INSOL International

Financing the Rescue Process – A Comparative Analysis of the Financing Regimes in Canada, South Africa, United Kingdom and United States of America

October 2018

Small Practice Special Report

Financing the Rescue Process – A Comparative Analysis of the Financing Regimes in Canada, South Africa, United Kingdom and United States of America

INSOL International
6-7 Queen Street, London, EC4N 1SP
Tel: +44 (0) 20 7248 3333 Fax: +44 (0) 20 7248 3384

Acknowledgement

When a company enters a restructuring process, it will almost immediately require some level of finance or funding in order to pay ongoing expenses and continue to function as a going concern. Post commencement finance has thus been described as the "life-blood" of the restructuring process. This Special Report for the Small Practice Group provides an overview of post-commencement finance principles including: the need for such finance in a restructuring process; the potential sources of and the challenges inherent in sourcing post-commencement finance; and the manner in which the provision of post-commencement finance is treated in the ranking of claims in a business rescue.

The report also includes a comparative analysis of the financing regimes applicable in South Africa, the United States, the United Kingdom, Canada and Australia. It examines the statutory regimes applicable to post commencement finance in those jurisdictions, the availability of finance and the status of finance in both a rescue and in the event of a bankruptcy / liquidation outcome.

Finally the report outlines the international guidelines available in respect of the need for and manner in which post-commencement finance should be made available to financially distressed companies which include recommendations provided by the World Bank's international publication titled Principles for Effective Creditor Rights and Insolvency Systems and UNCITRAL's Legislative Guide on Insolvency Law.

INSOL International sincerely thanks Dr Eric Levenstein, Director, Werksmans Attorneys, South Africa for this detailed analysis and for providing this Special Report primarily aimed at Small Practice Members.

October 2018

Financing the Rescue Process – A Comparative Analysis of the Financing Regimes in Canada, South Africa, United Kingdom and United States of America

By

Dr Eric Levenstein*, Director, Werksmans Attorneys, South Africa

1. An overview

1.1 Necessity

What is critical in the restructuring or reorganisation of the distressed entity is to protect and maintain the viability of the business and to ensure, whilst such process is ongoing, that the company can continue its operations and pay its debts as they become due in the ordinary course of its continued trade.

The objective of post-commencement finance is to preserve the going concern value of the company in these circumstances. Certain companies can rely on ongoing operations to continue to generate funding for the continued payments of overheads. Clearly, the ability to do so would only be realistic if the proceedings are limited in duration. However, if rescue processes are ongoing and are delayed for an inordinate period of time, the ability to continue to rely on this source of post-commencement finance becomes more difficult.

The continued incurrence of expenses in the restructuring process necessitates an urgent need for funding from the commencement of the rescue process. This includes the payment of leases, payment for the continued supply of goods and services, the payment of essential utility costs (water, light and electricity) and the ability to fund the payment of wages and salaries of employees. Funding is further required for the services of the supervisor, support services such as legal, accounting, tax and other critical professional services which would enable the continued survival of the entity whilst it goes through the restructuring process.

If there is an inability on the part of the company or its supervisor to source adequate post-commencement finance, then the restructuring / rescue process may be terminated and the company placed into bankruptcy or liquidation.

Post commencement finance has been described as the "life-blood" of the restructuring process. Without it, the prospects of the survival of the entity rapidly diminishes.

1.2 Keeping the company afloat

In any rescue regime, there will be a need for financial support by the provision of additional funding. Ironically, when rescue is most needed, businesses often struggle to obtain additional credit. The availability and extent of post-commencement financing available to the financially distressed entity is an initial determinant for the supervisor as to the prospects of success for the restructuring of the company. The supervisor does not have time on his or her side. The company will in most cases already be suffering from the burden of extensive pre-commencement debt, with unpaid creditors and critical suppliers (often aggressively) pushing for payment. In order to gain time to effect the restructuring, the supervisor needs to keep the company "afloat", where trading continues in the ordinary course of business.

There will be a need to switch existing suppliers from supplying goods and services on credit, to one of cash supply. Many of these suppliers, having already been told that pre-commencement debt will in all likelihood be compromised, will be reluctant to continue to supply goods and services to the "near insolvent" entity. These suppliers will have to be persuaded that without continued supply of these goods and services (often critical), the company will fail and be placed into liquidation. The upside of course will be the prospect for the supplier of retaining an ongoing customer which, if successfully restructured, will continue to be a source of future business. If the supervisor, backed by the appropriate local legislation, can legitimately offer these suppliers enhanced priority of payment and security for such post-commencement finance, this makes his or

* The views expressed in this paper are the views of the author and not of INSOL International, London.

her task all the easier. In order for the supervisor to make such representations to suppliers, access of the debtor company to a line of new money, that is post-commencement finance, is necessary.

The lender of these funds, often a party with no past lending relationship with the distressed entity, must be offered similar priority ranking and a security package that makes such loan finance a worthwhile and secure endeavour.

As long as the distressed entity can continue to trade, the prospects for the supervisor of delivering a solvent (albeit restructured) company back into the economy is greatly enhanced.

Some of the benefits to lenders of providing post-commencement finance may include:

- it provides financiers with a measure of control over the process in that if there is no post-commencement finance, the company will not be in a position to trade during business rescue and will need to consider options other than business rescue, such as liquidation;

- it may be provided to the company in distress in exchange for security taken over unencumbered assets of the company. Post-commencement finance funders are generally considered to rank in priority to the claims of previously secured creditors and unsecured creditors, but behind the claims of the practitioner and the employees for services rendered during business rescue;

- it will be paid in preference to the claims of unsecured post-commencement finance and in the order incurred; and

- the order of preference will remain in place, even if the company is placed into liquidation.

1.3 Sources of funding

The challenge, of course, is for the supervisor to locate and source post-commencement finance. Not everyone is willing to lend new monies to a company that is already in the throes of financial distress and where liquidation / bankruptcy is a potential possibility. The difficulty will be for the supervisor to persuade such lenders that the company remains a viable entity and a going concern. Lenders will need to be persuaded that in order to ensure that a successful outcome is delivered at the end of the restructuring process, such lenders should consider providing finance to the distressed company in the circumstances. Thus, the ability to attract post-petition financing is challenging but is, notwithstanding, essential to a successful restructuring process. Sources of finance include the following:

1.3.1 *Shareholders*

It might be that the company can obtain new funding from its shareholders who are willing to provide further working capital, on loan account, to the distressed company.

1.3.2 *Suppliers*

Suppliers of goods and services to the debtor company, subsequent to the commencement of the restructuring process, are also recognised as post-commencement "financiers", as often they are essential to the ongoing viability of the entity and its ability to trade during the restructuring process.

1.3.3 *Existing lenders*

Lenders who have an ongoing relationship with the indebted company and its business would clearly be a source of post-commencement finance. These lenders may advance new funds or provide new terms for trade credit in order to enhance the likelihood of recovering their existing (pre-commencement) claims through the provision of ongoing finance. Often, additional security is provided to such lenders in respect of such post-commencement finance.

1.3.4 *New lenders*

Third party lenders may be approached, even though they have no prior connection to the business of the debtor, for the provision of post-commencement finance. Such a lender could possibly be motivated by the prospect of achieving higher returns by lending to the distressed company with favourable interest rates or terms of repayment.

The attraction of lending to a distressed company is varied. Suppliers of goods and services post the commencement of the restructuring process would recognise that the ongoing provision of such goods and services could result in the debtor surviving the restructuring process and thereby continue to be a source of ongoing business in the future.

Third party providers of post-commencement finance may loan money to the distressed company, with a view to being placed in an advantageous position which allows them to make an offer for the company's business and / or its assets and / or the shares of the company. Such third-party funder may provide post-commencement finance with a "loan to own" strategy with a view to them becoming the new owners of the company. Of course, these lenders would be advised to conduct detailed due diligence in order to establish whether or not the provision of such post-commencement loan finance is viable and whether there is an upside for such new lending.

