Exploring Diverse Jurisdictional Approaches to Debtor-in-Possession Financing in pursuit of balance

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1. Introduction

The concept of debtor controlled, or debtor-in-possession (“DIP”) restructuring is well established in certain jurisdictions, most notably the United States. The regime under Chapter 11 of the *United States Bankruptcy Code*[[1]](#footnote-1) is the globally-recognized standard for corporate rehabilitation and DIP restructuring. Key to virtually every DIP restructuring is the need for liquidity, both to fund the restructuring and to maintain operations. How to finance the liquidity required is frequently a major issue in restructurings. To encourage such financing it is necessary for it to have priority ahead of existing secured creditors. This is noted in the eighth principle of the *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*[[2]](#footnote-2),

1. f additional funding is provided during the [s]tandstill [p]eriod or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

While there is little debate about the principle itself, how this principle is applied varies by jurisdiction. This paper reviews the regimes of three common-law jurisdictions with well-developed insolvency regimes, but markedly different approaches: the United States under Chapter 11, Canada under its large-corporations restructuring statute the *Companies’ Creditors Arrangement Act*[[3]](#footnote-3), and the United Kingdom under it recently-adopted DIP restructuring plan process introduced through the *Corporate Insolvency and Governance Act 2020*[[4]](#footnote-4)*.* How these three jurisdictions address the need for financing, the ability to non-consensually prime existing creditors and to “roll-up” existing debt varies dramatically and, as explored herein, requires a balance.

1. La Grande Dame: The United States

Statutory Regime and Court Approval

The most well-known and established DIP regime is Chapter 11 of the Bankruptcy Code. The US regime provides for extensive DIP financing, with a variety of priorities available.

The Bankruptcy Code authorizes unsecured borrowing by a debtor.[[5]](#footnote-5) It is understandable that such borrowing occurs infrequently because, by definition, an insolvent creditor does not have sufficient assets to repay its unsecured creditors in full. Advancing further unsecured credit by a party would be funding a virtually-guaranteed compromised recovery.

Accordingly, the Bankruptcy Code goes on to provide that, if such borrowing is not available, the court may authorize credit[[6]](#footnote-6):

* 1. with priority ahead of administrative expenses (practically meaning ahead of unsecured creditors), and if that is not available,
  2. secured against unencumbered property, and if that is not available,
  3. secured by a lien equal to or in priority to secured creditors.

By the time of filing for creditor protection, a debtors’ assets are generally fully encumbered[[7]](#footnote-7), so option (c) is the most common form of DIP financing. However, in order to grant a lien under (c) above, the court must be satisfied that there is adequate protection of the interests of the holders of the liens which the DIP lender’s charge will be equal or in priority to.[[8]](#footnote-8) This requirement for ‘adequate protection’ can be addressed through a determination that the creditor is “over secured”, the granting of an additional lien on assets the prepetition lender did not have a charge against, or the provision of principal and interest payments through the proceeding, among other things.[[9]](#footnote-9)

The Incumbent Lender Problem

As noted above, at the time of filing for Chapter 11 protection, a company’s assets are generally fully encumbered. The US system provides a number of incentives to incumbent lenders to provide DIP financing over seeking third-party financing. As discussed below, this is often detrimental to more junior stakeholders.

Adequate Protection

First, the time and costs of litigating the value and sufficiency of adequate protection acts as a barrier to third-party DIP financing, and encourages the use of incumbent lenders.[[10]](#footnote-10) With so many issues to be addressed in a restructuring, particularly at the beginning of a proceeding, the time and cost of fighting with incumbent secured lenders can be a material deterrent and encourage a less-desirable incumbent DIP loan.

Quick Approval

The DIP loan and priority are generally approved at the commencement of a proceeding by interim order, and then a final order is later granted, in theory after greater scrutiny. However, scholars have noted that approval is frequently done in a rushed approval process, and creates a momentum that is generally not disturbed[[11]](#footnote-11).

