INSOL INTERNATIONAL

FOUNDATION CERTIFICATE IN INTERNATIONAL INSOLVENCY LAW

Module 3A Guidance Text

Insolvency System of the United States

2023 / 2024

CONTENTS

1. Introduction to the insolvency system of the United States 1

2. Aims and outcomes of this module...2

3. Recommended reading (not compulsory)...2

4. Sources of law 3

5. Introduction to United States Chapters 7 and 11 6

6. Cross-border insolvency law 61

7. Recognition of foreign judgments 68

8. Insolvency law reform 71

9. Useful information 71

Annexure A: Feedback on self-assessment questions 73

This guidance text is part of the study material for the Foundation Certificate in International Insolvency Law and its use is limited to this certificate programme. Unauthorised use or dissemination of this document is prohibited.

INSOL International

6-7 Queen Street, London, EC4N 1SP, UK
Tel: +44 (0)20 7248 3333
Fax: +44 (0)20 7248 3384

www.insol.org

Module Author

Laura R Hall
INSOL Fellow
New York
United States of America

Copyright © No part of this document may be reproduced or transmitted in any form or by any means without the prior permission of INSOL International. The publishers and authors accept no responsibility for any loss occasioned to any person acting or refraining from acting as a result of any view expressed herein.

Copyright © INSOL INTERNATIONAL 2023. All Rights Reserved. Registered in England and Wales, No. 0307353. INSOL, INSOL INTERNATIONAL, INSOL Globe are trademarks of INSOL INTERNATIONAL.

Published: September 2023

1. INTRODUCTION TO THE INSOLVENCY SYSTEM OF THE UNITED STATES

Welcome to **Module 3A**, dealing with the **Insolvency System of the United States**. This Module is one of the compulsory module choices for the Foundation Certificate.

The purpose of this guidance text is to provide a relatively detailed overview of the insolvency system of the United States. The guidance text for this module and the module dealing with the insolvency system of the United Kingdom (Module 3B), have been written in such a way so as to provide students with a comparative view of the two systems. The idea is to show, using the same or similar headings in each of the guidance texts, how each of the systems function. In this way both the common features and the differences between the two systems can be highlighted. Although students are not required to do both these modules, it would be useful to do so as most insolvency regimes around the world show features of one or the other (or both) system(s).

This guidance text is all that is required to be consulted for the completion of the assessment for this module. You are not required to look beyond the guidance text for the answers to the assessment questions, although bonus marks will be awarded if you do refer to materials beyond this guidance text when submitting your assessment.

Please Note

If you have selected this module as one of your **compulsory modules**, the formal assessment for this module must be submitted by **11 pm (23:00) GMT on 1 March 2024**.

If you have selected this module as one of your **elective modules**, you have a choice as to when you must submit the assessment. You may either submit the assessment by **11 pm (23:00) GMT on 1 March 2024**, or by **11 pm (23:00) BST (GMT +1) on 31 July 2024**. However, if you elect to submit your assessment on 1 March 2024, you may not submit the assessment again on 31 July 2024 (for example, to obtain a higher mark).

Please consult the Foundation Certificate in International Insolvency Law website for both the assessment and the instructions for submitting the assessment via the course web pages. Please note that **no extensions** for the submission of assessments beyond 1 March 2024 (or 31 July 2024, depending on whether you have taken this module as a compulsory or elective module) will be considered.

For general guidance on what is expected of you on the course generally, and more specifically in respect of each module, please consult the course handbook which you will find on the web pages for the Foundation Certificate in International Insolvency Law.

2. AIMS AND OUTCOMES OF THIS MODULE

After having completed this module you should have a good understanding of the following aspects of the insolvency system of the United States (or US):

- sources of law and the terminology used in bankruptcy proceedings;
- the participants in bankruptcy proceedings;
- general overview of the various bankruptcy proceedings available;
- eligibility of debtors and jurisdiction of the courts under the various proceedings;
- relatively detailed understanding of the chapter 7 and chapter 11 procedures and the purpose of each;
- a relatively detailed understanding of insolvency litigation under US bankruptcy procedures;
- a relatively detailed understanding of the principles of cross-border insolvency law that apply in the US; and
- a relatively detailed understanding of the principles applying to the recognition of judgments in the US.

After having completed this module you should be able to:

- answer direct and multiple-choice type questions relating to the content of this module;
- be able to write an essay on any aspect of US bankruptcy law; and
- be able to answer questions based on a set of facts relating to the US bankruptcy system.

Throughout the guidance text you will find a number of self-assessment questions. These are designed to assist you in ensuring that you understand the work being covered as you progress through text. In order to assist you further, the suggested answers to the self-assessment questions are provided to you in Appendix A.

3. RECOMMENDED READING (NOT COMPULSORY)

- Administrative Office of the US Courts, "Bankruptcy Basics," https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics;
- Richard B Levin, George M Treister, J Ronald Trost, Leon S Forman and Kenneth N Klee, *Fundamentals of Bankruptcy Law*, 7th edition (ALI 2009);

- *Robert E Ginsberg, Robert D Martin and Susan V Kelley, Ginsberg and Martin on Bankruptcy*, 5th edition (Wolters Kluwer 2008);

- Lawrence P King (editor), *Collier on Bankruptcy*, 15th edition Rev (1996).

4. SOURCES OF LAW

4.1 Sources

US Bankruptcy Code (title 11 of United States Code):[1]

- **Chapter 1**
  - General provisions applicable to proceedings under chapters 7, 11, 12, 13 and 15.
  - Contains definitions, but not all key terms are defined in the Bankruptcy Code.
  - Section 109 defines who is eligible to be a debtor under each chapter.
- **Chapter 3**
  - Case administration provisions applicable to proceedings under chapters 7, 11, 12 and 13.
  - Defines powers of a trustee / debtor in possession.
- **Chapter 5**
  - Defines rights of creditors, debtors and the estate in proceedings under chapters 7, 11, 12 and 13.
  - Certain sections are also applicable in chapter 15 proceedings.
- **Chapter 7**
  - Duties of trustee and creditors' committee in liquidation proceedings.
  - Procedures applicable in to liquidate and distribute the debtor's assets.

---

[1] All references to chapters and sections herein are to the US Bankruptcy Code unless otherwise noted. The Bankruptcy Code may be accessed for free online at https://www.law.cornell.edu/uscode/text/11. US case law may be accessed for free online at https://scholar.google.com by selecting "Case law" below the search bar and entering the volume, reporter and first page citation (eg, "200 F.3d 154") into the search bar.

- **Chapter 9**
  - Procedures applicable in proceedings with respect to a municipality (ie, city or county).[2]
  - Incorporates by reference numerous chapter 11 provisions.
- **Chapter 11**
  - Duties of trustee and creditors' committee in reorganization proceedings.
  - Procedures applicable to proposal and confirmation of a plan of reorganization.
  - Subchapter V added by the Small Business Reorganization Act.
- **Chapter 12**
  - Provisions applicable to adjustment of debts for family farmer or fisherman with regular income.
- **Chapter 13**
  - Provisions applicable to adjustment of debts for individual with regular income.
- **Chapter 15**
  - Enactment of UNCITRAL Model Law, with certain modifications.
  - Procedures for recognition of foreign proceedings and coordination of US and foreign proceedings.

Certain entities, such as insurance companies and banks, are excluded from eligibility to be a debtor in bankruptcy and are instead subject to state or federally regulated proceedings, such as those administered by the FDIC for insured depository institutions.

The US Bankruptcy Code, as federal law, supersedes contrary state law, but where the laws are not in conflict, "applicable non-bankruptcy law" has a substantial role in determining the property of the debtor and the claims of creditors.

While US state law provides certain common law creditor protections, such as the ability to commence a receivership or foreclose on pledged property, such actions are displaced if the debtor commences bankruptcy proceedings.

[2] Note that insolvency proceedings for the US territory of Puerto Rico and its governmental corporations is under special PROMESA legislation because only subdivisions of states are eligible for Ch 9.

Procedures in bankruptcy proceedings are governed by the Federal Rules of Bankruptcy Procedure (the **Bankruptcy Rules**), which frequently incorporate by reference the Federal Rules of Civil Procedure, particularly with respect to litigation of disputed issues in contested matters or adversary proceedings. Forms for common bankruptcy filings are required to be used where they apply.[3] In addition, each bankruptcy court will have local rules of procedure, and each judge issues personal practices, which are periodically updated, all available on the website of the bankruptcy court.[4] The local rules and practices not only contain preferred working procedures of the judges, but can modify deadlines for filing and responding to pleadings.

As the US is a common law jurisdiction, case law plays a critical role in giving meaning to the US Bankruptcy Code and the operation of non-bankruptcy law in bankruptcy proceedings. The US federal court system is divided into regions called "circuits" and differences of law arise between circuit courts of appeal, which can be resolved only by a decision of the United States Supreme Court or by one of the circuit courts changing position which requires *en banc* review– consideration by all active judges of that court.

Self-Assessment Exercise 1

Question 1

Which sections of the Bankruptcy Code apply in a Chapter 7 liquidation?

Question 2

True or False: The Bankruptcy Code is the only law that applies in bankruptcy proceedings.

Question 3

What rules should you review when preparing a filing for a bankruptcy court?

For commentary and feedback on self-assessment exercise 1, please see APPENDIX A

4.2 Terminology

US law (and US lawyers) use the term "bankruptcy" for all proceedings under the Bankruptcy Code, regardless of the nature of the debtor, the solvency of the debtor, or whether proceedings are for liquidation or reorganization. Additional relevant terms of art are defined in the Overview of the Participants section below.

3 Available at http://www.uscourts.gov/forms/bankruptcy-forms.

4 For an example, the local rules of the Bankruptcy Court for the District of Delaware are available at http://www.deb.uscourts.gov/local-rules-and-orders and the personal practices of Chief Judge Christopher S Sontchi of that court are available at http://www.deb.uscourts.gov/content/chief-judge-christopher-s-sontchi (click on the tab labeled "Chambers Procedures").

5. INTRODUCTION TO UNITED STATES CHAPTERS 7 AND 11

5.1 Overview of the participants

The **bankruptcy court** – unusually, the US has special federal courts for bankruptcy matters (separate from general corporate matters, which are generally subject to state law). Because these courts were created by legislation, rather directly by Article III of the US Constitution, bankruptcy judges are appointed by courts of appeal, rather than the president, do not have lifetime tenure and have limited jurisdiction to enter final orders other than on core bankruptcy issues. The relationship between bankruptcy courts and federal district courts is discussed further in paragraph 5.3.4.4 below.

The **debtor** is the individual or entity that is the subject of the bankruptcy proceeding. In chapter 11 proceedings, where no trustee has been appointed to manage the debtor's affairs, it is a **debtor in possession**. A debtor may agree to change management or corporate governance, such as by appointing a Chief Restructuring Officer to replace the CEO, to avoid a challenge to its ability to operate as a debtor in possession.

You will see that the Bankruptcy Code frequently refers to the powers of a **trustee**, but in fact, in most chapter 11 proceedings, no trustee is appointed and the debtor in possession exercises these powers.[5] Thus, the debtor in possession assumes duties to safeguard the interests of creditors as a whole, and may not prefer the interests of equity holders as would be expected outside of bankruptcy.[6] The appointment of a trustee is compulsory in chapter 7 proceedings and subject to a showing of good cause (a high threshold) in chapter 11 proceedings. The selection is made by the US Trustee from a panel of eligible individuals for the district in which the case is filed. The trustee is appointed by the court on an interim basis, following which a meeting of creditors is convened to either affirm the selection or select an alternative trustee.

The office of the **US Trustee** is a program within the US Department of Justice responsible for oversight of the administration of bankruptcy cases and the appointment of private trustees. A representative of the US Trustee is assigned to each case and has the right to object to or comment on all filings; typically the debtor will try to obtain the approval of the US Trustee prior to filing significant motions. Particular areas of concern in business cases tend to be the compensation of professionals and the provisions of plans of reorganization. The program is funded through mandatory quarterly fees based on the value of the debtor's disbursements in a given quarter.

A **claim** in bankruptcy is any legal or equitable right, including contingent rights, against the debtor, and a holder of a claim is a **creditor**. If the claim is accompanied by a lien on property of the estate, it is a **secured claim** entitled to special protection where the debtor or trustee proposes to use or sell the collateral. There is a well-developed market in the trading of US

---

5 11 USC, § 1107. For proceedings under subchapter V of chapter 11, trustees are appointed in every case to assist debtors in navigating the bankruptcy process and report to the court, but debtors remain in possession. 11 USC, § 1183(b).

6 The text of this module generally assumes that, in the context of a ch11 proceeding, there is a debtor in possession rather than a Ch 11 trustee.

bankruptcy claims, often by hedge funds seeking to amass a substantial position and improve recoveries through negotiation and often litigation with the debtor.

The US Trustee uses the debtor's schedules, typically filed with or shortly after the petition, to identify the holders of the 20 largest unsecured claims and solicit participation of these creditors in the **Committee of Unsecured Creditors** (also known as the **Unsecured Creditors Committee** or **UCC**). Members of the committee undertake statutory duties to all unsecured creditors and can retain counsel and financial advisors at the estate's expense to evaluate the debtor's proposals and to pursue litigation for the benefit of the estate where existing management refuse to do so (for example, against officers and directors). Other committees may also be formed depending on the circumstances of the case; an equity committee will be authorized only where the estate appears to be solvent such that a return to equity is likely. *Ad hoc* committees may also form to represent allied creditors; they too may have their professional fees paid by the estate if, for example, the terms of their pre-petition debt so require.

While the US has relatively low levels of union membership outside of certain industries such as hospitality or shipping, and therefore unions are not as involved in US bankruptcy proceedings as those in other countries, participation by employees and recipients of pension and disability benefits may be significant. The Pension Benefit Guaranty Corporation, a US government agency that insures private sector defined benefit pension funds, is a frequent participant in corporate bankruptcies.

In several places, the Bankruptcy Code gives **parties in interest** the right to seek relief or object to relief sought by others.[7] The term "party in interest" includes "the debtor, the trustee, a creditors' committee, an equity security holders' committee, or any indenture trustee,"[8] but it also encompasses any person or entity whose legal interests may be affected in the circumstances of the particular case, such as a government regulator, neighboring land owner, or creditor of an affiliate. The interest must, however, be legal to give standing, and so advocacy groups on environmental or social issues, for example, are not parties in interest.

Self-Assessment Exercise 2

Question 1

What is the difference between a bankruptcy trustee and the US Trustee?

[7] For example, s 362(d) permits a party in interest to move for relief from the automatic stay.
[8] 11 USC, § 1109(b).

Question 2

Which of the following could *not* be considered a "party in interest"?

(a) the debtor
(b) the debtor's non-debtor affiliate that has guaranteed certain of its debts
(c) the debtor's landlord
(d) the US Internal Revenue Service
(e) persons exposed to harmful chemicals by the debtor but not experiencing symptoms
(f) a non-profit consumer advocacy organization

For commentary and feedback on self-assessment exercise 2, please see APPENDIX A

5.2 Brief overview of Chapter 7 and Chapter 11

For most businesses, bankruptcy proceedings may be commenced under chapter 7 or chapter 11 and in either case enjoy the protection of the worldwide automatic stay of creditor enforcement proceedings from the moment a petition commencing proceedings is filed (typically electronically).

Chapter 7 proceedings entail the appointment of a trustee to take control of the estate, collect and liquidate property (which may include prosecuting claims the estate possesses against others), and distribute the proceeds to creditors in accordance with statutory priorities.

Chapter 11 is a US innovation in restructuring – the worldwide automatic stay of any proceeding against the debtor or its property provides breathing space for a debtor to continue operating more or less in the ordinary course of business and work with its key constituencies to propose a plan of reorganization that will adjust its debts. Significantly, the plan of reorganization may be confirmed by the court without the approval of all classes of creditors, referred to as a **cramdown**. To qualify for cramdown, the plan must be approved by at least one impaired class of creditors (who are getting less than 100% on their claims) and make the crammed down class no worse off than they would be in chapter 7 liquidation. Through the plan, the debtor can also force its secured creditors to accept altered terms on their debt. A chapter 11 proceeding typically concludes after a plan of reorganization is approved by the requisite creditor class(es) and the terms of the plan are executed, but a chapter 11 proceeding may be dismissed if the court is satisfied that dismissal is in the interest of both the debtor and creditors. Where the dismissal is on terms that keep in place certain rulings during the course of proceedings (such as resolution of disputed claims, sales of property or partial distributions of assets), it is termed a **structured dismissal**.

The chapter 11 debtor in possession (like the trustee in a chapter 7 proceeding) has the ability to reject burdensome contracts, sell assets free and clear of liens and pursue claims for recovery

of preferential or fraudulent transfers to increase the value of the estate for creditors. With advance planning and creditor support, a **pre-pack** chapter 11 proceeding may take just a few months to restructure a debtor's financial obligations, but complex and contentious proceedings can last for years. Alternatively, a chapter 11 proceeding may be used for an orderly wind-down and liquidation, and is typically chosen over a chapter 7 liquidation if continued business operations up to the date of sale are necessary to realize maximum value. A chapter 11 proceeding may be converted to chapter 7 (or *vice versa*), and a creditor's threat to seek conversion to chapter 7 (and thereby oust management) may be a powerful bargaining tool.

Subchapter V of chapter 11, added to the Bankruptcy Code by the Small Business Reorganization Act of 2019, creates a modified chapter 11 proceeding for businesses with debts below a statutory threshold. Under Covid-19 relief legislation, the statutory threshold was raised to USD 7,500,000 until March 2022 and, as of June 30, 2023, this threshold will remain in effect until 2024. In a subchapter V case, the debtor continues to operate its business, but a trustee is also appointed to collect information and assist in development and implementation of a plan of reorganization. The debtor has exclusivity to propose a plan and must do so within the first 90 days of the case unless circumstances, for which the debtor is not responsible, provide cause for an extension. The plan may cram down dissenting creditors without an accepting impaired class, and the absolute priority rule does not apply – permitting the business owner to retain its equity in the reorganized business without paying all creditors in full. To obtain confirmation of a cramdown plan, however, the debtor must use all projected disposable income over the next three to five years to make payments under the plan and discharge is not granted until all payments have been made.

In the remainder of this text, and the summative assessment, references to chapter 11 do not include subchapter V, which disapplies or modifies many chapter 11 provisions.

Self-Assessment Exercise 3

Question 1

What are two differences between chapter 7 proceedings and chapter 11 proceedings?

Question 2

What are three debtor-friendly aspects of chapter 11 proceedings?

For commentary and feedback on self-assessment exercise 3, please see APPENDIX A

5.3 Opening of insolvency proceedings

5.3.1 Introduction

This section discusses the legal and practical requirements for the commencement of chapter 7 and 11 proceedings. Compared to other jurisdictions, both the threshold for eligibility to qualify as a US debtor and the paperwork required at the outset of the case are minimal, consistent with the debtor-friendly orientation of the Bankruptcy Code.

5.3.2 Eligibility of the debtor

The minimum requirement to be a debtor under any chapter of the Bankruptcy Code is the presence of the debtor or its place of business or any of its assets in the United States.[9] This requirement may be met by minimal or intangible assets, such as a retainer paid to a US attorney or a claim under a US law.

Certain entities may *not* be debtors under chapter 7, including railroads, insurance companies, banks and certain other financial institutions.[10] Special liquidation proceedings for these entities exist under other state and federal laws.

Eligibility to be a chapter 11 debtor is slightly broader, in that railroads and certain types of financial institutions qualify, but stockbrokers and commodity brokers, which may be chapter 7 debtors, cannot be chapter 11 debtors;[11] operation of such entities in bankruptcy is governed by other federal statutes.

5.3.3 Commencement of the insolvency proceedings

5.3.3.1Voluntary and involuntary commencement

A debtor may commence a **voluntary** proceeding under any applicable chapter by filing a petition.[12] The Federal Rules of Bankruptcy Procedure specify a number of schedules, such as lists of assets and creditors, that are to be filed with a voluntary petition, but even if they are absent, a "naked" petition is sufficient to invoke the automatic stay and commence a case under the Bankruptcy Code. The form for a voluntary petition for an entity (rather than a natural person) is only four pages long. While the form requires the debtor to disclose estimated funds on hand, number of creditors, assets and liabilities, it need not be or claim to be insolvent.[13]

Creditors may commence an **involuntary** proceeding against an eligible debtor under either chapter 7 or chapter 11.[14] Involuntary proceedings cannot be commenced under the other

---

9 *Idem*, § 109.
10 *Idem*, § 109(b).
11 *Idem*, § 109(d).
12 *Idem*, § 301.
13 Forms for the petition and schedules, as well as other common bankruptcy filings, can be downloaded from www.uscourts.gov/forms/bankruptcy-forms.
14 11 USC, § 303.

chapters or against a farmer, family farmer or not-for-profit corporation. The number of petitioning creditors required depends on how many non-contingent, non-insider creditors the debtor has – if it has fewer than 12 such creditors, only one is required to file an involuntary petition; if it has 12 or more such creditors, at least three qualifying creditors must join in the petition.

To qualify as a petitioning creditor, the creditor must have a claim against the debtor that is:

- Non-contingent
  - A contingent claim is one that depends on the occurrence of a future event. For example, a claim under a guarantee is typically contingent on the occurrence of a default under the guaranteed obligation.
  - A debt that is unmatured (because the payment is due in the future) is not contingent if all requirements for liability, other than the passage of time, have occurred.
- Not the subject of *bona fide* dispute as to liability or amount
  - A bona fide dispute exists if there is an objectively reasonable basis for a dispute as a matter of fact or law; the debtor's subjective belief that the debt is not owed or the amount claimed is incorrect is not sufficient.
  - If a portion of the amount claimed is disputed, the creditor cannot use the undisputed portion to reach the monetary threshold required in the next bullet, but a dispute as to one claim does not disqualify application of other, undisputed claims held by the same creditor to meet petitioning creditor requirements.
- Unsecured or undersecured, separately or in the aggregate with all other petitioning creditors' claims, in the amount of at least USD 16,750 (this amount is periodically increased due to inflation).

