PRACTICAL LAW COMPANY®

PRACTICAL LAW

MULTI-JURISDICTIONAL GUIDE 2012/13

RESTRUCTURING AND INSOLVENCY

The law and leading lawyers worldwide

- Essential legal questions answered in 28 key jurisdictions
- Rankings and recommended lawyers in 49 jurisdictions
- Analysis of critical legal issues
- Top 10 global firms identified

INCLUDES PLC WHICH LAWYER? www.whichlawyer.com

AVAILABLE ONLINE AT WWW.PRACTICALLAW.COM/RESTRUCTURE-MJG

PRACTICAL LAW COMPANY®

United States

Michael J Reilly, Jeffrey S Sabin, Stephanie W Mai and Matthew J Cursio

Bingham McCutchen LLP

www.practicallaw.com/7-501-6870

FORMS OF SECURITY

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

Immovable property

The creation and enforcement of security interests in immovable property (that is, real property, including items permanently affixed thereto) is governed by the law of the state in which the real property is located.

Common forms of security. The most common forms of security granted over real property (including items permanently affixed thereto) are:

- **Security instruments.** Depending on the law of the state in which the real property is located, real property is generally secured by either a:
  - mortgage; or
  - deed of trust.

  The primary difference between a mortgage and a deed of trust is who holds legal title as opposed to equitable title with the right of possession. Under a mortgage, the mortgagor (borrower) possesses full title (that is, legal and equitable title) to the secured property. Under a deed of trust, the trustor (borrower) only retains equitable title with the right to possession while a third-party trustee retains legal title for the benefit of the lender (referred to as the beneficiary).

  The process by which a secured party exercises rights against the real property after default by the borrower also differs. In most states, foreclosure on a mortgaged property requires a judicial process, whereas foreclosure under a deed of trust can be accomplished through a non-judicial sale.

  Regardless of the method of foreclosure, state foreclosure laws usually provide certain protections for borrowers, such as notice of foreclosure or a right to redeem the property by curing the default.

- **Non-consensual liens.** A debtor's real property may be subject to non-consensual liens, such as:
  - court imposed judicial liens (related to a judgment);
  - tax liens (for failure to pay taxes);
  - mechanics' liens (for failure to pay for improvements made to the property).

Formalities. Formalities vary from state to state. Notice to third parties is universally required in order for a mortgagee or beneficiary to have a lien priority over subsequent creditors. Notice can be made in one of the following ways:

- Actual.
- Constructive (where a third party reasonably should know about the lien based on the circumstances).
- Of "record" (when the security interest is filed with the appropriate government agency and becomes a publicly available and searchable document).

Under the "first to file" rule, the creditor that properly files its security instrument first generally has the highest priority lien on that real property. However, mechanics' liens and certain statutory tax liens are given priority over all other security interests in the real property, regardless of when the security interest was created.

Effects of non-compliance. Failure to comply with the required formalities renders a security interest invalid, unenforceable, without priority, and/or voidable, resulting in an unsecured and/or subordinated debt. In bankruptcy, invalid or unenforceable security interests in property may be avoided, leaving the creditor with an unsecured claim (*see Question 9*).

Movable property

Common forms of security. A creditor may secure the credit it extends by obtaining from the debtor a lien on, or security interest in, the debtor's movable property (that is, personal property). The creation and enforcement of security interests in most types of movable property is generally governed by the Uniform Commercial Code (UCC). The UCC is a proposed set of model rules and has been adopted by every state, with some variations between states. Security interests in certain types of personal property are governed by other state or federal laws (for example, security interests in automobiles, boats, aircraft, and non-consensual liens).

Formalities. The formalities for creating a security interest in personal property depend on the type of and intended use for the property being used as collateral. In most circumstances, there are three requirements for the creation of a security interest under the UCC:

- Value given by the creditor to the debtor.
- A written security agreement between the parties or possession of the collateral by the creditor.
- The debtor has rights in the asset allowing it to grant a security interest.

Unless there is actual or constructive notice to a third party, the security interest must then be "perfected" for the security interest holder to have lien priority over subsequent creditors. Perfection usually requires filing proof of the security interest (a form UCC-1 financing statement) with a centralised state agency. A financing statement must meet certain minimum criteria. Under the UCC it must:

- Be filed in the state in which the borrower is located.
- Accurately state both the borrower's name and creditor's name and mailing address.
- Describe the collateral in, at the very least, general terms sufficient to give third parties inquiry notice of the security interest.

To maintain perfection, a new financing statement must be filed every five years or when the debtor either relocates or changes its name in a significant way. In most circumstances, lien priority in personal property is determined by the first to file rule.

Effects of non-compliance. See above, *Immovable property: Effects of non-compliance.*

CREDITOR AND SHAREHOLDER RANKING

2. Where do creditors and shareholders rank on a company's insolvency?

In bankruptcy cases, the United States Bankruptcy Code (the federal law governing all bankruptcy cases in every state (Code)) dictates the order of priority of claims and interests. The order of priority of claims and interests relevant to corporate bankruptcy cases is generally:

- Secured creditors.
- Administrative claimants.
- Priority unsecured creditors.
  - certain court-related administrative expenses and fees and charges assessed against the estate;
  - claims arising in the ordinary course of business after the filing of an involuntary bankruptcy petition but before the appointment of a trustee or entry of the order for relief;
  - wages, salaries or commissions, certain benefits, or sales commissions (up to a specified amount);
  - contributions to an employee benefit plan;
  - prepetition deposits of money in connection with the purchase, lease or rental of property or purchase of services that were not delivered or provided;
  - claims of governmental units generally for taxes or duties;
  - claims based on any debtor's commitment to a federal depository institutions regulatory agency to maintain the capital of an insured depository institution.
- General unsecured creditors.
- Equity holders.

