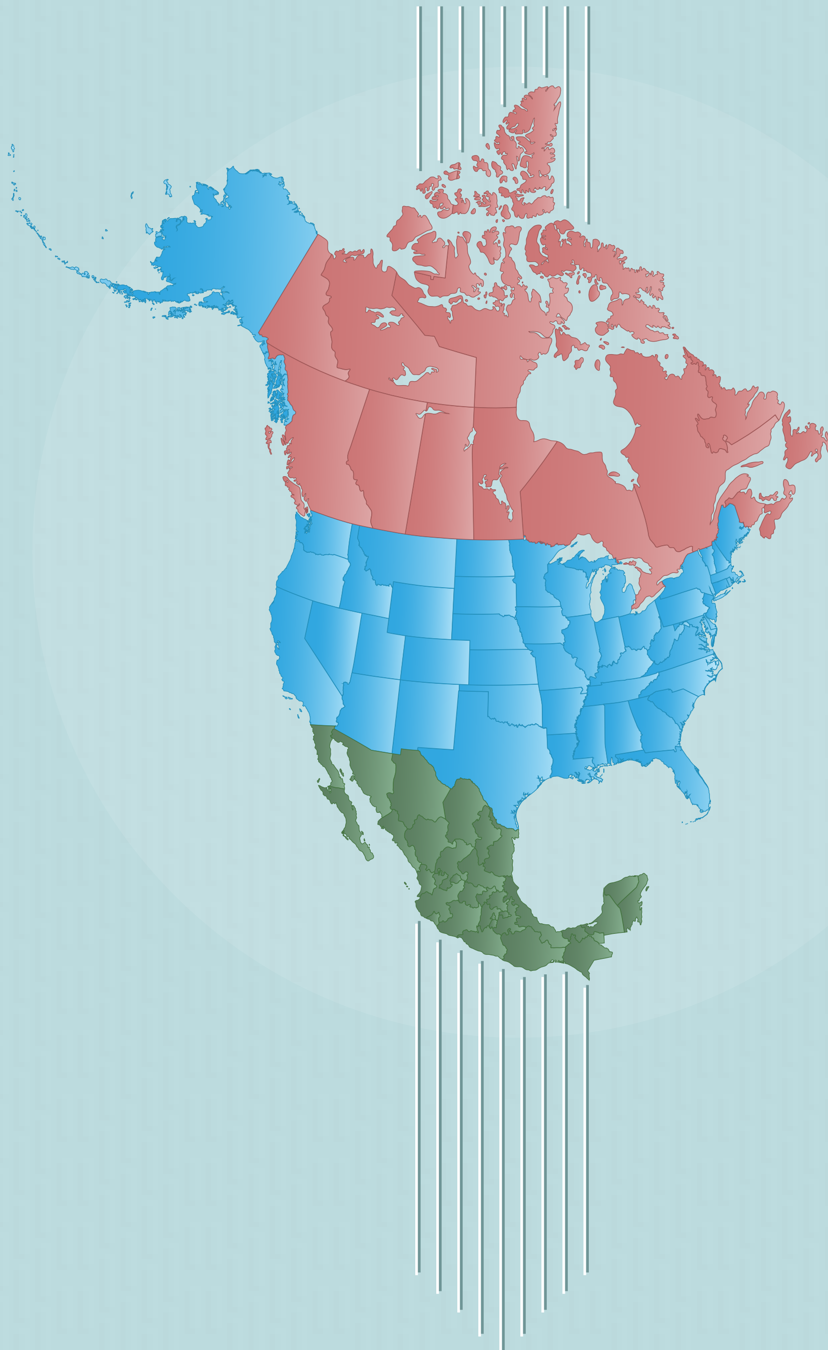
ICTF
THE ASSOCIATION OF INTERNATIONAL CREDIT AND TRADE FINANCE PROFESSIONALS

INSOLVENCY LAWS IN CANADA, MEXICO AND THE U.S.

A COMPARATIVE LAW ANALYSIS FOR TRADE CREDITORS



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

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1. Insolvency laws and courts overview

UNITED STATES:

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

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

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

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

CANADA:

Canada is a federal state made up of one federal, ten provincial and three territorial governments. The authority to enact legislation with respect to various matters is divided between the federal Parliament and the provincial legislatures, and bankruptcy and insolvency fall within the legislative competence of the federal Parliament. The Canadian insolvency regime is centered around two pieces of federal legislation, the *Bankruptcy and Insolvency Act* (the "**BIA**") and the *Companies' Creditors Arrangement Act* (the "**CCAA**").

There are two separate reorganizational regimes in Canada, the BIA and the CCAA. The BIA regime is generally used in smaller, less complicated reorganizations and contains a comprehensive set of rules and guidelines within which the liabilities of a debtor can be rearranged while, at the same time, providing temporary relief from creditors. The CCAA, on the other hand, is a very brief statute that is intended to be a more flexible, judicially driven reorganizational regime. Both the BIA and the CCAA reorganizational regimes can be used by foreign corporations conducting business or having assets in Canada.

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Under the BIA, both liquidations and reorganizations take place with a relatively small degree of court intervention. The statute contains extensive provisions that deal with almost all of the matters involved in the liquidation or reorganization of an insolvent debtor including the criteria for commencing proceedings, the administration of the estate once a proceeding has been commenced, the rights of the secured and unsecured creditors of the debtor, the procedures for proving claims, priorities among the various creditors, and the augmentation of the estate.

The use of court- and privately-appointed receivers is common in Canada. It is common for security agreements to permit the secured creditor to appoint a receiver of its collateral on default. In addition, the BIA and various pieces of provincial legislation provide for the appointment of a receiver on the application of a secured creditor. The BIA and various pieces of provincial legislation impose duties and obligation on court- and privately-appointed receivers.

It is important to understand that while the Canadian insolvency regime is centered on federal legislation, when viewed as a whole, it is a mosaic of both federal and provincial laws. Under the division of powers between the federal and provincial governments, the provincial legislatures are assigned responsibility for enacting laws in relation to "property and civil rights." The assignment of this head of legislative competence to the provinces has had a major impact on the Canadian insolvency regime because it has been interpreted by the courts to provide the province with the authority to pass laws that deal with substantial portions of the debtor/creditor relationship. The provinces have, for example, enacted legislation respecting fraudulent conveyances, receiverships, secured creditors and other commercial law matters that are relevant in an insolvency. As a result, the administration of an insolvency in Canada requires an understanding of relevant provincial laws, as well as the BIA and the CCAA.

There is no dedicated insolvency or bankruptcy court in Canada. The BIA and the CCAA both assign jurisdiction to existing courts in each in the provinces. That being said, there are often Judges assigned specifically to deal with insolvency proceedings in large commercial centers such as Toronto and Montreal.

MEXICO:

Law

Insolvency law in Mexico is set forth in the *Ley de Concursos Mercantiles* (LCM). This law is federal regulation and has nationwide application.

Under article 1, LCM is expressly declared as public order and general interest law because the Mexican State is interested in both preservation of enterprises and the avoidance of generalized breaching of payment obligations that may give rise to either the viability or the existence of such undertakings.

Where the LCM is not specific on regulation, the Commercial Code, commercial legislation in general, the Federal Code of Civil Proceedings and the Civil Code applicable in Federal matters are supplementary law.

Besides the LCM, some decisions of Federal Collegiate Circuit Courts and the Supreme Court are of mandatory application.

Bankruptcy proceedings under LCM are reserved for individuals and businesses that engage in commercial activities on a regular basis.

Currently, commercial bankruptcy proceedings ("*Concurso Mercantil*") have two different (and generally successive) stages, independently of the person filing the request: (i) Conciliation[1]; and, (ii) Bankruptcy *stricto sensu* (LCM §2). Conciliation is aimed to reach an agreement with recognized creditors in order to preserve the company, while bankruptcy seeks its sale.

