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US Chapter 11 Bankruptcy and Australian Voluntary Administration Compared

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Key elements of Australian and US procedures compared

Voluntary administration and Chapter 11 bankruptcy

Both the Australian voluntary administration procedure and the US Chapter 11 bankruptcy procedure have as their goal the realization of greater value through the restructuring of a distressed company rather than its immediate liquidation. Each procedure includes a "moratorium" on certain enforcement and other action against the company during the pendency of the procedure, and a statutory "cram down" of an approved reorganization plan on dissentient creditors (in each case, with some important differences between the two procedures, explained below).

The following table highlights the key differences, and some advantages and disadvantages, of restructuring through the voluntary administration procedure in Australia and the Chapter 11 bankruptcy procedure in the United States.

Creditors' schemes of arrangement

The Australian creditors' scheme of arrangement procedure may also be used to restructure a class or classes of debts of a company — a key difference from voluntary administration is the ability under a scheme of arrangement to effect "cram down" of a reorganization plan on secured creditors of a company (rather than only *unsecured* creditors, as permitted in voluntary administration). In this sense, the scheme of arrangement offers a wider "cram down", which is similar to Chapter 11 bankruptcy.

That wider "cram down" has been used in a number of high-profile Australian restructures since 2010 including Alinta Energy, Nine Entertainment and Centro. The scheme of arrangement procedure has therefore become an increasingly important feature of the Australian restructuring landscape in appropriate cases.

The scheme of arrangement procedure, however, does not have any "moratorium" protection available to the company (as is available under voluntary administration and Chapter 11 bankruptcy). The procedure is therefore not, in many senses, readily comparable to Chapter 11 bankruptcy. For that reason, schemes of arrangement are not dealt with in the comparison table, but are discussed in greater detail below.

Additional detail on the various procedures

The section following the comparison table then provides more detailed overviews of each of:

- Chapter 11 proceedings (a Chapter 11 Case) under title 11 of the United States Code (the Bankruptcy Code),
- Voluntary administration under the *Australian Corporations Act 2001* (Cth) (the Corporations Act),
- Creditors' schemes of arrangement under the Corporations Act,

including the basic goals and objectives commonly implemented, the procedural steps and the roles of the various stakeholders.

Comparison table — voluntary administration and Chapter 11 bankruptcy

	VOLUNTARY ADMINISTRATION	CHAPTER 11 BANKRUPTCY
Commencement	Usually appointed by the board of directors, virtually instantaneous. Directors must form the opinion that the company is insolvent or likely to become insolvent; consent of a registered liquidator to act as administrator is required. Can be appointed by a secured creditor in some circumstances.	Effective on filing of a petition by the debtor company (no insolvency requirements) or upon entry of order for relief in an involuntary case.
Role of existing directors/ management	Completely superseded by the administrator, who is the only person authorized to act for the company.	Existing management stays in place and continues to control the company, hence the company in Chapter 11 is referred to as a "debtor-in-possession."
Drivers to appoint	Court has a supervisory role, but is not a mandatory part of the process and may have no involvement at all.	No insolvent trading liability for directors in the US; the primary driver will usually be the implementation of a reorganization plan, or, increasingly, effecting a going-concern sale of the business through a section 363 sale followed by confirmation of a plan of liquidation.
Court involvement	Court has a supervisory role, but is not a mandatory part of the process and may have no involvement at all.	Court controlled process; the debtor cannot undertake actions outside the ordinary course of business (e.g. asset sales) without court approval.
Moratorium	Most claims suspended during the period of the administration, which is intended to be relatively short - exceptions for some secured creditors, including secured creditors with security over the whole or substantially the whole of the assets of the company.	Complete moratorium on account of automatic stay provisions. All creditors, including secured creditors, are stayed from enforcement or collection efforts unless they first obtain court relief from the automatic stay.
Termination by counterparties to contracts with the company (ipso facto clauses)	No protection against contractual provisions entitling counterparties to terminate by reason of the appointment of the administrator or by reason of the company's insolvency.	Protection against automatic termination (ipso facto) clauses in Chapter 11; such clauses are void and of no legal effect.
Termination by the company/ administrator of company contracts	Administrator has no formal power to disclaim contracts but may repudiate or not perform some contracts, leaving a remedy in damages.	Ability to disclaim "executory contracts" with the other party left with unsecured claim for damages. The debtor is able to "cherry-pick" the contracts it wants to assume or assign.

	VOLUNTARY ADMINISTRATION	CHAPTER 11 BANKRUPTCY
Avoiding powers	Administrator has no power to avoid pre-administration transactions (unlike a liquidator who has extensive powers in relation to voidable transactions).	Company can avoid certain transfers including: (a) fraudulent conveyances (two year look-back for actual fraud and four year look-back for constructive fraud); and (b) preferential payments made to non-insider creditors within 90 days of the petition and within one year for insiders. Recoveries are for the benefit of the estate and do not improve the collateral position of secured creditors. The estate steps into position of avoided liens (security).
Post-appointment funding	Some funding priority can be obtained, but not over existing secured creditors without their consent. Administrator is personally liable for debts incurred in trading on post-appointment.	Debtor may seek court approval for "DIP" financing that provides for the granting of "priming" liens on encumbered assets, new liens on unencumbered assets and administrative or super priority administrative claim status.
Sale of assets	Administrator can sell without court or general creditor approval (but assets will still be subject to secured creditor rights).	Court approval is required; secured creditor liens may to some extent be overridden by the court where the collateral value is less than the aggregate face amount of all liens.
Reorganization plan	Reorganization plan is approved by the company's creditors and is documented in a deed of dompany arrangement or "DOCA". A DOCA can be proposed by the directors or any other party from the time of the administrator's appointment to the time of the second meeting of creditors (generally held within 1 to 2 months from the commencement of the administration although this period can be extended by the Court) to decide the company's future. The company generally does not emerge out of external administration until the DOCA is effectuated. All creditors, shareholders and company officers are bound by the DOCA, apart from secured creditors who did not vote in favour of it.	Reorganization plan must be approved by the court. At least one impaired class of creditors must accept the plan and no junior classes of creditors can receive value under the plan unless the senior classes are paid in full or consent. The company has the exclusive right to file a plan of reorganization for 120 days and 60 days after filing to seek acceptances. The 120 day period may be extended by court order but not to a date that is more than 18 months after the petition date. If a plan is not confirmed by that deadline, any "party in interest" can file a competing reorganization plan. Once the plan is filed and approved, the company emerges from Chapter 11 and all creditors and "parties in interest" are bound regardless of whether they voted in favour.