Generally a junior class of creditors cannot receive any recovery until the senior class of creditors above them have received payment in full on their claims (the absolute priority rule). However, a confirmed plan of reorganisation (*see Question 6*) or enforceable intercreditor agreement may dictate otherwise. All classes are subject to being primed by a court-approved lender that provides new financing for the debtor during the bankruptcy case (*see Question 11*). In addition, claims may be subordinated in priority by agreement between the parties or by order of a court. If the estate cannot pay a class of creditors in full, each creditor of that class receives a pro rata distribution.

Secured creditors

Secured creditors hold liens on or interests in the debtor's real or personal property. A secured creditor's claim is secured only up to the value of its collateral. If the value of the collateral is less than the amount of the claim, the secured creditor's claim for the balance of the debt is bifurcated into a secured claim and an unsecured deficiency claim. Additionally, in Chapter 11 reorganisation cases (*see Question 6*), a secured creditor has the option of treating its entire claim as secured, even if the collateral is worth less than its total claim, but must relinquish any unsecured deficiency claim against the debtor's bankruptcy estate.

Administrative claimants

Administrative expenses arise from post-bankruptcy transactions with the debtor that are necessary for the administration of the bankruptcy case. Administrative expenses generally include those for:

- The trustee that administers the bankruptcy case.
- Postbankruptcy expenses necessary to preserve the debtor and/or its property (for example, postpetition transactions with trade vendors, postpetition rent on property, and postpetition employee wages).
- Fees for professionals retained by a debtor, trustee or court-appointed committee.
- Postpetition taxes.

Priority unsecured creditors

The Code prioritises certain unsecured claims over others, including:

- Prepetition employee wage claims and certain claims for sales commissions.
- Customer deposits for certain goods or services that were not delivered or rendered by the debtor.
- Prepetition taxes.

General unsecured creditors

General unsecured creditors hold claims that are not secured by any of the debtor's assets or entitled to priority under the Code. If there is no specified priority for the claim, all unsecured creditors rank *pari passu*, having claims of equal priority.

Subordinate creditors

Subordinated claims are not expressly set out in the Code's list of priority of claims and interests. However, the Code recognises the subordination of claims. Subordinated creditors hold claims they have voluntarily subordinated in priority to other claims by agreement (for example, subordinated debt instruments or inter-creditor agreements), or that have been subordinated by court order (*see Question 9, Equitable subordination*).

Equity interest holders

Equity interest holders are the owners of the debtor and, generally, receive no recovery from a debtor's estate until all creditors have been satisfied in full. If there is a recovery for equity, the preferred stock is paid in full before common stock.

UNPAID DEBTS AND RECOVERY

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

Trade creditors are able to secure unpaid debts under the UCC or other applicable state laws, and are subject to the same limitations both in and out of bankruptcy (*see Question 1, Movable property*). Under the UCC, a seller that finances the purchase of goods can require the buyer to execute a purchase money security interest (PMSI), which grants the seller a security interest in the goods being sold.

State law may also entitle trade creditors that render improvements to the debtor's real or personal property to impose a mechanic's or artisan's lien on that property (*see Question 1*).

Unpaid trade creditors that sold goods to a debtor in the ordinary course of business within 20 days before the filing of a bankruptcy petition are entitled to administrative expenses against the estate under the Code. In addition, subject to the rights of creditors holding a competing security interest in goods, sellers of goods may reclaim goods received by an insolvent debtor within 45 days before the commencement of a bankruptcy case if the seller makes a timely written reclamation demand.

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

Creditors can bring an action in state court to recover unsecured debts without involving federal bankruptcy courts. A lawsuit can be commenced to seek a judgment on the unsecured debt and utilise various common procedures to secure otherwise unsecured debts, including:

- **Attachment.** The court holds a hearing to determine if it should put a temporary freeze on the debtor's assets before issuing a final judgment on the alleged debt. Attachment involves assets that the debtor currently possesses. If the court rules that a creditor's claim is valid, the creditor can then take possession of or sell the attached assets to satisfy the debt. A judgment creditor on the debt can also seek the aid of the state court for attachment on a judgment debtor's assets as a judgment lien.
- **Garnishment.** Similar to attachment, the court holds a hearing to determine if it should put a temporary freeze on the debtor's assets before issuing a final judgment on the alleged debt. Garnishment involves assets in the possession of a third party owned or owed to a debtor. If the court rules that a creditor's claim is valid, the creditor can then take possession of or sell the garnished assets to satisfy the debt. A judgment creditor on the debt can also seek the aid of the state court for garnishment on a judgment debtor's assets as a judgment lien.
- **Receivership.** A court may impose a receivership over a debtor's property and appoint a neutral third party (a receiver) to take possession of the property. Receiverships are normally used when:
  - creditors are concerned that the debtor will either diminish the value of the property through misuse or destruction or transfer the property before a judgment;
  - the property requires maintenance or upkeep during the pendency of the legal proceeding.
- **Offsets.** The Code and most state laws permit (but do not mandate) a debtor and creditor to offset reciprocal and mutual debts incurred pre-bankruptcy. Before bankruptcy, most state laws allow a creditor to offset mutual debts by self-help. In a bankruptcy case, creditors may be required to obtain bankruptcy court approval to offset mutual debts. Where the same precise parties are involved in distinct and independent transactions, a creditor may "net" the mutual debts (a set-off), but must first obtain a bankruptcy court order granting relief from the automatic stay (*see Question 6*). Where the reciprocal debts between the same precise parties arise from a single transaction, a creditor may "net" the mutual obligations (a recoupment) without bankruptcy court approval, which is not restricted by the automatic stay.

