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Tripping the Light Fantastic: A Comparative Analysis of the European Commission's Proposals for New and Interim Financing of Insolvent Businesses

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Tripping the Light Fantastic: A comparative analysis of the European Commission's proposals for new and interim financing of insolvent businesses

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Com, and trip it as ye go,
On the light fantastick toe.
John Milton, L'Allegro, 1645[2]

1. Introduction

In the aftermath of the global financial crisis, the importance of jurisdictions having in place effective mechanisms to enable the rescue of viable, but financially distressed, businesses is increasingly recognized. Some jurisdictions have had such mechanisms in place for a while, notably, Canada and the United States. Others have lagged. This issue is one to which the European Commission has recently turned its attention, with a Restructuring Recommendation in 2014,[3] and a draft Directive in 2016.[4]

There are a number of key elements in the European Commission's proposals, including that the restructuring mechanism is debtor-in-possession, available pre-insolvency, that it can be imposed on dissenting creditors, including cross-class cramdown, and has the benefit of a broad statutory stay. The proposals also seek to facilitate restructuring by creating new provisions for financing. Proposed Articles 16 and 17 provide minimum protection for new financing necessary to implement a restructuring plan, for interim financing incurred to ensure a business' continuity during restructuring negotiations, and for other transactions concluded in close connection with a restructuring plan. "Interim financing" means any funds, whether provided by an existing or new creditor, that are reasonably and immediately necessary for the debtor's business to continue operating or to survive, or to preserve or enhance the value of that business pending the confirmation of a restructuring plan.[5] The Commission's proposal defines "new financing" as any new funds, whether provided by an existing or a new creditor, that are necessary to implement a restructuring plan that has been agreed to by creditors and subsequently confirmed by a judicial or administrative authority.[6]

As the European Union moves through consideration of these changes, it needs to "trip the light fantastic", an expression used to signify dancing and moving nimbly or lightly around and through a situation. Building consensus around an approach to insolvency financing will not be easy, given different preferences by Member States for more or less rigidity regarding priority of claims. There is also the more fundamental question of whether harmonization under the Directive is, in itself, the optimal goal, but that question is beyond the scope of this paper.

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[2] Raymond Havens, *The Influence of Milton on English Poetry* (New York: Russell & Russell, 1961).
[3] European Commission, Recommendation of 12 March 2014 on a new approach to business failure and insolvency, C (2014) 1500 final.
[4] Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures designed to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, COM (2016) 723 final, 22 November 2016. http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf.
[5] *Ibid,* at Article 2(12).
[6] *Ibid,* at Article 2(11).

The European Commission's proposals were strongly influenced by the provisions for such financing in the United States ("US") under Chapters 7 and 11 of the US Bankruptcy Code.[7] Yet the Commission's proposal contains some key differences, not least the fact that the Commission seeks to minimize the role of the court in the restructuring process.[8]

The focus of this paper is on the interim and new financing arrangements proposed by the Commission, analysed in the light of lessons learned from several other jurisdictions that have developed judicial or statutory measures to deal with this issue, principally the US and Canada, or where a market-based response has emerged, such as in the UK. Companies continue to require financing during the period that debt restructuring is taking place, and securing such financing can increase the company's chance of survival. It can be difficult to attract such financing, however, and for this reason, some jurisdictions have included advantageous treatment of lenders who provide finance in this period.

One common method is for the law to provide that such finance has priority over existing creditors' claims so as to overcome the debt overhang problem that can otherwise act as a deterrent to the extension of working capital to the company and the debtor's ability to restructure and survive.[9] Such an intervention necessarily constrains the rights of existing creditors, and requires a careful balance to be maintained between existing creditors' rights, on the one hand, and protection of the creditor providing financing during insolvency, on the other. The Commission's proposals are at an early stage and are still relatively undeveloped. It is unclear whether they will strike the appropriate balance. There is much that these proposals can learn from jurisdictions that have already successfully grappled with these issues, in particular, the public policy implications of subordinating pre-insolvency creditors, the need for monitoring and accountability in terms of the size and cost of such financing, and the role of the courts and insolvency professionals in approving such financing.

The paper is structured as follows. Part 2 explores some of the underlying policy rationale and benefits of having post-commencement financing available to financially distressed debtors. It canvasses some of the potential types of charges or priority that may be given to such financing, and their contours, undertaking comparative analysis of various domestic regimes, drawing on the experience of post-commencement financing elsewhere, most notable in the US and Canada. Part 3 discusses the risks in respect of interim and new financing, including discussion of concerns regarding cost, control, timing, and cross-collateralization that have arisen in the US. Part 4 then examines in detail the European Commission's proposed interim and new financing, commenting on its proposed provisions in light of the insights gained from the other jurisdictions examined in this paper. It concludes that while the European Commission's wish to include such measures in its restructuring proposals is understandable, the measures that are included raise concerns, particularly regarding the possibility of priority for the grantors of new and interim finance. While it is understandable that the European Commission has decided that no one approach works for all Member States, we suggest four fundamental aspects of such financing for which the Directive could give guidance to Member States implementing interim and/or new financing: effective notice, thresholds for the debtor to qualify, a menu of criteria that could be considered, and an important role for the court in resolving disputes and serving as an accountability check on interim financing arrangements.

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[7] US *Bankruptcy Code,* USC title 11, Chapter 7 and §§1101-1074 ("Chapter 11").

[8] Proposal for a Directive, *supra* note 4, Art 4(3).

[9] This issue the parties can arrange contractually between themselves, by way of contractual subordination, see eg *Re Maxwell Communications Corporation plc (No 2)* [1994] 1 All ER 737, although it is not always straightforward, and such an arrangement can also be subject to delays while negotiations occur, and the use of hold up rights by creditors, in order to extract value.

A note about terminology. The European Commission uses the terms interim and new financing; Canada uses the terms interim and exit financing; the US uses "debtor-in-possession" ("DIP") financing or post-petition financing; the UK Insolvency Service, "rescue financing"; and the UNCITRAL *Legislative Guide on Insolvency Law* generally refers to post-commencement financing to describe both interim and exit or going-forward financing during insolvency proceedings.[10] All of these terms relate to some aspect of providing financing to financially distressed companies during the period that they are trying to figure out if the business will survive as a going concern, with the terms new financing and exit financing referring more specifically to the funds that will help the debtor company exit the process. To the extent possible, the authors have used the precise terminology when referring to the particular jurisdiction. When discussing the issues more generally, we use interim financing as the term that covers a variety of financing options during insolvency or restructuring proceedings.

2. The Policy Rationale and Benefits of Financing during Insolvency

Financing is needed during the period that a financially distressed company is attempting to work out its affairs with its creditors.[11] Financing is also needed to implement whatever plan is agreed between the parties. It is important to note the distinction between interim financing, aimed at keeping the "lights on"[12] for a specified period so that the debtor can negotiate with creditors, and "exit" or "new" financing, aimed at either a financial restructuring of the company, implementing whatever plan is agreed to, or another way for the debtor company to exit the process. Often interim financing is needed on an urgent basis to ensure the continuity of the business. Interim financing can also have a signalling effect, in that the financing can send a message to the market and/or the debtor company's creditors that there is confidence in the future prospects of the business. From a policy perspective, it is important that the mechanism for approval be timely and effective. If the court is required to approve the financing, there can be a higher degree of transparency for other creditors, including any prejudice to their pre-filing claims.

The UNCITRAL *Legislative Guide* discusses the policy rationale and purpose of interim financing provisions. It specifies that provisions on post-commencement finance are aimed at: facilitating finance to be obtained for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the estate; ensuring appropriate protection for the providers of post-commencement finance; and ensuring appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.[13] It states that a country's insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative where the insolvency representative determines it necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the estate. The insolvency law may require the court to authorize, or creditors to consent to, the provision of post-commencement finance.[14] In jurisdictions in which the court is authorized to approve financing in priority to pre-

[10] UNCITRAL Legislative Guide on Insolvency Law, 2004, http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf. See also, UNCITRAL Legislative Guide on Insolvency Law, Part III on post-commencement financing in a business enterprise group context, http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part3-ebook-E.pdf; and principle c.16.2 of the World Bank Principles, Principles for Effective Insolvency and Creditor/Debtor Regimes, 19 November 2015, http://documents.worldbank.org/curated/en/518861467086038847/pdf/106399-WP-REVISED-PUBLIC-ICR-Principle-Final-Hyperlinks-revised-Latest.pdf.
[11] Janis Sarra, *Rescue! The Companies' Creditors Arrangement Act,* 2d ed (Toronto: Carswell, 2013).
[12] *Ibid,* at 209.
[13] UNCITRAL *Legislative Guide on Insolvency Law,* Parts One and Two (2004), *supra* note 10, recommendation 63.
[14] *Ibid.*

filing creditors, the courts recognize the risk to the existing secured creditors and authorize these types of priority somewhat reluctantly, and in some jurisdictions, as a last resort.[15]

If financially distressed but viable businesses can be restructured, it can be beneficial to the debtor, to diverse creditors, and to stakeholders more generally. The availability of financing is a key aspect of any effective corporate rescue regime. Whilst short term cash flow difficulties may not always precipitate a company's entry into formal insolvency proceedings, financing will almost always be a vital piece of any solution that seeks to remedy a company's financial plight. Where an insolvent debtor company does not have funds available to meet its immediate cash flow needs, it will have to seek financing from third parties. There are different reasons for lenders to agree to such financing. One is to preserve going-concern value.

Interim financing can come from several different sources. It may take the form of trade credit extended to the debtor by suppliers of goods and services or these creditors agreeing to temporarily forbear on enforcing their claims. Pre-insolvency lenders that have an ongoing relationship with the debtor and its business may decide to advance additional funds, extend timelines for repayment of loans, or forbear on enforcement of claims for a specified period. This willingness is because creditors want to enhance the likelihood of recovering their existing claims, protect their pre-existing claims from being too deeply eroded by new financing that takes priority over existing claims, and potentially realize additional value in a going-concern solution. Post-commencement financiers also realize that they can charge higher rates for the new lending, which may encourage pre-filing lenders to serve in that role. However, interim financing may come from an entirely new lender, whose incentive is either simply the higher returns garnered by such financing and/or because the lender has an interest in acquiring a stake in the business going forward. In either case, the incentive to lend into an insolvency situation, where assets are substantially or entirely encumbered, is the opportunity to have a priority charge on the assets.

Interim financing can be provided with a charge on unencumbered assets or as a second claim on security interest on already encumbered assets where the value of the encumbered asset is sufficiently in excess of the amount of the pre-existing secured obligation. A charge on those assets means that no special protections may be required for the pre-filing secured creditors, as their rights will not be adversely affected unless circumstances change such that the assets over which they have secured claims devalue.[16] Yet, in such situations, any interim financing further restricts the assets to which unsecured creditors have a claim if the company is eventually liquidated.

Where there are limited or no unencumbered assets, there is often little or no interest from third parties to act as interim financing providers, unless they are paid a premium over the rate they would get for their capital elsewhere or they hope to leverage that financing to take a stake in a going-concern solution. Thus, often where there are no unencumbered assets, debtors will focus their efforts on negotiating financing with current lenders and stakeholders.[17]

It is not always necessary for the law to intervene to provide the foundation for interim or exit financing: markets may formulate their own solutions to these issues. In the UK, for example, there is a robust debt restructuring regime in existence, but, in contrast to other regimes, such as the US, it lacks a broad and long-established market in specialist rescue finance. No statutory provisions presently exist in the UK that specifically relate to this issue,[18] but neither does UK law actively

[15] *Ibid* at 115.
[16] *Ibid.*
[17] See for example: *Re Performance Sports Group Ltd. (2016)*, 2016 ONSC 6800, 2016 CarswellOnt 17492 (Ont. S.C.J. [Commercial List]).
[18] It has been suggested that section 19(5) and schedule B1 paragraph 99 of the Insolvency Act 1986 provides a potential route to post-petition financing: G McCormack, 'Super-priority New Financing and Corporate Rescue' [2007] *JBL* 701-732;

prevent such financing.[19] Typically, new funding in administrations is provided by the existing floating charge holder, who has no need to vary its existing security, and any assets not covered by the floating charge will already be subject to fixed charges. In practice in the UK, if the business is judged to be viable, additional funding will generally be provided by existing creditors on a consensual basis or by using a scheme of arrangement, without the need for specific legislation. The absence of particular protection for interim financing arrangements enables creditors to signal, via their willingness to continue to support the company, that the company is judged to have value as a going concern.

The UNCITRAL *Legislative Guide* notes that, in many instances, the insolvency representative may be in a better position to assess the need for new finance; and where secured creditors consent to revised treatment of their security interests, approval of the court may not be required.[20] It also states that where the insolvency law establishes the level of priority that generally can be given, for example, an administrative priority, court approval may not be required, suggesting that there could be a monetary threshold established, above which court approval would be needed.[21]

Depending on the way in which proceedings are commenced under a state's insolvency law, the debtor company may seek interim financing prior to commencing proceedings, or, in countries such as the US where there is a time gap between application and approval of commencement of a proceeding, during this notice period. In Canada, the interim financing is usually arranged prior to commencement of a restructuring proceeding and approved by the court at the first day hearing, as part of the initial order and stay orders, with the court periodically revisiting the scope and amount of the financing on request of the parties.[22] Exit financing is often negotiated during the proceedings, and can take the form of equity or debt, including credit bidding, as discussed below.

There are two primary reasons for interim financing to keep a business operating during a debtor company's efforts to find a solution to its financial distress. If there is a possibility of a going-concern business plan, either under pre-insolvency owners or sale of the business as a going concern, the operations need to be preserved. Interim financing may also allow for continued employment for employees and enhance the prospect that they will have jobs going forward. Equally, however, if there is to be a sale on a liquidation basis, the assets may be more valuable if they are maintained during the workout period. Mining equipment is a good example, since it rapidly depreciates in value if not maintained.

For jurisdictions seeking to implement a statutory framework for interim and exit or new financing, there are a number of different tools that might be utilized: (i) the new lenders may be advantaged by being provided with priority over existing lenders, including protection against having their security primed by future interim or new financing lenders; (ii) there could be a special priority charge for critical suppliers; (iii) the costs of the rescue finance may be given priority as administrative expenses; (iv) there might be a priority charge for the expenses of certain stakeholders; and/or (v) the new lender may be given protection from the financing being declared void, voidable or unenforceable subsequently.

