ALLEN & OVERY

Restructuring across borders

United States of America

Corporate restructuring and insolvency procedures | February 2022

allenovery.com

Contents

Introduction

The U.S. laws governing financial reorganization and liquidation are generally divided between federal and state law. Most proceedings, however, are administered pursuant to the Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-1532 (as amended) (the **Bankruptcy Code**) in the federal bankruptcy courts.

Chapter 7 (*Liquidation*) and Chapter 11 (*Reorganization*) of the Bankruptcy Code are the principal corporate provisions of the Bankruptcy Code. Chapter 15 authorizes bankruptcy courts to recognize qualified foreign proceedings upon the proper commencement of a case under Chapter 15 by a foreign representative and to grant assistance in the U.S. to such foreign representative in connection with the foreign proceeding.

Chapter 11 (Reorganization cases)

Chapter 11 cases provide the debtor with the opportunity to reorganize its financial affairs, although it can also be used to effectuate the orderly liquidation of the debtor's business and property. The goal of Chapter 11 is to preserve the debtor and its going-concern value and to maximize the value of the debtor's estate for the benefit of the debtor's stakeholders. To that end, the debtor may sell assets, reorganize its capital structure (often by obtaining new financing), rid itself of its burdensome contracts and leases and effect changes in management.

Chapter 11 cases generally culminate in the proposal and confirmation (ie court approval) of a plan of reorganization (or liquidation) pursuant to which claims against and interests in the debtor may be compromised. Each impaired class of claims and interests is entitled to vote on the plan and the plan is confirmed if at least two-thirds in value and more than one-half in number of each class of claims and two-thirds in value of each class of interest holders vote in favor of the plan, and provided the other requirements for confirmation are satisfied. It should be noted that a plan can also be confirmed, notwithstanding when a dissenting class of claims rejects the plan, provided that at least one impaired class of claims votes in favor of the plan, the plan is fair and equitable, and no claim or interest holder junior to the dissenting class receives a recovery (if the dissenting creditors are not paid in full by the plan) and the other requirements for confirmation are met (so-called "cramdown"). In short, Chapter 11 seeks to provide creditors with greater recoveries than would otherwise be available if the debtor were liquidated under Chapter 7.

Chapter 7 (Liquidation cases)

A liquidation under Chapter 7 generally results in the cessation of the debtor's business and the marshaling and liquidation of its assets by a court-appointed trustee without reference to the going-concern value of the enterprise. A court-appointed Chapter 7 trustee may be authorized to continue to operate the debtor's business for a short period of time, but the aim of Chapter 7 is to provide a framework for the collection, liquidation and distribution of the estate in accordance with the established priorities under the Bankruptcy Code.

Eligibility to be a debtor

Only a person (including a corporation) that resides or has a domicile, place of business, or property located in the U.S. may be a debtor under the Bankruptcy Code. In practice, this threshold is very low as even possessing a bank account in the U.S. has been found to be a sufficient nexus to establish jurisdiction over a foreign debtor. Generally, domestic banks and insurance companies are not eligible to be debtors under the Bankruptcy Code as these entities are subject to special federal and state regulation.

Commencement of proceedings

There is no insolvency requirement before relief can be obtained by a debtor filing a voluntary petition under the Bankruptcy Code. Either the debtor or its creditors can commence cases pursuant to Chapter 11 or Chapter 7 of the Bankruptcy Code.

A bankruptcy case is commenced by the filing of a petition and the payment of the requisite filing fee. A debtor commences a case by filing a "voluntary petition". The commencement of a voluntary case constitutes an order of the bankruptcy court for relief under either Chapter 7 or 11, based on the debtor's election. Relief in a Chapter 15 case is not automatic upon the filing of a petition, however, provisional relief may be available prior to recognition of a foreign proceeding to avoid irreparable harm to the debtor.

If, however, the debtor's creditors commence the case against the debtor, the creditors file an "involuntary petition". If the debtor has twelve or more creditors, the involuntary petition must be filed by at least three creditors who hold claims against the debtor that are not contingent as to liability or the subject of a bona fide dispute as to liability or amount and aggregate at least USD 15,775 more than the value of any lien on property of the debtor. The creditors must assert that the debtor is generally not paying its debts as they fall due. A foreign representative may file an involuntary case concerning the debtor in a foreign proceeding in order to administer assets in the U.S. The debtor will have a reasonable opportunity to contest the petition before the bankruptcy court orders relief, during which period of time the bankruptcy court may for cause order the petitioning creditors to file a bond to indemnify the debtor in the event the court dismisses the involuntary petition.

