Restructuring and insolvency in the United States: overview

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FORMS OF SECURITY

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

Immovable property

Common forms of security and formalities. Immovable property in the US is known as real property. Real property includes land and, generally, whatever is built or growing on or affixed to the land (known as fixtures).

Security over real property can take the form of a mortgage or a deed of trust. Mortgages are more common than deeds of trust. Mortgages give the lender/mortgagor the right to foreclose on the property if the borrower/mortgagor defaults on the loan. Foreclosure usually involves judicial action, but non-judicial foreclosure is common in states that permit deeds of trust. Certain states also permit non-judicial foreclosure in connection with a mortgage.

Generally, a valid mortgage or deed of trust must include:

- The name of the secured party.
- A legal description of the real property.
- The terms and conditions of the security interest in the real property.

The borrower must sign the mortgage for it to be valid and enforceable. A notary public must acknowledge the borrower's signature. Signatures of two witnesses may also be required under state law and, in any event, are strongly recommended.

The local land registry where the real property is situated must record the mortgage or deed of trust. If the mortgage is not recorded, it is ineffective against other creditors and subsequent purchasers of the real property.

Effects of non-compliance. Under state law, a legally defective mortgage can still be enforceable under certain legal principles, including:

- Equitable mortgage.
- Equitable subrogation.
- Constructive notice.
- Substantial compliance.

However, in proceedings under Title 11 of the United States Bankruptcy Code (Bankruptcy Code), the trustee or debtor-in-possession may be able to avoid a defective mortgage and recover the real property for the benefit of the debtor's estate and creditors (sections 544 and 548).

Movable property

Common forms of security and formalities. Moveable property in the US is known as personal property. Personal property includes physical assets, such as inventory and equipment, as well as bank accounts, intellectual property, and other intangible assets.

Creditors take a security interest in and over personal property under applicable state law. Federal law applies in certain cases, including intellectual property. All fifty states and the Commonwealth of Puerto Rico have adopted Article 9 of the Uniform Commercial Code, which provides a set of standard rules governing secured transactions in personal property.

Under Article 9, the security interest is created and becomes enforceable against the property when it attaches to it. Attachment generally requires that:

- The debtor has rights in the property.
- Value has been given for the security.
- Either the:
  - debtor has authenticated a security agreement that adequately describes the property; or
  - secured creditor is in possession or control of the property.

The security interest must be perfected to be effective against, and have priority over, third parties. Perfection is typically accomplished by filing and recording a financing statement (Form UCC-1) or by taking possession or control of the property, depending on the type of collateral. The financing statement must contain:

- The name of the debtor.
- The name of the secured party or its representative.
- A description of the property.

For personal property other than intellectual property, the financing statement is filed with the secretary of state in the state where the borrower is located, regardless of whether the personal property or collateral is located in another state. To perfect a security interest in intellectual property, it is usually advisable to record under both Article 9 and with the applicable federal agency. For patents and trademarks:

- An Article 9 filing perfects the security interest.
- A filing with the US Patent and Trademark Office protects against subsequent bona fide purchasers.

For registered copyrights, a filing with the US Copyright Office perfects the security interest. For unregistered copyrights, subject to certain exceptions, it may be best to register the mark and file with the US Copyright Office to perfect it. However, an Article 9
filing may be sufficient to perfect a security interest in an unregistered mark.

**Effects of non-compliance.** The secured party can enforce an unperfected security interest against the debtor, but the unperfected lien will not have priority over a subsequent third party with a perfected security interest. In bankruptcy proceedings, a trustee or debtor-in-possession may be able to avoid an unperfected lien (sections 544 and 547, Bankruptcy Code). The trustee or debtor-in-possession may also be able to avoid a security interest even if it has been perfected if the secured party did not provide reasonably equivalent value (sections 544 and 548, Bankruptcy Code).

### CREDITOR AND CONTRIBUTORY RANKING

**2. Where do creditors and contributories rank on a debtor's insolvency?**

The ranking of allowed claims and equity interests under the United States Bankruptcy Code is the same in all cases under the Bankruptcy Code.

**Order of priority**

The priority of claims and equity interests is as follows, in descending order:

- Secured claims.
- Administrative expenses and claims with statutory priority under the Bankruptcy Code.
- Allowed claims of general unsecured creditors.
- Subordinated claims.
- Equity interests.

In certain circumstances involving creditor consent, a Chapter 11 plan of reorganisation can modify the strict priority rules of the Bankruptcy Code.

**Secured claims**

Allowed claims secured by liens valid under state law and unavoidable under bankruptcy law must be paid first. State law determines the priority of competing liens against the same collateral. The amount of the allowed secured claim is determined under section 506 of the Bankruptcy Code. Any excess proceeds from a cash sale of the collateral are used to pay lower ranking claims. If the value of the collateral is not sufficient to satisfy the lien, the deficiency becomes a general unsecured claim.

**Administrative expenses and claims with statutory priority under the Bankruptcy Code**

Certain expenses and claims have priority of payment (section 507(a), Bankruptcy Code). In corporate bankruptcies, they rank in the following order:

- Expenses relating to administration of the bankruptcy case, including trade debt and professional fees. These are further prioritised in the following order:
  - super-priority claims under section 364(c)(1) of the Bankruptcy Code relating to unsecured portion of debtor-in-possession (DIP) financing in Chapter 11 cases;
  - super-priority claims under section 507(b) of the Bankruptcy Code relating to compensation for a secured creditor for the debtor's failure to provide adequate protection while the automatic stay is in effect and the trustee or debtor-in-possession uses the collateral;
  - administrative expenses, in the order of priority listed in section 503(b) of the Bankruptcy Code (section 507(a)(2), Bankruptcy Code).

