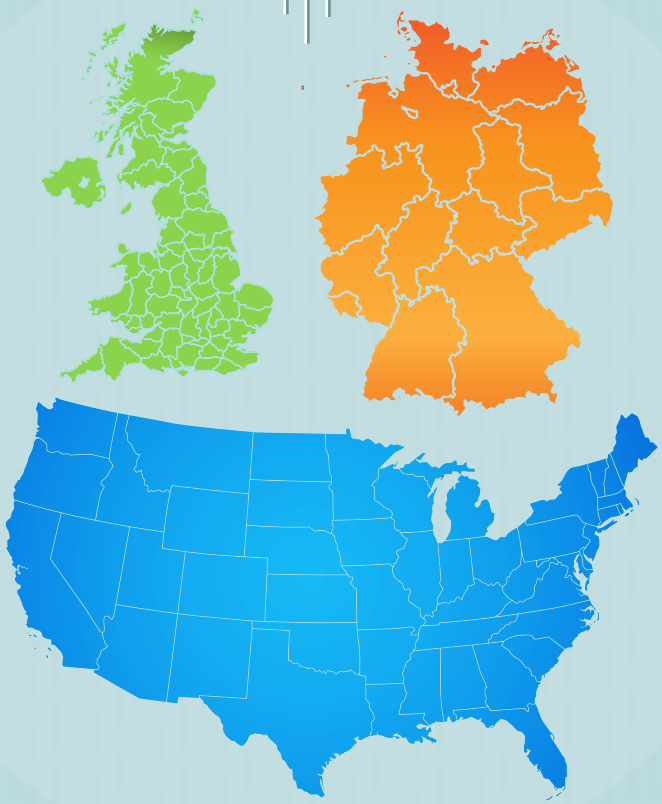
ICTF
THE ASSOCIATION OF INTERNATIONAL CREDIT AND TRADE FINANCE PROFESSIONALS

INSOLVENCY LAWS IN GERMANY, U.K. AND THE U.S.

A COMPARATIVE LAW ANALYSIS FOR TRADE CREDITORS



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Insolvency Laws in Germany, U.K. and the U.S. – A Comparative Law Analysis for Trade Creditors

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1. Insolvency laws and courts overview

UNITED STATES:

- The insolvency laws in the U.S. are primarily set forth in the U.S. Bankruptcy Code, which is Federal law, applicable throughout the U.S.

- There are Federal Bankruptcy Courts located in each state of the U.S. and each court applies the Bankruptcy Code.

- In addition to the Bankruptcy Code, there are published court decisions that become applicable law as well. These decisions can vary from state to state, but for the most part, are uniform throughout the Bankruptcy Court system.

- Bankruptcy Courts are subject to appeals to the U.S. District Courts, the U.S. Court of Appeals and the U.S. Supreme Court. Most states have insolvency laws that are based on state corporate law. These laws are not well developed and are rarely used.

GERMANY:

- The German Insolvency regime is regulated by the Germany Insolvency Act (Insolvenzordnung). The German Insolvency Law is centralised on federal level. Thus, the 16 single states of Germany do not have their own applicable insolvency law.

- The insolvency proceedings are conducted and controlled by special insolvency courts (Insolvenzgerichte), which are part of the local courts (Amtsgerichte).

- Disputes between creditors and debtors or insolvency administrators are subject to ordinary civil courts (and not to special insolvency courts).

Insolvency proceedings can be opened regarding the estate of legal entities as well as of natural persons. However, this hand-out only relates to insolvency proceedings over the assets of legal entities.

UNITED KINGDOM:

a) Legislation

UK insolvency law is primarily set out in the *Insolvency Act 1986* (**IA 1986**). This legislation is supported by detailed secondary legislation (known as the *Insolvency Rules 1986* - **IR 1986**). Over time, both have been extensively reviewed and interpreted by a considerable body of case-law.

The term "insolvency" in the UK is used interchangeably to refer both to a debtor's inability to pay its debts and to the formal insolvency procedures prescribed under UK law. The term "bankruptcy" is used specifically only in relation to the formal insolvency procedure by which the assets of an insolvent individual (rather than a corporate) are distributed to creditors in return for extinguishing their pre-bankruptcy debts.

The UK insolvency regime has its origins in laws aimed solely at protecting creditors against defaulting debtors. While many of the principles of creditor protection remain, in recent years both the *IA 1986* and the *IR 1986* have been substantially revised so as to promote a "rescue culture" aimed at increasing rates of business rescue, saving jobs and improving returns to creditors. Generally, the changes introduced as part of the rescue culture are regarded as having been successful in terms of: improving the speed and ease with which formal debtor rescue procedures are implemented; and reducing damaging interference by individual creditors.

There are three legal jurisdictions within the United Kingdom: England & Wales; Scotland;[1] and Northern Ireland. The insolvency regime in each jurisdiction is substantially similar in most respects. That said, there are a number of important differences in procedure and legal principle that are beyond the scope of this note. For ease of reference, the UK elements of this note focus on the jurisdiction in England & Wales, which accounts for the vast majority of UK insolvency cases

[1] This may change if the referendum on Scottish independence results in a 'yes' vote in 2014.

by volume and value and is most widely encountered in cross-border insolvency matters.

The IA 1986 and IR 1986 set out the framework for the implementation and conduct of all formal UK insolvency procedures. Broadly-speaking they fall into three categories: rescue procedures; terminal procedures; and secured creditor self-help procedures. Under this legislation, all formal UK insolvency procedures are administered or supervised by specialist licensed, professional insolvency practitioners (typically qualified accountants) with a wide range of statutory powers to deal with the debtors' affairs and to promote the interests of the creditors generally. The procedures are:

Procedure	Corporate	Personal
Rescue	Administration Company Voluntary Arrangement	Individual Voluntary Arrangement Debt relief orders
Terminal	Liquidation (aka "winding up")	Bankruptcy
Creditor self-help	Administrative receivership Fixed charge (or LPA) receivership	Fixed charge (or LPA) receivership

b) The Courts

The Chancery Division of the High Court of Justice (the **High Court**) has primary jurisdiction in most formal corporate insolvency matters and higher value personal insolvency matters. As such, the Chancery judges are specialists in determining key issues in insolvency matters. If the debtor in question is based outside of London then the matter will be dealt with by the relevant District Registry of the High Court in that company's district. All District Registries are part of the Chancery Division. If the company in question is based within the district of London then the matter will be dealt with by the Companies Court (part of the Chancery Division).

The County Court responsible for the locality where the debtor is resident has jurisdiction in most personal insolvency matters and any compulsory liquidation

matters involving companies with paid up share capital or less than £120,000. Judges in such cases are, generally, not insolvency law specialists.

Following the implementation of the rescue culture, the degree of involvement of the courts in implementing and regulating UK insolvency procedures is much diminished. Instead, the appointed insolvency practitioner is typically answerable to the debtor's creditors in the first instance, with recourse to the courts in the event of any dispute or major difficulty. This is seen as beneficial in reducing the cost and improving speed of delivery of any debtor rescue.

The principal exceptions to this are "hostile", creditor-initiated winding up and bankruptcy petitions which are filed at court and, following a court hearing to determine the debtor's insolvency, will often result in a court order for the compulsory liquidation or bankruptcy[2] of the debtor.

[2] Draft legislation is currently proposed with a view to taking most personal bankruptcy matters out of the jurisdiction of the courts and into the hands of specialist 'adjudicators'. Although it fits with the rescue culture and government plans to cut expenditure, this reform is not without its critics and may not survive Parliamentary scrutiny.

2. Informal insolvency "proceedings"

UNITED STATES:

- Insolvent companies are not required to file for protection under the U.S. Bankruptcy Code. Companies can attempt to restructure their obligations, the operations and their contracts "informally" by direct negotiation with creditors.

- These informal insolvency proceedings are known as "work-outs" and often result in a "forbearance" agreement, which is a contract between the insolvent company and its creditors. There can be separate 'forbearance" agreements, for example, one for secured lenders and one for unsecured creditors.

GERMANY:

- Informal restructuring agreements between creditors and debtors are possible, but only as long as the company is not insolvent.

- Directors are obliged to file for insolvency if the company is illiquid or over-indebted.

- In case of infringement of the obligation to file for insolvency the directors face a severe penal liability (up to three years imprisonment) as well as civil liability for nearly all company payments made after the moment of insolvency or over-indebtedness.

UNITED KINGDOM:

- There is no specific event which makes it compulsory for a company to enter a formal insolvency procedure. It is therefore possible for an insolvent debtor to seek to restructure its obligations, operations and/or contracts informally, outside of a formal insolvency procedure, by direct negotiation with creditors. In practice, this can prove difficult where large numbers of creditors are involved given the lack of protection against individual creditor action and absent a specific trigger forcing creditors to reach a mutually acceptable compromise.

- In addition, the debtor (and anyone responsible for directing its affairs) must take great care to avoid personal liability in such cases. Specifically, where insolvency looms, the primary duty of the directors of a corporate debtor is to act in the best interests of the debtor's creditors. Failure to do so could result in personal liability for the resulting losses to creditors (see question 12 below for further details).

- Accordingly, properly advised, debtors or their directors will typically seek the protection of an appropriate formal insolvency procedure in most cases in order to implement either the rescue or closure of the business and remove further risk of personal liability.

3. Commencement of formal insolvency proceeding

a. Jurisdictional requirements

UNITED STATES:

Bankruptcy Code Section 109, provides that a person that resides or has a domicile, a place of business or property in the United States may be a debtor under the Bankruptcy Code.

Where a company is incorporated can determine where a company is domiciled in the U.S. For example, many U.S. corporations are incorporated under the laws of Delaware. Accordingly, often those companies may seek Chapter 11 protection in U.S. Bankruptcy Courts, sitting in Delaware.

GERMANY:

Insolvency proceedings are opened following a filing for insolvency by the debtor or a creditor, if an insolvency reason exists and the assets of the debtor cover at least the costs of the proceedings.

An insolvency reason is given, if the debtor is unable to meet its mature obligations to pay (illiquidity according to sec. 17 Insolvency Act) or the debtor will most likely not be able to pay its due liabilities of the current and the next fiscal year (impending illiquidity according to sec. 18 Insolvency Act), or if the debtor is over-indebted according to sec. 19 Insolvency Act.

UNITED KINGDOM:

In order for any formal insolvency procedure to begin, the debtor, its directors (in the case of a corporate) or its creditors (depending on the relevant rules, as explained below) must take the necessary, pro-active steps to initiate the relevant procedure.

a) Jurisdiction

Whether and how a debtor's affairs will fall subject to the jurisdiction of UK insolvency law will be determined by either UK domestic insolvency law (for

debtors whose affairs are located solely in the UK), European Union law (for debtors with a presence both inside and outside of the UK but within the borders of the EU) and international law (for debtors with a presence both inside and outside of the UK and within the borders of subscriber nations to the Model Law on Insolvency Proceedings) (further outlined in question 14 below).

Broadly-speaking, the UK has exclusive jurisdiction to open "main" formal insolvency proceedings to administer the affairs of a debtor whose "centre of main interests" (**COMI**) is within UK borders. The UK has more limited jurisdiction to deal with the UK-based assets of debtors whose COMI lies elsewhere.

What constitutes a debtor's COMI will often depend on the facts of any given case. In summary, however:

- the location of a company's registered office is presumed to be its COMI in the absence of proof to the contrary; and
- a debtor's COMI should correspond to the place where the debtor conducts the administration of its interests on a regular basis, and therefore can be ascertained by third parties.

