Baker McKenzie.

Global Restructuring & Insolvency Guide

United States

Overview and Introduction

This Guide discusses the legal framework in the United States for the restructuring of debt and liquidation of insolvent businesses. The US Constitution specifically provides for a federal bankruptcy system under the jurisdiction of the US federal courts. In addition, the laws of each state provide for certain types of insolvency and dissolution proceedings, either by statute or common law traditions that trace their roots to English common law. The primary focus of this Guide is the United States Bankruptcy Code (the "**Bankruptcy Code**"), chapters 7 (liquidation) and 11 (reorganization), as state proceedings are generally limited to the jurisdiction of the particular state, while the Bankruptcy Code has nationwide application and in many instances, international reach. The structure of debtor's and creditor's rights as provided in the Bankruptcy Code has a profound effect on the structuring of debtor–creditor relationships in the US and can have a similar effect in foreign jurisdictions where US businesses have assets and creditor relations.

In addition, the Bankruptcy Code has also influenced the development of insolvency regimes and regulations in foreign jurisdictions that have adopted some, even if not all, of the key concepts embedded in the Bankruptcy Code.

Applicable Legislation

The Bankruptcy Code is codified in title 11 of the United States Code ("**USC**"): 11 USC §§ 101–1532. It provides for, among other things, individual and business liquidations under chapter 7, individual and business reorganization under chapter 11 (this chapter can also be used for controlled liquidation), bankruptcy payment plans for individuals under chapter 13 and recognition of foreign insolvency proceedings by US courts under chapter 15. The Bankruptcy Code was adopted in 1978, replacing the former regime under the Bankruptcy Act of 1898, and has survived relatively intact since that time, although significant amendments were made in 1984, 1994 and 2005. The Bankruptcy Code and the Federal Judgeship Act of 1984 created a national system of bankruptcy courts, adjuncts of the Federal District Courts, through which all bankruptcy cases are administered.

A company may also choose to liquidate through dissolution proceedings under the corporate laws of any one of the states. In addition, each state has statutes or common law procedures for placing businesses into receivership, and many provide a statutory framework for an "assignment for the benefit of creditors", which may be a useful and often more cost-effective mechanism for the liquidation of a business whose assets are primarily located in a single state.

Types of Business Bankruptcy Cases

Chapter 7

A company may elect to be liquidated by a trustee under chapter 7 of the Bankruptcy Code. Upon commencement of a case under chapter 7, an estate, comprised of all assets of the company, is created and a trustee is appointed to administer that estate. The trustee is responsible for collecting and liquidating all estate assets and then making distributions to creditors holding allowed claims against the estate. In this regard, the trustee is also responsible for reviewing all claims asserted against the estate, consenting to the allowance of claims and objecting to claims, as appropriate. The trustee is authorised to pursue and defend any pending litigation and to file new lawsuits on behalf of the estate, including legal actions under the Bankruptcy Code to recover preferences and fraudulent transfers (discussed further below). The trustee's goal is typically to fully administer the estate and make distributions to creditors holding allowed claims on a *pro rata* basis in accordance with the statutory priorities of claims under the Bankruptcy Code, as discussed below.

Chapter 11

A company may elect to restructure and reorganise its business under chapter 11 of the Bankruptcy Code. Upon the filing of a voluntary petition under chapter 11, an order for relief is deemed to be entered. Similar to chapter 7, an estate is immediately deemed to arise, consisting of all of the assets of the company as of the commencement of the case. Absent malfeasance or similar circumstances, the current management of a company remains in control of the company and continues to manage the company's day-to-day affairs during the chapter 11 proceedings.

A company is not required to be insolvent in order to file for chapter 11 relief and may elect to use chapter 11 in order to effectuate a financial (balance sheet) restructuring, an operational restructuring (or a combination of both), or a liquidation. Chapter 11 can enable a business debtor to implement a balance sheet restructuring by reducing a reorganised company's debt burden to better align with its ability to generate cash flows to service debt. This often involves a plan of reorganisation that converts all or a portion of existing secured and/or unsecured debt to new equity in the reorganised debtor, and in most cases, effectively cancelling old equity interests. Although less frequent, old equity holders may be permitted to continue to participate in the reorganised debtor, with either warrants or a substantially diluted equity position, provided creditors are paid in full or consent.

