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International Insolvency and Bankruptcy

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Chapter 29

International Insolvency and Bankruptcy

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§ 29:1 Introduction

As the number of multinational enterprises doing business in many countries has increased, so has the number of multinational workouts and bankruptcies. For that reason, the rights of creditors and debtors, as well as other stakeholders, may be determined by a host of disparate laws providing different rights and treatment. This

chapter provides a checklist of key issues that parties in interest may wish to explore when confronted with a multinational company involved in one or more bankruptcy or insolvency proceedings in multiple jurisdictions or that appears to be on the brink of such proceedings.

These key issues—each of which is discussed below—include the following:

- Jurisdiction and Choice of Law
- Form of Proceeding
- Control and Management of Debtor
- Participation in Proceedings
- Rights of Secured Creditors
- Priority Schemes
- Status of Contractual Obligations
- Financing of Company Undergoing Restructuring
- Avoidance Actions
- Liability for Directors and Officers
- Ancillary Proceedings and International Insolvency Treaties

§ 29:2 Jurisdiction and Choice of Law

Although there are multinational regulations and treaties (such as the European Union Insolvency Regulation[1] and the UNCITRAL Model Law on Cross-Border Insolvency)[2] that attempt to foster international cooperation among various jurisdictions in administering a bankruptcy estate, the most immediate task when a multinational company experiences financial difficulty is to determine which country or countries actually has jurisdiction over the company and how those laws may affect the potential reorganization or liquidation. Whether a country has jurisdictional reach over a debtor will ultimately affect where a debtor can file for bankruptcy (or where creditors can place a debtor into bankruptcy) and thus ulti-

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1. European Union Regulation 1346/2000, 2000 O.J. (the "EU Regulation"), http://ue.eu.int/ueDocs/cms_Data/docs/dynadoc/jo/jai/EN/ST005630_00ORIEN.pdf.
2. UNCITRAL Model Law on Cross-Border Insolvency of the United Nations Commission on International Trade Law (1997) (the "MODEL LAW") was promulgated by the United Nations Commission for International Trade Law in 1997 and is available at www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html (follow "General Assembly resolution" hyperlink).

mately determines what laws will be applied in administering the debtor's estate. Jurisdiction in any particular country can be premised on, among other things,

(1) whether the debtor has any assets in that country;

(2) the debtor's principal place of business or where it has its "center of main interests"; and/or

(3) the debtor's country of incorporation or domicile.

It is likely that any single debtor with multinational operations can meet the jurisdictional criteria for a bankruptcy filing in many different countries, thus leading potentially to forum-shopping by the debtor (or potentially creditors) who can select the most favorable forum available under the different jurisdictions' laws. The choice of forum can also affect the availability of ancillary bankruptcy proceedings in another country, as the country with the "main proceeding" (described below in the context of the Model Law and the EU Regulation) might or might not recognize ancillary proceedings. Therefore, the first questions with respect to what insolvency law might apply to the debtor are the location of its property, executive and other offices, operations, country of incorporation or domicile, creditors, and other stakeholders. Then the different statutory requirements of those countries' insolvency laws where these factors may be present should be explored. Finally, an examination of what differences in those countries' insolvency laws might affect the different parties' interests should be conducted. Below are some examples of how jurisdictional statutes differ in a few representative countries.

§ 29:2.1 United States

The eligibility for becoming a debtor in a U.S. bankruptcy case is found in section 109 of the U.S. Bankruptcy Code,[3] which provides that any person that "resides or has a domicile, a place of business, or property in the United States" can commence a plenary bankruptcy proceeding in the United States.[4] Both the U.S. Bankruptcy Code and certain case law interpreting it, however, have somewhat limited the jurisdictional reach of section 109. For instance, a U.S. bankruptcy court has the power to dismiss a petition filed in bad faith under section 1112(b) of the U.S. Bankruptcy Code, and such a dismissal may be appropriate where "property has been specifically placed or lent in the United States for the sole purpose of creating

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3. 11 U.S.C. § 101 *et seq*. (the "U.S. Bankruptcy Code").

4. *Id.* § 109(a). Section 109 also excludes certain types of businesses, such as U.S. domestic banks and insurance companies, from being eligible to be a debtor. *Id.* § 109(b).

eligibility that would not otherwise exist."[5] Similarly, under section 305 of the U.S. Bankruptcy Code, a court may dismiss a plenary proceeding if (1) the interests of creditors and the debtor would be better served by such dismissal or suspension; or (2) a petition under section 1515 of the U.S. Bankruptcy Code for recognition of a foreign proceeding has been granted and the purposes of chapter 15 of the U.S. Bankruptcy Code would be served by such dismissal.[6]

§ 29:2.2 Examples from Other Jurisdictions

[A] Japan

In Japan, whether a debtor can qualify for relief depends on the type of proceeding sought by the debtor. There are three main types of bankruptcy proceedings in Japan:

(1) bankruptcy, where an insolvent debtor's assets are liquidated and the proceeds are distributed to creditors;

(2) civil rehabilitation, which is similar to U.S. chapter 11 proceedings, but designed for small and medium businesses and individuals, where a debtor in possession continues its business and conducts its affairs under the supervision of a court until a rehabilitation plan is accepted by a majority of creditors and approved by the court; and

(3) corporate reorganization, which is similar to civil rehabilitation, but designed for large corporations.[7]

Japan's insolvency law was amended in 2002 to incorporate jurisdictional requirements for each of the insolvency proceedings listed above. To qualify for relief under the Bankruptcy Law or the Civil Rehabilitation Law, the debtor must have a domicile, a place of business or property in Japan, whereas under the Corporate Reorganization Law, the debtor must have a place of business in Japan.[8] Thus, the eligibility requirements under the Corporate Reorganization Law are stricter than the requirements under the Bankruptcy

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5. *In re* McTague, 198 B.R. 428, 432 (Bankr. W.D.N.Y. 1996) (concluding that a debtor's removal of $6,000 from a bank account just prior to filing and leaving $194 in the bank account created an inference that $194 was left to create a basis for chapter 11 eligibility); *see also In re* Yukos Oil Co., 320 B.R. 130 (Bankr. S.D. Tex. 2004) (dismissing Russian company's U.S. bankruptcy case under section 1112 on the basis of the "totality of the circumstances").
6. 11 U.S.C. § 305.
7. Hideo Horikoshi, *Guide to Japanese Cross-Border Insolvency Law*, 9 L. & BUS. REV. AM. 725, 726–29 (2003).
8. *Id.* at 731.

Law or the Civil Rehabilitation Law, as mere property will not suffice. At least one commentator has opined that such stricter requirements are justified because Corporate Reorganization Law is designed for larger corporations and the proceeding will have significant effects on parties in interest.[9]

[B] European Countries

Most European countries also have jurisdictional requirements to open insolvency proceedings in those countries. For instance, in France, French courts have jurisdiction to entertain a bankruptcy proceeding against a foreign debtor that does business in France or a debtor whose registered office is abroad, but whose principal activity takes place in France.[10]

When insolvency proceedings involve more than one member country of the European Union, however, jurisdiction is governed by the EU Regulation, which came into effect on May 31, 2002, and governs in most cases where a debtor is eligible to file for bankruptcy among member countries, except for Denmark.[11] With respect to jurisdiction, the EU Regulation provides that the member country in which the debtor's "centre of a debtor's main interests" is situated shall have jurisdiction to "open" the main insolvency proceedings.[12] The phrase "centre of main interests" is not specifically defined, but the preamble of the EU Regulation states that "the centre of main interests should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties."[13] Furthermore, under the EU Regulation, there is a rebuttable presumption that the center of main interests is the country in which a company's registered office is located, in the absence of proof to the contrary.[14] However, as much as the EU Regulation and the jurisdictional parameters of "centre of main interests" were intended to unify the process of determining where a debtor could file for bankruptcy among EU member countries, the result has been time-consuming

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9. *Id.*
10. 2 COLLIER INTERNATIONAL BUSINESS INSOLVENCY GUIDE ¶ 22.08[2][b][i] (15th rev. 2005) (hereinafter "COLLIER INTERNATIONAL").
11. 2 COLLIER INTERNATIONAL ¶ 21.03[3][c].
12. EU Regulation art. 3(1).
13. *Id.* recitals ¶ 13 (internal quotations omitted).
14. *Id.* art. 3(1).

litigation in multiple countries with differing results regarding where a debtor's center of main interests lies.[15]

§ 29:3 Form of Proceeding

A key issue in any multinational insolvency is the form of the proceeding. Different countries, of course, offer different legal structures embodying important policy preferences through substantive and procedural requirements. Distinct rights and protections flow from each type of proceeding, making the form of the proceeding a key consideration whenever confronting the insolvency of a multinational company.

For the most part, these legal structures can be characterized as either liquidation or reorganization proceedings. Liquidation tends to be a faster, closely controlled mechanism by which the debtor's assets are sold to pay creditors' claims. Reorganization tends to be a longer process, giving the debtor breathing space to restructure debt, gain concessions, and shed unwanted assets and liabilities in an attempt to continue as a going concern. For many years, the laws of most jurisdictions outside the United States and Canada focused on the liquidation of distressed companies rather than their reorganization. In recent years, however, there has been a global trend toward encouraging reorganization. Today, more jurisdictions offer a variety of insolvency regimes, both reorganization and liquidation.

Additionally, in most jurisdictions, insolvency proceedings can be either voluntary or involuntary. An involuntary proceeding is commenced by creditors or other stakeholders, which usually must satisfy certain statutory criteria, while a voluntary proceeding is commenced by the distressed company (typically through its board of directors or other managing entity).

Within the reorganization umbrella, many jurisdictions offer so-called "prepackaged" (or "prenegotiated") reorganization proceedings by which a distressed company can negotiate and enter into agreements with creditors (typically bank creditors and bondholders) before commencing an insolvency proceeding. This mechanism provides a useful tool for reaching private agreements before enter-

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15. *See, e.g.*, Case 147/04, *In re* Eurofoods IFSC Ltd., 2004 B.C.C. 383 (Irish Supreme Court claiming jurisdiction in respect of main insolvency proceedings commenced against Eurofoods IFSC Limited while Eurofoods was admitted to insolvency administration also in Italian courts). *See also* Case C-341/04, *In re* Eurofoods IFSC Ltd., 2006 E.C.R. I-3813 (European Court of Justice ruling that where a company carries on its business in the member state where its registered office is situated, the mere fact that its economic choices are or can be controlled by a parent company located in another member state is not enough to rebut presumption).

ing a court-supervised system in which debtors and creditors may have less control and flexibility.

The type of insolvency regime has a major impact on debtors and other stakeholders. As noted above, in many jurisdictions, debtors and creditors may have the ability to pursue a particular insolvency regime, either through selecting the forum or selecting a particular type of insolvency proceeding in that forum. For example, in some jurisdictions, an attorney representing a secured party with a lien on sufficient collateral might prefer quick and prompt payment under a liquidation regime, while an equity holder may prefer a more prolonged reorganization that offers the possibility of preserving or enhancing the value of the ongoing business.

For illustrative purposes, examples of different forms of proceedings that might be encountered are described below.

§ 29:3.1 United States

In the United States, there are several bankruptcy, insolvency, or similar regimes available. The most important regimes are under the U.S. Bankruptcy Code. In addition, each of the fifty states has its own insolvency laws governing receivership and the "winding down" of businesses. State insolvency procedures are typically invoked by small businesses that do not wish to incur the expense of a federal bankruptcy proceeding or by entities, such as insurance companies and banks, which are precluded from becoming debtors under the U.S. Bankruptcy Code.[16] However, in most circumstances, a proceeding properly filed under the U.S. Bankruptcy Code will preempt any state filings.

The U.S. Bankruptcy Code allows for the reorganization or liquidation of business entities. Companies generally have the option of reorganizing under chapter 11 of the U.S. Bankruptcy Code or liquidating under chapters 7 or 11 of the U.S. Bankruptcy Code. Large or complex businesses seeking to liquidate frequently seek relief under chapter 11 in order to allow existing management to continue operating the business as they seek to sell the company as a going concern.