What is clear, however, is that the ability to raise new cash or loan capital and to incur new debt in the post-petition period (although difficult to obtain), is critical to the success of the restructuring process. In certain instances, lenders can take new security for the ongoing provision of new money, however, where there are fully encumbered assets, with no further security available, it becomes a much more difficult task to source post-commencement finance. It is possible for new money to be provided without security in place, however, the latter is difficult to source, unless of course the lenders have a particular risk profile that they are willing to take on board.

1.4 Ranking

The inducement for post-commencement lenders is the required certainty that post-commencement finance is afforded special preferential treatment in the recovery (repayment) of such post-commencement finance. In this regard, the ranking of the post-commencement finance becomes an important consideration. Certainty of where post-commencement funders will rank in the restructuring "waterfall" of payments provides an inducement for the provision of these loan facilities. The manner in which these claims are ranked, with certain lenders being provided a priority over others, will be the driver of the source and availability of post-commencement finance in the distressed company situation.

It is therefore important that applicable legislation, within the jurisdiction, provides lenders with comfort that their post-commencement finance will rank ahead of secured creditors or, alternatively, will rank behind such secured creditors but with some preference in place.

The protection afforded to creditors who are secured prior to the commencement of the restructuring process may therefore be rendered nugatory in bankruptcy / liquidation if their claims are not satisfied out of the security that they hold and they receive payment of their claims only after post-commencement financiers receive payment. Such a ranking would in effect place secured creditors' claims further down the "waterfall" and undermine the very reason why secured creditors take security for their claims, particularly if a company ends up in bankruptcy / liquidation. In these circumstances, secured creditors might prefer the company to go into liquidation. This would work against the intention of restructuring financially distressed companies in that the focus should be on rescuing companies, rather than liquidating them. In order to encourage lenders to put up post-commencement finance and where they do not face the prospect of their repayment prospects being diminished, many would argue that by them placing further finance into an already distressed entity, the legislation should support their recoveries being paid out on a preference basis, even to the prejudice of secured lenders. If this were not the case, then the availability of post-commencement finance would reduce.

Certain suppliers of goods and services during the restructuring process are also viewed as providers of post-commencement finance. This category may also include employees. Such suppliers (and employees) would want to continue to supply goods and services to the company (perhaps on a cash only basis) if there is a reasonable expectation that the company will be rescued and that their post-commencement finance will be given a priority for repayment. In certain jurisdictions, priority is afforded to these suppliers of goods and services during the period of restructuring. This is done on the basis that such goods and services are extended to the supervisor himself / herself (with the incurrence of personal liability), rather than to the company in distress.

Certain jurisdictions require post-commencement finance to be approved by the court or by the distressed company's creditors. In some jurisdictions, such priority would rank above the level of supervisor's fees and / or administrative creditors. In most instances, any new financing is afforded priority over the old pre-commencement debt. What is clear is that lenders need to have a proper understanding of and certainty as to the priority of their claims in both the restructuring and in a subsequent liquidation, so as to encourage post-commencement lending in the first place.

1.5 Acquisition finance

Lenders routinely use post-commencement financing to gain effective control over debtor companies and their restructuring processes. This can sometimes be seen as an inhibiting factor when one allows post-commencement suppliers of finance a vote on the restructuring plan where they can, in some way, influence the outcome of the reorganisation. Care must be taken not to "over-leverage" the debtor company, whereby it becomes subject to burdensome new debt which ultimately scuppers the restructuring process and leads to the bankruptcy / liquidation of the distressed company.

There are many instances where post-commencement lenders have used the provision of new finance as a lever to gain control away from the supervisor or from the debtor company itself. These lenders often exert influence over decisions such as the implementation of capital improvements, setting prices for the sale of the debtor company assets, the replacement of executive management and the imposition of lender approved service providers. Whilst many of these actions have been criticised, nevertheless, without accessibility to post-commencement finance, many financially distressed companies cannot survive the pressures of the restructuring process and will end up in bankruptcy / liquidation in any event.

The restructuring of businesses provides venture capitalists, private equity funds and foreign investors with an opportunity to buy into distressed companies in order to leverage good-value assets at relatively cheap prices.

Often, distressed companies are targeted by investors who seek to use the restructuring process to their advantage. These investors look to identify financially distressed companies with high-value assets. Such investors offer supervisors, practitioners, creditors and shareholders alternatives to bankruptcy / liquidation, namely the purchase of the shares or business of companies at deeply discounted values.

Negotiations for a potential buy-out may commence either before the company formally enters into the restructuring process or after the supervisor is appointed. The negotiations might cover the provision of post-commencement finance coupled with an opportunity to make an offer for the shares (or a portion thereof) or the business (assets) of the company. It has become common for investors to put up post-commencement finance and then consummate an acquisition of the company's shares (loan to own strategy).

The final acquisition proposal is concluded between the investor or offeror and the company (represented by the supervisor) and is generally subject to the final approval of a scheme of arrangement / business rescue plan. The scheme / plan is published and includes details of the transaction. The plan is then placed before affected persons (mainly creditors) for their approval. Should the plan be approved, the supervisor will implement the transaction with the investor exiting from the restructuring process with either the shares of the company or the business (assets).

In this regard, the manner in which post-commencement finance is ranked will influence the decision of parties who wish to fund a company undergoing a restructuring process. If there is no firm indication that such a post-commencement financier will rank before secured creditors, the enthusiasm to introduce post-commencement finance and thereafter conclude an acquisition of the share or assets of the company will quickly diminish.

Often, prospective acquirers approach supervisors / practitioners at an early stage in the restructuring process and submit offers to purchase the shares or business or assets of these distressed companies. These acquisitions are often accompanied by post-commencement finance to ensure that the company's ongoing administration, overhead and running costs are paid while the acquisition transaction is being finalised.

2. South Africa

2.1 Statutory Regime

Once a company is under supervision pursuant to Chapter 6 of the Companies Act, 73 of 2008 (the 2008 Companies Act), it will almost immediately require some level of ongoing finance in order to continue functioning in the marketplace. In South Africa, such funding is known as post-commencement finance.

The 2008 Companies Act distinguishes between two types of post-commencement finance:

- funds which becomes due and owing to employees for rendering services to the company during the business rescue; and

- funds which are provided to a company, during the company's business rescue, by means unrelated to employment.

Section 135(1) states that to the extent that any remuneration, reimbursement for expenses or other amount of money relating to employment becomes due and payable by a company to an employee during the company's business rescue proceedings, but is not paid to the employee, the money is regarded to be post-commencement financing. Such post-commencement funding will be paid in the order of preference set out in subsection 135(3).

2.2 Ranking

Section 135(2)(b) of the 2008 Companies Act governs the extent and ranking of loan finance (post-commencement finance) in the business rescue process. Such post-commencement finance may be secured to the lender by utilising any asset of the company to the extent that it is not otherwise encumbered and is repaid in the order of preference set out in sections 135(3)(a) and (b).

Section 135(3)(a) confirms that all post-commencement claims will be treated equally, ranking after payment of the practitioner's remuneration and expenses and other claims arising out of the costs of the business rescue proceedings, but will have preference over loan financing (irrespective of whether or not such claims are secured) and all unsecured claims against the company.

Generally, post-commencement finance will have preference in the order in which such loans were incurred over all unsecured claims against the company (section 135(3)(b)). This preferential status will be maintained in any subsequent liquidation proceedings.

