POST-COMMENCEMENT FINANCE
EXCERPTS FROM DRAFT UNCITRAL
LEGISLATIVE GUIDE ON INSOLVENCY LAW
INTERNATIONAL INSOLVENCY INSTITUTE
JUNE 2004

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4. Treatment of cash proceeds

238. Where “liquid” encumbered assets, i.e. encumbered assets, such as inventory, that are easily converted to cash, are sold in the course of insolvency proceedings, most laws provide that a secured creditor with an interest in an encumbered asset continues to hold an equivalent interest in any cash derived from the disposal of that asset.

239. Those cash proceeds can represent an important source of capital for the insolvency estate during the course of insolvency proceedings, especially in reorganization, and may be used for a number of purposes associated with the running of the business, such as payment of electricity and other service charges. In order to use cash proceeds, an insolvency representative must generally pursue one of two courses of action. Cash proceeds may be used with the consent of the relevant secured creditor on the terms agreed between the parties or, alternatively, following provision of notice to effected creditors, the debtor may seek a court order to use the cash proceeds. In general, a court will make three inquiries before authorizing such use: both the relevant security interest and the value of the underlying property will need to be determined; the risk to the secured creditor will need to be identified; and the court will need to determine whether sufficient measures are in place to protect the economic value of the secured claim (see chapter II.B. 8(b))

D. Post-commencement finance

1. Need for post-commencement finance

240. The continued operation of the debtor’s business after the commencement of insolvency proceedings is critical to reorganization and, to a lesser extent, liquidation where the business is to be sold as a going concern. To maintain its business activities, the debtor must have access to funds to enable it to continue to pay for crucial supplies of goods and services, including labour costs, insurance, rent, maintenance of contracts and other operating expenses, as well as costs associated with maintaining the value of assets. In some insolvency cases, the debtor may already have sufficient liquid assets to fund the ongoing business expenses in the form of cash or other assets that can be converted to cash (such as anticipated proceeds of receivables). Alternatively, those expenses can be funded out of the debtor’s existing cash flow through operation of the stay and cessation of payments on pre-commencement liabilities. Where the debtor has no available funds to meet its immediate cash flow needs, it will have to seek financing from third parties. This financing may take the form of trade credit extended to the debtor by vendors of goods and services, or loans or other forms of finance extended by lenders.

241. To ensure the continuity of the business where this is the object of the proceedings, it is highly desirable that a determination on the need for new finance is made at an early stage, in some cases even in the period between the making of the application and commencement of proceedings. Beyond that initial period, particularly in reorganization proceedings, the availability of new finance will also be important after commencement of the proceedings and
before consideration of the plan; obtaining finance in the period after approval of the plan generally should be addressed in the plan, especially in those jurisdictions which prohibit new borrowing unless the need for it is identified in the plan.

242. Notwithstanding that it might be desirable for the proceedings for the debtor to be able to obtain new money, a number of jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority for its repayment in insolvency, creating uncertainty. Under some laws, for example, new money can only be provided on the basis of security as provision of a preference for new lending is prohibited. In those cases where there are no unencumbered assets that the debtor can offer as security or no excess value in already encumbered assets, no new money will be available unless the lender is prepared to take the risk of lending without security or unless it can be obtained from sources such as the debtor’s family or group companies. The provision of finance in the period before commencement may also raise difficult questions relating to the application of avoidance powers and the liability of both the lender and the debtor. Some insolvency laws provide, for example, that where a lender advances funds to an insolvent debtor, it may be responsible for any increase in the liabilities of other creditors or the advance will be subject to avoidance in any ensuing insolvency proceedings. In other examples, the insolvency representative is required to borrow the money, potentially involving questions of personal liability for repayment.

243. Where an insolvency law promotes the use of insolvency proceedings that require the insolvent business to continue trading, whether it be reorganization or sale of the business in liquidation as a going concern, it is essential that the issue of new funding is addressed and limitations such as those discussed above are considered. An insolvency law can recognize the need for such post-commencement finance, provide authorization for it and create priority for repayment of the lender. The central issue is the scope of the power, and in particular, the inducements that can be offered to a potential creditor to encourage it to lend. To the extent that the solution adopted impacts the rights of existing secured creditors or those holding an interest in assets that was established prior in time, it is desirable that provisions addressing post-commencement finance are balanced against the general need to uphold commercial bargains, protect the pre-existing rights and priorities of creditors and minimize any negative impact on the availability of credit, in particular secured finance, that may result from interfering with those pre-existing security rights and priorities. It is also important to consider the impact on unsecured creditors who may see the remaining unsecured assets disappear to secure new lending, leaving nothing available for distribution, especially if the reorganisation were to fail.

244. In addition to issues of availability and security or priority for new lending, an insolvency law will need to consider the authorization required to obtain that new money (discussed further below) and, where a reorganization fails and the proceedings are converted to liquidation, the treatment of funds that may have been advanced before the conversion (discussed further below).