- Wages of up to US$12,475 earned within 180 days before the bankruptcy filing (section 507(a)(4), Bankruptcy Code).
- Unsecured claims for contributions to employee benefit plans arising from services rendered within 180 days before the bankruptcy filing (section 507(a)(5), Bankruptcy Code). Wages and benefits exceeding the statutory limits are general unsecured claims.
- Certain unsecured tax claims of government units (section 507(a)(8), Bankruptcy Code).

If a debtor borrows new money during Chapter 11 proceedings (DIP financing), the DIP financing lender usually obtains a right of first recovery out of all assets, except where the lender agrees to be junior to existing liens.

### 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?**

A trade creditor can seek to obtain a statutory lien on both movable and immovable property to secure payment for services, labour or goods provided to the debtor. Statutory liens are subject to state law and include:

- An artisan's lien.
- Mechanic's lien.
- Carrier's lien.
- Warehouseman's lien.

The requirements for obtaining these types of liens vary by state. Statutory liens are generally enforceable in a bankruptcy case if they are valid and perfected under applicable state law.

The Bankruptcy Code provides certain rights to trade creditors to reclaim goods that they sold to the debtor within 45 days before the bankruptcy filing (section 546(c), Bankruptcy Code). In certain circumstances, suppliers can assert a priority claim for the value of any goods received by the debtor within 20 days before the bankruptcy filing (section 503(b)(9), Bankruptcy Code).

**4. Can creditors invoke any procedures (other than the formal rescue or insolvency procedures described in Questions 6 and 7) to recover their debt? Is there a mandatory set-off of mutual debts on insolvency?**

Creditors can work together with the distressed company to restructure the debt in an out-of-court proceeding. Out-of-court restructuring mechanisms include:

- Debt refinancing.
- Debt for equity swaps.
- Exchange offers.
- New capital infusions of debt or equity, such as rights offerings and second lien or convertible debt offerings.
- State law remedies, such as assignments for the benefit of creditors or receiverships, both of which may involve minor court action.

Alternatively, creditors can bring a collection action against a borrower in accordance with the loan documents and applicable law. However, if the borrower files for bankruptcy, any pending collection action against the new debtor is automatically stayed (section 362(a), Bankruptcy Code).
In certain circumstances, creditors can also exercise rights of:

- Set-off, where court approval is required (section 553, Bankruptcy Code).
- Recoupment, where court approval is not required.

There is no mandatory set-off of mutual debts under the Bankruptcy Code.

**STATE SUPPORT**

5. Is state support for distressed businesses available?

State support for distressed businesses is generally not available. The US Government has recently provided billions of dollars in loans and other financing to systemically important entities such as General Motors, Chrysler Corporation and American International Group. However, in general, such support is controversial and rare.

**RESCUE AND INSOLVENCY PROCEDURES**

6. What are the main rescue/reorganisation procedures in your jurisdiction?

Reorganisation under Chapter 11 of the Bankruptcy Code

**Objective.** Chapter 11 provides a distressed entity with the opportunity to preserve its business as a going concern while implementing an operational or financial restructuring.

The debtor can seek to adjust its debt by reducing the amount owed or extending repayment terms. The automatic stay (section 362, Bankruptcy Code) gives the debtor time to address creditors' demands and avoids creditors' racing to obtain a judgment first by imposing a moratorium on actions against the debtor and its assets.

A debtor's prospects for recovery will depend, in part, on the debtor's ability to generate or obtain sufficient cash flow to pay the costs of administering the case and formulating a feasible Chapter 11 plan. At a minimum, creditors must recover value that is no less than what they would have recovered in a liquidation (section 1129(a)(7), Bankruptcy Code).

**Initiation.** A Chapter 11 case starts with the filing of a petition for relief with a specialised US Bankruptcy Court. If the debtor files a petition (voluntary petition), the order for relief is entered automatically. Contrary to the procedure in many other countries, there is no requirement that the debtor be insolvent or that the court approve the filing. If creditors file a petition (involuntary petition) and the debtor opposes the filing, the Bankruptcy Court must decide whether the:

- Creditors meet the statutory test to be able to file an involuntary petition.
- Debtor is generally not paying its debts as they become due.

An entity is eligible to be a Chapter 11 debtor if it has a domicile, a place of business or property in the US. The property does not need to be substantial. In certain jurisdictions, it may include a bank account or an unearned fee retainer held by a law firm.

Section 109 of the Bankruptcy Code provides that certain entities, including banking and insurance institutions, are not eligible to be a debtor. Stockbrokers and commodity brokers can only file for Chapter 7 liquidation under the Securities Investors Protection Act.

**Substantive tests.** A company can be solvent and still obtain Chapter 11 relief. There is no requirement that its liabilities exceed its assets or that it has an inability to pay its debts as they become due. There is no requirement for an insolvent company to file for bankruptcy. Unlike in other countries, there are no wrongful trading laws if an insolvent company does not file for bankruptcy.