	VOLUNTARY ADMINISTRATION	CHAPTER 11 BANKRUPTCY
Discrimination between creditors	May be permitted if justified but employee entitlements priority must be preserved, unless employees vote to vary that priority.	All members in a class must be treated equally; similarly situated creditors must be in same class.
Voting on the reorganization plan	To be approved, the DOCA must be passed by a 50% majority in value and a 50% majority in number of all creditors voting including secured creditors (i.e. creditors vote as one class); the administrator has a casting vote in the event of a deadlock.	For impaired classes only, class must accept by two-thirds in dollar amount and more than half in number of the voting creditors in that class. Permits a blocking stake to be built by the holder of one-third of the dollar amount of any impaired class. In the event the class is deemed to vote no, the debtor may seek to effect a "cram down" in order to confirm the plan. No vote if class not impaired.
"Pre-pack"	There is not an established practice for a "pre-pack" DOCA, and independence requirements for an administrator tend against the practice. The pre-pack market, however, is developing slowly.	There is an established practice and market for "pre-pack" Chapter 11 plans.
Speed	Theoretically, a company can be in and out of administration in less than one month although practically it is usually longer, particularly for large companies or companies in corporate groups.	A "free fall" Chapter 11 Case generally takes from 18 to 24 months and sometimes longer if the debtor's exclusive period lapses and competing plans are proposed. In a "pre-pack" Chapter 11 Case, a plan can be confirmed in as little as 30 to 90 days.
Secured creditors	Secured creditors with security over the whole of the assets of the company can enforce their security "over the top" of the administrator and appoint a receiver within 13 business days. Secured creditors rights generally are unaffected except for: ▪ a moratorium on enforcement of the security during the period of the administration except in limited cases (including a secured creditor with security over all or substantially all of the assets of the company acting within 13 business days); ▪ the administrator can dispose of encumbered property in the "ordinary course of business" or with the consent of the secured lender or the Court (where the interests of the secured creditor have been adequately protected); and	Secured creditors are subject to the moratorium. Secured creditors may seek court approval during the Chapter 11 Case to commence or continue foreclosure proceedings. Enforcement by secured creditors is a much slower process than in Australia, as it is necessary to first obtain a foreclosure judgment which will take at least a number of months. Secured creditors are entitled to retain their pre petition liens (security) on the same collateral (or the proceeds thereof) and to be paid in full plus interest at their contractual rate of interest. However, a secured creditor's claims may be bifurcated into a secured and unsecured claim under section 506 of the Bankruptcy Code, in cases where the collateral is worth less than the face amount of the secured creditor's claim.

	VOLUNTARY ADMINISTRATION	CHAPTER 11 BANKRUPTCY
	■ to the extent that a secured creditor votes in favour of a DOCA, the secured creditor will be bound by it.	A secured creditor may avoid the effects of such bifurcation, by making an election under section 1111(b) of the Bankruptcy Code to retain the full amount if its lien (security) on the collateral.
Rights of shareholders	Shareholders rank behind unsecured creditors as a result of amendments to the Corporations Act in 2010.	Shareholders rank behind unsecured creditors in relation to all their claims and cannot receive distributions under a plan unless senior classes consent or are paid in full. However, the New Value Exception to the Absolute Priority Rule may provide a basis for old equity to participate in a plan.
Transfer of existing shares	An administrator of a DOCA may, with leave of a Court, mandatorily transfer existing shares in the company to a new shareholder (provided the transfer does not unfairly prejudice the interests of shareholders).	The Court has no power to mandatorily transfer existing shares in the company.
Transition to liquidation	At the second meeting of creditors, if creditors vote in favour of liquidation, or on termination of a DOCA before it has been given full effect.	At any time "for cause" including if a plan is not confirmed and there is no reasonable prospect for reorganization.

Australian voluntary administration

Overview

The voluntary administration procedure in the Corporations Act was introduced in 1993. Prior to this time the only formal mechanism for a company to compromise with its creditors was by a creditors' scheme of arrangement, a process often regarded as costly, time consuming and cumbersome.

The primary objective of voluntary administration is to provide for the business, property and affairs of an insolvent company to be administered in a way that:

- maximises the chances of the company, or as much as possible of its business, continuing in existence; or
- if it is not possible for the company or its business to continue in existence – results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

The voluntary administration process gives a company a short breathing space, during which there is a general moratorium on the enforcement of creditors' claims. It also enables the administrator to continue to trade the company's business during the administration period, and for any proposal to rehabilitate the company or otherwise maximise returns to creditors (other than via an immediate winding up) to be put before creditors and, if approved, implemented via a deed of company arrangement or "DOCA" binding on key stakeholders including the company, its shareholders and its creditors.

The voluntary administration process is intended to be quick, although in more complex administrations (such as corporate groups) it is usual for the court to extend relevant time limits and the administration period may be extended for over a year.

In addition to providing a mechanism to maximise returns to creditors by allowing a distressed company to trade on, the voluntary administration procedure has other benefits including that:

- it is fast to implement by a simple resolution of the company's board of directors;
- it requires no Court involvement;
- the appointment of an administrator effectively avoids insolvent trading liability for the directors of the company in respect of the period post-appointment;
- the voluntary administration procedure imposes a moratorium in respect of various claims against the company and property in its possession during the period of the voluntary administration.

Comparison to US Chapter 11

Australia's voluntary administration procedure has the same aim of corporate rehabilitation as the US Chapter 11 process, but has some important differences including that:

- the company's directors are deprived of any power during the administration period and the administration is conducted by an independent insolvency practitioner who must be a registered liquidator;
- a voluntary administration can take place entirely without Court involvement;
- contractual counterparties are generally at liberty to terminate their contracts with the company if they have a right to do so arising from the appointment of the administrator (but owners and lessors of property in the possession of the company are not able to remove that property during the administration period without the administrator's consent or the leave of the Court); and

- a secured creditor with a security interest over the whole or substantially the whole of the property of the company is entitled to enforce that security within 13 business days after the appointment of the administrator (or such longer time as the Court may order or the administrator may agree).

Commencement of voluntary administration

A voluntary administration is usually commenced by the directors of a company resolving that, in their opinion, the company is insolvent or is likely to become insolvent in the future and that an administrator should be appointed. Although less common, a secured creditor who is entitled to enforce a security interest over the whole or substantially the whole of the property of the company or a liquidator of the company may also appoint an administrator in certain circumstances.

The consent of the proposed administrator must be obtained before the appointment is effective. The administrator must be a registered liquidator, registered with the Australian Securities and Investments Commission (ASIC) and must not be disqualified from accepting the appointment under the Corporations Act.

It is normal to have two or more administrators appointed jointly and severally, including to ensure appropriate continuity in the event of absence or ill health.

Role and powers of the voluntary administrator

The administrator takes control of the affairs and business of the company, and acts as agent of the company. An administrator is a fiduciary and, as an officer of the company, is subject to the duties applicable to company officers.

The administrator has very broad powers including to trade on the company and sell its assets. The administrator is not subject to an equivalent of the strict obligation pursuant to section 420A of the Corporations Act that applies to a receiver in selling assets of the company (as discussed below).

Importantly, the administrator is personally liable for debts of the company incurred during the administration period for services rendered, goods bought, property leased or occupied and funds borrowed. This personal liability is intended to encourage suppliers, employees and customers to continue to trade with the company during the voluntary administration period, and does not extend to pre-appointment liabilities of the company. However, the personal liability means that an administrator will be reluctant to trade on (including to retain employees or cause the company to perform contracts) where there are not available funds to do so or where this would prejudice the position of creditors. This may mean that an administrator seeks to renegotiate the basis on which he or she will cause the company to continue to perform pre-appointment contracts.

The administrator has a right of indemnity out of the property of the company for debts or liabilities incurred by the administrator and for the administrator's remuneration. This right of indemnity takes priority over unsecured debts of the company (including debts which had been secured by a security interest that vested in the company on the appointment of the administrator), and also over any debts secured by any circulating security interest (broadly equivalent to assets which were previously the subject of floating charges, and including cash, receivables, inventory and similar assets), at least until the secured creditor enforces their security (to the extent that they are able to do so consistently with the statutory moratorium discussed below), such as by the appointment of a receiver.