In practice, business rescue practitioners rank claims in the business rescue proceedings in the following order of preference:

- business rescue practitioners' remuneration, expenses and claims arising out of the costs of the business rescue proceedings (inclusive of disbursements such as legal and other professional costs);

- remuneration for employees from the date of commencement of the business rescue proceedings;

- secured lenders / creditors, for any loan / supply of goods or services made after business rescue proceedings commenced (secured post-commencement finance);

- unsecured lenders / creditors, for any loan / supply of goods or services made after business rescue proceedings commenced (unsecured post-commencement finance);

- secured lenders or other creditors, for any loan or supply of goods made before business rescue proceedings commenced;

- employees, for any remuneration which became due and payable before business rescue proceedings commenced;

- unsecured lenders or other creditors, for any loan or supply of goods and services made before business rescue proceedings commenced.

Interestingly, section 135 does not deal with the manner in which secured creditors who were secured prior to the commencement of business rescue will be paid if the assets over which they hold security are not sold during the business rescue process.

In *Merchant West Working Capital Solutions (Pty) Ltd v Advanced Technologies and Engineering Company (Pty) Ltd and another*,[1] the court ruled on the ranking of claims in a business rescue even though the issue of their ranking was not before the court. It confirmed the above-mentioned ranking of claims.

The decision in the *Merchant West* case is controversial and has been criticised by many stakeholders. It is an *obiter* decision and fails to take into account the position of secured creditors, both prior to and during business rescue. In practice, certain parties are of the view that the court's exposition of the ranking of claims is incorrect. The argument is that the court failed to recognise the basic distinction between encumbered assets and free residue and, as a result, prejudiced secured creditors. This distinction, which is trite in South African insolvency law, is supported by the provisions in business rescue. For instance, section 134(3) expressly regulates the rights of secured creditors during business rescue proceedings and makes it clear that, if the property is sold, the secured claim must be "promptly" paid from the proceeds or otherwise (alternative) security for its payment must be provided to the satisfaction of the secured creditor. This principle applies throughout the business rescue proceedings.

There is continued debate in South Africa (although to an extent now dealt with by the South African courts) as to whether or not secured creditors (pre-business rescue) rank higher than all secured post-commencement finance claims. There has been a call for amendments to section 135 of the 2008 Companies Act to obtain certainty on this issue.[2]

2.3 Availability of finance

Distressed organisations in South Africa have experienced increased difficulty in attracting post-commencement finance in the form of loan capital and private equity capital. Obtaining post-commencement finance often presents a challenge for financially distressed companies and the business rescue practitioner would initially attempt to establish whether the company is in a position to continue to trade and can continue to pay its own expenses and overheads in the ordinary course of its business i.e. can the company "wash its own face"? If not, then other alternative sources of post-commencement finance need to be considered.

Generally, the first port of call is internal funding from shareholders, which are mostly non-existent in a distressed situation. Shareholders in South Africa are often reluctant to place new funding (even on loan account) into the distressed entity. At that point, one often finds that shareholder loans are already substantial and where prior substantial shareholder funding has already been provided to the company.

The next source of post-commencement finance would be existing lenders, namely the company's existing bankers and financial institutions. Many South African financial institutions have amended their standard-form loan documentation (facility letters) to include the commencement of business rescue of a company as an event of default entitling the financial institution concerned to immediately terminate the overdraft or loan facility available to the company – resulting in the immediate freezing or cessation of the company's access to finance to pay ongoing expenses in the ordinary course of its business. Without ongoing funding, the chances of preserving the company's business and goodwill are greatly diminished. The result will almost inevitably be liquidation. Thus, the provision of post-commencement finance becomes all the more critical in such a situation.

In South Africa, often traditional avenues of post-commencement finance are closed to a company in business rescue. Banks tend to react to business rescue in the same way as they do to a winding-up, by immediately cancelling all credit and loan facilities. The problem is exacerbated by the fact that in most cases there are no or almost no unencumbered assets left to provide security. Often

[1] (13/12406) [2013] ZAGPJHC 109 (10 May 2013).
[2] See E. Levenstein *SA Business Rescue Procedure* (Lexis Nexis) (October 2017), Chapter 9.6, 9-88.

lenders have no choice but to provide post-commencement finance without taking security. Existing lenders are concerned about the risk of exposing new funding in an already distressed situation. Banks are often sceptical about rescue prospects and particularly where they have already incurred a substantial pre-commencement exposure. The lender's existing (internal) risk exposure often limits the provision of such further funding.

If traditional funding is not available, companies in distress may seek additional funding from third party funders, prospective third-party offerors for the company or from venture capital funds that might be interested in taking up the position of post-commencement financiers to the company.

Despite the preferential treatment accorded to post-commencement lenders, it is likely that these types of loans will attract a high rate of interest, not only because of the high risk involved in providing the funding, but also because of the preference provided by the business rescue procedure to payment of the business rescue practitioner's expenses, and thereafter the claims of employees, prior to any repayment to the lenders (this is the case even if the post-commencement lender has security for its claim). This diminishes the willingness on the part of post-commencement funders to provide further finance to the distressed entity.

2.4 Acquisition opportunities

As business rescue has become more common in South Africa, there has been an increase in interest from venture capitalists, private equity funds and foreign investors in the business rescue space. The aforesaid entities are particularly interested in providing post-commencement finance and thereby positioning themselves to acquire distressed assets through the business rescue mechanism.

As an emerging market, South Africa offers opportunities for foreign and local investors and distressed funds to consider the purchase of valuable assets that might become available at heavily discounted prices as a result of a company's financial distress. The provision of post-commencement finance has become a tool in this process.

The business rescue process is fast becoming a mechanism for cash flush investors (able to put up post-commencement finance) to take up opportunities by identifying valuable assets in distress, engaging with the business rescue practitioner and working towards the acquisition of either the company or its assets. The final acquisition proposal is what is ultimately placed in a business rescue plan and put to the vote by creditors and shareholders (the latter only if their rights are affected).

The transactions that one can conclude during business rescue vary. The business rescue practitioner may put forward a proposal to rescue the company which involves a sale of the assets of the company, a sale of the business of the company or a sale of shares of the company.

It is common for third party funders to acquire shares in the distressed company. In such an instance, the shares are often sold for nominal value, with funds made available to pay creditors' claims at a reduced and compromised amount (higher than liquidation value).

These acquisitions have resulted in the market and stakeholders (including creditors) becoming confident in the business rescue process and the ability for business rescue to be a real and viable option for parties that seek strategic acquisitions in South Africa of good value assets with significant upside for the acquirors.

Acquisition opportunities require an early identification of a distressed asset, the immediate availability of cash to fund the acquisition, as well as a commitment to propping up the company by introducing post-commencement finance funding to pay on-going expenses and overheads while the company is going through its restructuring and acquisition process in business rescue.

The appetite for third party offerors to put up post-commencement funding with the ultimate objective of converting such loan capital (loan to own) to equity provides new opportunities for merger and acquisition activity in South Africa.

2.5 Status of post-commencement finance in a rescue

Another area of uncertainty and where clarification is required, is whether or not post-commencement financiers should be allowed to vote on the business rescue plan. Unfortunately, there is no definition of "creditor" in the 2008 Companies Act and thus the "voting interests" of such post-commencement finance creditors remain moot and undecided. In practice, most business rescue practitioners will allow post-commencement lenders a vote on the business rescue plan. They are recognised as "creditors", even though their claims are established post-commencement of the business rescue process. Such post-commencement financiers are deemed to have an "interest" in the outcome of the plan (and the consequent repayment of their post-commencement finance) and thus are provided with a vote on the business rescue plan.

2.6 Bankruptcy / liquidation outcomes

Section 135(4) states –

> *"If business rescue proceedings are superseded by a liquidation order, the preference conferred in terms of this section will remain in force, except to the extent of any claims arising out of the costs of liquidation."*

If business recue proceedings are converted into liquidation proceedings, then the preferential status of post-commencement finance is recognised by the duly appointed liquidator, but after payment of the costs of liquidation (liquidator's fees and costs of the administration of the insolvent estate).

