Toward a New DIP-Financing Regime Under European Restructuring Plans: Views from Spain

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The EU Directive on restructuring and insolvency [1] has imposed an obligation to Member States to introduce relevant changes in their legal regimes on restructuring plans, which can be implemented even if the entity is in "*the likelihood of insolvency*." [2] The purpose of the EU Directive is to encourage companies to address insolvency problems at a very early stage so they avoid one of the effects of formal insolvency proceedings: the social stigma, which, unfortunately, is still common in European countries. [3]

In accordance with article 288 of the Treaty of the Functioning of the European Union, [4] directives in the EU "*shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.*" Thus, as opposed to European Regulations (such as the European Insolvency Regulation), the exact specific solution and wording will depend on national instruments and will differ within each EU Member State.

The EU Directive specifically addresses a debtor's need to finance their restructuring. Specifically, the EU Directive on restructuring and insolvency introduces a specific regime for interim and new financing under restructuring plans:

- Article 2(7) of the Directive on restructuring and insolvency defines "new financing" as "any new financial assistance provided by an existing or a new creditor in order to implement a restructuring plan and that is included in that restructuring plan."
- Under article 2(8) of the Directive on restructuring and insolvency, "interim financing" is defined as "any new financial assistance, provided by an existing or a new creditor, that includes, as a minimum, financial assistance during the stay of individual enforcement actions, and that is reasonable and immediately necessary for the debtor's business to continue operating, or to preserve or enhance the value of that business."

The EU Directive broadly defines the concept of financial assistance, referring expressly that it could include not only the provision of new money but also "third-party guarantees and the supply of stock, inventory, raw materials and utilities, for example through granting the debtor a longer repayment period."

The purpose of this new European regime for new money is clear, as the success of a restructuring will also depend on the financial assistance provided during both the negotiations and the implementation of a confirmed restructuring plan.

EU Member States had the obligation to implement the Directive by July 17, 2022. By mid-August, only 18 EU countries had complied with their implementation obligation. [5] At the end of August, Spain implemented the EU Directive, being the nineteenth European country to do so.

The Specific Protection of Interim and New Financing Under the EU Directive on Restructuring and Insolvency

Chapter 4 of the EU Directive on restructuring and insolvency addresses the necessary protection for interim and new financing and other restructuring-related transactions. As explained under Recital 66, if such protection is not granted, it could "jeopardise the availability of financing" in practice.

In this regard, Article 17 of the EU Directive requires EU Member States to protect interim and new financing in an adequate manner. Thus, EU countries, at a minimum, shall ensure:

- protection of interim and new financing from actions that could declare it "void, voidable or unenforceable"; and
- protection of grantors of the interim and new financing from "civil, administrative or criminal liability" on the sole ground of the financing being detrimental to the general body of creditors. [6]

When providing this protection, EU Member States may:

- require an *ex ante* control to interim financings in order to grant them this protection only when the financing is "reasonably and immediately necessary for the continued operation or survival of the debtor's business"; [7]
- require confirmation of the restructuring plan (by either an administrative or judicial authority) to grant protection to new financing;
- only provide protection to interim financing when the debtor is under a state of current insolvency (as opposed to imminent insolvency or under the likelihood of insolvency); and
- regulate a priority regime for the repayment of interim and new financing in subsequent insolvency proceedings in order to encourage new lenders to provide financial assistance.

Specific Provisions on DIP Financing Under Spanish Restructuring Plans

The Spanish reform of the Insolvency Act that implements the EU Directive on restructuring and insolvency [8] adopts the concepts of interim financing (new article 655) and new financing (new article 666) of the EU Directive.

Protection from Avoidance Actions

In the event of subsequent insolvency proceedings ("*concurso de acreedores*") in Spain, interim and new financings are protected from clawback and avoidance actions only if the claims affected by a court-sanctioned [9] restructuring plan affect at least 51% of the liabilities of the insolvent company. Therefore, confirmation of the restructuring plan by the commercial court ("*Juzgado de lo Mercantil*") in Spain is required in order to obtain such protection. Nevertheless, the reformed Spanish law expressly mentions that there is no protection from avoidance actions (even when the 51% threshold is met) if the financing was granted in fraud of creditors.

In cases where the restructuring plans do not affect at least 51% of the liabilities of the insolvent company, interim and new financings are not protected from avoidance actions. However, there is still a benefit for the financing provider as, if an avoidance action is brought under a subsequent *concurso de acreedores*, these financings will be excluded from the presumptions of acts that are detrimental to the general body of creditors. The detriment to the insolvency estate in these cases should then need to be proved.

A clear advance **[10]** has occurred with regard to financing provided by especially related persons. **[11]** The reform foresees that the interim and new financings these persons provide will also be protected from avoidance actions. However, in these cases, the threshold of affected claims by the court-sanctioned restructuring is higher, as it needs to reach 60% of the total liabilities of the company (excluding the claims of the financing-providers). **[12]**

If financing provided by especially related persons does not meet the threshold, no protection from avoidance actions is granted. Furthermore, in these cases, the law does not exclude these acts from the application of the legal presumptions of being detrimental to the insolvency estate in the case of avoidance actions.

Priority in Payment Under a Scenario of Subsequent Insolvency Proceedings

Finally, the reform grants priority for the repayment of interim and new financing under confirmed restructuring plans in subsequent insolvency proceedings. This solution is similar to what was foreseen in the past in Spain under refinancing agreements — the previous restructuring tool that has been substituted by the restructuring plans — although only for new financing. In this respect:

- Fifty percent of the interim or new financing obtains the priority treatment of post-petition claims ("*crédito contra la masa*"); and **[13]**
- The remaining 50% receives the treatment of a pre-petition claim with general privilege ("*crédito con privilegio especial*"), **[14]** with priority over both ordinary and subordinated claims.

Especially related persons also obtain this priority if 60% of the total liabilities of the company (excluding the claims of the financing providers) are affected by the confirmed restructuring plan under which the financing is granted.

Conclusion

In practice, companies in distress usually need additional financial assistance for their restructuring process to be successful. Minimum rules on the protection of interim and new financing under pre-insolvency scenarios, such as the provisions of the EU Directive on restructuring and insolvency, encourage this additional financial assistance.

Among other European countries, Spain has recently transposed the EU Directive on restructuring and insolvency and has improved the protection granted to interim and new financings. The advance has been clear with regard to the protection of interim financings within the frame of restructuring plans (which were not protected under the previous refinancing agreements) and the new treatment granted to financial assistance provided by especially related persons.

As the reform in Spain came into force recently (on Sept. 26, 2022), we still have to verify whether the new provisions truly encourage DIP financings under restructuring plans.

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[1] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency), *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019L1023.

[2] In this regard, article 1 of the Directive on restructuring and insolvency on "Subject matter and scope" states that "This Directive lays down rules on: (a) preventive restructuring frameworks available for debtors in financial difficulties when there is a likelihood of insolvency, with a view to preventing the insolvency and ensuring the viability of the debtor." Under article 2(2) of the Directive, a definition of "*likelihood of insolvency*" is not provided, as it is stated that the concept is to be understood as defined by each national law. To provide an example, under Spanish national law, it is defined as "*when it is objectively foreseeable that, if no restructuring plan is reached, the debtor will not be able to meet its payment obligations that are due in the next two years in a regular manner*" (article 584.2 of the Spanish Insolvency Act).

[3] In this regard, recital 72 of the Directive on restructuring and insolvency.

[4] Consolidated version of the Treaty of the Functioning of the European Union, *available at* https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12012E/TXT:....

[5] M. Mailly, "New Preventive and Restructuring Schemes adopted in EU Member States," *Eurofenix – The journal of INSOL Europe*, Autumn 2022, p. 42-43, n.89.

[6] However, different grounds could be regulated under national laws. Recital 67 references fraud, bad faith and a relationship with the grantor of the financing that could imply a conflict of interest (i.e., because it is a "especially related person").

[7] This nuance is referred to under Recital 68 of the Directive on restructuring and insolvency in order to avoid any potential abuse.

[8] Ley 16/2022, de 5 de septiembre, de reforma del texto refundido de la Ley Concursal, aprobado por el Real Decreto Legislativo 1/2020, de 5 de mayo, para la transposición de la Directiva (UE) 2019/1023 del Parlamento Europeo y del Consejo, de 20 de junio de 2019, sobre marcos de reestructuración preventiva, exoneración de deudas e inhabilitaciones, y sobre medidas para aumentar la eficiencia de los procedimientos de reestructuración, insolvencia y exoneración de deudas, y por la que se modifica la Directiva (UE) 2017/1132 del Parlamento Europeo y del Consejo, sobre determinados aspectos del Derecho de sociedades (Directiva sobre reestructuración e insolvencia). Recast text after the reform *available at* **https://www.boe.es/buscar/act.php?id=BOE-A-2020-4859**.

[9] In this respect, dissenting creditors affected by a restructuring plan may oppose plans that "unfairly damage the interests of creditors" (article 670.1.3° of the Spanish Insolvency Act).

[10] Traditionally, Spanish insolvency provisions have excluded especially related persons from any protection and their claims have been recognized as subordinated claims ("*créditos subordinados*"). There was an initial advance in the temporary provisions introduced due to COVID-19, which, under certain circumstances, granted new financing from especially related persons the rank of "ordinary claims ("*créditos ordinarios*") instead of subordinated claims. In this regard, consult J. Carles, C. Cuesta & M. Mas, "Debtor-in-possession financing. Lecciones a aprender de Estados Unidos y propuesta para España," in *Actualidad Mercantil* 2022 (Tirant lo Blanch 2022).

[11] For debtor companies, especially related persons are defined under article 283.1 of the Spanish Insolvency Act. The concept includes, for example, shareholders with a certain stake in the company (5% if the company is not listed and 10% if it is), companies within the group, the legal and *de facto* administrators, or the general manager with general power of attorney to act on behalf of the company.

[12] The wording of article 668 of the reform is not clear, as it refers to "those persons," and this could be understood as "the especially related persons" or "the especially related persons that provide the interim and/or new financing." In the view of the author, it seems to exclude from the calculation of the threshold only the claims from the providers of the interim and/or new financing who are also especially related persons.

[13] Article 242.1.17º of the reformed Spanish Insolvency Act.

[14] Article 280.6º of the reformed Spanish Insolvency Act.

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A Theoretical Framework for Evaluating Debtor-in-Possession Financing

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A THEORETICAL FRAMEWORK FOR EVALUATING DEBTOR-IN-POSSESSION FINANCING

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ABSTRACT

The U.S. Bankruptcy Code provides enhanced priority and security features to debtor-in-possession (DIP) loans which can be obtained from a lender with whom the borrower may have no past lending relationship. The enhanced priority of DIP financing, and the choice of a DIP lender, significantly impact the investment decisions made by the firm. We show DIP loans from an existing lender leads to a higher level of investment. We also show that a higher priority of DIP financing also leads to higher investment by the firm. A bankruptcy judge should take these incentives into account when approving the DIP loan.

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> *Philadelphia Newspapers LLC is accusing its pre-bankruptcy lenders of engineering a financing pact that hijacks the publisher's restructuring process and places it in the hands of the lenders . . . the publisher of the Philadelphia Inquirer warned that its control over the [c]hapter 11 proceedings could be in jeopardy if its bankruptcy loan of choice is not approved . . . . The terms of the prepetition lenders' DIP (debtor-in-possession) loan give those lenders a veto power . . . . The company remains locked in a dispute with the lenders over two bankruptcy loan proposals currently on the table. Philadelphia Newspapers prefers the $15 million package offered by Republic First Bank, but lenders say it strips them of necessary protections. They argue that their $15 million financing package is superior. Six hours of supervised mediation on Thursday was not enough to bring the two parties to a consensus . . . . As a result, the courtroom showdown over the bankruptcy loan has been postponed until next Friday, when a judge will also examine the ''exclusivity'' clause currently shielding the company from rival plans.*[1]
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> —Dow Jones Institutional News, August 21, 2009

> *[Referring to auto industry bailout] . . . . The government functioned as a debtor-in-possession, or DIP, lender. DIP lenders take equity positions and negotiate a reorganization plan that makes sure that every single creditor is made better off than they would have been . . . .*[2]
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> —Lawrence Summers, the director of the White House's National Economic Council, Interview with Wall Street Journal, December 27, 2009

INTRODUCTION

When a firm can no longer meet its debt obligations should it be liquidated or should it be restructured? In a world with no frictions or asymmetric information the answer is straightforward: the choice that leads to preservation of most value is the socially optimal choice.[3] However, significant uncertainty about the future prospects as well as conflict of interests between debt holders, equity holders, and operating managers can make this a difficult decision.[4] A

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[1] Rachel Feintzeig. *DJ Philadelphia Newspapers Spars With Lenders Over Loan, Plan*, DOW JONES DAILY BANKRUPTCY REVIEW, Aug. 21, 2009.

[2] Lawrence Summers, *Lawrence Summers on the U.S. as Investor*, THE WALL STREET JOURNAL, Dec. 27, 2009.

[3] How to divide the value of a firm that is unable to service its financial obligations between its various claim holders is an important, but separate question that we do not focus on in this paper. *See generally* Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988) (providing a good review of optimal bankruptcy design).

[4] *See generally id.*

primary public policy goal of the 1978 Bankruptcy Reform Act (commonly referred to as the Bankruptcy Code or simply as the Code) is to identify distressed firms, where the going-concern value is higher than the liquidation value.[5] The goal is then to protect those firms against efforts to force their liquidation.[6] The Code provides two key mechanisms to avoid immediate liquidation of a firm that defaults on its debt. First is the ‘‘automatic stay”[7] provision and the second is ‘‘exclusivity period.’’[8] The automatic stay (§ 362 of the Code) ensures that a firm filing for reorganization under chapter 11 of the Code is protected from any civil actions (e.g., seizing collateral, collection of claims, creation of liens, etc.).[9] The exclusivity period, provided under § 1121(b), ensures that the management team of the filing firm is the only party allowed to propose the initial plan of reorganization (POR).[10] The combined effect of these two provisions is that the debtor (i.e., the incumbent management) retains control of the assets and operations.[11] Thus, after filing for petition under chapter 11, the debtor is referred to as ‘‘debtor-in-possession” (DIP).[12]

However, simply stopping the creditors from enforcing their collection claims is not enough to keep a firm operating as a going concern. A bankruptcy filing is likely to trigger a liquidity crisis for the firm.[13] For example, most firms depend on credit from their suppliers to keep day-to-day operations running.[14] Typically, few suppliers are willing to ship goods on credit to a firm operating under chapter 11, since their claim will not be secured, and will rank lowest in priority (trade credit is typically unsecured and receives the lowest priority under the Code).[15] A chapter 11 filing would induce most suppliers to demand cash upfront, which can paralyze the smooth operations of the firm filing for chapter 11 protection.[16] If the filing firm can line up a new source of

5 *See* H.R. Rep. No. 595, at 220 (1978), as *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138–39.

6 *See id.* (“The purpose of a business reorganization, unlike a liquidation case, is to restructure a business’s finances so that it may continue to provide its employees with jobs, pay its creditors, and produce a return for its shareholders.”).

7 11 U.S.C. § 362 (2012).

8 *Id.* § 1121(b)

9 *See id.* § 362.

10 *Id.*

11 *See* David A. Skeel Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1916–19 (2004).

12 11 U.S.C. § 1101(1) (2012).

13 *See* Skeel Jr., *supra* note 11, at 1930.

14 *See* Travis N. Turner, *Kmart and Beyond: A “Critical” Look at Critical Vendor Orders and the Doctrine of Necessity*, 63 WASH. & LEE L. REV. 431, 438–39 (2006).

15 *See* 7 COLLIER ON BANKRUPTCY ¶ 1129.03[3] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

16 *See* Turner, *supra* note 14, at 438; Matter of Jartran, Inc., 732 F.2d 584, 586 (7th Cir. 1984).

financing (e.g., a new line of credit), it may be able to overcome such liquidity problems.[17] Potential lenders, however, are unlikely to provide new debt to a borrower that has filed for bankruptcy.[18] This reluctance arises from significant uncertainty about the repayment ability of the borrower.[19] Thus, there are few funding options for a firm that is operating under the protection of chapter 11. The Code addresses this problem by providing special creditor rights to loans made after the chapter 11 filing.[20] Specifically, § 364 of the Code allows for a special kind of post-petition financing, usually referred to as DIP financing.[21] The DIP lenders enjoy certain rights, which are unavailable to the creditors of firms not operating under chapter 11 protection.[22] Historically, the U.S. bankruptcy law has always allowed some form of special financing for distressed firms (especially railroads) attempting to reorganize their operations.[23] However, the 1978 Code went much farther in providing broader rights to DIP financing.[24] DIP financing has become an increasingly common source of financing for U.S. firms filing for protection under chapter 11.[25] Dahiya et al. report that the fraction of bankrupt firms, who obtain DIP financing, has been rising.[26] By the mid-1990s, almost half of the public firms filing for chapter 11 obtained DIP financing.[27] Ayotte and Morrison study chapter 11 filings by public firms in 2001 and report that 50 percent of the filers obtained DIP financing and an additional 26 percent obtained permission to use cash under terms very similar to those of DIP loans.[28] DIP financing is also credited with making the reorganization process more creditor friendly as DIP lenders have used this type of lending to exert control over the

[17] *See* Stephen R. Dubè, *Practical Management Initiatives in a Company's Chapter 11 Preparation*, 29-7 AM. BANKR. INST. J. 44, 44 (2010); 1 COLLIER ON BANKRUPTCY ¶ 15.04[3] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

[18] Mark L. Prager, *Financing the Chapter 11 Debtor: The Lenders' Perspective*, 45 BUS. LAW. 2127, 2127 (1990).

[19] *See* Daniel V. Goodsell, *Extending Post-Petition Credit to Reorganizing Debtors: Understanding the Tricks and Traps of Bankruptcy Code Section 364*, 1990 UTAH L. REV. 93, 93 (1990).

[20] *See* George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 901 (1993).

[21] *Id.*

[22] *See id.*; Sandeep Dahiya et al., *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259, 260 (2003).

[23] *See* Skeel, Jr., *supra* note 11, at 1908–13.

[24] In the late nineteenth century, financially distressed railroads, attempting reorganization, would issue a "receiver's certificate," which was a promissory note that would have the highest priority. *See id.* (providing a detailed discussion of the historical development of DIP financing).

[25] Dahiya, *supra* note 22, at 260.

[26] *Id.*

[27] Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 515 (2009).

[28] *Id.* at 523.

reorganization process.[29] For example, Bharath et al. and Adler et al. document significant reduction in absolute priority deviations in favor of equity holders in recent years.[30] They argue that increased use of DIP financing is a key driver for their findings.[31] Ayotte and Skeel propose that many features of the bankruptcy law, including provision for DIP financing, mitigate the liquidity problem of the borrower as few (if any) lenders will be willing to provide debt to a distressed borrower.[32] The superior creditor control rights have made DIP financing as contract of choice for large scale restructuring involving private firms and government.[33] For example, the U.S. Government chose to inject over $300 million in General Motors via a DIP line of credit.[34] Similarly, to help with its restructuring, the city of Detroit used a $120 million DIP loan from Barclays bank, the first deal of its kind for a municipal bankruptcy.[35]

Legal scholars, however, are not unanimous in endorsing DIP financing.[36] It is possible that DIP financing can distort a firm's investment choices.[37] Bebchuk and Fried as well as Warren outline the drawbacks of senior and secured financing.[38] Since DIP financing is an extreme form of senior secured lending, their argument against such loans is especially relevant.[39] They argue that such credit provides strong risk-shifting incentives, specifically for shareholder aligned managers of a distressed firm.[40] By pledging unencumbered assets as security, a borrower can transfer wealth from pre-existing unsecured creditors to the new secured creditors.[41] Thus, DIP

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29 Barry E. Adler et al., *Value Destruction in the New Era of Chapter 11*, 29 J. L. ECON. 461, 464 (2012).

30 *Id.*; Sreedhar T. Bharath, Venky Panchapagesan & Ingrid Werner, *The Changing Nature of Chapter 11*, 13 (Indian Institute of Management Bangalore, Working Paper No. 461, 2014).

31 Bharath, *supra* note 30, at 11–12; Adler, *supra* note 29, at 464.

32 Kenneth M. Ayotte & David A. Jr. Skeel, *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1604–06 (2013).

33 Skeel, *supra* note 11, at 1919–20.

34 Motors Liquidation Co. Avoidance Action Tr. v. JPMorgan Chase Bank, N.A. (*In re* Motors Liquidation Co.), 552 B.R. 253, 258 (Bankr. S.D.N.Y. 2016).

35 *UPDATE 2-Detroit Gets $350 mln Financing Lifeline from Barclays*, REUTERS (2013), http://www.reuters.com/article/usa-detroit-financing/update-2-detroit-gets-350-mln-financing-lifeline-from-barclays-idUSL1N0I11RM20131011.

36 Ayotte, *supra* note 27, at 514–15.

37 *Id.* at 515.

38 *See* Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 873–74 (1996); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1379 (1996–1997).

39 Robin Phelan & Ocean Tama, *The Use of DIP Financing as a Mechanism to Control the U.S. Corporate Restructuring Process*, INT'L BAR ASS'N LEGAL PRACTICE DIV., Oct. 2010, at 24.

40 *See* Bebchuk, *supra* note 38, at 873–74; Warren, *supra* note 38, at 1379.

41 Bebchuk, *supra* note 38, at 891–94.

financing is likely to worsen the wealth-transfer incentives of the management.[42] Stultz and Johnson and Schwartz argue, however, that higher priority financing can address the under-investment problem better.[43] The Code provides the bankruptcy judge with a wide latitude to approve an appropriate level of priority that a DIP loan can hold.[44] Thus, it is useful to examine how the priority level of DIP loans affects the investment decision of the borrower. This paper aims to provide a theoretical framework, which allows a bankruptcy judge to evaluate the appropriate priority level of a DIP loan.

Another related issue for the bankruptcy court arises when a borrower requests a DIP loan from a lender who may or may not have any prior (pre-petition) loan exposure to that borrower. The Code allows a distressed borrower to get its DIP financing from either its existing (pre-petition) lender, or from a new lender.[45] There are significant benefits for a pre-petition lender to continue as the DIP lender. For example, an existing lender already has a relationship with the borrower which provides the lender an information and cost advantage over a new lender.[46] Furthermore, by not providing DIP financing, the existing lender risks diluting its security on the pre-petition loans.[47] Finally, the Code allows (although rarely) for a pre-petitioned *unsecured* lender to provide DIP financing, and the use of collateral, to secure *both* the unsecured pre-petition loan as well as the post-petition loan.[48] This rare type of DIP financing is allowed under the cross-collateralization clause of the Code.[49]

These arguments imply that the pre-petition lead lender is the *''Natural DIP Lender.''*[50] There are, however, competing reasons that favor a new lender as the sole provider of DIP financing. First, there is considerable disagreement among the various claimholders regarding the value of the firm, and how it

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42 *Cf. id.* at 870–71; Warren, *supra* note 38, at 1374–76.

43 *See* Rene M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. FIN. ECON. 501, 512–19 (1985); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 466–69 (1997).

44 *See* 11 U.S.C. § 364 (2012).

45 *Id.* § 364(d).

46 *See* Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data*, 49 J. FIN. 3, 5–6 (1994).

47 *See* PAUL ZUMBRO, DIP AND EXIT FINANCING TRENDS AND STRATEGIES IN A CHANGING MARKET 6 (2016).

48 11 U.S.C. § 552(b) (2012).

49 *Id.*

50 *See* Petersen, *supra* note 46, at 5–6; ZUMBRO, *supra* note 47, at 6–7.

should be divided among the various classes.[51] The pre-petition lender (hereafter, the inside bank) enjoys substantial inside information compared to the trade creditor or public debtholders.[52] The inside bank and the firm have strong incentives to collude and extract higher concessions from the uninformed claimholders.[53] LoPucki and Whitford describe occurrences of this form of collusion, prior to the adoption of the absolute priority rule in 1939.[54] Bulow and Shoven and Gertner and Scharfstein discuss the coalition formation by the shareholders and the inside bank to achieve similar wealth transfers.[55] Berlin, John, and Saunders provide a theoretical setting, which describes a rational junior claimholder who anticipates the possible collusion of the inside bank and the firm.[56] Therefore, such a creditor will be unwilling to accept the plan of reorganization proposed by this coalition.[57] By allowing a new lender to provide DIP financing, a firm adds credibility to its reorganization plan.[58] Also, the under-investment problem, caused by the debt overhang, may be mitigated if the new lender provides DIP financing.[59]

Second, Sharpe and Rajan provide another reason for turning to a new lender for post-petition financing.[60] Both studies show theoretical models of the bank-borrower relationship.[61] These models show that the inside bank can

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[51] *See* David T. Brown, *Claimholder Incentive Conflicts in Reorganization: The Role of Bankruptcy Law*, 2 REV. FIN. STUD. 109, 109–10 (1989); Ronald M. Giammarino, *The Resolution of Financial Distress*, 2 REV. FINANCIAL STUDIES 25, 27 (1989). Even among the same class (e.g., secured creditors), having multiple creditors can make renegotiation challenging. Ernst-Ludwig von Thadden, Erik Berglof & Gerard Roland, *Claimholder Incentive Conflicts in Reorganization: The Role of Bankruptcy Law*, 23 REV. FIN. STUD. 2648, 2649–51 (2010).

[52] SANDEEP DAHIYA, KOSE JOHN, MANJU PURI & GABRIEL RAMIREZ, THE DYNAMICS OF DEBTOR-IN-POSSESSION FINANCING: BANKRUPTCY RESOLUTION AND THE ROLE OF PRIOR LENDERS 5 (2000).

[53] *See* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reogranization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 132 (1990).

[54] *Id.*

[55] *See* Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1189–1222 (1991).

[56] Mitchell Berlin, Kose John & Anthony Saunders, *Bank Equity Stakes in Borrowing Firms and Financial Distress*, 9 REV. FIN. STUD. 889, 892 (1996).

[57] A number of recent news stories highlight these conflicts. For example, in the 2013 bankruptcy filing of GMX resources, both the unsecured creditors as well as a group of preferred shareholders filed objections to its $50 million DIP loan. *See, e.g.*, Matt Chiappardi, *GMX Investors Blast $50M Ch. 11 Loan as Unfair*, LAW 360 (Apr. 26, 2013), https://www.law360.com/articles/436469/gmx-investors-blast-50m-ch-11-loan-as-unfair.

[58] Darla D. Moore, *How to Finance a Debtor in Possession*, 6 COM. LENDING REV. 3, 8 (1990).

[59] Stuart Gilson, *Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. APPLIED CORP. FIN. 23, 28 (2012).

[60] Stephen A. Sharpe, *Asymmetric Information, Bank Lending and Implicit Contracts: A Stylized Model of Customer Relationships*, 45 J. FIN. 1069–1087 (1990); Raghuram G. Rajan, *Insiders and Outsiders: The Choice between Informed and Arm's-Length Debt*, 47 J. FIN. 1367–1400 (1992).

[61] Sharpe, *supra* note 60, at 1071; Rajan, *supra* note 60, at 1370–72.

extract monopoly rents from its borrowers, due to its information advantage.[62] This monopoly power likely plays a significant role in the period leading up to the chapter 11 filing, as the distressed debtor tries to renegotiate his debt.[63] The increasing rent extraction by the inside bank can make the securing of DIP financing from a new lender more attractive.[64] The assumption of a competitive market for the supply of loans implies there are many new lenders willing to extend DIP loans.[65] In some instances, lenders use DIP financing as an opportunity to replace old banking relationships.[66] These arguments imply that there are strong incentives for a firm to approach a new lender to provide post-petition credit.[67]

Our discussion thus far, underscores the importance of priority level of DIP loans, and the choice of DIP lenders in shaping the investment decisions of borrowers. In this paper we provide a theoretical model that examines these issues. The two papers most closely related to our papers are Gertner and Scharfstein, and Triantis.[68] Gertner and Scharfstein primarily focus on how priority and maturity structure of existing debt affects the restructuring outcomes.[69] Our paper focuses more narrowly on the issues that arise due to special protection offered to DIP loans by § 364 of the Code. Triantis develops a theoretical model for judicial oversight of DIP financing.[70] Our paper presents a more formal treatment of his model and provides extensions to the cases where a DIP loan enjoys ‘‘cross-collateralization” as well as analyzing the case of DIP financing being provided by an existing junior creditor. The financing by a junior creditor typically happens when a large trade creditor agrees to provide funding for restructuring. For example, Pinnacle Air, a small regional airline, obtained a $75 million DIP loan from Delta Airlines which was its largest trade creditor and customer at the time of chapter 11 filing.[71]

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62 Sharpe, *supra* note 60, at 1069.

63 Rajan, *supra* note 60, at 1368.

64 Sharpe, *supra* note 60, at 1069.

65 ZUMBRO, *supra* note 47, at 15–16.

66 *See, e.g.*, David Neustadt, *Lending to Bankrupt Companies Seen as Opportunity to Gain Some Assets*, AM. BANKER, Oct. 27, 1987. Chemical Bank, the industry pioneer in 1990's, used DIP financing to generate new lending and investment banking businesses from the firms that it previously had no relationship with. One of its managing directors stated, "we approach the market as a new business opportunity and typically have no existing exposure to the debtor." Moore, *supra* note 58, at 8.

67 Neustadt, *supra* note 66; Moore, *supra* note 66, at 8.

68 Gertner, *supra* note 55, at 1189; Triantis, *supra* note 20, at 901.

69 Gertner, *supra* note 55, at 1189, 1192.

70 Triantis, *supra* note 20, at 918–19.

71 Pinnacle Airlines Corp., 483 B.R. 381, 389, 396 (Bankr. S.D.N.Y. 2012).

The plan of the paper is as follows: in Section 2 we briefly describe the chapter 11 process, and discuss the various financing options available to the firm operating under chapter 11. This section also provides the details of § 364 of the Code, which governs the DIP lending process. In Section 3, the basic model is laid out and solved for alternative bankruptcy regimes. We conclude in Section 4.

I. BACKGROUND

A. *The Chapter 11 Reorganization Process*

One of the major differences between state and federal non-bankruptcy debt collection laws, and the Code, is the idea of a fresh start for the debtors.[72] For a corporate borrower, this is usually achieved via a chapter 11 filing.[73] As described by Epstein, Nickles, and White, there are various stages to a chapter 11 case.[74] A voluntary filing by the debtor marks the first stage of the reorganization process.[75] The filing immediately results in an automatic stay on all payments to pre-petition creditors, all collection efforts, and all foreclosure actions.[76] Thus, the automatic stay provides a major incentive for a distressed borrower to seek protection under chapter 11.[77]

Simultaneously, this borrower reduces the power of pre-petition creditors, while allowing the incumbent management to maintain operating control of the debtor's assets.[78] The result is that the debtor is in possession of his own affairs or a ''debtor-in-possession.''[79] But the protection from creditors comes at a cost. The debtor-in-possession (i.e., incumbent management) faces several restraints on how the debtor-in-possession can use the estate's assets, and, in

72 *In re* Neiheisel, 32 B.R. 146, 147 (Bankr. D. Utah 1983).

73 The use of chapter 11 is not restricted to a business entity only; some of the lower courts barred individual chapter 11 filings until the Supreme Court ruled that individual debtors may file for relief under chapter 11. Toibb v. Radloff, 501 U.S. 157, 166 (1991).

74 DAVID G. EPSTEIN, STEVE H. NICKLES, AND JAMES J. WHITE, BANKRUPTCY, HORNBOOK SERIES STUDENT EDITION, 1993.

75 In few cases, the commencement of chapter 11 is initiated by an involuntary petition by the creditors under §303. 11 U.S.C. §§ 301, 303 (2012).

76 *Id.* § 362.

77 Erin Y. Baker, *The Automatic Stay in Bankruptcy: An Analysis of the Braniff Chapter 11 Proceeding*, 14 TEX. TECH L. REV. 433, 433 (1983).

78 While the Code allows the bankruptcy judge to replace the existing management by a court appointed trustee to operate the firm, in practice, the appointment of a trustee is very rare, and incumbent management usually continues in place, at least in the period immediately after the filing. *Id*.

79 *Id*. at 452–53.

particular, the liquid assets, such as cash.[80] The various guidelines and restrictions on the use, sale, and lease of assets are contained in § 363 of the Code.[81]

The debtor-in-possession plays two critical roles. First, the debtor-in-possession formulates a plan of reorganization and, second, runs the day-to-day business of the firm.[82] Once the firm has filed for bankruptcy, the incumbent management continues to operate its business while formulating a plan of reorganization.[83] At this stage the firm requires some form of financing, including DIP financing.[84] Next, we discuss the various financing options available to a firm operating under chapter 11.

B. *The Post-petition Financing Process*

Let us now turn to the institutional details of the post-petition financing process. Table 1 shows the menu of financing choices available to a firm after filing for chapter 11. The first and natural source of funds for a business is the cash flow generated by its operations.[85] This can be a substantial resource, as the firm is no longer paying interest on its pre-petition debt.[86] Although § 363 of the Code allows the firms to engage in the ordinary course of business without prior approval of the bankruptcy court, the use of cash is subject to extensive restraints.[87] Section 363(c)(2) specifically prohibits even the ordinary use of ‘‘cash collateral’’ without permission from the court.[88] Thus, obtaining court approval for the use of cash collateral provides the firm with its first source of liquidity.[89]

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[80] 11 U.S.C. § 363 (2012).

[81] *Id.*

[82] This exclusivity period is for 120 days from the date of a chapter 11 filing but is usually extended. Thomas G. Kelch, *The Phantom Fiduciary: The Debtor in Possession in Chapter 11*, 38 WAYNE L. REV. 1323, 1323, 1327, 1330 (1992).

[83] *Id.*

[84] Moore, *supra* note 58, at 4–5.

[85] Kristin C. Wigness, *Back to Basics: Obtaining Court Approval of DIP Financing*, LAW 360 (July 17, 2013), https://www.law360.com/articles/456314/back-to-basics-obtaining-court-approval-of-dip-financing.

[86] *Id.*

[87] 11 U.S.C. § 363 (2012).

[88] Section 363(a) defines cash collateral to mean cash, negotiable instruments, documents of title, securities, deposit accounts, and other cash equivalents. *Id.* § 363(a).

[89] *Sources of Liquidity and Factors Affecting Firm's Liquidity*, FINANCE TRAIN, http://financetrain.com/sources-of-liquidity-and-factors-affecting-firms-liquidity/ (last visited Sept. 9, 2017).

The use of cash collateral may not adequately meet all the firm's financing needs.[90] Therefore, the firm may need to raise funds through DIP financing.[91] In most cases, the firm tries to arrange DIP credit before the formal filing of the chapter 11 petition.[92] If the firm is able to arrange DIP financing, then the petition is accompanied by a request of approval for DIP financing.[93] DIP financing can be obtained under § 364 of the Code, which has four subsections.[94] As Table 1 describes, ''§ 364 was structured with an escalating series of inducements that a debtor-in-possession may offer to attract credit in the post-petition period.''[95] Subsections (a) through (d) provide an increasing level of priority and security for the DIP lender.[96] Section 364 is progressive in nature, since the benefits provided in each subsection are not available until it has been established that a good faith effort to obtain credit was unsuccessful.[97]

DIP financing under § 364(a) is the easiest to arrange, as it does not require any court approval.[98] It allows the debtor to obtain unsecured credit in the ordinary course of business.[99] This credit must fund an expense that is otherwise eligible for treatment as an administrative expense under § 503(b), and enjoys the administrative expense priority.[100] The restriction of credit under § 364(a) to the ordinary course of business means that this financing is usually limited to trade credit.[101]

DIP financing under § 364(b) can be used for purposes other than the ordinary course of business, but its use must be approved by the bankruptcy court after a due notice and hearing.[102] The lenders prefer this form of financing because it removes the ambiguity surrounding whether or not the

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90 *Chapter 11-Bankruptcy Basics*, UNITED STATES COURTS, http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics (last visited Sept. 9, 2017).

91 *Id.*

92 *Id.*

93 Wigness, *supra* note 85.

94 11 U.S.C. § 364 (2012).

95 *In re* Photo Promotion Assocs., Inc., 87 B.R. 835, 839 (Bankr. S.D.N.Y. 1988).

96 *Id.*

97 11 U.S.C. § 364 (2012).

98 *Id.*

99 *Id.*

100 Within the class of general unsecured loans, §507(a) assigns different priorities to different types of unsecured claims. 11 U.S.C. § 507(a) (2012). Administrative expenses, as defined in §503(b), are entitled to first priority, among unsecured claims. 11 U.S.C. § 503(b) (2012). The examples of administrative claims include professional fees, costs of selling or liquidating assets, etc.

101 11 U.S.C. § 364 (2012).

102 *Id.*

credit is made in the ordinary course of business.[103] As with the credit under § 364(a), the loans under § 364(b) are unsecured.[104]

Section 364(c) provides stronger incentives to the lenders. Under three clauses, it empowers the debtor to grant a DIP lender:

1. priority over all other administrative expenses in the case,
2. security interest in unencumbered assets, or
3. a junior lien on already encumbered assets.[105]

Section 364(c), like § 364(b), requires court approval after the due notice and hearing.[106] Furthermore, the debtor must prove to the court that it could not obtain financing on an unsecured basis under § 364(a) and § 364(b).[107]

The court can approve financing under § 364(d) if the priorities and security offered by § 364(c) are insufficient to obtain new credit.[108] This allows the debtor to offer a lien on the already pledged collateral that is senior to existing liens, referred to as *priming liens*.[109] The approval of such a priming lien is subject to several requirements. First, as in § 364(c), the debtor-in-possession must prove that it was unable to obtain financing under § 364(a), § 364(b), or § 364(c).[110] Second, the debtor-in-possession must prove that the interests of the lender being primed are adequately protected.[111] Finally, § 364(e) protects the DIP lenders from the adverse effects of a subsequent reversal, or modification, on appeal of the bankruptcy court's orders authorizing the super-priority and priming lien.[112]

There is case law in which the pre-petition, unsecured lender agrees to provide DIP loans, provided that the collateral for the post-petition loan can also be pledged as security for the pre-petition, unsecured loans.[113] This arrangement is called ''cross-collateralization,'' and provides additional incentives for a pre-petition lender to extend post-petition financing.[114]

[103] *Cf.* David Epstein, *Postpetition Lending Under Section 364: Issues Regarding the Gap Period and Financing for Prepackaged Plans*, 27 WAKE FOREST L. REV. 103 (1992).
[104] 11 U.S.C. § 364(b) (2012).
[105] *Id.* § 364(c).
[106] *Id.*
[107] *Id.* § 364(d)(1).
[108] *Id.* § 364(d)(1)(A).
[109] *See* Epstein, *supra* note 103.
[110] 11 U.S.C. § 364(d)(1)(A) (2012).
[111] *Id.* § 364(d)(1)(B).
[112] *Id.* § 364(e); Epstein, *supra* note 103.
[113] *See In re* Vanguard Diversified. Inc., 31 Bankr. 364, 366 (Bankr. E.D.N.Y. 1983).
[114] *Id.*

Whether or not it is permitted under the Code remains a controversial and unsettled issue.[115]

Table 2 provides the priority structure of claims for a hypothetical firm that has contracted post-petition financing under all the subsections of § 364.

II. THE MODEL

The focus of this paper is to examine how DIP financing affects the investment incentives of a borrower. For a financially distressed firm, the legal recourse to the same, or higher priority, DIP financing is unique to the Code.[116] We examine how a financially distressed firm would invest if the only source of DIP financing is from one of its existing borrowers. Here, we focus on how changing the priority of the DIP loan, compared to existing pre-petition loans, would influence the investment decisions of the borrower. Next, we introduce the possibility of obtaining DIP financing from a new lender, and examine its impact on the investment policy of the borrower.