To the extent that the UK has jurisdiction, in the case of corporate formal insolvency procedures, consideration must also be given to whether the legal entity fits within the categories of debtors to whom the procedures are intended to apply. Companies incorporated under UK companies legislation and most forms of business partnership will be subject to most, if not all, of the various formal insolvency procedures listed above and summarised below:

b) Rescue procedures

The following summaries focus exclusively on the available formal insolvency proceedings relevant to UK corporates.

Administration is the primary UK collective corporate rescue procedure. It is the closest UK equivalent to the Chapter 11 procedure in the US. Administration can be instigated by court application on a voluntary or involuntary basis. However, in most cases it is commenced out of court by the debtor, its directors or a lender who holds the requisite type of security simply filing the requisite sworn forms at court in an appointment process than can take as little as 48 hours.

The impact and great benefit of these filings is that, once made, the debtor is protected from all forms of creditor legal action without the consent of the administrator (once appointed) or permission of the court. This "moratorium" precludes individual creditors from taking unilateral action which would undermine the prospects of achieving a rescue that maximizes returns to all.

Administrators can only take an appointment if satisfied that they can achieve one of the statutory purposes of administration:

- Rescuing the company as a going concern; or, if that is not possible
- Achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration); or, if that is not possible
- Realizing the company's property in order to make a distribution to one or more secured or preferential creditors.

Once appointed, it is the task of the administrator to prepare and submit to creditors for approval their proposals for achieving the relevant statutory purpose that achieves the optimum outcome for creditors. This typically will involve a reorganization of the debtor's debts through a CVA or Scheme of Arrangement (see below) or, in many cases, a sale of the debtor's business and assets that realizes maximum value. If proposing to realize assets, administrators can only make distributions of realizations to ordinary unsecured creditors with the permission of the court – generally this task will fall instead to any liquidator who takes office following the conclusion of the administration.

Administrators have wide-ranging executive powers (in place of those of the directors/partners) to manage the affairs of the debtor, including to trade on its business pending delivery of the objective set out in their proposals. In carrying out their duties, administrators act as the debtor's agents without personal liability.

Administrations last for a maximum period of 12 months unless the administrators seek an early exit or seek to extend the term of the administration – which they can do for up to 6 months by consent of creditors or (theoretically) for an unlimited period by court order. At the end of the administration the debtor will either be:

- returned to the control of management (for example through a CVA compromise of debts);

- placed into liquidation (for example if there are assets to distribute to unsecured creditors or claims of pre-insolvency wrongdoing to investigate); or
- dissolved (if the debtor is incapable of rescue and is there are no further assets for a liquidator to realize and distribute).

Company Voluntary Arrangement (CVA) is a binding form of debt compromise or restructuring between a debtor company and its creditors and which is regulated by insolvency legislation. A CVA proposal will typically comprise an agreement by some or all classes of the debtor's unsecured creditors to accept reduced or rescheduled repayment terms out pre-CVA debts.

The CVA is implemented and supervised by a qualified insolvency practitioner (who is referred to as the 'nominee' prior to the CVA being approved, and the 'supervisor' following its approval).

The CVA can be used in conjunction with administration; with the administration moratorium giving the debtor breathing space to agree any proposals with creditors.

The CVA procedure can be commenced by the directors or a liquidator or administrator (if one has been appointed). They must hold a meeting of the members (and obtain approval for the CVA from at least 50% in value of the members present in person or by proxy and voting) and a meeting of creditors (and obtain approval for the CVA from at least 75% in value of the creditors present in person or by proxy and voting). Once approved, the CVA terms are binding on all affected creditors unless, within brief time-limits, they can prove (on application to court) a material irregularity in the CVA approval process or unfair prejudice to them resulting from the CVA.

c) Terminal Procedures

Liquidation (or 'winding-up') is the collective process by which the affairs of a corporate debtor are brought to an end through the appointment of a liquidator. It is the role of the liquidator to convert all of its assets into their cash value and distributing them to members (if the debtor is solvent) or creditors (if the debtor is insolvent). In that sense it is broadly equivalent to Chapter 7 proceedings in the US. When a debtor is placed into liquidation, the liquidator assumes control of

the debtor and the directors' powers automatically cease, unless special provision is made for them to continue.

- Once the liquidation is complete the debtor is dissolved (at which point it ceases to exist).

- Liquidation can be commenced by the debtor on a voluntary basis or on application to court by various parties (most commonly an unpaid creditor, but also the debtor or its directors) for a winding up order on a compulsory basis.

- **Voluntary liquidation** comes in two forms, depending on whether the debtor's directors are prepared to swear a statutory declaration that the debtor is able to pay all of its debts within 12 months (i.e. that it is solvent). In they do, a Members' Voluntary liquidation (**MVL**) can be commenced by a resolution of the debtor's members appointing a liquidator to wind up the debtor's affairs. Having paid or adequately provided for all creditor claims, the liquidator's role is then to distribute the surplus assets to the debtor's members according to their shareholdings. For trade creditors, the important thing to remember about an MVL is that the MVL process ought to result in their being paid in full. If, at any point, it appears to the liquidator that the debtor is in fact insolvent (i.e. not all creditors will be repaid in full), the liquidator is obliged to convene a meeting of creditors with a view to converting the process into a Creditors' Voluntary Liquidation (**CVL**). This occurs only rarely in practice.

- Most CVLs are in fact commenced by the debtor's directors convening meetings both of the debtor's members and its creditors to pass resolutions that the debtor be wound up due to its insolvency and that a named insolvency practitioner be appointed liquidator. As with an MVL, the debtor is in CVL from the point when the debtor's members pass the requisite resolution. However, unlike an MVL, the creditors' meeting (known as a "section 98" meeting) ultimately determines the identity of the appointed liquidator in a CVL.

- This theme continues throughout the CVL with the liquidator being primarily answerable to creditors as a whole, rather than to the debtor's directors or members. The liquidators' key functions are to realize the debtor's remaining assets and, after payments are made to prior-ranking creditors, to distribute the proceeds to its ordinary unsecured creditors pro rata the value of their claims (under a cornerstone principle of UK insolvency law known as the "pari passu" principle). As part of this process the liquidator must decide on the validity and value of submitted creditor claims. This process usually begins with notification

from the liquidator inviting creditors to submit details of their claim in the form of a "proof of debt". Disagreements on the liquidator's decision in relation to proofs of debt can be referred to court if necessary.

- It also falls to the liquidator in a CVL to investigate the past conduct of the debtor and its officers and to bring claims against them if there is evidence of wrongdoing. Essentially, recoveries under any such claims will form part of the asset realisations available for distribution to creditors. Given that asset distributions will be risked in the context of conducting such claims, the liquidator will typically secure the approval of creditors or the court before proceeding with them.

- There is no automatic stay on proceedings against a company in CVL. However, on application by the liquidator the court may order that any particular proceedings are stayed under its general, discretionary power. It will generally do this if, by allowing the proceedings to continue, this would prejudice the position of creditors generally and in particular if it would otherwise impinge on the fair and equal distribution of the debtor's assets.

- **Compulsory liquidation** is similar in most respects to CVL save that the procedure for putting a debtor into compulsory liquidation involves a court application. The process begins with presentation of a winding up petition at the relevant court (see above). This can be presented by various interested parties but most commonly it is presented by a creditor who is owed £750 or more by the debtor and whose debt is due and unpaid. Following its presentation, its service on the debtor and its advertisement, the petition is heard by the court at a public hearing. If the court is satisfied that the debtor ought to be wound up (the most common ground for this conclusion being that the debtor is unable to pay its debts), it will make a winding up order placing the debtor into liquidation compulsorily.

- There are a number of other key differences between CVL and compulsory liquidation that are worthy of mention. The standard winding up order typically appoints a government official (known as the Official Receiver or OR) to conduct the winding up of the debtor's affairs, effectively as liquidator. In certain cases the OR or the debtor's creditors can convene a creditors' meeting so as to appoint an insolvency practitioner to act as liquidator. Typically this will occur where there are substantial assets to realize or investigations to be conducted and claims made.

The liquidator in a compulsory liquidation can only exercise a more limited range of powers than in a CVL unless he has the approval of either the court or a duly appointed committee of the debtor's creditors.

Unlike CVL, in a compulsory liquidation there is an automatic stay of legal proceedings against the debtor or its assets. Anyone who wishes to bring or pursue legal proceedings against the debtor must first apply to court for permission. Generally only claims that have a proprietary nature are allowed to continue. If an applicant's claim is for monetary relief only, they are unlikely to be granted permission. The stay does not extend to the enforcement of security or the forfeiture of a lease.

d) Creditor self-help

Receivership – Most security documents used by major UK lenders will include a right on the part of the lender to appoint a receiver or manager in the event of the debtor defaulting on the terms of the loan. The receiver will normally have powers under the security to manage and, if necessary, to sell the secured asset and to apply the proceeds of sale in priority to the claims of the debtor's other creditors. Most commonly such receivers are fixed charge receivers (known as LPA receivers) appointed under a piece of security over a specific asset (usually real estate).

In a small number of cases, the lender may also have the right to appoint an administrative receiver who has much wider powers to manage, trade on and sell the whole of the debtor's business and assets in similar fashion to an administrator. Unlike administrators, the primary duty of all LPA and administrative receivers is to the secured lender who appointed them. For that reason, UK insolvency legislation was amended in 2002 to ban the appointment of administrative receivers under any all-assets security created after 15 September 2003. Instead such lenders have been afforded the legal right to appoint an administrator to the debtor.

In a more limited range of cases (for example where the facts prevent the implementation of any other formal insolvency procedure) the court has the power on application by interested parties to appoint its own receiver to a debtor. The remit of the receiver in such cases will be prescribed by the court order and will depend on the facts involved.

b. Venue

UNITED STATES:

If a debtor is domiciled in more than one jurisdiction in the U.S., then venue rules guide where a debtor may file for Chapter 11. Usually venue is proper where a debtor is incorporated or where the debtor maintains its principal place of business.

GERMANY:

The competent insolvency court is determined by the district in which the debtor's center of main interest (COMI) is located. Usually this corresponds with the statutory seat of the corporation.

UNITED KINGDOM:

See number 1 (b) above.

c. Voluntary petition

UNITED STATES:

A Chapter 11 bankruptcy filing is commenced by the voluntary filing of a "petition for relief", which includes minimal information about the company, including a Federal Tax I.D. number, the address of the debtor, the identity of legal counsel for the debtor and a summary of assets and liabilities of the debtor.

The Chapter 11 voluntary petition is deemed an "order for relief". There is no procedural opportunity for creditors to challenge the filing of a petition for relief (except that creditors may later seek to dismiss a petition on certain specified grounds).

Along with the petition, debtors are obligated to file schedules of assets and liabilities, which detail the debtor's assets, liabilities, classes of creditors,

shareholders, affiliated companies, and executory contracts. In addition, debtors are obligated to file a "statement of financial affairs" which contains a disclosure of pertinent information about the debtor, including location of books and records and prior transactions with creditors and insiders of the debtor including affiliated companies and officers and directors.

- Debtors are also obligated to file a list of its top creditors.

GERMANY:

- The management may voluntarily file for insolvency if the company will most likely not be able to pay its due liabilities of the current and the next fiscal year (impending illiquidity according to sec. 18 Insolvency Act).

- Creditors cannot file for insolvency on the ground of impending illiquidity.

UNITED KINGDOM:

- See number 3 (b) and (c) above with regard to Voluntary Liquidation, Administration and CVA.

d. Involuntary petition

UNITED STATES:

- Under Section 303 of the Bankruptcy Code, creditors may commence a bankruptcy filing against a debtor company.

- An involuntary filing requires the filing of an "involuntary petition" by three or more creditors who hold claims that are not contingent as to liability and not subject to a bonafide dispute. The claims must exceed, in the aggregate, $14,425 (2013, escalates each year). Petitioning creditors must also establish that the debtor is not "generally paying its debts as they come due."