(i) Priority for the interim and new financing over existing lenders' security

V Finch, 'The Dynamics of Insolvency Law: Three Models of Reform' [2009] *Law and Financial Markets Review* 438-448, although this option has not been fully explored.

[19] Indeed, options for super priority do exist, for example, in administration, administrators have statutory powers allowing them to borrow funds and grant security over the property of a company (UK *Insolvency Act 1986*, Sch 1) and the costs of finance rank highly in the hierarchy of administration expenses.

[20] UNCITRAL *Legislative Guide on Insolvency Law, supra* note 10 at 116.

[21] *Ibid* at 117.

[22] Sarra, *Rescue, supra* note 10 at 208.

One concern for the interim financier, whether a new or existing creditor of the company, will be how the interim financing will rank compared to existing lenders with otherwise equal or superior claims, whether or not the proceeding results in the company's rescue or in liquidation. Often it is difficult to obtain additional financing unless the creditor receives some priority in terms of securing the credit. Given the financial distress of the company, the interim financier is taking on a more significant risk than a lender to a solvent company, and thus will want to extract a premium for this risk, namely, priority in payment in any subsequent restructuring plan or liquidation outcome. If there are assets that are unencumbered, this security is relatively straightforward. However, where all of the company's assets are already subject to secured creditor claims, it is not possible to get this protection unless either the secured lenders consent to the new lender's claim having priority to their claims, or the law intervenes to impose this priority on existing lenders.

Interim and new financing on a priority or "primed" basis has an impact on the rights of existing secured creditors. Full priming affects all pre-filing creditors, whereas interim financing that places security only on previously unencumbered assets only subordinates pre-filing unsecured creditors. Yet these creditors – trade suppliers, employees, pensioners – may be some of the creditors who are most vulnerable to suffering losses.

A number of jurisdictions, including the UK, have no statutory provisions in place at present that would facilitate this form of priority, although the UK Insolvency Service made some proposals to this effect in May 2016.[23] However, other jurisdictions have well developed regimes that grant priority for interim financing. In particular, the US and Canadian statutory provisions illustrate the types of priority that may be given.

A. Priority charges under US bankruptcy legislation

While historically, US bankruptcy law allowed some forms of financing,[24] the US Bankruptcy Code's current framework was enacted in the 1978 amendments to the Code, creating the ability to prime the financing. The court is given broad discretionary authority to approve DIP financing, but that discretion must be exercised pursuant to highly codified statutory language.[25] The Bankruptcy Code

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[23] Insolvency Service, *A Review of the Corporate Insolvency Framework: a consultation on options for reform*, May 2016, para 10.21e. Specifically, the Insolvency Service proposed that a debtor should be able grant security for new finance; that the company should be able to grant security to new lenders over company property already subject to charges, where that new security might rank as an additional but subordinate charge on the property or possibly as a first charge on the property where the existing holder does not object; and, further, where the assets against which the new charge is secured prove insufficient to discharge the amount owed, any shortfall would rank above preferential and floating charge holders. In practice, however, these interim financing arrangements seem unlikely to be introduced in the UK. Of the respondents to the Consultation Paper who commented on rescue finance, 73% disagreed with the proposals: Insolvency Service, *Summary of Responses – A Review of the Corporate Insolvency framework*, September 2016, para 5.2.

[24] David Skeel, "The Past, Present and Future of Debtor-in-Possession Financing" (2004) 25 *Cardozo Law Review* 1905.

[25] § 364 (a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1203, 1204, or 1304 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

(b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt—

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
(3) secured by a junior lien on property of the estate that is subject to a lien.

specifies four ways in which a lender may achieve priority for money advanced to a debtor after the bankruptcy petition date. If the debtor-in-possession or the trustee borrows "in the ordinary course of business", §364(c) provides three forms of protection that can be granted to a lender, after notice and a hearing. Where there is a limit to the debtor's or trustee's ability to obtain unsecured credit or to incur unsecured debt, the court may authorize such credit or debt with priority over any or all administrative expenses of a specified kind, secured by a lien on property of the estate that is not otherwise subject to a lien, or secured by a junior lien on property of the estate that is subject to a lien.[26] This provision is aimed at protecting post-petition trade vendors and suppliers. §361 sets out some ways in which adequate protection can be provided and prohibits others.[27] There are also provisions for sale or lease of property, in the ordinary course of business, without notice, where the proceeds can be used in the ordinary course of business; not technically considered DIP financing, but a form of permissible activity that helps to "keep the lights on" during the workout period.[28]

(d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—

(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

(e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

(f) Except with respect to an entity that is an underwriter as defined in section 1145(b) of this title, section 5 of the Securities Act of 1933, the Trust Indenture Act of 1939, and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security does not apply to the offer or sale under this section of a security that is not an equity security.

[26] "Trustee" in this provision also means the debtor company: Need authority for this point.

[27] 11 USC § 361, which specifies: When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property. (Pub. L. 95–598, Nov. 6, 1978, 92 Stat. 2569; Pub. L. 98–353, title III, § 440, July 10, 1984, 98 Stat. 370.)

[28] § 363(c)(1) specifies: "If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing. Of note also is § 552 of the Code as an important source of freeing up sources of funding by cutting off after-acquired property clauses. It specifies:

11 U.S. Code § 552 - Postpetition effect of security interest

(a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

(b) (1) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

(2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case

In addition, §364(d) allows the debtor or trustee to seek approval of financing on a priority basis, i.e. the claim can be secured by a lien equal to or senior to an existing lien, if the applicant can establish that it was unable to obtain credit otherwise, and there is "adequate protection" of pre-filing secured creditors.[29] The burden of proving adequate protection is on the party seeking the priority charge. In most cases, priming liens are approved where there is no objection from the pre-petition secured lender, but the court does have authority to approve the priming lien over the objections of secured lenders and has in the past exercised that authority.[30]

The purpose of the adequate protection requirement under §364(d) is to protect existing lienholders from any decrease in value of their security interest; "the prepetition creditor receives the value for which the creditor bargained pre-bankruptcy".[31] Adequate protection can be provided by periodic cash payments, replacement liens or other relief resulting in the "indubitable equivalent" of the secured creditor's interest.[32] Alternatively, adequate protection can be established by demonstrating that the pre-petition lienholder is over-secured with a substantial equity cushion.[33] What constitutes adequate protection is a fact-based inquiry decided "flexibly" by the court, having regard to the specific circumstances.[34] In this respect, there is an intrinsic tension between the idea that priming liens are necessary or there will be no availability of interim financing, and the idea that creditors need not be concerned because they will be adequately protected.[35]

The premise underlying the ability of the court to grant a priming charge over pre-filing creditors is that it is the only way in which financing may be available to restructure a business. There are also provisions protecting any grant of priority or a lien if there is a reversal or modification on appeal of an authorization for the financing where the credit was extended in good faith.[36] While notice of the motion for DIP financing must be given before a court order is issued, the US court has held on at least two occasions that the "notice and a hearing" requirements of §364 mean that the bankruptcy court may act without a hearing if notice has been given, the notice being appropriate in the circumstances, and a hearing has not been requested or there is insufficient time for one.[37] Bankruptcy Rule 4001 (c) was promulgated after some of these decisions, as a reaction to early abuses in the DIP financing regime, among them, lack of notice. Bankruptcy Rule 4001 provides for an interim hearing at the beginning of the case, followed by a more comprehensive approval, giving creditors at least 15 days' notice.

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and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

[29] *Ibid.*

[30] *In re Health Diagnostic Laboratory Inc.* (2015) WL 4915621 (Bankr. Ct. E.D. Virginia); *Credit Alliance Corp v. Dunning-Ray Ins Agency Inc (In re Blumer)* (1986) 66 B.R. 109, 113 (9th Cir. Bank. Appeal Panel); *In re Monach Circuit Indus. Inc* (1984) 41 B.R. 859 (Bankr. E.D. Pa.).

[31] *In re Sonora Desert Dairy LLC et al* (2015) WL65301 (US Bankruptcy Appellate Panel 9th Cir.); *M Bank Dallas, NA v. O'Connor* (1987) 808 F. 2d 1393 (10th Cir.); *In re Mosello* (1996) 195 B.R. 277, 288 (Bank. S.D.N.Y.).

[32] *In re Sonora Desert Dairy LLC et al, ibid; In re Stoney Creek Techs LLC* (2007) 364 B.R. 882, 890 (Bankr. E.D. Pa.).

[33] *Pistole v. Mellor (In re Mellor)* (1984) 734 F. 2d 1396, 1400 (9th Cir.); *In re Health Diagnostic Laboratory Inc.* (2015) WL 4915621 (Bankr. Ct. E.D. Virginia). An equity cushion of 20% has frequently been found by US courts as constituting adequate protection; *In re Franklin Equip. Co* (2009) 416 B.R. 483, 528 (Bankr. Ct. E.D. Va.); *In re Kost* (1989) 102 B.R. 828, 831 (D. Wyo.).

[34] *In re Sonora Desert Dairy LLC et al,* (2015) WL65301 (US Bankruptcy Appellate Panel 9th Cir.) at 11.

[35] *The Law of Debtors and Creditors: Text, Cases, and Problems*. 7th ed, E Warren, J L Westbrook, K Porter and J Pottow, Aspen Casebook Series. New York: Wolters Kluwer, 2014.

[36] § 364 (2)(e), US Bankruptcy Code.

[37] See for example, *Credit Alliance Corp v. Dunning-Ray Ins Agency Inc (In re Blumer)* (1986) 66 B.R. 109, 113 (9th Cir. BAP).

Pre-filing lenders may advance the financing to protect their priority positioning, or they may have information such that they are in a better position to assess risk and potential return regarding the financially distressed debtor company. Realistically, the pre-filing senior secured creditor often agrees to the priority charge because it is the only means by which additional capital will be available for the debtor post-petition, and the lender wants the company to continue operating, either to maximize its claims or because it wants a going-concern solution to the bankruptcy. The debtor-in-possession or trustee must show the court that financing was not available with one of the lower priorities, including demonstrating efforts that have been made to find financing on less onerous terms. The DIP financing order can include a provision that disallows or precludes compensation for professional costs over a certain amount; however, if a reorganization plan is confirmed, the plan must pay off administrative expense claims.[38]

The issue of cash collateral is also closely connected to DIP financing in the US. Security agreements typically give the secured creditor a first-priority security interest in all of the debtor's inventory, accounts receivable and proceeds of inventory. In bankruptcy, the secured creditor or creditors can lay first claim to cash coming in to the business, and the debtor cannot access the encumbered cash or cash equivalents ("cash collateral") without the permission of the secured creditor or a court order.[39] In the period between filing the bankruptcy petition and the court hearing, the debtor can continue to operate its business under Chapter 11 of the Bankruptcy Code ("Chapter 11") without a court order until the judge orders otherwise. But, even if a debtor has sufficient cash coming in through accounts receivable and new orders, it is unable to use this cash or cash equivalent without the permission of secured creditors and/or the court.

Where the debtor is seeking court approval, an objecting secured creditor has the burden of proving the "validity, priority or extent" of its interest in cash collateral.[40] The debtor has the burden of proving that the pre-petition lender is "adequately protected".[41] Both requests for interim financing and approval of cash-collateral usage are brought to the court within days of the debtor filing a petition, frequently on an urgent basis. The materials filed include all the terms and conditions of the proposed financing such that other creditors and the court can see the benefits and limitations of the proposed financing.[42]

The provisions in the US Bankruptcy Code according priority status to DIP financing have facilitated an active distressed debt market for financing during insolvency of US debtors. Interim financing in the US has been found to typically involve short-term revolving lines of credit that restrict use of the proceeds to working capital; the loan incorporating a number of covenants that allow the interim financier to actively monitor the debtor's activities.[43] A critically important feature is the automatic stay, which commences on filing a Chapter 11 proceeding, freezing the rights of pre-petition creditors to enforce their claims.[44] Interim financiers usually ensure the stay under the Code remains in place for the entire period that the DIP financing is outstanding, and covenants often expressly require the DIP financing to be repaid in full under confirmation of a reorganization plan.[45] DIP

[38] *In re Molycorp Inc* (2017) 562 B.R. 67, 63 Bankr. Ct. 153 (US Bankr. Ct. D. Del.), citing § 1129(a) of the Code. In the US, fees are often examined in extensive detail before the court will make an order approving the fees at plan confirmation.
[39] §364(c), US Bankruptcy Code.
[40] *Ibid,* at 3.
[41] §364(d) and §361, US Bankruptcy Code.
[42] See the discussion in part 3 below regarding risks associated with insufficient time to assess the request.
[43] S Chatterjee, U Dhillon and G Ramirez, "Debtor-in-Possession Financing" (2005) 16 *Journal of Banking and Finance*, discussing positive stock and bond price reaction to the announcement of DIP financing, at 3-4.
[44] I Hasan, G Ramirez and G Zhang, *supra* note 37 at 6.
[45] *Ibid,* at 4, 16.

financing under the US Bankruptcy Code is often granted to facilitate a sale of assets,[46] which can be in the form of a blanket lien on specified assets.[47]

There are numerous cases in the US in which the interim financier is also the "stalking horse" bidder and ultimate purchaser, even in cases where the financier was a significant equity holder pre-Chapter 11 proceedings.[48] In such cases, the bankruptcy court may appoint an examiner to serve as an independent fiduciary to investigate proposals or transactions.[49] The DIP financing has been used to credit bid, sometimes bolstering the credit bidding of pre-petition debt, with approval of the court.[50]

DIP lending is generally viewed as an important feature of the US system.[51] One empirical study found that firms that received DIP financing were much more likely to spend less time in bankruptcy proceedings than firms that did not have access to such financing, and ultimately exit the process as a going-concern business; and that lenders with a prior relationship with the debtor company were much more likely to offer DIP financing to smaller firms than new lenders.[52] Another study of 658 Chapter 11 filings by large public US firms found that 60% of such firms filing for Chapter 11 protection obtained post-petition financing, primarily from pre-petition bank lenders.[53] It found that loan-to-own interim financing lenders were more likely in smaller firms or where pre-petition bank lenders' loans were over-collateralized, whereas prepetition secured bank lenders were more likely to provide the financing in Chapter 11 firms with better operating performance.[54] Hedge fund and private equity funds have entered the US distressed debt market, particularly in the past fifteen years, and the financing often has a "trigger" clause allowing lenders to replace senior debt with newly issued equity upon case resolution, becoming an important route for the "loan-to-own" strategy.[55] It also found that of the firms that emerge and continue to file with the Securities and Exchange Commission as publicly-traded companies, there is an 80% director turnover, and 50% have at least one activist investor from a private equity or hedge fund on the board during and/or post-restructuring.[56] The DIP financing market grew considerably after codification of the priority charge in 1978, reaching $24 billion by 2002.[57]

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[46] *In re Neogenix Oncology Inc* (2015) 61 Bankr. Ct. 191 (US Bankr. Ct. D. Maryland).