Benefits

There are a number of benefits to an incumbent lender acting as DIP lender, that arguably outsize the influence they ought to have as a secured creditor.[[12]](#footnote-12) Being the DIP lender allows the incumbent lender to exercise more/continued control over the debtors assets.[[13]](#footnote-13) It can provide extensive influence in the drafting of a plan through milestones, processes, and other measures, including roll- up (discussed below). While there have been arguments presented that the existing lender can also use its inside knowledge to underbid third party lenders (and benefit stakeholders with a reduced DIP financing cost)[[14]](#footnote-14), scholars reviewing this hypothesis have found the contrary: the use of incumbent lenders generally resulted in materially higher costs. The authors reviewed the “pass-through” benefit of insider knowledge would make DIP loans less expensive that incumbents, or whether the “lock-in” effect would dominate.[[15]](#footnote-15) The results concluded that, debtors frequently stay with their incumbent lenders, but at a cost that is about 44% higher than a new third-party DIP loan.[[16]](#footnote-16)

Roll-up

A further feature of US DIP loans is the ability to “roll-up” pre-filing debt. While not strictly necessary, this generally occurs where the DIP lender and a secured lender are the same party. There are two primary types of roll-up, ‘creeping roll-up’ and single-advance roll-up.[[17]](#footnote-17)

Under a creeping roll-up, realizations from pre-petition assets are used to pay down the pre-petition secured creditor. Practically, this is generally the collection of accounts receivable and inventory sales, though it can apply to sale of other assets acquired pre-filing.[[18]](#footnote-18) As a result, this diverts revenue to pay down the pre-filing secured lender, while the debtor must borrow from the DIP loan to continue operations and fund the restructuring (instead of using internally generated revenue). This means the DIP goes up, while the pre-filing secured debt goes down, and in effect the secured debt is slowly rolled into the DIP loan.[[19]](#footnote-19) This differs from a single-advance roll-up, where a portion of the the advanced DIP loan is used to directly repay all or part of the pre-filing secured debt.[[20]](#footnote-20)

Roll-ups cause a number of problems in a fair restructuring which, while being flagged, do not appear to have impacted their use. First, roll-ups are not expressly authorized under the US Bankruptcy Code, and the repayment of pre-filing debt prior to a plan or liquidation is contrary to the moratorium concept of Chapter 11 proceedings – namely that pre-filing creditors don’t get paid until the end of the proceeding.[[21]](#footnote-21)

In addition, roll- ups *de facto* elevate the pre-petition debt to have DIP lien priority – this means that, to the extent the pre-petition debt was under-secured or unsecured, it violates the absolute priority rule.[[22]](#footnote-22) It also eliminates the risk of cram-down or compromise that would be potentially faced by pre-filing debt, and likewise challenges to the validity and priority.[[23]](#footnote-23)

In response to these criticisms, the American Bankruptcy Institute in its report proposing reforms to Chapter 11, flagged the issue with roll-ups and noted:[[24]](#footnote-24)

* 1. as a general rule, roll-up DIP loans should not be approved;
  2. the exceptions should be:
  3. where the DIP lender is not a pre-petition lender, and is in effect ‘taking out’ the existing secured lender,
  4. the lender is providing substantial new credit and provides more financing on better terms than the alternatives, or
  5. the court otherwise finds the proposed financing is in the best interest of the estate.

Despite this, scholars have found that roll-ups are increasing, and the oft used justification – that roll-up is required as an inducement due to tight credit markets – is incorrect and there is no correlation between the availability of capital and the use of roll-ups.[[25]](#footnote-25) The detrimental effects of increased financing costs, that roll-up contributes nothing to the restructuring (because it is not new money), and the oversized influence it can give an incumbent lender turned DIP lender, have led some scholars to argue that the case for the continued use of roll-ups “is weak”.[[26]](#footnote-26)

Equity conversions

A number of COVID and post-COVID era cases have highlighted the development of equity conversions in the US DIP financing context. Broadly speaking, these cases can be divided into those that permit the debtor to elect to convert the DIP loan to equity, or those where it is at the DIP lender’s option.[[27]](#footnote-27) While commentators have noted the potential benefits of an equity conversion, including decreased cost and risk for obtaining exit financing[[28]](#footnote-28), the courts have applied more scrutiny. In particular, courts have been concerned that such provisions could be categorised as “sub rosa” transaction - a transaction that is in part a restructuring but is not approved in accordance with the Bankruptcy Code. This is because the ability to have an equity participation right is something properly reserved for a plan (and a vote), not a DIP loan, which is meant to be temporary.[[29]](#footnote-29) Accordingly, while the use of equity conversion is growing, the courts are alive to the issues they pose.

