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The Treatment of Debtor-in-Possession Financing in Reorganization Procedures: An Economic and Comparative Approach

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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. 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 rescue or debtor-in-possession ("DIP") financing that seeks to encourage lenders to extend credit to financially distressed firms. They do so by providing DIP lenders with a preferential treatment in the ranking of claims that typically ranges 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 from Asia, Latin America, Europe, Africa, and North America, this article shows that there are many similarities in the treatment of DIP financing around the world. Namely, based on the type of super-priority potentially offered to DIP lenders, it will be shown that most DIP financing regimes can be summarised into four primary regulatory models. The article then examines the risks and costs potentially created by a DIP financing regime. It will conclude by analysing whether and, if so, how countries should adopt DIP financing provisions taking into account their legal, economic and institutional environment.

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Table of Contents

1. **Introduction** 4
2. **Rationale of DIP financing** 4
3. **The regulation of DIP financing: A comparative perspective** 6

3.1. The treatment of DIP financing around the world 6

3.2. No DIP financing provisions 7

3.2. Weak DIP financing provisions 9

3.2.1. Weak DIP financing provisions in formal reorganization procedures 9
3.2.2. Weak DIP financing provisions in hybrid procedures 11

3.3. Semi-strong DIP financing provisions 12

3.4 Strong DIP financing provisions 13

3.4.1. Introduction 13
3.4.2. DIP financing provisions in the United States and Singapore: Similarities and divergences 14

4. **The perils of a system of DIP financing** 18
5. **Policy recommendations for the adoption of DIP financing provisions** 19
6. **Conclusion** 23

Electronic copy available at: https://ssrn.com/abstract=4067966

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. 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 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 a preferential treatment in the ranking of claims that typically ranges from a basic administrative expense priority to the possibility of becoming a junior or, in some jurisdictions, even a senior secured creditor.

The adoption of DIP financing provisions encourages lenders to extend new financing to insolvent firms, making insolvency law a powerful mechanism to provide liquidity to viable but financially distressed firms.[2] Therefore, DIP financing can help create or preserve value. This article seeks to provide an economic and comparative analysis of DIP financing provisions. To that end, Section II starts by analysing the rationale of DIP financing provisions. Section III examines the different regulatory models of DIP financing generally observed around the world. Section IV highlights some of the risks and unintended costs potentially arising from a system of DIP financing. Section V discusses whether, and if so, how countries should adopt DIP financing provisions. Section VI concludes.

2. Rationale of DIP financing

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. Therefore, in the absence of any mechanism to incentivise the debtor's counterparties to keep providing labour, loans, goods and services, viable but financially distressed firms may end up being destroyed.[3] In other words, many viable but insolvent firms may become non-viable businesses just because they were unable to obtain new financing to keep operating and pursuing value-creating projects.[4] Therefore, the primary rationale of a DIP financing regime consists of preserving value for the benefit of society as a whole.

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[1] This article will use the terms 'DIP financing', 'rescue financing', and 'post-petition financing' interchangeably.

[2] Kenneth Ayotte and David A. Skeel Jr., 'Bankruptcy Law as a Liquidity Provider' (2013) 80 University of Chicago Law Review 1557.

[3] For the benefits and rationale of DIP financing, see George G Triantis, 'Debtor-in-Possession Financing in Bankruptcy' in Barry E. Adler (ed), *Research Handbook on Corporate Bankruptcy Law* (Elgar Publishing 2020) 177-192.

[4] A firm is no longer viable when the business has a going concern value that is smaller than the value of the assets on a break-up basis, and also smaller than zero. See John Armour, 'The Law and Economics of Corporate Insolvency: A Review' (2001) ESRC Centre for Business Research, University of Cambridge Working Paper 197, at 4 <https://www.cbr.cam.ac.uk/wp-content/uploads/2020/08/wp197.pdf> accessed 19 August 2021. This definition seems consistent with the concept of "economically efficient firms" also used in the economic literature. See Michelle J White, 'The Corporate Bankruptcy Decision' (1989) 3(2) Journal of Economic Perspectives 129; Michelle J White, 'Does Chapter 11 Save Economically Inefficient Firms?'

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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"). Therefore, this situation can lead to an *underinvestment* problem, that is, a situation where value-creating projects are not pursued.[5] As a result, the lack of new financing will hamper the maximisation of the value of the firm and the creation of jobs and wealth in society.[6] Moreover, when a company is heavily indebted, the shareholders may not have incentives to fund new investment projects with positive net present value ("NPV") if they know that, due to the company's financial situation, most (if not all) of the project's payoff will go to the creditors and the shareholders will bear any losses associated with the new investments.[7] Therefore, the existence of this problem, generally referred to as *debt overhang*, may lead to another situation of underinvestment that can destroy value for the creditors and society as a whole.[8]

Third, due to the loss of value –in terms of actual losses or at least opportunity cost– experienced by financially distressed firms unable to obtain credit to pursue value-creating projects, the returns to the creditors will be reduced. *Ex post*, this situation will undermine the financial position of the creditors involved in the insolvency proceeding, even leading to other corporate insolvencies – especially among non-diversified creditors highly exposed to the debtor's default.[9] Additionally, in the context of financial creditors, the losses borne by the creditors will increase the levels of non-performing loans in the banking industry.[10] Therefore, in extreme scenarios, it can even jeopardise the stability of the financial system. *Ex ante*, the expectation of receiving lower recoveries in a hypothetical event of insolvency will make lenders more reluctant to extend

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(1994) 72(3) Washington University Law Quarterly 1319. For other authors, however, a business is no longer viable if the firm's revenues cannot cover its costs, exclusive of financing costs. See Alan Schwartz, 'A Normative Theory of Corporate Bankruptcy' (2005) 91(5) Virginia Law Review 1199, 1200-1201.

[5] See Stewart C. Myers, 'The Determinants of Corporate Borrowing' (1977) 5(2) Journal of Financial Economics 147.

[6] See Ayotte and Skeel (n 2).

[7] See Myers (n 10). Challenging the existence of this problem, however, see Julian R. Franks and Sergey V. Sanzhar, 'Evidence on Debt Overhang from Distressed Equity Issues' (2005), Working Paper (available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=570068>). See also Robert Parrino and Michael Weisbach, 'Measuring investment distortions arising from stockholder-bondholder conflicts' (1999) 53(1) Journal of Financial Economics 3.