3. USA

3.1 Statutory regime

In a Chapter 11 process in the USA, a successful reorganisation is very dependent upon obtaining the necessary bankruptcy financing. Without access to post-commencement funding, a company would head towards bankruptcy with significant loss of value.

In a US-styled Chapter 11 process, such post-commencement financing is known as debtor-in-possession or DIP financing (DIP finance). DIP finance is used to enhance the reorganisation process and makes fresh capital available to the distressed entity.

Once a company has filed for Chapter 11, it must have access to funds to allow it to operate and trade in the ordinary course of its business.

The first and natural source of funds for the business is the cash flow generated by its ongoing operations. Section 363 of the US Bankruptcy Code allows companies to engage in the ordinary course of business without approval of the bankruptcy court. The use of cash resources is, however, subject to extensive restraints such as limited use of "cash collateral" without permission from the court.

The use of cash collateral may not adequately meet all of the company's financing needs. As a result, the company will attempt to arrange DIP financing before the formal filing of the Chapter 11 petition. If the company is able to arrange DIP financing, then the petition to the court is accompanied by a request for the approval of such DIP financing. Section 364 of the US Bankruptcy Code provides the debtor company with access to such DIP financing.

3.2 Ranking

Under section 364 of the US Bankruptcy Code, lenders or investors who provide credit to a company under Chapter 11 proceedings are granted superior priority status relative to a company's pre-petition creditors. These lenders are often the first to be repaid once the firm exits the Chapter 11 process. At a minimum, DIP lenders will be given an unsecured first priority administration claim, and at most they can be given a secured claim which might include a senior claim on assets that have previously been pledged to other lenders. This places DIP lenders at the very top of the capital structure in a Chapter 11 process.

Section 364 is progressive in nature, as the benefits provided are not made available to the debtor company until it has been established that a good faith effort to obtain credit has been unsuccessful. Section 364 has four sub-sections, all dealing with the different levels of DIP financing that can be made available to the debtor company. This includes the following:

- the provision of unsecured credit in the ordinary course of business without court approval;[3]
- DIP financing to be used by the company other than in the ordinary course of its business with approval of the court;[4]
- DIP lending with priority, security interest and the imposition of a junior lien on already unencumbered assets with court approval;[5] and
- DIP financing made available with court approval where "priming liens" are granted to lenders on already pledged collateral.[6]

In the US, the US Bankruptcy Code offers the company a number of mechanisms for accessing DIP finance. It gives current or new lenders priority in relation to the provision of DIP financing (i.e. a right of repayment priority) through the provision of financing and loans to the debtor company on favourable interest terms for that company. Access to DIP financing may be obtained in the ordinary course of business transactions without court approval. Court approval is required for DIP financing sought otherwise than in the ordinary course of business. In such cases, the court would authorise a debtor company to incur unsecured post-petition debt as a first-priority administration expense or secured debt over unencumbered assets or remaining portions of unencumbered assets. In effect, DIP financing allows for the payment of expenses necessary to cover the day-to-day operations of the business while the company is under the Chapter 11 process.[7]

Few Chapter 11 companies are capable of continuing in business without obtaining some additional financing. Debtors under Chapter 11 generally require additional injections of cash to finance adjustments that they must make in order to restore their profitability.

3.3 Availability of finance

The ability of the debtor company to obtain DIP financing is important in the US context of ensuring that confidence is restored amongst the debtor company's suppliers, customers and bankers. It establishes that there is now capacity for the debtor to continue to trade, pay ongoing expenses and overheads and which allows the operations of the company to continue during the reorganisation process.

The level of success in obtaining DIP finance in a US Chapter 11 proceeding will be dependent on the DIP financier's appetite for pricing and risk. Some lenders look for a "par recovery", whilst others might be looking for higher returns.

Often, DIP financing is provided by a debtor company's pre-petition secured lenders (i.e. defensive lenders) who are generally comfortable in advancing finance with a view to maintaining the value of their security and the ongoing business of the company. These secured lenders are often the drivers of the restructuring process and negotiations.

Alternative funding includes finance made available by lenders who do not have a pre-petition relationship with the debtor company. These lenders are often termed "offensive" or "new money" lenders. The feasibility of the provision of new money is often determined by what unencumbered collateral remains available to such lenders. In certain instances, such new lenders obtain the consent of pre-petition lenders to being "primed", i.e. where the debtor company grants the DIP lender security that has priority over pre-bankruptcy secured creditors.[8]

---

3 Section 364(a).
4 Section 364(b).
5 Section 364(c).
6 Section 364(d).
7 See Ferriell and Janger *Understanding Bankruptcy*, 732.
8 Mayer Brown JSM 'Debtor in Possession Financing in Asia - Considerations for Financial Institutions' *Legal Brief Asia* (29 August 2018). It should be noted that Singapore have recently adopted the DIP finance model where there has been the grant of special relief to loan providers in the form of super-priority status to such lenders. Singapore recently amended its Companies Act (Chapter 50), Act 42 of 1967 and introduced section 211E applicable since May 2017. The Singapore regime is largely modelled on the equivalent provisions in the US Bankruptcy Code and incorporates concepts of DIP financing that are similar to Chapter 11 reorganisations.

Many prospective lenders who enter into a Chapter 11 proceeding will not be confident of the debtor's ability to propose, confirm and consummate a reorganisation plan. Thus, the debtor company may not be able to find lenders who are willing to provide further extensions of credit on an unsecured basis. Accordingly, section 363(c) of the US Bankruptcy Code also permits the court to allow the debtor company to obtain funding and permits the court to grant the post-petition creditor either a super-priority claim or a security interest over the debtor's assets. Moreover, if existing secured creditors can be adequately protected, the court may authorise the debtor to provide a new lender with a senior lien on already encumbered assets.

In practice, the debtor company is expected to provide prospective DIP financiers with budgets, forecasts and cash flow analysis so that the DIP financier can correctly and accurately identify the level of DIP finance required.

Importantly, the need for DIP financing in a US Chapter 11 proceeding must be and will often be established early on in the process. Delay will complicate the ability to source the DIP funding and the identification of the finance requirement. Clearly, experienced restructuring professionals can work with the debtor company from the outset to establish DIP financing requirements and further establish, with a degree of certainty, the ability of the debtor company to service the loans provided in the Chapter 11 proceeding.

Ultimately, DIP financing in the context of a Chapter 11 restructuring provides financially distressed companies the opportunity to raise new capital to fund the investment needed to preserve the company as a going concern, which is an essential pre-requisite to a successful restructuring process.

3.4 Acquisition opportunities

In the US, acquisitions of distressed companies can take various forms. These transactions can occur through a pre-packaged and pre-negotiated bankruptcy plan, through a section 363 bankruptcy sale process or through a conventional plan process. Distressed companies often are the focus of a planned acquisition strategy and where their stock and debt are traded at considerably reduced and favourable prices. Such acquisitions may take the form of buying existing or newly issued stock / shares; a potential merger of the acquiror with the targeted distressed entity; the purchase of businesses and / or assets; or the purchase of existing debt with the aim of a conversion of debt to equity.

The opportunities are varied. Some distressed companies have severe liquidity issues with no significant debt maturity issues. These companies might be acquired by offers made where negotiated forbearance agreements, waivers and amendments of bank and bond debt are concluded. If impending debt obligations of the target company is an issue, then acquisitions might include a distribution of the existing equity holders' ownership of the distressed company or its assets. Strategies might include asset sales, rights offers, debt repurchase or restructuring arrangements, exchange offers and foreclosure sales.