STATE SUPPORT

5. Is state support for distressed businesses available?

The recent economic crisis has spurred the federal government to bail out certain industries and entities on its own initiative and discretion, but bail outs are a rare exception, not a rule. There are generally no formal state or federal government programmes to support distressed business enterprises. Some government agencies provide low interest rate loans, tax breaks, or financial subsidies to businesses or selected industries, such as recent federal government programmes to support alternative energy companies, but these programmes are targeted at specific industries for policy reasons rather than to help struggling businesses in general.

There are also programmes that support aspects of distressed businesses and affected parties. For example, the Pension Benefit Guaranty Corporation guarantees certain claims of qualified pensions whose plan may be underfunded and terminated, and the Code requires a debtor to continue funding retiree benefits and precludes a debtor from unilaterally modifying or terminating retiree benefits except in accordance with the Code.

RESCUE AND INSOLVENCY PROCEDURES

6. What are the main rescue and insolvency procedures?

Subject to certain exceptions, any person or business entity that resides or has a domicile, place of business or property in the US and US municipalities may be a debtor under the Code. Entities not eligible to be a debtor under the Code include:

- Banking and insurance institutions.
- Government units that are not municipalities.

These entities are governed by separate statutes that, among other things, regulate insolvency.

Chapter 11 reorganisation

Objective. The general purpose of a Chapter 11 reorganisation process is to preserve the debtor's business as a going concern by restructuring its debts and equity interests and confirming a plan to make equitable distributions to creditors. If a plan of reorganisation is accepted by the requisite classes of claims and interests and is approved by the bankruptcy court, creditors and equity interest holders can only seek recovery on account of their prepetition debts or interests from the debtor's estate as set forth in the plan. In a successful Chapter 11 reorganisation, the debtor emerges with a fresh start and can continue operating as a going concern through a distinct reorganised entity with a restructured and serviceable debt structure.

Initiation. A Chapter 11 case may be commenced voluntarily or involuntarily. A debtor commences a voluntary bankruptcy case by filing a petition for relief with the bankruptcy court. There is no prerequisite of insolvency or inability to pay debts as they become due for a debtor to be eligible to file for bankruptcy under the Code.

An involuntary case may be commenced by a creditor or group of creditors under specific requirements of the Code and is conducted like a voluntary bankruptcy case. In most cases a bankruptcy court will only enter an order for relief in an involuntary bankruptcy case if the debtor is generally not paying its debts as they become due. A Chapter 11 case may be converted to a Chapter 7 case (*see below, Chapter 7 liquidation cases*).

Substantive tests. In order to confirm a plan of reorganisation, the debtor must gain acceptances from each class of impaired (that is, receipt of less than 100% recovery) creditors and interest holders entitled to vote. A class of claims has accepted the plan of reorganisation if it has been accepted by creditors holding at least two-thirds in amount and more than one-half in number of the allowed claims of that class of creditors. A class of interests has accepted a plan if at least two-thirds in amount of the allowed interests approve the plan.

A bankruptcy court must approve the plan for it to be binding on all parties. The Code sets out the requirements for confirmation, including, among other things:

- Good faith.
- Certain disclosures.
- Interest of the creditors and equity holders.
- Feasibility.

An impaired class of creditors that rejects the plan may still be bound by its terms if the court confirms the plan (subject to satisfying certain requirements in the Code) and imposes the plan's terms on the objecting class (known as a cram down), so long as the plan does not discriminate unfairly among creditors of equal priority and is fair and equitable in accordance with the absolute priority rule (*see Question 2*).

Supervision and control. Bankruptcy courts oversee bankruptcy cases. The Office of the United States Trustee supervises the overall bankruptcy process and parties involved (*see Question 7*). During a bankruptcy case, a debtor entity and its existing management ordinarily continue to operate the business as a debtor in possession. However, a bankruptcy court may appoint a trustee (or examiner with expanded powers) to administer the bankruptcy estate in which case, the debtor (through its board of directors) loses its powers to manage the business and administer the bankruptcy case (*see Question 7*). A committee of creditors may be appointed to monitor a Chapter 11 case and consult with the debtor in possession or trustee throughout the case.

Protection from creditors. The filing of a bankruptcy petition triggers an automatic stay that prohibits any entity from taking any further action that in any way affects the debtor or its property, including litigation, collection actions (for example, issuing demand letters), set-off, and unilateral termination of contracts or leases, regardless of whether an entity has notice of the bankruptcy proceeding. The automatic stay remains in place for the duration of the bankruptcy case, although it may be lifted by a bankruptcy court order and is subject to certain limited exceptions (such as governmental regulatory actions). Any action taken in violation of the automatic stay is void, and the violating party may be liable for damages to the estate.

In a Chapter 11 case, a plan of reorganisation may (among other things):

- Provide a corporate debtor with a discharge of its debts and obligations.
- Release the debtor and other parties from certain liabilities.
- Enjoin creditors from commencing or continuing specified actions against the debtor or its property.

Length of procedure. Numerous factors affect the length of a traditional Chapter 11 case, including the size of the creditor body and the complexity of the legal issues presented in the case. Under the Code, a debtor has the exclusive right to file a plan of reorganisation during, at most, the first 18 months of a Chapter 11 case. However, a bankruptcy court may terminate the exclusivity for cause shown, including fraud. Once exclusivity has terminated (whether by passage of time or by bankruptcy court order), any party in interest may propose a plan of reorganisation. This time limitation encourages, but does not guarantee, debtors to propose a plan of reorganisation more quickly (and the possibility of a shorter case) in order to limit the ability of parties in interest to file a competing plan.