Courts

Bankruptcy is of federal jurisdiction only; therefore a District Court Judge in the state where the company subject to the bankruptcy procedure is headquartered will hear bankruptcy claims.

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[1] The only case whereby it will not be necessary to exhaust the conciliation proceedings is when the failing company files for bankruptcy directly.

Decisions issued by the District Court Judge are subject to appeal before a Unitary Circuit Court Judge.

2. Informal insolvency "proceedings"

UNITED STATES:

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

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

CANADA:

Insolvent business are not required to initiate formal insolvency proceedings. An insolvent business can attempt to restructure their obligations, the operations and their contracts informally by direct negotiation with creditors. These informal "proceedings" are typically known as "work-outs" and often result in forbearance agreements, which are contracts between the debtor and their creditors.

MEXICO:

Although there is no informal or extrajudicial proceedings set forth in the LCM, debtors are not constrained to engage in negotiations with creditors and corporate restructuring in an attempt to avoid bankruptcy.

3. Commencement of formal insolvency proceeding

a. Jurisdictional requirements

UNITED STATES:

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

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

CANADA:

There is no requirement in the BIA that a business debtor be incorporated in Canada in order for it to become bankrupt in Canada. The BIA is applicable to any corporation, wherever incorporated, that does business or has assets in Canada. It is, therefore, possible for a foreign corporation with assets in Canada to be liquidated under the BIA. The fact that a corporation has already become bankrupt in a non-Canadian proceeding is not a bar to the commencement of a Canadian bankruptcy.

The BIA provides for both voluntary and involuntary liquidation proceedings. A debtor can become bankrupt voluntarily by making an assignment for the general benefit of its creditors or can be petitioned into bankruptcy, i.e. involuntarily placed into bankruptcy, by its creditors. A debtor can also become bankrupt as a result of the failure of a BIA reorganization (discussed later).

a. Assignment

To commence a voluntary bankruptcy under the BIA, a debtor must have obligations owing to its creditors of at least CAD1,000, and either be incapable of meeting its obligations, have ceased paying its obligations as they come due or have liabilities totalling more than the value of its assets. A bankruptcy is commenced through the debtor filing standard form documentation to assign its

property for the benefit of its creditors and naming a trustee to administer the estate.

b. Bankruptcy Applications

Involuntary bankruptcy proceedings can be commenced by any creditor, whether resident in Canada or not, having an unsecured claim of at least CAD1,000. The process is initiated by the creditor making an Application to the court seeking that a Bankruptcy Order be made in respect of the debtor. The Application must be supported by an affidavit verifying the truth of the allegations made in the Application, i.e. the creditor is owed at least CAD1,000, the insolvency of the debtor and the fact that the debtor has committed one of ten "acts of bankruptcy" set forth in the BIA within the six months preceding the petition date.

If the debtor does not dispute the creditor's Application, a Bankruptcy Order – a standard form order declaring the debtor bankrupt and appointing a trustee – will be made by the court on a summary basis. If, however, the debtor defends the Application, a hearing is held at which the creditor must establish, using documentary evidence and/or witness testimony, that the creditor is owed at least CAD1,000 and that an act of bankruptcy has been committed. While a Bankruptcy Order will generally be made if the creditor establishes that the debtor owes CAD1,000 and an act of bankruptcy, the court has discretion to refuse to make a Bankruptcy Order in appropriate circumstances.

During the interim between the filing of the Application and the making of a Bankruptcy Order, an interim receiver may be appointed over the debtor's assets. The role of the interim receiver is to preserve the debtor's estate until the petition is heard.

c. Deemed Assignment

When a BIA reorganization is commenced by the debtor filing a Notice of Intention to Make a Proposal (discussed further below), an automatic bankruptcy results if the debtor does not meet certain filing deadlines**.** Similarly, if the debtor's proposal is refused by its unsecured creditors or, if accepted by the unsecured creditors, is not approved by the court, the debtor is deemed to have made an assignment.

BIA Proposal

There is no requirement in the BIA that a business debtor be incorporated in Canada in order for it to initiate proceedings under the BIA. The BIA is applicable to any corporation, wherever incorporated, which does business or has assets in Canada. It is, therefore, possible for a foreign corporation with assets in Canada to reorganize under the BIA. In order to initiate a reorganization under the BIA, a debtor must have obligations owing to its creditors of at least CAD1,000, and either be incapable of meeting its obligations, have ceased paying its obligations as they come due or have liabilities totalling more than the value of its assets.

Under the BIA, there are two means by which a reorganization can be initiated: filing an actual proposal – the debtor's reorganization plan – or filing a Notice of Intention to Make a Proposal. The Notice of Intention is by far the most common means of commencing a BIA reorganization. Upon the filing of a Notice of Intention, all creditors are stayed for an initial period of 30 days. This stay prohibits any creditor, including a secured creditor, from exercising any remedy against the debtor or its property, or commencing or continuing any action, execution or other proceeding for the recovery of a claim provable in bankruptcy. The time for filing a proposal – and the stay – can be extended by the court for a maximum period of six months. On an application to extend, the burden is upon the debtor to establish that it has acted in good faith, that a viable proposal is likely to be developed if the extension is granted and that no creditor will be materially prejudiced by the extension of the stay.

Once a proposal is filed, a further stay takes effect and remains in effect until the proposal is fully performed or the debtor becomes bankrupt.

CCAA Reorganization

A CCAA reorganization is commenced by making an application to the court for protection while a reorganization is developed. CCAA reorganization can be commenced by either a debtor or a creditor.

An initial application under the CCAA can be made either on notice to the company's creditors or ex parte – without notice. The commencement of the proceeding is discretionary on the part of the court and the debtor is required to establish that circumstances exist that make an order under the CCAA appropriate. A court will generally exercise its discretion to grant protection

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where a reorganization is favourable to the creditors, the debtor company is viable as a going concern and can develop an acceptable plan, and the company has no improper motive for making the application. In general terms, provided the debtor company can establish that it meets the requirements of the CCAA, the burden will be upon opposing creditors to show why the court should not permit the reorganization to proceed.

The CCAA provides for an initial stay of proceedings for a period of up to 30 days. Prior to the expiry of the initial stay, the debtor may request an extension of the stay. There are no statutory restrictions on the period for which the stay can be extended. When seeking an extension, the burden is on the debtor to establish not only that the stay is appropriate, but that it has acted and is acting in good faith and with due diligence. The scope of the stay generally granted by the court in CCAA reorganizations is quite broad. The courts have interpreted the stay provisions of the CCAA very broadly in order to protect the integrity of the debtor's business while the debtor attempts to formulate a reorganization.

MEXICO:

Pursuant to article 17 of the LCM, bankruptcy claims must be filed before the judge seated in the place where the company is headquartered.

Regarding branches of foreign companies, LCM article 4 fraction III provides that the claims must be filed where the branch has its main place of business in Mexico.

According to article 16, branches of foreign companies can be subject to bankruptcy insofar as to assets and transactions executed within Mexican territories.

According to the Amendments to the Bankruptcy Law of December 27, 2007 a new chapter was added "Bankruptcy Procedure with Pre-approved Program of Restructure", which provides the basis of a consensual bankruptcy procedure agreed between debtors and creditors, previous to the moment when debtor enters into insolvency status. The Pre-approved Program of Restructure is the agreement signed by the debtor and 40% of its creditors for restructuring the debts. This document is the one the Court will consider basis for the proceedings.

Small commercial enterprises ("SCE") with a debt of less than 400,000 UDIS can only be subject of the LCM if they file it voluntarily. One of the main criticisms of the LCM is that SCE with a debt of less than 400,000 UDIS that do not agree to be subject to the Bankruptcy Law are in some legal *limbo* because they are not subjected to the LCM, and since they are commercial entities, cannot be subject to the provisions of Civil Bankruptcies ("*Concurso Civil*") as provided in the State Codes of Civil Procedures.

b. Venue

UNITED STATES:

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

CANADA:

See above.