**Consent and approvals.** There is an initial period of 120 days during which only the debtor can file a Chapter 11 plan (section 1121(b), Bankruptcy Code). The Bankruptcy Court can extend this exclusive period for up to 18 months, if the debtor can provide sufficient cause for the court to do so. Interested parties can seek to terminate the debtor's exclusive period in order to file their own Chapter 11 plan, or file their own plan after the debtor's exclusive period expires. An interested party includes any creditor or equity holder.

Eligible holders of claims and interests are entitled to vote to accept or reject a proposed Chapter 11 plan (section 1126, Bankruptcy Code). Claims and interests are divided into classes. Each class is comprised of substantially similar claims or interests. Administrative claims are not classified, and each secured claim is generally placed in a separate class.

Only classes of creditors or shareholders having claims or interests that are impaired under the plan are entitled to vote. An impaired claim or interest is one that is not paid in full or whose rights are otherwise modified in any manner. Each impaired class represents a potential voting block: acceptance by a class of impaired claims requires consent by holders of claims equaling at least two-thirds in amount and a majority (more than half) in number of the voting claims in the class. To confirm a plan, only one impaired class of creditors needs to accept the plan. This is known as "cramdown".

Classes of unimpaired claims or interests are deemed to accept the plan. However, classes of claims or interests receiving no distribution under the plan are deemed to reject the plan.

**Supervision and control.** In Chapter 11 proceedings, the debtor entity and its management continue to operate the business as the debtor-in-possession. The Bankruptcy Court supervises the proceedings but is not involved in the day-to-day affairs of the business. The debtor-in-possession is required to seek the Bankruptcy Court's approval for transactions that are outside the ordinary course of business. In rare circumstances involving fraud, dishonesty, incompetence or gross mismanagement, the Bankruptcy Court can appoint an independent trustee to take over the management of the debtor's affairs.

The Office of the United States Trustee, part of the US Department of Justice, has a supervisory role in Chapter 11 proceedings. The US Trustee is generally responsible for:

- Monitoring whether the case is filed in the appropriate venue.
- Monitoring the employment and compensation of estate professionals.
- Appointing the members of the official committees in the case.
- Monitoring the adequacy and timeliness of the debtor's filing of required disclosures.
- Ensuring a proposed Chapter 11 plan is fair and feasible.

If an official committee of unsecured creditors is appointed, it serves as an advocate for, and owes fiduciary duties to, the entire body of general unsecured creditors (section 1102(a)(1), Bankruptcy Code). It will scrutinise the debtor's conduct and work to maximise unsecured creditors' recoveries in the case.

**Protection from creditors.** The filing of a bankruptcy petition triggers an automatic stay, which, in effect, is an injunction against all actions affecting the debtor or its property, wherever the debtor or its property is located (section 362, Bankruptcy Code). Although the stay has extra-territorial effect, the practical impact of its reach can be limited. The stay lasts for the duration of the bankruptcy case.

While the stay is in effect, creditors cannot:

- Collect debt.
• Enforce liens.
• Obtain collateral.
• Improve or attempt to improve the position they were in before the bankruptcy filing.

The Bankruptcy Court can grant a creditor relief from the stay if the creditor demonstrates, on notice and at a hearing, that there is sufficient cause for such relief (section 362(d), Bankruptcy Code). Actions taken by a creditor that violate the stay are generally void. Parties violating the stay can be held liable for damages.

Ipsos facto or bankruptcy termination provisions are unenforceable under section 365(e) of the Bankruptcy Code. Ipsos factoclauses are contractual or non-bankruptcy law provisions under which the bankruptcy or financial condition of the debtor is treated as a default permitting the non-debtor counterparty to terminate the contract. If the contract or licence can be validly terminated for other reasons, the counterparty must first seek relief from the stay. Certain financial contracts, including commodity and derivative contracts, are exempt from the stay (section 365(c), Bankruptcy Code); as a result, the creditor can exercise set-off rights and enforce existing contractual termination rights.

Length of procedure. Traditional Chapter 11 cases can be lengthy, lasting a year or more, especially if an operational restructuring is involved. Pre-packaged or pre-negotiated cases can be expedited in court, but the negotiations leading up to the filing of such cases can still take many months.

Conclusion. A Chapter 11 case concludes if one of the following occurs:
• There is a confirmed Chapter 11 plan that has become effective.
• The case has been converted to a Chapter 7 case (sections 348 and 1122, Bankruptcy Code), possibly due to an inability to reorganise or to pay administrative expenses necessary to operate the debtor’s business (among other reasons).
• The case is dismissed for cause (sections 349 and 1102(b), Bankruptcy Code).

The confirmed Chapter 11 plan binds all interested parties and generally discharges a non-liquidating debtor of its original obligations. The debtor’s former obligations can be replaced by new obligations, as provided in the plan. If the debtor fails to implement the plan, the case can be dismissed or converted to Chapter 7 liquidation.

A structured dismissal of a Chapter 11 case following a sale of substantially all of the debtor’s assets is increasingly being used to reduce the cost of a proceeding and maximise creditor recoveries. A structured dismissal generally involves a dismissal conditioned on certain principles agreed in advance by stakeholders and later approved by the Bankruptcy Court, as distinguished from an unconditional dismissal under section 1122(b) of the Bankruptcy Code. Despite the increased use of structured dismissals, courts in the US are split regarding their permissibility under the Bankruptcy Code.