2. Sources of post-commencement finance

245. Post-commencement lending is likely to come from a limited number of sources. The first is pre-insolvency lenders or vendors of goods who have an ongoing relationship with the debtor and its business and may advance new funds or provide trade credit in order to enhance the likelihood of recovering their existing claims and perhaps gaining additional value through the higher rates charged for the new lending. A second type of lender has no pre-insolvency connection with the business of the debtor and is likely to be motivated only by the possibility of high returns. The inducement for both types of lender is the
certainty that special treatment will be accorded to the post-commencement finance. For existing lenders there are the additional inducements of the ongoing relationship with the debtor and its business, the assurance that the terms of their pre-commencement lending will not be altered and under some laws, the possibility that, if they do not provide post-commencement finance, their priority may be displaced by the lender who does provide that finance.

3. Attracting post-commencement finance—providing security or priority

246. A number of different approaches can be taken to attracting post-commencement finance and providing for repayment, including the provision of security on unencumbered or partially encumbered assets or, where that option is not available, establishing a priority.

(a) Granting security

247. Where the lender requires security, it can be provided on unencumbered property or as a junior or lower security interest on already encumbered property where the value of the encumbered asset is significantly in excess of the amount of the pre-existing secured obligation. In that case, no special protections will generally be required for the pre-existing secured creditor, as their rights will not be adversely affected unless circumstances change at a later time (such as that the value of the encumbered assets begin to erode) and they will retain their pre-commencement priority in the encumbered asset, unless they agree otherwise. Frequently, the only unencumbered assets that may be available for securing post-commencement finance will be assets recovered through avoidance proceedings.

(b) Establishing priority

248. Where the approaches discussed above are either insufficient or not available, for example because there are no unencumbered assets or there is no excess value in those assets already encumbered, insolvency laws adopt a variety of approaches to encouraging the provision of new finance.

249. Some insolvency laws provide that new lending will be afforded some level of priority over other creditors, in some cases including existing secured creditors. One level of priority is classed as an administrative priority (see chapter V.B), which will rank ahead of ordinary unsecured creditors, but not ahead of a secured creditor with respect to its security. In some cases, this priority is afforded on the basis that the new lending is extended to the insolvency representative, rather than to the debtor, and becomes an expense of the insolvency estate. Some insolvency laws require such borrowing to be approved by the court or by creditors, while other laws provide that the insolvency representative may obtain the necessary finance without approval, although this may involve an element of personal liability and, where it does, is likely to result in reluctance to seek new finance.

250. Other insolvency laws provide for a “super” administrative priority, which ranks ahead of administrative creditors or a priority that ranks ahead of all creditors, including secured creditors (sometimes referred to as a “priming lien”). In countries where this latter type of priority is permitted, insolvency courts recognize the risk to the existing secured creditors and authorize these types of priority reluctantly and as a last resort. The granting of such a priority may be subject to certain conditions such as the provision of notice to affected secured creditors and the opportunity for them to be heard by the court; proof by the debtor that it is unable to obtain the necessary finance without the priority; and the provision of protection for any diminution of the economic value of encumbered assets, including by a sufficient excess in the value of the encumbered asset so that the existing secured creditor will not be exposed to an unreasonable risk that its position will be affected beyond that of the super priority. In some legal systems, all of these options for attracting post-commencement finance are available. As a
general rule, the economic value of the rights of pre-existing secured creditors should be protected so that they will not be unreasonably harmed. If necessary (and as already discussed in relation to protection of the insolvency estate: see chapter II.B.8) this can be achieved by making periodic payments or providing security rights in additional assets in substitution for any assets that may be used by the debtor or encumbered in favour of new lending.

4. **Authorization for post-commencement finance**

251. It may be desirable to link the issue of authorization for new lending to the damage that may occur or the benefit that is likely to be provided as a result of the provision of new finance. A number of insolvency laws permit the insolvency representative to determine that new money is required for the continued operation or survival of the business or the preservation or enhancement of the value of the estate and provide that the insolvency representative (or a debtor-in-possession where that approach is followed) can obtain unsecured credit without approval by the court or by creditors, while other laws require approval by the court or creditors in certain circumstances. Given that new finance may be required on a fairly urgent basis to ensure the continuity of the business, it is desirable that the number of authorizations required be kept to a minimum, although clearly an insolvency law may take a hierarchical approach, depending upon the security or priority to be provided. Although generally requiring court involvement may assist in promoting transparency and provide additional assurance to lenders, in many instances the insolvency representative may be in a better position to assess the need for new finance. In any event, the court generally will not have expertise or information additional to that provided by the insolvency representative on which to base its decision.

252. The question of providing security over unencumbered assets or assets that are not fully encumbered is not one that should generally require approval of the court. Where the insolvency law establishes the level of priority that generally can be given, for example, an administrative priority, court approval may not be required. Should court approval be considered desirable, an intermediate approach may be to establish a threshold above which approval of the court is required. However, where the security or priority to be given affects the interests, for example, of existing secured creditors and those secured creditors do not support what is proposed, approval of the court should be required. Where secured creditors consent to revised treatment of their security interests, approval of the court may not be required.

5. **Effects of conversion**

253. Some insolvency laws provide that any security provided in respect of new lending can be set aside in a subsequent liquidation, and may give rise to liability for delaying the commencement of liquidation and potentially damaging the interests of creditors. Such an approach has the potential to act as a disincentive to commence reorganization. A more desirable approach may be to provide that creditors obtaining priority for new funding will retain that priority in any subsequent liquidation. A further approach provides that the priority will be recognized in a subsequent liquidation, but will not necessarily be accorded the same level of priority and may rank, for example, after administrative claims relating to the costs of the liquidation or *pari passu* with administrative expenses.
Revisions and comments proposed in May 2004 to reconcile text to recommendations and to improve text.