[47] See for example, *In re Gunboat International Ltd.* 2016 WL 4272238 (US Bankr. Ct. E.D. North Carolina).

[48] See for example, *Old Cold LLC* (2016) 558 B.R. 500, 63 Bankr. Ct. 86 (US Bankr. Appellate Panel First Circuit) where the Court affirmed a judgment of the Bankruptcy Court dismissing allegations of collusion and bad faith regarding the interim financier/purchaser in a sale of substantially all the assets of the debtor company. In that case, the US Trustee and an independent examiner were appointed to oversee the sale process because it involved a proposed insider transaction and credit bid under §363(k) of the US Bankruptcy Code.

[49] *Ibid,* at 505.

[50] *Ibid,* at 506. See also, "Procedural Guidelines for Prepackaged Chapter 11 Cases in the United States Bankruptcy Court for the Southern District of New York,
http://www.nysb.uscourts.gov/sites/default/files/pdf/Prepackaged_Chapter_11_Guidelines.pdf

[51] S Dahiya, K John, M Puri, and G Ramirez, "Debtor-in-possession financing and bankruptcy resolution: Empirical evidence" (2003) 69 *Journal of Financial Economics* 259-280; FA Elayan, and TO Meyer, "The impact of receiving debtor-in-possession financing on the probability of successful emergence and time spent under Chapter 11 bankruptcy" (2001) 28 *Journal of Business Finance and Accounting* 905-940.

[52] S Dahiya, K John, M Puri, and G Ramirez, "The Dynamics of Debtor-in-Possession Financing: Bankruptcy Resolution and the Role of Prior Lenders", 2000. See also I Hasan, G Ramirez and G Zhang, "Lock-in Effects in relationship Lending: Evidence from DIP Loans", http://ssrn.cm/abstract=1785685 at 6.

[53] Kai Li and Wei Wang, "Debtor-in-Possession Financing, Loan-to-Loan, and Loan-to-Own (2016), http://ssrn.com/abstract=2275635 at 1.

[54] *Ibid,* at 20. See also, K N Daniels and G Ramirez, "Information, Credit Risk, Lending Specialization and Loan pricing, Evidence from the DIP Financing Market", http://SSRN.com/abstract=1133522.

[55] Kai Li and Wei Wang, "Debtor-in-Possession Financing, Loan-to-Loan, and Loan-to-Own (2016), http://ssrn.com/abstract=2275635 at 1.

[56] *Ibid,* at 3.

[57] Daniels and Ramirez *supra* note 54 at 5.

B. Priority charges under Canadian insolvency law

Canada's interim financing provisions are more codified than the European Commission's proposed provisions, but are more flexible that the US provisions. The premise underlying the Canadian statutory provisions is that interim financing is a benefit to all stakeholders as it allows the debtor to protect going-concern value while it attempts to devise a plan of compromise or arrangement acceptable to creditors. A distinction can be made between interim financing that allows the debtor corporation to continue operating during a brief period of workout negotiations and a variety of other court-ordered charges that are given priority in order to cover the expenses of the restructuring proceedings or to protect particular vulnerable creditors, often called priming liens.[58]

The provisions regarding interim financing in the Canadian Bankruptcy and Insolvency Act ("BIA") [59] and Companies' Creditors Arrangement Act ("CCAA")[60] are identical. For example, section 11.2 of the CCAA[61] specifies that on application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, a court may make an order declaring that all or part of the company's property is subject to a security or charge, in an amount that the court considers appropriate, in favour of an interim financing lender. Thus, the priority charge can rank ahead of all pre-filing secured creditors. In deciding whether or not to approve the financing, the court is to consider, among other factors, the period during which the company is expected to be subject to insolvency proceedings; how the company's business and financial affairs are to be managed during the proceedings; whether the company's management has the confidence of its major creditors; whether the loan would enhance the prospects of a viable compromise or arrangement being made in respect of the company; the nature and value of the company's property; whether any creditor would be materially prejudiced as a result of the security or charge; and the monitor's views.[62]

One protection for the interim financier is that the priority charge cannot be primed by additional interim or exit financing except with the consent of the interim financier. Thus, where the court

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[58] Notwithstanding that there was no express language in the CCAA prior to 2009 providing for interim financing, Canadian courts found that they had the jurisdiction to order such financing under their broad statutory remedial authority; for a discussion see Sarra, *Rescue, supra* note 9. Effective 2009, the CCAA contains provisions for interim financing, essentially a codification of the tests that the courts had been applying, but with specific protections built in, such as notice and protection of pre-filing security.

[59] Canada, Bankruptcy and Insolvency Act*,* RSC 1985, c B-3, as amended (BIA), section 50.6.

[60] Canada, Companies' Creditors Arrangement Act, RSC 1985, c C-36, as amended (CCAA).

[61] Section 11.2 of the CCAA is set out below:

11.2 (1) Interim financing—On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, a court may make an order declaring that all or part of the company's property is subject to a security or charge—in an amount that the court considers appropriate—in favour of a person specified in the order who agrees to lend to the company an amount approved by the court as being required by the company, having regard to its cash-flow statement. The security or charge may not secure an obligation that exists before the order is made.

(2) Priority — secured creditors—The court may order that the security or charge rank in priority over the claim of any secured creditor of the company.

(3) Priority — other orders—The court may order that the security or charge rank in priority over any security or charge arising from a previous order made under subsection (1) only with the consent of the person in whose favour the previous order was made.

(4) Factors to be considered—In deciding whether to make an order, the court is to consider, among other things,

(a) the period during which the company is expected to be subject to proceedings under this Act;

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

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

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

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

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

(g) the monitor's report referred to in paragraph 23(1)(b), if any.

[62] CCAA, s. 11.2(4).

grants interim financing on a priority basis, the court cannot make an additional interim financing order that has priority over the initial financing without that interim financier's consent. However, the Canadian interim financing provisions expressly prohibit cross-collateralization, specifically, the security or charge may not secure an obligation that exists before the order is made.

The Canadian statutes' non-exhaustive list of factors the court will consider in approving interim financing are a codification of previous caselaw. The provisions expressly allow the court to order a super-priority over all secured claims, and they do not contain any of the US-type provisions for adequate protection. The court must consider all the statutory criteria set out in section 11.2(4), which allows an assessment of the governance of the debtor, the nature and value of the assets, and, importantly, whether or not any creditor will be materially prejudiced as a result of the priority charge. The CCAA supervising judge also has the benefit of advice from a court-appointed officer under the CCAA, the monitor, and the proposal trustee under the BIA*,* who are to give their professional advice to the court on the benefits and potential prejudice in a proposal for interim financing.[63] Canadian courts frequently look to the monitor, proposed monitor or proposal trustee for their opinion, particularly where the proposed order is extensive and goes beyond a mere temporal order affecting the rights of creditors to realize on their claims. These court-appointed officers serve in a monitoring role and as an accountability check for the court and the creditors.

Mr. Justice Clément Gascon, then of the Québec Superior Court, observed that there are five principles operating in the court's consideration of applications for interim financing and priority charges or priming liens: adequate notice of interim financing and priming requests, so that creditors can fully assess the impact of interim financing decisions; sufficient disclosure; timeliness of the request; balancing the prejudice to creditors and other stakeholders; and the principle of granting priority financing as an extraordinary remedy, in the sense that it gives priority over pre-existing claims and thus there must be an appropriate rationale.[64] Canadian courts apply these principles in an effort to find the optimal balancing of prejudice in the exercise of their jurisdiction to grant interim financing or other priority charges. The court must weigh the likely risks against the likely gains of authorizing such financing. This application of principles and balancing of interests is intended to create certainty in credit transactions, while meeting the objectives of the Canadian insolvency legislation.[65]

The Canadian provisions leave much of the balance of the prejudice in the hands of the court, aided by the monitor's expert views. Arguably, pre-filing secured creditors have greater statutory protection under the US provisions, but practically, Canadian courts are reluctant to grant priority charges where the senior secured creditors are opposed. If they do, it tends to be for a very limited period to encourage parties to the bargaining table. Integral to the financing issue is the question of who gets notice of the application for interim financing with a priority charge. In Canada, secured creditors must be given notice, but not unsecured creditors, although often the court will limit the amount of interim financing approved until effective notice has been given to all stakeholders, and any parties who wish to can bring a motion arguing that the quantum of financing or its priority is not appropriate in the circumstances.[66] Canadian court orders commencing insolvency restructuring proceedings contain what are called "come-back" provisions in the order. The come-back provisions allow creditors that did not receive notice of a particular decision by the court, including an interim financing decision, to come before the court and seek to have it set aside. In such instances, the onus is on the party that initially sought and received the interim financing order to justify it, rather

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[63] There are other priority charges under Canadian insolvency legislation, as discussed in parts 2(ii) to (iv) below.
[64] *Re Boutiques San Francisco inc.,* 2003 CarswellQue 13882, [2003] Q.J. No. 18940 (Que. S.C.), citing Janis Sarra, "Debtor in Possession Financing: The Jurisdiction of Canadian Courts to Grant Superpriority Financing in *CCAA* Applications" (2000) 23 Dalhousie Law Journal 337.
[65] Sarra, *Rescue, supra* note 11 at 199.
[66] *Ibid* at 58-60.

than on the party coming before the court to express its concern, essentially a reversal of the ordinary rules of evidentiary proof. The come-back order is a protective device that encourages debtors to give appropriate notice to unsecured creditors, even where the statute does not require such notice, as it is in their interest to address concerns about potential prejudice regarding the interim financing prior to the request being before the court.[67]

Both the US and Canada thus offer working models of interim financing provisions and of the priority that may be given for the interim and new financing over existing lenders' security. As indicated above, there can be huge benefits to such priority financing if protections are in place for pre-filing creditors and other stakeholders.[68] If the market does not develop such financing options, the development of legislative or court-developed support for interim financing can provide debtors with a valuable tool to help them deal with their financial difficulties.

Priority interim financing engages both policy and practice questions, including the general need to uphold commercial bargains; protect the pre-existing rights and priorities of creditors; and minimize any negative impact on the availability of credit, in particular secured finance, that may result from interfering with those pre-existing security rights and priorities.[69] It is also important to consider the impact on unsecured creditors who may see the remaining unencumbered assets disappear to secure new lending, leaving nothing available for distribution, especially if the reorganization were to fail. This risk must be balanced against the prospect that preservation of going-concern value by the continued operation of the business will benefit those creditors.[70]

The provision of super-priority for new finance inevitably raises issues about the position of existing creditors, most acute where new lenders are given priority over existing secured creditors of the company. The law traditionally seeks to protect those creditors with proprietary rights and interim financing therefore inevitably raises the issue of how the rights of the existing secured creditors are to be balanced against the need for the company to secure adequate working capital during the period of restructuring.

(ii) Priority charge for critical suppliers

Some jurisdictions impose a type of interim financing by designating trade suppliers as "critical suppliers", requiring them to continue supplying during the negotiations for restructuring. The law may designate certain contracts, for example, the supply of essential services such as utilities, as incapable of being terminated on the grounds of insolvency alone.[71] Alternatively, the court may make an order declaring a person to be a critical supplier to the company if the court is satisfied that the person is a supplier of goods or services to the company and the goods or services supplied are critical to the company's continued operation.[72] The court order essentially forces the supplier to continue to supply.

In Canada, for example, if the court makes an order designating the supplier a critical supplier, the court must, in the order, declare that all or part of the property of the company is subject to a security or charge in favour of the person declared to be a critical supplier, in an amount equal to

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[67] *Ibid* at 60.
[68] They also offer some insights into the risks associated with priority charges, as discussed in part 3 below.
[69] *UNCITRAL Legislative Guide, supra* note 10 at 114.
[70] *Ibid,* at 115.
[71] In the UK see, eg, The Insolvency (Protection of Essential Supplies) Order 2015, SI 2015/989.
[72] The UK Insolvency Service has suggested the introduction of a mechanism whereby certain contracts can be designated as "essential" and thus incapable of termination on the grounds of insolvency alone, at least while the business continues to pay its debts during the period of a moratorium: UK Insolvency Service, A *Review of the Corporate Insolvency Framework*, part 8.

the value of the goods or services supplied under the terms of the order.[73] Notice must be given to any affected creditor where the debtor is making an application to declare a supplier a critical supplier within the meaning of the statute.[74] The Canadian notion of "critical supplier" was developed from a procedure used from time to time in the context of proceedings under US Chapter 11, whereby the debtor sought court approval to pay the arrears due to certain key suppliers, called "critical vendors" in the US, out of a concern that without such payments of arrears, these suppliers would stop delivering goods or providing services after the filing, in turn leading to the premature demise of the debtor.[75]

The Canadian jurisprudence is illustrative of the supervising court's concern that both forcing critical suppliers to continue supplying and according them a priority charge are matters that require a careful balancing of interests. The court will consider whether the interruption of supply by the critical suppliers could have an immediate material adverse impact on the debtor's efforts to find a solution to its financial distress.[76] The court can also direct its court-appointed officer to monitor weekly amounts owing to each critical supplier, protecting both the supplier and the creditors being primed.[77] This oversight by the court is viewed in Canada as a positive feature of the statutory provisions, in terms of monitoring both the benefits and prejudice to pre-filing creditors.

In reality, suppliers will continue to supply goods and services to the debtor or the insolvency professional on credit if they have a reasonable expectation of payment ahead of pre-filing unsecured creditors,[78] but codification of this charge avoids preference or avoidance claims by pre-filing creditors.