7. What are the main insolvency procedures in your jurisdiction?

Liquidation under Chapter 7 of the Bankruptcy Code

Objective. The purpose of Chapter 7 of the Bankruptcy Code is to implement an orderly liquidation of the distressed entity. The court-supervised process involves a trustee selling assets and distributing the proceeds to claimholders in accordance with the statutory priorities provided in the Bankruptcy Code (see Question 2), as well as pursuing available causes of action. The extent of a secured creditor’s recovery depends on the value of its collateral. The extent of an unsecured creditor’s recovery depends on the value and availability of unencumbered assets, particularly as administrative expenses must be paid first. If the estate has few unencumbered assets, unsecured creditors typically receive a small fraction of their claims. Equity holders rarely receive a distribution in Chapter 7 cases.

Initiation. Chapter 7 cases can be initiated voluntarily or involuntarily. The rules for filing Chapter 11 petitions apply to Chapter 7 petitions (see Question 6).

Substantive tests. Chapter 7 relief is available to business entities regardless of whether they are insolvent or solvent. Individual debtors must satisfy a “means test” in order to be eligible for Chapter 7 relief.

Supervision and control. Once a Chapter 7 petition is filed, the US Trustee appoints an independent interim trustee to administer the case (section 701, Bankruptcy Code). The interim trustee holds a meeting of creditors after the petition is filed. If the creditors do not elect a trustee at the meeting, the interim trustee becomes the trustee (section 702(d), Bankruptcy Code). The trustee is responsible for, among other things, investigating the debtor’s financial affairs and liquidating the estate’s assets for distribution to stakeholders (section 704, Bankruptcy Code). The Bankruptcy Court supervises the proceedings.

Protection from creditors. See Question 6.

Length of procedure. Chapter 7 cases typically conclude within a few months to a year unless there are complicated assets involved or complex litigation for the trustee to pursue.

Conclusion. To close the Chapter 7 case, the trustee files a final report and final account, in which the trustee certifies that the estate has been fully administered. Interested parties and the US Trustee have 30 days to object. If there is no objection, the estate is presumed to have been fully administered. The Bankruptcy Court then discharges the trustee and closes the case.

Liquidation under Chapter 11 of the Bankruptcy Code

In certain circumstances, a Chapter 11 case can be used to facilitate an orderly liquidation of assets through a Chapter 11 plan of liquidation. The debtor-in-possession remains in control and the administration of the case is generally the same as for a Chapter 11 reorganisation case (see Question 8).

Liquidation under state law

State law also provides the following mechanisms for liquidation of a debtor’s assets and satisfaction of its debt obligations:
• Assignment for the benefit of creditors.
• Receivership.
• Sale under Article 9 of the Uniform Commercial Code or foreclosure.

These procedures do not generally provide interested parties with the same level of certainty as a federal bankruptcy proceeding, and generally are not feasible if the debtor has complex operations, numerous creditors or a complicated capital structure.

STAKEHOLDERS’ ROLES

8. Which stakeholders have the most significant role in the outcome of a restructuring or insolvency procedure? Can stakeholders or commercial/policy issues influence the outcome of the procedure?

Debtor-in-possession

In a Chapter 11 case, the debtor entity becomes the debtor-in-possession, and its existing management continues to operate the business. The debtor-in-possession is responsible for making all business decisions and proposing a Chapter 11 plan during the
exclusive period. The debtor-in-possession must seek Bankruptcy Court approval for all transactions outside the ordinary course of its business. See Question 6.

Official Committee of Unsecured Creditors

In a Chapter 11 case, the US Trustee appoints an official committee of creditors who hold unsecured claims. The committee frequently comprises the seven largest unsecured creditors willing to serve on the committee. The creditors’ committee owes fiduciary duties to the body of general unsecured creditors and works to maximise unsecured creditors’ recoveries. The creditors’ committee can play an important role in the outcome of the case and is involved in:

• Monitoring the debtor's on-going operations.
• Consulting with the debtor on major business decisions.
• Participating in negotiating the Chapter 11 plan.

The Bankruptcy Code authorises the creditors’ committee to hire professionals, including attorneys, accountants, investment bankers and other agents.

The US Trustee has discretion to appoint additional official committees representing other constituencies, such as equity holders or retirees.

Secured creditors

A Chapter 11 debtor requires the consent of its secured creditor or the Bankruptcy Court’s authority to use a secured creditor’s collateral. This rule also applies to cash collateral, such as accounts receivable and bank accounts. The debtor must provide adequate protection to a secured creditor to compensate the creditor for any diminution in the value of its collateral resulting from the debtor’s use or sale of such collateral (section 361, Bankruptcy Code). Adequate protection is designed to ensure that the secured creditor does not receive less when it finally realises its interest than it would have received had the collateral been surrendered or liquidated immediately.

DIP financing lenders

DIP financing lenders (see Question 2) usually have a significant role in Chapter 11 cases. They act in accordance with the loan documents and the Bankruptcy Court order approving the DIP financing, both of which frequently contain milestones and other covenants designed to allow the lenders to maintain control.