MEXICO:

Pursuant to to LCM article 17 the proper venue for a bankruptcy claim to be heard is that where the company is headquartered.

c. Voluntary petition

UNITED STATES:

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

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

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

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

CANADA:

See above.

MEXICO:

In Mexico the debtor may directly file the motion for bankruptcy before a District Court Judge.

The motion shall include name and address of its main place of business and else premises, the facts that led the company to insolvency, under which law provisions the motion is submitted and the express request for the company to be declared bankrupt.

The petitioner must submit along with the motion the financial statements (balance sheets) for the last three years, a list of its creditors and debtors, an inventory of the assets of the company, a list of the judicial proceedings it is party

of and an offer to grant a guarantee should the request be approved for the commencement of the proceedings.

d. Involuntary petition

UNITED STATES:

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

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

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

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

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

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

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

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

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

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

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

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

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

CANADA:

See above.

MEXICO:

LCM article 21 provides that motion to commence bankruptcy proceedings in Mexico may be filed by any creditor, tax authorities or the Attorney General (*Ministerio Público).*

A single creditor may file for bankruptcy of a debtor, however, a debt with a single creditor –for bigger that could be- will not suffice for a bankruptcy declaration, since it will be necessary at least the existence of non-compliance with obligations towards two different creditors that represents 35% of all debts of the commercial entity or the commercial entity does not have sufficient assets to cover 80% of the matured obligations.

In addition to the name of the creditor filing the motion, the motion must include the same information as the voluntary petition along with supporting evidence of its creditor condition.

The creditor may request interim relief measures to secure assets of the debtor such as: (i) banning to make payments of previous obligations after the filing of the complaint or the bankruptcy declaration; (ii) forbidding to make wire transfer to third parties; (iii) to intervening the cash-flow; (iv) forbidding to create any lien, security or encumbrance.

Once the motion has been filed, the judge will grant a 9-day period for the creditor to refute the involuntary petition and present supporting evidence.

Once the voluntary or the involuntary motion has been filed and the judge determines it complies with the legal requirements, Article 20 of the LCM provides two options for the commencement of the proceedings:

i. Unless requested otherwise, when the petition is filed and the legal requirements are met, the Judge will start the proceedings in reorganization stage.

Once the aforementioned requirements are met, the Judge will request the Federal Institute of Experts in Bankruptcy Proceedings to appoint a visitor (*visitador*) that will asses the financial status to ultimately determine if the company is in such condition to be legally declared insolvent.

ii. If expressly requested and if the legal requirements are met, the Judge may start the proceedings in liquidation stage.

4. Role of Management

UNITED STATES:

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

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

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

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

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

CANADA:

In a bankruptcy or receivership, management is "displaced" by a licensed bankruptcy trustee.

During the course of a BIA reorganization the debtor generally remains in possession of its assets and continues to manage its business. Notwithstanding that the debtor is not dispossessed, a trustee must be appointed in every BIA reorganization. The function of a trustee in a BIA reorganization is mainly to monitor the debtor's financial situation. In the event that a debtor chooses to file a Notice of Intention, the court may appoint an interim receiver to monitor the debtor's business and financial affairs.

MEXICO:

In Mexico, the debtor remains in possession of the assets that it legally owns,[2] and continues operating the business.[3] However, the statute provides for the mandatory appointment of a conciliator (*conciliador*).[4]

LCM provides the mandatory appointment of a conciliator, who closely supervises debtor's management and, to a certain extent, controls its activities, as well as the appointment of examiners (*interventores*).[5] The Mexican statute does not provide the appointment of creditors committees.

[2] LCM, art. 70. Interested parties might request to repossess those assets whose property has not been transmitted to the debtor.

[3] LCM, arts. 74-75.

[4] LCM. art. 43, frac. IV. The court, within the insolvency declaration (*sentencia de concurso mercantil*), shall order IFECOM to appoint a conciliator.

[5] LCM, arts. 62-64. The so-called "*interventores*" have similar functions to the ones examiners have under Chapter 11.

5. Appointment of administrator or receiver

UNITED STATES:

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

CANADA:

Bankruptcy Trustee

In bankruptcy proceedings, management is displaced. A licensed trustee is appointed and all of the debtor's property "vests" in the trustee by operation of law. The trustee has the ability to carry on the debtor's business should it chose to do so, but it is not common for a trustee to carry on the debtor's business.

Trustees are licensed by the Superintendent of Bankruptcy – the government office responsible for the administration of the BIA – and are generally from the accounting profession. In bankruptcy proceedings, trustees are responsible for, among other things, collecting and disposing of the bankrupt's property, reviewing and settling the claims of creditors and distributing the dividends to the unsecured creditors. Inspectors appointed by the creditors oversee the trustee's administration of the estate.

Receiver

The enforcement of security through the appointment of a receiver is a common feature in Canadian insolvency practice. A receiver is appointed either by a creditor pursuant to a security instrument or by a court pursuant to legislation that provides for the appointment of a receiver to take possession of the assets of a debtor.

A receiver who is appointed pursuant to an agreement creating a security interest in the debtor's property acts under the direction of the creditor pursuant to whose security the receiver was appointed.

The appointment of a receiver by a court is governed by the legislation – either the BIA or provincial legislation – that provides the court with jurisdiction to appoint a receiver, which generally provide that a court may appoint a receiver in

cases where it is "just or convenient to do so". Once appointed, court-appointed receivers act as officers of the court and take their directions from the court.

Because receivership and bankruptcy both arise in the context of an insolvency, there is often some ambiguity between the two concepts. It is important to recognize, however, that receivership as a remedy is not synonymous with bankruptcy and the two are separate and distinct remedies, although they can, and often do, occur contemporaneously.

Under the BIA a receiver is required to provide creditors with notice of its appointment and to prepare reports respecting the receivership that must be filed with the Superintendent of Bankruptcy. Receivers are also required to act honestly and in good faith, and deal with the debtor's property in a commercially reasonable manner. The court can order a receiver to comply with its obligations and restrain the receiver from dealing with the debtor's property until these obligations have been complied with. In addition, a receiver is entitled to apply to a court for advice and direction concerning the administration of the property under his control.

MEXICO:

Administrator

If the conciliator deems that displacement of the merchant is convenient for the protection of the assets, the conciliator may request the judge to remove the merchant from the administration of the company and appoint the conciliator to conduct the business instead.

Receiver

Under the LCM the appointment of the receiver will take place once the Judge orders the begging of liquidation proceedings (bankruptcy *stricto sensu*).

The receiver is an expert registered before and appointed by the Federal Institute of Experts in Bankruptcy Proceedings.

The receiver will follow the management of the company and will report the debtors´ activities to the judge on a regular basis.

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

a. Enjoined creditors

UNITED STATES:

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

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

CANADA:

In all insolvency proceedings except private receiverships – receiverships initiated by the appointment of a receiver by a secured creditor pursuant to a contractual right in a security agreement – there is a broad stay that prevents creditors from taking steps to enforce pre-filing claims against the debtor. This stay arises either by statute or as a result of a court order.

MEXICO:

Pursuant to article 65, from the issuance of the Judgment declaring Bankruptcy and until the end of the Conciliation stage, any enforcement or forfeiture proceedings cannot be enforced against the commercial entity.

b. **Penalties for violation**

UNITED STATES:

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

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

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

CANADA:

Any violation of a court-ordered stay is punishable as contempt. The court may also impose sanctions for violation of a statutory stay.

Any steps taken in contravention of a stay will be considered void, unless leave is later granted to "cure" the violation.