Following entry of the order for relief, the debtor will also file a list of its largest creditors, equity security holders and a corporate ownership statement. In addition, the debtor must file schedules of assets and liabilities, a schedule of current income and expenditures, a schedule of executory contracts and unexpired leases and a statement of financial affairs.

Management of the debtor

Under Chapter 11, and unless the bankruptcy court orders otherwise, the debtor and its management remain in possession of the debtor's business and property during the pendency of the debtor's Chapter 11 case. The so-called "debtor in possession" continues to operate its business and is empowered to deal with its contracts and property in a manner provided by the Bankruptcy Code under the bankruptcy court's oversight. The debtor in possession has nearly all the powers and duties of a trustee appointed by the bankruptcy court. However, a party-in-interest (or the U.S. Trustee) can request that a trustee be appointed to assume control of the business. A trustee is likely to be appointed in cases where the existing management have been fraudulent or dishonest, or have grossly mismanaged or abandoned the business. It should be noted that it is not unusual for the existing management to be replaced by new managers as an alternative to appointing a trustee. Promptly following entry of the order for relief under Chapter 7, the U.S. Trustee appoints an interim trustee to displace the debtor's management and take control of the debtor's business and property.

Thereafter, the debtor's creditors may vote to appoint a permanent trustee. The trustee must collect and liquidate the debtor's property, distribute any available proceeds to unsecured creditors with allowed claims and close the estate as expeditiously as is compatible with the best interests of all parties-in-interest. The trustee will also investigate the debtor's financial affairs, among its other statutory duties.

Assets and the insolvent estate

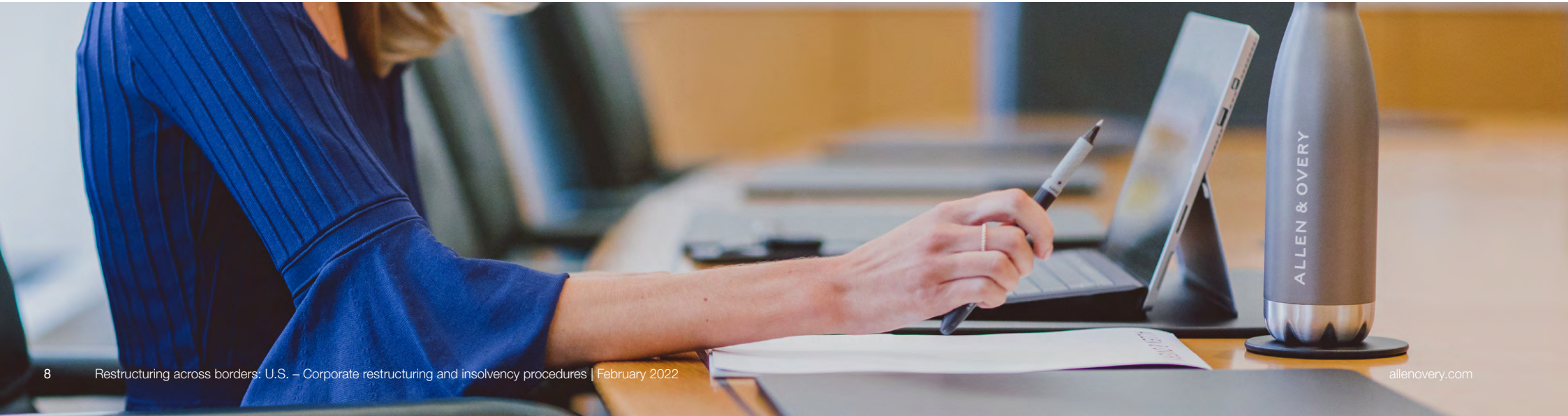
The commencement of a Chapter 7 or Chapter 11 case creates an estate. The estate comprises all of the debtor's property. The debtor's property includes all legal or equitable interests of the debtor, wherever located, as of the commencement of the case. However, property in which the debtor holds, as of the commencement of the bankruptcy case, only legal title and not an equitable interest becomes property of the estate only to the extent of the debtor's legal title to such property. For example, a debtor that served pre-bankruptcy as trustee of an express trust generally has no right to the assets kept in trust. With respect to leased assets, property of the estate includes the debtor's interest in unexpired leases, so that a lessor would not be able to terminate a lease or re-possess leased property without first obtaining relief from the automatic stay or other appropriate relief from the court.

