Appendix C Summary of US Chapter 11

The Advisory Committee thanks Beatrice O'Brien, Director, New York Bar Review Pty Ltd, for her assistance in preparing this summary.

Prerequisites for initiating the procedure

A company may seek the protection of Chapter 11 of the US Bankruptcy Code by filing a petition in the Bankruptcy Court.

The Code does not have any financial stress or other prerequisite test for entry into Chapter 11. However, some US Bankruptcy Courts have imposed a 'good faith' requirement on applications for Chapter 11 protection. This can be used, for instance, to stop clearly solvent companies obtaining the protection of Chapter 11 simply to gain a debt holiday or some other commercial advantage.

The Courts may also at any time dismiss Chapter 11 proceedings if they consider that a company can neither reorganise nor provide a better return to creditors by the company's assets being sold over time.

Debtor in possession

A company that has gone into Chapter 11, known as a debtor in possession (DIP), retains control of its own affairs, though all or some of the incumbent board or other managers may be replaced.* The DIP can also choose to employ outside expertise, such as 'turnaround' professionals, to assist the rehabilitation.

---

* R Broude, 'How the rescue culture came to the United States and the myths that surround Chapter 11' *Australian Insolvency Journal* April/June 2003 4 at 8 quotes research showing that a large proportion of managers of companies that go into Chapter 11 subsequently lose their positions in that company: 'The debtor in possession is the company, not the individual. Companies survive; managers most often do not, at least not in their jobs'.

While the board of the DIP must approve certain actions, for instance the filing of a plan of reorganisation, its role in a Chapter 11 proceeding is subject to the supervisory role of the Bankruptcy Court.

Role of the Court

The Bankruptcy Court is closely involved in the corporate reorganisation process under Chapter 11. For instance, its prior approval is necessary before a DIP may act outside the ordinary course of its business. Also, the Court can replace the board of the DIP with a trustee if it considers that the board has been fraudulent, dishonest or incompetent or has grossly mismanaged the company. Furthermore, creditors can challenge managerial decisions in Court or request the Court to appoint an examiner, whose role may include providing information to the Court or mediating disputes between parties in Chapter 11 litigation. Also, a reorganisation plan cannot proceed without the prior approval of the Bankruptcy Court.

Committee of creditors

The committee of creditors plays a vital and significant role in the Chapter 11 process. These committees are entitled to employ lawyers, accountants and other professionals to review the directors' proposals and, if necessary, their conduct. The costs of these experts are met from the company's assets. An active committee enables the DIP's creditors to have an effective voice in that company's reorganisation and to ensure that its managers remain accountable for their actions. The costs of these committees may be relatively more burdensome for smaller than for larger enterprises.

Personal liability of directors for insolvent trading

The board of the DIP retains control of the company throughout the Chapter 11 rehabilitation period, subject to the supervision of the Bankruptcy Court. However, the issue of director liability for insolvent trading does not arise in the US, which has no equivalent of the Australian insolvent trading provisions.

Automatic stay

The initiation of a Chapter 11 proceeding immediately freezes the rights of all creditors, secured as well as unsecured, as at that date. The freeze, known as the automatic stay, remains until the Chapter 11 proceedings are completed or the Court, after notice and a hearing, modifies that stay.

This automatic stay is one of the most important features of the US bankruptcy system. As a result, all creditors of the DIP are prohibited from taking any steps to collect on debts, even if that company has defaulted on its obligations. This freeze applies to all property of the DIP, including security previously seized by a secured creditor, but not yet sold by that creditor before the petition is filed. There is no equivalent of the Australian VA provisions permitting some secured creditors to exercise their proprietary rights, regardless of a VA.

There is a statutory prohibition on creditors enforcing ipso facto clauses, other than in limited circumstances. The right of set-off is preserved by the Bankruptcy Code, though it is subject to the automatic stay.

A secured creditor may seek to lift the automatic stay on the grounds that the value of its security is declining and that the DIP has failed to provide it with 'adequate protection'.

The reorganisation plan

In order to emerge from bankruptcy protection, a DIP must have its reorganisation plan confirmed by the Bankruptcy Court. The Court will consider whether each class of creditors has approved the plan. However, under the 'cramdown' section of the Bankruptcy Code, the Court may approve a reorganisation plan, despite the objection of one or more impaired classes of creditors, if at least one impaired class assents and the proposed plan is found by the Court to be 'fair and equitable' to any objecting class. A class is impaired if the plan would alter any of the legal rights of its members compared with their pre-Chapter 11 position.