Although the voluntary petition does not require the debtor to assert that it is insolvent, in *In re LTL Management*,[15] the Third Circuit Court of Appeals dismissed a bankruptcy petition as not filed in good faith because the company was not in financial distress but rather elected to use bankruptcy court rather than mass tort litigation to resolve product liability suits. The debtor was a subsidiary of Johnson & Johnson and created through a divisional merger under Texas law to isolate liabilities relating to talc products (the so-called "Texas two-step"). It benefited from a financial support agreement with Johnson & Johnson that was expected to cover the amount required to settle the talc product liability cases, and therefore did not have a shortfall of assets as compared to liabilities. Following dismissal, the financial support agreement was revised to be less generous and the debtor filed a new bankruptcy case. The motion to dismiss that case on the same grounds is expected to be decided by August 2023. Similarly, bankruptcy petitions filed by Aearo Technologies and other 3M Corporation subsidiaries facing numerous lawsuits

[15] *In re LTL Mgmt.*, LLC, No. 22-2003, 2023 WL 1098189 (3d Cir Jan 30, 2023).

for defective products have been dismissed for lack of good faith and absence of a "valid reorganizational purpose" because the companies are currently "financially healthy" and benefit from a funding agreement with 3M, though the dismissal is without prejudice to re-filing should their financial condition change.[16] The decision has been certified for direct appeal to the Seventh Circuit Court of Appeals. (See paragraph 5.3.5 below regarding appeals from bankruptcy court orders.)

Unlike the voluntary petition, which requires no allegation of insolvency, the involuntary petition form requires the petitioning creditors to allege either that the debtor is generally not paying its debts as they become due, unless they are the subject of a *bona fide* dispute as to liability or amount or that, "within 120 days before the filing of this petition, a custodian, other than a trustee, receiver, or an agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession."[17]

A foreign representative of an estate in a foreign proceeding may commence an involuntary chapter 7 or chapter 11 petition against the debtor even if the foreign proceeding has not been the subject of a petition for recognition under chapter 15.[18]

Absent an order by the bankruptcy court, the debtor who is the subject of an involuntary petition remains in control of its business and may operate in the ordinary course, including disposing of property. Thus, if the purpose of the involuntary proceeding is to divest management of control over the business, the petition should be accompanied by a motion for the appointment of an interim trustee on an expedited basis.

The involuntary debtor may also seek dismissal of the bankruptcy proceedings by controverting the involuntary petition and showing that the claims held by the petitioning creditors do not meet the requirements set out above. Upon dismissal, a debtor may be entitled to damages and attorneys' fees. However, even if the petitioning creditor requirements prove not to have been met, the court can refuse to dismiss the proceedings if the debtor is not generally paying undisputed debts as they become due or has, within preceding 120 days, had a trustee, agent or receiver be appointed or take possession of substantially all of the debtor's property. If the proceeding is not dismissed, the debtor must then file the required schedules.

5.3.3.2 Filing of schedules

The debtor must file, together with a voluntary petition or on a date specified by the court, a number of schedules disclosing its assets, including all property, executory contracts (defined in paragraph 5.4.5 below), and unexpired leases of real and personal property, and its liabilities, including identifying its secured and 20 largest unsecured claims. These schedules are electronically filed on the docket of the proceedings and therefore are publicly available. The social security numbers of individual persons and names of minors must be redacted, but other redactions or filing under seal are granted only by leave of court and subject to limitations due

[16] *In re Aearo Technologies LLC*, Case No. 22-02890-JJG-11, 2023 WL 3938436 (Bankr SD Ind June 9, 2023).
[17] Form B205 at 2.
[18] 11 USC, § 303.

to the presumption that the public should be permitted to access information about pending legal proceedings. Debtors preparing for a voluntary filing should consider whether such disclosures may violate contractual or other confidentiality obligations, including under foreign data privacy law, and confer with the US Trustee about appropriate measures. The US Trustee will strongly oppose any sealing request that would prevent it from soliciting creditors to constitute the Committee of Unsecured Creditors.

Self-Assessment Exercise 4

Question 1

Which of the following is true for a corporation filing a voluntary bankruptcy petition?

a) The corporation must be insolvent on a balance sheet basis – that is, its liabilities must exceed its assets.
b) The corporation must be insolvent on a cash flow basis – that is, it is not meeting its debts as they come due.
c) The corporation need not be insolvent.

Question 2

Consider the following hypothetical: A consortium of Mexican banks has made several loans, totalling millions of dollars, to Mexican businesses owned by the Caruso family, who guaranteed the loans. The businesses have defaulted on the loans and are now in insolvency proceedings in Mexico, in which the banks have appeared to collect on their notes. The Carusos have made only partial payment on the guarantee, which has given rise to suit by the banks in Mexico on the guarantee. The Carusos own several properties in the United States. May the Mexican banks commence involuntary bankruptcy proceedings in the US against the Carusos individually?

For commentary and feedback on self-assessment exercise 4, please see APPENDIX A

5.3.4 *Allocation of bankruptcy proceedings to a court*

5.3.4.1 Introduction

The US federal court system established under Article III of the US Constitution consists of trial-level district courts, regional courts of appeal called circuit courts, and the US Supreme Court. All Article III judges are appointed for life by the US President, subject to the consent of the US Senate. Each US state has one or more federal district courts; where there is more than one district court in a state, each district is responsible for a particular region – thus, the state of New York has Northern, Southern, Eastern and Western Districts. Appeals from a district court go to the circuit court responsible for the region – New York is in the Second Circuit, while Delaware

is in the Third Circuit.[19] The rulings of a given circuit court are binding only on the district courts in the state in that circuit, though may be have persuasive effect outside the circuit. One purpose of the US Supreme Court is to resolve "circuit splits" between the precedents of the circuit courts.

Bankruptcy courts were not part of the original federal court system, but were created by legislation under power granted to Congress by Article I of the US Constitution. This has important implications for their jurisdiction and powers, discussed in detail in paragraph 5.3.4.4 below. Bankruptcy courts are established as adjuncts of the district courts with the same geographical divisions – for example, the Bankruptcy Court of the Southern District of New York. Bankruptcy judges are appointed for 14 year terms by the circuit court for the jurisdiction in which they will serve.

Choice of a forum for bankruptcy proceedings can have important consequences, in particular because the interpretation of the Bankruptcy Code on key points may differ between regional circuit courts of appeal for a number of years before being resolved by a decision of the US Supreme Court, a statutory amendment, or a change of position by one of the courts of appeal. Choice of forum may also, depending on the number of bankruptcy judges in a given district, enable a debtor to predict which judge will preside over the proceedings. Because of regional differences in the US economy, certain courts also have greater experience in cross-border proceedings or with debtors in specialized industries, such as oil and gas.

5.3.4.2Jurisdiction of the courts

Federal district court jurisdiction over matters relating to bankruptcy proceedings distinguishes among:

- "cases under title 11";[20]
- "civil proceedings arising under title 11";
- "civil proceedings . . . arising in . . . cases under title 11"; and
- "civil proceedings . . . related to cases under title 11".[21]

A ***case under*** title 11 is the bankruptcy proceeding itself, initiated by a voluntary or involuntary petition. A case under title 11 is committed to the exclusive jurisdiction of the federal district court.[22] Once a case under title 11 has been commenced in a particular district, that district court has exclusive jurisdiction over all property of the debtor as of the date of commencement of the case and all property of the estate, in each case, wherever such property may be located.[23]

---

[19] A map showing the district courts and which states make up each circuit is available at http://www.fedbar.org/Public-Messaging/About-US-Federal-Courts_1.aspx; https://www.supremecourt.gov/about/Circuit%20Map.pdf.

[20] Recall that the Bankruptcy Code is title 11 of the United States Code, hence the citations in the form 11 USC, § ●.

[21] 28 USC, § 1334.

[22] *Idem*, § 1334(a).

[23] *Idem*, § 1334(e).

Civil proceedings ***arising under*** title 11 are those that adjudicate the rights and duties established by the statutory provisions of the Bankruptcy Code, such as a proceeding for turnover of estate property under section 542.[24] The jurisdiction of the district court is non-exclusive with respect to such proceedings, except that it has exclusive jurisdiction over all claims relating to the retention of professionals by the debtor or trustee.

Civil proceedings ***arising in*** cases under title 11 are those that adjudicate rights and duties not created by the Bankruptcy Code, but that would not exist but for the pending bankruptcy proceeding, such as claims in the nature of malpractice, negligence or fraud in the administration of the estate. The district court's jurisdiction in these matters is also non-exclusive.

Civil proceedings ***related to*** cases under title 11 are those that, while not falling in any of the prior categories, would affect the bankruptcy estate, such as a claim against a non-debtor for which the debtor acts as guarantor and therefore could face a claim on the guarantee if the non-debtor does not satisfy its obligation. Where a proceeding is only related to a case under title 11 and was brought in federal court only on the basis of bankruptcy jurisdiction,[25] the federal court must abstain from hearing such a proceeding if a parallel proceeding is commenced in an appropriate state forum and "can be timely adjudicated."

5.3.4.3Venue

Proper venue for the commencement of plenary bankruptcy proceedings, including those under chapters 7 and 11, may be based on either the attributes of the debtor itself or those of an affiliate that is also a debtor in bankruptcy. Venue is proper in the district in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the debtor or its affiliate have been located for the 180 days immediately preceding such commencement, or for a longer portion of such 180 period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of such person were located in any other district.[26]

Domicile, for a business, is its place of incorporation. Because many corporate groups include one or more Delaware corporations, the District of Delaware has become a venue of choice for many large group bankruptcies, even where the business of the group is centered elsewhere. Likewise, a corporate group may have an affiliate based in New York, making the Southern District of New York a proper venue for the entire group.

Domicile of an individual is the place where they have a physical presence and intend to remain indefinitely, though they may have several residences.

---

[24] *Idem*, § 1334(b).

[25] US federal courts have limited subject matter jurisdiction. Outside the bankruptcy context, their jurisdiction is generally limited to disputes under federal law ("federal question jurisdiction") or between citizens of different states ("diversity jurisdiction"). Subject matter jurisdiction (whether a court can hear a certain type of legal claim) is distinct from personal jurisdiction (whether the court's exercise of its power over the defendant would be consistent with the US Constitution's guarantee of due process).

[26] 28 USC, § 1408(1) and (2).

A **principal place of business** is determined on a "nerve center" test – it is where the organization's management makes decisions, not where, for example, the largest number of employees work or the most customers visit. Absent exceptional circumstances, a company has only one principal place of business, which may differ from its domicile.

Venue for ancillary proceedings under chapter 15 are subject to a different venue statute. For such cases, venue is proper in the district:

(1) in which the debtor has its principal place of business or principal assets in the United States;

(2) if the debtor does not have a place of business or assets in the United States, in which there is pending against the debtor an action or proceeding in a Federal or State court; or

(3) in a case other than those specified in paragraph 1) or 2), in which venue will be consistent with the interests of justice and the convenience of the parties, having regard to the relief sought by the foreign representative.[27]

Under either venue statute, proper venue is determined only by comparing different districts within the US; thus, it is no barrier to venue that more substantial assets or places of business exist outside the US. Venue can be created in a particular district by depositing funds with counsel as a retainer in that district, so long as there are no more substantial assets in any other district.

Improper venue is not a jurisdictional defect, so a petition filed in the improper venue is not dismissed, but rather, on motion of an interested party, will be transferred to a district with proper venue. Where more than one venue is proper, venue can be transferred from one proper venue to another for the convenience of the parties or in the interests of justice.[28]

5.3.4.4Relationship between the district court and the bankruptcy court

As discussed briefly in paragraph 5.3.4.1 above, the bankruptcy courts are creatures of federal legislation, specifically the 1978 Bankruptcy Code, rather than established with most other federal courts by Article III of the US Constitution. In a series of decisions, the US Supreme Court has held that judges who have not been appointed pursuant to and with the protections of Article III, cannot exercise jurisdiction over matters subject to Article III.

Because the issues that arise in and relate to bankruptcy proceedings involve statutory and contract rights that otherwise would be within the jurisdiction of Article III courts, the Supreme Court struck down the jurisdictional provisions of the 1978 Bankruptcy Code as unconstitutional.[29] In response, new jurisdictional provisions were enacted to grant to

[27] *Idem*, § 1410.
[28] *Idem*, § 1412.
[29] *Northern Pipeline Construction Co v Marathon Pipe Line Co*, 458 US 50 (1982).

jurisdiction over bankruptcy proceedings to district courts and permit district courts to refer such proceedings to the bankruptcy courts of their district.[30]

The referral statute creates a distinction between "**core**" and "**non-core**" matters, and permits bankruptcy judges to hear and determine only core proceedings.[31] The statute contains a non-exhaustive list of core proceedings, which is set forth in the margin.[32] As to non-core proceedings, the bankruptcy court may hear the non-core proceedings if they are sufficiently related to a bankruptcy proceeding,[33] but cannot make a final determination; instead, it submits proposed findings of fact and conclusions of law to the district court, to which interested parties may object, for the district court's final decision.[34] At the outset of each motion or pleading, parties must state whether the matter at issue is core or non-core, so that the bankruptcy court can determine the scope of its jurisdiction and power to render a final order or judgment.

The referral statute also provides a procedure by which a district court may **withdraw the reference** of its jurisdiction to bankruptcy court at its discretion. Withdrawal of the reference is mandatory if the proceeding involves substantial questions under federal statutes other than the Bankruptcy Code. Withdrawal of the reference is also commonly sought on the basis that the issue is one for which the US Constitution grants the right of jury trial, though filing a proof claim in bankruptcy has been held to be a waiver of the jury trial right and submission to the jurisdiction of the bankruptcy court.[35] Although bankruptcy courts may conduct jury trials with party consent, this is exceedingly rare; at least one party will usually prefer withdrawal of the

---

[30] 28 USC, §§ 157 and 1334.

[31] *Idem*, § 157.

[32] Core proceedings include, but are not limited to—
(A)matters concerning the administration of the estate;
(B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for the purposes of confirming a plan under chapter 11, 12, or 13 of title 11but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11;
(C) counterclaims by the estate against persons filing claims against the estate;
(D) orders in respect to obtaining credit;
(E) orders to turn over property of the estate;
(F) proceedings to determine, avoid, or recover preferences;
(G) motions to terminate, annul, or modify the automatic stay;
(H) proceedings to determine, avoid, or recover fraudulent conveyances;
(I) determinations as to the dischargeability of particular debts;
(J) objections to discharges;
(K) determinations of the validity, extent, or priority of liens;
(L) confirmations of plans;
(M) orders approving the use or lease of property, including the use of cash collateral;
(N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate;
(O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims; and
(P) recognition of foreign proceedings and other matters under chapter 15 of title 11.
11 USC, § 157(b)(2).

[33] If a matter is non-core and not within "related to" jurisdiction, the proper forum for the matter will depend on whether there is another basis for federal court jurisdiction; if not, the matter will have to be resolved in state court.

[34] 28 USC, § 157(c).

[35] *Langenkamp v Culp*, 498 US 42 (1990).

reference to the district court to obtain a different judge, or at least one with experience conducting a jury trial.

Following the 1984 amendments of the Bankruptcy Code, the bankruptcy courts' jurisdiction to resolve issues presented in core proceedings seemed well established, and thus intense focus was placed on the core / non-core distinction. In 2011, however, the US Supreme Court shocked bankruptcy practitioners by holding, in *Stern v Marshall*,[36] that even in core proceedings, a bankruptcy court cannot issue final orders that invade Article III jurisdiction. In that case, a bankruptcy claim had been filed against the debtor and the debtor counterclaimed. At the same time, the issues in the counterclaim were the subject of separate state court proceedings. US law permits parallel proceedings in state and federal courts, and provides that the first judgment issued is binding on the parties. Here, the bankruptcy court issued its judgment first, awarding USD 400 million to the debtor, but the state court case continued while the bankruptcy judgment was appealed to the district court. The state court jury verdict in favour of the claimant issued before the district court's judgment affirming the bankruptcy court. Although 28 USC § 157 provides that a counterclaim is a core proceeding as to which a bankruptcy court can issue a final order, the US Supreme Court held that the bankruptcy court's issuance of a final order over a state law claim was unconstitutional under Article III. Thus, the jury verdict was the first final judgment and was conclusive of the issues.

Stern threw the already complicated area of bankruptcy court jurisdiction into new turmoil, as litigants and courts wrestled with its implications. Subsequent US Supreme Court rulings and amendments to the Bankruptcy Rules have provided more guidance. Because district courts have exclusive jurisdiction to adjudicate a petition commencing bankruptcy proceedings, a bankruptcy court may exercise a district court's delegated authority to enter a final order on a motion challenging the validity of a petition. The US Supreme Court has held that bankruptcy judges may determine a core proceeding over which they lack constitutional authority by issuing a report and recommendation for review by the district court,[37] the same procedure as in non-core proceedings, or, with the consent of the parties, may issue final orders.[38] The Bankruptcy Rules have implemented these rulings by requiring litigants to state in their pleadings whether they consent to the entry of final orders or judgment by the bankruptcy court,[39] and by permitting a district court that determines that a bankruptcy court did not have jurisdiction to enter a final order to treat that its order as proposed findings of fact and conclusions of law.[40]

Finality of an order or judgment as a matter of constitutional authority differs from whether an order is final for purposes of appeal, which is discussed in the next section.

---

[36] 564 US 462 (2011).

[37] *Executive Benefits Ins Agency v Arkinson*, 134 S. Ct. 2165 (2014).

[38] *Wellness Int'l Network, Ltd. v. Sharif*, 135 S Ct 1932 (2015).

[39] Fed R Bankr P 7008. If this requirement is not complied with, a court may deem the non-compliant party to have consented to its exercise of jurisdiction. See, eg, Delaware Bankruptcy Local Rule 7008-1.

[40] Fed R Bankr P 8018.1.

Self-Assessment Exercise 5

Question 1

Consider the following hypothetical: American Coal Corp is the parent company of a group of mining companies with operations throughout the south-eastern United States. ACC is incorporated in Delaware and headquartered in Missouri. Its subsidiaries are incorporated, headquartered, or have their principal assets located in Kentucky, Missouri, Ohio, Pennsylvania, Virginia, and West Virginia. In what jurisdiction(s) would venue be appropriate for all members of the group?

Question 2

For each of the following matters, state the nature of the bankruptcy court's jurisdiction and whether each core or non-core:

(a) Involuntary bankruptcy petition;
(b) Creditor's claim against the debtor;
(c) Creditor's claim against an affiliate of the debtor that has guaranteed the debtor's obligation to the creditor;
(d) Motion for approval of DIP financing.

For commentary and feedback on self-assessment exercise 5, please see APPENDIX A

5.3.5 Appeals

5.3.5.1 Who may appeal?

Bankruptcy court orders can be appealed by not only the litigants involved in a particular issue, but also other persons who are adversely affected by the ruling and therefore have standing to seek review.[41]

5.3.5.2 What orders may be appealed?

US non-bankruptcy procedure distinguishes between final and interlocutory orders. Final orders are those that dispose of all issues, leaving nothing further to be decided, whereas interlocutory orders resolve only some issues or claims. Final orders may be appealed as of right, whereas interlocutory orders may be appealed only with leave of the appellate court. In bankruptcy proceedings, this same framework applies, except that orders extending the period of

[41] In some, but not most, circuits, a person aggrieved must have participated in litigation of the order appealed unless it did not receive sufficient notice to permit it to do so. See, eg, *In re Schulz Mfg Fabricating Co*, 956 F 2d 686 (7th Cir 1992).

exclusivity to propose a plan are appealable as of right.[42] The distinction between interlocutory and final orders can be an elusive one where a court resolves not simply claims between two parties, but an issue of broad applicability, such as the post-petition interest rate applicable to the debtor's obligations. Recognizing the unique nature of bankruptcy proceedings as "an aggregation of individual controversies," the US Supreme Court has held that a bankruptcy order resolving a discrete dispute is a final order for appeals purposes.[43]

An order that is constitutionally final because the bankruptcy court had authority to enter it is not final for purposes of appeal if it does not resolve the entire issue in dispute. Conversely, an order that resolves an entire dispute and therefore would be final for purposes of appeal may not be final in the constitutional sense if the parties have not consented to the bankruptcy court's jurisdiction. Section 5.3.5.4 below discusses how this distinction affects the standard of review by the district court.

5.3.5.3What court hears the appeal?

In general, appeals from bankruptcy court decisions are heard by the district court for the district in which they sit.[44] In certain circuits,[45] however, bankruptcy appeals are heard by a Bankruptcy Appellate Panel (BAP), convened from the judges of the bankruptcy courts within the circuit. In those circuits, a party has the option to request that the appeal be heard by the district court instead. From the district court or BAP, there is a further appeal of right (assuming the initial order was one from which an appeal of right was available) to the circuit court of appeals. In rare circumstances, an appeal from a bankruptcy court may go directly to the court of appeals, where the bankruptcy court or district court certifies that either that (i) the appeal raises a question of law as to which there is no controlling decision of the circuit or the US Supreme Court, or requires resolving conflicting controlling decisions, or (ii) immediate appeal may materially advance the progress of the case.[46] The court of appeals has discretion whether to accept a case so certified.

5.3.5.4What standard of review is applied?

If the ruling below was in a core proceeding over which the bankruptcy court had authority (whether by law or by consent of the parties) to enter a final order, the district court or BAP reviews conclusions of law *de novo* and reviews findings of fact for abuse of discretion, recognizing that the bankruptcy court had greater opportunity to weigh the evidence. If the ruling was in a noncore proceeding or the bankruptcy court otherwise did not have authority to enter a final order, the district court or BAP reviews *de novo* all findings of fact and conclusions

---

42 28 USC, § 158(a)(2).

43 *Bullard v Blue Hills Bank*, 135 S Ct 1686 (2015).

44 The first appeal from a bankruptcy case will go to a randomly assigned judge, who will then generally hear all future appeals from those bankruptcy proceedings.

45 The First, Sixth, Eighth, Ninth and Tenth Circuits have elected, pursuant to 28 USC, § 158(b), to form Bankruptcy Appellate Panels.

