Short Paper for Global Insolvency Practice Course 2023

Midori Yamaguchi

How to Encourage Debtor-in-Possession Financing – Comparison on Protection of DIP Financing between the US and Japan

<u>**Table of contents**</u>

1. Introduction

2. General Overview of DIP Financing

3. United States of America

3.1 Legislative Provisions on DIP Financing

3.1.1. Basic Principle – Administrative Expense Priority under Section 364(b) and 503(b)

3.1.2. Super Priority under Section 364(c)

3.1.3. Priming Lien under Section 364(d)

3.2. Practical Ways to Protect DIP Financing – Roll-up and Cross-collateralization

3.3. Effect on Market of DIP loans

4. Japan

4.1. A New Financing during Out-of-court Proceedings

4.1.1. DIP financing and “Pre-DIP” Financing

4.1.2. Rule-based Preliminary Insolvency Proceedings

4.1.3. Necessity to Protect “Pre-DIP” Financing

4.2. Legislative Provisions on DIP financing and Pre-DIP financing

4.2.1. DIP financing

4.2.2. Pre-DIP Financing

4.3. Practical Ways to Protect DIP Financing – Collateral

4.4. Effect on Market of DIP loans

5. Analysis on Comparison between the US and Japan

6. Conclusion

Bibliography

1. Introduction

Debtor-in-possession ("DIP") financing is known as the supply of additional financing to financially distressed debtors who are in process of insolvency procedure. This kind of loans is now getting an essential component of restructuring as rescue financing for debtors on the verge of cash shortage.

Historically, the US developed the legislation in favor of DIP lenders by giving special protection to DIP loans in the restructuring process of chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code"). This is a liberal way to promote DIP loans and resulted in creating a large DIP financing market.

In Japan, the laws have protected DIP financing to some extent during the in-court restructuring procedure. Whereas, Japan has distinctive pre-insolvency regime characteristics, which are rule-based workouts which must adhere certain rules, guidelines or even laws under the assessment of impartial experts during the process. Under these rule-based systems, Japan has the legislation to protect rescue financing during the pre-insolvency phase, which we call as "pre-DIP financing." In 2021, the legislative amendment was taken into effect to extend the protected pre-DIP financing and it shows the trend to broaden the protection and promote the financing for restructuring.

This paper seeks to analyze and compare the legislative provisions and practical methods adopted for DIP financing in the US and Japan, including the ability to prime existing lenders and roll-up pre-petition debt into the DIP facility, with some comments on the market of DIP loans in both countries.

2. General Overview of DIP Financing

A large amount of funds is required to continue the business during the restructuring and accomplish the business turnaround. On a debtor side, a new loan as DIP financing gives necessary working capital to sustain the firm. DIP financing also indicates to vendors and customers that the debtor has enough capital to maintain operations during the insolvency process or to perform a sale properly that would maximize the existing lenders' return. As a result, DIP financing can encourage other lenders, suppliers, and employees to keep doing business with the debtor and offer credit enhancement resulting in avoidance of a deterioration in the company's creditworthiness due to the filing of the process.

From the lender's viewpoints, DIP Financing may preserve the value of their existing loans to the company. In many instances, if the debtor is compelled to liquidate quickly after running short of funds, such lenders would almost definitely suffer considerably reduced loan recovery. Some pre-petition existing lenders may provide DIP financing as a defensive manner, with a view to increasing the recovery rate of existing loans and maintaining the collateral value. On the other hand, offensive DIP financing occurs when a lender has never made a loan to the debtor before the petition and makes a fresh loan to the debtor, in which case the primary goal is to gain interest and fee money.

Despite of these benefits, because debtors' credit status is already extremely deteriorated and most assets are often pledged to cover their existing debts, it is higher risk for lenders to execute DIP loans, and in other words, it is often incredibly difficult for debtors in the insolvency process to attract new financing under standard terms. Therefore, the legislation is necessary to promote a new loan and facilitate rehabilitation by providing legal protection for a new loan after the commencement of proceedings. At the same time of the promotion, some concerns should be solved on whether the protection of new financing would infringe on the rights of other creditors and how the existing creditors should be safeguarded.