A pre-packaged Chapter 11 case is the shortest Chapter 11 proceeding. In a pre-packaged case, the debtor proposes and solicits acceptance for a plan of reorganisation prior to the commencement of the bankruptcy proceeding. Assuming no major issues arise during the case, a pre-packaged bankruptcy case can be completed in as little as two months.

A pre-negotiated Chapter 11 case is a hybrid of pre-packaged and traditional Chapter 11 cases. In a pre-negotiated case, the debtor and its major creditors negotiate and agree on the terms of a plan of reorganisation before commencing the bankruptcy case. The debtor then solicits acceptances for the plan soon after commencement of the Chapter 11 case, so the case concludes more quickly than a traditional Chapter 11 case.

A pre-packaged or a pre-negotiated case is often used where there is broad creditor support for a debtor's reorganisation, but not all constituencies are available or willing to approve an out-of-court restructuring.

Conclusion. After the bankruptcy court confirms a plan of reorganisation, the reorganised debtor emerges from bankruptcy and consummates the plan. After confirmation of a plan, many matters may remain pending, including resolution of claims and litigation involving the bankruptcy estate. A Chapter 11 case concludes after the bankruptcy estate is fully administered in accordance with a confirmed plan of reorganisation and the case is closed by the bankruptcy court.

Chapter 7 liquidation

Objective. A Chapter 7 liquidation is primarily for debtors who are unable to service their existing debts and are unlikely to reorganise. In a Chapter 7 case, the debtor's assets are liquidated as quickly as possible and available proceeds are distributed to creditors and equity interest holders in the order of priority in the Code (*see Question 2*). In effect, the debtor goes out of business and ceases operations.

Initiation. The process for initiating a Chapter 7 case is the same as for a Chapter 11 case (*see above, Chapter 11 reorganisation: Initiation*.) A Chapter 7 case may be converted to a Chapter 11 case.

Substantive tests. A Chapter 7 trustee appointed to administer a Chapter 7 case has a fiduciary duty to protect the interests of all creditors and other beneficiaries of a debtor. Unlike a Chapter 11 process, however, a Chapter 7 case does involve creditor acceptance, a plan, or bankruptcy court approval of a plan.

Supervision and control. The role of a bankruptcy court and United States Trustee in a Chapter 7 case is the same as in a Chapter 11 case (*see above, Chapter 11 reorganisation: Supervision and control*). On commencement of a Chapter 7 case, most management personnel and employees are dismissed, and a trustee is appointed by the United States Trustee or elected by creditors to expeditiously collect, liquidate, and distribute the debtor's assets to creditors and interest holders. The Chapter 7 trustee may temporarily retain some employees to assist with the liquidation of the estate.

Protection from creditors. The filing of a bankruptcy petition triggers an "automatic stay" in the same way as for a Chapter 11 case (*see above, Chapter 11 reorganisation: Protection from creditors*). A Chapter 7 corporate debtor is not entitled to a discharge, so a liquidated corporate debtor must dissolve under state law after the conclusion of a Chapter 7 case.

Length of procedure. In order for a Chapter 7 trustee to close a Chapter 7 case, the trustee must complete all asset collection efforts (including any litigation) and the claims administration process, the length of which will depend on factors such as the size of the estate and the complexity of the collection and distribution efforts.

Conclusion. A Chapter 7 case concludes after the Chapter 7 trustee:

- Makes final distributions to creditors and equity interest holders.
- Files a final report and account of the administration of the estate with the bankruptcy court and the United States Trustee.

STAKEHOLDERS' ROLES

7. Which stakeholders have the most significant role in the outcome of a restructuring or insolvency procedure?

Chapter 11 reorganisation cases

The stakeholders with the most significant roles include the following.

Debtor in possession or Chapter 11 trustee. See *Question 10*.

Examiner. When a Chapter 11 trustee is not appointed, the court will appoint an examiner on request of a party in interest or the United States Trustee if either of the following conditions is satisfied:

- It is in the best interest of creditors, equity holders and other estate interests.
- If the debtor has more than US$5 million of debt (as at 1 March 2012, US$1 was about EUR0.7).

The bankruptcy court order defines the timing, scope and responsibilities of an examiner, which generally is limited to conducting and reporting on an investigation of the debtor and/or other parties for allegations such as fraud, misconduct or mismanagement. Often in a consensual Chapter 11 case, a bankruptcy court will not appoint an examiner.

United States Trustee. The Office of the United States Trustee, a unit of the United States Department of Justice, consists of regional offices in a nationwide system tasked with supervising the administration of bankruptcy cases and appointed trustees. The United States Trustee is a federal government representative who acts on behalf of the public interest for the purpose of preserving the integrity of the bankruptcy system. The United States Trustee's responsibilities include administrative functions, such as conducting and presiding over an examination of the debtor and convening a meeting of creditors, monitoring the general progress of a bankruptcy case and parties' compliance with applicable laws, and participating in the case to uphold the policies of the bankruptcy process.

Creditors' committee. Creditors do not have a direct role in operating the debtor's ongoing business. However, early in a Chapter 11 case, the United States Trustee will appoint an official committee of unsecured creditors to represent the interests of all general unsecured creditors of the debtor. A committee of creditors consists of holders of unsecured claims (usually the largest creditors) who have volunteered to serve on the committee. A creditors' committee plays a significant role in a Chapter 11 case, including monitoring the debtor's ongoing operations, consulting with the debtor on major business decisions, and generally representing the interests of all unsecured creditors in a matter before the bankruptcy court. A committee can retain legal counsel and other professional advisors to help the committee perform its functions.

The United States Trustee may also appoint other committees, if necessary, to ensure that those interests are adequately represented in the cases, such as a committee of equity security holders or employee interests.