46 28 USC, § 158(d).

of law to which a party has objected. The order of a district court or BAP is reviewed by a circuit court of appeal *de novo* as to conclusions of law and for abuse of discretion for findings of fact.[47]

5.3.5.5 What is the effect of taking an appeal?

Appeal as of right or the granting of permission to pursue an interlocutory appeal divests the bankruptcy court of jurisdiction to alter its decision, but does not stay its effect.[48] A stay pending appeal may be obtained from the bankruptcy court or, if that request is not timely granted, from the appropriate appellate court. The standard applied is the same as that applicable to injunctive relief generally – the party seeking a stay must establish that it has a likelihood of success on appeal, that it faces imminent, irreparable harm if the stay is not granted and that the equities of the situation favour granting the stay. Failure to obtain a stay may result in the appeal becoming equitably moot if the parties cannot be returned to their original positions in the event of a reversal of the bankruptcy court's decision.

5.3.6 Order for relief

A key feature of the US bankruptcy system is that a voluntary petition (under any chapter other than chapter 15, discussed in paragraph 6 below) is immediately effective to open proceedings and impose the statutory automatic stay. Unless the petition is challenged by the filing of a motion to dismiss, no further order of court will be made with respect to the existence of the case.[49] Involuntary petitions are also immediately effective to invoke the automatic stay and, unless timely challenged by the debtor, the court will enter an order confirming the petition.

5.4 Effect of opening of proceedings

5.4.1 Bankruptcy estate

Upon filing of a plenary bankruptcy proceeding (that is, under any chapter other than chapter 15), an **estate** is created consisting of all of the debtor's property interests as of the **petition date**, subject to certain exclusions for individual debtors.[50] The automatic stay protects property of the estate from creditor enforcement actions with respect to pre-petition claims.

---

[47] Where the bankruptcy court has authority to issue a final order, the district court (or BAP) and court of appeals perform the same review, with no deference by the court of appeals to the district court. This can create a lengthy appeals process, but courts of appeal are reluctant to let parties skip the district court / BAP stage, finding that they create a useful filtering mechanism for appeals not warranting pursuit to the court of appeals and help parties refine their arguments in the cases that do go through the whole process.

[48] Bankruptcy Rule 6004(h) stays the effectiveness of bankruptcy orders relating to the use, sale, or lease of property other than cash collateral for 14 days after entry to allow parties time to choose whether to appeal. This delay period can be reduced or waived by the court in appropriate circumstances, such as where the debtor needs immediate access to the proceeds.

[49] 11 USC, § 301(b) ("The commencement of a voluntary case under a chapter of this title constitutes an order for relief under such chapter.").

[50] *Idem*, § 541. The exclusions permit individual debtors to protect certain property from being used to satisfy creditors' claims.

If, prior to the bankruptcy, a custodian, receiver or similar agent was appointed by creditors, it must turn over the estate property to the debtor-in-possession or trustee.[51] Turnover obligations are also imposed on any other persons holding estate property,[52] so that if a pre-petition transaction has been reversed through use of the avoidance powers, the amounts received pre-petition become estate property whose turnover is required.

Unless a trustee is appointed, the debtor-in-possession is free to continue to operate its business in the ordinary course, which may include, for example, the sale of inventory. Non-ordinary course transactions such as sale or abandonment of estate property requires court approval following notice and a hearing.

5.4.2 Automatic stay

5.4.2.1Introduction

The worldwide automatic stay[53] comes into effect immediately on the filing of any plenary petition and provides the debtor breathing room to formulate a restructuring plan, negotiate with creditors and realize the value of its assets in an orderly process culminating in the payment of creditor claims in accordance with the priorities set out in the Bankruptcy Code.

5.4.2.2Scope of the stay

The scope of the automatic is extremely broad – it applies to any interference with the property of the estate anywhere in the world. In particular, the Bankruptcy Code specifically prohibits:

- litigation on pre-petition claims;
- enforcement of pre-petition judgment against the debtor or property of the estate;
- any act to obtain possession or control of property of the estate;
- creation, perfection or enforcement of a lien against property of the estate on account of a pre-petition claim;
- any attempt to collect on pre-petition claims (including through demand letters or calls);
- setoff of any pre-petition debt against any pre-petition claim.[54]

An act taken in violation of the stay (even if taken without notice of the filing of the petition) constitutes contempt of court and is void or voidable (depending on the circuit in which the bankruptcy is pending due to a circuit split on this issue). Parties in interest may, however, seek to lift the stay prospectively to permit or retroactively to validate an act that would otherwise be

---

[51] *Idem*, § 543.
[52] *Idem*, § 542.
[53] *Idem*, § 362.
[54] *Idem*, § 362(a).

a stay violation. Failure to obtain relief from the stay may result in the imposition of contempt sanctions against the stay violator, which may include payment of the debtors' attorneys' fees and requiring the violator to take affirmative acts to undo the effect of its violation. However, the US Supreme Court recently held that the stay only prohibits affirmative acts that change the *status quo* of the estate's property. For example, a car that was impounded before the debtor's bankruptcy petition was filed may remain impounded.[55] Where the court is concerned the violator may not act promptly, it can impose coercive contempt sanctions, such as a daily fine to be paid to the court until the stay violation has been rectified.

The stay only applies to property of the estate; it does not apply after the property in question is removed from the estate by sale or abandonment. The sale or abandonment order may alter creditors' interest in the property so that, for example, it is no longer subject to creditor security interests (see paragraph 5.4.3.2 below).

In exceptional circumstances, the stay may be extended to cover third parties or their property under the court's equitable powers.[56] As the automatic stay is an injunction against creditor action, the non-bankruptcy test for the grant of injunctive relief must be satisfied by showing the prospect of irreparable harm to the estate. A showing that estate has an interest in property of a third party is sufficient for the automatic stay to apply by its own terms (because the estate consists of all interests in property), without satisfying the injunction standard.

The stay is subject to certain statutory exceptions:

- criminal proceedings;
- regulatory investigations;
- family law matters such as custody, child support and divorce (except that distribution of marital property is stayed);
- exercise of rights under commodity, forward, or security contract;
- exercise of rights under a financial repo contract;
- exercise of rights under a swap agreement;
- eviction of a debtor-tenant from non-residential property where the lease has expired;
- termination of educational accreditation or licensing.[57]

Each reflects a legislative judgment that effects of, for example, freezing certain financial transactions, would be more harmful to the public than is warranted to protect the debtor. For

---

55 *City of Chicago v Fulton,* 529 US 140 (2021).

56 "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." – 11 USC, § 105(a).

57 11 USC, § 362(b).

debtors in certain industries, these exceptions to the automatic stay are important to recall in considering a bankruptcy filing because they may result in the debtor not having the protection from creditors it might expect the automatic stay to provide.

5.4.2.3Timing

Thanks to electronic filing, a bankruptcy petition may be filed at any day or time, and weekend filings are often chosen for publicly listed companies to avoid turmoil in the stock market. By statute, the stay comes into effect immediately on filing, even if the relevant court is closed, and without any court order or notice to creditors being required.

Unless lifted or modified by court order, the stay terminates only upon dismissal of the case or the conclusion of proceedings pursuant to a plan of reorganization or liquidation.

5.4.2.4Relief from the stay

The automatic stay may be lifted on creditor request (through a **lift-stay** or **relief from stay** motion) to permit otherwise prohibited creditor actions in certain circumstances:[58]

(1) Lack of **adequate protection** of an interest in property of the estate (such as that of a secured creditor, lessor or co-owner of the property) where the value of the property may decline during the course of proceedings and result in the interested party making less than a full recovery. Adequate protection may not be a concern where a creditor is oversecured (the value of the collateral exceeds the debt it secures), but assessing the value of the property is essential to this determination and therefore valuation is frequently litigated in the context of determining whether secured creditors are adequately protected. The other element of the analysis is the value of the secured creditor’s claim, which is determined by applicable non-bankruptcy law (usually the law of the contract). If adequate protection is indeed found to be lacking, the debtor can avoid the stay being lifted to allow the creditor to pursue remedies with respect to the property only if it provides the “indubitable equivalent” of the value that may otherwise be lost – this is typically through periodic cash payments or the grant of replacement liens on unencumbered estate property.[59] If the court-ordered adequate protection proves insufficient, the shortfall is given administrative expense priority.

(2) The debtor has no equity in the property and it is not necessary for reorganization. As with the prior section, valuation will be a key issue for the creditor with an interest in the property to establish that the value of its interest exceeds the value of the property. In chapter 7, the second element of this exception will not be relevant because no reorganization is contemplated; in a chapter 11 case, the debtor must show a reasonable prospect of reorganization within a reasonable time to avoid the stay being lifted.

(3) Where the sole asset of the debtor is a single piece of real property encumbered by an interest of the moving party and debtor has not (i) filed a plan within 90 days or (ii) made

[58] *Idem*, § 362(d).

[59] Section 361 outlines the options for providing adequate protection and s 362(d) provides authority for the recording of such liens in state property registries.

monthly payments a non-default contract rate of interest, the stay should be lifted to permit the creditor to foreclose or pursue other non-bankruptcy remedies.

(4) Where a creditor is secured by real property and the court finds that the debtor's filing for bankruptcy "was part of a scheme to delay, hinder, or defraud creditors that involved either–(A) transfer of all or part ownership of, or other interest in, such real property without the consent of the secured creditor or court approval; or (B) multiple bankruptcy filings affecting real property."

In addition to these specific situations, the court may terminate the automatic stay as of a given future date, annul the stay retrospectively (validating acts that otherwise would have been void or voidable as stay violations), modify the stay to permit specific act (for example, to file a lawsuit against the debtor to avoid lapsing of statute of limitations) or condition the continuance of the stay on the debtor's compliance with a condition to protect the affected party's interest in the property, in each case for cause shown.[60]

5.4.2.5Notice and a hearing

The Bankruptcy Code provides that the bankruptcy court may take certain actions, including granting relief from the automatic stay, only "after notice and a hearing." This requirement is satisfied if notice is given and there is an opportunity for a hearing;[61] the hearing need not be held if no one objects to the relief. The court may also waive the requirement for notice and a hearing where there is insufficient time for a hearing to be held before the act must be taken.[62] In such circumstances, including **first day motions** filed with the petition and heard within the a few days after the petition is filed, the court typically will order interim relief limited to what is immediately required and then will hold a hearing to consider final relief once parties in interest have received notice.

Self-Assessment Exercise 6

Question 1

True or false: Following the filing of an involuntary bankruptcy petition, the automatic stay does not come into effect until the court enters an order for relief.

60 11 USC, § 362(d).
61 *Idem*, § 102(1).
62 *Idem*, § 102(1)(B).

Question 2

Which of the following actions is *not* prohibited by the automatic stay?

(a) foreclosure on the debtor's non-US property securing a debt;
(b) commencing an arbitration against the debtor under the rules of the International Chamber of Commerce;
(c) the debtor filing a lawsuit in state court against a creditor for breach of contract;
(d) execution of a securities contract to which the debtor is a party;
(e) filing a claim in the debtor's bankruptcy proceedings.

Question 3

Debtor-in-possession Hotelco operates a chain of franchised hotels, and each property is subject to a separate mortgage. With respect to Hotel X, the amount outstanding on the loan is USD 1 million. The secured lender contends that Hotel X is worth only USD 800,000 and has filed a motion to lift the automatic stay so it can foreclose on the Hotel X property. How might Hotelco oppose the motion?

For commentary and feedback on self-assessment exercise 6, please see APPENDIX A

5.4.3 *Dealings with property*

5.4.3.1Introduction

The powers of the debtor in possession or trustee to deal in estate property depends on whether the case is under chapter 7 or chapter 11, whether the transaction is in the ordinary course of business and whether the interest of another in the property is affected.

5.4.3.2Chapter 11

A debtor in possession in chapter 11 proceedings, operating with the protection of the automatic stay, has in some senses more power over its affairs than it had pre-petition. It can mostly deal with its property in the ordinary course of business without court or creditor interference and can sell its property free and clear of creditor interests with court approval in a **363 sale**.[63] It also has a "home court" in which to consolidate litigation of creditor claims relating to those interests.

[63] Pursuant to s 363(f), an asset may be sold free and clear with creditor consent, where the creditor interest is disputed or where the value of the property exceeds the value of the interest. In such circumstances, a creditor's interest will attach to the proceeds of the sale and it will receive priority in distribution of those proceeds.

Chapter 11 was enacted to permit a debtor in possession to continue to operate its business in the ordinary course while carrying out an organizational and / or financial restructuring, but is now commonly used as a vehicle for the sale of substantially all of the debtor's assets, either to a strategic purchaser or a successor corporate entity. The advantage of using chapter 11, as compared to chapter 7, for this process is that the purchase price is likely to be higher because of the ability to continue operating the business during the bankruptcy proceedings. Both the debtor and potential purchasers may also prefer a 363 sale over an out-of-court sale because the bankruptcy sale is free and clear of creditor interests[64] and a good faith purchaser may retain the property notwithstanding a subsequent reversal of court approval for the sale on appeal.[65] Also, as discussed further in paragraph 5.4.5 below, the debtor can transfer its interests in key contracts that are required to operate the business (such as supply and employment contracts), even where they contain contractual restrictions on assignment or purport to terminate upon a bankruptcy filing.[66] Licensees of patents and copyrights owned by the debtor are protected such that their licenses may not be terminated in connection with the sale of the intellectual property without their consent.[67]

A debtor in possession is free to use, sell or lease estate property in "the ordinary course of business", but this term is not defined by the Bankruptcy Court. Court decisions have developed a two-prong test that considers the "vertical dimension" (the expectations of a hypothetical creditor of the debtor) and the "horizontal dimension" (how business is conducted by other businesses similar to the debtor).[68] A particular transaction is in the ordinary course only if both prongs of the test are met. Sophisticated parties dealing with a debtor will insist on a 363 sale if there is any question as to the status of the transaction, but this test will be easily satisfied for small, routine sales of the debtor's inventory. Note, however, that debtor's right to deal with property in the ordinary course does not trump provisions requiring adequate protection of other's interests in estate property.

In particular, ordinary course of business is not sufficient authorization for debtor to use **cash collateral** – the debtor's financial accounts that are subject to security interests. For this reason, among the first day motions typically filed is a cash collateral motion for authorization for the debtor to use cash collateral to pay the expenses of administering the estate.[69] Adequate protection of the interests of the secured parties is nearly always required, as the debtor's use of cash indisputably removes assets that would otherwise be available to satisfy secured creditors (but equally are necessary to the continued operation of the debtor's business).[70]

---

[64] 11 USC, § 363(f).

[65] *Idem*, § 363(m).

[66] *Idem*, §§ 365(c) and (e). Where the property includes personal information collection pursuant to a privacy policy that would bar its transfer, s 363(b)(1) provides for appointment of a consumer privacy ombudsman to oversee the terms of transfer.

[67] *Idem*, § 365(n).

[68] *In re Dant & Russell, Inc*, 853 F.2d 700 (9th Cir 1988).

[69] Section 363(c)(3) provides parameters for issuing limited preliminary relief at the first day hearing.

[70] Notwithstanding the character of the funds as cash collateral, a creditor may not be entitled to adequate protection in connection with their use if it is oversecured, particularly by other, non-cash assets of the estate that cannot be sold without court approval.

For non-ordinary course transactions, most commonly 363 sales of property, a debtor in possession must establish that it is proposing the transaction in its business judgment (in connection with which it owes a fiduciary duty to consider the interests of creditors) and that the transaction is in the best interests of the estate as a whole. The UCC will usually be closely involved in scrutinizing proposed transactions and is authorized to retain financial advisors at the estate's expense to assist it.

While no particular procedure for 363 sales is specified by the Bankruptcy Code, the practice in large cases for significant sales is to conduct an auction with a "stalking horse" bidder. The debtor (sometimes with the assistance of a financial advisor or investment banker) will market the property and invite interested parties to conduct due diligence, ultimately leading to negotiation of proposed transaction documents with a single party. Upon court approval of these documents, this party's bid becomes the stalking horse for the auction, which another bid must exceed in price or terms to be selected as highest and best offer. Because the stalking horse bidder invests substantial time and expense in this process, it is typically paid a "break fee" if another bid is selected at the auction. If no other qualified bids are received, the auction will be cancelled and the stalking horse bid accepted.

A creditor holding a security interest in property that is to be sold may "credit bid" by offsetting a portion of the purchase price of such property against the amount of its claim secured by the property.[71] For example, a bank holding a USD 100,000 mortgage on a piece of real property may bid USD 150,000 to purchase the property, but pay only USD 50,000 in cash to the estate. The ability to use secured claims in this way creates a market in secured claims against the estate, so a prospective purchaser of the property may purchase the mortgage from the bank at a discount because of the borrower's distress, but credit bid the full value of the claim. Because credit bids diminish the value that comes into the estate, unsecured creditors may challenge credit bids if the value of the secured claim is in doubt.

Other common issues litigated in connection with 363 sales include whether the debtor has carried out a robust marketing process, whether the purchaser is an insider or affiliate (in which case greater scrutiny for fairness is required), and whether the property is best sold together with other assets of the debtor or separately. Where substantially all of the debtor's assets are being sold, creditors may object that the transaction constitutes a ***sub rosa* plan**. As discussed in paragraph 5.5.3 below, plans of reorganization, which determine the distribution of value to creditors and may include asset sales, are subject to detailed statutory requirements and the vote of affected creditors. Court approval of a sale may be denied if the sale short circuits the plan process by dictating the ultimate allocation of value, but, while *sub rosa* plan objections are frequently advanced, they are rarely successful.

---

[71] 11 USC, § 363(k).

Self-Assessment Exercise 7

Question 1

Hotelco (introduced in Self-Assessment Exercise 6) wants to issue year-end bonuses to its employees. What analysis should Hotelco's lawyers perform to determine whether court approval is required?

Question 2

Hotelco wants to sell Hotels X and Y in a single 363 sale. The secured lender on Hotel X wishes to credit bid its USD 1 million debt claim on the Hotel X mortgage for the two hotels, and a third party is offering USD 900,000 cash for the two hotels. Which of these offers should Hotelco ask the court to approve?

For commentary and feedback on self-assessment exercise 7, please see APPENDIX A

5.4.3.3Chapter 7

A court may authorize the trustee to operate the debtor's business for "a limited period, if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate,"[72] but the trustee has no ability to operate, even in the ordinary course, without court approval. Instead, the trustee's activity will focus on sales of the estate's property, for which it may be necessary to retain the services of the debtor's pre-petition employees to market and administer the assets during the sales period. All such sales will require notice and a hearing as the debtor's ordinary course of business ceases upon entry into chapter 7 proceedings, if not before.

5.4.4 Post-commencement financing

Being a debtor in a US chapter 11 bankruptcy is very expensive. The estate must pay on an ongoing basis for the debtor's post-petition business expenses and for its lawyers and other advisors, as well as for the lawyers and advisors of the unsecured creditors' committee, any other statutory committee and any other creditor who may have contractual entitlements to payment of fees in enforcement proceedings (such provisions are common in bonds and loans). Rare is the debtor who can finance the process from ordinary course of business receipts. To maximize the chances of a successful reorganization, the Bankruptcy Code provides incentives to lenders and counterparties to extend credit to the debtor. This is commonly referred to as **debtor in possession (DIP) financing**.

[72] *Idem*, § 721

There are four alternative ways the estate may obtain creditor incur debt, in order of escalating protections to the counterparty and concomitant increase in the burden on the debtor show that such protections are necessary to obtain sufficient credit:[73]

(a) The debtor in possession can incur unsecured debt or obtain unsecured credit (for example, from suppliers) in the ordinary course of business without court approval, with the debt being granted administrative priority expense (whereas, had it been incurred pre-petition, it would be only a general unsecured claim).

(b) The debtor in possession can incur unsecured debt or obtain unsecured credit outside the ordinary course of business with court approval after notice and a hearing, with the debt again having administrative expense priority.

The debtor is unlikely to obtain credit under (a) or (b) unless the estate has substantial unencumbered assets that assure potential lenders that all administrative priority claims will be satisfied.

(c) Upon a showing that the debtor has been unable to secure sufficient funding under (a) or (b), the court can authorize one of the following, after notice and a hearing:

    (1) unsecured debt having priority ahead of all other administrative expenses;

    (2) secured debt with a lien on unencumbered estate property;

    (3) secured debt with a junior lien on encumbered estate property.

The possibility of obtaining financing on any of these terms will depend on whether the estate has any unencumbered assets or encumbered assets with sufficient equity value to support a junior lien.

(d) If financing cannot be obtained on any other terms, the court may grant a **priming lien** that is senior or equal to a pre-petition lien on estate property to secure post-petition financing. The debtor also must demonstrate that the interest of the secured creditor being primed is adequately protected.

The risk to a secured creditor of being primed, notwithstanding any adequate protection payments being offered, often incentivizes existing creditors to extend further credit to the debtor. Pre-petition creditors also may be able to improve their position by "rolling up" – refinancing pre-petition debt that was unsecured or undersecured into the facility granted the priming lien. The court's approval of a roll-up will depend on whether any other source of funds is available that does not contain such provisions and whether substantial additional credit is being made available to the debtor.

---

[73] *Idem*, § 364. To widen the scope of who may serve as a DIP lender, s 364(f) grants a partial exemption from US and state securities laws.

As with a good faith purchaser at a 363 sale, a good faith DIP lender is protected from the effects of a reversal of a DIP financing order on appeal.[74]

Self-Assessment Exercise 8

Question 1

The secured lender on Hotel X has offered to extend Hotelco USD 5 million in DIP financing, to consist of USD 1 million in refinancing the existing Hotel X facility and USD 4 million in cash, to be secured by a super senior lien on all of the Hotelco's properties, priming the mortgage lenders on those properties. What arguments might the other mortgage lenders make in opposition to Hotelco's motion for approval of this financing arrangement?

For commentary and feedback on self-assessment exercise 8, please see APPENDIX A

5.4.5 Executory contracts

The ability to assume, reject or assume and assign executory contracts is another debtor-friendly feature of Bankruptcy Code.[75] Like other important concepts, such as adequate protection, what makes a contract executory is not defined by statute, but rather has been given meaning through case law.