- If there are fewer than 12 creditors, the debtor, one creditor holding a claim against the debtor may file an involuntary petition. This rarely occurs since creditors usually do not have access to the debtor's books and records to determine whether or not the debtor has 12 or fewer creditors.

- The filing of an involuntary petition is similar to the filing of a lawsuit, in that the debtor has 30 days to respond to or refute the involuntary petition. If the debtor does not respond, at the expiration of the 30 day period, Bankruptcy Courts normally enter an order for relief. If the debtor refutes the involuntary petition, the Bankruptcy Court will conduct a hearing to determine whether or not an order for relief should be entered. If an order for relief is ultimately entered, it is effective as of the date of the filing of the involuntary petition.

- During the period of time from the filing of an involuntary petition until the order for relief is known as the "gap" period. During the gap period, debtors are permitted to operate in the ordinary course of business, including buying and selling assets and incurring liability.

- During the "gap" period (time period between the date of the involuntary petition and the date a Bankruptcy Court enters an order for relief) note the following:

  - the automatic stay is in effect upon the filing of the involuntary petition;

  - claims arising during the "gap" period, including extensions of unsecured credit, are second-tier priority claims, which are subordinate to claims arising after the order for relief is entered;

  - If an order for relief is entered, payments on pre-petition debts made during the "gap" period can be voided as avoidable post-petition transactions if no value was provided in the "gap" period.

- Creditors may seek the immediate appointment of an interim trustee if there is a concern that the debtor may be dissipating assets.

- A creditor considering an involuntary petition should always analyze payments received in the prior 90 days, as the involuntary filing will establish the 90 day preference period.

- Often petitioning creditors will file an involuntary petition under Chapter 7 of the Bankruptcy Code relating to liquidation, for a variety of reasons. Debtors have the right to convert a Chapter 7 case to a Chapter 11 reorganization. In fact, it is common for debtors, in response to an involuntary Chapter 7 petition, to agree to an order for relief under Chapter 11 of the Bankruptcy Code.

- Once a debtor has converted a case to Chapter 11, it becomes obligated to file the associated pleadings mentioned above with respect to voluntary petitions.

GERMANY:

- The Insolvency Act obliges the management to file for insolvency without undue delay, if one of the insolvency reasons has occurred (illiquidity or over-indebtedness), however no later than three weeks.

UNITED KINGDOM:

- See number 3 (b), (c) and (d) above with regard to Compulsory Liquidation and Administration as well as Receivership.

4. Role of Management

UNITED STATES:

- In Chapter 11, the filing of a petition does not alter the management of the company. The board of directors stays in place as do the officers of the company. In Chapter 11, deference is generally given to the reasonable "business judgment" exercised by existing management of the company.

- Under Chapter 7, which is a liquidation proceeding, debtors are generally not entitled to continue to operate the business and a Chapter 7 trustee is automatically appointed. The Chapter 7 trustee effectively supplants the debtor's management.

- In a Chapter 11 case, creditors can displace management by filing a motion for the appointment of a Chapter 11 trustee. The basis for the appointment of a Chapter 11 trustee is "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case … or if such appointment is in the best interest of the creditors, any equity security holders, and other interests of the estate…. A motion to appoint a trustee must be "noticed" to all creditors and be the subject of a Bankruptcy Court hearing.

- In cases where the Bankruptcy Court does not appoint a Chapter 11 trustee, on the request of any party in interest in the Chapter 11 case, the Bankruptcy Court, after notice of hearing, "shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or any other irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if such appointment is in the interest of creditors, equity security holders and other interests of the estate or if the debtor's fixed, liquidated, unsecured debts other than debts for goods, services, or taxes or owing to an insider exceed $5 million."

- Motions for the appointment of a Chapter 11 trustee or for the appointment of an examiner in a Chapter 11 case are infrequent, although in notable fraud cases or "Ponzi" schemes, Chapter 11 trustees or examiners are common.

GERMANY:

- With the opening of the insolvency proceedings the role of the management in the insolvency proceedings differs between the regular insolvency administration ("reguläres Insolvenzverfahren") and the Self-administration proceedings / debtor-in-possession proceedings ("Eigenverwaltung").

- In the regular insolvency administration an insolvency administrator is appointed by the insolvency court. With the opening of the insolvency proceedings the debtor loses its ability to manage and transfer its assets. Only the insolvency administrator can act for the insolvency estate. The management however remains obliged to support the administrator in the execution of his duties and to disclose any circumstances relating to the insolvency proceedings to the insolvency court, the insolvency administrator and the creditors' committee.

- Under certain circumstances self-administration proceedings ("Eigenverwaltung") is possible. The management remains in power to manage and transfer the assets of the debtor. A custodian ("Sachwalter") is appointed by court and supervises the debtor.

- Both procedures are preceded by a correspondent preliminary procedure (usually for three months), in which a preliminary administrator resp. a custodian is appointed to secure the insolvency estate. Additionally, the insolvency court will appoint an independent expert to determine, if the company is insolvent. The independent expert is usually the same person as the preliminary administrator resp. custodian.

- During the opening procedures, the management remains in charge for the business of the company. Its rights to manage the assets are however restricted by the provisional measures ordered by court to avoid any detriment to the financial status of the debtor. This includes usually the order that transfer of assets by the debtor is only valid, if the preliminary insolvency administrator consents. Additionally, payments of debtors with discharging effect are to be made to the preliminary insolvency administrator.

UNITED KINGDOM:

- Whilst a corporate debtor is trading solvently, the duties of its management are owed to the debtor for the benefit of present and future members.

- The common law duty of a director when a corporate debtor is insolvent or of doubtful solvency is to act in the interests of the creditors, with a view to minimising the loss to the creditors of the debtor.

- Once an administrator or liquidator is appointed then they will have control of the debtor and its assets and the powers of management are suspended. If any directors are also employees of the company, the administrator/liquidator will also advise them when their employment is terminated.

- Management's responsibilities do not, however, cease entirely. Their main responsibility will be to supply information about the debtor's affairs to the administrator/liquidator but they may also be asked to assist the administrator/liquidator as they carry out their role e.g. by assisting with the sale of assets. The directors are under an obligation to provide all assistance reasonably requested.

5. Appointment of administrator or receiver

UNITED STATES:

- There are no receivers or administrators appointed under the United States Bankruptcy Code, except as described above, a Chapter 7 trustee, a Chapter 11 trustee or an examiner in a Chapter 11 case.

GERMANY:

- The administrator is appointed by the court. The court is generally obliged to follow a unanimous proposal of the (preliminary) creditors committee, if the suggested person is qualified.

- At the first creditor's meeting, the creditors have the power to replace the insolvency administrator.

- The same applies to the custodian in case of self-administration (Eigenverwaltung).

UNITED KINGDOM:

- See number 3 (b) and (d) above in relation to Administration and Receivership.

6. Pre-petition collection or enforcement actions that are enjoined or prohibited

a. Enjoined creditors

UNITED STATES:

- Section 362 of the Bankruptcy Code dealing with the "automatic stay" provides that the filing of a bankruptcy petition operates as a stay "applicable to all entities" … which would include secured and unsecured creditors, equity holders, counter parties to contracts and landlords.

- The automatic stay enjoins essentially any act that has adverse consequences to the debtor or its property, known as "property of the estate" which is broadly defined in Section 541 of the Bankruptcy Code. The automatic stay enjoins actions including the commencement or continuation of any legal process that was or could have been commenced before the bankruptcy filing; the enforcement of any judgment obtained before the bankruptcy filing; any act to obtain possession of property of the estate or to exercise control over property of the estate; any act to create, perfect or enforce a lien against property of the estate, or the setoff of mutual debts that arose before the filing of the bankruptcy petition.

GERMANY:

The following applies to all creditors:

- Before the insolvency filling creditors are not prohibited to take enforcement actions.

- Shortly after the filing for insolvency the insolvency courts generally enjoins from enforcement actions against the debtor (§ 21 Abs. 3 InsO) (with the exemption of real estate assets).

- During the insolvency proceedings enforcement is not possible (§ 89 InsO).

- With the opening of the insolvency proceedings enforcement acts, which took place within a month prior to the filing for insolvency, become void (§ 88 InsO), except the creditor's claim was fulfilled though the enforcement.

- After the opening of the insolvency proceedings enforcement actions carried out prior to the insolvency filling are often subject to claw back claims. The insolvency administrator is obliged to claw back transactions which have had a detrimental effect on creditors and which were carried out in the run-up to the opening of an insolvency proceeding. The legal consequence of a successful challenge is that the beneficiary of the transaction must return everything which it received pursuant to the transaction together with interest since the insolvency opening (see section 12).

UNITED KINGDOM:

- See number 3(b) and (c) above for details of the moratoria that apply automatically in the context of Administration and Compulsory Liquidation and on application to court in CVL.

- Other sections of the IA 1986 seek to prevent public utilities suppliers from holding to ransom debtors that are subject to the various forms of insolvency proceeding (i.e. on condition of payment for pre-insolvency supplies). These provisions are currently under review with a view to extending them to private sector utilities suppliers and to cover supplies of vital IT services.

b. Penalties for violation

UNITED STATES:

- The Bankruptcy Code provides that any individual injured by any willful violation of the automatic stay is entitled to recover actual damages including costs and attorneys' fees and in an appropriate circumstances punitive damages.

- The debtor must prove that the violation of the stay was "willful" and that the debtor was actually injured by the stay violation.

Courts have been split on whether "technical" violations of the automatic stay such as computer generated dunning letters, are willful. Creditors should exercise due caution with respect to any post-petition actions involving the debtor.

GERMANY:

There are no special penalties for the violation of the injunction.

UNITED KINGDOM:

If a creditor does act in breach of the moratorium, the consequences set out below may result:

Contempt of court

Technically, to breach the moratorium is to commit contempt of court. However, in practice it is rare for a creditor to face sanctions for contempt of court in this situation.

Damages claim

An attempt to enforce security over the debtor's property will give rise to a claim in damages for breach of statutory duty and case law has suggested that damages may also be available to remedy the breach of any of the other parts of the moratorium.

Legal proceedings stayed

Where proceedings are underway against a debtor that becomes the subject of a moratorium, the court is likely to stay such proceedings at the earliest opportunity.

Proceedings issued in breach of the moratorium, even if issued by a creditor who was aware of the moratorium, are not a nullity and are capable of receiving retrospective permission from the court or the administrator.

c. Exceptions to or relief from the injunction

UNITED STATES:

- Section 362 of the Bankruptcy Code regarding the automatic stay, also provides for "relief from the automatic stay". Upon a motion by a party in interest, and after notice to creditors and a court hearing, the court may grant "relief from the automatic stay" to allow a creditor to proceed with a specific action regarding the debtor.

- The most common form of relief from stay relates to secured creditors who hold a pledge of the debtor's assets as collateral security for the obligations owed to the secured lender. The grounds for relief from stay include "for a cause, including the lack of adequate protection of an interest in property" if the debtor does not have equity in such property and such property is not necessary for an effective reorganization.

- Because of this right in favor of secured lenders, debtors often agree to provide lenders "adequate protection" in the form of continued loan and/or interest payments, or replacement liens.

- If assets are integral in the debtor's normal business operation, it is often difficult to prove that the assets are not necessary to an effective reorganization. The issue of whether or not there is equity in the assets, over and above the secured debt owed with respect to such assets, is often a contested issue based on expert valuations of the assets.

- Although there are many instances where Bankruptcy Courts grant relief from stay, often Bankruptcy Courts deny relief from stay, except in extreme circumstances, to give debtors an opportunity to reorganize for the benefit of all stakeholders including employees.