Lenders. Secured lenders holding pre-bankruptcy security interests in a debtor's property may restrict the debtor's ability to use, sell, or lease its collateral outside the ordinary course of the debtor's business. In order for the debtor to take those actions outside of the ordinary course of business, it must obtain either:

- The consent of the secured lender.
- Court authorisation, subject to providing the secured creditor adequate protection for any diminution in value of the secured lender's interest in the property caused by, among other things, a debtor's use of such property and/or the imposition of the automatic stay (*see Question 11*).

If the debtor fails to provide a secured creditor with adequate protection for any diminution in value of the creditor's interest in the collateral, the secured creditor may seek relief from the automatic stay to exercise rights against the collateral.

Lenders that provide a debtor with new credit during the bankruptcy case to allow the debtor to continue operations and administer the case may have leverage over the debtor to obtain priority claims, liens on estate property, consent or consulting rights over the sale of estate assets, and other protections (*see Question 11*).

Both pre-bankruptcy and post-bankruptcy lenders may restrict the use of cash to pay specified expenses (for example, under a budget) and influence the course and length of the bankruptcy case (for example by requiring milestones for the debtor to satisfy during the case).

Chapter 7 liquidation cases

The stakeholders with the most significant roles include the following.

Chapter 7 trustee. See *Question 10*.

Debtor. The debtor's role in a Chapter 7 proceeding is generally more limited than in a Chapter 11 case. A significant responsibility of a corporate Chapter 7 debtor is to prepare accurate and updated disclosure of its assets with the filing of its bankruptcy petition.

LIABILITY

8. Can a director, parent company (domestic or foreign) or other party be held liable for an insolvent company's debts?

Directors and officers

Generally, directors and officers are protected by the business judgement rule for decisions made on an informed basis in good faith for, what they believe to be, the best interest of the business entity. However, certain statutes impose personal liability on directors and officers for actions taken in their official capacity and debts incurred by the business entity, such as:

- Failure to remit withholding and sales taxes or to pay taxes under certain federal and state tax codes.
- Wilful failure to pay wages.
- Payment of a dividend or a stock purchase or redemption in violation of state statutes.

Additionally, directors and officers may be liable for breaches of their fiduciary duties, including the duty of care and the duty of loyalty, but these claims can be difficult to prove in the face of the business judgement rule, unless there is self-dealing or fraud by the directors and officers. Typically, however, directors and officers have insurance to cover such claims, except for fraud or gross negligence.

Affiliate entities

Ordinarily, owners of corporations or limited liability companies are shielded from liability for the business entity's debts because the corporation or limited liability company is a separate and distinct legal entity. However, a court may lift/pierce the corporate veil of an owner/parent entity and hold it liable for the debts of its subsidiary. A court will conduct a fact-intensive analysis of factors to determine whether to apply the common law doctrine of piercing the corporate veil, such as:

- Failure of the owner/parent entity to observe corporate formalities.
- Gross undercapitalisation.
- Operating the subsidiary as a single economic unit.
- Fraud or injustice.

An analogous common law theory is reverse veil piercing, which, if granted by a court, allows creditors to reach the assets of a subsidiary to satisfy the debts of its owner/parent entity.

Disregarding the corporate veil is an exception to the general rule of limited liability and is extraordinary relief that courts may be reluctant to grant.

Substantive consolidation

The general rule is that each debtor and its estate stands separate from its affiliates and is responsible for the claims of its respective creditors, but not the creditors of its affiliates. An exception to this is if a plan of reorganisation provides for the substantive consolidation of the estates of affiliated debtors (which relief is not provided for under the Code).

Substantive consolidation is a concept that exists only within bankruptcy and is an equitable remedy that has an effect similar to veil piercing (*see above, Affiliate entities*). The court disregards the legal separateness of a debtor and one or more other entities (usually debtor affiliates) and merges their assets and liabilities to implement a plan. The result is that the assets and liabilities of the consolidated entities are pooled, intercompany claims among the consolidated entities are eliminated, and the pooled assets are used to satisfy the pooled liabilities of the consolidated entities. Substantive consolidation is considered extraordinary relief and is an exception, not a rule.

SETTING ASIDE TRANSACTIONS

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

To ensure the equal treatment of similarly situated creditors under the Code, pre-bankruptcy transfers of cash or other property or the incurrence of certain debts or guarantees that unfairly benefit certain creditors may be subject to scrutiny and avoidance (for example, undoing the transfer and recovering the property to increase the value of the estate or reprioritising claims). Claims belonging to the bankruptcy estate may be brought by an appropriate party in interest, such as the debtor in possession or trustee, or a party in interest granted standing (if necessary) by the bankruptcy court. The actions are not mutually exclusive and each can apply to any given set of facts.

Strong arm powers

The Code vests a debtor in possession or trustee with strong arm powers, which grant the debtor in possession or trustee the rights of the following parties:

- A hypothetical judicial lien creditor.
- A hypothetical creditor extending credit and obtaining an execution against the debtor that is returned unsatisfied.
- A hypothetical *bona fide* and perfected purchaser of real property.

A debtor in possession or trustee utilises the strong arm powers to avoid liens, transfers and obligations, which under applicable non-bankruptcy law (generally state law) would be deemed to be junior to the debtor in possession or trustee's rights as a hypothetical lien creditor, a hypothetical creditor that has extended credit, or a hypothetical *bona fide* purchaser of property. The strong arm powers are most commonly exercised to avoid invalid, unenforceable, lapsed, unperfected and/or otherwise voidable security interests (*see Question 1*).

The Code also allows a debtor in possession or trustee to stand in the place of an actual creditor and bring state law creditor actions against third parties to avoid any voidable transfer or obligation of the debtor (state fraudulent transfer/conveyance statutes).