Ad hoc groups

Ad hoc groups of creditors (groups of secured or unsecured creditors in a similar position) are playing an increasingly important role by actively participating in Chapter 11 cases. Ad hoc groups exercise more influence than individual creditors acting independently. Their co-ordination can reduce professional fees and other expenses. However, ad hoc group members are subject to certain disclosure requirements under US bankruptcy and securities laws. One court held that an ad hoc group owes fiduciary duties to other members of the class. In addition, ad hoc group members can receive material non-public information that can temporarily limit their ability to trade.

US Trustee

The Office of the US Trustee is not a true stakeholder. However, it can play an important role in Chapter 11 cases (see Question 8).

Other parties in interest

Other creditors and equity holders can participate in the case and be heard on most issues as interested parties. The following parties also have the right to be heard:

• Securities and Exchange Commission.
• Internal Revenue Service.
• Government authorities, unions and retirees (in some cases).

LIABILITY

9. Can a director, partner, parent entity (domestic or foreign) or other party be held liable for an insolvent debtor’s debts?

Directors and officers

A director or officer cannot generally be held liable for an insolvent debtor’s debts. Unlike many other jurisdictions, the US does not have a concept of wrongful trading. However, a director or officer can be held directly liable:

• For payroll and certain other taxes.
• In some states, for wages and Worker Adjustment and Retraining Notification Act (WARN Act) damages for breaches of a federal law requiring certain employers to provide 60 days’ advance notice of a plant closing or mass lay-off to certain parties.

A director or officer can also be liable for breach of fiduciary duties and similar causes of action under traditional corporate law, but this is an action for damages, not direct liability for a debtor’s debts.

Partners

A general partner is liable for the debts of a partnership, subject to applicable state law. In Chapter 7 proceedings, the trustee has a claim against a general partner if:

• There is insufficient estate property to pay all allowed claims against the partnership in full.
• The general partner is personally liable for that deficiency under state law.

A limited partner who does not exercise control over the partnership is generally not liable for the debts of the partnership. Only the capital contributed by the limited partner to the partnership can be used to pay the partnership’s debts under applicable state law.

Parent entity (domestic or foreign)

A parent entity can be held liable for the debts of an insolvent subsidiary under a number of common law principles, including:

• Alter ego.
• piercing the corporate veil.
• Single business enterprise.
• Agency.

These principles generally apply if the parent has disregarded corporate formalities and has actively participated in, or exercised control over, the subsidiary’s operations so that the subsidiary is effectively a mere instrument of its parent.

A parent entity can also be liable under:

• State corporate and creditors’ rights laws.
• Federal bankruptcy laws for fraudulent or preferential transfers of subsidiary assets.

Both of these types of liability are rare.

Where both affiliates are debtors, such as a parent and a subsidiary, the bankruptcy estates are treated as separate and their assets and liabilities remain separate, unless they are substantively consolidated (see below). However, for convenience, the bankruptcy cases will be jointly administered so that the same docket is used for both cases.

Substantive consolidation is an equitable remedy that allows the Bankruptcy Court to permit the assets and liabilities of affiliated
debtor to be treated as a single pool. It is similar to the alter ego and piercing the corporate veil doctrines because each theory permits the court to disregard the separate nature of the corporate entities.

There are also “control group” state and federal liability statutes that hold a parent liable for certain claims against its subsidiaries. These include certain environmental, pension, labour and tax claims, including claims in bankruptcy.

Other party
A third party that is a guarantor or a surety of an insolvent debtor’s debts can be held liable for the insolvent debtor’s obligations.

SETTING ASIDE TRANSACTIONS

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

An insolvent debtor’s pre-insolvency transactions can be avoided or set aside by the trustee or debtor-in-possession under the following circumstances:

• Preferences.
• Fraudulent transfers.
• Similar provisions of state law.

A creditor’s committee or, less commonly, an individual creditor can seek derivative standing to prosecute avoidance actions if the trustee or debtor-in-possession is unwilling or unable to pursue such actions.

Preferences
A preferential transfer is a transfer of the debtor’s property to, or for the benefit of, a creditor within the 90-day period immediately before the bankruptcy filing where the creditor is treated more favourably than other creditors (section 547, Bankruptcy Code). The time limit is one year if the creditor is an “insider”.

In certain circumstances, the debtor can unwind the preferential transfer and recover the transferred property for the benefit of all creditors of the estate. However, the preferential transfer cannot be unwound where a transaction is in the ordinary course of the debtor’s business, or where a debtor receives new value in exchange for the transfer.

Examples of preferential transfers include:

• Late payment or varying the historical payment schedule of trade debt.
• Granting a security interest to a previously unsecured or undersecured lender.
• Delayed perfection of a security interest granted by the debtor contemporaneously with the incurrence of debt.

The debtor is presumed to be insolvent during the 90 days before the bankruptcy filing. The transferee can present evidence to rebut that presumption. For insider transfers, the trustee or debtor-in-possession must prove that the debtor was insolvent between 90 days and one year prior to the bankruptcy filing.

Fraudulent transfers
The debtor can avoid any transfer that it made within two years before the bankruptcy filing if either the (section 548, Bankruptcy Code):

• Transfer was made by the debtor with actual intent to hinder, delay or defraud its creditors.
• Debtor received less than reasonably equivalent value for the transaction at a time when the debtor was:
  • Insolvent on a balance sheet basis, either before, or as a result of, the transfer;
  • Left with unreasonably small capital for engaging in its business;
  • Unable to pay its debts as they became due.

