costs of goods (producer prices increased 11.7% year-over-year in September 2021). Going forward, experts will be evaluating whether struggling companies can continue to be buoyed by the low-cost debt available to marginal issuers on favourable terms, or whether companies may succumb to the effects of increased corporate debt levels and the prolonged effects of COVID-19 in the real economy.

2. STATUTORY REGIMES GOVERNING RESTRUCTURINGS, REORGANISATIONS, INSOLVENCIES AND LIQUIDATIONS

2.1 Overview of Laws and Statutory Regimes

In the USA, business reorganisations and liquidations are undertaken under both federal and state law regimes. At the federal level, restructuring and liquidation 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 and apply to federal bankruptcy cases under Chapter 7 (liquidation) and Chapter 11 (reorganisation) of the Bankruptcy Code. As federal law, the Bankruptcy Code is supreme and pre-empts conflicting state laws that may also provide for business liquidations, receiverships and similar regimes.

At the state level, several regimes exist under common law and statutory law to facilitate the liquidation or restructuring of failing businesses. In addition to the state-law regimes described below, debtors can also contract for new debt terms through out-of-court restructurings and "workouts," see **3. Out-of-Court Restructurings and Consensual Workouts**.

2.2 Types of Voluntary and Involuntary Restructurings, Reorganisations, Insolvencies and Receivership

Federal Regimes

Under the Bankruptcy Code, with some exceptions, there are two primary types of bankruptcy cases: Chapter 7 liquidation cases and Chapter 11 reorganisation cases. Chapter 9 permits eligible municipalities to file for bankruptcy. There are also distinct Bankruptcy Code provisions

that apply to railroad, family farmers, fishermen and other businesses.

Chapter 7 liquidation cases are relatively straightforward. Under Chapter 7, an "estate" comprising of all of the debtor's property and rights is created and then liquidated under the administration of a Chapter 7 bankruptcy trustee. Creditors are then paid based on their respective statutory payment priorities set by the Bankruptcy Code and state law.

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. However, Chapter 11 may also be used to liquidate a business pursuant to a Chapter 11 plan of liquidation.

State Law Regimes

State common law and state statutory law also provide for the liquidation or restructuring of failing businesses. Unlike the Bankruptcy Code that is uniform across jurisdictions, state common law and state statutory law vary across the 50 states.

Assignments for the Benefit of Creditors

General assignments for the benefit of creditors (ABCs) are available under 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. Similar to a Chapter 7 trustee, the assignee or receiver 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 Chapter 7 cases. However, an ABC generally does not impose a bankruptcy-like automatic stay of the exercise of creditor rights and remedies. Thus, creditors could still commence an involuntary bankruptcy case or pursue other remedies against the company.

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, 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. Further, such statutes typically require that provision must be made for the payment of creditors before any distributions can 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 USA, there is no law that requires insolvent companies to be placed into bankruptcy or

insolvency proceedings. Accordingly, there are no formal civil or criminal penalties for failure to file bankruptcy cases. Companies are typically placed in bankruptcy at the discretion of their directors and officers, who must weigh the practical, legal and financial consequences. Failure to commence bankruptcy at the appropriate time can lead to issues with contract counterparties, the loss of a company's access to liquidity and capital markets, the loss of going-concern value, and events of default under the company's credit facilities that may cause rapid business deterioration and losses.

In some circumstances, directors and officers with fiduciary duties may face personal liability for their failure to conduct the business and preserve its value in a manner consistent with state and federal laws.

2.4 Commencing Involuntary 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 to initiate a Chapter 7 or 11 bankruptcy case against a debtor company. If a debtor has 12 or more creditors who hold non-contingent and undisputed claims, an involuntary bankruptcy petition against the debtor may be filed by no fewer than three such creditors holding claims totaling at least USD16,750. If the debtor has fewer than 12 such creditors, an involuntary bankruptcy petition may be filed by one or more creditors holding at least USD16,750 of such claims.

Following the filing of an involuntary bankruptcy petition, the debtor subject to the petition may contest it. If the debtor opposes the petition, the bankruptcy court, after a trial, will grant the petition, and the case will commence, only if the petitioning creditors show that:

- the entity is generally unable to pay its debts as they become due (excluding debts subject to a bona fide dispute); or
- a custodian, receiver or trustee was appointed to take charge of substantially all of the debtor's property within the 120 days before the involuntary petition was filed.

Outside of a bankruptcy, under applicable state laws, one or more creditors may request a state court to appoint a receiver for an insolvent entity, see **7.1 Types of Voluntary/Involuntary Proceedings**.

2.5 Requirement for Insolvency

A business entity need not be insolvent to qualify for, and commence, a case under either Chapter 7 or 11 of the Bankruptcy Code. However, some level of financial distress is generally required in order 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 the 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.

2.6 Specific Statutory Restructuring and Insolvency Regimes

Banks are not eligible to be debtors under the Bankruptcy Code. Instead, federal US banking laws permit the Federal Deposit Insurance Corporation (FDIC) to close a financially troubled bank and act fairly autonomously 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.

Domestic US insurance companies are also 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 to provide courts, trustees and receivers with guidance on how to administer an insolvent insurance company.

In the USA, 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). The Securities Investor Protection Corporation (SIPC) enjoys a great deal of autonomy when administering an insolvent securities broker.

Chapter 12 of the Bankruptcy Code provides the statutory framework for the reorganisation of a family farm or family fishery. A subchapter of Chapter 11 deals with the reorganisation of a railroad, and permits a railroad liquidation in limited circumstances. Chapter 9 provides 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

Benefits of Out-of-Court Restructurings

A company in need of financial restructuring may pursue and complete a restructuring without commencing a Chapter 11 case if it has sufficient liquidity and time to reach an agreement with its financial creditors and other primary stakeholders. Even if a company is unable to restructure entirely out of court, it can save considerable time and money by reaching agreement on restructuring terms with key stakeholders prior to commencing a Chapter 11 case.

Sophisticated creditors, debtors and restructuring professionals understand that a negotiated out-of-court financial restructuring is often preferable to potentially litigious and less certain in-court restructuring outcomes. 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 it 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 during a Chapter 11 case. Even if a restructuring cannot be consummated entirely out of court, negotiations may culminate in a prepackaged (a "prepack") or a pre-negotiated bankruptcy case, both generally swifter than a traditional bankruptcy case. Creditors who do not consent to the terms of the out-of-court restructuring will be bound by the bankruptcy court process, so long as the terms of the restructuring have adequate creditor support, and the plan complies with the statutory confirmation requirements.

Negotiation Dynamics

Typically, out-of-court restructurings are the product of fluid and multi-faceted negotiations between a company, primary stakeholders and their advisers. There are no strict frameworks or rules. The lack of a formal framework encourages multi-party agreements and creative solutions.

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 an "operational restructuring"). Obtaining unanimous approval on restructuring terms from diverse and unorganised creditor constituencies is usually extremely difficult or impossible. For that reason, the rights of diverse general unsecured creditors, including contract counterparties, employees, trade creditors, etc, are most often left unimpaired in an out-of-court restructuring. Additionally, securities laws can complicate a restructuring process for companies with publicly traded debt. It follows that balance sheet restructurings based on negotiated agreements with organised, sophisticated financial creditors predominate in out-of-court restructurings.