A business debtor can also implement an operational restructuring of its business model in chapter 11. This can involve rejecting burdensome executory contracts and leases, selling unprofitable business units and streamlining operations to yield a more efficient business model.

A chapter 11 case can also be used to implement an orderly liquidation of a company, with management remaining in control throughout the liquidation process. This can involve management's sale of substantially all the assets of the company in one or more sales under § 363 (discussed below). It can also involve the formation of a liquidation trust to pursue causes of action or market and sell illiquid assets for the benefit of creditors over a period of time after a liquidation plan is confirmed.

Important Players in a Chapter 11 Case

There are multiple players in a chapter 11 case that participate in every aspect of bankruptcy cases and are likely to be heard in the negotiations over a proposed plan.

US Trustee

The Office of the United States Trustee, a division of the Department of Justice (the "**US Trustee**"), is charged with overseeing the bankruptcy system. A local representative of the US Trustee is typically assigned to monitor every chapter 11 case.

The US Trustee is responsible for the appointment of statutory committees of creditors and equity holders in a chapter 11 case, and can be heard on any issue in the case. The US Trustee typically intervenes to ensure compliance with the operating and reporting rules applicable to debtors in bankruptcy, regulate compensation of professionals retained in the case and address concerns regarding overall fairness to creditors.

Creditors' Committee

In nearly every chapter 11 case, the US Trustee appoints an official committee of unsecured creditors: the creditors' committee. The US Trustee usually sends out invitations to serve on the creditors' committee to the debtor's 20 largest unsecured creditors, as listed on the petition filed by the debtor at the commencement of the chapter 11 case, and selects from among the largest holders that respond in the affirmative.

Members of the creditors' committee serve as fiduciaries for the interests of all unsecured creditors during the case and are reimbursed for out-of-pocket expenses incurred. The creditors' committee may retain counsel, and sometimes financial advisors, at the expense of the debtor's estate, to represent the interests of unsecured creditors during the case.

Equity Committee

In cases where the debtor is not hopelessly insolvent (i.e. residual value may exist for holders of equity interests after payment of creditors), the US Trustee may appoint an official committee of equity holders, usually consisting of holders of the largest amounts of equity securities of the debtor. The members of the equity committee also serve as fiduciary representatives of the interests of equity holders during the chapter 11 case, and are entitled to retain counsel, and sometimes financial advisors, at the expense of the debtor's estate.

Other Parties

Depending upon the circumstances of the case, other active players can include: (i) individual creditor entities, including large unsecured and secured creditors; (ii) committees (official and/or *ad hoc*) of bondholders, tort claimants or other large constituencies of claimants; (iii) unions; (iv) government agencies, such as the Pension Benefit Guaranty Corporation (if pension liabilities cannot be met), US and state environmental protection agencies, and others; (v) parties to critical executory contracts; and (vi) any other constituencies that may be impacted by the administration of the case or proposed bankruptcy plan.

Bankruptcy Law Fundamentals

Automatic Stay (Bankruptcy Code § 362)

Upon the commencement of a bankruptcy case, the debtor obtains immediate protection from actions against its assets and operations by virtue of the automatic stay implemented under § 362 of the Bankruptcy Code. By operation of the automatic stay, creditors are prohibited from commencing or continuing litigation against the debtor and are prohibited from attempting to collect pre-petition debts of the debtor. Actions against the property of the debtor, such as foreclosure and similar proceedings to execute against assets of the debtor, are likewise stayed.

Automatic stay is one of the most fundamental debtor protections provided by the Bankruptcy Code. It prevents a "race to the courthouse" by creditors seeking to improve their position in the Bankruptcy Code's priority scheme, whether by perfecting a secured claim, reducing an unsecured claim to judgment and obtaining a judgment lien, or otherwise obtaining payment ahead of similarly situated creditors. The automatic stay provides a debtor with breathing space to reorganise by allowing the debtor time to address the myriad issues that arise upon insolvency, while concurrently managing the debtor-in-possession through the bankruptcy case. Violations of the automatic stay can result in sanctions, penalties and fines for the offender.

