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The International Comparative Legal Guide to:

Corporate Recovery and Insolvency 2013

7th Edition

A practical cross-border insight into corporate recovery and insolvency work

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Chapter 39

USA

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1 Issues Arising When a Company is in Financial Difficulties

1.1 How does a creditor take security over assets in the United States?

The means by which a creditor may obtain a valid and enforceable security interest over assets in the United States in most instances is governed by state law and therefore varies to some degree from state to state. However, the Uniform Commercial Code (UCC), promulgated to harmonise state law regarding commercial transactions, has been enacted in some form in all fifty states.

Article 9 of the UCC governs the creation of a security interest in personal property, among other things, and requires a written security agreement or possession of the collateral to create an enforceable security interest. While a security agreement governs rights between a debtor and its creditor, perfection of the security interest is required before the secured party may gain priority in the collateral over a third party. A creditor may perfect its security interest by filing a financing statement in the debtor's state of formation. In most states, a creditor obtains a security interest in real property through a deed of trust or mortgage and perfects such interest by recording such document in the county in which the real property is located. Other methods of perfection, such as possession, may be available depending on the type of property or interests involved.

1.2 In what circumstances might transactions entered into whilst the company is in financial difficulties be vulnerable to attack?

Transactions entered into by an entity in financial distress may be attacked as an actual or constructive fraudulent transfer or as a preference under the Bankruptcy Code and/or state law.

Under the Bankruptcy Code, a transfer may be avoided as fraudulent if it occurred within two years before the bankruptcy filing, and the debtor made the transfer with actual intent to defraud creditors, regardless of whether the debtor was insolvent. In addition, a trustee may recover a transfer as constructively fraudulent that occurred within two years before the bankruptcy filing if the debtor received less than reasonably equivalent value in exchange for such transfer and (i) was insolvent, (ii) was engaged in business for which the debtor was insufficiently capitalised, (iii) intended or believed it would incur debts beyond its ability to repay, or (iv) made such transfer to, or for, the benefit of an insider. Bankruptcy trustees can also invoke state fraudulent transfer laws, which may have longer reachback periods, to recover transfers for the benefit of the estate.

A transfer of an interest of the debtor in property made on account of an antecedent debt, while the debtor was insolvent and within the 90 days prior to a bankruptcy filing (or within one year before the bankruptcy filing if the transferee was an insider) that enables the creditor to receive more than it would have received in a liquidation can be avoided as a preference. There is a rebuttable presumption that a debtor is insolvent during the 90 days before the bankruptcy filing.

1.3 What are the liabilities of directors (in particular civil, criminal or disqualification) for continuing to trade whilst a company is in financial difficulties in the United States?

Directors are not personally liable for continuing to trade while the company is in financial distress.

The fiduciary duties of a company's directors are defined by the law of the state of the company's incorporation. The primary duties of directors are those of care and loyalty. The duty of care requires a director to discharge duties with the care an ordinarily prudent person in a like position would exercise under similar circumstances. The duty of loyalty requires directors to act in the best interests of the corporation; it prohibits self-dealing and the usurpation of corporate opportunities by directors. Ordinarily, decision making by directors is protected by the business judgment rule, even when a company is insolvent. Civil liability may arise if the directors fail to adhere to their duties of loyalty or care.

When a company becomes insolvent the directors must exercise their fiduciary duty in the best interests of the corporation, taking into account the interests of, among others, creditors. Upon insolvency, creditors may under certain circumstances bring derivative claims on behalf of the corporation against directors. Causes of action for breach of fiduciary duty, fraud and fraudulent conveyance may be appropriate to challenge the wrongful actions of directors of insolvent corporations.

In addition, directors may be criminally or civilly liable under federal and state laws for failure to comply with certain disclosure obligations or for insider trading, or for the company's failure to pay certain taxes and wages, among other things.