GERMANY:

- There are no exceptions or reliefs.

UNITED KINGDOM:

- The moratoria in administration and compulsory liquidation do not prevent a party from enforcing its contractual rights (for example by terminating a contract because the other party's entry into formal insolvency has triggered a termination right).

- Although the moratoria restrict a creditor's ability to issue proceedings against a debtor in administration or compulsory liquidation, they do not stop any limitation period from running. Consequently, a creditor could, in principle, find its claim statute-barred, despite being unable to issue proceedings (and so beat the limitation) because of a moratorium.

- In some cases, particular creditor actions can be taken with the consent of administrators or liquidators or the permission of the court. In considering such a request, the court will conduct a balancing exercise, weighing the interests of the claimant creditor against those of the debtor's unsecured creditors as a whole.

7. Selling to an insolvent company after filing

Any procedures that must be followed? What priority of payment? Is it "safe" to extend credit post-petition? Or are cash terms required?

UNITED STATES:

- Upon the filing of a Chapter 11 by a customer, vendors must determine whether to sell to the debtor post-petition.

- To avoid the inherent risk of a Chapter 11, vendors often sell on a cash before delivery or "CBD" basis.

- In a recent Bankruptcy Court ruling, a supplier was ordered to disgorge a cash before delivery payment received from the debtor after the Chapter 11 filing. The reason for the ruling was because the debtor did not have authority under the Bankruptcy Code to use its cash. It is incumbent on suppliers to verify that the debtor in fact has permission to use its cash for payments to suppliers in exchange for goods sold, either pursuant to a DIP financing order or an order permitting the use of cash collateral.

- To remain competitive, vendors are sometimes compelled to extend credit terms to Chapter 11 customers. In this event, creditors should carefully evaluate the risk of non-payment in Chapter 11.

- The Bankruptcy Code treats credit extended to a Chapter 11 debtor in the ordinary course of business as an administrative expense priority claim. As indicated below regarding claim priorities, administrative expense claims enjoy a "high priority" and are generally paid, absent an "administrative insolvency".

- By contrast, extensions of credit that are not in the ordinary course of business must first be approved by the Bankruptcy Court, or they are not entitled to administrative expense priority treatment.

- At the time of the Chapter 11 filing, it is common for vendors to have open purchase orders from debtors that arose prior to the Chapter 11 filing, that provide for post-petition shipment by the vendor.

- In a recent Bankruptcy Court ruling, the Court denied the vendor administrative expense priority status for post-petition shipments on pre-petition purchase orders since the shipment arose from a pre-petition contract.

- The practical solution to this problem has been for vendors to require the pre-petition purchase orders to be re-issued post-petition.

- Many debtors, particularly in larger cases, file a "first day" motion seeking an order from the Bankruptcy Court granting administrative claim priority for post-petition shipments on pre-petition orders, to avoid the re-issuance of purchase orders.

- In the case of a pre-petition supply contract which provides for credit terms, debtors may assert that such contracts impose an obligation on the vendor to extend credit. While Bankruptcy Courts usually compel a vendor who is a party to a supply contract to ship goods, Bankruptcy Courts have rarely forced a vendor to extend credit to a Chapter 11 debtor.

- Since a Chapter 11 filing effectively relieves the debtor of pre-petition debt, the debtor's post-petition cash flow may actually be healthier than it was pre-petition. However, creditors should independently evaluate the risks of extending credit to a Chapter 11 debtor. A key component of this evaluation should be the debtor's DIP financing and its impact on the debtor's working capital requirements.

GERMANY:

- As long as the business is continued, a supplier may sell to an insolvent company. However the arising claims are only insolvency claims. Only contracts concluded after the opening of the insolvency proceedings with the insolvency administrator or the self-administration debtor create preferred claims (claims against the insolvency estate).

- Therefore some precautions are necessary. It is especially important to determine what kind of orders the insolvency court has issued.

- If the insolvency court has appointed a *strong* preliminary insolvency administrator, i.e. an administrator with the power to act instead of the debtor, the resulting purchasing price claim is a preferred claim against the insolvency estate.

- If the insolvency court ordered preliminary self-administration under a protective shield (*Schutzschirmverfahren*) and expressly granted the debtor power to create generally preferred claims against the insolvency estate (§ 270b Abs. 3 InsO), the resulting purchasing price claim is a preferred claim against the insolvency estate.

- If the insolvency court has appointed a preliminary insolvency administrator or has ordered a preliminary self-administration and granted the preliminary insolvency administrator resp. the debtor/the custodian (still on-going discussions who is to be empowered) the power to create specific preferred claims against the insolvency estate (*Einzelermächtigungen*) and the respective claim of the vendor is specified in the court decision, the resulting purchasing price claim is a preferred claim against the insolvency estate.

- If none of the above mentioned courts orders have been issued the procedure under 0 should be followed.

Any procedures that must be followed?

- Deliverance against cash is recommended. In case this is not feasible, securities can be taken.

- Common is furthermore a trust scheme to secure creditors, which perform during the preliminary insolvency proceedings. Usually the preliminary insolvency administrator acts as trustee.

- The taking of securities as well as the trust scheme has to be evaluated carefully as there are many pitfalls, inter alia in connection with the rules of avoidance.

- The preliminary insolvency administrator's reassurance of performance is to be treated carefully as it is only dependable, if the preliminary insolvency administrator has explicitly accepted personal liability.

What priority of payment?

- Claims resulting from contracts and performance during the preliminary insolvency proceedings are usually ordinary insolvency claims as presented under 1.1a). Exceptions from this rule exist in regard to the above mentioned special court orders (under **Error! Reference source not found.**).

Is it "safe" to extend credit post-petition?

- It is generally not safe to extend credit prior to the opening of the insolvency proceedings. Because with the opening of the insolvency proceedings, all unsecured (credit) claims generally are only satisfied pro rata. Credit extension should be accompanied either by the above mentioned court orders or collateralised.

- Credit granted after the opening of the insolvency proceedings is to be repaid in full by the insolvency mass.

Or are cash terms required?

- Cash terms are recommended (see above).

UNITED KINGDOM:

- Once an administrator or liquidator is appointed then they will have control of the company and its assets and the powers of the board of directors are suspended.

- An administrator has statutory powers under the IA 1986 which make him an agent of the company and give him the power to carry on the business of the company and all other things incidental to that power. Accordingly, an

administrator can order goods and services as agent of the company. Payment for such goods or services, when ordered by the administrator, will rank for payment an 'administration expense' payable in priority to the administrator's own fees and also unsecured creditors. It is therefore generally considered 'safe' to extend credit to administrators, within reason and subject to due enquiry and normal risk considerations.

If a company wishes to sell goods or make payments for supplies while a winding-up petition is in progress, the liquidator must first obtain authorization from the court. Failure to do so will render void any payment made by the debtor (or any other disposition by the debtor of its assets) if the winding up petition culminates in the debtor being placed into compulsory liquidation.

8. Post-petition financing

a. DIP financing from lender

UNITED STATES:

- In almost every Chapter 11 proceeding, the debtor will file a number of "first day" motions which are usually scheduled for hearing a day or two after the bankruptcy filing. Most of the "first day" motions are procedural and administrative, but there are also substantive motions. Perhaps the most substantive first day motion is the debtor's motion to approve debtor in possession or "DIP" financing.

- The Bankruptcy Code provides that pre-petition liens on collateral do not extend to property acquired by the debtor post-petition. In addition, the Bankruptcy Code provides that the debtor may not use as working capital the lender's "cash collateral", which is the cash generated by inventory sales and accounts receivable collections, unless the lender consents or the Bankruptcy Court permits the debtor to use cash collateral over the lender's objection.

- For these reasons, it is common for a debtor and its lender to reach a consensual post-petition financing arrangement, called DIP financing.

- Very often the lender has a superior negotiating position and thus the DIP financing agreement appears one-sided. Bankruptcy Courts almost always approve DIP financing as necessary to allow a debtor to continue operating, although creditor objections can modify or eliminate objectionable provisions of the DIP financing.

- Clearly there are substantive rights of other creditor's constituents that can be compromised as a result of a DIP financing, and creditors' committees often file objections to DIP financing proposals.

- In light of the global credit crisis, lenders' willingness and perhaps ability to make DIP loans has been impacted.

As an alternative source of cash, Debtors unable to obtain DIP financing may seek Bankruptcy Court permission to use the lender's "cash collateral" over the lender's objections.

GERMANY:

See number 7 above.

UNITED KINGDOM:

Unlike Chapter 11 proceedings in the United States, UK insolvency law does not adhere to the concept of the debtor in possession (DIP).

Instead, during the administration period the administrator will have control of the debtor and its assets (as the powers of management will be suspended). Any additional funding requirements effectively have to be met from funds available to the debtor at the date of its entry into formal insolvency, or those generated through ongoing trading or asset realisations or those provided by existing creditors (typically first ranking existing creditors) rather than by any super-senior 'DIP financing'.

b. Extension of credit from suppliers

UNITED STATES:

See number 7 above.

GERMANY:

See number 7 (c) above.

9. Pre-petition contracts

Such as a sales contract. How are they treated? What are the parties' rights under the contract? Any contracts treated specially, such as union contracts or technology licensing agreements?

UNITED STATES:

- Executory contract is the Bankruptcy Code term given to essentially any contract between a debtor and a non-debtor party where both parties owe material performance to the other. A promissory note would NOT be an executory contract since the holder of the note has no performance obligation. However, a supply contract or other sales agreement would almost always meet the requirements of an executory contract under the Bankruptcy Code. Real estate leases are also treated as executory contracts.

- The Bankruptcy Code Rules for rejecting executory contracts and leases are debtor-friendly which is precisely why retailers who want to close stores often choose Chapter 11 as the vehicle to accomplish such goal.

- The Bankruptcy Code provides debtors the right to assume or reject executory contracts and leases. If a debtor rejects an executory contract, the non-debtor party receives a general unsecured claim for damages arising from the debtor's "breach" of contract. Thus, a debtor escapes the contract with little cost.

- On the other hand, the debtor also has the right to assume or assign a contract. In this instance, the Bankruptcy Code requires that the debtor "cure" the contract by paying existing defaults. Presumably, debtors would assume contracts that they deem to be valuable either because they insure an uninterrupted supply of needed goods and contain favorable pricing or terms. For a creditor who is a party to an executory contract, the assumption of such contract can be an effective vehicle to obtain payment of pre-petition debt.

- Debtors in Chapter 11 must assume or reject an executory contract before or in conjunction with the confirmation of the Chapter 11 Plan. The non-debtor party to the contract can file a motion seeking a court order to set a shorter time if it will be harmed by the delay in the debtor's decision.

- The Bankruptcy Code requires that the non-debtor party to an executory contract must continue to perform its obligations under the contract pending the debtor's decision to assume or reject such contract, and provided that the debtor is in fact performing its obligations of the contract post-petition.

- A supply agreement impacts a creditor's rights as a critical vendor since the leverage of not shipping is arguably eliminated in the context of an executory contract.

GERMANY:

- With the opening of the insolvency proceedings claims under an existing contract are no longer enforceable.

- If a mutual contract was not (or not completely) performed by both parties the insolvency administrator may choose to perform such contract replacing the debtor and claim the other party's consideration (§ 103 InsO). The claim of the creditor becomes a preferred claim against the insolvency estate.

- If the insolvency administrator does choose not to perform such a contract, claims for compensation due to non-performance (§ 103 Abs. 2 InsO) may only be registered to the insolvency table.