MEXICO:

Bankruptcy law does not provide a particular penalty for violating the stay, however, any individual injured by any willful violation of the automatic stay is entitled to recover actual damages under general civil liability provisions.

c. Exceptions to or relief from the injunction

UNITED STATES:

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

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

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

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

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

CANADA:

There are a number of limited exceptions to the stay of proceedings. In bankruptcy proceedings, secured creditors are not subject to the stay and may generally enforce their security over the debtor's assets, subject to a specific order

being made preventing them from doing so. The BIA and the CCAA also provide exemption for "eligible financial contracts" and certain regulatory actions.

Creditors impacted by a stay can apply to the court for leave. It is rare for a creditor to obtain leave to take steps that would adversely impact a reorganization or remove assets from a bankruptcy or receivership.

MEXICO:

Mexican law provides exceptions on debts related to labor and tax issues.

The merchant must not discontinue wage payment at any stage of the proceeding. Attachment of assets may be granted to secure payment of wages.

Fulfillment of tax obligations and social security contributions must not be discontinued at any time.

Enforcement of tax debts and liabilities will be suspended upon Judgment of Bankruptcy until the end of Conciliation stage.

7. Selling to an insolvent company after filing

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

UNITED STATES:

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

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

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

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

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

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

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

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

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

Many debtors, particularly in larger cases, file a "first day" motion seeking an order from the Bankruptcy Court granting administrative claim priority for post-

petition shipments on pre-petition orders, to avoid the re-issuance of purchase orders.

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

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

CANADA:

There is no statutory protection for persons who supply goods or services to a reorganizing debtor on creditor. Both the BIA and the CCAA permit a supplier to require immediately payment in cash for goods or services supplied pots-filing and suppliers are expected to look out for their own interests.

Bankruptcy trustees or receivers that contract with a supplier post-appointment are liable to pay for any goods or services supplied to them. Suppliers must, however, be careful to ensure that the trustee or receiver does not "disclaim" personal liability.

MEXICO:

Under LCM there is no specific reference as to new suppliers executing agreements with the bankrupt company, however it may be considered that it an insolvent company can engage in any type of transaction after filing under supervision of the conciliator as long as it directly concerns the ordinary course of business.

LCM authorizes the debtor in possession to carry out all of its ordinary business operations under supervision of the conciliator.

Whoever had executed an Agreement with the Commercial entity will have the right to a declaration as to whether the conciliator will oppose to the compliance of the Agreement. If the conciliator expresses that it will not oppose, then the Commercial entity must guarantee compliance with the agreement.

8. Post-petition financing

a. DIP financing from lender

UNITED STATES:

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

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

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

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

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

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

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

CANADA:

The court has jurisdiction to make an order, on any conditions it considers appropriate, granting security over a reorganizing debtor's assets in favour of a lender who agrees to lend money to the debtor. Secured creditors whose security might be "primed" by the charge granted by the court to secure interim financing have to be given notice.

In considering whether to authorize interim financing, the court will be required to consider a number of specific factors:

(a) the period during which the debtor is expected to be subject to reorganization proceedings;

(b) how the debtor's business and financial affairs are to be managed during the proceedings;

(c) whether the debtor's management has the confidence of its major creditors;

(d) whether the loan would enhance the prospects of a viable proposal being made in respect of the debtor or debtor company;

(e) the nature and value of the debtor's property;

(f) whether any creditor would be materially prejudiced as a result of the security or charge; and

(g) the report the trustee is required to prepare with respect to the debtor's cash flow projections.

MEXICO:

Under LCM provisions, post-petition financing always requires conciliator's approval.

The conciliator, considering the opinion of the examiners, may authorize a debtor in possession to obtain secured or unsecured credit, in or outside the ordinary course of business.[6] Post-petition unsecured credit is granted administrative expense status.[7]

LCM does not allow granting a primary lien; therefore, a post-petition credit may only be secured by unencumbered property or by a junior lien.

b. Extension of credit from suppliers

UNITED STATES:

See number 7 above.

[6] LCM, art. 75.
[7] LCM, art. 224.

9. Pre-petition contracts

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

UNITED STATES:

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

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

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

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

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

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

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

CANADA:

Bankruptcy trustees and receivers are not bound by the debtor's contracts, but can adopt the debtor's contracts if they chose to do so.

In BIA and CCAA reorganizations, parties to contracts with the reorganizing debtor are generally prohibited from terminating those agreements without permission from the court. Provisions in an agreement that permit termination on the basis of insolvency are not enforceable.

The BIA and the CCAA permit a reorganizing debtor to disclaim agreements and to make provision for any damages caused by the disclaimer in its proposal. There is no requirement in the BIA or the CCAA that the debtor "assume" its contract post-filing.

Subject to being declared "critical", suppliers are not required to supply goods or services to a reorganizing debtor on credit and can demand immediate payment for goods or services provided post-filing.

The BIA and the CCAA also permits the debtor to force the assignment of an agreement notwithstanding its terms.

MEXICO:

The general rule is that debtor must honor the executory contracts unless the Conciliator rejects them. Even if the debtor or its management remains in control of the business, the Conciliator is empowered to accept or reject executory

contracts, incur new indebtedness, substitute collateral and sell assets outside the regular course of business. If the Conciliator decides to terminate a lease under which the debtor is the lessee, the lessor is entitled to three months' rent.

A non-debtor party to a contract may ask the Conciliator to decide if it will reject the contract. If the Conciliator responds that it will not, then the debtor must honor the contract. If the Conciliator states that it will reject the contract, or does not respond, the non-debtor party to the contract may terminate it by giving notice to the Conciliator.

Notwithstanding the general rule, the following contracts are automatically terminated on the date the Order for Relief is issued: agreements to repurchase stock, stock loan agreements, and agreements regarding futures, or financial derivative operations that become due after the Order for Relief. Construction agreements (*obra a precio alzado*) will be also automatically terminated by the bankruptcy of one of the parties, unless the parties and the Conciliator agree to assume it.

The LCM provides certain protections to sale contracts. Specifically, a seller is not bound to deliver the goods or the real estate if the price has not been paid or an agreed guarantee has not been provided. Moreover, in the case of movable property that has not been paid for, when the debtor/buyer commences a bankruptcy case prior to the delivery of goods, the seller may refuse to deliver unless the purchase price has been paid in full.

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

Procedure and use of proceeds

UNITED STATES:

Section 363 of the Bankruptcy Code allows a debtor to sell substantially all of its assets free and clear of liens with liens attaching to proceeds of sale. This provision allows for the quick and efficient liquidation of a debtor's assets without having to first resolve the extent, validity and priority of liens on assets.

This allows assets to be sold relatively quickly and avoids further erosion of value due to operating losses.

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

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

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

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

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

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

CANADA:

A bankruptcy trustee or private receivers can realize on – sell -- the debtor's property without prior approval of the court, unless the property is being sold to a party related to the debtor. The sale of property in a bankruptcy is under the control of Inspectors, individuals appointed by the creditors to supervise and direct the trustee's administration. The sale of property in a private receivership is generally directed by the secured creditor, although the private receiver has an obligation to not act in an improvident manner.

In a court-ordered receivership, the receiver requires authority of the court to sell property. The order appointing the receiver will generally provide authority for the receiver to complete de minimus sales, but specific permission from the court will generally be required for larger transactions.

Both the BIA and the CCAA prohibit a reorganizing debtor from selling property without approval from the court. The BIA prohibits a reorganizing debtor from selling or disposing of assets outside of the ordinary course of business. The Court does, however, have the jurisdiction to approve out-of-the-ordinary-course assets sales and to vest assets in a purchaser free and clear of security interests.

MEXICO:

LCM provides that the debtor can continue running the business.

LCM authorizes the debtor in possession to carry out all of its ordinary business operations under supervision of the conciliator.