In some jurisdictions, a priority is afforded on the basis that the new credit for suppliers is extended to the insolvency representative, rather than to the debtor, and thus becomes an expense of the insolvency estate.[79] Some jurisdictions require trade supplier credit to be approved by the court or by creditors, while others do not.[80]

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[73] For example, s. 11.4 of the *Companies' Creditors Arrangement Act,* RSC 1985, c 36, as amended (*CCAA*), expressly authorizes the court to order a party to be a critical supplier. The trade supplier is forced to continue to supply and but gets a priority charge. The section specifies:
11.4 (1) Critical supplier—On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, the court may make an order declaring a person to be a critical supplier to the company if the court is satisfied that the person is a supplier of goods or services to the company and that the goods or services that are supplied are critical to the company's continued operation.
(2) Obligation to supply—If the court declares a person to be a critical supplier,
the court may make an order requiring the person to supply any goods or services specified by the court to the company on any terms and conditions that are consistent with the supply relationship or that the court considers appropriate.
(3) Security or charge in favour of critical supplier—If the court makes an order under subsection (2), the court shall, in the order, declare that all or part of the property of the company is subject to a security or charge in favour of the person declared to be a critical supplier, in an amount equal to the value of the goods or services supplied under the terms of the order.
(4) Priority—The court may order that the security or charge rank in priority over the claim of any secured creditor of the company.
[74] CCAA, s. 11.4(1).
[75] In the US, some courts have questioned the merit of some of these "critical vendor" orders. See, for example, *In re Kmart Corp.*, 359F. 3d 866 (7th Cir. 2004), Court of Appeal. For a discussion, see Sylvain Rigaud and Philippe Bélanger, La réforme en matière d'insolvabilité: Nouveautés et codifications de pratiques existantes, Éditions Yvon Blais (2009).
[76] See, for example, *Re Northstar Aerospace, Inc.,* 2012 ONSC 3974; *Re Priszm Income Fund*, 2011 CarswellOnt 2258 (Ont. S.C.J.). See also the discussion in Sarra, *Rescue, supra* note 11.
[77] *Re Catalyst Paper Corporation*, order dated February 6, 2012, British Columbia Supreme Court (Sewell J.), Court File # S120712.
[78] UNCITRAL *Legislative Guide*, *supra* note 10 at 114.
[79] *Ibid.*
[80] *Ibid.*

(iii) Priority for the costs of interim and new/exit financing as administrative expenses

In some jurisdictions, the expenses incurred in the operation of the business are entitled, under insolvency law, to be paid as administrative expenses, administrative priority often ranking first after secured creditors with respect to their charge on the insolvency estate, ranking ahead of ordinary unsecured creditors and any statutory priorities, for example, taxes or social security claims.[81]

There are, of course, costs associated with putting any rescue finance package in place. Providing priority for these payments can facilitate restructuring. Some insolvency laws provide for a "super" administrative priority if credit or finance is not available, where the cost of providing such finance is ranked as an administrative claim that is *pari passu* with other administrative claims such as fees of the insolvency professional.[82]

In the UK, the expenses of administration, including the remuneration of the administrator, receive priority over all other claims, including unsecured creditors and floating charge holders.[83] In 2009, as part of the then Government's consultation on measures to encourage company rescue, one proposal suggested giving super-priority status to rescue finance costs in administration. This super-priority would have meant these costs would have ranked ahead of all other administration expenses.[84] Consultation responses suggested that, since administration expenses are discharged in full in most administrations, the impact of this proposal would be modest. Some respondents also suggested that raising such costs above the administrator's own expenses could discourage insolvency practitioners from taking appointments as administrators, therefore harming prospects of business rescue. Ultimately this proposal was not implemented.[85]

Canadian insolvency legislation authorizes the court to grant a priority charge in respect of the monitor, including any fees and expenses of any financial, legal or other experts engaged by the monitor in the performance of the monitor's duties.[86] It authorizes the court to make orders, for a security or charge, where it considers appropriate, in respect of the fees and expenses for financial, legal or other experts engaged by the debtor company for purposes of the proceeding.[87] Notice must be given to the secured creditors likely to be affected by the security or charge. The court may order that the security or charge rank in priority to the claims of any secured creditor of the company.[88]

However, these priority charges for administrative expenses do not to extend to professional fees incurred prior to commencement of proceedings. The Ontario Superior Court has observed that the CCAA does not expressly state whether an administration charge can or cannot cover past outstanding fees or disbursements, but the language would appear to imply that it is to cover only current fees and disbursements.[89] The Court also held that an administration charge can only be granted to cover work done in conjunction with a CCAA proceeding, not to protect fees of lawyers in other jurisdictions who may be engaged by the debtor in foreign insolvency proceedings or other litigation such as class action suits.[90]

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[81] *Ibid*, at 116.
[82] *Ibid.*
[83] Insolvency Act 1986, s 176ZA, although litigation expenses do not have priority over claims to property comprised in a floating charge unless the requisite approval has been obtained (Insolvency (England and Wales) Rules 2016 (SI 1024/2016) r 6.44-6.48.
[84] Insolvency Service, *Encouraging Company Rescue – A Consultation*, June 2009.
[85] For discussion see UK Insolvency Service, A *Review of the Corporate Insolvency Framework*, paras 10.16-10.17
[86] CCAA, s. 11.52.
[87] *Ibid*.
[88] *Ibid*, s. 11.52(2).
[89] *Re Performance Sports Group Ltd*, 2016 ONSC 6800, 2016 CarswellOnt 17492 (Ont. S.C.J. [Commercial List]).
[90] *Ibid.*

Priority charges are also available to cover the professional fees of unsecured creditors' committees ("UCC") in US Bankruptcy Code Proceedings.[91] The Code contemplates that the UCC will serve as a fiduciary for all unsecured creditors, promoting and protecting their interests. Its professional fees are paid out of the assets of the debtor's estate. However, the issue of cost versus effectiveness is debated among scholars and practitioners.[92] Of note for the purposes of the interim financing discussion, is concern expressed that the UCC adds considerably to costs of proceedings, due to increased litigation brought by the UCC against the debtor, conflicts of interest among creditor members, some creditors seeking to advance their self-interest rather than the general interests of creditors, and lack of a cap on the professional fees of the UCC.[93] All of these factors can increase the amount of financing that comes out of the debtor's assets, diminishing value to the unsecured creditors, particularly in a liquidation outcome.

(iv) Priority charge for legal and professional advice for vulnerable stakeholders

Canadian insolvency legislation has a somewhat unique feature, in that a priority charge can be sought and granted to finance representation for vulnerable parties in the proceedings who may not have the resources for effective representation. The CCAA and BIA grant authority to the court to make orders to cover the fees and expenses of any financial, legal or other experts engaged by parties if the court is satisfied that the security or charge is necessary for their effective participation in the proceedings, the request for such financing to be made on notice to affected secured creditors.[94] These provisions allow the court to order representative counsel or other expertise where there are stakeholders before the court who do not have the resources to cover such costs, such as pensioners, non-unionized employees and tort claimants.

For example, in the Nortel Networks CCAA proceeding, the Ontario Superior Court of Justice approved representative counsel for current and former employees and pensioners, to coordinate the legal, financial, actuarial and advisory resources needed to resolve the claims of a large number of former employees. The Court held that the appointment would have the benefit of streamlining and introducing efficiency to the process for all parties.[95]

(v) Protection from the financing being declared void, voidable or unenforceable subsequently

Many jurisdictions put in place insolvency provisions designed to protect creditors, by rendering void, voidable or unenforceable provisions entered into before the company goes into insolvency. It is common for jurisdictions to enact provisions that target transactions prior to insolvency that seek to prefer one creditor above other creditors and transactions that disturb the statutory order of distribution, which is, after all, what interim financing will generally entail. The law may render such transactions void or voidable, or declare the contractual provisions unenforceable, and may target those creditors in receipt of the preferential treatment in some way, imposing liability of some kind on them as a consequence of their role in the transaction.

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[91] For a discussion of these issues, see Michelle Harner and Jamie Marincic, "Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganization" (2011) 64 *Vanderbilt Law Review* 749 and the articles cited therein.
[92] A subject beyond the scope of this paper.
[93] Harner and Jamie Marincic, *supra* note 91 at 756.
[94] CCAA, s. 11.52. Justice Newbould made specific reference to s. 11.52(1)(a)(b) and (c). Regarding (a), a monitor is appointed in the initial order and its duties are performed during the CCAA proceeding, not before. Regarding (b), the language "for the purpose of proceedings under this Act" would appear to relate to proceedings, and not some other work such as a lawyer for the debtor defending litigation against the debtor. *Re Performance Sports Group Ltd*, 2016 ONSC 6800, 2016 CarswellOnt 17492 (Ont. S.C.J. [Commercial List]).
[95] *Re Nortel Networks Corp.* (2009), 2009 CarswellOnt 3028 (Ont. S.C.J. [Commercial List]).

Often such provisions will not aim to prevent beneficial transactions, and will generally exclude transactions to the extent that the creditor gives new value, since in those circumstances, the creditor will not be regarded as having gained an advantage. For example, in the UK, there are provisions in place targeting preferences given by companies in administration or liquidation to any person in the period prior to administration or liquidation.[96] The court can, on the application of the office-holder, make such order as it sees fit for restoring the position to what it would have been if the company had not given that preference and give consequential relief.[97] These provisions aim to prevent preferential treatment being given to creditors, such that the creditor's position is improved at the expense of other creditors. This preferential treatment might include a payment to the creditor, the provision of security for past advances or the transfer of assets in reduction or discharge of the company's liability.

However, it is clear that to the extent that a creditor gives new value, she gains no advantage and will not fall within these provisions.[98] Since a preference involves a payment or similar act that, should the company go into liquidation thereafter, would put the creditor in a better position than if the payment had not been made, or other act preformed, the preference provisions cannot apply to the extent that new value is provided, since the creditor does not thereby achieve a better position as the expense of other creditors.[99] Similarly, there are provisions that render void a floating charge for past value given in the period prior to liquidation or administration.[100] The purpose of this provision is to prevent the conferment of an unfair advantage on an existing creditor at a time when the company is in financial difficulty. However, a floating charge given for new value falls outside the ambit of this provision.[101]

Depending on the drafting of these provisions, and the clarity of any exclusions, such as the exact meaning of "new value", these provisions may provide a barrier for the provision of interim financing, if potential interim financiers are concerned about the potential for the financing to be subsequently invalidated and, possibly, liability attached to them as a consequence.

Canada has a highly-codified regime for both preferences and transfers at undervalue in periods leading up to insolvency proceedings, making a distinction between arms-length and non-arms-length transactions in terms of clawing back assets for the benefit of creditors.[102] However, this avoidance regime does not really impact interim financing because of the language in the court order approving the interim financing, and now the protective language of the statute. For example, the Model Orders used for commencing CCAA proceedings in Canada specifically address liability protection, by specifying in the order granting the financing that the payments made by the debtor pursuant to the order and the granting of the charges, "do not and will not constitute preferences, fraudulent conveyances, transfers at undervalue, oppressive conduct or other challengeable or voidable transactions under any applicable law".[103]

A much-debated issue in the US is the amount of time that an unsecured creditors' committee is allowed to challenge the pre-petition liens of existing lenders under US avoidance provisions when these lenders have agreed to provide interim financing after commencement of bankruptcy

[96] Insolvency Act 1986, ss. 239(1)-(3), 238(1), 240, 241.
[97] *Ibid*, s. 240(2).
[98] Eg, *Robertson v Grigg* (1932) 47 CLR 257.
[99] See R Goode, *Principles of Corporate Insolvency Law* (4th Ed, Sweet & Maxwell, 2011) 13-84.
[100] Insolvency Act 1986, s. 245.
[101] Goode, *supra* note 99 at 13-114 – 13-119.
[102] See Bankruptcy and Insolvency Act, ss. 95, 96.
[103] See, for example, Alberta Model Order CCAA, https://albertacourts.ca/docs/default-source/Court-of-Queen's-Bench/ccaa-initial-order-template-(pdf).pdf?sfvrsn=4.

proceedings. DIP lenders would prefer to halt such processes, as they do not want to lend to entities that are pursuing avoidance claims against them. Since recoveries from avoidance remedies accrue largely to unsecured creditors, such actions can create a tension between these creditors. There is also a live question as to whether or not a post-petition lender can obtain a security interest or charge over avoiding powers or actions clawing-back assets; US courts are split on this issue.[104]

3. The Risks of Interim and New/Exit Financing

Notwithstanding the importance and potential benefits of interim and new/exit financing, there are some notable risks. This part identifies some of those risks, while the ways that these risks have been addressed is considered in part 4, alongside the discussion of the EU proposals. Risks include (i) risks associated with information asymmetries and timing of the request for financing; (ii) costs; (iii) overreaching control provisions; and (iv) risks of unnecessarily or inappropriately disrupting the priority of claims.

(i) Information Asymmetries and Time Pressures

The request for interim financing is generally brought on an urgent basis, often because a payroll is due the following day or a balloon payment is imminent. The court may feel pressure to approve the interim financing on short notice, in order to keep the business operating during the workout period. Thus, one pitfall is where the court, the court-appointed officer and pre-filing creditors do not have sufficient time to extensively review and understand the complexities of the financing, and the court feels tremendous pressure to grant the order. Pre-filing creditors may be prejudiced in various ways that are not immediately discernable on a quick look at a proposed financing package. Such financing can affect the trajectory of the ultimate resolution of the debtor's financial distress. If a sales process is contemplated, there is a risk that the interim financier will negatively affect the integrity of the sales process, by pressuring for a truncated process that may not find the best value for the company's assets and thus returns to creditors overall, or in creating a "stalking horse" bidding process that fails to have a sufficiently robust process in the market.

Another concern is where the terms of the financing are opaque or where the court is being asked to make a confidentiality order in respect of the terms of the financing. Creditors cannot make an informed decision in respect of any proposed financing if they do not have access to the terms and conditions, in order to assess potential benefits and risk. One solution has been to allow creditors access to the confidential information to be able to assess terms and conditions of the financing, on condition that they abide by a confidentiality agreement.

One concern about timeliness that is sometimes expressed regarding rescue finance is that such provisions should not be available to extend the life of a dying business. These concerns were raised recently in response to the UK Insolvency Service's proposals for the introduction of rescue finance provisions.[105] At present, in the UK this economic assessment is left to the market, through credit providers (existing or new) who undertake the risk analysis before deciding to lend to a distressed company; the legal system does not interfere with this process. However, if measures are introduced to assist providers of rescue finance by giving them contractual priority or additional security, there is a danger that the playing field may be unevenly skewed in favour of opportunistic lenders making use of the insolvency regime to benefit themselves at the expense of others. In

[104] The authors are grateful to Professor Bruce Markell for drawing this issue to our attention. This issue could easily be the subject of another paper.
[105] UK Insolvency Service, *Summary of Responses: A Review of the Corporate Insolvency Framework*, September 2016.

practice, however, in jurisdictions that have rescue finance in place the market mechanism persists, even with statutory provisions enacted, because lenders will not lend into a hopeless situation.