4. Treatment of cash proceeds

238. Where “liquid” encumbered assets, i.e. encumbered assets, such as inventory, that are easily converted to cash, are sold in the course of insolvency proceedings, most laws provide that a secured creditor with an interest in an encumbered asset continues to hold an equivalent interest in any cash derived from the disposal of that asset.

239. Those cash proceeds can represent an important source of capital for the insolvency estate during the course of insolvency proceedings, especially in reorganization, and may be used for a number of purposes associated with the running of the business, such as payment of electricity and other service charges. In order to use cash proceeds, an insolvency representative must generally pursue one of two courses of action. Cash proceeds may be used with the consent of the relevant secured creditor on the terms agreed between the parties or, alternatively, following provision of notice to effected creditors, the debtor may seek a court order to use the cash proceeds. In general, a court will make three inquiries before authorizing such use: both the relevant security interest and the value of the underlying property will need to be determined; the risk to the secured creditor will need to be identified; and the court will need to determine whether sufficient measures are in place to protect the economic value of the secured claim (see chapter II.B. 8(b))

_There are a couple of missing pieces with respect to post-commencement operation of business that need to be addressed that I had noted in my pre-working group memos. Thinking about post-commencement finance reminded me of them because they are inter-related. First, I think it would be helpful to add something to Recommendation 104 (duties and functions of insolvency representative) concerning operation of the business. There is no clear statement anywhere that I could find of authority to operate a business even though the implications of operation are addressed pervasively. You could just add a sentence at the end of 104: “When necessary to maximize the value of the assets, either in a liquidation or a reorganization, the insolvency representative may operate the debtor’s business.” I also think we have to add language concerning the DIP’s functions when there is no insolvency representative, maybe just by adding to the end of Recommendation 97(a): “When the debtor is a debtor in possession, the law should specify those functions of the insolvency representative that may be performed by the debtor in possession.”_
I made the following suggestions previously and think they are still appropriate:

23. Relative to II C., beginning on p. 94:

221, 2d sentence: When the insolvency representative continues the operation of the debtor’s business, either during a reorganization proceeding or to enable a sale of the business as a going concern, decisions as to use and disposal in the ordinary course...[as is up to] or a hearing of the court. Delete the rest of the sentence. Put the current first sentence of 223 here…”Including a distinction…”

New last sentence: When the property is subject to a security interest or other rights of a non-debtor (for example a lessor), the economic rights of that party must be protected.

223. [Reverse current 222 and 223 so that this discussion comes after 221]. Begin with second sentence of current version. At the end of current 223, add “Sale or other disposal of assets outside of the ordinary course of business implicates several complicated issues which are discussed below, including the method of sale designed to generate the most value to the estate, the sale of assets which are subject to a security interest when the value of the estate will be enhanced or when there is a dispute concerning the validity or amount of the secured claim, notice to parties in interest and an opportunity for interested buyers to submit higher and better offers, prompt sale in the case of perishable assets and the power to abandon assets which have no value to the estate.

D. Post-commencement finance

1. Need for post-commencement finance

240. The continued operation of the debtor’s business after the commencement of insolvency proceedings is critical to reorganization and, to a lesser extent, liquidation where the business is to be sold as a going concern. To maintain its business activities, the debtor must have access to funds to enable it to continue to pay for crucial supplies of goods and services, including labour costs, insurance, rent, maintenance of contracts and other operating expenses, as well as costs associated with maintaining the value of assets. In some insolvency cases, the debtor may already have sufficient liquid assets to fund the ongoing business expenses in the form of cash or other assets that can be converted to cash (such as anticipated proceeds of receivables). Alternatively, those expenses can be funded out of the debtor’s existing cash flow through operation of the stay and cessation of payments on pre-commencement liabilities. Where the debtor has no available funds to meet its immediate cash flow needs, it will have to seek financing from third parties. This financing may take the form of trade credit extended to the debtor by vendors of goods and services, or loans or other forms of finance extended by lenders.

241. To ensure the continuity of the business where this is the object of the proceedings, it is highly desirable that a determination on the need for new finance is made at an early stage, in some cases even in the period between the making of the application and commencement of proceedings. The way that we have drafted “Provisional measures” does not provide authority for this. (27)(d) permits “Any other relief of the type applicable automatically on
commencement...” and there is no automatic right to incur post-petition debt on a priority or security basis. If we change “automatically applicable” to “available” we will be OK; do we have the ability to do that? Beyond that initial period, particularly in reorganization proceedings, the availability of new finance will also be important after commencement of the proceedings and before consideration of the plan; obtaining finance in the period after approval of the plan generally should be addressed in the plan, especially in those jurisdictions which prohibit new borrowing unless the need for it is identified in the plan.