As a theoretical matter, the automatic stay applies to all entities, wherever domiciled, and all property of the debtor, wherever located. Enforcement of the automatic stay, however, is limited by, among other things: (i) the bankruptcy court's territorial jurisdiction – the US and its territories; (ii) the bankruptcy court's jurisdiction over persons and entities – those domiciled in the US or that have minimum contacts with the US; and (iii) considerations of comity with non-US governments that may prevent a bankruptcy court from upsetting non-US government processes, entering orders against non-US persons and adjudicating disputes over property outside of the US. The intricacies of the extra-territorial application of the automatic stay are beyond the scope of this discussion. However, entities doing business with US debtors or that have property in the US (or expect to in the future) should give due consideration before taking actions that may violate the stay, even as regards property and entities in a non-US jurisdiction.

Unless modified by a court order, the automatic stay remains in place throughout the pendency of the case. In most cases, debtors will incorporate a continuation of the automatic stay and injunctions against collection actions in the provisions of their chapter 11 plan of reorganisation to provide for exclusive resolution of all pre-petition obligations of the debtor in the bankruptcy court to the greatest extent possible.

Any party considering adverse action against a debtor should first seek a bankruptcy court order providing relief from the automatic stay. Generally, secured creditors may seek relief from the automatic stay on the basis that their collateral is eroding in value and the debtor is not maintaining the value of their collateral, thereby entitling them to adequate protection from any diminution or relief from the automatic stay to permit foreclosure. Adequate protection may consist of monthly cash payments to compensate for erosion in value, additional or substitute liens on new collateral, or other negotiated protections. Creditors may seek relief from the automatic stay on several other grounds, including that the debtor lacks equity in the collateral property and such property is not necessary to an effective reorganisation.

Sales of Assets (Bankruptcy Code § 363)

Although, as noted earlier, a debtor is authorised to continue conducting its business in the "ordinary course" during a chapter 11 case, it must seek bankruptcy court approval to sell any assets of the estate "outside the ordinary course of business" under § 363 of the Bankruptcy Code (a "**363 sale**"). Section 363 provides that such sale may be free and clear of all liens, claims and interests under certain circumstances, including by attachment of such liens, claims and interests to the proceeds of the 363 sale at closing. A debtor need only provide a "good business reason" to justify proposing a 363 sale, even if the sale will be tantamount to a liquidation of substantially all of the debtor's assets, with creditors left to assert their claims against the sale proceeds.

For a potential purchaser of assets, a 363 sale provides the best means to obtain clear title within a significantly expedited timeframe. Typically, a 363 sale must be made subject to a market test. The most common procedure is to conduct an open auction of the assets, with a "stalking horse" purchaser first negotiating the terms of a final sale, the terms of which are publicly disclosed and provide the floor bid at the auction. The stalking horse bidder is typically provided with bidding protections, such as a break-up or termination fee and reimbursement of expenses associated with due diligence and negotiation of the stalking horse bid. If the debtor has conducted significant marketing and it is clear that there is only one interested party, or if the value of the assets do not justify an expensive auction process, a 363 sale may be conducted in a private sale, with the material terms of the deal disclosed and subject to objection by creditors and other parties in interest.

A 363 sale is an extremely effective tool permitting the debtor to maximise the value obtained from purchasers by separating the assets from related liabilities, such as secured claims, mass tort claims and successor liability claims, that may cloud title and control of the asset in the hands of the debtor. Claims may take years to resolve, and the 363 sale process permits the asset value to be preserved by removing it from the bankruptcy estate, with related liabilities left for resolution in the bankruptcy process and payment from the proceeds of the 363 sale. If the asset to be sold is subject to the liens of secured creditors, the proposed sale price must be "greater than the aggregate value of all liens" on the assets, unless the secured creditor's interest is the subject of a *bona fide* dispute or it consents to the sale. Generally, secured lenders are entitled to "credit bid" their secured liens up to the amount of their allowed secured claim at any 363 sale of the assets which serve as their collateral, as discussed below.