Unlike many jurisdictions, a debtor seeking voluntary protection under the U.S. Bankruptcy Code does not have to prove insolvency, either in the context of reorganization or liquidation. However, if the bankruptcy filing is challenged, the debtor may have to demonstrate that it faces significant financial distress and that the bankruptcy proceeding is necessary to preserve value for the debtor's

16. 11 U.S.C. § 109 (prescribing entities that may or may not be a debtor under the U.S. Bankruptcy Code).

creditors.[17] In contrast, creditors filing an involuntary bankruptcy proceeding must demonstrate that the debtor company is generally not paying its debts as they become due.[18]

§ 29:3.2 Examples from Other Jurisdictions

[A] England

In England, there are four main types of reorganization or liquidation:

(1) administrative receivership,[19]

(2) voluntary arrangements with creditors,[20]

(3) winding-up (whether creditors' or members' voluntary winding-up or compulsory winding-up),[21] and

(4) administration.[22]

Bankruptcy is a term that applies only to individuals, not companies.

Administrative receivership occurs when a creditor, having the benefit of security that includes a floating charge and by which all or substantially all of the debtor's assets and undertaking are secured, appoints an administrative receiver to enforce its security interest. The administrative receiver acts as the agent of the debtor,[23] but owes its primary duties to the secured creditor.[24] The insolvency or quasi-insolvency of the debtor is not a precondition to appoint-

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17. *See*, *e.g.*, *In re* Integrated Telecom Express, Inc., 384 F.3d 109, 129 (3d Cir. 2004) (dismissing chapter 11 bankruptcy case because the debtor was not in financial distress).
18. 11 U.S.C. § 303.
19. *See* Insolvency Act 1986 part III.
20. *See id.* part I; Companies Act 1985 § 425. Voluntary arrangements can also be effected on a purely contractual basis, although there is no special legal protection of the company or means to bind dissentient creditors.
21. *See* Insolvency Act 1986 parts IV, V.
22. *See id*. part I.
23. *Id.* § 44.
24. The administrative receiver generally owes only three limited duties to the debtor and any other creditors with an interest: (1) to act bona fide for the purposes of realizing the assets to repay the secured creditor; (2) to obtain the best price reasonably obtainable on such realization; and (3) if the administrator decides to operate the business of the company for any period, to do so with "due diligence." Medforth v. Blake, [2000] Ch. 86, per Scott V.C.

ment, provided that the debt is due and the security interest is valid and, in accordance with its terms, has become enforceable.[25]

Voluntary arrangements can be made pursuant to the formal procedures set forth in part I of the Insolvency Act of 1986 and under a compromise or composition made by scheme of arrangement pursuant to section 425 of the Companies Act of 1985 or through contractual arrangements.

Liquidation (also known as "winding up") is usually commenced by the company's creditors, but can be commenced by the company, the company's directors (acting as a body),[26] and, in certain circumstances, by the company's shareholders.[27] The company can also be wound up on the petition of the secretary of state on grounds of the public interest.[28]

Administration is the mechanism by which a company can reorganize and obtain the benefit of a statutory moratorium against creditor action. The appointment of an administrator can be made by the company, its directors (acting as body), secured creditors having the benefit of a "qualifying floating charge" over the whole or substantially the whole of the company's assets and undertaking that has become enforceable in accordance with its terms,[29] or by the court upon petition.[30] In all cases, except for the appointment by a secured creditor under an enforceable qualifying floating charge,[31] the company must be insolvent or likely to become insolvent.[32] Upon appointment, the administrator is empowered to exercise all the managerial powers of the company, and the board is effectively displaced other than to the extent that the administrator permits.[33]

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25. The power to appoint a receiver is contractual, arising from the terms of the debenture and so it follows that if the debenture is not valid, or the preconditions to appointment have been satisfied, then any purported appointment of a receiver will be invalid.
26. Insolvency Act 1986 § 124.
27. Such circumstances occur principally under section 84 of the Insolvency Act 1986 (members' voluntary winding-up), where the shareholders are also a "contributory" for the purposes of the Insolvency Act 1986 and are therefore entitled to petition under section 124 of the Insolvency Act 1986.
28. Insolvency Act 1986 parts II, III.
29. *Id.* sched. B1 ¶¶ 14, 35.
30. *Id.* sched. B1 ¶ 12.
31. *Id.* sched. B1 ¶¶ 14, 35(2).
32. *Id.* sched. B1 ¶¶ 11(a), 22, 27(2)(a).
33. *Id.* sched. B1 ¶ 64.

[B] Korea

Previously the Republic of Korea offered three bankruptcy regimes for business entities: (1) the Bankruptcy Act, (2) the Corporate Reorganization Act, and (3) the Composition Act. A bankruptcy under the Bankruptcy Act is most analogous to a chapter 7 liquidation under the U.S. Bankruptcy Code. Corporate reorganization and composition are both variations on chapter 11 reorganization proceedings under the U.S. Bankruptcy Code.

The New Consolidated Insolvency Law, however, which became effective April 1, 2006, repeals and consolidates the current insolvency laws (the Bankruptcy Law, the Corporate Reorganization Law, the Composition Law, and the Individual Debtor Rehabilitation Law).[34] The composition proceeding under the Composition Law is repealed. Instead, rehabilitation proceedings will uniformly apply to all reorganizations of insolvent companies.

Upon the filing of a petition for the commencement of a corporate rehabilitation proceeding under the New Consolidated Insolvency Law, the court typically first issues a preservation order, which prevents the debtor from taking certain actions such as payment of prepetition debt.[35] The court must then determine whether to commence a corporate rehabilitation by issuing a separate court order, based on a variety of considerations, including whether the debtor has shown cause for the commencement of the proceeding, whether the petition was filed in good faith, and whether the rehabilitation proceeding would be suitable for the benefit of the creditors in general.[36] Once the court issues this order, most claims against the debtor company that arose prior to the date of commencement are automatically stayed, while claims arising after commencement are generally not subject to the rehabilitation proceeding.[37] Upon commencement, the court will, in principle, appoint a receiver, who has the power to conduct all of the company's business and manage all its property, subject to the court supervision.[38] If it becomes apparent, either before or after the court approves the plan, that the company cannot be rehabilitated, the court may discontinue the proceeding.[39]

A bankruptcy proceeding under Korean law is a court-administered process designed to liquidate an insolvent debtor's assets. The bankruptcy process formally begins when the court determines that

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34. New Consolidated Insolvency Law, Addendum, arts. 1, 2.
35. *Id.* art. 43.
36. *Id.* arts. 34, 42, 49.
37. *Id.* arts. 131, 179, 180.
38. *Id.* arts. 50, 56, 74.
39. *Id.* arts. 285, 286, 288.

the debtor is indeed "bankrupt," with the key test being whether the debtor is unable to pay debts, generally and continuously, as they come due.[40] In the case of a corporate debtor, an additional cause for bankruptcy exists if the liabilities of the corporation exceed its assets (as determined by the going concern value).[41] The adjudication of bankruptcy also has the effect of automatically staying all unsecured creditors from executing on their claims against the bankruptcy estate.[42] The trustee appointed by the court will be vested with the exclusive right to manage and dispose of the bankruptcy estates, and conduct an investigation and assessment of the bankruptcy estate.[43] After reviewing the reports prepared by the trustee, the creditors will have a meeting and vote on a resolution deciding whether to continue or discontinue the debtor's business and the manner of safeguarding the bankruptcy estate.[44] The trustee distributes the proceeds from the liquidation of the bankruptcy estate to the creditors in proportion to their claims, subject to the applicable priority scheme.[45]

[C] Mexico

Mexico's insolvency regime for mid- and large-sized companies is set forth in the *Ley Concursos Mercantiles* (LCM), which provides for a single gateway for both (1) *conciliation*, during which the debtor may attempt to reorganize, and (2) *quiebra*, during which the debtor liquidates its business under supervision of the court.[46] Either the debtor or its creditors may commence the insolvency process by requesting that a court declare the debtor to be insolvent.[47] The key test is whether the debtor is insolvent, as measured by its general inability to perform its obligations.[48]

Shortly after the filing of the insolvency application, an independent examiner must verify that the debtor satisfies the insolvency test under the LCM.[49] The examiner may make recommendations to the court to approve interim measures such as the stay of execu-

40. *Id.* arts. 294, 302, 305, 306, 311.
41. *Id.* art. 306.
42. *Id.* art. 424.
43. *Id.* arts. 384, 479, 482.
44. *Id.* art. 489.
45. *Id.* arts. 505, 507.
46. INTERNATIONAL STATEMENT OF MEXICAN LAW 18, 26–27 (Am. Law Inst. 2003). Small businesses with liabilities under a threshold level are not subject to the LCM.
47. *Ley Concursos Mercantiles* [L.C.M.] [Mexican Business Reorganization Act], *Diario Oficial de la Federación* [D.O.], 12 Mayo de 2000 (Mex.) arts. 20, 21. Debtors have the ability to contest an involuntary case. *Id.* art. 27.
48. *Id.* arts. 9, 10, 11.
49. *Id.* arts. 29, 30, 35.

tion proceedings, appointment of a receiver, or issuance of an order preventing selling or encumbering of assets.[50] Following the submission of the examiner's report, a judge must decide whether the debtor is insolvent.[51]

If so, the debtor can proceed to the conciliation phase and the court will require the appointment of a conciliator, who works with the debtor and its creditors to achieve a consensual reorganization plan.[52] Among other things, in connection with the declaration of insolvency, the court will order the debtor to suspend payments, subject to certain exceptions, for debts arising as of the date for which the declaration is effective and staying certain attachments or execution orders against the debtor's assets.[53] The conciliator has significant powers and duties, including submitting reports to the court, pursuing avoidance actions, and supervising management of the debtor. If the court does not enter an insolvency declaration, the debtor (and all of its debts) returns to the status quo, as if the insolvency proceeding had not commenced.[54]

A debtor under the LCM can be declared bankrupt when

(1) the debtor so requests,

(2) the conciliation period has expired, or

(3) the judge grants the conciliator's request to enter a bankruptcy declaration because there is no reasonable prospect for reorganization.[55]

Upon entry of the bankruptcy declaration, a trustee (*síndico*) is appointed.[56]

§ 29:4 Control and Management of Debtor

Another threshold issue in any multinational insolvency proceeding is determining who has control of the debtor's property and business. An important question under any particular insolvency regime is whether current management will continue to operate the company and make day-to-day business decisions, subject to court

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50. *Id.* art. 37.
51. *Id.* art. 42. The LCM sets forth a variety of conditions and presumptions for insolvency. *See id*. arts. 9, 10, 11.
52. *Id.* art. 148. The initial period for obtaining such consensual agreements is 180 days, but this period may be extended by the court upon request of the conciliator or requisite number of creditors. *Id.* If the debtor so requests, the court can enter a declaration of *quiebra* (bankruptcy). LCM art. 167.
53. *Id.* arts. 43, 65.
54. INTERNATIONAL STATEMENT OF MEXICAN LAW, *supra* note 46, at 38.
55. LCM arts. 150, 167.
56. *Id.*

or other supervision, or whether current management must step aside to allow a trustee, receiver, or administrator to run the business. This question matters for many reasons. Companies doing business with the debtor, such as suppliers and customers, need to know who they should deal with to resolve problems and discuss future business relations. Investors considering the possibility of purchasing the assets need to know who is running the sale process. Creditors or equity holders need to know who is directing the restructuring process in order to protect their rights and negotiate the terms of the restructuring.

Historically, many jurisdictions have favored the appointment of a third party (typically a professional trustee, receiver, or administrator with experience in overseeing troubled companies) to operate the business after the commencement of an insolvency proceeding. Other jurisdictions, such as the United States (at least with respect to reorganization cases under chapter 11), have tended to favor the continuation of existing management, unless there are significant allegations of fraud, gross mismanagement, or other misconduct.

