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An Overview of U.S. Bankruptcy Law for Japanese Companies

Client Advisories

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May 20, 2020 - The economic effects of the COVID-19 pandemic have already led to increased bankruptcy filings in the United States and additional U.S. businesses are virtually certain to follow. Japanese business partners, lenders, and creditors of distressed U.S. companies should be preparing for these U.S. bankruptcy filings. To assist, this alert provides a general overview of U.S. bankruptcy law.

The U.S. bankruptcy system protects a bankrupt company from its creditors while the company attempts to reorganize. Once the company files for bankruptcy, U.S. bankruptcy law limits the actions of creditors and grants the bankrupt company powerful rights that are unavailable outside of bankruptcy. However, creditors can take steps both before and after the filing to protect their rights and maximize potential recoveries.

The Immediate Consequences of a Bankruptcy Filing

In the United States, large companies that file for bankruptcy typically seek to reorganize under chapter 11 of the Bankruptcy Code. Upon the filing of a chapter 11 reorganization petition, three important consequences immediately and automatically occur:

1. The filing of the case creates a bright line division between prepetition obligations, *i.e.*, all of the debtor's obligations that exist at the time of the filing, and postpetition obligations, which arise for the first time after the filing. The Bankruptcy Code treats prepetition and postpetition obligations according to different sets of rules. Parties with prepetition rights must assert those rights in the bankruptcy or lose them; there is no option to wait for the bankruptcy case to end and then assert prepetition rights once the case is over.

2. The filing of the case automatically stops all actions by creditors and other parties in interest to enforce or improve their rights. The purpose of this "automatic stay" is to prevent a creditor from improving its position vis-à-vis the debtor or other creditors. The automatic stay also prevents creditors from trying to "opt out" of the bankruptcy and exercise remedies elsewhere. There are strong sanctions for violations of the automatic stay, including punitive damages.

3. The commencement of the bankruptcy case also creates an "estate", comprising all legal and equitable rights of the debtor of any kind—not only property rights, but rights under contracts, rights to use licensed assets, and rights to exercise control over property of others in the debtor's possession. Any action taken to exercise control over, or obtain possession of, property of the debtor's estate violates the automatic stay.

The combined effect of these three immediate and automatic consequences of filing a chapter 11 case is that virtually all third parties having dealings with the debtor are brought into the case, required to assert their rights, and barred from doing anything to exercise those rights outside of the bankruptcy. As much as non-U.S. creditors might want to stay away from a U.S. bankruptcy case, they risk permanently losing their rights if they do so.

Executory Contracts and Licenses

In furtherance of the principle of a "fresh start," U.S. bankruptcy law changes the relative rights and obligations of parties to contracts, unexpired leases, and licenses when one of the parties is in bankruptcy. In particular, the Bankruptcy Code permits the debtor, with court approval, to "reject" or "assume" an executory contract. As executory contracts are contracts where there is future performance owing from both parties to the contract, most contracts are executory.

The debtor does not have to decide whether to assume or reject an executory contract right away. Unless the court orders otherwise, the debtor may wait until the date of confirmation of its plan of reorganization. The date of confirmation may take place anytime from a few months to more than a year after the bankruptcy case commences. Until there is a determination to assume or reject an executory contract, both the debtor and the non-debtor counterparty must continue to perform under the contract.

The debtor is likely to reject any contract that is economically burdensome to the debtor. When this occurs, the non-debtor party may assert a claim for any damages that it suffers from the rejection of the contract. For example, a debtor that is obligated to make monthly payments under a license may decide to reject the license. If that happens, the licensor would be able to assert a claim for the remaining payments due under the license. This type of claim is treated in the bankruptcy as a prepetition unsecured claim.

The debtor's ability to assume a contract, and sometimes to assign the contract to another party, is more complicated. The debtor can only assume a contract if it cures all defaults that exist under the contract and provides adequate assurance of future performance under the contract. Notably, as long as the debtor meets these requirements, it may assign its rights under the contract to a third party, even if the non-debtor party to the contract disagrees with the assignment.

In addition, the U.S. Bankruptcy Code invalidates certain contractual provisions by rendering them unenforceable. Contractual counterparties are generally unable to enforce any financial consequence that comes into effect upon the filing of a bankruptcy case. This principle applies to contractual provisions that, upon the filing of a bankruptcy case, purport to accelerate payments, provide buy-out rights, or grant termination rights.

Protecting Your Rights as a Creditor

Unless the debtor agrees to a claim, it is usually necessary to file a "proof of claim" to be treated as a creditor in a chapter 11 bankruptcy. The proof of claim indicates the type and amount of the claim as of the date of the bankruptcy filing, and attaches supporting documents. There is a specific date, called the bar date, by which a proof of claim must be filed with the bankruptcy court. Failure to file a proof of claim in time may prevent a creditor from voting on the debtor's plan of reorganization or obtaining any distribution under that plan.

The distribution of estate assets follows a priority scheme set forth in the Bankruptcy Code. In a chapter 11 proceeding, secured creditors with a valid and perfected security interest in property of the estate have the highest payment priority. If assets remain after payments to secured creditors, the unsecured creditors share *pro rata* in the remaining assets, with priority given to payments for the actual, necessary costs of preserving the estate, including professional costs and postpetition expenses, and other categories of expenses, including taxes and employee claims.

Japanese companies doing business with distressed U.S. companies should consider taking steps to protect themselves well in advance of a potential bankruptcy filing. Such steps may include, among other things, trying to recover or re-characterize past due amounts, obtaining liens or security interests on property, or terminating contracts. Once there is a chapter 11 filing, these options will be foreclosed by the automatic stay and other features of the Bankruptcy Code.

Japanese companies should also be aware that, once the debtor files for chapter 11 protection, it has certain "avoidance" powers. These powers allow the debtor to attempt to avoid transfers of money or property that took place prior to the filing. The avoidance power generally applies to transfers made up to 90 days prior to the bankruptcy filing, with longer periods applicable to, among other things, transfers to insiders. Business partners of entities that may become debtors should keep in mind that any payments they receive shortly before the filing may have to be paid back.

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Hughes Hubbard's Corporate Reorganization & Bankruptcy group can assist with these issues both in and out of court. We have represented Japanese creditors and investors in complex U.S. bankruptcies. We successfully handled the liquidations of Lehman Brothers Inc. and MF Global Inc., respectively the largest and eighth-largest bankruptcies in history. We also have extensive experience in restructurings involving aviation, commodities, energy, manufacturing, media and entertainment, retail, shipping and technology.

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