Automatic stay

One of the most fundamental principles of U.S. bankruptcy law is that, upon the filing of a petition for relief under the Bankruptcy Code, the debtor and its property are subject to the protection of the "automatic stay" which has the effect of an injunction against any actions against the debtor or the debtor's property or assets on account of claims, subject to certain exceptions. Except as noted below, in Chapter 15 cases, the automatic stay has worldwide effect and prohibits the commencement or continuation of any action or proceeding, whether state, federal or foreign. Actions taken in violation of the stay are void, and violations of the automatic stay can lead to sanctions by the bankruptcy court, including punitive damages in the case of an individual debtor for willful violations of the automatic stay.

The automatic stay has a very broad scope. A central purpose of the stay is to prevent any resort by creditors to self-help remedies (including exercising a right of set-off, subject to certain exceptions – see further below). Courts have held that the stay prevents even the sending of demand letters to a debtor after a bankruptcy case has been commenced. However, creditors are not left without recourse. They are entitled to seek relief from the automatic stay, and such course of action is usually prudent where even the slightest doubt exists as to whether the creditor's contemplated conduct might constitute self-help. Lessors, upon a debtor's post-bankruptcy payment default, will typically assert a claim for administrative expense (ie priority) treatment for unpaid post-bankruptcy lease payments; they may also ask the court to compel the debtor to assume or reject the lease in an expedited fashion.

The Bankruptcy Code contains certain "safe harbors" from the automatic stay (and the prohibition on "ipso facto" clauses, discussed below) that allow for the netting or termination of certain financial instruments, including securities, commodity, forward, repurchase (or "repo") and swap agreements. These safe harbors provide certain entities (eg financial institutions and securities clearing agencies) with the ability to close out and terminate the financial contracts, notwithstanding the automatic stay, subject to certain conditions.



Effect of bankruptcy proceedings on existing contracts

The debtor's contracts and leases remain in place following commencement of a bankruptcy case. In fact, with few exceptions, the Bankruptcy Code prohibits the termination or modification by a counterparty of the debtor's executory contracts and unexpired leases solely because of a provision in such agreements that is conditioned upon the insolvency of the debtor or the commencement of a case under the Bankruptcy Code (ie so-called "*ipso facto*" clauses that, with certain exceptions, are not enforceable).

Subject to bankruptcy court approval, the debtor may reject, assume or assume and assign its executory contracts and unexpired leases with certain exceptions (such as contracts providing financial accommodation and personal services contracts). Rejection of an executory contract or an unexpired lease constitutes a breach of the agreement entitling the non-debtor party to assert a claim for damages, which in the case of real property leases and employment contracts may be limited by statute.

In order to assume an executory contract or unexpired lease, the debtor must cure all defaults, or provide the non-debtor party with assurance that the debtor will promptly cure such defaults, including the payment of any actual pecuniary loss to the non-debtor party. Non-debtor parties to executory contracts and unexpired leases may apply to the court to compel the debtor to determine within a specified period of time whether it will reject or assume its contract or lease.

As discussed above, there are certain safe-harbor protections that apply to special kinds of executory contracts including securities, commodity, forward, repurchase and swap agreements.

Ranking and lodging of claims

As a general rule, all creditors (including foreign creditors) of the debtor will be obliged to share equally in a common pool of assets with other creditors in their class.

First ranking creditors are secured creditors, whose secured claims are tied to the value of their available collateral, with potential unsecured deficiency claims where the value of any such collateral is less than the total claim. General unsecured creditors rank below secured creditors, however, certain unsecured claims have statutory priority over general unsecured claims including administrative expenses (which include the costs incurred in conducting the proceedings), certain employee expenses and certain taxes. Finally, at the end of the priority line are the equity holders or interests.

A debtor may obtain financing following the filing of a petition under the Bankruptcy Code. This debtor-in-possession (or **DIP**) financing can be secured (indeed, it can be granted a priming lien over existing lien-holders in certain circumstances) or otherwise given a super-priority status, entitling the DIP lender to repayment before all other priority unsecured creditors and general unsecured creditors.