A party who acquired property from the debtor (the initial transferee) for value and in good faith has a lien on, or can retain, any interest transferred, to the extent that the transferee gave value to the debtor in exchange for the transfer (section 548(c), Bankruptcy Code).

Examples of potential fraudulent transfers include:

• Transferred assets or incurred obligations that involve an affiliate or another person for which the debtor did not receive reasonably equivalent value in return.
• Non-judicial foreclosure on real estate when the property is sold at a distressed sale bargain price.
• Certain up-stream and cross-stream guarantees where a subsidiary guarantees the debt of its parent or sister company without receiving reasonably equivalent value.

State law
A debtor can also use applicable state law to avoid certain transfers (section 544(b), Bankruptcy Code). This is particularly useful with respect to fraudulent transfers, as all states have fraudulent transfer provisions and most states have a two to six year “look-back” period. Preference actions also exist under some state laws if the debtor is winding up under an applicable state law procedure.

Safe harbours for subsequent transferees
The trustee or debtor-in-possession cannot recover an avoided transfer from a secondary transferee who acquired the property from an initial transferee for value, in good faith, and without knowledge that the transfer is avoidable.

The trustee or debtor-in-possession cannot recover from a subsequent transferee who acquired the property in good faith from the secondary transferee, whether or not it provided value (section 550(b), Bankruptcy Code).

CARRYING ON BUSINESS DURING INSOLVENCY

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

The Chapter 11 debtor is automatically authorised to continue operating and managing its business without specific court approval (see Question 9). Existing management ordinarily remains in place. In rare cases involving fraud or gross mismanagement, for example, a Chapter 11 trustee can be appointed to replace the debtor’s management. In Chapter 7 cases, a trustee is always appointed (see Question 7). The Bankruptcy Court supervises the debtor, and the US Trustee and the creditors’ committee monitor the Chapter 11 debtor (see Question 8). The conduct of the debtor’s business is subject to certain constraints of the Bankruptcy Code.

Property transactions
The debtor can generally use, sell or lease its property in the ordinary course of business without special authorisation from the Bankruptcy Court (section 363(b), Bankruptcy Code). The
Bankruptcy Court must approve the sale of property, other than inventory, outside the ordinary course of business. The debtor can sell property that is subject to a security interest if the secured creditor consents or other statutory criteria are met. Under section 363 of the Bankruptcy Code, the secured claim can be satisfied with the proceeds from the sale of the collateral, or the secured creditor may “credit bid” the amount of his debt. Chapter 11 debtors are generally restricted from selling all or substantially all of their assets outside the context of a plan, unless the debtor establishes sufficient business justification for the sale.

Cash collateral
The debtor cannot use cash collateral without court authorisation, unless the secured creditor consents to such use. If the debtor does not have consent, it must provide the secured party with adequate protection (see Question 8). Common forms of adequate protection are interest payments or replacement liens on other property.

Executory contracts
The debtor can assume (accept) or reject the obligations of an executory contract. A contract is executory if both parties have material performance obligations remaining, such as unexpired leases or supply agreements (section 365(b), Bankruptcy Code). Contracts to make a loan or provide other financial accommodations cannot be assumed or assigned. A debtor is likely to assume a contract that has favourable terms or is likely to be difficult or impossible to replace.

If the debtor wishes to assume an executory contract, it must fulfil any outstanding obligations and provide adequate assurance to the counterparty that it can perform future obligations under the contract (section 365(b), Bankruptcy Code). The debtor can also reject an executory contract containing onerous terms. Rejection constitutes a breach of the bankruptcy filing date. As a result, any proven damages arising out of the breach are general unsecured claims.

ADDITIONAL FINANCE

12. Can a debtor that is subject to insolvency proceedings obtain additional finance both as a legal and as a practical matter (for example, debtor-in-possession financing or equivalent)? Is special priority given to the repayment of this finance?

A Chapter 11 debtor can continue to obtain unsecured credit and incur unsecured debt, such as trade debt, in the ordinary course of business unless the Bankruptcy Court orders otherwise. Credit obtained in this manner has priority over all pre-petition unsecured claims. Post-petition trade debt is treated as an administrative expense (see Question 2).

A Chapter 11 debtor also can obtain DIP financing with court approval (see Question 2 and 6). The Bankruptcy Court can authorise the DIP financing as:

- Having super-priority over all other administrative expenses.
- A lien on unencumbered property of the estate.
- A junior lien on property that is already subject to a lien.
- In special circumstances, an equal or senior (priming) lien on property that is already subject to a lien.
- A “roll-up” loan, by which a pre-petition secured lender provides a post-petition facility that effectively pays off (or “rolls-up”) the pre-petition secured debt, thereby effectively transforming the existing lender’s pre-petition claim into a post-petition, administrative expense.

A Chapter 11 debtor may also need to obtain exit financing in order to:

- Make the payments required under the Bankruptcy Code and by the plan of reorganisation.
- Provide funds to support the reorganised debtor’s business operations.

Rights offerings are a common form of exit financing. In a bankruptcy rights offering, creditors or equity holders are offered the right to purchase shares in the reorganised company, sometimes at a significant discount. Each participant is generally offered the right to purchase its pro rata share of the equity available under the offering which is the same percentage that its current holdings represent. Rights offerings are usually backstopped for a fee by a third party that agrees to purchase any unsubscribed shares in order to ensure that the reorganised debtor’s capital needs are met.