Our model is similar to the one used by Gertner and Scharfstein.[117] The model has two dates. At time 0, the only asset that the firm possesses is cash L and an opportunity to invest in a project requiring total outlay of I. The firm has debt of face value B, due at date 0 that is held by a syndicate of lenders. The the firm is insolvent at date 0, i.e., $B > L$. The investment opportunity can only be exploited by the firm and cannot be sold separately. Thus, the firm needs $I - L$ to finance the investment opportunity, and it has the choice of arranging DIP financing from either its old lenders, or from a new lender. If no DIP loan can be arranged, the firm will be liquidated for L. The project requiring an investment of I, generates a stochastic cash flow X, which is distributed over $[0, \infty)$, with a probability distribution $f(X)$. All parties are assumed to be risk neutral, and the risk-free rate is assumed to be zero.[118] Thus, in case the firm has a terminal cash flow (X), larger than the

[115] *See, e.g.*, *In re* Saybrook Mfg. Co., 963 F.2d 1490 (11th Cir. 1992); *In re* Monarch Circuit Indus., Inc., 41 B.R. 859 (Bankr. E.D. Pa. 1984) (prohibiting cross-collateralization).

[116] For example, the U.K. insolvency law requires that an Administrator, typically a qualified insolvency practitioner, replaces the board of directors as the manager of the company in administration (i.e., reorganization). However, in recent years some countries are amending their bankruptcy statutes to allow some form of senior secured lending for the reorganizing firm. For example, in 2009 Canada amended its Companies Creditors Arrangement Act (CCAA) to codify the circumstances in which courts will allow DIP loans. *See* Epstein, *supra* note 103.

[117] *See* Gertner, *supra* note 55.

[118] While assumption of zero risk free rate is not realistic, it allows us to abstract away from determining the interest rate and, instead, allows us to focus on the effect that priority has on the investment incentives of

face value of the total debt (B), the residual surplus is retained by the coalition of DIP lender and the shareholders of the firm. This surplus can be shared between the borrower and lender, although we do not model the sharing contract. To keep model tractable, we make the same assumption as Gertner and Scharfstein and assign the entire surplus to the DIP lender.[119]

We define the first best investment policy (socially optimal) for the firm as one that increases the total value of the firm. Let NPV^* (Socially Optimal) denote the minimum level of expected NPV of a project, such that the project would increase the value of the firm. It is easy to see that $(\text{NPV})^*_{SociallyOptimal} = 0$, i.e., all positive NPV projects should be undertaken. Thus, every project requiring an investment I that has an expected return, $\overline{X}$ greater than I, should be undertaken. In the next section, we examine how the presence of pre-existing risky debt, and the priority of DIP loans, affects the investment policy.

A. DIP Financing Provided by Pre-petition (Old) Lender

We shall first restrict our analysis where one of the firm's existing lenders, which we refer to as ''Old or Pre-petition Lender,'' provides DIP loans. Additionally, we focus on the impact of different priority levels of DIP loans on the investment incentives of the borrower.

1. The Pre-petition Bank Provides Financing at the Same Priority as Pre-petition Loans

Assume that the bank provides the DIP loan and has a fraction φ of the pre-petition loan. Thus, the face value of its existing debt is φB. If the firm does not get DIP financing, it will be liquidated. In that case, the potential DIP lender with fraction φ of the old loan would realize a cash flow equal to φL. Thus, the pre-petition bank will provide a DIP loan only if:

$$\int_0^Z \frac{\varphi B + I - L}{Z} Xf(X)dX + \int_Z^\infty [X - (1-\varphi)B] f(X)dX - (I - L) > \varphi L. \quad (1)$$

Where $Z = B + (I - L)$ denotes the total face value of debt (DIP loan and pre-petition) at time 1. Equation 1 is the incentive compatibility constraint for the old lender willing to provide a DIP loan. The first term is the pay-off to the

the firm. Gertner and Scharfstein also make this assumption in analyzing the effect of the reorganization law on workouts. *See id.*

[119] *See id.*

DIP lender when the firm's cash flow is not sufficient to cover the entire debt repayments. The second term is the pay-off to DIP lender when the cash flow is adequate to pay off the debt, and the DIP lender takes the residual value.[120] The first term in Equation 1 can be rewritten as $\int_0^Z \frac{B+I-L}{Z} Xf(X)dX - \int_0^Z \frac{(1-\varphi)B}{Z} Xf(X)dX$. Also the second term can be expanded and rewritten as $\int_Z^\infty Xf(X)dX - \int_Z^\infty (1-\varphi)Bf(X)dX$. Finally, $\overline{X} = \int_0^\infty Xf(X)dX$. Thus, equation 1 can be rearranged as:

$$\overline{X} - I > \int_0^Z \frac{(1-\varphi)B}{Z} Xf(X)dX + \int_Z^\infty (1-\varphi)Bf(X)dX - L + \varphi L. \tag{2}$$

Let us define V_B^E as:

$$V_B^E = \int_0^Z \frac{B}{Z} Xf(X)dX + \int_Z^\infty Bf(X)dX. \tag{3}$$

Conceptually V_B^E is the value of existing debt conditional on the firm obtaining a DIP loan regardless of who provides the financing. Substituting the value of V_B^E in Equation 2, it can be rewritten as:

$$\overline{X} - I > (1-\varphi)[V_B^E - L] = (NPV)^*_{EqualPriority}. \tag{4}$$

The expected NPV of undertaking the investment is $\overline{X} - I$. Thus, the right hand side of the inequality in Equation 4 is the minimum expected NPV of the project, for which an old lender would provide DIP financing at a priority level equal to that of pre-petition loans. If $[V_B^E - L]$ is equal to zero, then we obtain the socially optimal outcome: all projects with positive NPV are financed. This is the case if the decision to obtain DIP financing makes the value of existing debt exactly equal to the pay-off if the firm is liquidated. This implies that there is no wealth transfer to or from existing debt holders arising from the decision to invest in the project financed by new DIP loan. This socially optimal outcome can also occur if the pre-petition lender is the *only existing lender*, i.e., $\varphi = 1$. In this case, the investment problem is trivial, since old lenders would always finance only positive NPV projects. If $[V_B^E - L]$ is not equal to zero, however, then the firm's investment policy will deviate from the

[120] For simplicity, we assume that entire surplus is paid to the DIP lender. This assumption can be relaxed to allow sharing of the surplus between the DIP lender and shareholders, but would add complexity without any additional insights on how priority of DIP loan affects the investment choice.

socially optimal. If $[V_B^E - L] < 0$, the right hand side of Equation 4 will be negative. Thus, the firm will invest in some projects that are negative NPV implying over-investment. On the other hand, if $[V_B^E - L] > 0$, the minimum cut-off point above which the firm will invest is strictly greater than zero. This implies that the firm will forego some positive NPV projects resulting in under-investment.

2. The Pre-petition Bank Provides DIP Financing at a Priority Higher to Pre-petition Loans

If the DIP lender is able to get higher priority, then the incentive compatibility constraint can be rewritten as:

$$\int_0^{I-L} Xf(X)dX + \int_{I-L}^{Z} [(I-L) + \varphi(X-(I-L))] f(X)dX;$$
$$+ \int_Z^{\infty} [X-(1-\varphi)B] f(X)dX - (I-L) > \varphi L. \tag{5}$$

The first term in Equation 5 is the pay-off to the DIP lender if cash flow is less than the face value of the DIP loan ($I-L$). The second and third terms describe the pay-offs to DIP lenders at increasing levels of realized cash flows. The second term can be expanded and rewritten as $\int_{I-L}^{Z} (1-\varphi)(I-L) f(X)dX + \int_{I-L}^{Z} Xf(X)dX - \int_{I-L}^{Z} (1-\varphi) Xf(X)dX$. Rearranging the terms gives:

$$\overline{X} - I > \int_Z^{\infty}(1-\varphi)Bf(X)dX + \int_{I-L}^{Z}(1-\varphi)Xf(X)dX - \int_{I-L}^{Z}(1-\varphi)(I-L)f(X)dX - (1-\varphi)L. \tag{6}$$

Let us define V_B^H as:

$$V_B^H = \int_{I-L}^{Z} [X-(I-L)] f(X)dX + \int_Z^{\infty} Bf(X)dX. \tag{7}$$

Conceptually, V_B^H is the value of an existing loan conditional on a firm obtaining a new DIP loan (regardless of who provides this loan) at a *higher priority* compared to existing loan. Substituting V_B^H in Equation 6 yields:

$$\overline{X} - I > (1-\varphi)[V_B^H - L] = (NPV)^*_{HigherPriority}. \tag{8}$$

Denoting $(1-\varphi)[V_B^H - L]$ by $(\text{NPV})^*_{HigherPrio\ rity}$, Equation 8 describes the minimum level of expected NPV from a project for which the pre-petition lender would provide DIP loans. The higher priority of DIP loan would induce the lender to finance a larger set of projects, since the minimum acceptable NPV is lower for a lender, who gets higher priority for his DIP loan as summarized in the following lemma:

Lemma 1 (L:L1) $(NPV)^{*}_{EqualPriority}$ is strictly greater than $(NPV)^{*}_{HigherPriority}$. This implies that the cut-off level for NPV below which the project will not be financed is lower if the DIP loan is at at a higher priority compared to the existing loans. Thus, a higher priority of a DIP loan results in a higher level of investment.

Intuitively, the increased willingness to invest, due to a higher priority of a DIP loan, addresses the well-known problem of ''debt overhang'' as discussed in Myers.[121] Thus, for firms that have an attractive set of investment projects, but face a large debt overhang, access to a higher priority DIP loan would lead to more efficient investment. However, the higher priority may not be an optimal outcome for all borrowers. For borrowers with poor investment opportunities, higher investment may lead to inefficient risk-shifting in negative NPV projects.[122] For such borrowers, DIP financing should be provided (if at all) at equal priority.[123] We summarize this intuition in the following proposition:

Proposition 1 (P:OldPriority)

DIP financing at higher priority should only be granted for the borrowers that have good investment opportunities.[124]

3. *Cross-collateralization*

Cross-collateralization is a controversial feature of the Code, under which the bankruptcy judge can allow the old lender, providing DIP financing, to have higher priority for both the DIP financing and its proportion of the old loan.[125] In some cases, the pre-petition lender can ''roll-up'' its old loans into the new DIP loan, effectively using part of the

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121 Stewart Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 147–75 (1977).

122 Michael C. Jensen, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

123 *Id.*

124 *Id.*

125 Cross-collateralization has been defined by the Second Circuit as follows: "In return for making new loans to a debtor-in-possession under [chapter 11], a financing institution obtains a security interest on all assets of the debtor, both those existing at the date of the order, and those created in the course of the [chapter 11] proceeding." This is not only for the new loans (the propriety of which is not contested), but also for existing indebtedness to it. Otte v. Mfrs. Hanover Com. Corp., 596 F.2d 1092, 1094 (2d Cir. 1979).

DIP loan to retire the old loan.[126] Conceptually, a roll-up facility is similar to a cross-collateralized DIP loan.[127] We examine the investment incentives if the DIP loan is cross-collateralized as highest priority.

The face value of total loans extended by a pre-petition DIP lender would equal $\varphi B + I - L$, which can be rewritten as $Z - (1-\varphi)B = T$. In order for the DIP lender to be willing to provide financing that is cross-collateralized, the equation must hold:

$$\int_0^T Xf(X)dX + \int_T^Z (I + \varphi B - L) f(X)dX + \int_Z^\infty [X - (1-\varphi)B] f(X)dX - (I - L) > \varphi L. \quad (9)$$

The first term of Equation 9 reflects the cross-collaterlization, since both the pre-petition loan exposure of the DIP lender as well as the new DIP loans enjoy first priority. Note that the fraction of pre-petition loan owned by lender(s) not providing the DIP loan is effectively subordinated. Rearranging the terms we get:

$$\overline{X} - I > \int_Z^\infty (1-\varphi) Bf(X)dX + \int_T^Z [X - (I + \varphi B - L)] f(X)dX - (1-\varphi)L,$$

which can be rewritten as:

$$\overline{X} - I > (1-\varphi)\left(\int_Z^\infty Bf(X)dX + \int_T^Z \frac{[X - (I + \varphi B - L)]}{(1-\varphi)} f(X)dX - L \right). \quad (10)$$

Let us define V_B^C as:

$$V_B^C = \int_Z^\infty Bf(X)dX + \int_T^Z \frac{[X - (I + \varphi B - L)]}{(1-\varphi)} f(X)dX. \quad (11)$$

Substituting V_B^C in Equation 10 we get:

$$\overline{X} - I > (1-\varphi)[V_B^C - L]. \quad (12)$$

Thus $(1-\varphi)[V_B^C - L]$ is the minimum level of expected NPV for a project that would be financed by a cross-collateralized DIP loan. We denote this by NPV^* (cross-collateral). Effectively, cross-collaterlization is an even higher level of priority, compared to the case where only the DIP loan had higher priority. This can be summarized in the following proposition:

[126] *In re* Capmark Fin. Group Inc., 438 B.R. 471, (Bankr. D. Del. Nov. 1, 2010).

[127] *In re* Coda Holdings, Inc., (Bankr. D. Del. Sept. 6, 2017).

Proposition 2 (P:Cross)

For borrowers that have an attractive investment opportunity set, DIP financing can be cross-collateralized with the pre-petition debt. Conversely, for borrowers with a poor investment opportunity, set DIP financing should not be cross-collateralized.

Again, the result is expected due to an increase on the priority of the loan, which makes the lender willing to finance a larger set of projects.

So far, we have examined how the priority of a DIP loan affects the investment decisions of the firm. However, we restricted the firm's choice of DIP lender to one of its existing pre-petition lenders. In the next section, we examine what happens when the firm raises DIP loans from a new lender. This new loan, the so called ''pure debtor-in-possession financing,'' happens when a lender with no pre-petition relationship to the firm agrees to provide DIP financing.[128]

4. New DIP Lender is Allowed

In this section, we show that for same level of priority, the minimum level of expected NPV, required to induce a new DIP lender to lend, is always higher than the minimum NPV required by a DIP lender, who also holds some pre-petition debt. This situation is captured in the following proposition:

Proposition 3 (P:NewLender1)

For the same level of priority, the minimum acceptable NPV for a project required by a new DIP lender is higher than the one required by the loan provided by a pre-petition lender.

The intuition here is that new DIP lender must break even on the DIP loan only as it has no outstanding debt. An existing borrower will be willing to finance a project with somewhat lower NPV as long it leads to some increase in value of existing loan. Thus, the existing lender may be willing to invest, even if the DIP loan does not break even on a stand-alone basis, as long as the old loan recovery level is high enough.

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128 *See In re* Gen. Growth Prop., Inc., 412 B.R. 122, 126 (Bankr. S.D.N.Y. 2009).

5. *Same Priority DIP Financing from an Existing Lender vs. Higher Priority DIP Financing from a New Lender*

Another interesting issue is when a bankruptcy judge is presented with competing offers from an existing lender, who is willing to provide DIP loans at equal priority, and a new lender, who is willing to provide DIP financing at a higher priority. While at first glance it may appear unfair to grant the new lender higher priority, the investment decision would in fact depend on how large a fraction of the pre-petition loan (i.e., φ) is owned by the existing lender, who willingly provides DIP financing. This situation is formalized in the following proposition:

Proposition 4 (P:NewLender2)

DIP financing, from an existing lender at the same priority, would still lead to more investment than DIP financing at a higher priority from a new lender, only if the pre-petition lender holds a fraction $\varphi > \varphi_{min}$, where: $\varphi_{min} = \frac{V_B^E - V_B^H}{V_B^E - L}$.

This proposition captures the idea that if the old lender holds a large enough fraction of existing debt, the ability to increase the value of this outstanding debt is strong enough to induce the lender to provide DIP financing at the same priority and achieve similar investment incentives, which a new DIP lender will achieve only if granted higher priority.

B. *DIP Financing from the Pre-petition Senior Lender vs. the Pre-petition Junior Lender*

So far, we have considered a firm with only one class of pre-petition debt. In this section we examine what happens if the firm has two different classes of pre-petition debt and the DIP financing can be provided by either of them. While the basic framework of our model remains the same, the firm now has senior debt of face value B and junior debt of face value J. We assume that that there are only two pre-petition lenders with one holding the senior debt and the other holding the junior debt. We also assume that the liquidation value L of the firm is lower than B, so that both classes of creditors would lose part of the face value in case the firm is liquidated. The DIP financing is assumed to be at the same level as the senior debt.[129] If the senior creditor provides the DIP financing, the following condition must be satisfied:

$$\int_0^{Z_1} Xf(x) + \int_{Z_1}^{Z_2}(I-L+B)f(x)dx + \int_{Z_2}^{\infty}(X-J)f(x)dx - (I-L) > L \Rightarrow$$
$$\overline{X} - I > \int_{Z_1}^{Z_2}[X-(I-L+B)]f(x)dx + \int_{Z_2}^{\infty}Jf(x)dx = k_1, \qquad (13)$$
where $Z_1 = I - L + B$ and $Z_2 = I - L + B + J$.

The junior creditor would be willing to provide DIP financing if:

$$\int_0^{Z_1}\frac{I-L}{Z_1}Xf(x) + \int_{Z_1}^{\infty}(X-B)f(x)dx - (I-L) > 0 \Rightarrow$$
$$\overline{X} - I > \int_0^{Z_1}\frac{B}{Z_1}Xf(x)dx + \int_{Z_1}^{\infty}(B)f(x)dx - L = k_2. \quad (14)$$

The right-hand side of Equation 13 gives the lowest NPV project that the firm with DIP financing from it senior creditors would be able to finance. Similarly the right-hand side of Equation 14 gives the lowest NPV project for the firm with DIP financing from its junior creditor.

To examine the investment policy of the firm with DIP financing from different class of pre-petition lenders we compare k_1 and k_2 . If $k_2 - k_1 < 0$, the financing from junior creditor will lead to greater investment as the minimum cut-off level of NPV is lower in that case. From Equations 13 and 14,

$$k_2 - k_1 = \int_0^{Z_1}\frac{B}{Z_1}Xf(x)dx + \int_{Z_1}^{Z_2}Bf(x)dx + \int_{Z_2}^{\infty}Bf(x)dx - L$$
$$-\int_{Z_1}^{Z_2}(X - Z_1)f(x)dx - \int_{Z_2}^{\infty}Jf(x)dx. \qquad (15)$$

The above equation can be rewritten as

$$k_2 - k_1 = \int_0^{Z_1}\frac{B}{Z_1}Xf(x)dx + \int_{Z_1}^{Z_2}(2B+I-L-X)f(x)dx + \int_{Z_2}^{\infty}(B-J)f(x)dx - L. \qquad (16)$$

It is difficult to get sharp predictions on the investment policy of the firm from Equation 16. We restrict our analysis to the special case in which X is distributed uniformly over an interval $[0, M]$, where $M > Z_2$.[130] We further

[129] We also consider the case where the DIP financing is provided at a priority higher than the senior pre-petition debt. The results remain qualitatively the same and are not reported.

[130] Distributions with more support in respective tails have not been considered and are left for future work.

assume that $M > 2I$, this implies that the firm invests only in positive NPV projects.

Let the total indebtedness of the firm be denoted by $T = B + J$. Thus, the combination of senior and junior debt can be denoted by $(B, B - T)$. The following proposition describes the effect of the mix of total debt T on the investment incentives of the firm:

Proposition 5 (P:5) For any given level of total debt T, and for every level of senior debt B, there exists a unique level of liquidation $L_{T^*}(B)$ such that:

1. If the liquidation value of the firm $L > L_{T^*}(B)$, financing from the junior pre-petition lender would lead to higher levels of investment $(k_2 - k_1 < 0)$,

2. If the liquidation value of the firm $L < L_{T^*}(B)$, financing from the senior pre-petition lender would lead to higher levels of investment $(k_2 - k_1 > 0)$, where:

$$L_T^*(B) = \frac{B\left[1 - \frac{I + B}{2M}\right] + (T - B)\left[\frac{2I + T + B}{2M}\right]}{\left[1 - \frac{B}{2M}\right] + \left[\frac{T - B}{M}\right]}. \tag{17}$$

CONCLUSION

The Code provides unusual incentives to potential lenders to provide credit to firms reorganizing under chapter 11. These include higher priority and enhanced security for the loans commonly referred to as DIP financing.[131] Furthermore, either the existing lenders, or a new lender, can provide the DIP financing.[132] A major requirement for DIP loans is the approval from the bankruptcy court.[133] This article focuses on the implications of allowing different priority levels of DIP loans, as well as the effect of allowing pre-petition versus new DIP lender to provide DIP loans.

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131 *See* John D. Ayer et al., *Obtaining Dip Financing and Using Cash Collateral*, 23 AM. BANKR. INST. J. 16 (2004).

132 *See id.*

133 *See id.*

Our main result is that a higher level of priority for DIP loans would provide incentives to invest a larger amount. This outcome would be desirable for firms with attractive investment opportunities but with large debt overhang. Thus, for firms faced with an ''under-investment'' problem, a bankruptcy judge should allow a high priority level for the DIP financing. The increased investment may not be optimal for firms that do not have many good investment opportunities. In this case, the high priority DIP financing can lead to dissipative investment in high risk, negative NPV projects.

A bankruptcy judge should keep this risk-shifting incentive in mind when approving DIP financing and should scrutinize the higher priority DIP financing proposals more closely. Cross-collaterlization is shown to be an extreme form of high priority DIP financing and, as such, should be allowed only when there is a reasonable degree of certainty that the firm possesses good investment opportunities. In choosing between an existing or new lender to provide DIP financing, the bankruptcy judge would need to ascertain the desirability of higher investments because, for any given level of priority, DIP loans from existing lenders are likely to induce more investments. Thus, for firms faced with the ''under-investment'' problem, DIP loans from existing lenders would be optimal. For firms that are prone to risk-shifting, the higher profitability requirement of a new DIP lender would provide better monitoring.

APPENDIX

Proof of Lemma 1:

Equations 4 and 8 describe the minimum acceptable NPV for equal priority and higher priority DIP loans respectively. To prove Lemma 1, we need to show $V_B^E - V_B^H > 0$. Let $V_B^E - V_B^H = K$.

Substituting the values from Equations 3 and 7, we get:

$$K = \left(\int_0^Z \frac{B}{Z} Xf(X)dX + \int_Z^\infty Bf(X)dX \right) - \left(\int_{I-L}^Z [X-(I-L)]f(X)dX + \int_Z^\infty Bf(X)dX \right);$$

$$K = \int_0^Z \frac{B}{Z} Xf(X)dX - \int_{I-L}^Z [X-(I-L)]f(X)dX. \quad (1)$$

Since $B = Z-(I-L)$, substituting and rearranging the terms of Equation 1, we get:

$$K = \int_0^{I-L} \left(1 - \frac{(I-L)}{Z}\right) Xf(X)dX + \int_{I-L}^Z \left(1 - \frac{(I-L)}{Z}\right) Xf(X)dX - \int_{I-L}^Z [X-(I-L)]f(X)dX;$$

$$K = \int_0^{I-L} \left(1 - \frac{(I-L)}{Z}\right) Xf(X)dX + \int_{I-L}^Z (I-L)(1-\frac{X}{Z}) f(X)dX. \quad (2)$$

Since $(I-L) < Z$ and $X < Z$ over the interval $(I-L, Z)$ it follows that $K > 0$.

Proof of Proposition 1:

Follows immediately from Lemma 1, as higher priority always leads to greater investment. This higher investment is only optimal provided the borrower has enough good, positive NPV projects.

The result is intuitively appealing, as the higher priority on the DIP loan should induce the lender to finance a larger set of investment projects. Simple numerical examples illustrate the investment decisions made by the firm.

Case 1: Liquidation value is low but investment opportunities are good ($V_B^E > V_B^H > L$)

Consider a firm with pre-petition debt of face value B equal to 100, held by two lenders that equally share (φ = 0.5). The firm has a liquidation value L equal to 80. One of the existing pre-petition lenders provides the DIP financing. Further, let $V_B^H = 90$ and $V_B^E = 110$.[134] If the DIP loan is at the same priority as the pre-petition loan, then the lowest level of NPV, for which a DIP lender would be willing to lend, can be estimated using Equation 4:

$$(0.5)(110\text{-}80)=15.$$

In this case, the firm would forego all projects with expected NPV between 0 and 15. Though, if the same firm were to obtain its DIP financing at a higher priority, then the cut-off level of NPV, above which the DIP lender would be willing to finance, is (using Equation 8):

$$(0.5)(90\text{-}80)=5.$$

Thus, the firm with higher priority DIP financing invests more than the firm with equal priority DIP financing. For a firm that has investment projects that are mostly positive NPV, higher priority of DIP financing is more likely to induce value increasing investments.

Case 2: Liquidation value as well as investment opportunities are mediocre ($V_B^E > L > V_B^H$)

Again, using the example described above, let us consider a firm for which $V_B^E = 70$, $L = 60$, and $V_B^H = 50$. If the firm receives a DIP loan with equal level priority to its pre-petition loans, it undertakes all projects with a NPV equal to:

$$(0.5)(70\text{-}60)=5.$$

While the cut off NPV project for a firm with a higher priority DIP loan is:

$$(0.5)(50\text{-}60)=\text{-}5.$$

The higher priority DIP financing results in the firm investing in negative NPV projects. In this case, equal priority of DIP loans results in better investment incentives.

Case 3: Liquidation value is high and investment opportunities are poor ($L > V_B^E > V_B^H$)

Again, using the example described above, let us consider a firm for which $L = 50$, $V_B^E = 40$, and $V_B^H = 30$. If the firm receives a DIP loan with equal

134 The value of V_B^H and V_B^E would also depend on distribution $f(X)$ of cash flows as well as the liquidation value L.

level priority to its pre-petition loans, it undertakes all projects with NPV equal to:

(0.5)(40-50)=-5.

While the cut off NPV project for a firm with a higher priority DIP loan is:

(0.5)(30-50)=-10.

Here the optimal decision is to liquidate the firm. If, on the other hand, DIP financing were to happen, equal priority would cause less value destruction.

Proof of Proposition 2:

Proposition 2 implies that cross-collaterlization would lead to even higher investment than a higher priority of DIP loan, i.e., minimum level of NPV required by a lender with a cross-collaterlized DIP loan is even lower than the cut-off NPV required by high-priority DIP lender. Thus, we need to show that $V_B^H - V_B^C > 0$. Since $\varphi B + (I-L) = Z - (1-\varphi)B = T$. From Equations 7 and 11:

$$V_B^H - V_B^C = \left(\int_{I-L}^{Z} [X-(I-L)] f(X) dX + \int_{Z}^{\infty} Bf(X) dX \right)$$
$$- \left(\int_{Z}^{\infty} Bf(X) dX + \int_{T}^{Z} \frac{[X-(I+\varphi B-L)]}{(1-\varphi)} f(X) dX \right);$$
$$V_B^H - V_B^C = \int_{I-L}^{Z} [X-(I-L)] f(X) dX - \int_{\varphi B+I-L}^{Z} \frac{[X-(I+\varphi B-L)]}{(1-\varphi)} f(X) dX. \quad (3)$$

Let $X-(I-L) = S$. Rearranging the right-hand side of Equation 3, we get:

$$V_B^H - V_B^C = \int_{I-L}^{\varphi B+I-L} Sf(X) dX + \int_{\varphi B+I-L}^{Z} Sf(X) dX - \int_{\varphi B+I-L\varphi}^{Z} \frac{[X-(I+\varphi B-L)]}{(1-\varphi)} f(X) dX$$
$$= \int_{I-L}^{\varphi B+I-L} Sf(X) dX + \int_{\varphi B+I-L}^{Z} Sf(X) dX - \int_{\varphi B+I-L}^{Z} \frac{[X-(I+\varphi B-L)]}{(1-\varphi)} f(X) dX$$
$$= \int_{I-L}^{\varphi B+I-L} Sf(X) dX + \frac{1}{(1-\varphi)} \int_{\varphi B+I-L}^{Z} [(1-\varphi)S - S + \varphi B] f(X) dX$$
$$= \int_{I-L}^{\varphi B+I-L} Sf(X) dX + \frac{\varphi}{(1-\varphi)} \int_{\varphi B+I-L}^{Z} [B + (I-L) - X] f(X) dX$$
$$= \int_{I-L}^{\varphi B+I-L} Sf(X) dX + \frac{\varphi}{(1-\varphi)} \int_{\varphi B+I-L}^{Z} [Z - X] f(X) dX \quad (4)$$

Since Z is always greater than X for $\varphi B+(I-L)<X<Z$, and $S>0$ for $(I-L)<X<\varphi B+(I-L)$, the right-hand side of Equation A-4 is always positive. Thus, $V_B^H - V_B^C >$ 0.

Proof of Proposition 3:

We need to show that the minimum acceptable NPV, for a project to be acceptable to a new DIP lender, is higher than the one required by an existing lender. We derive this for the case when both the old and the new lender provide DIP loans at equal priority, and then, we derive the same result for higher priority DIP loans.

Case 1: The new lender provides financing at the same priority as the pre-petition lender

We first consider the case in which the DIP financing is provided by a new lender and at the same priority as the old loans. The incentive compatibility constraint for a new DIP lender is:

$$\int_0^Z \frac{I-L}{Z} Xf(X)dX + \int_Z^\infty (X-B) f(X)dX - (I-L) > 0$$

$$\overline{X} - I > \int_0^Z \frac{B}{Z} Xf(X)dX + \int_Z^\infty (B) f(X)dX - L$$

$$\overline{X} - I > V_B^E - L \tag{5}$$

V_B^E is as defined before in Equation 3.

Equation A-5 allows us to compare the investment policy of the firm, which obtained DIP financing from an existing lender, to the investment policy of the firm that obtained DIP from a new lender. The cut-off level of NPV for a project is (1-φ) $[V_B^E - L]$ for the firm with the DIP loan from its pre-petition lender (Equation 4). The lowest level of NPV project that is financed by a new DIP lender is $[V_B^E - L]$ (Equation A-5). Since $0 \le \varphi \le 1$, the proof follows immediately.

Case 2: The new lender provides financing at the higher priority than the pre-petition loans.

In this case, a new lender provides the DIP financing, and the DIP financing carries higher priority than the old loans.

The new lender would finance provided that:

$$\int_{0}^{I-L} Xf(X)dX + \int_{I-L}^{Z} (I-L)f(X)dX + \int_{Z}^{\infty}(X-B)f(X)dX - (I-L) > 0$$

$$\overline{X} - I > \int_{I-L}^{Z} [X-(I-L)]f(X)dX + \int_{Z}^{\infty} Bf(X)dX - L;$$

$$\overline{X} - I > V_B^H - L. \tag{6}$$

V_B^H is as defined in Equation 7.

Equation A-6 allows us to compare the investment policy of the firm, which obtained higher priority DIP financing from an existing lender, to the investment policy of the firm that obtained higher priority DIP financing from a new lender. The cut-off level NPV for a project is $(1\text{-}\varphi)[V_B^H - L]$ for the firm with the DIP loan from its pre-petition lender (Equation 8). The lowest level of NPV project, financed by a new DIP lender, is $[V_B^H - L]$ (Equation 7). Since $0 \le \varphi \le 1$, the proof follows immediately. The discussion of two cases shows that if the priority level of DIP loan by existing lender or new lender is assumed to be the same, the DIP financing by its existing pre-petition lender leads to a higher level of investment. In other words, the minimum acceptable NPV of a project is higher for a new DIP lender than the cut-off required by a DIP lender who already has loans outstanding. The intuition behind this is the fact that the new DIP lender receives the pay-off only from his DIP loan, while a pre-petition lender can achieve some additional pay-off if the value of the old loan increases. Again, for borrowers who face severe debt-overhang, but have good investment opportunities, allowing an existing lender to provide DIP financing would address the under-investment problem more effectively. If the borrower does not have many good investment projects though, the higher threshold required by a new DIP lender results in better investments.

Proof of Proposition 4:

Equation 4 provides the cut-off level of NPV required by an old lender willing to lend at equal priority, while Equation A-6 describes the same for a new DIP lender willing to lend at higher priority. The investment level would be higher for DIP loans from old lenders only if:

$$(1-\varphi)[V_B^E - L] < [V_B^H - L];$$

$$\varphi > \frac{V_B^E - V_B^H}{V_B^E - L}. \tag{7}$$

Again, the desirability of higher investment depends on the set of investment opportunities that the borrower has. If the firm needs to be provided with higher investment incentives, an equal priority DIP loan from an existing lender would achieve this outcome as long as the existing lender has a sufficiently large outstanding loan.

Proof of Proposition 5:

The intuition behind Proposition 5 is that if the firm has high liquidation value the senior creditors would suffer relatively smaller losses in case of liquidation and thus would only finance projects with relatively higher NPV. On the other hand, the junior debt-holders have little to gain from the liquidation and would finance a larger set of projects. However, if the firm has a very low liquidation value then the senior lenders would have incentives to lend as the investment would offer some probability of recovering their outstanding debt.

By assumption X: Unif $[0,M]$ hence $f(x)=1/M$.

Substituting in Equation 16 we get:

$$k_2-k_1=\int_0^{Z_1}\frac{B}{Z_1}\frac{X}{M}dx+\int_{Z_2}^{M}(B-J)f(x)dx+\int_{Z_1}^{Z_2}(2B+I-L-X)f(x)dx-L \tag{8}$$

Let us define the following:

$$T_1=\int_0^{Z_1}\frac{B}{Z_1}\frac{X}{M}dx=\frac{BZ_1}{2M}, \tag{9}$$

$$T_2=\int_{Z_2}^{M}(B-J)f(x)dx=\frac{(B-J)}{M}[M-Z_2], \tag{10}$$

$$T_3=\int_{Z_1}^{Z_2}\frac{(2B+I-L-X)}{M}dx=\frac{(2B+I-L)}{M}[Z_2-Z_1]-\frac{(Z_2)^2-(Z_1)^2}{2M}. \tag{11}$$

The Equation 8 can be rewritten as:

$$k_2-k_1=T_1+T_2+T_3-L\Rightarrow$$
$$k_2-k_1=B\left(1-\frac{Z_1}{2M}\right)+J\left(\frac{Z_1+Z_2}{2M}-1\right)-L. \tag{12}$$

If $k_2-k_1<0$, we know that the firm will invest in a larger set of projects if the DIP financing is provided by the junior creditor. If $k_2-k_1=0$, the investment decisions are unaffected by the choice of DIP lender. If $k_2-k_1>0$, the investment is higher if DIP financing is from the senior creditor.

Since $J = T - B$ substitution for J yields:

$$k_2 - k_1 = B\left(1 - \frac{Z_1}{2M}\right) + (T - B)\left[\frac{Z_1 + Z_2}{2M} - 1\right] - L. \tag{13}$$

For $k_2 - k_1 = 0$, we get the critical liquidation value:

$$L_T^*(B) = \frac{B\left[1 - \frac{I + B}{2M}\right] + (T - B)\left[\frac{2I + T + B}{2M}\right]}{\left[1 - \frac{B}{2M}\right] + \left[\frac{T - B}{M}\right]}. \tag{14}$$

Further, $k_2 - k_1$ is a decreasing function of L as shown below in Equation 15. Note that the right-hand side of Equation 15 is always negative under the assumption that $M > Z_2$.

$$\frac{\partial(k_2 - k_1)}{\partial L} = \frac{(B - 2J)}{2M} - 1. \tag{15}$$

It follows thus if L is below the critical liquidation value ($k_2 - k_1 > 0$) then the DIP financing by the senior creditor leads to greater investment. On the other hand, if L is above the critical liquidation value($k_2 - k_1 < 0$) then the DIP financing by the junior creditor leads to higher investment.

Table 1
The Hierarchy of Financing Options for a Firm Operating Under Chapter 11

Relevant Section of the Bankruptcy Code	**Features of the Financing Arrangement**	**Security and Priority of the Post-petition debt**	**Legal Requirements**
§ 363(c)(2)	Use of Cash Collateral	Not Applicable	Approval of the bankruptcy court
§ 364(a)	Debt incurred in the ordinary course of business	Unsecured, Administrative Priority	No court approval required
§ 364(b)	Debt incurred for purposes other than ordinary course of business	Unsecured, Administrative Priority	Approval of the bankruptcy court, Notice and Hearing
§ 364(c) Various subsections discussed below	Super-priority Debt		Debtor has to show that it could not get financing under Sections 364(a) or 364(b)
§ 364(c)(1)		Unsecured, Senior Administrative Priority	
§ 364(c)(2)		Lien on unencumbered assets, Senior Administrative Priority	
§ 364(c)(3)		Junior lien on unencumbered assets, Senior Administrative Priority	
§ 364(d)	Primed Debt	Secured by a senior or equal lien on assets already subject to lien or pledge	Same as Section 34(c) and show that existing holders of the security are adequately protected
§ 522(b)	Cross-collateralization	Collateral securing the pre-petition as well as post-petition debt	Court Approval (rarely given)

Table 2

Priorities of Major Creditor Classes for a Chapter 11 Firm

Priority Rank	**Claim and Relevant Priority Section**
	The primed lien DIP loans under § 364 (d).
	Secured claim holders (up to the value of collateral) under § 506 (a).
	Super-priority claims of the DIP lender under § 364 (c).
	Administrative claims under § 507 (a) (1), § 503 (b), § 364 (a) and § 364 (b).
	Involuntary gap creditor claims under § 507 (a) (2) and § 502 (f).
	Unsecured claims (including the shortfall of collateral for secured claims) § 506 (a).

An Overview of Debtor in Possession Financing

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Introduction

When companies with existing credit facilities are in financial distress, whether as a result of adverse market forces, covenant or other defaults under their debt facilities or unexpected business interruption, they may lose access to liquidity under their existing credit facilities or face the potential exercise of remedies by lenders under their existing credit facilities. In such circumstances, since a leveraged company's assets are typically pledged to secure its existing indebtedness, it is nearly impossible to attract new capital to continue operations or to refinance existing debt. A chapter 11 bankruptcy can provide such a distressed company with an opportunity to obtain financing in the form of debtor in possession financing ("DIP Financing").

DIP Financing provides a lifeline to companies that would otherwise run out of cash and have no ability to satisfy near-term obligations, including debt service, payroll, rent and other operating expenses. Lenders may be willing to provide DIP Financing to otherwise non-credit-worthy companies because they receive lender protections that are not available outside of a chapter 11 process, including the ability to prime existing liens, court approval of the financing terms to avoid future challenges by other creditors and strict controls on how the borrower spends the funds.

While the benefits to the debtor are obvious, creditors and lenders have strategic incentives to provide or consent to the DIP Financing. As a simple economic matter, DIP Financings typically have higher interest rates and fees than lenders can obtain outside of chapter 11 for similar loans, and are a relatively safe investment due to the protections afforded by the Bankruptcy Code and the Bankruptcy Court. As a result, DIP Financing is a relatively safe high yielding investment.

In addition, the debtor's existing pre-bankruptcy lenders frequently use the various mechanisms available to DIP lenders to help protect their existing investment in the debtor and, in some cases, make a play for ownership of the reorganised entity post-emergence through the DIP Financing. An understanding of the basics of DIP Financing and how the various and often conflicting interests of the debtor, its DIP lenders, and creditors are addressed within a chapter 11 case provides a crucial insight into one of the driving forces of the reorganisation process.

DIP Financing Under the Bankruptcy Code

DIP Financing, like other aspects of chapter 11 bankruptcy, is governed by chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code").[1] Specifically, section 364 of the Bankruptcy Code authorises DIP Financing arrangements by allowing the "debtor" to obtain post-petition (i.e., post-bankruptcy filing) credit.[2] It also incentivises both new and existing lenders to make loans by offering them special protections.

If the debtor needs to incur unsecured debt outside the ordinary course of business during the pendency of the chapter 11 case, it must obtain approval of the Bankruptcy Court under section 364(b) of the Bankruptcy Code. To encourage lenders ("DIP Lenders") to extend unsecured financing to a debtor, the Bankruptcy Code provides DIP Lenders with an administrative expense priority under section 503(b) of the Bankruptcy Code. Being granted a priority as an administrative expense means that a DIP Lender's claim for repayment of the unsecured DIP Financing will have priority over all other pre-petition unsecured claims, which must be paid in full, in cash in order for the debtor to emerge from bankruptcy, unless otherwise agreed to by the lender.