The following explains the protection of DIP financing lenders and existing lenders under legislative provisions in the US and Japan.

3. United States of America

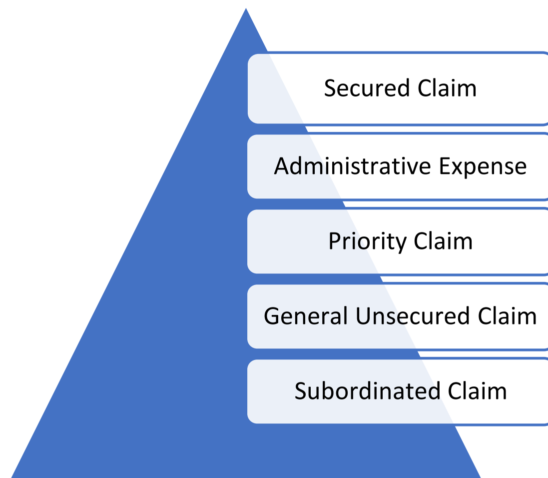
3.1. Legislative Provisions on DIP Financing

3.1.1. Basic Principle – Administrative Expense Priority under Section 364(b) and 503(b)

Under the Bankruptcy Code, claims and interests are entitled to payment in the following ranking of priority in chapter 11 in the US. Secured claims is repaid to the extent of the value of the collateral.[1]

[1] Shinnosuke Fukuoka, *An Overview of the United States Bankruptcy Code (the Second Edition)*, Shojihomu Co., Ltd., p 190.

Table: Ranking of priority



During the chapter 11 case, a debtor must acquire the Bankruptcy Court's approval in accordance with section 364(b) if it needs to incur unsecured debt outside of the ordinary course of business. If the loan is incurred in the ordinary course of business, the court approval is not needed under 364(a), but DIP financing is generally injected as the debt outside of the ordinary course of business with the court permission.[2] The Bankruptcy Code grants this kind of DIP lenders an administrative expense priority under section 503(b) in order to meet the demand for the protection of DIP financing and incentivize lenders to offer unsecured financing to a distressed debtor. Without the court approval, the claim would be treated as an unsecured claim. Given a priority as an administrative expense, a DIP lender's claim for repayment of the unsecured DIP financing will take precedence over all other pre-petition unsecured claims.

3.1.2. Super Priority under Section 364(c)

As mentioned above, it is challenging to find a lender for a debtor who has filed for a procedure under the Bankruptcy Code. An administrative expense priority alone frequently isn't enough to convince lenders to offer unsecured funding, especially when some debtors do not have enough resources to repay even administrative expenses. Therefore, if a debtor is unable to acquire unsecured financing, the Bankruptcy Court may permit the debtor to receive secured financing under section 364(c) by any of the following methods after notice and a hearing.

[2] Sumitomo Mitsui Bank Corporation, Corporate Restructuring Group and Bankruptcy Law Division, Legal Studies Department, Tokyo Bar Association, *Business Turnaround Finance Practices*, Kinzai Institute for Financial Affairs, Inc. (2022), p 348.

(i) Priority over any or all administrative expenses of the estate
(ii) Security interest in any unencumbered assets
(iii) Junior lien on any assets that are already encumbered

Financing under (i) is called “super priority” because it has priority over all administrative expenses. The court may permit more than one method out of (i) through (iii). In granting this priority, the debtor shall prove to the court that it could not obtain financing on an unsecured basis. Even in cases where super priority is granted, in practice, contracts often include a provision such as carve-out in which fees for attorneys and other professionals are paid first, followed by the DIP financing claim.[3]