If a company has sufficient liquidity for extended negotiations and is a good candidate for an out-of-court restructuring, the threat or prospect of a Chapter 11 filing can be a powerful negotiation tool. If a financially distressed company has developed the creditor support needed to confirm a Chapter 11 plan, the company may convince dissenting creditors that its proposed out-of-court restructuring is more beneficial than a Chapter 11. Creditors that refuse to agree to the terms of an out-of-court restructuring run the risk that a company will file a prepackaged or pre-negotiated bankruptcy case and obtain approval of a plan, despite their dissent, that treats them less favourably than 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.

3.2 Consensual Restructuring and Workout Processes

There is no standard timeline or singular process for out-of-court restructurings. 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 the 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 advisers will simultaneously pursue out-of-court negotiations and prepare for and negotiate a prepackaged 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.

Typical Process and Related Agreements

While the timeline may be 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 advisers to evaluate the company and its financial condition. Lenders and bondholders will conduct business and legal due diligence, including reviewing the company's business plans and projections, financial covenants, debt structure, liquidity and assets to determine what, if any, restructuring options are feasible.

Creditors and their advisers 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 mate-

rial non-public information (MNPI) clause in the NDA agreement, preventing 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 (or forbearance) agreements or waivers of credit agreement defaults from lenders, pursuant to which such parties agree that they will not exercise specified remedies otherwise available to them for a specified time period. Lenders may also agree to waive their rights to declare defaults and to exercise default remedies for expected company violations of specific financial covenants. In exchange for their agreements, creditors will often receive fees and the company's agreement that it will pay the costs of the lenders' advisers and counsel.

It is common for ad hoc creditor groups or steering committees to form during out-of-court restructuring negotiations. These groups help a company structure an effective process for negotiating and reaching agreement on restructuring terms. Companies often agree to pay the group's fees.

Intercreditor Agreements

Creditor groups may negotiate and reach intercreditor agreements. Intercreditor agreements (and subordination agreements) between two or more creditors may fix and prioritise 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.

An intercreditor agreement may restrict a junior-lien creditor's rights in bankruptcy, eg, by limiting the junior 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 bankruptcy.

3.3 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 new or existing lenders in exchange for new loans.

If substantially all of a company's assets are already encumbered by liens, existing lenders may offer new credit to a company under new loan agreements 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.

3.4 Duties on Creditors

A creditor's legal obligations to a company are typically defined contractually by the terms of the agreement between the parties. Generally, creditors owe no fiduciary duties to the company or to each other, and are free to act in their own self-interest, even if doing so disadvantages the company or other creditors.

However, in rare bankruptcy cases, a creditor's misconduct may cause its claim to be "equitably subordinated", ie, a court orders lower priority claims to recover ahead of a claim held by the creditor who has acted inequitably. Equitable subordination is appropriate only if a creditor's conduct has resulted in an inequitable injury to other parties.

In certain circumstances, a creditor may lose its right to vote on a plan of reorganisation based on its conduct. Under Section 1126(e) of the Bankruptcy Code, a bankruptcy court may designate or disallow a creditor's vote on a plan of reorganisation if the vote was not cast in good faith. Courts have deemed vote designation appropriate in cases where:

- a creditor casts its vote in an attempt to obtain an advantage that other similarly situated creditors are not entitled to;
- has an ulterior motive (eg, the pursuit of a competitive advantage);
- acts inconsistently with protecting its self-interest as a creditor; or
- attempts to put the debtor out of business.

3.5 Out-of-Court Financial Restructuring or Workout

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

Outside of bankruptcy, companies are generally unable to bind minority dissenting creditors or dissenting equity holders to restructuring terms. A small minority of dissenting creditors may exert outsized leverage to block an out-of-court restructuring. If a dissenting minority refuses to agree to the terms of the restructuring, the company may choose to file a prepackaged or pre-negotiated bankruptcy to effect the terms of the restructuring and bind dissenting creditors, see **6.1 Statutory Process for a Financial Restructuring/Reorganisation**.

4. SECURED CREDITOR RIGHTS, REMEDIES AND PRIORITIES

4.1 Liens/Security

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

Generally, non-bankruptcy law (and, where applicable, contractual agreements) 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. The priority among secured creditors with liens on the same collateral usually depends on when each creditor perfects its liens. Unless otherwise contractually agreed, creditors who perfect their liens first typically have first priority rights with respect to any relevant proceeds of shared collateral.

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 the collateral (11 USC Section 506(a)). Generally, outside of an insolvency process, secured creditors are able to enforce payment of an obligation by foreclosing on their 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.

Forms of Security. A creditor's security may 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 50 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 shares, debt instruments, accounts and other intangible types of property. In addition to the mechanisms described above, creditors may become secured by 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 trade marks, copyrights and patents include provisions for recording certain interests in intellectual property. Each recording system differs, and the rights protected in trade marks, copyrights and patents by proper recordation also differ.

4.2 Rights and Remedies

Generally, each state's laws (and contractual agreements, if applicable) 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 are generally 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, including receiverships and ABCs, see **2.2 Types of Voluntary and Involuntary Restructurings, Reorganisations, Insolvencies and Receivership** and **7.1 Types of Voluntary/Involuntary Proceedings**. Secured creditors may assert their secured claim rights in state law receivership proceedings and ABCs in accordance with the applicable state law.

Bankruptcy constrains secured creditors from asserting their claims and enforcing their liens and security interests without further order of the bankruptcy court. When a voluntary bankruptcy petition is filed, 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 to collect on a debt owed by the debtor. Unless there is 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 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 lenders with paramount liens and adequate protection rights may often dictate or block debtor-in-possession financing terms, or provide such financing them-

selves, and require the debtor to meet case progress milestones as a condition to new financing and the use of secured creditors' cash collateral. In addition, senior secured lenders have considerable influence over the terms of the debtor's Chapter 11 plan, which can only be confirmed over their objection if certain statutory requirements are met, see **4.3 Special Procedural Protections and Rights**.

In Chapter 7 liquidation cases, validly perfected secured creditors have paramount "adequate protection" rights under the Bankruptcy Code protecting their pre-petition 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 usually cannot use the collateral of secured creditors without their consent. However, a debtor or trustee may surcharge collateral for the necessary costs of preserving or disposing of such collateral (11 USC Section 506(c)).

4.3 Special Procedural Protections and Rights

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 seek "adequate protection" of their liens and security interests in debtor property to protect against any diminution in the 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 post-petition financing liens on the property. Adequate protection includes periodic cash payments to the secured creditor (usually in the amount of post-petition interest that would otherwise be payable contractually) and/or granting the secured creditor replacement liens on other debtor property. The general purpose 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 during the pendency of a bankruptcy case.

Relief from Automatic Stay

Section 362(d) of the Bankruptcy Code gives secured creditors the right to seek a bankruptcy court order granting the secured creditor relief from the Section 362 automatic stay to exercise remedies against the secured creditor's collateral. A bankruptcy court may lift or modify the automatic stay in the following circumstances:

- "for cause", including "the lack of adequate protection" of the secured creditor's lien interest in debtor property;
- 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 reorganization"; or
- if 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

If a debtor proposes in a plan of reorganisation to not pay a secured creditor in full, and the secured creditor does not vote to accept the plan, the debtor must show that the proposed plan either:

- 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;
- 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

that provides the secured creditor with an opportunity to credit bid; or
- provides the secured creditor with the "indubitable equivalent" of the allowed amount of its secured claim.

The "indubitable equivalent" standard requires that the secured creditor receives 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.