§ 29:4.1 United States

In a U.S. chapter 11 proceeding, a debtor's existing board of directors and management are permitted to remain in control of the debtor and its property as a "debtor in possession."[57] In such circumstances, the goal is to ensure that the business continues to operate in the ordinary course while its debts are being restructured. The debtor must obtain court approval for all transactions outside the ordinary course of business. For these kinds of transactions, the debtor has the burden of demonstrating that its actions are guided by a sound business judgment and that they meet the requirements of one or more specific statutory provisions that may govern the type of transaction.[58] In a chapter 7 case, however, the court must appoint a trustee to manage the affairs and liquidation of the debtor.[59]

In a chapter 11 case, a party in interest may seek to appoint a trustee to operate the business on grounds of fraud, dishonesty, gross mismanagement, or incompetence.[60] A court may also appoint a trustee when doing so is in the interests of creditors, equity security holders, and other interests of the estate.[61] Furthermore,

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57. 11 U.S.C. §§ 1101, 1107.
58. *See, e.g.*, *id.* § 363(b) (sale, lease, or use of property); *id.* § 364 (postbankruptcy financing); *id.* § 365 (assumption or rejection of executory contracts).
59. *Id.* §§ 701, 702.
60. *Id.* § 1104(a)(1).
61. *Id.* § 1104(a)(2).

under recent amendments to the U.S. Bankruptcy Code, the Office of the United States Trustee, a division of the U.S. Department of Justice, must seek the appointment of a trustee if there are "reasonable grounds" to suspect that a current member of the debtor's governing body, the debtor's chief executive or chief financial officer, or the debtor's governing body who selected such persons, participated in "actual fraud, dishonesty, or criminal conduct" in the management of the debtor or its public financial reporting.[62]

In addition, a party in interest in a chapter 11 case has the ability to seek the appointment of an examiner to conduct an investigation of the debtor, including an investigation into allegations of fraud or mismanagement.[63] In certain circumstances, if so requested, the court must appoint an examiner, though the court typically has discretion to define the scope of the examiner's investigation.[64]

§ 29:4.2 Examples from Other Jurisdictions

In some jurisdictions outside the United States, insolvency proceedings require the appointment of trustee, receiver, administrator, or similar official to manage the affairs or liquidation of the debtor, resulting in the ouster of prior boards of directors or other management from control of the debtor's assets, operations, and claims reconciliation process. In other jurisdictions, however, the existing board and management are allowed to run the day-to-day business in reorganization proceedings, subject to court supervision and limitations.

For example, under English insolvency law, a licensed insolvency practitioner is appointed to liquidate or operate the business in an administrative receivership, winding-up, and an administration.[65] Under Mexico's LCM, a representative of the debtor undergoing the conciliation phase may continue to be operated by its management, but important decisions must be approved by the conciliator. In addition, management may be removed by the court upon request of the conciliator, in which case the conciliator assumes the role of a trustee (*síndico*).[66] In a bankruptcy situation under the LCM, the debtor's management is removed and replaced with a *síndico*, which has the authority and responsibility for liquidating the estate,

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62. *Id.* § 1104(e).
63. *Id.* § 1104(c).
64. *Id.*
65. In a voluntary arrangement under Part I of the Insolvency Act 1986, a nominee must be appointed to supervise the implementation of the arrangement, although the day-to-day management powers remain with the board subject to nominee interventions.
66. LCM art. 74.

including the sale and disposition of property, and taking other actions, including the commencement of avoidance actions.[67] Under Korea's New Consolidated Insolvency Law, effective April 1, 2006, an existing representative of a debtor undergoing a rehabilitation proceeding can be appointed by the court to act as a receiver, except in certain circumstances such as where the directors and managers are substantially responsible for the debtor's insolvency through improper management.[68] If the debtor is a small- or medium-sized company, however, the court might not appoint a receiver and a representative of the debtor may effectively serve as the receiver.[69] In the case of a bankruptcy proceeding under Korean law, the court appoints a trustee to liquidate the company's assets under court supervision.[70]

§ 29:5 Participation in Proceedings

In almost every jurisdiction, creditors and other parties in interest have some ability to participate in the reorganization or liquidation proceeding. It is important to understand the extent to which creditors, equity holders, and other stakeholders can participate in the proceeding, particularly their ability to impact the ultimate plan for reorganization or liquidation. Obviously, if creditors have strong voting rights, the debtor (or any entity seeking to restructure the debtor) will need to address creditor concerns within the construct of the proceeding, including priority schemes and the respective rights of the plan proponent, debtor, creditors, or equity holders to force concessions. In jurisdictions where creditors can be "crammed down," the debtor or classes of creditors may have the ability to impose a reorganization plan on certain dissenting creditor or equity holder classes.

§ 29:5.1 United States

In a U.S. chapter 11 proceeding, creditors and equity holders have three basic means by which they may participate in the reorganization or liquidation:

(1) filing pleadings and seeking relief directly from the bankruptcy court,

(2) negotiating and voting on the plan of reorganization or liquidation, and

67. *Id.* art. 178.
68. New Consolidated Insolvency Law art. 74.
69. *Id.*
70. *Id.* arts. 355, 384.

(3) filing a proof of claim or interest in order to receive a distribution (or payment) in the bankruptcy case.

First, creditors or equity holders have the ability to seek relief directly from the bankruptcy court. In the United States, creditors or equity holders may attempt to participate in almost every aspect of the debtor's bankruptcy,[71] including attending statutorily required meetings of the creditors during which the debtor may be asked questions under oath,[72] seeking the appointment of a trustee or examiner,[73] and objecting to actions proposed by the debtor. For example, creditors (both unsecured and secured) or parties to contracts with the debtor can ask the bankruptcy court to deny its approval of a proposed sale of the debtor's assets.

In addition, unsecured creditors may become members of the official committee of unsecured creditors that is appointed by the Office of the United States Trustee, a division of the U.S. Department of Justice, in almost every large or complex case.[74] This committee is responsible for monitoring the case and helping to ensure that the interests of all unsecured creditors are appropriately considered. Such committees frequently retain lawyers and financial advisors, whose fees may be paid out of the estate after review by the bankruptcy court. In certain circumstances, where it appears that the value of the debtor company is sufficient to cover its debt, the United States Trustee may appoint an official committee of equity holders to represent the interest of equity holders.[75]

Second, creditors and equity holders in a chapter 11 case may participate in the development and approval of a plan of reorganization, which determines the basis upon which all creditor claims and equity interests will be resolved and how the debtor will emerge from bankruptcy. Following the bankruptcy court's approval of a disclosure statement, which describes the key provisions and risks of the proposed plan, the proponent of the plan must solicit acceptances of the plan from the requisite number of creditors and equity holders entitled to vote.[76]

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71. 11 U.S.C. § 1109 (stating that any party in interest or an indenture trustee "may raise and may appear and be heard on any issue in a case under" chapter 11).
72. *Id.* § 341; FED. R. BANKR. P. (hereinafter, the "Bankruptcy Rules") 2003(b).
73. *Id.* § 1104 (permitting any party in interest to seek the appointment of a trustee for various reasons, including fraud, dishonesty or gross mismanagement of the debtor by the current management or to seek appointment of an examiner to conduct an investigation of the debtor as appropriate, including any allegations of fraud, dishonesty or mismanagement of the debtor's current management).
74. *Id.* § 1102(a).
75. *Id.*; *In re* Emons Indus., Inc., 50 B.R. 692, 694 (Bankr. S.D.N.Y. 1985).
76. 11 U.S.C. §§ 1125, 1126.

Creditors and equity holders are organized into distinct classes of claims or interests under a proposed chapter 11 plan and are required to vote by class. Only classes that are impaired by the proposed plan and are to receive some distribution under the plan are entitled to vote to accept or reject the plan. A claim is impaired if the plan alters the legal, equitable or contractual rights to which the holders of such claims or interests are otherwise entitled.[77] In most circumstances, a plan must be approved by at least (1) a majority in number of claimholders voting in each impaired class and (2) two-thirds of the dollar amount of the claims voted in each class.[78] Classes that are not impaired by the plan are presumed to accept the plan, and classes that are to receive no distributions are presumed to reject the plan.[79] As discussed below, a bankruptcy court may confirm a plan even though not all impaired classes have voted in favor of the plan under the "cram-down" provisions of the U.S. Bankruptcy Code.[80] Following voting on the plan, the bankruptcy court must hold a hearing, upon notice to all creditors and equity holders, to determine whether the plan meets all the requirements for confirmation as set forth in section 1129 of the U.S. Bankruptcy Code.[81] Any party in interest may object to confirmation.[82]

Third, creditors may file a proof of claim and equity holders may file a proof of interest. In fact, in a chapter 11 case, unless the court orders otherwise, any creditor whose claim is not identified on the schedule of assets and liabilities filed by the debtor with the bankruptcy court must file a proof of claim before the court-imposed deadline in order to receive any distribution from the debtor.[83] Similarly, any creditor identified in the debtor's schedules as the holder of a claim, but which claim is listed as disputed, contingent, or unliquidated, must timely file a proof of claim.[84] Failure to do so in either case precludes the creditor from voting on the plan or receiving

77. *Id.* § 1124(1).
78. *Id.* § 1126(c). Plans that include permanent injunctions against the assertion of present or future tort claims (*e.g.*, injunctions prohibiting asbestos tort claimants from asserting claims against a reorganized debtor and requiring such claims to be channeled to a trust fund, *see id.* § 524(g)(2)(B)(ii)(IV)(bb)) are subject to more stringent voting requirements.
79. *Id.* § 1126(f), (g).
80. *Id.* § 1129(b).
81. *Id.* § 1128(a).
82. *Id.* § 1128(b).
83. Bankruptcy Rule 3003(c)(2). All debtors are required to file with the bankruptcy court a list of creditors that (1) identifies the amount, if any, owed to each creditor and (2) states whether such claim is contingent, unliquidated, or disputed. 11 U.S.C. § 521(1).
84. Bankruptcy Rule 3003(c)(2).

any distributions, unless the creditor obtains an order of the bankruptcy court allowing its vote or the late filing of its claim.

A proof of claim should assert all claims, even if contingent or unliquidated at the time of the bankruptcy petition date. A proof of claim executed and filed in accordance with the Bankruptcy Rules "constitute[s] prima facie evidence of the validity and amount of the claim."[85] However, a debtor (and, in most instances, other parties in interest) has the opportunity to object to the proof of claim on a variety of grounds. Usually, such objections are accomplished through so-called "omnibus objections" that attempt to disallow and expunge multiple (often hundreds of) claims in a single motion. Upon the filing of an objection, the objecting party has the initial burden to produce evidence sufficient to overcome the rebuttal presumption of the validity of the claim.[86]

§ 29:5.2 Examples from Other Jurisdictions

Most jurisdictions outside the U.S. also permit creditors and equity holders to participate in reorganization or liquidation proceedings. For example, some jurisdictions, such as Korea, provide for the appointment of a creditors committee in reorganization (or rehabilitation) proceedings of large companies.[87] To illustrate other potential participation rights, and the impact they can have on the process, plan participation rights in a few jurisdictions are described below.