In the most common formulation,[76] a contract is said to be executory if there are material unperformed obligations on both sides. For example, if the debtor is party to a construction contract with a builder and, as of the petition date, construction and payment are only partially complete, the contract is executory, whereas if construction is complete, but the debtor had not made its final payment, the contract would not be executory.

In a chapter 7 case, the trustee must make decisions about assumption and assignment or rejection of executory contracts within 60 days of the petition date. In a chapter 11 case, by contrast, the debtor has until the confirmation of its plan of reorganization to make this election, but a deadline can be imposed by the bankruptcy court on the request of a counterparty for cause. One exception is that decisions about unexpired leases of non-residential property are required to be made within 120 days of the order for relief.[77]

The election to assume or reject a contract must be based on the business judgment of the debtor in possession or trustee that the reorganization of the debtor or the liquidation of assets

[74] *Idem*, § 364(f).
[75] *Idem*, § 365.
[76] Called the "Countryman test" because it derives from an influential law review article by Professor Vern Countryman.
[77] 11 USC, § 365(d)(4). While this period can be extended to 90 days for cause, any subsequent extension requires the consent of the lessor, giving landlords of commercial premises substantial leverage.

to pay creditors will be facilitated thereby. The court may only deny approval of the election where the choice is not made in good faith or in a reasonable exercise of business judgment.

In the construction scenario above, if the contract is executory, the debtor could elect to:

- Reject the contract. The effect of rejection is that the debtor is deemed to have breached the contract immediately before the petition date, giving the counterparty an unsecured pre-petition claim in damages.[78] The contract is not treated as void, and therefore a counterparty ordinarily can retain whatever it received under the contract pre-petition.

- Assume the contract. To assume a contract, the debtor must cure defaults and give the counterparty sufficient assurances of its future performance.[79] If, after assuming the contract, the debtor subsequently decides to reject it, the damages due to the counterparty are a post-petition administrative expense of the estate.

- Assume and assign the contract – transfer the debtor's rights under the contract to a third party. Such transferee must give the counterparty adequate assurances of future performance.[80]

In certain circumstances, a debtor may be deemed to have assumed a contract based on its conduct, such as when a debtor continues to occupy leased premises despite purporting to reject the lease.

Importantly, the Bankruptcy Code abrogates contractual restrictions on assignment to enable the debtor to achieve a higher value for its assets than if such provisions were enforced. Counterparty consent is only required where the contract is one to make a loan or other financial accommodation, or where substantive non-bankruptcy law (such as intellectual property licensing law) provides that the counterparty cannot be compelled to accept performance from a transferee.[81] Because the prohibition is phrased as prohibiting either assumption or assignment, some courts have concluded that a debtor may not assume an executory contract that it would not be permitted to assign (the **hypothetical test**).[82] Thus, for example, a licensee of a third-party's intellectual property might not be able to assume and continue performing under a pre-petition license without the licensor's consent. Other courts have held that this provision applies only where the debtor actually intends to assign the agreement (the **actual test**).[83]

[78] *Idem*, § 365(g)(1).
[79] *Idem*, § 365(b)(1).
[80] *Idem*, § 365(f).
[81] *Idem*, § 365(c).
[82] This test is applied in the Third, Fourth, Ninth and Eleventh Circuits.
[83] This test is applied in the First Circuit and in lower courts outside the circuits listed in the preceding footnote. The circuit courts of appeal in the remaining circuits have not ruled on this issue.

The value of the debtor's ability to assign contracts is also increased by the nullification of ***ipso facto* clauses** that would permit the termination of or alteration in rights under any contract solely based on the fact that the debtor is insolvent or files for bankruptcy.[84]

Other bases for termination or events of default may be given effect, for example, if the debtor ceases performance post-petition. In that event, however, the counterparty will require relief from the automatic stay to terminate the contract, and the debtor has the option to cure such defaults if it wishes to assume or assume and assign the contract.

Self-Assessment Exercise 9

Question 1

Which of the following contracts to which Hotelco is party are executory and, if executory, may be assigned without counterparty consent?

(a) Franchise agreement with Brand Name Hotels Inc.
(b) Employment contract with former CEO, requiring Hotelco to indemnify him in any future lawsuit.
(c) Lease of office space containing provision requiring landlord approval of any assignment.

Question 2

Mr Q, a majority shareholder of Hotelco, has granted an unconditional guarantee of Hotelco's revolving credit facility. Hotelco's commencement of bankruptcy is an event of default under the facility. May the lender demand payment on the guarantee or is it barred by the prohibition on *ipso facto* clauses?

For commentary and feedback on self-assessment exercise 9, please see APPENDIX A

5.4.6 *Effect on employees*

US employees rarely have employment contracts, except in the context of unionized workforces operative under **collective bargaining agreements (CBAs)**. Unionized workforces are less common in the US than in many other countries.

[84] 11 USC, § 365(b)(2) . *Ipso facto* clauses may still play a role where a corporate affiliate's insolvency or bankruptcy filing triggers termination rights (eg, in guarantees) and the entities file at different times, which occurred in the bankruptcy filings of various Lehman Brothers entities. *See Lehman Bros Special Financing Inc v Bank of Am NA (In re Lehman Bros*, 553 BR 476, 497 (Bankr SDNY 2016).

Certain employee expenses, primarily for unpaid salaries and contributions to employee benefits plans for the 180 days prior to the petition date or cessation of business, are given administrative priority under chapter 7 and, under the **absolute priority rule** can receive no worse treatment under a plan of reorganization than they would have received in a chapter 7 liquidation unless they consent.

In a chapter 11 case, the debtor is likely to wish to alter any CBAs currently in effect as part of its reorganization, but it cannot simply follow the executory contract rejection process.[85] The debtor must make a proposal to an employee representative that is based on all the information available at the time and is "necessary to permit the reorganization of the debtor". The proposal also must treat all affected parties "fairly and equitably" so that the reorganization does not come at disproportionate cost to a particular group.

The union receiving the proposal must be provided with the information necessary to evaluate it and be given the opportunity to meet with the debtor to discuss it. The debtor is obligated to negotiate in good faith to achieve an agreed modified CBA. If the union refuses without good cause to accept a proposal meeting the requirements of the Bankruptcy Code and the equities support rejection, the court will approve a rejection of the existing CBA.[86] A key question is when a modification is "necessary to permit the reorganization of the debtor."[87] The Third Circuit has held that this standard is satisfied only where the proposed modifications are "essential to avoid the liquidation of the debtor in the short term."[88] Most circuit courts of appeal, however, including the Second Circuit, have held that "necessary" is not a synonym of either "essential" or "desirable", and that the relevant time horizon is not avoidance of liquidation but rather the somewhat longer term that will determine whether a reorganization is successful.[89] This 30-year circuit split should be taken into consideration in bankruptcy planning for a business with a unionized workforce.

5.4.7 *Information*

The debtor must file certain schedules with or shortly after the petition,[90] and, as discussed in paragraph 5.3.3.1 above, official forms must be used to ensure all required information is provided. For a corporate debtor under chapter 7 or 11, the following schedules are required:

A/B Real and personal property

D Secured creditors

---

[85] 11 USC, § 1113. In *NLRB v Bildisco & Bildisco*, 465 US 513 (1984), the US Supreme Court held that a debtor's unilateral rejection of a CBA as an executory contract in its bankruptcy was not an unfair labor practice. In response, Congress added s 1113 to the Bankruptcy Code to improve labor protection in employer bankruptcies.

[86] *Idem*, § 1113(c).

[87] *Idem*, § 1113(b)(1)(A).

[88] *Wheeling-Pittsburgh Steel Corp v United Steelworkers of America*, 791 F.2d 1074, 1088-89 (3d Cir 1986).

[89] See *Truck Drivers Local 807 v Carey Transp Inc*, 816 F2d 82, 90 (2d Cir 1987) ("[T]he necessity requirement places on the debtor the burden of proving that its proposal is made in good faith, and that it contains necessary, but not absolutely minimal, changes that will enable the debtor to complete the reorganization process successfully.").

[90] 11 USC, § 521. Bankruptcy Rule 1007 governs the time within forms and schedules are required to be filed, unless time is extended by the court.

E/F Unsecured creditors

G Executory contracts and unexpired leases

H Co-debtors

In a chapter 11 case, a list of the 20 largest non-insider creditors also is required for use by the US Trustee in soliciting participation in the UCC.

5.4.8 Publicity and notification of opening of proceedings

Notice of the petition and the order opening proceedings must be mailed to interested parties, including creditors and indenture trustees.[91] Where notice by mail is impracticable or it is desirable to give wider notice, notice by publication is authorized, subject to the court determining the form and manner of notice by publication.[92]

Because notice of a number of other significant filings or orders is required to be given to the creditor body, it is typical in large bankruptcy cases for the debtor to retain a notice agent. The notice agent frequently will maintain a website where docket information is freely available, lessening the need for administrative time to be spent answering creditor questions.[93]

5.4.9 Procedures for claims filing and verification

As noted in paragraph 5.4.7 above, the debtor is required to file a list of creditors in its schedules. To demand payment on a claim, the creditor must file a **proof of claim** on or before the **bar date** specified by the court. The listing of a claim on the debtor's schedules as not contingent, unliquidated or disputed is deemed to be the filing of a claim, but a creditor wishing to receive payment on its claim must file a proof of claim for itself.[94] A secured creditor's failure to file a claim will not void its lien.

Claims may be sold or otherwise transferred before or after the filing of a proof of claim; if after filing, a record of the transfer must be filed.

Filed claims are deemed **allowed** unless objected to by the debtor, trustee or another party in interest. A claim is subject to **disallowance** where it is filed after the bar date without good cause or where the debtor has a defence to the claim (such as prior satisfaction of the debt).[95] The claim of a creditor who received an avoidable transfer and has not returned the property is also subject to disallowance.[96]

---

91 Bankruptcy Rule 2002.
92 Bankruptcy Rule 9008.
93 All US bankruptcy court filings are already available online through the court links at www.pacer.gov (unless sealing is required to protect trade secrets or other sensitive information), but there is a per-page cost for accessing most documents.
94 11 USC, § 1111(a); Bankruptcy Rules 3002 and 3003.
95 *Idem*, §§ 502 and 726.
96 *Idem*, § 502(d).

Claims are ordinarily on account only of pre-petition obligations of the debtor. Claims arising after the petition date may be allowed in four circumstances:[97]

- In an involuntary case, a claim arising from the ordinary course of the debtor's business after the petition date but before the appointment or a trustee or entry of an order for relief is treated as a pre-petition claim.
- A claim arising from the rejection of an executory contract is treated as a pre-petition claim.
- A claim arising from recovery of a voidable transfer is treated as a pre-petition claim.
- Tax claims that arise after commencement are treated as pre-petition tax priority claims.

Other post-petition expenses, such as payment of professional fees and rents, are paid as administrative expenses on an ongoing basis, subject to court approval after notice and a hearing. Applications for payment of administrative expenses are submitted as motions rather than proofs of claim.

An estate is **administratively insolvent** if it lacks sufficient liquidity to pay its on-going administrative expenses. This is a basis for conversion from chapter 11 to chapter 7.

Self-Assessment Exercise 10

Which of the following are entitled to file a claim in the Hotelco bankruptcy?

(a) Secured lender owed USD 1 million on Hotel X mortgage.
(b) Lessor of office space owed pre-petition rent.
(c) Cleaning staff owed pre-petition wages.
(d) Franchisor Brand Name Hotels Inc following rejection of the franchise agreement.
(e) Mr Q, the majority shareholder, based on his stock ownership.
(f) Mr Q, for the obligations he may pay on behalf of Hotelco under his guarantee.

For commentary and feedback on self-assessment exercise 10, please see APPENDIX A

5.5 Reorganization (Chapter 11)

5.5.1 Introduction

Chapter 11 is the centrepiece of the US Bankruptcy Code's debtor-friendly rehabilitation regime. Its success and popularity have led other national legislatures to adopt some of its key

[97] *Idem*, §§ 502(f) – (i).

features in their domestic insolvency regimes. Among those features are the automatic stay, powers to sell assets free and clear, avoid pre-petition transactions, and reject unprofitable contracts, and the adjustment of debts through a plan of reorganization. This reorganization model does come with some costs, including procedural complexity, frequent involvement of the court if matters cannot be resolved consensually between the debtor and its creditors, and substantial fees for lawyers and other professionals being borne by the estate.

5.5.2 Overview of the process

Summarized here is the lifecycle of a hypothetical chapter 11 case. Some steps will be familiar from the discussion above because these steps apply in both chapter 7 and chapter 11 cases. Other steps that are unique to chapter 11 will be discussed in further detail below. Note that the steps below are not listed in chronological order—in a **pre-packaged bankruptcy** ("**pre-pack**"), the plan may be negotiated with some or all creditors prior to the petition being filed.

- Initiation by voluntary petition or order for relief on involuntary petition.
- Automatic stay effective on filing of petition (even if involuntary).
- Continued business operations by the debtor in possession in ordinary course of business unless a trustee is appointed for cause (a heavy burden for creditor or other party in interest to establish).
- The debtor may also use, sell or lease property outside the ordinary course of business with court approval.
- The debtor discloses information, including assets, liabilities, and executory contracts. The US Trustee forms the UCC from the list of 20 largest creditors.
- The debtor negotiates with creditors (and potentially with non-creditors interested in purchasing assets or financing its bankruptcy and / or post-bankruptcy operations) to develop a plan of reorganization.
- The plan of reorganization is voted upon by creditors and must be confirmed by the court.
- The plan is implemented and the case is closed.

5.5.3 *Formulation of a plan*

5.5.3.1Introduction

A plan of reorganization is not written on a blank slate; the Bankruptcy Code specifies both requirements of a plan for a corporate debtor and additional items that may be included in a plan:[98]

- Designation of **classes** of claims or interests held by creditors. Because classes are the basis of voting on the plan, only like claims or interests can be put in the same class and divisions of similar claims or interests into separate classes must have a reasonable basis. A typical set of classes would be (i) creditors secured by real property, (ii) creditors secured by personal property, (iii) unsecured creditors and (iv) shareholders (equity).

- Specify which classes are **unimpaired** and which are **impaired**. A class is impaired unless, as to every claim or interest in the class, the plan leaves the holder's "legal, equitable, and contractual rights unaltered", except that a class may be deemed unimpaired where the plan reverses contractual acceleration by curing any monetary default and compensating the holder for any damages.[99] Delayed payment in full (after the effective date of the plan) is considered impairment. Only impaired classes have the right to vote on the plan.

- Specify the treatment of impaired claims – the value they will receive as a percentage of the value of their claims and the form in which that value will be provided (for example, cash, new securities to be issued by the debtor, payment over time).

- Application of the same treatment to all claims in a class is required unless a creditor agrees to less favourable treatment.

- Compliance with the absolute priority rule – no creditor or class of creditors may receive less under a plan of reorganization than it would under a hypothetical chapter 7 liquidation, in which the claims would be paid in accordance with statutorily required priorities, without consent of the affected creditor. In a chapter 11 plan, however, a more senior creditor may consent to receiving less than the absolute priority rule would require if distribution of the funds to lower priority claimants is necessary to obtain their approval of the plan.

- State how the plan will be implemented – what assets (including executory contracts) will be retained and what will be sold or rejected, what defaults will be cured and how, what securities will be issued and to whom, the cancellation or modification of liens, and the modification of terms of existing securities.

---

98 *Idem*, §§ 1123(a) and (b). The US Courts website contains a form that a small business debtor can use to create a simple plan: https://www.uscourts.gov/sites/default/files/b_425a_1217_0.pdf.

99 *Idem*, § 1124. Four circuit courts of appeal have held that a claim whose recovery is limited by the Bankruptcy Code (such as the limitation on recovery of post-petition interest under 11 USC §502(b)(2)), rather than the bankruptcy plan, is not impaired and therefore not entitled to vote on the plan. *See In re LATAM Airlines Group SA*, 55 F.4th 377 (2d Cir 2022); *In re PPI Enters (US), Inc*, 324 F.3d 197 (3d Cir 2003); *In re Ultra Petroleum Corp*, 943 F.3d 758 (5th Cir 2019); and *In re L&J Anaheim Assocs*, 995 F.2d 940 (9th Cir 1993).

- Any amendment to the debtor's charter or merger into another corporate entity.

- If the plan includes the issuance of equity securities, the issuance of non-voting securities must be prohibited and "an appropriate distribution of [voting] power" provided if the debtor will have multiple classes of equity securities.

- Limitation on provisions for selection of officers, directors, and trustees to those "consistent with the interests of creditors and equity security holders and with public policy".

Any number of additional provisions may be included to the extent not prohibited by the Bankruptcy Code.

5.5.3.2Exclusivity periods

The Bankruptcy Code gives the debtor an **exclusivity period** for 120 days from the order for relief (the petition date in a voluntary case) in which only the debtor may propose a plan of reorganization.[100] During this period, the debtor negotiates with the unsecured creditors' committee and other key creditor constituencies to attempt to develop a plan that will be acceptable to them. Once the debtor proposes a plan, there is a further 60 days for consideration by the creditors, during which no competing plan can be proposed, for a total exclusivity period of 180 days.

After the exclusivity period terminates, a creditor or other party in interest may propose a plan without the debtor's agreement or approval. If the plan is accepted by the requisite class(es) of creditors and confirmed by the court, the debtor can be forced to accept a reorganization on creditors' terms, rather than its own. The termination of the exclusivity period can therefore mark a substantial shift in the relative bargaining power of the debtor versus its creditors.

The exclusivity period may be extended upon request of the debtor for cause, subject to a maximum of 18 months from the order for relief for the filing of a plan by the debtor and 20 months from the order for relief for the acceptance of the debtor's plan by the requisite creditors.[101]

5.5.3.3Information

To assist creditors in determining how to vote on a proposed plan, the plan proponent must also provide a disclosure statement containing "adequate information".[102] This requirement supersedes the securities laws that might otherwise apply to securities proposed to be issued under the plan, but securities regulators may be heard by the court on the adequacy of the information.[103] The disclosure statement is subject to court approval before it is circulated, with the plan, to creditors for their vote.

---

[100] *Idem*, § 1121.
[101] *Idem*, § 1121(d). Parties in interest may invoke the same provision to seek a reduction of the exclusivity period for cause.
[102] *Idem*, § 1125.
[103] *Idem*, § 1125(d).

5.5.3.4Substantive consolidation

Substantive consolidation is the treatment of two or more debtors as a single debtor and the cancellation of inter-debtor claims, with their joint assets being made available to satisfy the claims of a creditor of either entity. In some cases, courts have approved "deemed substantive consolidation" in which claims were satisfied as if such substantive consolidation had occurred. Authority for substantive consolidation is found in the court's general equitable powers.

Substantive consolidation disregards corporate separateness and is therefore disfavoured.[104] In nearly every case, there exists a creditor who will be worse off if debtors are substantively consolidated because its claim against one debtor was a larger percentage of that claims pool than will be its claim against the combined debtors, even if the assets available to pay on that claim increase. Substantive consolidation is most likely to be appropriate where the corporate form was disregarded during the debtors' pre-petition operations, either through fraud or lack of respect for the formalities of related entities such that creditors extended credit on the basis of the entities as a whole. Substantive consolidation may also be appropriate where the expense of untangling the affairs of related debtors is greater than any benefit to creditors of ascertaining the liabilities of each debtor. Substantive consolidation will rarely be approved by a court over the objection of a creditor that can show it extended credit on the basis of corporate separateness – for example, it obtained an affiliate guarantee of a particular debt, which would be wiped out by substantive consolidation.

5.5.4 Approval, modification and confirmation of the plan

5.5.4.1Introduction

After the court has approved the disclosure statement to accompany the proposed plan, it will set a time period for creditor voting. The mechanics of distributing and tabulating ballots will, in a large case, be handled by a vendor retained by the estate. The debtor typically will have proposed a plan it expects to be supported by key creditor constituencies, but it may need to revise the plan during the voting period to obtain approval. Not all creditor constituencies must approve the plan for it to be confirmed, however, the Bankruptcy Code provides for **cramdown** of dissenting classes.

A given class of creditors approves the plan if a simple majority of the creditors in the class, holding at least two-thirds of the value of claims in the class, vote in favour or, for equity interests, if two-thirds in amount of interests vote in favour.[105] An unimpaired class (including, as noted above, one whose acceleration of debt has been reversed) is deemed to accept the plan, and a

---

[104] The leading cases on the requirements for substantive consolidation are *In re Augie / Restivo Baking Co*, 860 F.2d 515, 518 (2d Cir 1988) (tests for substantive consolidation are "(i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors") (internal citations and quotations omitted) and *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir 2005) (same). In a case involving substantive consolidation of entities used to perpetuate a Ponzi scheme, the Bankruptcy Court for the District of Minnesota gave a thorough review of the history of and the different circuits' tests for substantive consolidation—*In re Petters Co Inc*, 506 BR 784, 792-800 (Bankr D Minn 2013).

[105] 11 USC, §§ 1126(c) and (d).

class that will receive nothing is deemed to reject the plan.[106] Thus, the balance of decision-making power lies with those who have the most to gain or lose: the impaired classes.

5.5.4.2Confirmation

If all impaired classes have accepted the plan, the court must then determine whether to **confirm** the plan. To be confirmed, a plan must:[107]

- be feasible and not rely on speculative or improbable events to be capable of execution – for example, if the plan is based on the assumption that a key commodity price is X, the plan will not be feasible if the prevailing price at the time of confirmation is one-half of X;
- not be likely to be followed by liquidation or the need for further financial reorganization (unless that liquidation or reorganization is provided for in the plan);
- comply with the requirements of the Bankruptcy Code for formulation of a plan (set out in paragraph 5.5.3.1 above);
- be accepted by one impaired class, disregarding the votes of insiders, unless there is no impaired class; and
- except where different treatment is elected by a holder of a claim, provide for the cash payment on the effective date or deferred cash payments equal to allowed amounts of all administrative priority claims.

