Global Restructuring and Insolvency Guide - United States

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# Initial Considerations

## Can you take security over all types of assets, including accounts receivable?

**Chapter 11 of the United States Bankruptcy Code**

Generally, yes. In general, security interests are created and perfected under the non-bankruptcy laws of the various states and applied with equal force under all chapters of the Bankruptcy Code. While liens and security interests in real property may take different forms from state to state, such interests in personal and intangible property tend to be governed by the provisions of the Uniform Commercial Code as adopted in most of the 50 states.

## What is the nature of the insolvency process?

**Chapter 11 of the United States Bankruptcy Code**

Chapter 11 of the United States Bankruptcy Code ("**Bankruptcy Code**") may be used to effect an operational restructuring, balance sheet deleveraging and/or commence a court-supervised sale of the business, in whole or in part, as a going concern, with assets sold to a purchaser free and clear of liens, claims and encumbrances under an order of the Bankruptcy Court.

## What is the solvency requirement for a company to file a case in this jurisdiction?

**Chapter 11 of the United States Bankruptcy Code**

A US or eligible foreign company can file a voluntary petition for relief under Chapter 11 without regard to solvency, so long as it enters the process with a good faith purpose and intention to restructure its financial condition and/or sell its assets on a going-concern basis. In an involuntary bankruptcy case commenced by creditors, the petitioning creditors must establish that the company is generally not paying its debts as they become due.

## Is there a requirement to demonstrate COMI ("centre of main interests") for a company to file a case in this country?

**Chapter 11 of the United States Bankruptcy Code**

No. The concept of COMI comes into play in the US only in cases filed under Chapter 15 of the Bankruptcy Code, seeking recognition and relief in connection with a foreign proceeding pending in another jurisdiction. The eligibility requirements for a Chapter 11 filing are quite liberal, requiring only that the debtor have a domicile, place of business or property in the US. As a result, and particularly in the last two years, a growing number of foreign companies have elected to effectuate their financial restructurings through US Chapter 11 cases rather than the laws of their home countries.

If COMI exists elsewhere, creditors may ask the court to dismiss the case in favor of commencement of the proceedings in another jurisdiction; however, this effort by creditors has failed in many cases.

## Is restructuring of both secured and unsecured claims possible?

**Chapter 11 of the United States Bankruptcy Code**

Yes. While secured and unsecured claims must be classified and treated separately under a Chapter 11 plan, both classes of claims are subject to and bound by the restructuring proceeding.

## Are the claims of creditors and shareholders put into separate classes for purposes of voting and treatment under the plan or scheme?

**Chapter 11 of the United States Bankruptcy Code**

Yes. Only similarly situated creditors can be placed in the same class for voting purposes; however, the proponent of a Chapter 11 plan has some flexibility in the classification scheme, so long as the proposed classification does not result in unfair discrimination or otherwise violate the Bankruptcy Code, including the absolute priority rule. Creditors and shareholders must be classified separately.

## Is shareholder approval needed to commence a case? Are shareholders entitled to vote on a plan?

**Chapter 11 of the United States Bankruptcy Code**

The commencement of a Chapter 11 case requires the approval of a company's board of directors or managers. Absent a provision in the organizational documents requiring approval by equity holders, such approval is not required.

As the lowest level of stakeholders under the Bankruptcy Code's absolute priority rule, shareholders are often "out of the money," receive or retain nothing under a Chapter 11 plan, and accordingly are deemed to have rejected the plan without the necessity of a vote. If the company has sufficient value to provide for some recovery to shareholders, they are typically granted the right to vote on a plan, subject to "cram down" in the form of the Court confirming the plan, notwithstanding the vote of the shareholder class to reject it.

## Is there an ability to bind minority dissenting creditors (i.e., cramdown)?

**Chapter 11 of the United States Bankruptcy Code**

A Chapter 11 plan may bind a dissenting member of an accepting class so long as it meets the requirements imposed by the Bankruptcy Code, including the requirement that each class of creditors receive at least as much in the form of recovery under the plan as it would have received in a Chapter 7 liquidation.

The plan must be fair and equitable to bind a dissenting creditor class and must not unfairly discriminate against the dissenting class.

A dissenting class of secured creditors must retain its liens and receive an amount equal to the present value of the assets securing the claim or the amount of its secured claim.

The plan must satisfy the absolute priority rule for an unsecured dissenting class.