If the transactions contemplated by the plan involve a sale of the secured creditor's collateral, then to cram down the secured creditor the creditor must be provided with an opportunity to credit bid.

5. UNSECURED CREDITOR RIGHTS, REMEDIES AND PRIORITIES

5.1 Differing Rights and Priorities

Applicable state laws control the priority of payment rights of creditors, and may vary across jurisdictions. Typically, secured creditors have priority over unsecured creditors with respect to the proceeds of their collateral.

If the debtor enters bankruptcy, unsecured creditors may assert their unsecured claims as permitted by the Bankruptcy Code and any applicable bankruptcy court order, and may recover on their claims to the extent distributions are made to unsecured creditors. 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.

Creditor Priority

The Bankruptcy Code's hierarchical creditor priority scheme is as follows:

- secured claims;
- administrative expense claims;
- priority unsecured claims;
- general unsecured claims; and
- subordinated claims.

Secured creditors have first priority payment rights in bankruptcy to the extent of the value of their collateral. A creditor's claim may be partially secured and partially unsecured. If a secured creditor's claim is greater than the value of its collateral, 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 USC Section 506(a)). A secured creditor 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, see **5.5 Priority Claims in Restructuring and Insolvency Proceedings**.

A general unsecured claim is a debt or other obligation owed by the debtor that is not secured by a lien or security interest. The general rule is that all pre-petition 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 pre-petition unsecured claims that are entitled to payment in full before lower ranked general unsecured claims receive a distribution.

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 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 pre-petition trade claims are generally 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 pre-petition 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 pre-petition 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 can pay the pre-petition claims of critical vendors, the debtor must obtain a bankruptcy court order authorising such payments.

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 for Unsecured Creditors

Upon the commencement of a bankruptcy case, 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**.

Unsecured creditors and other parties-in-interest in a bankruptcy case may, in limited circumstances, move the bankruptcy court to dismiss a voluntary bankruptcy petition "for cause", which may include unreasonable delays by the debtor. 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 and improper management of the estate). 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 the 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 the confirmation of a proposed Chapter 11 plan. Unless a Chapter 11 plan provides for payment in full of unsecured claims or provides for no distribution to such creditors, unsecured creditors have the right to vote to accept or reject the plan.

As discussed below, the interests of general unsecured creditors are represented by an official committee of unsecured creditors, which is typically appointed in most large Chapter 11 cases, see **6.3 Roles of 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 judgment against the debtor, so that the creditor can collect against the debtor's property if successful in the litigation.

5.5 Priority Claims in Restructuring and Insolvency Proceedings

Under the Bankruptcy Code, 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, for which a confirmed Chapter 11 plan must provide payment in full unless the holders of such claims agree to different treatment. Administrative expense claims are claims for "the actual, necessary costs of preserving the estate". Administrative priority expenses include post-petition operating expenses such as post-petition 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.

Other priority unsecured claims receive payment after administrative expense claims, but before general unsecured claims. Common priority claims under the Bankruptcy Code are certain employee unpaid wage claims up to certain dollar amounts incurred during the 180 days prior to the bankruptcy filing, certain employee benefit programme 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.

6. STATUTORY RESTRUCTURING, REHABILITATION AND REORGANISATION PROCEEDINGS

6.1 Statutory Process for a Financial Restructuring/Reorganisation

A rehabilitative financial restructuring in the USA is achieved by a US bankruptcy court's confirmation of a Chapter 11 plan of reorganisation in a Chapter 11 case under the 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 confirmed Chapter 11 plan binds 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 terms out-of-court, and can take the form of a prepackaged, pre-negotiated or traditional case.

Prepackaged Cases

When there are minority dissenting creditors objecting to a consensual restructuring, a company may commence a prepackaged or a pre-negotiated Chapter 11 bankruptcy case in order to bind dissenting creditors to otherwise agreed terms of a restructuring. Before commencing a prepackaged or pre-negotiated bankruptcy case, the debtor and its supporting creditors will typically execute a restructuring support agreement (RSA), which is generally enforceable in bankruptcy and binds the debtor and supporting creditors to the 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.

In a prepackaged bankruptcy case, the debtor company negotiates and documents a plan of reorganisation and solicits votes on the plan prior to filing for Chapter 11. A debtor does not need creditors to unanimously accept the plan – only a majority in number of voting creditors that hold at least two thirds of the dollar amount of debt voted in a class are needed to confirm a plan. Once the requisite votes are obtained, the company files its Chapter 11 case and submits its prepackaged plan for confirmation. A court date is obtained for a hearing on confirmation of the prepackaged plan, often within weeks of the bankruptcy filing.

Pre-negotiated Cases

A pre-negotiated bankruptcy is similar to a prepack, except that, by definition, creditors will not have voted on the Chapter 11 plan of reorganisation prior to commencement of the debtor's Chapter 11 case. An RSA may be signed before or after a company files for bankruptcy, but votes on the plan of reorganisation are not solicited until after the company has sought bankruptcy protection and the solicitation and disclosure documents are approved.

Pre-negotiated bankruptcies may be required when rights of diverse, unorganised classes of creditors will be impaired by the terms of a Chapter 11 plan and where a broad, public solicitation of votes on a Chapter 11 plan prior to bankruptcy is usually impracticable or impossible, and likely to damage going-concern business operations and values. Although pre-negotiated bankruptcies may be speedy and last only a few months, the frequent lack of complete restructuring agreements and an agreed Chapter 11 plan at the time of filing creates additional risks and uncertainties.

Traditional Cases

If pre-bankruptcy restructuring negotiations fail and significant creditors begin to exercise remedies against the company, or if the financially distressed company lacks the liquidity needed to operate its business and continue negotiations outside of bankruptcy, it may commence a "traditional" Chapter 11 reorganisation case. In the Chapter 11 case, the company may:

- obtain post-petition debtor-in-possession financing needed for continued business operations and to pay the costs of a Chapter 11 case;
- restructure its business operations;
- negotiate with creditors and formulate reorganisation plan terms;
- propose and solicit creditor acceptances of a reorganisation plan; and
- thereafter, obtain bankruptcy court confirmation of its reorganisation plan.

A traditional Chapter 11 reorganisation process may take months or even years.

Chapter 11 plan

A Chapter 11 plan is 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.

Under Section 1123 of the Bankruptcy Code, a plan must include, among other provisions, terms that:

- 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 favourable treatment; and
- 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 terms of a particular plan are unique and highly negotiated. The terms of a confirmed Chapter 11 plan, to the extent they are 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, see **7.1 Types of Voluntary/Involuntary Proceedings**.

Numerous types of Chapter 11 plan-based transactions may be used to restructure financially distressed companies. For instance, Chapter 11 reorganisation plans may provide for:

- a conversion of certain creditor claims into equity of the reorganised company;
- a new money investment by old equity holders giving them continued ownership and control of the reorganised company;
- a treatment that leaves unimpaired (or unchanged) the claims of certain creditors;
- a third-party equity investment under the plan giving the third party ownership of the reorganised company; and
- sales of the company or its assets.

Plan formulation and solicitation

A Chapter 11 plan may be confirmed consensually with votes of acceptance by all classes entitled to vote. If not all classes vote to accept the plan, the confirmation of a plan requires that it be accepted by the requisite majorities of creditors voting in at least one impaired creditor class without counting the votes of insiders. A class of creditors accepts a plan if holders of at least two thirds in amount and more than one half in number of those actually voting vote to accept the plan.