Preferences

The Code allows a debtor in possession or trustee to avoid preferential transfers, which are transfers of the debtor's property to, or for the benefit of, a creditor made within 90 days before the commencement of the bankruptcy case (or within one year of the commencement of the case if the creditor is an insider). The Code contains exceptions that protect certain transfers that would otherwise constitute avoidable preferences, including, among others, transfers:

- Of less than US$5,850 (this amount may be adjusted periodically).
- Made in the ordinary course of the debtor's business or according to ordinary business terms.
- In which the debtor received new value in exchange.

Additionally, a security interest perfected within 30 days of receipt of the debtor's property cannot be avoided as a preferential transfer.

Fraudulent transfers

The Code permits a debtor in possession or trustee to avoid transfers by a debtor that fall under the Code or state law fraudulent transfer statutes or state bulk transfer laws. Under the Code, fraudulent transfers are any transfer by a debtor made within two years before the commencement of the bankruptcy case to which either of the following conditions apply:

- A transfer made with actual intent to hinder, delay, or defraud its creditors (actual fraud).
- A transfer for which the debtor received less than reasonably equivalent value at a time when the debtor was either:
  - insolvent (either before, or as a result of, the transfer);
  - left with unreasonably small capital; or
  - left unable to pay its debts as they became due as a result of the transfer (constructive fraud).

In general, most state fraudulent transfer laws have a longer "look back" period than the Code. However, state statutes may require additional evidence, such as that at least one unpaid creditor still exists from the time of the transfer or harm to an actual unsecured creditor.

Under the Code, a good faith transferee of a fraudulent transfer that has given value to the debtor may retain the benefit of its bargain, but only to the extent of the value provided to the debtor and to the extent the transfer or obligation is not otherwise avoidable.

Equitable subordination

A bankruptcy court may order the subordination of a creditor claim to otherwise junior claims (but not to equity interests) when the claim holder has engaged in inequitable or improper conduct (*see Question 2*). This remedy does not set aside a pre-bankruptcy transaction or result in the disallowance of a claim, but adjusts the priority of a creditor's claim downward. Courts generally apply a three-part test to determine whether equitable subordination of a claim is appropriate. The court will examine whether:

- The creditor engaged in inequitable conduct.
- The conduct injured the debtor's creditors or gave the claimant an unfair advantage.
- Equitable subordination is otherwise consistent with the Code.

Recharacterisation

A bankruptcy court can exercise its equitable power to order the recharacterisation of a debt claim as an equity interest, which has the lowest priority under the Code (*see Question 2*). Recharacterisation does not set-aside a pre-bankruptcy transaction, but may result in a creditor receiving little or no recovery from the bankruptcy estate. Courts look at a number of factors to determine whether recharacterisation is warranted, including, among other things, the:

- Form of instrument evidencing the debt.
- Fixed maturity date and schedule of payments.
- Fixed interest rate and interest payments.

- Source of repayments.
- Adequacy of capitalisation.
- Identity of interest between creditor and stockholder.
- Security.
- Corporation's ability to obtain third-party financing.
- Subordination of claims of third party creditors.
- Use to acquire capital assets.
- Sinking fund, if any, to provide repayment.

CARRYING ON BUSINESS DURING INSOLVENCY

10. In what circumstances can a company continue to carry on business during insolvency or rescue proceedings? In particular, who has the authority to supervise or carry on the company's business and what restrictions apply?

Whether a company may continue to carry on business during a bankruptcy proceeding depends on whether it has filed for protection under Chapter 11 (a reorganisation case) or Chapter 7 (a liquidation case) (*see Question 6*).

Chapter 11 reorganisation cases

Circumstances. A primary goal of Chapter 11 is to rehabilitate and reorganise a debtor with minimal interruption (continuing operations) during the bankruptcy process so that the debtor emerges as a successful going concern. Ordinarily, the debtor and its existing management continue to manage the debtor's affairs and operate the debtor's business as debtor in possession and are responsible for steering the reorganisation process.

Authority/supervision. The debtor in possession is free to conduct its business as it had before filing for protection under Chapter 11, except for actions deemed to be outside the ordinary course (such as obtaining new credit, use, sale or lease of assets outside the ordinary course of the debtor's business, or assuming or rejecting executory contracts or unexpired leases), in which case, the debtor in possession must obtain court approval.

In some instances, on request of a party in interest and after notice and a hearing, a bankruptcy court may appoint a Chapter 11 trustee (or an examiner with expanded powers) to administer the bankruptcy estate and operate the debtor's business for cause shown (such as fraud, dishonesty, incompetence, or gross mismanagement) or where such appointment is in the interest of creditors, equity holders and other estate interests.

Chapter 7 liquidation cases

Circumstances. A Chapter 7 debtor generally ceases operations.

Authority/supervision. In a Chapter 7 case, the United States Trustee appoints a trustee from a panel of approved trustees or the creditors elect a trustee. A Chapter 7 debtor generally ceases operations, however, the bankruptcy court may authorise a Chapter 7 trustee to continue operating the debtor's business for a limited period of time if it is in the best interest of the estate and consistent with an orderly liquidation. For example, a Chapter 7 trustee may seek to continue manufacturing operations for a period of time because the finished product will result in greater value for the estate than the raw materials.

Intellectual property licences

The Code defines intellectual property to include, among others:

- Trade secrets.
- Patents and patent applications.
- Copyrights.
- Mask works to the extent protected by applicable non-bankruptcy law.

Trade marks are not included in the definition.

The Code generally allows a debtor in possession or trustee to assume (that is, continue) or reject executory contracts, such as intellectual property licences. Where the debtor is a licensor of intellectual property, the debtor in possession or trustee may assume or reject the intellectual property licence if it meets the requirements in the Code. Licensee counterparties of rejected intellectual property licences (for example, copyrights and patents, but not trade marks) have special protections under the Code and may retain rights under the intellectual property licence in exchange for payment of royalties.