2 Formal Procedures

2.1 What are the main types of formal procedures available for companies in financial difficulties in the United States?

Chapter 7 provides the procedure for liquidation of a company. Chapter 11 is the primary procedure by which companies

reorganise, although it may also be used for the purposes of an orderly liquidation. Chapter 15 provides the procedure for recognition of a foreign proceeding and conducting an ancillary proceeding in the United States.

2.2 What are the tests for insolvency in the United States?

Under the Bankruptcy Code, the primary test for insolvency is balance sheet insolvency. An entity is balance sheet insolvent if its debts are greater than its assets, at fair valuation, exclusive of property exempted or fraudulently transferred. However, bankruptcy courts may also use an equity insolvency test in certain circumstances, which requires that a debtor be unable to pay its debts as they become due.

2.3 On what grounds can the company be placed into each procedure?

Insolvency is not a prerequisite for chapter 7 or chapter 11 relief. A company may file a voluntary case under chapter 7 or chapter 11 if the company has a domicile, place of business or property in the United States.

An involuntary case may be commenced under chapter 7 or chapter 11 when creditors meeting certain statutory eligibility requirements file a petition. If the case is not timely controverted, the court will order relief. However, if the petition is controverted, the creditors must establish that the debtor is generally unable to pay its debts as they come due unless such debts are disputed, or that a custodian was appointed within 120 days of the petition date.

2.4 Please describe briefly how the company is placed into each procedure.

A voluntary case under any chapter of the Bankruptcy Code is commenced when the company files a petition with the bankruptcy court. The filing of a voluntary chapter 7 or chapter 11 petition constitutes an order for relief.

An involuntary case is commenced by the filing of a petition against the company by three or more creditors that hold non-contingent, undisputed claims against the company. The creditors (or an indenture trustee representing them) must hold claims that aggregate $15,325 more than the value of any collateral securing the creditors' claims. If there are fewer than 12 creditors, a single creditor may file the petition. The court will order relief if the petition is uncontroverted or if creditors establish the criteria described above. Involuntary petitions filed in bad faith may result in damages awarded against the petitioning creditor(s).

2.5 What notifications, meetings and publications are required after the company has been placed into each procedure?

Creditors must receive notice of all material events in the bankruptcy case, including the filing of the petition, the deadline for filing proofs of claim and the deadline for voting on a plan of reorganisation. Notice is governed by the Federal Rules of Bankruptcy Procedure as well as the local rules of the bankruptcy court in which the case is filed. Notice requirements may be adjusted where the court approves a case management order. A court may order notice by publication if it finds that notice by mail is impracticable or that it is desirable to supplement such notice.

Within a reasonable time after the entry of an order for relief, the U.S. trustee must convene a meeting of creditors and may convene a meeting of equity security holders. In a chapter 11 case, the U.S. trustee must appoint an unsecured creditors' committee unless the court orders otherwise, and may appoint additional committees of creditors or equity security holders.

2.6 Are "pre-packaged" sales possible?

"Pre-packaged" sales may be achieved either by means of (i) a pre-packaged chapter 11 plan, which the Bankruptcy Code is designed to facilitate, or (ii) a sale under section 363 of the Bankruptcy Code which has been negotiated by the parties and documented prior to the chapter 11 petition being filed.

3 Creditors

3.1 Are unsecured creditors free to enforce their rights in each procedure?

The filing of a bankruptcy petition automatically operates as a stay that enjoins unsecured creditors from taking most actions against the debtor or property of the estate absent further order of the court. The stay of actions against the debtor's property continues until such property is no longer property of the estate or the case is closed or dismissed.

3.2 Can secured creditors enforce their security in each procedure?

Secured creditors are prevented by the automatic stay from enforcing their security interests, absent relief for cause, which includes lack of adequate protection of the secured creditor's interest in its collateral, or where the debtor lacks equity in the collateral and it is not necessary to an effective reorganisation.