The debtor in possession has immediate access to cash generated on the regular course of business, but such cash can only be used for ordinary operations.

a. Procedure

- LCM establishes that the sale of estate's assets outside the ordinary course of business requires the approval of the conciliator, who has to consider the non-binding opinion of appointed examiners.[8] If the subject of the sale is a perishable asset or an asset whose conservancy cost is higher than its expected recovery value, the conciliator might not request the examiners' opinion.[9]

- LCM does not have an explicit provision regarding the use of cash-collateral. However, it provides that the substitution of a guarantee outside of the debtor's ordinary course of business requires conciliator approval and the consent of the interested creditor. [10] Hence, it might be argued that by authorizing collateral substitution, LCM implicitly authorizes the use of cash-collateral because on secured transactions the use of cash-collateral automatically implies the substitution of a guarantee.[11]

- LCM does not explicitly address the sale of estate's assets free and clear of any secure interest during the reorganization proceeding. However, besides authorizing the sale of estate's assets and collateral substitution, LCM provides that alienation of assets, at least within the liquidation stage, should be done in a manner that maximizes recovery.[12]

[8] LCM, art. 75.
[9] LCM, art. 77.
[10] LCM, art. 75.
[11] For example, a working capital loan extended for the acquisition of raw materials is initially secured with the acquired supplies. When the raw materials are transformed, the loan is secured with the resulting inventory. Later on, the loan is secured with the account receivable derived from the inventory sales. Once the receivable is collected, the cash itself becomes collateral, but if the borrower uses the cash again, the loan is now secured with whatever has been acquired.
[12] LCM, art. 197. This provision corresponds to the liquidation stage.

11. Vendor remedies

UNITED STATES:

a. *"Unsecured" claims, priority and payment.*

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

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

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

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

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

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

b. 20 Day Administrative Claim

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

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

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

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

c. Critical Vendor

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

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

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

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

d. Reclamation

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

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

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

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

e. Setoff and Recoupment

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

pays B $50 and the accounts are settled. The Bankruptcy Code codifies this common law remedy and in fact provides that the creditor has a secured claim to the extent of the value of its setoff claim.

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

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

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

f. *Statutory Liens*

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

g. *Disclosure*

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

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

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

h. *Motion to Convert to Chapter 7*

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

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

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

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

The Chapter 7 trustee will take control of the debtor and its assets and any creditors' committee or individual creditors will have less influence in the

bankruptcy process. For example, a Chapter 7 trustee may have more incentive to aggressively pursue avoidance actions such as preferences against creditors.

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

i. Motion to Appoint a Trustee or Examiner

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

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

j. Claims Sale

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

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

Claim purchasers will only purchase claims that are not disputed or contingent as to liability. Claim purchasers will usually agree to buy claims based on the debtor's schedules of assets and liabilities. However, purchasers will not buy

claims based on a creditors' proof of claim if it is materially greater than the claim listed on the debtor's schedules, at least until the claim is resolved in the claims reconciliation process.

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

k. *Creditors' committees.*

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

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

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

CANADA:

a. *"Unsecured" claims, priority and payment.*

With limited exceptions, unsecured claims enjoy no priority under Canadian law. The BIA provides enhanced priority to a very limited number of unsecured claims – funeral expenses, some claims for rent, some employee

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claims, etc. -- in a bankruptcy. These claims rank below secured claims, but ahead of other unsecured claims.

b. *Setoff and Recoupment*

The BIA The BIA and the CCAA preserve set-off and the law of compensation rights.

In Canada, a right of set-off may arise by agreement, in law or in equity. While set-off by way of agreement is rather self-explanatory, legal and equitable set-off are extremely complex and muddled areas of the law.

There are two requirements that must be met in order for the claim of legal set-off to be made: (a) the cross claims must be liquidated, enforceable and mature, and (b) the claims must have arisen between the same parties acting in the same capacity – the claims must be mutual. Equitable set-off does not require that the claims be liquidated, enforceable and mature, or that they be mutual. When determining if equitable set-off is available, the courts will, however, inquire into the connection between the claims. Equitable set-off will only be available where it would be inequitable to allow one claim to be enforced without taking the other claim into account.

The courts have determined that the ordinary rules of set-off contained in the bankruptcy portion of the BIA apply in a BIA reorganization. As a result, a creditor owed money as at the date a reorganization is commenced can exercise contractual, legal or equitable set-off to reduce obligations owing to the reorganizing debtor after the reorganization has been commenced.

Compensation is a right arising in Quebec under the Civil Code. It is, essentially, the netting out of cross-obligations by operation of law and is the civil law equivalent of set-off.

c. *Unpaid supplier rights*

The BIA provides unpaid sellers with certain rights to recover goods supplied in the 30 day period immediately before a bankruptcy or receivership. There are a number of exceptions to the application of these provisions and they are generally of limited value as a result of the difficulty most suppliers encounter in recovering their goods.

Certain suppliers – farmers, fishermen and aquaculturists – are provided with enhanced rights to secured obligations owing for inventory delivered to a debtor in the 15 days prior to a bankruptcy or receivership.

There are no specific protections in the BIA or the CCAA that provided to suppliers who supplied goods to a reorganizing debtor in the period immediately preceding the commencement of the reorganization.

MEXICO:

a. Priority of "unsecured claims"

LCM provides the following ranking and priorities to pay off creditors' claims in bankruptcy:

i. Debts for wages and indemnities in favor of employees accrued during the 2 years prior the insolvency declaration.
ii. Administrative claims associated to the management, preservation, custody and sale of debtor's assets;
iii. Expenses incurred in the litigation of assets of the estate;
iv. Fees of the independent professionals appointed by the Institute;
v. Secured creditors.
vi. Labor debts other than those described on number 1 above.
vii. Tax debts.
viii. Creditors with statutory or contractual liens.
ix. Unsecured creditors.

Secure creditors only have to contribute to the expenses mentioned in paragraphs 2 and 3 above when incurred strictly in connection with their collateral. Secured creditors do not contribute to the payment of the independent professionals.

In the event the assets of the estate, other than collateral in favor of secured creditors are not sufficient to pay the labor debts listed in number 1 above, the trustee is entitled to use the proceeds of the sale of the collateral for paying such labor credits, passing over to secured creditors only the remaining proceeds.

LCM does not respect the absolute priority rule, which essentially provides that creditors or holders of equity interests may not receive any recovery of their claims or interests unless the creditors with a higher priority have received full payment of their claims. As a matter of fact, pursuant LCM provisions, as long as holders of the specific amount of debt accept the plan, shareholders of a debtor company could retain their equity interests even though the company's unsecured creditors are not receiving full payment.

b. *Setoffs*

After the date on which the Order for Relief is entered, only the following claims may be set off:

i. Any rights in favor of and obligations owed by the debtor arising out of the same transaction, unless the transaction is terminated by operation of law as a result of the Order for Relief;
ii. Any rights in favor of and obligations owed by the debtor that became due before the Order for Relief, where the setoff is authorized under applicable law; and
iii. Any tax refunds to and tax claims payable by the debtor.

c. *Reclaim goods*

LCM provides that a seller can reclaim real estate property if the corresponding sale has not been recorded at the Public Registry of Property and the debtor has not paid the corresponding price.

A seller has the right to reclaim movable assets in cash sales if debtor has not paid the full price.

A seller has the right to reclaim movable assets and real estate property in credit sales, if the rescission clause was recorded at the corresponding registry and there has been a breach of contract.

d. *Separation of assets*

Where the debtor holds easily identified assets that belong to another party, those assets may be separated from the estate. The following assets are considered easily identified and may be separated from the estate: any property held by the debtor that is subject to a possessory claim; and assets in possession of the debtor as bailee, trustee, consignee, etc. Property of the estate held by third parties (other than secured creditors) must be turned over to the Trustee.

e. *Essential vendor*

The concept of "critical vendor" is theoretically incorporated in the Law since the debtor must not suspend payments deemed necessary for its ordinary course of business. The Law entitles the conciliator to determine which payments are "deemed necessary" without needing the prior approval of the court. The court must only be informed within the next 24 hours after payments are made.