[8] See Myers (n 10). By contrast, an overinvestment problem exists when a company pursues investment projects that should not be undertaken. See Elazar Berkovitch and E. Han Kim, 'Financial Contracting and Leverage Induced Over - and Under-Investment Incentives' (1990) 45(3) Journal of Finance 765, 766.

[9] From an empirical perspective, analysing the harmful "domino effect" potentially generated by a situation of insolvency, see Efraim Benmelech, Nittai Bergman, Anna Milanez and Vladimir Mukharlyamov, 'The Agglomeration of Bankruptcy' (NBER Working Paper 20254, June 2014); Arata Yoshiyuki, 'Bankruptcy Propagation on a Customer-supplier Network: An empirical analysis in Japan' (RIETI Discussion Paper Series 18–E–040, June 2018).

[10] See Antonia Menezes, Sergio Muro, Clara Martins Pereira and Mahesh Uttamchandani, 'How Insolvency and Creditor/Debtor Regimes Can Help Address Nonperforming Loans' (World Bank Group, 2021) <http://documents1.worldbank.org/curated/en/163151612172227669/pdf/How-Insolvency-and-Creditor-Debtor-Regimes-Can-Help-Address-Nonperforming-Loans.pdf> accessed 19 August 2021.

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credit.[11] Therefore, it will lead to an undesirable increase in the cost of debt that can 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] This situation can encourage other lenders, supplier, and employees to keep operating with the firm. In fact, some empirical studies have shown a direct relation between DIP financing and an increased probability of successfully completing a reorganization procedure, and doing so faster.[14]

Lastly, the agreements between debtors and DIP lenders can often lead to an improvement in the corporate governance of the insolvent firm.[15] For instance, DIP loan contracts can detail terms as specific as the division of the company, the fate of an asset, and even the terms of a transfer of control.[16] Where the company has an incompetent management or the directors exclusively act in the interest of the shareholders, the power of creditors to influence the composition and direction of the board can be beneficial for the survival and successful reorganization of the insolvent firm. [17]

3. The regulation of DIP financing: A comparative perspective

3.1. The treatment of DIP financing around the world

Insolvency systems deal with DIP financing in different ways. This article identifies four primary models, or regulatory options, for the treatment of DIP financing. The first approach includes jurisdictions, or procedures within a jurisdiction, that do not provide any form of DIP financing provisions. The second regulatory model includes regimes with weak DIP financing provisions. Under this model, this article will include regimes where lenders can typically enjoy an administrative expense priority and, if so, a security interest over unencumbered property. The third model includes regimes with more comprehensive or "quasi-strong" form of DIP financing provisions. Under this regime, lenders can get different forms of super-priority, including an administrative expense priority, a security interest over unencumbered property, and a junior lien over encumbered property. Finally, the fourth regulatory approach includes regimes with strong DIP financing provisions. Under this model, DIP lenders can enjoy several forms of super-priority that include an administrative expense priority, a priority over all other administrative expenses, a security interest over unencumbered property,

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[11] John Armour, Antonia Menezes, Mahesh Uttamchandani and Kristin van Zwieten, 'How do creditor rights matter for debt finance? A review of empirical evidence' in Frederique Dahan (ed), *Research Handbook on Secured Financing of Commercial transactions* (Edward Elgar Publishing 2015) 3-25.
[12] *Ibid*.
[13] Fayez A. Elayan and Thomas O. Meyer, 'The Impact of Receiving Debtor-in-Possession Financing on the Probability of Successful Emergence and Time Spent Under Chapter 11 Bankruptcy' (2001) 28 (7) Journal of Business Finance & Accounting 934.
[14] *Ibid*.
[15] David A. Skeel, Jr., 'The "New" New Corporate Governance in Chapter 11' (2003) 152(2) University of Pennsylvania Law Review 917.
[16] *Id*, at 919.
[17] *Id*, at 931.

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junior and senior liens. Table 1 summarises these regulatory models as well as the jurisdictions, or procedures within a jurisdiction, adopting each approach.

Table 1: Regulatory models of DIP financing around the world

Regulatory model	**Types of super-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, the United Kingdom, and Virgin Islands
Weak DIP financing regime	Administrative expense priority Security interest over unencumbered property	Formal reorganization procedures 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 Hybrid procedures in France, Germany, Italy, the Netherlands and Spain
Semi-strong DIP financing regime	Administrative expense priority Security interest over unencumbered property Junior lien over encumbered property	Brazil (judicial reorganization) Dominican Republic (restructuring) India (corporate insolvency resolution process) The Philippines (court-supervised rehabilitation)
Strong DIP financing regime	Administrative expense priority Priority over other administrative expense Security interest over unencumbered property Junior lien over encumbered property Senior lien over encumbered property	United States (Chapter 11 reorganization procedure) Singapore (scheme of arrangement and judicial management) Colombia (reorganization) (*) *(*) DIP regime adopted temporarily*

3.2. No DIP financing provisions

Jurisdictions not providing any form of DIP financing provisions in formal reorganization procedures are rare.[18] In most jurisdictions, post-petition debts

[18] For the concept of formal reorganization procedures, and how they differ from completely out-of-court restructuring and hybrid procedures, see Jose Maria Garrido, *Out-of-Court Debt Restructuring* (World Bank Studies 2012) pp. 1–52

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and expenses enjoy some forms of priority. Therefore, this regulatory model is generally found only in jurisdictions that do not have formal reorganization procedures such as Hong Kong and the Cayman Islands.[19] Despite the lack of a formal reorganization procedure, however, jurisdictions such as Hong Kong and Cayman Island still provide debtors with a debt restructuring tool: a scheme of arrangement.[20] This procedure also exists in many other jurisdictions around the world, including Australia, Bermuda, Canada, Cayman Islands, Hong Kong, 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.[21] In the typical scheme of arrangement, the primary tool existing to facilitate a debt restructuring is a majority rule (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 help reduce some of the holdout problems generally existing in a total out-of-court restructuring (“workout”). In some jurisdictions, however, the scheme of arrangement may include additional tools seeking to facilitate a debt restructuring. For instance, in Malaysia, debtors can enjoy a moratorium.[22] Also, an approved liquidator is appointed to assess the viability of the scheme.[23] In Singapore, the scheme of arrangement existing prior to the 2017 reforms already provided debtors with a limited moratorium.[24] Since 2017, debtors conducting a scheme of arrangement in Singapore have access to many other restructuring tools, including a comprehensive system of DIP financing.[25] 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 existing in several jurisdictions such as the United Kingdom, Nigeria and Brunei. As it happens with the scheme of arrangement, these procedures provide debtors with very limited tools to facilitate a debt restructuring. Essentially, this procedure 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

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<https://openknowledge.worldbank.org/bitstream/handle/10986/2230/662320PUB0EPI00turing09780821389836.pdf?sequence=1&isAllowed=y> accessed 30 January 2022.