[A] Mexico

Under Mexico's LCM, creditors and the debtor negotiate the plan during a 180-day conciliation phase, and any party may propose a plan to others. The conciliator submits a plan to creditors for approval when it believes the requisite support has been achieved.[88] The debtor, the court, and a majority of recognized, unsecured claims must approve the proposed reorganization plan.[89] The plan may be imposed on dissenting unsecured creditors by a majority of such creditors, if dissenting creditors receive equal treatment with

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85. Bankruptcy Rule 3001(f); *see also* 11 U.S.C. § 502(a) (stating that proofs of claim are deemed allowed, unless a party in interest objects); *In re* Reilly, 245 B.R. 768, 773 (B.A.P. 2d Cir. 2000), *aff'd*, 242 F.3d 367 (2d Cir. 2000).
86. *In re* King, 305 B.R. 152, 164 (Bankr. S.D.N.Y. 2004); *In re* St. Johnsbury Trucking Co., 206 B.R. 318, 323 (Bankr. S.D.N.Y. 1997), *aff'd*, 221 B.R. 692 (S.D.N.Y. 1998), *aff'd*, 173 F.3d 846 (2d Cir. 1999).
87. New Consolidated Insolvency Law arts. 20–22.
88. LCM art. 161.
89. *Id.* arts. 157, 163, 164.

approving creditors representing at least 30% of the unsecured debt in terms of

(1) extension of maturity; or

(2) forgiveness of principal and interest; or

(3) some combination thereof.[90]

Once approved by the court, the plan is generally binding upon all creditors.[91]

[B] Korea

Under the New Consolidated Insolvency Law of Korea, in the case of rehabilitation proceedings, the debtor or any creditor or equity holder whose claim or interest has been reported to the court may submit a draft rehabilitation plan.[92] The rehabilitation plan is formally set forth and approved over the course of three or more statutory meetings of interested parties, including creditors. At the third meeting, creditors vote on a resolution approving the draft rehabilitation plan that was deliberated at the second meeting.[93] If the plan is not approved, then a revised plan or plans may be drafted and voted on at subsequent meetings.[94] In order for the resolution to pass, it must be affirmed by (1) unsecured creditors holding unsecured rehabilitation claims totaling not less than two-thirds of the total unsecured claims within the same class, and (2) secured creditors holding secured rehabilitation claims totaling not less than three-fourths of the total secured claims within the same class.[95] Equity holders are eligible to vote on the draft rehabilitation plan if assets exceed liabilities.[96]

Once the requisite creditors or equity holders approve the draft rehabilitation plan, the court will determine whether to approve the plan based upon requirements under Korea's New Consolidated Insolvency Law.[97] Similar to the cram-down under U.S. bankruptcy law, the court may modify and approve a proposed plan to prescribe terms that protect the rights of the group of creditors who did not vote in favor of the plan, as long as one class of creditors approves the plan.[98]

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90. *Id.* art. 159.
91. *Id.* art. 165.
92. New Consolidated Insolvency Law art. 221.
93. *Id.* art. 232.
94. *Id.* art. 238.
95. *Id.* art. 237. If the rehabilitation plan contemplates the liquidation of the debtor where the debtor's going concern value is less than the liquidation value, at least four-fifths of the total secured claims within the same class must approve the plan. *Id.* arts. 222, 237.
96. *Id.* art. 146.
97. *Id.* arts. 242, 243.
98. *Id.* art. 244.

§ 29:6 Rights of Secured Creditors

It is important to understand the rights of secured creditors under the insolvency regimes that might be applicable, as these rights can vary substantially across jurisdictions and materially affect a secured creditor's recovery on its collateral and the ability of other classes of creditors or equity holders to recover on their claims or interests. Generally, every jurisdiction employs somewhat differing standards to determine what constitutes a security interest and how a creditor can properly obtain a security interest. The most prominent issue in insolvency proceedings for secured creditors is whether and the extent to which a secured creditor is able to seize its collateral or, if the debtor retains the collateral securing the security interest, the extent to which a secured creditor can obtain some remuneration for any decrease in the value of such collateral. In some jurisdictions, secured creditors are unaffected by the insolvency proceedings, allowing them to foreclose on their collateral as they see fit, whereas in other proceedings, secured creditors (and, indeed, all parties) are stayed from taking actions against the debtor or its property. Finally, in some jurisdictions, creditors are only stayed at the specific request of the debtor, while in others, such as the United States, an automatic injunction protecting the debtor and its property is invoked when an insolvency petition is filed. Because of the special nature of secured claims, however, most countries grant a number of rights and protections for the holders of secured claims, as compared with unsecured claims and interests of equity holders.

§ 29:6.1 United States

The U.S. Bankruptcy Code generally adheres to the principle that a secured creditor is entitled to priority payment out of the value of its collateral. Whether a creditor has a secured claim is determined pursuant to section 506(a) of the U.S. Bankruptcy Code, which generally provides that an allowed claim of a creditor secured by a lien on property in which the estate has an interest is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property.[99] Thus, a secured creditor will have a secured claim to the extent of the value of the collateral securing the claim, and to the extent that the claim exceeds the value of such

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99. 11 U.S.C. § 506(a). The U.S. Bankruptcy Code further defines "lien" as any "charge against or interest in property to secure payment of a debt or performance of an obligation." *Id.* § 101(37). Thus liens under the U.S. Bankruptcy Code can include voluntary liens (real property mortgages or security interests under the Uniform Commercial Code) or involuntary liens (judicial or tax liens).

collateral, the creditor will have an unsecured claim for such amount.[100]

Upon a debtor's filing of a petition under the U.S. Bankruptcy Code, the automatic stay of section 362 is invoked, which has the effect of staying, among other things, any act to obtain possession of property of the estate or exercise of control over property of the estate or to enforce any lien against property of the estate, subject yo certain exceptions.[101] Thus, upon a debtor's filing of a petition, creditors holding secured claims are enjoined from enforcing their liens on collateral (or seizing collateral) that is part of the debtor's estate. Any action by a creditor against a debtor taken in violation of the stay is void and can result in a judgment of contempt against the offending creditor, possibly including costs and attorneys' fees.[102]

The primary recourse for a creditor holding a secured claim includes (1) seeking to lift the automatic stay or (2) seeking "adequate protection" from the debtor. Adequate protection is protection against a diminution in value of a secured creditor's collateral during the course of the bankruptcy proceeding. Section 362(d) of the U.S. Bankruptcy Code permits granting relief from the automatic stay (and thus allows a secured creditor to take recourse against its collateral), among other reasons, (1) for "cause," including a secured creditor's lack of adequate protection in the collateral;[103] or (2) when the debtor lacks equity in the property and the property is not necessary to an effective reorganization.[104] Section 361 of the U.S. Bankruptcy Code includes the following examples of what can constitute "adequate protection":

(1) requiring the debtor to make a cash payment or periodic cash payments to the secured creditor;

(2) providing the secured creditor an additional or replacement lien; or

(3) or granting any other relief to the secured creditor.[105]

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100. *Id.* § 506(a).
101. *Id.* § 362(a)(3)–(5).
102. *See* Schewe v. Fairview Estates, 94 B.R. 938, 946 (Bankr. W.D. Mich. 1989) (actions taken in violation of automatic stay are void and can lead to sanctions for contempt, including attorneys' fees and possibly punitive damages pursuant to § 362(h) of the U.S. Bankruptcy Code).
103. U.S. Bankruptcy courts have found (1) a lack of adequate protection in circumstances where a creditor lacks a sufficient equity cushion in the collateral and (2) "cause" where the debtor or its principals have acted in bad faith or engaged in general malfeasance. *In re* Newpower, 233 F.3d 922 (6th Cir. 2000); *In re* 652 W. 160th St. LLC, 330 B.R. 455 (Bankr. S.D.N.Y. 2005).
104. *In re* Newpower, 233 F.2d 922; *In re* 652 W. 160th St. LLC, 330 B.R. 455.
105. 11 U.S.C. § 361.

Furthermore, the U.S. Bankruptcy Code only permits interest to continue to acquire on secured claims after the date the insolvency proceeding is filed (and reasonable fees, costs or charges provided for in the agreement underlying the claim to accrue) to the extent that the value of the secured creditor's collateral exceeds its claim amount on the date the debtor's insolvency proceeding is filed.[106]

The U.S. Bankruptcy Code allows the debtor in possession to recover, from property securing an allowed secured claim, the reasonable and necessary costs and expenses of preserving or disposing of collateral to the extent of any benefit to the holder of such claim.[107] Also, a secured creditor's collateral may be retained by a debtor for use in its business under a plan of reorganization, even if the secured creditor does not consent to such use, if, among other things, the secured creditor "retain[s] the liens securing [its] claims" and "receive[s] on account of such claim deferred cash payments totaling at least the allowed amount of such claim."[108]

§ 29:6.2 Examples from Other Jurisdictions

[A] Japan

As with U.S. law, Japanese law also recognizes security interests on real property as well as personal property.[109] There is no automatic stay of legal proceedings or enforcement claims under any of the Japanese insolvency laws other than the Corporate Reorganization Law.[110] Specifically, under the Civil Rehabilitation Law, while there is no automatic stay of secured creditors, the debtor or any creditor can petition the court for an injunction, which the court will normally allow if the court is convinced that such an injunction would meet the general interests of unsecured creditors while not unfairly affecting any lien holder's interests.[111] Thus, secured creditors may enforce their security interests without regard to the insolvency proceedings unless the debtor requests (and the court grants)

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106. *Id.* § 506(b).
107. *Id.* § 506(c).
108. *Id.* § 1129(b)(2)(A)(i).
109. 3 COLLIER INTERNATIONAL ¶ 29.05[10] (describing the various types of security interests available under Japanese law).
110. *Id.* ¶ 29.06[14].
111. *Id.* ¶ 29.06[4][a]. Additionally, the Civil Rehabilitation Law provides that a debtor has the ability to extinguish a lien upon those assets of the debtor that are "vital for the rehabilitation of the debtor" by making a cash deposit in the amount of the value (determined by the debtor or the court in the event of a dispute) of the assets so that the court can distribute such cash to the lien holders. *Id.* ¶ 29.06[14].

an injunction.[112] Similar to Civil Rehabilitation Law, under the Bankruptcy Law, no automatic stay is imposed, but an injunction can be requested by the debtor and often is at the same time that the debtor files the petition.[113] Under the Corporate Reorganization Law, during the period after the filing of the petition until the court commences a case (the so-called "gap period"), there is no automatic stay of collection efforts.[114] However, during the gap period, the debtor, a creditor, or a shareholder can file a petition for an injunction or the court can issue an injunction of its own accord.[115] Upon a court's granting of the petition and the official commencement of a corporate reorganization proceeding, compulsory execution, attachment, and foreclosure are automatically stayed.[116]

[B] Germany

There are two periods in the course of insolvency proceedings in Germany that are critical to understanding the rights of secured creditors: (1) the period after the filing of the petition, which usually lasts about up to three months and allows the court to gather all the information necessary to determine if the prerequisites for the commencement of the process are met, and (2) the period commencing after the court orders commencement of the proceeding until the debtor's assets are distributed.[117] During the first period there is no automatic stay, although the court, in order to secure the debtor's assets, may prohibit or temporarily enjoin any acts of execution on the debtor's personal property and may enjoin execution on the debtor's real property if such a request is substantiated by prima facie evidence that the stay is necessary in order to prevent the "further deterioration of the debtor's financial situation."[118] Upon the commencement of the second period, a stay is imposed, and creditors (including secured creditors) can no longer enforce their claims outside the insolvency proceedings unless their claim pertains to an asset not belonging to the estate.[119]

§ 29:7 Priority Schemes

A priority scheme in bankruptcy will often determine how the proceeds of any liquidation or reorganization are distributed. It is

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112. *Id.* ¶ 29.06[14].
113. *Id.* ¶ 29.08[3][a].
114. *Id.* ¶ 29.04[3].
115. *Id.* ¶ 29.04[3][a].
116. *Id.* ¶ 29.05[4].
117. 2 *id.* ¶ 23.04[4].
118. *Id.* ¶ 23.04[6][a].
119. *Id.* ¶ 23.04[6][a]–[b].

thus important for creditors and debtors to appreciate the differences in various jurisdictions of how claims might be treated in an insolvency proceeding. Furthermore, some insolvency laws permit the debtor or trustee to subordinate the treatment of certain types of claims and some laws provide priority treatment for certain types of unsecured claims, such as the claims of governmental taxing authorities or employees of the debtor. Each of these factors could clearly have material effects on the ultimate distribution to creditors. For instance, in Russia, secured creditors are not paid until all administrative claims, personal injury claims, and employee claims are paid.[120] Thus, secured creditors in Russia are placed in a more junior position vis-à-vis such creditors respectively, incentivizing them to perhaps keep close watch on the amount of administrative claims (a function in the United States that more heavily befalls the unsecured creditors, because secured creditors are entitled to the value of the collateral before payment of any unsecured priority or administrative claims).