The standard "does not discriminate unfairly" generally means that similarly situated creditors must be treated similarly. For example, the treatment of general unsecured creditors must provide generally equivalent value for the rejecting crammed-down class as for the other classes of general unsecured creditors. As the Bankruptcy Code prohibits only "unfair discrimination," a plan may provide for disparate treatment of similarly situated classes of creditors so long as the differences are not "unfair" to the dissenting class.

The fair and equitable test for a plan cramdown differs for secured creditors, unsecured creditors and equity holders. As the test is applied to unsecured creditors and equity holders, it requires that the members of the class receive property of a value equal to the allowed amount of their claims or that junior classes or interests receive nothing because of their claims or interests under the absolute priority rule (discussed below).

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

The absolute priority rule holds that if a class is impaired and votes against the confirmation of a proposed plan, then the class must be paid in full (including unpaid accrued interest) before any junior class of claims or interests may receive anything of value under the plan due to their prepetition claims or interests.

Accordingly, in cases where old equity wishes to retain an interest in the reorganized debtor despite paying creditors less than the full amount of their claims, the absolute priority rule can pose significant challenges. Under those circumstances, old equity holders must argue that they are not receiving anything because of their prepetition interests, but because of new value contributed to the reorganized debtor under the new value exception to the absolute priority rule. The existence of the new value exception has been long debated and is still open to legal challenges. However, if the court recognizes the exception, old equity holders must establish that (i) they are making a new contribution in money or money's worth; (ii) the contribution is reasonably equivalent to the value of the interest retained in the reorganized debtor; and (iii) the new value contribution is necessary for the implementation of a feasible plan of reorganization. Even if these requirements are met, the opportunity to invest in the reorganized debtor must be subjected to a market test such that old equity holders do not receive an exclusive opportunity to invest in the reorganized debtor because of their prepetition interests. The nature and scope of this market test can vary from case to case, depending on the facts and circumstances.

# Commencing the Process

## Who can commence?

**Chapter 11 of the United States Bankruptcy Code**

A voluntary case can be commenced by the debtor itself, with relief deemed granted automatically upon filing of the voluntary petition.

An involuntary case may be commenced by less than all of the general partners in a partnership, or in most instances, by three or more creditors holding unsecured claims aggregating USD 16,750 (effective 1 April 2019) that are "not contingent as to liability or the subject of a bona fide dispute as to liability or amount." Where the involuntary debtor has fewer than 12 such creditors, the case may be commenced by a single eligible creditor.

Unlike a voluntary petition, the filing of an involuntary case does not automatically lead to relief or place the alleged debtor "in bankruptcy"; rather, the petitioning creditor(s) must establish through an evidentiary hearing that the debtor is not generally paying its debts as they become due.

A debtor that is the subject of an involuntary petition may consent to the grant of relief, effectively converting the case to a voluntary case without the necessity of a trial to establish the "equitable insolvency" of the debtor as described above.

## Is there an ability to consolidate group estates?

**Chapter 11 of the United States Bankruptcy Code**

Yes, with such "consolidation" taking a number of different forms.

As each corporate entity must file or be the subject of its own Chapter 11 case, the bankruptcy court may order that cases of related debtors be "jointly administered" as an administrative convenience, with all court filings made in the case designated as the "lead case." Unlike substantive consolidation addressed below, joint administration does not combine the assets or liabilities of the related debtors.

Bankruptcy courts may authorize the substantive consolidation of debtors' estates in limited circumstances. Substantive consolidation is considered an extreme remedy and is generally only available where it is impracticable to disentangle the assets and liabilities of the different entities or where creditors can demonstrate that the entities held themselves out as a single economic unit and the creditors relied on that. In other limited circumstances, debtors have proposed plans calling for "deemed substantive consolidation," in which the claims of all creditors are paid from a common pool of assets drawn from the various debtor entities, with each entity retaining its separate corporate existence after confirmation of the plan.

## Is there any court involvement?

**Chapter 11 of the United States Bankruptcy Code**

A federal bankruptcy court oversees the proceeding and court approval is required for the use, sale and lease of assets outside the ordinary course of the debtor's business. Court approval is not required for activities within the ordinary course of business, including the incurrence and payment of an unsecured debt through continued trading and business activity while in Chapter 11.

## Who manages the debtor?

**Chapter 11 of the United States Bankruptcy Code**

In a Chapter 11 case, the debtor in almost all cases will be operated as a "debtor in possession" by the same directors and officers under the same principles of governance as prior to the bankruptcy filing, subject to the supervision of the bankruptcy court. In rare and extraordinary cases in which the court is persuaded upon application of a creditor or party in interest that the existing management has engaged in acts rising to the level of fraud, dishonesty, incompetence or gross mismanagement, a Chapter 11 trustee would be appointed, and upon appointment, succeed to all of the powers, rights and duties of the former board.