If at least one impaired creditor class votes to accept the plan and the plan otherwise satisfies all other requirements of the Bankruptcy Code, the plan will be binding on all creditors and equity interest holders, regardless of whether or not they voted to accept the plan, ie, the plan can be "crammed-down" on dissenting creditor and equity classes if the Bankruptcy Code's Section 1129(b) requirements are met, see **4.3 Special Procedural Protections and Rights**.

A company 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 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, which may be extended for up to a maximum of 18 months after the commencement of the Chapter 11 case. Before the debtor may solicit votes on the plan, it must obtain bankruptcy court approval of a disclosure statement that provides "adequate information" to those entitled to vote on the plan about the Chapter 11 case, the plan and their treatment under the plan (11 USC Section 1125).

A Chapter 11 debtor files a statement of financial affairs and schedules of assets and liabilities early in its case. The schedules include a listing of known creditors and their respective claims. The schedules of claims are the initial basis for Chapter 11 claims recognition, and indicate whether particular claims are unliquidated, contingent and/or disputed. After a debtor files its schedules and 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 (or claims "bar date") is approximately 45 to 60 days after 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.

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 a similar type are grouped in classes of "substantially similar" claims for Chapter 11 plan treatment and voting purposes (11 USC Section 1122). When a class is unimpaired under 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.

After votes have been solicited and obtained from classes entitled to vote on a plan, and after the deadline for filing objections to the confirmation

of a Chapter 11 plan has passed, the bankruptcy court holds an evidentiary hearing on the confirmation of the plan. At the confirmation hearing, the plan proponent 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 cramdown requirements under Section 1129(b), if relevant, see **6.12 Restructuring or Reorganisation Agreement**.

Confirmation order and effective date

The bankruptcy court will consider and sustain or overrule confirmation objections. 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 the confirmation and consummation of a Chapter 11 plan, the reorganised company must perform its obligations and effectuate the transactions contemplated by the plan, including implementing the plan's treatment of various classes of creditors and equity interests (11 USC Section 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 the implementation of the plan.

6.2 Position of the Company

Upon the filing of a voluntary Chapter 11 petition by a debtor, the company is automatically authorised (without need for court approval) to proceed in bankruptcy as a "debtor-in-possession", and may continue to operate its business (11 USC Section 1108). The Chapter 11 company's internal governance and management continue under the applicable non-bankruptcy law. The debtor company's incumbent directors and officers continue to manage the company's business and properties, and perform the debtor'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 USC Section 363), see **6.7 Restrictions on a Company's Use of Its Assets** and **6.8 Asset Disposition and Related Procedures**. 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 USC Section 364), see **6.10 Priority New Money**.

In circumstances 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 debtor and incumbent management, and to take

control of the debtor's property and business (11 USC Section 1104(a)). In other cases, 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 debtor not to perform (11 USC Sections 1104(c), 1106(b)).

The Bankruptcy Code specifies the rights, functions and duties of a Chapter 11 debtor 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 USC Sections 521, 1107, 1108).

Automatic Stay

During a Chapter 11 case, the debtor company is protected by the automatic stay of Section 362 of the Bankruptcy Code, which 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. Subject to certain statutory exceptions, the Section 362 stay applies globally, automatically and generally to all persons and entities. The stay gives a Chapter 11 debtor company an opportunity to stabilise its business and affairs, negotiate with creditors and other stakeholders, and formulate and propose a Chapter 11 plan of reorganisation.

Wilful 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 in certain circumstances (11 USC Section 362(d)), see **4.3 Special Procedural Protections and Rights** and **6.3 Roles of Creditors**.

6.3 Roles of Creditors

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 may file motions seeking bankruptcy court relief (including relief from the automatic stay), file objections to motions filed by the debtor or others, and object to confirmation of a Chapter 11 plan. However, many individual creditors do not organise and individually do not play an active role in a Chapter 11 case.

Similarly situated creditors under particular credit agreements or debt instruments 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 agreements. Such agents and indenture trustees may take instructions from controlling creditors and "steering committees" or "ad hoc committees" of such creditors, and may employ sophisticated counsel and financial advisers to represent particular creditor group interests.

Official Committee of Unsecured Creditors

The rights of unsecured creditors in a Chapter 11 case are usually represented by an official committee of unsecured creditors. The Bankruptcy Code requires the United States Trustee (the "US Trustee") to appoint an official committee of creditors holding unsecured claims "as soon as practicable" after the commencement of a Chapter 11 case. The US Trustee may appoint additional committees of creditors or equity

security holders as he or she deems appropriate (11 USC Section 1102(a)).

Ordinarily, the members of an official committee of unsecured creditors appointed by the US Trustee are those willing to serve who hold the seven largest unsecured claims against the debtor (11 USC Section 1102(b)). In practice, the US Trustee exercises discretion, will interview those who express interest in serving, and will take into account the views of the Chapter 11 debtor about whether particular creditors should be appointed.

An official committee in a Chapter 11 case monitors developments in the case and acts as it deems appropriate to advance the interests of the parties it represents. An official committee owes fiduciary duties to the parties it represents, and may be expected to provide information requested by class members and to recommend to them whether to accept or reject a proposed plan. An official committee may employ attorneys, financial advisers and other professionals to assist the committee in its role, and the 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.

The official committee typically plays an active role in the Chapter 11 process and is involved in plan formulation, negotiation and confirmation and may:

- consult with the debtor concerning the administration of the case; and
- 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.

The official committee has standing to be heard on all matters, and may take positions adverse to the debtor and/or object to the confirmation of the Chapter 11 plan. A bankruptcy court may give standing to an official committee to commence estate causes of action against third parties in certain circumstances.

6.4 Claims of Dissenting Creditors

Creditors whose claims are impaired under a proposed Chapter 11 plan may vote to reject the plan. However, unanimous creditor acceptance is not required.

Individual dissenting creditors can thwart confirmation of a plan if they can show that the plan does not satisfy the best interest of creditors test. This test requires that the plan provide them with at least as much value on account of their claims as they would receive in a hypothetical liquidation of the debtor under Chapter 7 (11 USC Section 1129(a)(7)(A)(ii)).

When a class of creditors has voted as a class to accept a plan, the terms of the confirmed plan will be binding on all creditors within the class, including individual creditors who voted against the plan.

In addition, a Chapter 11 plan may be confirmed over the dissent of entire non-accepting creditor classes. If one or more impaired creditor classes vote as a class to accept the plan, non-accepting creditor classes can be "crammed down" on such classes if the plan provides that each creditor in a non-accepting class receives at least as much value as it would receive in a hypothetical Chapter 7 liquidation of the company and the plan:

- does not discriminate unfairly against non-accepting classes; and
- is "fair and equitable" with respect to each such class (11 USC Section 1129(b), providing cram-down requirements).

The cram down requirements for non-accepting unsecured creditor classes include that no class junior to a non-accepting unsecured creditor class will receive any payment until the non-accepting class is paid in full, and that no class senior to the non-accepting unsecured creditor class will receive more than the allowed amount of their claims (11 USC Section 1129(b)(2)(B)). Likewise, a plan may be confirmed and crammed-down over the dissent of a non-accepting secured creditor class if it satisfies the requirements of Section 1129(b)(2)(A), as discussed above, see **4.3 Special Procedural Protections and Rights**.

The Bankruptcy Code also provides for the cram-down of non-accepting classes of equity interests (11 USC Section 1129(b)(2)(C)).