Impact of a voluntary administration

The powers of the company's officers are suspended during the administration period, although those officers are required to assist the administrator in his or her investigation into the company's affairs. Although some senior management may be retained by the administrator for continuity, they are required to discharge their duties and perform their functions subject to the direction of the administrator.

Generally, only the administrator can deal with the property of the company during the administration period.

A transfer of shares in a company, or an alteration of the status of its shareholders, after the commencement of an administration is void unless done with the consent of the administrator or pursuant to an order of the court.

The appointment of an administrator does not, of itself, constitute a repudiation of contracts to which the company is a party. However, it would be usual for the appointment of an administrator to give rise to an express right to terminate on the part of contractual counterparties ("ipso facto" clauses). By contrast to the US position, there is no prohibition in administration on counterparties relying on ipso facto clauses and terminating for an insolvency event of default, subject to the limitations on parties taking property in the possession of the company during the moratorium applicable in administration, discussed further below.

Although the administrator does not have statutory power to disclaim contracts as a liquidator does, the administrator may repudiate contracts requiring performance by the company, particularly where the administrator is not trading on some or all of the business (such as where he or she does not have funds to do so). This leaves counterparties to pursue their entitlement to damages for breach of contract by way of proof of debt in any subsequent creditors' voluntary winding up or deed of company arrangement.

The company also has the benefit of a statutory moratorium during the administration period, as discussed below.

The moratorium

During the administration period:

- creditors, including some secured creditors, are prohibited from taking any action against the company to recover debts, enforce security interests or have the company wound up; and
- owners or lessors of property that is being used by or is in the possession of the company - including leased premises and goods subject to retention of title terms - are prohibited from seizing or reclaiming property (notwithstanding that they may have contractual rights to do so);

in each case without the consent of the administrator or order of the Court. In addition, guarantees granted by directors of the company cannot be enforced during the administration period.

The main exceptions to the moratorium are:

- in relation to perishable goods;
- where enforcement has commenced prior to the appointment of the administrator; or
- where a secured creditor who has a security interest over the whole or substantially the whole of the company's property (which, where relevant, has been perfected under the *Personal Property Securities Act 2009* (Cth)) enforces their security interest within the "decision period", being 13 business days from the giving of notice by the administrator of their appointment or from the commencement of the administration (or such further time as may be permitted by order of the Court or consent of the administrator).

The administrator is not able to deal with property subject to a security interest (including property the subject of retention of title terms) unless in the ordinary course of business, or with the consent of the secured creditor/owner or the leave of the Court. Where retention of title property is used by the administrator in the ordinary course of business, the Corporations Act requires the administrator to act reasonably in exercising any rights to dispose of that property and to apply the proceeds of sale in a particular manner according to the statutory priority of interests in that property.

Meetings of creditors in a voluntary administration

There are two meetings of creditors required to be held in a voluntary administration.

The first meeting of creditors must be convened immediately after the appointment of the administrator and be held within 8 business days of the appointment.

The only official business at the first meeting is to consider the possible replacement of the administrator (which rarely happens), and to determine whether creditors wish to appoint a committee of creditors and if so to appoint the committee. The real value of the first meeting is in meeting the administrator, asking questions, and obtaining information about the administration.

The second meeting of creditors is more substantive in terms of outcomes. It must be convened within 20 business days of the administrator's appointment,[1] unless an extension of time is granted (as is common in larger and more complex administrations). In convening this meeting, the administrator must provide creditors with a report (Section 439A Report) which:

- discusses the company's business, property, affairs and financial circumstances;
- sets out the details of any proposed deed of company arrangement or DOCA to be put to creditors; and
- provides the administrator's opinion as to whether it is in the interests of the creditors for the company to execute any DOCA which has been proposed, for the administration to end (and the company be returned to the control of its directors) or for the company to be wound up, and the reasons for that decision.

The Section 439A Report will, where a DOCA is proposed, consider the likely returns to creditors in a winding up compared to the likely returns under the proposed DOCA, both as to quantum and likely timing. This will involve a consideration of what liquidator's recoveries may be available if the company is wound up (such as unfair preference or insolvent trading recoveries), as these are not available in an administration or DOCA.

The second meeting of creditors may be adjourned for up to 45 business days (or such further time as allowed by the Court).

For each meeting, the administrator will ask creditors to submit proofs of debt for voting purposes, and proxies (if the creditor is a corporation or an individual not attending the meeting in person).

Voting in voluntary administration

There is no voting by separate class of creditors in voluntary administration, and voting is done on the basis that all creditors (including secured creditors) are the one class.

Voting at meetings of creditors in administration is "on the voices" unless a poll is demanded (as is usual).

If a poll is demanded, a resolution will only be passed if a simple majority of creditors voting is obtained by both value and number. If only one of these majorities is met, the administrator will exercise a casting vote. There is no requirement that the administrator's casting vote be exercised with the value vote or the number vote, and an administrator will generally exercise their vote in accordance with the recommendation they made to creditors as to what outcome was in their best interests in the Section 439A Report.

Any exercise of a casting vote by the administrator, and the passing of (or the failure to pass) a resolution on the votes of related creditors can be challenged in Court.

1 Unless the appointment occurs in December, or within 25 business days before Good Friday, in which case the meeting must be convened within 25 business days of appointment.

A DOCA binds the company, its creditors, officers, shareholders and administrators, however, secured creditors can only be bound by a DOCA if they voted in favour of it.

Committee of creditors

A committee of creditors may be appointed at the first meeting of creditors in an administration.

Essentially, the committee of creditors is available to consult with the administrator, such as on any proposal to seek an order to extend the convening period for the second meeting of creditors. Generally, the administrator will seek approval of his or her remuneration from the committee of creditors.

Outcome of voluntary administration

As noted above, prior to the second meeting of creditors, the administrator must investigate the financial situation and affairs of the company and recommend to the company's creditors in the Section 439A Report whether it is in their interests to:

- end the administration and hand the company back into the control of its directors (which is uncommon and would only be appropriate if the company is solvent);
- have the company enter into a DOCA to effect a compromise with its creditors; or
- have the company wound up by transition to a creditors' voluntary winding up.

The administration usually ends when creditors resolve at the second meeting of creditors in favour of one of these options or, if the creditors resolve that the company enter into a DOCA, on its execution (which must be within 15 business days of the second meeting of creditors or such further time as allowed by the Court).

A deed of company arrangement or DOCA

A DOCA is a statutory contract between the company and its creditors that governs the relations between the company and its creditors after the end of the voluntary administration. The Corporations Act specifies certain minimum requirements of a DOCA including the nature and duration of any moratorium period, property available to pay creditors, the order of payments to creditors (usually in accordance with the statutory priorities applicable in a winding up) and the release of the debts of the company.

A DOCA is administered by a deed administrator who is usually (but is not necessarily) the same person who was appointed as the voluntary administrator of the company.

A DOCA may allow the company to trade on, including under the control of its directors, and will provide for a fund for distribution to creditors. Such a fund which will often be contributed by a third party, such as a director or shareholder, and represent funds that would not otherwise be available for the benefit of creditors in a winding up of the company.

A DOCA must give employee entitlements the statutory priority to which they would be entitled in a winding up out of assets of the company coming under the control of the deed administrator (including the statutory priority of these entitlements in respect of any assets subject to a circulating security interest), unless the relevant employee creditors have voted separately to modify this priority. The statutory priority employee entitlements are wages and superannuation, leave and redundancy entitlements.