However, where the debtor is a licensee of intellectual property, the ability of a debtor in possession or trustee to assume an intellectual property licence is restricted and will depend on the jurisdiction in which the debtor's bankruptcy case is pending. If the licence counterparty consents to assumption, there is no issue. For non-consensual assumption of an intellectual property licence, the jurisdiction in which the bankruptcy case is pending will apply one of the following two tests:

- Under the actual test, if applicable non-bankruptcy law (for example copyright and patent law, and possibly trade mark law) prohibits the assignment of an executory contract, then the debtor in possession or trustee cannot assume the contract if the debtor in possession or trustee intends to assign the agreement.
- Under the hypothetical test, if applicable non-bankruptcy law prevents the assignment of an executory contract to a hypothetical third party, then the executory contract cannot be assumed by the debtor in possession or trustee, regardless of the debtor in possession or trustee's intent to assign the executory contract.

ADDITIONAL FINANCE

11. Can a company that is subject to insolvency proceedings obtain additional finance (for example, debtor in possession financing or equivalent)? Is special priority given to the repayment of this finance?

A debtor in possession or trustee authorised to continue operating the debtor's business may obtain financing during the bankruptcy case. Obtaining additional financing often provides critical and necessary liquidity to administer the bankruptcy estate.

A debtor in possession or trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business, unless the bankruptcy court orders otherwise. Unsecured financing is generally allowable as an administrative expense having priority over other unsecured claims and equity interests. However, it is often impossible to obtain unsecured credit because lenders are generally unwilling to provide unsecured credit to a bankrupt entity.

Secured financing is an option if a debtor in possession or trustee is unable to obtain unsecured credit. A court may authorise a debtor in possession or trustee to obtain secured financing with priority over administrative expenses and/or secured by liens on property of the bankruptcy estate. If estate property already is encumbered, a lender can be granted security interests and liens that are either:

- Junior to the existing security interests in and liens on such property.
- Equal or senior to the security interests in and liens on such property, but only if the holder of the prior security interest or lien consents or is granted adequate protection (for example, cash payments, additional or replacement liens, administrative expense priority, reimbursement of fees and expenses, or additional guarantees) to compensate it for any diminution in value of its interest in the collateral.

The protections (such as validity of the debt, priority of security interests) granted to a post-bankruptcy lender that extended credit in good faith remain in effect even if the order authorising such financing is later reversed or modified on appeal, except if the implementation of the authorisation for such financing has been stayed pending appeal.

An alternative to seeking additional financing after filing for bankruptcy is for a debtor in possession or trustee to utilise cash on hand to finance the debtor's operations and the administration of the bankruptcy case. However, if the cash is encumbered (that is, cash collateral), without the secured creditor's consent and/or on the provision of adequate protection, the debtor in possession or trustee's use of such cash collateral is restricted (*see Question 7*).

MULTINATIONAL CASES

12. What are the rules regarding recognition, concurrent proceedings and international treaties in multinational cases? What are the procedures for foreign creditors?

Recognition

Chapter 15 of the Code (enacted in 2005) incorporates the majority of the UNCITRAL Model Law on Cross-Border Insolvency 1997 (UNCITRAL Model Insolvency Law). The stated purposes of Chapter 15 are, among others:

- To foster co-operation between the parties involved in US bankruptcy cases and those involved in foreign bankruptcy cases.
- To provide fair and efficient administration of cross-border insolvencies.

As a guiding principal, US bankruptcy courts apply the doctrine of international comity in Chapter 15 cases and, if necessary, may defer to the law of the foreign proceeding.

Chapter 15 requires a bankruptcy court to recognise a foreign bankruptcy proceeding if the following criteria are met:

- The foreign proceeding is either a:
  - foreign main proceeding (that is, the proceeding is pending in the country of the debtor's centre of main interest);
  - foreign nonmain proceeding (that is, the proceeding is pending where the debtor has an establishment, which is where it conducts non-transitory economic activity).
- A qualified foreign representative (a person or a body authorised to administer the debtor's foreign bankruptcy proceeding) files a petition for recognition with the bankruptcy court.
- The petition for recognition meets the technical requirements set out in the Code.

If those criteria are met, a bankruptcy court may only deny recognition if it would be manifestly contrary to US public policy.

On filing a petition for recognition, the bankruptcy court may grant the foreign representative certain preliminary relief before ruling on recognition, such as a temporary restraining order. On recognition of a foreign proceeding, whether main or nonmain, the court may grant any appropriate relief that gives effect to the purposes of Chapter 15 (*see above*), at the request of the foreign representative. In addition, the foreign representative has standing to intervene in US cases in which the foreign debtor is a party.

Certain relief is automatically granted if the bankruptcy court recognises a foreign main proceeding, including a stay (with limited exceptions) with respect to the foreign debtor's US assets and the right of the foreign representative to use, sell or lease the debtor's US assets and to operate the debtor's business.

Concurrent proceedings

A Chapter 15 case in the US bankruptcy court is an ancillary case to a foreign proceeding. After the bankruptcy court enters an order of recognition of a foreign main proceeding, and if the foreign debtor has assets in the US, the foreign representative can commence a voluntary plenary case under Chapter 7 or Chapter 11, subject to the same filing requirements as a domestic debtor seeking relief under either Chapter. If the recognised foreign proceeding is a nonmain proceeding, the foreign representative can only commence an involuntary plenary proceeding against the debtor.