242. The following discussion is really confusing because it jumbles priority and security together in certain respects and I think that they have to be carefully separated. This could be the cause of the anomaly that you noted in your email to me. I do think that the recommendations came out OK but they got ahead of the commentary. A priority claim is one that ranks above general claims in right of payment from assets that are not encumbered. If there are no such assets which could provide security to a lender (which seems to be the sole basis under “some laws” mentioned below), then there would be no assets to satisfy a priority either, making the type of law discussed nonsensical. In addition, I think we have proceeded elsewhere in the drafting on the premise that obtaining credit or incurring debt on an administrative expense priority basis is the first choice and easier for the debtor and is automatic in the ordinary course situation. It is implicit in the definition of “administrative claim or expense” that expenses incurred in the ordinary course of business by a debtor or an insolvency representative will be administrative expenses. Administrative expenses will be ranked first among claims other than secured claims under Recommendation 174. Costs for use of third party-owned assets under (40C), for performance under a contract prior to continuation or rejection under (66) and for damages for breach after continuation of a contract under (67) all are administrative expenses. We should say in ¶246 that where the business continues to operate post-commencement, trade credit and unsecured finance should automatically be entitled to administrative expense priority. (In 40c and 66 we use the phrase “expense of administering the estate. We should probably just use the defined term “administrative claim or expense”; we should also consider shortening the term to “administrative expense”.)

Super-priority and then security are harder to get approved and require some showing that that the credit/financing is not available with the lower level of priority or without security. In the U.S., there is a progression in the treatment of post-petition credit and finance. Unsecured credit and debt incurred in the ordinary course of business is automatically entitled to administrative expense status. Unsecured credit and debt outside the ordinary course can be given administrative status by the court. The progression thereafter, all of which requires court authority, is as follows: priority over other administrative expenses; security on unencumbered property; security by junior lien on encumbered property; security by equal or senior lien on encumbered property, with adequate protection afforded to the existing secured creditor. Notwithstanding that it might be desirable for the proceedings for the debtor to be able to obtain new money, a number of jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority for its repayment in insolvency, creating uncertainty. Under some laws, for example, new money can only be provided on the basis of security as provision of a preference for new lending is prohibited. Since either the security or the preference serve the same purpose of making assets available to pay post-petition debt, the logic of such laws is suspect. In those cases where there are no unencumbered assets that the debtor can offer as security or no excess value in already encumbered assets that the debtor can offer as security or with which the debtor can satisfy an administrative expense priority claim, no new money will be available unless the lender is prepared to take the risk of lending without security or unless it can be obtained from sources such as the debtor’s family or group companies. The...
the absence of enabling or clarifying treatment in the insolvency law, the provision of finance in the period before commencement may also raise difficult questions relating to the application of avoidance powers and the liability of both the lender and the debtor. Some insolvency laws provide, for example, that where a lender advances funds to an insolvent debtor, it may be responsible for any increase in the liabilities of other creditors or the advance will be subject to avoidance in any ensuing insolvency proceedings. In other examples, the insolvency representative is required to borrow the money, potentially involving questions of personal liability for repayment.

243. Where an insolvency law promotes the use of insolvency proceedings that require [permit] the insolvent business to continue trading, whether it be reorganization or sale of the business in liquidation as a going concern, it is essential that the issue of new funding is addressed and limitations such as those discussed above are considered. An insolvency law can recognize the need for such post-commencement finance, provide authorization for it and create priority or security for repayment of the lender. The central issue is the scope of the power, and in particular, the inducements that can be offered to a potential creditor to encourage it to lend. To the extent that the solution adopted impacts the rights of existing secured creditors or those holding an interest in assets that was established prior in time, it is desirable that provisions addressing post-commencement finance are balanced against the general need to uphold commercial bargains, protect the pre-existing rights and priorities of creditors and minimize any negative impact on the availability of credit, in particular secured finance, that may result from interfering with those pre-existing security rights and priorities. It is also important to consider the impact on unsecured creditors who may see the remaining unsecured assets disappear to secure new lending, leaving nothing available for distribution, especially if the reorganisation were to fail. This risk must be balanced against the prospect that preservation of going concern value by continued operation of the business will benefit those creditors.

244. In addition to issues of availability and security or priority or security for new lending, an insolvency law will need to consider the authorization required to obtain that new money (discussed further below) and, where a reorganization fails and the proceedings are converted to liquidation, the treatment of funds that may have been advanced before the conversion (discussed further below). I reversed the order of priority and security because I think priority should be automatic in ordinary course situations and otherwise easier to obtain than security. I propose reversal as well of 3 (a) [§247] and (b) [§248 et seq] below. Let me throw in one more observation here because I don’t know where else to put it. Obtaining unsecured, priority trade credit and secured financing are usually complementary and not mutually exclusive. Trade suppliers often will extend credit if they are comfortable that there is sufficient available financing to fund the repayment of that credit as an administrative expense. They may be more comfortable relying on the financing than on the debtor’s cash flow; in many businesses, in and out of bankruptcy, financing is necessary to balance inconsistent cash flows. I leave it you whether to add this point to the commentary.

2. Sources of post-commencement finance

245. Post-commencement lending is likely to come from a limited number of sources. The first is pre-insolvency lenders or vendors of goods who have an ongoing relationship with the debtor and its business and may advance new funds or provide trade credit in order to enhance the likelihood of recovering their existing claims and perhaps gaining additional value through the higher rates charged for the new lending. A second type of lender has no pre-insolvency connection with the business of the debtor and is likely to be motivated only by the possibility of high returns. The inducement for both types of lender is the certainty that special
treatment will be accorded to the post-commencement finance. For existing lenders there are the additional inducements of the ongoing relationship with the debtor and its business, the assurance that the terms of their pre-commencement lending will not be altered and under some laws, the possibility that, if they do not provide post-commencement finance, their priority may be displaced by the lender who does provide that finance.