Secured creditors have certain special rights, however. A secured creditor may be entitled to adequate protection in the form of cash payments, replacement liens or the "indubitable equivalent" of the value of its collateral to the extent such value is depreciating as a result of the stay or the debtor's use of it. If secured creditors are oversecured, they have the right to receive post-petition interest generally at the applicable contract rate. Secured creditors may also be well-positioned to provide debtor-in-possession financing, which provides the secured creditor greater influence over the reorganisation process. Secured creditors generally are also afforded the right to credit bid in a sale of their collateral.

3.3 Can creditors set off sums owed by them to the company against amounts owed by the company to them in each procedure?

The Bankruptcy Code generally preserves a creditor's non-bankruptcy set off rights. A claim for set off is treated as a secured claim and a creditor seeking to exercise such right must first obtain relief from the automatic stay. However, creditors that possess set off rights under certain types of repurchase agreements and other specified financial contracts may exercise such rights without violating the stay.

4 Continuing the Business

4.1 Who controls the company in each procedure? In particular, please describe briefly the effect of the procedures on directors and shareholders.

In chapter 11, management retains control, remains "in possession", and continues to run the daily business operations of the debtor company, subject to oversight by the company's board of directors. A chief restructuring officer or similar professional is often added to the management team. Transactions which are not in the ordinary course of business require bankruptcy court approval. Official and unofficial committees generally consult with the debtor concerning the administration of the estate, may investigate conduct, assets and liabilities of the debtor and participate in the formulation of a plan. A chapter 11 trustee may be appointed where there has been gross mismanagement or fraud.

In chapter 7, a trustee is appointed to marshal the assets of the company, reduce them to cash and pay creditors. Officers and directors are displaced.

4.2 How does the company finance these procedures?

A trustee or debtor in possession may use free cash in the ordinary course of business without notice or a hearing, unless the court orders otherwise. The debtor may not use encumbered cash unless each entity with an interest in the cash collateral consents or the court authorises such use upon a finding of adequate protection.

A trustee or debtor in possession may also obtain unsecured financing in the ordinary course of business that will be allowed as an administrative priority expense to pay the actual and necessary costs of preserving the estate, including the payment of wages and salaries after the commencement of the case, as well as taxes.

In addition, if the trustee or debtor in possession is unable to obtain unsecured credit, the court may authorise the debtor to obtain financing, including, under certain circumstances, financing secured by liens equal or senior to existing liens. Such financing may also enjoy the benefit of a super-priority claim over all claims, including other administrative expense claims.

4.3 What is the effect of each procedure on employees?

In chapter 11, the company may continue to employ its workers and to pay their salaries and wages in the ordinary course of business. To the extent the company owes pre-petition salaries and wages, claims therefor will be entitled to priority status but only to the extent of $12,475 for each individual earned within 180 days before the bankruptcy filing.

The Bankruptcy Code restricts payments to "insiders". Before a company incurs an obligation to retain such a person, the court must determine, among other things, that the obligation is essential because such person has received a job offer at the same or greater rate of compensation and that the obligation incurred is not greater than ten times the amount of an obligation incurred to non-management employees. A severance payment to an officer or director may not be allowed or paid unless the payment is part of a programme generally applicable to all full-time employees and the amount of the payment is not greater than ten times the mean amount of severance pay provided to non-management employees.

A chapter 7 trustee will likely terminate most employees. They will hold administrative priority claims for post-petition labour and lower priority claims for any pre-bankruptcy filing wages owing to the extent described above.

4.4 What effect does the commencement of any procedure have on contracts with the company and can the company terminate contracts during each procedure?

A chapter 11 debtor or chapter 7 trustee may assume or reject most executory contracts or unexpired leases, subject to the court's approval. In chapter 7, the trustee must assume a contract or lease within 60 days of the order for relief or it will be deemed rejected, unless an extension of time is granted by the court within such 60-day period. In chapter 11, subject to time limits applicable to commercial real estate leases, the debtor may assume or reject a contract or lease at any time before confirmation of a plan but the court may order the debtor to act within a shorter time period. In most cases, the counterparty to the contract must continue to perform until the debtor assumes or rejects the contract.