Often, a simple administrative expense priority is insufficient to induce lenders to provide unsecured DIP Financing. If the debtor is unable to obtain unsecured financing, the Bankruptcy Court may authorise a debtor to obtain secured financing under section 364(c) of the Bankruptcy Code. Under section 364(c), the DIP Lender's DIP Financing will be given a superpriority over any and all other administrative expenses of the estate along with a security interest in any unencumbered assets, or a junior lien on already encumbered assets. Credit obtained under section 364(c) not only requires the approval of the Bankruptcy Court, but also requires the debtor to prove to the court that it could not obtain financing on an unsecured basis.

If the debtor is still unable to obtain sufficient funding secured only by previously unencumbered assets and a junior lien on already encumbered assets, the debtor can obtain secured financing under section 364(d) of the Bankruptcy Code. Under that section, a debtor can also offer a priming lien, which is a lien on collateral senior to existing, pre-petition liens on such collateral and requires the DIP Lender's claims to be paid prior to the payment of claims by the existing lenders secured by the same collateral, regardless of whether the source of payment is the sale of proceeds of the common collateral. Financings under section 364(d) are similar to financings authorised under 364(c) in the sense that this section is only available to the debtor if the debtor proves to the Bankruptcy Court that, without a priming lien, it could not otherwise obtain such financing. This ability to offer a priming lien on already encumbered assets is not available outside of chapter 11 and is one of the primary reasons that debtors can attract DIP Financing in chapter 11 when access to credit, even secured debt, was unavailable outside of bankruptcy.[3]

While the ability to prime liens is of great benefit to DIP Lenders, because of the impact such liens have on the interests of the existing secured lenders, the Bankruptcy Code provides significant protections to the existing lenders whose liens are being primed. If the debtor seeks to prime existing liens, the debtor must either obtain consent from the lenders being primed or it must ensure that the interest of such lenders in the collateral is adequately protected against diminution of value resulting from the priming. Adequate protection, as defined in section 361 of the Bankruptcy Code, may include:

1. a cash payment or periodic cash payment by the debtor to the creditor to the extent that the value of the creditor's collateral depreciates or otherwise decreases;
2. an additional or replacement lien to make up for any decrease in the value of the creditor's collateral; or
3. granting such other relief as will result in the realisation of the "indubitable equivalent" of the creditor's interest in the collateral.

Existing lenders will typically resist getting primed and will challenge the adequacy of the protections being offered. Insofar as a contested priming fight can be a very difficult, highly contentious, and destabilising proceeding for the business, debtors typically try to avoid a "priming fight" in the early stages of its case and will seek consent from the existing lenders or negotiate with them to provide the DIP Financing. As a result, the priming DIP Financing is generally provided by existing lenders who prime their own existing liens as well as the liens of the co-lenders who do not participate in the DIP Financing.

Additional DIP Lender Incentives

There are a number of other reasons why a lender would be attracted to providing DIP Financing. First, DIP Financing typically provides lenders with relatively higher rates of interest than they would otherwise receive outside of chapter 11. The highest interest rate for DIP financings in 2019 was 20% in the chapter 11 cases of Remnant Oil and Generation Next Franchise Food Brands. On a sector basis, the highest interest rates came from the technology sectors, averaging 11.3% overall, followed by the energy sector at 8.6%, and the consumer staples sector at 8.3%.[4]

In addition, DIP Financing is a way for the debtor's existing lenders to safeguard the value of their existing loans to the company. In many cases, were the debtor forced to liquidate precipitously after running out of funds, such lenders would almost certainly be faced with significantly lower recoveries on their loans. DIP Financing signals to vendors and customers that the debtor has sufficient capital to continue operations during the bankruptcy process or to conduct an orderly sale or liquidation process that can help maximise the existing lender's recovery.

Furthermore, existing secured lenders may provide the DIP Financing as a defensive measure, as they may not want outside lenders to obtain junior or priming liens on the collateral that is already securing their loans or senior liens on unencumbered assets. Given their existing investment in the company, existing lenders often want to control their own destiny by providing the financing and dictating the direction and timeline of the chapter 11 proceeding. They risk losing such control if a third party lender comes in and provides the DIP Financing.

Lenders are always able to exert some control over their borrower through negotiated covenants in loan documents outside of bankruptcy. However, since typical corporate lending is not set up to closely monitor the borrower and close supervision has in some cases resulted in lender liability claims, outside of bankruptcy, lenders are typically hesitant to micromanage a borrower's actions. DIP Lenders' third party monitoring expenses are paid by the debtor. Moreover, the terms of their loans and the controls placed up on the debtor are approved by the Bankruptcy Court, and thus DIP Lenders are insulated from lender liability and similar claims. DIP Lenders can exert significant control over the debtor by requiring, among other things, strict compliance with an agreed-upon weekly budget and financial and non-financial covenants, detailed and frequent reporting, appointment of a chief restructuring officer acceptable to the DIP Lenders, and compliance with milestones for a condensed chapter 11 timeline.

While these controls keep a tight rein on the debtor's expenditures and provide the lender with very early warnings if the company deteriorates further, the DIP Financing milestones also provide the DIP Lender with significant control over the timing and direction of the case. For example, the DIP Financing may require the debtor to obtain court approval of a chapter 11 plan on an expedited timeline. The DIP Financing may also require a sale of substantially all of the debtor's assets under section 363 of the Bankruptcy Code if the plan milestones are not met.[5]

Where the DIP Lenders do not believe that a reorganisation of the debtor will be feasible or where they believe such reorganisation would be too costly or time-consuming, the DIP lenders may require the debtor to engage in a sale process quickly at the outset of the case. For example, given the current market pressures in the retail space, it is not uncommon for DIP Lenders providing financing to retailers to require a sale to occur within the first 30 to 60 days of the bankruptcy case.

A Bankruptcy Code 363 sale may be required by the DIP Financing (either from the outset or due to the debtor failing to meet a milestone). In such event, the DIP Lender has the advantage of being able to credit bid its secured claim under section 363(k) of the Bankruptcy Code. With a credit bid, a DIP Lender can use the amount of its secured claim to pay all or a portion of the sale price in an auction for the assets being sold, which protects the DIP Lender's interest in its collateral and ensures that its secured claim will not be undervalued.

Finally, existing pre-petition lenders that provide the DIP Financing may also negotiate for other special protections such as roll-up and cross-collateralisation provisions to ensure that their pre-petition claims are given priority over the claims of other pre-petition creditors. Roll-up provisions typically require the debtor to draw on the DIP Loan to pay off either some or all of the lender's pre-petition claims. In other words, the lender's pre-petition debt is "rolled up" into post-petition debt, which improves the lender's prospect of receiving a recovery on its pre-petition investment by elevating its pre-petition claim to a post-petition secured claim with a superpriority administrative expense status.

Cross-collateralisation is another avenue the parties may take to achieve the same result. Those provisions grant a debtor a security interest in otherwise unencumbered assets of the company for both the DIP Lender's pre- and post-petition claims.

It is worth noting that neither roll-ups nor cross-collateralisation are expressly authorised under section 364 of the Bankruptcy Code. Further, the improvement of the status of a DIP Lender's pre-petition claim over that of similarly situated pre-petition claims also conflicts with the general bankruptcy equitable principle that members of the same class of pre-petition claims receive equal treatment. Nevertheless, if the debtor has no other source of financing and lenders will not otherwise extend credit to the debtor without such provisions, Bankruptcy Courts frequently approve these provisions.

Lenders in syndicated credit facilities often take advantage of these benefits, as well as the ability to prime liens, to advantage their position over the other lenders within their credit facility. It is not unusual for several of the largest lenders under the existing facility to propose a DIP Financing that rolls up the pre-petition debt of the participating lenders and primes all of the liens securing the credit facility held by the non-participating existing lenders. If this group of lenders comprise the "required lenders" under the credit agreement, they may be able to direct the agent to consent to the priming of the liens and thus through the roll-up. Upon the roll-up, both the new money as well as their existing loans will become senior to the other lenders with whom they were previously *pari passu*. Of course, the minority lenders often object to such financing and may be afforded the opportunity to participate in the financing to resolve their objections.

Negotiating DIP Financing

Negotiating the DIP Financing is often undertaken during a compressed period of time, while the company is under significant financial strain and on the verge of running out of money. Given that the debtor is *in extremis* and often has no other options, DIP Lenders have significant leverage. Nevertheless, the Bankruptcy Court approval process helps to balance the leverage as the Bankruptcy Court may ultimately not approve provisions that it views as too onerous.

When negotiating the DIP Financing, as an in initial matter, the parties must agree on the type of chapter 11 case such as whether the case will involve a quick liquidation, an organised sale process or a lengthier reorganisation proceeding. Based on that, the parties must negotiate and agree upon the amount of financing needed and the structure of the loan. Depending on the anticipated length of the chapter 11 case and the agreed use of proceeds, the DIP Financing may be comprised of a term loan and/or a revolving credit facility (including asset-backed facilities). The parties also must negotiate the economic terms, the collateral securing the DIP Financing, including the interests to be primed, affirmative and negative covenants and other special protections like roll-ups and cross-collateralisation.

Determining the amount of DIP Financing required for a chapter 11 process is more complicated than simply determining the amount of money needed to keep the business' operations running at the status quo and pay for the chapter 11 case. It also involves a strategic analysis of how new financing might impact the perception of the company among its vendors and suppliers. Often, by the time a company has filed for bankruptcy, all trade credit has dried up and the company is operating on a cash-on-delivery basis. A key assumption in any DIP Financing budget is whether and how quickly trade credit will return. Given the strict budget compliance requirements, wrong assumptions on issues such as trade credit can quickly lead to a default under the DIP Financing.

DIP Financings are evidenced by loan documents that can be based on the loan documents for the debtor's existing debt. Even though the Bankruptcy Court order is sufficient to constitute a perfected priority security interest on collateral, DIP Lenders will typically document their security interests in collateral and take actions otherwise required by law to perfect those security interests. While it is generally the case that DIP Financings are made pursuant to executed loan documents, the Bankruptcy Court has the ability to approve DIP Financing terms, including priming liens, based on a term sheet which it may do under exigent circumstances, and the debtor and DIP Lenders will subsequently negotiate and execute loan documents.

Court Approval of DIP Financing

In any situation requiring court approval for DIP Financing, the debtor will need to file a motion with the Bankruptcy Court for authorisation to obtain post-petition credit ("DIP Motion"). The DIP Motion will be accompanied by the proposed order to be granted by the court ("DIP Order"), the underlying loan documents, as well as affidavits by the debtor explaining the process by which the financing was obtained and the need for the financing. Frequently, due to the short time frame before the filing, the parties are still negotiating the loan agreement when the motion is filed, so they may only attach to the motion a commitment letter or drafts of the loan agreement.

Approval of the DIP Financing is often a two-step process. As the DIP Motion is often filed on the first day of the bankruptcy case without the opportunity for the creditors of the debtor to receive more than a day or two's notice, the Bankruptcy Code only permits the bankruptcy judge to grant interim approval of the amount of the DIP Financing necessary to avoid irreparable harm to the debtor. The Bankruptcy Court will then hold a hearing during the first few days of the case to consider approval of disbursal of a portion of the DIP Financing on an interim basis. Thereafter, notice of the financing will be provided to all of the debtor's creditors and the court will hold a hearing at least 14 days later to consider final approval of the DIP Financing.

Because of the bifurcated hearing process, it is fairly common for creditors and creditors' committees to raise objections to the financing at the final hearing. Often, these objections will focus on the milestones and other controls placed on the debtor by the lender, the roll up and/or cross collateralisation and other protections and benefits built into the DIP Financing. Whether the court will approve these provisions despite the creditors' objections will often depend on the court's perceptions as to whether the lenders would still make the financing available even if the court cuts back or eliminates such protections and benefits.

Conclusion

With the continued need of chapter 11 restructuring for large and complex businesses, the importance of understanding the role that DIP Financing plays in such restructurings remains crucial to debtors and lenders alike. Financially distressed companies should allow as much time as possible to investigate the terms of all available sources of financing, and the challenges that each potential lender presents to its restructuring efforts. Lenders, on the other hand, should evaluate and weigh the benefits available as the provider of the DIP Financing. To do this, they must understand the full array of available protections and strategic control they may be able to exert on the debtor's case to best position themselves and protect their pre- and post-petition investments.

Endnotes

1. During a chapter 11 case, the debtor generally continues operations and restructures its debt under the Bankruptcy Court's protection and oversight, or can otherwise conduct an orderly liquidation or sale process. This is different than a chapter 7 case where a trustee is appointed to conduct a liquidation process.
2. A company operating under chapter 11 is referred to as the "debtor". Because the debtor remains in possession of its assets and its board remains in place, it is referred to as the debtor in possession.
3. There are many factors that may affect a lender's decision not to extend credit to a financially distressed company that has not yet filed for bankruptcy protection, such as potential avoidance actions or the impact of the automatic bankruptcy stay of creditor remedies.
4. Reorg Research, *2019 Year in Review* (Jan. 13, 2020).
5. Section 363 of the Bankruptcy Code provides, among other things, for the sale of a debtor's assets free and clear of all liens, claims, encumbrances and interests of third parties.

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ARTICLE

Debtor-in-Possession Financing in Reorganisation Procedures: Regulatory Models and Proposals for Reform

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Abstract

A situation of insolvency hinders a firm's ability to obtain external finance. As a result, viable but financially distressed firms might be unable to keep operating and pursuing value-creating investment projects. Consequently, value can be destroyed for debtors, creditors, employees, suppliers and society as a whole. To address this problem, several jurisdictions around the world have adopted a system of rescue or debtor-in-possession ('DIP') financing that seeks to encourage lenders to extend credit to viable but financially distressed firms. They do so by providing DIP lenders with different forms of priority that typically range from a basic administrative expense priority to the possibility of becoming a junior or, in some jurisdictions, even a senior secured creditor. After analysing the regulatory framework of DIP financing in more than 30 jurisdictions in Asia, Latin America, Europe, Africa and North America, this article shows that there are many similarities in the regulation of DIP financing around the world. Yet, there are also significant divergences, especially when it comes to the type of priority that DIP lenders can obtain as well as the system for the approval of DIP financing. The article concludes by examining the risks and costs potentially created by a DIP financing regime. It also discusses whether, and if so how, countries should adopt DIP financing provisions taking into account their legal, economic and institutional environment.

Keywords DIP financing · Rescue · Finance · Creditors · Priority · Security interest · Courts

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1 Introduction

A situation of insolvency hinders a firm's ability to obtain external finance. As a result, viable but financially distressed firms might be unable to keep operating and pursuing value-creating investment projects. Consequently, value can be destroyed for debtors, creditors, employees, suppliers and society as a whole. To address this problem, several jurisdictions around the world have adopted a system of rescue or debtor-in-possession ('DIP') financing that seeks to encourage lenders to extend credit to financially distressed firms.[1] They do so by providing DIP lenders with different forms of priority that typically range from a basic administrative expense priority to the possibility of becoming a junior or, in some jurisdictions, even a senior secured creditor. Thus, insolvency law can serve as a liquidity provider for viable but financially distressed firms.[2]

This article seeks to provide an economic and comparative analysis of DIP financing provisions in reorganisation procedures. To that end, Sect. 2 starts by analysing the rationale of DIP financing. Section 3 examines the different approaches and regulatory models for the treatment and approval of DIP financing generally observed around the world. Section 4 highlights some of the risks and costs potentially created by a DIP financing regime. Section 5 discusses whether, and if so how, countries should adopt DIP financing provisions. Section 6 concludes.

2 Rationale of DIP Financing

The existence of a DIP financing regime can be justified on the basis of several arguments. First, when a firm becomes insolvent, employees, lenders and suppliers may have incentives to terminate their business relationships with the insolvent firm even if it is economically viable. In the absence of any mechanism to incentivise the debtor's counterparties to keep providing labour, loans, goods and services, value can be destroyed.[3] In many cases, this loss of value can make viable firms become non-viable businesses that should be shut down.[4] Therefore, a DIP financing regime can contribute to the preservation of viable businesses that would otherwise disappear.

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[1] This article will use the terms 'DIP financing', 'rescue financing', 'new financing' and 'post-petition financing' interchangeably. Likewise, the terms 'insolvency law' and 'bankruptcy law' will be used as synonyms.

[2] See Ayotte and Skeel Jr (2013).

[3] For the benefits and rationale of DIP financing, see Triantis (2020).

[4] A firm is no longer viable when the value of the assets on a break-up basis exceeds the value of the business as a going concern. See Armour (2001). This definition seems consistent with the concept of 'economically inefficient firms' also used in the economic literature. See White (1989); White (1994). For other authors, however, a business is not economically viable if the firm's revenues cannot cover its costs, exclusive of financing costs. See Schwartz (2005), pp 1200–1201. Regardless of the definition of viability potentially chosen, the loss of suppliers, employees, lenders and other stakeholders can reduce the firm's ability to generate revenues, ultimately destroying going-concern value and making viable firms become non-viable businesses.

Second, the inability of financially distressed companies to obtain new financing may also prevent these firms from pursuing investment projects with positive net present value ('NPV'), leading to an *underinvestment* problem.[5] As a result, the lack of financing will hamper the maximisation of the value of the firm as well as the creation of jobs and wealth in society.[6] Moreover, when a company is heavily indebted, the shareholders may have no incentive to fund new investment projects with positive NPV as they know that, due to the company's financial situation, most (if not all) of the project's payoff will go to the creditors while the shareholders will bear any losses associated with the new investments.[7] Thus, the existence of this problem may lead to another situation of underinvestment that can destroy value for the creditors and society as a whole.[8]

Third, the loss of value – in terms of actual losses or at least opportunity cost – experienced by viable but financially distressed firms unable to obtain credit will reduce the recovery rate of creditors in insolvency proceedings. *Ex post*, this situation will undermine the financial position of the creditors involved in an insolvency proceeding, even leading to other insolvencies – especially among non-diversified creditors highly exposed to the debtor's default.[9] Moreover, the inability of the insolvency system to minimise losses for financial creditors may increase the levels of non-performing loans in the banking sector, sometimes jeopardising the stability of the financial system.[10] *Ex ante*, the expectation of receiving lower recoveries in a hypothetical event of insolvency will make lenders more reluctant to extend credit.[11] As a result, this will lead to an undesirable increase in the cost of debt that can ultimately harm firms' access to finance and the promotion of economic growth.[12]

Fourth, obtaining new financing can send a positive signal to the market by showing that lenders believe in the viability of the company.[13] Consequently, it can encourage other lenders, suppliers, and employees to keep dealing with the firm, increasing the likelihood of completing a successful reorganisation.[14]

Lastly, a DIP loan can often lead to an improvement in the corporate governance of insolvent firms.[15] Namely, DIP lenders may impose certain conditions that can create value.[16] In fact, where the company has an inefficient management team, the

5 See Myers (1977).

6 See Ayotte and Skeel Jr (2013).

7 An underinvestment problem exists when a company cannot pursue value-creating investment projects. See Myers (1977); Franks and Sanzhar (2006). See also Parrino and Weisbach (1999).

8 See Myers 1977). By contrast, an overinvestment problem exists when a company pursues investment projects that should not be undertaken. See Berkovitch and Kim (1990).

9 From an empirical perspective, analysing the harmful 'domino effect' potentially generated by a situation of insolvency, see Benmelech et al. (2014).

10 See Menezes et al. (2021).

11 Armour et al. (2015).

12 Ibid.

13 Elayan and Meyer (2001).

14 Ibid.

15 Skeel Jr (2003).

16 Ibid., at p 919.

power of DIP lenders to replace or influence management can contribute to the survival and successful reorganisation of the insolvent firm. [17]

3 Regulation of DIP Financing: A Comparative Perspective

3.1 The Treatment of DIP Financing

The treatment of post-petition financing and the type of priority potentially obtained by DIP lenders differ across jurisdictions. Depending on the different forms of priority available to DIP lenders, this article distinguishes four regulatory models of DIP financing, summarised in Table 1. The first model includes jurisdictions, or procedures within a jurisdiction, that do not provide any form of DIP financing provisions. The second regulatory model includes regimes where DIP lenders can obtain an administrative expense priority and, in some jurisdictions, a security interest over unencumbered property.[18] Due to the limited forms of priority potentially offered to DIP lenders, this regulatory approach will be classified as a weak DIP financing regime. The third regulatory model, classified as a semi-strong DIP financing regime, includes systems where DIP lenders can get several forms of priority, including an administrative expense priority, a security interest over unencumbered property, and a junior lien over encumbered property. Finally, the fourth regulatory model includes regimes with strong or comprehensive DIP financing provisions where DIP lenders can enjoy several forms of priority that generally include an administrative expense priority, a priority over all other administrative expenses, a security interest over unencumbered property, as well as junior and senior liens.

[17] Ibid., at p 931.

[18] For the purpose of this article, the term 'administrative expense priority' will be used broadly. Namely, it will include expenses generated by the procedure, such as fees charged by insolvency professionals, as well as debts and expenses incurred during the procedure. While administrative expenses generally enjoy a priority in most jurisdictions, the precise treatment of administrative expenses in the ranking of claims differs across jurisdictions. For example, in some jurisdictions, such as the United States, the proceeds generated by the sale of encumbered assets cannot be used to pay administrative expenses. Nonetheless, administrative expenses enjoy the highest level of priority over the debtor's *unencumbered* assets. In other jurisdictions, however, such as Brazil, administrative expenses are paid ahead of *secured* creditors. Thus, in the context of DIP financing, DIP lenders extending credit on an unsecured basis can ironically enjoy a better treatment than those obtaining a senior lien. For that reason, some authors have argued that, even if priming an existing lien is not formally allowed under the DIP financing provisions existing in Brazil, the controversial ranking of claims existing under Brazilian insolvency law leads to a *de facto* priming of existing liens when DIP lenders obtain an administrative expense priority. See Cavalli (2023). This situation leads to two general approaches to prime existing liens in the context of DIP financing. First, existing liens can be primed *directly* and *individually* by providing DIP lenders with a lien that will immediately affect the position of a particular secured creditor. Second, existing liens can also be primed *indirectly* and *collectively* by providing DIP lenders with a priority over the debtor's pre-existing secured creditors. Since this latter scenario is generally the result of a policy decision made when defining the ranking of claims rather than the design of DIP financing provisions, this article will focus on the former approach to prime existing liens, which is the approach followed in countries with more comprehensive DIP financing regimes such as the United States and Singapore. Yet, Sect. 5.2.4 will provide various policy recommendations for countries where obtaining new financing indirectly means priming pre-existing liens.

Table 1 Regulatory models of DIP financing

Regulatory model	Types of priority	Procedure/jurisdiction
No DIP financing regime	N/A	Most hybrid procedures, including the scheme of arrangement in Australia, Bermuda, Canada, Cayman Islands, Hong Kong, India, New Zealand, Nigeria, South Africa, United Kingdom and Virgin Islands
Weak DIP financing regime	Administrative expense priority Security interest over unencumbered property	Formal reorganisation procedures in most jurisdictions around the world, including Argentina, Australia, Brunei, Chile, China, Ecuador, Ghana, Italy, Indonesia, Japan, Malaysia, Mexico, Myanmar, New Zealand, Nigeria, South Africa, South Korea, Spain, Thailand, United Kingdom and Uruguay Hybrid procedures in France, Germany, Italy, Netherlands and Spain
Semi-strong DIP financing regime	Administrative expense priority Security interest over unencumbered property Junior lien over encumbered property	Brazil (judicial reorganisation) Dominican Republic (restructuring) India (corporate insolvency resolution process) Philippines (court-supervised rehabilitation)
Strong DIP financing regime	Administrative expense priority Priority over other administrative expenses Security interest over unencumbered property Junior lien over encumbered property Senior lien over encumbered property	United States (Chapter 11 reorganisation procedure) Singapore (scheme of arrangement and judicial management) Colombia (reorganisation) (*) (*) *DIP regime adopted temporarily*

However, it should be noted that, for the purpose of this article, the classification of a DIP financing regime as weak, semi-strong or strong does not depend on the ranking of DIP lenders in the event of liquidation or the level of protection that pre-existing creditors may get under a particular DIP financing regime. Instead, the proposed classification of DIP financing regimes is exclusively based on how comprehensive the system of DIP financing is from the perspective of the different forms of priority potentially offered to DIP lenders. For instance, in some countries, DIP lenders can only obtain an administrative expense priority and a new lien. Under the proposed classification of DIP financing regimes, countries adopting this approach would be classified among those with weak DIP financing provisions due to the limited forms of priority potentially offered to DIP lenders. Nonetheless, in some jurisdictions, administrative expenses are paid ahead of most (if not all) creditors, including secured creditors.[19] Thus, even if DIP lenders cannot get many forms of priority, this 'weak' DIP financing regime can still be more attractive to DIP lenders than other regimes potentially offering other forms of priority that may rank lower. Similarly, the proposed classification of DIP financing regimes does not take into account how attractive a DIP financing regime is from the perspective of the debtor's pre-existing creditors. As will be explored below, this aspect will depend on the system for the approval of DIP financing, as well as a variety of country-specific factors.

3.2 The Approval of DIP Financing

As shown in Table 2, this article also identifies several systems for the approval of DIP financing. First, there are systems where the new financing needs to be authorised by the court in charge of managing the insolvency proceeding. This type of court-led model for the approval of DIP financing is the approach traditionally existing in the United States, and it has also been adopted in other jurisdictions around the world, including Brazil, Colombia, Singapore and the Philippines. Second, other jurisdictions require that the new financing needs to be approved by the insolvency practitioner ('IP') appointed to manage or supervise the procedure. This type of IP-led model for the approval of DIP financing is generally followed in administration-style procedures existing in countries like the United Kingdom, Ghana, Nigeria and Australia. It has also been adopted in some civil law countries where insolvency proceedings often require the appointment of an insolvency practitioner to replace or supervise the debtor, as happens in Spain.[20] The third approach consists of providing creditors with the power to approve or veto the new financing. This type of creditor-led approach has been adopted in jurisdictions such as Chile (for DIP loans exceeding 20% of the debtor's liabilities), India and the Dominican Republic.[21] Finally, a

[19] For example, this scenario can be found in Brazil. See Cavalli (2023). It can also be found in India. See Insolvency and Bankruptcy Code of 2016, ss 5(13) and 53.

[20] See Insolvency Act 2020, Art. 242 – 10º.

[21] In Chile, see Insolvency Act of 2014 (Law 20,720), Art. 74. In the Dominican Republic, see Law 114 – 15 of 2015 on Restructuring and Liquidation of Companies, Art 87. In India, see Insolvency and Bankruptcy Code 2016, s 25I.

Table 2 Systems for the approval of DIP financing

Regulatory model	Jurisdiction
Court-led model	Brazil, France, Italy, Philippines, United States, Singapore
Debtor-led model	United States (for debts in the ordinary course of business)
IP-led model	Australia, Brunei, Ghana, Nigeria, Malaysia, United Kingdom, South Africa, Spain
Creditor-led model	Chile (for DIP loans exceeding 20% of the debtor's liabilities), Dominican Republic, India

fourth approach for the approval of DIP financing consists of allowing the debtor itself, without the approval of any third party acting as a 'gatekeeper', to obtain new financing and grant priority status to DIP lenders. This debtor-led model often applies in the context of debts in the ordinary course of business, as happens in the United States.[22]

3.3 A Closer Look at DIP Financing Regimes

3.3.1 Regimes with no DIP Financing Provisions

Jurisdictions not providing any form of DIP financing provisions in *formal* reorganisation procedures are rare.[23] In most jurisdictions, post-petition debts and expenses enjoy some forms of priority. As a result, jurisdictions without any type of DIP financing provisions are generally those without formal reorganisation procedures, such as Hong Kong and the Cayman Islands.[24] Despite the lack of a formal reorganisation procedure, however, jurisdictions like Hong Kong and the Cayman Islands still provide debtors with a debt restructuring tool: a scheme of arrangement.[25] This procedure also exists in many other jurisdictions around the world, including Australia, Bermuda, Canada, India, New Zealand, Nigeria, Singapore, South Africa, the United Kingdom and Virgin Islands.

Traditionally, a scheme of arrangement has only provided debtors with very limited tools to achieve a debt restructuring.[26] In the typical scheme of arrangement, the primary tool existing to facilitate a debt restructuring is a majority rule (or

[22] Bankruptcy Code, s 364(a). In other countries, such as Spain, *expenses* generally incurred as part of the debtor's ordinary course of business enjoy an administrative expense priority. See Insolvency Act 2020, Art. 242 – 11º. Nonetheless, new debts need to be authorised by the insolvency practitioner appointed to manage or supervise the insolvency proceeding, see Insolvency Act 2020, Art. 242 – 10º.

[23] For the concept of formal reorganisation procedures, and how they differ from completely out-of-court restructuring and hybrid procedures, see Garrido (2012), pp 1–52.

[24] Ibid.

[25] For a comprehensive analysis of the scheme of arrangement, see Payne (2014).

[26] Ibid.

intra-class cramdown). Based on this provision, a scheme of arrangement can be approved even if there are some dissenting creditors within a class. Therefore, the majority rule can reduce some of the holdout problems potentially existing in an out-of-court restructuring ('workout'). In some jurisdictions, however, the scheme of arrangement may include additional features. For instance, in Malaysia, debtors can enjoy a moratorium.[27] Also, an approved liquidator is appointed to assess the viability of the scheme.[28] In Singapore, the scheme of arrangement existing prior to the 2017 reforms provided debtors with a limited moratorium.[29] Since 2017, debtors conducting a scheme of arrangement in Singapore have access to many other restructuring tools, including a more powerful moratorium and a comprehensive system of DIP financing.[30] However, with the exception of Singapore, most schemes of arrangement around the world do not provide any form of DIP financing provisions.

Another procedure potentially used for debt restructuring that generally lacks DIP financing provisions is the company voluntary arrangement (CVA) existing in several jurisdictions, such as the United Kingdom, Nigeria and Brunei. As happens with the scheme of arrangement, this procedure provides debtors with very limited tools to facilitate a debt restructuring. Essentially, the CVA generally provides a majority rule that facilitates the adjustment of the debtor's liabilities or certain types of liabilities (e.g., unsecured creditors). Depending on the country or the type of company using the procedure, it can also provide a moratorium and may require the appointment of a supervisor.[31] DIP financing provisions, however, are not generally available in this procedure.

Nonetheless, it should be noted that the fact that a country or a particular procedure does not provide DIP financing provisions does not necessarily mean that DIP lenders might not enjoy a priority. For example, during a scheme of arrangement, the law does not generally prevent new lenders from getting either a security interest over the debtor's unencumbered assets or even a junior lien. In some jurisdictions, however, this type of transactions can be challenged *ex post*, especially if the debtor was already insolvent at the moment of providing the security interest. For that reason, various jurisdictions, particularly in Europe, have adopted certain provisions to protect these transactions from future avoidance actions and facilitate new financing in hybrid procedures.[32]

3.3.2 Regimes with Weak DIP Financing Provisions

3.3.2.1 Regimes with Weak DIP Financing Provisions in Formal Reorganisation Procedures Due to the importance of facilitating new financing to viable but insolvent

[27] Companies Act 2016, s 368.

[28] Companies Act 2016, s 367.

[29] Secured creditors were not affected by this moratorium though.

[30] McCormack and Wai (2019); Gurrea-Martinez (2022a)

[31] The possibility of obtaining a moratorium exists, for example, under the CVA in Brunei. It used to exist in the United Kingdom but only for small companies. Since the enactment of the Corporate Insolvency and Governance Act 2020, this moratorium is no longer available. Instead, a moratorium for all types of companies is available under the new restructuring framework.

[32] These countries include Spain and Italy. See n. 45.

firms, formal reorganisation procedures are generally designed to embrace at least a weak DIP financing regime.[33] Under this regulatory model, DIP lenders can get an administrative expense priority. Additionally, jurisdictions adopting this model often allow DIP lenders to obtain a security interest over the debtor's unencumbered property.

DIP lenders can get an administrative expense priority in the formal reorganisation procedures existing in most jurisdictions around the world, including Argentina, Australia, Brunei, Chile, China, Ecuador, Italy, Indonesia, Japan, Malaysia, Mexico, Myanmar, New Zealand, Nigeria, South Africa, South Korea, Spain, Thailand, the United Kingdom and Uruguay.[34] In some of these countries, such as Australia, Italy, Spain, Uruguay and the United Kingdom, the debtor can also provide DIP lenders with a security over unencumbered property.

The approval of new financing significantly differs among those jurisdictions that have adopted this regulatory model. For example, in jurisdictions with an administration-style procedure, such as the United Kingdom, Brunei and Malaysia, the insolvency practitioner appointed to manage the procedure is typically the actor entitled to borrow money and grant security over the property of the company.[35] In other jurisdictions that have implemented this weak form of a DIP financing regime, however, the approval of new financing may require the involvement of courts, the committee of creditors, or both. For instance, in China, new financing should be approved by the court or the creditors' committee.[36] In Uruguay, court approval

[33] For the purposes of this article, formal reorganisation procedures will exclude hybrid procedures (including scheme of arrangements) and out-of-court restructuring procedures ('workouts').

[34] For Argentina, see Art. 240 of the 1995 Insolvency Act (Law 24,522). For Australia, see Corporations Act 2001 (Cth), Part 5.3 A, ss 443D and 443E. For Brunei, see Insolvency Order 2016, s 147(1)(a). For Chile, see Insolvency Act 2014 (Law 20,720), Art. 74. For China, see Asian Business Law Institute (2020), pp 182–183, at para. 65. For Ecuador, see Corporate Reorganization Law of 1997, Art 48. For Italy, see Germinario et al. (2019). For Indonesia, see Bankruptcy and Suspension of Payments Act, Art. 69. For Japan, see Civil Rehabilitation Act (Act No. 225 of 22 December 1999), Arts. 120.1, 120.4 and 119(v) and Corporate Reorganization Act (Act No. 154 of 13 December 2002), Arts. 128.1, 128.2 and 127(v). See also Asian Business Law Institute (2020), p 382, at para. 44. For Mexico, see Commercial Bankruptcy Law, Art. 224. For Myanmar, see Insolvency Law 2020, s 196(b). For New Zealand, see Insolvency Act 2006, ss 273–274. For Nigeria, see Companies and Allied Matters Act 2020, Tenth Schedule (3). See also Idigbe (2022), p 72. For South Africa, see Companies Act 71 of 2008, s 135(3). See also Calitz and Freebody (2016). For South Korea, see Debtor Rehabilitation and Bankruptcy Act, Art. 179(1)1. For Spain, see Insolvency Act 2020, Art. 245 – 12. For Thailand, see Bankruptcy Act BE 2483 (1940), ss 24, 114, 130. For the United Kingdom, see Schedule B1 of Insolvency Act 1986, para. 3. For Uruguay, see Insolvency Act 2008, Art. 91.

[35] For the United Kingdom, see Insolvency Act 1986, Schedule 1, para. 3. For Brunei, see Insolvency Order 2016, Second Schedule, para. 3. For Malaysia, see Insolvency Act 1967, s 61(e).

[36] For example, in China, new financing must be approved by a resolution from the creditors' meeting or by the People's Court before the first creditors' meeting, see Shanghai High People's Court, Shanghai High People's Court (2019), Provisions (III) of the Supreme People's Court on Several Issues Concerning the Application of the Enterprise Bankruptcy Law of the People's Republic of China, Fa Shi [2019] No. 3, http://www.hshfy.sh.cn/shfy/web/xxnr_yshj.jsp?pa=aaWQ9MjAyMjYyNzMmeGg9MSZsbWRtPUxNMTIxNAPdcssPdcssz&zd= (accessed 14 September 2022).

is required when the debtor seeks to grant a security interest over property whose value exceeds 5% of the debtor's assets.[37] In Chile, insolvent debtors can borrow provided that the loans do not exceed 20% of the company's liabilities. Otherwise, the new financing needs to be approved by a majority of the company's creditors.[38]

Finally, jurisdictions adopting this approach also differ on how to deal with the harmful effects potentially generated by the approval of new financing. This problem may exist, for example, when the new financing does not end up creating or preserving value and the priority given to the DIP lender reduces the pie available for unsecured creditors. To address this problem, countries have adopted different approaches. For instance, in jurisdictions where the new financing has been authorised by courts or committees of creditors, the actor in charge of approving the DIP financing is not generally liable for these decisions. Thus, the losses potentially associated with the decision to approve new financing will be borne by the general body of unsecured creditors. In jurisdictions where the new financing is approved by an insolvency practitioner, however, the situation might be different. For instance, in the United Kingdom, the administrator is not automatically liable for the new debts. Nonetheless, given that the administrator acts as an agent of the company, it can be held liable if, for example, it is shown that the new financing was obtained in a negligent manner.[39] By contrast, in Australia, the administrator automatically becomes personally liable for the debts and expenses incurred during the procedure.[40] As a result, it is not surprising that the use of DIP financing is very rare in Australia.[41]

3.3.2.2 Regimes with Weak DIP Financing Provisions in Hybrid Procedures Many jurisdictions around the world have adopted various forms of hybrid procedures over the past years.[42] Generally, a hybrid procedure provides debtors with some of the advantages associated with informal workouts (especially in terms of flexibility, confidentiality, low stigma and minimal court involvement) while offering some of the tools traditionally found in formal reorganisation procedures such as a moratorium and a majority rule.[43]

Some hybrid procedures, such as the traditional scheme of arrangement existing in most common law countries, do not provide DIP financing provisions. Other hybrid procedures, however, include certain provisions to facilitate DIP financing. For example, under the new restructuring procedure adopted in Germany and the Netherlands, lenders extending new credit to financially distressed firms can obtain a security interest that, under certain conditions, is protected against a potential avoidance action if

[37] See Insolvency Act 2008, Art. 75.

[38] See Insolvency Act 2014 (Law 20,720), Art. 74.

[39] See Insolvency Act 1986, Schedule B1, para. 69. See also *Stewart v. Engel* [2000] BCC 741, 744D.

[40] See Corporations Act 2001 (Cth), s 443 A.

[41] Recognising the risks borne by administrators seeking to borrow in administration, see *Intergen Energy Holdings (Australia) Pty Ltd (Administrators Appointed) (Receivers and Managers Appointed)* [2016] FCA 1585, at paras. 8–9.

[42] Gurrea-Martinez (2022b).

[43] Garrido (2012), pp 47–49. See also Gropper and Menezes (2021); Bauer et al. (2021); Gurrea-Martinez (2020b).

the debtor ultimately ends up in a formal insolvency proceeding.[44] This protection against avoidance actions also exists in Spain and Italy.[45] In certain hybrid procedures, such as the French conciliation proceeding, new financing enjoys preferential treatment in the ranking of claims provided that various requirements are met.[46]

3.3.3 Regimes with Semi-strong DIP Financing Provisions

Other jurisdictions around the world, including Brazil, the Dominican Republic, India and the Philippines, have adopted a semi-strong DIP financing regime where DIP lenders can enjoy various forms of priority.[47] Yet, there are significant divergences among these regimes, especially when it comes to the approval of new financing.

In Brazil, a recent insolvency reform has allowed debtors to provide DIP lenders with various forms of priority, including an administrative expense priority, a lien over unencumbered assets, and a junior lien.[48] It also allows debtors to provide DIP lenders with a 'fiduciary lien' consisting of a temporary transfer of property until the debt has been paid in full.[49] All forms of priority associated with new financing require court approval in Brazil. Nonetheless, following the approach existing in the United States, post-petition debts and expenses in the ordinary course of business can enjoy an administrative expense priority without requiring court approval.[50]

Under the court-supervised rehabilitation procedure existing in the Philippines, DIP lenders can enjoy several forms of priority. First, they can enjoy an administrative

[44] See Clifford Chance (2021). In the Netherlands, the debtor can seek court approval to obtain emergency financing to continue the daily operations of the business during preparation of the plan. Such court approval insulates the transaction against the risk of clawback in the event the restructuring fails and the debtor is declared bankrupt. See Berkenbosch et al. (2021).

[45] In Spain, see Insolvency Act 2020, Art. 667. For an analysis of the Italian regime, see Germinario et al. (2019).

[46] In France, see Art. L. 611 – 11 of the French Commercial Code.