The Australian Courts have held that a DOCA cannot effect a compromise of the claims of creditors of a company against third parties, such as the party or parties contributing to a deed fund available under the DOCA for distribution to creditors. This limitation has in part been responsible for the growing popularity in recent years of creditors' schemes of arrangement (discussed further below).

The DOCA does not affect the rights of future creditors of the company if it continues to trade and incur debts. If the DOCA is terminated because it has been fully effectuated, the company is returned to the control of its directors. However, if the DOCA is terminated prematurely, it is likely that the company will proceed into liquidation.

Once a DOCA is in effect, the deed administrator of the DOCA may transfer existing shares in the company, if the administrator has obtained the consent of the affected shareholders or the leave of a Court. The Court may only give leave if it is satisfied that the transfer would not unfairly prejudice the interests of members of the company.

The Corporations Act provides for a DOCA to be set aside on an application to the Court in particular circumstances, and for a DOCA to be varied.

Once effectuated, a DOCA operates to release the claims of creditors against the company as provided for in the DOCA.

A variation on a DOCA is the transfer of specified assets, together with the claims of creditors, to a creditors' trust, enabling the company to emerge immediately from DOCA. A detailed discussion of creditors' trusts is beyond the scope of this document, but a creditors' trust will not be subject to the statutory regime applicable to DOCAs and for this reason, ASIC takes the view that special circumstances should exist to justify a creditors' trust being proposed.

Prepackaged DOCAs

Unlike the United Kingdom (or the US), there is no an established practice or procedure in Australia for "pre-pack" DOCAs or administration sales. Broadly, this may be explained by the stringent independence requirements imposed on administrators under the Corporations Act and the professional practice rules applicable to administrators under their professional standards.

There is no prohibition, however, on a company's management, an interested bidder and other relevant stakeholders from developing a pre-pack proposal for an administration and DOCA for the company. It will not ordinarily be possible, however, for the proposed administrator to give a binding commitment to proceed with that proposal prior to his/her appointment as administrator.

The role of the Court in voluntary administration

The Court has no role in the appointment of a voluntary administrator.

While it is entirely possible that the Court will have no involvement in a voluntary administration, it is common for the Court to be asked to extend the period in which the second meeting of creditors must be convened, on the application of the administrator. This extension is sometimes sought and granted on more than one occasion during a voluntary administration.

However, the Court has very broad powers to make orders in connection with administrations, and an administrator can seek directions from the Court and is subject to the supervision of the Court. Creditors and other persons aggrieved by an act, omission or decision of an administrator or a deed administrator (including the adjudication of their proof of debt) can appeal to the Court.

Concurrent voluntary administration and receivership

It will often be the case that voluntary administration takes place concurrently with receivership.

A receiver (often strictly a "receiver and manager") is the most common form of what is referred to as a "controller" in the Corporations Act, a concept that also encompasses a mortgage in possession or their agent.

A privately appointed receiver is appointed by a secured creditor over some or all of the property of the company that is subject to their security interest, to realise that property in reduction of the secured debt. The receiver is normally specified in the security and appointment documents to be the agent of the debtor company, rather than of the secured creditor, in undertaking his or her tasks. A receiver, as an officer of the company, is subject to the duties applicable to company officers.

As with an administrator, a receiver must be a registered liquidator, registered with ASIC. Additionally, there are a range of circumstances disqualifying a person from accepting an appointment as a receiver which are designed to ensure that receivers are appropriately independent. It is normal to have two or more receivers appointed jointly and severally, including to ensure appropriate continuity in the event of absence or ill health.

Also, as with administration, the receiver is personally liable for debts incurred in the course of the receivership for services rendered, goods purchased or property leased or occupied. The receiver has an equitable right of indemnity from the assets of the company, as well as (usually) an indemnity from the appointing secured creditor.

There is no moratorium or stay on the enforcement of claims against the company in receivership, as there is in administration. This is one reason why there is often a concurrent administration with a receivership, as the receiver will effectively have the benefit of the statutory moratorium applicable in administration.

A distinctive feature of receivership is the obligation imposed by section 420A of the Corporations Act on a receiver (or other form of controller) in exercising a power of sale in respect of property of a company, to take all reasonable care to sell the property for market value (assuming the property has a market value when it is sold) or otherwise, for the best price reasonably obtainable having regard to the circumstances existing when the property is sold. There is no direct equivalent obligation in relation to administrators. It is the obligation imposed on receivers by section 420A that means they will often undertake public auction and tender processes to sell property to which they have been appointed.

A concurrent receivership with a voluntary administration or DOCA generally means that:

- the receiver will have control of the assets of the company, and be responsible for trading on its business. Accordingly, dealings in relation to operational matters (such as continued supply to the company, or the continued performance by the company of its contractual obligations) or in connection with the sale of assets, are appropriately conducted by the receiver;
- the claims of unsecured creditors are progressed by way of the administration or DOCA. Meetings of creditors will be held by the administrator or deed administrator and accordingly proofs of debt and proxies are lodged with the administrator or deed administrator who will adjudicate on creditors' claims for voting or dividend purposes.

Australian creditors' schemes of arrangement

Overview

A creditors' scheme of arrangement is a compromise or arrangement between a company and a class or classes of its creditors effected pursuant to the process prescribed in Chapter 5.1 of the Corporations Act. This process requires:

- ASIC as companies regulator being provided with a draft of the scheme documents at least 14 days in advance of the initial or first court hearing;
- an initial or first court hearing at which orders are made convening a meeting or meetings of the affected creditors and approving the material (explanatory statement) to be despatched to those creditors;
- a meeting or meetings of the affected creditors be held to vote on the proposed scheme of arrangement;
- a second court hearing to approve the proposed scheme of arrangement, assuming it has been passed by the requisite majority at the meeting or meetings of creditors. A creditors' scheme of arrangement is effective once the orders made at the second court hearing are lodged with ASIC.

Generally, this process takes around three months to complete, assuming that the terms of the proposed scheme of arrangement have already been determined and - usually - negotiated and agreed with critical parties.

The above process can be, and often is, used to effect a members' scheme of arrangement, or a friendly take-over, discussion of which is beyond the scope of this paper.

Voting threshold on a creditors' scheme of arrangement

Unlike creditors voting to approve a DOCA, where voting is done on the basis that all creditors form the one class, in a creditors' scheme of arrangement voting is by each class of affected creditors.

To approve a creditors' scheme of arrangement in each relevant class, a majority of creditors in that class present and voting (either in person or by proxy) must vote in favour of the scheme at the relevant meeting. In addition, the majority which is required to approve the scheme must constitute creditors whose debts or claims against the company amount in the aggregate to at least 75% of the total amount of debts and claims of the creditors present and voting in person or by proxy in the relevant class.

Notwithstanding achievement of the necessary statutory majorities of creditors, the Court retains an overriding discretion as to whether or not to approve a creditors' scheme of arrangement. The Court will take into consideration issues of fairness in considering whether or not to approve a creditors' scheme of arrangement.

A creditors' scheme of arrangement binds all creditors in the affected classes, which can include secured creditors.