[19] *Ibid.*

[20] For a comprehensive analysis of the scheme of arrangement, see Jennifer Payne, *Scheme of Arrangement* (Cambridge University Press 2014).

[21] *Ibid.*

[22] Companies Act 2016, s 368.

[23] Companies Act 2016, s 367.

[24] See Companies Act (Cap 50, 2006 Rev Ed), s 210(10), which allowed the court to restrain proceedings against the debtor after the proposal of a scheme of arrangement.

[25] Gerald McCormack and Wai Yee Wan, ‘Transplanting chapter 11 of the US bankruptcy code into Singapore's restructuring and insolvency laws: Opportunities and challenges’ (2019) 19 (1) Journal of Corporate Law Studies 69; Aurelio Gurrea-Martinez, ‘Building a Restructuring Hub: Lessons from Singapore’, Singapore Management University School of Law Research Paper No. 16/2021 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3940512> accessed 30 January 2022.

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type of company using the procedure, it can also provide moratorium and it may require the appointment of a supervisor.[26] DIP financing provisions are not generally available in this procedure.

3.2. Weak DIP financing provisions

3.2.1. Weak DIP financing provisions in formal reorganization procedures

Due to the importance of facilitating new financing to viable but insolvent firms, formal reorganization procedures in most countries around the world adopt a weak DIP financing regime.[27] 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.[28]

The administrative expense priority can be obtained in the formal reorganization procedures existing in most jurisdictions around the world, including those existing in 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.[29] In some of these

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[26] The possibility of obtaining a moratorium exists, for example, under the CVA existing 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.

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

[28] For example, this priority is allowed in Australia and the United Kingdom provided that certain requirements are met. See (n 31).

[29] For Argentina, see art. 240 of the 1995 Insolvency Act (Law 24522). For Australia, see Corporations Act 2001 (Cth), Part 5.3A, ss 443D and 443E. For Brunei, see the Brunei Insolvency Order 2016, s 147(1)(a). For Chile, see art. 74 of the 2014 Insolvency Act (Law 20720). For China, see *Corporate Restructuring and Insolvency Law in Asia* (Asian Business Law Institute, 2020) p 182–183, at para 65. For Ecuador, see its Corporate Reorganization Law of 1997, Art 48. For Italy, see https://www.lw.com/thoughtLeadership/lw-italian-insolvency-code-new-rules-on-debtor-in-possession-financing (16 April 2019). For Indonesia, see its Bankruptcy and Suspension of Payments, Art 69. For Japan, see Civil Rehabilitation Act (Act No 225 of 22 December 1999), Art 120.1, 120.4 and 119(v) and Corporate Reorganization Act (Act No 154 of 13 December 2002), Art 128.1, 128.2 and 127(v). See also *Corporate Restructuring and Insolvency Law in Asia* (Asian Business Law Institute, 2020) p 382, at para 44. For Mexico, see *Ley de Concursos Mercantiles* (Commercial Bankruptcy Law), Art 224-225. For Myanmar, see its Insolvency Law 2020, s 196(b). For New Zealand, see its Insolvency Act 2006, ss 273 – 274. In Nigeria, see section 537 of the Companies and Allies Matters Act of 2020. See also Anthony Idigbe, 'Nigeria', in Comparative Review of Approaches to Rescue or Debtor-in-Possession (DIP) Financing in Restructuring and Insolvency Regimes (INSOL International, 2022) 72. For South Africa, see its Companies Act 71 of 2008, s 135(3). See also Juanitta Calitz and Giles Freebody, 'Is post-commencement finance proving to be the thorn in the side of business rescue proceedings under the 2008 Companies Act?' (2016) De Jure 265, 271. For South Korea, see its Debtor Rehabilitation and Bankruptcy Act, Art 179(1)1. For Spain, see Insolvency Act 2020, Art. 245-12. For Thailand, see its Bankruptcy Act BE 2483 (1940), ss 24, 114, 130. In the United Kingdom, see Schedule B1 of Insolvency Act 1986, paragraph 3. In Uruguay, see article 91 of the Insolvency Act 2008.

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countries, such as the United Kingdom and Australia, the debtor can also provide DIP lenders with a security over unencumbered property.[30]

The approval of new financing differs significantly across jurisdictions adopting this regulatory model. For example, in jurisdictions with an administration or judicial management 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.[31] In other jurisdictions adopting this regulatory model, however, the approval of DIP financing may require the involvement of courts, the committee of creditors, or both. For instance, China requires the new financing to be approved by the court or the creditors' committee.[32] In Chile, debtors can borrow provided that the loans do not exceed 20% of the company's liabilities. Otherwise, the new financing will need to be approved by a majority of the company's creditors.[33]

Finally, jurisdictions adopting this approach also differ on how to deal with an eventual harm generated by the approval of new financing. This problem may exist, for example, when the new financing does not eventually create or preserve value. Therefore, the priority given to the DIP lender will reduce the pie available for distribution to the general body of unsecured creditors. To address this problem, countries adopt 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 new financing is not generally liable for these decisions. Therefore, the losses associated with this decision 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 personally liable for the new debts but can be liable if they breach their duties by, for instance, obtaining new financing in a negligent manner.[34] By contrast, in Australia, the administrator becomes personally liable for the debts and expenses incurred during the procedure.[35] Hence, this aspect discourages the use of DIP financing in Australia.[36] Therefore, among the jurisdictions with a weak DIP

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[30] In the United Kingdom, see Insolvency Act 1986, A26. In Australia, secured rescue finance is often sought in an application for a Corporations Act 2001 (Cth), s 447A order. See also Corporations Act 2001 (Cth), ss 588FL and 588FM.

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

[32] For example, in China, the new financing must be approved by a resolution from the creditors' meeting or by the people's court before the first creditors' meeting, see 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 (issued 27 March 2019; enacted 28 March 2019).

[33] See art. 74 of the 2014 Insolvency Act (Law 20720).