Because the court may deny confirmation of a plan notwithstanding its approval by the requisite number and kind of creditors, confirmation provides a dissenting creditor or other party in interest an opportunity to have its grievances heard. A contested confirmation hearing may take days and include testimony from the vote tabulation agent, management (as to the feasibility of the plan), and valuation experts (as to the fairness of asset sales or deferred payments proposed under the plan) – it is a major event in the life of the case and all the expense of preparing the plan and soliciting the votes may be for naught if confirmation is denied. The possibility of a denial of confirmation may cause the debtor to give a dissenter better treatment (though it must not violate the principle of equality of treatment of creditors of a given class in so doing).

5.5.4.3Cramdown

To mitigate the holdout problem that would occur if all impaired classes of creditors had to approve a plan, a plan may be confirmed by "cramming down" dissenting impaired classes.[108] To use cramdown, all the other requirements of confirmation described above need to be met, and at least one impaired class (not counting insiders) must have voted to accept the plan. In addition, the plan must not "discriminate unfairly" and must be "fair and equitable" to the non-

[106] *Idem*, §§ 1126(f) and (g).
[107] *Idem*, § 1129.
[108] *Idem*, § 1129.

consenting impaired classes.[109] That is, differential treatment of non-consenting classes must have a reasonable basis, be proposed in good faith, and be required for a plan that can be confirmed and consummated. The statute sets forth factors relevant to fair and equitable treatment,[110] but compliance with these factors alone is not sufficient to show that the requirement of fair and equitable treatment is met.

Because only one consenting impaired class is required, class definition can become a battleground – a non-insider with an impaired claim who supports the plan, if classified into a one-creditor class, may be sufficient to invoke cramdown of all other dissenting creditors. The dissenters, for their part, may challenge the reasonable basis for the separate classification that creditor (see paragraph 5.5.3.1 above).

Self-Assessment Exercise 11

Question 1

To cramdown a plan over the objection of a class of secured creditors, what does the "fair and equitable" provision of section 1129 require with respect to treatment of their claims?

---

[109] *Idem* § 1129(b).

[110] "[T]he condition that a plan be fair and equitable with respect to a class includes the following requirements:
(A) With respect to a class of secured claims, the plan provides--
(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
(iii) for the realization by such holders of the indubitable equivalent of such claims.
(B) With respect to a class of unsecured claims--
(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.
(C) With respect to a class of interests--
(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or
(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property."
11 USC, § 1129(b)(2).

Question 2

Hotelco has proposed a plan under which its majority shareholder, Mr Q, receives payment in full on the liquidated amount of his claim relating to his guarantee of Hotelco's debts, but the payment is not made until 60 days after the effective date of the plan. Mr Q is classified into a different class than other unsecured creditors. Mr Q's class is the only accepting impaired class. On what basis might other creditors challenge Hotelco's use of cramdown?

For commentary and feedback on self-assessment exercise 11, please see APPENDIX A

5.5.4.4Modification

While only one confirmed plan can exist at a time, a plan may be modified before or after confirmation, so long as the modifications do not take the plan out of compliance with the requirements for classification of claims and the contents of the plan.[111] Any modification is subject to approval and circulation of a new disclosure statement explaining the change.

Modification prior to confirmation is a common method to address issues that arise in the course of the plan voting process, which only requires circulating the revised plan and disclosure statement to all creditors for voting, and may result in an agreed plan to be presented for confirmation, or at least remove some objections.

Modification of a confirmed plan is possible only prior to **substantial consummation** of the plan and requires not only approval of the disclosure statement but also what is essentially a further confirmation hearing. Substantial consummation is defined as:

"(A) transfer of all or substantially all of the property proposed by the plan to be transferred;

(B) assumption by the debtor or the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and

(C) commencement of distribution under the plan."[112]

5.5.5 Pre-packaged plans

As noted in the overview of the chapter 11 process, in **pre-pack** bankruptcies, the debtor submits a proposed plan together with its voluntary petition.[113] In a pre-pack, the negotiations with creditors occur prior to formal proceedings, often pursuant to a formal or informal forbearance agreement with key creditors. The debtor may memorialize its creditors' support

[111] 11 USC, § 1127 (referencing 11 USC, §§ 1122 and 1123).
[112] *Idem*, § 1101.
[113] *Idem*, § 1121(a).

for the plan in a restructuring support agreement or similar document, and pre-petition votes in favour of the plan will be effective so long as creditors had adequate disclosure of information at the time of their vote.[114] In the absence of a court-approved disclosure statement, a debtor may rely on applicable non-bankruptcy law or regulation, such as securities regulations, in determining what information to provide.[115] The pre-pack bankruptcy can be dramatically shorter and less expensive than a typical chapter 11 proceeding, with far less disruption to and uncertainty for the debtor's business, while still providing access to the powerful statutory tools, such as for selling property and rejecting unprofitable contracts, that make chapter 11 so popular.[116] In February 2021, a new record for shortest time in bankruptcy was set in the *Belk* case, in which only 16 hours elapsed between the filing of the petition on a Tuesday evening and the confirmation of a chapter 11 plan at a Wednesday afternoon hearing.[117]

5.5.6 *Effect of confirmation*

Confirmation of the plan converts it to a court order that is binding on the debtor and all parties in interest, including those who objected or did not have the opportunity to vote because they were either unimpaired or received nothing.[118] Confirmation also terminates all pre-petition equity interests in the debtor unless the plan provides otherwise.[119] Where the debtor will be continuing in business after consummation of the plan, confirmation also discharges all debts that arose prior to confirmation except for certain taxes and penalties owed to domestic government entities.[120] Confirmation also vests the property of the estate in the debtor (or other successor entity specified in the plan) free and clear of all claims or interests (except as provided in the plan).[121]

The legal effects of the confirmation order can be reversed on the request of a party in interest made within 180 days of the confirmation order "only if such order was procured by fraud."[122] The revocation order must protect any entity that acquired rights in good faith reliance on the order of confirmation.

A confirmation order can be appealed by any aggrieved party, but unless a stay pending appeal is obtained from the bankruptcy or appellate court, the consummation of the plan may moot the appeal.

---

[114] *Idem*, § 1126(b).
[115] *Ibid*.
[116] *See* Edward I Altman, "The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations", 22 Am Bankr Inst L Rev 75 (2014) (finding that pre-packs are more likely to be successful in resulting in emergence as a going concern and not refiling for bankruptcy within in the next five years than other types of filings).
[117] *In re FULLBEAUTY Brands Holdings Corp*, 19-22185-rdd (Bankr SDNY).
[118] 11 USC, § 1141(a).
[119] *Idem*, § 1141(d)(1)(B).
[120] *Idem*, § 1141(d).
[121] *Idem*, § 1141(b).
[122] *Idem*, § 1144.

5.5.7 Performance of the plan

While confirmation of a plan is a critical event with substantial legal consequences, it is not the end of the case. The debtor's consummation of the plan will usually take a number of months to effect, according to a timetable for performance set out in the plan. During the consummation period, the debtor may be obligated to make periodic payments to its creditors. The bankruptcy court has the power to order the debtor or other parties in interest to take actions required to consummate the plan.[123]

If the debtor fails to consummate the plan, the case may be dismissed or converted to chapter 7.[124]

5.5.8 Case management

US bankruptcy judges are specialists in the area of law on which they rule (unlike federal district court judges, whose dockets range from criminal matters to patent litigation), and there is typically one judge who oversees each case from filing to conclusion. A case may come before the court frequently because of the need for notice and a hearing for a wide variety of acts. Despite this wealth of expertise and close attention to cases, however, chapter 11 has been criticized for producing extremely long-lived proceedings.[125] Some have even suggested that chapter 11 and attendant delays may be used for strategic advantage.[126]

Other scholars have noted the reluctance of bankruptcy judges to convert cases to chapter 7 liquidations, even where the prospects of reorganization are very speculative and to displace management through the appointment of an examiner or chapter 11 trustee, notwithstanding that management of the debtor in possession may be responsible for the debtor's predicament.[127]

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act made a number of amendments to the Bankruptcy Code to address certain of these criticisms, as well as a number of issues in personal bankruptcies not relevant here. In particular, BAPCPA sets a deadline for assuming or rejecting leases of non-residential real property, limits the extension of the exclusivity period for proposing a plan, lowers the standard and shortens the timetable for consideration of a motion to convert a case to chapter 7, and requires courts to hold more status

[123] *Idem*, § 1142(b).
[124] *Idem*, § 1112.
[125] *Cf* Elizabeth Warren and Jay Lawrence Westbrook, "The Success of Chapter 11: A Challenge to the Critics", 107 *Michigan Law Review* 603 (2009) (arguing that conventional wisdom that ch 11 results in "endless delay" is belied by statistical analysis of case durations and outcome).
[126] See, eg, Michele M Rocawich, "Bleak House Then and Now: The Abuse of the Bankruptcy Code", 84 *Illinois Bar Journal* 634 (1996) (discussing the use of ch11 by companies facing massive products liability claims or union benefits obligations). Charles Dickens' novel *Bleak House*, concerning *Jarndyce and Jarndyce*, a fictional English chancery case that drags on for generations until the estate is exhausted by legal fees, is a favorite point of reference for both US legal commentators and courts concerning lengthy bankruptcy proceedings. See also *Stern v Marshall*, 564 US 462 (2011); *In re Owens Corning*, 419 F.3d 195 (3d Cir 2005).
[127] *See* A Mechele Dickerson, "Privatizing Ethics in Corporate Reorganizations", 93 *Minn L Rev* 875, 899-900 (2009) ("[C]ourts presume that at least some mismanagement and incompetence exists in every bankruptcy case.").

conferences to manage the progress of cases. The effects of these changes are still being analyzed, particularly as the global financial crisis occurred shortly after enactment, but it appears that the changes may have driven a shift away from full reorganizations in chapter 11 toward pre-packs, structured dismissals and, for lease-dependent retail chains, liquidations.[128]

5.5.9 *Closure*

Following substantial consummation of the plan, the case is considered closed, but resolution of claims issues through litigation (including appeals) may continue for a considerable period of time. If the plan fails to be consummated, the case can be converted to chapter 7 liquidation or the plan modified (as described in paragraph 5.5.4.4 above) to provide for liquidation. Note that a chapter 11 plan may be a plan of liquidation instead of restructuring.[129] See also paragraph 5.8 below.

5.5.10 *Small business debtors*

The term "small business debtor" is defined as an individual or corporate entity engaged in commercial or business activities with aggregated non-contingent liquidated secured and unsecured debts (excluding debts to affiliates or insiders) as of the order for relief of not more than a certain amount (currently USD 3,024,725 and periodically adjusted for inflation) and as to which the US Trustee has not appointed a committee of unsecured creditors or the committee has not actively supervised the debtor.[130] Note that requesting designation as a "small business debtor" is different from commencing a subchapter V proceeding, as established by the Small Business Reorganization Act, and the principal differences from the ordinary rules of chapter 11 are additional reporting duties (with shorter time limits) for the trustee or debtor in possession, as well as a requirement to meet with the US Trustee to discuss prospects for reorganization.[131] The US Trustee may seek dismissal or conversion of the case if reorganization is not reasonably likely.

5.6 Distribution of Assets in a Chapter 7 Liquidation

A chapter 7 liquidation may be initiated through the same petition mechanism as a chapter 11 proceeding or a proceeding under another chapter may be converted to chapter 7. Many of the powers and duties of the trustee in a chapter 7 are the same as those of a debtor or trustee in chapter 11 (both being found in chapters 3 and 5 of the Bankruptcy Code). The focus of the chapter 7 trustee differs, however, in that its only purposes are to liquidate the estate's assets and distribute the proceeds.

---

[128] See ABI Commission to Study the Reform of Chapter 11, *Final Report and Recommendations* (2014) at 11 and 131.

[129] 11 USC, § 1123(a)(5)(d)). As discussed in paras 5.2 and 5.4.3.2 above, it may be preferable to use chapt11 to effect a going concern sale of substantially all of the debtor's assets, followed by distribution to creditors, and it is not necessary to convert the case simply because liquidation is in prospect. See 11 USC, § 1112(b).

[130] *Idem*, § 101(51D).

[131] *Idem*, §§ 308 and 1116.

5.6.1 *Priority of payment*

Distributions in chapter 7 are made to holders of allowed unsecured claims in accordance with a detailed list of priorities, but such distributions are made only after satisfaction of secured claims from their respective collateral. If a priming lien was granted for post-petition financing, that financing will have priority in collateral over the pre-petition secured lenders. Fully secured claims are paid in full (after payment to the trustee of any costs of maintaining the property during the case, such as taxes); secured creditors are entitled to interest and costs if the value of the collateral permits it.[132] Undersecured claims are paid as secured claims to the extent of the value of the collateral, with the deficiency being treated as an unsecured claim.[133]

Unsecured claims are paid from unencumbered assets in accordance with a statutory scheme of priorities. Claims are paid *pro rata* within each class, except that, where the case was converted to chapter 7 from another chapter under the Bankruptcy Code, post-conversion claims under section 503(b) have priority over pre-conversion claims under that section.

The classes of priority unsecured claims are:[134]

- domestic support obligations of individual debtors;[135]
- administrative expenses:[136]
  - "actual, necessary costs of preserving the estate" including post-petition wages and taxes;
  - compensation of a trustee, examiner or consumer privacy ombudsman;
  - "actual, necessary expenses" and "reasonable" professional fees incurred by:
    - a petitioning creditor – that is, one who successfully filed an involuntary petition;
    - a creditor that recovers property for the benefit of the estate that the debtor has transferred or concealed;
    - a creditor that has participated in the prosecution of a criminal offense relating to the case or the business or property of the debtor;
    - party in interest other than a statutory committee that makes a substantial contribution to a chapter 11 case (for example, in overseeing the debtor's affairs or engaging in litigation benefiting the estate);

[132] *Idem*, § 506(b).
[133] *Idem*, § 506(a)(1).
[134] *Idem*, § 726(a)(1).
[135] *Idem*, § 507(a)(1).
[136] *Idem*, § 507(a)(2) (referencing administrative expenses allowed under s 503(b)).

- a pre-petition custodian;
- members of statutory committees for performance of committee duties;

- with respect to a non-residential lease of real property that was assumed and subsequently rejected, two years of lease payments from the later of the date of rejection of the lease or turnover of the property;[137]
- "actual, necessary costs" of closing a health care business, including costs of disposing of patient records and transferring patients to other facilities;
- value of goods received by the debtor within 20 days before the petition date if such goods were sold to the debtor in the ordinary course of the debtor's business;
- repayment of DIP financing granted this level of priority;

- ordinary course of business expenses incurred between the commencement of an involuntary case and the earlier of the appointment of a trustee or an order for relief;[138]
- capped amounts (per employee) of claims for wages and benefits due within 180 days before the earlier of debtor's cessation of business or petition date;[139]
- capped amount (per claimant) of claims by persons engaged in the grain or fishing industry;[140]
- capped amount (per individual) of claims for return of deposits for leases or services not delivered;[141]
- claims by governmental units for certain taxes and duties;[142]
- claims relating to the federal deposit insurance program;[143]
- claims for injury or wrongful death arising from the debtor's operation of a vehicle or vessel while intoxicated;[144]
- claims arising from shortfalls in adequate protection of secured creditors and for repayment of DIP financing granted this level of priority.[145]

---

[137] Any additional amounts due under the lease have lower priority.
[138] 11 USC, § 507(a)(3) (referencing allowance of such claims under s 502(f)).
[139] *Idem*, §§ 507(a)(4) and (5).
[140] *Idem*, § 507(a)(6).
[141] *Idem*, § 507(a)(7).
[142] *Idem*, § 507(a)(8).
[143] *Idem*, § 507(a)(9).
[144] *Idem*, § 507(a)(10).
[145] *Idem*, § 507(b).

Rent on real estate that a debtor continues to occupy is usually paid on an ongoing basis post-petition as an administrative expense, but during the Covid-19 pandemic a number of bankruptcy courts held that leased premises that were closed due to lockdown measures did not benefit the debtors' estates and therefore rent on such premises did not have administrative priority.[146]

Following payment of all administrative expense claims, the remaining classes of creditors in chapter 7, in order of priority are:[147]

- payment of allowed general unsecured claims if timely filed, or tardily filed due to lack of notice in time to timely filed and filed in sufficient time to permit payment;
- payment on all other tardily filed allowed general unsecured claims;
- payment on allowed claims (whether secured or unsecured) for a fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages in excess of actual damages arising before the order for relief or appointment of the trustee;
- payment of interest on all claims "at the legal rate"[148] from the petition date;
- remaining value is returned to the debtor (to equity interests in a corporate case).

The absolute priority rule requires that payment in full must be made to each category of claims before the next category receives anything. In a chapter 11 plan, deviation from the absolute priority rule is permitted with the consent of affected creditors, but deviation is not permitted in chapter 7, where the statutory priorities must be strictly followed.

Self-Assessment Exercise 12

What priority would a claim by a taxing authority for unpaid taxes, late fees, and penalties for failure to file have?

For commentary and feedback on self-assessment exercise 12, please see APPENDIX A

[146] *See*, *eg*, *In re Pier 1 Imports, Inc*, No 20-30805-KRH, 2020 WL 2374539 (Bankr ED Va May 10, 2020).

[147] *11 USC*, §§ 726(a)(2) – (6).

[148] Courts are split on whether "at the legal rate" means the rate specified in a contract between the debtor and creditor or a statutorily prescribed rate, such as the rate payable on federal judgments. See, eg, *In re Cardelucci*, 285 F.3d 1231 (9th Cir 2002) (federal judgment rate); *In re Dow Corning Corp*, 456 F.3d 668 (6th Cir 2006) (contractual default interest rate). Because the provision requiring payment of interest to oversecured creditors (s 506(b)) speaks only of "interest on such claim", courts are in agreement that the contractual default rate is the applicable interest rate for those claims.

5.6.2 *Valuation of collateral*

Valuation of collateral is important for determining whether a creditor is fully secured or undersecured, not only for determining the amount payable to the secured creditor on its claim, but also in connection with adequate protection, cramdown of dissenting impaired classes, and other issues. The sales price of the collateral may not resolve the question if a creditor has a lien on only part of a package of assets being sold and the purchase price is not allocated to individual assets. The court is directed to determine the value of the collateral "in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a [chapter 11] plan."[149] Thus, a given asset should not be valued at a distressed or foreclosure sale price if it is sold in a going concern sale. Conversely, where property may have a higher value in a different use (for example, a housing development), the lower value in its actual, intended use (for example, a wildlife preserve) is the relevant value for valuing the secured creditor's lien.

5.6.3 *Subordination*

A claim may be subordinated from one level of priority to another under certain circumstances:[150]

- enforcement of a subordination agreement (such as an inter-creditor agreement) to the extent enforceable under applicable non-bankruptcy law;

- claims relating to purchase or sale of a security (including damages awarded in a judgment relating to such purchase or sale) are subordinated to the priority of a claim on such security, unless the security is common stock, in which case such claims share that priority (the lowest priority);

- where principles of equitable subordination warrant, typically due to creditor misconduct that prejudices the rights of other parties in interest for which equitable subordination provides a remedy. This occurs most often where the creditor is an insider and therefore can exercise control over the debtor's pre- or post-petition conduct;

- in most cases, the bankruptcy court will enforce intercreditor agreements that provide for subordination of certain claims. However, the bankruptcy court may approve a plan that departs from the creditors' contractually agreed priority of claims.[151]

A similar loss of priority can occur when a claim of one type is **recharacterized** as a claim of another type. Most commonly, this occurs with respect to loans made to a debtor by its parent or affiliate being recharacterized as capital contributions having the status of equity interests.

---

[149] 11 USC § 506(a)(1).
[150] *Idem*, § 510.
[151] See *in re Tribune,* 972 F.3d 228 (3d Cir 2020).

5.7 Insolvency litigation

5.7.1 Introduction

This section discusses causes of action that the Bankruptcy Code provides to the trustee or debtor in possession to recover property for the estate from pre-petition transferees. These claims are in addition to, and do not pre-empt, claims the debtor or trustee may have claims under applicable domestic or foreign law, but those established by the Bankruptcy Code may be more favourable to the debtor than other laws and the Bankruptcy Code provisions generally apply without the need to perform a conflicts of law analysis.[152]

This section also considers claims that may be brought against the directors of a debtor for the benefit of the estate.

5.7.2 Preferences

5.7.2.1Elements to be proved

A preference is a transfer of the debtor's property made in a suspect period before the petition date that must be returned to the estate if it exceeds the amount the recipient would have received in a chapter 7 liquidation had the transfer not been made.[153] Importantly, there is no need to show any fault of either the debtor or the recipient in connection with the payment having been made, and the recipient creditor suffers no penalty other than return of the transfer (and, potentially, prejudgment interest from the date of the transfer). The avoidance of preferences is intended to equalize treatment of similarly situated creditors and disincentivize a race to collect from a distressed debtor. The recipient of a preference that is avoided has an unsecured claim for the value returned to the estate.[154]

The elements of a preference claim are:

(1) A transfer of an interest of the debtor in property.

The transfer may be of funds, property or an interest in property – that is, the granting of a lien. Transfer of property in which the debtor does not have an interest, such as property held as agent for another, cannot be a preference.

(2) To or for the benefit of a creditor.

---

[152] Applicability of these provisions to pre-petition transactions that occurred wholly outside the United States was called into question by the US Supreme Court's decision in *Morrison v National Australia Bank*, 561 US 247 (2010), which held that federal statutes should be presumed to have purely domestic application unless Congressional intent for extraterritorial application appears in the statute. Courts have disagreed whether the inclusion within the bankruptcy estate of all of the debtor's interests in property wherever located and the worldwide automatic stay are sufficient indication that Congress intended the preference and avoidance provisions to apply to extraterritorial transactions and, if not, what test should be applied to determine when a transaction is extraterritorial.

[153] 11 USC, § 547.

[154] *Idem*, § 502(h).

If the recipient was not a creditor of the debtor prior to the transfer, the transfer cannot be a preference, but may be recoverable as a fraudulent conveyance, as discussed in section 5.7.3 below.

(3) For or on account of an antecedent debt owed by the debtor before such transfer was made.