12. Avoidance actions

UNITED STATES:

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

Preferences

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

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

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

- The ordinary course of business defense is based on the notion that the payment in question was consistent with the ordinary course of business between the debtor and the particular creditor or consistent with industry standards generally.
- Subsequent new value is simply that creditors provided additional value in the form of goods or services after receipt of the payment that in essence replenished the estate's assets. The defense exists to the extent of such new value.
- Contemporaneous exchange for value is where the parties intended the payment to be substantially contemporaneous with the creditor providing new value. The classic example of contemporaneous exchange for value is where a debtor desperate for goods promises to send a check if the creditor will release goods. Documentation of the parties' intent of payment in exchange for specific value is critical to this defense.

Fraudulent Transfers

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

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

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

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

CANADA:

Preferences

Under the BIA, a fraudulent preference is a transaction carried out by an insolvent debtor with a view to preferring one or more of its creditors over others.

A transaction in favour of an arm's length creditor is attackable where it is entered into in the three months prior to the date of the initial bankruptcy event – the day the insolvency proceedings against the debtor were first initiated – or during the period between the initial bankruptcy event and the date of bankruptcy. The trustee will have to establish that the transaction was undertaken with a view to giving the creditor a preference. Where, however, the transaction has the effect of preferring the creditor, a rebuttable presumption will arise that the transaction was undertaken with a view to preferring the creditor. Where a creditor does not deal at arm's length with the debtor, a transaction in favour of that creditor is attackable where it is entered into in the 12 months prior to the date of the initial bankruptcy event or during the period between the initial bankruptcy event and the date of bankruptcy. The trustee will have to establish only that the transaction had the effect of giving the creditor a preference — the intention underlying the transaction will be irrelevant.

b. Transfer at Undervalue

The BIA provides for the attack of what are called "transfers at undervalue". A "transfer at undervalue" is defined to mean a disposition of property or services where no consideration is received by the debtor or where the consideration received by the debtor is "conspicuously" less than the fair market value of the consideration given by the debtor. Where the trustee establishes that there is a transfer at undervalue that was entered into in circumstances where a remedy is

available, the court may — but is not required to — declare that the transaction is void as against the trustee. Also, the court may, if it declares the transaction void, grant a judgment against the other party to the transaction and any other person privy to the transaction for the difference between the actual consideration given or received and the fair market value of the property or services transferred or received. For the purposes of awarding damages, a “person who is privy” is defined as a person who: (a) is not dealing at arm’s length with a party to the transfer; and (b) by reason of the transfer, directly or indirectly receives a benefit or causes a benefit to be received by another person.

Whether a remedy will be available in respect of a transfer at undervalue depends on whether or not the other party to the transaction dealt with the debtor at arm’s length. In the case of an arm’s length transfer at undervalue, a remedy will be available where: (a) the transaction occurred up to one year prior to the initial bankruptcy event; (b) the debtor was insolvent at the time the transaction took place (or was rendered insolvent by the transaction); and (c) the debtor intended to defeat its creditors by entering into the transaction. In the case of a non-arm’s length transaction, a remedy will be available where: (a) the transaction occurred in the period beginning one year prior to the initial bankruptcy event and ending on the date of bankruptcy, regardless of the debtor’s financial state or the intention underlying the transaction; or (b) the transaction occurred up to five years prior to the initial bankruptcy event and the debtor: (i) was insolvent at the time the transaction took place (or rendered insolvent by the transaction); or (ii) intended to defeat its creditors.

c. Improper Dividends and Corporate Distributions

The BIA permits the trustee to challenge payments of dividends or redemptions of shares for cancellation that were carried out when the company was insolvent or where the payment or redemption rendered the company insolvent. In a challenge by the trustee, there is a reverse onus on the directors and shareholders to prove that the company was not insolvent at the time. If this onus is not met, the court may award judgment jointly and severally against the company’s directors for the amounts involved and against any shareholders who are related to any of the directors or the company for the amounts they received in the transaction. Directors who objected to the payment of the dividend or the redemption of shares in accordance with the applicable corporate legislation will not be liable under these provisions.

d. Provincial Legislation

There are a variety of provincial laws dealing with preferences and settlements that can be used by a trustee to attack transactions. These laws vary from province to province, but typically require that the trustee establish intent.

e. Liquidations vs Reorganizations

Generally speaking, in Canada, avoidance proceedings are more common in liquidations than in reorganizations. It is relatively rare for pre-filing transactions to be challenged in a reorganization proceeding under the BIA or the CCAA, although it is possible.

MEXICO:

Under the LCM, certain transfers may be avoided as preferential. In general, avoidance as a preference under Mexican law requires a finding of fraudulent intent. Under the LCM, the issuance of the Order for Relief effectively sets a "look-back" period of 270 calendar days before the entry of the Order for Relief during which suspect transfers may have occurred.

Likewise, there are three criminal federal offenses provided in the Bankruptcy Law §§271-277, which can be punished with prison. The main hypothesis for those crimes are the following: (i) intentional behavior aimed to aggravate the non-compliance of the commercial entity, for example, the alteration, destruction or falsification of the accounting records of the commercial entity; (ii) during the term granted by the Judge, the commercial entity does not deliver to the Judge the information so requested; (iii) the request of a non-existing or simulated credit[13]. These crimes are prosecuted by the Federal District Attorney previous the complaint of the affected party ("*querella*").

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13 These are federal crimes because they are provided in a federal law. See the Organic Law for the Judicial Federal Power §50-I a). These crimes are not considered "grave" by the Federal Code of Criminal Proceedings §194, and therefore, the indicted will have the possibility to be released previous granting of a bail.

13. Restructuring plan

UNITED STATES:

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

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

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

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

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

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

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

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

CANADA:

***Bankruptcy and Insolvency Act* Reorganizations**

i. Initiation of BIA Reorganizations

As mentioned above, there is no requirement in the BIA that a business debtor be incorporated in Canada in order for it to initiate proceedings under the BIA. The BIA is applicable to any corporation, wherever incorporated, which does business or has assets in Canada. It is, therefore, possible for a foreign corporation with assets in Canada to reorganize under the BIA. In order to initiate a reorganization under the BIA, a debtor must have obligations owing to its creditors of at least CAD1,000, and either be incapable of meeting its obligations, have ceased paying its obligations as they come due or have liabilities totalling more than the value of its assets.

Under the BIA, there are two means by which a reorganization can be initiated: filing an actual proposal – the debtor's reorganization plan – or filing a Notice of Intention to Make a Proposal. The Notice of Intention is by far the most common means of commencing a BIA reorganization. Upon the filing of a Notice of Intention, all creditors are stayed for an initial period of 30 days. This stay prohibits any creditor, including a secured creditor, from exercising any remedy against the debtor or its property, or commencing or continuing any action, execution or other proceeding for the recovery of a claim provable in bankruptcy. The time for filing a proposal – and the stay – can be extended by the court for a maximum period of six months. On an application to extend, the burden is upon the debtor to establish that it has acted in good faith, that a viable proposal is likely to be developed if the extension is granted and that no creditor will be materially prejudiced by the extension of the stay.

Once a proposal is filed, a further stay takes effect and remains in effect until the proposal is fully performed or the debtor becomes bankrupt.

A secured or unsecured creditor may apply for relief from the stay imposed in a BIA reorganization. A court may grant relief from the stay where it is satisfied that the creditor will be materially prejudiced by the continued operation of the stay or where it is equitable on other grounds to do so. Generally a creditor seeking relief from the stay must establish that its indebtedness or security is at risk of being prejudiced or that there has been some improper conduct on the part

of the debtor. Merely showing inconvenience is not sufficient as creditors are expected to live with some inconvenience. The burden of proof in an application for relief from stay in a BIA reorganization falls on the creditor and it is generally seen as being a difficult burden to meet. Even if a stay is lifted, restrictions may be imposed.

ii. The Proposal

For the purposes of a proposal, creditors are divided into classes. Generally, there will be one class of unsecured creditors and one or more classes of secured creditors. The division of secured creditors into classes is determined based on the concept of "commonality of interest". Whether or not sufficient, commonality of interest exists between creditors is determined based on the nature of the debt, the nature and priority of the creditor's security, the remedies that are available to the creditor, and how the creditor's claim is treated under the proposal. In the event that there are some disputes as to the composition of the classes, a determination can be made by the court.