Primarily because of the protracted process and substantial expense associated with a chapter 11 case, and the scarcity of lenders willing to provide debtor-in-possession financing (discussed below), 363 sales of all or part of a debtor's business as a going concern have become a growing trend. Recent examples include GM and Chrysler, which have provided significant and favourable precedents for the use of 363 sales as effective restructuring strategies. In recent years, lenders have become more reluctant to provide financing for prolonged bankruptcy cases and instead typically impose short financing terms that require a confirmed plan or a 363 sale. Also contributing to the growing trend in favour of 363 sales are the 2005 amendments to the Bankruptcy Code which reduced, among other things: (i) a debtor's exclusive right to propose a plan of reorganisation to a maximum of 18 months after the filing of the petition; and (ii) the time within which a debtor must decide to assume or reject a lease of commercial real estate to a maximum of 210 days after the filing.

Assumption or Rejection of Executory Contracts (Bankruptcy Code § 365)

One of the most powerful weapons available to a debtor reorganising under chapter 11 – and sometimes the primary motive for the commencement of a chapter 11 case – is the ability, under the provisions of § 365 of the Bankruptcy Code, to reject burdensome executory contracts while retaining profitable or beneficial contracts. Specifically, § 365 permits a debtor to: (i) assume favourable contracts and compel performance from counterparties upon cure of pre-petition breaches (even if the contract contains a clause terminating the contract upon insolvency or bankruptcy); (ii) assume and assign contracts to third parties (including, with certain specified exceptions, contracts that contain anti-assignment clauses); or (iii) reject an unfavourable contract, resulting in a deemed breach as of the date of the bankruptcy filing, the damages for which are pre-petition unsecured claims that may be of little cost to the debtor's business going forward (and of little value to the counterparty).

However, executory contracts cannot be rejected in part: they must be either assumed or rejected in their entirety. Nevertheless, the threat of rejecting an executory contract is frequently a powerful tool to use as leverage in the renegotiation of unfavourable terms, because a debtor can assume a contract "as modified" with consent of the counterparty. Certain rejection claims are capped. For example, claims arising from the rejection of long-term real estate leases are capped at the greater of one year's rent or 15% of the remaining term of the lease, not to exceed three years. This cap can lead to significant savings, especially for retail companies with numerous burdensome, long-term real estate leases.

In general, a debtor may decide whether to assume or reject an executory contract at any time before the confirmation of a chapter 11 plan, and counterparties must continue to perform pending the debtor's decision, unless they first obtain relief from the automatic stay to terminate their services. Certain types of executory contracts, however, must be assumed or rejected within specific timeframes. For example, commercial real estate leases must be assumed or rejected within 120 days, subject to one 90-day extension. A counterparty may, at any time, request that the bankruptcy court force the debtor to decide at an earlier date based upon the facts and circumstances particular to that party.

Avoiding Powers

The Bankruptcy Code grants a debtor the authority to avoid certain transfers and make recoveries for the benefit of the estate. These avoiding powers are generally intended to "level the playing field" by avoiding transactions that unfairly benefit certain unsecured creditors that should instead share in recoveries on an equal or *pro rata* basis with other similarly situated creditors. Toward this end, the debtor's avoiding powers include the power to:

- set aside preferential transfers made to non-insider creditors within 90 days prior to the petition date and, with respect to insiders, within one year prior to the petition date. Generally, insiders are directors, officers, and other control persons or their relatives, and any affiliated entities, and any insider of those entities;
- undo security interests and other pre-petition transfers of property that were not properly perfected under non-bankruptcy law at the time of the petition date; and
- recover fraudulent transfers, that is, transfers made with actual intent to hinder, delay, or defraud creditors or transfers made for less than reasonably equivalent value while the debtor was insolvent, or was rendered insolvent or left with unreasonably small capital. Bankruptcy courts can look back to transfers within two years of the petition date using the Bankruptcy Code's fraudulent conveyance provisions and up to four years (or six years in some jurisdictions) using state law.

Claims and Priority

The Bankruptcy Code requires a chapter 11 plan to designate claimants into classes of claims and interest holders for treatment under a proposed plan of reorganisation. The term "claim" is broadly defined and includes a right to payment or a right to an equitable remedy for a failure of performance if the breach gives rise to a right of payment.