Comparison between a creditors' scheme of arrangement and a DOCA

A creditors' scheme of arrangement is generally considered to be costly, time consuming and cumbersome, which is why the voluntary administration and DOCA processes described above are more suitable in many cases. Unlike in an administration and DOCA, the Court is heavily involved in a creditors' scheme of arrangement, and ASIC also has a critical role.

Creditors' schemes of arrangement have some benefits over DOCAs, and are increasingly being used in appropriate cases for corporate insolvency and restructuring in Australia, including because:

- there is no requirement that an external administrator be involved in managing the company during the process - existing management may remain in control;
- the absence of an independent external administrator from the process means that there is greater scope for supporting creditors to pre-pack the scheme of arrangement (compared to an administration and DOCA, where the independent administrator will, as required by professional and statutory obligations, look to independently assess proposals for the future of the company);
- creditors' schemes of arrangement can bind secured creditors of a company;
- creditors' schemes of arrangement can be tailored to only compromise with a particular class of creditors, such as secured creditors, and leave other classes of creditors, such as trade creditors, unaffected (and of course, those other creditors are not entitled to vote on the scheme of arrangement);
- if a third party is contributing funds for the benefits of creditors, that third party can be effectively released from claims by those creditors via a creditors' scheme of arrangement but not via a DOCA. Accordingly, creditors' schemes of arrangement were used to effect a number of settlements in the liquidations of entities that had engaged in securities lending activity as the third party lenders who settled with the liquidators of those entities were able to obtain releases from the affected creditors in consideration for the settlement payments made by them;
- creditors' schemes of arrangement - which involve two separate court hearings - generally cannot be set aside by Court order, unlike a DOCA, and so there is greater certainty as to their ultimate implementation;
- although the proposing of, and entry into, a compromise with creditors by way of scheme of arrangement will usually constitute an insolvency event of default under any well drafted Australian contract, any diminution of value caused by a creditors' scheme of arrangement is better able to be managed than in other types of formal insolvency. If a creditors' scheme of arrangement is done independently of any other formal insolvency regime (such as administration, receivership or liquidation), the company essentially avoids any significant period of external control by an insolvency practitioner. In addition, as a restructured solvent outcome has been pre-arranged, the perceived impact of the process is far less damaging than with other forms of external administration, and stakeholders are able to be proactively managed.

The administration/DOCA procedure, however, does have advantages over a creditors' scheme of arrangement:

- the administration procedure triggers an automatic stay and moratorium during the process, whereas there is no such stay or moratorium available in relation to a scheme of arrangement. Including for this reason, a creditors' scheme of arrangement will generally not be as suitable for compromises with trade and other unsecured creditors as it is for compromises with secured creditors (or particular classes of secured creditors);
- the personal liability of the administrator encourages continued trade with the company by suppliers during the administration procedure;
- the administration and DOCA procedure, generally speaking, is quicker, cheaper and requires reduced disclosure to creditors, when compared to a scheme of arrangement;

- there is no Court approval requirement or ASIC involvement in formulation and approval of a DOCA;
- a DOCA may (with Court approval) facilitate transfer of existing shares in the company to a new shareholder without shareholder approval.

Accordingly, there are advantages and disadvantages to both procedures, and the relative merits of a DOCA and a creditors' scheme of arrangement will be something to be assessed in light of the circumstances of each case.

It is possible for a creditors' scheme of arrangement to be effectuated as part of the liquidation of a company, as has been used in Australia where a fund for the benefit of creditors has been provided by a third party, to enable that third party to be released from claims against it.

To address the absence of a moratorium, it would also be possible for a creditors' scheme of arrangement to be "twinned" with an administration (and DOCA). This technique has also emerged, in similar circumstances, in European restructurings effected through partnering an English creditors' scheme of arrangement with an English administration and company voluntary arrangement.

US Chapter 11 bankruptcy

A company can effectively implement an operational and/or financial restructuring that is binding on dissenters under a confirmed plan of reorganization in a Chapter 11 Case.

A Chapter 11 Case can enable a debtor company to:

- implement operational "fixes" to its business model, such as for example rejecting certain burdensome executory contracts as part of a plan of reorganization
- implement a balance sheet restructuring to re-align the company's debt with existing and projected cash flows available to service that debt, or provide for the conversion of all or certain debt into new equity, through the formulation and confirmation of a plan of reorganization and/or
- attract capital and/or asset purchasers by providing mechanisms for new lenders to "prime" pre-bankruptcy lenders with court approval or for asset purchasers to purchase substantially all of the debtor's assets free and clear of claims and interests, with such claims and interests attaching to the proceeds of sale at closing.

US bankruptcy court decisions have made clear that, broadly speaking, a foreign company may open a Chapter 11 Case with only limited connectivity to the United States.

A Chapter 11 Case can also be used to implement an orderly liquidation during which management remains in control of the liquidation process. A plan of liquidation can also provide for the establishment of a liquidation trust for the benefit of creditors. Such liquidating trusts are commonly used to provide for the sale of assets and pursuit of causes of litigation for the benefit of creditors over a period of time after a plan is confirmed.

In some circumstances, a Chapter 11 Case may be converted to a case under Chapter 7 of the Bankruptcy Code (Chapter 7) whereupon the liquidation of the assets and liabilities of the estate is performed by a Chapter 7 trustee appointed by the Office of the United States Trustee (US Trustee).[2]

A plan in a Chapter 11 Case can also provide for a partial liquidation and/or reorganization, for example by containing provisions for a liquidation trust to handle "bad assets" or to pursue litigation for the benefit of creditors, while the operational assets are retained by the reorganized debtor.

Below is an overview of certain terms and concepts relevant to a Chapter 11 Case in the context of these strategies.

Commencement of the Case

A Chapter 11 Case is commenced upon the bankruptcy court's entry of an "order for relief."

If a debtor files a voluntary petition for relief under Chapter 11, the filing of the petition itself constitutes the order for relief.

In the case of an involuntary petition against a debtor, the order for relief must be entered by the court in order for the Chapter 11 Case to commence. Generally, an involuntary petition may be filed against a debtor by three creditors holding unsecured claims of at least US$13,475 in the aggregate. If the debtor has less than 12 creditors, a single creditor owed at least US$13,475 may file the petition. The petitioning creditor(s)

2 A discussion of the provisions of Chapter 7 is beyond the scope of this document; however, as a basic matter, the goal of a trustee in a Chapter 7 Case is to liquidate the debtor's assets and liabilities and make distributions to creditors on a pro rata basis in accordance with their respective priorities. Generally, a trustee in a Chapter 7 Case has most of the administrative and avoidance powers afforded to a debtor in a Chapter 11 Case, except with respect to the operation of the debtor's business and the ability to implement a plan of reorganization.

must prove that the debtor is insolvent or is not paying its debts as they become due. The debtor may seek to disqualify petitioning creditors if their claims are the subject of a bona fide dispute. An involuntary petition filed in bad faith may result in fines and penalties against the petitioning creditors, including the costs of the debtor's legal fees and expenses.

Characteristically, "first day" orders are also sought on the commencement of the case, which generally seek authorization to pay certain prepetition creditors at the outset of the case so the company continue to operate in the ordinary course. For example, a debtor will typically seek authorization to pay prepetition employee claims (including to maintain existing healthcare plans) and critical vendors, including utilities suppliers, taxing authorities, and insurance providers. Sometimes a debtor will also seek authorization to obtain post-petition financing at the outset of the case. First day motions are generally uncontroversial and readily approved by the bankruptcy court so that the company can continue operations without interruption from the bankruptcy filing.