Creditors or equity security holders file proofs of claims or interests with the clerk of the bankruptcy court, or typically in large cases, with a claims agent appointed for such purpose. In Chapter 11 cases, it is typical for the court to establish a bar date (ie deadline) for the submission of claims by creditors. If the debtor lists a creditor's claim in the debtor's schedule of assets and liabilities as non-contingent, undisputed, and in a liquidated amount, it is unnecessary for the creditor to file a claim (if the creditor agrees with the scheduled amount) but it is common practice to file a claim nonetheless. Otherwise, the creditor must file a proof of claim on or before the bar date if it wishes to share in the distribution of proceeds by the bankruptcy estate. Unlike some non-U.S. jurisdictions, failure to timely file a claim before the established bar date generally results in the claim being time-barred and disallowed, absent extraordinary circumstances.

It should be noted that the beneficial holder of a claim is entitled to file a claim. This means that individual bondholders are entitled to file a claim even though the legal title to their claim is held by an indenture trustee or common depositary. In practice, the indenture trustee often files a claim on behalf of all of its bondholders.

Asset sales

Asset sales in bankruptcy cases have several advantages, including the ability to sell assets free and clear of all liens, claims and encumbrances, thus providing greater certainty to buyers, limiting the amount of required due diligence, and often maximizing the value of the assets. Asset sales in bankruptcy cases are usually subject to higher and better offers.

The bankruptcy court will normally approve procedures for the solicitation of offers and the conduct of the hearing to approve the sale or any auction, which all can be accomplished in a relatively short timeframe. Secured creditors in U.S. bankruptcy cases are generally entitled to receive the proceeds from the sale of their collateral by the debtor. Secured creditors' liens would generally attach in the same relative priorities to any sale proceeds. Secured creditors are also generally entitled to credit bid up to the amount of their claim in any sale of their collateral (even if the claim amount exceeds the value of the collateral.

Treatment of set-off rights

With certain limitations, the Bankruptcy Code recognizes and preserves valid set-off rights established under non-bankruptcy law (eg contract law, federal and state statutory and common law). The timing of when a creditor acquires a set-off right or exercises such right (ie before or after the bankruptcy case has been commenced) will determine the extent to which such limits apply in bankruptcy. Upon the commencement of a case under Chapters 7 or 11, or upon recognition in a Chapter 15 case of a foreign main proceeding (as discussed below), the automatic stay would apply to enjoin the free exercise of set-off rights (except as permitted in the case of safe-harbored transactions discussed above). A holder of such a set-off right will thus experience some delay until such holder obtains relief in the U.S. bankruptcy court for authority to effect a set-off against the debtor. During the pendency of a motion for such relief, however, the creditor could place a temporary administrative hold over the debtor's account or withhold payment to the debtor to preserve its set-off right without violating the automatic stay provided such creditor acts promptly to obtain relief in the bankruptcy court.

Obligations which may be avoided

Under certain circumstances, the incurrence of an obligation or the making of a transfer of property by the debtor may be subject to avoidance under the Bankruptcy Code or non-bankruptcy law. The applicable "reach-back period" applicable to such transfers or obligations may be up to six years under state law (eg as is the case under New York State law) and is two years under the Bankruptcy Code.

Fraudulent transfers

The Bankruptcy Code authorizes the avoidance of obligations or transfers made or incurred by the debtor with the intent to hinder, delay or defraud a past or future creditor (ie actual fraud). The Bankruptcy Code also provides similar relief for constructive fraud. A constructively fraudulent transfer does not require malicious intent, but arises when a debtor transfers property or incurs an obligation that is made or incurred within the two-year period before the debtor's bankruptcy case, and for which (voluntarily or involuntarily):

(i) the debtor received less than the reasonably equivalent value in exchange for such transfer or incurrence; and

(ii) (1) the debtor was insolvent on the date that the transfer was made or the obligation was incurred or became insolvent as a result; or

(2) the debtor was engaged in a business for which its remaining property was an unreasonably small capital given the nature of the debtor's business; or

(3) the debtor intended to incur, or believed that it would incur, debts that would be beyond the debtor's ability to pay such debts as they matured; or

(4) in the case of transfers to insiders of the debtor, the debtor made such transfer or incurred such obligation under an employment contract and outside the ordinary course of business. Each of the 50 U.S. states have adopted laws that provide for the avoidance of constructively fraudulent transactions pursuant to similar standards, which state laws can be applied inside or outside a bankruptcy case (and which generally provide for longer reach-back periods). The case authority regarding avoidable transfers is varied and the outcome in any case will depend heavily on the facts and circumstances of that case.