UNITED KINGDOM:

- With limited exceptions (generally involving the pre-insolvency grant of proprietary interests in certain assets) administrators, receivers and liquidators are not bound to perform the company's pre-insolvency contracts. However, they can adopt any of the debtor's contracts if to do so would further the purpose of the formal insolvency procedure involved. Losses arising from the debtor's to perform contracts post-insolvency will form the basis of claims (usually unsecured) by the contracting counterparty lodged in the insolvency proceedings.

- The moratorium in administration and liquidation proceedings will not prohibit counterparties from terminating those agreements, unless such termination constitutes legal proceedings.

- A liquidator has a specific statutory power to disclaim contracts or property that they deem to be onerous.

- Save for certain critical supplies such as electricity and water, suppliers are not required to supply goods or services to a company in administration or liquidation.

10. Debtor's ability to sell assets during the insolvency

Procedure and use of proceeds

UNITED STATES:

- Section 363 of the Bankruptcy Code allows a debtor to sell substantially all of its assets free and clear of liens with liens attaching to proceeds of sale. This provision allows for the quick and efficient liquidation of a debtor's assets without having to first resolve the extent, validity and priority of liens on assets. This allows assets to be sold relatively quickly and avoids further erosion of value due to operating losses.

- Buyers of assets often favor acquiring assets in a Section 363 sale (thus requiring a Chapter 11 filing) since sales to good faith purchasers are not subject to later challenge.

- Generally a Section 363 sale is initiated with a "stalking horse" buyer who enters into an asset purchase agreement with the debtor, as the initial bidder. The Court approves "bidding procedures." After appropriate advertising and marketing, an auction is conducted where interested buyers are permitted to overbid the stalking horse bid and thus allow the estate to obtain the greatest possible value for its assets. There is usually a required percentage bidding increment and the stalking horse bidder often has bid protection in the form of a break-up fee and expense reimbursement.

- Secured creditors are generally entitled to "credit bid" their secured debt, provided the secured claim is not disputed.

- Although a Section 363 sale can be a valuable tool for maximizing the liquidation value of a debtor's assets, such sales can also create an inherent tension between the secured creditor who asserts liens on the assets being sold and other creditors of the estate. The secured creditor's goal is payment of its secured debt, while other creditors seek to achieve a sale in excess of secured debt to generate proceeds for other creditors. The quickest sale does not necessarily produce the best sale, however, prolonged sales processes have the disadvantage of higher administrative costs.

- With increasing frequency, and due to the recent trend of high loan to value ratios, many Section 363 sales have produced sales proceeds less than the amount owed to secured creditors. These "short sales" create an administrative insolvency where only secured creditors benefit from the sale. Many courts have required the secured creditor to pay administrative claims associated with the Chapter 11 proceeding to obtain the benefit of the Chapter 11 process and protections. This has been euphemistically referred to as the "pay to play" rule. In addition, creditors often assert that the Chapter 11 process contemplates a benefit to all creditor classes and thus unsecured creditors should receive a "carve-out" of the sale proceeds to fund a dividend to unsecured creditors.

- In the recent Clear Channel case, the Ninth Circuit (includes California) Bankruptcy Appellate Panel (BAP) ruled that in the case of a "short sale", the Section 363 sale was NOT "free and clear", and the buyer acquired the assets SUBJECT TO the junior liens. Whether Clear Channel is an aberration remains to be seen.

GERMANY:

- The debtor generally cannot sell the assets which form part of the insolvency mass. The insolvency mass is formed by all of the assets owned by the debtor on the date when the proceedings were opened and those acquired by him during the proceedings.

Procedure

- With the insolvency filling, the preliminary insolvency administrator has to secure all the assets of the debtor. If there is not a positive going-concern prognosis, it is he insolvency administrator who liquidates the assets.

Use of Proceeds

- The proceeds are used to (partly) satisfy the creditors.

UNITED KINGDOM:

- Once an administrator or liquidator is appointed then they will have control of the debtor and its assets and the powers of the board of directors are suspended.

- An administrator has statutory powers under the IA 1986 which make him an agent of the company, contracting without personal liability.

- A liquidator, unlike an administrator, is not made an agent of the debtor to which he is appointed by statutory provision. However, as a consequence of his taking over the management powers and causing the debtor to act, a liquidator becomes the *de facto* agent of a debtor.

- Both administrators and liquidators' powers include the power to sell any of the debtor's property and execute documents in the name of the debtor without the need for permission from the court.

11. Vendor remedies

UNITED STATES:

a. "Unsecured" claims, priority and payment.

The Bankruptcy Code sets forth clear priorities of payment or entitlement to payment by types of creditors or claims as follows:

- Secured creditors, as a result of pre-petition consensual liens on assets and proceeds of assets.
- Administrative claims, which are the costs associated with the administration of the post-petition bankruptcy estate. These would include purchases of goods and services post-petition as well as professional fees associated with the administration of the bankruptcy estate.
- Claims arising during the "gap" period, which is the time period between the filing of an involuntary petition by three or more creditors and the date on which an order for relief is entered by the Bankruptcy Court.
- Employee wage claims of not more than $11,725 for 2013.
- Certain employee benefit contribution claims as defined by the Bankruptcy Code.
- Deposit claims of not more than $2,600 for 2013 for deposits made by individuals for the purchase of goods or services for family or household use.
- Certain government tax claims as defined by the Bankruptcy Code.
- Allowed unsecured claims of a Federal Depository Institution regarding capital requirements of an insured depository institution.
- General unsecured claims.
- Equity interests.

- Secured, administrative and priority claims are generally paid in full while unsecured claims are rarely paid in full and in fact rarely receive any material dividend. Equity interests are almost always canceled at no value.

- There are many exceptions to the general rules. In the case of an "administrative insolvency", the value of the debtor's assets are insufficient to pay the lender's claims and also the administrative claims. With increasing frequency, and as a result of very high loan to collateral value ratios, assets are insufficient to pay lenders in full much less claims "below the line". Often lenders will find it necessary to pay professional fees associated with negotiating and closing a sale of its collateral in connection with a Bankruptcy Code Section 363 sale. Lenders often resist paying other administrative claims, creating lack of equality in treatment of similarly situated claims.

- Absent an administrative insolvency, administrative claims are generally paid in full, as the Bankruptcy Code requires that such claims be paid in full as a condition precedent to confirmation of any plan of reorganization.

- Moreover, while not a specific requirement of the Bankruptcy Code, a debtor is generally obligated to "pay as it goes" while in Chapter 11, meaning it must be able to pay its ongoing administrative claims in the ordinary course of business. A material build up in unpaid administrative claims indicates a potential inability to obtain plan confirmation, and thus, provides the grounds for a conversion of the Chapter 11 proceeding to a liquidation proceeding under Chapter 7.

b. 20 Day Administrative Claim

- The 2005 Bankruptcy Code Amendments added Section 503(b)(9) to the Bankruptcy Code which provides that sellers of goods are entitled to an administrative priority claim for the value of goods delivered to a debtor within 20 days prior to the bankruptcy filing.

- The case law addressing Section 509(b)(a) provides some predictability on how this remedy will benefit vendors.

- There are two essential components to the 20 day administrative claim: 1) allowance of the claim as an administrative claim in the first instance; and 2) payment of the claim by the bankruptcy estate. Upon a motion by the creditor, most courts have allowed vendors an administrative claim for the value of goods delivered within 20 days prior to the filing. As a result of the general rule that unsecured claims receive little or no distribution and administrative claims are generally paid in full, converting any portion of an unsecured claim to administrative claim is a material benefit to the vendor.

- Courts have been less willing to order immediate payment of 20 day administrative claims, instead allowing them to be paid in connection with plan confirmation or in connection with the sale of substantially all of the debtor's assets. As with any other administrative claim, if the Chapter 11 proceeding is administratively solvent, payment of the 20 day administrative claim is probable. In cases where the debtor's Chapter 11 proceeding is "insolvent", the likelihood of payment is compromised. However, payment on such claims nevertheless exceeds what would be paid absent the 20 day administrative claim.

c. Critical Vendor

- Critical vendor is a creditor remedy based on a theory that a particular vendor is so essential to a debtor's ability to continue operating that without the uninterrupted flow of the seller's goods, the debtor cannot continue to operate and thus has no realistic chance of a successful reorganization. In these instances, a Bankruptcy Court has broad authority to order relief that facilitates a successful reorganization.

- Only a debtor can make the determination that a particular vendor is critical and seek court approval of same. A creditor cannot independently impose its critical vendor status on a debtor.

- Critical vendor payments have become increasingly controversial and certain court rulings, including the Kmart decision, have limited the critical vendor remedy. Some jurisdictions refuse to entertain a critical vendor motion. However, Delaware and New York continue to be jurisdictions where critical vendor payments can be approved in appropriate circumstances. As recently as September, 2013, the Delaware Bankruptcy Court in the Furniture Brands International, Inc. case approved about $12 million of critical vendor payments.

- Vendors who are truly critical to a debtor-customer should seek critical vendor status as a means of getting paid. In doing so, vendors should be careful to not violate the automatic stay by conditioning future business on payment of pre-petition debt. Moreover, vendors should be aware that payment as a critical vendor will likely be conditioned on providing normal lines of credit, pricing and terms, or other "customary trade procedures."

d. Reclamation

- Historically, reclamation has been a standard vendor remedy. Reclamation is a state law remedy arising from the Uniform Commercial Code's provisions on sales of goods. In particular, most states allow a vendor to reclaim goods delivered to a customer (or stop goods in transit or cash before delivery), if the seller learns of the customer's insolvency.

- Prior to the 2005 Bankruptcy Code Amendments, the Bankruptcy Code recognized the state law remedy of reclamation but also recognized that permitting vendors to reclaim goods would be disruptive to a debtor's attempted reorganization. Accordingly, the Bankruptcy Code allowed a bankruptcy court to grant a lien or administrative claim to the seller in lieu of the actual return of goods.

- The 2005 Bankruptcy Code Amendments eliminated the provision allowing a bankruptcy judge to grant a lien or administrative priority in lieu of the actual return of goods.

- Sellers of goods should nevertheless continue the practice of sending a reclamation demand which must be sent within 20 days after the Chapter 11 filing and can cover invoices for goods delivered within 45 days prior to the bankruptcy filing.

e. Setoff and Recoupment

- An often overlooked remedy, setoff arises from the settlement of mutual debts or accounts owed between a debtor and a creditor. Simply, if A owes B $100 and B owes A $50, then the debts can be resolved as follows: $100 - $50 = $50, so A pays B $50 and the accounts are settled. The Bankruptcy Code codifies this

common law remedy and in fact provides that the creditor has a secured claim to the extent of the value of its setoff claim.

- The debts owing must be owed to and from precisely the same legal entities and the debts must arise either both pre-petition or both post-petition. The debts do not, however, have to arise out of the same transaction.

- The exercise of a setoff remedy requires relief from the automatic stay from the Bankruptcy Court. Moreover, there are somewhat complicated rules regarding exercise of setoff during the 90 days prior to the bankruptcy filing, which if not followed, could result in preference exposure.

- Recoupment is similar to setoff, except that the mutual debts must arise from the same transaction.

f. *Statutory Liens*

- Vendors in possession of goods belonging to a debtor may be able to assert a valid possessory lien under state law. The Bankruptcy Code recognizes these liens, and treats the vendor as a secured claimant to the extent of the value of the goods in the vendor's possession. States' laws differ on the extent and priority of the lien and whether it covers all amounts owed to the vendor or is limited to amounts directly related to the goods in its possession.

g. *Disclosure*

- In addition to the information provided in the debtor's Schedules of Assets and Liabilities, and in the Statement of Financial Affairs, the Bankruptcy Code provides all creditors substantial rights to learn details about the debtor's financial condition, historical transactions and prospects for reorganization. Although creditors have the right to appear at and attend the Section 341 "first meeting of creditors", this is rarely productive. Modern practice has been that the Office of the United States Trustee conducts the 341 meeting and covers primarily administrative issues with limited opportunity for creditors to examine the debtor's representatives.