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

[35] See Corporations Act 2001(Cth), section 443A.

[36] 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.

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financing regime, Australia is one of the countries with the weakest DIP financing provisions.

3.2.2. Weak DIP financing provisions in hybrid procedures

Many jurisdictions around the world have been adopting hybrid procedures in the past years.[37] 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 reorganization procedures such as a moratorium and a majority rule.[38]

While some hybrid procedures, such as the traditional scheme of arrangement existing in most common law countries, do not provide DIP financing provisions, other forms of hybrid procedures 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, would be protected against a potential avoidance action if the debtor ultimately ends up in a formal insolvency proceeding.[39] This protection against avoidance actions also exists in Spain and Italy.[40] Additionally, in the Spanish hybrid procedure, as well as in the French conciliation proceeding, the new financing enjoys a preferential treatment in the ranking of claims provided that various requirements are met.[41]

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[37] Aurelio Gurrea-Martinez, 'The Future of Insolvency Law in a Post-Pandemic World' (Forthcoming, 2022) International Insolvency Review (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3916244).

[38] For the concept and nature of hybrid procedures, see Jose M. Garrido, *Out-of-Court Debt Restructuring* (The World Bank 2012), 47-49. See also Antonia Menezes and Akvile Gropper, 'Overview of Insolvency and Debt Restructuring Reforms in Response to the COVID-19 Pandemic and Past Financial Crises: Lessons for Emerging Markets' (2021) World Bank Group, Equitable Growth, Finance and Institutions COVID-19 Notes Finance Series; Andreas Bauer, Sean Craig, José Garrido, Kenneth H Kang, Kenichiro Kashiwase, Sung Jin Kim and Yan Liu and Sohrab Rafiq, 'Flattening the Insolvency Curve: Promoting Corporate Restructuring in Asia and the Pacific in the Post-C19 Recovery' (2021) IMF Working Paper No. 2021/016. For the rise of these procedures around the world, see Aurelio Gurrea-Martinez, 'The Future of Reorganization Procedures in the Era of Pre-Insolvency Law' (2020) 21(4) European Business Organization Law Review 829.

[39] See https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2021/01/new-german-restructuring-scheme-a-revolution-of-german-restructuring-law.pdf (*Clifford Chance,* January 2021) accessed 15 March 2022. 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 Jasper Berkenbosch, Sid Pepels and Erik Schuurs, 'Legislative Update: The Dutch Scheme Has Arrived' (Jones Day Business Restructuring Review, March 2021) <https://www.jonesday.com/en/insights/2021/03/legislative-update-the-dutch-scheme-has-arrived> accessed 15 March 2022.

[40] In order to enjoy this protection against avoidance cations, however, the new financing should be provided as part of a refinancing agreement meeting certain requirements.

[41] In France, see Article L. 611-11 of the French Commercial Code. In Spain, 50% of the new financing will enjoy an administrative expense priority and the remaining 50% will be considered a preferential claim to be paid ahead of unsecured creditors unless the new financing comes from directors, parent companies or shareholders with more than 5% (listed companies) or 10% (non-

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3.3. Semi-strong DIP financing provisions

Other jurisdictions around the world such as Brazil, Dominican Republic, India, and the Philippines have adopted a semi-strong DIP financing regime where DIP lenders can enjoy various forms of super-priority.[42] Yet, there are significant divergences among these regimes, especially when it comes to the approval of the new financing.

In Brazil, a recent insolvency law has allowed debtors to provide DIP lenders with various forms of super-priority, including an administrative expense priority, a lien over unencumbered assets, and a junior lien.[43] 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.[44] All forms of super-priority associated with new financing require court approval in Brazil.

A similar regime exists in the Philippines. Namely, under the court-supervised rehabilitation procedure existing in the Philippines, DIP lenders can enjoy three forms of super-priority. Firstly, they can enjoy an administrative expense priority.[45] Secondly, debtors can also provide DIP lenders with a security interest over its unencumbered property.[46] Thirdly, DIP lenders can also obtain a junior lien provided that it is approved by the secured creditor with a security interest over the encumbered property.[47] Regardless of the type of super-priority, the new financing needs to be approved by the court upon the recommendation of the rehabilitation receiver.[48]

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listed companies) of the company's share ownership. See Spanish Insolvency Act, s 704 and 280-6.

[42] 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, Art 86 (iii) and 87. While, to the best of my knowledge, courts in the Dominican Republic have not interpreted this provision yet since it came into force in 2017, a literal interpretation of the law seems to favour this view. If this interpretation is eventually adopted, however, the veto right enjoyed by a majority of creditors would not provide any effective protection to the secured creditors affected by a senior lien eventually granted to the DIP lender. Therefore, if the lawmaker sought to allow the possibility of priming an existing lien, it would have been more consistent, or at least more desirable, if the creditors primarily affected by the approval of the super-priority –that is, the affected secured creditors– had those veto rights. In other jurisdictions, such as India, this possibility seems to exist, but it is subject to the approval of the affected secured creditor. See Insolvency and Bankruptcy Code of 2016, s 20(c).

[43] It should be noted that, despite this super-priority, DIP lenders are still subordinated to certain labour claims, as well as the essential expenses of the management of the bankruptcy estate. See Brazilian Bankruptcy Act, article 84, I-B.

[44] Liv Machado, 'Brazil', in Comparative Review of Approaches to Rescue or Debtor-in-possession (DIP) Finance in Restructuring and Insolvency Regimes (INSOL International, 2022) 13-14.

[45] Financial Rehabilitation and Insolvency Act 2010, s 55.

[46] *Ibid.*

[47] *Ibid.*

[48] *Ibid.*

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In India, the new financing enjoys an administrative expense priority.[49] However, nothing prevents the interim resolution professional from obtaining new financing using unencumbered property and even encumbered property so long as the affected secured creditor consents.[50] Therefore, the Indian framework seems to recognise three forms of super-priority potentially offered to DIP lenders. Unlike the regime existing in the Philippines and Brazil, however, the new financing in India needs to be authorised by the committee of creditors.[51] 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 of this decision –that is, the creditors. However, as the committee of creditors is usually formed by financial creditors, and many financial creditors are secured creditors, those in charge of deciding whether the new financing should be approved do not often have incentives to make value-maximising decisions.

