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Problems of New and Interim Financing in Restructuring Proceedings

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Abstract

This article focuses on problems of new and interim financing in restructuring proceedings. It discusses the needs for additional financing in restructuring proceedings and how it should be granted. Also, the authors analyse the regulation and protection of interim and new financing in the European Union law. The authors argue that though Directive on restructuring and insolvency aims to increase effectiveness of restructuring proceedings, the regulation of interim and new financing triggers questions whether it is compatible with the goals of restructuring proceedings.

Keywords: restructuring proceedings, new and interim financing, European Union law.

Need of Additional Financing in Restructuring Proceedings

Restructuring proceedings are commenced to rescue a debtor which has encountered solvency problems (Bork, 2020; *165*). Such proceedings shall be effective (Tamošiūnienė, 2020; Drescher, 2013; Finch, 2009). Since restructuring is based on the idea that a debtor continues business activities during all restructuring proceedings, additional financing ("working capital") [1] may be required to ensure continuation of a debtor's business imme-

[1] According to the study of the European Law Institute "Rescue of Business in Insolvency Law", there are various synonyms to this notion, for instance, "new financing", "post-commencement finance", "post-insolvency financing", "post-bankruptcy financing", "new priority finance", "new financing", "additional funding", "new money", "fresh money", and "interim finance".

diately after commencement of restructuring proceedings and preserve the going concern value of a debtor's estate. Such continuation of business activities is possible only if a debtor has necessary capital to pay off debts and salaries, perform contracts and actively participate in the market. A debtor may need additional capital to buy necessary assets, improve commercial activities and perform other actions which would rescue a company and allow continuation of business; thus, a restructuring plan is implemented. Also, without new financing, not supplying the cash needs of a company can cause business to be closed or liquidated (Epstein, 1992). Therefore, in some cases it would not be possible to reach the goals of restructuring proceedings without additional financing. Availability of new and interim financing for financially distressed companies can promote the continued operation and survival of the debtor company (Payne, Sarra, 2017). It has been recognised in the US bankruptcy law that "on permitting parties to negotiate market agreements that do not overreach or negatively impact the rights of other stakeholders beyond the terms necessary to obtain postpetition credit in a particular case" (ABI Study, 2014; *77*).

In restructuring proceedings usually new lenders, instead of shareholders should provide cash to meet the necessary costs of continuation of business activities.

Provision of additional financing for the debtor in restructuring proceedings is established in the US restructuring law. Pursuant to 346 of the US Bankruptcy Code if the trustee is authorised to operate the business of the debtor under section 721, 1108, 1183, 1184, 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. The court, after notice and hearing, may authorise the trustee to obtain unsecured credit or incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b (1) of this title as an administrative expense. Thus, in the US bankruptcy law provision the approval of the court of additional financing in restructuring proceedings is needed. This *ex ante* confirmation of lawfulness of additional financing is an important element for lawfulness of such financing. The general idea of provision of addition financing in the US bankruptcy law has served as a source of inspiration for the Directive (McCormack, 2021; *3*). Also in other countries provision of additional financing may be required by the creditors. For instance, pursuant to Article 160(2) of the Insolvency Law of Germany, the creditors' committee is also required to approve relevant interim financing.

The need for additional financing as an instrument for effective restructuring proceedings has been already accepted in international soft law documents on insolvency law. For instance, UNCITRAL Legislative Guide on Insolvency Law has recognised that to ensure continuity of the business, it is highly desirable that a determination on the need for new finance be made at an early stage, in some cases even in the period between the time the application is made and commencement of proceedings. Availability of new finance will also be important in reorganisation proceedings between commencement of the proceedings and approval of the plan (United Nations, 2004; *114*). However, there are no specific rules how and in which situations exactly additional financing should be granted and how transactions which grant additional financing should be protected.

The need for additional financing was also recognised by the European Law Institute in the Study on Rescue of Business in Insolvency Law in which two types of additional financing are distinguished:

- interim finance which is described as short-term funds that are necessary for the debtor to cover administrative expenses after the commencement of restructuring or insolvency proceeding until either the implementation of the restructuring plan or the sale of the debtor's business is a going concern;
- new finance which is described as any new funds, whether provided by an existing or a new creditor, that are provided to fund the implementation of a restructuring plan (European Law Institute, 58; *63*).