The DIP's ability to effect a freeze or automatic stay on creditors' rights by commencing Chapter 11 proceedings, together with the

cramdown rules, enhance the opportunities for its management to negotiate with creditors at an early stage on the design of a reorganisation plan. Equally, however, secured creditors who choose to provide a company in financial distress with further financing may have considerable power over the future conduct of that company and the terms of any reorganisation plan through the terms and conditions they can impose on that funding.

Over time, the Chapter 11 process has become more settled, with rules that are widely understood and applied more uniformly. In consequence, debtors and creditors have increasingly negotiated reorganisation plans outside Chapter 11. This method of informal pre-Chapter 11 negotiation (known as a 'pre-pack') allows the debtor company to avoid the expense of seeking protection under Chapter 11. Typically, a pre-Chapter 11 reorganisation plan is implemented by a formal Chapter 11 filing.

Timetable

US Chapter 11 generally gives the DIP the exclusive right for four months to file a reorganisation plan, with another two months for it to be accepted by creditors. These periods may be, and are routinely, extended by the Bankruptcy Court.

The US legislation does not have any prescribed period of time within which the reorganisation plan must be completed.

Post-petition financing

The DIP may incur ordinary course debt without prior court approval. However, all post-petition financing must be approved by the Bankruptcy Court. In either case, the debt is an administrative expense and takes priority over unsecured pre-commencement debts.

Lenders may be unwilling to advance an unsecured loan to a DIP because of lack of priority. To overcome this, the Court has power, after notice to creditors and a hearing, to authorise a loan secured over any unencumbered assets of the DIP. The Court may even permit a loan that ranks equally with, or has priority over, the claims of existing secured creditors, provided that those secured creditors receive adequate protection.

The Bankruptcy Court can also grant a DIP the right to use as a security for a new borrowing excess value in any collateral that has already been pledged to another secured lender. The DIP must demonstrate that the prior secured lender is 'adequately protected' in that the amount of loan outstanding to that lender is substantially less than the total value of the collateral. The 'cushion of collateral' available for the new loan would be the difference between the value of the security and the lesser amount owed to the original security holder (being the principal plus any accrued interest).

Ipso facto clauses

A DIP cannot be placed in default merely because it has filed for protection under Chapter 11. However, in limited circumstances, a counterparty may enforce rights arising in consequence of this filing. For instance:

- a lender to a company that goes into Chapter 11 can rely on an ipso facto clause to the extent of not having to provide further funds to the company, though it cannot accelerate repayments
- a person can rely on an ipso facto clause to terminate a contract for the provision of personal services (in comparison, a creditor providing goods to the company cannot rely on an ipso facto clause to refuse to supply further goods, but is entitled to immediate payment for any goods supplied while the company is under Chapter 11).

It also appears that US law allows anyone who has agreed to take up shares in a company that has subsequently gone into Chapter 11 to decline to do so, relying on an ipso facto clause.

Voiding antecedent transactions

A DIP may commence an action to recover payments made on account of antecedent debts prior to the commencement of the Chapter 11 proceeding. In addition, that company may commence an action to avoid certain fraudulent transactions. In certain circumstances, the committee of creditors may also seek to avoid certain transactions.

Assigning or terminating executory contracts

A DIP may assign an executory contract, regardless of its terms, provided that the contract is of a type that is generally assignable and the assignee gives appropriate assurances of future performance.

A DIP may also terminate an executory contract, regardless of its terms, with the counterparty having a corresponding claim.

Exchange listing

US listed entities subject to Chapter 11 can remain listed, and therefore their shares can be traded, on the stock exchange.

Comparative table

	VA	US Chapter 11
Prerequisites	Insolvency or likely insolvency.	Good faith only.
Who can commence the procedure	The directors, a liquidator or provisional liquidator or a substantial chargee.	The directors.
Role of the court in commencing the procedure and approving the plan	No mandatory role in either situation, though the court has various ancillary powers exercisable on application.	Procedure initiated by petition to the court. Continuing close court involvement in the rehabilitation procedure, including final approval of plan.
Who controls the company during the rehabilitation procedure	The administrator, who must be a registered liquidator.	Management, subject to court supervision. The court may replace management under certain, rare, circumstances.
Committees of creditors	Limited functions, namely to consult with the administrator in relation to the administration and consider reports by the administrator.	Major role. Can employ professional advisers at the company's expense.
Information to creditors	Report by the administrator about the company's business, property, affairs and financial circumstances and a recommendation about what is to be done.	Court-approved disclosure statement.
Moratorium on claims against the company	Automatic moratorium, with significant exceptions for some secured creditors and property owners.	Automatic moratorium, which applies to all secured and unsecured creditors.
Ability of contractual counterparties to enforce ipso facto clauses	Yes.	Only in limited circumstances.
Liability for goods and services	Administrator personally liable, with a right to an indemnity out of the company's assets.	Company liable for post-Chapter 11 debts, which have a priority over pre-Chapter 11 debts.
Loan financing during rehabilitation procedure	Lender is an ordinary unsecured creditor of the company.	The court can give a lender a priority over all existing unsecured creditors and, if necessary, over existing secured creditors.