3. Attracting post-commencement finance—providing security or priority or security

246. A number of different approaches can be taken to attracting post-commencement finance and providing for repayment, including Trade credit or indebtedness incurred in the ordinary course of business by an insolvency representative or a debtor in possession may be treated automatically as an administrative expense. When obtaining credit or incurring indebtedness is essential to maximizing the value of the assets and the credit or finance is not otherwise available as an administrative expense or is to be incurred outside the ordinary course of business, the court may authorize that the non-ordinary course credit or debt be incurred as an administrative expense, that it be afforded super-priority ahead of other administrative expenses or that it be supported by the provision of security on unencumbered or partially encumbered assets or, where that option is not available, establishing a priority.

(a) Establishing priority

248. Where the business of the debtor continues to operate after commencement of the insolvency proceedings, either incident to an attempted reorganization or to preserve value by sale as a going concern, then the expenses incurred in the operation of the business should typically be entitled to be paid as administrative expenses. “Priority” implies a ranking of rights to be paid from unencumbered assets. Administrative priority creditors do not rank ahead of a secured creditor with respect to its security. Administrative claims are generally afforded a first priority (see chapter V.B), which will rank ahead of ordinary unsecured claims and would also be paid before any other statutory priorities, for example for taxes or social security claims. Suppliers of goods and services would only furnish those goods and services to the insolvency representative on credit if they had a reasonable expectation of payment ahead of pre-commencement unsecured creditors. In some cases, this priority is afforded on the basis that the new credit or lending is extended to the insolvency representative, rather than to the debtor, and becomes an expense of the insolvency estate. Some insolvency laws require such borrowing or the incurring of such credit to be approved by the court or by creditors, while other laws provide that the insolvency representative may obtain the necessary credit or finance without approval, although this may involve an element of personal liability and, where it does, is likely to result in reluctance to seek new finance.

250. Other insolvency laws provide for a “super” administrative priority if credit or finance is not available when ranked as an administrative claim which is pari passu with other administrative claims such as fees of the insolvency representative or professionals employed in the case. The “super” priority ranks ahead of other administrative creditors.

(b) Granting security

247. Where the lender requires security, it can be provided on unencumbered property or as a junior or lower security interest on already encumbered property where the value of the encumbered asset is significantly in excess of the amount of the pre-existing secured obligation. In that case, no special protections will
generally be required for the pre-existing secured creditors, as their rights will not be adversely affected unless circumstances change at a later time (such as that the value of the encumbered assets begin to erode) and they will retain their pre-commencement priority in the encumbered asset, unless they agree otherwise. Frequently, the only unencumbered assets that may be available for securing post-commencement finance will be assets recovered through avoidance proceedings. Granting security on avoidance actions is controversial in the US and the exception rather than the rule. The thinking is that avoidance fosters equality of treatment among unsecured creditors, some whom were inequitably favored by receiving a transfer within the suspect period for preferences or by receiving a transfer at undervalue or by fraud. I don’t think we should leave the last sentence of this paragraph unless we add an explanation that security on avoidance recoveries may not always be permitted.

(b) Establishing priority

248. Where the approaches discussed above are either insufficient or not available, for example because there are no unencumbered assets or there is no excess value in those assets already encumbered, insolvency laws adopt a variety of approaches to encouraging the provision of new finance.

249. Some insolvency laws provide that new lending will be afforded some level of priority over other creditors, in some cases including existing secured creditors. One level of priority is classed as an administrative priority (see chapter V.B), which will rank ahead of ordinary unsecured creditors, but not ahead of a secured creditor with respect to its security. In some cases, this priority is afforded on the basis that the new lending is extended to the insolvency representative, rather than to the debtor, and becomes an expense of the insolvency estate. Some insolvency laws require such borrowing to be approved by the court or by creditors, while other laws provide that the insolvency representative may obtain the necessary finance without approval, although this may involve an element of personal liability and, where it does, is likely to result in reluctance to seek new finance. 250.

250. Other insolvency laws provide for a “super” administrative priority, which ranks ahead of administrative creditors or a priority that ranks ahead of all creditors, including secured creditors (sometimes referred to as a “priming lien”). In countries where this latter type of priority is permitted, insolvency courts recognize the risk to the existing secured creditors and authorize these types of priority reluctantly and as a last resort. The granting of such a priority may be subject to certain conditions such as the provision of notice to affected secured creditors and the opportunity for them to be heard by the court; proof by the debtor that it is unable to obtain the necessary finance without the priority; and the provision of protection for any diminution of the economic value of encumbered assets, including by a sufficient excess in the value of the encumbered asset so that the existing secured creditor will not be exposed to an unreasonable risk that its position will be affected beyond that of the super priority. In some legal systems, all of these options for attracting post-commencement finance are available. As a general rule, the economic value of the rights of pre-existing secured creditors should be protected so that they will not be unreasonably harmed. If necessary (and as already discussed in relation to protection of the insolvency estate: see chapter II.B.8) this can be achieved by making periodic payments or providing security rights in additional assets in substitution for any assets that may be used by the debtor or encumbered in favour of new lending.