6.5 Trading of Claims against a Company

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.

6.6 Use of a Restructuring Procedure to Reorganise a Corporate Group

It is common for bankruptcy cases of affiliated business entities to be "jointly administered" before a single bankruptcy court and judge. Affiliated Chapter 11 debtor companies are routinely represented by the same bankruptcy counsel and other advisers and a single "joint Chapter 11 plan" may be used to reorganise all the affiliated debtor entities.

6.7 Restrictions on a Company's Use of Its Assets

On commencement of a Chapter 11 case, a debtor's legal and equitable interests in property become property of the debtor's estate (11 USC Section 541). Any use, sale or lease of estate property outside the ordinary course of business requires bankruptcy court approval (11 USC Section 363(b)). If a use, sale or lease of property requires bankruptcy court approval, it will be granted if the use, sale or lease is shown to be a sound exercise of the debtor's business judgement.

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 USC Section 363(b)). A court will generally defer to a debtor's business judgement 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**.

6.9 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 **4.3 Special Procedural Protections and Rights** and **7.2 Distressed Disposals**.

6.10 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 debtor 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 USC Section 364(a)).

A debtor may need significant additional borrowings of new money financings during the Chapter 11 case. The Bankruptcy Code authorises the debtor to obtain unsecured or secured post-petition financing outside of the ordinary course of business ("DIP Financing"), with bankruptcy court approval after notice and a hearing. DIP Financing may be secured by a lien on unencumbered property, a junior lien on already-encumbered property, or a "priming" lien that is senior or equal to existing liens on the property. The bankruptcy court and debtor 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 USC Section 364(b)-(d)).

The Bankruptcy Code permits a Chapter 11 debtor to use "cash collateral" (ie, cash, cash equivalents and cash proceeds of debtor accounts receivable and other collateral property that is subject to pre-existing liens and security interests) with the consent of all holders of liens on or security interests in the cash collateral, or if there is no consent, by order of the bankruptcy court if the order provides "adequate protection" of such liens and security interests (11 USC Section 363 (c), (e)).

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 if certain conditions are satisfied. Senior pre-petition 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 super-priority DIP Financing lenders typically have the highest payment priority rights in a Chapter 11 case.

6.11 Determining the Value of Claims and Creditors

The Chapter 11 process may establish and determine the allowed amount of creditor claims, and whether they are secured or unsecured. Substantive non-bankruptcy law usually determines whether asserted claims are valid and allowable, and in what amounts. In Chapter 11 cases, the allowed amount of most claims, as well as whether such claims are secured or unsecured, is determined in an allowance/disallowance process (or "claims reconciliation process"), often occurring after a Chapter 11 plan is confirmed and consummated, see **6.1 Statutory Process for a Financial Restructuring/Reorganisation**.

6.12 Restructuring or Reorganisation Agreement

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 incorporate other provisions of the Bankruptcy Code (for instance, Section 1123(a)'s requirement for inclusion of certain mandatory provisions in a Chapter 11 plan). 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;
- the plan proponent must comply with applicable provisions of the Bankruptcy Code;
- 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 or 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 must be approved or subject to regulatory approval;
- the plan must provide that any holder of a claim or interest in an impaired accepting class that did not vote to accept the plan will receive or retain property of a value not less than it 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 the plan may be confirmed by "cram-down" of any impaired non-accepting class if the applicable requirements of Section 1129(b) cram-down are satisfied);
- the plan must provide for payment in full in cash of the allowed amount of administrative expense claims and certain other priority claims, unless the holders of such claims agree to different treatment;
- one impaired class of claims must have voted as a class to accept the plan without counting the votes of insiders;
- the plan must be feasible;
- all fees payable to the US Trustee 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.

6.13 Non-debtor Parties

The terms of a confirmed Chapter 11 plan may release non-debtor parties from actual or potential claims held by the debtor against such parties. Bankruptcy courts typically require showings that some consideration was provided for the releases received. Such consideration may be monetary or other contributions to the debtor during the Chapter 11 case or pursuant to the plan. 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 in consideration of their services to the company during the Chapter 11 case, although such releases have been subject to increased scrutiny.

Chapter 11 plans may also propose and effectuate "non-consensual third-party releases" on creditors 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 "released parties" (including current and former officers, directors and employees of the debtor, official committee members, lenders to the Chapter 11 company, plan funders, purchasers and other parties who have made it possible for the plan to be confirmed). Such non-consensual third-party releases are often contentious.

6.14 Rights of Set-Off

In Chapter 11 cases, creditors may have rights to off-set and reduce a pre-petition obligation they owe to the debtor by the amount of a pre-petition obligation owed by the debtor to the creditor. Such "set-off" 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 set-off rights unless the creditor obtains a bankruptcy court

order modifying the automatic stay, but does not preclude exercise of recoupment rights. In practice, set-off and recoupment rights are usually determined and exercised in connection with the bankruptcy claims reconciliation process.

6.15 Failure to Observe the Terms of Agreements

Chapter 11 plans and confirmation orders usually include injunctions that prohibit creditors and other parties from taking actions that are inconsistent with plan terms. If a debtor or other party fails to perform according to the confirmed plan, the bankruptcy court may direct the performance of such acts (11 USC Section 1142(b)). Failure to comply may result in contempt of court sanctions, damages and penalties.

A party may also request the bankruptcy court to convert the Chapter 11 case to a case under Chapter 7 in circumstances where a debtor 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 where a confirmed plan is terminated due to the occurrence or non-occurrence of a condition specified in the plan.

6.16 Existing Equity Owners

Existing equity owners of a Chapter 11 company may pursuant to a Chapter 11 plan (and depending on the facts and circumstances):

- receive no distribution on account of their equity;
- retain equity; or
- receive distributions of value on account of their equity interests.

Generally, equity holders do not retain ownership of the reorganised company if the company is insolvent. Typically in that circumstance, the Chapter 11 plan provides that old equity interests are cancelled without any distribution on account of such interests, but the facts and circumstances may permit better plan treatment.

In some cases, existing equity holders may retain their ownership interests in exchange for making contributions of substantial "new value" to the debtor's estate. Any new equity to be received by an existing equity holder on account of such new value must be subject to a market test, ie, be subject to higher and better third-party offers.

7. STATUTORY INSOLVENCY AND LIQUIDATION PROCEEDINGS

7.1 Types of Voluntary/Involuntary Proceedings

Insolvent companies may be liquidated voluntarily or involuntarily under federal law, pursuant to Chapter 7 or Chapter 11 of the Bankruptcy Code, see **2. Statutory Regimes Governing Restructurings, Reorganisations, Insolvencies and Liquidations**.

Alternatively, an insolvent company may also be liquidated pursuant to varying laws of the 50 states that provide for:

- the appointment of receivers;
- general assignments for the benefit of creditors; and
- the dissolution of business entities.

See **2.2 Types of Voluntary and Involuntary Restructurings, Reorganisations, Insolvencies and Receivership**.

In the United States, the point at which a liquidation proceeding may be commenced by a company is generally in the company's discretion. Exceptions include the commencement by creditors of an involuntary Chapter 11 or

Chapter 7 case, when a state court orders the appointment of a receiver, or the dissolution of the insolvent entity.

Chapter 11 Liquidations

A key advantage of a Chapter 11 liquidation is that the 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 maximise going-concern values when business assets are sold.