The priority schemes of differing jurisdictions also have an effect on whether a debtor can meet the requirements to confirm a plan. Some countries employ strict guidelines on the treatment of differing classes of creditors in order to confirm a plan, whereas others give more discretion to a court in determining whether to confirm a plan if a debtor does not obtain the required consents. This can ultimately have a distinct impact on the leverage of various classes of creditors and equity holders in negotiating a plan and their ultimate recoveries.

§ 29:7.1 United States

The U.S. Bankruptcy Code provides a general distribution scheme in chapter 7 liquidation proceedings, which is also relevant in chapter 11, but because claims in chapter 11 reorganizations are dealt with in a plan of reorganization (which essentially acts as a settlement among creditors regarding how to treat their respective claims), the rules regarding treatment of various classes of creditors in chapter 11 can be varied by class consent in certain circumstances. In general, claims are prioritized in the following order:

(1) secured creditors,

(2) administrative creditors who benefited the estate,

(3) priority unsecured creditors,

(4) general unsecured creditors, and

(5) equity holders.[121]

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120. 3 *id.* ¶ 38.07[9].
121. 11 U.S.C. § 726.

The U.S. Bankruptcy Code lists certain unsecured claims that will have priority over other unsecured claims, such as claims for postpetition administrative expenses, up to $10,000 in individual claims for prepetition wages, salaries, prepetition claims for contributions to employee benefit plans and prepetition claims of individuals who deposited money with the debtor for the purpose of ultimately acquiring consumer property or services from the debtor.[122] It should be noted that in order to confirm a plan under section 1129 of the U.S. Bankruptcy Code, the plan must provide for the payment of all administrative claims (and most other priority claims) in full.[123] Moreover, the rights of holders of priority claims are still subject to the rights of secured creditors.[124]

Also, the absolute priority rule (often termed a "cram-down") requires that if any class of claims or equity interests does not approve a plan, then the plan can still be confirmed so long as junior classes of claims or equity interests do not receive any property under the plan and the creditors in the rejecting class are receiving at least as much as they would in a chapter 7 liquidation.[125] The U.S. Bankruptcy Code does leave open the possibility that some claims will be subordinated. Pursuant to section 510, a court can subordinate (1) claims related to damages from the purchase or sale of a debtor's securities to the level of those securities or below those securities and (2) claims based on the principles of inequitable conduct.[126]

§ 29:7.2 Examples from Other Jurisdictions

[A] Japan

The priority scheme in Japan is similar to the U.S. scheme. Generally, under the Civil Rehabilitation Act, postpetition expenses incurred for "the common interest of the creditors" is a broad category entitled "common benefit claims," which includes, among other things, expenses categorized as administrative costs in the United States and certain tax claims.[127] These "common benefit claims" can be paid as the need arises outside of the insolvency proceedings

122. *Id.* § 507(a). Within section 507(a), priority claims are prioritized and paid in the precise order listed therein.
123. *Id.* § 1129(a)(9).
124. *Id.* § 507(a).
125. 11 U.S.C. § 1129(b).
126. *Id.* § 510.
127. Kent Anderson, *Small Business Reorganizations: An Examination of Japan's Civil Rehabilitation Act Considering U.S. Policy Implications and Foreign Creditors' Practical Interests*, 75 AM. BANKR. L.J. 355, 387 (2001).

and without court approval.[128] Otherwise, claims and interests are classified and treated according to the following priorities:

(1) secured claims;

(2) common benefit claims if not already paid;

(3) priority claims (which typically include unpaid salary, bonus and severance pay);

(4) ordinary unsecured claims; and

(5) equity.[129]

Generally, only secured and unsecured creditors vote on a plan, and a plan will only provide one class each for secured and unsecured creditors, respectively.[130] There is no comparable "cram-down" provision under Japanese insolvency law, however, if the required votes under a plan are not obtained (thus giving the court the ability to terminate the insolvency proceedings), a court may amend and confirm a plan

(1) with respect to a secured creditor, by keeping its lien in place or paying the secured claim out of net sale proceeds upon the sale of the collateral;

(2) with respect to unsecured creditors, by paying an amount equivalent to what the court determines such unsecured creditors' distribution would be in a liquidation;

(3) paying the fair market value of the claim as determined by the court; or

(4) providing other fair and equitable protection.[131]

[B] Germany

The distribution scheme in Germany, by contrast, is markedly different than that in Japan and the United States. The major difference between the priority scheme in Germany and in Japan or the United States is that there are generally no priority claims other than general administrative claims and claims incurred in the course of the insolvency proceedings. Creditor claims in Germany under the German Insolvency Act are divided into the following groups:

(1) creditors with right to separate satisfaction (or secured creditors);

(2) creditors of the estate;

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128. *See id*.
129. 3 COLLIER INTERNATIONAL ¶ 29.05[18][b].
130. *Id.*
131. *Id.*

(3) insolvency creditors; and

(4) subordinate insolvency creditors.[132]

Of highest priority in German liquidation proceedings are the secured creditors, whose claims will be satisfied by the proceeds of their collateral when it has been liquidated.[133] Creditors of the estate, the next class in priority, are essentially administrative claims, or claims that are incurred in the course of the insolvency proceedings.[134] Next in priority are insolvency creditors, which are unsecured creditors (including unsecured tax claims and other claims that do not have any priority status).[135] Finally, the lowest priority claims, subordinate insolvency claims, include claims for reimbursement of a shareholder's equity-replacing loan and claims that have been consensually subordinated between a creditor and the debtor.[136]

§ 29:8 Status of Contractual Obligations

Another key issue to be considered in any reorganization or insolvency proceeding is the impact such proceedings have on the contractual obligations of a debtor. Most jurisdictions provide debtors with some opportunity to discharge, rescind, or minimize contractual obligations, subject to certain limitations. For suppliers and customers contracting with a distressed company, such rights create a potentially significant risk. For potential acquirers, however, a debtor's ability to discharge or minimize contractual obligations can be a key benefit to the insolvency process. In addition, the threat of taking such action provides the debtor (or a potential acquirer) with significant leverage to renegotiate onerous contracts.

§ 29:8.1 United States

Subject to certain exceptions, section 365(a) of the U.S. Bankruptcy Code permits a debtor to assume or reject an "executory contract" or unexpired lease during the bankruptcy case or as part of its plan of reorganization or liquidation.[137] Although the statute does

132. 2 *id.* ¶ 23.04[7].
133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.* Subordinate insolvency claims rarely receive distributions in German insolvency proceedings and must not be filed with the insolvency administrator unless specifically permitted by the insolvency court.
137. 11 U.S.C. § 365(a). Certain types of contracts and leases are subject to special provisions limiting the debtor's ability to reject them. *See, e.g., id.* § 365(h) (rejection of real property leases, where the debtor is the lessor); *id*. § 1113 (rejection of collective bargaining agreements).

not define the term "executory contract," the legislative history suggests that executory contracts are those in which performance is due to some extent on both sides.[138] Courts have struggled to fill in the details on the definition of executory contracts, with most courts adopting the so-called Countryman test, which provides that an executory contract is any contract under which the only outstanding obligation of both the debtor and the other party are so far unperformed that the failure of either side to complete performance would constitute a material breach excusing the performance of the other party.[139]

A debtor's decision to assume or reject an executory contract or unexpired lease must be approved by the bankruptcy court, which reviews the decision on the basis of a deferential business judgment standard.[140] In order to assume an executory contract or unexpired lease on which there has been a default (other than a default arising from the bankruptcy filing, insolvency, or other financial conditions of the debtor, which the U.S. Bankruptcy Code invalidates), the debtor must

(1) cure, or provide adequate assurance that it will promptly cure, the monetary defaults;

(2) compensate, or provide adequate assurance of compensation, for actual pecuniary loss; and

(3) provide adequate assurance of future performance under the contract or lease.[141]

Alternatively, a debtor may seek to reject the executory contract or unexpired lease, thereby giving the nondebtor party a right to assert a claim based on the rejection or breach of its contract rights.[142] In general, any such claim is considered a prepetition claim, deter-

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138. *See* H.R. REP. NO. 95-595, at 347 (1977); S. REP. NO. 95-989, at 58 (1978).

139. *In re* Terrell, 892 F.2d 469 (6th Cir. 1989); Sharon Steel Corp. v. Nat'l Fuel Gas Distribution Corp., 872 F.2d 36 (3d Cir. 1989). The Countryman test is named after Professor Vern Countryman, who published a leading article on the subject of executory contracts. *See* Vern Countryman, *Executory Contracts in Bankruptcy*, Part I, 57 MINN. L. REV. 439, 460 (1973).

140. Nat'l Labor Relations Bd. v. Bildisco & Bildisco, 465 U.S. 513, 523 (1984); Control Data Corp. v. Zelman (*In re* Minges), 602 F.2d 38, 42 (2d Cir. 1979); *In re* G Survivor Corp., 171 B.R. 755, 757 (Bankr. S.D.N.Y. 1994).

141. 11 U.S.C. § 365(b)(1)(A)–(C).

142. *Id.* § 365(f). There are a number of specific provisions giving special protections to certain types of executory contracts and unexpired leases, including, for example, non-residential real property leases (*id.* § 365(d)(3), (h)), shopping center leases (*id.* § 365(b)(3)), and intellectual property licenses (*id.* § 365(n)).

mined as of the date of the commencement of the bankruptcy proceedings.[143]

§ 29:8.2 Examples from Other Jurisdictions

Many jurisdictions outside the United States also permit a debtor to reject, rescind, or minimize contractual obligations. Approaches taken under Korean and Mexican reorganization law are described below as examples.

[A] Korea

Under Korea's New Consolidated Insolvency Law, subject to certain exceptions, the receiver (or the debtor if no receiver is appointed) may either rescind executory contracts or assume them and demand performance from the other party.[144] Further, the nondebtor party may demand that the receiver make a decision as to whether it will rescind or assume the contract. If the receiver (or the debtor) then fails to make a decision within thirty days of the request, the receiver (or the debtor) will lose the right to rescind the contract and it is deemed to have assumed the contract.[145] If the receiver (or the debtor) elects to rescind, the other party is entitled to seek any damages resulting from such termination as a rehabilitation claim under the rehabilitation plan.[146] If the contract is assumed by the receiver (or the debtor), the claims of the other party are claims for common benefit (akin to administrative claims under the U.S. Bankruptcy Code), which are repaid when due and are not subject to the rehabilitation plan.[147] While under the former Corporate Reorganization Law there was no time limit by which the receiver may rescind an executory contract, the New Consolidated Insolvency Law imposes a deadline after which the receiver (or the debtor) may not rescind an executory contract. For instance, the receiver (or the debtor) may not rescind an executory contract after the completion of the second interested parties' meeting convened for the deliberation of the draft rehabilitation plan.[148]

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143. *Id.* §§ 365(g), 502(g). Rejection damages for non-residential leases under which the debtor is a lessee are capped under 11 U.S.C. § 502(b)(6).
144. Certain types of contracts (*e.g.*, collective bargaining agreements, repurchase agreements, and securities settlement agreements) are subject to special treatment.
145. New Consolidated Insolvency Law art. 119 ¶ 2.
146. *Id.* art. 121.
147. *Id.* art. 179 item 7.
148. *Id.* art. 119 ¶ 1.