In the Dominican Republic, DIP lenders can get several types of super-priority. As a general rule, the new financing will enjoy an administrative expense priority.[52] However, subject to the approval of the court and, if so, the affected secured creditor, DIP lenders can also obtain a lien over the debtor's encumbered and unencumbered assets.[53] When the type of super-priority eventually enjoyed by the DIP lender consists of a security interest, a majority of creditors can veto the approval of DIP financing.[54] Moreover, the approval of new financing needs to be requested by the insolvency practitioner.[55] Therefore, the existence of several gatekeepers eventually scrutinising the desirability of the new financing makes the Dominican Republic have one of the most protective approaches for the authorisation of new financing observed around the world. Yet, that does mean that this system of approval of new financing is necessarily desirable. In fact, as it will be mentioned in Section 5, a model generally relying on the involvement of courts and insolvency practitioners for the approval of DIP financing will not be desirable in countries with weak institutional environments such as the Dominican Republic.

3.4 Strong DIP financing provisions

3.4.1. Introduction

Under the strong DIP financing regime existing in jurisdictions such as the United States and Singapore,[56] post-petition lenders can enjoy different forms of super-

[49] Insolvency and Bankruptcy Code of 2016, ss 5(13) and 53.
[50] Insolvency and Bankruptcy Code of 2016, s 20(c).
[51] Insolvency and Bankruptcy Code of 2016, s 25I.
[52] 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, Art 86 (iii) and 87.
[53] Law 114-15 on Restructuring and Liquidation of Companies of 2015, Art 87.
[54] *Ibid.*
[55] *Ibid.*
[56] Colombia has also adopted a strong system of DIP financing. However, this regime has only been implemented temporarily as a response to the COVID-19 crisis. See Law Decree 560/2020, 15 April 2020, Art 5 (available at

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priority.[57] First, they can enjoy an administrative expense priority.[58] Hence, in the event of liquidation, the DIP lender will get paid ahead of the general body of unsecured creditors. Second, they can enjoy a priority over other administrative expenses.[59] In this case, the DIP lender would also get paid ahead of other administrative expenses. Third, DIP lenders can also obtain a lien over unencumbered assets.[60] This priority would make the DIP lender a secured creditor who is entitled to be paid with the value of the collateral. Fourth, the DIP lender can also obtain a junior lien.[61] In such cases, the DIP lender would also become a secured creditor. However, it would 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.[62] In these scenarios, the DIP lender would also become a secured creditor. Moreover, by "priming" an existing lien, the DIP lenders would get paid ahead of the pre-existing secured creditor.

3.4.2. DIP financing provisions in the United States and Singapore: Similarities and divergences

Despite the similarities existing between the DIP financing regimes adopted in the United States and Singapore, there are still significant divergences. First, Singapore requires court approval for all forms of post-petition debts and expenses involving any type of super-priority.[63] In the United States, however,

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https://www.supersociedades.gov.co/nuestra_entidad/normatividad/normatividad_decretos/DECRETO_56 0_DEL_15_DE_ABRIL_DE_2020.pdf).

[57] For the forms of super-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 Ajinderpal Singh and Adriel Chioh, 'Rescue Financing in Singapore: Navigating Uncharted Waters' (2020) Singapore Academy of Law Practice 1; Jo Tay and Ee Jia Min, 'Singapore', in Comparative Review of Approaches to Rescue or Debtor-in-Possession (DIP) Financing in Restructuring and Insolvency Regimes (INSOL International, 2022) 91-103; David Chew, 'Super Priority Rescue Financing in Singapore' (Singapore Global Restructuring Initiative Blog, 19 November 2020) <https://ccla.smu.edu.sg/sgri/blog/2020/11/19/super-priority-rescue-financing-singapore> accessed on 26 March 2022. For an analysis of the regulation of DIP financing in the United States, see George G Triantis, 'A Theory of the Regulation of Debtor-in-Possession Financing' (1993) 46 Vanderbilt Law Review 901; David A Skeel Jr, 'The Past, Present and Future of Debtor-in-Possession Financing' (2004) 25 Cardozo Law Review 1905; Barry E Adler, Douglas G Baird and Thomas H Jackson, *Bankruptcy: Cases Problems and Materials* (4th edn, Foundation Press 2007), 475–520; Richard Squire, *Corporate Bankruptcy and Financial Reorganization* (Wolters Kluwer 2016), 235–260.

[58] 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).

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

[60] 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).

[61] 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).

[62] 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).

[63] Some practitioners and commentators have argued, however, that the fourth super-priority (security interest over an unencumbered asset) should not require authorisation in Singapore,

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the trustee or debtor-in-possession can obtain DIP financing without court approval where the new debt is incurred in the ordinary course of business and the type of priority given to the DIP lender is an administrative expense priority.[64]

Second, in the United States, debtors seeking to obtain court approval for new financing –usually because the new financing is not in the ordinary course of business or the DIP lender is expected to get a super-priority other than a basic administrative expense priority– should show that they were unable to obtain credit otherwise. In Singapore, while this condition is formally required for all forms of super-priority except for new financing that provides DIP lenders with a basic administrative expense priority, courts have still required debtors to show some "reasonable attempts" to obtain new financing without this form of priority.[65]

Third, despite the criticism over the practice of given a super-priority to pre-petition debts ("roll-ups"), sometimes in the form of a security interest over a pre-petition unsecured debt ("cross-collateralisation"),[66] and the absence of any formal regulatory framework for these practices,[67] roll-ups and cross-collateralisations are very common in DIP financing arrangements in the United States.[68] In Singapore, since the adoption of DIP financing provisions in 2017, there has only been one case that dealt with roll-ups.[69] In that case, the DIP lender was granted an administrative expense priority to be paid ahead of other administrative expenses. Therefore, roll-ups have been formally allowed in Singapore – at least, when the new financing involves an administrative expense priority and in fact, an administrative expense priority that is to be paid ahead of other administrative expenses.

It remains unclear, however, whether cross-collateralisations will be allowed in Singapore. While some authors have argued that the approval of a roll-up has left the door open for cross-collateralisations,[70] a literal interpretation of the law seems to reject this hypothesis.[71] Indeed, under the current regulatory framework for rescue financing in Singapore, an administrative expense priority –including those to be paid ahead of other administrative expenses– can be granted to

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despite the wording of the law. However, obtaining court approval would provide more certainty to creditors, especially in the event of a hypothetical situation of insolvency in the future.