4. Authorization for post-commencement finance

251. It may be desirable to link the issue of authorization for new lending to the damage that may occur or the benefit that is likely to be provided as a result of the provision of new finance. A number of insolvency laws permit the insolvency representative to determine that new money is required for the continued operation
or survival of the business or the preservation or enhancement of the value of the estate and provide that the insolvency representative (or a debtor-in-possession where that approach is followed) can obtain unsecured credit without approval by the court or by creditors, while other laws require approval by the court or creditors in certain circumstances. Given that new finance may be required on a fairly urgent basis to ensure the continuity of the business, it is desirable that the number of authorizations required be kept to a minimum, although clearly an insolvency law may take a hierarchical approach, depending upon the security or priority to be provided. Although generally requiring court involvement may assist in promoting transparency and provide additional assurance to lenders, in many instances the insolvency representative may be in a better position to assess the need for new finance. In any event, the court generally will not have expertise or information additional to that provided by the insolvency representative on which to base its decision.

252. The question of providing security over unencumbered assets or assets that are not fully encumbered is not one that should generally require approval of the court. Where the insolvency law establishes the level of priority that generally can be given, for example, an administrative priority, court approval may not be required. Should court approval be considered desirable, an intermediate approach may be to establish a threshold above which approval of the court is required. However, where the security or priority to be given affects the interests, for example, of existing secured creditors and those secured creditors do not support what is proposed, approval of the court should be required. Where secured creditors consent to revised treatment of their security interests, approval of the court may not be required.

5. Effects of conversion

253. Some insolvency laws provide that any security provided in respect of new lending can be set aside in a subsequent liquidation, and may give rise to liability for delaying the commencement of liquidation and potentially damaging the interests of creditors. Such an approach has the potential to act as a disincentive to commence reorganization. A more desirable approach may be to provide that creditors obtaining priority for new funding will retain that priority in any subsequent liquidation. A further approach provides that the priority will be recognized in a subsequent liquidation, but will not necessarily be accorded the same level of priority and may rank, for example, after administrative claims relating to the costs of the liquidation or pari passu with administrative expenses.
Excerpts from completed portion of glossary of terms relevant to post-commencement finance:

**Cash proceeds**
Proceeds, if subject to a security interest, of the sale of encumbered assets.

**Encumbered asset**
An asset in respect of which a security interest has been obtained by a creditor.

**Priority claim**
A claim that will be paid before payment of general unsecured creditors

Excerpt from glossary, terms to be resolved:

**Claim**
[A right to claim from the debtor money or assets payment from the estate of the debtor, which might be based upon whether arising from a debt, a contract or other theory of legal obligation, whether may be liquidated or unliquidated, matured or unmatured, disputed or undisputed, secured or unsecured, fixed or contingent.]

[Footnote: Some jurisdictions recognize the ability or right, where permitted by applicable law, to recover [assets][goods] from the debtor as a claim.]

**Creditor**
[A natural or legal person which has a claim against the debtor that arose on or before the commencement of the insolvency proceedings].

**Ordinary course of business**
[Transfers or Transactions consistent with both (i) the operation of the debtor’s business prior to insolvency proceedings; and (ii) ordinary business terms.]

**Priority**
[The right of a person to rank ahead of another person where that right arises by operation of law.]

**Secured claim**
[A claim assisted by a security interest taken as a guarantee for a debt enforceable in case of the debtor’s default, when the debt falls due the amount of which secured claim shall be equal to the value of the security interest. Any amount by which the claim exceeds the value of the encumbered asset shall be an unsecured claim.]

**Secured creditor**
[A creditor holding either a security interest. covering all or part of the debtor’s assets or a security interest in a specific asset entitling the creditor to priority ahead of other creditors with respect to the secured asset.]

**Secured debt**
[Aggregate amount of secured claims] or [claims pertaining to secured creditors.]
Security interest

[A right or interest in an encumbered asset to guarantee payment of a claim granted by a party committing the party to pay or perform an obligation. Whether established voluntarily or by agreement, a security interest generally includes, but is not necessarily limited to, mortgages, pledges, charges and liens. “Securities” means any shares, bonds or other financial instruments or assets (other than cash), or any interest therein.]

Superpriority

[A priority that will result in claims to which the superpriority attaches being paid before administrative claims.]
Excerpts from revised draft recommendations of provisions relevant to post-commencement finance:

**Assets constituting the estate (paras. 156-168)**

(24) The insolvency law should specify that the estate should include:

(a) Assets of the debtor\(^1\) including the debtor’s interest in assets subject to a security interest and in third party-owned assets;

(b) Assets acquired after commencement of the insolvency proceedings; and

(c) Assets recovered through avoidance and other actions.

(24A) \[from A/CN.9/551, para. 41\] The insolvency law should specify the date from which the estate is to be constituted, being either the date of application for commencement or the effective date of commencement of insolvency proceedings.

**Relief from measures applicable on commencement (paras. 207-9)**

(38) The insolvency law should specify that a secured creditor may request the court to grant relief from the type of measures applicable on commencement on grounds that may include that:

(a) The encumbered asset is not necessary to a prospective reorganization or sale of the debtor’s business;

(b) The value of the encumbered asset is eroding [as a result of the commencement or insolvency proceedings] and the secured creditor is not protected against the erosion of that value;

(c) In reorganization, a plan is not approved within any applicable time limits.