MULTINATIONAL CASES

13. What are the rules that govern a local court’s recognition of concurrent foreign restructuring or insolvency procedures for a local debtor? Are there any international treaties or EU legislation governing this situation? What are the procedures for foreign creditors to submit claims in a local restructuring or insolvency process?

Recognition
In 2005, the US adopted the UNCITRAL Model Law on Cross-Border Insolvency 1997 (UNCITRAL Model Insolvency Law) (with modifications) in the form of Chapter 15 of the Bankruptcy Code. Chapter 15 enables a foreign representative to seek recognition of a foreign insolvency proceeding in the US.

The Bankruptcy Court grants recognition if the relief would not be manifestly contrary to US public policy (section 1506, Bankruptcy Code). This means that the applicable foreign insolvency law and process must be consistent with applicable US bankruptcy law and process.

Chapter 15 provides for recognition of foreign main and non-main proceedings that relate to a local debtor and applies where:

- A foreign court or foreign representative seeks assistance in the US with a foreign proceeding.
- A US court or party in interest in a US proceeding seeks assistance in a foreign court in connection with a US proceeding.
- A foreign proceeding and a US proceeding with respect to the same debtor are pending concurrently.
- Creditors or other interested persons in a foreign country request the commencement of, or participation in, a US bankruptcy proceeding.

The federal appellate court for the Second Circuit, including New York, has held that only an entity that resides or has a domicile, a place of business, or property in the US can be a Chapter 15 debtor (section 109(a), Bankruptcy Code). The Bankruptcy Court in Delaware has held the contrary, that a Chapter 15 debtor does not need to reside or have property or a place of business in the US.

The foreign representative of the debtor must file a Chapter 15 petition for recognition of the foreign proceeding with the Bankruptcy Court (sections 1504, 1505(a) and 1515, Bankruptcy Code). The Bankruptcy Court can grant provisional relief during the period from the time a Chapter 15 petition is filed until the court rules on the petition if such relief is urgently needed to protect the assets of the debtor or the interests of creditors (section 1513, Bankruptcy Code). After recognition, there is a broad range of relief available to the foreign representative in a foreign main proceeding (sections 1520 and 1521, Bankruptcy Code). The relief available on recognition of a foreign non-main proceeding is more limited.

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On recognition, the foreign representative has full access to courts in the US concerning the debtor. The US court typically grants comity and recognises and enforces foreign court judgments made in foreign proceedings. If recognition is denied, the foreign representative's access to US courts is limited to its right to sue the debtor to collect or recover a claim against, or an account receivable of, the debtor (section 1509(f), Bankruptcy Code).

Concurrent proceedings
A Chapter 15 case is ancillary to a main or non-main proceeding pending in a foreign jurisdiction. A debtor or creditor can also commence a plenary Chapter 11 or Chapter 7 case to run concurrently with a foreign proceeding, assuming the debtor meets the requirements of section 109 of the Bankruptcy Code. Chapter 15 requires the Bankruptcy Court to communicate, co-operate and co-ordinate with the foreign courts and foreign representative so that any relief granted in the foreign proceeding is consistent with relief granted in the US proceeding. US courts can enter into protocols with foreign courts for the efficient administration of concurrent proceedings. In concurrent proceedings, a creditor who received payment in a foreign proceeding cannot receive payment for the same claim in the US proceeding, provided that the payment to other creditors of the same class is proportionately less than the payment the creditor has already received (section 1532, Bankruptcy Code).

International treaties
The US has not entered into any special insolvency treaties. It is also not subject to any multinational regimes of the type that exist in the EU. Chapter 15 reflects the adoption of the UNCITRAL Model Law on Cross-Border Insolvency 1997 (UNCITRAL Model Insolvency Law) into US law.

Procedures for foreign creditors
Foreign creditors in a Chapter 11 or Chapter 7 case have the same rights as US creditors and are treated in the same way. Foreign creditors are also subject to the US automatic stay, although the practical effect of this depends on whether the foreign creditor:
- Has submitted to jurisdiction in the US, either expressly or by doing business or having assets in the US.
- Seeks any recovery or relief in the US case.

REFORM

14. Are there any proposals for reform?

Several bills aimed at addressing the financial distress of the Commonwealth of Puerto Rico have been proposed to the US Congress. The Puerto Rico Chapter 9 Uniformity Act of 2014 (H.R. 5305) and the Puerto Rico Chapter 9 Uniformity Act of 2015 (H.R. 870 and S.1774) would amend the Bankruptcy Code to treat Puerto Rico as a state under Chapter 9 (adjustment of municipal debt). In its current form, the Bankruptcy Code precludes Puerto Rico from authorising its distressed municipalities to file for relief under Chapter 9.

On 1 December 2014, the US House of Representatives passed the Financial Institution Bankruptcy Act of 2014 (H.R. 5421) (FIBA). However, the bill was not passed by the US Senate. If it had become law, it would have allowed “too big to fail” financial institutions to reorganise using the Chapter 11 bankruptcy process. Currently, these financial institutions are subject to federal receivership proceedings under Title II of the Dodd-Frank Act, which provides for an orderly liquidation of the failing entity under the direction of the Federal Deposit Insurance Corporation (FDIC) as receiver. On 9 July 2015, FIBA was reintroduced in substantively identical form as the Financial Institution Bankruptcy Act of 2015 (H.R. 2947).