The timelines and duration of Chapter 11 liquidations vary from case to case. Chapter 11 provides maximum flexibility for a liquidation, but it is the most expensive and 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 a bankruptcy court, which may take many months or longer.

Confirmation of a liquidating Chapter 11 plan requires satisfaction of the same legal standards for confirmation of a Chapter 11 plan of reorganisation, see **6.1 Statutory Process for a Financial Restructuring/Reorganisation**. The "feasibility" requirement requires a showing of sufficient funding to consummate the liquidating plan. Unless there is sufficient net sale proceeds or other funding required to pay secured and administrative expense claims in full and to fund the plan, the legal standards for confirming a liquidating Chapter 11 plan cannot be satisfied.

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:

- substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;
- gross mismanagement of the estate;
- failure to file a disclosure statement, or to file or confirm a plan, within the time fixed either by the Bankruptcy Code or by order of the court; and
- inability to effectuate substantial consummation of a confirmed plan.

Instead of converting its Chapter 11 case to Chapter 7 when a liquidating plan cannot be confirmed or consummated, a Chapter 11 debtor may seek a "structured dismissal" of its bankruptcy case, ie, 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 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 the 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 or uncooperative. Administrative expenses are generally lower in Chapter 7 than in Chapter 11.

Upon the commencement of a Chapter 7 case, the incumbent management and directors of the debtor are immediately replaced by an interim

Chapter 7 trustee who is appointed by the US Trustee (11 USC Section 701(a)). The interim trustee exercises complete control over the debtor's estate and properties in accordance with the Bankruptcy Code and will continue as trustee unless creditors holding undisputed, non-contingent unsecured claims elect a different permanent Chapter 7 trustee of their own choosing (11 USC Section 702).

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 USC Section 704). 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. 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 exercise set-off rights in Chapter 7, subject to the automatic stay. Set-off rights are generally resolved before a creditor receives any distributions from the Chapter 7 trustee.

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 the subsequent commencement of a bankruptcy case that may supersede and stay the receivership.

Generally, state courts have authority to appoint receivers under applicable state law, either by statute or under their general equitable authority. The authority of state law receivers is typically limited to liquidating a company's assets and distributing the 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. 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.

Following commencement:

- receivers file schedules of assets and liabilities;
- creditors may file claims (which the receiver may object to);
- notice is provided to creditors prior to a sale or other disposition of assets; and
- the receiver may pursue litigation on behalf of the insolvent entity.

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.

A receivership's duration varies. A court may use its equitable authority and judicial discretion to order a stay of litigation against an insolvent company in receivership. 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 set-off 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 of the debtor's assets 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 either be 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. The transfer of assets is subject to any and all creditor claims and pre-existing valid liens and security interests encumbering such assets. The assignee as a fiduciary for creditors acquires all right, title and interest in the assigned assets for the 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.

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.

The winding-down process typically includes:

- prosecuting and defending or settling to conclusion all civil, criminal or administrative suits;
- disposing of the corporation's property;
- paying or making adequate provision for payment of the corporation's actual, disputed, contingent and foreseeable liabilities; and
- 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. The notice will usually 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.

Although some states 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 the 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 the factual circumstances and applicable state law and procedures. Once the winding-up process is completed and all distributions are made, the corporation's dissolution is complete.

In a corporate dissolution, the corporation must generally 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 may exercise set-off rights in accordance with applicable state laws and any relevant contractual agreements between the creditor and the company. No special set-off rules apply during the dissolution process.

7.2 Distressed Disposals

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.

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 assignee exercises its discretion about how best to liquidate assets and maximise their value. 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. 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 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, or a Chapter 11 or Chapter 7 trustee, may abandon property that is burdensome or of inconsequential value.

363 Sales in Bankruptcy Cases

In Chapter 11 and Chapter 7 cases, the debtor or trustee, as applicable, is authorised to sell assets outside the ordinary course of business with bankruptcy court approval, pursuant to Section 363 of the Bankruptcy Code. Section 363 sales often include the assumption and assignment to a purchaser of particular executory contracts and unexpired leases if the pur-

chaser wants to assume the debtor's rights and obligations under such agreements.

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 business judgement and is 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, such as:

- the proportionate value of the assets to be sold compared to the value of the debtor's estate as a whole;
- the amount of time elapsed since the commencement of the bankruptcy case;
- the likelihood that a Chapter 11 plan of reorganisation will be proposed and confirmed in the near future;
- the effect of the proposed disposition on future plans of reorganisation;
- the amount of proceeds to be obtained from the disposition relative to any appraisals of the property;
- which of the alternatives of use, sale or lease the proposal envisions; and
- 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 is flexible and tailored to maximise value in light of the particular facts and circumstances of the 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 the following:

- "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;
- 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;
- requirements for "qualified" bids, including the deadline for submitting bids, required cash deposits and the form of purchase agreement;
- 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
- 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.

Stalking horse bidders

In many 363 sales, a potential purchaser is selected as the "stalking horse" bidder, setting a floor value for the sale and assuring that the debtor has a sale transaction to consummate before further efforts are undertaken to seek a higher bid. Section 363(k) of the Bankruptcy Code specifically permits a secured creditor that is a prospective asset buyer to credit as purchase price (or "credit bid") the amount of any claims it may have that are secured by the property being sold. Credit bidding rights give a secured creditor some control over a sale of collateral property to ensure the collateral is being sold for the highest price. 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 when the valid-

ity of the bidder's asserted secured claim is in dispute at the time of the proposed sale. If the secured creditor is the successful bidder, the creditor's claim is reduced by the amount of its credit bid.

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 1-3.5% of the value of the stalking horse bid, plus an expense reimbursement, both of which are payable in accordance with the negotiated terms of the bidder protections, usually if a transaction is consummated with an alternative buyer. A limited "no shop" period may protect a stalking horse bidder during the time between the execution of its purchase agreement and when the bankruptcy court approves the bidder protections. Bidder protections are not immediately enforceable and must be approved by the bankruptcy court.

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 the Chapter 11 case is commenced. An officer of the debtor will execute the sale agreement before bankruptcy, but the company's obligations will remain subject to bankruptcy court approval of the agreement.

363 sale benefits and protections

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 order approving the sale is overturned on appeal.

Section 363 sales are often viewed favourably by potential purchasers for the following reasons:

- 363 sales are generally quicker and less expensive than the process needed to sell assets under a Chapter 11 plan;
- purchasers have the ability to select the specific assets they wish to purchase and the liabilities they are willing to assume;
- assets can generally 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;
- 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
- the waiting period for US antitrust approval may be shortened to 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:

- the applicable non-bankruptcy law would permit a sale of such property free of the interest;
- consent of the non-debtor party holding the interest;
- the interest is a lien and the sale price is greater than the aggregate value of all liens on the property being sold;
- the interest is in bona fide dispute; or
- 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 may often be disputed. Whether Section 363(f) permits a 363 sale free and clear of all successor liability claims is not clear.

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 to recover additional consideration from the purchaser.

7.3 Organisation of Creditors or Committees

In a Chapter 11 case, an official committee of unsecured creditors is typically appointed by the US Trustee, see **6.3 Roles of 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 not authorised to take any substantive action without first consulting with the Chapter 7 trustee, and is 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 and 11 members, all of whom must hold an allowable unsecured claim against the debtor (11 USC Section 705).

There are no official committees of creditors in state law receivership, ABC or corporate dissolution proceedings.