Therefore, a difference is made between short-term funds which are necessary to maintain a debtor's business activities and new funds which are primarily necessary for continuation of business activities.

The main aspects of additional financing in restructuring proceedings are: 1) administrator of the estate (insolvency practitioner or debtor in possession) has the right to take out interim finance based on their own discretion; 2) any priority for new finance repayment claims in a subsequent insolvency requires a specific clause in the restructuring plan and consequently require approval of creditors and the court; 3) statutory safe harbour for interim and new finance from lenders liability or claw back claims in case subsequent (formal) insolvency should be established; 4) protection of lenders of interim or new financing should follow the general rules of civil law rules (European Law Institute, 2017). Thus, it is recognised that additional financing should be provided when a debtor believes it is necessary for continuation of business. Also, it should be approved by the court and certain legal protection is provided to transactions which grant additional financing. However, the questions arise: what incentives should be established in the restructuring law for provision of interim and new financing; how transactions which provide additional financing should be protected; whether approval of the court is always necessary for interim and new financing; how abuse of restructuring law can be avoided when such additional financing is provided.

Regulation of Additional Financing in Restructuring Proceedings in the European Union Law

The need for additional financing in restructuring proceedings had been recognised by the Member States of the European Union even before the adoption of the Directive on restructuring and insolvency[2] (thereinafter – Directive). It was

[2] Directive (EU) 2019/1023 of the European Parliament and 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) OL L 172.

established that protection of new financing and interim financing (essential in ensuring restructuring plans' success) varies among Member States, ranging from minimum protection from avoidance actions to a form of priority over existing debt in subsequent insolvency procedures. [3]

The Directive aims to harmonise certain aspects of corporate restructuring proceedings. This is the first attempt in the European Union law to regulate certain material aspects of corporate restructuring proceedings. The Directive does not establish comprehensive restructuring proceedings which would overlap national legislation of corporate restructuring proceedings of the Member States. Instead, it only regulates certain elements of restructuring proceedings which are important to ensure effective restructuring proceedings. One of the aims of the Directive is to ensure viable enterprises and entrepreneurs that being in financial difficulties have access to effective national preventive restructuring frameworks which enable them to continue operating (Recital 1 of the Directive). Thus, the Directive aims not only to provide restructuring mechanism, but also requires that a debtor shall continue operating during restructuring proceedings. This is a particularly relevant goal since in restructuring proceedings a debtor already has solvency problems but continuation of business activities is crucial for effectiveness of restructuring. Also, some authors argue that the debtor will benefit from a time-limited "breathing space" from enforcement action in order to facilitate negotiations on successful restructuring (McCormack, 2021, 3).

The main goal of the Directive is to increase efficacy of restructuring proceedings. It aims not only at preventing the liquidation of the entity but also at preventing the need to open a fully-fledged insolvency procedure supervised by the courts and coordinated by an insolvency practitioner (Weijs, 2018). Namely one of the elements which should allow to reach this goal is interim and new financing. Thus, the Directive establishes certain rules on interim and new financing which should increase effectiveness of restructuring proceedings and harmonise the regulation of restructuring proceedings in this area.

The Directive provides definitions of interim and new financing. Pursuant to Article 2(1)(8) of the Directive, "interim financing" means 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 definition of new financing is broad and encompasses any financial assistance for operation of business after commencement of restructuring proceedings. Thus, interim financing could be provided from the moment of commencement of restructuring proceedings and confirmation of restructuring plan. Since this period can be sufficiently long, a debtor may need additional financing to support continuation of business activities.

[3] Proposal for the Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU COM/2016/0723 final.

According to Article 2(1)(7) of the Directive, "new financing" means any new financial assistance provided by an existing or new creditor to implement a restructuring plan and everything included in that restructuring plan. The substance of new financing is established similarly to interim financing and encompasses any financial assistance. However, the major difference between these types of additional financing is provision in time. New financing is required for proper implementation of a restructuring plan, meaning that such financing is primarily necessary to ensure that the debtor will effectively implement the restructuring plan when it is confirmed. Thus, new financing is used from the moment of confirmation of a restructuring plan until the end of restructuring proceedings (implementation of a restructuring plan). Interim financing is granted after commencement of restructuring proceedings when negotiations for a restructuring plan between a debtor and creditors begin. It seems that the definitions of interim and new financing in the Directive are compatible with the current international definition of these types of additional financing in restructuring proceedings.