In the case of a bankruptcy proceeding, an executory contract may be rescinded or assumed by the court-appointed trustee.[149] However, unlike the rehabilitation proceedings, there is no time limit with respect to the exercise of such right by the trustee. The other party may demand that the receiver make a decision as to whether it will rescind or ratify the contract. If the receiver (or the debtor) then fails to make a decision within a reasonable time period, it is deemed to have been rescinded.[150] If the contract is rescinded, the other party is entitled to exercise its damage claims as bankruptcy claims.[151] If the contract is assumed, then the other party's claims are treated as estate claims.[152]

[B] Mexico

Mexico's LCM provides that, subject to certain exceptions, contracts for which performance is due as of the date of the insolvency declaration must be performed, unless the conciliator opposes such performance in the interest of the estate.[153] Modifications that both worsen contractual terms and arise solely by virtue of the entry of an insolvency declaration are null and void.[154] The counterparty to the contract may demand that the conciliator declare whether performance will be opposed.[155] If the conciliator does not object, the debtor must perform or secure performance of the contract; if the conciliator opposes performance or does not reply to the counterparty's demand, the counterparty can rescind the agreement upon notice to the conciliator.[156] Rejection of the contract by the conciliator gives rise to damages in the form of an unsecured claim.[157] If there is an existing default under the contract, the counterparty can demand a postacceptance guarantee and a cure of the existing default.[158] Some contracts or leases, such as employment agreements and real property leases, cannot be rescinded,[159] or are subject to limitations on rescission.[160]

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149. *Id.* art. 335 ¶ 1.
150. *Id.* art. 335.
151. *Id.* art. 337.
152. *Id.* art. 473 item 7.
153. LCM art. 86.
154. *Id.* art. 87.
155. *Id.* art. 92.
156. *Id.*
157. INTERNATIONAL STATEMENT OF MEXICAN LAW, *supra* note 46, at 64.
158. *Id.*
159. LCM art. 107.
160. *See*, *e.g.*, *id*. art. 108 (fixed price construction contracts); *id*. art. 106 (real estate leases).

§ 29:9 Financing of Company Undergoing Restructuring

It is also important to understand a debtor's ability to obtain postpetition financing after it files for bankruptcy protection. As cash flow is the backbone of any business, a debtor's ability to obtain financing materially affects its ability to survive in insolvency proceedings. Thus, such financing can ultimately increase the recoveries of existing creditors as it enhances the debtor's ability to move through the critical preliminary stages of an insolvency proceeding and ultimately reorganize as a going concern or liquidate its assets. Post-insolvency-proceeding financing, however, is usually not available without some risks. As described further below, in some jurisdictions, courts are authorized to grant post-insolvency-proceeding lenders so-called "priming liens" that could trump the interests of other secured and unsecured creditors. In other jurisdictions, post-insolvency-proceeding financing is not given "super-priority" status and is given the status of administrative claims (which are generally paid after secured claims, but before unsecured claims), and still in other jurisdictions, such financing might be permitted on a secured basis only if there is unencumbered property, or only on an unsecured basis. Whether a jurisdiction allows a debtor to obtain post-insolvency-proceeding financing and the priority such financing is granted could materially affect the potential distributions of all other creditors.

§ 29:9.1 United States

Under the U.S. Bankruptcy Code, debtors are authorized to obtain credit pursuant to section 364 in accordance with the following four methods. First, the debtor can incur unsecured indebtedness "in the ordinary course of business" and the lender will have an administrative claim in the amount so lent.[161] This provision is generally available for the protection of trade creditors that extend credit to the debtor. Second, the debtor can incur unsecured indebtedness outside of the ordinary course of business if approved by the court after notice and a hearing.[162] Third, if the debtor cannot obtain unsecured credit, the court may authorize the granting of a "super-priority" administrative claim (a claim having priority over all other administrative claims) or a lien to a lender in any of the debtor's unencumbered property or a junior lien on encumbered property.[163]

161. 11 U.S.C. § 364(a).
162. *Id.* § 364(b).
163. *Id.* § 364(c).

Finally, if the debtor cannot otherwise obtain credit through the granting the protections described in the previous sentence, the U.S. Bankruptcy Code authorizes the debtor to obtain credit through the granting of a security interest on property already subject to a lien that is "senior or equal" to such preexisting lien (often referred to as a "priming" or "superpriority" lien).[164] A court's granting of a priming lien requires that the lender whose lien is primed be adequately protected (described above).

§ 29:9.2 Examples from Other Jurisdictions

[A] Japan

In Japan, under the Civil Rehabilitation Law, a debtor can borrow money to the extent such borrowing is indispensable for continuing the business of the debtor.[165] If the debtor seeks to obtain financing after the filing of the petition, but prior to the commencement of the proceeding, it is required to obtain the consent of the court or the supervisor in a civil rehabilitation or the provisional trustee in a corporate reorganization.[166] The creditor extending the postpetition financing will have a priority claim for such financing as a "common benefit claim" (discussed above), but there is no comparable rule allowing for "superpriority" status of either a lien or claim.[167] This obviously creates a disincentive for lenders to provide such financing, because unless the debtor has unencumbered assets, a preexisting secured lender of the debtor would have to voluntarily subordinate its security interest in order to provide the new lender with any security.

[B] Germany

Under German insolvency law, the insolvency administrator can borrow money and other credits in order to secure the necessary financing for the continuation of the debtor's business.[168] Such indebtedness is given treatment as claims of a "creditor of the estate," which are paid as they are incurred during the course of the insolvency proceedings and can be enforced by the lender without regard to the proceedings (unless the estate cannot discharge in full all administrative claims and other "creditors of the estate").[169] Further, if

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164. *Id.* § 364(d).
165. Anderson, *supra* note 127, at 387–88.
166. *Id.*
167. *Id.*
168. 2 COLLIER INTERNATIONAL ¶ 23.06[2].
169. *Id.*

a debt is to be incurred that would significantly burden the estate, the insolvency administrator is required to obtain the consent to the loan by the creditors' committee (normally appointed by the court) or the creditors' assembly (if a committee has not been appointed).[170]

§ 29:10 Avoidance Actions

A fundamental concern in any insolvency proceeding is the extent to which a preinsolvency transaction with the debtor can be avoided or rescinded. Many jurisdictions permit a debtor, trustee, or receiver to avoid transactions occurring in a specific time period before the commencement of the proceeding, typically on the basis that such transaction

(1) was intended to evade the claims of other creditors, or

(2) preferred the transferee over other creditors, either because the transfer was for less than its reasonable value or because the transfer reduced assets available for distribution to other creditors when the debtor was insolvent.

Avoidance considerations are important to parties that deal with distressed companies. First, avoidance actions create the risk that funds or assets received from a distressed company will have to be returned to the debtor for distribution to the estate. Second, in some jurisdictions, avoidance actions, particularly fraudulent transfers, can give rise to personal or criminal liability.

§ 29:10.1 United States

[A] Preferences

In the United States, certain prebankruptcy transactions are avoidable if they are deemed to provide preferential treatment to certain creditors.[171] Under the U.S. Bankruptcy Code, transfers of a debtor's property that are made for the benefit of a non-insider creditor, on account of an antecedent debt, when the debtor is insolvent, and within ninety days of the commencement of the bankruptcy proceedings can be avoided.[172] Additionally, in order to be avoidable,

170. *Id.*
171. 11 U.S.C. § 547(b).
172. In the case of insiders, the preferential reach-back period is one year before the commencement of bankruptcy proceedings. Under 11 U.S.C. § 547(f), "the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition."

the transfer must have conferred on the creditor more than it would have received if the debtor's estate were liquidated under chapter 7 of the U.S. Bankruptcy Code.[173] A debtor (or debtor representative) challenging such a transaction does not need to prove an improper or unlawful intent.

Not all such transfers, however, are avoidable preferences. There are certain well-defined exceptions to encourage creditors to continue to deal with financially troubled entities. For example, payments made in the ordinary course of business according to ordinary business terms between the parties are not avoidable preferences.[174] Under the new-value exception, transfers otherwise considered preferential that extend new value to the debtor either (1) in a contemporaneous exchange or (2) subsequent to the transfer might not be avoided.[175]

[B] Fraudulent Conveyances

Fraudulent conveyances (or transfers) are proscribed both by the U.S. Bankruptcy Code[176] and by relevant state law. Section 548 of the U.S. Bankruptcy Code provides after-the-fact protection to the debtor's creditors by invalidating certain transactions engaged in by the debtor. A fraudulent conveyance consists of a transfer of a debtor's property that was made, or an obligation that was incurred by a debtor, which either (1) had as its purpose an intent to hinder, delay, or defraud the debtor's creditors (so-called actual fraud, which may be proven by various objective indicia, known as "badges of fraud"),[177] or (2) was made while the debtor was in a precarious financial condition, and the transaction did not provide the debtor with a reasonably equivalent value in exchange for the item transferred or the obligation incurred.[178] Additionally, the trustee or debt-

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173. *Id.* § 547(b)(5).
174. *Id.* § 547(c)(2).
175. *Id.* § 547(c)(4).
176. *Id.* § 548. There are several "safe harbors" that exempt certain types of financial transactions from avoidance under federal fraudulent conveyance laws. *See*, *e.g.*, *id*. §§ 555, 559–61.
177. Section 548(a)(1)(A) provides for avoidance of any transfer made with "actual intent to hinder, delay or defraud" any present or future creditor. *Id.* Because direct evidence of actual intent is difficult to demonstrate, an inference of actual intent may be drawn from various "badges of fraud," such as the (1) absence of or negligible amount of consideration, (2) value which the transfer took away from the debtor's estate, (3) time in which the transfer occurred, (4) relationship between the debtor and the transferee, including whether the transferee was an insider of the debtor, and (5) debtor's financial position at the time of the transfer.
178. § 548(a)(1)(B). Unlike the provisions related to preference actions, under section 548, there is no presumption that the debtor was insolvent during the ninety days before bankruptcy.

or in possession may avoid prebankruptcy transactions based on applicable state law.[179] The statutory reach-back period for avoiding a fraudulent conveyance under the U.S. Bankruptcy Code is two years preceding the commencement of bankruptcy proceedings. However, the reach-back period is usually significantly longer under most state statutes.

§ 29:10.2 Examples from Other Jurisdictions

[A] England

English law permits reversal of certain transactions entered into by the debtor before insolvency. There are seven principal heads upon which preinsolvency transactions can be avoided:

(1) preferences;[180]

(2) transactions at an undervalue;[181]

(3) extortionate credit transactions;[182]

(4) floating charges given otherwise than for specified forms of new value;[183]

(5) registrable, but in fact unregistered, security interests;[184]

(6) dispositions of the company's property made without leave of the court following presentation of a winding up petition;[185] and

(7) transactions in fraud of creditors.[186]

In addition, the liquidator and the administrator are entitled to avail themselves of any action the company may have under the general law to avoid ostensibly binding obligations (for example, for misrepresentation, common law fraud, doctrines of mistake and frustration, etc.).

Preferences deserve special mention. Under English law, a preference arrangement will be voidable by the court if

179. Most states have enacted either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act.
180. Insolvency Act 1986 § 239.
181. *Id.* § 238.
182. *Id.* § 244.
183. *Id.* § 245.
184. Companies Act 1985 § 395.
185. Insolvency Act 1986 § 127.
186. *Id.* § 423.

(1) the company has gone into administration or insolvent liquidation;

(2) the arrangement in question was entered into within two years (if made with a person connected with the company) or otherwise six months, prior to the commencement of the administration or winding-up;

(3) the company was unable to pay its debts as they fell due at the time of the arrangement in question, or became unable to do so as a result;

(4) the arrangement constituted a preference (that is, it has the effect of putting a person in position better than the one he would be in on the insolvency of the company had the arrangement not been entered into); and

(5) the company, in giving the preference, must have been influenced by a desire to produce the result described in clause (4) above (but this desire is presumed in the case of an arrangement with a company-connected person).