All of the above options allow US (or foreign) investors in distressed assets opportunities to acquire interests in, assets from or control of the distressed company.[9]

As a result of increased bankruptcy filings and debt restructurings in the US, a strong secondary market for trading in the financial claims of distressed companies has emerged.[10] The strategies that are used are diverse some investors prefer to acquire the debt claims of a company while it tries to reorganise under Chapter 11 so that they can position themselves to influence the terms of reorganisation or wait until the company's debt is converted into a major equity stake that can be used to influence company policy. Some investors prefer to purchase senior claims, others junior claims and still others spread their purchases throughout the entire capital structure.[11]

In the US there is a market for virtually every kind of distressed claim, ranging from bank loans to debentures, trade payables, private placements, real estate damages and claims for legal damages, and lease contracts.[12]

9 See Wachtell, Lipton, Rosen and Katz 'Distressed mergers and acquisitions' (April 2018) 159-214.
10 See S. Jain 'Investing in distressed debt' *Alternative Investment Analyst Review* 1:2 (2012), 32–50, https://www.caia.org/sites/default/files/alternative_investment_analyst_review_q2_2012.pdf.
11 R. Harmer 'Comparison of trends in national law: The Pacific Rim' *Brooklyn Journal of International Law* 23:1 (1997), 149.
12 S.C. Gilson 'Investing in distressed situations' 8.

In the US, the explosion in growth on the demand side of the distressed debt market has greatly reduced the number of opportunities for buying under-priced claims. There is always a risk in buying distressed claims as they are highly firm-specific. In the US, distressed funds are generally legal and institutional in nature and most risk is controlled through careful planning and the conduct of adequate due diligence. Many firms are represented by individuals who have a sound working knowledge of bankruptcy law. Many of these individuals are former practising bankruptcy attorneys or have access to legal counsel experienced in bankruptcy matters.[13]

Many organisations have been set up purely to invest in companies which are performing poorly and which are financially distressed. These entities, often referred to as "vulture funds", look to enhance the value of their investments by taking positions in undervalued companies and where the upside, once such company is restructured, is significant. Vulture funds can add or subtract value in a corporate reorganisation process and are fairly controversial. Often the term 'vulture' is equated to 'raider' and used to describe proactive investors in a takeover market. In the US, many bankruptcy judges are philosophically opposed to the idea that people can insert themselves into a distressed situation for profit while at the same time the firm's original lenders and stockholders are being asked to make material financial sacrifices. Such hostility to the activities of vulture investing overlooks the critical role it plays in creating value in a restructuring situation.[14]

The 'loan to own' principle in Chapter 11 restructuring is fast taking a hold of the objectives of debt purchasing by vulture funds in the US. By purchasing debt, professional debt investors in Chapter 11 cases facilitate control of the firm, with the potential acquisition of the equity as a viable outcome. In a 'loan to own' strategy, the investor extends DIP finance to the debtor in order to facilitate the investor's ultimate objective, ownership of the debtor's business, through a debt-for-equity exchange or sale transaction.[15] Activist institutional investors might purchase company debt to change management and board members or to assist in operational strategies, in the acquisition of asset holdings or in the restructuring of the company's capital structure. Such activist behaviour might not benefit the debtor and other stakeholders. As a result, financially troubled companies that are targeted by such activist investors might file for bankruptcy as a defensive measure to a hostile takeover bid.[16]

3.5 Status of DIP financiers in a restructuring

As lenders are generally reluctant to extend credit to financially troubled companies, the rules relating to the order in which claims are paid are favourable to lenders who provide DIP financing. Section 364(d) of the US Bankruptcy Code gives super-priority status to new lenders if they can prove that no other financing is available to the company.

DIP financing in the US has been criticised for operating as a lever of control over management as well as transferring value to "privileged" creditors at the expense of ordinary creditors and shareholders.

3.6 Bankruptcy / liquidation outcomes

Often, DIP financing is offered to the debtor company in order to provide the lender with the opportunity to convert the DIP finance into "exit financing" arrangements geared towards the ability of the debtor company to service the debt, pay the loan down and then allow for a bankruptcy exit plan. What must be averted (if possible) is a conversion of a Chapter 11 into a Chapter 7, which can happen if too much debt is incurred during the initial Chapter 11 proceeding. Once a conversion takes place, DIP finance claims (as super-priority claims) will be considered by the US Bankruptcy Court and the Court will determine whether such super-priority claims, granted in the pre-conversion Chapter 11 case, retains its priority status over all other claims in the bankruptcy proceedings, including administrative expenses incurred in the post-conversion Chapter 7 case.[17]

---

13 Ibid. 13 and, for an analysis of the profile of risk in distressed debt investing, 13–22.

14 Ibid. 23. See Wachtell, Lipton, Rosen and Katz 'Distressed mergers and acquisitions' (April 2018) 159–214.

15 For an analysis of empirical data supporting these investment practices in Chap. 11 proceedings, see M.M. Harner 'Trends in distressed debt investing: An empirical study of investors' objectives'. See also M.M. Harner 'The corporate governance and public policy implications of activist distressed debt investing' and M.J. Whitman and F. Diz *Distress Investing: Principles and Techniques*.

16 M.M. Harner, 'The corporate governance and public policy implications of activist distressed debt investing' 703 and 705.

17 See M. Foster 'The effect of conversion on a post-petition lender's super-priority claim over a Chapter 7 trustee's post-conversion administrative expense claim' *St John's Bankruptcy Research Library* (2014) Vol. VI No. 14.

4. UK (England and Wales)

In 2009, the UK government embarked on a national consultation to encourage rescue and equivalent post-commencement financing. Responses to the proposal indicated a negative interest from the UK financing community and therefore no further action was taken. More recently, in May 2016, the UK government issued a consultation on the UK corporate insolvency framework including a proposal to introduce super-priority rescue finance. The government's response to this and a further consultation in March 2018 was published in August 2018. Whilst it confirmed its intention to introduce radical proposals to reform UK insolvency law, including the introduction of a new moratorium to give viable, but financially distressed companies breathing space to address their problems, significantly, the UK government has decided not to introduce super-priority rescue finance. While there was some support for the proposals, many respondents to the consultation thought that the existing framework provides options to encourage the provision of new financing in rescue scenarios, for example the statutory ranking of the costs of finance in the administration expenses hierarchy (see further below). The UK government was persuaded by the arguments put forward by the large majority of respondents who were opposed to the measures and therefore decided not to proceed with the rescue finance proposals at this time, but indicated that it will keep the issue under review.

4.1 Statutory regime

Although the concept of post-commencement finance is not expressly mentioned in the UK Enterprise Act 2002, the Insolvency Act 1986 does allow the administrator to exercise the management powers of borrowing money and granting security on the company's behalf. These 'loan obligations' are viewed as a super-priority in repayments in an administration process.

Post-commencement finance is addressed generally under a number of different provisions in the Insolvency Act 1986 relating to the powers and authority of an administrator, how the costs of such financing is paid for and in what priority these charges are paid.

The Insolvency Act, 1986 makes provision for an administrator to exercise management powers including "… *to borrow money and grant security on behalf of the company* …" (paragraph 3 of Schedule 1 of the Insolvency Act 1986).

Paragraph 99 of Schedule B1 of the Insolvency Act, 1986 provides that "… *a sum payable in respect of a debt or liability arising out of a contract entered into by the former administrator … shall be … (a) charged on and payable out of property of which the former administrator had custody or control … payable in priority to any charge arising under sub-para 3 …*" [fees and remuneration … and therefore by implication payable in priority to floating charge realisations in the administration].

Insolvency Rule 3.50 of the Insolvency Act, 1986 sets out what costs, charges and expenses incurred in the course of the administration can be treated as expenses of the administration, and therefore paid in priority to ordinary claims. The priority of expenses themselves (that is, between different types of expenses) is the subject of Insolvency Rule 3.51(2).

