

A view from across the pond: Chapter 11 of the US Bankruptcy Code

Introduction

This briefing takes the opportunity to consider some of the key provisions of Chapter 11 of the US Bankruptcy Code and the effect these provisions may have on non-US entities.

Chapter 11: Fundamental Principles

There are two fundamental principles that pervade the fabric of the US Bankruptcy Code: (a) those burdened with debt are entitled to a “fresh start”; and (b) equality of distribution of the assets of the debtor to creditors of like priority. Although the Chapter 11 process may be used to facilitate either a debtor's rehabilitation or liquidation, it contains certain tools that a debtor may use to emerge from bankruptcy.

The Debtor-in-Possession

In the US, unlike in many other jurisdictions, the management of the entity under protection of the US Bankruptcy Code is not automatically displaced upon the commencement of the bankruptcy case. Rather, the US Bankruptcy Code intends that management will continue and the debtor will remain “in possession” of its business and assets, absent demonstrable cause for displacement. The debtor-in-possession, accordingly, is permitted to continue its normal business operations in the “ordinary course” without the prior approval of its creditors or the court. For actions outside of the ordinary course of operations, the US Bankruptcy Code requires the debtor-in-possession to provide notice to creditors and an opportunity for a hearing on the proposed action, typically resulting in a court order.

There are several counterweights to the debtor-in-possession's management, the first and foremost being that the debtor-in-possession acts as a fiduciary for all parties in interest in the bankruptcy case. Second, the statutory scheme contemplates the appointment of an official committee of unsecured creditors to act as a fiduciary representative of general unsecured creditors with standing to negotiate with the debtor, to appear at hearings and to contest the debtor's proposed actions and to participate in the plan of reorganization process. Finally, specialized insolvency and restructuring professionals may be retained by each estate fiduciary with the approval of the court to render advice and, independently, to discharge fiduciary responsibilities to the estate.

The Automatic Stay

Fundamental to the reorganization principles is the “automatic stay” – an automatic, statutory prohibition against the commencement or continuation of any act to obtain or affect the rights or assets of a debtor. The stay, which is applicable to secured and unsecured creditors alike, arises upon the filing of the bankruptcy petition and requires no affirmative act beyond the commencement of the case. Though there exist important exceptions to the automatic stay, and though the bankruptcy court may either modify or lift the stay after notice and a hearing, it remains a bulwark against piecemeal dismemberment of a debtor's assets and the foundation for the opportunity for reorganization.

Key Issues

A fresh start

Fair distribution

The Debtor-in-Possession

The Automatic Stay

Preferences and Fraudulent Conveyances

Long arm reach of the US Bankruptcy Courts

If you would like to know more about the subjects covered in this publication or our services, please contact:

[Andrew Brozman](#) +1 212 878 8134

[Jennifer DeMarco](#) +1 212 878 8125

[David Sullivan](#) +1 212 878 4948

[Wendy Rosenthal](#) +1 212 878 3142

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA
www.cliffordchance.com

Financing the Debtor

Because Chapter 11 primarily is concerned with the process of business reorganization, one of its most critical features deals with the ability of and manner in which a debtor may obtain access to financing. Generally, there are three ways in which a debtor can finance its Chapter 11 case. First, a debtor can use cash or receivables not subject to any lien in the ordinary course of its business. Second, to the extent the debtor has cash that is subject to a lien, the debtor may use such cash if (a) the creditor consents to such use or (b) the court authorizes the use of such cash collateral provided such creditor's interests are adequately protected. Finally, the debtor may be able to obtain debtor-in-possession financing. Though a debtor may incur unsecured debt in the ordinary course of its business (for example, unsecured trade credit) without a court order, it may not borrow money on any other basis without notice and a hearing and in compliance with particular statutory requisites.

If the debtor is unable to borrow money on an unsecured basis, it may only borrow or obtain credit: (a) on an unsecured administrative "super" priority claim basis (that is, with priority over all other post bankruptcy unsecured obligations of the debtor in possession); (b) with a security interest and lien in unencumbered property of the debtor; or (c) with a junior lien on encumbered estate property. If, as is typically the case, the lender is unwilling to extend credit absent a first priority senior lien or the debtor has no acceptable unencumbered property to offer as collateral, the US Bankruptcy Code nonetheless will permit the financing with a lien senior or equal to existing liens if the debtor can demonstrate that: (a) it is unable to obtain financing on any other basis; and (b) the interests of the existing lien holder will be adequately protected.

Assumption or Rejection of Contracts and Leases

During the course of a Chapter 11 case, a debtor-in-possession (subject to court approval) may assume or reject certain executory contracts and unexpired leases. In order to assume an executory contract or lease, the debtor generally must (a) cure any defaults and (b) provide adequate assurance of future performance. A contract or lease may only be rejected or assumed in its entirety. In the event that an executory contract is rejected, the party to such executory contract will have a prepetition unsecured claim for damages arising from the rejection.