During the time between the filing of an involuntary petition and the entry of an order for relief by the court, the debtor may continue to conduct business in the ordinary course. Creditors that do business with a debtor during this "gap period" are entitled to priority status for their claims, however, such claims would be junior to any administrative claims that may arise in a subsequent Chapter 11 Case upon entry of an order for relief.

Management

A company in a Chapter 11 Case is known as a "debtor-in-possession" or "debtor."

The same pre-bankruptcy management team continues to manage the assets and affairs of the debtor-in-possession in the ordinary course of business. However, the debtor must seek the approval of the bankruptcy court for any transactions that are deemed "outside the ordinary course of business," including one-off transactions such as transactions for the sale of assets outside the company's core business operations. Chapter 11 Cases generally involve substantial court involvement and significant legal fees.

The debtor-in-possession is deemed, by operation of law, to be a fiduciary for all creditors and shareholders of the company and is required to comply with significant operating and reporting requirements under the Bankruptcy Code and related rules. Any "party-in-interest" in the Chapter 11 Case can seek to replace management with an interim trustee or convert the case to one a liquidation under Chapter 7 which would then be administered by an independent Chapter 7 trustee.

Conversion of the Chapter 11 Case for cause

Throughout the dependency of the Chapter 11 Case any “party in interest” can seek to dismiss the case entirely or convert the case to a liquidation under Chapter 7 if the moving party can prove “cause” exists for either dismissal or conversion.

Some examples of factors that would constitute “cause” include continuing diminution, loss or reduction in value of the debtor’s estate, gross mismanagement or self-dealing by insiders, fraud or abuse of the bankruptcy process, the debtor’s inability to develop or implement a plan of reorganization, or delays that are materially harming creditors.

In the event of conversion, the company’s liquidation would be administered by an independent Chapter 7 Trustee.

Automatic stay (including the invalidation of “ipso facto” provisions)

Upon the commencement of a Chapter 11 Case, the debtor obtains immediate protection from any adverse actions against its assets and operations by virtue of the automatic stay implemented under section 362 of the Bankruptcy Code. Any pending litigation, collection efforts, foreclosure proceedings or similar actions, including by secured creditors, are immediately stayed. The debtor is therefore able to focus on implementing operational fixes, arranging for extensions of credit and otherwise preparing in the early stages of a Chapter 11 Case to build consensus for an eventual plan of reorganization.

The automatic stay is one of the most fundamental debtor protections provided by the Bankruptcy Code. Violations of the automatic stay by third parties that are on notice of the commencement of the case can result in penalties and fines.

Theoretically, the automatic stay applies to all entities, wherever domiciled, and all property of the debtor, wherever located. However, enforcement of the automatic stay may be practically limited by the bankruptcy court's territorial jurisdiction (being the US and its territories) and its jurisdiction over people and entities (those domiciled in the US or with some minimal contact with the US). Considerations of comity with non-US governments may also be relevant. Regardless, entities doing business with US debtors, or that (or may have) have property or a presence in the US, should give careful consideration before violating the automatic stay, even outside the US.

Unless modified by court order, the automatic stay remains in place throughout the Chapter 11 Case. In some cases, debtors incorporate a continuation of the automatic stay and injunctions in the provisions of their proposed plan. Any party considering adverse action against a debtor must therefore first obtain relief from the automatic stay from the bankruptcy court.

Generally, secured creditors may seek relief from the automatic stay on the basis that their collateral is eroding in value and the debtor is not protecting their collateral from erosion thereby entitling them to adequate protection or relief from the automatic stay. Adequate protection may consist of monthly cash payments to compensate for any erosion in value of the collateral, additional or substitute liens (security) on other collateral, or other negotiated protections. Courts will be reluctant to lift the automatic stay where a debtor has a reasonable possibility of reorganizing and the lenders' collateral is necessary for reorganization and will instead award some adequate protection to creditors. Creditors may also seek relief from the automatic stay on the grounds that the debtor lacks equity in the subject property and that the property is not necessary to an effective reorganization. In single asset real estate cases, the automatic stay is automatically terminated if a debtor does not file a plan of reorganization or commence interest payments to the secured lender within 90 days of the petition.

In addition to the protection of the automatic stay, section 365(e)(1) of the Bankruptcy Code also invalidates any provision in an agreement which permits its termination due to the bankruptcy, insolvency or financial condition of a party. In other words, a counterparty cannot terminate the agreement solely because the debtor filed for bankruptcy or because of the financial condition of the debtor after the bankruptcy filing. These "ipso facto" provisions, however, are enforceable prior to the bankruptcy filing. There is a very limited carve-out that provides that an ipso facto clause can be valid if "*... applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties.*" This exception is generally limited to personal service contracts.

Assumption or rejection of executory contracts

One of the most powerful weapons available to a debtor in a Chapter 11 Case is the ability to cherry-pick among its executory (or unperformed) contracts those contracts that it wishes to assume, assume and assign to a third party, and/or to reject as a whole.

While executory contracts cannot be rejected in part, the ability to reject a burdensome executory contract gives the debtor a powerful tool to compel a renegotiation of unfavourable terms in most circumstances. Absent a renegotiation acceptable to the debtor, most executory contracts may be rejected, leaving the party to the contract with an unsecured claim for breach of contract effective as of the date the case was commenced.

In general, if a contract is assignable under applicable state law, the contract may be assumed and assigned to third parties by the debtor. Prior to any assumption, however, the debtor must "cure" the contract by paying any amounts outstanding as of the assumption and assignment.

With respect to timing, as a general rule, the debtor is not obligated to make its decision to assume or reject an executory contract until the confirmation of a plan. However, certain types of executory contracts must be assumed or rejected within specific time frames. For example, commercial real estate leases must be assumed or rejected within 120 days, subject to one 90 day extension. Notwithstanding these deadlines, a party to the contract may request the bankruptcy court to set an earlier deadline based upon the facts and circumstances particular to that party.

Sale of assets

A debtor in a Chapter 11 Case may seek bankruptcy court approval to sell some or all of its assets "outside the ordinary course of business" under section 363 of the Bankruptcy Code, free and clear of claims and interests, with such claims and interests attaching to the proceeds of sale at closing (363 sale).

It is well established that the debtor need only show "good business reason" for such a sale, even if the sale will be tantamount to a liquidation with creditors left to assert their claims against the sale proceeds and any assets excluded from the sale that remain in the estate.

For a potential purchaser of assets, a 363 sale provides the best and clearest title in the fastest time frame while also providing bidding protections such as break-up and reimbursement fees similar to those available outside of bankruptcy.

A 363 sale can be an effective tool for leaving "bad assets" and "bad liabilities" (such as legacy liabilities, mass tort claims and successor liability claims) with the estate while allowing the purchaser to acquire only the valuable assets and related necessary operational liabilities such as owed to necessary vendors and executory contracts that the purchaser chooses to assume.

Typically, a 363 sale must be made subject to a market test. The most common procedure is to conduct an open auction of the assets, with a "stalking horse" bidder (with the usual deal protections) first negotiating the terms of a final sale the terms of which are disclosed and which provide the floor bid at the auction. If the debtor has conducted significant marketing and it is clear there is only one bidder, or if the value of the assets do not justify the expense of an auction process, a 363 sale may be conducted in a private sale, with the material terms of the deal disclosed and subject to objection by creditors and other interested parties.