## What is level of disclosure of process to voting creditors?

**Chapter 11 of the United States Bankruptcy Code**

A Chapter 11 plan must be accompanied by a disclosure statement that has been preapproved by the bankruptcy court as containing "adequate information" about a debtor's financial affairs and a proposed plan to enable creditors to make an informed decision on whether to accept the plan. With few exceptions, no votes in favor of (or against) a proposed plan can be solicited after the Chapter 11 filing until such time as the court has approved the disclosure statement.

## What entities are excluded from customary insolvency or reorganisation proceedings, and what legislation applies to them?

**Chapter 11 of the United States Bankruptcy Code**

Section 109 of the Bankruptcy Code provides that certain types of entities may not be debtors under the Bankruptcy Code.

These entities include insurance companies and commercial banks. Investment banks can file for Chapter 7 bankruptcy, which provides for liquidation but not for bankruptcy under Chapter 11, which contemplates reorganization.

State insurance law governs insurance company insolvencies.

Under the federal Dodd-Frank Act, federal regulators can take over the holding company of a systemically important financial institution and its subsidiaries. If the US Treasury, backed by two-thirds of the votes of the Federal Reserve Board of Governors and the Federal Deposit Insurance Corporation (FDIC) board, concludes that a financial company is on the verge of default or has defaulted and that its failure would have a severe adverse effect on financial stability in the US, it can trigger resolution by filing a petition in federal court — Section 2020 of the Dodd-Frank Act. Resolution under the Dodd-Frank Act only contemplates receivership, not reorganization under a conservator.

US bank supervisors may appoint the FDIC as a conservator or receiver of an insolvent bank. The FDIC may appoint itself as a conservator based on the statutory standards for appointment and to prevent a loss to the deposit insurance fund. In either instance, the holding company of the bank, and direct subsidiaries of the holding company, remain eligible to file and administer their own cases under Chapter 11.

## How long does it generally take for a creditor to commence the procedure?

**Chapter 11 of the United States Bankruptcy Code**

As described above, subject to certain conditions, creditors may commence an involuntary case by filing a petition with the bankruptcy court. The petition must be properly served on the company along with a summons. If an involuntary petition is filed against a company, the company may contest the petition within 21 days of receiving a summons, which typically involves the filing of an answer or motion to dismiss. If the company contests the involuntary petition, litigation will ensue as to whether the requirements discussed above have been met, and sometimes can last several months. If the bankruptcy court ultimately rules in favor of the petitioning creditors, it will enter an order for relief that officially places the company into bankruptcy. See above for more information on the requirements for filing an involuntary case.

During the interim period between when the involuntary petition is filed and when the court makes a determination as to whether the requirements for an involuntary filing have been met, the company may continue to operate its business and use and acquire or dispose of its property as if an involuntary bankruptcy case had not been filed. An exception exists for the appointment of an interim trustee, in the rare instance in which the petitioning creditor(s) can establish that such appointment is "necessary to preserve the property of the estate or prevent loss to the estate."

# Effect of Process

## Does debtor remain in possession with continuation of incumbent management control?

**Chapter 11 of the United States Bankruptcy Code**

Yes — see Topic: Commencing the Process.

A debtor in possession may conduct the ordinary course of its business without court approval.

Bankruptcy court approval is required for any transaction that is outside the debtor's ordinary course of business, such as for major business decisions (e.g., sale of assets and entering into secured financing).

The debtor also has the exclusive right to propose a Chapter 11 plan for 120 days, subject to further extension of up to not more than 18 months from the date of the order for relief. After this period expires or is terminated by the court, other parties in interest may propose their own Chapter 11 plan.

## What is the stay/moratorium regime (if any)? Is the stay or moratorium worldwide?

**Chapter 11 of the United States Bankruptcy Code**

Upon the commencement of a bankruptcy case, the debtor obtains immediate protection from actions against its assets and operations by virtue of the automatic stay implemented under Section 362 of the Bankruptcy Code. By operation of the automatic stay, creditors are prohibited from attempting to collect prepetition debts of the debtor, seize assets of the debtor or otherwise exercise control over the property of the debtor. For example, the automatic stay prohibits the commencement or continuation of litigation against the debtor or an attempt by a creditor to foreclose on the property of the debtor.