[47] These forms of priority generally include an administrative expense priority, a security interest over unencumbered property, and a junior lien. In some jurisdictions included in the semi-strong model of DIP financing provisions, such as the Dominican Republic, the law does not clarify whether a senior lien over an encumbered property can be provided. See Law 114 – 15 on Restructuring and Liquidation of Companies of 2015, Arts. 86(iii) and 87. If this interpretation were adopted, however, the veto right enjoyed by a majority of creditors would not provide an effective protection to the secured creditors potentially affected by the senior lien granted to the DIP lender. Therefore, it would be more desirable if those veto rights were enjoyed by the affected secured creditors. In other jurisdictions, such as India, this possibility seems to exist, but it is subject to the approval of the affected secured creditors. See Insolvency and Bankruptcy Code of 2016, s 20(c).

[48] While the regime for DIP financing in Brazil does not formally allow the possibility of priming an existing lien, this outcome can be indirectly achieved if DIP lenders get an administrative expense priority. See n. 18. Moreover, it should be noted that, even if DIP lenders get an administrative expense priority, they will still be subordinated to certain labour claims as well as the essential expenses needed for the management of the bankruptcy estate, see Brazilian Bankruptcy Act, Art. 84, I-B.

[49] Machado (2022), pp 13–14.

[50] This administrative expense priority, however, ranks lower than other administrative expenses. See Brazilian Bankruptcy Act, Art. 84, I-E.

expense priority.[51] Second, debtors can provide DIP lenders with a security interest over unencumbered property.[52] Third, DIP lenders can obtain a junior lien provided that it is approved by the secured creditor with a security interest over the encumbered property.[53] Regardless of the type of priority potentially granted, the new financing needs to be approved by the court upon the recommendation of the rehabilitation receiver.[54]

In India, the new financing obtained during a formal insolvency proceeding enjoys an administrative expense priority.[55] Moreover, nothing prevents the interim resolution professional from obtaining new financing using unencumbered property and even encumbered assets provided that the affected secured creditor consents.[56] Therefore, the Indian insolvency legislation allows post-petition lenders to obtain different forms of priority. Unlike the regime existing in the Philippines and Brazil, however, any form of new financing in India needs to be authorised by the committee of creditors.[57] At first glance, it seems that, under the Indian regime, the new financing needs to be approved by those ultimately bearing the costs and gains associated with this decision – that is, the creditors. Nonetheless, it should be noted that the committee of creditors is usually formed by financial creditors. Consequently, as many financial creditors are often secured creditors and DIP lenders get paid ahead of secured creditors,[58] they might not always have incentives to approve DIP financing even when it creates or preserve value. Thus, the Indian model for the approval of DIP financing can lead to an inefficient outcome.

In the Dominican Republic, DIP lenders can get several types of priority. As a general rule, the new financing will enjoy an administrative expense priority.[59] However, subject to the approval of the court and, if applicable, the affected secured creditors, DIP lenders can also obtain a lien over the debtor's encumbered and unencumbered assets.[60] When the type of priority enjoyed by the DIP lender consists of a security interest, a majority of creditors can veto the approval of DIP financing.[61] Moreover, the approval of new financing needs to be requested by the insolvency practitioner.[62] Thus, the involvement of several gatekeepers makes the system for

51 Financial Rehabilitation and Insolvency Act 2010, s 55.

52 Ibid.

53 Ibid. In Brazil, however, a junior lien does not need to be approved by the pre-existing secured creditors but just by the court. See Brazilian Bankruptcy Act, Art. 69-C.

54 Ibid.

55 Insolvency and Bankruptcy Code of 2016, ss 5(13) and 53.

56 Ibid., s 20(c).

57 Ibid., s 25I.

58 Insolvency and Bankruptcy Code of 2016, ss 5(13) and 53. This policy choice adopted in India can lead to some of the paradoxical outcomes mentioned in the context of Brazilian insolvency law. See n. 18.

59 This administrative expense priority, however, is subordinated to the payment of other debts, including salaries owed to employees as well as the costs of the procedure (including the remuneration of insolvency practitioners). See Law 114 – 15 on Restructuring and Liquidation of Companies of 2015, Arts. 86(iii) and 87.

60 Law 114 – 15 on Restructuring and Liquidation of Companies of 2015, Art. 87.

61 Ibid.

62 Ibid.

the approval of new financing in the Dominican Republic one of the most protective ones observed around the world. Yet, that does not mean that this system is necessarily desirable. The optimal design of a DIP financing regime will depend on a variety of country-specific factors, as discussed in Sect. 5.

3.3.4 Regimes with Strong DIP Financing Provisions

3.3.4.1 Introduction Under the strong DIP financing regime existing in jurisdictions such as the United States and Singapore,[63] post-petition lenders can enjoy different forms of priority.[64] First, they can enjoy an administrative expense priority.[65] Thus, in the event of liquidation, they will get paid ahead of the general body of unsecured creditors.[66] Second, DIP lenders can enjoy a priority over other administrative expenses.[67] In this case, the DIP lender will also get paid ahead of other administrative expenses. Third, DIP lenders can also obtain a lien over unencumbered assets.[68] This priority will make the DIP lender a secured creditor entitled to be paid with the value of the collateral. Fourth, DIP lenders can also obtain a junior lien.[69] In such cases, the DIP lender will also become a secured creditor. However, it will only get paid with the proceeds of the collateral if the secured creditor with a senior lien has been paid in full. Finally, the United States and Singapore also allow DIP lenders to obtain a senior lien over the debtor's encumbered property.[70] In these scenarios, the DIP lender will also become a secured creditor. Moreover, by 'priming' an existing lien, the DIP lender will get paid ahead of the pre-existing secured creditor.

3.3.4.2 DIP Financing Provisions in the United States and Singapore: Similarities and Divergences Despite the similarities existing in the types of priority potentially obtained by DIP lenders in the United States and Singapore, there are various divergences between both DIP financing regimes. First, the United States does not provide a formal definition of DIP financing. In Singapore, however, the concept of 'rescue

[63] Colombia has also adopted a strong system of DIP financing. See Law Decree 560/2020, 15 April 2020, Art. 5. However, this regime has only been implemented temporarily as a response to the COVID-19 crisis.

[64] For the forms of priority offered under the insolvency framework in the United States, see Bankruptcy Code, s 364. In Singapore, see Insolvency, Restructuring and Dissolution Act 2018, ss 67 and 101. For a deeper analysis of the rescue financing provisions in Singapore, see Chioh and Singh (2020); Ee and Tay (2022); Chew (2020). For an analysis of the regulation of DIP financing in the United States, see Triantis (1993); Skeel Jr (2004); Adler et al. (2007), pp 475–520; Squire (2016), pp 235–260.

[65] In Singapore, see Insolvency, Restructuring and Dissolution Act 2018, ss 67(1)(a) and 101(1)(a). In the United States, see Bankruptcy Code, ss 364(a) and 364(b).

[66] In some jurisdictions, such as Brazil, administrative expenses are also paid ahead of *secured* creditors. See n. 18.

[67] Bankruptcy Code, s 364(c)(1).

[68] In Singapore, see Insolvency, Restructuring and Dissolution Act 2018, ss 67(1)(c)(i) and 101(1)(c)(i). In the United States, see Bankruptcy Code, s 364(c)(2).

[69] In Singapore, see Insolvency, Restructuring and Dissolution Act 2018., ss 67(1)(c)(ii) and 101(1)(c)(ii). In the United States, see Bankruptcy Code, s 364(c)(3).

[70] In Singapore, see Insolvency, Restructuring and Dissolution Act 2018, ss 67(1)(d) and 101(1)(d). In the United States, see Bankruptcy Code, s 364(d).

financing' is defined in the insolvency legislation and refers to the financing that meets either or both of the following conditions: (i) it is necessary for the survival of the company that obtains the financing or of the whole or any part of the undertaking of that company, as a going concern; and (ii) it is necessary to achieve a more advantageous realisation of the assets of a company that obtains the financing than on a winding-up of that company.[71] Thus, any attempt to provide a priority to DIP lenders should first meet the definition of 'rescue financing'.[72]

Second, in the United States, court approval is not required to incur debts and expenses in the ordinary course of business where new lenders get an administrative expense priority.[73] In Singapore, however, any form of 'rescue financing' requires court approval.[74] Nonetheless, as mentioned in Sect. 3.3.1, in the context of a scheme of arrangement, nothing seems to prevent debtors from providing DIP lenders with a junior lien or a security interest over unencumbered property even if the transaction has not been approved by the court.[75] This is due to the hybrid nature of the scheme of arrangement – as opposed to a formal insolvency proceeding such as the U.S. Chapter 11 – and the fact that debtors are generally allowed to keep managing and selling assets during this procedure.[76] Yet, getting approval from the court may protect lenders from future avoidance actions or even liability for wrongful trading.[77] Therefore, even if court approval is not formally required to provide new lenders with a new lien or a junior lien during a scheme of arrangement, subjecting the transaction to court approval under the formal DIP financing regime will provide additional protection to the lender.

Third, in the United States, when the new financing is not in the ordinary course of business or the DIP lender is expected to get a priority other than a basic administrative expense priority, debtors need to obtain court approval. In those scenarios, they need to show that they were unable to obtain credit otherwise.[78] In Singapore, this latter condition is required for all forms of priority except for new financing

[71] See Insolvency, Restructuring and Dissolution Act 2018, s 67(9) (for the definition of 'rescue financing' for the purpose of the scheme of arrangement). See also Insolvency, Restructuring and Dissolution Act 2018, s 101(10) (for the definition of 'rescue financing' for the purpose of judicial management).

[72] See *Re Design Studios* [2020] 5 SLR 850. See also Chew (2020).

[73] Bankruptcy Code, s 364(a).

[74] In Singapore, see Insolvency, Restructuring and Dissolution Act 2018, ss 67(1) and 101(1).

[75] These restrictions can exist contractually though. For example, they can be included in the covenants potentially imposed by some of the debtor's pre-existing creditors.

[76] In some jurisdictions, however, debtors can be subject to certain restrictions during the scheme of arrangement. For example, in Singapore, on an application made by any creditor of a relevant company at any time during a moratorium period in a scheme of arrangement, the court can issue either or both of the following orders: (i) an order restraining the relevant company from disposing of the property of the relevant company other than in good faith and in the ordinary course of the business of the relevant company; (ii) an order restraining the relevant company from transferring any share in, or altering the rights of any member of, the relevant company. See Insolvency, Restructuring and Dissolution Act 2018, s 66(1).

[77] Under the new regime for wrongful trading existing in Singapore, the debtor's counterparty can also become liable under certain scenarios, see Insolvency, Restructuring and Dissolution Act 2018, s 239.

[78] Bankruptcy Code, s 364(c).

that provides DIP lenders with a basic administrative expense priority. Even if the proof of the debtor's inability to obtain credit otherwise is not formally required to provide DIP lenders with an administrative expense priority, Singapore courts have still asked debtors to show some 'reasonable attempts' to obtain new financing on an unsecured basis.[79]

Fourth, despite the criticism over the practice of allowing DIP lenders to get a priority not only for the new financing but also for some pre-petition debts ('roll-ups'),[80] sometimes in the form of a security interest provided to cover a pre-existing unsecured debt ('cross-collateralisation'),[81] roll-ups and cross-collateralisations are not uncommon in the United States.[82] In Singapore, since the adoption of the regime for rescue financing in 2017, there has only been one reported case that dealt with roll-ups.[83] In that case, the DIP lender was granted an administrative expense priority to be paid ahead of other administrative expenses.

It remains unclear, however, whether cross-collateralisations will be allowed in Singapore. While it has been argued that the approval of a roll-up has left the door open for cross-collateralisations,[84] a literal interpretation of the law seems to reject this hypothesis.[85] Indeed, under the current regulatory framework for rescue financing in Singapore, an administrative expense priority – including the administrative expense priority to be paid ahead of other administrative expenses – can be granted to financing 'obtained or to be obtained' by the debtor.[86] Thus, the law allows the possibility of giving a priority to pre-petition lenders, and therefore roll-ups, provided that the priority consists of an administrative expense priority. In the case of security interests, however, the law requires that the financing needs 'to be obtained' by the debtor.[87] Thus, the possibility of granting a new lien, a junior lien or a senior lien under the regime for rescue financing in Singapore only seems to be possible for *new* financing obtained after initiating the procedure and obtaining court approval. As a result, Singapore insolvency law does not seem to allow cross-collateralisations.

A different discussion is whether cross-collateralisations *should* be allowed. To answer that question, it should be kept in mind that the policy justification for allowing cross-collateralisations and roll-ups is very similar: the need to preserve or create value even if that leads to favouring some pre-petition creditors.[88] Nonetheless,

79 *Re Attilan Group Ltd* [2018] 3 SLR 898, [61].

80 Cho (2018); Tung (2020); Triantis (2020).

81 Distinguishing between roll-ups and cross-collateralisations, see *Re Design Studios* [2020] 5 SLR 850. In this case, cross-collateralisations were defined as 'the granting of the debtor's assets as collateral for both the new and pre-existing loans'. Therefore, they can be understood as a subcategory of roll-ups, i.e., a type of roll-up in which the DIP lender gets a security interest instead of other forms of priority.

82 Cho (2018); Tung (2020).

83 See *Re Design Studios* [2020] 5 SLR 850.

84 Chua et al. (2020).

85 Insolvency, Restructuring and Dissolution Act 2018, ss 67 and 101.

86 Ibid., ss 67(1)(a) and 67(1)(b), as well as ss 101(1)(a) and 101(1)(b).

87 See Insolvency, Restructuring and Dissolution Act 2018, ss 67(1)(c) and 67(1)(d), as well as ss 101(1)(c) and 101(1)(d).

88 See Triantis (2020).

DIP lenders obtaining an administrative expense priority still bear certain risks if, for example, the debtor ends up in liquidation without any unencumbered assets. By contrast, DIP lenders obtaining a new lien or a senior lien will secure the repayment of their loans provided that the value of the collateral exceeds the value of the debt. Put differently, DIP lenders obtaining a new lien or a senior lien will unlikely bear any losses potentially associated with the continuation of the company. Moreover, by securing part of their pre-existing unsecured debt, they will improve their overall position in the insolvency proceeding. Under this scenario, DIP lenders may have incentives to extend new credit regardless of the viability of the company. Hence, cross-collateralisations could undesirably contribute to the continuation of non-viable businesses. As a result, the higher risks existing in the context of cross-collateralisations compared to roll-ups seem to justify the implied prohibition of cross-collateralisations in Singapore.

If cross-collateralisations were hypothetically allowed in Singapore, they would have to be subject to stricter scrutiny by courts. Namely, in addition to the requirements generally imposed for the authorisation of DIP financing, courts should be required to verify that the company obtaining the new financing is economically viable.[89] Still, due to the difficulties associated with determining this aspect as well as the fact that the costs or benefits created by the new financing will be ultimately experienced by the creditors, it would be more desirable if the decision to authorise DIP financing, including any cross-collateralisation, were made by the creditors as suggested in Sect. 5.2.3.

Apart from these divergences in the regulation of DIP financing in the United States and Singapore, both jurisdictions require similar conditions for the approval of DIP financing. First, the new financing should create or preserve value.[90] Second, the terms of the proposed financing should be fair, reasonable and adequate.[91] Third, the injection of new financing should be based on a sound and reasonable business judgement.[92] Fourth, the debtor should be unable to obtain other forms of financing, and other offers or proposals are not available.[93] Fifth, the new financing should be in the best interest of the company and the creditors as a whole.[94] This last requirement seems to reflect the economic rationale of DIP financing: the ability of the new financing to create or preserve value for the creditors as a whole.[95] As a result, the courts in the United States and Singapore should make sure that the new financing makes everybody better off. In other words, the DIP financing needs to represent a

[89] For the concept of viable firms, see White (1989) and Armour (2001).

[90] See *Re Attilan Group Ltd* [2018] 3 SLR 898, *Re Design Studios* [2020] 5 SLR 850, and *re Mid-State Raceway, Inc* 323 BR 40 (Bankr. ND New York, 2005). See also Triantis (2020), p 184.

[91] See *Re Attilan Group Ltd* [2018] 3 SLR 898, *Re Design Studios* [2020] 5 SLR 850, and *re Mid-State Raceway, Inc* 323 BR 40 (Bankr. ND New York, 2005).

[92] Ibid.

[93] See *Re Attilan Group Ltd* [2018] 3 SLR 898, *Re Design Studios* [2020] 5 SLR 850, and *In re Western Pacific Airlines, Inc* 223 BR 567 (Bankr. D Colo, 1997).

[94] Ibid.

[95] See Triantis (2020).

Pareto improvement, that is, a transaction making everybody or at least somebody better off without making anyone worse off.[96]

Finally, both regimes impose very stringent conditions for the authorisation of a senior lien over encumbered property. Namely, along with the general requirements needed for the approval of DIP financing, a senior lien can only be granted if the affected secured creditors are 'adequately protected'.[97] For that purpose, both countries adopt a similar concept of adequate protection that includes cash payments, replacement liens, and indubitable equivalent value.[98] This latter form of adequate protection can generally be shown when there is an equity cushion over existing encumbered assets,[99] or when the company has a going-concern surplus,[100] even though the latter can be more subjective as it depends on several factors determining the value of the firm.[101] By requiring adequate protection, the new financing will not make the pre-existing secured creditor worse off. Therefore, if the new financing makes the creditors as a whole better off *and* does not make anyone worse off, the Pareto improvement principle inspiring the regime of DIP financing will be respected. As a result, the new financing should be authorised. Moreover, as the pre-existing secured creditors would not be worse off, the existence of this form of priority should not lead to an *ex ante* increase in the cost of debt, provided that the creditors are confident that the courts will not deviate from this value-enhancing principle that justifies the authorisation of DIP financing. Hence, as can be observed, the desirability and success of the DIP financing regime existing in the United States and Singapore heavily rely on the ability of the court to distinguish between value-creating DIP financing that should be authorised and DIP financing that destroys or only redistributes value and thereby should be rejected.[102]

96 For the concept of Pareto improvements and Pareto efficiency, see Varian (2010). See also Posner (2011), pp 17–20; and Mokal (2003). Arguing that a court must ensure that DIP financing is authorised when it is efficient, and therefore when value is created or preserved so that no party is made worse off as a result of the DIP financing, see Triantis (2020).

97 In Singapore, see Insolvency, Restructuring and Dissolution Act 2018, ss 67(6) and 101(7). In the United States, see Bankruptcy Code, s 364(d).

98 In Singapore, see Insolvency, Restructuring and Dissolution Act 2018, ss 67(6) and 101(7). In the United States, see Bankruptcy Code, s 361.

99 See *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 441 (Bankr. S.D.N.Y. 2010); *Wilmington Trust Co. v. AMR Corp.* (In re AMR Corp.), 490 B.R. 470, 478 (S.D.N.Y. 2013); *In re Big Dog II, LLC*, 602 B.R. 64, 70 (Bankr. N.D.Fla. 2019). Although the amount of equity sufficient to constitute an equity cushion differs on a case-by-case basis, courts have generally found that an equity cushion of less than 10% is insufficient to constitute adequate protection. See *In re LeMay*, 18 B.R. 659 (Bankr. D.Mass. 1982); *In re Castle Ranch of Ramona, Inc.*, 3 B.R. 45 (Bankr. S.D.Cal. 1980); *In re McGowan*, 6 B.R. 241 (Bankr. E.D.Pa. 1980); and *In re Tucker*, 5 B.R. 180, 12 (Bankr. S.D.N.Y. 1980). On the other hand, an equity cushion of more than 20% has generally been held to constitute adequate protection. See *In re Ritz Theaters, Inc.*, 68 B.R. 256 (Bankr. M.D.Fla. 1986); *In re Dunes Casino Hotel*, 69 B.R. 784 (Bankr. D.N.J. 1986); *In re Lake Tahoe Land Co., Inc.*, 5 B.R. 34, 37 (Bankr. Nev. 1980); *In re Nashua Trust Co.*, 73 B.R. 423 (Bankr. D.N.J. 1987); and *In re San Clemente Estates*, 5 B.R. 605 (Bankr. S.D.Cal. 1980).

100 See *In re Residential Capital LLC*, 501 B.R. 549, 591–595 (Bankr. S.D.N.Y. 2013); *In re Rash*, 520 U.S. 953, 962 (1997).

101 These factors include, among other aspects, the company's future cash-flows as well as the company's weighted average cost of capital (WACC). Analysing the importance of these factors in the valuation of companies in financial distress, see Sontchi (2012); Ayotte and Morrison (2018).

102 Emphasising the importance of having courts with the ability to distinguish between both types of DIP financing, see Triantis (1993), p 919.

4 The Perils of a DIP Financing Regime

By obtaining a new lien, a junior lien or an administrative expense priority, DIP lenders will get paid ahead of the general body of unsecured creditors. As a result, if new financing does not end up creating or preserving value, the authorisation of DIP financing will make the debtor's pre-existing unsecured creditors worse off. Thus, paradoxically, insolvency law will ultimately reduce, rather than increase, the recoveries of the debtor's pre-existing creditors. A similar problem occurs when DIP lenders obtain an administrative expense priority paid ahead of other administrative expenses. Indeed, if the debtor's assets are insufficient to cover all the administrative expenses, some post-petition creditors interacting with the debtors on the basis that they would be paid in full will suffer some losses. Therefore, from an *ex ante* perspective, they will be reluctant to do business with a viable but financially distressed debtor, leading to the underinvestment problem that DIP financing provisions seek to solve. Finally, if an insolvency system allows the possibility of priming an existing lien,[103] the affected secured creditor faces the risk of not being paid in full if it is not adequately protected and the value of the collateral is insufficient to cover both the DIP loan and the debt owed to the pre-existing secured creditor. As a result, the value of a security interest will be diluted, and lenders will be reluctant to extend credit or they will significantly increase the cost of debt from an *ex ante* perspective.[104] Hence, the existence of a DIP financing regime may end up harming firms' access to finance and the promotion of economic growth.

Additionally, there are other risks and challenges that need to be addressed when adopting a DIP financing regime. First, the new financing obtained by insolvent debtors may be used to keep non-viable firms alive or just postpone an inevitable liquidation. If so, the expenses incurred and any loss of value experienced until the liquidation of the firm will reduce the returns to creditors. Moreover, the possibility of keeping non-viable firms alive will also hamper the efficient reallocation of resources in the economy.

Second, while it seems clear that DIP financing should only be authorised if it creates or preserves value,[105] distinguishing between value-enhancing and value-destroying DIP financing is not always easy. This problem can be exacerbated by the fact that the actors in charge of authorising the new financing might not have the expertise, resources or incentives to make value-maximising decisions. Therefore, the risk of being subordinated to new lenders in a hypothetical event of insolvency may encourage lenders to increase the cost of debt. In jurisdictions where pre-existing secured creditors can also be subordinated without their consent, the authorisation of new financing can be even more problematic. Indeed, since a security interest is specifically provided to protect secured creditors against the debtor's risk of insolvency, the possibility of altering the position of pre-existing secured creditors may

[103] This outcome can be achieved directly, through the DIP financing regime, or indirectly through the system of priorities in the ranking of claims existing in the insolvency legislation. See n. 18.

[104] For an empirical analysis of the effects associated with an unattractive treatment of secured creditors in insolvency proceedings, see Davydenko and Franks (2008).

[105] Triantis (2020), p 179.

adversely affect lending markets. For these reasons, jurisdictions such as the United States and Singapore require the adoption of several safeguards when this form of priority is provided, and other countries, such as the United Kingdom, have traditionally been sceptical about the implementation of a strong form of DIP financing provisions that would allow the possibility of priming existing liens.[106]

Finally, some empirical studies have shown that the imposition of certain conditions in DIP loans can make DIP lenders very powerful in the restructuring process.[107] This power may lead to an undesirable outcome for the creditors as a whole,[108] sometimes in the form of fire sales.[109] Therefore, if the terms of the DIP loans are not carefully examined before the DIP financing is approved, the approval of DIP financing will actually exacerbate, rather than improve, some of the problems among creditors that insolvency law seeks to solve.[110]

These risks can be minimised, at least in theory, through the existence of an independent, reliable and sophisticated third party authorising DIP financing. Yet, it has been shown that the approval of value-diverting or value-destroying DIP financing can even take place in jurisdictions such as the United States, where the third party in charge of approving the new financing meets those criteria.[111] Thus, if independent and sophisticated gatekeepers, such as a bankruptcy judge in the United States, often err when it comes to the approval of new financing, this risk will be exacerbated in jurisdictions with poor institutions and unsophisticated actors assessing whether, and if so under what conditions, DIP financing should be approved. Therefore, as will be analysed in Sect. 5, this article argues that the traditional systems for the *approval* of new financing need to be revised.

5 Policy Recommendations for the Adoption of DIP Financing Provisions

5.1 Introduction

The inability of viable but insolvent firms to obtain new financing can destroy value for debtors, creditors and society as a whole. In countries with a developed financial system comprising a strong capital market, a competitive banking sector, and a deep market for distressed assets and alternative finance, viable firms – even if they face financial trouble – may have more chances to obtain external finance. Unfortunately,

106 See UK Insolvency Service (2016), s 5.2.

107 According to Ayotte and Ellias (2021), 86% of DIP financing agreements currently include 'milestones' setting – for instance, sale of the company's assets if the debtor does not propose a restructuring plan within a few months of filing for bankruptcy. Other studies have shown that more than 90% of DIP loans include these conditions, see Eckbo et al. (2020).

108 See Ayotte and Ellias (2021). See also Tung (2020).

109 See Ayotte and Morrison (2009). For a more optimistic view of DIP lenders, however, see Jenkins and Smith (2014).

110 For the role of insolvency as a mechanism to solve problems among creditors, see Jackson (1982); Jackson (1986). See also Casey (2020).

111 See Ayotte and Ellias (2021).

not many countries have this type of dynamic financial system. Even if they do, lenders may still be reluctant to extend credit to many viable but financially distressed firms. Hence, countries should ideally adopt a *strong* system of DIP financing that can provide DIP lenders with several forms of priority.

5.2 Optimal Design of DIP Financing Provisions

5.2.1 Rethinking the System of Approval of New Financing

In order to minimise the risks and costs potentially created by the adoption of a strong DIP financing regime, the design of a regulatory framework for DIP financing should be tailored to the particular features of the country. Therefore, the key policy question to be addressed is not whether countries should adopt DIP provisions but *how* these provisions should be designed, especially when it comes to the actors in charge of approving the new financing.

5.2.2 Towards a System of DIP Financing Approved by Creditors in Countries Without Sophisticated Courts and Insolvency Practitioners

In jurisdictions without sophisticated, independent, efficient and reliable courts, which is the scenario often found in emerging economies and even in some advanced economies,[112] courts should not be involved in the approval of DIP financing.[113] Otherwise, the inability of the court to accurately distinguish between value-enhancing and value-destroying DIP financing, or the lack of independence and predictability of the court, will generate several costs. *Ex post*, it can destroy or opportunistically redistribute value. Additionally, if the new financing is used to keep non-viable firms alive, the decision to authorise new financing will destroy value for the creditors and will also hamper the efficient reallocation of resources in the economy. *Ex ante*, a system favouring the approval of DIP financing that can destroy or opportunistically redistribute value will make lenders more sceptical to extend credit, leading to an undesirable increase in the cost of debt. Consequently, the adoption of a DIP financing regime may end up doing more harm than good.

The same problem occurs when the decision to authorise DIP financing is made by non-sophisticated insolvency practitioners. When insolvency practitioners do not have a high level of expertise, credibility and independence, they will unlikely be able to distinguish between value-enhancing and value-destroying new financing. In those situations, insolvency practitioners should be prevented from making the decision to authorise new financing unless they are held personally liable for this

[112] Some advanced economies may not have the problems of corruption and lack of independence existing in many emerging economies. However, their judicial systems may suffer from the lack of competent judges to deal with insolvency matters. Alternatively, even if the country has competent judges, the judicial system may not be very efficient. Therefore, any of these weaknesses would also justify the proposed approach for DIP financing suggested for emerging economies.

[113] Gurrea-Martinez (2020a).

decision, as happens in certain countries such as Australia.[114] In those cases, however, it is very unlikely that the insolvency practitioners will borrow, even if the new financing is value-enhancing. Thus, if this system is adopted, the remuneration of insolvency practitioners should be ideally linked to the returns obtained by the creditors.[115] Thus, the system would incentivise insolvency practitioners to obtain new financing when it can be value-enhancing. At the same time, it will also discourage insolvency practitioners from borrowing when it is not clear that the new financing will be beneficial for the creditors as a whole.

Most emerging countries have weak institutional environments that generally comprise an inefficient judiciary, a weak rule of law and even problems of corruption.[116] Additionally, emerging economies do not usually have a strong body of sophisticated insolvency practitioners.[117] Therefore, the involvement of the judiciary and insolvency practitioners should be avoided in these jurisdictions. In other countries, including many advanced economies, corruption might not be a significant problem. Yet, judges and insolvency practitioners might not have a high level of expertise in commercial and financial matters. Thus, they will unlikely be able to make value-maximising decisions when it comes to the approval of DIP financing. Finally, even if a country has competent judges, the judicial system may not be very efficient, and the delay associated with getting court approval can end up destroying value and even jeopardising the survival of viable but financially distressed firms. For that reason, in all of these jurisdictions, including both emerging economies and advanced economies with any type of institutional weakness, the decision to approve DIP financing should be made by the creditors.

5.2.3 The Need to Confer Veto Rights on Creditors in Countries with Sophisticated Courts and Insolvency Practitioners

For countries with efficient, reliable and competent courts and insolvency practitioners, it can be argued that the decision to authorise DIP financing can be made by courts or insolvency practitioners. Yet, as the empirical literature on DIP financing shows,[118] even sophisticated gatekeepers — such as bankruptcy judges in the United States — can often make decisions that may lead to inefficient outcomes. For that reason, creditors should always be allowed to *veto* the decision to approve new

114 See Corporations Act 2001 (Cth), s 443 A.

115 Mentioning this model for the remuneration of insolvency practitioners, see INSOL International (2017).

116 Some exceptions can include Uruguay and, to a lesser extent, Costa Rica and Chile. According to the 2022 Rule of Law Index prepared by the World Justice Project, Uruguay ranks 25th out of 140 jurisdictions. Costa Rica and Chile rank 29th and 33rd, respectively, see World Justice Project (2022). In the 2022 Corruption Perception Index, Uruguay, Chile and Costa Rica rank 14th, 27th and 48th, respectively, out of 180 jurisdictions, see Transparency International (2022).

117 In the past years, however, some emerging economies such as India have taken significant steps to develop expertise in insolvency and restructuring and create a sophisticated body of insolvency professionals.

118 See Ayotte and Ellias (2021) and Tung (2020).

financing made by third parties such as courts and insolvency practitioners. Thus, in countries with sophisticated courts and insolvency practitioners, these third parties would have the opportunity to add value by providing their credibility and expertise and reducing the costs associated with the decision made by the creditors. Nonetheless, the actors experiencing the costs and benefits of the approval of DIP financing – that is, the creditors – would ultimately decide whether the new financing should be authorised.

Due to a variety of factors, including asymmetries of information and lack of expertise, it can be argued that many creditors might not be well equipped to accurately assess the desirability of the new financing. As a result, creditors would face similar problems to those mentioned in the context of unsophisticated judges and insolvency practitioners.[119] Against this potential criticism, however, it is important to note that, unlike courts and insolvency practitioners, creditors have skin in the game. Thus, even if they may not always make a value-maximising decision, the fact that they are the residual claimants of the firm and thereby they will experience the costs and benefits associated with the company's actions makes creditors the most suitable actors to decide whether the new financing should be authorised.[120] Put differently, even if courts and insolvency practitioners have the expertise, credibility, independence and resources to assess the desirability of the new financing, they might not have *incentives* to make value-maximising decisions. After all, unlike the company's creditors, judges will not be rewarded or punished depending on the value potentially created or destroyed by their decision. And the same applies to insolvency practitioners, unless their remuneration is based on the recoveries received by creditors and, as in Australia, they are personally liable for the authorisation of new debts.

Finally, it could also be argued that other problems potentially faced by creditors, such as collective action problems and passive behaviour, may also justify the approval of new financing by courts or insolvency practitioners. Yet, that explanation does not sound entirely convincing either. First of all, the existence of an insolvency proceeding that provides a single forum for the resolution of a debtor's financial distress already reduces the collective action problems generally faced by creditors.[121] Second, any coordination problems potentially faced by creditors can also be reduced by adopting several strategies, such as the creation of a creditors' committee. Finally, the problems associated with coordination costs and passive behaviour of the company's creditors can also be minimised by reducing the costs of being involved in the insolvency proceeding (for instance, facilitating disclosure and favouring the use of electronic devices), designing voting rules exclusively based on the value of the claims and not on any headcount test, or delegating the decision to

[119] They would have skin in the game if, for example, they were made personally liable for poor decisions and their remuneration were linked to the returns received by the creditors. However, not many insolvency systems provide such a combination of sticks and carrots for insolvency practitioners. In the cases of judges, this system of incentives is even more rare.

[120] For the concept of residual claimants, see Jackson (1986), p 167; Daniels and Triantis (1995), p 1100.

[121] Jackson (1986).

authorise the new financing to a committee formed by the largest creditors among those most directly affected by the approval of DIP financing. As discussed in the following section, the group of creditors most directly affected by the approval of DIP financing will depend on the type of priority potentially offered to the DIP lender. Identifying the group (or groups) of creditors most directly affected by the approval of new financing will be essential for the optimal design of a DIP financing regime.

5.2.4 Type of Creditors Involved in the Approval or Veto of DIP Financing

The type of creditors involved in the approval or veto of DIP financing should depend on the type of priority potentially obtained by the DIP lender. Thus, the decision would be made by the creditors most directly affected by the approval of new financing. For instance, in countries where secured creditors get paid first, followed by administrative expenses and then unsecured creditors,[122] the creditors most directly affected when the debtor grants an administrative expense priority to DIP lenders are the general body of unsecured creditors. Indeed, as DIP lenders obtaining an administrative expense priority will get paid ahead of unsecured creditors, any new financing that does not end up creating or preserving value will make unsecured creditors worse off. As a result, the new financing should be approved by *unsecured creditors*.[123] When the priority offered to the DIP lender consists of a new lien, a junior lien or an administrative expense priority to be paid ahead of other administrative expenses, the approval of value-destroying DIP financing will be detrimental to both unsecured creditors and pre-existing administrative expense claimants. Therefore, the new financing should be approved by *both* groups of creditors directly affected by the approval of new financing, that is, unsecured creditors and pre-existing administrative expense claimants.

Finally, if the priority offered to DIP lenders consists of a senior lien over encumbered property, the creditor most directly affected by this priority is the pre-existing secured creditor with a lien over that property.[124] Hence, the decision to authorise DIP financing should be approved or vetoed by the affected secured creditor.[125] This solution should also be adopted in countries where, as happens in Brazil, DIP lenders obtain an administrative expense priority *and* administrative expenses are paid ahead of secured creditors.[126] In these latter scenarios, the new financing would

[122] This is the ranking of claims existing in jurisdictions such as the United States and Singapore.

[123] Gurrea-Martinez (2020a).

[124] Technically speaking, administrative expense claimants and unsecured creditors can also be affected if a DIP lender gets a senior lien. Nonetheless, they are not the creditors *most directly* affected by the priority given to the DIP lender. In fact, they will only be affected if the value of the collateral exceeded the value of the debt owed to the pre-existing secured creditor before the senior lien was granted. In those cases, however, granting a senior lien will be less likely because the debtor could have provided a junior lien.

[125] A similar solution exists in various jurisdictions, such as India and the Philippines. As regards the Philippines, see Financial Rehabilitation and Insolvency Act 2010, s 55(b). In India, see Insolvency and Bankruptcy Code of 2016, ss 25(2)(c) and 28(1)(b).

[126] See n. 18.

prime all pre-existing liens. Thus, it should also be approved or vetoed by the company's pre-existing secured creditors. It can be argued that, given that the approval of the affected secured creditor is required, this form of priority will not be commonly used. Yet, this outcome would not be very different from what is observed in countries allowing courts to individually prime an existing lien such as the United States and Singapore. Indeed, as granting a senior lien over an encumbered asset in Singapore and the United States is subject to various stringent conditions including the ability of the debtor to provide adequate protection to the affected secured lender, this priority is not often provided in the United States and has not been granted in Singapore since the rescue financing provisions were adopted in 2017. Moreover, it should be kept in mind that if the new financing really creates value, the affected secured creditors should not be worse off. Additionally, secured creditors often have unsecured claims against the debtor. Therefore, provided that the new financing can increase their overall recoveries, secured creditors may have incentives to approve DIP loans potentially priming their pre-existing liens. More importantly, this system for the approval of DIP financing affecting pre-existing secured creditors would provide more certainty in lending markets. Thus, it can be a more desirable approach to facilitate firms' access to finance and the promotion of economic growth.

6 Conclusion

A situation of insolvency hinders a firm's ability to obtain external finance. As a result, viable but financially distressed firms might be unable to keep operating and pursuing value-creating investment projects. Therefore, value can be destroyed for debtors, creditors, employees, suppliers and society as a whole. To address this problem, several jurisdictions around the world have adopted a system of DIP financing that seeks to encourage lenders to extend credit to viable but financially distressed firms. They do so by providing DIP lenders with various forms of priority that typically range from a basic administrative expense priority to the possibility of becoming a junior or, in some jurisdictions, even a senior secured creditor. After analysing the regulatory framework of DIP financing in more than 30 jurisdictions in Asia, Latin America, Europe, Africa and North America, this article has shown that there are many similarities in the treatment of DIP financing around the world. Namely, based on the type of priority potentially offered to DIP lenders, it has been shown that most DIP financing regimes can be summarised into four primary models.

The article has examined the risks and costs potentially created by a DIP financing regime, and has concluded by analysing whether, and if so how, countries should adopt DIP financing provisions. To that end, it has been argued that the adoption of DIP financing provisions should be considered a desirable policy even in countries with developed financial systems. Moreover, countries should ideally adopt a strong DIP financing regime. Thus, the key policy question to be addressed is not whether DIP financing provisions should be adopted but how. In this regard, it has been pointed out that the optimal design of DIP financing provisions should depend on the particular features of a country. In jurisdictions with sophisticated judges and insolvency practitioners, these actors may play a role in the approval of new financing. Yet, since even sophisticated courts and insolvency practitioners can err and they might not have incentives to make value-maximising decisions, creditors should have the ability to veto the decision to authorise DIP financing. By contrast, in jurisdictions without sophisticated courts and insolvency practitioners, the decision to approve DIP financing should be exclusively made by the creditors. It has been argued that the type of creditors entitled to approve or veto the new financing should depend on the priority potentially granted to the DIP lender and therefore on the creditors most directly affected by the approval of DIP financing.

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Rescue Financing: Roll-Ups in the USA, Italy, Singapore and Spain

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Introduction

Rescue financing is often a feature of large cross-border restructurings. Lenders are reluctant to loan additional capital to a company that has entered a restructuring process unless they are granted first lien security over the debtor's property. Where all of the debtor's property is already subject to liens, the lender may seek to prime existing lenders and other advantageous credit terms. In certain jurisdictions, a practice has developed to allow lenders not only to obtain first lien status, but also to 'roll-up' part of their pre-existing pre-petition loans into the new money loan with senior lien status. Over the past decade, roll-ups have become a common feature in rescue financing in the US, but elsewhere the idea of rolling-up pre-petition debt is relatively novel.

In this paper, the first aspect discussed is what roll-ups are and how they feature in US Bankruptcy Law. The paper then moves to discuss the evolution of roll-ups in super priority rescue financing in Singapore with the approval of roll-up financing in *Re Design Studio Group Ltd and other matters*[1] in 2020. It then turns to Italy, where roll-ups are virtually unknown to the restructuring practice, for a discussion of whether roll-ups are aligned with the Italian bankruptcy regime and should be expressly allowed. Finally, the paper looks at Spain, where roll-ups are implicitly allowed under refinancing agreements but are not available under formal insolvency proceedings as they deviate from the *par condicio creditorum* principle.

1. Overview of Roll-Ups

In bankruptcy parlance, a roll-up occurs when a pre-petition debt is paid off through the proceeds of a post-petition debt. Most commonly, a roll-up is effected where a debtor's pre-petition secured creditor provides a post-petition DIP loan, the proceeds of which are used to pay off or replace the pre-petition secured debt.[2] As a result, "the entirety of the pre-petition and

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post-petition debt enjoys the post-petition protection of section 364(c) and/or (d) [of the Bankruptcy Code] as well as the terms of the DIP order."[3] These terms can provide significant protection for pre-petition lenders and result in different forms of roll-ups.