Preferences only arise where the debtor is paying a creditor for a pre-existing debt. As further discussed below, a contemporaneous exchange of value is not a preference. In addition, a prepayment for goods and services cannot be a preference because debt, if any, is not incurred until the debtor receives the product and owes more than it has paid.[155] The Bankruptcy Code looks to applicable non-bankruptcy law to determine when a debt arose and when a transfer of an interest in the debtor's property occurred.

The date of the transfer, where the transfer is a security interest, is the date of perfection of the security interest (for example, filing a financing statement or taking possession of the collateral) if perfection occurred more than 30 days after the transfer became effective between the parties.[156] Thus, a delay in perfection may cause a transfer to be deemed not to have occurred contemporaneously and may also move the date of the transfer into the preference period. If a security interest is not perfected before the petition date, the automatic stay will bar the interest from being perfected and the security interest will be unenforceable.[157]

(4) Made while the debtor was insolvent.

The debtor is presumed to have been insolvent on and during the 90 days prior to the petition date for purposes of determining preference claims.[158] A creditor may present evidence to rebut the presumption, and the ultimate burden of proving insolvency on a balance sheet basis at the time of the transfer is on the trustee or debtor.[159]

(5) Made during the suspect period.

The suspect period for transfers to third parties is 90 days prior to the petition date, and the suspect period for insiders is one year prior to the petition date. With respect to a corporate debtor, insiders are the debtor's officers, directors, controlling persons, general partner,

---

[155] *See In re Hechinger Inv Co of Delaware, Inc* No 01-3170(PBL), 2004 WL 3113718, at *2 (Bankr D Del Dec 14, 2004) ("It is well established that advance payments are prima facie not preferences because the transfer from the debtor to the creditor is not for or on account of an antecedent debt.").

[156] 11 USC, § 547(e).

[157] The trustee or debtor in possession is deemed to have the powers of a *bona fide* purchaser in due course and the holder of a judicial lien as could have been granted immediately prior to the filing of the petition and thus can avoid all unperfected security interests. 11 USC, § 544(a).

[158] 11 USC, § 547(f).

[159] *Idem*, § 101(32). Determining the solvency of the debtor will typically be a matter for expert valuation evidence. See, eg, *In re American Classic Voyages Co*, 367 BR 500 (Bankr D Del 2007) (evaluating expert valuation testimony on value of travel company as a going concern at time of transfer and concluding presumption of insolvency was rebutted).

partnerships of which the debtor is a general partner, affiliates and insiders of affiliates.[160] The longer preference period for insiders prevents those with the greatest knowledge of the debtor's financial condition from benefiting from asset-stripping transactions prior to the 90 day preference period, even if there was nothing improper about the transactions. However, for transfers between 91 days and one year prior to the petition date, there is no presumption of insolvency.

(6) That enables the creditor to receive more than it would have in a chapter 7 liquidation.

A transfer is only an avoidable preference if it resulted in the creditor improving its position as compared to the result of a liquidation had the transfer not occurred. Where the transfer is, for example, foreclosure by a secured creditor on a portion of its collateral, there is no preference because the secured creditor would have been entitled to recover first from that collateral in a liquidation.

This analysis can be difficult to perform in a chapter 11 proceeding where the company continues to operate, because the court must assess what value would have been realized and available for distribution to creditors, and what administrative priority expenses would have been incurred if the company had instead begun liquidation on the petition date. Expert valuation evidence will often be required if this element of a preference claim is disputed.

5.7.2.2Defences

Introduction

The (relative) simplicity of the elements of the preference cause of action may be deceiving, as creditors have a number of defences and safe harbours that may allow them to keep pre-petition transfers that occurred during the suspect period. Here we consider only defences relevant in corporate debtor cases.

Contemporaneous new value

Consistent with the element of the preference claim that the transfer must be on account of an antecedent debt, a transfer cannot be avoided where the recipient contemporaneously gave the debtor new value.[161] This defence is not established where the creditor simply substitutes a new obligation for an old one – the creditor must give money, goods, services or new credit.[162] This defence essentially mirrors the element of the preference claim that the payment be on account of an antecedent debt.

---

[160] *Idem*, § 101(31).

[161] *Idem*, § 547(c)(1) ("The trustee [or debtor in possession] may not avoid under this section a transfer to the extent that such transfer was (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and (B) in fact a substantially contemporaneous exchange.").

[162] "New value" is defined to exclude "an obligation substituted for an existing obligation". 11 USC, § 547(a)(2).

Whether a transfer is substantially contemporaneous with the provision of new value is determined as a matter of fact, considering the totality of the circumstances. If a security interest is involved, the gap between the initial transaction and perfection of the interest cannot be more than 30 days.[163] Transfers not involving the perfection of security interests, however, may be found not substantially contemporaneous even where less than 30 days passes, particularly if it is one of a series of delayed transfers, which tends to undermine the contention that the transfer was intended to be substantially contemporaneous.[164]

Ordinary course payments

Transfers that occur in the ordinary course of the debtor's business during the suspect period may not be avoided as preferences. To qualify for this defence, the transfer by the debtor to the creditor have been part of a transaction that occurred in the ordinary course of the debtor's business and either (i) subject to the terms ordinarily applicable to such transactions between the parties, *or* (ii) subject to "ordinary business terms".[165] With respect to the nature of the transaction of which the transfer is a part and consistency with prior terms, whether the transaction was in the ordinary course of business between the debtor and the creditor is determined on a subjective standard – that is, the typical practice between the two parties over the course of their relationship. Thus, this defence will be difficult for a creditor to establish if it has had only one or two transactions with the debtor, as compared to a regular supplier or lender with a track record to which to compare the challenged transaction. Where the relationship is of shorter duration, however, the transfer may still be retained by the creditor if the terms of the transaction are consistent with the prevailing practices of the relevant industry – an objective standard that often is established by expert testimony.

Purchase-money security interests

The grant of a security interest in property is not a preference if the debt secured thereby was incurred by the debtor to purchase that property.[166] The security interest must be perfected within 30 days of the debtor's receipt of the property for the creditor to invoke this defence.

Net result rule

A transfer cannot be avoided as a preference if, subsequent to the challenged transfer, the creditor advanced additional new value to or for the benefit of the debtor without receiving a perfected security interest or repayment from the debtor.[167] Thus, for example, a creditor may require, as a condition of extending new credit to a distressed borrower that the borrower repay pre-existing debt to that creditor without that repayment being avoided as a preference. In the

---

[163] 11 USC, § 547(e). This period was only 10 days prior to 2005.
[164] See, eg, *In re Quality Sales, LLC*, 521 BR 450 (Bankr D Conn 2014) (holding that an 18-day delay from last delivery of goods to debtor's first payment rendered transfer not substantially contemporaneous under 11 USC, § 547(c)(1)).
[165] 11 USC, § 547(c)(2).
[166] *Idem*, § 547(c)(3).
[167] *Idem*, § 547(c)(4).

absence of this defence, financially troubled companies would have far greater difficulty obtaining credit.

After-acquired accounts and inventory

Where the collateral for a secured loan changes over time, as is common with receivables and inventory pledged as collateral, any receivable or inventory added to the collateral pool in the period prior to the petition date could qualify as an avoidable preference. At the same time, however, the secured lender may have released its lien over other collateral because the receivable is paid or the inventory is sold. To protect the secured lender, its security interest in the collateral added to the pool in the suspect period is not avoidable as a preference unless, looking at the period as a whole, the secured lender's position improved and then only to the extent of the improvement of position.[168]

Statutory liens

A lien created by state law that comes into effect during the suspect period cannot be avoided as a preference.[169] Instead, a different provision of the Bankruptcy Code permits the avoidance of such statutory liens where they are (1) premised on the debtor's insolvency, appointment of a custodian, financial condition or petition for bankruptcy; (2) not perfected or enforceable at the petition date, or (3) for rent.[170] In essence, this section gives no effect to state law liens that function like *ipso facto* clauses and would disrupt creditor priorities in bankruptcy.

Reclamation rights

Where the debtor is in possession of goods supplied by the creditor in the ordinary course of business in the 45 days before the petition date and the debtor was insolvent at the time of delivery, the creditor may reclaim its goods within 45 days of delivery (or within the first 20 days of the case if the 45 days expires after the petition date) without such reclamation constituting a preference.[171]

Safe harbors for securities and commodities contracts

Because of need for certainty and finality in the operation of the financial markets, certain types of payments cannot be avoided as preferences or fraudulent conveyances (discussed in paragraph 5.7.3 below) unless the transfer was made with the intent to defraud creditors:[172]

---

[168] *Idem*, § 547(c)(5).
[169] *Idem*, § 547(c)(6).
[170] *Idem*, § 545.
[171] *Idem*, § 546(c). Similar rights of reclamation are granted to producers of grain and fishermen under s 546(d). Rights of reclamation cannot be exercised if the goods are subject to a security interest or have been sold or delivered to a customer of the debtor.
[172] *Idem*, §§ 546(e)-(g) and (j). The terms used in this section are defined in the Bankruptcy Code, but also have been the subject of substantial litigation as parties have asserted the involvement of financial institutions in a portion of a complex transaction to shield all transfers that occurred in the transaction. In *Merit Management Group, LP v FTI Consulting, Inc*, the US Supreme Court held that the safe harbors apply only where the transaction as a whole

- margin payment;
- settlement payment made by, to, or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clear agency;
- transfer by, to, or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clear agency in connection with a securities contract, commodity contract, or forward contract;
- transfer made by, to, or for the benefit of a repo participant or financial participant in connection with a repo agreement;
- transfer made by, to, or for the benefit of a swap participant or financial participant in connection with a swap agreement;
- transfer made by, to, or for the benefit of a master netting agreement participant or financial participant in connection with a master netting agreement.

5.7.2.3Summary

As the foregoing list of defences illustrates, the simple concept of avoidance of preferences to ensure equality of treatment of creditors is subject to numerous exceptions reflecting the need to balance numerous competing principles and values, such as protecting secured parties, encouraging lending to distressed businesses, and preventing the bankruptcy of a financial market participant from having a "domino effect" on its counterparties.

Self-Assessment Exercise 13

Question 1

In 2010, Local Bank lent Hotelco USD 1 million, secured by a mortgage on Hotel Y. In 2018, as Hotelco's financial distress becomes evident, Local Bank reviews its documents and discovers that the mortgage on Hotel Y was never registered with the local property registry. No other mortgage was registered between 2010 and 2018. Local Bank registers its mortgage on March 1, 2018. On May 1, 2018, Hotelco files for bankruptcy. What is the status of Local Bank's mortgage in the bankruptcy?

Question 2

Six months before Hotelco's bankruptcy, it borrows USD 500,000 from majority shareholder Mr Q and grants him a second lien security interest in Hotel Z, which Mr Q perfects immediately by making a filing with the property registry. May the security interest be avoided as a preference?

---

comes within one of the statutory provisions and not where one component of a larger transaction involves the use of a financial institution as a conduit. 138 S.Ct 883 (2018).

For commentary and feedback on self-assessment exercise 13, please see APPENDIX A

5.7.3 *Fraudulent conveyances*

While preference avoidance is aimed largely at transactions immediately prior to bankruptcy (except in the case of insiders), other transactions within a two year period prior to the petition date may also be avoided if they constitute **fraudulent conveyances**. Despite the nomenclature, transactions may be avoided as **constructive fraudulent conveyances** without a showing of fraudulent intent.

An **actual fraudulent conveyance** is proven by showing that the debtor made a transfer or incurred an obligation "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted."[173] A debtor may expect to become "indebted", as used in this provision, when it anticipates liability under a money judgment, settlement, penalty or similar obligation arising from violation of state or federal securities laws or fraud, deceit, or manipulation in the sale of a registered security.[174] Intent may be proven circumstantially, by reference to "badges of fraud" developed in state fraudulent transfer law:[175]

(1) the transfer or obligation was to an insider;

(2) the debtor retained possession or control of the property transferred after the transfer;

(3) the transfer or obligation was disclosed or concealed;

(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

(5) the transfer was of substantially all the debtor's assets;

(6) the debtor absconded;

(7) the debtor removed or concealed assets;

(8) the value of the consideration received by the debtor was not reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

---

[173] *Idem*, § 548(a).

[174] *Idem*, § 548(e)(2).

[175] See *Ritchie Capital Mgmt, LLC v Stoebner*, 779 F.3d 857 (8th Cir 2015) (relying on badges of fraud listed in Minnesota's enactment of the Uniform Fraudulent Transfer Act to determine whether intent has been proven for purposes of a s 548 actual fraudulent conveyance claim).

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) the debtor transferred the essential assets of the business to a lienor that transferred the assets to an insider of the debtor.

A **constructive fraudulent conveyance** is proven by showing that the debtor received less than reasonably equivalent value in exchange for a transfer or incurrence of obligation and one of the following additional factors was present:

- the debtor was insolvent at the time of or became insolvent as a result of the transaction;
- the debtor was unreasonably undercapitalized for the business or transactions it was engaged in or planned to engage in;
- the debtor intended to or believe it would incur debts beyond its ability to pay on maturity; or
- the transfer was made to or for the benefit of an insider, or the debtor incurred an obligation under an employment contract with an insider outside the ordinary course of business.[176]

The recipient of an actual or constructive fraudulent transfer may nonetheless retain the property received or enforce the obligation created if it took for value (to the extent of the value provided) and in good faith unless the transfer is otherwise avoidable as a preference, statutory lien, or unperfected security interest.[177] The same entities protected from preference avoidance (listed in paragraph 5.7.2.2.9 above) are deemed to take for value upon receipt of a payment from the debtor.[178]

In addition to these provisions of the Bankruptcy Code, applicable non-bankruptcy law, such as a state and foreign fraudulent conveyance laws, may be invoked by the debtor in possession or trustee.[179] Such laws may have longer look-back periods (six years from transfer or two years from discovery in New York, for example) and may not be subject to extraterritoriality limitations.

[176] 11 USC, § 548(b).
[177] *Idem*, § 548(c).
[178] *Idem*, § 548(d)(2).
[179] *Idem*, § 544(b).

Self-Assessment Exercise 14

Public Co, the parent of an international group of companies in the aerospace sector, borrows USD 1 billion from Bank Syndicate. Public Co's obligation to repay the loan is guaranteed by each of its subsidiaries. If a subsidiary subsequently became a debtor in US chapter 11 proceeding, could the subsidiary's guaranty obligation be avoided as a fraudulent transfer?

For commentary and feedback on self-assessment exercise 14, please see APPENDIX A

5.7.4 Setoff

The Bankruptcy Code exempts the exercise of rights of setoff arising under non-bankruptcy law from avoidance as preferences under certain circumstances.[180] Setoff permits a creditor holding a claim against the debtor and simultaneously owing money to the debtor to net out the two (or more) obligations. Because setoff rights can improve the position of the creditor as compared to other unsecured creditors who are not owed money by the debtor because it decreases its obligation to the estate by the full amount owed by the debtor rather than the lesser amount the debtor would pay on the unsecured claim, setoff is not permitted in a number of circumstances:

- the creditor's claim against the estate is disallowed;
- the creditor's claim against the estate was acquired post-petition or in the 90 days prior to the petition at a time when the debtor was insolvent;[181]
- the creditor's obligation to the debtor was incurred in the 90 days prior to the petition at a time when the debtor was insolvent for the purposes of exercising setoff rights;
- the creditor improves its position by setoff as compared to its position had setoff been exercised 90 days prior to the petition.

For purposes of these limitations, the debtor is presumed insolvent during the 90 days prior to the petition date, but the presumption can be rebutted by the creditor.

A number of transactions are, however, exempted from these restrictions on setoff, most importantly commodity, forward, security, repurchase, swap, and master netting contracts.

[180] *Idem*, § 553.
[181] This provision prevents a party obligated to the estate from acquiring claims against the estate for purposes of setoff.

5.7.5 *Director liability*

Director liability is a matter for state law of the state of incorporation; the discussion in this section is based on the law of Delaware, which is the pre-eminent US jurisdiction for corporate law.[182] In general, US director liability is more limited than that elsewhere. Directors owe a fiduciary duty of loyalty to the corporation's best interest and a duty of care in educated decision-making, but are protected from liability for errors of judgment by the **business judgment rule**. Under the business judgment rule, the board of directors is presumed to have acted in good faith on the basis of reasonable information. This presumption can be rebutted only by showing that a majority of the board in fact were not reasonably informed, did not honestly believe that their decision was in the corporation's best interest, or were not acting in good faith. Unless the presumption is rebutted, the directors will not be liable in the absence of a showing of gross negligence. In addition, directors may be exculpated by a corporation's certificate of incorporation from liability for breach of the duty of care (but not for breach of the duty of loyalty).[183] The business judgment rule does not apply where a transaction is approved by a board majority that is not disinterested and independent or a controlling shareholder is on both sides of the transaction. In such circumstances, the transaction will be void unless the **entire fairness standard** is satisfied.

Directors' duties are owed to the corporation and its shareholders, not to creditors, even in circumstances where the corporation is potentially insolvent and therefore the shareholders stand to receive nothing in bankruptcy. The Delaware Supreme Court has put to rest any suggestion that directors owe duties to creditors when a company is operating "in the zone of insolvency", or indeed is actually insolvent.[184] Thus, there is no equivalent under US law of the concept of "wrongful trading" or "deepening insolvency".[185]

5.8 Closure of proceedings

A bankruptcy case is closed upon the completion of all administrative tasks and discharge of any trustee.[186] A case may remain open for a substantial period following the consummation of a plan as claims are resolved and paid. Proceedings can be reopened for cause.[187]

---

[182] According to the Delaware Secretary of State's Division of Corporations, over two-thirds of all Fortune 500 companies, and 1.3 million companies total, are incorporated in Delaware as of 2018. In addition, many other US states have modeled their corporate laws on Delaware's legislation.

[183] Del Gen Corp L, § 102(b)(7).

[184] *North Am Catholic Educational Programming Foundation, Inc v Gheewalla*, 930 A.2d 92, 103 (Del 2007) ("[I]ndividual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation . . . .").

[185] *See Trenwick Am Litig Trust v Ernst & Young, LLP*, 906 A.2d 168 (Del Ch 2006) ("Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm.").

[186] 11 USC, § 350(a).

[187] *Idem*, § 350(b).

6. CROSS-BORDER INSOLVENCY LAW

6.1 Background

US bankruptcy courts, due to the low jurisdictional threshold for the commencement of plenary proceedings and the importance of US state and federal law in the global economy, regularly hear bankruptcy cases with international implications and generally have taken a universalist approach, subject to certain limitations for the protection of US assets and creditors. The tradition of comity to foreign courts was recognized by the US Supreme Court at least as early as 1895,[188] and continued following the adoption of the Bankruptcy Code. Prior to 2005, recognition and enforcement of foreign insolvency proceedings was governed by section 304 of the Bankruptcy Code (repealed in the legislation adopting chapter 15). In cases under section 304, US bankruptcy courts adopted practices for cooperation and coordination that continue under chapter 15. In particular, in the *Maxwell* case in the early 1990s, the US and UK courts proposed that the parties enact a cross-border protocol to manage the relationship of the plenary proceedings pending in each country;[189] this paved the way for the widespread use of protocols in cross-border cases. In at least one subsequent case, a weeks-long joint trial has been held between a US bankruptcy court and a Canadian court, and more limited joint hearings have been held pursuant to cross-border protocols in many cases where common issues needed to be resolved in the context of parallel proceedings in each jurisdiction.[190] The Judicial Insolvency Network's Guidelines on Court-to-Court Communications have been adopted by local rules in the bankruptcy courts in Delaware, the Southern District of New York and the Southern District of Florida.

6.2 Chapter 15

6.2.1 Adoption of UNCITRAL Model Law

In 2005, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act, the US adopted the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law") nearly verbatim, as chapter 15 of the Bankruptcy Code. Section 1 of the Model Law became section 1501 of the Bankruptcy Code, setting out the purpose of chapter 15:

(1) facilitating co-operation between courts and parties to insolvency proceedings in the United States and foreign countries;

(2) greater legal certainty for trade and investment;

(3) fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and parties in interest;

(4) protection and maximization of the value of the debtor's assets; and

---

[188] *Hilton v Guyot*, 159 US 113 (1895) (enforcing French judgment against US citizen as a matter of comity).

[189] *In re Maxwell Comm Corp plc*, 93 F.3d 1036, 1054-55 (2d Cir 1996) ("[I]n this unique case involving cooperative parallel bankruptcy proceedings seeking to harmonize two nations' insolvency laws for the common benefit of creditors, the doctrine of international comity precludes application of the American avoidance law to transfers in which England's interest has primacy.").

[190] *See In re Nortel Networks, Inc*, 532 B.R. 494 (Bankr D Del 2015) (allocation trial opinion).

(5) facilitating the rescue of financially troubled businesses, thereby protecting investment and preserving employment.[191]

This purpose is to be taken into account in interpreting and applying the provisions of chapter 15.

Chapter 15 created a new type of US bankruptcy proceeding – an **ancillary** as opposed to **plenary** proceeding, where the US does not exercise jurisdiction or authority over the entire estate (indeed, no estate is created under chapter 15) but rather provides assistance to the foreign proceedings concerning the debtor. There is no reciprocity of treatment required; US courts will recognize proceedings in countries that would not recognize US proceedings.[192]

6.2.2 Commencement of chapter 15 proceedings and COMI

A case under chapter 15 is commenced only by the filing of a petition by the foreign representative of the debtor–the debtor cannot be placed in chapter 15 involuntarily by a creditor filing.[193] The filing of the petition, however, does not automatically invoke a stay of creditor action; the stay arises only upon the petition for recognition of a foreign main proceeding being granted and is limited to the property of the debtor within the territorial jurisdiction of the United States.[194] The Bankruptcy Court may grant a stay or other assistance on an interim basis pending recognition or following recognition of a non-main proceeding.[195]

The requirements of recognition are minimal: the foreign representative must establish that a foreign court or administrative proceeding with respect to the debtor is pending and that the foreign representative is empowered to act by the proceeding.[196] A foreign proceeding need not resemble a US bankruptcy case to be recognized. A foreign proceeding is defined by the Bankruptcy Code as "a collective judicial or administrative proceeding in a foreign country . . . . under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation."[197] Under this definition, proceedings as diverse as English schemes of arrangement, Brazilian *recuperação judicial* and Australian creditor-appointed receivers have been granted recognition. However, where the foreign proceeding is

---

[191] 11 USC, § 1501(a).