A foreign representative may choose to initiate a plenary case because in ancillary cases, foreign representatives do not enjoy the full powers of a trustee or debtor in possession. However, a plenary case that is commenced after recognition only governs a foreign debtor's US assets, unless the foreign debtor's non-US assets meet each of the following conditions:

- They fall within the jurisdiction of the bankruptcy court.
- They are not subject to the jurisdiction and control of a recognised foreign proceeding.
- Jurisdiction over those assets by a US court is necessary to implement co-operation and co-ordination under Chapter 15.

Country Q&A

Under Chapter 15, courts must grant consistent relief in concurrent proceedings. If a plenary case is open at the time of the foreign representative's petition for recognition, the relief granted in the ancillary case must be consistent with that granted in the plenary case and the section of Chapter 15 that grants automatic relief upon recognition of a foreign main proceeding is inapplicable. Likewise, if a plenary case is commenced after recognition or the filing of the petition for recognition, the bankruptcy court must modify or terminate any relief in the ancillary case that is inconsistent with that granted in the plenary case, including the automatic stay granted on recognition of a foreign main proceeding. If the bankruptcy court grants recognition to multiple foreign proceedings for affiliated debtors the following conditions apply:

- Relief granted in a foreign nonmain proceeding must be consistent with that granted in a foreign main proceeding.
- If all foreign proceedings are foreign nonmain proceedings, the relief granted in each proceeding must be consistent and the court can modify or terminate any relief that was previously granted in one proceeding that now hinders the co-ordination of the proceedings.

International treaties

The majority of the UNCITRAL Model Insolvency Law has been incorporated into the Code in Chapter 15 (*see above, Recognition*). Otherwise, the US is not party to any international treaty regarding insolvency or bankruptcy laws that govern private sector debtors.

Procedures for foreign creditors

Foreign creditors are granted the same substantive and notification rights under the Code as domestic creditors. Chapter 15 expressly prohibits foreign creditors from being given a lower priority of claim than that of a general unsecured creditor solely because they are foreign creditors.

In addition, a creditor of a foreign debtor cannot receive payment in either an ancillary or plenary case if both of the following conditions apply:

- It has already received payment with respect to that claim in a foreign proceeding.
- The other creditors in the same class in the foreign proceeding have received a smaller proportional distribution.

REFORM

13. Are there any proposals for reform?

There are no significant proposals for reforming the Code at this time.

CONTRIBUTOR DETAILS

MICHAEL J REILLY

Bingham McCutchen LLP
T +1 212 705 7763
+1 860 240 2748
F +1 860 240 2576
E *michael.reilly@bingham.com*
W *www.bingham.com*

Qualified. New York, US, 2007; District of Columbia, US, 2007; Connecticut, US, 1976; Registered foreign lawyer in England and Wales

Areas of practice. Global financial restructuring; creditors' rights; bankruptcy; debt restructuring; out-of-court workouts; financial transactions; acquisitions of troubled assets.

Recent transactions

- Representation of secured creditor group in Visteon.
- Representation of substantial creditor position in Lehman, General Growth Properties, Allied Capital, PGA West, Delta Air Lines, US Airways, American Airlines, Atlas Air, Transportadora de Gas del Norte (Argentina), and Transportadora de Gas del Sur (Argentina).
- Representation of secured and unsecured noteholder groups, including in Transtech (UK), Purolator Courier, Controladora Comercial Mexicana, Corporación Durango (Mexico), Grupo Mexico and Cablevision (Argentina).

STEPHANIE W MAI

Bingham McCutchen LLP
T +1 212 705 7671
F +1 212 702 3675
E *stephanie.mai@bingham.com*
W *www.bingham.com*

Qualified. New York, US, 2002

Areas of practice. Financial restructurings; creditor rights representations; bankruptcy litigation; insolvency; financial services transactions.

Recent transactions

- Representation of Chapter 11 trustee of Refco Capital Markets and the plan administrators of Refco and Refco Capital Markets.
- Representation of postpetition financing agent and/or lenders in Bombay Company, Goody's Family Clothing, Gottschalks, and Pizzeria Uno.
- Representation of senior secured agent and lenders in PLVTZ, Muzak, Steve & Barry's and Borders.
- Representation of official creditors' committee of BearingPoint and The Cliffs Club & Hospitality Group.
- Representation of noteholders in PetroRig.

JEFFREY S SABIN

Bingham McCutchen LLP
T +1 212 705 7747
F +1 212 702 3668
E *jeffrey.sabin@bingahm.com*
W *www.bingham.com*

Qualified. New York, US, 1978

Areas of practice. Global financial restructuring; creditors' rights; bankruptcy; debt restructuring; out-of-court workouts; financial transactions; and acquisitions of troubled assets.

Recent transactions

- Representation of official creditors' committee and liquidating trustee in LandAmerica.
- Representation of official creditors' committee in BearingPoint.
- Representation of secured lender in Pacific Energy Resources.
- Representation of secured creditors in General Motors, Chrysler, Spansion, and Lyondell.
- Representation of prepetition and postpetition lenders in TLC Vision.
- Representation of steering committee of secured lenders in MGM Studios.
- Representation of multiple creditors and counterparties in Lehman.

MATTHEW J CURSIO

Bingham McCutchen LLP
T +1 212 705 7277
F +1 212 508 1451
E *matthew.cursio@bingham.com*
W *www.bingham.com*

Qualified. New York, US, 2012

Areas of practice. Financial restructuring; creditor rights representation; bankruptcy litigation.

Recent transactions

- Representation of the postpetition debtor in possession administrative agent and facility lender in TBS International Ltd.
- Representation of creditors in Lehman.
- Representation of noteholders of a troubled South American entity.
- Representation of timber company regarding bankruptcy rejection of leases.
- Representation of a lender of a distressed North American energy company.