Preferences

Certain transfers or payments made by the debtor in the period immediately preceding the debtor's bankruptcy case may be subject to avoidance as an unlawful preference. Briefly, the trustee or the debtor could avoid any transfer of an interest of the debtor in property by establishing that the transfer was made (a) to or for the benefit of a creditor; (b) for or on account of an antecedent debt owed by the debtor before the transfer was made; (c) made while the debtor was insolvent (which the debtor is presumed to be for the 90 days prior to filing); (d) on or within the 90 days (or one year in the case of insiders) before the commencement of the bankruptcy case; and (e) that enables the creditor to receive more than such creditor would receive in a hypothetical liquidation or if the transfer had not been made. The trustee or the debtor would have the burden of proof in respect of each of the foregoing elements (a)-(e) to establish a preference. There are several statutory defenses provided under the Bankruptcy Code that might shield a payment or transfer received from being an unlawful, avoidable preference.

Closing proceedings

Unless the Chapter 11 plan or the order confirming the plan provides otherwise, the confirmation of a plan releases the debtor from all claims and interests of creditors, equity security holders and general partners. However, if the Chapter 11 plan is a liquidating plan (such that the plan provides, inter alia, for the liquidation of all or substantially all of its property), the confirmation of a plan does not discharge the debtor. Similarly, Chapter 7 (liquidation) does not result in a discharge for the debtor unless the debtor is an individual.

Chapter 11 proceedings customarily result in the reorganized debtor emerging from Chapter 11 and continuing its business. However, as previously stated, Chapter 11 proceedings can be used to liquidate a debtor and in these cases all of the debtor's assets are distributed and the company is wound up. Similarly, Chapter 7 proceedings result in an empty shell without assets which is usually then dissolved.

A pre-arranged Chapter 11 can be concluded in as little as 60 to 90 days. However, the average lifespan of a major Chapter 11 case is estimated to be between one and three years, depending on the complexity of the case, including any litigation which may need to be resolved.

Directors' liability

A majority of the states in the U.S. recognize the "business judgment rule" which protects directors from liability in relation to certain business decisions. The business judgment rule presumes that, in making decisions, directors act on an informed basis, in good faith and in the reasonable belief that their actions are in the corporation's best interest.

The duties of directors of a corporation are governed by the law of the jurisdiction in which it is incorporated. In Delaware (the jurisdiction of incorporation of many U.S. firms), the duties of directors always run in relation to the corporation as a whole; however, when a corporation is insolvent the focus of those duties can shift from managing the firm for the benefit of its shareholders to pursuing value maximizing strategies that recognize that the firm's creditors have become its residual beneficiaries and that the firm's principal objective is the protection of those beneficiaries' interests. In all events, however, the primary object of the directors' duties remains the corporation. There is no concept of "wrongful trading" in the U.S. (as there is in the UK) and the business judgment rule will protect directors who take ordinary operational risks in the "zone of insolvency", provided the directors reasonably believe that the risks have a good chance of success (and the directors are free from a conflict of interest in relation to the contemplated transaction).

It should be noted that the "business judgment rule" will not insulate directors from civil and/or criminal liability in the case of fraud or violations of otherwise applicable laws, including securities law.

Chapter 15 (Cases ancillary to foreign insolvency proceedings)

U.S. bankruptcy courts historically cooperated with foreign insolvency courts and administrators through ancillary proceedings under section 304 of the Bankruptcy Code. Enacted in 2005, Chapter 15 of the Bankruptcy Code effectively repealed section 304 and adopted the UNCITRAL Model Law on Cross-Border Insolvency. Subject to meeting the eligibility requirements, Chapter 15 authorizes bankruptcy courts to recognize foreign insolvency proceedings and to grant assistance in the U.S. to aid such proceedings. Chapter 15 prescribes guidelines for (i) access for representatives of foreign debtors and their creditors to U.S. federal and state courts; (ii) recognition of a foreign proceeding and related relief (eg injunction enforcing in the U.S. an order of the foreign court); (iii) cooperation and direct communication with foreign courts and representatives; and (iv) concurrent proceedings and the coordination of foreign and domestic proceedings.
The automatic stay and the ability to dispose of assets located in the U.S. (each of which is discussed above), would apply as a matter of right in a Chapter 15 case upon the recognition of the foreign proceeding as a "main" proceeding.
The bankruptcy court however could order equivalent relief if such proceeding is recognized as a "non-main" proceeding.