[192] As discussed in para 7 below, this is also true of the US approach to recognition of foreign judgments.

[193] 11 USC, § 1515(a). Prior to the recognition of a ch15 proceeding however, and subject to the requirements of s 303, creditors may commence an involuntary ch 7 or 11 proceeding against an entity that is in foreign bankruptcy proceedings unless barred from doing so by the law of those proceedings. A foreign representative may seek dismissal of US plenary proceedings against a foreign debtor only if the foreign proceeding is recognized under ch 15 and the court concludes that the purposes of ch 15 would be best served by dismissal. 11 USC, § 305(b).

[194] *Idem*, § 1520(a)(1).

[195] *Idem*, § 1519. The test applicable for determining whether interim relief is warranted is the same standard as applicable to a request for an injunction–likelihood of success on the merits, risk of irreparable harm, balancing of the equities, and the public interest.

[196] *Idem*, § 101(23). Chapter 15 proceedings may not be commenced with respect to certain persons: persons who may not be subject to ch 7 proceedings, US citizens or permanent residents eligible to be debtors under ch 13, or entities subject to proceedings under the Securities Investor Protection Act or the stockbroker or commodity broker provisions of ch 7. 11 USC, § 1501(c).

[197] *Idem*, § 101(23).

commenced solely for the purposes of investigation and not for the adjustment of debts, recognition may be denied as failing to meet the chapter 15 definition of a foreign proceeding.[198]

While a proceeding meeting these requirements may be refused recognition or assistance where if manifestly contrary to US public policy, this exception is very narrow, and rarely applicable to the mere act of recognition, as opposed to the grant of additional assistance.[199]

The one point of contention that may arise at the recognition stage is the characterization of the foreign proceedings as **foreign main** or **foreign non-main**, as this determines the scope of relief available to the debtor following recognition. Foreign main proceedings are those that are commenced in the debtor's **center of main interests** (**COMI**). COMI is a concept foreign to US law, which as discussed above typically uses the concepts of domicile, principal place of business, and location of assets in determining jurisdiction and venue.[200] A debtor's COMI is presumed to be its place of incorporation, but this is rebuttable.[201] Relevant factors in the COMI analysis include:

- location of headquarters;
- location of management;
- location of primary assets;
- location of a majority of debtor's creditors or a majority of the creditors that will be affected by the relief requested by the foreign representative; and
- jurisdiction whose law will apply to most disputes.[202]

A debtor's COMI should be ascertainable by its creditors or other third parties on the basis of objective evidence.[203] Proceedings in a jurisdiction other than the debtor's COMI can be recognized as foreign non-main proceedings only if the debtor had an **establishment** in the jurisdiction – a place where it carried out non-transitory economic activity – prior to the commencement of chapter 15 proceedings.[204]

---

198 *In re Global Cord Blood Corp*, Case No 22-11347 (DSJ), 2022 WL 17478530 (Bankr SDNY Dec 5, 2022) (concerning the appointment of joint provisional liquidators in the Cayman Islands).

199 11 USC, § 1506.

200 *See Morning Mist Holdings Ltd v Krys (In re Fairfield Sentry Ltd)*, 714 F.3d 127, 133-34 (2d Cir 2013) (determining COMI as of filing of ch 15)).

201 11 USC, § 1516(c). One court has held that the "good faith filing" requirement applicable to plenary proceedings was not applicable in ch 15 and therefore the debtor's commencement of the case to frustrate enforcement of a judgment was not a basis to deny recognition (*In re Black Gold SARL*, 635 BR 517 (9th Cir BAP 2022).

202 *In re SPhinX, Ltd*, 351 BR 103, 117 (Bankr SDNY 2006)

203 *Morning Mist*, 714 F.3d at 134.

204 11 USC, § 1502(2). Like COMI, the concept of establishment is another legal concept imported from European insolvency law via the Model Law.

In the *Bear Stearns* case,[205] for example, the US bankruptcy court held that the Cayman Islands could not be the COMI for a Cayman-incorporated hedge fund because the fund was an "exempt" company, licensed on the basis that it would not have operations in the Cayman Islands. The court also found that the Cayman liquidation could not be recognized as a non-main proceeding because the debtor had had no establishment there prior to its insolvency.

As a result of the *Bear Sterns* case, and the conclusion of most US courts that COMI is to be assessed as of the date of the US petition, not the commencement of foreign proceedings, a process has been developed of shifting COMI through the conduct of the foreign proceedings themselves. For example, a liquidator appointed in the Cayman Islands over an "offshore" company will move the books and records of the debtor into the country, appoint local agents to marshal the debtor's assets, and hold meetings with creditors and the debtor's management in the country for a period of several months prior to the filing of a chapter 15 petition.[206] This practice has attracted criticism from certain commentators. Most notably, the UNCITRAL Working Group have revised the implementation manual for the Model Law to specify that COMI is to be tested as of the date of the commencement of the foreign proceeding, and the National Bankruptcy Council (an influential group of judges, practitioners and academics) have proposed that the Bankruptcy Code be amended accordingly.[207] In response, practitioners in the offshore space have emphasized (and US bankruptcy courts have recognized) that COMI shifting is often undertaken to use consistent, efficient, and transparent policies of offshore corporate law, and existing case law permits a US bankruptcy court to deny recognition where it finds that the debtor's COMI was manipulated in bad faith.[208]

6.2.3 *Relief available upon recognition*

Upon recognition of a foreign main proceeding, certain provisions of the Bankruptcy Code automatically apply to the debtor's property within the territorial jurisdiction of the United States:[209]

- automatic stay;[210]

---

[205] 374 BR 122 (Bankr SDNY 2007).

[206] See, eg, *In re Ocean Rig UDW Inc*, 570 BR 687 (Bankr SDNY 2017).

[207] UNCITRAL, *Guide to Enactment and Interpretation* (rev 2013) ¶¶ 158-60 (stating that COMI and existence of an establishment should be analyzed as of the date of commencement of the foreign proceeding)(available at https://www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf);
National Bankruptcy Conference, Letter to Representatives Marino and Cicilline and Senators Grassley and Feinstein (Aug 20, 2018) (proposing revisions to cha 15 to conform to UNCITRAL Guide) (available at https://drive.google.com/file/d/1DIfvi1wP9vQHFugAk1rcsPChmhw6VDX1/view). See also 11 USC, § 1508 ("In interpreting [chapter 15], the court shall consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions.").

[208] Norton Rose Fulbright, Letter to Representatives Marino and Cicilline and Senators Grassley and Feinstein (Jan 14, 2019) (responding to National Bankruptcy Conference letter and citing caselaw) (available at http://risa.ky/wp-content/uploads/2019/01/NRF-letter-regarding-the-proposed-revisions-to-Chapter-15-14-Jan-2019.pdf).

[209] 11 USC, § 1520. Also, upon recognition of either a foreign main or non-main proceeding, the foreign representative is granted the right to intervene in any US state or federal court proceedings to which the debtor is a party. 11 USC, § 1524.

[210] The automatic stay in a ch 15 proceeding is subject to a carveout to permit the filing of a plenary US bankruptcy proceeding even after the recognition of a foreign proceeding. 11 USC, § 1520(c).

- operation of the debtor's business in the ordinary course by the foreign representative;
- sale, transfer or use of property outside the ordinary course;
- avoidance of post-petition transfers and post-petition perfection of security interests.

Upon recognition of a foreign non-main proceeding, any of the above relief may be granted on a discretionary basis. In addition, following recognition as either foreign main or foreign non-main, the following relief also may be granted on a discretionary basis:[211]

(1) authorization of discovery regarding the debtor's assets and affairs;

(2) entrusting administration of the debtor's US assets to the foreign representative or other person;[212]

(3) extension of provisional relief;

(4) any other relief "necessary to effectuate the purposes of [chapter 15] and to protect the assets of the debtor or the interests of creditors."[213]

Where discretionary relief is sought in a foreign non-main proceeding, the bankruptcy court must be satisfied that it is appropriate under US law for the assets in question to be administered in the foreign non-main proceeding.[214] Moreover, the ability of the bankruptcy court to condition relief on sufficient protection of interested parties and to discontinue discretionarily granted relief on the application of a party in interest makes recognition as a foreign non-main less protective than recognition as a foreign main proceeding.[215]

The above list of relief available is not exhaustive. Subject to the limitations discussed in the paragraph 6.2.4 below, a court may provide additional assistance under the Bankruptcy Code or other US law consistent with the principle of comity and the values underlying the Bankruptcy Code.[216]

---

[211] 11 USC, § 1521.

[212] The power to operate the debtor's business in the ordinary course and the power to sell outside the ordinary course subject to court approval, which come into effect upon recognition of a foreign main proceeding, do not authorize the foreign representative to return funds collected in the US proceeding to the foreign proceeding for distribution. The grant of such relief is discretionary and requires the foreign representative to show that "the interests of creditors in the United States are sufficiently protected." 11 USC, § 1521(b).

[213] 11 USC, § 1521(a).

[214] *Idem*, § 1521(c).

[215] *Idem*, § 1522.

[216] *Idem*, § 1507(b). The specific factors for the court's consideration are, in addition to principles of comity, "(1) just treatment of all holders of claims against or interests in the debtor's property; (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding; (3) prevention of preferential or fraudulent dispositions of property of the debtor; (4) distribution of proceeds of the debtor's property substantially in accordance with the order prescribed by this title; and (5) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns."

6.2.4 *Relief not available*

Article 23 of the Model Law addresses the powers granted to a foreign representative upon recognition of a foreign proceeding with respect to "Actions to avoid acts detrimental to creditors" – that is, avoidance actions. The Model Law does not prescribe which powers should be granted, but indicates, in bracketed text, that the enacting legislature should "refer to the types of actions to avoid or otherwise render ineffective acts detrimental to creditors that are available in this State to a person or body administering a reorganization or liquidation." The reference to "in this State" is to the enacting jurisdiction and thus suggests that the avoiding actions available to the foreign representative will be those that a domestic debtor or trustee would be able to use. Chapter 15, despite closely following the Model Law in many respects, excludes from the rights granted to foreign representatives the use of avoidance powers provided by the Bankruptcy Code.[217]

This provision has been widely, but not universally, interpreted only to apply to the use of the Bankruptcy Code's powers of avoidance of preferences and fraudulent conveyances, and not to bar a foreign representative from seeking to avoid pre-petition transactions under other applicable US or foreign law.[218] This is consistent with practice in cases under section 304 of the Bankruptcy Code prior to the enactment of chapter 15.

A foreign representative can only invoke the Bankruptcy Code avoidance powers in a plenary proceeding such as chapter 7 or 11.[219] In some circumstances, such a proceeding was commenced by a debtor or its creditors prior to involvement of the foreign representative; in other, rarer circumstances, the foreign representative may choose to commence a plenary proceeding under the Bankruptcy Code after recognition of the foreign proceeding under chapter 15.[220] In those circumstances, the scope of the plenary proceeding is limited to the debtor's US assets and will be coordinated with the foreign proceeding.[221] A foreign representative may wish to commence plenary proceedings to obtain access to the Bankruptcy Code's avoiding powers where relief under other applicable law is unsatisfactory, such as where the statute of limitations has expired or applicable law does not allow claims for constructive fraudulent conveyance.

6.2.5 *A note about section 363 sales in chapter 15*

Section 363 of the Bankruptcy Code, providing for sale of assets outside the ordinary course free and clear of all liens and other interests, is automatically applicable upon recognition of foreign main proceedings, and its application commonly is requested and granted upon the recognition of foreign non-main proceedings as well. As discussed in paragraph 5.4.3.2 above, sale pursuant to section 363 can achieve improved recoveries on assets of the estate and greater protection of purchasers.

---

[217] *Idem*, § 1521(a)(7) (excluding from discretionary relief that may be granted upon recognition "relief available under sections 522, 544, 545, 547, 548, 550, and 724(a)").

[218] *In re Condor Ins Ltd*, 601 F.3d 319, 329 (5th Cir 2010).

[219] 11 USC, § 1523(a).

[220] *Idem*, § 1511.

[221] *Idem*, § 1528.

In parallel proceedings, however, coordination problems may arise where the foreign court also must approve the sale of US assets. In the *Fairfield Sentry* case, British Virgin Islands (BVI) liquidators of a hedge fund that had invested in the Madoff Ponzi scheme obtained approval from the BVI court to sell the fund's claim in the liquidation of the Madoff estate, but before they could seek the approval of the US bankruptcy court in a which the fund's chapter 15 proceeding was pending, the Madoff liquidator announced substantial additional funds had been recovered for that estate, increasing the value of the BVI fund's claim. The Second Circuit Court of Appeals held that section 363 applied to the sale of the claim, because it was a claim in a US proceeding, and that the US bankruptcy court had to determine the fairness of the compensation offered as of the date of the 363 sale motion, not at the earlier date on which the BVI court approved the sale.[222] Thus, where approvals of two courts are required, the foreign representative may wish to hold a single sale hearing before both courts (by telephone or video conference) if such a procedure is available in the case.

6.3 Notable cases

Important cases in the development of cross-border insolvency law and practice include:

In re SPhinX, Ltd[223] – identifying factors relevant to COMI determination;

In re Bear Stearns High-Grade Structured Credit Strategies Master Fund[224] – holding that Caymanian proceedings for a Cayman-incorporated hedge fund could not be recognized as foreign main or foreign non-main proceedings due to lack of COMI or establishment in Cayman;

In re Condor Ins Ltd[225] – approving use of applicable non-bankruptcy law to pursue avoidance actions in chapter 15 proceedings;

In re Ephedra Products Liability Litigation[226] – recognizing and enforcing Canadian court's claims resolution procedure in Muscletech insolvency proceedings, despite absence of jury trial right claimants would have in the US;

In re Vitro SAB de CV[227] – affirming bankruptcy court's grant of recognition to foreign proceedings where foreign representatives were selected by debtor and not foreign court, and affirming denial of enforcement of Mexican *concurso*'s third-party releases where *concurso* plan was adopted by the votes of insiders and a majority of non-insider creditors voted against it;

Morning Mist Holdings Ltd v Krys (In re Fairfield Sentry Ltd)[228] – holding that determination of COMI is to be made as of filing of chapter 15;

---

[222] *In re Fairfield Sentry, Ltd.*, 768 F.3d 239, 243-48 (2d Cir 2013) ("[T]he bankruptcy court must consider as part of its section 363 review the increase in value of the SIPA Claim between the signing of the Trade Confirmation and approval by the bankruptcy court.").
[223] 351 BR 103 (Bankr SDNY 2006).
[224] 374 BR 122 (Bankr SDNY 2007).
[225] 601 F.3d 319 (5th Cir 2010).
[226] 349 BR 333 (SDNY 2011).
[227] 701 F.3d 1031 (5th Cir 2012).
[228] 714 F.3d 127, 133-34 (2d Cir 2013).

In re Fairfield Sentry, Ltd[229] – holding that US bankruptcy court must independently analyse proposed sale under section 363 and not defer to approval of sale in foreign proceeding;

Jaffe v Samsung Electronics Co, Ltd[230] – affirming bankruptcy court's denial of recognition of termination of US patent licenses in Qimonda AG's German proceedings as a matter of US public policy under section 1506;

In re Sino-Forest Corp[231] – enforcing third-party releases in Canadian CCAA plan that terminated securities class action claims against debtor's former auditor;

In re Nortel Networks, Inc[232] – allocation trial opinion following joint trial with Canadian court;

In re Ocean Rig UDW Inc,[233] – approving of COMI-shifting for purposes of effective reorganization;

In re Platinum Partners Value Arbitrage Fund LP[234] – discussing discovery available to foreign representative in chapter 15 proceedings;

In re ENNIA Caribe Holding NV[235] – granting recognition to Curacao administrative proceeding for insolvent foreign insurance companies as foreign main proceedings;

In re Modern Land[236] - holding that chapter 15 recognition effectuates a discharge under US law that should satisfy the requirements of the *Gibbs* rule with respect to US law-governed debts (responding to concerns raised in *In the Matter of Rare Earth Magnesium Technology Group Holdings Limited* [2022] HKCFI 1686).

7. RECOGNITION OF FOREIGN JUDGMENTS

Although suits to enforce foreign judgments are comparatively rare in the commercial context,[237] US courts routinely recognize foreign judgments, and the process for a judgment holder to achieve such US recognition of a foreign judgment is generally neither prohibitively expensive nor complex.[238] While there are grounds to defend against the recognition and

---

[229] 768 F.3d 239 (2d Cir 2013).
[230] 737 F.3d 14 (4th Cir 2013).
[231] 501 BR 655 (Bankr SDNY 2013).
[232] 532 BR 494 (Bankr D Del 2015).
[233] 570 BR 687 (Bankr SDNY 2017).
[234] 18-cv-5176 (DLC), 2018 WL 3207119 (Bankr SDNY June 29, 2018).
[235] 18-12908 (MG), 2018 WL 672124966 (Bankr SDNY Dec 20, 2018).
[236] 641 BR 768 (Bankr SDNY 2022).
[237] Most reported cases concern enforcement of foreign custody, support, or asset division orders in the context of divorce. The rareness of commercial cases is likely because businesses generally pay judgment debts and many cross-border commercial relationships are governed by agreements that require the parties to arbitrate any disputes. Enforcement of arbitral awards under the Federal Arbitration Act and the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards is more common than proceedings to recognize and enforce foreign judgments.
[238] Orders granting injunctions, relating to taxes, or imposing fines or other penalties are not subject to recognition under ordinary principles of recognition of judgments.

enforcement of foreign judgments, a US court generally recognize a validly procured foreign judgment without examining very deeply the merits of the underlying dispute and without any showing that the foreign court would recognize a US judgment. The US is not party to any treaties relating to enforcement of civil judgments.[239]

Foreign money judgments may be rendered enforceable in the US under the Uniform Foreign–Country Money Judgments Recognition Act (the **UFCMJRA**), a statue that the majority of US states have enacted (in current or prior form).[240] The UFCMJRA requires that the foreign judgment be:

- final and enforceable in the rendering jurisdiction;[241]
- for a sum of money;
- issued by a court with personal jurisdiction over the defendant; and
- issued by a court in a legal system that provides reasonable due process safeguards.

With respect to the personal jurisdiction of the foreign court, the judgment-defendant must have:

- been personally served in the foreign forum;
- appeared voluntarily and consented to the forum's jurisdiction;
- submitted to jurisdiction by agreement of the parties;
- been incorporated or headquartered in the forum country at the time the foreign action began; or
- had sufficient relevant contacts with the foreign forum through a business office located there.[242]

Where a defendant appears in the foreign court and unsuccessfully challenges its exercise of personal jurisdiction, a US court will typically defer to the foreign court's conclusion as to jurisdiction.

---

[239] The US is party to a number of bilateral and multi-lateral treaties relating to taxes that are beyond the scope of this module.

[240] States that have not enacted the uniform act typically apply similar factors under their common law. Information about which states have enacted which version of the UFCMJRA is available at www.uniformlaws.org.

[241] Recognition proceedings may be stayed where the judgment sought to recognized is subject to appeal.

[242] UFCMJRA, § 5.

Only a handful of countries have been found to have such inadequate judicial systems that their judgments should not be recognized because of a lack of due process: Liberia;[243] Iran;[244] Nicaragua;[245] and Ecuador.[246] US courts recognize that the fundamentals of due process do not require compliance with the procedures required by the US Constitution, such as jury trials, but do require reasonable notice to the defendant and the opportunity to be heard.

The US court has discretion to deny recognition to a foreign judgment meeting these requirements if:

- the foreign court lacked subject-matter jurisdiction;
- the judgment was obtained by fraud;
- the defendant lacked notice of the proceedings;
- the judgment offends public policy;[247]
- the judgment conflicts with another final judgment; or
- the parties had agreed to some other forum for resolving their dispute.

Fraud may be asserted as a basis for non-recognition but will rarely succeed unless the fraud is extrinsic to the foreign legal process – such as misleading the defendant about the time and place of the hearing. Fraud intrinsic to the proceeding, such as the submission of false evidence, should be raised in the first instance with the foreign court and is only a basis for non-recognition if the foreign court's response to such issues calls into question the integrity of the tribunal.

US courts may also recognize the judgments of foreign courts on the principle of comity, which provides a basis for US federal courts to recognize a foreign court's judgment on a matter "when (1) the foreign judgment was rendered by a court of competent jurisdiction, which had jurisdiction over the cause and the parties, (2) the judgment is supported by due allegations and proof, (3) the relevant parties had an opportunity to be heard, (4) the foreign court follows procedural rules, and (5) the foreign proceedings are stated in a clear and formal record."[248]

---

[243] *Bridgeway Corp v Citibank*, 45 F.Supp.2d 276, 287 (SDNY 1999).

[244] *Bank Melli Iran v Pahlavi*, 58 F.3d 1406 (9th Cir 1995).

[245] *Osorio v Dole Food Co*, 665 F.Supp.2d 1307 (SD Fla 2009).

[246] *Chevron Corp v Donziger*, 974 F.Supp.2d 362, 610-617 (SDNY 2014).

[247] For example, a French court order requiring Yahoo! to remove certain posts from a website was denied recognition because it conflicted with the freedom of speech guaranteed by the First Amendment to the US Constitution. *Yahoo! Inc v La Ligue Contre Le Racisme et L'Antisemitisme*, 433 F.3d 1199 (9th Cir 2006).

[248] *Int'l Transactions, Ltd v Embotelladora Agral Regiomontana, SA de CV*, 347 F.3d 589, 594 (5th Cir 2003).