There are two basic forms of roll-ups. First, a "creeping" roll-up occurs where a pre-petition secured lender advances post-petition funds, agreeing to do so where the proceeds of pre-petition collateral are applied post-petition to reduce to pre-petition loan over time.[4] Usually, creeping roll-ups are employed with revolving lines of credit; "the pre-petition revolver is gradually 'paid off' and replaced with the post-petition revolver."[5] Alternatively, in a "full" roll-up, a postpetition lender lends sufficient amounts through a DIP facility to allow the debtor to simply pay off the existing, prepetition loan, thereby converting all of the lender's prepetition debt to postpetition debt.[6]

2. Roll-Ups Under United States Bankruptcy Law

a. History and Evolution of Roll-Ups

In the US, roll-ups evolved out of another controversial feature of DIP financing called cross-collateralization.[7] Cross-collateralization occurs where a prepetition lender takes a postpetition security interest in previously unencumbered property not only to secure the postpetition extension of credit (*i.e.* the DIP loan), but also to secure previously unsecured prepetition claims against the debtor.[8] This type of cross-collateralization is often referred to as "*Texlon*-type cross-collateralization," named after the Second Circuit case that first described it.[9] For years, cross-collateralization was considered (at least by some courts) to be permissible, though controversial.[10]

In 1992, though, the permissibility of *Texlon*-type cross-collateralization was considered by a Court of Appeal for the first time in *Saybrook*.[11] There, the Eleventh Circuit "conclude[d] that cross-collateralization is inconsistent with bankruptcy law for two reasons. First, cross-collateralization is not authorized as a method of post-petition financing under section 364 [of the Bankruptcy Code]. Second, cross-collateralization is beyond the scope of the bankruptcy court's inherent equitable power because it is directly contrary to the fundamental priority scheme of the Bankruptcy Code."[12] After *Saybrook*, the practice of cross-collateralization more or less came to an end.[13]

Although, post-*Saybrook*, courts have not uniformly rejected cross-collateralization in DIP financing, it is now certainly a disfavored practice.[14] Instead, lenders have turned to the use of roll-ups as an alternative to explicit cross-collateralization.[15] Roll-ups in DIP financing increased during the financial crisis (and resulting tightening of credit conditions) in 2009[16] and reached a turning point in the mega case of Lyondell.[17] Lyondell filed for bankruptcy listing total assets exceeding $27 billion and debts exceeding $19 billion and requested approval of an $8.25 billion DIP financing package, which far exceeded any previously-granted financing in chapter 11.[18] The proposed financing consisted of two facilities: a $6.5 billion term facility that consisted of equal amounts of new money and rolled-up prepetition debt and a $1.54 billion revolving asset-based facility.[19]

Prior to *Lyondell*, roll-ups traditionally involved asset-backed revolvers, but the "creative twist" in that case was that it involved the roll-up of term loans.[20] After a hotly-contested three day hearing, Judge Gerber approved the proposed DIP financing, including the controversial roll-up.[21] In approving the DIP facilities, though, Judge Gerber made clear that the outcome was heavily influenced by the extraordinary market conditions of the time:

> I assume, or at least hope that economic conditions in this country, including freeze-ups of the lending markets and the very limited present availability of credit will ultimately improve. What I'm of a mind to recognize and respect now in the way of economic reality will be trumped by the facts on the ground with respect to economic conditions at the time of the next financing I'm asked to approve. And people should be wary of using this case as a precedent in the next one that comes down the road, especially if that's the case after the liquidity markets have loosened up.[22]

Other contemporaneous courts and commentators similarly suggested that roll-ups were short-term solutions in light of the financial crisis. Indeed, one prominent practitioner suggested that the bankruptcy court's denial of DIP financing in *Trico Marine* "may reverse, at least for now, a trend that seemed to favor lenders being able to use DIP financing to obtain control over a debtor's chapter 11 proceeding" because it "indicat[ed] that the parties would have to develop a more substantial evidentiary record in order for the roll-up to be approved."[23]

Though roll-ups did begin to decline once credit markets began to loosen in the 2010s, they have returned with a vengeance "as courts continue to permit it as a necessary economic term to allow the debtor-in-possession to obtain financing and preserve the debtor's going-concern value."[24]

b. What are the Benefits (and Pitfalls) of Roll-Ups?

Although roll-ups are often said to be "generally viewed as a more controversial form of adequate protection that courts will approve sparingly,"[25] data suggests that, when requested, roll-ups are almost invariably approved.[26] Roll-ups are extremely attractive to potential DIP lenders. Theoretically, a roll-up of a fully-secured (or over-secured) prepetition loan is merely a convenience, given that the loan is (again, theoretically) sure to be repaid.[27] In practice, though, "the bankruptcy process often does not examine the old collateral's adequacy and the old loan's bona fides carefully," if at all.[28] "If the [pre-petition] loan is under-collateralized, the roll-up can effectively convert the unsecured portion into secured obligations."[29] In this situation, if the pre-petition debt is under-secured "the roll-up has the same effect as *Texlon* cross-collateralization [because it] diverts resources to a preferential satisfaction of the pre-petition financier's unsecured claim, all to the potential detriment of other unsecured claims."[30]

But even where the prepetition loan is fully secured, "the postpetition lender often bargains for substantial procedural protections that are not available to protect its prepetition loans" that, through a roll-up, "can sometimes shift the dynamics of a chapter 11 reorganization dramatically because of the increased rights that the holder of an administrative claim may have as compared to the holder of a prepetition secured claim."[31] Among other things a roll-up:

ensures the quick payment-in-full of a prepetition secured creditor's debt (both the secured and unsecured portions), which reduces the risk of nonpayment should the reorganization fail;[32]

- gives the secured creditor greater control by eliminating (or greatly reducing) potential challenges to the validity of the prepetition debt;[33]
- may give the secured creditor greater control over the cases by allowing it to exercise remedies in the event of the debtor's default;[34]
- cannot be crammed down[35] in a plan;[36] and
- earns interest at a "healthy rate" during the bankruptcy case, which only would occur if and to the extent it was over-secured in the absence of a roll-up.[37]

To be sure, roll-ups can be beneficial to debtors as well. Principally, a debtor's agreement to controversial provisions of DIP financing can avoid a costly and uncertain priming fight with its prepetition secured lender.[38] Also, if the lender is over-secured and the interest in connection with prepetition debt is more expensive than the DIP facility, then the debtor will realize a benefit.[39]

c. The Present (and Future) of Roll-Ups

Perhaps because of secured lenders' leverage over distressed companies,[40] what was once extraordinary has essentially become ordinary.[41] Indeed, two recent studies suggest that the "vast majority" of DIP credit agreements contained so-called "extraordinary provisions," like roll-ups.[42] In practice, bankruptcy courts are more amenable to the inclusion of a roll-up in a DIP facility if the DIP lender is also advancing new money to the debtor.[43] Frequently, the permissible amount of a roll-up "is often proportional to the amount of postpetition financing provided, such as one dollar of roll-up for each dollar of postpetition financing."[44]

Despite the near ubiquity of roll-ups in DIP financing, there are notable dissenters from the practice. In 2014, the Commission to Study the Reform of Chapter 11 established by the American Bankruptcy Institute issued a comprehensive report after a three-year process that included legislative and judicial recommendations. Recognizing the "opportunity for abuse" in certain circumstances,[45] the ABI Commission crafted the following proposed principle related to roll-ups:

- A court should not approve any proposed postpetition financing under section 364 of the Bankruptcy Code that contains a provision to roll up prepetition debt into the postpetition facility or to pay down prepetition debt in part or in full with proceeds of the postpetition facility. This provision should not apply to postpetition financing, including a facility that refinances in part or in full prepetition debt, to the extent that—

- the postpetition facility (a) is provided by lenders who do not directly or indirectly through their affiliates hold prepetition debt affected by the facility or (b) repays the prepetition facility in cash, extends substantial new credit to the debtor, and provides more financing on better terms than alternative facilities offered to the debtor; and
- the court finds that the proposed postpetition financing is in the best interests of the estate[46]

Some, however, question roll-ups entirely. In a recent concurrence, Judge Jordan of the Eleventh Circuit *sua sponte* raised the permissibility of roll-ups, stating that DIP financing with such a provision "is due for some serious review."[47] Specifically, Judge Jordan pointed to the Eleventh Circuit's prior opinion in *Saybrook*, stating that roll-ups are "a formally distinct but functionally similar financing arrangement" to cross-collateralization, noting that "it is unclear why any court that rejects forward cross-collateralization would be more sympathetic to roll-ups, which appear to have precisely the same effect."[48]

3. Roll-Ups in Singapore

a. Rescue financing regime in Singapore

In Singapore, the courts have noted that US cases may provide some guidance as to the factors the court should consider in exercising its discretion, since the rescue financing provisions in Singapore were adapted from the United States Bankruptcy Code.[49]

The Singapore court in *Re Design Studio* considered whether roll-ups could constitute rescue financing given that the new funds would be used to pay off pre-existing debt; and found that the provision was sufficiently broad to encompass roll-ups as roll-ups constitute a form of financing.[50] The Court held that roll-ups would fall under the definition of "rescue financing" as long as they are necessary for the survival of the company as a going concern, or necessary for a more advantageous realization of its assets as compared to winding up.[51] No express mention was made of any prohibition of roll-ups in the legislative provision, and there also did not appear to be any legislative intent to prohibit all roll-ups from constituting rescue financing.[52]

However, it was important that any roll-up loan had to constitute additional financing and provide new value for the company, for it be regarded as rescue financing. New funds which are almost entirely used to repay old debts create little new value, and are not roll-ups which should be regarded as rescue financing. The amount of new funds put in as new value should not merely be a minuscule or token amount. If this was the case, it may show a lack of *bona fides*, justifying a refusal by the court to exercise its discretion in favor of the application.

In coming to its decision in *Re Design Studio*, the Singapore court recognized that roll-ups have been allowed in some cases in the US, such as *Lyondell*, but that roll-ups continue to attract concerns.[53] One evident concern noted above, is that roll-ups effectively allow a pre-existing creditor to have its pre-petition debt repaid first, and also have its post-petition debt repaid in priority to other existing creditors, leapfrogging over their backs to get to the front of the queue for assets upon liquidation, with possibly no or little benefit to the rest. Thus one factor that the court needs to consider in exercising its discretion to grant super-priority to roll-ups is the extent to which other unsecured creditors are likely to benefit or be prejudiced if super-priority were to be permitted.[54]

In *Re Design Studio*, although some amount would go to repaying existing debts, the majority of the money would constitute new funding which could be used to create new value.[55] The DIP loan also had relatively low interest rates and fees, as compared to the other offers. The court was further satisfied that in light of the prevailing market conditions and that financing had largely dried up because of the ongoing virus pandemic, it may well have been the only viable possibility.[56] Finally, it was also significant that none of the creditors opposed the terms of the proposed financing. It therefore remains to be seen in Singapore how the law on rescue financing and roll-ups will continue to develop, but one would expect to see roll-ups quite regularly, with a healthy dose of skepticism.

4. The Italian rules on rescue financing: The story of a long fine-tuning process

a. The introduction of a facilitating regime for rescue financing

Italy enacted its first set of rules on interim and new financing in 2010.[57] The purpose of the new regulation was facilitating access to credit to distressed businesses undergoing an out-of-court or in-court restructuring proceeding (namely, *accordo di ristrutturazione dei debiti* and *concordato preventivo*). In that vein, the Italian legislature set in place the following combination of 'sweeteners' for rescue financing:

- *(i)* a claim resulting out of an interim or new financing enjoys an administrative expense priority,[58]
- *(ii)* the relevant loan transaction, possibly including a security interest over unencumbered property, is exempted from avoidance actions should the restructuring fail and debtor become insolvent,[59] and
- *(iii)* lenders to distressed companies are statutorily exempt from civil and criminal liability, if any, that could be triggered in connection with the act of lending to such companies.[60]

b. The limited practical impact of the new system and legislative reforms

Despite the set of inducements briefly outlined above, practice has shown a limited capability for Italian distressed businesses, especially micro, small and medium-sized enterprises (MSMEs) to obtain interim and new financing.[61] Anecdotal evidence has shown that DIP financing in Italy is, in fact, an option only for large firms undergoing a restructuring. Where lenders do extend new credit to distressed companies, the lenders' main objective is to maximize the recovery prospects of their pre-petition claims. In this regard, the rules introduced in 2010 have fallen short of the policy goal of setting the conditions for establishing a market for distress financing in Italy.

The reason for the limited impact of the 2010 Italian DIP financing regime is multifaceted. First, the small size of average Italian businesses and the dispersion of indebtedness leaves financial creditors with weak incentives to provide interim and new finance. Second, vagueness and ambiguity in the 2010 regime has led to uncertainty in how the law would be applied, which has also discouraged potential lenders. This latter issue has been exacerbated by a widespread reluctance by courts to deviate from the *pari passu* principle (*par condicio creditorum*), resulting in a strict following of case law on the matter.[62]

As a partial response, the Italian legislature engaged in a prolonged fine-tuning process through a series of legislative reforms[63] that aimed to streamline the process for granting 'protected' interim and new financing while also preserving the fundamental features of the system (i.e., the inducements outlined above).

c. The Situation Today: Old and New Issues

In 2019, the Italian Insolvency Code (*Codice della crisi d'impresa e dell'insolvenza* or CCI) was adopted.[64] However, the current regime for interim and new financing was not materially amended by these comprehensive reforms of Italian insolvency law. This is because the financing regime has over time partially achieved its intended goal of reducing uncertainty and risk for lenders. The protracted fine-tuning process has also managed to steer courts to a more favorable approach to distress lending, as shown by recent case law.[65]

Nevertheless, there are old and new issues that have slowed the development of innovation of DIP financing practices in Italy. In addition to the fact that most restructurings in Italy involve MSMEs, which does not appear likely to change in the short-term, the Italian usury laws pose regulatory obstacles to making interim and new financing remunerative for lenders. For example, Italian usury laws make it unlawful for a lender to apply interest or other charges in connection with a financing transaction in excess of a statutory threshold rate, regardless of the nature or financial condition of the borrower (i.e. 'statutory usury').[66]

Such statutory threshold rate is most often too low for the case of interim and new financing; as a result, only preexisting creditors may find it lucrative to extend new credit since they obtain, on top of the accrued interest, a larger recovery on their pre-petition claims. Any attempt to set DIP financing out of the scope of usury law or, at least, adapt the threshold to account for rescue financing have so far proved unsuccessful.

Over the last five years, a set of new issues has arisen from the EU-derived regulatory framework for banks. Although such issues do not directly affect the Italian regime for interim and new financing, the EU regulatory framework has a significant impact on the Italian regime by artificially posing obstacles to the extension of new credit to distressed businesses by financial lenders.

First, several banks—under the nudging of their supervisory authorities—have been selling large portfolios of non-performing exposures (NPEs), including claims *vis-à-vis* distressed but viable businesses (i.e. 'unlikely-to-pay' or UTP claims), to credit servicers. The sudden growth of the NPEs market imposed an unplanned increase in the number and size of credit servicers, most of which did not manage to set up the organizational and financial resources required to play a proactive role in the context of restructurings and, particularly, to provide interim and new financing. As a result, there were a number of restructurings that although viable in theory, resulted impossible in practice do to the passive approach taken by credit servicers, replacing the banks as the largest claimants.

Second, the bank regulatory framework has posed artificial costs on banks that seek to provide DIP financing to a pre-existing client undergoing a restructuring. Such costs are the result of the combination of the following provisions:

- banks are required to maintain a minimum level of prudential capital (i.e. 'own funds'),
- the classification of an exposure as non-performing implies a reduction in the bank's regulatory prudential capital,[67]
- the classification is debtor-based for non-retail clients, and thus any new exposure *vis-à-vis* a non-performing client is *per se* deemed as non-performing (notwithstanding any possible security/priority that may appear suitable to ensure full repayment.)

Since maintaining a sufficient level of own funds is expensive for banks, and even more so in the current market conditions, the decision to extend new credit to a pre-existing distressed client comes with an additional cost.[68] Such cost, in fact, contributes to further reduce the effective interest rate accrued by the bank on DIP financing, which is already not fully adequate to remunerate the risks involved in the transaction due to the thresholds set forth by the usury law described above.

d. Opportunities for roll-ups in Italy

Roll-ups, if deemed admissible under the Italian law, would serve the policy objective of further incentivizing lenders and, eventually, increasing the availability of new finance to distressed, but viable, firms. Indeed, allowing lenders to roll-up pre-petition amounts would provide an additional incentive to prepetition creditors. This would compensate lenders for the interim or new financing extended to the debtor which could be added on to the negotiated interest rate. That increase in the remuneration awarded to the lender would offset, in whole or in part, the inability to extend credit above the usury interest rates thresholds described above.

Although roll-ups are virtually unknown to the Italian restructuring practice and courts do not appear to have the explicit power to grant priority status to pre-petition claims, statute and case law seem to leave open a small opportunity for courts to allow transactions that amount to a roll-up.

Similar to the 'full' roll-ups described in the U.S. section above, it is conceptually possible, although yet presently untested, that a court has the power to authorize an Italian company to engage in a transaction substantially similar to a roll-up by paying its prepetition lender in full, pending the restructuring, on its prepetition claim as a material condition for extending new credit and financing the distressed business. Provided that no other lender would be available to financially support the restructuring attempt and that the restructuring would help preserve value, the position of that creditor would be no different from the one of a 'critical vendor' from a substantial Italian law standpoint.[69]

The authority for payment of 'critical vendors' can be found in Article 100 of the CCI (which replaced Article 182-quinquies, par. 5, of the Italian Insolvency Act). While the definition of 'critical vendor' provided under Article 100 CCI applies to someone supplying "goods and/or services" material for the continuation of the business, thereby not including a lender, the prevailing view is that the payment of pre-petition claims out of the scope of Article 100 CCI is permissible upon judicial authorization, if in the best interest of creditors.[70]

This same 'best interest' rationale could be easily extended to DIP financing, since the supply of financial resources' might well be pivotal for the continuation of the business and there may be no other lender available to provide new finance except for the one requiring the payment of its prepetition claim. If the continuation of the business would be in the best interest of creditors, the court should be entitled to allow the reimbursement of the lender's prepetition claim under Article 100, achieving an outcome that substantively amounts to a roll-up. Although this argument has not yet been tested in court, it appears reasonable and sufficiently grounded. However, it should be noted that there are significant obstacles both from a normative and practical standpoint with respect to the possibility of witnessing the development of a roll-ups in Italy.

First, the additional recovery obtained by the creditor on the prepetition claim as a result of the 'roll-up' (i.e., the difference between full recovery and the estimated recovery in the absence of a roll-up) could be interpreted by courts as a form of additional "interest or other charge" in connection with the DIP financing. Should the court adhere to such a view, the usury threshold would be implicated and pose a rigid and unvaried limit on the ability of the lender to seek appropriate remuneration for extending rescue finance. Second, roll-ups imply a deviation from the *par condicio creditorum* (pari passu) principle where the rolled-up prepetition claim would not have received full payment otherwise (which indeed is that very case when the roll-up is more beneficial to the lender). Courts may not be inclined to creatively construe the framework in favor of roll-ups where it would require a deviation from the *par condicio creditorum* principle.

Further, from a more practical standpoint, the high degree of uncertainty concerning the possibility of obtaining the pre-petition claim payments in connection with interim or new financing is likely to discourage lenders from seeking court approval of any such roll-up. Given that a fundamental precondition to approving payment of a prepetition claim is that the restructuring is in the best interest of creditors, it is more likely that prepetition financial creditors would cooperate to jointly provide DIP financing (rather than taking the risk of individually attempting to obtain the benefit of prepetition claim payment).

When weighing all of the factors above, one must conclude that although roll-ups appear theoretically possible in Italy, they are procedurally unattractive to lenders and unlikely to develop without further legal changes to the regime. That conclusion leads to a reflection on whether it would be desirable to amend the Italian framework to expressly allow roll-ups. The short answer seems to be no: Roll-ups would (at least in part) redress a distortion (namely, the lack of adequate remuneration in connection with DIP financing) by introducing a further distortion (namely, a material deviation from the *par condicio creditorum*). This could also lead to the unintended consequences noted in the U.S. section above, where nearly all rescue financing contains roll-up relief.

Instead, facilitating interim and new financing in Italy could be better pursued in a different and more direct way, by means of excluding the application of the usury thresholds to interim and new financing and aligning the EU-derived bank regulatory framework to the 'rescue culture' that the EU legislature has planned on establishing across Member States.

5. Roll-Ups Under Spanish Bankruptcy Law

a. The introduction of a facilitating regime for rescue financing in Spain

Spain's modern insolvency regime dates from 2003. The solution for both personal bankruptcies and companies under a state of current or imminent insolvency was merged into one single formal insolvency proceedings (*concurso de acreedores)*.[71] At that time, the Spanish regime did not foresee out-of-Court workouts or hybrid pre-insolvency solution, as no provisions were made for these types of solutions in the 2003 insolvency regime.

Under formal insolvency proceedings, a bankruptcy trustee (*administra-*

tor concursal) is appointed.[72] The general rule is that the bankruptcy trustee is appointed with intervention powers (which means their authorization is needed) if the debtor has filed for its insolvency (voluntary proceedings), while the trustee is vested with substitution powers —hence, substituting the current directors of the insolvent debtor—when the insolvency procedure has been filed by a creditor (forced proceedings).[73] Thus, under formal insolvency, the debtor remains in possession only in voluntary proceedings, and under the intervention of the bankruptcy trustee. This means that any decision made by the debtor on the administration of its estate (i.e. placing orders with vendors, making payments, obtaining new financing or granting security, etc.) needs to be agreed with the trustee.

In 2009, a hybrid pre-insolvency-proceeding (*preconcurso*) aimed at reaching an early arrangement with creditors was included in Spain's insolvency law as a second possible solution for distressed companies.[74] This relatively new proceeding is commenced by a simple communication to the Commercial Court and grantsd the insolvent debtor a four-month term to negotiate an early arrangement with its creditors prior to entering into a full insolvency proceeding. Importantly, the initiation of the *preconcurso* does not result in the appointment of bankruptcy trustee, so the debtor remains fully in possession during the part of the proceeding. However, this four-month period was also used in practice to reach out-of-Court agreements that avoided a subsequent insolvency proceeding.

These agreements (mainly with financial institutions) included security where the loans were previously unsecured and increased the guarantees where the loans were already secured. Nevertheless, when these insolvent debtors finally filed for insolvency, Spanish Commercial Courts allowed for the avoidance of the security provided under these refinancing agreements on the grounds that the new security granted was detrimental to the aggregate assets of the insolvent company[75], which in turn led to financial institutions abandoning the practice of entering into new re financing agreements with insolvent companies.[76] As banks withdrew their support from companies seeking to restructure their business by means of a *preconcurso* and refinancing agreements (*acuerdos de refinanciación*), the legislature introduced further regulatory reforms to protect refinancing agreements from avoidance actions (Article 71 bis of the Insolvency Act).

In 2011,[77] refinancing agreements were formally included under the scope of the *preconcurso* and it became possible to extend their effects to some non-participating parties through their Court sanctioning or *homologación* (Additional Provision 4 of the Insolvency Act). The 2011 reform also referred to the need of rescue financing towards the continuity of Spanish businesses[78] and introduced, for the first time, DIP financing provisions in Spain.

b. DIP financing provisions under Spanish Bankruptcy Law

Spanish Bankruptcy Law includes 'sweeteners' similar to the Italian rescue financing regime, as it foresees certain priority for new money lent both under *preconcurso* and *concurso de acreedores*. More specifically, in the case of a refinancing agreement under a pre-insolvency scenario, 50% of the new money will be considered a post-petition debt (*crédito contra la masa*)[79] and the remaining 50% will be considered a pre-petition debt with general privilege (*crédito con privilegio general*)[80] in the event that the insolvent debtor eventually files for bankruptcy. Refinancing agreements may also include new encumbrances and rights *in rem* that would grant the financing provider a secured claim (*crédito con privilegio especial*) on specific encumbered assets. This implies that the assets must have been previously unencumbered or that any previous liens would have priority (and thus the provider of new financing under the refinancing agreement relies on the equity cushion in the value of those assets), as there is no authority for courts to grant priming liens in Spain (unlike in the US). Similar to Italian law, these refinancing agreements (and any encumbrance of assets included therein) that have been sanctioned by the Commercial Court are exempt from avoidance actions should the insolvent debtor finally enter into a formal *concurso de acreedores*.[81]

In case of an arrangement with creditors under an insolvency scenario, 100% of the new money necessary to finance the viability plan and comply with the obligations under the arrangement would be considered post-petition debt (*crédito contra la masa*)[82]. It should be noted, however, that there is still a certain stigma in Spain on 'especially related persons' (including other companies of the same company group as the debtor).[83] Therefore, if the rescue financing was made by 'especially related persons', the loans would not be granted any priority.[84] On the contrary, the debt would be subordinated debt (*créditos subordinados).*

Spanish law does not expressly regulate the priority of an eventual rescue financing between the date of the insolvency opening and the date of the Court-approval of an arrangement with creditors (interim financing).[85] One solution would be to obtain approvals to encumber assets pursuant to Article 205 of the Spanish Insolvency Act Recast, which regulates that the debtor under formal insolvency. If the debtor were to obtain approval of the bankruptcy trustee and Court sanctioning, interim rescue financing that grants security similar to a roll-up could be achieved. However, there are no incentives for financial institutions to provide financing in that stage, given that, as is the case in Italy, (i) Spain has legal limits on usury, limiting the possible interest rates applicable to these transactions with high risk[86] and (ii) the EU-derived regulatory framework noted above also applies in Spain and banks must report losses for non-performing loans (or loans to companies under insolvency that have still not an arrangement with creditors approved), impacting lenders willingness to provide rescue financing.

c. Opportunities for roll-ups in Spain

When considering whether roll-ups could be implemented in Spain, we must differentiate between refinancing agreements (pre-insolvency scenario) and new financing under a formal insolvency proceeding.

The most likely context for roll-ups in Spain is under refinancing agreements in the pre-insolvency scenario. In pre-insolvency refinancing agreements, the Spanish Insolvency Act Recast requires that the agreement include "*at least a significant increase of the available credit or the modification or termination of its obligations, either through an extension of its maturity date or through new obligations which substitute the previous ones*".[87] Thus, under a pre-insolvency refinancing agreement, there could be an implicit roll-up where the previous unsecured debt maturity has been extended (or all the new obligations that substitute the previous obligation) and the previously inexistent security guarantees repayment in the event of insolvency (therefore, not subject to the *par condicio creditorum* rule). And, as explained above, this security would not be avoidable.

Under a formal insolvency proceeding and similarly to Italy, the *par condicio creditorum* rule (the basic rule and rationale of insolvency proceedings in Spain) makes it hard to admit roll-ups under the Spanish legal system. Indeed, Spanish Insolvency Law provides for a favorable treatment for new financing as a post-petition claim (*crédito contra la masa*), but this treatment does not extend to pre-petition claims of the providers of new financing. Therefore, prepetition lenders do not appear to be able to benefit from roll-ups under formal insolvencies in Spain.

d. Implementation of the EU Directive and the impact on roll-ups

Spain is currently implementing the EU Directive on Preventive Restructuring Frameworks,[88] which includes, under its Chapter 4, a set of measures to protect interim and new financing granted under pre-insolvency scenarios.

Among other measures, article 17 of the EU Directive on Preventive Restructuring Frameworks provides that rescue financing under a pre-insolvency scenario[89] shall not be declared void, voidable or unenforceable. It also includes the possibility for State Members to give priority in payment to the lenders of interim or new financing in the context of subsequent insolvency procedures. The imminent reform of the Spanish Insolvency Act Recast replicates, for restructuring plans, the already existing measures in Spain for refinancing agreements, which are similar to those proposed under the EU Directive on Preventive Restructuring Frameworks. Additionally, it improves the position of financing provided by especially related persons, which will be granted priority and protection from avoidance actions if the restructuring plan affects over 60% of the total liabilities of the company (excluding those of especially related persons).

Nevertheless, the implementation of the EU Directive on Preventive Restructuring Frameworks is a step forward in Spain, as it now extends (i) the protection against claw-back actions and (ii) the priority in payment not only to new financings under a restructuring plan but also to interim financings while the plans are being negotiated[90]. Allowing roll-ups in Spain under defensive DIP financings would incentivize lenders to grant new funds to companies under distress (as it happens in the US).[91] However, as it also happens in Italy, the difficulty in Spain is not the *par condicio creditorum* rule *per se* or the lack of legal reference to roll-ups; the main difficulty derives from the lack of interest of financial institutions to provide financing to companies under distress given (i) the impact of the compulsory write-offs of these financings in their balance sheets and (ii) the limits on interest rates derived from usury legislation.

6. Conclusion

As the paper shows, each of the jurisdictions is at a different stage on the continuum of rescue financing and allowance of roll-up relief. Of those jurisdictions that allow for roll-ups a robust market has grown for rescue financing. However, the flourishing of the rescue financing market has come at a cost and that cost is that lenders are no longer interested in providing much needed capital to distressed companies without providing for roll-ups. Once roll-ups become rooted in the general practice, it appears very difficult to 'roll back' the practice. Particularly when comparing Italy and Spain, where roll-ups have yet to take root, perhaps a better solution to encourage rescue financing would be to amend existing usury laws and creating other incentives for lenders.

NOTES:

[1][2020] 5 SLR 850

[2]In re Capmark Fin. Grp. Inc., 438 B.R. 471, 511 (Bankr. D. Del. 2010). For a helpful graphic depiction of roll-ups in DIP financing, *see* Tung, Frederick, "Do Economic Conditions Drive DIP Lending?: Evidence from the Financial Crisis" (September 20, 2017). Boston Univ. School of Law, Law and Economics Research Paper No. 16-38, Available at SSRN: https://ssrn.com/abstract=2828295 or http://dx.doi.org/10.2139/ssrn.2828295, at p. 32.

[3]*Capmark*, 438 B.R. at 511.

[4]3 COLLIER ON BANKRUPTCY ¶ 364.06[2] (16th ed.).

[5]*Capmark*, 438 B.R. at 511 n. 15. *See also* In re Cranberry Growers Coop., 592 B.R. 325, 329–30 (Bankr. W.D. Wis. 2018) (*rev'd sub nom* Cranberry Growers Coop. v. Layng, 930 F.3d 844, 329–30 (7th Cir. 2019)).

[6]3 COLLIER ON BANKRUPTCY ¶ 364.06[2] (16th ed.).

[7]Frederick Tung, "Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis," 37 Yale J. on Reg. 651, 668 (Spring 2020) (hereinafter "Tung").

[8]3 COLLIER ON BANKRUPTCY ¶ 364.06[1] (16th ed.).

[9]Otte v. Manufacturers Hanover Comm. Corp. (In re Texlon Corp.), 596 F.2d 1092, 1094 (2d Cir. 1979).

[10]*See generally* Charles J. Tabb, "A Critical Reappraisal of Cross-Collateralization in Bankruptcy," 60 S. Cal. L. Rev. 109 (Nov. 1986).

[11]Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.), 963 F.2d 1490 (11th Cir. 1992).

[12]*Saybrook*, 963 F.2d at 1494 (citing Charles J. Tabb, "A Critical Reappraisal of Cross-Collateralization in Bankruptcy," 60 S.Cal.L.Rev. 109 (1986)).

[13]Tung, 37 Yale. J. on Reg. at 668.

[14]3 COLLIER ON BANKRUPTCY ¶ 364.06[1] (16th ed.).

[15]Mark J. Roe and Frederick Tung, "Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain," 99 Va. L. Rev. 1235, 1253 (Oct. 2013) (hereinafter "Roe & Tung") ("Before roll-ups, DIP lenders tried cross-collateralization, a more transparent way of pursuing secured status for under-secured pre-bankruptcy loans . . .Once it became clear to lenders and their lawyers that bankruptcy courts would not regularly countenance cross-collateralization, these lenders innovated the roll-up structure."); Nicole Stephansen, "Roll-Up Financing Gains Prominence," *Cadwalader Restructuring Review* (June 2010) at p. 10.

[16]3 COLLIER ON BANKRUPTCY ¶ 364.06[2] (16th ed.)

[17]In re Lyondell Chem. Co., Case No. 09-10023 (REG) (Bankr. S.D.N.Y. Jan. 6, 2009).

[18]John J. Rapisardi, "*Lyondell*: the largest commercial DIP in history," 7 JIBFL 393, at p. 2 (1 Aug. 2009) (hereinafter "Rapisardi").

[19]Rapisardi, at p. 2.

[20]Rapisardi, at p. 3.

[21]David Griffiths, "Roll-up, Roll-up, Read All about It!," *Weil Bankruptcy Blog* (Oct. 6, 2010).

[22]Transcript of February 27, 2009 Hearing, *in re Lyondell Chem. Co.*, Case No. 09-10023 (REG) (Bankr. S.D.N.Y.), Docket No. 3740 at 740:4—20.

[23]Marcia L. Goldstein *et al.*, "Chapter 11 Business Reorganizations: Debtor in Possession Financing and Second Lien/Subordination Issues," SS029 ALI-ABA 1, at § IV.D (April 2011) (hereinafter "Goldstein").

[24]3 COLLIER ON BANKRUPTCY ¶ 364.06[2] (16th ed.) (citing cases).

[25]1 COLLIER LENDING INSTITUTIONS & THE BANKRUPTCY CODE ¶ 5.03[2][b] (citing cases)

[26]Tung, 37 Yale J. on Reg. at 667.

[27]Roe & Tung, 99 Va.L.Rev. at 1251.

[28]Roe & Tung, 99 Va.L.Rev. at 1252.

[29]Kenneth Ayotte and David A. Skeel, Jr., "An Efficiency-Based Explanation for Current Corporate Reorganization Practice," 73 U. Chi. L. Rev. 425, 464 n. 95 (2006).

[30]1B SECURED TRANSACTIONS UNDER THE UCC § 9D.05[5] (2019).

[31]3 COLLIER ON BANKRUPTCY ¶ 364.06[2] (16th ed.).

[32]Tung, 37 Yale J. on Reg. at 669.

[33]Tung, 37 Yale J. on Reg. at 670.

[34]Nicole Stephansen, "Roll-Up Financing Gains Prominence," *Cadwalader Restructuring Review* (June 2010), at p. 10 ("[U]pon the occurrence of certain events of default under the terms of the DIP credit facility, the DIP agreement and the DIP financing order may authorize the lender to proceed against the postpetition collateral without first obtaining relief from the automatic stay. In the absence of a roll-up, the prepetition lender's ability to exercise remedies with respect to its prepetition collateral would be subject to the automatic stay . . . ").

[35]"Cramdown allows the debtor to confirm a plan over a secured lender's objection by essentially continuing the pre-bankruptcy secured loan at a rate of interest reflecting the risk of the loan." Tung, 37 Yale J. on Reg. at 670.

[36]3 COLLIER ON BANKRUPTCY ¶ 364.06[2] (16th ed.).

[37]Tung, 37 Yale J. on Reg. at 671; *see generally* 1 COLLIER LENDING INSTITUTIONS & THE BANKRUPTCY CODE ¶ 5.03[2][e].

[38]Goldstein, SS029 ALI-ABA 1, at § IV.D; *see also Cranberry Growers*, 592 B.R. at 330 ("From the debtor's perspective, it can maintain its relationship with its prepetition lender.").

[39]Goldstein, SS029 ALI-ABA 1, at § IV.D.

[40]*See, e.g.,* Jonathan C. Lipson, "The Secret Life of Property: Corporate Reorganization After *Jevic*," 93 Wash. L. Rev. 631, 689 (June 2018):

> The concern is that lenders like CIT in Jevic can bargain for a roll-up because they can make it difficult for the debtor to shop elsewhere for a loan. If, for example, the prebankruptcy lender learns that a troubled debtor is attempting to negotiate for DIP financing as part of its bankruptcy planning, the secured creditor may not cooperate with other potential lenders or declare a default, forcing the debtor to commence a Chapter 11 case before it is ready to do so. Because corporate debtors' assets are often fully encumbered, their lender's prebankruptcy priority will give them leverage to become the only lender—and thus the lender under a priority-enhancing DIP loan.

See also Jonathan C. Gordon, "Government Guaranties for Corporate Bankruptcies," 43 Vt. L. Rev. 251, 286 (Winter 2018):

> One proposed solution is that courts should simply stop approving these aggressive DIP loans. But when the court is presented with only one option, and the debtor in possession claims it cannot find financing elsewhere, the court has its hands tied. If the court rejects the loan, the debtor in possession will likely be unable to operate and the reorganization will fail. Alternatively, the court can approve the loan, as it has often done. The debtor in possession may lose substantial control rights, but at least there is a chance that the reorganization will still succeed.

[41]*See, e.g.,* 3 COLLIER ON BANKRUPTCY ¶ 364.06[2] (16th ed.) ("With apparently increasing frequency, working capital lenders providing postpetition financing demand that the debtor in possession satisfy prepetition secured indebtedness to avert the need for contentious adequate protection or priming litigation."). Indeed, "[i]f anything, the percentage of roll-ups appears greatest post-crisis." Tung, Frederick, Do Economic Conditions Drive DIP Lending?: Evidence from the Financial Crisis (September 20, 2017). Boston Univ. School of Law, Law and Economics Research Paper No. 16-38, Available at SSRN: https://ssrn.com/abstract=2828295 or http://dx.doi.org/10.2139/ssrn.2828295, at p. 28.

[42]*See* Tung, 37 Yale J. on Reg. at 667; Loan Syndications & Trading Ass'n, "The Trouble With Unneeded Bankruptcy Reform: The LSTA's Response to the ABI Chapter 11 Commission Report," at 23 (2015).

[43]1B SECURED TRANSACTIONS UNDER THE UCC § 9D.05[5] n. 25 (2019).

[44]3 COLLIER ON BANKRUPTCY ¶ 364.06[2] (16th ed.) ("courts generally allow the 'roll-up' particularly if the new facility has at least some potential for truly advancing new credit (that is, increasing the aggregate commitment of the lender's pre- and post-petition claims to an amount greater than the lender's exposure on the petition date").

[45]Harner, Michelle M., "Final Report of the ABI Commission to Study the Reform of Chapter 11" (2014), at p. 77.

[46]Harner, Michelle M., "Final Report of the ABI Commission to Study the Reform of Chapter 11" (2014), at p. 73.

[47]Reynolds v. Servisfirst Bank (In re Stanford), 17 F.4th 116, 128 (11th Cir. 2021) (Jordan, J., concurring).

[48]Reynolds v. Servisfirst Bank (In re Stanford), 17 F.4th 116, 128 (11th Cir. 2021) (cleaned up) (quoting Daniel J. Bussel & Kenneth N. Klee, "Recalibrating Consent in Bankruptcy," 83 Am. Bankr. L.J. 663, 707 n. 209 (2009).

[49]See *Attilan Group Ltd*, *Re* [2018] 3 SLR 898 and *Re Design Studio,* [2020] 5 SLR 850

[50]*Re Design Studio,* [2020] 5 SLR 850 at 863

[51]*Id.*

[52]Second Reading of the Companies (Amendment) Bill (Bill No 13/2017) (Singapore Parliamentary Debates, Official Report (10 March 2017) vol 94

[53]*Re Design Studio,* [2020] 5 SLR 850 at 864–865

[54]*Re Design Studio,* [2020] 5 SLR 850 at 863

[55]*Re Design Studio,* [2020] 5 SLR 850 at 866–867

[56]*Id.*

[57]Law Decree No. 78/2010, converted into Law No. 122/2010, amending the Royal Decree No. 267/1942 ("Italian Insolvency Act").

[58]Article 182-*quater*, par. 1 and 2, of the Italian Insolvency Act.

[59]Article 67, par. 2(e), of the Italian Insolvency Act, clearly set forth such protection only for new financing, leaving interim financing in a limbo. Since the enactment of the new rules, the prevailing view has been that the exemption from avoidance action applies also to interim financing. See L. Stanghellini, *Finanziamenti-ponte e finanziamenti alla ristrutturazione*, in Fallimento, 2010, 1351.