Additionally, the American Bankruptcy Institute (ABI), a private organisation of insolvency professionals and a member of INSOL International, released a report and recommendations for broader Chapter 11 reform in December 2014 that will be presented to Congress in due course. It may take several years before any new laws are enacted. According to ABI, the need for reform is due to the new environment in which financially distressed companies operate, with more complex debt and capital structures than those in 1978 when the modern Bankruptcy Code was enacted.

ONLINE RESOURCES

Legal Information Institute
[www.law.cornell.edu/ucc](http://www.law.cornell.edu/ucc)
[www.law.cornell.edu/uscode/text/11](http://www.law.cornell.edu/uscode/text/11)

Description. The Legal Information Institute's website is hosted by Cornell University Law School and contains up-to-date versions of the Bankruptcy Code and the Uniform Commercial Code, as well as related rules, statutes, and legislative history.

United States Court

Description. The website is maintained by the Administrative Office of the US Courts. It provides an overview of the US bankruptcy laws and the bankruptcy system in the US, as well as information about the judicial branch of the US Government.

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**Professional qualifications.** Bar Admission, New York; Court Admissions, US District Court for the Eastern District of New York, US District Court for the Southern District of New York

**Areas of practice.** Corporate restructurings, with an emphasis on creditors’ committees and bondholder committees in large, complex cases both out of court and in Chapter 11.

**Recent transactions**

- Counsel to the Official Committee of Unsecured Creditors of Nortel Networks Inc.
- Counsel to the Official Committee of Unsecured Creditors of Hawker Beechcraft, Inc.
- Counsel to the Ad Hoc Committee of Second Lien Note-holders of Eastman Kodak
- Counsel to the Official Committee of Unsecured Creditors of Saint Vincent's Catholic Medical Centers.
- Counsel to the Official Committee of Unsecured Creditors of Delta Air Lines, Inc.
- Counsel to the Official Committee of Unsecured Creditors of Loral Space and Communications, Ltd.
- Counsel to the Official Committee of Unsecured Creditors of Pegasus Satellite Television, Inc.

**Professional associations/memberships**

- New York State Bar Association (Member).
- American Bankruptcy Institute (Member).
- NALP Foundation’s National Advisory Board (Member).

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**Professional qualifications,** Bar Admission, District of Columbia, New Jersey, New York; Court Admissions, US District Court of the Eastern District of New York, US District Court of the Southern District of New York, US District Court of New Jersey

**Areas of practice.** Corporate restructuring and creditors’ rights in a variety of areas, including manufacturing, airlines, mining, media, retail and real estate. Extensive experience in representing debtors, informal groups of creditors and official creditors’ committees in Chapter 11 cases and out-of-court restructurings.

**Recent transactions**

- Counsel to first lien lenders in Walter Energy.
- Counsel to the ad hoc note-holders group in YRC Worldwide.
- Counsel to the debtor in Metro Affiliates, Inc. (Atlantic Express).
- Counsel to the acquirer in Journal Register Company.
- Counsel to the debtor in Pinnacle Airlines Corp. (conflicts counsel).
- Counsel to the Official Committee of Unsecured Creditors of Nortel Networks Inc.
- Counsel to the Official Committee of Unsecured Creditors of Delta Air Lines.
- Counsel to the liquidators of Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.

**Professional associations/memberships.**

- American Bankruptcy Institute (Board Member).
- Dean’s Advisory Board of Boston University School of Law (Board Member).
- American College of Bankruptcy (Fellow).

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Areas of practice. Experienced in representing debtors, secured and unsecured creditors, equity holders and purchasers. Handles a wide range of restructuring matters, including cases under Chapter 11 of the Bankruptcy Code, out-of-court workouts and cross-border insolvency proceedings.

Non-professional qualifications. Appointed to Bankruptcy Editorial Advisory Board, Law 360 (2015 Term)

Recent transactions
• Counsel to the official committee of unsecured creditors in In re Chassix Holdings, Inc.
• Counsel to the ad hoc group of note-holders in In re Inversiones Alsacia S.A.
• Counsel to the debtor in In re Metro Affiliates, Inc.
• Counsel to the company in the out-of-court restructuring of CEVA Group Plc.
• Counsel to the ad hoc committee of note-holders in In re Eastman Kodak Company.
• Counsel to the purchaser of the sex.com domain name in In re Escom, LLC.
• Counsel to the debtors in In re Loral Space & Communications Ltd.

Professional associations/memberships
• International Women's Insolvency & Restructuring Confederation (Member).
• International Association of Restructuring & Insolvency and Bankruptcy Professionals (INSOL) (Member).
• American Bankruptcy Institute (Member).
• New York State Bar Association (Member).
• New Jersey State Bar Association (Member).
• Active volunteer with pro bono organisations such as Her Justice and Kids in Need of Defence (KIND).

Publications. Author of:
• Two chapters in the online treatise, Bloomberg Law: Bankruptcy Treatise.
• “Chapter 11: The Successful Exit”, BNA's Bankruptcy Law Reporter.
• “Court-Appointed Expert on Valuation Can Help Speed up Complicated Cases”, Dow Jones Daily Bankruptcy Review.