Under the US scheme, the court often only grants enough financing to "keep the lights on" or to "to avoid irreparable damage" pending the full review of the request for financing.[106] Such a requirement reduces the risks associated with time pressures in approving such financing. However, even with this approach, US bankruptcy courts have expressed concern that requests for financing at short notice tend to overreach in their scope.[107] In some cases, the court will insist that the creditors' committee must already be formed, so that it can consider the financing proposal before the court finally approves it.

In many circumstances, the law will need to intervene, particularly when a stay exists, because pre-insolvency creditors cannot move to enforce their unpaid claims during the stay period without permission of the court. The UK does not have a restructuring moratorium at present, so this concern does not arise.[108]

Part of both the timeliness question and the issue of costs, discussed below, is the size and type of business for which it makes sense to have interim financing in place. Realistically, interim financing is likely to be available to larger debtor companies, and possibly some medium size companies. Even where larger debtors do not have unencumbered assets, the infrastructure, production facilities and employees in place, and a robust market for the debtor's products or services may result in a financier agreeing to give the interim financing. But even here, if the lender determines the company is not viable, the debtor will not receive the financing. Micro and small businesses are generally more leveraged and reliant on bank financing, they have significantly higher non-performing loan ratios, and they frequently cannot get interim financing when they are financially distressed unless the owners have personal assets they can use as a guarantee.[109] Be it outside or inside formal insolvency proceedings, without the willingness of creditors to forbear or extend financing, these businesses are not able to survive even where potentially viable.[110]

The availability of interim financing is likely only to be available to certain kinds of companies and in particular circumstances. There is not a uniform approach among jurisdictions, because of the different nature and types of debt, the different hierarchy of claims, and the different sectors and markets in which debtors operate.

In Canada, part of the inquiry on an application for interim financing is the court's assessment of creditors' confidence in the management and any prejudice to creditors, so issues of undue time pressures and creditors' ability to access the terms, conditions and information underpinning the financing, are an important part of the decision process. While the courts exercise some deference

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106 As noted above, Bankruptcy Rule 4001 provides for an interim hearing at the beginning of the case, followed by a more comprehensive approval, giving creditors at least 15 days' notice.

107 Judge Peter Walsh, Delaware Bankruptcy Court, Open letter to Bankruptcy Judge to the Delaware Bar, dated April 2, 1998, quoted in John D Ayer, Michael Bernstein and Jonathan Friedland, "Obtaining DIP Financing and Using Cash Collateral", ABI Journal, Vol. XXIII, No. 7, September 2004; which noted that even with Rule 4001 in place, there are numerous items asked for that the court will be reluctant to grant, including unnecessary provisions; provisions that state the court has examined all of the underlying loan documents; statements that parties in interest have been afforded "sufficient and adequate notice"; and attempts to limit the committee's right to challenge a lender's pre-petition position to less than 60 or 90 days; and provisions that expressly or by their terms have the effect of divesting a debtor of any discretion in formulating a plan

108 There are proposals for a restructuring moratorium to be introduced, however: UK Insolvency Service, A *Review of the Corporate Insolvency Framework*, 10-18.

109 Ronald Davis, Stephan Madaus, Alberto Mazzoni, Irit Mevorach, Riz Mokal, Barbara Romaine, Janis Sarra, and Ignacio Tirado, *The Modular Approach to MSME Insolvency,* forthcoming 2017, Oxford University Press at 6, 23.

110 *Ibid,* at 101.

to the debtor's business judgment, in the area of interim financing, Canadian courts rely heavily on their court-appointed officers to ensure a fair process and to reduce the risks associated with information asymmetries and time pressures.

(ii) Risks from the high cost of interim and exit financing

Given the limited pool of distressed debt financiers globally, the premium such creditors can extract in exchange for providing post-commencement financing can be significant. In assessing the fairness and reasonableness of such financing, the court may not be given the appropriate benchmarks against which to assess the risks to the debtor's creditors. Even where such benchmarks are available, the limited market means that the costs are high.

In Canada, Rostom and Fell have observed that the pricing elements of interim financing can include a combination of commitment fees, unused line fees, cash pay interest, extension fees, exit fees, cost and professional fee reimbursements; observing that the total upfront administration, closing or commitment fees charged by interim financiers ranges from 2% to 6.15%, while the average interest rate premium over the applicable base rates was over 6%.[111] They observe that the existence of exit fees in some cases, even where only nominal funds have been released, can have the effect of entrenching the interim financier as it would be very expensive to replace the financing even where the relationship sours during the restructuring proceeding.[112] In the US, the litigation costs are extremely high, with much of the litigation focusing on the question of whether the pre-petition lender is "adequately protected".

Some jurisdictions have attempted to control risks associated with the high cost of interim financing by granting only a certain percentage of interim financing requested, with the ability of the debtor or the insolvency professional to come back before the court to ask for more. There have also been "drip DIP", whereby the court authorizes a global amount of financing, but it is made available only in tranches as periodically approved by the court.[113]

Kent, MacFarlane and Maerov have observed that the introduction of "drip DIP" may have addressed the problem of excessively large interim financing facilities.[114] They point to the drip financing facilities in the Canadian Ivaco and Royal Oak cases as examples of where the debtor corporation was permitted to draw down only on a portion of an unused interim financing facility that was required for its continued operations during the restructuring process. To access another tranche of the interim financing facility, the debtor was required to apply to the court on notice to all affected stakeholders. They suggest that this mechanism may offer one means of ensuring that stakeholders are provided with timely information of the financing requirements of the debtor and the opportunity to provide their views to the court on the necessity of the draw down, as well as acting as a temper on any managerial slack that has arisen from a generous interim financing facility. However, even the measured approval of drip financing can be problematic, as usually the expensive fees for the financing facility are paid up front, whether or not the financing is ultimately drawn down by the debtor or the insolvency professional.[115]

(iii) Control risk

[111] Waël Rostom and Caitlin Fell, "Recent Trends in Interim Financing" (2016) *IIC* at 2-3.
[112] *Ibid,* at 3.
[113] Sarra, *Rescue, supra* note 11 at 247-248.
[114] Andrew Kent, Alex MacFarlane and Adam Maerov, "Who is in Control? A Commentary on Canadian DIP Lending Practices", May 2004.
[115] For a discussion, see Sarra, *Rescue, supra* note 11.

There have been cases where the interim financing is tied to fundamental changes in governance and capital structures.[116] In such instances, there is the risk of terms and conditions being overly onerous for the debtor company, which can cause considerable prejudice to the creditors being subordinated. An example of control risk is that the interim financier may insist on appointing one or more directors to the debtors' board. One study found that hedge funds and private equity funds in particular actively intervene in the restructuring process, gaining control over incumbent management and the board, in a way that does not generally occur with loan-to-loan lenders.[117] While control terms requiring appointment of directors may bring some much needed expertise to governance of the debtor, the downside risk is that they act in the best interests of the appointing creditor, rather than the best interests of the debtor company and all its stakeholders.

Canadian courts have expressed concern where proposed interim financiers insist on "control provisions", the courts serving as gatekeepers in the balancing of benefit and prejudice. Canadian courts have observed that the court must be constantly vigilant against strategies by interim financiers to take advantage of the "chaos and uncertainty" of the proceeding to gain an unfair advantage at the expense of other stakeholders in the proceedings, particularly where interim financing is being sought on an urgent basis.[118]

The Canadian Court has refused to approve provisions in an interim financing agreement where the financier is seeking governance or control provisions that are overreaching, such as a provision that would cause an event of default unless a plan of arrangement provides for either payment in full of all obligation of the interim financier's pre-filing claims.[119] In the *Essar Steel Algoma* CCAA proceedings, the Court ordered the parties to amend provisions of the interim financing facility to include a ten-day moratorium before an event of default could occur for failing to meet a milestone.[120]

Control provisions in interim financing arrangements may limit the debtor company's options for a possible restructuring, and Canadian courts have said that they will scrutinize such provisions, with the assistance of their court-appointed officer, the monitor. Overreaching provisions can include: aggressively short "milestones" to run a sale process and failure to achieve the milestones constituting a default; restrictions on the borrower's ability to support a plan or get approval of a sale transaction where it does not provide for payment in full of the interim financier's pre-filing obligations; and provisions that attempt to limit the authority of the court.[121]

By imposing overly tight time frames as a condition of interim financing, the debtor may not be able to consider a restructuring plan that allows the business to go forward without a sale, as there may be insufficient time to negotiate with pre-filing creditors or to look for a new injection of debt or equity capital. Aggressively short timeframes, benchmarks and milestones as a condition of interim financing may result in a truncated process that does not create a robust sales process that will maximize value for all creditors.[122] Firm timelines are important to the workout process, but they should be negotiated as an accountability check on the debtor, not as a strategy by the interim

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[116] See, for example, *Re Crystallex International Corp,* 2012 ONSC 2125 (Ont SCJ (Commercial List)), affirmed 2012 CarswellOnt 7329 (Ont CA), additional reasons 2012 CarswellOnt 9479 (Ont CA), leave to appeal refused 2012 CarswellOnt 11931 (SCC).
[117] Kai Li and Wei Wang, "Debtor-in-Possession Financing, Loan-to-Loan, and Loan-to-Own (2016), http://ssrn.com/abstract=2275635 at 1.
[118] *Re Great Basin Gold Ltd*, 2012 BCSC 1459 (BC SC) at para 179.
[119] See, for example, *Essar Steel Algoma Inc,* (9 November 2015) (Ont SCJ) (Endorsement of Newbould J).
[120] *Ibid,* at para. 2.
[121] Rostom and Fell, *supra* note 111 at 5.
[122] Sarra, *Rescue, supra* note 11.

financier to precipitate an early default or to limit processes that are aimed at maximizing the value of the enterprise for the benefit of all stakeholders.

In *Re Endurance Energy Ltd*, in determining a request for an initial order under the CCAA and for confirmation of a sales process granted *ex parte,* the Alberta Court of Queen's Bench considered allegations by creditors that the interim financing loan contained an "offensive term, namely a right of first refusal (ROFR) that will chill the entire process and unduly hobble the company", the monitor and the court in dealing with potential purchasers.[123] Interim financing was essential to a sales process, but the lender was insisting on the ROFR as an essential term and, without it, there would be no funding. The Court approved the financial advisor's fees in the administration charge; however, with respect to the interim financing loan, after considering the factors set out in section 11.2(4) of the CCAA, the Court refused to approve the loan with the ROFR term. The Court held "I see no point in confirming a short sale process with complicated assets, using the most expensive financial advisor, and then crippling the process by fettering the Court's discretion in allowing a ROFR" in favour of the interim financier. The Court further observed that while it was mindful that the interim financier had said that it would not fund without this term, the court was satisfied that there was no point in running an expensive sale process only to have the lender thwart the process with its override ability.[124] "If this means there is no sale process and the company closes its doors, I am still satisfied that I have balanced the stakeholder interests appropriately." The Court further clarified that it would confirm the loan and priority charge should the lender change its mind about the ROFR term.[125] The interim financier subsequently agreed to the financing without the ROFR term. The case illustrates the important role of the court in preventing powerful parties from hijacking the restructuring process through unnecessary control provisions in interim financing agreements.

US Courts have also occasionally expressed concern about overreach of control provisions within the interim financing arrangements. For example, in *In re Tenney Village Co*, the Court held that "under the guise of financing a reorganization" the DIP lenders would "seize control of the reins of reorganization" and "pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specifically crafted for the benefit of the bank".[126]

In other instances, control provisions may be used to disadvantage particular groups of creditors. For example, US courts have approved DIP financing agreements that set milestones specifying that the debtor will only receive continued financing if it successfully modifies terms and conditions of workers' employment under the collective bargaining agreement and reduces retiree benefits obligations.[127] Agreements have specified that failure to meet such requirements triggers a default under the financing agreement leading to full-scale liquidation.[128] The difficulty with such judgments is that they give one creditor the ability to force a renegotiation of a collective bargaining agreement that reduces benefits and protections for workers or retirees. Yet why should one creditor dictate the terms of such agreements? It inappropriately disadvantages employees and retirees and runs contrary to the idea of a collective insolvency process where there is give and take by all stakeholders to achieve a successful restructuring plan.

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[123] *Re Endurance Energy Ltd,* 2016 ABQB 324, application for leave to appeal dismissed, *Canadian Imperial Bank of Commerce v. Endurance Energy Ltd*., 2016 ABCA 217.
[124] *Ibid,* at para 5.
[125] *Ibid,* at para 5.
[126] *In re Tenney Village Co Inc* (1989) 104 B.R. 562 (Bank. Ct. D. N.H.) at 568.
[127] See, for example, *In re Alpha Natural resources Inc* (2016) 552 B.R. 314 (Bank. Ct. E.D. V.) There is a process for negotiation and approval under §1113, §1114 of the US Bankruptcy Code, and workers receive far less protection from their collective bargaining agreements being eroded than in other countries, such as Canada and France.
[128] *Ibid,* at 334.