Plan of Reorganization

The plan of reorganization provides a means for a debtor to successfully exit the Chapter 11 process. A plan of reorganization may provide for the rehabilitation of the debtor or it may involve a liquidation of the debtor, either as a going concern or on an orderly asset disposition basis. In either case, the plan will pass consideration according to its terms to the debtor's various creditor groups and, if appropriate, equity holders.

The debtor has a statutory exclusive right to file a plan during the first 120 days of the case. That is subject to extension (limited to 18 months from the commencement of the case) or termination for cause shown. Once the debtor's exclusive right has expired or otherwise has been terminated by order of the court, any party in interest may file a plan.

In order to be approved by the court, or "confirmed," a plan must comply with statutory requirements and must have been the subject of a court approved disclosure statement providing sufficient information about the plan and its promises to enable a creditor to make a reasonably informed judgment as to whether the plan should be accepted or not. That judgment is important because one of the statutory requirements for confirmation is that the plan be accepted by the vote of each class of creditors, the rights of which have been impaired by virtue of the treatment proposed in the plan.¹ Other important plan related provisions are: (a) the plan must afford each dissenting creditor more than it would receive on account of its claim in a chapter 7 liquidation; (b) no junior class may receive or retain anything of value unless all senior classes are paid in full or such classes consent to the treatment of the junior class; (c) creditors grouped in a class must have substantially similar claims; (d) creditors within a class must receive uniform treatment under the plan; and (e) the costs of administering the chapter 11 case and certain other special categories of claims must be paid in full under the plan.

Preferences and Fraudulent Conveyances

The US Bankruptcy Code provides for certain causes of action that may be brought to avoid certain obligations or transfers, including preferences and fraudulent transfers.

¹ There are important statutory exceptions to this rule. A dissenting class of creditors may be "crammed down" (that is, the plan may be confirmed over its objection) under limited and defined circumstances.

Preferences

Preference actions are designed to assist the distribution of the debtor's assets in accordance with the priorities established by the US Bankruptcy Code. As such, the US Bankruptcy Code allows for the avoidance of certain pre-petition transfers of a debtor's property. The transfers which may be subject to avoidance as a preference are generally those that are made to creditors within 90 days of the commencement of the case, while the debtor was insolvent and enabled the creditor to receive more than it would in a liquidation. Certain defenses can be raised to preference actions including, if it can be shown that the payment or transfer was made in the ordinary course of business, or the transferee made a contemporaneous exchange of, or subsequently provided, new value in exchange for the payment or transfer.

Fraudulent Conveyances

There are two types of fraudulent transfers, actual and constructive. The statute of limitations for fraudulent transfers differs under federal and state law and by state to state but generally there is the ability to look at transfers going back four to six years. An actual fraudulent transfer is a transfer made or obligation incurred with the actual intent to hinder, delay or defraud creditors. A constructive fraudulent transfer would be a transfer made or obligation incurred where the debtor did not receive "fair consideration" or "reasonably equivalent value", if any of the following are true: (a) the debtor is, or as a result of making the transfer or incurring the obligation becomes, insolvent; (b) the debtor was engaged or about to engage in a business or transaction for which remaining assets were unreasonably small in relation to the business or transaction; or (c) the debtor intended to incur, or believed, or reasonably should have believed, it would incur, debts beyond its ability to pay them as they came due. These concepts are broader than the simple balance sheet solvency test.

Long arm reach of the US Bankruptcy Courts

The perception of the US as one of the most debtor friendly jurisdictions, and one, where the burden for establishing jurisdiction may be relatively low for foreign debtors who seek its protection, is reflected in the ability of a foreign debtor to file a petition for relief under Chapter 11. It has been remarked upon that there is "virtually no formal barrier" to have US Federal Courts adjudicating on a foreign debtor's bankruptcy, and jurisdiction has, in some cases, been founded on the basis of the presence of US bank accounts alone. While jurisdiction may be found to exist in a particular case, a US Bankruptcy Court may dismiss a Chapter 11 case of a foreign debtor if it determines that an effective reorganization cannot be achieved in the US. Provided the reorganization may be effectively prosecuted in the US, the US Bankruptcy Court may provide a safe haven for foreign debtors who wish to make a fresh start.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ.

www.cliffordchance.com

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571.

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications.

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Budapest ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Prague ■ Riyadh* ■ Rome ■ São Paulo ■ Shanghai ■ Singapore ■ Tokyo ■ Warsaw ■ Washington, D.C.

* co-operating office

© Clifford Chance US LLP September 2008