For a proposal to be accepted, a majority of the creditors in each class of unsecured creditors, holding two-thirds in value of the total debt represented by that class at the meeting must vote in favour of it. Secured creditors do not influence the approval of the proposal, but if a class of secured creditors does not approve of the proposal, they are no longer bound by the stay and are free to deal with their collateral. Rejection by a class of secured creditors can, therefore, seriously jeopardize the possibility that the debtor will be able to continue as a going concern and, as a practical matter, rejection by secured creditors will often spell the end of a proposal. It is common for a reorganizing debtor to exclude secured creditors from a proposal and negotiate private arrangements with its secured creditors.

Once a proposal has been accepted by the creditors, it must be approved by the court before it becomes binding. As a practical matter, this approval is usually granted if the proposal is reasonable, meets the requirements of the BIA and is for the general benefit of the creditors. As a practical matter, it is incumbent upon a creditor opposing the proposal to establish why the court should not approve it.

Once a proposal has been accepted and approved, it becomes binding on all of the unsecured creditors and on the secured creditors in the classes that approved of it. It is the trustee's role to monitor the implementation of the proposal, and any default by the debtor that is not waived or remedied must be reported to the creditors. The court continues to have jurisdiction over the implementation of the proposal after approval has been given but has only a very limited role in

supervising the implementation of the proposal. Where, for example, a default occurs under a proposal, the court may annul the proposal on the application of a creditor.

iii. Failure of Reorganization

If a proposal is not accepted by the required majority in any class of unsecured creditors, the debtor is deemed to have made an assignment in bankruptcy. Similarly, if the court refuses to approve the debtor's proposal or the proposal is subsequently annulled as a result of a default by the debtor, there will be an automatic bankruptcy.

B. *Companies' Creditors Arrangement Act* Reorganizations

i. Initiation of CCAA Proceedings

A CCAA reorganization is commenced by making an application to the court for protection while a reorganization is developed. CCAA reorganization can be commenced by either a debtor or a creditor.

An initial application under the CCAA can be made either on notice to the company's creditors or *ex parte* – without notice. The commencement of the proceeding is discretionary on the part of the court and the debtor is required to establish that circumstances exist that make an order under the CCAA appropriate. A court will generally exercise its discretion to grant protection where a reorganization is favourable to the creditors, the debtor company is viable as a going concern and can develop an acceptable plan, and the company has no improper motive for making the application. In general terms, provided the debtor company can establish that it meets the requirements of the CCAA, the burden will be upon opposing creditors to show why the court should not permit the reorganization to proceed.

The CCAA provides for an initial stay of proceedings for a period of up to 30 days. Prior to the expiry of the initial stay, the debtor may request an extension of the stay. There are no statutory restrictions on the period for which the stay can be extended. When seeking an extension, the burden is on the debtor to establish not only that the stay is appropriate, but that it has acted and is acting in good faith and with due diligence. The scope of the stay generally granted by the court in CCAA reorganizations is quite broad. The courts have interpreted the stay provisions of the CCAA very broadly in order to protect the integrity of the debtor's business while the debtor attempts to formulate a reorganization.

ii. Plan under the CCAA

For purposes of CCAA arrangements, the creditors are divided into classes and vote on a class-by-class basis. The majority required to accept a plan is the same as under the BIA – two-thirds in value and majority in number. If the required majority is not achieved in a class, the plan is not binding on the creditors in that class. As a matter of practice, many plans require that all classes accept the plan in order for it to be implemented.

It is the initial responsibility of the debtor to classify creditors into classes for the purposes of the reorganization plan. The basic division of classes under the CCAA is between secured and unsecured creditors, but secured and unsecured creditors may be divided into smaller classes. There are no criteria for dividing the creditors into classes in the CCAA and basic principles have been developed by the courts. The general principle underlying the classification of creditors in a CCAA reorganization is commonality of interest – creditors with common interests vis-à-vis their claims against the debtor company are grouped together.

Once accepted by the creditors, a plan must be approved by the court. The court will generally approve a plan provided that the CCAA has been complied with, and it is fair and reasonable. If a plan has been accepted by the creditors, an inference that the plan is fair and reasonable is created, but the court has the discretion to refuse a plan even though it has been accepted by the creditors.

iii. Consequences of a Failed CCAA Reorganization

Where a CCAA restructuring is not successful, there is no automatic liquidation such as arises in the case of a failed BIA restructuring. That being said, a failed CCAA restructuring inevitably leads to secured creditors taking steps to enforce their security over the debtor's assets. This often takes place through the appointment of a receiver by the secured creditor.

MEXICO:

LCM does not provide an exclusivity period in which only the debtor may file a plan. Indeed, any party in interest may propose a plan at any time during the

reorganization stage. Actually, the plan is negotiated outside the court, regularly at conciliator's initiative.

Once the conciliator considers that the debtor and the creditors required to accept a plan have a favorable opinion about a proposed plan, he files into the court a proposal of the plan to be considered by all the parties in interest.

a. *Classes of creditors*

In light of a restructuring plan, LCM classifies creditors in three groups:

i. Secured claims creditors
ii. Unsecured claims creditor
iii. Tax liabilities and labor related creditors

b. *Priority of payment*

LCM provides that the plan must consider payment of the visitor, receiver and conciliator fees, payment of credits against the bankrupt´s estate, secured credits and tax and labor related credits.

c. *Requirements of approval*

Besides the plan relating to labor and tax affairs, the debtor is forbidden from agreeing individually with any creditor. If this should happen, said agreement will be void and the creditor with whom the agreement was intended, will lose its rights as creditor.

After all the parties had been given the chance to review the proposal, the conciliator may file the reorganization plan that the debtor and the required creditors have signed.

The plan must be filed no longer than 185 days after the insolvency judgment was published in the Federal Official Gazette otherwise the debtor will be declared in

liquidation. This timespan can be extended up to 90 days at the conciliator´s request and the creditors that hold at least 90% of the total allowed claims. In any case, the period for filing a plan cannot exceed 365 days.

The plan will include all the debts except for those arising from tax liabilities and labor credits. The merchant must agree on a restructuring plan with employees and tax authorities. The provisions of these agreements must be disclosed to the other debtors.

Pursuant to article 157 of the LCM for a plan to be valid it must be agreed by the merchant and the creditors that represent at least half of:

i. The allowed amount of the unsecured claims
ii. The allowed amount of the secured claims

After the creditors and the debtor have signed the document, it must be submitted for the final approval of the Judge. If the plan complies with the legal requirements, the judge will issue a binding decision for the debtor and creditors under the terms and conditions set forth in the plan.

Creditors holding secured claims do not waive their collateral or their lien priority by subscribing the plan; therefore, any claim provided for in the plan is still secured by the collateral with the corresponding lien priority.

14. Cross-border insolvency

UNITED STATES:

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

When a multi-national business faces insolvency, assets in more than one country likely require administration and protection. It is sometimes not clear what country's law will apply, and which jurisdiction will control the insolvency

process. This can be determinative of outcome since countries' laws and approach to business insolvencies can differ materially.