(iv) Risk of unnecessary or inappropriate disruption in priority of claims

Most interim financing disrupts pre-filing priority of claims, as discussed above. However, there are particular features that may unnecessarily or inappropriately alter priorities. Depending on the jurisdiction one is from, cross-collateralization in interim financing may be viewed as a benefit or a risk. Canadian legislation expressly prohibits cross-collateralization; specifically, interim financing cannot be used to pay down pre-filing debts, whereas in the US, this practice is permissible.[129] One common requirement in the US is that cross-collateralization be identified in a motion, so the judge does not inadvertently miss seeing the request, and can balance the various interests affected.[130]

"Roll-up interim financing" is also a feature that can be viewed as a benefit or a risk to the restructuring proceeding. A roll-up interim financing is where an interim financier's pre-filing debt, some or all of it, is paid back, usually incrementally, by using advance from the interim financing, the notion being that the pre-filing debt is then rolled-up into the interim financing facility. There are variations on the concept of roll-up. Canadian courts have had mixed views on "creeping roll-ups", which are where interim financing proceeds are used to pay down the pre-filing debt owed to the interim financier, or where new cash coming in to the company is directed towards paying down the pre-filing claims of the interim financier.[131]

The argument in support of allowing roll-ups is that since the pre-filing working capital lender's loan was used to generate working capital, the pre-filing creditor should be able to recover that collateral rather than having it dissipate during the proceeding, which in turn may increase the willingness of pre-filing lenders to offer interim financing.[132] The risk associated with roll-ups is that they can alter the priority of the claims of creditors, all of whom have resources invested in the debtor pre-filing and hence their relative priorities should not be negatively affected. Another risk is that if creditors that were not given appropriate notice or information on the effect of the financing are able to

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[129] Section 501, US Bankruptcy Code specifies: (a) (1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.
(2) If the debtor is an individual in a case under chapter 7 or 13, such value with respect to personal property securing an allowed claim shall be determined based on the replacement value of such property as of the date of the filing of the petition without deduction for costs of sale or marketing. With respect to property acquired for personal, family, or household purposes, replacement value shall mean the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined.
(b) To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.
(c) The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property.
(d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless—
(1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or
(2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title. (Pub. L. 95–598, Nov. 6, 1978, 92 Stat. 2583; Pub. L. 98–353, title III, § 448, July 10, 1984, 98 Stat. 374; Pub. L. 109–8, title III, § 327, title VII, § 712(d), Apr. 20, 2005, 119 Stat. 99, 128.)
[130] John Ayer, "Obtaining DIP Financing and Using Cash Collateral", American Bankruptcy Institute Newsletter.
[131] *Re Cow Harbour Construction Ltd* (7 April 2010), Doc. 24-115359 (Alta QB).
[132] Rostom and Fell, *supra* note x at 8.

successfully challenge it, the nature of the financing approved may specify that it cannot be undone on any appeal or reconsideration.

Under the US regime, 11 USC §1129(a)(9) makes payment of all administrative claims in full a condition of plan confirmation;[133] thus when a lender insists on a roll-up, it is insisting on converting its pre-petition claim into a post-petition administrative claim. Such a strategy essentially gives a DIP lender a veto over any plan by making payment of the DIP loan in full, which includes the pre-petition debt, a condition of confirmation. In turn, it eliminates any possibility of cramdown, which only applies to pre-petition debt.

The recent judgment of the US Supreme Court in *Czyzewski v Jevic Holding Corp* may affect this situation in the future.[134] The context is that under Chapter 11, if parties cannot agree on a plan, the court can dismiss the case,[135] and the Code provides for what is, in effect, a restoration of the pre-petition *status quo*.[136] In *Czyzewski v Jevic Holding Corp,* the bankruptcy court dismissed a Chapter 11 bankruptcy, but did not restore the pre-petition *status quo*; rather, it ordered a distribution of estate assets that gave money to high-priority secured creditors and to low-priority unsecured creditors, but skipped mid-priority creditors who would have been entitled to payment ahead of general unsecured creditors in a Chapter 11 plan or Chapter 7 liquidation.[137] The Supreme Court held that a bankruptcy court has no authority to deviate from the basic priority rules and order a priority-skipping distribution in connection with a Chapter 11 dismissal, absent consent of the parties.[138]

A brief summary of the facts illustrates the significance of this judgment. Jevic Transportation filed for Chapter 11 bankruptcy two years after being purchased in a leveraged buyout by Sun Capital Partners. The bankruptcy prompted two lawsuits. In the first, a group of former Jevic truck drivers ("petitioners") was awarded a judgment against Jevic for its failure to provide proper notice of termination, in violation of the state Worker Adjustment and Retraining Notification (WARN) Act.[139] Part of that judgment counted as a priority wage claim under §507(a)(4), entitling the workers to payment ahead of general unsecured claims against the Jevic estate.[140] In the second suit, a court-authorized committee representing Jevic's unsecured creditors sued Sun Capital and CIT Group for fraudulent conveyance in connection with the leveraged buyout. These parties negotiated a settlement agreement that called for a structured dismissal of Jevic's Chapter 11 bankruptcy, in which the petitioners would receive nothing on their WARN claims, but the lower-priority general unsecured creditors would be paid. The petitioners argued that the distribution violated the Bankruptcy Code's priority rules by paying general unsecured claims ahead of their own. The Bankruptcy Court nevertheless approved the settlement agreement and dismissed the case, reasoning that because the proposed payouts would occur pursuant to a structured dismissal rather than an approved plan, the failure to follow ordinary priority rules did not bar approval.[141] The District Court and the Third Circuit affirmed.[142] On further appeal, the Supreme Court held that

133 Which is why a Chapter 11 discharge operates to discharge all debs in existence at the time of plan confirmation, because they are all paid in full or treated under the plan; 11 USC §1129(a)(9).

134 *Czyzewski v Jevic Holding Corp* 137 S Ct 973, 63 Bankr Ct Dec (CRR) 242, 22 March 2017.

135 11 USC §1112(b).

136 *Czyzewski v Jevic Holding Corp, supra* note 134, citing 11 USC §349(b).

137 *Ibid* at 1, citing 11 USC §§507, 725, 726 and 1129.

138 *Ibid* at 2, 11, 12. A "structured dismissal" is a hybrid dismissal and confirmation order, permitting the bankruptcy court, for cause, to alter a Chapter 11 dismissal order's ordinary restorative consequences, the Supreme Court noting that while the Bankruptcy Code does not expressly mention structured dismissals, they "appear to be increasingly common", *ibid* at 3.

139 Leaving the petitioner truck drivers with a judgment worth between $8.3 million and $12.4 million, *ibid* at 7.

140 *Ibid* at 6.

141 *Ibid* at 8.

142 *Ibid* at 8-9, *In re Jevic Holding Corp* 2014 WL 268613 (D Del). Third Circuit affirming in 787 F 3d at 175.

bankruptcy courts may not approve structured dismissals that provide for distributions that do not follow ordinary priority rules without the consent of affected creditors.[143]

The US Supreme Court held that, given the importance of the priority system, it was necessary to look for an affirmative indication of intent before concluding that Congress intended to make a major departure from the statutory priorities, and nothing in the statute evinced such intent.[144] Insofar as the dismissal sections of Chapter 11 foresee any transfer of assets, they seek a restoration of the prepetition financial *status quo.*[145] What is important about the judgment for this paper is that the Court indicates that a court can approve interim distributions that violate ordinary priority rules, such as critical vendor orders and roll-ups such as discussed above, when doing so would "enable a successful reorganization and make even the disfavoured creditors better off".[146] Here, the structured dismissal did not make the petitioners better off, did not advance a restructuring and did not restore the *status quo ante.* The Court held that the violation of ordinary priority rules that occurred did not have any offsetting bankruptcy-related justification, with potentially serious consequences, including departing from Congress' protection of the employee wage priority, and risk of collusion by secured creditors and unsecured creditors to squeeze out priority creditors.[147]

One commentator writing about the judgment has observed that the judgment specifically distinguished interim distributions that violate ordinary priority rules, such as those occurring via critical vendor orders and DIP financing roll ups, but suggests that the court offered no compelling reason for a distinction between interim and final distribution.[148] Brubaker observes that roll-ups and cross-collateralization in DIP financing can result in alteration of priority rules, and if the legal rule is that the judge can approve a priority-violating settlement only if no settlement is possible without the priority-violating distribution of the settlement, DIP lenders would always insist that roll-ups and cross-collateralization are the deal-breaker in order to bootstrap their pre-filing priorities, skewing both priorities and bargaining power.[149] He suggests that all of the Jevic Court's reasoning for an interpretive presumption denying bankruptcy courts any power to authorize priority-violating distributions, therefore, would seem to apply with full force, to interim priority-violating transactions, absent consent of parties, particularly since the Code's priority system constitutes a basic underpinning of business bankruptcy law.[150]

The risks associated with roll-ups can be compounded in cross-border insolvency proceedings, when different countries have different hierarchies of claims. A foreign representative of a main insolvency proceeding in one country may seek to be recognized in another country. For countries

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[143] *Ibid* at 11.
[144] *Ibid* at 13-14.
[145] The Court held that the "for cause" provision appears to protect rights acquired in reliance on the bankruptcy case, not to make general end-of-case distributions of assets, let alone final distributions that do not restore the *status quo* or protect reliance interests acquired in bankruptcy*, ibid* at 13-14.
[146] *Ibid* at 15. The Court held that the priority-violating distribution is attached to a final disposition, does not preserve the debtor as a going concern, does not make the disfavoured creditors better off, does not promote the possibility of a confirmable plan, does not help to restore the *status quo ante*, and does not protect reliance interests. The Court held that Congress did not authorize a "rare case" exception, as found by the Third Circuit, that permits courts to disregard priority in structured dismissals for "sufficient reasons", and the difficulty in giving precise content to the concept of "sufficient reasons" threatens to turn the court's exception into a more general rule, resulting in uncertainty that has potentially serious consequences of departing from the protections granted particular classes of creditors, changes in the bargaining power of different classes of creditors even in bankruptcies that do not end in structured dismissals, risks of collusion, and increased difficulty in achieving settlements. The lower judgments were reversed and remanded for further proceedings consistent with the Supreme Court Judgment. *Ibid* at 16-18.
[147] *Ibid* at 17-18.
[148] Ralph Brubaker, "Taking Bankruptcy's Distribution Rules Seriously: How the Supreme Court Saved Bankruptcy from Self-Destruction", April 2017 37:4 *Bankruptcy Law Letter,* Thompson Reuters, at 12.
[149] *Ibid* at 8.
[150] *Ibid* at 12.

that have enacted the UNCITRAL Model Law, if the in-bound court recognizes the foreign proceeding as a foreign main proceeding, certain mandatory orders flow, such as a stay of proceedings. However, the foreign representative may also seek financing from the in-bound jurisdiction to support the debtor in the foreign main proceedings. Such requests can be further complicated where the entities have intercompany debt or guarantees.

The 2016-2017 proceedings of *Re Performance Sports Group Ltd* is illustrative of the difficulties of navigating the Canadian prohibition in a cross-border insolvency proceeding with the US.[151] The debtor entities were designers and manufacturers of high performance sports equipment and apparel, and had commenced parallel proceedings under the CCAA and US Chapter 11. The debtors entered into an asset purchase agreement ("stalking horse agreement") for the sale of substantially all their assets to a group of investors led by the holder of 17% of the shares and another company. The stalking horse agreement contemplated that the debtors would continue as a going concern under new ownership, and that secured debt would be fully repaid and payment would be made to trade creditors. Justice Newbould of the Ontario Superior Court of Justice was satisfied that the interim financing should be approved, taking into account the factors in the *CCAA.* The Court held that section 11.2(1) of the CCAA provides that security for an interim financing facility may not secure an obligation that existed before the order authorizing the security was made, thus an interim facility may not be used to repay pre-filing obligations. In this case, Newbould J. noted that one of the facilities was a revolving facility and under its terms receipts from operations could be used to pay down the existing facility.

Newbould J. held that no advances under the facility would be used to pay pre-filing obligations and there was inserted in the initial order a provision that expressly prevented that. The provision that proceeds from operations of the entities post-filing may be used to pay down the existing facility was approved. The judge noted the court's general jurisdiction to permit payment of pre-filing obligations to persons whose services are critical to the ongoing operations of the debtor companies. Newbould J. was satisfied that an order should be made permitting the payments as requested, as any interruption of supply or services by the critical suppliers could have an immediate adverse impact on the entities' business.[152] He noted that the Canadian entities were expected to have positive net cash flows during the CCAA proceeding, and part of that money would be used to fund the deficit expected to be experienced by the US entities during the same period. The applicants sought approval to effect intercompany advances, secured by an intercompany charge on the basis that the business was highly integrated and depended on intercompany transfers. Newbould J. expressed concern about cash leaving Canada during the CCAA process while unpaid amounts owing to employees in Canada were outstanding, but deferred to the monitor's view that the intercompany charge was the best way to protect the Canadian creditors.

4. The European Commission's Proposals

As noted in the introduction, the European Commission has published a proposed Directive that aims to harmonize a number of aspects of insolvency law and restructuring frameworks in EU Member States.[153] The Commission's proposals are a key aspect of its Capital Market Union project.[154] At the core of the European Commission's proposals is a desire to facilitate mechanisms

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[151] *Re Performance Sports Group Ltd. (2016)*, 2016 ONSC 6800, 2016 CarswellOnt 17492 (Ont. S.C.J. [Commercial List]).
[152] *Ibid.* The court also approved continued use of the debtors' current transfer pricing model, on the understanding that in providing such approval, Newbould J. was not to be taken as making any judgment as to its validity.
[153] See Draft Directive, *supra* note 3.
[154] European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan on Building a Capital Markets Union, COM (2015) 468 final, 30 September 2015.

whereby businesses that are merely financially distressed, i.e. they are cash-flow insolvent but are nevertheless economically viable, can be rescued, and for there to be a measure of harmonization across Member States in this regard. It is estimated that of the 200,000 firms that go bankrupt in the EU each year, resulting in 1.7 million direct job losses, one in four of the insolvencies are cross border and involve creditors and debtors in more than one Member State.[155] If these businesses can be rescued, rather than go into liquidation, it is good for the debtor, for creditors, for employees, and for other stakeholders.

A key aspect of these proposals are rules governing the restructuring of financially distressed businesses.[156] These proposals follow the Commission's Restructuring Recommendation in 2014, which encouraged Member States to put in place a restructuring framework containing a number of minimum requirements.[157] The 2014 Restructuring Recommendation was not binding, and in any event, very few Member States took action to introduce restructuring provisions along the lines set out in that document. Consequently, the Commission has introduced this proposed Directive as the next stage in its plan to harmonize the provision of restructuring mechanisms in Member States.