The notion of *financing* is not provided in the Directive. However, pursuant to Recital 66 of the Directive, financial assistance should be understood in a broad sense, including the provision of money or third-party guarantees and the supply of stock, inventory, raw materials and utilities, for example through granting the debtor a longer repayment period. Thus, interim and new financing should not only mean financial support in strict sense (for instance, grant of a loan or a guarantee), but also supply of necessary means for continuation of a debtor's business. This broad interpretation of financing means that the Directive aims to attract more financial support to the debtor which is relevant for restructuring proceedings.

Protection of Interim and New Financing Related Transactions

Interim and new financing are specific forms of financing. It is generally accepted that in restructuring proceedings transactions which provide such additional financing should be protected and the general rules of transaction avoidance are applicable to a limited extent. This is one of the major incentives for grantors of interim and new financing. Also, providers of additional financing often enjoy a priority ranking of their claims in case of debtor's liquidation. Such protection of new and interim financing is an important incentive for provision of additional financing since the lenders are often not willing to lend money to the company which has encountered financial problems. Nevertheless, protection of transactions of interim and new financing in the Directive has already attracted scholars' attention and triggered discussions whether these rules are compatible with the goals of restructuring proceedings (Weijs, 2018; Payne, Sarra, 2017; McCormack, 2020; Tollenaar, 2017).

According to Recital 66 of the Directive, interim financing and new financing should therefore be exempt from avoidance actions which seek to declare such financing void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures. Moreover, the Directive establishes a significant safe harbour for providers of interim and new financing. Pursuant to Recital 67 of the Directive, national insolvency laws providing for avoidance actions of interim and new financing or providing that new lenders may incur civil, administrative or criminal sanctions for extending credit to debtors in financial difficulties could jeopardise the availability of financing necessary for a successful negotiation and implementation of a restructuring plan. The exceptions to the rules of protection of transactions of interim and new financing are mentioned in Recital 68 of the Directive which establishes that when interim financing is extended, the parties do not know whether the restructuring plan will be eventually confirmed or not. Therefore, Member States should not be required to limit the protection of interim finance to cases where the plan is adopted by creditors or confirmed by a judicial or administrative authority. To avoid potential abuses, only financing that is reasonably and immediately necessary for the continued operation or survival of the debtor's business or the preservation or enhancement of the value of that business pending the confirmation of that plan should be protected. Furthermore, this Directive should not prevent Member States from introducing an *ex ante* control mechanism for interim financing. Member States should be able to limit the protection for new financing to cases where the plan is confirmed by a judicial or administrative authority and for interim financing in cases where it is subject to *ex ante* control. An *ex ante* control mechanism for interim financing or other transactions could be exercised by a practitioner in the field of restructuring, by a creditor's committee or by a judicial or administrative authority. Protection from avoidance actions and protection from personal liability are minimum guarantees that should be granted to interim financing and new financing.

The rules on protection of transactions of interim and new financing are regulated in Article 17 of the Directive. According to Article 17(1), Member States shall ensure that new financing and interim financing are adequately protected. As a minimum, in the case of any subsequent insolvency of the debtor:

(a) new financing and interim financing shall not be declared void, voidable or unenforceable;
(b) the grantors of such financing shall not incur civil, administrative or criminal liability, on the ground that such financing is detrimental to the general body of creditors, unless other additional grounds laid down by national law are present.

These rules are rather vague and provide almost absolute protection of transactions of interim and new financing. Some authors have rightly pointed out that the Directive offers too little protection against abuse and opportunistic use of interim financing by both debtor and interim lender and it is insufficiently clear as to what problems it seeks to provide a solution for (Weijs, 2018). It can be noted that the Directive does not harmonise the rules on transaction avoidance. Instead, it protects transactions which provide new and interim financing by declaring that such transactions are uncontestable in the court. Also, protection of grantors of new and interim financing is established. It is also doubtful whether such protection is proportionate particularly regarding application of criminal liability. Nevertheless, according to Article 17(2–3) of the Directive, there are exceptions which the Member States may choose to transpose in national laws:

- Member States may provide that paragraph 1 shall only apply to new financing if the restructuring plan has been confirmed by a judicial or administrative authority, and to interim financing which has been subject to *ex ante* control;
- Member States may exclude from the application of paragraph 1 interim financing which is granted after the debtor has become unable to pay their debts as they fall due.