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

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

[66] For criticisms of roll-ups and cross collateralisation, see Frederick Tung, 'Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis', (2020) 37(2) Yale Journal on Regulation 651; Seung Hee Cho, 'Roll-Up & Cross-Collateralization in DIP (Debtor-In-Possession) Financing as Measures of Creditor Control' (2018) The Wharton School, University of Pennsylvania. See also Triantis (n 3) 186–187.

[67] See Delaware Bankruptcy Local Rules 2002, rule 4001-2(a)(i) and Southern District of New York Local Bankruptcy Rules, rule 4001-2.

[68] Cho (n 66).

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

[70] Meiyen Tan, Keith Han, Angela Phoon and Zephan Chua, 'Recent Developments in Singapore's Restructuring Regime' (Global Restructuring Review, 2020) <https://globalrestructuringreview.com/review/asia-pacific-restructuring-review/2021/article/recent-developments-in-singapores-restructuring-regime> accessed on 25 August 2021.

[71] Insolvency, Restructuring and Dissolution Act 2018, ss 67 and 101.

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financing "obtained or to be obtained" by the debtor.[72] Thus, the law allows the possibility of providing a super-priority to pre-petition lenders, and therefore roll-ups, provided that the super-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.[73] Therefore, the possibility of granting a new lien, a junior lien or a senior lien to DIP lenders only seems to be possible for *new* financing obtained after initiating the procedure and obtaining the approval of the court. Therefore, in my view, Singapore insolvency law does not currently allow cross-collateralisations.

A different discussion is whether cross-collateralisations *should* be allowed. To that end, 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 lenders.[74] Nonetheless, it should be kept in mind that 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. In cases where the value of a collateral significantly exceeds the debt owed to a senior secured creditor, even a junior lien can serve as an equally protective measure for DIP lenders. Therefore, cross-collateralisations can lead to additional problems, such as the continuation of non-viable businesses and moral hazard problems. Indeed, since the DIP lender taking a security interest will not likely bear any losses eventually associated with the company's insolvent liquidation, they may have incentives to provide the new financing even if the insolvent firm is not economically viable. Thus, the existence of cross-collateralisations can contribute to the continuation of non-viable businesses at the expense of creditors and society as a whole. As a result, the higher risks created by cross-collateralisations compared to roll-ups seem to justify the implied prohibition of cross-collateralisations in Singapore. Nonetheless, due to the sophistication of the judiciary in Singapore, the insolvency courts have the expertise to prevent the potential problems associated with cross-collateralisations. Therefore, allowing cross-collateralisations in Singapore would not involve significant risks and it can often lead to a desirable outcome. As a result, cross-collateralisations should be allowed. Yet, they should be subject to a higher scrutiny by the court. Namely, in addition to the requirements generally imposed for the authorisation of DIP financing, including the creation or preservation of value, and therefore the effect of making all the

[72] Insolvency, Restructuring and Dissolution Act 2018, ss 67(1)(a) and 67(1)(b), as well as ss 101(1)(a) and 101(1)(b).
[73] It is not clear whether court approval is needed to give a security interest over unencumbered assets, though Singapore legislation seem to require it, see *Ibid*. However, companies conducting a scheme of arrangement are generally not subject to any restrictions relating to the disposal of assets, barring certain exceptions. Therefore, there is an argument that debtors proposing a scheme of arrangement should be allowed to offer a security interest over an unencumbered assets without court approval.
[74] See Triantis (n 3).

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creditors better off, the court should verify that the company obtaining the new financing is economically viable.[75]

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.[76] Second, the terms of the proposed financing should be fair, reasonable and adequate.[77] Third, the injection of new financing should be based on a sound and reasonable business judgment.[78] Fourth, the debtor should be unable to obtain other forms of financing, and other offers or proposals are not available.[79] Fifth, the new financing should be in the best interest of the company and the creditors as a whole.[80] 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.[81] As a result, even if granting a super-priority to DIP lenders may *prima facie* appear harmful to the interests of unsecured creditors, 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 Pareto improvement, that is, a transaction making everybody or at least somebody better off without making anyone worse off. [82]

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 provided if the affected secured creditor is "adequately protected".[83] For that purpose, both countries adopt a similar concept of adequate protection that includes cash payments, replacement liens, and indubitable equivalent value.[84] This latter form of adequate protection can generally be shown when there is an equity cushion over existing encumbered assets,[85] or when the company has a

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[75] For the concept of viable firms, see White, 'The Corporate Bankruptcy Decision' (n 3) and Armour (n 3).

[76] See *Attilan Group* (n 65), *Design Studios* (n 69), and *re Mid-State Raceway, Inc* 323 BR 40 (Bankr, ND New York, 2005). See also Triantis (n 3), 184.

[77] See *Attilan Group* (n 65), *Design Studios* (n 69), and *Mid-State Raceway* (n 74).

[78] *Ibid*.

[79] See *Attilan Group* (n 65), *Design Studios* (n 69), and *In re Western Pacific Airlines, Inc 223 BR 567 (Bankr, D Colo, 1997)*.

[80] *Ibid.*

[81] See Triantis (n 3).

[82] For the concept of Pareto improvements and Pareto efficiency, see Hal R. Varian, *Intermediate Microeconomics: A Modern Approach* (W.W. Norton and Company, 2010, 8th ed), 15. See also Richard A. Posner, *Economic Analysis of Law* (Wolters Kluwer, 2011, 8th ed), 17-20; and Rizwaan Jameel Mokal, 'On Fairness and Efficiency' (2003) 66(3) Modern Law Review 452. Arguing that a court must ensure that the DIP financing is authorised when, and only 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 (n 3).

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

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

[85] 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

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going concern surplus,[86] even though the latter can be more subjective as it depends on several factors determining the value of the firm.[87] 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* it 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 super-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 rescue financing. Therefore, as it can be observed, the desirability and success of the DIP financing regime existing in the United States and Singapore heavily relies on the ability of the court to distinguish between value-creating or value-preserving DIP financing that should be authorised, and value-destroying or value-redistributing DIP financing that should be rejected.[88]

4. The perils of a system of DIP financing

While the adoption of a system of DIP financing may bring many benefits, it can also entail certain risks and costs. First, the new financing may be used to keep non-viable firms alive. If so, the expenses incurred and any loss of value experienced until the liquidation of the firm will reduce the recoveries for the creditors. Moreover, it would also hamper the quick reallocation of assets of non-viable businesses.