Such financing arrangements are permitted under the Act and the charges for which are payable in priority to other expenses (including the administrator's own remuneration) and ordinary or certain of the secured (floating charge) claims in the administration. In practice, particularly in relation to complex financing deals, one should approach the court and obtain directions approving the financing arrangements, including any security or priority aspects (many commentators also believe this was the intention of the UK legislature in not expressly setting out specific post-petition financing legislation).

Due to the rise in UK pre-packaged administrations, the need for creative mechanisms for post-petition financing has diminished. Although paragraph 99 of Schedule B1 of the Insolvency Act provides a mechanism for the establishment of such finance on a super-priority basis, these possibilities are not being fully explored. Pre-packs often come with their own funding package (provided by the prospective buyer) and which reduces the need for the establishment of such post-petition finance. In cases where a pre-pack process is not used, and a trading administration ensues, then funding becomes of primary importance.

4.2 Ranking

Administration expenses in the UK rank ahead of all preferential debts. This 'golden rule' of UK insolvency practice, whereby the expenses of the procedure take priority over all other claims (except those secured by means of a fiscal charge), is embodied in the legislation. Immediately upon appointment, the administrator will need to consider the funds available to finance trading. If the company has not granted security, the focus will be on the liquidity of the company's assets to meet the cost of trading. When the company has granted debenture security, the administrator's access to assets for trading expenses will be restricted to the pool of floating charge assets.

4.3 Availability of finance

In practice, the administrator approaches financial institutions for loans to contribute to working capital to assist in the carrying on of the business during the company's administration. Application of the London Rules (applicable since 1990)[18] would ensure that banks and, where appropriate, creditors, work together to reach a collective view on whether and how the company should be given financial support during the course of its administration.

In the UK, companies often raise capital in the administration process by securing bank loans secured by floating charges. This is consistent with English judicial and legislative policy which encourages financing through secured loans at interest rates that are reduced by giving secured creditors high levels of protection.

4.4 Acquisition opportunities

As set out above, the UK Insolvency Act (as amended by the Enterprise Act, 2002) provides a company with both restructuring (administration) and liquidation alternatives. In contrast to the position in Chapter 11 proceedings in the US, in restructuring proceedings in the UK a company's management is subject to the direction and control of a third-party administrator. Institutional investors in the UK pursue distressed debt investing opportunities, depending on the value existing in the distressed company. Negotiations would ensue between the administrator and the investor in respect of a possible debt-for-equity exchange. These negotiations would occur with little or no substantive court involvement.[19]

The issue of value creation or destruction is present in both the US and in the UK. Again, investors looking to acquire the company or to take control via a debt-to-equity swap will have influence over management and existing shareholders. These objectives must be carefully managed because they can result in destruction of value while the company is in administration.[20]

However, not every distressed investment situation leads to conflict. A distressed debt investor might be the only source of rescue capital for the company. A distressed debt investor that offers new capital to the restructured company, whether directly or by impairing the company's balance sheet through a debt-equity exchange, can give a troubled company a second chance.[21]

In the UK, interest in corporate debt trading began to emerge once the US market began to get saturated. Making use of vulture funds to provide alternatives for the acquisition of debt was encouraged by the Bank of England. The involvement of vulture funds was supported thus:

> *"[Such funds] make the whole [restructuring] process a much quicker and less expensive way to proceed and also you get very sophisticated investors who are able to spend the time to try fix the company and bankruptcy, even though they have a profit motive. If they can fix the company, make a profit and get out, that's fine. For the banking community and the trade creditor community it provides a market to sell out. They don't have to hang in for the uncertainty of bankruptcy over a two or three or five year period."*[22]

---

[18] The "London Rules" or "London Approach" to corporate workouts was established by the Bank of England in 1990. It sets out widely used principles which govern how banks are to respond to corporate customers experiencing financial difficulty. See L. Kent, former Executive Director of the Bank of England 'Corporate Workouts – a UK Perspective' *International Insolvency Review* (1997).

[19] M.M. Harner 'The corporate governance and public policy implications of activist distressed debt investing' 720.

[20] Ibid. 721.

[21] Ibid. 722.

[22] J. Flood 'The vultures fly east: The creation and globalisation of the distressed debt market' in D. Nelken and J. Feest (eds) *Adapting Legal Cultures* 272. Flood also provides an excellent synopsis of distressed debt funding in mainland Europe, the UK, the US and Canada.

The Bank of England's motives were clear. For economic reasons it preferred that companies not be placed into liquidation unnecessarily. Jobs and productive capacity had to be preserved. With the increasing use of the London Rules approach to restructuring and the need to restructure balance sheets, the need for funding introduced by distressed debt investors was a strong reason for vulture fund investors to consider entering the UK market.[23]

4.5 Status of financiers in the administration process

As the UK, does not have the concept of a "super-priority" financing regime, no special or preferential status is given to third parties or creditors who might provide finance to the company under administration. Such additional funding arrangements are concluded between the lender and the administrator on specific contractual terms, which will include terms for repayment. Such loans (financing arrangements) are often concluded with the taking of the requisite security, such as floating charges and in terms of the provisions of Schedule B1 of the Insolvency Act, 1986.

4.6 Insolvency outcomes

Once a company exits from its administration and enters a winding-up process in terms of the UK Insolvency Act, the duly appointed liquidator will, if there are sufficient funds in hand, declare and distribute dividends amongst the creditors (including loan providers), but will do so subject to the retention of such sums as may be necessary for the expenses of the winding-up. The distribution will occur in the order or priority of distribution derived from the proceeds realised from assets and in terms of the UK Insolvency Act, and after the payment of administration expenses.[24]

5. Canada

5.1 Statutory regime

While DIP financing was only codified in the Canadian Companies' Creditors Arrangement Act (CCAA) in 2009, previously courts approved post-commencement financing on the basis of their inherent jurisdiction.

Effective in 2009, the Canadian Parliament codified the use of interim financing and the test to be applied by the court in approving DIP financing in Section 11.2 of the CCAA.

Section 11.2(1) of the CCAA allows a court to grant a charge (a charge is a priming lien) on the property of a debtor company for the purposes of obtaining what is referred to as 'interim financing' under the CCAA. The application must be made on notice to affected secured creditors and the quantum of the charge is capped at an amount determined to be appropriate by the court, although in almost all cases the charge secures the full amount of all obligations under the financing (including fees, costs etc.). Section 11.2(2) of the CCAA expressly allows the court to order that the charge ranks in priority to the claims of existing secured creditors of the debtor company. There is no requirement in Canada of "adequate protection" for existing secured creditors of the company by priming them with this charge.

The CCAA does offer a form of protection to existing secured creditors in that section 11.2(1) of the CCAA provides the court with a broad discretion to consider any relevant factors on an application for a priority financing charge. In making the assessment, the court is expressly required to consider both:

(i) the nature and value of the property subject to the charge (11.2(4)(e)); and

(ii) whether any creditor would be materially prejudiced as a result of the security or charge (11.2(4)(f)).

This involves a consideration of whether there is equity in the collateral beyond the secured indebtedness owed to the creditor and, in the event that there is such equity, whether the equity value is likely to be maintained over the course of the proceedings.

---

[23] Ibid. 272.

[24] See I.F. Fletcher *The Law of Insolvency, paragraphs* 24-014 - 24-020, 5th edition (Sweet & Maxwell) (May 2017).

5.2 Ranking

In determining whether it is appropriate to give a lender priority over existing secured creditors, the Canadian courts have discretion to consider the extent to which those secured creditors would be adversely affected. There must be cogent evidence that the benefit of such financing clearly outweighs the potential prejudice to the lenders whose security is being subordinated. To make this assessment, courts require information about the value of the collateral and the amount of the secured obligation.