The authors believe that these exceptions could significantly contribute to establishing lawfulness of transactions of interim and new financing. As it has been mentioned in other countries, for instance in the US, the confirmation of the court of additional financing in restructuring proceedings is necessary. Though the Directive aims to limit involvement of the court in restructuring proceedings, namely an *ex ante* control of the court of transactions of interim and new financing could ensure lawfulness of such transactions and allow avoiding abuse of this protection. Another exception relates to the need of additional financing to ensure solvency of a debtor. In case a debtor becomes insolvent, it is doubtful whether provision of interim and new financing contributes to the goals of restructuring proceedings.

Furthermore, the Directive establishes a significant incentive for provision of interim and new financing. Pursuant to Article 17(4) of the Directive, Member States may provide grantors of new or interim financing to be entitled to receive payment with priority in the context of subsequent insolvency procedures in relation to other creditors that would otherwise have superior or equal claims. Therefore, a grantor of interim or new financing may enjoy priority in the ranking of creditors in case of subsequent insolvency proceedings. This rule encourages creditors to support a debtor secure their claim. Some authors argue that namely the possibility of a priority charge for interim and new financing have the greater potential effect for incentives to provide additional financing (Payne, Sarra, 2017). Such argument is well founded since such incentives for the grantors of additional financing should be provided.

The Directive does not regulate how the debtor should use interim and new financing. Recital 68 of the Directive establishes that to avoid potential abuses, only financing that is reasonably and immediately necessary for the continued operation or survival of the debtor's business or the preservation or enhancement of the value of that business pending the confirmation of that plan should be protected. Nevertheless, Article 17 of the Directive which regulates protection of new and interim financing does not establish any guidance when such financing should be granted. The authors believe that absence of such regulation in the text of the Directive may open doors for possible abuse of restructuring law. This is a particularly significant issue since the sole purpose of such financing could be a possibility of pay off debts and interim and new interim financing might be used in a restructuring plan, there is a real risk that the new money borrowed will in part be used to pay off the creditors who have guarantee from management or shareholders (Weijs, 2018). In such cases management and shareholders of the debtor may pretend that they used interim or new financing for restructuring purposes, but, in reality, use such financing to increase a balance sheet solvency situation and reduce the risk of their liability towards the creditors in case liquidation proceedings are commenced latter.

Thus, even the Directive introduces interim and new financing for the purpose to ensure continuation of debtor's business activities. It lacks safeguards which would ensure that such financing would be used for legitimate purposes. Moreover, even grantors of interim and new financing could seek unlawful goals, for instance, to provide such financing in order to secure position and priority ranking in satisfaction of creditors' claims. Considering the possibility of abuse of restructuring law, the authors believe that an *ex ante* judicial control of interim and financing should be mandatory. Though the Directive limits involvement of a court in restructuring proceedings, namely judicial control could ensure lawfulness of interim and new financing.

Conclusions

The Directive aims to improve effectiveness of restructuring proceedings. One of the elements of effective restructuring proceedings is the possibility for a debtor to acquire additional financing which may be necessary to continue operation of a debtors' business. The authors agree that harmonisation of interim and new financing is not needed. In contrast, certain harmonised legal regulation in this area could contribute to effectiveness of restructuring proceedings. Also, incentives to provide additional financing for financially distressed companies is beneficial and important.

Nevertheless, though pursuant to Recital 66–68 of the Directive it requires a fair balance between the protection of interests of providers of interim and new financing, the text of the Directive opens doors for discussions whether this balance is achieved. First, the regulation of interim and new financing in the Directives is rather vague. The Directive does not specify when interim and new financing should be provided and does not deal with the question how a debtor should use such additional financing. Second, though the Directive provides certain exceptions to protection of interim and new financing, it is not sufficient to achieve fair balance between the interests of all participants of restructuring proceedings. The authors argue that in order to ensure lawfulness of provision of interim and new financing, *ex ante* judicial control is mandatory.

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