If a debtor chooses to assume the contract or lease, it will be bound by the contract's terms. The debtor may not assume such contract or lease unless it: (i) cures or provides adequate assurance that it will cure any default; (ii) compensates, or provides adequate assurance that it will compensate, the counterparty for any actual pecuniary losses resulting from the default; and (iii) provides adequate assurance of future performance under the contract or lease. However, a debtor does not have to cure a default that arises because of a provision in the contract conditioned on the insolvency of the debtor. The debtor may not assume a contract where applicable law excuses the counterparty to the contract from accepting performance from or rendering performance to an entity other than the debtor, such as a personal services contract.

A debtor may reject a contract where it determines that performance of the contract would be unduly burdensome. Rejection of an executory contract or unexpired lease constitutes a breach and generally gives rise to a general unsecured claim for damages.

If a contract or lease has been assumed, the debtor may assign it, notwithstanding a provision in the contract that prohibits or conditions such an assignment.

5 Claims

5.1 Broadly, how do creditors claim amounts owed to them in each procedure?

In chapter 11, or in chapter 7 when there will be a distribution to the holders of allowed claims, a creditor or indenture trustee generally must file a proof of claim and an equity security holder must file a proof of interest. A proof of claim or interest is *prima facie* evidence of the claim or interest and is deemed allowed, unless a party in interest objects.

In chapter 11, however, where the debtor has filed a schedule of liabilities listing the claim or interest as undisputed, non-contingent and liquidated, the creditor need not file a claim if it agrees with the amount listed.

In chapter 7, creditors must file proofs of claim or interest not later than 90 days after the first meeting of creditors. In chapter 11, the court will fix the deadline, or bar date, for filing proofs of claim or interest.

5.2 What is the ranking of claims in each procedure? In particular, do any specific types of claim have preferential status?

Claims of secured creditors are entitled to priority with respect to their interests in collateral and are secured only to the extent of such interests. If a creditor is undersecured to some extent, such portion is a general unsecured claim.

The Bankruptcy Code confers priority on various categories of claims. All claims in a higher priority must be paid in full before claims with a lower priority may be paid. First priority is reserved for unsecured claims for certain domestic support obligations (if the debtor is an individual). Second priority is conferred on claims for expenses incurred in connection with the administration of the estate. Administrative priority expenses include wages and salaries for employees for post-petition services rendered and compensation for professionals retained in the case. Lower priority categories include claims for certain prepetition wages and employee benefit plan contributions and prepetition tax claims, among others. General unsecured claims generally rank equally with each other.

5.3 Are tax liabilities incurred during each procedure?

Tax liability is incurred during the pendency of a bankruptcy case and claims for such liability are generally paid as administrative expenses.

6 Ending the Formal Procedure

6.1 What happens at the end of each procedure?

In chapter 11, at least one impaired class of creditors must accept, and the court must confirm, a plan of reorganisation, which governs distributions to creditors. Creditors have accepted a plan if each impaired class of creditors (by two-thirds in amount and a majority in number of those voting) vote to accept the plan. As discussed below, under certain circumstances a plan may be "crammed down" but at least one impaired class of creditors, not including insiders, must vote for it. The court may confirm a plan only if specified criteria are met, notwithstanding its approval by creditors. Despite the entry of the confirmation order, a case continues until the court resolves all claims objections and adversary proceedings and enters an order closing the case.

In chapter 7, all assets of the debtor will be liquidated, the trustee will make a final report on the liquidation and the court will then enter an order closing the case.

7 Restructuring

7.1 Is a formal procedure available to achieve a restructuring of the company's debts in the United States?

A Company can achieve a restructuring of its debts through a chapter 11 case but out-of-court restructurings are commonplace.