**Protection of the value of the encumbered asset (paras. 210-15)**

(39) The insolvency law should specify that upon application to the court, a secured creditor should be entitled to protection of the value of the assets in which it has a security interest. The court may grant appropriate measures of protection that may include:

(a) Cash payments by the estate;

(b) Provision of additional security; or

(c) Such other means as the court determines.

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\(^1\) Ownership of assets would be determined by reference to the relevant applicable law, where the term “assets” is defined broadly to include property, rights and interests of the debtor, including the debtor’s rights and interests in third-party owned assets.
C. Use and disposal of assets

Recommendations

Purpose of legislative provisions

The purpose of provisions on use and disposal of assets is to:

(a) Permit the use of assets, including encumbered assets and assets owned by a third party in the insolvency proceedings and specify the conditions for their disposal;

(b) Establish the limits to powers of use and disposal;

(c) Provide notice to creditors of proposed disposal, where appropriate; and

(d) Provide for the treatment of burdensome assets.

Contents of legislative provisions

Power to use and dispose of assets of the estate

(40) The insolvency law should permit:

(a) The use and disposal of assets of the estate (including assets subject to security interests) in the ordinary course of business except cash proceeds; and

(b) The use or disposal of assets of the estate (including assets subject to security interests) other than in the ordinary course of business, subject to the requirements of recommendations (41) and (43).

(40A) [text from A/CN.9/551, para. 54] The insolvency law should specify that, where the secured creditor does not agree, the court may authorize the use of cash proceeds provided specified conditions are satisfied, including:

(a) The secured creditor was given the opportunity to be heard by the court; and

(b) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

(40B) [text from A/CN.9/551, para. 46] The insolvency law should specify that assets subject to security interests may be further encumbered, subject to the requirements of recommendations 50, 51 and 52.

(40C) [text from A/CN.9/551, para. 47] The insolvency law should specify that the insolvency representative may use assets owned by third parties and in the possession of the debtor provided specified conditions are satisfied, including:

(a) The interests of the third party will be protected against diminution in the value of the assets; and

(b) The costs under the contract of continued performance of the contract will be paid as an expense of administering the estate.

Procedure for notification of disposal

Assets constituting the estate (paras. 156-168)
(24) The insolvency law should specify that the estate should include:

(a) Assets of the debtor\(^2\) including the debtor’s interest in assets subject to a security interest and in third party-owned assets;

(b) Assets acquired after commencement of the insolvency proceedings; and

(c) Assets recovered through avoidance and other actions.

Relief from measures applicable on commencement (paras. 207-9)

(38) The insolvency law should specify that a secured creditor may request the court to grant relief from the type of measures applicable on commencement on grounds that may include that:

(a) The encumbered asset is not necessary to a prospective reorganization or sale of the debtor’s business;

(b) The value of the encumbered asset is eroding [as a result of the commencement or insolvency proceedings] and the secured creditor is not protected against the erosion of that value;

(c) In reorganization, a plan is not approved within any applicable time limits.

Protection of the value of the encumbered asset (paras. 210-15)

(39) The insolvency law should specify that upon application to the court, a secured creditor should be entitled to protection of the value of the assets in which it has a security interest. The court may grant appropriate measures of protection that may include:

(a) Cash payments by the estate;

(b) Provision of additional security; or

(c) Such other means as the court determines.

C. Use and disposal of assets

Recommendations

Purpose of legislative provisions

The purpose of provisions on use and disposal of assets is to:

(a) Permit the use of assets, including encumbered assets and assets owned by a third party in the insolvency proceedings and specify the conditions for their disposal;

(b) Establish the limits to powers of use and disposal;

(c) Provide notice to creditors of proposed disposal, where appropriate; and

(d) Provide for the treatment of burdensome assets.

\(^2\) Ownership of assets would be determined by reference to the relevant applicable law, where the term “assets” is defined broadly to include property, rights and interests of the debtor, including the debtor’s rights and interests in third-party owned assets.
Contents of legislative provisions

Power to use and dispose of assets of the estate

(40) The insolvency law should permit:

(a) The use and disposal of assets of the estate (including assets subject to security interests) in the ordinary course of business except cash proceeds; and

(b) The use or disposal of assets of the estate (including assets subject to security interests) other than in the ordinary course of business, subject to the requirements of recommendations (41) and (43).

(40A) [text from A/CN.9/551, para. 54] The insolvency law should specify that, where the secured creditor does not agree, the court may authorize the use of cash proceeds provided specified conditions are satisfied, including:

(a) The secured creditor was given the opportunity to be heard by the court; and

(b) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

(40B) [text from A/CN.9/551, para. 46] The insolvency law should specify that assets subject to security interests may be further encumbered, subject to the requirements of recommendations 50, 51 and 52.

(40C) [text from A/CN.9/551, para. 47] The insolvency law should specify that the insolvency representative may use assets owned by third parties and in the possession of the debtor provided specified conditions are satisfied, including:

(a) The interests of the third party will be protected against diminution in the value of the assets; and

(b) The costs under the contract of continued performance of the contract will be paid as an expense of administering the estate.

(41) The insolvency law should specify that adequate notice of any disposal conducted outside the ordinary course of business is given to creditors\(^3\) and that they have the opportunity to be heard by the court.

(42) The insolvency law should specify that notification of public auctions be provided in a manner that will ensure the information is likely to come to the attention of interested parties.