Rule 2004 of the Bankruptcy Rules permits creditors broad rights to examine the debtor under oath and penalty of perjury about its financial affairs, historical transactions and prospects for reorganization, and to obtain relevant documents.

These tools allow a creditor to obtain details about the debtor's financial condition necessary to evaluate the risk and probability of payment.

h. Motion to Convert to Chapter 7

A party in interest including a creditor or creditors' committee may file a motion seeking to convert a Chapter 11 case to a Chapter 7 liquidation case if the creditor can establish "cause" and that a conversion is in the best interest of creditors. "Cause" includes:

- Substantial losses and no reasonable likelihood of reorganization.
- Gross mismanagement of the estate.
- Failure to maintain insurance.
- Unauthorized use of cash collateral.
- Failure to pay taxes.
- Failure to file or confirm a plan of reorganization within the applicable time period.

Assuming a creditor has the appropriate grounds for conversion, the creditor should nevertheless consider several issues.

Since a Chapter 7 trustee cannot operate the business, a conversion will likely result in a closure of the business operation and a quicker liquidation or auction of the assets, or an abandonment of the assets to the secured lender.

The Chapter 7 trustee will take control of the debtor and its assets and any creditors' committee or individual creditors will have less influence in the bankruptcy process. For example, a Chapter 7 trustee may have more incentive to aggressively pursue avoidance actions such as preferences against creditors.

- A conversion to Chapter 7 will end Chapter 11 administrative expenses; however, the Chapter 7 trustee and its counsel will incur administrative expenses that will have priority over the Chapter 11 administrative expenses. Moreover, the Bankruptcy Code allows the trustee to be paid a percentage of funds distributed to creditors, which can be as high as 3%.

i. Motion to Appoint a Trustee or Examiner

- A party in interest including a creditor or creditors' committee can also file a motion seeking the appointment of a trustee or an examiner. A Chapter 11 trustee would supplant management and take control of the debtor's bankruptcy estate and assets. An examiner does not supplant management or take control of the debtor's estate; rather, an examiner investigates discrete issues, usually relating to questionable transactions, and reports findings to the Court and creditors.

- A creditor may seek the appointment of a trustee or an examiner for cause including fraud, dishonesty, incompetence or gross mismanagement, if such appointment is in the best interest of creditors or if grounds to convert to Chapter 7 exists.

j. Claims Sale

- In the U.S., there is a private market for the purchase of bankruptcy debt, particularly in larger bankruptcy cases. The purchasers are usually Wall Street funds that are in essence seeking to purchase claims at a discount in hopes that the ultimate dividend, whether in the form of cash payments or stock in the reorganized entity, will provide a return on such investment.

- Often investors purchase debt as a means to impact the bankruptcy process and to obtain control of the equity of the reorganized debtor.

- Claim purchasers will only purchase claims that are not disputed or contingent as to liability. Claim purchasers will usually agree to buy claims based on the debtor's schedules of assets and liabilities. However, purchasers will not buy claims based on a creditors' proof of claim if it is materially greater than the claim listed on the debtor's schedules, at least until the claim is resolved in the claims reconciliation process.

- Claims purchasers are documented in a claim purchase agreement, usually drafted by the purchaser. There are many pitfalls in these contracts that claims' sellers should consider.

k. *Creditors' committees.*

- An official unsecured creditors' committee is appointed in cases, where there is creditor interest, generally consisting of the persons that hold the seven largest claims against the debtor. The size of a committee may depend upon the different types of unsecured creditor constituencies involved in a case. Persons serving on a creditors' committee owe a fiduciary duty to all creditors, which they fulfill by advising creditors of their rights and the proper course of action in the bankruptcy proceedings.

- Chapter 11 also allows the court, if necessary to assure adequate representation, to appoint other official committees to represent certain classes of creditors or equity holders. These appointments occur upon the request of a party in interest. The U.S. Trustee selects the members of the committee, and generally seeks resumes from those persons standing for appointment. If approved by the court, these official committees may retain lawyers, accountants and other agents, all at the cost of the debtor's estate.

- Committees consult with the debtor concerning the administration of the case and are empowered to investigate all aspects of the debtor's business, including the desirability of its continuation. A statutory committee is a party in interest with the right to appear and be heard on any issue in a Chapter 11 case. One of its major roles is its participation in the formulation and negotiation of a plan of reorganization.

GERMANY:

a) *Priority of "unsecured" claims*

- The Insolvency Act differentiates between insolvency claims (Insolvenzforderungen) and claims against the insolvency estate (Masseverbindlichkeiten).

- The costs of the insolvency proceedings (§ 54 InsO) (court fee, (preliminary) administrator/custodian fee, member of the (preliminary) creditors committee fee)

  and

  other claims against the insolvency estate (§ 55 InsO) (claims arising in connection with the purchase of goods or services during the insolvency proceedings or in case a *strong* preliminary administrator was appointed during the preliminary insolvency proceedings [rarely], some tax claims originated during the preliminary insolvency proceedings)

  are paid in full amount (except in case of insufficiency of the insolvency estate).

- The insolvency claims (§ 38 InsO) (claims originated before the opening of the insolvency proceedings) receive payment only, if the claims against the insolvency estate are satisfied. Usually the insolvency rate amounts to less than ten per cent.

- Payments on subordinated claims (§ 39 InsO) (e.g. interest and cost on insolvency claims accrued after the opening of the insolvency proceedings, repayment of and interest on credits of shareholders), which are ranked below insolvency claims, are very rare.

b) *Setoff*

- Under the German insolvency regime a creditor can still setoff, if the creditor could have set off before the opening of the insolvency proceedings (§ 94 InsO).

- If the (civil law) opportunity to set off an insolvency claim arises after the opening of the insolvency proceedings the admissibility by insolvency law depends on (i) when the bases of the claims originated and (ii) which claim falls due first. A set-off of an insolvency claim against a claim of the insolvency estate is only admissible, if the bases of the claim of the insolvency estate existed before the opening of the insolvency proceedings and the insolvency claim fails due before or at the same time as the claim of the insolvency estate.

The creation of a setoff opportunity through assignment of claims after the opening of the insolvency proceedings is not possible as in such cases insolvency law treats the setoff as being void. If the claim was assigned after the filing for insolvency but before the opening of the insolvency proceedings a following set-off would usually be void according to the rules of avoidance (§ 96 Abs. 1 Nr. 3 InsO). This protects the insolvency estate against debtors of the insolvency debtor buying claims of creditors with big discounts to erase their debts.

For creditors of the insolvency estate there are no insolvency law restrictions regarding setoff (excerpt in the case of insufficiency of the insolvency estate). This is justified by the fact, that they can expect full payment.

c) *Reclaim goods*

Reclamation of delivered goods is only possible, if the seller took a security over those goods. If the ownership of the delivered goods was already transferred to the now insolvent buyer the seller does not have special rights in those goods.

However, in Germany sale under retention of title is very common as under German law no special formal acts are required. Buyer and seller just have to agree on retention of title. Furthermore it is very common to extend seller's rights to buyer's claims arising from the resell of the sold good or to the product, which was produced by the buyer with the sold good.

d) *Return of goods*

Goods in the possession of the debtor, which are not property of the debtor, have to be returned to the owner. For the duration of the preliminary insolvency proceedings the court can order, that the buyer can continue to use such goods (§ 21 Abs. 2 Nr. 5 InsO).

e) *Essential vendor*

The German Insolvency Code does not recognize an essential vendor remedy. There are no special rights for critical vendors. Nevertheless sometimes a critical vendor can by its commercial power obtain payment of outstanding debts during the preliminary insolvency proceedings. However, after the opening of the

insolvency proceedings the insolvency administrator usually can claim such payments back.

f) *Sale of claim to 3rd party for cash*

There are no restrictions for creditors to sell their insolvency claims. A developed market for insolvency claims does however not exist.

g) *Right to withhold performace*

If a creditor learns of the filing for insolvency it can stop all pending deliveries to the debtor, which are not yet fully paid, until the debtor fulfils its obligation or provides security (§ 321 BGB (German Civil Code)). The application of § 321 BGB (German Civil Code) depends on the question, whether German law governs the sales contract.

UNITED KINGDOM:

a.) *Instigating formal insolvency proceedings*

As noted above at 3(b),(c) and (d), creditors have the right to:

- apply to court to appoint administrators;
- to appoint administrators out of court if they hold the requisite all-assets floating charge security (known as a qualifying floating charge);
- to seek the debtor's compulsory winding up; or
- to appoint receivers on default of any security that they hold.

Such action is not an end in itself. The position for secured creditors is likely to be more favourable given that they will have direct recourse to realisations of the secured assets when looking to recover their debts. By taking steps to place a company into either administration or liquidation an unsecured creditor is potentially crystallising their losses, which (other than limited priority afforded for the costs of taking such steps) will rank for payment pro rata with all other unsecured claims.

'Unsecured' claims, priority and payment

With limited exceptions, unsecured claims enjoy no priority under UK law. The IA 1986 provides 'preferential' priority to a very limited number of unsecured claims in an administration or liquidation. These preferential and prescribed part claims rank below fixed charge secured claims, but ahead of floating charge secured claims and other unsecured claims (see the table below).

The Statutory Scheme

FIRST: **Fixed charge holders**
(I.e. Those creditors with fixed charge security* over assets)

SECOND: **Expenses of the insolvent estate**
(I.e. Debts incurred by administrators or liquidators while in office (e.g. to employees, suppliers, agents and advisers), statutory claims (such as taxes incurred in the insolvency) as well as their own fees)

THIRD: **Preferential Creditors**
(I.e. claims by employees for wages or salary in the period of 4 months prior to the company's entry into formal insolvency up to £800)

FOURTH: **The Prescribed Part**
(I.e. a protected portion of money which can only be distributed amongst unsecured creditors. 50% is taken from the first £10,000 of floating charge realizations and 20% from any excess up to a maximum of £600,000)

FIFTH: **Floating Charge Creditors**
(I.e. those creditors with floating charge security)

SIXTH: **Unsecured Creditors**
(I.e. creditors with no security)

SEVENTH: **Members of the Company**

* Fixed charge security holders are typically banks or other financial institutions.

b) Set-off

The rules of insolvency set-off are mandatory, automatic and self-executing and may not be varied by contract. Account must be taken of the mutual dealings between the creditor and the company in liquidation or, if the administrator is proposing to make a distribution to unsecured creditors, in administration. The sums due from one party must be set off against the sums due from the other, except that sums due from the insolvent shall not be taken into account if the other party had notice at the time they were incurred of:

- a resolution or petition to wind-up; or
- an application for an administration order or of notice of intention to appoint an administrator

All claims, including future, contingent and unliquidated sums, must be brought into account.

c) Reclaiming goods - Retention of Title

Some vendors will have included retention of title (**ROT**) clauses (sometimes referred to as Romalpa clauses) in their sale of goods contracts with a debtor. ROT clauses give the seller of goods priority over secured and unsecured creditors of the debtor if the debtor fails to pay for the goods because it is insolvent, or for some other reason which may be specified in the clause.

ROT clauses come in a variety of forms:

- Basic ROT clause – this provides that title to the goods is retained by the seller until it has received full payment for the particular goods;
- An all monies ROT clause – this provides that the seller reserves ownership of the goods supplied until the buyer has paid not only for those particular goods, but also for any other goods supplied by the seller to the buyer, and has repaid all other sums owed to the seller, regardless of how such indebtedness arose;
- A proceeds of sale ROT clause – this provides that, where the goods supplied are to be sold on by the buyer, the seller is able to assert rights in the proceeds of sale in order to satisfy the purchase price of the goods; and
- A mixed goods ROT clause – This provides that, where the seller is selling goods for use in a manufacturing process and the goods supplied may be mixed or combined with other goods owned by the buyer or by third parties, the seller is able to assert rights of ownership in any new product resulting from the manufacturing process.