With respect to secured creditors, the proposed sale price must be "greater than the aggregate value of all liens (security interests)" over the subject collateral, unless the secured creditor's interest is the subject of a bona fide dispute or it consents to the sale. Courts are divided whether this means greater than the face amount of the liens (security) or greater than the value of the subject collateral. It is generally accepted that secured lenders are entitled to credit bid their liens up to the amount of their secured claim at any 363 sale which includes assets subject to their collateral.

Primarily due to the protracted process and substantial expense associated with a Chapter 11 plan of reorganization, and the scarcity of lenders willing to provide debtor-in-possession or DIP financing (or to provide DIP financing on terms that do not compel a 363 sale), 363 sales of a debtor's business as a going concern have become a growing trend.

Avoiding powers

The Bankruptcy Code grants a debtor the authority to avoid certain transfers and make recoveries for the benefit of the estate. These avoiding powers include the power to:

- set aside preferential transfers made to non-insider creditors within 90 days prior to the petition and with respect to insiders within one year prior to the petition. Generally, "insiders" are directors, officers, and other control persons or their relatives, and any affiliated entities, and any insider of those entities;
- undo security interests and other pre-petition transfers of property that were not properly perfected under non-bankruptcy law at the time of the commencement of the Chapter 11 Case;
- recover fraudulent transfers made, generally within a 2 year period prior to the petition date for transfers made with actual intent to hinder, delay, or defraud creditors and within a 4 year period prior to the petition for transfers made for less than reasonably equivalent value while the debtor was insolvent, or was rendered insolvent or with unreasonably small capital; and
- pursue remedies available under state law such as bulk transfer claims.

A full discussion of remedies against insiders and non-insiders is beyond the scope of this document, however, the debtor's avoidance powers can be powerful tools in negotiations with secured creditors that may have technical flaws in the perfection of their collateral or that may have participated in pre-bankruptcy leveraged buy-outs, spin-offs or similar restructuring transactions that may be attacked as fraudulent conveyances.

Claims and priority

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

The debtor is required to file schedules with the court listing all of its creditors, and may list creditors as holding disputed, unliquidated or contingent claims. Even if listed as undisputed, a creditor should file a "proof of claim" with court by the claims bar date set by court order. The proof of claim should set forth all of the legal and factual bases for the creditor's claim, attach supporting documentation, and reserve the right to amend the claim to a higher amount with respect to any of the claims asserted in the proof of claim.

Claims are generally treated in accordance with the priority scheme contemplated in section 507 of the Bankruptcy Code pursuant to which the classes of claim and interest holders are generally categorized according to the following priority:

> *Secured creditors* — individuals or entities holding claims against the debtor that are secured by a lien (security interest) over property of the debtor;

Unsecured creditors entitled to priority — claims incurred during administration of the Chapter 11 Case and that were necessary or benefitted the preservation of the debtor's estate (administrative expenses), certain reclamation claims, individuals or entities holding claims statutory priority over other unsecured creditors (e.g. certain wage and benefit claims, tax and governmental obligations);

General unsecured creditors — individuals or entities holding allowed unsecured claims; and

Equity security holders — individuals or entities holding interests in equity securities of a debtor.

DIP financing

While a debtor may continue to engage in "ordinary course" transactions during the Chapter 11 Case, and parties to such transactions are automatically entitled to administrative claim status, financing transactions are typically viewed as out of the ordinary transactions that require court approval.

A debtor can seek to entice lenders to provide "debtor-in-possession financing" or "DIP financing" as it is widely known with a range of tools that are routinely approved by bankruptcy courts.

First, the debtor can offer the proposed lender priority administrative claim status or a "super-priority" administrative claim (having priority over all other administrative claims). However, lenders typically require more than a simple administrative priority in order to lend to a company in a Chapter 11 Case as they are understandably reluctant to run the risk of administrative insolvency (insufficient funds to pay administrative claims in full).

At the next level, the debtor may seek court approval to grant the proposed lender a lien (security interest) over its unencumbered assets.

Third, the debtor may seek court approval to grant the proposed lender a lien (security interest) over encumbered assets that is equal or senior to existing liens. However, in this case, the debtor must establish that the existing lender is adequately protected notwithstanding the proposed senior or "priming" liens, potentially resulting in evidentiary hearings with competing presentations as to the value of the collateral at issue.

Rights of secured creditors

Secured creditors are bound by the automatic stay. However, a secured creditor may seek relief from the automatic stay at any time in the Chapter 11 Case to commence or continue pre bankruptcy foreclosure proceedings. State law foreclosure proceedings to enforce security typically take anywhere from 12 to 18 months to conclude, and in some cases longer, and can be thwarted by the debtor filing for Chapter 11 shortly before, or upon, a foreclosure judgment being obtained.

Generally, secured creditors are entitled to retain their pre-petition liens (security interests) over the same collateral (or the proceeds thereof) and to be paid in full plus interest at their contractual rate of interest, provided there are no defects or grounds for the debtor to seek to avoid those liens (for example, if such liens are unperfected or can be set aside as fraudulent transfers or preferences).

However, a secured creditor's claims may be bifurcated into a secured and unsecured claim under section 506 of the Bankruptcy Code, in cases where the collateral is worth less than the face amount of the secured creditor's claim. A secured creditor may avoid the effects of such bifurcation by making an election under section 1111(b) of the Bankruptcy Code to retain the full amount of its lien on the collateral thereby waiving the right to receive any distributions on the unsecured portion of its claim on confirmation of the plan or reorganization but retaining the hope that it may recover a higher amount if the collateral increases in value after confirmation of the plan.

The intricacies and strategies related to a section 1111(b) election are beyond the scope of this document. However, it is worth noting that the secured creditor would typically take into account the likelihood of whether its unsecured claim would enable it to assert a blocking position in the unsecured creditor class thereby preventing the debtor from obtaining the requisite acceptance of its reorganization plan by at least one impaired class of claims. Such a blocking position would typically enable the secured creditor to gain leverage to negotiate better treatment of its secured claim under the debtor's plan of reorganization.

Another strategy is to make the election in cases where the debtor's revenues would be insufficient to make deferred cash payments having a present value equal to the creditor's fully secured claim, thereby defeating any attempted cram-down of the plan of reorganization (discussed below).

Players in the formulation of a Chapter 11 plan of reorganization

There are multiple players in a Chapter 11 Case with seats at the proverbial table of negotiations over a plan of reorganization.

The US Trustee

The US Trustee, a division of the Department of Justice, is charged with oversight of the US bankruptcy system. A local representative of the US Trustee is typically assigned to monitor every Chapter 11 Case.

The US Trustee is responsible for the appointment of statutory committees of creditors and equity holders in a Chapter 11 Case, typically comments on applications to retain professionals, and can be heard on any issue in the case. The US Trustee typically intervenes to ensure compliance with the operating and reporting rules promulgated by the US Trustee and concerns regarding overall fairness to creditors.

The Creditors' Committee

The US Trustee typically appoints an official committee of unsecured creditors in almost every Chapter 11 Case (the Creditors' Committee) consisting of members that are willing to serve, and hold the seven largest claims against the debtor. The US Trustee usually sends out invitations to serve to the debtors' 20 largest unsecured creditors, as listed on the petition filed by the debtor upon commencing the Chapter 11 Case, and selects among the largest holders that respond in the affirmative.