Ability to sell assets of the estate free and clear of encumbrances and other interests

(43) The insolvency law should permit the insolvency representative to sell assets that are encumbered or subject to other interests free and clear of those encumbrances and other interests, outside the ordinary course of business, provided that:

(a) The insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;

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\(^3\) When the assets are encumbered assets or subject to other interests, recommendation (43) applies.
(b) The holders are given the opportunity to object to the proposed sale;
(c) Relief from the stay has not been granted; and
(d) The priority of interests in the proceeds of sale of the asset is preserved.

General methods of sale

(45) The insolvency law should specify methods of sale for sales conducted outside the ordinary course of business that will maximize the price obtained for assets being sold in insolvency proceedings, and permit both public auctions and private sales.

Urgent sales

(46) The insolvency law should permit urgent sales of assets to be conducted outside the ordinary course of business, where the assets by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy. The insolvency law may provide that prior approval of the court or of creditors is not required in such circumstances.

Disposal of assets to related persons

(47) The insolvency law should require any proposed disposal of assets to related persons to be carefully scrutinised before being allowed to proceed.

D. Post-commencement finance

Recommendations

Purpose of legislative provisions

The purpose of provisions on post-commencement finance is to:
(a) Facilitate finance to be obtained for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the estate;
(b) Ensure appropriate protection for the providers of post-commencement finance;
(c) Ensure appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.

Contents of legislative provisions

Authority for post-commencement finance (paras. 240-44; 251-52)

(49) The insolvency law should facilitate and provide incentives for the insolvency representative obtaining post-commencement finance where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the estate. The insolvency law may require authorization by the court or creditors (or the creditor committee).
Security for post-commencement finance (para. 247)

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

(51) The law\(^4\) should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation (52).

(52) The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interest provided specified conditions are satisfied, including:

(a) The existing secured creditor was given the opportunity to be heard by the court;

(b) The debtor can prove that it cannot obtain the finance in any other way;

(c) The interests of the existing secured creditor will be protected.\(^5\)

Priority for post-commencement finance (para. 248-250)

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

Effect of conversion on post-commencement finance (para. 253)

(54) The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority provided to post-commencement finance in the reorganization should continue to be recognized in the liquidation.\(^6\)

\(^4\) This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

\(^5\) See chapter II.B.8.

\(^6\) The same order of priority may not necessarily be recognized. For example, post-commencement finance may rank in priority after administrative claims relating to the costs of the liquidation.
Revisions and comments proposed in May 2004 to recommendations on use and disposal of assets:

Use and disposal of assets
Recommendations

Purpose of legislative provisions
The purpose of provisions on use and disposal of assets is to:

(a) Permit the use of assets, including encumbered assets and assets owned by a third party in the insolvency proceedings and specify the conditions for their use and disposal;

(b) Establish the limits to powers of use and disposal;

(c) Provide notice to creditors of proposed use and disposal, where appropriate; and

(d) Provide for the treatment of burdensome assets.

Contents of legislative provisions

Power to use and dispose of assets of the estate

(40) The insolvency law should permit: the insolvency representative to use and dispose of assets of the estate (including assets subject to security interests and assets owned by third parties in the possession of the debtor) in the ordinary course of business except cash proceeds.

(a) If the assets are owned by a third party, the assets will be protected against diminution in value and the costs under a contract for use of the assets will be paid as an expense of administering the estate.

(40X) The insolvency law should permit the insolvency representative to use [and dispose of ]cash proceeds if:

(a) The secured creditor consents to such use; or

(b) The secured creditor was given notice of the proposed use and an opportunity to be heard by the court; and

(c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

(40Y) The insolvency law should permit the insolvency representative to use or dispose of assets of the estate (including assets subject to security interests) [except cash proceeds] other than in the ordinary course of business if:

(a) Creditors were given notice and an opportunity to be heard by the court; and

(b) The interests of a secured creditor will be protected against diminution in the value of the assets; and
(c) If the assets are encumbered or subject to other interests and are to disposed of free and clear of those interests, the requirements of recommendation 43 are satisfied.

(40B) [text from A/CN.9/551, para. 46] The insolvency law should specify that assets subject to security interests may be further encumbered, subject to the requirements of recommendations 50, 51 and 52.

**Procedure for notification of disposal and sale**

(41) The insolvency law should specify that adequate notice of any disposal conducted outside the ordinary course of business is given to creditors\(^7\) and that they have the opportunity to be heard by the court.

(42) The insolvency law should specify that notification of public auctions be provided in a manner that will ensure the information is likely to come to the attention of interested parties.

(45) The insolvency law should specify methods of sale for sales conducted outside the ordinary course of business that will maximize the price obtained for assets being sold in insolvency proceedings, and permit both public auctions and private sales.

**Ability to sell assets of the estate free and clear of encumbrances and other interests**

(43) The insolvency law should permit the insolvency representative to sell assets that are encumbered or subject to other interests free and clear of those encumbrances and other interests, outside the ordinary course of business, provided that:

(a) The insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;

(b) The holders are given the opportunity to object to the proposed sale;

(c) Relief from the stay has not been granted; and

(d) The priority of interests in the proceeds of sale of the asset is preserved.

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\(^7\) When the assets are encumbered assets or subject to other interests, recommendation (43) applies.