Second, the new financing should only be authorised if it creates or preserves value.[89] Unfortunately, distinguishing between value-enhancing and value-destroying DIP financing is not always easy. Also, the actors authorising the new financing might not have the expertise to distinguish between these two types of DIP financing. Therefore, from an *ex ante* perspective, lenders may respond to this uncertainty by increasing the cost of debt. This problem can be exacerbated

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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 8.R. 605 (Bankr.S.D.Cal.1980).

[86] 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).

[87] These factors include, among other aspects, the company's future cash-flows as well as the company's weighted average cost of capital (WACC). Analyzing the importance of these factors in the valuation of companies in financial distress, see Christopher Sontchi, 'Valuation Methodologies: A Judge's View' (2012) 20 (1) American Bankruptcy Institute Law Review 1; Kenneth Ayotte and Edward Morrison, 'Valuation Disputes in Corporate Bankruptcy' (2018) 166 University of Pennsylvania Law Review 1819.

[88] Emphasising the importance of the expertise required for approval of DIP financing, see Triantis, 'A Theory of the Regulation of Debtor-in-Possession Financing' (n 57).

[89] Triantis (n 3), 179.

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in the context of a super-priority that alters the rights of pre-existing secured creditors. For these reasons, jurisdictions such as the United States and Singapore adopt several safeguards for this type of super-priority, and other countries such as the United Kingdom have traditionally been sceptical about the adoption of any strong or quasi-strong form of DIP financing provisions.[90]

Finally, some empirical studies have shown that the imposition of strict conditions in DIP loans may make DIP lenders very powerful in the restructuring process.[91] This power may lead to an undesirable outcome for the creditors as a whole,[92] sometimes in the form of fire sales.[93] Therefore, if the terms of the DIP loans are not carefully examined before the DIP financing is approved, the approval of DIP financing would actually exacerbate, rather than improve, some of the problems among creditors that insolvency law seeks to solve.[94]

These risks can be minimised through the existence of an independent, reliable and sophisticated third party authorising the DIP financing. Yet, as it has been shown by various empirical studies, the approval of value-diverting or value-destroying DIP financing can even take place in jurisdictions with highly sophisticated courts such as the United States.[95] Therefore, if sophisticated courts often err when it comes to approving value-enhancing DIP financing, this risk will be exacerbated in jurisdictions with poor institutions and unsophisticated actors assessing whether and, if so, under which conditions, DIP financing should be approved.

5. Policy recommendations for the adoption of DIP financing provisions

5.1. Introduction

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[90] See UK Insolvency Service, 'A Review of the Corporate Insolvency Framework: Summary of Responses' (September 2016), para 5.52 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/578524/Summary_of_responses_26-10-16_Redacted.pdf>.

[91] According to Ayotte and Ellias, 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. See Kenneth Ayotte and Jared A. Ellias, 'Bankruptcy Process for Sale', (2021) 39(1) Yale Journal on Regulation 1. Other studies have shown that more than 90% of DIP loans include these conditions. See B. Espen Eckbo, Kai Li, and Wei Wang, 'Rent extraction by super-priority lenders', Tuck School of Business Working Paper 3384389, March 13, 2020, 41 (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3384389).

[92] See Ayotte and Ellias (n 91). See also Tung (n 66).

[93] See Kenneth M. Ayotte and Edward R. Morrison, 'Creditor Control and Conflict in Chapter 11 Bankruptcy' (2009) 1(2) Journal of Legal Analysis 511. For a more optimistic view of DIP lenders, however, see Mark Jenkins and David C. Smith, 'Creditor Conflict and the Efficiency of Corporate Reorganization' (2014) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2444700.).

[94] For the role of insolvency as a mechanism to solve problems among creditors, see Thomas H. Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91(5) The Yale Law Journal 857; Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986), 7–19. See also Anthony Casey, 'Chapter 11's Renegotiation Framework and The Purpose of Corporate Bankruptcy' (2020) 120(7) Columbia Law Review 1709.

[95] See Ayotte and Ellias (n 91).

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The inability of viable but insolvent firms to obtain new financing can destroy value for debtors, creditors and society as a whole. Therefore, all countries should adopt policies to make sure that these firms have access to finance. In some countries, these policies may include the development of a diverse financial system comprising a strong capital market, a developed venture capital industry, and the promotion of alternative sources of finance such as crowdfunding and Initial Coin Offerings. Thus, viable firms –even if they face financial trouble– will have more chances to obtain external finance. Unfortunately, not many countries have this type of developed and diverse financial system that exists, for example, in jurisdictions such as the United States, the United Kingdom, Hong Kong and Singapore. Even in those jurisdictions, lenders may be reluctant to extend credit to financially distressed firms. Therefore, the adoption of DIP financing provisions should be considered a desirable policy in any jurisdiction, and even more so in jurisdictions with underdeveloped financial systems, as it typically occurs in emerging economies.

5.2. The optimal design of DIP financing provisions

An insolvency system should ideally adopt a strong DIP financing regime. Thus, viably but financially distressed firms will have more chances to obtain new financing. However, in order to minimise the costs eventually created by the adoption of DIP financing provisions, the design of these provisions should be tailored to the particular features of a jurisdiction, especially when it comes to the *actor* in charge of approving the new financing.

In jurisdictions without sophisticated, independent, efficient and reliable courts, as it generally occurs in emerging economies and some advanced economies,[96] courts should not be involved in the approval of new financing.[97] 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 will destroy value for the creditors and it will also hamper the efficient reallocation of assets in the economy. *Ex ante*, a system favouring the approval of DIP financing that destroys or opportunistically redistributes value will make lenders more sceptical to extend credit, leading to an undesirable increase in the cost of debt. Therefore, the adoption of a DIP financing regime may end up doing more harm than good for companies and the economy as a whole.

The same problem occurs when the decision to authorise DIP financing is made by non-sophisticated insolvency practitioners. When insolvency practitioners do

[96] 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.

[97] Aurelio Gurrea-Martinez, 'Insolvency law in Emerging Markets' (Ibero-American Institute for Law and Finance, Working Paper 3/2020, 20 May 2020) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3606395).