Members of the Creditors' Committee serve as fiduciaries for the interests of all creditors during the case and are reimbursed for out-of-pocket expenses incurred. The Creditors' Committee may retain counsel, and sometimes financial advisors, at the expense of the debtor's estate to represent the interests of unsecured creditors during the case.

The Equity Committee

In certain cases, except in cases where a debtor is deemed to be hopelessly insolvent, the US Trustee may appoint an official committee of equity security holders, typically consisting of holders of the seven largest amounts of equity securities of the debtor.

The members of the Equity Committee also serve as fiduciaries during the Chapter 11 Case, but for holders of equity securities, and are entitled to retain counsel, and typically financial advisors, at the expense of the debtor's estate.

Other parties

In some cases, active players can include individual or a committee of bondholders, secured creditors, unions, and parties to critical executory contracts.

Disclosure Statement

A debtor is required to prepare and distribute a disclosure statement prior to solicitation of acceptance of its plan of reorganization. The disclosure statement must contain adequate information regarding the assets, liabilities and affairs of the debtor so as to enable the holder of a claim or interest to make an informed judgment about the proposed plan of reorganization.

Filing of a plan

During the first 120 days after commencement of the Chapter 11 Case, only the debtor may file a proposed plan of reorganization. That period of "exclusivity" may be extended by the court for cause to a date that is not more than 18 months after the petition date. The debtor has an additional 60 days after the filing of its plan of reorganization to solicit acceptances of the plan from each impaired class. Voting does not take place at a physical meeting but by mail solicitation.

If the debtor fails to file a plan of reorganization within the fixed deadline, or if the plan is not accepted by the creditors within the deadline for soliciting acceptances, any "party in interest" may file its own competing plan of reorganization. The typical time from the filing of a Chapter 11 Case to confirmation of a plan of reorganization is 18 months and sometimes up to two years or more. This time can be shortened significantly with the use of a "prepackaged plan" (discussed below).

Content of a plan

A proposed plan of reorganization must meet certain minimum requirements, including that it must:

- designate all classes of claims and interests (substantially similar claims or interests must be categorized in the same class);
- specify which classes are impaired and not impaired;
- specify which classes are entitled to vote (only impaired classes are entitled to vote);
- specify the treatment of all classes;
- treat all members within a class equally;
- provide adequate means to implement the plan; and
- not contain any provisions that violate the Bankruptcy Code.

Plans of reorganization can provide for financial or operational overhaul of the debtor's business that includes sales of assets, modification or refinancing of secured debt, assumption or rejection of contracts, releases in favour of the debtor's board of directors, management and professionals, amendments to the debtor's corporate charter, the cancellation of existing stock and issuance of new stock, and the swapping of debt for equity.

Prepackaged plans

Prepackaged plans of reorganization can provide a debtor the significant advantages of a Chapter 11 Case without the protracted delay and substantial expense often associated with a typical bankruptcy case.

In a prepackaged Chapter 11 Case the prospective debtor can negotiate the terms of a plan, acceptances and rejections before initiating a Chapter 11 Case. Typically, a committee of creditors is formed and counsel is retained to represent those creditors and negotiate the terms of the plan. The debtor may form more than one committee, for example one for bondholders and another for trade creditors. Once committee support is secured, the plan and disclosure statement are sent to impaired classes of creditors for approval with the support and recommendation of the committees.

Usually, the plan and disclosure statement are filed immediately upon commencement of the Chapter 11 Case and the pre-bankruptcy class acceptances are then used at an expedited confirmation typically held within 30 to 90 days.

A prepackaged plan can be an effective tool for persuading dissenting bondholders, for example, to support a restructuring that is likely to be implemented in a Chapter 11 Case. The risks of a prepackaged plan arise mostly from dissenting creditors that may seek to take action against the debtor or property of the debtor during the plan negotiation process while there are no automatic stay limitations.

Plan confirmation

In order for the bankruptcy court to confirm its proposed plan of reorganization, a debtor must meet all of the requirements of section 1129 of the Bankruptcy Code. These requirements include establishing that:

- at least one impaired class has accepted the plan and, with respect to any non-accepting class, the requirements for a "cram-down" have been met (see below);
- the plan meets the "best interests of creditors test" which requires in essence that each impaired class has either accepted the plan or receives no less than it would receive in a liquidation under Chapter 7;
- the plan is feasible (not likely to be followed by a liquidation or need for further reorganization);
- the plan was proposed in good faith; and
- the plan does not violate any provisions of the Bankruptcy Code.

Voting

With respect to an impaired class of creditors, the class is deemed to accept a plan if voting creditors that hold more than two-thirds in dollar amount and more than one-half in number of the claims in the class vote to accept the plan, excluding any votes not solicited or cast in good faith, as determined by the court on request of any "party in interest".

"Cram-down"

Provided all of the requirements set forth in section 1129 of the Bankruptcy Code are met, the bankruptcy court may confirm a plan notwithstanding the rejection of the plan by one or more classes of impaired creditors provided the court determines the plan "does not discriminate unfairly" and is "fair and equitable" with respect to each impaired class that has not accepted the plan. This is referred to as a "cram-down."

The "fair and equitable" test for a plan cram-down differs for secured creditors, unsecured creditors, and equity holders. Generally, however, the test for unsecured creditors and equity holders requires that dissenting junior classes receive nothing on account of their claims unless senior classes are paid in full under the so called "Absolute Priority Rule" (discussed below).

With respect to secured creditors, the "fair and equitable" test generally requires that each secured creditor keep its lien (security interest), receive deferred cash payments equal to at least the allowed amount of its lien claim; and as of the effective date of the confirmed plan, the value of the payments to be made must have a present value equal to at least as much as the secured creditor's interest in the collateral within a reasonable time after confirmation (for example, from a proposed sale of assets contemplated in the plan). If a secured creditor's claim exceeds the value of its collateral, it retains its lien on the collateral or proceeds thereof and may submit an unsecured claim for the deficiency.

The Absolute Priority Rule

The priorities in Chapter 11 were detailed under the heading "Claims and Priority."

Under the Absolute Priority Rule, if a class is impaired and votes against confirmation of a proposed plan, then the class must be paid in full (including unpaid accrued interest of secured creditors), and if paid less than in full, then no junior class of claims or interests may receive anything of value under the plan of reorganization. For this reason, in almost all cases, existing equity is cancelled.

However, in cases where "old equity" wishes to retain an interest in the reorganized debtor, the old equity holders may argue that a "new value exception" to the Absolute Priority Rule applies and must establish the following at confirmation that:

- they are making a new contribution in money or money's worth;
- the contribution is reasonably equivalent to the value of the interest retained in the reorganized debtor; and
- the new value contribution is necessary for implementation of a feasible plan of reorganization.

Effect of confirmation of the plan

Once the plan of reorganization is confirmed, the debtor's assets and liabilities are subject to the terms of the plan and all creditors and "parties in interest" are bound to the terms of the plan, whether or not they voted for the plan. Typically, the bankruptcy court retains jurisdiction to enforce the terms of the plan and resolve any disputes arising from the plan or that impact distributions to be made under the plan.

If a plan is not confirmed, the debtor and/or other "parties in interest" may seek to propose an alternative plan, as the debtor's exclusive period to propose a plan will have lapsed at this point. Parties may also seek to convert the case to a liquidation if there is no reasonable prospect of reorganization.

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