Claims in a bankruptcy case are generally afforded the following priority:

- secured creditors – individuals or entities holding claims against the debtor that are secured by a lien on property of the estate;
- unsecured creditors entitled to priority under § 507 of the Bankruptcy Code – for example, those holding claims incurred during administration of the case and that were necessary for or benefited the preservation of the debtor's estate, certain reclamation claims, or claims with statutory priority over other unsecured creditors (e.g. certain wages, pensions, taxes);

- general unsecured creditors – individuals or entities holding allowed unsecured claims; and
- equity holders – individuals or entities holding interests in equity securities of a debtor (e.g. stock in a corporation).

The Claims Allowance Process

The debtor must file various lists and schedules, including lists of the debtor's secured creditors, unsecured creditors and equity holders. If the debtor lists its debts as undisputed, non-contingent or liquidated, the claims are allowed in the scheduled amount (unless an objection to the claim is filed later) and a proof of claim need not be filed to evidence the claim.

If a proof of claim must be filed (because the claim was not scheduled, or because it was scheduled as contingent, disputed or unliquidated), then it must be filed before the bar date. In a chapter 11 case, the court will set the bar date after a motion is filed and a hearing is held. Any claim filed after the bar date can be disallowed as untimely.

A proof of claim filed in the case is deemed allowed unless a party in interest objects. If an objection is filed, the claim can be disallowed only after a hearing before the court. If a claim is disallowed, then the claimant cannot obtain a distribution from the estate or the reorganised debtor. The claimant may collect, however, from non-debtor parties such as guarantors.

If a claim is contingent or unliquidated as of the date of the order for relief, the court may estimate the claim. An estimation hearing is essentially a truncated trial to liquidate a pre-petition claim.

After the bar date, the debtor is given an opportunity to object to claims. Objections may be based on, among other things, the following arguments: (i) defences based on state law; (ii) the creditor owing money to the estate that must be returned before the claim is allowed; or (iii) the creditor filing an untimely proof of claim.

Rights of Secured Creditors

Generally, over-secured creditors (whose collateral has a value greater than the amount of the creditors' lien) are entitled to retain their pre-petition liens on the same collateral (or the proceeds thereof) and to be paid in full plus interest at their contractual rate of interest, provided there are no defects or grounds for the debtor to seek to avoid those liens (e.g. if such liens are unperfected under applicable law or can be set aside as fraudulent transfers or preferences).

However, where a creditor's collateral is worth less than the face amount of the creditor's lien, a secured creditor's claims may be bifurcated, under § 506 of the Bankruptcy Code, into a secured claim up to the value of the collateral and an unsecured claim for the balance. A creditor may avoid the effects of such bifurcation by making an election under § 1111(b) of the Bankruptcy Code to retain the full amount of its lien on the collateral, thereby waiving the right to receive any distributions on the unsecured portion of its claim on confirmation of the plan. This effectively permits the under-secured creditor's full lien amount to "ride through" the chapter 11 case (avoiding bifurcation under § 506 of the Bankruptcy Code), enabling the creditor to obtain a higher recovery in the future if the collateral increases in value after confirmation of the plan.

If a debtor chooses to sell the collateral in bankruptcy, generally, secured creditors have the right to "credit bid" up to the full face amount of their debt – regardless of the actual value of the collateral securing the debt. This right is preserved whether such sale is via a 363 sale or pursuant to a chapter 11 plan, and even if the collateral is sold pursuant to a chapter 11 plan that otherwise provides the secured creditor with the "indubitable equivalent" of its claim.

Debtor-in-Possession Financing

A debtor can seek to entice lenders to provide debtor-in-possession financing ("**DIP financing**") with a range of tools that are routinely approved by bankruptcy courts. First, the debtor can offer administrative expense status to a potential lender. Next, if unable to obtain a loan on that basis, the debtor can offer the proposed lender a super-priority administrative claim (having priority over all other administrative claims). However, lenders typically require more than a simple administrative priority or super-priority claim in order to lend to a company in a chapter 11 because they are typically reluctant to run the risk of administrative insolvency (i.e. insufficient funds to pay administrative claims in full).