[60]Stanghellini, in Fallimento, 2010, at 1361.

[61]See L. Stanghellini, C.G. Paulus, R. Mokal, I. Tirado, *Best Practices in European Restructuring*, Wolters Kluwer, 2018, 60, showing—based on extensive empirical research on restructurings occurred in Italy within the period 2009–2015—that DIP financing has been available in 25–30% of the cases, of which a vast majority was involving large firms.

[62]See, *inter alia*, Supreme Court No. 33350/2018, which makes also extensive reference to other cases.

[63]The Italian DIP financing regime has, thus, been amended in 2012, 2015, and in 2021. See Law Decree No. 83/2012, converted into Law No. 134/2012; Law Decree 83/2015, converted into Law No. 132/2015; Law Decree No. 118/2021, converted into Law No. 147/2021.

[64]Delegated Decree No. 14/2019.

[65]Exemplary, in that regard, is the recent decision by the Supreme Court No. 41772/2021.

[66]Law No. 108/1996.

[67]See the ECB 2018 *Addendum to the guidance on non-performing loans ("NPLs")*, available at *www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.npl_addendum_201803.en.pdf*.

[68]L. Stanghellini, C.G. Paulus, R. Mokal, I. Tirado, 2018, at 61.

[69]Article 100 CCI provides that "The debtor filing a proposal for a judicial composition with creditors pursuant to Article 44 and 87, providing for the continuation of the business activity, may require the court to authorize, on the basis of a summary assessment, the payment of prepetition claims arisen in connection with the supplying of goods and/or services, provided that an independent expert has certified that the payment be material to the continuation of the business and beneficial to creditors". Although the above provision would not be applicable to the payment of a prepetition claim by a lender (see below), the payment of such a claim may well be material to continuation and beneficial to creditor if any DIP financing is conditional to such payment.

[70]Supreme Court No. 3324/2016.

[71]Insolvency Act 22/2003, of 9 July, currently Spanish Insolvency Act Recast, Royal Legislative Decree 1/2020, of 5 May or "Spanish Insolvency Act Recast". Spain opted to provide for one single formal insolvency proceedings applicable to both companies and personal bankruptcies, leaving behind the different procedures that existed until then: *quita y espera* and *concurso de acreedores* for personal insolvencies and *quiebra* and *suspension de pagos* for companies or businesspersons.

[72]Spanish Insolvency Act Recast. Article 28.4.

[73]Spanish Insolvency Act Recast Article 106.

[74]Royal Decree Law 3/2009, of 27 March, on urgent tax, financial and insolvency measures considering the evolution of the economic situation.

[75]Article 71.3.2 of the Insolvency Act of 2003 (current article 228.2 of the Spanish Insolvency Act Recast) included among the rebuttable presumptions of acts subject to avoidance actions "*the granting of security to guarantee pre-existing obligations or new obligations incurred as a substitution of pre-existing obligations".*

[76]J Quijano González, 'El contexto, las claves y los aspectos principales del sistema 'concursal' español en las sucesivas reformas' in *Hacia un nuevo paradigma del derecho europeo de insolvencias. Sistemas jurídicos a debate* (EuriConv 2016).

[77]Act 38/2011, dated 10 October 2011, on reform of the Spanish Insolvency Act.

[78]*Ibid*, section V of its preamble.

[79]Article 704(1) of the Spanish Insolvency Act Recast. It requires that the refinancing agreement is not subject to avoidance actions and that it generates "*new cash inflows*". The rescue financing shall be necessary for the debtor to comply with the viability plan attached to the refinancing agreement.

[80]Articles 280(6) and 704(2) of the Spanish Insolvency Act Recast.

[81]Article 698 of the Spanish Insolvency Act Recast. This provision makes express reference to any encumbrances and/or guarantees executed under the refinancing agreement which is subject to *homologación*.

[82]Article 242(14) Spanish Insolvency Act Recast.

[83]Article 28 of the Spanish Insolvency Act Recast.

[84]Article 242(14) with regard to new money provided by especially related persons under arrangements with creditors under formal insolvency and 704(3) with regard to new money provided by especially related persons under refinancing agreements.

[85]In fact, article 242(14) of the Insolvency Act Recast only grants the treatment of post-petition claims or *créditos contra la masa* to new financing under the Court-approved arrangement with creditors that, as explained, provides the necessary funds to comply with the viability plan and obligations under the arrangement. It does not include, however, any special treatment for interim financing.

[86]Law of 23 July 1908 on the avoidance of usurious loan contracts.

[87]Article 606 of the Spanish Insolvency Act.

[88]Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency). Its Chapter 4 is titled "*Protection for new financing, interim financing and other restructuring related transactions*".

[89]The projected pre-insolvency mechanisms in Spain, restructuring plans (*planes de reestructuración*), will replace the previous refinancing agreements. Restructuring plans are regulated under articles 614 and following of the Draft Law for the reform of the Insolvency Act Recast, published on 4 July 2022 at the Boletín Oficial de las Cortes Generales (Senado), núm. 360. The Spanish Congress approved this draft law recently on 25 August 2022 but, at the date of this article, it still has not been published in the Spanish Official Gazette. Most of the provisions of the law will enter into force 20 days after its publication in the Spanish Official Gazette.

[90]*Ibid*. Protection against clawback actions is foreseen under article 667(2). On the priority in payment and similarly to what happened with refinancing agreements, article 242(17) grants 50% of the interim or new financing the priority treatment of *créditos contra la masa* and article 280(6) grants the other 50% the treatment of claim with general privilege (*créditos*

con privilegio especial).

[91] J Carles, C Cuesta and M Mas, 'Debtor-in-possession financing. Lecciones a aprender de Estados Unidos y propuesta para España' in *Actualidad Mercantil 2022* (Tirant lo Blanch 2022).

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The Past, Present and Future of Debtor-in-Possession Financing

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THE PAST, PRESENT AND FUTURE OF DEBTOR-IN-POSSESSION FINANCING

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INTRODUCTION

There's a new kid on the block in Chapter 11. Actually, the new kid—the debtor-in-possession ("DIP") financers who now figure prominently in many of the most high profile Chapter 11 cases—isn't new at all. Chapter 11's distinctive post-petition financing rules trace their ancestry back to the origins of large scale corporate reorganization in America in the nineteenth century. Corporate reorganization began with the common law "equity receiverships" that were used to reorganize America's troubled railroads.[1] Almost from the beginning, courts promised special priority to lenders who would help finance reorganization efforts. Originally known as "receiver's certificates," these loans helped to keep the railroads going during the often lengthy restructuring process, much as DIP financing does today.[2]

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[1] The origins of large scale corporate reorganization in America are described in detail in DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 48-69 (2001).

[2] The current debtor-in-possession ("DIP") financing provision can be found in section 364 of the Bankruptcy Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as 11 U.S.C. § 364). Section 364 provides in pertinent part that:

> (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

In this sense, post-petition financing has always been with us. But in the past decade, the role of the financers has changed. After a century in the shadows, post-petition lenders have stepped onto center stage. The DIP loan agreement has become the single most important governance lever in many large Chapter 11 cases. After United Airlines filed for bankruptcy, the bank syndicate that provided its DIP financing pressured the company to obtain substantial wage concessions from its unions.[3] FAO Schwarz's lenders gave the posh toy company two months to reorganize or sell its assets, or the lenders would shut it down.[4]

To be sure, DIP financing isn't for every debtor. Even among publicly held debtors, roughly half do not obtain DIP financing in connection with their Chapter 11 case. But the percentage that do has steadily increased over the past decade,[5] and there is no evidence that this trend will be reversing any time soon. Moreover, the largest and most prominent debtors are the ones that are most likely to look to a DIP financer for funds.

Why have these formerly bashful financers suddenly started hogging the spotlight? I argue in this article that the generous terms offered to DIP financers have encouraged lenders to make loans to cash-starved debtors, and that these lenders have used their leverage to fill a governance vacuum that was created by the enactment of the 1978 Code. Prior to the New Deal, J.P. Morgan and a handful of other Wall Street banks dominated the governance process when large companies were reorganized. The New Deal reformers kicked the Wall Street banks out in 1938, and required that a trustee be appointed to run the debtor's business in large reorganization cases. When the 1978 Code eliminated the mandatory trustee requirement, it left a governance void

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(3) secured by a junior lien on property of the estate that is subject to a lien.

(d)(1) The court, after notice and a hearing, amy 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 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.

3 *See generally* Marilyn Adams, *Low-Cost Carrier Plan Trips Up UAL*, USA TODAY, Mar. 14, 2003, at 3B (noting United's plan to ask for rejection of union contracts because it "needs those savings to meet cash-flow targets set by lenders").

4 *See, e.g.*, *F.A.O. Schwarz Parent Reaches Agreement With Lenders*, N.Y. TIMES, Feb. 1, 2003, at C4. FAO successfully reorganized, but landed back in bankruptcy before the end of the year. *See, e.g.*, Constance L. Hays, *FAO to File for Bankruptcy and Break Up Toy Empire*, N.Y. TIMES, Dec. 3, 2003, at C10.

5 The percentage of publicly held debtors that obtained DIP financing rose from 7.41% in 1988 and 10.42% in 1989, to 48.21% in 1996. Sandeep Dahiya et al., *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259, 266 (2003).

in Chapter 11. After creditors were burned in a number of post-1978 cases, bank lenders began using their post-petition financing agreements to rein in debtors' managers, and to influence the course of the reorganization process.

After recounting this history in Part I of the Article, I describe the current DIP financing arrangements in Part II. There are two general kinds of DIP loans. In most cases, the DIP financing takes the form of a standard loan. By structuring the loan as a revolving credit agreement, and imposing strict conditions on each new round of financing, the lender is assured that it will have significant leverage over the debtor's managers' decision-making throughout the Chapter 11 process. I call these arrangements "loan-oriented" DIP financing. I refer to the second type of DIP financing arrangement as "loan-and-control" financing. In these cases, the DIP loan is used to transfer control to the DIP lender itself, either through a sale to the DIP lender or as the intended outcome of the Chapter 11 reorganization.

Although DIP lenders have improved Chapter 11 governance in the past decade, there are significant grounds for concern as well. I explore these concerns in Part III. With loan-oriented DIP financing, the principal concerns are that the lender may have too great an incentive to force the debtor to liquidate assets, due to the lender's priority status; and that the lender will use the post-petition loan to improve the status of loans it extended prior to bankruptcy. The principal danger with loan-and-control transactions is that the DIP financing arrangement will divert value from general creditors or stymie other competing bids for control of the troubled company.

I offer a variety of proposals for counteracting these problems. Courts should refuse to permit provisions that protect a pre-petition loan, for instance; better yet, the pre-petition and post-petition loans should be separated, and the pre-petition portion paid last. With loan-and-control transactions, I argue that provisions that could chill alternative bids should be subject to at least as much scrutiny as anti-takeover devices receive outside of bankruptcy. I also argue that claims trading is often a superior mechanism for transferring control, and should be encouraged by reducing some of the frictions that interfere with the market.

If Part I explores post-petition financing's past, and Part II focuses on the present, the proposals outlined in Part III can be seen as my hope for the future. The future of debtor-in-possession financing isn't limited to Chapter 11, however; other jurisdictions have adopted similar provisions, or are considering doing so. Part IV concludes the Article by very briefly describing some of the implications of the analysis for other jurisdictions.

I. THE PAST: FROM RECEIVER'S CERTIFICATES TO DIP FINANCING

Like just about everything in U.S. corporate reorganization, debtor-in-possession financing can be traced back to seeds that were first planted in the era of the nineteenth-century railroad receiverships. In the discussion that follows, I begin by briefly describing the railroad receivership process that eventually led to Chapter 11, then turn to the financial innovations that paved the way for debtor-in-possession financing.[6]

A. *Equity Receiverships and the Origins of DIP Financing*

The classic equity receiverships involved moderately large railroads— railroads whose tracks crossed several state lines, and which had issued common stock, preferred stock, and several different mortgage bonds to raise money over the years. If the railroad encountered financial distress, and failed to make the requisite interest payments on its bonds, a creditor would first file a "creditor's bill" asking the court to appoint a receiver to oversee the defaulting railroad's property. The principal reason for appointing a receiver was that doing so technically shifted control of the railroad's assets to the receiver and out of the reach of prying creditors. If a creditor tried to obtain a lien against railroad property, for instance, the receiver would simply ask the court for an injunction.

The next step was to file a second "bill," the foreclosure bill. In form, the foreclosure bill asked the court to schedule a sale of the property (and solemnly invoked the liquidation-oriented language of traditional foreclosure law). In reality, the sale would be put off for months, and often years, while the parties negotiated over the terms of a reorganization plan.

In the meantime, the investment banks that had underwritten the railroad's bonds would quickly form a bondholders' committee to represent bondholders in the negotiations. If the firm had issued more than one class of bonds, several committees might form; and there might also be committees of common stockholders and preferred stockholders. The virtue of forming a committee was that it centralized the bargaining process, and theoretically gave thousands of widely scattered bondholders a champion— which, in large receiverships at the turn of the century, usually meant J.P. Morgan and Company, Kuhn,

[6] The initial discussion of equity receiverships is drawn in part from SKEEL, *supra* note 1, at 58-59.

Loeb, or one of a small group of other Wall Street banks.

To ensure their authority, the committee representatives asked, investors to "deposit" their bonds (or stock, for a stockholders committee) with the committee. By depositing their bonds, investors gave the committee complete control over the bonds for the duration of the negotiations, with one limitation: bondholders would have the right to withdraw their bonds if they disapproved of the plan that the committee negotiated on their behalf.

The goal of the negotiations was to rework the railroad's capital structure, reducing its obligations so that it could get back on track financially after the receivership. Often this meant converting fixed obligations into variable ones, or reducing interest rates, or extending the payback period.[7] Once they had agreed to an overall plan, the committees were combined to form a single super-committee called the "Reorganization Committee." It was the Reorganization Committee that "purchased" the railroad's assets at the foreclosure "sale." Since the Reorganization Committee had all of the deposited securities at its disposal, and could bid the face value of the securities as a substitute for cash, no one else bothered to bid at the auction. In the words of Paul Cravath, one of the leading receivership lawyers: "[c]ounsel who have acted frequently for reorganization committees have spent a great many anxious hours preparing for the unexpected bidder, but in my own experience he has never appeared. . . . Manifestly in most sales where the security holders . . . have . . . placed their interest in the hands of a committee there is not likely to be serious competition at the sale."[8]

As soon as the Reorganization Committee purchased the assets, it transferred them to a shell corporation that had been set up for just this purpose. The stock and other securities of the new corporation were then distributed to the old investors on the terms laid out in the reorganization plan.

The dry recitation of facts that have I have just given doesn't even begin to convey the ingenuity of the receivership process. The biggest marvel of all was where it came from: in form, the equity receivership was a dramatic elaboration of the traditional foreclosure procedure, the humble device that had been used for generations, and is, of course, still

[7] For a description of the adjustments made in one typical receivership, see Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 BUS. HIST. REV. 1, 15 (1997). In a fascinating recent analysis of the railroad receiverships, Stephen Lubben argues that the reorganizers tried to give the reorganized company a capital structure that was typical for the industry, rather than aiming for an optimal structure, and as a result often did not scale down the railroad's obligations enough. Stephen J. Lubben, Railroad Receiverships and Modern Bankruptcy Theory 67 (Dec. 3, 2003) (unpublished manuscript).

[8] Paul D. Cravath, *Reorganization of Corporations: Certain Developments of the Last Decade*, *in* SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION, AND REGULATION 153, 204-05 (1922).

used by secured creditors to force a sale of the debtor's collateral after the debtor has defaulted on his or her obligations. The development of the equity receivership was one of the great innovations of the common law in nineteenth-century America.[9]

The procedures I have described didn't end the adaptive process. An important problem both before and during the receivership was that the railroad needed to pay its suppliers—the company that provided coal to fire the engines, the supplier of iron or steel—in order to keep the railroad running. The question was how. Troubled railroads generally didn't have a great deal of cash on hand, and the limited cash they had was needed to make payments on their mortgage bonds and other priority debt. But suppliers were reluctant to deal with the railroad on credit if it looked like there might be a receivership on the horizon, since the supplier's right to payment was subordinate to the rights of creditors who had mortgages on the railroad's assets.[10] This meant that a supplier who sold goods on credit might end up helping out the higher priority creditors—who were more likely to get paid if the railroad kept going—while the supplier itself, as an ordinary unsecured creditor, got paid only a portion of what it was owed. Not surprisingly, railroad suppliers weren't especially enthusiastic about extending credit for the benefit of other creditors.

The courts lent a helping hand to railroad debtors by developing a doctrine known as the "six months" rule. The six months rule, which was endorsed by the Supreme Court in 1878,[11] permitted the debtor to pay suppliers in full, rather than treating them like other non-priority creditors, for supplies that were provided within six months of the initiation of a receivership. Courts assumed that the railroad's priority creditors would be happy for the suppliers to get paid, since suppliers might cut the railroad off at the first sign of financial distress if they weren't sure about repayment in the event of a receivership. "Every railroad mortgagee in accepting his security," the Supreme Court concluded, "impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income."[12] In its initial incarnation, the six month rule applied to wages, supplies and essential services. It was later

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[9] I do not mean to suggest that receiverships were perfect. Critics complained about the fees charged by the Wall Street banks and lawyers who spear-headed them, and to some extent about the efficacy of the process itself. For evidence that many of the railroads that failed later defaulted again, see Lubben, *supra* note 7.

[10] This problem is referred to in the corporate finance literature as an "underinvestment" or "debt overhang" problem. Lenders will refuse to lend even for desirable projects if the proceeds of the project will be soaked up by existing creditors. For discussion in the receivership context, see Tufano, *supra* note 7, at 7-9.

[11] *See* Fosdick v. Schall, 99 U.S. 235 (1878).

[12] *Id.* at 252.

expanded to include key trade creditors under the "doctrine of necessity," "so long as the claimant is in position to demand payment as the price of future labor and materials."[13] (Over a century later, the necessity doctrine continues to be applied in something like its early form, although its validity has recently been called into question by a high profile case.[14])

By itself, the six months rule solved only part of the problem; there was also the rather important question of where the cash would come from. This is where a second innovation came in. To help troubled railroads raise money during the receivership process, courts authorized the receiver to issue a "receiver's certificate." It was the receiver's certificate that eventually gave rise to debtor-in-possession financing as we know it today.

A receiver's certificate was a promissory note issued by the receiver, "by which the railroad borrowed from investors against the credit of the 'whole estate' of the railroad" on a short term basis.[15] The beauty of the certificates, at least from the receiver's perspective, was that they were given priority over all of the railroad's other obligations–even over existing mortgages. Mortgage payments weren't made until the receiver's certificate obligations were taken care of first, and the holders of receiver's certificates were also entitled to first dibs on the proceeds of any sale of the property that secured the certificates. (The explanation for the superpriority of receiver's certificates was that they were an obligation of the receivership, rather than of the debtor, and creditors of the debtor were entitled to payment only from the assets of the railroad, net of receivership expenses.) Given the high probability of repayment, investors were happy to help finance the receivership by investing in receiver's certificates.

The description of one series of receiver's certificates in *Union Trust Co. v. Illinois Midland Railroad Co.*[16] gives the flavor of some of the expenses that were financed by the certificates. "There are four certificates of the eighteenth series," the Court noted,

> three of them for $10,000 each, and one for $8,288.98, all at 8 per cent. interest, issued under another order made June 29, 1881, which set forth that the receiver had expended on the Illinois Midland road,

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13 Benjamin Wham, *Preference in Railroad Receiverships*, 23 ILL. L. REV. 141, 147 (1928), *quoted in* Lubben, *supra* note 7, at 39 n. 128.

14 The Seventh Circuit ruled in the Kmart bankruptcy that, because there was no finding that Kmart's disfavored creditors would be better off, the necessity doctrine did not justify the extensive payments to prepetition creditors that the bankruptcy court had approved in that case. Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 823 (N.D. Ill. 2003), *rev'd*, 2003 U.S. Dist. LEXIS 17437, *aff'd*, 2004 U.S. App. LEXIS 3397 (7th Cir. 1991).

15 Tufano, *supra* note 7, at 8. The contours of receiver's certificate doctrine were treated in exhaustive detail in an early monograph. *See* William A. Car, *Receiver's Certificates*, 1 PA. L. SERIES 595 (1895).

16 117 U.S. 434 (1886).

> for side tracks and other betterments, $80,037.98, of which $42,664.98 had been expended on the line between Paris and Decatur; that, of the $80,037.98, $63,037.98 had been paid out of the earnings of the line, of which $38,288.98 was expended on the line between Paris & Decatur; that the earnings of the whole line had not be sufficient to meet the usual expenses of operation and the ordinary repairs of the permanent way; and that the receiver had incurred unpaid debts to a larger amount than $63,097.38, in the usual operation of the line and in ordinary repairs of the permanent way.[17]

Under the practice that developed, the receiver would identify the immediate cash needs of the railroad and ask the court to authorize him to issue receiver's certificates. Often the certificates were issued for projected expenses, but sometimes (as in the *Union Trust* description above) the receiver requested funding for expenses that had already been incurred.

Over time, the use of receiver's certificates gradually expanded. The earliest receiver's certificates were premised on the belief that there was a public interest in preserving troubled railroads, and were issued for the limited purpose of maintaining tangible collateral.[18] Within a few years, courts had begun authorizing certificates for the costs of operating the railroad, even where these costs didn't relate directly to protecting tangible collateral. If the situation was hopeless, courts sometimes rejected a receiver's request to sell certificates, but they were generally permitted, despite the interference with existing mortgages. "So far as such an impairment is necessary to the conservation of the road," the Sixth Circuit wrote in a prominent opinion, "and the performance of its public and private duties, [mortgage holders] must submit to the impairment . . . but [they] should not . . . suffer . . . further than actually necessary for conservation and due operation of the system."[19]

By the end of the nineteenth century and the outset of the twentieth, an increasing number of non-railroads had begun to use the receivership process to restructure. Because the public interest in preserving non-railroads was less obvious, the courts were much tougher about authorizing receiver's certificates in non-railroad receiverships. If financing was needed to preserve corporate assets (a category that was construed broadly enough to include insurance premiums and wages for watchmen), courts would generally permit the receiver to sell priority certificates. But expenses that arose from

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17 *Id.* at 453.

18 For a useful overview of the developments described in this paragraph, see Harvey J. Baker, *Certificates of Indebtedness in Reorganization Proceedings: Analysis and Legislative Proposals*, 50 AM. BANKR. L.J. 1, 8-16 (1976).

19 American Brake Shoe & Foundry Co. v. Pere Marquette R. Co., 205 F. 14 (6th Cir. 1913), *cert. denied*, 229 U.S. 624 (1913), *quoted in* Baker, *supra* note 18, at 10.

ordinary operations were treated as out of bounds. The line between "preservation" and "operations" was blurry, of course, and receivers stuffed everything they could into the "preservation" category, but the receiver's certificates had a notably narrower scope outside of the railroad context.[20]

B. *DIP Financing as a Governance Device*

As the discussion thus far suggests, receiver's certificates were a crucial source of short term financing for railroads and other corporations that were reorganizing under the equity receivership process. What we don't see when we revisit the receivership era, however, is the holders of receiver's certificates playing a central oversight role. No one would describe these investors as dictating, or even influencing, the governance of the debtor.

The obvious question is, what happened? How did DIP financing agreements become the most important governance lever in contemporary corporate reorganization cases?

The answer lies in two historical developments. The first was the transformation of traditional large scale reorganization during the New Deal. The magicians of the reorganization process, as we saw in the last section, were the Wall Street banks and lawyers who formed bondholder and shareholder committees, then hashed out the terms of the restructuring with the debtor's managers.[21] The New Deal reformers were deeply suspicious of the Wall Street reorganizers' handling of the receivership process, which seemed designed to maximize the professionals' fees rather than to protect investors. "Managements and bankers," they concluded in an extensive SEC study overseen by William Douglas, a Yale law professor who later became chair of the SEC and then a Supreme Court Justice, "seek perpetuation of [their] control for the business patronage it commands, which they take for themselves or allot to others, as they will."[22]

The reformers' solution to the traditional receivership process was Chapter X, a new set of large scale corporate reorganization provisions that Douglas and the New Deal SEC inserted into an extensive overhaul of the bankruptcy laws that was enacted in 1938.[23] Chapter X required that the managers of a corporate debtor be replaced by a trustee after the

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[20] *See* Baker, *supra* note 18, at 16; Lyman M. Tondel, Jr. & Robert H. Scott, Jr., *Trustee Certificates in Reorganization Proceedings Under the Bankruptcy Act*, 27 BUS. L. 21, 31-32 (1971).

[21] *See supra* note 7 and accompanying text.

[22] SKEEL, *supra* note 1, at 111.

[23] *See id.* at 109-27 (discussing the reforms, and Douglas's role in detail).

firm filed for bankruptcy.[24] It was the court-appointed trustee, rather than the existing managers, who would run the business and develop the terms of a reorganization plan, and the plans were subject to close scrutiny by the SEC.[25] Chapter X also introduced tough new disinterestedness requirements that prohibited bankers or lawyers who had represented the debtor prior to bankruptcy from participating in the bankruptcy case.[26]

Chapter X's mandatory trustee and disinterestedness provisions thrust a dagger in the heart of large scale corporate reorganization practice as the reorganizers had known it. In a traditional receivership, the existing managers remained in place, and the same Wall Street professionals who had underwritten the debtor's securities before the receivership also oversaw the restructuring negotiations. After 1938, none of these parties was permitted to show its face in a Chapter X case. The new provisions had precisely the effect the New Deal reformers had intended: they destroyed the traditional, Wall Street reorganization process. Within a few years the Wall Street banks and bar were gone.[27]

Of particular importance for our purposes, this disappearance dramatically altered the governance of large scale reorganization cases. In Chapter X cases, the trustee and SEC oversight took the place that had previously been occupied by the Wall Street banks and bar. But by the 1960s, many large corporate debtors had begun filing their cases in Chapter XI, the chapter that was intended for small firms.[28] In Chapter XI, neither the trustee nor the SEC was anywhere to be seen. When current Chapter 11 was enacted in 1978, the drafters adopted a presumption that managers rather than a trustee would run the company in bankruptcy and largely eliminated the role of the SEC, thus taking their cue from Chapter XI—the oversight-free zone—rather than Chapter X.[29]

The second crucial development was the continuing expansion of the scope of receiver's certificates. As described in the last section, the use of receiver's certificates was initially linked to the public interest in reorganizing troubled railroads, and the proceeds were used both to preserve the value of the railroad's assets, and to finance operations during the receivership process. Courts later permitted receivers to sell

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24 *See* Chandler Act, § 156, 52 Stat. 840, 888 (codified prior to repeal at 11 U.S.C. § 156 (1938)) (appointment of trustee).

25 *See id.* § 172 (reorganization plan in any case over three million dollars required to be submitted to the SEC for comments).

26 *See id.* §§ 157 (lawyer disinterestedness), 158 (bank underwriter disinterestedness).

27 For further discussion of the demise of the Wall Street reorganization practice, see SKEEL, *supra* note 1, at 125-27.

28 *See id.* at 161-81 (recounting the increasing use of Chapter XI, and the eventual repudiation of the Chapter X approach to large scale reorganization).

29 *See id.* at 181; *see also* 11 U.S.C. § 1107 (2000) (debtor in possession has rights of trustee).

the certificates in reorganizations that did not involve a "public interest," but were more restrictive about the scope of the certificates.

Until the 1930s, corporate reorganization—and thus the use of receiver's certificates—was a creature of the common law. Receivership practice was first added to the bankruptcy laws in the early 1930s with the codification of railroad receivership in 1933 and of non-railroad reorganization the following year.[30] The new statutes explicitly authorized the issuance of receiver's certificates for short term financing. The provision that made its way into Chapter X of the Chandler Act in 1938 stated, for instance, that:

> [T]he court may upon cause shown authorize a receiver, trustee, or debtor in possession, . . . to issue certificates of indebtedness for cash, property, or other consideration approved by the judge, upon such terms and conditions and with such security and priority in payment over existing obligations, . . . as in the particular case may be equitable.[31]

The most noteworthy aspect of this rather vague provision is that it does not include any reference to the distinction between "preservation" and "operation." The absence of this qualification even in non-railroad cases seems, as a later commentator noted, to have "rendered that distinction obsolete," and thus to have further expanded the scope of this financing technique.[32] After the 1930s, it was clear that receiver's certificates could be used to finance the ordinary operations of any corporate debtor, regardless of whether the debtor's business was quasi-public in nature.

The enactment of the 1978 Bankruptcy Code brought the most dramatic expansion of all. Not only did the last vestiges of the distinction between quasi-public and private businesses fall by the wayside, but the drafters removed any expectation that the financing be tied to specific expenditures. Section 364, which governs debtor-in-possession financing, is a broad-based source of authority for all kinds of post-petition credit.[33] Under § 364, the debtor can borrow on an unsecured basis, with the promise of administrative expense treatment

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30 Railroad receivership was added to the Bankruptcy Act as Section 77, and non-railroads were included in an analogous set of provisions known as Section 77B. The non-railroad provisions were replaced by Chapter X in 1938. For discussion, see, for example, SKEEL, *supra* note 1, at 105-09; Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 28-30 (1995).

31 Bankruptcy Act § 116(2), 11 U.S.C. § 516(2) (repealed 1978). An almost identical provision applied in Chapter XI. *See* Bankruptcy Act § 344, 11 U.S.C. § 744 (repealed 1978).

32 Baker, *supra* note 18, at 17 n.68.

33 Consistent with this breadth, § 364 is entitled simply "obtaining credit." The leading bankruptcy treatise characterizes § 364 as "derived from provisions in current law governing certificates of indebtedness, but [as] much broader. It governs all obtaining credit and incurring of debt by the estate." COLLIER ON BANKRUPTCY App. Pt. 4(d)(i), at 1480 (15th ed. 2003) (1996) (volume covering legislative history).

for the lender, without first seeking court approval.[34] If unsecured financing is unlikely to be available, the court can give the DIP financer priority over all other administrative expenses; or authorize a lien on either unencumbered or already encumbered property.[35] The court's most dramatic power is the right to authorize a new "priming" lien that has priority over an existing lien on the same property.[36]

With the advent of § 364, bankruptcy financing looked very different from the carefully tailored receiver's certificates that courts had authorized in the late nineteenth century. It wasn't simply a stop-gap anymore.

II. PRESENT: THE NEW CONTOURS OF DIP FINANCING

The developments just described set the stage for the process we see today, with DIP lenders dictating the course of many large reorganization cases. But the transformation was not immediate. For the first decade after the enactment of the 1978 Bankruptcy Code, the debtor and its managers seemed to control the course of many large scale Chapter 11 cases. They were the only ones who could propose a reorganization plan for at least the first 120 days of the case, and they also controlled the company's ordinary operations and had the right to propose extraordinary transactions such as major asset sales. The debtor's managers could use this agenda control to drag out the case, extract concessions from its creditors, or both.

In the mid and late 1990s, DIP lenders started using the terms of the debtor's post-petition financing arrangements to counteract this debtor hegemony, and to fill the governance vacuum.[37] DIP financing and DIP lender monitoring didn't begin in the 1990s. But since this time, it has become the most important governance lever in many large Chapter 11 cases. In this part, I briefly describe the contours of current DIP financing arrangements. I then describe the increasing use of DIP financing agreements to transfer control to the DIP financer.

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[34] Bankruptcy Code § 364(a).

[35] *Id.* § 364(b) & (c).

[36] *Id.* § 364(d).

[37] I have described these developments in detail in David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003) , describing the increasing use of DIP financing arrangements and performance-based managerial pay as governance levers.

For an argument suggesting that DIP lenders have not exerted as much control as I and other commentators have argued, see Stephen J. Lubben, The Illusion of Control Rights—A Comment on the "New Chapter 11" (Dec. 6, 2003) (unpublished manuscript).

A. *Loan-Oriented DIP Financing Arrangements*

By the time a corporate debtor files for bankruptcy, its DIP financing arrangement is usually securely in place, awaiting only the initial approval of a bankruptcy court in connection with the debtor's so-called first day orders. To understand the contours of DIP financing, we must therefore go back to the period before the debtor actually shows up at the bankruptcy court to file a bankruptcy petition.

When a company's fortunes start spiraling downward, the decline often triggers a default under an existing loan agreement with the company's bank lenders; or if there is no existing bank loan, forces the company's managers to obtain one in order to meet its cash flow needs. The bank (or more often, syndicate of banks) usually insists that the company make significant changes. This increasingly means bringing in a chief restructuring officer ("CRO") to work with the board of directors to develop a plan for getting the company back on its feet. The banks may influence the choice of CRO in a variety of ways, such as providing a short list of acceptable candidates or, at the least, giving a thumbs up or thumbs down to the person proposed by the debtor's managers.[38]

If the debtor's financing isn't already structured as a revolving loan, this is the form it will take after the parties have negotiated the terms of continued financing.[39] In a revolving loan, the amounts borrowed by the debtor come due on a regular, relatively short-term basis, such as every eighteen months or two years. If the banks are satisfied that the debtor is in compliance with the terms of the loan at that point, they will roll the loan over for another term and continue to make disbursements. During the interim, moreover, the debtor is generally required to meet strict cash flow targets.

If the debtor's financial condition is sufficiently dire, the parties' immediate plans may include bankruptcy. In this case, the debtor's managers will seek court approval for the restructuring loan under § 364 as soon as the debtor files for bankruptcy. Even if the parties do not plan for bankruptcy at the outset, bankruptcy will soon be on the horizon if there are any glitches in the restructuring.

As the analysis thus far suggests, the most likely source of debtor-in-possession financing is the company's existing lenders. Almost sixty

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[38] *See, e.g.*, Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. (forthcoming 2004) (describing influence of banks over choice of WorldCom restructuring officer).

[39] For a similar point, see Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 784 (2003), stating that "[i]n the typical case, there is a revolving credit facility put in place when financial distress appears on the horizon."

percent of the time, some or all of the company's existing lenders also provide its post-petition financing.[40] They are the lenders that know the debtor's finances best. But a substantial minority of the time, the debtor ends up looking elsewhere. Because § 364 offers so much protection for lenders who provide post-petition financing, there is an active and still growing market for DIP financing.

Whoever the financing comes from—whether it be a familiar face or someone new—the debtor's managers almost always line up the financing before they actually file for bankruptcy. Entering Chapter 11 without financing in place is a recipe for trouble. Debtors that go this route often face an immediate cash crunch and their managers will waste valuable time at the outset of the case as they try to secure financing.

How exactly, do DIP lenders use the post-petition financing arrangements to dictate the course of a Chapter 11 case? We have already seen one aspect of lender control: influence over managerial personnel.[41] If the lenders believe that the company needs new management to oversee the restructuring process, they will insist on a change at the outset of the loan. When there is management turnover shortly before a company files for bankruptcy, this is often because the lenders have been pulling their strings.

Equally important is the use of affirmative and negative covenants in the loan agreement itself. The starkest strategy is to include one or more affirmative covenants with explicit drop dead dates. When FAO Schwarz filed for bankruptcy in 2002 (for what turned out to be the first of two filings), one of the covenants authorized the lenders to insist that the toy chain be liquidated unless it either sold all of its assets or confirmed a reorganization plan by April 4, 2002.[42] In effect, the loan agreement served as a guillotine, giving the debtor's managers one limited chance to restructure the company.

A slightly more subtle approach is to use affirmative covenants to keep the debtor on a tight leash, rather than imposing an explicit timeline for emerging from bankruptcy. In the United Airlines case, for instance, the DIP loan agreement required the airline to meet strict cash flow requirements as a condition of keeping the financing in place. Although the lending agreement didn't explicitly require United to layoff workers and renegotiate its collective bargaining agreement, the lenders and the debtor's managers were well aware that the only way United could satisfy the cash flow provision was by cutting its labor

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[40] *See, e.g.*, Dahiya et al., *supra* note 5, at 265 (finding that fifty-eight percent of DIP financers were pre-petition lenders).

[41] *See supra* note 38 and accompanying text.

[42] *See supra* note 4 and accompanying text.

costs.[43]

In a number of other recent cases, lenders have used their control over the cash spigot to force what bankruptcy lawyers refer to as a "slow liquidation." In these cases, the lenders reduce the amount of cash they make available in succeeding disbursements, which forces the company to sell assets in order to meet its cash flow needs. Over time, the company finds itself liquidating an increasing number of significant assets, and what began as an effort to reorganize under Chapter 11 becomes a prolonged asset sale.

The negative covenants in the loan agreement further reinforce the DIP lenders' control. "In 90% of the cases," according to one recent study, "DIP loans have restrictions on specified operating expenses and operating activities." (By way of comparison, only six percent of junk bonds and sixty-seven percent of ordinary bank loans include comparable restrictions.[44])

It is important to note that many corporate debtors file for Chapter 11 and do not ever arrange for DIP financing, either before or after they file. The authors of a study of publicly held companies that filed for bankruptcy between January 1, 1988 and December 31, 1997 found, for instance, that slightly less than thirty-one percent of these debtors obtained DIP financing.[45] The percentage of cases with DIP financing had risen sharply by the end of the study—to nearly fifty percent—but this still means that there is no DIP financing in half of all large Chapter 11 cases.

In the cases that do involve DIP financing—which tend to be the largest and most viable debtors—DIP financing is superficially similar to the receiver's certificates from which it evolved. The financing is short-term in nature– the median loan is 1.5 years—and the proceeds are used primarily to maintain operations during the Chapter 11 case. But rather than serving simply as a source of stop-gap funding, the DIP financing agreement is now the most important corporate governance lever in these cases.

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43 *See generally* Susan Carey, *UAL Will Lay Off 1,500 Workers As Part of Cost-Cutting Strategy*, WALL ST. J., Jan. 6, 2003, at A3 ("UAL Corp. said it intends to shed 14% of its management and salaried employees by Jan. 19, part of its plan to lower expenses to meet the strict terms of its debtor-in-possession financing package."); Adams, *supra* note 3, at 3B ("UAL is scheduled to ask the bankruptcy court as soon as Monday to let it break all its labor contracts to get billions of dollars a year in reduced labor costs. The airlines need those savings by May 1 to meet cash-flow targets set by lenders.").

44 *See* Chatterjee et al., Debtor-in-Possession Financing 9 (May 31, 2001) (unpublished manuscript).

45 *See* Dahiya et al., *supra* note 5, at 266.

B. *DIP Financing and the Market for Corporate Control*

In a recent speech before several hundred investors in distressed debt, Harvey Miller, who was the nation's most prominent bankruptcy lawyer for several decades before joining the investment bank Greenhill and Company, bemoaned the current state of Chapter 11 practice.[46] Current cases are little more than asset sales and auctions he complained; the days of traditional negotiated reorganizations are behind us.

While Miller may have exaggerated the extent of the changes to the Chapter 11 landscape, there is no question that bankruptcy practice has changed. Bankruptcy cases are dominated by merger and acquisition activities, as Miller notes, and lengthy backroom negotiations play less and less of a role. The use of DIP financing agreements as a governance lever isn't the only development that has contributed to this trend. The value of New Economy assets deteriorates quickly, for instance, and markets for assets are much more fully developed than in the past, both of which may make asset sales a better way to maximize value than a negotiated restructuring. But DIP financing has also figured prominently in the increase of M&A practice in bankruptcy.[47]

The DIP financing strategies we saw in the last section, such as metering the debtor's access to cash, have increased the pressure on debtor's managers to sell assets during the pendency of the Chapter 11 case. This section briefly describes how DIP financing agreements have been used to effect auctions and other transfers of control.