Upon recognition under the UFCMJRA or principles of comity, the US court's judgment should be enforceable in all other US states on the basis of the US Constitution's requirement that each state grant "full faith and credit" to the legal acts of other states.[249]

8. INSOLVENCY LAW REFORM

The American Bankruptcy Institute formed a Commission to Study the Reform of Chapter 11 in 2011, based on a view that changes in the US financial markets required corresponding changes to the US Bankruptcy Code. The ABI Commission met and collected evidence from 2012-2014 and issued its report at the end of 2014.[250] The report's proposals include appointment of a neutral party to manage investigation and resolution of disputed matters, removing the requirement of an accepting impaired class from the cramdown procedure, formalizing the use of section 363 to sell substantially all of a debtor's assets, and creation of an alternative process of bankruptcies of small-to-medium-size enterprises. The Small Business Reorganization Act of 2018 was introduced in November 2018 and includes some of the features recommended by the Commission.[251] The legislation was reintroduced and enacted as the Small Business Reorganization Act of 2019, which became effective in March 2020.

As discussed above in paragraph 6.2.2, the National Bankruptcy Conference has recently written to legislators with a number of recommendations for amendments to the Bankruptcy Code relating to chapter 15 proceedings, including a change in the time at which COMI should be determined.[252] The NBC has also indicated its support for the Small Business Reorganization Act.

In late 2020, Senators Warren and Cornyn re-introduced the Bankruptcy Venue Reform Act they had introduced in each of the preceding several legislative sessions, which would limit the venue of a corporate debtor's bankruptcy in most cases to the jurisdictions in which it had its principal place of place of business or principal assets 180 days prior to its filing. This legislation has faced substantial opposition from representatives for Delaware and New York in prior sessions (including from then-senator Joseph Biden), and has not progressed during the current session.

9. USEFUL INFORMATION

The following websites are excellent resources for developments in US bankruptcy law and practice:

- American Bankruptcy Institute: www.ABI.org;

---

[249] But see *Ahmad Hamad Al Gosaibi & Bros Co v Std Chartered Bank*, 98 A.3d 998, 1008 (DC 2014) (finding a New York recognition judgment not entitled to full-faith-and-credit recognition due to nature of the judgment and New York's more relaxed standards to recognize foreign-country judgments).

[250] The report is available at https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h.

[251] Text of the bill as introduced is available at https://www.congress.gov/bill/115th-congress/house-bill/7190/text.

[252] Available at https://drive.google.com/file/d/1DIfvi1wP9vQHFugAk1rcsPChmhw6VDX1/view.

- National Bankruptcy Conference: www.NBConf.org;
- Harvard Law School Bankruptcy Roundtable: blogs.harvard.edu/bankruptcyroundtable/.

APPENDIX A: COMMENTARY AND FEEDBACK ON SELF-ASSESSMENT EXERCISES

Self-Assessment Exercise 1

Question 1

Which sections of the Bankruptcy Code apply in a chapter 7 liquidation?

Question 2

True or False: The Bankruptcy Code is the only law that applies in bankruptcy proceedings.

Question 3

What rules should you review when preparing a filing for a bankruptcy court?

Commentary and Feedback on Self-Assessment Exercise 1

Question 1

Chapters 1, 3, 5, and 7 apply to proceedings in a chapter 7 case. Provisions of chapter 15 may be relevant if there are foreign proceedings to be coordinated with the chapter 7 case.

Question 2

False. Foreign, state and federal law apply to determine the rights of debtors and creditors except to the extent the they conflict with and are pre-empted by the Bankruptcy Code.

Question 3

You should review the Bankruptcy Rules, the Federal Rules of Civil Procedure, the local rules of the bankruptcy court and the judge's personal practices. If you do not practice regularly in a jurisdiction, consult with a local practitioner for advice on unwritten local practices.

Self-Assessment Exercise 2

Question 1

What is the difference between a bankruptcy trustee and the US Trustee?

Question 2

Which of the following could *not* be considered a "party in interest"?

a) the debtor
b) the debtor's non-debtor affiliate that has guaranteed certain of its debts
c) the debtor's landlord
d) the US Internal Revenue Service
e) persons exposed to harmful chemicals by the debtor but not experiencing symptoms
f) a non-profit consumer advocacy organization

Commentary and Feedback on Self-Assessment Exercise 2

Question 1

The US Trustee is an office of the US Department of Justice charged with oversight of bankruptcy proceedings. A representative of the US Trustee participates in each case. The US Trustee is responsible for selecting bankruptcy trustees from a slate of eligible private practitioners; the creditors' committee may then affirm its selection or select a different trustee. The bankruptcy trustee is a fiduciary of the estate and charged with the debtor's operations (if any), disposal of property and pursuit of actions for the benefit of the estate, and the resolution and payment of creditor claims.

Question 2

Each of (a)-(e) have been held to have party in interest status in cases whether the entities or individuals had a financial, even if contingent, stake in the outcome of the matters before the court. Advocacy organizations (f) have consistently been held not have part in interest standing.

Self-Assessment Exercise 3

Question 1

What are two differences between chapter 7 proceedings and chapter 11 proceedings?

Question 2

What are three debtor-friendly aspects of chapter 11 proceedings?

Commentary and Feedback on Self-Assessment Exercise 3

Question 1

In chapter 7 proceedings, a trustee must be appointed; in chapter 11, the debtor may remain in possession. In chapter 7 proceedings, the debtor must cease operations and liquidate; in chapter 11 proceedings, the debtor may continue to operate in the ordinary course of business and may reorganize or liquidate.

Question 2

Debtor-friendly aspects of chapter 11 discussed in this section include:
- Worldwide automatic stay on filing
- Rejection of burdensome contracts
- Sale of assets free and clear of liens
- Avoidance of preferential and fraudulent transfers
- Cramdown of dissenting classes in approving a plan
- The ability to pre-pack a case by soliciting creditor support for a plan of reorganization before the bankruptcy filing.

Self-Assessment Exercise 4

Question 1

Which of the following is true for a corporation filing a voluntary bankruptcy petition?
a) The corporation must be insolvent on a balance sheet basis – that is, its liabilities must exceed its assets.
b) The corporation must be insolvent on a cash flow basis – that is, it is not meeting its debts as they come due.
c) The corporation need not be insolvent.

Question 2

Consider the following hypothetical: A consortium of Mexican banks has made several loans, totalling millions of dollars, to Mexican businesses owned by the Caruso family, who guaranteed the loans. The businesses have defaulted on the loans and are now in insolvency proceedings in Mexico, in which the banks have appeared to collect on their notes. The Carusos have made only partial payment on the guarantee, which has given rise to suit by the banks in Mexico on the guarantee. The Carusos own several properties in the United States. May the Mexican banks commence involuntary bankruptcy proceedings in the US against the Carusos individually?

Commentary and Feedback on Self-Assessment Exercise 4

Question 1

c) The corporation need not be insolvent to file a voluntary petition for bankruptcy. The petition may, however, be dismissed if it has been filed for an improper purpose.[253]

Question 2

Yes, (1) each of the alleged debtors is indebted to three or more of the petitioners for an amount aggregating in excess of USD 10,000.00; (2) this debt is liquidated and non-contingent, and is not subject to a bona fide dispute; (3) the alleged debtors are not paying their debts as they become due; and (4) the alleged debtors are qualified debtors under the Bankruptcy Code because they own property in the United States.[254]

Self-Assessment Exercise 5

Question 1

Consider the following hypothetical: American Coal Corp is the parent company of a group of mining companies with operations throughout the south-eastern United States. ACC is incorporated in Delaware and headquartered in Missouri. Its subsidiaries are incorporated, headquartered, or have their principal assets located in Kentucky, Missouri, Ohio, Pennsylvania, Virginia, and West Virginia. In what jurisdiction(s) would venue be appropriate for all members of the group?

Question 2

For each of the following matters, state the nature of the bankruptcy court's jurisdiction and whether each core or non-core:

a) Involuntary bankruptcy petition
b) Creditor's claim against the debtor
c) Creditor's claim against an affiliate of the debtor that has guaranteed the debtor's obligation to the creditor
d) Motion for approval of DIP financing

[253] *See In re SGL Carbon Corp*, 200 F.3d 154 (3d Cir 1999) (holding, and citing other courts of appeal as holding, that absence of good faith in filing petition is cause for dismissal)
[254] Adapted from *In re Xacur*, 216 BR 187 (Bankr SD Tex 1997).

Commentary and Feedback on Self-Assessment Exercise 5

Question 1

Venue would be proper for all members of the group in any of Delaware, Kentucky, Missouri, Ohio, Pennsylvania, Virginia and West Virginia under 28 USC, § 1408, so long as the first petition filed in a given jurisdiction is on behalf of an entity incorporated, headquartered or having its principal assets in that jurisdiction. Venue is thereafter proper for all other members of the corporate group on the basis of a pending proceeding with respect to an affiliate. Note, however, that a filing in Delaware, where venue is proper only on the basis of incorporation of one entity, may attract a motion by creditors for transfer of venue to a jurisdiction with a greater connection to the assets of the estates and the creditors as a whole.[255]

Question 2

a) The petition commences a **case under** title 11, and is a core proceeding.
b) The allowance of claims is governed by section 502 of the Bankruptcy Code and therefore allowance of a claim is a matter **arising under** the Bankruptcy Code and is a core proceeding. To the extent that the debtor asserts a counterclaim in response to a creditor's claim, the bankruptcy court has **arising in** jurisdiction and the matter is core.
c) Assuming that the resolution of the suit on the guarantee may affect the debtor's estate, such as by reducing its liability to the creditor or by giving rise to an obligation for the debtor to indemnify the guarantor, the bankruptcy court will have **related to** jurisdiction and the matter will be non-core.
d) The debtor's ability to obtain debtor in possession financing is a matter **arising under** the Bankruptcy Code and is core.

Self-Assessment Exercise 6

Question 1

True or false: Following the filing of an involuntary bankruptcy petition, the automatic stay does not come into effect until the court enters an order for relief.

[255] Adapted from *In re Patriot Coal Corp*, 482 BR 718 (Bankr SDNY 2012) (holding that the creation of New York-incorporated subsidiaries to create bankruptcy venue in New York was not in bad faith but would be considered in determining whether to transfer venue in the interest of justice and transferring cases to the Eastern District of Missouri on motion of creditors).

Question 2

Which of the following actions is *not* prohibited by the automatic stay?

a) Foreclosure on the debtor's non-US property securing a debt
b) Commencing an arbitration against the debtor under the rules of the International Chamber of Commerce
c) The debtor filing a lawsuit in state court against a creditor for breach of contract
d) Execution of a securities contract to which the debtor is a party
e) Filing a claim in the debtor's bankruptcy proceedings

Question 3

Debtor-in-possession Hotelco operates a chain of franchised hotels, and each property is subject to a separate mortgage. With respect to Hotel X, the amount outstanding on the loan is USD 1 million. The secured lender contends that Hotel X is worth only USD 800,000 and has filed a motion to lift the automatic stay so it can foreclose on the Hotel X property. How might Hotelco oppose the motion?

Commentary and Feedback on Self-Assessment Exercise 6

Question 1

False, the automatic stay comes into effect upon the filing of an involuntary petition, without the need for any action by the court.

Question 2

c, d and e. The automatic stay has worldwide effect, so actions to control the debtor's foreign property (a) or commence a lawsuit outside the US court system (b) is barred. The debtor, however, may commence suits, including outside the bankruptcy court (c); a creditor will want to seek approval from the bankruptcy court or agreement of the debtor before filing a counterclaim in such a suit. Execution of securities contracts (d) is excepted from the automatic stay, and filing a claim in the debtor's bankruptcy proceedings (e) also does not violate the automatic stay.

Question 3

Hotelco could present its own valuation showing that the value of the property is greater than USD 1 million, and therefore the creditor is oversecured. Alternatively, Hotelco could offer the secured lender adequate protection, such as periodic cash payments to lower the balance of the loan until it is below the appraised value of the property or a junior lien in another property that has an equity cushion.

Self-Assessment Exercise 7

Question 1

Hotelco (introduced in Self-Assessment Exercise 6) wants to issue year-end bonuses to its employees. What analysis should Hotelco's lawyers perform to determine whether court approval is required?

Question 2

Hotelco wants to sell Hotels X and Y in a single 363 sale. The secured lender on Hotel X wishes to credit bid its USD million debt claim on the Hotel X mortgage for the two hotels, and a third party is offering USD 900,000 cash for the two hotels. Which of these offers should Hotelco ask the court to approve?

Commentary and Feedback on Self-Assessment Exercise 7

Question 1

Hotelco's attorneys should consider whether Hotelco has unencumbered funds to make the bonus payments. If its bank accounts or rents are pledged as collateral, it will require court approval to use cash collateral to make any payments. If it does have unencumbered cash, Hotelco's attorney should consider whether year-end bonuses qualify as ordinary course payments by looking at whether it paid year-end bonuses to employees in pre-petition years and whether such bonuses are common among hotels in the area.

Question 2

A secured creditor may only credit bid for an asset to the extent it has a lien on the asset, and the secured lender here only has a lien on Hotel X. Thus, the credit bid essentially gives no value for Hotel Y and its secured lender (as Self-Assessment Exercise 6 noted, each hotel property is subject to a mortgage). The USD 900,000 cash offer that would return money to both secured creditors is therefore the preferable offer.

Self-Assessment Exercise 8

The secured lender on Hotel X has offered to extend Hotelco USD 5 million in DIP financing, to consist of USD 1 million in refinancing the existing Hotel X facility and USD 4 million in cash, to be secured by a super senior lien on all of the Hotelco's properties, priming the mortgage lenders on those properties. What arguments might the other mortgage lenders make in opposition to Hotelco's motion for approval of this financing arrangement?

Commentary and Feedback on Self-Assessment Exercise 8

The mortgage holders might object to the existing secured loan being refinanced at full value, given that the value of the property securing the loan is asserted (in Self-Assessment Exercise 6) to be only USD 800,000 and it would otherwise only have an unsecured claim for USD 200,000 for the remainder. The mortgage holders also might object to the extent that there exists other unencumbered estate property on which a lien could be placed, or encumbered estate property with an equity cushion on which a junior lien can be placed. They may also offer to extend DIP financing to Hotelco on better terms.

Self-Assessment Exercise 9

Question 1

Which of the following contracts to which Hotelco is party are executory and, if executory, may be assigned without counterparty consent?

a) Franchise agreement with Brand Name Hotels Inc.
b) Employment contract with former CEO, requiring Hotelco to indemnify him in any future lawsuit.
c) Lease of office space containing provision requiring landlord approval of any assignment.

Question 2

Mr Q, a majority shareholder of Hotelco, has granted an unconditional guarantee of Hotelco's revolving credit facility. Hotelco's commencement of bankruptcy is an event of default under the facility. May the lender demand payment on the guarantee or is it barred by the prohibition on *ipso facto* clauses?

Commentary and Feedback on Self-Assessment Exercise 9

Question 1

(a) and (c) are executory contracts. The franchise agreement is not assignable because it includes a license of Brand Name Hotel's trademarks, and trademark licenses are not assignable absent licensor consent.[256] The lease of office space is assignable without consent, notwithstanding the landlord approval provision. The employment contract (b) is not executory because the CEO's obligations were complete upon the termination of his employment, even though Hotelco has on-going obligations.

[256] *In re Trump Entertainment Resorts, Inc*, 526 BR 116 (Bankr D Del 2015) ("[F]ederal trademark law generally bans assignment of trademark licenses absent the licensor's consent.").

Question 2

The lender may pursue payment from the guarantor. *Ipso facto* clauses are given no effect only where they are asserted against a debtor with respect to its own filing or financial condition. The issuer of an unconditional guarantee cannot assert the debtor's own defences to the debt.

Self-Assessment Exercise 10

Which of the following are entitled to file a claim in the Hotelco bankruptcy?

a) Secured lender owed USD 1 million on Hotel X mortgage.
b) Lessor of office space owed pre-petition rent.
c) Cleaning staff owed pre-petition wages.
d) Franchisor Brand Name Hotels Inc following rejection of the franchise agreement.
e) Mr Q, the majority shareholder, based on his stock ownership.
f) Mr Q, for the obligations he may pay on behalf of Hotelco under his guarantee.

Commentary and Feedback on Self-Assessment Exercise 10

All of these are entitled to file claims, except for (e) Mr Q in his capacity as shareholder – a shareholder has an interest, not a claim. The secured lender is not obligated to file a claim to preserve its lien on the property, but must file a claim if it wishes to get paid (unless it is listed in the debtor's schedules as undisputed, noncontingent, and liquidated and the case is proceeding under chapter 11). Brand Name Hotels Inc will be deemed to have a pre-petition breach of contract claim upon the debtor's rejection of the franchise agreement. Mr Q's contingent claim for indemnification for potential liability under the guarantee will be reduced to an amount certain through the class allowance process if the contingency does not mature during the course of the case.

Self-Assessment Exercise 11

Question 1

To cram down a plan over the objection of a class of secured creditors, what does the "fair and equitable" provision of section 1129 require with respect to treatment of their claims?

Question 2

Hotelco has proposed a plan under which its majority shareholder, Mr Q, receives payment in full on the liquidated amount of his claim relating to his guarantee of Hotelco's debts, but the payment is not made until 60 days after the effective date of the plan. Mr Q is classified into a different class than other unsecured creditors. Mr Q's class is the only accepting impaired class. On what basis might other creditors challenge Hotelco's use of cramdown?

Commentary and Feedback on Self-Assessment Exercise 11

Question 1

Pursuant to 11 USC § 1129(b)(2)(A), a secured creditor must receive either (i) the retention of its lien on the collateral and deferred cash payments with a present value at least equal to the value of the collateral and the nominal value at least equal to the allowed amount of the claim; (ii) the indubitable equivalent of its claim; or (iii) attachment of its liens to the proceeds of sale of the collateral and either retention of the lien with deferred payments or the indubitable equivalent of its claim. Note that each of these options requires the court to value the collateral securing the claim as it is proposed to be used under the plan and to value the deferred payment stream or other consideration contended to be the indubitable equivalent of the creditor's claim.

Question 2

The votes of insiders must be disregarded to determine the existence of an accepting impaired class unless there is no impaired class, and Mr Q, as a majority shareholder, is a statutory insider.[257] In addition, even if Mr Q were not an insider, the delayed payment on his claim, absent a good reason he cannot be paid immediately on effectiveness of the plan, suggests that treatment of his claim may be an attempt to manufacture an accepting impaired class. If so, the requirement that a cramdown plan be proposed in good faith will not be met.[258]

Self-Assessment Exercise 12

What priority would a claim by a taxing authority for unpaid taxes, late fees, and penalties for failure to file have?

[257] 11 USC, § 101(31) (definition of insider includes a "person in control of the debtor").

[258] See, eg, *In re Village Green I, GP*, 811 F.3d 816, 819 (6th Cir 2016) (holding that delay in payments to former lawyer and accountant of debtor where debtor projected more than sufficient post-confirmation revenue to pay them immediately in full was "transparently an artifice" and plan was not proposed in good faith).

Commentary and Feedback on Self-Assessment Exercise 12

The portion of the claim representing unpaid taxes would have priority pursuant to section 507(a)(8). The portion of the claim representing fines and penalties would be subordinated to the payment of all allowed general unsecured claims pursuant to section 726(a)(2)(4). The section 726(a) subordination provision applies only in chapter 7; in chapter 11, the fines and penalties would be given the same priority as the unpaid taxes.

Self-Assessment Exercise 13

Question 1

In 2010, Local Bank lent Hotelco USD 1 million, secured by a mortgage on Hotel Y. In 2018, as Hotelco's financial distress becomes evident, Local Bank reviews its documents and discovers that the mortgage on Hotel Y was never registered with the local property registry. No other mortgage was registered between 2010 and 2018. Local Bank registers its mortgage on March 1, 2018. On May 1, 2018, Hotelco files for bankruptcy. What is the status of Local Bank's mortgage in the bankruptcy?

Question 2

Six months before Hotelco's bankruptcy, it borrows USD 500,000 from majority shareholder Mr Q and grants him a second lien security interest in Hotel Z, which Mr Q perfects immediately by making a filing with the property registry. May the security interest be avoided as a preference?

Commentary and Feedback on Self-Assessment Exercise 13

Question 1

Local Bank's mortgage is a voidable preference unless it can rebut the presumption that Hotelco was insolvent on March 1, 2018. Local Bank's registration of the mortgage on March 1, 2018 was the date of perfection of its security interest, and March 1 was less than 90 days before the petition date. Although the security interest was granted in connection with the extension of credit by Local Bank, the credit extended in 2010 was not substantially contemporaneous with the perfection of the security interest. Local Bank will have an unsecured claim for the amount owing on its loan.

Question 2

As Mr Q is an insider, the preference period is one year prior to the petition date. However, it does not appear that the grant of the security interest was on account of an antecedent debt to Mr Q and he provided contemporaneous new value to Hotelco by extending the loan. Thus, the grant of the security interest is not an avoidable preference.

Self-Assessment Exercise 14

Public Co, the parent of an international group of companies in the aerospace sector, borrows USD 1 billion from Bank Syndicate. Public Co's obligation to repay the loan is guaranteed by each of its subsidiaries. If a subsidiary subsequently became a debtor in US chapter 11 proceeding, could the subsidiary's guaranty obligation be avoided as a fraudulent transfer?

Commentary and Feedback on Self-Assessment Exercise 14

The subsidiary's guarantee of its parent's obligations is termed an "upstream" guarantee and may be avoided as a constructive fraudulent transfer if the subsidiary is insolvent at the time of the transaction or is rendered insolvent by incurring the guarantee liability, and does not receive value reasonably equivalent to the USD 1 billion obligation. It will be a question of fact whether and to what extent the subsidiary is benefited by the parent's borrowing – for example, if some portion of the borrowed funds used for capital expenditures in the subsidiary's business or to ensure the continued operation of a central administrative function on which the subsidiary relies. In some circumstances, an upstream guarantee might have the badges of fraud associated with an actual fraudulent transfer; for example, if instead of a Bank Syndicate the beneficiary of the guarantee was an insider of Public Co, the subsidiary received little or no value from the transaction, and / or the enforcement of the guarantee against the subsidiary was a pretext to deprive a creditor of the subsidiary of recovery.

INSOL International
6-7 Queen Street
London
EC4N 1SP
Tel: +44(0) 20 7248 3333 | Fax: +44(0) 20 7248 3384
www.insol.org