8. INTERNATIONAL/ CROSS-BORDER ISSUES AND PROCESSES

8.1 Recognition or Relief in Connection with Overseas Proceedings

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

Eligible non-US insolvency proceedings are recognised in the USA through Chapter 15 of the Bankruptcy Code, which provides for the commencement of an ancillary US 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. More than 50 nations or territories have adopted legislation based on this Model Law, which is premised on international comity. A Chapter 15 bankruptcy case serves both protective and facilitative functions, protecting the non-US debtor by allowing it to stay both actions against its assets in the USA and litigation pending against it in US courts. It also facilitates a foreign debtor's restructuring efforts by allowing it to administer, sell or transfer property within the jurisdiction of the USA, and to take other actions in furtherance of its restructuring.

Foreign Representatives and Proceedings

By filing a petition under Chapter 15 of the Bankruptcy Code, a "foreign representative" petitions a US bankruptcy court for recognition of a "foreign proceeding". A "foreign representative" is 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 USC Section 101 (24)). A "foreign proceeding" is a "collective" judicial or administrative proceeding in a foreign country under the supervision of a non-US court and the laws of that jurisdiction relating to reorganisation, insolvency or liquidation of the debtor. In order to be eligible to seek recognition under Chapter 15, a non-US entity must either be domiciled, conduct business or hold property in the USA.

Upon the filing, 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 "non-main" proceeding. The distinction between "main" and "non-main" is crucial. If the foreign proceeding is recognised as a main proceeding, because the foreign proceeding is in the country where the debtor's centre of main interests is located, the US 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 non-main proceeding (ie, the centre 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 US bankruptcy court.

For a foreign proceeding to be recognised as a main proceeding, the debtor's "establishment" (ie, 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. 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 US bankruptcy court may also consider which foreign jurisdiction's laws will apply to most disputes between the debtor and its creditors.

8.2 Co-ordination in Cross-Border Cases

One of the policies underlying Chapter 15 is to encourage co-operation between US courts and their non-US counterparts. To effectuate this policy, and to facilitate co-ordination and communication between courts, US courts have employed a number of procedures with varying degrees of formality. A bankruptcy court may appoint a person or entity to act at the direction of the court, or may enter into a cross-border protocol or cross-border agreement with a non-US court. Protocols and agreements clarify and allocate the responsibilities of the relevant US 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

Debtors in Chapter 15 cases will often seek to allocate and clarify the scope of authority of the various courts in Chapter 15 and plenary cases, sometimes through a cross-border protocol. Generally, US 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 USC Section 1506). This public policy exception to the recognition of foreign decisions has been interpreted narrowly and will generally only apply in exceptional circumstances.

While Chapter 15 serves important facilitative and protective functions, it was not designed to reconcile differences between the insolvency regimes of various nations. It is important for creditors to understand their rights and remedies under various insolvency regimes because a debtor's decision to file a plenary proceeding in a certain jurisdiction may operate to alter such rights and remedies, even if the debtor also files an ancillary proceeding, such as a Chapter 15 case.

8.4 Foreign Creditors

Foreign creditors are treated no differently than domestic creditors under the Bankruptcy Code.

8.5 Recognition and Enforcement of Foreign Judgments

The recognition of foreign judgments is generally a matter of state law because the USA is not a signatory to any treaties that address the recognition of foreign judgments, and the federal government has not passed a statute to govern this matter.

Most states have adopted a version of the Uniform Foreign Money Judgments Recognition Act of 1962 or the updated Uniform Foreign-Country Money Judgments Recognition Act of 2005 (together, the "Model Acts"), each of which apply only to foreign judgments that grant or deny a sum of money (ie, the Model Acts do not apply to foreign judgments that provide other relief such as injunctive relief). In the states that have not enacted a statute, general principles of comity and more specific standards in the common law will govern.

When deciding whether to recognise a foreign judgment, US courts are primarily guided by the principles of comity and due process. Typically, US courts will recognise foreign judgments that are:

- final and conclusive;
- enforceable in the rendering jurisdiction; and
- for a specific amount of money.

As a general matter, US courts will not recognise foreign judgments if the foreign court lacked jurisdiction, failed to provide sufficient notice to the defendant, or otherwise granted relief that is repugnant to public policy. The Model Acts provide additional permissive grounds for non-recognition, including if the judgment was obtained by fraud, conflicts with another final judgment, or conflicts with the parties' agreement to use an alternative forum or form of dispute resolution. Finally, some states will only recognise judgments from jurisdictions that would similarly recognise a judgment from its courts.

A foreign judgment must be recognised before it can be enforced in the USA. Once a US court recognises a foreign judgment, then the foreign judgment is generally enforceable through the Uniform Enforcement of Foreign Judgments Act, which provides that the same state law mechanisms used to enforce local judgments apply to the enforcement of the recognised foreign judgment.

9. TRUSTEES/RECEIVERS/STATUTORY OFFICERS

9.1 Types of Statutory Officers

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, these individuals and entities include, among others, bankruptcy court judges, the US Trustee, official committees of unsecured creditors or equity holders, Chapter 7 and 11 trustees, and examiners.

Various federal and state law-based insolvency proceedings, including receiverships, 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 FDIC is appointed as receiver for the failed bank; and
- various state laws govern who may be duly authorised 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 Bankruptcy Code. Bankruptcy courts are units of the federal court system, and 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, decide numerous contested matters that arise in a case, and ultimately decide whether proposed Chapter 11 plans of liquidation or reorganisation may be confirmed in compliance with the Bankruptcy Code.

United States Trustee

The US Trustee is an official in the US Department of Justice who acts as a governmental "watchdog" in Chapter 7 and 11 cases. Among other things, the US Trustee interviews the debtor, appoints members of official committees, reviews professional employment and fee applications, and reviews, comments on and sometimes objects to motions filed in the bankruptcy case if it believes the relief sought is inconsistent with the Bankruptcy Code, other federal law or public policy.

Creditors' Committee

An official committee of unsecured creditors in a Chapter 11 case monitors developments in the Chapter 11 case and acts as it deems appropriate to advance the interests of unsecured creditors, see **6.3 Roles of Creditors**. An official creditors' committee in a Chapter 7 case functions differently, see **7.3 Organisation of Creditors or Committees**.

Trustee

In Chapter 7 liquidation cases, a trustee displaces the debtor's existing management, and liquidates the assets of the estate and distributes the proceeds to creditors. A Chapter 7 trustee has the right to employ attorneys and other professionals, with bankruptcy court approval.

Similarly, in the rare instance where a Chapter 11 trustee is appointed, the trustee takes on the roles and responsibilities of the debtor, displaces incumbent management, controls the debtor's properties and estate, is responsible for managing and operating the debtor's business, and files all reports and other pleadings, including a plan of reorganisation or liquidation. A Chapter 11 trustee has the right to employ attorneys and other professionals, with bankruptcy court approval.

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 litigation claims against third parties, and allegations of fraud, dishonestly, incompetence, misconduct or mismanagement 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 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. The receiver's authority is governed by the 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. As receiver, the FDIC assumes the task of collecting and selling assets of a failed bank and settling its debts, including claims for deposits in excess of the insured limit.

9.3 Selection of Officers

United States Trustee

The US Trustee is a federal official appointed by the President as an official in the US Department of Justice.

Creditors' Committee

Bankruptcy Code Section 1102 gives the US Trustee authority to appoint members of an unsecured creditors' committee in Chapter 11 cases. Members of an official creditors' committee in a Chapter 7 case are selected differently, see **6.3 Roles of Creditors** and **7.3 Organisation of Creditors or Committees**.