There are, however, some exceptions to the automatic stay. For example, the automatic stay does not apply to the government's policy or regulatory power. There are also exceptions to the automatic stay for certain types of financial arrangements, including with respect to enforcement against collateral provided for under certain derivatives contracts.

Creditors can petition the bankruptcy court to lift the automatic stay, but such relief is usually only granted in narrow circumstances. Generally, secured creditors may seek relief from the automatic stay on the basis that their collateral is eroding in value and the debtor is not maintaining the value of their collateral, thereby entitling them to adequate protection from any diminution or relief from the automatic stay to permit foreclosure. To avoid being sanctioned for violating the automatic stay, any party considering adverse action against a debtor should first seek a bankruptcy court order granting relief from the automatic stay or, if uncertain, that the stay does not apply to the act proposed to be undertaken.

The automatic stay is theoretically applicable worldwide, coextensive with the original and exclusive jurisdiction of the bankruptcy court over all property of the debtor, "wherever located." As a practical matter, enforcement of the stay against the debtor of its assets outside the United States can be difficult against a creditor that has no assets in the United States or other connection to the United States. In such instances, it may be advisable for the debtor and bankruptcy court to appoint a foreign representative or other person or body to commence an ancillary insolvency proceeding in the foreign country, obtain recognition of the Chapter 11 case in that proceeding, and seek enforcement of the stay by the foreign court.

## Is there a provision for debtor in possession or rescuer financing or superpriority or priming financing?

**Chapter 11 of the United States Bankruptcy Code**

Yes, and the provisions are quite extensive and more widely used in cases under Chapter 11 than in restructuring proceedings in many other countries.

A debtor can seek to entice lenders to provide debtor-in-possession financing ("**DIP financing**") with a range of tools that bankruptcy courts routinely approve. First, the debtor can offer administrative expense status to a potential lender. Next, if unable to obtain a loan on that basis, the debtor can offer the proposed lender a superpriority administrative claim (having priority over all other administrative claims). However, lenders usually require more than a simple administrative priority or superpriority claim to lend to a company in a Chapter 11 case because they are typically reluctant to run the risk of not being repaid in full as a result of administrative insolvency (i.e., insufficient funds to pay administrative claims in full).

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

At the highest level, a debtor may seek court approval to grant the proposed lender a lien on encumbered assets that is pari passu (of equal lien priority) with or that primes (of senior lien priority) existing liens. However, in this case, the debtor must establish "that it is unable to obtain such credit otherwise." Further, the debtor must establish that the interests of the existing lender are "adequately protected" notwithstanding the proposed pari passu or priming liens. This usually involves consideration of various factors, including (i) a valuation of the subject property to assess the nature of any equity cushion that may exist; (ii) whether the property is eroding in value; (iii) the nature of payments proposed or available; and (iv) whether the debtor has a reasonable prospect of reorganizing. Typically, holders of existing liens would object vigorously to any liens that are pari passu with or prime their existing liens, absent a clear showing of how their liens are adequately protected. As the above factors are often difficult to prove, it is rare that a bankruptcy court will approve this treatment unless the adversely affected secured creditor consents.

## Can procedure be used to implement a debt-to-equity swap?

**Chapter 11 of the United States Bankruptcy Code**

Yes — this is a common feature of balance sheet restructurings that occur in Chapter 11 cases. Shareholder consent is not required, and the debt-for-equity swap can occur over the objection of shareholders as a result of the absolute priority rule and cramdown (each discussed above). Indeed, increasingly in recent years, prepackaged and prenegotiated Chapter 11 plans are arranged with the holders of "fulcrum debt" — the tranche of debt that is only partly covered by the going concern value of the company — in advance of the bankruptcy filing; and debt-for-equity swap plans are confirmed quickly by the courts in accordance with such arrangements.

## Are third party releases available?

**Chapter 11 of the United States Bankruptcy Code**

This is a highly controversial question and a "hot topic" in the United States. The Bankruptcy Code has been interpreted differently on this point by appellate courts in the various judicial circuits, and the Supreme Court has yet to issue a definitive decision to bring some consistency to this oft-litigated question.

In jurisdictions where third-party releases are not absolutelyprohibited, non-debtors, including officers and directors of the debtor, may generally be released through a plan if such releases are consensual.

Non-consensual releases are generally approved only if essential to the debtor's reorganization, the parties being released are making a substantial financial contribution to the reorganization, and the affected creditors overwhelmingly support the plan.