At the next level, the debtor may seek court approval to grant the proposed lender a lien on its unencumbered assets or secured by a junior lien on property that is already encumbered by a lien. Even though general unsecured creditors may object and insist upon a showing of necessity for a proposed financing that involves granting liens on unencumbered assets, debtors typically prevail in such cases where they can show a reasonable prospect or likelihood for reorganisation.

At the highest level, a debtor may seek court approval to grant the proposed lender a lien on encumbered assets that is equal or senior to existing liens. However, in this case, the debtor must establish "that it is unable to obtain such credit otherwise". Further, the debtor must establish that the existing lender is adequately protected notwithstanding the proposed senior or "priming" liens. This typically involves consideration of various factors, including: (i) a valuation of the subject property to assess the nature of any "equity cushion" that may exist; (ii) whether the property is eroding in value; (iii) the nature of payments proposed or available; and (iv) whether the debtor has a reasonable prospect for reorganising. Typically, holders of existing liens would object vigorously to any priming liens on their collateral absent a showing of how their liens are adequately protected.

The Chapter 11 Plan Process

The ultimate goal of a debtor company in chapter 11 is to file and confirm a plan of reorganisation or liquidation. A brief description of the plan process is set forth below.

The Disclosure Statement

A debtor is required to prepare and distribute a disclosure statement prior to solicitation of votes from creditors and equity holders. The disclosure statement must contain adequate information regarding the assets, liabilities and affairs (income, projections, risks, etc.) of the debtor so as to enable the holder of a claim or interest to make an informed judgment about the proposed plan.

The Plan

During the first 120 days after commencement of the chapter 11 case, only the debtor may file a proposed plan. That period of exclusivity may be extended by the court to a date that is not more than 18 months after the petition date. The debtor has an additional 60 days after the filing of its plan to solicit acceptances of the plan from each impaired class of creditors. An impaired creditor is one whose legal rights are altered by the plan, and only impaired creditors may vote on the plan. Therefore, a class of creditors proposed to be paid in full is deemed to accept the plan and is not entitled to vote.

If the debtor fails to file a plan within the fixed deadline, or if the plan is not accepted by the requisite creditors within the deadline for soliciting acceptances, the debtor loses exclusivity and any party in interest may file its own plan.

Contents of a Plan

A proposed chapter 11 plan must meet certain minimum requirements in order to be confirmed. For example, it must:

- designate all classes of claims and interests (substantially similar claims or interests must be categorized in the same class);
- specify which classes are impaired and not impaired;
- specify which classes are entitled to vote (only impaired classes are entitled to vote);
- specify the treatment of all classes;
- treat all members within a class equally;

- provide adequate means to implement the plan; and
- not contain any provisions that violate the Bankruptcy Code.

Plans can provide for a financial or operational overhaul of the debtor's business that includes sales of assets, modification or refinancing of secured and unsecured debt, assumption or rejection of contracts, amendments to the debtor's corporate charter, the cancellation of existing stock and issuance of new stock, and the swapping of debt for equity. If the debtor's business has been sold before a plan has been proposed, it can provide for distribution of the proceeds in a plan of liquidation.

Confirmation of the Plan

In order for the bankruptcy court to confirm the proposed plan, a debtor must meet all of the requirements of § 1129 of the Bankruptcy Code. These requirements include establishing that:

- at least one impaired class has accepted the plan (without counting "insiders") and that, with respect to any non-accepting class, the requirements for a cramdown have been met (see below);
- the plan meets the "best interests of creditors test", which requires in essence that each impaired class has either accepted the plan or receives no less than it would receive in a liquidation under chapter 7;
- the plan is feasible (not likely to be followed by a liquidation or need for further reorganization);
- the plan was proposed in good faith; and
- the plan does not violate any provisions of the Bankruptcy Code.

Class Voting on the Plan

With respect to an impaired class of creditors, the class is deemed to accept a plan if voting creditors that hold at least two-thirds in dollar amount and more than one-half in number of the claims in the class vote to accept the plan, excluding any votes not solicited or cast in good faith, as determined by the court on request of any party in interest.