Trustee

In Chapter 7 liquidation cases, an initial interim Chapter 7 trustee is appointed by the US Trustee at the outset of the case. The interim trustee is selected from a panel of pre-qualified trustees in the district where the case is filed, and 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 Section 341 meeting of creditors required by the Bankruptcy Code.

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

Examiner

In Chapter 11 cases, the appointment of an examiner may be ordered by the bankruptcy court upon the request of a party in interest or the US Trustee, in which case the US Trustee selects and appoints the examiner in consultation with key parties in interest, subject to final court approval.

10. DUTIES AND PERSONAL LIABILITY OF DIRECTORS AND OFFICERS OF FINANCIALLY TROUBLED COMPANIES

10.1 Duties of Directors

US state and federal laws, governing documents and judicial decisions impose duties on officers, directors and managers of business entities. Such duties generally apply regardless of 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 publicly 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 apply to officers, directors and managers when a business entity is in bankruptcy. State laws generally provide for potential duties, including fiduciary duties, of officers, directors and managers of corporations and other business entities, that apply regardless of 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. The internal affairs doctrine is a conflicts of laws principle that recognises that only one state should have authority to regulate a corporation's internal affairs because otherwise a corporation could be faced with conflicting demands.

The full range of 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 in other states often look to Delaware law and judicial decisions when applying and interpreting their own corporate fiduciary laws.

Generally, officers, directors and managers of a financially distressed or insolvent entity who seek to fulfil their fiduciary duties should act with due care, in an informed manner, and with the benefit of professional advice after considering all reasonable alternatives, seeking to maximise the value of the company.

Fiduciary Duties of Directors and Officers of Delaware Corporations

The Delaware General Corporation 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.

Officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty.

Duty of loyalty

The duty of loyalty mandates that the best interest of the corporation (and, if the corporation is solvent, its shareholders) takes precedence over any interest possessed by a director or officer, and that the director or officer acts on an independent and disinterested basis in good faith solely in the best interest of the corporation. 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 so-called "subjective bad faith" – ie, fiduciary conduct motivated by an actual intent to do harm – and intentional dereliction of duty, which is a conscious disregard for one's responsibilities. Such conduct is "non-exculpable" and "non-indemnifiable".

Duty of care

The duty of care requires directors to fully inform themselves of all material information reasonably available to them (including reasonable alternatives) prior to making a business decision and then act with due care in the discharge of their duties. The greater the significance of the decision, the greater the requirement to consider alternatives. Generally, a breach of the duty of care will exist if directors are found to have been grossly negligent in the discharge of their duties. 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, meaning that directors must inform themselves, prior to making a business decision, of all material information reasonably available to them.

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 decision, claims for breach of fiduciary duty are analysed under one of several different standards of review, including the business judgement rule, "intermediate" scrutiny under the Delaware Supreme Court decisions in Unocal and Revlon, and entire fairness.

Business judgement rule

It is a fundamental statutory principle that the business affairs of a corporation are managed by or under the direction of the board of directors. The business judgement rule is a key corollary to that principle and has been alternatively described as a presumption, a substantive rule of law and a procedural guide for litigants. As a presumption, the business judgement 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 judgement rule presumption, if unrebutted, 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. The presumption is not available in cases of fraud, bad faith, gross negligence or self-dealing (or when the entire fairness standard applies). As a procedural guide, the business judgement rule places the initial burden on the plaintiff to rebut the presumption of the business judgement 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 liability per se.

If the business judgement rule presumption is 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 judgement rule presumption 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 judgement for the directors", nor 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:

- the 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 reorganization 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 and 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.

Unless there are 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: an exculpation provision under Section 102(b)(7) of the DGCL; and indemnification under Section 145 of the DGCL.

Section 102(b)(7)

Under 8 Del. C. Section 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.

Section 145

Under 8 Del. C. Section 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."

Fiduciary Duties of Managers of a Delaware Limited Liability Company

By default, managers of a Delaware limited liability company (an LLC) have traditional fiduciary duties, but those duties may be modified or limited by the LLC agreement.

Section 18-1101(c) of the Delaware Limited Liability Company Act (the "Act") provides 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 elimi-

nate the implied contractual covenant of good faith and fair dealing.

If an LLC agreement is silent regarding these matters, traditional fiduciary duties will be implied as a matter of Delaware law. Delaware courts have required that any provisions eliminating or restricting duties (including fiduciary duties) must be "clear and unambiguous."

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 the 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 by 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, do not generally 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 the duties of managers, members and other persons. Regardless of 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. 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.

10.2 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 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 maximize 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.

With respect to the rights of creditors outside bankruptcy, Delaware law is clear that, unless the LLC agreement provides otherwise, 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.

11. TRANSFERS/ TRANSACTIONS THAT MAY BE SET ASIDE

11.1 Historical Transactions

Federal bankruptcy law provides statutory causes of action to avoid (ie, set aside or unwind) certain transfers made to or for the benefit of third parties, primarily fraudulent transfer avoidance actions under Bankruptcy Code Section 548, and preferential transfer avoidance actions under Bankruptcy Code Section 547.

Fraudulent Transfers/Fraudulent Conveyances

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, which is a transfer made in exchange for less than “reasonably equivalent value”, at a time when the transferor was either insolvent, undercapitalised or generally unable to pay its debts as they came due.

The Bankruptcy Code provides some defences and limitations to fraudulent transfer liability. Transferees who “take for value” and in “good faith” may have a defence 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 also provides certain statutory safe harbours against fraudulent transfer liability with respect to certain otherwise-avoidable transfers.

Preferential Transfers

Preferential transfers may be avoided under Bankruptcy Code Section 547, which provides that a debtor or trustee may avoid:

- a transfer;
- of an interest of the debtor in property;
- to or for the benefit of a creditor;
- for or on account of an antecedent debt owed by the debtor before such transfer was made;
- made while the debtor was insolvent;
- 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 the petition, if the creditor was an insider at the time of the transfer); and
- that enables the creditor to receive more than it would receive if the case were a case under Chapter 7 of the Bankruptcy Code.

Affirmative defences may be asserted against voidable preference liability. The most common affirmative defences, each of which is fact-intensive, include the following:

- the ordinary course of business defence;
- the subsequent new value defence; and

- the contemporaneous exchange of value defence.

The burden is on the transferee to prove all elements of a claimed defence by a preponderance of the evidence.

11.2 Look-Back Period

Generally, under the Bankruptcy Code, fraudulent conveyances 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.

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 defences. The 90-day preference "reach-back" period is extended to one year prior to the bankruptcy case if the transferee was an insider of the debtor at the time of the transfer.

11.3 Claims to Set Aside or Annul Transactions

A bankruptcy trustee (or a Chapter 11 debtor) has standing to assert fraudulent conveyance and preference avoidance actions. A bankruptcy trustee's (or Chapter 11 debtor's) avoidance powers are exclusive during the bankruptcy case.

Creditors' committees and individual creditors may seek derivative standing to assert avoidance actions on behalf of the debtor's estate, especially in cases where the debtor 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.

State law fraudulent transfer actions may be asserted by creditors outside federal bankruptcy cases, but cannot be commenced or continued by creditors after the commencement of bankruptcy and the imposition of the automatic stay without approval from the bankruptcy court.

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