3.1.3. Priming Lien under Section 364(d)

If a debtor is still unable to obtain enough funds secured merely by previously unencumbered assets and a junior lien on already-encumbered assets, the debtor can get a stronger tool of secured financing under section 364(d) than super priority. With court approval, a debtor can offer to a DIP financing lender “a priming lien” on a collateral, which is senior to the existing, pre-petition liens on the collateral. Like 364(c), a debtor must prove that it is otherwise unable to obtain such credit without a priming lien. Practically, to demonstrate the essentiality to the court, a debtor presents several proposals of DIP financing from some lenders, each of which have super priority or priming lien condition, so that the court could be convinced that no lender is able to finance without the condition.[4]

This powerful tool, only used in chapter 11, prioritizes a post-petition claim over the pre-petition secured liens, which is one of the reasons why chapter 11 could attract lenders for DIP financing. Conversely, the priming may diminish the right or the value which the existing lien holders has on the collateral. Therefore, the debtor seeking to prime existing liens must either (i) acquire a consent from the lenders affected by the priming lien or (ii) ensure that “adequate protection” is granted to the interest of such lenders in the collateral against decreasing the value arisen from the priming.

“Adequate protection” is defined in section 361 and may be provided by the followings.

[3] DailyDAC, LLC (Distressed Asset Central), “90 Second Lesson: What is a “Professional Fee Carve-Out” in Chapter 11?” wrote on 9 February 2023, at <<https://www.dailydac.com/90-second-lesson-what-is-a-professional-fee-carve-out-in-chapter-11/>>, accessed on 4 July 2023.
[4] Financial Services Agency, Study Group on Financing and Rehabilitation Practices to Support Businesses, the minute for the second meeting held on 25 November 2020, at <<https://www.fsa.go.jp/singi/arikataken/gijiroku/20201125.html>>, accessed on 3 July 2023.

1) a cash payment or periodic cash payment by the debtor to the creditor to the extent that the priming results in a decrease in the value of the creditor's collateral;
2) an additional or replacement lien to the extent that the priming results in a decrease in the value of the creditor's collateral; or
3) granting such other relief as will result in the realization of the "indubitable equivalent" of the creditor's interest in the collateral.

Although the priming lien has the potential harm to the rights of existing lien holders, in practice, a debtor basically attempts to secure the consent of the existing lien holders prior to court approval or negotiate with them to deliver the DIP financing. In particular, when an existing secured creditor provides a DIP financing as a defensive measure, it is naturally easier to obtain the consent of an existing lien holder since it primes its own security interest. It may be more beneficial to the existing secured creditors as well if they would provide the DIP financing by their own rather than outside lenders appear and control the priority of the pre-existing liens.[5]

3.2. Practical Ways to Protect DIP Financing – Roll-up and Cross-collateralization

In addition to the legislative provisions explained above, DIP lenders who are also pre-petition lenders may seek for some special conditions such as the provisions of roll-up or cross-collateralization to extend their pre-petition claims priority over other creditors' pre-petition claims.

Roll-up clauses usually indicate that part or all of the new financing is used to repay the lender's pre-petition claims. Namely, this roll-up allows the lender to convert the pre-petition claims to post-petition claim which would be protected under section 364 demonstrated above.

The parties can also use cross-collateralization to accomplish the same goal. These clauses assign the debtor a security interest in otherwise unencumbered assets to both the pre-petition and post-petition claims of the DIP lender.

Notably, neither roll-ups nor cross-collateralization are specifically permitted by section 364. Furthermore, elevating a DIP lender's pre-petition claim beyond similarly situated pre-petition claims runs against to the general bankruptcy equitable concept that members of the same class of pre-petition claims are treated equally. Regardless of disputes as to whether such

[5] Julian S. H. Chung and Gary L. Kaplan, Fried, Frank, Harris, Shriver & Jacobson LLP, An "Overview of Debtor in Possession Financing", Lending & Secured Finance (2020), p 121.

special terms should be allowed legally, bankruptcy courts frequently permit these clauses if the debtor has no other means of financing and lenders won't otherwise offer loans to the debtor without them.[6]