Cramdown

Provided all of the requirements set forth in § 1129 of the Bankruptcy Code are met, the bankruptcy court may confirm a plan notwithstanding the rejection of the plan by one or more classes of impaired creditors, provided the court determines the plan "does not discriminate unfairly" and is "fair and equitable" with respect to each impaired class that has not accepted the plan.

The standard "does not discriminate unfairly" generally means that similarly situated creditors must be treated similarly. For example, the treatment of general unsecured creditors must provide generally equivalent value for the rejecting crammed-down class as for the other classes of general unsecured creditors.

The "fair and equitable" test for a plan cram-down differs for secured creditors, unsecured creditors and equity holders. As the test is applied to unsecured creditors and equity holders, it requires that the members of the class receive property of a value equal to the allowed amount of their claims or that junior classes or interests receive nothing on account of their claims or interests under the so-called Absolute Priority Rule (discussed below).

With respect to secured creditors, the "fair and equitable" test generally requires that the creditor keeps its lien and receives deferred cash payments totalling at least the allowed amount of its secured claim, and that the present value (as of the effective date of the confirmed plan) of the payments to be made equals or exceeds the secured creditor's interest in the collateral. A plan may also be deemed fair and equitable with respect to secured creditors if it provides for deferred cash payments having a present value equal to the creditors' allowed secured claim within a reasonable time after confirmation of the plan (e.g. from a proposed sale of assets contemplated in the plan).

Absolute Priority Rule

The Absolute Priority Rule holds that if a class is impaired and votes against confirmation of a proposed plan, then the class must be paid in full (including unpaid accrued interest) before any junior class of claims or interests may receive anything of value under the plan on account of their pre-petition claims or interests.

Accordingly, in cases where “old equity” wishes to retain an interest in the reorganised debtor despite paying creditors less than the full amount of their claims, the Absolute Priority Rule can pose significant challenges. Under those circumstances, old equity holders must argue that they are not receiving anything on account of their pre-petition interests but on account of “new value contributed” to the reorganised debtor under the “new value exception” to the Absolute Priority Rule. The existence of the new value exception has been long debated and is still open to legal challenge. But if the court recognises the exception, old equity holders must establish that: (i) they are making a new contribution in money or money’s worth; (ii) the contribution is reasonably equivalent to the value of the interest retained in the reorganised debtor; and (iii) the new value contribution is necessary for implementation of a feasible plan of reorganisation. Even if these requirements are met, the opportunity to invest in the reorganised debtor must be subjected to a market test such that old equity-holders are not receiving an exclusive opportunity to invest in the reorganised debtor on account of their pre-petition interests. The nature and scope of this market test can vary from case to case depending upon the facts and circumstances.

Effect of Plan Confirmation

Once the plan is confirmed by the bankruptcy court and becomes effective in accordance with its terms, the debtor’s assets and liabilities are subject to the terms of the plan and all creditors and parties in interest are bound by the terms of the plan, regardless of whether they voted for the plan. Typically, the bankruptcy court retains jurisdiction to enforce the terms of the plan and resolve any disputes arising from the plan or that impact upon distributions to be made under the plan.

If a plan is not confirmed, the debtor and/or other parties in interest may seek to propose an alternative plan, as the debtor’s exclusive period to propose a plan is likely to have lapsed by this point. Parties may also seek to convert the case to a chapter 7 mandatory liquidation if there is no reasonable prospect of reorganisation.

Chapter 15

The United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-border Insolvency is intended to serve as a model law for adoption by all countries in order to harmonise laws governing cross-border insolvencies. The 2005 amendments to the Bankruptcy Code substantially adopted the Model Law as chapter 15. Since its enactment in 2005, chapter 15 has become a well-used technique for the recognition of foreign proceedings in the US. Accordingly, the case law is developed, though not fully mature.

Chapter 15 applies in four distinct circumstances:

- when a foreign court or representative seeks assistance in the US with respect to a foreign proceeding;
- when assistance is required in a foreign country for a case pending in the US;
- when a foreign proceeding and a US proceeding are pending concurrently with respect to the same debtor; and
- when interested parties in a foreign proceeding have an interest in participating in or commencing a case under the Bankruptcy Code.