	VA	US Chapter 11
Who devises rehabilitation plan	The administrator.	Management of the company, usually in consultation with professional advisers, proposes the reorganisation plan. That plan must be approved by the board prior to filing in the Bankruptcy Court. The court may allow any party-in-interest to file a reorganisation plan.
Voiding antecedent transactions	No.	Yes.
Unilateral assignment or termination of executory contracts	No.	Yes.
Time to develop rehabilitation plan	Approximately one month, subject to the court extending the period.	120 days to file a plan, subject to the court extending the period.
Approval of rehabilitation plan	One meeting of all creditors.	The reorganisation plan must be approved by at least one class of impaired creditors. If all classes of impaired creditors do not approve the plan, the court may still approve it if it is fair and equitable.
Majority required to approve the plan	50% majority by number and by value of all the creditors who vote.	Two-thirds in amount, and more than one-half by number, of creditors who vote, class by class. A dissenting class can be overridden by the 'cramdown' rules.
Rehabilitation plan binding secured creditors	Yes, if the secured creditor agrees or the court so orders.	Yes, provided: • if impaired class of secured creditors, at least one impaired class assents • the plan is fair and equitable.
Rehabilitation plan discriminating between creditors	The creditors can approve a deed that discriminates against particular creditors.	Under the 'absolute priority' rule, senior creditors are paid before junior creditors. All creditors are paid before shareholders. One class cannot receive less than another class with identical priority without the consent of its members.
Time to implement rehabilitation plan	No prescribed limit.	No prescribed limit.

Appendix D Comparison of VA and schemes of arrangement

	Creditors' Scheme of Arrangement	VA
Prerequisite for commencing procedure	None.	Insolvency or risk of insolvency.
Can the directors commence the procedure	Yes.	Yes.
Who controls the company during the procedure	The directors.	An external administrator.
Personal liability of directors for any insolvent trading during the procedure	Yes.	No.
Court	Orders creditors' meetings and approves scheme. Public interest criteria for approving schemes.	No automatic role, however parties and other interested persons may apply to the court for intervention. No need for public interest criteria.
ASIC	Must be given draft scheme and explanatory statement and may address the court.	No role, unless on review of deed.
Information	Detailed explanatory statement containing all of the information known to the company that is material to a decision whether to approve the scheme and including copies of statutory accounts and a report as to affairs.	Report by the administrator about the company's business, property, affairs and financial circumstances and a recommendation about what is to be done. The report must be compiled quickly, in about three weeks, unless the court extends the time. In consequence, the report is often less detailed than for schemes.
Moratorium on claims against the company	Moratorium prior to final approval of scheme on application to court, but only for proceedings on foot at the time of that application.	Automatic moratorium once procedure commenced (with some exceptions).
Moratorium on directors' personal guarantees	No.	Yes, unless the court permits enforcement of the guarantee.
Method of approval	Meetings of each class of creditors. Each secured creditor may form a separate class.	One meeting of all creditors.

	Creditors' Scheme of Arrangement	**VA**
Majority	50% by number, and 75% by value, that vote at the meeting of each class.	50% majority by number and by value of the creditors, voting at a single meeting.
Discrimination between creditors	Not permitted. The principle of equality applies.	The creditors can approve a deed that discriminates against particular creditors.
Binding secured creditors	Yes, for any class that approves.	Yes, for any secured creditor that agrees or if the court so orders.
Shareholders	No role, but may appear as person interested when court orders creditors' meetings and approves scheme. Court may take their interests into consideration.	No role, unless they seek review of deed (for example where there is a prospect of an insolvent company trading out of its insolvency). They are bound by the deed.
Special provision for corporate groups	Yes—consolidation of meetings where a scheme involves multiple subsidiaries.	No.
Can be used for reconstruction	Yes.	Yes.
Reconstruction provisions	Yes—section 413.	No.
Assignment of liabilities	Yes.	No, other than through novation.
Acquisitions excluded from takeover provisions	Yes—Item 17 of s 611.	No.
Fundraising disclosure exemption	Yes—s 708(17).	No.
Product disclosure statement exemption	No.	No.