7.2 If such a procedure is available, is a debt for equity swap possible and how are existing shareholders dealt with?

Debt for equity swaps are possible both in-court and out-of-court. Depending on the terms of the debt for equity swap, existing equity may be substantially diluted or, if the valuation supports it, eliminated altogether.

7.3 Can dissenting creditors be crammed down?

In a chapter 11 case, a class of dissenting creditors may be crammed down under a plan of reorganisation over their objection if the plan does not discriminate unfairly and is "fair and equitable".

A plan does not unfairly discriminate if there is no disparity in treatment among creditors within the same class of claims.

A plan is fair and equitable if it complies with the absolute priority rule. With respect to secured creditors, members of the class must: (i) retain their liens and receive deferred payments with a value equal to the allowed amount of their secured claims, valued as of the effective date of the plan; (ii) receive the proceeds from the sale of their collateral, if such property is to be sold, including the right to a credit bid at any such sale; or (iii) receive the "indubitable equivalent" of their secured claims.

A plan is fair and equitable with respect to unsecured creditors if the members of the class receive property of a value equal to the allowed amount of their unsecured claims, or if such class is not paid in full, no junior class will receive any estate property under the plan.

7.4 Is consent needed from other stakeholders for a restructuring?

In a chapter 11 case, a plan of reorganisation cannot be confirmed unless, among other things, each class of impaired claims has voted to accept the plan or, in the event that a class votes to reject the plan, such dissenting class of creditors is crammed down as described above. A class of creditors is deemed to have voted in favour of a plan of reorganisation if creditors in such class holding a majority in number and two-thirds in amount of claims that are actually voted in such class accept the plan, as long as each dissenting creditor in the class receives at least as much as it would have received in a chapter 7 liquidation.

In an out of court restructuring, the threshold level of consent required from debt-holders is determined, in the first instance, by the terms of the governing debt instrument. In addition, high minimum exchange conditions (90 per cent plus) are common because they limit the number of holdouts and aid distressed issuers who need substantial relief from approaching debt maturities and high interest burdens.

8 International

8.1 What would be the approach in the United States to recognising a procedure started in another jurisdiction?

Chapter 15, enacted in 2005, governs ancillary proceedings in the U.S. and is modeled on the UNCITRAL Model Law on Cross Border Insolvency. Ancillary proceedings are those in aid of a "foreign proceeding" administered by a foreign representative and designed to foster cooperation between U.S. and foreign courts. The foreign representative may use such proceedings to request assistance from the U.S. court for such relief as entry of a stay with respect to property located in the United States.

Chapter 15 cases are commenced by a foreign representative filing a petition for recognition of a foreign proceeding in a U.S. bankruptcy court. A foreign proceeding is a collective judicial or administrative proceeding in a foreign country in which the assets and affairs of a debtor are subject to control or supervision by a foreign court for purposes of reorganisation or liquidation.

A bankruptcy court will recognise the foreign proceeding if: (i) the foreign proceeding qualifies as a "foreign main proceeding" (a foreign proceeding pending in the country where the debtor has the center of its main interests) or "foreign non-main proceeding" (a foreign proceeding pending in a country where the debtor conducts non transitory operations); (ii) the foreign representative applying for recognition is a person or body authorised to administer the reorganisation or liquidation of the debtor; and (iii) the petition is accompanied by sufficient evidence of the commencement of the foreign proceeding and of the appointment of the foreign representative.

Once the court has entered a recognition order, several provisions of the Bankruptcy Code take effect automatically, including the automatic stay and provisions governing the use, sale or lease of property of the debtor in the U.S., and other relief may be available upon request to the court. While such relief is not automatically available in a foreign non-main proceeding, the court has discretion to grant similar relief.

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The American Lawyer named Mr. Kornberg one of its Dealmakers of the Year in 2003. He has been selected as a leading lawyer by *Chambers USA* and *Legal 500*, and was chosen by his peers for *The Best Lawyers in America*.

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