3.3. Effect on Market of DIP Loans

Thanks to these proactive protections in the US on DIP financing as noted above, DIP financing is considered as a relatively safe high yielding investment among lenders. Furthermore, DIP lenders are incentivized by higher interest rates and fees than lenders can obtain outside of chapter 11 for similar loans. In the chapter 11 cases of Remnant Oil and Generation Next Franchise Food Brands, the interest rate was 20%, which was the highest interest rate for the DIP financings in 2019. The technology industry had the highest interest rates overall, averaging 11.3%, followed by the energy sector at 8.6% and the consumer staples sector at 8.3%.[7]

4. Japan

4.1. A New Financing during Out-of-court Proceedings

4.1.1. "Pre-DIP" Financing against DIP Financing

In Japan, besides in-court proceedings, out-of-court workout processes are getting common in a corporate restructuring, which is processed in a confidential way, faster and less costly to preserve more going-concern value. Whether in judicial rehabilitation or out-of-court workout, a distressed debtor is frequently facing shortage of liquidity. Consequently, in workouts as well, a debtor often obtains a new funding from lenders such as financial institution or a potential sponsor. In Japan, a new loan during an out-of-court proceeding is called "pre-DIP financing", while DIP financing is one during an in-court procedure, the same as other countries define.

4.1.2. Rule-based Preliminary Insolvency Proceedings

Japan has several forms of rule-based out-of-court workouts in which participants must follow particular rules, guidelines, or laws while the restructuring is supervised by independent specialists. As preliminary insolvency proceedings, all of them aim to standardize the workout process and help facilitate the negotiations between a distressed debtor and its creditors mainly limited to financial institutions. The first two of the following procedures are primarily employed in Japan, and the third one was installed in 2022.

---

[6] *Ibid*, p 121.
[7] *Ibid*, pp 120-121.

- **Turnaround ADR (Alternative Dispute Resolution)**

The procedure was established under the present Act on Strengthening Industrial Competitiveness. The process is supervised by experts (usually attorneys) who are selected as "operators" by the Japanese Association of Turnaround Professionals ("JATP"), which is a private organization but certified under the Act on Promotion of Use of Alternative Dispute Resolution. These operators would preside over the process and review a proposed restructuring plan. It mainly targets large to medium-sized companies due to its higher procedure fees than the latter, the Councils scheme.

- **The Councils Scheme**

Small and Medium Enterprises Vitalization Councils ("the Councils"), a public institution, support the process and organize "the review committee" to assign the examination of a proposed restructuring plan from the objective standpoint. This framework has been used rather by smaller or mid-sized enterprises.

- **Rehabilitation-type out-of-court workout for Small and Medium Enterprises**

This type of workout was newly adopted in 2022 under the Guidelines for Restructuring of Small and Medium Enterprises ("SME Restructuring Guidelines"). A distressed debtor which would like to use the scheme will appoint third-party supporting experts such as lawyers from the public list of accredited experts, with the consent of major creditors, to examine whether a proposed restructuring plan is fair. This scheme focuses on smaller or mid-sized enterprises. The difference between the first two and the third is that debtors may/have to choose the third-party experts.

4.1.3. Necessity to Protect "Pre-DIP" Financing

It's more difficult for a debtor to obtain pre-DIP financing in workout than DIP financing unless the financing is given some protection. It is especially because a lender would be concerned about the risk if it offers pre-DIP financing and then the debtor fails to acquire the unanimous consent of participating creditors for the restructuring plan, resulting in court insolvency proceedings. For such cases, Japanese laws present priorities to DIP and pre-DIP financing claims as follows in order to encourage lenders to grant these financings.

4.2. Legislative Provisions on DIP financing and Pre-DIP financing

4.2.1. DIP Financing

In Japan, the civil rehabilitation proceeding is the most common regime of judicial restructuring of insolvency proceeding. According to the Civil Rehabilitation Act, which stipulates the process of the civil rehabilitation, DIP financing claims after filing for the civil rehabilitation procedure is considered as "common benefit claims" under article 119(v) if a court permits or a supervisor approves/consents the DIP financing. As "common benefit claim" is a similar concept to administrative expense in the US and must be repaid ahead of other unsecured claims during the civil rehabilitation process, it's comparable to giving priority over unsecured claims like the conversion from unsecured claims into administrative expense under section 364(b) of the Bankruptcy Code in the US. However, there are no systems such as super priority or priming lien which allows them to be prioritized over all other administrative expenses or existing liens as explained above.