1. The Canadian Experience

Canadian proceedings under the *CCAA* frequently have DIP financing (known statutorily as “interim financing”[[30]](#footnote-30)). The *CCAA* is a very short statute, with many of its remedies being derived from judge-made law, and heavily influenced by the US Chapter 11 regime. Along this vein, Canadian insolvency courts originally found jurisdiction to grant DIP financing and a super-priority lien from their inherent jurisdiction[[31]](#footnote-31) and the general “catch all” provision of the *CCAA* that permits the court to make “any order it considers fit in the circumstances”[[32]](#footnote-32). In 2009, the jurisdiction to grant DIP financing and priority liens was codified in the *CCAA*.[[33]](#footnote-33) In deciding whether to permit DIP financing, and if appropriate grant a lien on the assets of the debtor in priority to other creditors, the court must look at a number of factors including: the period during which the proceedings is expected to continue, how the debtor’s affairs will be managed, if management has the confidence of creditors, whether the loan would enhance the prospects of a viable plan, the nature of the property, whether any creditor would be materially prejudiced as a result of the DIP loan charge, and the report of the court-appointed monitor.[[34]](#footnote-34) In addition, at the first day hearing, the DIP loan must be limited to what is necessary before the full comeback, which is heard 10 days later, generally on better notice to stakeholders.[[35]](#footnote-35)

Adequate Protection?

While the above factors suggest the concept of adequate protection, the application is not similar to that under US Chapter 11. A review of numerous DIP loans across Canada found a priority lien in virtually all scenarios. While the court certainly has the authority to make adequate protection-like requirements, this is not the norm and is likely a result of most Canadian insolvencies having a clear first-secured creditor with security over all of the debtors assets. The court does, however, have the ability to allocate court-ordered charges to various assets to ensure a fair distribution[[36]](#footnote-36) provided that such allocation cannot result in a particular security holder having to *pay* into the estate (ie. the allocation to a particular asset can be to the value of that asset, and not more).[[37]](#footnote-37) In addition, courts have found that the list of factors to be considered was not exhaustive, and that the court must not find all are met – this includes prejudice to a secured creditor[[38]](#footnote-38) and grants increased flexibility. Importantly though, the Canadian court has the benefit of a court-appointed monitor, which is an independent licenced insolvency trustee (generally a firm of accountants) appointed as the ‘eyes and ears’ of the court.[[39]](#footnote-39) The monitor is required to opine on the DIP financing and the DIP loan lien, meaning that, unlike Chapter 11 proceedings, the Canadian court often has an analysis from a court officer looking at the terms of the DIP loan, the process by which is was obtained/what alternatives there were, and an objective review of the relative prejudice to stakeholders.

The role of the DIP lender continues to have many of the advantages that it has in under US Chapter 11 – including an increased role in the direction of the restructuring. However, this role is somewhat tempered by the role of the monitor to ensure fairness and transparency.

Roll-up

Unlike US Chapter 11, the *CCAA* seeks to squarely address the issue of roll-up: it expressly provides that the security or charge granted cannot secure an obligation that exists before the order is made.[[40]](#footnote-40) On its surface, this would appear to prohibit roll-ups, and generally this is the case for single draw roll-ups. There are two important exceptions in Canada:

* 1. first, the Canadian courts have approved roll-ups as part of the recognition of US Chapter 11 proceedings notwithstanding the prohibition under the *CCAA*.[[41]](#footnote-41) However, this recognition has not been granted where it would be unfairly prejudicial to Canadian creditors.[[42]](#footnote-42)
  2. second, the courts have found that a creeping roll-up does not offend the *CCAA* provision, and while not common, they are permitted.[[43]](#footnote-43)

Finally, while not common, equity conversions are permissible as part of a Canadian DIP loan. Should they become more popular in the United States, it is likely they will get more traction, and scrutiny, in Canada.

1. Rule Britannia: The New British Regime

The United Kingdom poses an interesting foil to the US and Canadian regimes. While the British insolvency regime is well established, it does not offer an easy route to non-consensual financing. In part, this could be because of the UK’s tradition of more consensual restructuring, including the “London Approach”, with banks generally agreeing to be supportive and work through restructurings without a formal proceeding.[[44]](#footnote-44)

In 2020, the British government passed the *Corporate Insolvency and Governance Act 2020* which implemented two potentially useful tools to promote more debtor in possession restructurings: the moratorium under the *Insolvency Act 1986*[[45]](#footnote-45)and the restructuring plan under the *Companies Act* *2006*[[46]](#footnote-46). While both moved towards a more DIP restructuring regime, the amendments did not include the ability for non-consensual DIP financing.