The disparate treatment of releases is to be distinguished from the more common and less controversial practice of granting exculpation to third parties, including their respective professionals, for acts and conduct undertaken in the course of the Chapter 11 case.

## Are the proceedings recognised abroad?

**Chapter 11 of the United States Bankruptcy Code**

Yes. In accordance with the domestically adopted version of UNCITRAL or other applicable principles of international comity and/or treaties for other countries, cases under Chapter 11 are customarily granted recognition and enforcement in foreign courts, other than in those countries that as a matter of local law do not recognize foreign judgments.

## Has the UNCITRAL Model Law been adopted?

**Chapter 11 of the United States Bankruptcy Code**

Yes — the Model Law was adopted as Chapter 15 of the Bankruptcy Code in 2006, and a wealth of case law has developed over its application and interpretation.

## Can a debtor continue to carry on business during insolvency proceedings?

**Chapter 11 of the United States Bankruptcy Code**

Absent a finding by the bankruptcy court of fraud, dishonesty, incompetence, gross mismanagement or similar circumstances, the existing management of a company remains in control of the company and continues to manage its business operations and day-to-day affairs during the Chapter 11 case. A debtor can continue to do business during the Chapter 11 case, including trading and incurring unsecured debt in the ordinary course of its business, subject to obtaining court approval for any transactions outside of that ordinary course.

# Other Factors

## Are there any wrongful or insolvent trading restrictions and what is the directors' liability?

**Chapter 11 of the United States Bankruptcy Code**

None, other than a generally discredited theory of prolonging insolvency or deepening insolvency that has been recognized in rare circumstances only by a very small and shrinking minority of courts.

A company is not obligated to file for US bankruptcy or discontinue trade upon discovering its insolvency; there is no director liability per se for failing to file for bankruptcy or to continue trading while insolvent. Directors tend in most instances to be protected by indemnification provisions covered by insurance policies owned by the company, and further by exculpations that are commonly granted upon confirmation of Chapter 11 plans.

## What is the order of priority of claims?

**Chapter 11 of the United States Bankruptcy Code**

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

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

Secured creditors – individuals or entities holding claims against the debtor that are secured by a lien on property of the estate

Unsecured creditors are entitled to priority under Section 507 of the Bankruptcy Code – for example, those holding claims incurred during the administration of the case and that was necessary for or benefited the preservation of the debtor's estate, certain reclamation claims or claims with statutory priority over other unsecured creditors (e.g., certain wages, pensions and taxes)

General unsecured creditors – individuals or entities holding allowed unsecured claims

Equity holders – individuals or entities holding interests in equity securities of a debtor (e.g., stock in a corporation)

## Do pension liabilities have any priority over other unsecured claims?

**Chapter 11 of the United States Bankruptcy Code**

There is a partial, fifth-level priority created under section 507(a)(5) of the Bankruptcy Code for contributions to an employee benefit plan arising from services rendered within 180 days before the filing of the bankruptcy case (or cessation of the company's business, if earlier), limited to the amount of USD 13,650 multiplied by the number of employees covered by each such plan.

A debtor may also terminate its single-employer pension plans through a "distressed termination" in bankruptcy, leaving the US Pension Benefit Guaranty Corporation (PBGC) with an unsecured claim for the termination liabilities if the debtor can effectively show that it could not continue in business or successfully reorganize itself if it is unable to terminate its pension plan. The PBGC can force an involuntary termination but rarely does so.

## Is it possible to challenge prior transactions?

**Chapter 11 of the United States Bankruptcy Code**

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

Set aside preferential transfers made to non-insider creditors within 90 days prior to the petition date and, with respect to insiders, within one year prior to the petition date (generally, insiders are directors, officers and other control persons or their relatives, any affiliated entities and any insider of those entities)

Undo or nullify security interests and other prepetition transfers of property that were not properly perfected under non-bankruptcy law at the time of the petition date

Recover fraudulent transfers, that is, transfers made with actual intent to hinder, delay or defraud creditors or transfers made for less than reasonably equivalent value while the debtor was insolvent, or was rendered insolvent, or left with unreasonably small capital by such transfer

Bankruptcy courts can look back at transfers within two years of the petition date using the Bankruptcy Code's fraudulent conveyance provisions and up to four years (or six years in some jurisdictions) using state law; in rare instances in which the Internal Revenue Service was a creditor at the time of the subject transfer, some courts have extended the reachback period to 10 years.

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