The starting point of the proposed Directive is that "Member States shall ensure that, where there is a likelihood of insolvency, debtors in financial difficulty have access to an effective preventive restructuring framework that enables them to restructure their debts or business, restore their viability and avoid insolvency".[158] The proposals create a set of minimum principles with which Member States should comply. Debtors should have access to a mechanism that allows them to remain "totally or at least partially in control of their assets and the day-to-day operation of the business".[159] Creditors should be divided into classes to vote on the restructuring plan.[160] Classes should comprise those with rights that are "sufficiently similar to justify considering the members of the class a homogenous group with a commonality of interest", with secured and unsecured creditors being treated as separate classes, as a minimum.[161] The plan can be imposed on dissenting creditors, and the proposed Directive includes the possibility of a cross-class cram down, but confirmation by a "judicial or administrative authority" will be required where the plan affects the interests of dissenting affected parties,[162] in which case it will bind dissentients.[163] The proposed Directive also envisages a broad statutory stay[164] and protection for interim and new financing, in order to facilitate the restructuring.[165]

The Commission's proposals for a harmonized restructuring law broadly follow the ideas first put forward in the 2014 Recommendation, although in certain key regards, the draft Directive goes further than the Restructuring Recommendation, and introduces greater constraints on creditors' rights. The area of interim and new financing is one example of this expansion. The provisions in the

[155] Commission Staff Working Document, Impact Assessment accompanying Commission Recommendation on a New Approach to Business Failure and Insolvency, SWD(2014) 61 final, 12 March 2014, 2.
[156] Draft Directive, *supra* note 4, Title II. In addition, the proposed Directive puts forward rules governing the treatment of bankrupt entrepreneurs (Title III), a series of measures intended to enhance the efficiency of insolvency rules, principally requiring Member States to have competent and well-trained court and insolvency professionals able to operate in this area (Title IV) and measures designed to improve the collection and publication of data on national insolvency measures (Title V).
[157] Restructuring Recommendation, *supra* note 3.
[158] Draft Directive, *supra* note 4, Art 4(1).
[159] *Ibid,* Art 5(1).
[160] *Ibid,* Art 9(1) Where national law provides, shareholders may also vote on the plan in classes- although they should not be able to obstruct the restructuring: Art 12.
[161] *Ibid,* Art 9(2). It is left to Member States to lay down the requisite majorities, although Article 9(4) provides that it shall not be higher than 75% of the amount of claims or interest in each class.
[162] *Ibid,* Arts 10(1), 11, 13.
[163] *Ibid,* Art 14.
[164] *Ibid,* Arts 6, 7.
[165] *Ibid,* Art 16.

Recommendation in this regard were extremely flimsy,[166] and the provisions in the draft Directive are more developed, although they remain very brief, despite the statement within the Explanatory Memorandum to the proposed Directive that the protection of rescue financing is "essential in ensuring restructuring plans' success".[167]

As the Commission has noted, "The protection of new financing and interim financing (essential in ensuring restructuring plans' success) also varies among Member States, ranging from minimum protection from avoidance actions to a form of priority over existing debt in subsequent insolvency procedures."[168]

The Restructuring Recommendation merely suggested that those parties that provide new finance under a court-sanctioned restructuring plan should be shielded from the operation of transaction avoidance rules that could otherwise render the transaction "void, voidable or unenforceable as an act detrimental to the general body of creditors"[169] and from "civil and criminal liability relating to the restructuring process"[170] The Restructuring Recommendation was silent on the treatment of new finance extended between the commencement of the procedure and the plan confirmation, leaving it to national law to determine the priority to be afforded to such finance. The Restructuring Recommendation also avoided tackling the difficult issue of priority rules, particularly the question of whether priority over secured creditors could occur in any circumstances.[171]

Article 16 is the key provision relating to interim and new financing. It provides:

> **Protection for new financing, interim financing and other restructuring related transactions**
> *Article 16*
> *Protection for new financing and interim financing*
>
> 1. Member States shall ensure that new financing and interim financing are adequately encouraged and protected. In particular, new and interim financing shall not be declared void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures, unless such transactions have been carried out fraudulently or in bad faith.
>
> 2. Member States may afford grantors of new or interim financing the right to receive payment with priority in the context of subsequent liquidation procedures in relation to other creditors that would otherwise have superior or equal claims to money or assets. In such cases, Member States shall rank new financing and interim financing at least senior to the claims of ordinary unsecured creditors.
>
> 3. The grantors of new financing and interim financing in a restructuring process shall be exempted from civil, administrative and criminal liability in the context of the subsequent insolvency of the debtor, unless such financing has been granted fraudulently or in bad faith.

The proposed Directive extends the reach of the provisions to cover not only new finance, required to implement the plan, but also "interim finance", required to enable the business to survive pending the confirmation of the restructuring plan.[172] It is notable that the debtor company does not have to be insolvent in order to access the restructuring regime or interim financing provisions.

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[166] Restructuring Recommendation, *supra* note 3, recommendations 27-29.
[167] Draft Directive, *supra* note 4, at 3.
[168] *Ibid,* at 3.
[169] Restructuring Recommendation, *supra* note 3, recommendation 27.
[170] *Ibid,* recommendation 28.
[171] See European Commission, Impact Assessment accompanying the document Commission Recommendation on a New Approach to Business Failure and Insolvency (Commission Staff Working Document) SWD (2014) 61 final, section 7.2.5, which indicates that the Commission was anxious about the impact of recommending a super priority rule on secured creditor rights.
[172] Draft Directive, *supra* note 4, Art 16, Art 2(12).

This decision is somewhat surprising, and at odds with the approach in other jurisdictions. In Canada, the debtor must be insolvent, although the courts have liberally interpreted what it means to be insolvent.[173] Canadian courts have also allowed a solvent entity to be part of the CCAA restructuring where the other entities in a business enterprise group are insolvent and it is necessary to have the solvent company be part of a global workout.

The Commission's decision under the 2014 Restructuring Recommendation that interim financing will be available to a solvent firm is a change from previously. It is recommending that businesses be insolvent or that there be at least a "likelihood of insolvency" before the restructuring regime, including the provisions regarding protection for new financing, became available.[174] Some commentators on the provisions within the Restructuring Recommendation criticized this restriction, pointing to restructuring mechanisms such as the English scheme of arrangement that are available to both solvent and insolvent companies.[175] The early availability of the English scheme is one of its advantages as a rescue mechanism for financially distressed companies.[176] However, the volte-face of the European Commission on this issue is a concern as it fails to separate the different strands of the proposals being put forward. The availability of a restructuring mechanism *per se* prior to insolvency can be valuable for companies in order to allow them to address their financial difficulties at an early stage. However, other aspects of the Commission's draft Directive, including the provision the new and interim financing, should not be available to a debtor unless it is insolvent or on the verge of insolvency. There are two reasons.

First, the need to protect interim financing only arises once the debtor company is in financial difficulty. If the company is solvent, there should be creditors that are prepared to lend to it, and no intervention of the law should be necessary to facilitate such financing. As a follow on from this point, creditors to a company need commercial certainty; while they may understand that, in some jurisdictions at least, their claims may be "trumped" by an interim financier when the company is insolvent, the creditor should have assurance that such a situation cannot arise while the company remains solvent. Second, provisions introduced to protect and support new and interim lending involve very considerable inroads into the rights of creditors. They potentially allow existing creditors rights to be overridden by those of the new finance provider.[177] These very considerable constraints on the rights of creditors can only be justified if the company is in serious financial difficulty, and if appropriate protections are put in place to provide a measure of protection for those creditors. Notably the English scheme of arrangement does not have attached to it, at the present time, any legislative support or protection for rescue finance.[178] The fact that the English scheme is available pre-insolvency does not give rise to these issues.

Consequently, although the approach of the European Commission regarding allowing solvent companies to access the restructuring mechanism envisaged in the draft Directive is sensible and indeed potentially advantageous to companies, it should not be extended to the availability of the moratorium or to the provisions supporting new and interim finance. This issue is more relevant for

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[173] Canadian courts have held that a court should determine whether there is a reasonably foreseeable expectation at the time of filing that there is a looming liquidity condition or crisis that will result in the applicant running out of money to pay its debts as they generally become due in the future without the benefit of the stay and ancillary protection; see for example *Re Stelco Inc.* (2004), 2004 CarswellOnt 1211, 48 C.B.R. (4th) 299 (Ont. S.C.J. [Commercial List]), leave to appeal to C.A. refused (2004), 2004 CarswellOnt 2936 (C.A.).

[174] Restructuring Recommendation, *supra* note 2, recommendations 5(a) and 6(a).

[175] See eg H Eidenmüller and K van Zwieten, "Restructuirng the European Business Enterprise: The EU Commission Recommendation on a New Approach to Business Failure and Insolvency" (2015) 16 *EBOR* 625.

[176] J Payne, "Debt restructuring in English Law: Lessons from the US and the need for reform" (2014) *Law Quarterly Review* 282-305, and see the Commission's 2014 Restructuring Recommendation, 5(a).

[177] J Payne, "The role of the court in debt restructuring" available at ssrn: https://ssrn.com/abstract=2902528.

[178] Although see the recommendations of the UK Insolvency Service in this regard: Insolvency Service, *A Review of the Corporate Insolvency Framework: a consultation on options for reform*, May 2016.

priority charges that for protecting financing in the event of subsequent insolvency, since the latter envisages the protection only being relevant on the subsequent insolvency of the company.

There are two forms of protection envisaged: (i) protection from such financing being invalidated in some way, and protection from liability for the grantors of such financing, should the company subsequently become insolvent; and (ii) the potential for such financing to receive a priority charge.

It is notable, therefore, that only two of the five forms of priority or support for interim financing outlined in part 2 of this paper, and which are found in other jurisdictions that have developed mechanisms for dealing with this issue, find a place in the European Commission's proposals. Before considering in detail the two forms of protection that are contemplated by the draft Directive, it is worth reflecting on these choices. Although the European Commission recognizes the value and importance of a debtor company having in place adequate financial resources to support its operation through the restructuring negotiations and thereafter,[179] it does not make use of other forms of protection for such financing that has proven beneficial elsewhere. It is also striking that the thrust of the European Commission's proposals is on the protection for the financing and its grantors in the event of the debtors' subsequent insolvency, which is a rather marginal form of benefit, given that many Member States tackle this issue as a matter of course in their general insolvency provisions. It may be that, politically, this issue was therefore a relatively straightforward one on which to reach agreement among Member States. While there may be gains in one or two Member States regarding the introduction of this issue,[180] on the whole this focus is unlikely to encourage any significant development in the availability of interim finance within the EU.

Another explanation behind the narrow focus of the European Commission in this regard is the view that the restructuring process should involve only the financial creditors, so that throughout the restructuring, the company should continue to pay vendors and suppliers as usual. In part, this view is driven by the desire to reduce complexity in the restructuring and is in keeping with the principle of minimum intervention that is at the heart of the Commission's proposals.[181] This approach is in line with English schemes of arrangement to some extent. In general, schemes involve only the financial creditors, and not trade creditors. It is one reason why the English restructuring regime works relatively well even without a statutory stay: the creditors agreeing on the scheme are a group of sophisticated lenders that can either agree to a standstill arrangement or can appreciate the need to hold off from enforcing their claims in order to facilitate the rescue of the business. Of note, however, is, that changes to the credit market in the UK are starting to threaten this model. However, schemes do involve significant court oversight.[182]

(i) Protection for the financing and its grantors in the event of the debtor's subsequent insolvency

In line with the Restructuring Recommendation, Articles 16(1) and (3) provide that interim and new financing shall not be declared "void, voidable or unenforceable as an act detrimental to the general body of creditors"[183] and the grantors will be exempted from "civil, administrative and criminal

[179] Draft Directive, *supra* note 4, recital 31.

[180] See Directorate-General Justice & Consumers of the European Commission, Evaluation of The Implementation of The Commission Recommendation of 12.3.2014 On A New Approach To Business Failure And Insolvency, 30 September 2015, at 4, which identifies six Member States in which the provision of new finance does not seem to be protected in subsequent insolvent proceedings in any special way: Estonia, Croatia, Lithuania, Luxembourg, Poland and Sweden.

[181] Draft Directive, *supra* note 4, recital 18.

[182] See J Payne, *Schemes of Arrangement: Theory, Structure and Operation* (CUP, 2014), chapter 2.

[183] *Ibid,* Art 16(1).

liability in the context of the subsequent insolvency of the debtor"[184] unless fraud or bad faith is involved.[185] The rationale for this approach is set out in the recitals of the proposed Directive, namely that national insolvency laws providing for avoidance actions if a debtor becomes eventually insolvent or stipulating that new lenders may incur civil, administrative or criminal sanctions for extending credit to debtors in financial difficulties are jeopardising the availability of financing necessary for the successful negotiation and implementation of a restructuring plan.[186]

Article 17 extends the protection against a transaction being declared void, voidable or unenforceable, absent fraud or bad faith, to "other restructuring related transactions", including the payment of reasonable fees and costs of negotiating, adopting, confirming or implementing the restructuring plan[187] and "transactions such as new credit, financial contributions or partial asset transfers outside the ordinary course of business made in contemplation of and closely connected with negotiations for a restructuring plan.[188]

While it is important that such financing be protected from *ex post* claims, the Commission's proposals in this regard are unlikely to make much of a difference in most Member States. Most Member States have in place provisions providing for avoidance of certain transactions prior to the commencement of insolvency.[189] Although these provisions may vary in relation to details such as the length of the period prior to insolvency during which such transactions are vulnerable, they are generally aimed at improper transactions, for example, those where security is provided to a creditor for no new value.[190] The predominant focus of such legislation is situations in which the creditor is receiving disproportionate benefits, such as security for an existing unsecured debt or repayment of an existing loan facility.[191] As long as the new finance is genuine, *i.e.* there is a *quid pro quo* for the benefit that the creditor receives, it is unlikely to fall foul of such provisions.[192]

The issue of protection from the financing being declared void, voidable or unenforceable subsequently has not posed a problem in the jurisdictions that have enacted interim and exit financing provisions, for example in Canada. As noted above, Canadian orders commencing proceedings frequently expressly state that the interim financing will not be subject to preference claims. It also has not featured in US cases, although as noted above, sometimes the UCC go after the interim financier for the pre-insolvency debt that has been rolled-up in the interim financing.