In some cases, the lender is a new lender with no past dealings with the debtor. In other cases, the loan is obtained from an existing creditor. A pre-filing lender may extend funds to the debtor in order to enhance the lender's recovery on its pre-filing claim or to gain a greater ability to influence the direction of the restructuring.

A court can (on good grounds) make an order declaring that all or part of the debtor's property becomes subject to a security or charge in an amount that the court considers appropriate. Thus the CCAA in Canada utilises the concept of priority based financing, which provides for a super-priority charge in favour of a lender.

In the case of the CCAA, the provision and structure of such financing is generally approved by the court unchallenged, as the process to agree on the terms of such financing is resolved through intense negotiations between strategic stakeholders prior to the commencement of CCAA proceedings. Canadian courts do not tend to intervene in the financing proceedings unless the terms are controversial for example, where the lender is provided with super-priority security against the objections of existing creditors.

Generally, funding is required upfront because, as soon as the company makes a CCAA filing, existing lenders and creditors tend to terminate financing facilities or change the terms of their payments. Such funding would also contribute to increased confidence levels among existing creditors, in boosting the prospects of success of the distressed company. The authorisation of new financing is considered by Canadian courts on a 'balance of prejudices' test. Several enumerated criteria have to be met for the court to approve any new financing to the company. In CCAA proceedings, it is generally the responsibility of the courts to determine the relative ranking of charges. Courts will consider the extent to which secured creditors' rights will be adversely affected and have indicated that there must be "…*cogent evidence that the benefit of DIP financing clearly outweighs the potential prejudice to the lenders whose security is being subordinated*".[25]

Since the codification of DIP financing in Canada in 2009, the need to properly balance the protection of the DIP lender against the interests of the debtor company and other stakeholders has become the subject of debate. Market conditions often place the balancing of these interests in conflict, particularly when the value of recovery for existing creditors and, in some instances, for the DIP lenders themselves are in conflict. Increased tensions between the rights of DIP lenders and the objectives of the CCAA result in a need for the Canadian courts to provide greater oversight and direction in setting the standard of fairness within the parameters of the facts of each CCAA case.

5.3 Availability of finance

In some cases, the DIP lender is a new lender that has had no past dealings with the debtor. In other cases, the DIP loan is obtained from an existing creditor. A pre-filing lender may extend funds to the debtor in order to enhance its recovery on its pre-filing claim or to gain a greater ability to influence the direction of the restructuring. Under certain circumstances, courts have been willing to extend the scope of the DIP charge so that it covers pre-existing obligations that are unconnected to the DIP loan.

When there are two or more secured creditors who have security interests in different assets, disputes may arise as to the manner in which the super-priority of the DIP charge is to be allocated among the secured creditors. For example, one secured creditor may have a security interest in the land and other fixed assets, while another secured creditor may have a security interest in the inventory and accounts (current assets). Courts have been prepared to make orders that allocate the DIP super-priority unequally among the creditors if it is fair and equitable to do so.

[25] See *Re United Used Auto & Truck Parts Ltd* (1999), 12 C.B.P. (4th) 144 at para 28.

5.4 Acquisition opportunities

In Canada, the tightening of global credit markets since 2008 has brought about conditions in credit markets which present attractive opportunities for distressed debt funds. Canadian vulture funds look at acquiring the debt of a company that is either bankrupt or, more often, near bankruptcy at a considerable discount. As in the US, once debt has been purchased (either from creditors or from the companies themselves) such purchaser or investor is able to wield considerable influence over any subsequent restructuring or liquidation process.[26]

Canadian venture capital funds often see investing in distressed debt as an opportunity to make a profit either through the liquidation of the assets of the company or through having their debt converted to equity in a restructuring of the company and then emerging as a major shareholder. Such a shareholder will use its position to initiate change in an attempt to increase the value of its equity stake in the company. Access to short-term funding and a deteriorating debt market in Canada has left vulture funds considering and monitoring opportunities constantly.[27] As a result, management in Canada have to be aware at all times of who holds their company's senior debt, whether it be a primary lender or through secondary markets, as distressed debt investors may be focused on making their returns through the restructuring or liquidation process.[28]

5.5 Status of lenders in the CCAA process

A DIP lender obtains an enhanced ability to control the direction of the restructuring proceedings.[29] This may be beneficial to the creditors as a group if the interests of the DIP lender and the other creditors are aligned. However, it may also permit the DIP lender to use this control in order to steer the restructuring in a direction that is favourable to the DIP lender but unfavourable to the other creditors. For example, it may permit the DIP lender to force a sale of the business or to allow the DIP lender to obtain an advantage over other bidders on an auction of the business.[30]

5.6 Bankruptcy outcomes

In terms of the CCAA, creditors can terminate the restructuring proceedings and the court is given the ability to terminate if the restructuring attempt is unlikely to succeed. Once this occurs, the company is, in most instances, placed into bankruptcy. Once a trustee is appointed, creditors (including funders) would have to file claims in order to participate in the distribution of assets of the bankrupt estate. All post-filing creditors (who extended credit to the company in its restructuring proceedings) are in the same position as pre-filing creditors and will share *pari passu* with all the unsecured creditors. It is for this reason that post-filing creditors are often unwilling to grant credit to the debtor. If the lender of finance in the administration has a claim, and where security has been taken, such lender will be recognised as a secured creditor in the bankruptcy.

6. Australia

6.1 Statutory regime

In Australia, the legislation does not provide for the manner in which the financing of businesses which have filed for bankruptcy can occur. Any additional liquidity requirements would generally be met by funding from existing lenders and creditors.[31]

Voluntary administrators in Australia are able to provide the company to whom they are appointed the ability to borrow funds.

However, under section 443A(1) of the Corporations Act 2001 (Cth) (Corporations Act), administrators are personally liable for debts they incur in the performance or exercise of their functions and powers for:

[26] P. Magee and C. Partridge 'Distressed debt investors in the current market'.
[27] Ibid. 1.
[28] Ibid. 2. See also S. Muglich 'How not to buy a distressed business'.
[29] See R.J. Wood, *Bankruptcy & Insolvency Law,* Chapter 14, Section D(3).
[30] See D. Skeel 'The Past, Present and Future of Debtor-in Possession Financing' (2004) 25 Cardozo L. Rev. 1905; J. Sarra 'Governance and Control: The Role of Debtor-in-Possession Financing under the CCAA' in Janis P Sarra ed., *Annual Review of Insolvency Law, 2004* (Toronto: Carswell, 2005) 119.
[31] W. Du Preez 'The status of post-commencement finance for business rescue in South Africa' 33.

a) the repayment of money borrowed;

b) interest in respect of money borrowed; and

c) borrowing costs.

Administrators are indemnified out of company assets for such personal liability (section 443D), which indemnity is secured by a lien over such assets (section 443F).

Whilst it is not possible for administrators to contract out of this personal liability (section 443A(2)), the court can make an order under section 447A, limiting their liability entirely or otherwise, to the extent of the available assets of the company. However, before the court will make such an order, it needs to be satisfied that the creditors will not be prejudiced or disadvantaged by the modification order.

In circumstances where it is impractical to seek to obtain an order under section 447A (for example, in the case of large and complex administrations, where it would be impractical to obtain an order under section 447A, in respect of every contract the administrator caused the company to enter), the administrator(s) often seek to:

1) include a limitation of liability clause which, *inter alia*, requires the counterparty to waive and release the administrator(s) from all personal liability which cannot be paid or satisfied out of the assets of the company; and

2) seek to rely upon an estoppel argument to preclude counterparties from bringing an action against the administrators to recover amounts which cannot be paid or satisfied out of the administrators' lien over the assets of the relevant company. Although this has never been tested, it is becoming quite common practice, particularly in large Australian administrations.