Crucially, case law has illustrated that the desire to prefer can be negated where the company was being subjected to commercial pressure to grant the preference on the basis that the outcome, although predictable, was not desired.[187]

[B] Korea

Payments or other acts (such as granting security interests) performed by a company in corporate rehabilitation or bankruptcy may be avoided by the receiver or the trustee if, in general, they fall in one of the following four categories:

(1) malicious payments or acts with the actual intent to harm the creditors;

(2) any act detrimental to the creditors which was done after suspension of payment or filing for an insolvency proceeding;

(3) payments for obligations or granting of security interest without preexisting obligation to do so if such act was made after, or within sixty days before, suspension of payment or filing for an insolvency proceeding (under the New Consolidated Insolvency Law, the suspect period will be extended from sixty days to one year if a company-related party is the counterparty of a transaction); and

187. Re M.C. Bacon Ltd., [1990] B.C.C. 78, per Millett J (holding that the grant of security to the company's bank in the face of its foreclosure threats did not satisfy the intention requirement).

(4) any gratuitous act performed after, or within six months before, the suspension of payment or filing for an insolvency proceeding (under the New Consolidated Insolvency Law, the six-month period will be extended to one year if a specially related party is the counterparty of such action).[188]

§ 29:11 Liability for Directors and Officers

For any multinational company facing financial distress, a key issue is whether directors, officers, and other insiders may be exposed to potential personal liability, including criminal liability, based on actions or inactions occurring prior to the insolvency proceeding or upon entering the so-called "zone of insolvency." The liability exposure for officers, directors, and other insiders varies greatly from jurisdiction to jurisdiction. As with any issue, once a company enters the "zone of insolvency," officers, directors, and other insiders should consult local counsel in governing jurisdictions to assess the potential scope of liability and steps that need to be taken to address the potential exposure.

§ 29:11.1 United States

In the United States, there is no single statute or set of rules governing potential liability for directors and officers of a distressed or insolvent company. In general, according to the so-called "internal affairs" doctrine, liability of officers and directors of the debtor is governed by the law of the jurisdiction in which the debtor was formed. Other laws, such as federal securities laws and the U.S. Bankruptcy Code, also impact such liabilities.

Some courts have suggested that during the period immediately before a company's insolvency (that is, the "zone of insolvency"), its directors and officers may owe fiduciary duties to the company's creditors, as well as its shareholders.[189] Recent case law in Delaware significantly undercuts this view.[189.1] Once a corporation becomes

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188. New Consolidated Insolvency Law arts. 100, 101, 391, 392.

189. *See, e.g., In re* Hechinger Inv. Co. of Del., 327 B.R. 537, 547–49 (D. Del. 2005); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 De. Ch. LEXIS 215, at *108 n.55 (Del. Ch. Dec. 30, 1991).

189.1. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. Sup. Ct. 2007) (holding that "no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency" and that when "a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners").

insolvent, however, the directors' and officers' fiduciary duties to the corporation generally extend to the creditors.[189.2] Even so, creditors will likely have only derivative standing to assert such claims on behalf of the insolvent corporation and may be barred, as creditors, from asserting direct claims against directors and officers.[189.3] Like any person, directors and officers who receive such property during the applicable avoidance period may be required to return a fraudulent conveyance or preferential payment.[190] In addition, in some jurisdictions, they may be subject to claims for damages.[191] Although fraudulent conveyance statutes do not specifically impose personal liability on officers and directors who authorize fraudulent conveyances, those that do so may be vulnerable to allegations that they have breached their fiduciary duties or are personally liable for such decisions.[192]

Importantly, however, the business judgment rule generally shields directors and officers from liability arising from decisions that are made on an informed, good-faith basis, with an honest belief that the decision is in the corporation's best interest, as long as such decisions do not involve direct self-interest or self-dealing.[193]

Following the filing of the bankruptcy petition, non–ordinary course decisions made by the debtor's directors and officers are subject to bankruptcy court approval,[194] thereby providing further protection to directors and officers with respect to decisions made on an informed, good-faith basis. The U.S. Bankruptcy Code contains a list of specific duties to be undertaken by trustees, which also applies to debtors in possession under chapter 11.[195] In addition to

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189.2. Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985); Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 461 (6th Cir. 1982); Production Resources Group, L.L.C. v. NCT Group, Inc., C.A. No. 114-N, 2004 WL 2647593, at *13 (Del. Ch. Nov. 17, 2004).

189.3. *Gheewalla*, 2007 WL 1453705, at *7–*8.

190. 11 U.S.C. §§ 547, 548.

191. *See, e.g., In re* Penn Packing Co., 42 B.R. 502, 503–07 (Bankr. E.D. Pa. 1984) (holding that, on a showing of proper facts, state fraudulent conveyance law permitted imposition of damages on shareholders and directors that received property under fraudulent conveyance, in addition to the return of the property fraudulently conveyed).

192. *See, e.g.*, Clarkson Co. Ltd. v. Shaheen, 660 F.2d 506, 512–13 (2d Cir. 1981) (holding that officers and directors may be personally liable for breach of duty of care owed to creditors during insolvency); *see also* APS Sports Collectibles v. Sports Time, Inc., 299 F.3d 624, 630 (7th Cir. 2002) (affirming dismissal of lender's suit against officers and directors on fraudulent conveyance claims under state law).

193. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

194. 11 U.S.C. § 363(b) (providing that the use, sale, or lease of a debtor's property outside of the ordinary course is subject to court approval).

195. *Id.* § 1106; *id*. §§ 704(2), 704(5), 704(7), 704(8), 704(9) (by reference).

these specific duties, as a fiduciary, the trustee or debtor in possession owes the debtor's estate and its creditors a general duty of loyalty.[196]

§ 29:11.2 Examples from Other Jurisdictions

The potential obligations and liabilities of officers, directors, and other insiders vary greatly from jurisdiction to jurisdiction. In many jurisdictions, such individuals may be exposed to potential obligations and liabilities during the "zone of insolvency."[197] In some instances, certain actions taken by officers, directors, and other insiders during this period may give rise to criminal liability.

For example, directors of an English company are subjected to stringent fiduciary duties to act bona fide in the best interests of the company. When a company is solvent, this duty towards the company is broadly equated with the interests of the shareholders. When a company is insolvent, or in a questionable state of solvency, the focus of the directors' duties to the company is equated instead to the company's creditors, as the main parties in interest.[198] The liquidator and administrator, having all the powers to act on behalf and in the name of the company may, in circumstances where this duty would appear to have been breached, sue the directors for breach.[199] The liquidator and administrator can also bring actions to enforce directors' common law duties of care and skill.[200]

In addition, a liquidator (but not an administrator) can bring claims against current and former directors (whether formally appointed or not, and including a "shadow director") for wrongful trading and may seek an order from the court that the directors be made personally liable for some or all of the debts of the company.[201] The court will make such an order where (1) the company is in insolvent liquidation; and (2) at some time prior to the commencement of such liquidation, the directors knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation. The test of the directors' conduct is both objective

196. Commodity Futures Trading Comm'n, 471 U.S. 343; Wolfe v. Weinstein, 372 U.S. 633 (1963); Mosser v. Darrow, 341 U.S. 267 (1951).
197. For a useful summary of the potential obligations and liabilities of officers, directors and insiders during the "zone of insolvency" in various jurisdictions, see DIRECTORS IN THE TWILIGHT ZONE II (INSOL Int'l 2005), which is published by the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) and can be ordered from INSOL's website at www.insol.org.
198. W. Mercia Safetywear v. Dodd, [1988] B.C.L.C. 250.
199. Such actions may be brought in the company's name (as the recipient of the duty) or under the umbrella misfeasance procedure provided by section 212 of the Insolvency Act 1986.
200. Re D'Jan of London, [1993] B.C.C. 646; Insolvency Act 1986 § 212.
201. Insolvency Act 1986 § 214.

and subjective, the directors being deemed to possess both (1) the general knowledge skill and experience that may reasonably be expected of a person carrying on the same functions as those carried on by the director in question, and (2) the level of knowledge and skill such director actually has.

There is a defense for individual directors if they can show that they took "every step with a view to minimizing the potential loss to the company's creditors" that they ought to have taken.[202] Courts, however, treat this defense very restrictively. For example, simply resigning will not insulate a director from liability. If the court makes a wrongful trading order against a director, it may also disqualify that director under the Company Directors Disqualification Act of 1986 from acting as a director of an English company for a period usually between three and ten years (the statutory maximum is fifteen years), depending on the seriousness of the conduct, and breach of such an order carries criminal sanction and personal liability for any company debts.[203]

Another source of potential exposure is "fraudulent trading," which occurs when an officer, director, or any other person involved or dealing with an insolvent company is involved with carrying on the business or dealing with the company in a manner with intent to defraud creditors.[204] Given the requirement to prove fraud and the clear overlap with wrongful trading, successful fraudulent trading actions are relatively uncommon, but do allow for actions to be brought against contractual counterparties and others outside of the directorial function. Additional actions giving rise to personal and potentially criminal liability include fraud in anticipation of winding up the business (for example, concealing company assets, pledging or disposing of certain property obtained on credit and not yet paid for),[205] transactions in fraud of creditors (for example, causing removal of company property since, or within two months before, the date of an unsatisfied judgment),[206] destruction or falsification of a company's books,[207] and material omissions from public statements relating to a company's affairs.[208] Some actions, such as fraudulent trading and falsification of books, can give rise to criminal liability.[209]

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202. *Id.* § 214(3).
203. Re Sevenoaks Stationers (Retail) Ltd., [1991] Ch. 164, per Dillion LJ.
204. Insolvency Act 1986 § 213.
205. *Id.* § 206.
206. *Id.* § 207.
207. *Id.* § 209.
208. *Id.* § 210.
209. *Id.* § 209 (falsification of books); Companies Act 1985 § 458 (fraudulent trading).

§ 29:12 Ancillary Proceedings and International Insolvency Treaties

The often-conflicting insolvency laws of various jurisdictions have created thorny international disputes over how to deal with multiple insolvency proceedings in various jurisdictions, where a debtor's assets that are located all over the globe. The legal response to multinational insolvencies and the issues created thereby are encapsulated in two major international treaties: (1) the Model Law and its recent adoption in the United States as chapter 15 to the U.S. Bankruptcy Code, and (2) the European Regulation. Essentially, the Model Law and the EU Regulation create a comprehensive framework for dealing with insolvencies that impact multiple jurisdictions. The Model Law and the EU Regulation are related. In fact, although the EU Regulation was passed subsequent to UNCITRAL's adoption of the Model Law, the EU Regulation's origin and the concepts underpinning it were developed prior to UNCITRAL's formulation of the Model Law.[210]

§ 29:12.1 The Model Law and Chapter 15

The Model Law has now been adopted through legislation in the British Virgin Islands, Colombia, Eritrea, Great Britain, Japan, Mexico, New Zealand, Northern Ireland, Poland, Romania, South Africa, Serbia, Montenegro, and the United States. The Model Law does not provide guidelines for dealing with conflicts of law, nor does it provide substantive rules of bankruptcy law or change domestic law, except as necessary to permit results that are fair and sensible from a worldwide perspective. Rather, the Model Law is a procedural vehicle for cooperation among courts and deals with judicial cooperation during ancillary proceedings across other jurisdictions once a primary proceeding has commenced. In this context, the crux of the Model Law is the principle of recognition of foreign judgments in the adopting country: Each country adopting the Model Law must recognize judgments either of the foreign primary or the foreign secondary proceedings, unless such recognition would manifestly conflict with domestic public policy.[211] The Model Law covers four main areas:

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210. Jay Lawrence Westbrook, *Multinational Enterprises in General Default: Chapter 15, the ALI Principles, and the EU Insolvency Regulation*, 76 AM. BANKR. L.J. 1, 2–3 (2002) ("Beyond doubt, an important factor in [creating the Model Law] was the expertise developed by the delegates from the EU member states in the course of creating the EU Regulation.").

211. MODEL LAW art. 6 ("Nothing in this Law prevents the court from refusing to take an action governed by this Law if the action would be manifestly contrary to the public policy of this State."); *id.* art. 17(1).