4.2.2. Pre-DIP Financing

In out-of-court workouts, pre-DIP financing is basically repaid outside the restructuring plan with priority over other claims of the creditors involved in the workout, as the pre-DIP loan is not included as the subject claims affected in the process due to its indispensability.[8]

To the contrary, if an out-of-court workout is transferred to a judicial proceeding such as the civil rehabilitation, in principle, the pre-DIP financing claim during the workout is not automatically treated as common benefit claims (administrative expense) like DIP financing because the pre-DIP financing was not executed during the court procedure. It means the rehabilitation plan during the subsequent civil rehabilitation process basically cannot prescribe the priority of the pre-DIP financing claims over other unsecured claims, complying with the general bankruptcy equitable concept that members of the same class of pre-petition claims are treated equally.

However, it differs if the workout is the Turnaround ADR or the Councils Scheme procedures. After these processes are transferred to the civil rehabilitation procedure, the court may approve the proposed rehabilitation plan that creates a difference between the pre-DIP financing claims and the claims of other financial creditors participating in the workout, considering the confirmation and that equality will not be compromised. It is when JATP or the Councils confirms that (i) the new loan is indispensable for the continuation of the debtor's business and

[8] *Supra*, note 1, p 168.

(ii) the debtor has obtained the consent of all the participant creditors under article 56, 57 and 59-2 of the Act on Strengthening Industrial Competitiveness ("the Act"), which stipulates the Turnaround ADR and the Councils Scheme procedures. In other words, with the confirmation, the pre-DIP financing claims may be repaid preferentially in the subsequent court restructuring proceeding.

Though the ultimate decision is left the court on the priority of pre-DIP financing claim and the priority cannot be guaranteed, the court should respect properly the confirmation by JATP or the Councils and the consents of the financial creditors in practice.[9] This preferential treatment to a new loan during the Councils Scheme was introduced upon the amendment of the Act in 2021. On the other hand, it has not been adopted yet for the rehabilitation-type out-of-court workout for small and medium enterprises. It also should be noted that this preferential repayment is for the switching to a rehabilitation type procedure not when transferred to a bankruptcy procedure.

4.3. Practical Ways to Protect DIP Financing – Collateral

In Japan, there is no legislation, like section 364(c) of the Bankruptcy Code in the US, that grants DIP financing a secured interest in any unencumbered assets or a junior lien on any assets that are already encumbered. However, this does not hinder DIP or pre-DIP lenders from negotiating to obtain a secured interest in any unencumbered assets or a junior lien on any encumbered assets. Rather, it's common practically for lenders to demand collateral to secure the DIP or pre-DIP loans because there is no legal system as super priority and priming lien. It is more crucial especially for pre-DIP financing which cannot be guaranteed to convert into administrative expenses after the transition to the court procedure. As viable but distressed debtors in many cases already pledged substantial assets such as real properties to cover their existing debt, lenders frequently need to consider as collaterals liquid assets such as receivables and inventory, which are not commonly pledged for normal working capital loans.[10]

Besides, it is worth noting that the adoption of priming lien in Japan is recently being discussed in the context of the consideration on the amendment of the collateral law system and the creation of security interests on corporate businesses. The part of the argument is that even if a whole business of a distressed debtor is already pledged, it should be possible for DIP financing

[9] *Supra*, note 4.
[10] *Supra*, note 1, pp 220 and 244.

to be secured preferentially by any assets (out of the whole business), as priming lien does. Otherwise, no lenders are willing to extend the credit without any collateral. [11]