Two recent cases illustrate the range of loan-and-control transactions. In U.S. Air, the DIP lender, the Retirement Systems of Alabama, agreed to provide $240 million of initial financing and $500 million thereafter. In return, the Alabama pension was promised five of the thirteen seats on U.S. Air's board of directors, together with 37.5% of the stock, when U.S. Air emerged from bankruptcy.[48] Once the DIP

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[46] *See* Terry Brennan, *Miller: Liquidations Set to Rise*, THE DEAL, Dec. 2, 2003 ("Liquidation will replace reorganization in the U.S. over the next few years as bankrupt companies increasingly sell their assets, a leading bankruptcy [expert] predicted."); *see also* Harvey R. Miller & Shai Y. Waisman, *The Erosion of Debtor Protections in the Face of Expanding Creditors' Right and Controls* (Sept. 2, 2003) (unpublished manuscript) (presented at Lawrence P. King and Charles Seligson Workshop on Bankruptcy and Business Reorganization, New York University) (criticizing recent developments and defending traditional Chapter 11 reorganization process).

[47] *See, e.g.*, Skeel, *supra* note 37, at 925-26; Baird & Rasmussen, *supra* note 39.

[48] The governance terms were later renegotiated to give the Alabama pension an additional two seats on the board and to slightly reduce its ownership interest. *See, e.g.*, Micheline Maynard, *U.S. Air's Chief Lender Threatens the Ultimate*, N.Y. TIMES, Dec. 7, 2002, at C1 (describing the terms of the DIP financing, which were chosen by U.S. Air over a competing offer

financing agreement was in place, the pension's control over U.S. Air's access to cash enabled David Bonner, the financer's chief executive, to dictate the course of the reorganization case.[49]

In the U.S. Air bankruptcy, the change in control was effected by dictating the terms of the airline's reorganization plan. A similar result can also be achieved through an asset sale that is arranged or dictated prior to bankruptcy. When TWA filed for bankruptcy for the last time, for instance, American Airlines provided financing under a DIP loan agreement that required an auction of TWA's assets with American as the expected buyer.[50] As with U.S. Air, the buyer effectively was determined before the debtor ever filed for bankruptcy. The principal purpose of the bankruptcy in TWA, as with many asset sales, was to ensure that American could purchase the assets free and clear of any existing or future claims, and to eliminate the claims of TWA's unsecured creditors.

In each of these cases, the DIP lender was doing much more than simply providing financing. The loan agreement doubled as a mechanism for transferring control, usually to the DIP lender itself.

III. THE FUTURE? A CLOSER LOOK AT POTENTIAL MISUSES OF DIP FINANCING

The evolution of DIP financing vividly illustrates how private market actors adapt to their regulatory environment. In the beginning, it was called a receiver's certificate and was used to fund a corporate debtor's immediate cash needs. A century later, the DIP financing agreement has become the principal governance device in many Chapter 11 cases.

The emergence of DIP financing agreements as the principal governance lever in many current Chapter 11 cases has been, on the whole, a good thing. Chapter 11 put a great deal of decision making authority in the hands of the debtor's managers, and left a governance vacuum. Active governance by DIP financers has filled the void and counteracted the managers' agenda control.

But there are also reasons for concern. This part explores the dark side of each of the types of DIP financing arrangements discussed in

by Texas Pacific Group).

49 *See id.* (describing Bonner's threat to force a Chapter 7 liquidation unless U.S. Air obtained concessions from its employees).

50 *See, e.g.*, Susan Carey, *American Airlines' TWA Financing Plan is Approved, Although Rivals Cry Foul*, WALL ST. J., Jan. 29, 2001, at A3. Although Carl Icahn subsequently challenged the sale to American, American prevailed. *See, e.g.*, Susan Carey & Scott McCartney, *AMR Wins Court Approval of TWA Deal*, WALL ST. J., Mar. 13, 2001, at A3.

Part II, and suggests ways to control the problems they pose. I begin, however, by considering the incentives of the managers who negotiate a firm's DIP financing package. Because the managers face an endgame situation, their interests may diverge from the best interests of the corporation. It is this conflict that makes the other problems possible.

A. *Managerial Incentives on the Eve of Bankruptcy*

When the managers negotiate the terms of a DIP financing agreement, they establish the allocation of control rights that often will—if the court approves the agreement—govern the Chapter 11 case. If we could say with confidence that what's best for the debtor's managers on the eve of bankruptcy is also best for the corporation, there would be little reason to worry about DIP financing. Unfortunately, managers' interests will often be in sharp conflict with the interests of the corporation when the firm is teetering on the brink.

Put yourself in the shoes of the company's CEO. Perhaps the company is an upscale retail chain like the toy store FAO Schwarz whose future had looked quite promising only a few years before.[51] The company's flagship New York store featured prominently in a popular movie, and well-heeled parents roamed the aisles with their wide-eyed children. But the company stumbled as it tried to assimilate several smaller retail chains it had acquired. To make matters worse, a large, ruthlessly efficient discounter—say, Walmart—started offering some of the same luxury items at much lower prices. As the company runs out of cash, it opens negotiations with its lenders for debtor-in-possession financing and prepares to file for bankruptcy.

How is the CEO likely to view the negotiations? One possibility is that she remains convinced that the chain can regain its earlier luster, and that she is the one who will lead it back to glory. If this is the case, there is a danger that she will do whatever it takes to give herself and the company one more chance.[52] If the lenders agree to let the CEO stay in charge, she may cede too much power to the company's lenders, or agree to provisions that divert value from other creditors.

Alternatively, this may be the end of the line. As noted earlier, the

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[51] For a brief overview of FAO's decline, see, for example, Hays, *supra* note 4, at C10.

[52] The incentive to focus on the manager's own interests rather than the best interests of the firm is generally referred to as an "agency cost" problem. Whenever one party (here, the managers) acts as an agent for another (shareholders and/or other constituencies of the firm), agency cost issues arise. For an argument that agency costs are the central issue in all of corporate law, see REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW (2004). For a discussion of managers' conflict of interest when a company is financially troubled, see David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 YALE L.J. (forthcoming 2004) (reviewing KRAAKMAN ET AL., *supra*).

lenders often insist that the current managers be replaced by a new CEO or CRO, or at the least that a CRO be brought in to work with the board of directors. If so, the CEO is negotiating on behalf of a company she won't be working for in a few weeks. If the lenders dangle the prospect of a lucrative severance package during the negotiations, the CEO may focus more on the severance package than on the best interests of the company.

The CEO's incentives are less troubling if the terms of her exit aren't on the table. Most CEOs are faithful to their company, and want to do what's best for its future. But there still is reason to worry. The fact remains that a CEO who will soon be replaced isn't likely to be the best representative of the company's interests.

Suppose instead that the CEO is not the one who is leading the negotiations with the company's lenders. In reality, the board of directors—or more likely, some or all of its outside directors—often asserts an increasing amount of control as a company's fortunes decline. The outside directors' decision-making incentives are likely to be much less skewed than that of the CEO. But their perspective is still far from ideal. Although outside directors usually have much less at stake than the CEO, they too are looking at the end of the line. Most will be long gone by the time the company's bankruptcy case comes to an end.[53] As a result, we can not simply assume that the financing terms that the directors negotiate will be optimal.

For both the managers and the directors, bankruptcy is a classic end-game situation. When the relevant decision makers are in an end-period, we need to take a close look at the decisions they make.

B. *The Trouble with Loan-Oriented DIP Financing*

I have focused thus far on the debtor's decision making team. It takes two to tango, however; the DIP lenders obviously have a major say in the terms of the financing. If the DIP lenders have an incentive to maximize the value of the firm in bankruptcy, their incentives may counteract the distortion on the debtor's side.

In some respects, they do. The most obvious benefit of DIP lending oversight is that DIP lenders have a strong interest in preventing the debtor's managers from taking risks that jeopardize the value of the

[53] This has long been true, and is even more true today. For evidence of the high rate of managerial turnover in bankruptcy in the late 1980s and early 1990s, see, for example, Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355 (1990); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993).

firm. If the DIP lender is fully secured, its principal concern is that the value of its collateral could deteriorate. If the DIP-Bank makes a $100 loan, for instance, and the loan is secured by assets that are currently worth $120, the lender will veto activities that could jeopardize that $20 equity cushion. This means no sudden and risky shifts in corporate strategy. It also may mean shutting the corporation down if keeping the corporation going is a money losing proposition—if, as economists put it, the distress is economic rather than simply financial.[54] If the business no longer makes sense, simply keeping the doors open is a value-destroying proposition.

Although DIP lenders' efforts to clamp down on risk-taking have counteracted one of the most pressing problems in Chapter 11, the expansion of loan-oriented DIP lending has introduced two significant problems of its own. The first is the danger that the DIP lender will tighten the screws too much, that it will discourage even appropriate risk-taking. To stick with the simple example from the previous paragraph, assume that the company could invest the $120 of assets in a project that will be worth either $200, if it succeeds, or $80 if it doesn't. If there is a fifty percent likelihood of each outcome, the project is worth $140 to the company and should be pursued.[55] But this may not be the way DIP-Bank looks at it. What DIP-Bank sees is a fifty percent possibility that the venture will fail and the lender will get only $80, rather than the full $100 it is owed. DIP-Bank may pay less attention to the $200 upside, since its own upside is fixed at $100. As a result, DIP-Bank has an incentive to squelch the transaction, knowing that it will be paid in full if the company sticks with the assets it has.[56]

Now, there is at least one significant countervailing factor from DIP-Bank's perspective. DIP-Bank's horizon may extend beyond the Chapter 11 case if it expects to continue its lending relationship with the reorganized firm. In this case, DIP-Bank's stake is more than simply repayment of the $100. If the present value of DIP-Bank's expected post-bankruptcy loans in the event that the debtor's venture succeeds is greater than $20, DIP-Bank may be willing to take the risk, despite the possibility that it will not get paid in full on its current loan. The possibility of an ongoing lending relationship may give DIP-Bank an

[54] A company that is in financial distress needs to be restructured, either through a sale or through a reorganization that scales down its debt. A company that is in economic distress is not viable.

[55] The project has a positive net present value, since its present value is $140, whereas the assets currently are worth only $120.

[56] Alternatively, the debtor (or its unsecured creditors) could agree to pay the lender a portion of the proceeds—say, forty-one additional dollars—if the venture succeeds, in return for the lender's agreement to let the venture go forward. But the bankruptcy framework discourages side payments of this sort.

equity-like stake in the upside potential of the company.[57]

Although the existing data are quite limited, one finding can be seen as consistent with the view that DIP lenders' stake in the future offsets their tendency toward excessive risk aversion. If DIP lenders have little taste for risk, we might expect to find them pressuring too many firms to liquidate their assets rather than reorganizing. Yet the early DIP financing studies have consistently found that debtors who obtain DIP financing are more likely to reorganize—not less—than debtors who don't.[58] Perhaps this means that DIP lenders are picking firms whose prospects are promising, and are shepherding these firms through to successful reorganizations, after which the DIP lender will continue its lending relationship with the company. But perhaps not. The significance of the finding that DIP-funded firms are more likely to reorganize isn't entirely clear, given that so many of the cases that researchers code as "reorganizations" look an awful lot like liquidations on inspection.[59]

Another important and suggestive data point is that DIP lenders often include takeout fee provisions in the DIP financing agreement. If the DIP financer participates in the debtor's exit financing, it will waive the fee. But if the debtor's assets are sold or the debtor obtains exit financing from another lender, the DIP is entitled to receive the takeout payment. The inclusion of takeout fees can be seen as underscoring the DIP financer's commitment to an ongoing relationship with the debtor, but it also has the effect of simply increasing the DIP financer's control over the debtor's decision making.

The rather muddy conclusion we are left with is this: the prospect of post-bankruptcy business counteracts a DIP lenders' incentive to clamp down even on beneficial risk-taking, but it is not clear how strongly this influences a DIP lender's decision making. Despite the hedging, however there is an important takeaway point: our comfort level with DIP lender control should increase as the importance to the DIP lender of its post-petition relationship with the debtor increases; we

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57 *See* Skeel, *supra* note 37, at 121. For an analogous observation about bank lending in general, see David A. Skeel, Jr., *An Evolution Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1394 n.282 (1998), noting that "a bank's ongoing interest in its borrower's success gives it an equity-like stake in the borrower's future . . ., since the firm's future success means future loans for the bank". Bob Rasmussen makes a similar point, characterizing the lender's decision whether to force a sale or to continue lending as a real option. Robert K. Rasmussen, *Secured Credit, Control Rights and Real Options*, 25 CARDOZO L. REV. 1935 (2004).

58 *See, e.g.*, Chatterjee et al., *supra* note 44; Dahiya et al., *supra* note 5; Maria Carapeto, Does Debtor-in-Possession Financing Add Value? (Oct. 6, 2003) (unpublished manuscript).

59 A recent article by Douglas Baird and Bob Rasmussen points out, for instance, that seven of the large, publicly held debtors that exited from bankruptcy in 2002, and were treated as "emerging" under a plan of reorganization by a leading bankruptcy database, actually involved sales of assets. Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 676 (2003).

should be more concerned if the likelihood of an ongoing relationship is remote. I will return to this point below, after we consider the second danger with DIP financer control.

The second concerns stems from the conditions under which the DIP loan is initially authorized, rather than from the way the lender wields its influence thereafter. Nearly sixty percent of the time, the debtor's post-petition financer is a bank (or banks) that had already lent money to the debtor prior to bankruptcy.[60] In these cases, the new loan often subsumes an existing loan. To return to our example, if the debtor owed DIP-Bank $40 under a prior loan at the time of bankruptcy, the $100 DIP loan might consist of the existing $40 plus $60 of fresh lending under a revolving credit agreement. This is where problems can arise. If the pre-petition loan is unsecured, or undersecured, the lender may try to use the DIP financing facility to beef up its security. If the existing $40 loan is secured by collateral worth $30, and DIP-Bank negotiates for an expanded collateral pool worth $120 in connection with the DIP financing, the effect is to convert its undersecured pre-petition loan ($30 secured, $10 unsecured) into a fully secured loan.[61] DIP lenders achieve a similar effect by structuring the DIP lending facility so that the debtor's post-petition payments pay off the earlier loan first, which means that any amounts still outstanding at the end of the case will be due under the fully secured post-petition portion of the loan.[62]

The debtor may sometimes seem to benefit from this kind of bootstrapping arrangement. After all, a lender that can shore up its pre-petition loan may be willing to lend to debtor on better terms than a lender who is starting from scratch. The little boost to the earlier loan may mean a better interest rate, or even the difference between obtaining a loan and not getting one. But this is exactly the problem. If the debtor's condition is hopeless, it may be better if the company is

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60 *See, e.g.*, Dahiya et al., *supra* note 5, at 265 (finding that pre-petition lenders serve as DIP financer in fifty-eight percent of cases).

61 The use of the new loan's collateral to secure a pre-petition loan, some or all of which was unsecured, is referred to as cross collateralization. Courts have generally refused to allow the cross collateralization of an obviously unsecured or undersecured pre-petition loan. *See, e.g.*, Shapiro v. Saybrook Mfg. Co., 963 F.2d. 1490, 1494-95 (11th Cir. 1992). But it is not always entirely clear whether the old loan is fully secured. In these cases, the bank may be able to claim that the old loan was secured, and then subsume the old loan into the DIP financing, thus achieving a more subtle form of cross collateralization. For discussion of courts' treatment of cross collateralization, see, for example, Scott D. Cousins, *Post-Petition Financing of Dot-Coms*, 27 DEL. J. CORP. L. 759, 798-800 (2002).

62 Bruce Markell notes that "many of the [DIP lending] facilities I've seen 'roll up' the pre-petition debt into the first DIP draw," thus assuring that the pre-petition loan will be fully paid. E-mail from Bruce A. Markell to David Skeel (Feb. 10, 2003) (on file with author); *see also* Cousins, *supra* note 61, at 800-01 (discussing roll-up financing). The priority of the new loan assures that it must be paid in full to confirm a reorganization plan. 11 U.S.C. § 1129(a)(9) (2000).

shut down now rather than later. Using the special priority of § 364 to make a new loan possible can destroy value by postponing the shutdown date.[63]

Enhanced security and early payoff aren't the only strategies that DIP lenders use to buttress their pre-petition status. Pre-petition lenders have also insisted that the debtor waive its right to challenge any pre-petition payments as preferential transfers.

How should courts respond to these dangers? The most obvious point—but one worth underscoring—is that courts should refuse to approve DIP financing agreements that enhance the security of a pre-petition loan, and they should prohibit provisions that purport to protect the lender from preference attacks and other avoidance actions. Consistent with this, both Delaware and New York, the leading bankruptcy venues, have issued guidelines indicating that they will not permit preference waivers.[64]

Should courts adopt a more sweeping solution to DIP lender bootstrapping? One obvious possibility would be for courts to simply prohibit pre-petition lenders from participating in a post-petition financing facility. Recall that this is essentially the same strategy the New Deal reformers used to loosen the Wall Street banks' grip on large scale reorganization in the 1930s.[65] Would an analogous proposal improve DIP financing today?

It might, but the prospect of a blanket prohibition raises several significant concerns. First, existing lenders have better information about the debtor than anyone else, and excluding them from the DIP financing sweepstakes would squander the benefits of this information. The informational advantages of existing lenders cut both ways, however. Although existing lenders are particularly well-positioned to decide whether to finance the debtor's bankruptcy, their informational advantage may also have a chilling effect on other lenders' willingness to provide a loan.[66]

Two other objections seem more telling. The first is that prohibiting existing lenders from participating in a DIP loan could promote wasteful strategic behavior on the eve of bankruptcy. Debtors

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[63] Barry Adler has raised similar concerns about the danger of inappropriate continuation in another context. Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575 (1995) (discussing "earmarking" exception to avoidable preferences).

[64] *See* Judge Peter J. Walsh, Open Letter from Judge Peter J. Walsh to the Delaware Bankruptcy Bar re: First Day DIP Financing Orders (Apr. 2, 1998), *in* Marcus Cole, *Delaware Is Not a State: Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L. REV. 1845, 1910, app. A (2002); General Order No. M-274 of the United States Bankruptcy Court for the Southern District of New York (Sept. 9, 2002) (Bernstein, C.J.).

[65] *See supra* note 27 and accompanying text.

[66] For a discussion of the informational advantage that a debtor's lender has in an ongoing banking relationship, see, for example, Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1989).

would be forced to tiptoe around their existing lender as they made preparations for bankruptcy, since negotiations with potential DIP lenders would signal to the existing lender that bankruptcy is eminent. The prohibition also would discourage the loan facilities companies currently set up on the eve of bankruptcy, but prior to actually making a bankruptcy filing.[67]

The second objection returns us to our earlier discussion. If we had to predict which lenders are most likely to be influenced by the prospect of continuing their lending relationship with the debtor after bankruptcy, DIP financers who also lent to the debtor before bankruptcy are a likely choice. A court that excluded pre-petition lenders from consideration would therefore be cutting off the lenders who are most likely to be influenced by the possibility of a post-petition relationship with the debtor.

These concerns suggest that prohibiting pre-petition lenders from funding the debtor post-petition would be throwing the baby out with the bathwater. Although the prohibition would solve the bootstrapping problem, it would do so at a significant cost. But what about an intermediate solution that targeted the same concern about pre-petition lenders? What if courts continued to let pre-petition lenders provide post-petition financing, but separated the old loan from the new one? If this could be done, it would address the bootstrapping problem without excluding the debtor's pre-petition lender from the financing picture. We could keep the baby and throw out at least some of the bathwater.

The ideal way to separate old and new would be to treat them as entirely separate loans, each with its own collateral and bankruptcy treatment. Payments on the new loan would be treated as an administrative expense, and the loan would be secured by whatever lien the court approved. The old loan, by contrast, would be entitled to priority to the extent of any collateral, while the remainder would be treated as an unsecured claim.[68] The principal complication is that there often would not be enough unencumbered assets to support the new DIP loan.[69] Most or all will already be committed to the earlier loan. In some cases, it may be possible to allocate some of the collateral to the existing loan, and the rest to the new loan. If it isn't, and the same

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67 *See supra* notes 40-41 and accompanying text.

68 One could imagine lenders proposing an alternative strategy under which the lender agreed to relinquish its pre-petition lien and to "relend" the amount still owing in return for administrative priority treatment. Although administrative priority treatment is technically a lower priority than the financier's pre-petition lien, it would enable the lender to insist on payment in cash in full at confirmation. Bankruptcy Code § 1129(a)(9)(A) (2000). If anything, this would increase the financer's leverage. The strategy should therefore not be permitted.

69 The revolving credit facilities that lenders currently set up are usually secured by the company's key assets, including its inventory and accounts receivable. *See, e.g.*, Rasmussen, *supra* note 57, at 4 (noting that the loans are secured by inventory and accounts and that "the debtor is kept on a tight leash").

collateral secured both loans, the court could distinguish them by adopting a "last in, first out" strategy that gave precedence to the new loan both in priority and repayment. In effect, the earlier loan would be carved out and treated separately.

C. *The Anti-Takeover Risk of DIP Lending: Loan-and-Control Transactions*

Outside of bankruptcy, if the managers of a company walked into court with an agreement that transferred control over its board of directors and promised thirty-six percent of the company's stock to a Bidder, without any input from the company's shareholders, the court's most likely response would be, "nice try." In the corporate law context, courts are skeptical of stock lock-ups that commit a significant portion of a company's stock to a favored bidder, since the lock-up may exclude other bidders from making a higher bid for the company.[70] U.S. Air's DIP financing agreement had essentially the same effect—effectively transferring control to the DIP lender without any vote by U.S. Air's shareholders or creditors.[71] The similarities counsel in favor of similar skepticism when DIP financing agreements dictate the terms of post-bankruptcy control.

I should start by acknowledging that the U.S. Air agreement that I have used as my principal example wasn't quite so egregious as I have suggested thus far. The managers of U.S. Air didn't simply tap David Bonner of Alabama Retirement on the shoulder, and offer to hand the company over to him in return for a $740 million loan. The Alabama pension emerged as the lender of choice only after a spirited competition with the Texas Pacific Group. Moreover, with this and other DIP loan agreements, shareholders and creditors aren't shut out of the decision making process altogether. They are entitled to weigh in both at the initial hearing to preliminarily approve the DIP financing, and at the formal hearing that follows.[72]

That's the good news. The bad news is that the opportunity to object to a proposed DIP financing arrangement is hardly a substitute for the right to actually make the decision, which investors have with change-of-control transactions outside of bankruptcy.[73] We also can't

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[70] For a detailed discussion of the treatment of lock-ups (including asset lock-ups and break-up fees, as well as stock options) in corporate law and bankruptcy, see David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U. CIN. L. REV. 1243 (2000).

[71] *See supra* note 49 and accompanying text (describing DIP financing facility in U.S. Air case).

[72] *See* 11 U.S.C. § 364 (b)-(d) (2000) (calling for notice and a hearing).

[73] If the change in control is structured as a merger, for instance, it generally must be

take too much comfort from the fact that the Alabama pension and Texas Pacific competed for the right to finance and acquire U.S. Air. There's nothing that explicitly requires the debtor to entertain multiple offers. We don't have to look far, in fact, to find cases where the debtor's managers struck a deal with a single bidder, without getting competing bids.[74]

At first glance, it may seem that the Chapter 11 voting rules will take care of any problems.[75] Every class of creditors and shareholders is entitled to vote on the reorganization plan that is eventually proposed.[76] If it transfers control to the DIP financer too cheaply, they can simply vote no. But the DIP lender's control over the debtor's access to cash, together with the priority treatment of DIP loans, takes much of the bite out of the Chapter 11 vote. If the covenants of the DIP loan are restrictive enough—and they invariably are—the DIP financer can threaten to cut off the debtor's cash and force a liquidation unless the parties agree to the terms of the proposed plan. Since the DIP lender's loan is secured, it can make this threat without putting its own money at risk. In effect, the DIP lender has an option to take control of the company at the end of the case, and the debtor and its creditors are the ones who are paying for the option.

I do not mean to suggest that a DIP lender's use of this threat will never be in the company's best interests. In both U.S. Air and United, the DIP lender threatened to force a liquidation unless employees made significant wage and benefit concessions.[77] These concessions may well have been necessary for the viability of both companies. But there's no guarantee of this, given the "head's I win" (and take control of the company), "tails you lose" (the DIP lender takes its money and goes home, and the company's assets are liquidated piecemeal) quality of DIP loans that transfer control to the DIP lenders. A DIP lender may use its control to achieve an efficient resolution of the debtor's financial

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proposed by the directors and approved by a shareholder vote. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251 (2003).

[74] American's acquisition of TWA is an illustration of a loan-and-control transaction arranged after negotiations with a single lender prior to bankruptcy. *See, e.g.*, Carey, *supra* note 50, at A3 (noting that approval of "American Airlines' financing plan for beleaguered Trans World Airlines [was] a move rival carriers [criticized as giving] American an unfair advantage in bidding for TWA assets"). Although there was an auction of sorts for TWA's assets, American's DIP financer status gave it a tremendous informational advantage over other potential bidders.

[75] This seems to be true, at least in cases that do not involve a § 363 sale of most or all of the company's assets. In these cases, approval of the § 363 sale by the court essentially ends the case, since it reduces the debtor's assets to cash and thus ends much of the uncertainty as to who is entitled to what.

[76] *See, e.g.*, 11 U.S.C. § 1129(a)(8) (requiring approval by each class of claims and interests).

[77] *See, e.g.*, Maynard, *supra* note 48, at C1 (discussing the threat to force liquidation in U.S. Air); Carey, *supra* note 43, at A3 ("UAL Corp. said it intends to shed 14% of its management and salaried employees . . . to lower expenses to meet the strict terms of its debtor-in-possession financing package.").

distress, whether through a reorganization, a sale or a piecemeal liquidation. But it may also use its control to divert value from other creditors.[78]

Before DIP loans became a popular mechanism for taking control in a bankruptcy case, claims trading was the takeover device of choice.[79] The principal strategy for an acquisition-minded bidder was to buy control of a key class of claims—usually a class of unsecured claims. Since the unsecured claims ordinarily receive most or all of the stock of the reorganized company, a bidder who bought these claims could position itself to take control after bankruptcy, and then use the bankruptcy process to further this objective.[80] In recent years, claims trading has been hamstrung by a variety of impediments, the most important of which is the risk that extensive claims trading will destroy the debtor's ability to use any net operating losses ("NOL") that it accumulated prior to bankruptcy.[81] If we put these problems to the side for the moment, and simply compare claims trading and DIP loans as mechanisms for transferring control, the differences are striking. Unlike the DIP lender, a bidder who has traded claims has a direct stake in the treatment of the debtor's pre-bankruptcy claims. If the claims trader diverts value from the debtor's pre-petition creditors, it also is diverting value from itself. To be sure, this doesn't guarantee that the claims trader's incentives are always above reproach. It is possible, for instance, that a claims trader would be willing to jeopardize the payout to itself and other creditors if this increased the likelihood that the trader would wind up in control when the dust settled.[82] But claims traders are much more likely than DIP financers to have both real money at risk, and a financial stake in the treatment of the debtor's pre-petition creditors.

It is no doubt apparent where this is going. The basic implication is that we should focus on facilitating claims trading, on the one hand,

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[78] The concern that senior creditors might divert value from general creditors to themselves or other parties is a longstanding worry that gave rise to an important early Supreme Court decision. *See* Northern Pacific v. Boyd, 228 U.S. 482 (1913). There are important similarities between the dangers addressed in *Boyd*, which dates back to the equity receivership era, and the possibility of abuses in loan-and-control DIP financing arrangements.

[79] The contrast between debtor-in-possession financing and claims trading was suggested to me by Aviram Hazak, and is a topic he is exploring at length in a work-in-progress.

[80] This was the strategy used by Japonica Partners in the bankruptcy of Allegheny International, one of most prominent cases in which claims trading played a central role. Japonica's votes were disqualified by the bankruptcy court, but it nevertheless succeeded in obtaining control in connection with Allegheny's reorganization. *See, e.g.*, *In re* Allegheny International, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990) (confirmation decision by the bankruptcy court).

[81] For a recent overview, see, for example, John J. Rapisardi, *Thou Shalt Not Trade: Restrictions on Trading in Bankruptcy*, N.Y. L.J., Mar. 14, 2003, at 3.

[82] Japonica's actions in Allegheny, where it threatened to veto any proposed reorganization plan other than its own, can be seen as an illustration.

and on reining in loan-and-control transactions, on the other.[83] Start with claims trading. As noted above, the treatment of NOLs is the most important impediment to active claims trading. Under current tax law, a reorganized company that wishes to use all of its pre-bankruptcy NOLs must show that at least fifty percent of its stock is held by existing shareholders and creditors.[84] Here's the catch: a creditor only counts toward the fifty percent if it has held the debt for at least eighteen months before the bankruptcy filing. Because significant claims trading can jeopardize a company's NOLs, courts have agreed to limit claims trading in a number of recent cases. One obvious way to reverse the chilling effect this has on claims trading would be to relax the creditor ownership restrictions for preserving NOLs.

The underlying intuition is that the market for corporate control shouldn't disappear when a company files for bankruptcy. In at least one respect, the analogy to corporate law suggests the need for additional regulation in connection with more vigorous claims trading. Under the securities laws, an investor who acquires more than five percent of a company's stock is required to disclose that interest.[85] In bankruptcy, by contrast, the securities laws are called off, and there are no formal disclosure requirements for claims trading activity.[86] If the opportunities for claims trading were enhanced, it would also make sense to implement comparable disclosure requirements. An investor who acquired twenty percent of any given class of claims, for instance, should be required to disclose this fact.

Turn now to debtor-in-possession financing. Given the distorting effect that DIP lender status has in the loan-and-control context, there is a strong argument for prohibiting sales directly to the DIP lender. As a practical matter, the DIP lender may end up with a significant block of shares, through the reorganization process in some cases, but any DIP financing provisions that explicitly provide for a post-bankruptcy stake should be prohibited. The goal is not to discourage sales of assets, of course—just sales to the DIP financer.

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83 I should note that not everyone believes that claims trading is beneficial. For criticism of its effect on Chapter 11 negotiations, see, for example, Miller & Waisman, *supra* note 46, at 20-21; Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684 (1996). In my view, the criticisms understate the value of having an active market for corporate control in bankruptcy.

84 *See, e.g.*, Rapisardi, *supra* note 81, at 3 (describing the rules for retaining NOL's after a reorganization).

85 *See* Securities Exchange Act of 1934, Rule 13d-1, 17 C.F.R. § 240.13d-1 (2003).

86 *See* 11 U.S.C. § 1145 (2000). In the early 1990s, bankruptcy courts began scrutinizing the purchase and sale of claims, but Rule 3001(e) was amended in response to this trend. Current Rule 3001(e) requires only that the court and the transferor be notified of the transfer of a claim.

CONCLUSION: LESSONS FOR OTHER JURISDICTIONS

The previous three parts of this article have traced the evolution of debtor-in-possession financing from its humble origins in the receiver's certificates of the equity receivership era to the dominant role DIP financers play in many current bankruptcy cases. In the old days, receiver's certificates were used exclusively for financing the reorganization process; currently, the DIP financing agreement is often the single most important governance lever in bankruptcy.

The expanded role of DIP financing is, in many respects, a good thing. DIP financers have filled the governance vacuum left by the ouster of J.P. Morgan and the other Wall Street banks from corporate reorganization in the 1930s, and by the subsequent removal of the bankruptcy trustee and the SEC with the enactment of the 1978 Code. But there are dark sides to the expanded use of DIP financing as well. I have argued for restrictions both on loan-oriented DIP financing transactions—particularly those that involve a pre-petition lender—and on the use of DIP loan agreements to effect takeovers.

In recent years, as lawmakers and commentators have compared the bankruptcy regimes of different jurisdictions, they have increasingly pointed to DIP financing as one of the most important attributes of Chapter 11 in the U.S.[87] The significance of DIP financing in the U.S. raises the question of what lessons its history and current use may hold for other countries. Let me suggest two. First, the expansion of DIP financing has been tied to the distinctive interest group dynamic and political shocks of the U.S. context. In effect, the new DIP financers have emerged as a substitute for the investment banks that dominated large scale reorganization until the New Deal. In other interest group environments, one might expect to find a different governance profile, even if a DIP financing provision were incorporated into the bankruptcy framework. In many countries, for instance, a court-appointed administrator is appointed in bankruptcy. This administrator is likely to dominate governance in bankruptcy, even if the bankruptcy framework formally provides for DIP financing.

Second, the DIP financing provision will only provide access to cash if DIP financers are assured priority for their loans, and if many firms that default do so while they are still viable. Hungary, for instance, adopted a provision based on § 364 for its bankruptcy laws, but didn't provide special priority for the DIP lender.[88] As a result, it

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[87] *See, e.g.*, WORLD BANK, PRINCIPLES AND GUIDELINES FOR EFFECTIVE INSOLVENCY & CREDITOR RIGHTS SYS. 48 (Apr. 2001) (recommending priority funding in principle 18).

[88] *See, e.g.*, Katia Zhuravskaya, Remarks at the Bankruptcy-Corporate Governance Panel Meeting, Institute for Policy Dialogue, Columbia University (Sept. 24, 2003) (on file with author)

has seen less business than the proverbial Maytag repairman from the old television ad. Similarly, in jurisdictions where companies that fail are very unlikely to still be viable, a DIP loan provision will not get a great deal of use even if it promises special priority.

The moral, here as in other contexts, is that provisions that are transplanted from one nation's laws into another often have unintended consequences. Even in the U.S., which pioneered DIP financing, the effect of the DIP financing provision has been far different than anyone would have expected. Sometimes, as a lawyer once said in a very different context, "'what looks small may not be as small as you think,'" and "'what looks large may, in fact, be larger than you think. What looks large may actually be larger than you think!'"[89]

(characterizing the failure to give priority to DIP lending as a "key to the failure of [Hungary's reorganization] procedure in practice").

89 LAWRENCE JOSEPH, LAWYERLAND 225 (1997).

DEBTOR-IN-POSSESION FINANCING. LECCIONES A APRENDER DE ESTADOS UNIDOS Y PROPUESTA PARA ESPAÑA

José Carles Delgado, Carlos Cuesta Martín y Montserrat Mas Valdesoiro

SUMARIO

1. INTRODUCCIÓN

Las empresas en crecimiento necesitan financiación para realizar inversiones que, de otro modo, no podrían hacer. Asimismo, las empresas en dificultades que se encuentran en situación de insolvencia (sea actual o inminente) o en "*probabilidad de insolvencia*"[1] necesitan acceso a financiación. No solo para continuar operando en el mercado sino también para cubrir los costes de su propia reestructuración, tanto directos como indirectos.

En efecto, el éxito o fracaso de una sociedad sumida en un procedimiento de reestructuración (ya sea en sede preconcursal o dentro de un procedimiento formal de concurso de acreedores) dependerá, en gran medida, del acceso efectivo a dinero nuevo. Y del momento en que la empresa en situación de *distress* tiene acceso a dicha nueva financiación.

[1] Concepto introducido en España en el Proyecto de Ley de reforma del texto refundido de la Ley Concursal, aprobado por el Real Decreto Legislativo 1/2020, de 5 de mayo, para la transposición de la Directiva (UE) 2019/1023 del Parlamento Europeo y del Consejo, de 20 de junio de 2019, sobre marcos de reestructuración preventiva, exoneración de deudas e inhabilitaciones, y sobre medidas para aumentar la eficiencia de los procedimientos de reestructuración, insolvencia y exoneración de deudas, y por la que se modifica la Directiva (UE) 2017/1132 (Directiva sobre reestructuración e insolvencia), definido en la Exposición de Motivos como "*estado previo a la insolvencia inminente"*.

Sin embargo, uno de los grandes problemas que acucian a la mayoría de las empresas en dificultades en España es la falta de acceso a nuevas fuentes de liquidez. A modo de ejemplo, gran parte de las medidas excepcionales adoptadas en España como consecuencia de la pandemia del COVID-19 se han dirigido a facilitar la financiación de autónomos y empresas en dificultades (a través de los denominados "préstamos ICO" avalados por el Estado). No obstante, las líneas de avales quedaban sujetas a la normativa de ayudas de Estado, no estando disponibles, por tanto, para empresas en concurso de acreedores.

El sistema americano entiende tal necesidad de financiación en escenarios de *distress* y la regula mediante el denominado "*debtor-in-possesion financing"* (comúnmente denominado "*DIP financing"*), un sistema de prelación e incentivos que favorece a aquellos nuevos prestamistas de financiación dentro del procedimiento concursal sobre acreedores preexistentes (incluso con créditos con privilegio especial) de manera que permite el acceso efectivo al crédito de aquellas empresas que se encuentran en situación de insolvencia. Lógicamente, con esta financiación privada se logra la necesaria viabilidad económico-financiera de empresas en concurso de acreedores en el corto y medio plazo.

La obtención de financiación suele generar, además, una alta dosis de confianza por parte de los *stakeholders* de la compañía, sobre todo de clientes y proveedores del deudor, lo que también contribuye a la continuidad empresarial.

Contrariamente a lo que ocurre en Estados Unidos y pese a los avances en los últimos años en cuanto a privilegio del dinero nuevo, en España el acceso al crédito para empresas que se encuentran en concurso de acreedores es aún complicado.

La intención del presente artículo es abordar (i) cómo la figura del DIP *financing* permite la obtención de financiación a empresas en concurso de acreedores en Estados Unidos, (ii) si la regulación actual del régimen español es suficiente para fomentar y garantizar los derechos de los prestamistas de financiación a empresas concursadas y (iii) proponer medidas que podrían introducirse en nuestra legislación para favorecer este tipo de operaciones financieras.

2. CONCEPTO Y RÉGIMEN DE DEBTOR-IN-POSSESSION FINANCING EN ESTADOS UNIDOS

2.1. CONCEPTO DE DEBTOR-IN-POSSESSION (DIP)

En Estados Unidos, las empresas que quieren reestructurar su deuda mediante un convenio con sus acreedores ("*plan"*) tienen a su disposición el denominado "*Chapter 11*", también referido como "*reorganization chapter*".

El *Chapter 11* (y, por ende, los instrumentos previstos en dicho procedimiento) no sólo está disponible para empresas americanas. En virtud de lo establecido en la sección 109 (a) del Capítulo 11 del Título 11 del Código de los Estados Unidos ("*US Bankruptcy Code"* o Código de Insolvencia de Estados Unidos), tienen legitimación para ser declarados en *Chapter 11* empresas con domicilio, establecimiento ("*place of business*") o propiedad[2] en los Estados Unidos. Por tanto, si cumple estos requisitos, cualquier empresa extranjera podría acogerse al *Chapter 11*.

En dicho procedimiento de reestructuración financiera, las empresas obtienen una espera automática y generalizada hasta la aprobación del *plan* desde la solicitud de concurso[3], mientras continúan con su actividad de manera regular. El deudor sigue regido por el mismo órgano de administración (esto es, sin intervención de un *trustee*), lo que motiva que al deudor se le denomine "*debtor in possession*" o "*DIP*"[4]. Todo ello, bajo la supervisión y protección del juzgado (*Bankruptcy Court*).

Por tanto, podríamos definir el *Chapter 11* como la herramienta análoga al concurso de acreedores con solución de convenio en España, si bien en Estados Unidos, por regla general, no hay administración concursal y, por tanto, es el juzgado quien habrá de analizar y autorizar las operaciones que quiera realizar el deudor (como, por ejemplo, la obtención de nueva financiación).

Esta herramienta se diferencia del *Chapter 7*, que sería equivalente a nuestro concurso de acreedores en fase de liquidación, con suspensión de las facultades del órgano de administración y nombramiento del administrador concursal como liquidador. En el *Chapter 7*, el juez nombra un administrador concursal (*trustee*) para que implemente un proceso de liquidación[5], garantizando los derechos de los acreedores.

2.2. CONCEPTO DE DIP FINANCING

Pese a la espera automática que el *Chapter 11* implica para el pago de los créditos concursales, las compañías precisan de efectivo para poder continuar operando su negocio, pagando nóminas, proveedores, y todos aquellos créditos que se van generando tras la intervención judicial, incluidos los costes del propio proceso de reestructuración.

Aquí es donde entra en juego el *DIP financing*, un mecanismo regulado en la sección 364 del Capítulo 11 del Código de Insolvencia de Estados Unidos, que permite la obtención de nueva financiación por parte de la empresa concursada y fomenta la viabilidad en el corto plazo de la concursada al suponer una necesaria inyección de liquidez. Como contrapartida, el proveedor de nueva financiación obtiene un trato preferente o ciertas garantías (de diversos rangos).