ROT clauses do have limitations however, e.g.:

- If the buyer is a company in administration, the moratorium in place (explained in question 6 above) means that no steps can be taken to repossess goods without the consent of the administrator or the permission

of the court. This prohibition also applies during any interim moratorium in an administration;

- ROT clauses must be properly incorporated in a contract between the seller and the buyer in order to be enforceable as a contract term;
- ROT clauses may be ineffective if their operation is inconsistent with the overall trading relationship between the parties;
- ROT clauses will be of little or no practical benefit where the goods supplied are unidentifiable, perishable or have a low scrap value;
- Proceeds of sale and mixed goods clauses will typically be void and unenforceable as constituting security which has not been duly registered;
- ROT is an area which generates a rapidly changing body of case law and so any ROT clauses used by a seller should be reviewed regularly.

12. Avoidance actions

UNITED STATES:

Preferences, or recovery of pre-petition payments from vendors
Transfers of assets prior to insolvency

Preferences

- Bankruptcy Code Section 547 allows the debtor to recover pre-petition payments to third parties that were made within 90 days prior to filing as to non-insiders and within one (1) year prior to filing with respect to insiders. The requirements to assert a preference are that the payment in question be made within the appropriate time period, made while the debtor is insolvent, the payment is on account of antecedent debt and the payment allows the creditor to receive more than it would in a Chapter 7 liquidation. Debtors or trustees pursuing preference claims rarely have difficulty establishing these basic requirements.

- The statute of limitations on preference actions is two years from the petition date.

- Creditors who have received allegedly preferential payments have several defenses, the most common three being that the payment was made in the ordinary course of business, that the creditor provided subsequent new value after the payment at issue, or that the payment constituted a contemporaneous exchange for value.

    - The ordinary course of business defense is based on the notion that the payment in question was consistent with the ordinary course of business between the debtor and the particular creditor or consistent with industry standards generally.

    - Subsequent new value is simply that creditors provided additional value in the form of goods or services after receipt of the payment that in essence replenished the estate's assets. The defense exists to the extent of such new value.

    - Contemporaneous exchange for value is where the parties intended the payment to be substantially contemporaneous with the creditor providing new value. The classic example of contemporaneous exchange for value is where a debtor desperate for goods promises to send a check if the

creditor will release goods. Documentation of the parties' intent of payment in exchange for specific value is critical to this defense.

Fraudulent Transfers

- Section 548 of the Bankruptcy Code provides for the avoidance of transfers of property of the estate, which can be "actually" fraudulent transfers, or "constructively" fraudulent transfers.

- Fraudulent transfers is a partial misnomer because fraud is not required for "constructive" fraud. The debtor can recover payments made to non-insiders for transfers occurring within one (1) year prior to bankruptcy and for two (2) years with respect to insiders. The debtor can recover transfers that were made in an attempt to defraud creditors but also when the transfer was simply for "less than reasonably equivalent value".

- A statute of limitations on asserting fraudulent transfer claims is two (2) years from the petition date.

- Debtors and trustees in bankruptcy are also entitled to assert claims under state law fraudulent transfer statutes which are similar to the Bankruptcy Code fraudulent transfer statute but often have a longer statute of limitations, and the reach back period may be longer.

GERMANY:

- Under German Insolvency Law, certain transactions in the run-up of the opening of the insolvency proceedings with a detrimental effect for the insolvency mass may be challenged by the insolvency administrator. The legal consequence of a successful challenge is that the beneficiary of the transaction must return everything which it received pursuant to the transaction together with interest since the insolvency opening.

- Important to know is that transactions carried out within a period of three months prior to the filling for insolvency or after the filling are particularly sensitive,

especially in case of incongruent coverage (satisfaction), sec. 131 Insolvency Act. A satisfaction is incongruent, if the debtor's transaction did not comply with a contractual obligation. As a consequence, the German legislator has provided a lower threshold for claw back claims to make challenge on this ground easier.

Legal acts carried out by the debtor with the intention to disadvantage creditors may be subject to challenge, even if they have been executed up to ten years prior to the filling of the insolvency proceedings (sec. 133 Insolvency Act).

Performances of the debtor towards third parties that were effected free of charge may be contested by the administrator unless the respective performance was effected more than four years prior to the filling of the insolvency proceedings (sec. 134 Insolvency Act).

UNITED KINGDOM:

As indicated in question 2 above, there are various provisions in the IA 1986 which are designed to help liquidators and administrators overturn past transactions undertaken by the debtor in the period prior to the opening of formal insolvency proceedings.

The main claims available are as follows:

- **Transactions at undervalue** – an application to court for an order avoiding any transactions entered into in the two years before the administration or liquidation in which the value received by the debtor was significantly less than that provided to the third party. The transaction is only challengeable as being at a relevant time within the two year look-back period if the debtor was at the time (or as a result of the transaction became) unable to pay its debts as they fell due.

- **Preference** – an application to court for an order avoiding anything done or allowed by the debtor to be done which placed a creditor or guarantor of the debtor in a better position on insolvency than would otherwise have been the case and the debtor was influenced by a desire to produce that outcome. The look-back period for preferences in favour of unconnected parties is 6 months prior to the start of insolvency proceedings. For connected parties it is 2 years. Again, the preference will only be subject

to challenge as having occurred at a relevant time if the preference was given at a time when the debtor was insolvent or the debtor became insolvent as a result of it being given.

- **Extortionate credit transactions** – an application to reopen any credit transactions made on extortionate terms within the three years before the administration or liquidation.

- **Avoidance of floating charges -** A floating charge cannot be created in the year before a debtor's insolvency (or two years before, if the chargee is a connected person) to secure past indebtedness. Such a charge will be valid only to the extent of "new money" provided to the company.

- **Void transactions** – As noted above, if a company is wound-up via a compulsory liquidation then any disposition of the debtor's property made after the presentation of the winding-up petition is void (unless the court orders otherwise).

There are also a range of claims available to liquidators to use in prosecuting delinquent directors:

- **Wrongful Trading -** If a liquidator finds that any directors continued to run up a debtor's losses (usually through ongoing trading) when they knew or ought to have concluded that there was no reasonable prospect that the debtor would avoid going into such insolvent liquidation, they can apply to the court for the director to be made personally liable to make such contributions to the debtor's assets as the court thinks proper.

- **Fraudulent Trading -** If a liquidator finds that any business of the debtor has been carried on with the intent to defraud creditors of the debtor, they can apply to the court to obtain a contribution from those who were knowingly parties to the carrying on of the business in such a manner. Fraudulent trading may also constitute a criminal offence.

- **Misfeasance** – On application by the liquidator or any creditor or member of a debtor that a director of a debtor in liquidation has misapplied or retained the debtor's assets or has breached any fiduciary duty to the debtor, the court can order that the director repay's or accounts for the assets or contributes such sum to the company's assets as the court thinks just.

- **Transactions defrauding creditors -** A transaction is one to defraud creditors if it is at an undervalue and its purpose is to prejudice the interests, or put assets beyond the reach, of someone in relation to a claim

they may make against the Company. In the case of a company in liquidation, the liquidator is the person entitled to make an application but any person who is, or is capable of being, prejudiced by the transaction (referred to as a victim of the transaction) may bring an application with the leave of the court. An application brought by a victim is treated as a class action made on behalf of every victim.

13. Restructuring plan

UNITED STATES:

Classes of creditors
Priority of payment
Requirements of approval
Creditor voting
Procedures and court hearings

A Plan of Reorganization is essentially the debtor's contract detailing how the debtor will satisfy pre-petition claims. This can be in the form of cash distributions, an allocation of future profits, and/or redistribution of the debtor's equity.

For a Plan of Reorganization to become effective, it must be confirmed by the Bankruptcy Court.

- For purposes of Plan confirmation, similarly situated creditors are placed in classes of creditors, usually roughly corresponding to the claim priorities set forth above. If a class of creditors is unimpaired, meaning their claims are satisfied, that class is deemed to have accepted the Plan. For creditor classes that are impaired, the class must either consent to the Plan or be "crammed down". For a class to consent to a Plan, of the class members who vote, there must be more than 1/2 in number and 2/3 in dollar amount of creditors accepting the Plan.

- A debtor can "cram down" its plan on non-consenting classes if the Plan is "fair and equitable," does not "discriminate unfairly" within classes, and is in the "best interests of creditors," primarily that creditors will receive more in the Plan than in a Chapter 7 liquidation.

- The so-called "absolute priority rule" requires that a junior class of creditors cannot receive value on its claims unless senior classes are paid in full or vote to accept the plan. Thus, unless unsecured creditors are paid in full, equity holders are not permitted to retain their equity interest absent a capital contribution commensurate to the value of the reorganized debtor's stock.

- To be confirmed, a Plan must also be feasible. A key element of feasibility is usually whether or not a debtor has committed exit financing.

The current credit crisis may undermine the ability of Debtors to obtain exit financing, and thus exit Chapter 11.

GERMANY:

- The scope of possible regulations in an insolvency plan (*Insolvenzplan*), including a debt-to-equity swap, is enormous. The enterprise of the debtor can be reorganized and preserved by means of an insolvency plan.

b) *Classes of creditors*

- For the insolvency plan creditors have to be formed to groups according to the different legal situation. The groups shall be appropriately separated from each other. A distinction is to be made at least between secured creditors, unsecured creditors and employees.

- Insolvency plans can only be submitted by the debtor and the insolvency administrator. The creditors meeting can instruct the insolvency administrator to draft an insolvency plan.

c) *Priority of payment*

- The priority of payment is determined by the insolvency plan.

d) *Requirements of approval*

- The insolvency plan requires the approval of the creditors, the shareholder and the debtor in a special meeting.

e) *Creditor voting*

- The creditors vote by groups. The consent of every group is needed. Within a group the majority of creditors (as headcount) and the majority of debt need to approve the insolvency plan.

- The missing consent of a creditor group, the shareholders or the debtor can be overruled by the insolvency court, if the majority of creditor groups approve the insolvency plan and the economic situation of the opposing party does not deteriorate through the insolvency plan in comparison to a regular insolvency proceeding.

f) *Procedures and court hearings*

- A special creditor meeting is conducted for the discussion and approval of the insolvency plan. The insolvency plan has to be confirmed by the insolvency court. Creditors, shareholders and the debtor can make an appeal against the decision which confirmed or denied confirmation.

- When the confirming decision is unappealable, the insolvency plan is effective.

UNITED KINGDOM:

- See number 3(b) above in relation to Administration and CVA. See also our comments below in relation to Schemes of Arrangement.

14. Cross-border insolvency

UNITED STATES:

UNCITRAL Model Cross-border insolvency
U.S. Chapter 15

- When a multi-national business faces insolvency, assets in more than one country likely require administration and protection. It is sometimes not clear what country's law will apply, and which jurisdiction will control the insolvency process. This can be determinative of outcome since countries' laws and approach to business insolvencies can differ materially.

- Typically, a multi-national business located outside the United States with assets in the United States would seek insolvency protection under the laws of its country, but will also file an "ancillary" proceeding in the United States.

- There are many laws, treaties and regulations that address these issues, including:

  - Chapter 15 of the Bankruptcy Code on Ancillary Cases

    1) Mostly follows the United Nations' Model Law on Cross-Border Insolvency

    2) Chapter 15 passed as part of the 2005 Bankruptcy Code Amendments

  - UNCITRAL (United Nations Commission on International Trade Law) Model Law on Cross-Border Insolvency

    Goal: to "modernize and harmonize the rules on international business and to enhance predictability in cross-border commercial transactions".