(1) access of foreign representatives and creditors to local courts;

(2) recognition of a foreign proceeding and relief to be granted in connection therewith;

(3) cooperation between foreign courts and foreign representatives; and

(4) concurrent plenary proceedings.

Of primary importance in appreciating the nuances of the Model Law is an understanding of the distinction between a "foreign main proceeding" and a "foreign non-main proceeding," because the difference between being recognized as either will affect how such proceeding is treated by the adopting nation's courts and what specific provisions of the Model Law will apply. A "foreign main proceeding" is "a foreign proceeding taking place in the State where the debtor has the centre of its main interests," whereas a "foreign non-main proceeding" is "a foreign proceeding, other than a foreign main proceeding, taking place in a State where the debtor has an establishment."[212] The distinction between the concepts is important because once a local court recognizes a foreign main proceeding, this recognition carries with it an automatic stay of individual proceedings and an automatic suspension of the debtor's right to dispose of its assets.[213] There is no automatic stay and suspension effect in the case of a foreign non-main proceeding.

In order to commence a proceeding under the Model Law, a foreign representative[214] shall file an application with the court accompanied by

(1) a decision commencing the foreign proceeding and appointing the foreign representative;

(2) a certificate from the foreign court affirming the existence of the foreign proceeding and appointment of the foreign representative; or

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212. *Id.* art. 2(a)–(c). The term "establishment" is defined as "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services." *Id.* art. 2(f). While the Model Law does not contain a definition of the term "centre of main interests," it does provide that, in the absence of proof to the contrary, "the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of the debtor's main interests." *Id.* art. 16(3).

213. *Id.* art. 20(1)(a)–(c). Additionally, under chapter 15 of the U.S. Bankruptcy Code, certain enumerated provisions of the U.S. Bankruptcy Code will automatically apply upon recognition of a foreign main proceeding, but not of a foreign non-main proceeding. *See, e.g.*, 11 U.S.C. § 1520(a).

214. "Foreign representative" is defined as "a person or body, including one appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of the foreign proceeding." MODEL LAW art. 2(d).

(3) in the absence of (1) or (2), any other evidence acceptable to the court establishing the existence of the foreign proceeding and appointment of the foreign representative.[215]

After the filing of the petition, but before the court rules on the petition, the court can grant immediate relief if the foreign representative can show that such "relief is urgently needed to protect the assets of the debtor or the interests of the creditors."[216] Under the Model Law, a court will recognize a foreign proceeding where

(1) the foreign proceeding is main or non-main;

(2) the foreign representative is a person or body; and

(3) the petition meets the requirements set forth above.[217]

As noted above, upon a court's granting of recognition to a foreign main proceeding, three types of relief are automatically applicable:

(1) stay of actions or proceedings against the debtor concerning its assets or obligations;

(2) stay of execution against the debtor's assets; and

(3) suspension of debtor's right to transfer, encumber, or dispose of any assets.[218]

Additionally, the Model Law permits a court to grant additional relief to main or non-main proceedings "where necessary to protect the assets of the debtor or the interests of the creditors."[219]

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215. *Id.* art. 15(2). These requirements are intended to streamline the process for obtaining relief under the Model Law.

216. *Id.* art. 19. Under chapter 15 of the U.S. Bankruptcy Code, the criteria for granting immediate relief are based on the standards that U.S. courts generally use in determining whether to grant injunctive relief, such as a temporary restraining order or an injunction. 11 U.S.C. § 1519.

217. MODEL LAW art. 17.

218. *Id.* art. 20.

219. *Id.* art. 21. Additionally, under chapter 15 of the U.S. Bankruptcy Code, U.S. courts have the ability to grant "additional assistance" to foreign representatives upon the grant of recognition, beyond the relief enumerated in §§ 1519, 1520 and 1521 (as incorporated into chapter 15 from the Model Law), where consistent with the principles of comity and where such additional assistance will reasonably ensure (1) just treatment of creditors; (2) protection of U.S. creditors from prejudice and inconvenience; (3) prevention of fraudulent transfers; (4) distributions substantially in accordance with the order prescribed by the U.S. Bankruptcy Code; and (5) provision of a fresh start for individual debtors. 11 U.S.C. § 1507(b). This essentially tracks the language of old section 304, which formerly governed U.S. recognition of foreign proceedings, before adoption of chapter 15.

Finally, the Model Law provides specific rules to govern the cooperation of courts of adopting nations with foreign courts and foreign representatives.[220] Specifically, article 25 provides that "the court shall cooperate to the maximum extent possible with foreign courts or foreign representatives."[221] Article 25(2) gives courts specific authorization to communicate directly with such a foreign court or foreign representative in order to avoid the need for procedural formalities that might otherwise cause delay.[222] Finally, article 27 provides examples of the forms of cooperation authorized under the Model Law, including

(1) the appointment of a person or body to act at the direction of the court;

(2) communication of information by any means considered appropriate by the court;

(3) coordination of the administration and supervision of the debtor's assets and affairs;

(4) approval or implementation by courts of agreements concerning the coordination of proceedings; and

(5) coordination of concurrent proceedings regarding the same debtor.[223]

The U.S. version of the Model Law (chapter 15 of the U.S. Bankruptcy Code), which went into effect on October 17, 2005, tracks the language of the Model Law in great part. As noted above, however, there are some differences. One of the primary differences is that upon recognition of a foreign main proceeding under chapter 15, certain other sections of the U.S. Bankruptcy Code (which, prior to chapter 15's adoption, were not applied to ancillary cases under now-repealed section 304) will apply.[224] For example, upon recognition of a foreign main proceeding, section 361 (providing examples of "adequate protection," discussed above) and section 362 (providing for the imposition of the automatic stay) will apply with respect to the foreign debtor and its property.[225] Other examples are section 363 (governing postpetition transactions outside the ordinary

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220. MODEL LAW arts. 25–27.
221. *Id.* art. 25.
222. *Id.* art. 25(2).
223. *Id.* art. 27.
224. 11 U.S.C. § 1520(a).
225. *Id.* § 1520(a)(1). Such application makes applicable the U.S. exceptions and limitations to the restraints imposed on creditors, debtors, and others in a case under chapter 15 and allow a creditor to seek relief from the automatic stay under § 362(d).

course of business), section 549 (governing the avoidance of a transfer of property of the estate), and section 552 (governing the postpetition effects of security interests granted prior to the petition date).[226]

§ 29:12.2 The EU Regulation

The EU Regulation's purpose, like the Model Law's, is to create a cross-border insolvency system based on common rules of mutuality and cooperation. It applies to all collective insolvency proceedings that entail the partial or total divestment of a debtor that has its center of main interests in a member state (other than Denmark, which did not participate in adopting the EU Regulation). The EU Regulation can be divided into the following subsections:

(1) determining the jurisdiction of the main insolvency proceeding;

(2) choice of law rules;

(3) ensuring the recognition and enforcement of judgments;

(4) providing for the possibility of secondary proceedings;

(5) creating duties for liquidators in multiple proceedings to communicate and cooperate; and

(6) guaranteeing information for creditors and their rights to make claims.[227]

The EU Regulation provides that the member state in which a debtor has its "centre of main interests" has jurisdiction to open the main insolvency proceeding.[228] The main proceeding has universal scope because it aims to administer all the debtor's assets.[229] The law applicable to the main proceeding is the law of the member state in which the proceeding was opened and it determines all the

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226. *Id.* § 1520(a)(2). Application of these sections will add to the powers of a foreign representative to operate the debtor's business and exercise the powers of a trustee, but will also limit the foreign representative's ability to take actions outside of the ordinary course with respect to U.S. assets and operations by requiring U.S. court approval for such actions. *See id.* § 363(b)(1) ("The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.").

227. EU Regulation 1346/2000, 2000 O.J. arts. 3, 4, 15, 16, 27, 31, 40.

228. *Id.* art. 3(1).

229. *Id.* preamble ¶ 13.

substantive and procedural aspects of the proceeding.[230] The opening of a main proceeding will provide automatic recognition, meaning that the opening of the main proceeding yields the same effect in other member states as under the law of the state where the proceeding was opened.[231] Upon the opening of a main proceeding, a liquidator is appointed, whose primary job is to oversee the liquidation of a debtor's assets or the administration of its affairs.[232]

The EU Regulation also recognizes and gives debtors the ability to open secondary proceedings in order to protect the interests of local creditors or to aid and support the main proceeding.[233] Secondary proceedings can be requested by either the main liquidator or any other person or authority empowered under the domestic law in the state in which the secondary proceeding is requested, but only if the debtor has an "establishment" in that member state.[234] Secondary proceedings are limited in scope under the EU Regulation, as their effects are limited to those assets within the state of the opening of secondary proceedings and to the recovery of assets removed from the state in which such proceedings were opened.[235] Courts in the secondary proceeding also appoint a liquidator, whose responsibilities are like those of the main liquidator, but whose scope of authority is limited to the assets within the state of the opening of secondary proceedings.[236] Finally, as the main proceeding is intended to have paramount control over any secondary proceedings, the main liquidator can intervene in the secondary proceedings.[237]

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230. *Id.* art. 4(2). The law of the main proceeding will also govern, *inter alia*, the assets that will form the estate, the powers of the debtor and liquidator, the effects of the insolvency on contracts to which the debtor is a party, how to treat claims lodged against the debtor, the rules governing the distribution of proceeds from the realization of assets and the ranking of claims, the conditions for and the effects of closure of insolvency proceedings by composition, and creditors' rights after closure of the insolvency proceedings. *Id.*
231. *Id.* art. 17. One of the aspects flowing from automatic recognition is that the liquidator appointed in the main proceeding, as well as the liquidator's powers, will be automatically recognized in all other member states, allowing it to exercise all the powers conferred to it by the laws of the state of the opening of the main proceeding in all other member states. *Id.* art. 18.
232. *Id.* art. 18. Liquidator is defined as "any person or body whose function it is to administer or liquidate assets of which the debtor has been divested or to supervise the administration of his affairs." *Id.* art. 2(b).
233. *Id.* ch. III.
234. *Id.* art. 3(2), 29. Establishment is defined as any place of operations where the debtor carries out a non-transitory economic activity with human means and goods. *Id.* art. 2(h).
235. *Id.* art. 27.
236. *Id.* art. 31.
237. *Id.* preamble ¶ 20; *id.* art. 33.

The EU Regulation also imparts a rule that main and secondary liquidators are duty bound to cooperate and communicate information to each other.[238] Article 31 of the EU Regulation also provides that the secondary liquidator must give the main liquidator an early opportunity to submit proposals on the liquidation or use of assets in the main proceeding.[239] Additionally, the main liquidator can request a stay of the secondary proceedings, in whole or in part, for a period of up to three months, which can be rejected only if such a stay would be manifestly of no interest to the creditors in the main proceeding.[240] The court in the secondary proceeding, however, can require the main liquidator to take measures to guarantee the interests of the creditors in the secondary proceeding.[241]

Any creditor has the right to lodge a claim in the main proceeding and any secondary proceedings, provided, of course, that there is no double recovery.[242] Furthermore, main and secondary liquidators can participate in each other's insolvency proceedings as creditors and thereby lodge claims.[243] Also, once insolvency proceedings, whether main or secondary, are opened in a member state, the court of that state (or more often, the appointed liquidator) must immediately provide individual notice to known creditors who have their habitual residences, domiciles, or registered offices in a member state of the opening of the proceedings.[244]

§ 29:13 Conclusion

When a multinational company is in financial difficulty or already insolvent, parties in interest should review and analyze the foregoing key issues in determining how their interests might be affected by the law of the countries that have jurisdiction over the potential debtor company's assets and operations.

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238. *Id.* art. 31.
239. *Id.* art. 31(3).
240. *Id.* art. 31(1).
241. *Id.*
242. *Id.* arts. 20(2), 39, 32(1).
243. *Id.* art. 32(3).
244. *Id.* art. 40(1).