4.4. Effect on Market of DIP Loans

As stated above, the Japanese legislative protection on DIP financing is limited to the treatment as administrative expenses, which is a weaker protection than the US legislation. Because of this, DIP financing is regarded as a high-risk investment and the market of DIP financing in Japan is not as large as in the US. The interest rate of pre-DIP financing loans is around 5%[12] and the one of DIP financing is around 5% to 10%. In many cases, interest fees alone do not even cover actual costs, let alone profits, because the loan period is relatively short such as 3 to 6 months, interest income is limited, and regardless of the loan amount, closer monitoring is required beyond normal loans and reasonable costs such as personnel expenses are always incurred. This suggests that more profitability should be generated in the system so that DIP and pre-DIP financing could develop further in Japan. [13]

5. Analysis on Comparison between the US and Japan

To review what this article examined, the following points are mainly similar on DIP financing between the US and Japan.

- In principle, DIP financing is protected as administrative expenses in the court proceedings.
- The court approval is basically needed to protect DIP financing claims with priority over other unsecured claims.[14]

However, these systems in the two countries are quite different in the points below.

- The US authorizes some legal forms of priority on DIP financing other than administrative expenses such as priority over other administrative expenses or pre-existing secured claims with fulfilling the requirements and obtaining the court approval, while Japan does not have these provisions.

---

[11] *Supra*, note 4.
[12] *Supra*, note 1, p 231.
[13] *Supra*, note 1, p 246.
[14] As stated above, if the loan is incurred in the ordinary course of business, the court approval is not needed, but DIP financing is generally injected as the debt outside of the ordinary course of business with the court permission.

- The difference of legal protection of the DIP financing causes a wide gap in the development of the DIP financing market, backed up by higher interest rates in the US.
- Japan has a legal system in which a new financing during the preliminary insolvency workout can be protected in case of its transition to the judicial rehabilitation procedure. This preferential treatment is subject to the consent of the eligible creditors and the court approval.

6. Conclusion

As shown above, while Japan has relatively weakly protective regimes for DIP financing, the US has strongly protective provisions on DIP financing by offering various forms of priority from a basic administrative expense to a junior or a senior secured claim, which has made the hurdle for loan to distressed companies lower and has encouraged lenders to extend credit.

From the international perspective, some countries do not provide any DIP financing provisions in formal reorganization procedures and many countries have a DIP financing regime with only an administrative expense priority like Japan.[15] For these countries, the strong type of protection like the US system should be referred to in systemizing and developing DIP financing and effective reorganization.

[15] Gurrea-Martinez, Aurelio, "Debtor-in-Possession Financing in Reorganization Procedures: Regulatory Models and Proposals for Reform", European Business Organization Law Review (2023), p 5.

Bibliography

DailyDAC, LLC (Distressed Asset Central), “90 Second Lesson: What is a “Professional Fee Carve-Out” in Chapter 11?” wrote on 9 February 2023, at <<https://www.dailydac.com/90-second-lesson-what-is-a-professional-fee-carve-out-in-chapter-11/>>, accessed on 4 July 2023.

Financial Services Agency, Study Group on Financing and Rehabilitation Practices to Support Businesses, the minute for the second meeting held on 25 November 2020, at <<https://www.fsa.go.jp/singi/arikataken/gijiroku/20201125.html>>, accessed on 3 July 2023.

Gurrea-Martinez, Aurelio, “Debtor-in-Possession Financing in Reorganization Procedures: Regulatory Models and Proposals for Reform”, European Business Organization Law Review (2023), p 1ff.

Julian S. H. Chung and Gary L. Kaplan, Fried, Frank, Harris, Shriver & Jacobson LLP, An “Overview of Debtor in Possession Financing”, Lending & Secured Finance (2020), pp 120-123

Shinnosuke Fukuoka, *An Overview of the United States Bankruptcy Code (the Second Edition)*, Shojihomu Co., Ltd. (2017)

Sumitomo Mitsui Bank Corporation, Corporate Restructuring Group and Bankruptcy Law Division, Legal Studies Department, Tokyo Bar Association, *Business Turnaround Finance Practices*, Kinzai Institute for Financial Affairs, Inc. (2022)