  - European Union Regulation on Insolvency Proceedings

  - ALI NAFTA Transnational Insolvency Project

- COMI (or Center of Main Interests) is a key concept in Chapter 15, the UNCITRAL Model Law and the European Union Insolvency Regulation, all of which presume COMI is where an entity has its corporate registration.

- COMI impacts where the main proceeding should occur, based on where a business has its "center of main interests", which is analogous to the principal place of business. Thus, if COMI exists in a foreign country, a U.S. Bankruptcy judge should recognize a foreign insolvency proceeding as the "foreign main" proceeding and the U.S. Chapter 15 proceeding as an "ancillary" proceeding. If a debtor does not have COMI in the country where it files its insolvency proceeding, but has an "establishment" in such county, the U.S. Bankruptcy Court should recognize the foreign proceeding as a "foreign non-main" proceeding.

- If the foreign insolvency proceeding is recognized as a "foreign main" proceeding, the approval of the Chapter 15 proceeding will invoke the automatic stay. If the foreign insolvency proceeding is recognized as a "foreign non-main" proceeding, the Chapter 15 proceeding will not invoke the automatic stay protections.

- Important Chapter 15 court decisions

  - Bear Stearns
  - SAAD Investments
  - Condor Insurance
  - Vitro, S.A.B. de C.V.
  - Maxam Capital/Madoff
  - Fairfield Sentry

GERMANY:

Within the European Union (with the exception of Denmark) the European Insolvency Regulation sets the rules for cross-border insolvencies, in which the debtor has its centre of main interest in one of the Member States of the EU.

According to the European Insolvency Regulation the courts of the member state of the EU where the debtor has its main centre of interest (COMI) have jurisdiction to open insolvency proceedings. Courts of other member states of the EU can only open secondary insolvency proceedings over the assets in their state territory under special conditions and a restricted scope.

The law of the member state in which the insolvency proceedings are opened regulates the condition of the opening as well as the effects of the opening.

If a debtor has no COMI within the European Union, but assets in Germany, the Insolvency Act provides rules for the recognition of foreign insolvency proceedings and the opening of a particular insolvency proceeding over the assets of the debtor in Germany.

a) UNCITRAL Model Cross-border insolvency

The UNCITRAL Model Law was not incorporated into the German insolvency law.

b) U.S. Chapter 15

UNITED KINGDOM:

The English legal framework governing cross-border insolvency proceedings comprises of the following:

- The Cross-Border Insolvency Regulations 2006 (SI 2006/1030) (**Cross-Border Regulations**) which give effect to the UNCITRAL Model Law on Cross-Border Insolvency (**Model Law**);
- Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings (OJ 2000 L160/1) (**Insolvency Regulation**);
- Section 426 of the IA 1986;
- The common law.

NB: a special regime applies, within the European Economic Area, to insolvency proceedings commenced for credit institutions (The Credit Institutions (Reorganisation and Winding-up) Regulations 2004).

Cross-Border Regulations

The Model Law was adopted by the United Nations Commission on International Trade Law in 1997 and was implemented in Great Britain by the Cross-Border Regulations.

The Model Law is designed to provide uniform legislative provisions to deal with the recognition of foreign insolvency proceedings and the coordination of concurrent proceedings and to promote the objectives of:

- Co-operation between the courts and competent authorities involved in cases of cross-border insolvency;
- Fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtor;
- Protection and maximisation of the value of the debtor's assets; and
- Helping to rescue financially troubled businesses.

Legislation based on the Model Law has been adopted in the following jurisdictions:

Australia (2008)	**Montenegro (2002)**
British Virgin Islands (2003) (but not yet in force)	**New Zealand (2006)**
Canada (2009)	**Poland (2003**
Colombia (2006)	**Republic of Korea (2006)**
Eritrea (1998)	**Romania (2003)**
Great Britain (2006)	**Serbia (2004)**
Greece (2010)	**Slovenia (2007)**
Japan (2000)	**South Africa (2000)**
Mauritius (2009)	**United States of America (2005)**
Mexico (2000)	

Under the Cross-Border Regulations, a foreign representative administering foreign insolvency proceedings can apply to the British courts for recognition of those insolvency proceedings.

The Cross-Border Regulations provide for the recognition of two types of insolvency proceedings:

- **Foreign main proceedings** – i.e. proceedings that are taking place in the state in which the debtor company has its "centre of main interests" (**COMI**) (please see below); and

- **Foreign non-main proceedings** – i.e. proceedings that are taking place in a state in which the company has an "establishment" (which is defined as any place of operations where the debtor carries out an economic activity with human means and goods, which is not of a temporary nature)

If foreign proceedings are recognised as foreign main proceedings, an automatic stay will be granted in order to prevent:

- The commencement or continuation of actions or proceedings concerning the company's assets, rights, obligations or liabilities;
- Execution against the company's assets; and
- The transfer, encumbering or other disposal of the company's assets.

However the stay will not be able to:

- Affect a right to enforce security over the company's property or to exercise set-off (so long as such rights could be exercised in a UK winding-up); and
- Stay the commencement of UK insolvency proceedings (although any such proceedings will be limited to assets in UK).

For foreign non-main proceedings, no automatic stay applies, but appropriate discretionary relief may be granted to protect the assets of the company or the interests of creditors. The same discretionary relief may be granted in respect of foreign main proceedings, in addition to the automatic stay

The Insolvency Regulation

Article 3 of Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings OJ 2000 L160/1) (the Insolvency Regulation) stipulates that the courts of the EU Member State in which the company's is situated have exclusive jurisdiction to open main insolvency proceedings. Other EU Member States can then only open secondary proceedings.

The term COMI has been created by European Union law, based on the principles of mutual recognition and co-operation, in an attempt to help settle conflicts that can arise between jurisdictions in cross-border insolvencies.

- The Insolvency Regulation lays down rules for deciding where main insolvency proceedings can be opened in circumstances where a debtor has a presence in more than one EU Member State.

- The Insolvency Regulation is directly applicable to all EU Member States (with the exception of Denmark) and applies to all forms of debtors (with the exception of insurance undertakings, credit institutions or investment undertakings).

Main Proceedings

- Article 3 of the Insolvency Regulation stipulates that the courts of the EU Member State in which the debtor's COMI is situated have exclusive jurisdiction to open main insolvency proceedings. Other EU Member States can then only open secondary proceedings.

- The term COMI has been created by European Union law, based on the principles of mutual recognition and co-operation, in an attempt to help settle conflicts that can arise between jurisdictions in cross-border insolvencies.

- COMI is not defined in the Insolvency Regulation, however some guidance is given:

  - Article 3 states that the location of a company's registered office is presumed to be its COMI in the absence of proof to the contrary; and

  - Recital 13 states that a company's COMI should correspond to the place where the company conducts the administration of its interests on a regular basis, and therefore can be ascertained by third parties.

Territorial Proceedings

- Before main proceedings have been opened, local proceedings can be opened anywhere the company has an establishment. These proceeds are known as "territorial proceedings" and, like secondary proceedings, are restricted to the assets located in that EU Member State.

- Territorial proceedings can be both winding-up and reorganisation proceedings however they can only be opened in limited circumstances i.e.:

- Where there are objective factors preventing main proceedings from being opened; or
- Where territorial proceedings are requested by a creditor who has his domicile, habitual residence or registered office in the same EU Member State as the proposed territorial proceedings, or whose claim arises from the operation of the company's establishment in that EU Member State.

Once main proceedings have been instituted in the company's COMI, existing and new territorial proceedings must be converted to, or commenced as, secondary proceedings.

If there is a conflict between a provision in the Cross-Border Regulations and a provision in the Insolvency Regulation, the relevant provision of the Insolvency Regulation will prevail

Section 426 of the Insolvency Act

Under Section 426 of the Insolvency Act, a court in the Channel Islands, Isle of Man or any country or territory designated by the Secretary of State (mostly Commonwealth countries) can apply to the UK courts for assistance in insolvency proceedings.

In cooperating with foreign courts in relation to insolvency proceedings, the UK court has a wide discretion.

The UK court can apply UK insolvency law or the relevant foreign insolvency law.

15. Insolvency alternatives

UNITED STATES:

Workouts
Receiverships

- The two most common non-bankruptcy alternatives are the out of court workout, which may involve a composition agreement, or an assignment for the benefit of creditors under state law.

- A non-bankruptcy workout generally involves a forbearance agreement with secured lender(s) and a forbearance or composition agreement with unsecured creditors. Such composition agreement may involve a moratorium or delay in payment of debts owed and/or a compromise of the amount owed. Immediate cash payments for creditors usually require a discount, while a longer term payout may result in payment in full.

- Assignments for the benefit of creditors are governed by each states' laws, which differ materially from state to state. There is little uniformity among states' laws on assignments with some states having highly developed statutes and procedures and other states having virtually nothing.

- Conceptually, an assignment involves a transfer of all of the debtor's assets to a third party assignee, whose duties and responsibilities are similar to a Chapter 7 trustee. Assignees can operate a business enterprise, but assignments generally involve the ultimate sale of the assets.

- Assignments for the benefit of creditors are usually limited to smaller business enterprises whose assets are located within one state since the assignment laws in one jurisdiction cannot be imposed on assets in another jurisdiction.

GERMANY:

a) *Workouts*

Informal restructuring agreements between creditors and debtors are possible, but only as long as the company is not insolvent.

b) *Receiverships*

In Germany receivership does not exist. Only in regard to immovable objects a similar legal institute (*Zwangsverwaltung*) is possible.

UNITED KINGDOM:

As stated above in question 2, there is no specific event which makes it compulsory for a company to enter a formal insolvency procedure.

In order for any procedure to begin, the company, the directors or the creditors (depending on the relevant rules, as explained above) must take the necessary, pro-active steps to initiate the relevant procedure.

Therefore it is possible for an insolvent company to seek to restructure its obligations, operations and/or contracts informally, and outside of a formal insolvency procedure, by direct negotiation with creditors and/or members. A good example of this is a scheme of arrangement (outlined below). Note the difficulties and risks associated with this approach outlined at 2 above.

Directors of a company must be careful however as if a liquidator finds that any directors continued to trade a company when they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into such insolvent liquidation, they can apply to the court for the director to be made personally liable to make such contributions to the company's assets as the court thinks proper. This offence is known as 'wrongful trading'.

- Accordingly directors should file for insolvency when it is clear that all reasonably likely rescue options have been exhausted.

Scheme of Arrangement

- This is not an insolvency procedure but a procedure used in various circumstances, including by companies which are in financial difficulties, though they may still be solvent. In essence, the company's financial affairs are restructured with the consent of both its creditors and its members. The idea is to sort things out by putting in place some sort of financial compromise or restructuring of their existing rights, often to avoid more substantial losses to creditors if the company were to go into administration or liquidation. A key aspect of the process is determining the various classes into which the creditors and members will be split.

- Approval by the court is needed. At the first hearing, the court will order that separate meetings of the creditors and members take place to approve, or not as the case may be, the scheme being put forward. The court will then sanction the scheme if the relevant approvals are forthcoming and if the court considers that the scheme is fair and equitable, including the division of creditor and member classes under the scheme.

- The procedure therefore requires 2 court hearings and has itself no moratorium on creditor actions in the interim (unless it takes place as part of an administration). It carries with it, therefore considerable potential problems, including cost.

- Schemes of arrangement have been used in a manner similar to CVAs as a mechanism for delivering best value to creditors of a company that has first been placed into administration. For example, this is what happened to certain of the UK based entities in the failed Enron group.

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