6.2 Ranking

If the company in administration does proceed to liquidation, the provider of finance would generally be entitled to a priority under section 556(1)(c) of the Corporations Act.[32] In some cases they may be entitled to a higher priority or a lower priority, as determined by the nature and terms of the loan provided. That is, these debts for loan finance incurred by an administrator would effectively receive priority over pre-administration debts.

6.3 Availability of finance

Australian banks are usually more forthcoming with further financing if the company in question is in distress rather than insolvent. Thus, whether a company is in voluntary administration stage or being liquidated will make a significant difference to the willingness of banks to participate in further interim funding and to financial institutions' level of participation in supporting the corporate rescue. Generally, Australian banks are accepting of the need to provide finance to companies in administration.

6.4 Acquisition opportunities

In Australia, the secondary market for buying debt has grown. There is an increasing availability of distressed debt coupled with a deep market of buyers who are interested in acquiring Australian distressed debt. Buyers of debt in Australia are typically motivated by either trading profits or a longer-term interest in the assets and business of the borrower. Debt-to-equity swaps appear to be a driving factor in such investment strategies. Australian buyers of distressed debt have a number of options available to them when they are looking to convert debt to equity ownership under Australian law. Ownership can be achieved through recapitalisation of the existing business through a debt-to-equity swap or by the enforcement of security provided by the lender, which would lead to a sale of the company's assets to a party related to the lender. In Australia, a consensual debt-to-equity swap is an option but would have to be negotiated by the lender and the debtor company. Alternatively, there can be a consensual issue of equity to a financier in

[32] See section 443E.

consideration of forgiveness of the debt. A debt-to-equity swap would occur when the secured creditor uses the potential of enforcement as leverage in negotiations.

6.5 Status of lenders in the voluntary administration process

In Australia, the administrator would negotiate financing with banks and financial institutions for loan finance. These terms would be binding on the administrator personally as he / she is liable for all debts incurred in the course of the administration. This is intended to encourage banks and financial institutions to deal with the company and assist the administrator in carrying on the business of the company.

6.6 Bankruptcy outcomes

New borrowings (being amounts for which the administrators are indemnified) will also receive priority over unsecured creditors in a subsequent liquidation through the operation of the Australian Corporations Act (sections 443D and 556). For this reason, third parties are often comfortable lending to companies in administration, as they know they will be paid out ahead of the company's unsecured creditors.

7. World Bank and UNCITRAL guidelines

There are certain international guidelines available in respect of the need for and manner in which post-commencement finance should be made available to financially distressed companies. These include recommendations provided by the World Bank's international publication titled *Principles for Effective Creditor Rights and Insolvency Systems*[33] (the World Bank Principles) and UNCITRAL's *Legislative Guide on Insolvency Law*[34] (UNCITRAL Legislative Guide).

The World Bank Principles refer to the need to stabilise and sustain distressed companies by ensuring that there are mechanisms to ensure access to commercially sound forms of financing. The terms of these loans should provide for the repayment priority, taking into account the circumstances and extent of the financial distress in order to ensure that the company can meet its day to day operational needs.

The World Bank collaborated with UNCITRAL on this issue and made suggestions and recommendations for post-commencement finance. The UNCITRAL Legislative Guide sets out the need and necessity for post-commencement finance as well as the sources of such finance. Issues such as the manner in which companies can attract post-commencement finance and the priority that should be afforded to such loans are dealt with. Sources identified include available cash, funding provided by the sale of liquid assets, trade credit facilities and loans. The UNCITRAL Legislative Guide deals with the importance of the debtor having access to funds to pay for critical supplies of goods and services, labour costs, insurance, rent, maintenance of contracts and other essential operating expenses. Emphasis is placed on the need to ensure that the value of the assets and business of the company is maintained.

In circumstances where the debtor company has no further available funds to meet its immediate cash flow needs, it has little choice but to seek financing from third parties. A distinction is drawn in the UNCITRAL Legislative Guide between the need to obtain new funding, generally required at an early stage in the proceedings, and what would be required post approval of the restructuring plan.

The UNCITRAL Legislative Guide recommends that there is a need to ensure that legislation makes provision for post-commencement finance and in particular that priority and ranking issues are specifically catered for in such legislation. Without such legislative provision, uncertainty will prevail and which will diminish the ability to attract this (much needed) finance in any restructuring process. Specific legislative provision dealing with priority of payment (ranking) will induce creditors to lend. The impact that post-commencement finance will have on the ranking of existing secured creditors that were established pre-commencement of the restructuring process must be balanced against the rights of post-commencement funders. The impact on secured creditors who may see the remaining unencumbered assets disappear to secure new post-commencement lenders must also be taken into account.

[33] *Principles for Effective Creditor Rights and Insolvency Systems* (2011, revised 2015).
[34] *Legislative Guide on Insolvency Law* (2005).

In summary, both the World Bank and UNCITRAL deal with the specific and urgent need of debtor companies to have access to additional and new lines of funding that post-commencement funding can provide. Any corporate rescue regime should therefore make provision for such type of finance when developing its own specific restructuring laws. Without it, the downward spiral into liquidation / bankruptcy will be all the more rapid. The World Bank and UNCITRAL guides are available to jurisdictions that are in the process of developing or enhancing their own peculiar insolvency laws and regimes. These are not meant to be prescriptive but are used as a benchmark in the development of insolvency regimes worldwide.

8. Conclusion

The provision of post-commencement finance is a fundamental requirement for a successful restructuring process. It is an essential component of any restructuring / business rescue process, and without it, all efforts by the practitioner to rescue the company will be in vain. Access to post-commencement finance is necessary to allow the company to continue to operate and to preserve the going-concern value of the enterprise. Although post-commencement finance may come from various sources, it is submitted that the best source would be financial institutions and banks already providing loans or finance to the company. These institutions would already have an existing commercial relationship with the corporate entity and would have valuable information as to the entity's history and financial situation. Such institution would be in a far better position to expeditiously consider the necessity for post-commencement finance requirements. If banks and financial institutions realise that without immediate access to post-commencement finance, a distressed company is unlikely to be resuscitated, the enthusiasm to put up such post-commencement finance will increase.

Without a set of post-commencement financing legislative provisions (like we have seen in the various jurisdictions mentioned above) which define and legitimise the manner in which such post-commencement finance will be treated in the restructuring process, access to this form of new finance is extremely difficult.

What is required is detailed and effective legislation where priorities of post-commencement lending are set out and determined and which can work in a practical and effective manner. Such legislation will contribute to the continued establishment of a "rescue culture" across international jurisdictions and which will enhance the survival of financially distressed entities.[35]

[35] Consider the recommendations of the World Bank and UNCITRAL as set out above.

This paper is based on the legal status current as at 1 October 2018.

INSOL International
GROUP THIRTY-SIX

AlixPartners LLP
Allen & Overy LLP
Alvarez & Marsal
Baker McKenzie
BDO
Brown Rudnick LLP
BTG Global Advisory
Clayton Utz
Cleary Gottlieb Steen & Hamilton
Clifford Chance LLP
Conyers Dill & Pearman
Davis Polk & Wardwell LLP
De Brauw Blackstone Westbroek
Deloitte LLP
Dentons
DLA Piper
EY
Ferrier Hodgson
Freshfields Bruckhaus Deringer LLP
FTI Consulting
Goodmans LLP
Grant Thornton
Greenberg Traurig LLP
Hogan Lovells
Huron Consulting Group
Jones Day
King & Wood Mallesons
Kirkland & Ellis LLP
KPMG LLP
Linklaters LLP
Morgan Lewis & Bockius LLP
Norton Rose Fulbright
Pepper Hamilton LLP
Pinheiro Neto Advogados
PwC
Rajah & Tann Asia
RBS
RSM
Shearman & Sterling LLP
Skadden, Arps, Slate, Meagher & Flom LLP
South Square
Weil, Gotshal & Manges LLP
White & Case LLP