The response to leaving consensual DIP financing as the *status quo* has met with mixed reviews. A survey conducted by the British Government’s Insolvency Service (pre-2020 amendments) found that respondents believed financing was sufficiently available for companies capable of rescue, indicating their belief that the current system works.[[47]](#footnote-47) Other commentators, notably commenting after the 2020 amendments, disagreed, noting that,

Depending on their level of exposure, existing creditors may often be reluctant to advance new money, and in any case any decision to provide additional funding is idiosyncratic and based on a creditor’s broader loan and investment portfolio. DIP finance, with super-priority status for new lenders, provides an incentive that underpins an active rescue financing market and thereby supports a stronger rescue culture.[[48]](#footnote-48)

These commentators go on to note that a US-style DIP financing regime would enhance and encourage a rescue culture and enhance the prospect of successful restructurings in the UK.[[49]](#footnote-49)

1. Analysis and Conclusions

The UK, Canada, and the United States offer a continuum of DIP financing regimes, from the powerful US regime that allows extensive priming, roll-up and equity conversion on the one extreme, to the UK system that relies primarily on consensual agreement. However, when one reviews the empirical results and the commentary, it becomes clear that neither of these extremes is preferable, and instead, the more balanced Canadian approach is best situated to achieve DIP financing in non-consensual situations.

To reach this conclusion, one needs to start with the INSOL principle, discussed above, that DIP financing is often necessary, and if provided, should have first repayment priority.[[50]](#footnote-50) While a consensual arrangement is preferable for all involved, it must be acknowledged that it will not always be possible. Accordingly, a method to force non-consensual DIP financing is required.

However, the US system has shown that the regime must be policed in a balanced fashion, and that courts, faced with a multitude of applications at the beginning of a proceeding, are not the best placed to adjudicate what is fair in an often complex DIP financing agreement that can be many hundreds of pages long, and contain complex structures. Further, while the concept of adequate protection appears logical on the surface, as noted in the research cited, the costs (or risk of costs) valuing and administering adequate protection result in an unfair advantage to existing secured lenders, which materially increases the costs of the DIP financing to the detriment of other stakeholders.

The Canadian regime offers a more balanced approach that allows priming of secured creditors, balances the necessity of adequate protection, and provides an independent, financially knowledgeable court-officer to assist the court in understanding the terms of the DIP financing and its economic impact on stakeholders and the prospect of a successful restructuring.

Turning first to priming, the Canadian regime recognises the need to balance priming with the potential prejudice to secured creditors. However, the test is ‘material prejudice’, not “no prejudice”, and the court is granted broad discretion to craft an appropriate remedy. This includes adequate protection liens if desirable, but importantly leaves the court open to make a determination on the level of prejudice and the best remedy, in a holistic manner.

The role of the Canadian court-appointed monitor adds an important aspect to the balancing of prejudice and the administration of DIP financing. The monitor, generally a firm of accountants and trained licenced insolvency trustees as noted above, is able to provide the court with an objective view of prejudice, value and other important aspects when considering priming. In addition, the monitor can review, analyse and report to the court in relation to the contents of DIP financing, areas where the court should pay particular attention, and the process undertaken by the debtor to obtain the DIP financing/what other alternatives were available. This allows the court to review and consider the impacts of DIP financing more efficiently and effectively in the beginning of a restructuring, and avoid the potential time and cost delays of an adversarial fight. The use of the monitor can also ensure that the DIP lender does not seek or exercise oversized influence in the restructuring.

The limiting of roll-ups under the Canadian regime eliminates or limits the detrimental effects set out in the commentary discussed above. While a ‘creeping roll-up’ may be necessary or desirable to prevent undue prejudice to, for example, a receivables financier, the roll- up generally has proven to be costly and unnecessary. The restriction found in the Canadian regime, accordingly, makes sense, and the limited use of creeping-rollups with the oversight and analysis of the monitor, ensure a balanced application.

Finally, the growing use in the US of equity conversions should be watched very closely and limited to cases where it is absolutely necessary. While there may be scenarios where a DIP lender’s conversion to equity is in the best interests of the stakeholders, it should be determined on a case-by-case basis, and likely once the restructuring is more advanced. Allowing DIP lenders to ‘bake in’ lucrative conversion options at the outset of a proceedings leads to the risk of windfalls, and a lack of confidence in the system. While the US courts have acknowledged this concern, they have nonetheless allowed them in a number of cases.[[51]](#footnote-51) Having an analysis from the court-appointed monitor on the economic terms and true options available would be an asset in helping courts assess in what limited scenarios such conversions are desirable..

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51. *Supra* note 26. [↑](#footnote-ref-51)