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

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

- Chapter 15 of the Bankruptcy Code on Ancillary Cases

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

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

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

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

- European Union Regulation on Insolvency Proceedings

- ALI NAFTA Transnational Insolvency Project

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

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

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

- Important Chapter 15 court decisions

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

CANADA:

In 2009, Canada adopted a modified version of the UNCITRAL Model Law of Cross-Border Insolvency. Versions of the Model Law were added to both the BIA – Part XIII – and the CCAA – Part IV.

a) *Application for Recognition of the Foreign Proceeding*

The "entry point" for Part XIII and Part IV is an application for recognition of a foreign proceeding. A foreign representative will be entitled to apply to the court to have the foreign proceeding in respect of which that foreign representative was appointed recognized. Both Part XIII and Part IV define a "foreign proceeding" as a judicial or an administrative proceeding, including an interim proceeding, in a jurisdiction outside Canada dealing with creditors' collective interests generally under any law relating to bankruptcy or insolvency in which a debtor or debtor company's business and financial affairs are subject to control or supervision by a foreign court for the purpose of reorganization.

If the court is satisfied that the application for the recognition of a "foreign proceeding" relates to a foreign proceeding and that the applicant is a "foreign representative" appointed in that foreign proceeding, the court is required to make an order recognizing the foreign proceeding.

A foreign proceeding can be recognized as either a "foreign main proceeding" or a foreign non-main proceeding". A foreign proceeding commenced in a jurisdiction where the debtor has its "center of main interest" or "COMI" is a

"foreign main proceeding". A foreign proceeding in any other jurisdiction is a "foreign non-main proceeding".

b) *Automatic/Mandatory Relief*

Under the BIA and the CCAA, where a foreign proceeding is recognized as a foreign main proceeding, an automatic stay of proceedings arises that prevents proceedings from being taken against the debtor and suspends the debtor's ability to transfer or dispose of its property out of the ordinary course of business. This automatic stay/suspension is intended to be independent of any stay or suspension that arises in the foreign proceeding and not a recognition of the effects of whatever stay/suspension may have arisen or has been ordered in the foreign proceeding. It is a stand-alone remedy that arises from the recognition of the foreign proceeding and is intended to provide breathing space until appropriate measures can be put in place. The automatic stay/suspension is intended to be subject to any limitations for example, exceptions for secured, claims, payments made in the ordinary course of business, the exercise of rights of set-off, initiation of court action for claims that have arisen after the commencement of the insolvency proceeding (or after recognition of a foreign main proceeding), or completion of open financial-market transactions, etc. as would apply in a domestic insolvency proceeding.

c) *Discretionary Relief*

Under Part XIII and Part IV, once a foreign proceeding is recognized, the foreign representative may apply to the Canadian court seeking additional relief in Canada in connection with a foreign main or non-main proceeding.

d) *Canadian Plenary Proceeding*

Part XIII of the BIA and Part IV of the CCAA contain provisions that preserve the ability to commence proceedings in Canada on the recognition of a foreign main proceeding and where a stay is granted in connection with the recognition of a foreign non-main proceeding. The BIA and the CCAA, for example, exempt the commencement of domestic proceedings from the automatic stay that arises on the recognition of a foreign main proceeding and the discretionary stay that the court is entitled to grant where a foreign proceeding is recognized as a non-main proceeding. Both Part XIII and Part IV also permit a foreign representative to commence Canadian insolvency proceeding in respect of the debtor.

e) Co-ordination of Multiple Foreign Proceedings

Where the court has recognized a foreign non-main proceeding in respect of a debtor and then recognizes a foreign main proceeding respecting the same debtor, the court is required to make any discretionary relief granted in support of the non-main proceeding consistent with any discretionary relief granted in support of the main proceeding. The intention is that the discretionary relief granted in respect of the main proceeding will trump the discretionary relief granted in support of the non-main proceeding.

Where the court has recognized a foreign non-main proceeding in respect of a debtor and then recognizes another non-main proceeding respecting the same debtor, the court is required to review any discretionary relief granted in support of the non-main proceedings. In these circumstances, the court should be ensuring that the relief granted in respect of each of the non-main proceedings is consistent and appropriate.

f) Co-ordination of Foreign Proceedings with Domestic Proceedings

The CCAA and the BIA also deal with the co-ordination of foreign proceedings and any Canadian proceeding commenced in respect of the debtor. The intention is that where a Canadian proceeding is commenced, the court will review any discretionary relief provided in support of any foreign proceedings to make the discretionary relief consistent with the domestic proceeding.

g) Co-operation with Foreign Courts and Foreign Representatives

Both Part XIII and Part IV mandate that the Canadian courts cooperate "to the maximum extent possible" with the foreign representative and the court supervising the foreign proceeding "by any appropriate means". Examples of the types of cooperation that may be provided are: (a) the appointment of a person to act at the direction of the court; (b) the communication of information by any means considered appropriate by the court; (c) the coordination of the administration and supervision of the debtor company's assets and affairs; (d) the approval or implementation by courts of agreements concerning the coordination of proceedings; and (e) the coordination of concurrent proceedings regarding the same debtor company. This list is not, however, exhaustive. And, in case there is any doubt, both Part XIII and Part IV also preserve the court's jurisdiction to, on the application of a foreign representative or any other interested party, apply any legal or equitable rules governing the recognition of foreign insolvency order and

assistance to foreign representatives subject. The obligation to cooperate is independent of the automatic/mandatory stay and the discretionary relief that may be granted on the application of the foreign representative.

h) Obligation of the Foreign Representative

The foreign representative is required to advise the Canadian court of any substantial change in the status of the recognized foreign proceeding; (b) any substantial change in the status of the foreign representative's authority; and (c) any other foreign proceeding in respect of the same debtor that becomes known to the foreign representative. The foreign representative is also required to publish a notice containing the prescribed information with respect to the foreign proceeding.

i) Foreign Representative not Exposed to Jurisdiction

A foreign representative is not exposed to the jurisdiction of the Canadian court by applying for relief under Part XIII and Part IV, save and except as to costs. The court may, however, make the grant of relief conditional on the foreign representative complying with orders of the court.

j) Canadian "Foreign Representative"

The BIA and the CCAA provide the court with jurisdiction to authorize any person or body to be a representative in respect of Canadian insolvency proceedings for the purpose of having those proceedings recognized in a foreign jurisdiction.

k) Canadian Information Officer

It has become common practice for the court, on recognition of a foreign proceeding, to appoint a Canadian licensed trustee as the "information officer" to provide information to the court and Canadian creditors with respect to the foreign proceeding. This is particularly common in more complex cross-border insolvencies where there are no plenary proceedings commenced in Canada. However, it should be noted that this is not required by Part XIII or Part IV.

MEXICO:

a. UNCITRAL Model cross-border insolvency

Mexico was the second country to adopt and enact *verbatim* the UNCITRAL cross-border insolvency model law. It is part of the LCM on title XII.

The model law governs aspects such as:

i. The debtor has assets in more than one State.
ii. The administrator of a foreign insolvency proceeding has access to the courts of the States that have enacted the Model Law.
iii. The conditions that have to be met for the recognition of an insolvency proceeding in a foreign State.
iv. The conditions that have to be met to grant relief requested by foreign courts in insolvency proceedings.
v. Avoid legal formalities to establish communication between courts from different States.

15. Insolvency alternatives

UNITED STATES:

Workouts
Receiverships

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

A non-bankruptcy workout generally involves a forbearance agreement with secured lender(s) and a forbearance or composition agreement with unsecured

creditors. Such composition agreement may involve a moratorium or delay in payment of debts owed and/or a compromise of the amount owed. Immediate cash payments for creditors usually require a discount, while a longer term payout may result in payment in full.

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

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

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

CANADA:

An insolvent business can attempt to restructure their obligations, the operations and their contracts informally by direct negotiation with creditors. These informal "proceedings" are typically known as "work-outs" and often result in forbearance agreements, which are contracts between the debtor and their creditors.

The use of court- and privately-appointed receivers is common in Canada. It is common for security agreements to permit the secured creditor to appoint a receiver of its collateral on default. In addition, the BIA and various pieces of provincial legislation provide for the appointment of a receiver on the application of a secured creditor. The BIA and various pieces of provincial legislation impose duties and obligation on court- and privately-appointed receivers.

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