The foreign representative must petition for recognition of the foreign proceeding pursuant to § 1515, with proof of: (i) the existence of the foreign proceeding; (ii) the appointment of the foreign representative; and (iii) a summary of the foreign proceedings to date. Simply filing a petition for recognition does not subject the foreign representative to the jurisdiction of any court in the US for any other purpose.

If the US court recognises the foreign proceeding, chapter 15 can provide many of the same powers and protections of chapter 11 with less expense than a full chapter 11 proceeding. For example, a debtor can obtain the protections of the automatic stay, pursue avoidable transfers under the laws applicable to the foreign proceedings, conduct discovery, dispose of assets in the US, obtain permanent injunctive relief to implement a foreign bankruptcy/insolvency plan and prevent creditors from attempting to execute, levy or otherwise reach assets in the US.

Assignment for the Benefit of Creditors

In many states, another option that may be available to businesses in financial distress is an assignment for the benefit of creditors (commonly known as an "**ABC**"). An ABC is an insolvency proceeding governed by state law rather than federal bankruptcy law. An ABC is not a vehicle to reorganise a business, although it may be used for a sale of substantially all of the assets of a debtor to a new entity that continues the business. It is most often used as a process for asset liquidation. An ABC can provide some advantages over a bankruptcy, such as lower cost and increased speed, but also has some disadvantages, such as no ability to sell assets "free and clear" of liens absent the consent or full pay-off of lien holders.

An ABC is commenced by a formal, voluntary transfer of most, and usually all, of the business's assets to an assignee, in trust, to apply the assets or their proceeds to the payment of creditors, who are the beneficiaries of the trust. Unlike a chapter 7 bankruptcy, in which the trustee is randomly selected or is elected by the creditors, in an ABC the business can select the assignee. Also, in most states, an ABC is an out-of-court process in which the assignee is not obligated to seek court approval for the numerous acts of administration of the trust.

To begin the process, the debtor drafts a trust and assignment for the benefit of creditors agreement. Once the document has been executed by the debtor and accepted by the assignee, actual possession of the debtor's assets is immediately delivered to the assignee for the purpose of liquidating the assets. Shortly thereafter, the assignee will notify all of the debtor's creditors that an assignment has been made and the intended disposition of the debtor's assets and also include a verified claim form for each creditor to complete and return.

Assignees can operate a business to preserve the value of the assets while a buyer is sought. Typically, the consent of any secured lender is necessary for such interim operations. The assignee will typically sell assets at public auction. It is usual for an assignee to have received a "stalking horse" offer for most of the assets at the commencement of the assignment so that he has a "floor bid" going into the auction. Once the assets have been liquidated, the assignee has a fiduciary duty to distribute the proceeds to the creditors in accordance with the priorities established by law.

The advantages of an ABC include:

- speed – a sale can be achieved in a few days, whereas in bankruptcy it could take 30 to 60 days or more;
- cost – due to the lack of court proceedings, administrative costs are much lower than in bankruptcy; and
- competence – an assignee with experience and knowledge of a business can be chosen instead of a randomly selected bankruptcy trustee.

The disadvantages of an ABC include:

- sales – unlike a 363 sale, there is usually no ability to sell assets free and clear of liens and security interests without the consent or full pay-off of lien holders;

- contracts – an ABC is typically a default under most contracts and, unlike in bankruptcy, contracts may be terminated by the counterparty under any ipso facto clause. Additionally, leases and executory contracts cannot be assigned without the consent of counterparties; and
- automatic stay – an ABC does not provide an automatic stay. However, the assets that have been transferred to the trust are insulated from creditors, which generally deters creditors from pursuing claims outside of the ABC process.

United States

Baker & McKenzie LLP
300 East Randolph Street, Suite 5000
Chicago, Illinois 60601
United States

T +1 312 861 8000
F +1 312 861 2899

Baker & McKenzie LLP
452 Fifth Avenue
New York, New York 10018
United States

T +1 212 626 4100
F +1 212 310 1600

Baker & McKenzie LLP
2300 Trammell Crow Center
2001 Ross Avenue
Dallas, Texas 75201
United States

T +1 214 978 3000
F +1 214 978 3099