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2 A tales efectos, es irrelevante el valor de la propiedad que la empresa ostente en los Estados Unidos. De conformidad con lo previsto en *In re McTague, 198 B.R. 429 (Bankr. W.D.N.Y 1996)*, sería suficiente que la empresa concursada tenga "*un dólar, un centavo o un grano de pimienta*" ("*a dollar, a dime or a peppercorn").*

3 Lawrence P. King, 'Bankrupcty and other insolvency remedies' in Alan B. Morrison (ed), *Fundamentals of American Law* (Oxford University Press 2004).

4 El término "*debtor in possesion*" aparece entre las definiciones de la sección 1.101 del Subcapítulo I, Capítulo 11 del Título 11 del Código de los Estados Unidos.

Como excepción al régimen general (DIP), de conformidad con lo previsto en la sección 1.104(a), el juez nombrará un administrador concursal o *trustee* si detecta fraude, mala fe, incompetencia o mala gestión grave o si el nombramiento de éste redunda en interés de los acreedores, accionistas y otros intereses de la masa.

5 Los deberes del *trustee* bajo el Chapter 7 se regulan en la sección 704 del Subcapítulo I, Capítulo 7 del Título 11 del Código de los Estados Unidos.

Asimismo, los *DIP financings* prevén, como contratos de financiación, una serie de protecciones y de obligaciones de hacer y de no hacer ("*positive and negative covenants"*) que maximizan la posibilidad de plena recuperación de los financiadores, incluso en un escenario de liquidación. Algunas de estas cláusulas suelen prever, por ejemplo, el mantenimiento de una serie de *ratios* por encima de un nivel acordado, la amortización anticipada por venta de activos, prohibiciones de cualquier tipo de ejecución hasta que no se haya cancelado el *DIP financing*, la posibilidad de los financiadores de dar por vencida la financiación en caso de *Chapter 7* (*liquidación*) o si se nombra a un *trustee.*

La doctrina americana se ha referido al *DIP financing* como un componente esencial de los procesos de reestructuración. En efecto, aproximadamente un 70% de empresas en procedimiento de *Chapter 11* tienen acceso a este tipo de financiación[6]. Y no solo empresas con su domicilio en Estados Unidos. Como hemos referido, en tanto el *Chapter 11* está disponible para empresas extranjeras, es habitual que empresas no americanas hagan uso del *Chapter 11* para para tener acceso a la financiación disponible a través del mecanismo del *DIP financing* que, de otro modo, no podrían obtener fuera de los Estados Unidos[7]. A modo de ejemplo citamos los recientes casos de las aerolíneas Avianca[8] o LATAM Airlines[9], empresas no americanas (además, con gran parte de sus activos fuera de los Estados Unidos) que se han beneficiado del *DIP financing*, no disponible en sus países de origen (Colombia y Chile, respectivamente) gracias a haber llevado a cabo su procedimiento de reestructuración en Estados Unidos.

La financiación puede ser otorgada por los financiadores preexistentes en el momento de solicitud del *Chapter 11*. En este caso, la financiación se denomina "*defensive DIP*" porque el objetivo principal de los financiadores es proteger tanto su crédito previo como el valor de su garantía. En efecto, los financiadores preexistentes protegen su crédito mediante los denominados "*roll-ups"*, que implican una especie de conversión de deuda garantizada preexistente en *DIP financing*[10]. Y protegen el valor de su garantía en tanto

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[6] George Triantis, 'Debtor-in-possession financing in bankruptcy' en Barry E. Adler (ed), *Research Handbook on Corporate Bankruptcy Law* (Edward Elgar 2020) refiere cómo la cifra ascendió desde un 33% en la década de 1980 y principios de la década de 1990, a aproximadamente el 50% a finales de dicha década, hasta el 70% en la década del 2000. Entre las razones del crecimiento, el citado autor indica el paso de una financiación proveniente de acreedores eminente preconcursales en los años 80 a un incremento de financiación por parte de instituciones financieras y de financiación sindicada en este tipo de instrumentos en los años 90 y a un posterior uso de este instrumento para hacerse con parte del capital de empresas concursadas por parte de fondos de inversión.

Por su parte, Frederick Tung, 'Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis', en *37 Yale Journal on Regulation 651* (2020) hace referencia a un 62% de empresas en *Chapter 11* con acceso a *DIP financing* en Estados Unidos, en un estudio de una muestra de 278 casos en el período 2004-2012.

[7] En la decisión de acudir al *Chapter 11* en estos supuestos habrá de tenerse en cuenta, lógicamente, la posibilidad de reconocimiento del *Chapter 11* y del *DIP financing* tanto en el país de origen de la concursada como en aquellos terceros países donde ésta tenga bienes susceptibles de ejecución.

[8] Véase *In re Avianca Holdings SA*, 20-11133 (MG) (Bankr. SDNY 2020).

[9] Véase *In re LATAM Airlines Group SA*, No. 20-11254 (JLG) (Bankr. SDNY 2020).

[10] Richard J. Cooper *et al.*, 'Recent developments in DIP financing for international and domestic debtors' en *Americas Restructuring Review 2022* (Global Restructuring Review 2022), disponible en: https://globalrestructuringreview.com/review/restructuring-review-of-the-americas/2022/article/recent-developments-in-dip-financing-international-and-domestic-debtors.

evitan la posibilidad de que un nuevo proveedor de financiación pudiera obtener, con autorización judicial, prioridad sobre bienes que ya garantizan sus créditos preexistentes.

Asimismo, el proveedor de liquidez suele incluir en la nueva financiación una serie de limitaciones y/o condiciones en relación con la llevanza de la concursada que le garantizan una mayor influencia *de facto* en el procedimiento. A modo de ejemplo, límites presupuestarios, límites a la realización de ciertas inversiones, exigencia de presentar periódicamente información financiera y actualizaciones de las proyecciones de tesorería, el nombramiento de un "*Chief Restructuring Officer*" (comúnmente denominado CRO) una fecha límite para obtener autorización judicial del *plan*, etc. Los financiadores existentes, por tanto, pueden proveer la nueva financiación para no ceder tal influencia frente a nuevos proveedores de financiación.

La financiación también puede ser otorgada por nuevos financiadores. En estos casos, la intención del financiador (habitualmente fondos de inversión) suele ser bien lucrarse al máximo con una operación con suficiente garantía y altos tipos de interés[11], bien poder hacerse con los activos o con el control de la compañía mediante una posterior conversión de deuda en capital (por lo que suele conocerse como "*offensive DIP*"). En estos últimos supuestos, como fue el caso de Aeroméxico[12], se otorga al financiador una opción de capitalizar parte o la totalidad de los importes pendientes en ciertos momentos acordados y entrar de este modo a formar parte del capital social (lo que se conoce como "*loan-to-own strategy*").

2.3. RÉGIMEN DE PRIORIDAD Y GARANTÍAS DEL DIP FINANCING EN ESTADOS UNIDOS

Prestar a una empresa inmersa en un procedimiento de *Chapter 11* supone una mayor asunción de riesgo que en un escenario de no *distress*. Consecuentemente, la legislación americana favorece este tipo de operaciones previendo distintos mecanismos de protección para los financiadores y garantizando que aquellos que han otorgado DIP *financing* a la compañía recobrarán su crédito con preferencia al resto de acreedores (salvo los honorarios de aquellos profesionales cuyos servicios hayaconcurn sido aprobados por el Juzgado, y retenidos por el deudor y el comité de acreedores). De

[11] Como norma general, las operaciones de financiación se rigen por el binomio riesgo-beneficio por lo que, cuanto mayor es el riesgo asumido, mayor es también el beneficio esperado. Consecuentemente, los costes ("*fees*") e intereses de este tipo de transacciones suelen ser más elevados que los de las financiaciones otorgadas a empresas que no se encuentran inmersas en una situación de *distress*.

En 2020, el tipo de interés más alto ascendió al 20% en el *DIP financing* del *Chapter 11* de CEC Development. Véase, al respecto, Gary L. Kaplan *et al*., 'An Overview of Debtor in Possession Financing' en *Lending & Secured Finance 2021* (ICGL.com, 2021), disponible en https://iclg.com/practice-areas/lending-and-secured-finance-laws-and-regulations/19-an-overview-of-debtor-in-possession-financing.

En cuanto a los restantes costes y comisiones que suele fijarse en este tipo de operaciones, se incluyen: (i) una comisión pagadera en el momento de la firma de la carta de compromiso, (ii) una comisión para cubrir el coste de la *due diligence*, (iii) una serie de comisiones pagaderas en la fecha de la formalización de la financiación y (iv) comisiones por los compromisos de financiación asumidos y los desembolsos realizados a lo largo de la vigencia de la financiación.

[12] Evidentemente, de cara a autorizar el *DIP financing*, los Juzgados valoran, entre otros criterios, el porcentaje efectivo de nueva financiación que obtiene la concursada en el *roll-up*.

este modo, se reduce el riesgo de los nuevos financiadores y se posibilita la efectiva obtención de financiación por parte de las empresas concursadas.

El *DIP financing* suele estar garantizado con una garantía general sobre prácticamente todos los activos del deudor (los denominados "*blanket liens"*), de manera que los proveedores del *fresh money* se aseguran maximizar su posibilidad de recobro del capital prestado y del pago los intereses correspondientes.

En caso de nueva financiación garantizada, la concursada habrá de probar que no ha podido obtener nueva financiación sin garantías. Y, en caso de que la garantía sea de primer rango sobre bienes previamente garantizados, habrá de probarse que el acreedor privilegiado preexistente tiene adecuada protección.

Concretamente, la posibilidad de que el juez autorice la obtención de nueva financiación (garantizada o no) a empresas en *Chapter 11* se regula la sección 364 del Capítulo 11 del Código de Insolvencia de los Estados Unidos. Dicha sección diferencia entre:

(a) **Financiación no garantizada** ("*unsecured postpetition financing*") regulada en el apartado (b) de la referida sección 364.

Al no gozar de garantía real, es el crédito habitual de los proveedores (*"vendors*") tras la solicitud de concurso, en tanto los proveedores de financiación profesionales (piénsese en entidades financieras y fondos de inversión) exigen, lógicamente, que la financiación quede debidamente garantizada.

Si la financiación excede del giro ordinario de la empresa requiere previa autorización judicial[13]. Sin embargo, como el Código de Insolvencia de los Estados Unidos no define el concepto de "*ámbito ordinario de la empresa*", lo habitual en la práctica es que el *vendor* exija autorización judicial en todo caso para asegurarse el trato preferente.

Este tipo de financiación tiene el tratamiento prioritario de gasto pre-deducible de conformidad con lo previsto en la sección 503 (b) del Código de Insolvencia de los Estados Unidos ("*administrative expense priority"*). Es decir, en caso de liquidación tendrá prioridad en el orden de prelación de pagos sobre toda la deuda no garantizada devengada con anterioridad a la solicitud del *Chapter 11.* No obstante, el proveedor de financiación no tiene plena certeza de recobro, en tanto tendrán prioridad los créditos con garantía y los gastos súper prioritarios ("*superpriority claims"*).

(b) **Financiación con garantía sobre bienes libres de cargas** ("*secured financing by liens on unencumbered assets"*), prevista en el apartado (c)(2) de la referida sección 364.

Conlleva la consideración de gasto súper prioritario ("*superpriority*")[14], cuyo pago en escenario de liquidación tiene preferencia también sobre los *administrative expenses* (de ahí la denominación de "súper prioritario").

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[13] Si la financiación no garantizada entra dentro del ámbito ordinario de la empresa y salvo que el juzgado indique lo contrario, el procedimiento es más sencillo en tanto no requeriría notificación y no sería necesaria la autorización judicial (apartado (a) de la referida sección 364).

[14] Véase al respecto lo previsto en el apartado (c)(1) de la sección 364 del Código de Insolvencia de los Estados Unidos.

Supone una garantía de primer rango sobre activos libres de carga y requiere, en todo caso, autorización judicial.

(c) **Financiación con garantía de segundo rango sobre un activo previamente gravado** ("*secured financing by a junior lien on property of the estate that is subject to a lien"*), prevista en el apartado (c)(3) de la referida sección 364.

Conlleva también la consideración de gasto súper prioritario ("*superpriority*") y, en este caso, una garantía de segundo rango sobre activos previamente gravados (que mantienen su rango prioritario). Requiere, en todo caso, autorización judicial.

(d) **Financiación con garantía de primer rango sobre activos previamente gravados** ("*secured by a senior or equal lien on property of the estate that is subject to a lien")*, de conformidad con lo previsto en el apartado (d) de la referida sección 364.

La garantía que se ofrece al financiador es de primer rango (o, cuanto menos, rango paritario) sobre activos que ya estaban gravados de manera previa a la solicitud del *Chapter 11*. En caso de que la garantía sea de primer rango, supondrá que tendrá preferencia de pago sobre cualquier otro crédito garantizado con el mismo colateral, con independencia de cómo se haya realizado el activo.

Para obtener autorización judicial, el deudor también deberá demostrar que no ha podido obtener la financiación sin otorgar este tipo de garantía y, además, que el acreedor preexistente afectado está adecuadamente protegido.

Evidentemente, una garantía "privilegiada" o de primer rango sobre activos previamente gravados ("*priming lien"*) sólo podría ser otorgada con el consentimiento de los acreedores que ya disponen de garantía sobre dichos activos. Por ende, la posibilidad absolutamente excepcional, en un escenario de *Chapter 11*, de desplazar a los acreedores privilegiados preexistentes sin su consentimiento, requiere que el juez estime que los acreedores con garantías previas están adecuadamente protegidos pese al otorgamiento de la garantía de primer rango en favor del nuevo prestamista de *DIP financing*.

El concepto de protección adecuada ("*adequate protection*") implica, como regla general, que exista un margen de cobertura (*"equity cushion"*) en el valor del bien objeto de la garantía, de modo que el acreedor previamente privilegiado tendría suficiente garantía pese a ver degradado su rango. Al respecto, ha de tenerse en cuenta que el *DIP financing* en sí puede aumentar el valor de la garantía, aumentando en consecuencia el margen de cobertura.

En último término, en caso de que el valor del colateral disminuyera por la degradación en rango a favor del *priming lien* del *DIP financing*, el Código de Insolvencia de los Estados Unidos[15] determina que los acreedores cuya carga se vea desplazada de rango pueden quedar adecuadamente protegidos mediante (i) un pago en efectivo o pagos periódicos en efectivo por parte del deudor al acreedor perjudicado; (ii) el otorgamiento de una garantía adicional o sustitutiva al acreedor desplazado; o, en general, (iii) la concesión de cualquier otra medida que tenga como resultado la realización por parte de dicha entidad de un equivalente indudable de la participación del acreedor en la garantía.

[15] Véase al respecto la sección 361 del Código de Insolvencia de los Estados Unidos.

2.4. PROCEDIMIENTO DE OBTENCIÓN DE DIP FINANCING

El proceso de obtención de *DIP financing* por una empresa en *Chapter 11* pasa por una fase inicial de negociación y *pricing* entre el interesado y las entidades financiadoras, seguido (en algunos casos de forma simultánea) del procedimiento para la necesaria aprobación judicial. Lo habitual en este tipo de financiaciones es que las negociaciones de los términos y condiciones aplicables transcurran dentro de las dos semanas previas a la solicitud del *Chapter 11*[16] y que las operaciones de *DIP financing* se formalicen en el primer mes del procedimiento.

Tras la entrega por el proveedor de nueva financiación de una carta de compromiso ("*engagement letter"*) por un importe acordado, se realiza un procedimiento de *due diligence* (cuyo coste es trasladado al deudor vía cobro de comisiones[17]). Dado que los plazos para llevar a cabo la *due diligence* son muy reducidos, la revisión legal se centra, a diferencia de un proceso de financiación en escenario no *distress*, en el estado y valoración de los activos que pueden ser gravados (de modo que el proveedor de financiación pueda verificar de qué manera puede quedar suficientemente garantizado), además de las proyecciones financieras del deudor (de las que se deduce la viabilidad futura de la compañía).

Si la *due diligence* es satisfactoria, se fija el importe y condiciones de la financiación en la documentación final que se presenta para obtener la aprobación judicial. Para dar una mayor confianza tanto al mercado como a los acreedores, es habitual que los *DIP financings* se formalicen por importes superiores a las necesidades reales de la compañía.

Dada la necesaria agilidad, el sistema americano prevé la posibilidad de solicitar autorización judicial para obtener financiación nueva incluso en el momento inicial del procedimiento mediante lo que se conoce en Estados Unidos como "*first day motions*"[18]. A esta solicitud se acompaña[19]: (i) la documentación de la financiación, (ii) la propuesta concreta de resolución judicial que habría de emitir del Juzgado y (iii) las declaraciones juradas (*affidavits*) del deudor detallando el proceso de búsqueda y negociación de la financiación, así como las circunstancias que hacen necesaria la autorización de dicha financiación. Si la compañía sigue en proceso de negociación, únicamente se incluirá la carta de compromiso de los financiadores y/o los borradores de la documentación.

Como mecanismo de protección tanto de los proveedores de financiación preexistentes como de los intereses de la masa de acreedores, el *US Bankruptcy Code* estable un mecanismo de notificación y audiencia ("*notice and hearing"*) previo a la aprobación de

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[16] Véase al respecto, Marshall S. Huebner, 'Debtor-in-possession financing' disponible en https://indexarticles.com/economy/rma-journal-the/debtor-in-possession-financing.

[17] Véase al respecto, 'DIP Financing: Overview, Practical Law Practice Note Overview', Practical Law Bankruptcy & Restructuring and Practical Law Finance (Thomson Reuters, 2022), disponible en https://uk.practicallaw.thomsonreuters.com/1-383-4700?transitionType=Default&contextData=(sc.Default)&firstPage=true.

[18] Pueden consultarse, como ejemplo, las "*First Day Motion Guidelines for Chapter 11 Cases*" de 2 de mayo de 2019 de los Juzgados de Insolvencia del Distrito Norte de California, disponibles en https://www.canb.uscourts.gov/procedure/first-day-motion-guidelines-chapter-11-cases, que incluyen las pautas relativas a la solicitud de DIP *financing* en ese momento inicial en esos juzgados en particular.

[19] Al respecto, la solicitud se regirá por el contenido de la *Rule 4001, Part IV – The debtor: duties and benefits, de las Federal Rules of Bankruptcy Procedure: Relief from Automatic Stay; Prohibiting or Conditioning the Use, Sale, or Lease of Property; Use of Cash Collateral; Obtaining Credit; Agreements*.

las cargas de primer rango sobre activos ya gravados, así como la de los créditos súper prioritarios (*superpriority*) en relación con la financiación *DIP*. Es el deudor quien ostenta la carga de la prueba y debe demostrar que (i) no podía obtenerse financiación similar sin garantía y, en particular, sin la garantía concreta que se propone y (ii) en caso de *priming* liens, que los acreedores que ven su garantía desplazada están siendo adecuadamente protegidos.

A los pocos días de la solicitud del *Chapter 11* tiene lugar una audiencia provisional ("*interim DIP hearing"*), en la que se tratan las características y circunstancias del caso *ad hoc* y se pretende obtener la aprobación para disponer de los fondos necesarios hasta que se celebre la audiencia definitiva. Se notifica a (i) los acreedores cuya carga se verá desplazada (de haberlos), (ii) los 20-50 mayores acreedores no garantizados del deudor (en función de la composición de pasivo de la compañía en cuestión, y (iii) la oficina del *US Trustee*.

El aspecto más discutido en esta audiencia es si los acreedores que verán su garantía desplazada están adecuadamente protegidos o no. Si el Juez considera que sí lo están, emitirá una orden provisional ("*interim DIP Order"*) aprobando una primera disposición de la financiación y fijando la fecha de la audiencia definitiva.

A los 35-45 días desde el nombramiento del comité de acreedores no garantizados ("*creditors committee"*), una vez que este ha podido revisar las condiciones y documentación relativa al *DIP financing*, y en ningún caso antes de los 14 días desde que se haya instado la solicitud[20], tiene lugar la audiencia definitiva ("*final hearing*") para la aprobación de la nueva financiación.

En esta audiencia, el punto más discutido es el paquete de garantías, aunque el comité también puede oponerse a otros términos del acuerdo. El juzgado emitirá la orden definitiva ("*final DIP Order"*), rechazando, en su caso, las objeciones que no hayan sido resueltas vía negociación.

En caso de revocación o la modificación de la *DIP Order*, la legislación americana prevé que no quede afectada la validez de cualquier deuda contraída, o cualquier prioridad o gravamen otorgado a una entidad que concedió el crédito de buena fe, salvo que el efecto de la *DIP Order* hubiera quedado suspendido hasta la resolución del recurso.

En cuanto al perfeccionamiento de las garantías otorgadas a los proveedores la financiación *DIP*, los juzgados o "*Bankruptcy Courts"* tienen jurisdicción sobre los activos titularidad del deudor. Consecuentemente, las resoluciones judiciales relativas a *DIP* suelen contener una disposición que establece que las garantías de la financiación *DIP* se perfeccionan sin necesidad de realizar ninguna otra formalidad adicional. No obstante, para protegerse frente a ejecuciones instadas ante otras jurisdicciones, los financiadores suelen exigir la formalización de la documentación y trámites habituales (aunque sea después del cierre financiero, mediante la imposición de una obligación contractual) como, por ejemplo, el reconocimiento de la *DIP Order* en otras jurisdicciones.

3. RÉGIMEN DE FINANCIACIÓN DE EMPRESAS EN DISTRESS EN ESPAÑA

[20] *Vid.* nota 23.

3.1. RÉGIMEN DE PRIORIDAD PARA EL DINERO NUEVO INTRODUCIDA EN ESPAÑA EN 2011

La legislación española introdujo, en 2011[21], un sistema de prioridad para fomentar la nueva financiación facilitada al deudor en situación de *distress*.

No obstante, a diferencia de Estados Unidos, no se prevé la posibilidad de que la financiación se otorgue al inicio del procedimiento concursal. En España se prevé un régimen de prioridad en la calificación de los créditos para el dinero nuevo bien en sede preconcursal (concretamente, el *fresh money* incluido en acuerdos de refinanciación) bien en sede concursal (con la aprobación de un convenio de acreedores), siempre que la finalidad de la nueva financiación sea poder cumplir el plan de viabilidad previsto en el convenio judicialmente aprobado.

En caso de acuerdo de refinanciación, el 50% del dinero nuevo nueva se calificará, en un eventual concurso consecutivo al acuerdo de refinanciación, como crédito con privilegio general[22]. El 50% restante se calificará como crédito contra la masa[23]. En todo caso, los nuevos financiadores pretenderán dotarse de garantías (privilegio especial) en caso de existir activos libres de carga.

Por su parte, si la financiación se otorgase en sede concursal, el dinero nuevo necesario para financiar el plan de viabilidad y cumplir con las obligaciones asumidas en el convenio de acreedores, se considerará como crédito contra la masa[24].

No obstante, la prioridad referida no alcanza a la nueva financiación que pueda otorgarse por personas especialmente relacionadas con el deudor sea en sede preconcursal o concurasl[25], incluidas las sociedades que pertenecen al mismo grupo de empresas que el deudor[26]. Como regla general, los créditos derivados de nueva financiación otorgada por cualquier persona especialmente relacionada, no solo no tendrán trato prioritario, sino que además serán considerados como créditos subordinados.

Por último, nuestra legislación no se pronuncia acerca de la calificación de la financiación que pudiera facilitarse al deudor desde la solicitud de concurso hasta la

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[21] La Ley 38/2011, de 10 de octubre, de reforma de la Ley 22/2003, de 9 de julio, Concursal, incorpora en España el denominado "*privilegio del dinero nuevo*", haciendo referencia expresa a su contribución a la continuidad empresarial en el apartado V de su Preámbulo.

[22] En relación con el privilegio general, véanse artículos 280(6) y 704(2) del TRLC del Real Decreto Legislativo 1/2020, de 5 de mayo, por el que se aprueba el texto refundido de la Ley Concursal (en adelante, "TRLC").

[23] En relación con la consideración de crédito contra la masa, véase el artículo 704(1) del TRLC, que requiere que el acuerdo de refinanciación sea "*no rescindible*" y haya generado "*nuevos ingresos de tesorería*".

[24] Véase el párrafo primero del artículo 242(14).

[25] Véase el párrafo segundo del artículo 242(14) del TRLC, en relación al dinero nuevo para financiar el plan de viabilidad del convenio de acreedores aprobado y el artículo 704 (3) en cuanto al dinero nuevo relativo a un acuerdo de refinanciación.

[26] Véase el párrafo primero del artículo 283(3) del TRLC.

aprobación del convenio. En caso de otorgarse, podría entenderse que, al devengarse con posterioridad a la declaración del concurso, el dinero nuevo habrá de considerarse como crédito contra la masa y, por lo tanto, ser atendido a su debido vencimiento. Sin embargo, el artículo 242(14) del TRLC únicamente reconoce dicha calificación a la nueva financiación que permita hacer efectivo el plan de viabilidad sobre el que se sustente el convenio. Por tanto, no parece posible extender dicho tratamiento a nueva financiación que pudiera obtenerse antes de que exista un convenio con su respectivo plan de viabilidad.

Otra línea de razonamiento —la que defendemos los autores del presente artículo— sería considerar que, de conformidad con el art. 205 TRLC, para gravar los bienes y derechos del deudor es necesaria previa autorización judicial (salvo que considerásemos aplicable lo previsto en el art. 206 TRLC, en sus apartados 2º y 3º TRLC). Por ende, nada obstaría a que se pudiese obtener autorización judicial para constituir garantías para el dinero nuevo desde la solicitud de concurso hasta la aprobación del convenio[27].

3.2. RÉGIMEN TRANSITORIO PARA FINANCIACIÓN PROVINIENTE DE PERSONAS ESPECIALMENTE RELACIONADAS A RAÍZ DE LA PANDEMIA DEL COVID-19

El Real Decreto-ley 16/2020, de 28 de abril, de medidas procesales y organizativas para hacer frente al COVID-19 en el ámbito de la Administración de Justicia, entre otras medidas, deja temporalmente sin efecto las normas de subordinación de la nueva financiación de personas especialmente relacionadas.

En particular, el artículo 12 del citado Real-Decreto especifica que la nueva financiación aportada por personas especialmente relacionadas desde el 14 de marzo de 2020 hasta el 14 de marzo de 2022 en sede preconcursal (evitando, por tanto, un concurso de acreedores) será considerada como crédito ordinario (en lugar de subordinado).

En caso de empresas que ya estén en concurso de acreedores y en los que la financiación de la persona especialmente relacionada se materialice en un convenio o reconvenio, también desde el 14 de marzo de 2020 hasta el 14 de marzo de 2022 y de conformidad con lo previsto en el artículo 9.3 del citado Real-Decreto, el crédito será considerado como contra la masa en un eventual escenario de posterior liquidación (en lugar de subordinado).

Sin embargo, como se ha referido, el régimen de no subordinación para la nueva financiación de personas especialmente relacionadas es transitorio y expirará el 14 de marzo de 2022. En opinión de los autores, partiendo de la base de que el crédito derivado del dinero nuevo no se privilegia por razón del titular que lo ostenta, sino por su finalidad (fomentar el otorgamiento del *fresh money* compensando a la entidad financiadora por el incremento de riesgo asumido en escenario *distress*), cualquier nuevo financiador (incluidas las personas especialmente relacionadas) habría de

[27] Al respecto, téngase en cuenta que, en virtud de lo establecido en el art. 106.1 TRLC, el ejercicio de las facultades de administración y disposición sobre los bienes del deudor está sometido a la intervención de la administración concursal.

beneficiarse del tratamiento preferente general, de forma permanente y no meramente transitoria.

3.3. RÉGIMEN DE LA DIRECTIVA EUROPEA SOBRE MARCOS DE REESTRUCTURACIÓN PREVENTIVA

En aras a incentivar la inyección de *fresh money* en empresas en situación de probabilidad de insolvencia, la Directiva Europea sobre Marcos de Reestructuración Preventiva[28] contempla (concretamente, en su Capítulo 4) un elenco de medidas orientadas a favorecer y proteger "*la nueva financiación, la financiación provisional y otras operaciones relacionadas con la reestructuración*". Son medidas orientadas a favorecer los marcos preconcursales. Específicamente, pretenden favorecer el acceso a financiación interina para la supervivencia de la empresa durante las negociaciones de los acuerdos de reestructuración (lo que la Directiva Europea denomina "*financiación provisional*") o la financiación que se otorga en el seno de los planes de reestructuración en sí (lo que la Directiva Europea denomina "*nueva financiación*"). Por tanto, no son medidas pensadas para favorecer la financiación durante el procedimiento concursal en sí.

El artículo 17 de la Directiva Europea introduce una obligación para los Estados Miembros de garantizar la protección adecuada tanto de la nueva financiación como de la financiación provisional. El precepto señala que, como mínimo, (i) estas financiaciones no podrán ser declaradas nulas, anulables o inejecutables (esto es, quedarán a salvo de potenciales acciones rescisorias) y que (ii) no se podrá exigir responsabilidad de índole civil, administrativa o penal a los financiadores en el caso de una posterior insolvencia del deudor sobre la base de que la financiación sea perjudicial para el conjunto de los acreedores, salvo que concurrieran motivos adicionales establecidos a nivel nacional. La finalidad evidente de la Directiva Europea es asegurarse de que en la práctica los inversores estarán dispuestos a otorgar financiación sin miedo a que peligre el repago del importe objeto de financiación.[29]

En el caso de la financiación interina o provisional, los Estados Miembros podrán requerir que sea necesario un control *ex ante*. En el caso de la financiación definitiva, los Estados Miembros podrán requerir la aprobación judicial (o por autoridad administrativa, en su caso del acuerdo de reestructuración (en cuyo seno se incluirá la financiación definitiva).

Se prevé también la facultad (por ende, mera facultad, no obligación) de los Estados Miembros de dar prioridad, en el orden de prelación en un procedimiento de insolvencia, a los prestadores de nueva financiación o financiación adicional. Se pretende así posibilitar la mejora en el rango de los proveedores de nueva financiación o financiación adicional "*frente a otros acreedores que, de otro modo, tendrían pretensiones iguales o superiores sobre el efectivo o los activos*". Como ejemplo, el procedimiento de *examinership* en Irlanda permite que el *examiner* solicite autorización judicial para la obtención de financiación provisional, teniendo el *fresh money* la consideración de créditos contra la masa y, por tanto, prededucibles.

3.4. PROYECTO DE LEY DE REFORMA DEL TEXTO REFUNDIDO DE LA LEY CONCURSAL

[28] *Ibid* 2.

[29] Lynch Fannon, 'Chapter 4. Protection for new financing, interim financing and other restructuring related transactions' en Paulus/Dammann (eds), *European Preventive Restructuring. Article-by-Article Commentary* (Beck Hart Nomos, 2021).

En consonancia con la Directiva Europea, el Proyecto de Reforma del Texto Refundido de la Ley Concursal —aún en trámite parlamentario— introduce un nuevo capítulo sobre la protección de la financiación en sede preconcursal.

En su artículo 665, el Proyecto define el concepto de "*financiación interina*" como aquella concedida por quien no fuera acreedor o por acreedor preexistente si en el momento de la concesión fuera razonable y necesaria inmediatamente, para (i) asegurar la continuidad empresarial del deudor (total o parcial) durante las negociaciones con los acreedores hasta la homologación del plan de reestructuración, o para (ii) maximizar el valor de la empresa o sus unidades productivas. Este concepto es el que supone una novedad en Derecho español.

Por su parte, el artículo 666 del Proyecto define la "*nueva financiación*" como aquella prevista en el plan de reestructuración y que sea necesaria para su cumplimento, sea concedida por quien no fuera acreedor o por acreedor preexistente. Este concepto es similar al ya existente de dinero nuevo en el marco de los antiguos acuerdos de refinanciación.

Siguiendo los parámetros establecidos por la Directiva Europea, la legislación proyectada plantea, en su artículo 667, los requisitos para la irrescindibilidad de la financiación, nueva o interina, en un eventual concurso posterior. Concretamente, esta financiación será irrescindible si el plan reestructuración homologado afectaba a créditos que suponían al menos el 51% del pasivo total, salvo prueba de que se realizaron en fraude de acreedores.

En el caso de que la financiación nueva o interina provenga de personas especialmente relacionadas con el deudor, se prevé una mayoría reforzada para que gocen de irrescindibilidad. Concretamente, los créditos afectados por el plan de reestructuración homologado (excluidos los créditos de que fueran titulares esas personas) habrán de representar más de dos tercios del pasivo total.

El Proyecto prevé además (artículo 669) que en el momento de la homologación del plan de reestructuración el Juez del concurso evalúe que la nueva financiación no causa un perjuicio injusto a los intereses de los acreedores.

En cuanto a la "*súper prioridad*" que otorga el texto proyecto tanto a la financiación interina como a la nueva financiación, el régimen es similar al actual para el dinero nuevo. En particular, el artículo 242(18) prevé la consideración de crédito contra la masa, en un concurso posterior, del 50% de los créditos derivados de la financiación interina o nueva y el artículo 280(6) prevé la consideración de crédito privilegiado general del 50% restante. Supone un avance, como señalábamos, porque el trato prioritario no se aplica sólo a la financiación nueva, sino que también se aplicaría a la financiación interina que, bajo el régimen actual, no goza de protección alguna.

4. PROPUESTA DE FINANCIACIÓN POST CONCURSO PARA ESPAÑA

El Proyecto de Ley de Reforma del Texto Refundido de la Ley Concursal supone un ligero avance en sede preconcursal, dando nuevos incentivos a la financiación interina necesaria para lograr la homologación de un plan de reestructuración.

Sin embargo, el Proyecto de Ley de Reforma del Texto Refundido de la Ley Concursal no avanza en cuanto a la financiación interina que pudiera necesitarse en los momentos iniciales de un procedimiento concursal. Bajo el régimen existente y el proyectado, en el hipotético supuesto de otorgarse financiación nueva en un momento inicial y no llegarse a aprobar un convenio, se abriría la fase de liquidación y, al no tener ningún tipo de tratamiento favorable ni garantía específica, los proveedores de dinero nuevo inicial en España podrían no llegar a recuperar prácticamente nada de su crédito.

Por tanto, puede afirmarse que el régimen español priva a potenciales proveedores de dinero nuevo de cualquier incentivo de financiar a empresas en concurso con carácter previo a la aprobación judicial de un convenio de acreedores, pese a que en muchas ocasiones la concursada no podrá sobrevivir en el corto plazo sin la referida financiación nueva en el momento inicial (desde la declaración de la solicitud de concurso).

Al respecto, para promover la financiación de empresas en concurso desde el inicio, debería diseñarse un sistema de incentivos a los financiadores vía garantías, privilegios y prioridades en el cobro de su crédito semejante al previsto en Estados Unidos, con su debida autorización judicial para la correcta protección de los intereses afectados y la debida seguridad del proveedor de financiación nueva.

Concretamente, dentro del artículo 205 TRLC, podría incluirse una previsión expresa relativa a la necesaria autorización judicial para las operaciones de financiación de dinero nuevo durante la fase común, incluida, en su caso, la constitución de garantía sobre bienes no gravados o, en su caso, la constitución de una garantía de posterior rango para bienes previamente gravados. Los autores entendemos en todo caso que, aunque no exista tal previsión de forma explícita, se encuentra implícita en la literalidad actual de dicho artículo.

No vemos plausible en España —al menos por el momento— la incorporación del régimen americano de *priming liens*, dada la alteración que se produciría en el mercado de financiación no *distress* ante la pérdida de valor que supondría el otorgamiento de garantías que pudieran quedar excepcionalmente desplazadas en un escenario *distress*. Por consiguiente, podrían hacer uso del mecanismo propuesto empresas que aún no tengan todo su patrimonio gravado (o con margen de cobertura suficiente en los activos ya gravados).

El trámite de solicitud de la autorización judicial habría de ser lo suficientemente ágil como para permitir la viabilidad de la concursada en el corto plazo. Al igual que en Estados Unidos, podría preverse una primera autorización provisional por el importe imprescindible en el momento de la propia solicitud de concurso (con una menor intervención de la administración concursal de cara a lograr la necesaria agilidad) y una autorización definitiva posterior por el importe total necesario tras la verificación, más pausada, de las debidas garantías (autorización definitiva que, en el caso de España, podría contar con una mayor intervención de la administración concursal). De este modo se extrapolaría el nuevo régimen de financiación interina en sede preconcursal (antes de la homologación del plan de reestructuración) al procedimiento concursal (antes de la aprobación del convenio).

En el escrito de solicitud, el deudor debería justificar documentalmente, entre otros extremos, que (i) la masa de acreedores no se ve perjudicada (el sistema propuesto sería más sencillo que el de Estados Unidos, en tanto si no se incluyese en el sistema español el mecanismo del *priming lien*, los acreedores con privilegio especial de rango anterior no se podrían ver perjudicados y, por ende, no necesitarían adecuada protección), (ii) la financiación es necesaria, de modo que la compañía se vería abocada a la liquidación en caso de no obtenerla (al respecto, sería conveniente exigir la aportación de una prueba pericial económica) y (iii) la financiación no puede ser obtenida sin la garantía propuesta ni en condiciones más ventajosas de las previstas en la solicitud de autorización judicial. Para mayor facilidad procesal, podría suplirse este último requisito por la introducción de un plazo breve de tiempo para la presentación de condiciones más ventajosas por parte de otro financiador de dinero nuevo.

Asimismo, para la financiación nueva de acreedores concursales de la concursada ("*defensive DIP"*) habría de ser posible el mecanismo del *roll-up,* esto es, que la nueva garantía otorgada cubra no sólo el importe del dinero nuevo sino también el importe preconcursal (si no totalmente, al menos en parte), incentivándose así el otorgamiento de nuevos fondos al mejorarse de este modo la posición crediticia del financiador preexistente.

En último término, este régimen no habría de penalizar la financiación nueva de personas especialmente relacionadas con la concursada, sino que habría de privilegiar toda la financiación de *fresh money* por igual, sin perjuicio de cual fuera la naturaleza del financiador, siguiendo con el espíritu de la normativa transitoria derivada del COVID-19.

5. CONCLUSIÓN

El marco español actual de financiación de empresas en concurso de acreedores resulta insuficiente, en tanto no permite la efectiva reestructuración de las compañías en dificultades que necesitan de fondos adicionales para subsistir en el corto plazo tras la declaración de concurso y ser viables en el medio y largo plazo.

Hay mucho trabajo por hacer y podemos poner el punto de mira en Estados Unidos, cuyo régimen de *DIP financing* ha sido testado con éxito y usado en una mayoría de procedimientos de *Chapter 11* americanos, incluso por compañías no americanas.

Consecuentemente, la propuesta de los autores consiste en transponer una serie de elementos del sistema americano de *DIP financing* mediante normas claras, suficientemente ágiles y flexibles que favorezcan la financiación de empresas declaradas en concurso de acreedores y permitan la constitución de garantías sobre el patrimonio del deudor (y, a diferencia de Estados Unidos, sin *priming liens*) durante la fase común del procedimiento.

Más allá del ligero avance del Proyecto de Ley de Reforma del Texto Refundido de la Ley Concursal en cuanto a la financiación interina preconcursal, dichas normas habrán de transmitir la necesaria seguridad jurídica y transmitir confianza en la regulación jurídica de nuestro país a los proveedores de financiación, tanto nacionales y extranjeros, por lo que habrá de contar con un régimen de autorizaciones judiciales que garantice que los derechos de los acreedores no se vean vulnerados. De nuevo, lo suficientemente ágil para permitir, al menos, la obtención de la financiación provisional necesaria para la subsistencia en la etapa inicial del procedimiento concursal.

En opinión de los autores, las medidas propuestas contribuirían a la viabilidad de ese núcleo de sociedades en España que, sin acceso a financiación inicial, se encuentran al filo de un abismo que fácilmente podría ser evitado. Por supuesto, con las debidas garantías y salvaguardas para aquellos que asumen el riesgo de prestar a un deudor insolvente.

6. REFERENCIA BIBLIOGRÁFICA ADICIONAL

Además de las referencias ya citadas en las notas a pie de página, se mencionan las siguientes referencias bibliográficas:

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