To obtain recognition of a foreign proceeding as "main", a foreign representative must demonstrate that the foreign proceeding is pending in the jurisdiction where the foreign debtor has its center of main interests (**COMI**) (ie the debtor's principal place of business). COMI is not defined in the Bankruptcy Code, but Chapter 15 affords a rebuttable presumption that, in the absence of evidence to the contrary, a debtor's registered office is the location of its COMI. Recognition of foreign insolvency proceedings as "non-main" turns on whether the foreign debtor maintains an "establishment" in the jurisdiction where its foreign proceeding is pending.
The Bankruptcy Code defines "establishment" as "any place of operations where the debtor carries out non-transitory economic activity".
Recent case authority suggests foreign representatives could be advised to undertake appropriate planning prior to a Chapter 15 filing to ensure they will satisfy the formulaic test to obtain relief thereunder.

Key contacts

If you require advice on any of the matters raised in this document, please contacts any of our partners or your usual contact at Allen & Overy, or email **rab@allenovery.com**

Emanuel Grillo
Partner
Tel +1 212 610 6384
emanuel.grillo@allenovery.com

Daniel Guyder
Partner
Tel +1 212 756 1132
daniel.guyder@allenovery.com

Elizabeth Leckie
Partner
Tel +1 212 610 6317
elizabeth.leckie@allenovery.com

Laura Hall
Partner
Tel +1 212 756-1171
laura.hall@allenovery.com

Robin Spigel
Partner
Tel +1 212 610 6360
robin.spigel@allenovery.com

Jennifer Marshall
Partner
Tel +44 20 3088 4743
jennifer.marshall@allenovery.com

Katrina Buckley
Partner
Tel +44 20 3088 2704
katrina.buckley@allenovery.com

Sigrid Jansen
Partner
Tel +31 20 674 1168
sigrid.jansen@allenovery.com

Lucy Aconley
Counsel
Tel +44 20 3088 4442
lucy.aconley@allenovery.com

Jon Webb
Senior PSL
Tel +44 20 3088 2532
jon.webb@allenovery.com

Harini Viswanathan
Associate
Tel +44 20 3088 3992
harini.viswanathan@allenovery.com

Mark Pugh
Associate
Tel +44 20 3088 7179
mark.pugh@allenovery.com

Further information

Developed by Allen & Overy's market-leading Global Restructuring Group, **"Restructuring Across Borders"** is a free and easy-to-use website that provides information and guidance on all key practical aspects of restructuring and insolvency in Europe, the Middle East, Asia and the U.S.

To access this resource, please **click here**.

For more information, please contact:

Los Angeles

10250 Constellation Boulevard
Suite 1000
Los Angeles, CA 90067
United States of America

Tel +1 424 512 7150
Fax +1 424 512 7199

New York

1221 Avenue of the Americas
New York, NY 10020
United States of America

Tel +1 212 610 6300
Fax +1 212 610 6399

Silicon Valley

550 High Street, 2nd Floor
Palo Alto, CA 94301
United States of America

Tel +1 650 388 1650
Fax +1 650 388 1699

Washington, D.C.

1101 New York Avenue, NW
Washington, D.C. 20005
United States of America

Tel +1 202 683 3800
Fax +1 202 683 3999

London

Allen & Overy LLP
One Bishops Square
London
E1 6AD
United Kingdom

Tel +44 20 3088 0000
Fax +44 20 3088 0088

Global presence

Allen & Overy is an international legal practice with approximately 5,600 people, including some 580 partners, working in more than 40 offices worldwide. A current list of Allen & Overy offices is available at www.allenovery.com/global_coverage.

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. Allen & Overy LLP is a limited liability partnership registered in England and Wales with registered number OC306763. Allen & Overy LLP is authorised and regulated by the Solicitors Regulation Authority of England and Wales.

The term partner is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings. A list of the members of Allen & Overy LLP and of the non-members who are designated as partners is open to inspection at our registered office at One Bishops Square, London E1 6AD.

CS2201_CDD-67497_ADD-99631