The issue of protection from the financing being declared void has also not really featured in UK discussions on this issue, where financing is market driven. It has been raised as a concern in the EU discussions, and thus may account for the proposed provision. Member States may tackle concerns about creditors being advantaged by preferential treatment as compared to other creditors when the company is financially distressed in a number of ways, and if the response involves providing for

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[184] *Ibid*, Art 16(3).
[185] *Ibid,* recommendation 29.
[186] *Ibid,* at recital 31.
[187] *Ibid,* Art 17(2)(a).
[188] *Ibid,* Art 17(2)(e). Member States may require such transactions to be approved by a restructuring practitioner or a judicial or administrative authority in order to benefit from this protection: Art 17(3). An example of the latter type of transaction, provided in the recitals to the proposed Directive, is the selling of a subsidiary to obtain cash which an enterprise in financial difficulties needs in order to continue operating the business during restructuring negotiations: *ibid,* recital 33.
[189] See, eg, UK Insolvency Act, ss, 238, 239, 245; In Germany, § 133 Insolvenzordnung.
[190] See the discussion in part 2(v) of this paper for a discussion of the position in the UK. In Germany, the court (Bundesgerichtshof) has developed a similar approach, see eg BGH, 12 May 2016 - IX ZR 65/14, ZIP 2016, 1235 para. 14, which states that the mental elements of § 133 Insolvenzordnung are not established if the act is part of a reasonable and well-founded rescue plan.
[191] See R Bork, 'Transactions at an Undervalue—A Comparison of English and German Law' (2014) 14 *Journal of Corporate Law Studies* 453.
[192] Insolvency Act 1986, s. 245(2).

avoidance actions if and when the debtor becomes subsequently insolvent, or imposing civil, administrative or criminal sanctions on new lenders, then it may make it difficult for debtors to acquire interim or new financing.[193]

The question, therefore, is whether this protection needs to be specifically spelled out or whether it can, rather, be left to the general insolvency law of Member States to deal with, given that it is common for such laws to seek to protect new finance when there is a reciprocal flow of benefits and obligations from creditors to the debtor. In favour of such a provision, it could be said that civil law countries require the statutory language in order to ground the protection, and if there are indeed Member States lacking such protection in their general insolvency law, then this provision could ensure that all Member States are brought up to a minimum level. However, as discussed previously, these provisions seem unlikely to make a material change to the existence or operation of new and interim finance in the EU.

(ii) Interim and new financing to receive a priority charge

In addition, Article 16 includes reference to priority issues. However, it does not create anything akin to the super-priority regime for new financing that is seen in §364 of the US Bankruptcy Code.[194] The form of priority envisaged is at a much lower level and the details are, in any case, left to Member States to determine. Member States "may" afford priority to the providers of new or interim financing, but are not required to do so. If they do so, however, Article 16(2) provides that it shall rank "at least senior to the claims of ordinary unsecured creditors",[195] but the Article is otherwise silent as to how such a priority should operate. So, if the Directive is adopted, Member States will be free to give credit providers priority over the claims of ordinary, secured creditors, but they are not required to provide such priority.

The Commission therefore accepts that there can be value in Member States introducing such provisions. It can be seen from the discussion in part 2 that there can be considerable value for debtor companies where interim financing is available. Empirical evidence in the US, for example, suggests that companies with DIP financing are more likely to emerge from Chapter 11 as a going-concern business,[196] and that the ability to allow the DIP financier to take priority over existing lenders is often key to such financing being agreed. The draft Directive does not require priority to be made available to those providing new and interim finance, but leaves this decision to Member States to determine.

Leaving the ability to grant priority charges to Member States significantly undermines one of the aims of the proposed Directive, which is to promote harmonization of restructuring processes across the EU in order to facilitate restructuring plans for cross-border groups of companies with subsidiaries in more than two Member States. Yet there is a lot of diversity between Member States in this regard. The proposed Directive notes that the protection for interim financing "varies among Member States, ranging from minimum protection from avoidance actions to a form of priority over existing debt in subsequent insolvency procedures."[197] For example, in Sweden, a new financier can

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[193] Draft Directive, *supra* note 4, recital 31.
[194] This is despite calls for a European regime akin to the US DIP financing regime: see eg Association of Financial Markets in Europe (AFME)/Frontier Economics*, Potential economic gains from reforming insolvency law in Europe* (February, 2016) at 18.
[195] *Ibid*, Art 16(2).
[196] I Hasan, G Ramirez and G Zhang, "Lock-in Effects in relationship Lending: Evidence from DIP Loans", http://ssrn.cm/abstract=1785685 at 6.
[197] Draft Directive*, supra* note 4 at 3.

be given a 'super-priority' right in respect of any new debt provided by it in certain circumstances.[198] Other jurisdictions contain no specific interim financing arrangements, such as Germany and the UK.

The Commission's approach of devolving the detail regarding priority to Member States is understandable in some ways. Notwithstanding the existence of priority provisions for post-commencement financing in some jurisdictions, there is no consensus globally on which pre-filing assets should be used to secure such financing. For example, the World Bank Doing Business 'Resolving Insolvency' indicators give the highest marks to countries that have a new financing framework, but only where there is no provision for super-priority over existing secured debt.[199]

It may not be realistic for the EU to promulgate one approach to the priming issue given the diversity of approaches among Member States. This issue is not straightforward and a one-size-fits-all approach is unlikely to be successful. The experience of other countries suggests that different approaches can be tailored to the norms and practices of particular jurisdictions, and while challenging, such approaches can successfully co-exist, for example, the requirement of adequate protection under US law and a more court-supervised balancing of interests and prejudice under Canadian insolvency law.

Even if interim financing works well elsewhere, simply transplanting those ideas into an entirely different legal culture is unlikely to be successful. For example, compare the US and the UK. The UK is more creditor-friendly and much less litigious than the US, with different developed mechanisms for funding restructuring in place at present that seem to work well. There is a danger that simply transplanting a regime that works well elsewhere, such as Chapter 11 in the US, would do more harm than good. Introducing priority for interim financing into the UK that allowed existing security interests to be overridden, could potentially jeopardize the funding for financially distressed companies that existing lenders are currently prepared to provide.

The advice provided to the Commission in the Staff Working Document that preceded the draft Directive was that the issue of priority is best left to each Member State to decide, since proposals need to be consistent with national laws regarding priority rights and security interests.[200] Nevertheless, this approach has implications for the value of the EU-wide regime being proposed. Not least, the delegation of this matter to Member States raises the possibility that mistakes may be made at Member State level and that an appropriate balance may not always be struck between the debtor company, the suppliers of interim finance, and the remaining creditors. As part 3 of this paper explores, there are many risks involved in interim financing and jurisdictions need to be vigilant to deal with these risks appropriately. The current text of the draft Directive is almost silent on the way in which priority for new and interim financing might operate. The draft Directive should have gone much further in this regard, setting out various guidelines or minimum criteria that should apply where priority to new and interim financing is provided. If the Directive is going to address interim financing, it should step up to provide meaningful guidance to Member States or it should say nothing at all.

We suggest that the priority provision in Article 16 should be considerably enhanced in order to meet the Directive's express objective of ensuring that new and interim financing are adequately encouraged and protected.[201] While not imposing one approach, it could reflect the need for some basic principles and protections, based on the lessons from other jurisdictions.

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[198] See Swedish *Preferential Rights of Creditors Act* (1970;979).
[199] See the 2017 DB Report para 2.7.7.
[200] SWD (2016) 357 final at 140.
[201] As specified in Article 16, 1.

Article 16 of the Directive could, for example, specify the following types of guidance that would assist Member States to consider the risks and benefits of interim and new financing:

1. If adopting a priority for interim or new financing in insolvency, the debtor should be required to give effective notice to pre-filing creditors and allow them the opportunity to be heard by a court if they object. The UNCITRAL *Legislative Guide* suggests that such notice is of fundamental importance.[202] Member States may also wish to consider whether statutory preferred creditors and unsecured creditors should also receive notice.

2. If adopting a priority for interim or new financing in insolvency, the Member State should consider what threshold the debtor must meet in order to seek such financing,[203] such as proof by the debtor that it is unable to obtain the necessary finance without the priority; and/or provision of protection for any diminution of the economic value of encumbered assets, including by a sufficient excess in the value of the encumbered asset.[204]

3. If adopting a priority for interim or new financing in insolvency, the Member State should consider whether one or more of the following criteria are appropriate to assess in approving such financing on a priority basis:
    a. Do creditors have confidence in how the debtor's business and financial affairs are being managed during the restructuring proceeding?
    b. Does the financing enhances the prospects of a viable going-forward business?
    c. Do the benefits of the financing outweigh the risks?[205]
    d. Are any creditors materially prejudiced as a result of the priming charge?[206]
    e. Has there been a process identifying the best and most reasonably priced financing possible in the circumstances.[207]

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[202] UNCITRAL Legislative Guide ss. 64-68

Priority for post-commencement finance

64. The insolvency law should establish the priority that may be accorded to post-commencement finance, ensuring at least the payment of the post-commencement finance provider ahead of ordinary unsecured creditors, including those unsecured creditors with administrative priority.

65. The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on an unencumbered asset, including an after-acquired asset, or a junior or lower priority security interest on an already encumbered asset of the estate.

66. The law should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67.

67. The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including: *(a)* The existing secured creditor was given the opportunity to be heard by the court; *(b)* The debtor can prove that it cannot obtain the finance in any other way; and *(c)* The interests of the existing secured creditor will be protected.

Effect of conversion on post-commencement finance

68. The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.

[203] Including, as discussed above, whether a necessary pre-condition should be that the debtor is insolvent or on the threshold of insolvency.

[204] *Ibid.*

[205] For example, the Member State should consider the benefits and risks of allowing cross-collateralization of the interim financier's pre-filing claims. If the statutory language prohibits cross-collateralization of pre-filing debt and post-commencement financing, pre-existing creditors will not be unfairly disadvantaged by lenders with deeper pockets "boot strapping" their pre-filing unsecured debt. The prohibition under the Canadian insolvency law is aimed at preventing this practice as it was viewed as unfair to pre-filing secured creditors.

[206] Using the Canadian criteria as one possible option; and including consideration of a US-type provision regarding "adequate protection".

[207] Competing proposals for interim financing can allow the debtor to negotiate more favourable terms, can impose discipline on pricing of the loans, help prevent the cost and disruption of potential last-minute proposals being

4. If adopting a priority for interim or new financing in insolvency, court approval should be required.[208] This proposal is at odds with the approach of the European Commission's proposals, which are based on the principle of minimum intervention by courts and judicial authorities.[209] The Commission's proposals are inspired by Chapter 11's substantive rules, but not its costs. However, one lesson evident from the experience in the US and Canada is the central importance of the court in balancing the various competing interests where interim and new financing is provided, and particularly where existing creditors' claims are overridden in favour of creditors that provide rescue finance. Although it is understandable that a goal of the Directive in encouraging restructuring is to reduce the involvement of the court,[210] the potential prejudice to creditors' pre-filing contracts and claims makes court approval of interim financing necessary to ensure fairness to all stakeholders and maintenance of the integrity of the process,[211] particularly where that financing involves priority being given to the provider of such financing as Article 16(2) contemplates.

5. Conclusion

It is difficult to capture, in a scholarly paper, the immediacy of the need for continued financing when a financially distressed company seeks to negotiate and implement a debt restructuring. If there is to be any chance of a going-concern workout of a debtor company's financial distress, "lights on" financing at a minimum is immediate and urgent. Different jurisdictions have different levels of secured lending pre-insolvency, which directly affects the ability to arrange interim financing. Given the urgent need for financing, notice is not always as fulsome as it could be, which arguably is a reason to think about a two-fold process, one that keeps the lights on in the sense of continuing operations for a brief period time, until parties can receive effective notice and make their views known to the court. Such immediate relief would be followed by interim financing to cover the costs of negotiating with creditors and preserving going-concern value of the debtor during the workout period. As illustrated above, interim financiers will often make unreasonable demands in terms of onerous conditions attached to any interim or exit financing, and absent some guidance, courts may have a difficult time determining when such proposed terms are a 'bluff', in the sense of not really being a deal-breaker, the interim financier trying to enhance its financial position and bargaining power on threat of withdrawing its proposed financing if it is not approved on its terms.

The proposed EU Directive is merely a draft put forward by the Commission, and is subject to the co-decision procedure. The Council and the European Parliament will therefore have the opportunity to make amendments to this proposal. It may be some time before a final version of this Directive emerges, and after it is final, Member States will have two years in which to implement its measures. There is therefore still time for these provisions regarding new and interim finance to be amended in accordance with the proposals put forward in this paper.

There is no doubt that the availability of new and interim financing for financially distressed companies can promote the continued operation and survival of the debtor company. The European

presented to the court for tactical reasons; and give the court approving the financing a higher measure of confidence that efforts were made to obtain financing under the best terms possible. Rostom and Fell, *supra* note x at 8.

[208] As discussed above, such a prohibition is included in the Canadian legislation, but not the US.

[209] Draft Directive, *supra* note 3, recital 18.

[210] Draft Directive, *supra* note 4, Art 4(3).

[211] It is accepted that a provision allowing the parties, including the debtor, creditors, employees and insolvency professional, to agree to forego court involvement, could be beneficial, especially for SMEs, but for such a provision to operate effectively, informed consent of the parties will be needed, and the role of an independent insolvent practitioner will be vital.

Commission's inclusion of provisions aimed at promoting and protecting such financing, as part of its package of provisions aimed at facilitating effective restructuring mechanisms in all Member States, is understandable. In some jurisdictions, market solutions to this issue may develop, but in others, legislative or judicial assistance may be required to enable such financing to develop. The US and Canada provide examples of two jurisdictions in which interim finance has been developed further within the respective statutory frameworks to provide a valuable resource for financially distressed companies. The UK offers a market-based approach.

There are, however, significant risks associated with interim financing, as the experience in the US and Canada illustrates. It is understandable that the European Commission has not adopted a forceful top-down approach to legislating in this area. Instead the proposals are rather modest. Those regarding protection for financing and its grantors in the event of the debtor's subsequent insolvency are likely to be of marginal benefit, given that protection will often be in place in the general insolvency law of Member States to deal with this issue. This form of protection is unlikely to do much to encourage interim financing. It is the proposals regarding the possibility of a priority charge for interim and new financing that have the greater potential effect. The proposals themselves are minimal, doing little more than putting this option on the table for Member States, but they open up the possibility of Member States affording the grantors of new or interim financing priority in a subsequent liquidation. These provisions are potentially of significant benefit to debtors and to the new lenders of finance, but also bring with them the potential for abuse of existing creditors.

In introducing these provisions, the European Commission needs to trip the light fantastic. A level of agility is needed to deal with these issues, which is lacking in the present proposals. Even the minimal provisions in Article 16(2) bring with them the potential for problems if Member States introduce priority protection for new and interim lenders without appreciating the risks involved and the need to protect the existing creditors. If it wishes to continue with this Directive, which will require implementation by Member States, the Commission should also make reference to the kinds of protections that should be made available to creditors, as described in part 4 of this paper. An effective mechanism to restructure insolvent but viable enterprises is essential to a modern insolvency regime, and it is important for the European Commission to find the best path forward in meeting that goal.