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not have a high level of expertise, credibility and independence, they will unlikely be able to authorise the new financing only when it is value-maximising. In those situations, insolvency practitioners should be prevented from making these decisions unless they are made personally liable for this decision, as it actually happens in certain countries such as Australia.[98] 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 based on the returns to creditors.[99] Thus, the system would incentivise insolvency practitioners to obtain new financing when it can be value-enhancing. At the same time, it will 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. In fact, in addition to the lack of an efficient and competent judiciary often existing in these countries, most emerging economies even suffer from problems of corruption and a weak rule of law.[100] Additionally, emerging economies do not generally have a developed body of sophisticated insolvency practitioners.[101] 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. Therefore, they will unlikely be able to distinguish between value-enhancing and value-destroying DIP financing. Additionally, even if a country eventually has competent judges, the judicial system may not be very efficient, as it actually occurs in various advanced economies such as Italy, Portugal and Spain.[102] In all of these jurisdictions, including both emerging economies and advanced economies with any type of institutional weakness, the approval of new financing should be decided by the creditors.

However, in countries with efficient, reliable and competent courts and insolvency practitioners, and therefore a strong institutional environment for the management of insolvency cases, the decision to authorise DIP financing can be made by courts or, if so, insolvency practitioners. Yet, as the empirical literature on DIP financing shows that even sophisticated intermediaries –such as bankruptcy judges in the United States– can often make suboptimal decisions,[103] creditors should be allowed to have some involvement in the authorisation of new

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[98] See Corporations Act 2001(Cth), section 443A.

[99] Mentioning this model for the remuneration of insolvency practitioners, see INSOL International, Office-holder Remuneration – Some International Comparisons (INSOL International, 2017).

[100] Some exceptions can include Uruguay and, to a lesser extent, Cosa Rica and Chile. According to the 2021 Rule of Law Index prepared by the World Justice Project, Uruguay ranks 25th out of 139 jurisdictions. Costa Rica and Chile rank 31st and 32nd, respectively. See https://worldjusticeproject.org/rule-of-law-index/global/2021/ranking. In the 2021 Corruption Perception Index, Uruguay, Chile and Costa Rica rank 18th, 27th and 39th, respectively, out of 180 jurisdictions. See https://www.transparency.org/en/cpi/2021

[101] 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.

[102] 'European judicial Systems: Efficiency and quality of justice' (2018), CEPEJ Studies No. 26 <https://rm.coe.int/rapport-avec-couv-18-09-2018-en/16808def9c>.

[103] See Ayotte and Ellias (n 91) and Tung (n 66).

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financing even in these countries. In this case, however, the role of the creditors should be more limited. Namely, instead of approving the new financing, the creditors should be allowed to *veto* the decision eventually made by the court or the insolvency practitioner. Thus, courts or insolvency practitioners would have the chance to add value by providing their credibility and expertise and reducing the costs of the decision-making process. Nonetheless, the actors bearing the costs and benefits of the approval of DIP financing –that is, the creditors– would ultimately decide whether the new financing should be authorised.

It can be argued that, due to a variety of factors, including asymmetries of information, passive behaviour and lack of expertise, many creditors might not be well-equipped to accurately assess the desirability of the new financing. Therefore, they would face similar problems than those mentioned in the context of unsophisticated judges and insolvency practitioners.[104] However, unlike courts and insolvency practitioners, creditors have skin in the game. Therefore, even if they do not eventually make a value-maximising decision, the fact that they are the residual claimants of the firm, and therefore they bear the costs and benefits associated with the company's actions,[105] makes the creditors the most suitable actors to decide whether the new financing should be authorised. In countries with strong institutional environment, this authorisation will be given by not challenging the decision made by courts or, if so, insolvency practitioners. By contrast, in countries without weak institutional environments, the authorisation from the creditors will be given by expressly approving the new financing without any involvement of courts or insolvency practitioners.

The type of creditors involved in the approval or, if so, veto of the new financing should depend on the type of priority potentially obtained by the DIP lender. For instance, when the debtor seeks to provide the DIP lender with a basic administrative expense priority, or with a lien over an unencumbered asset, the new financing should be approved (or vetoed) by the creditors mainly experiencing the costs and benefits associated with this decision: *unsecured creditors*.[106] If the DIP lender intends to obtain a super-priority to get paid ahead of both unsecured creditors and other administrative expenses, the new financing should be approved (or vetoed) by *both* unsecured creditors and administrative expense claimants.[107] Finally, if the new financing provides DIP lenders with a senior lien over a secured asset, the transaction should be approved (or vetoed) by the *secured creditor* affected by the new financing.[108] Even if the affected secured creditor will unlikely authorise the new financing *unless* the creditor is under-secured and the new financing is value-enhancing, this outcome would not

[104] They would have skin in the game if, for example, they were made personally liable for poor decisions and their remuneration were based on the returns to creditors. However, not many insolvency systems, if any, provide such a combination of sticks and carrots for insolvency practitioners and even more rare would result for judges.
[105] For the concept of residual claimants, see Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press 1986) 167; George Triantis and Ronald Daniels, 'The Role of Debt in Interactive Corporate Governance' (1995) 83 California Law Review 1073, 1100.
[106] See Gurrea-Martinez, 'Insolvency law in Emerging Markets' (n 96).
[107] *Ibid.*
[108] A similar solution exists in various jurisdictions such as India and the Philippines. In 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).

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be very different in jurisdictions allowing courts to prime an existing lien, as it happens in the United States and Singapore.

Indeed, as it has been mentioned, granting 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. For that reason, this priority is not often provided in the United States, and it has not been used in Singapore since the new rescue financing provisions were adopted in 2017. In many cases, companies cannot convincingly show that the new financing is value-enhancing and insolvent debtors are not generally in the capacity to provide adequate protection. Indeed, if the debtor is already in a formal insolvency proceeding, it might not have liquidity to make cash payments. Also, it will unlikely have unencumbered assets to be used as a replacement lien, and their encumbered assets might not have an equity cushion that can be considered indubitable equivalent value. Therefore, the only adequate protection potentially provided to the affected secured creditors is the company's going concern surplus. However, the affected secured creditor will be reluctant about the use of the going concern surplus as a mechanism to provide adequate protection because this surplus is subject to many subjective considerations. Therefore, in practice, debtors will unlikely be able to provide adequate protection.

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 financially distressed firms. They do so by providing DIP lenders with a preferential treatment in the ranking of claims that typically ranges 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 from 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 super-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 then examined the risks and costs potentially created by a DIP financing regime, and it 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. Therefore, the question is not whether DIP financing provisions should be adopted but how. In this regard, it has been stated that the optimal design of DIP financing provisions will mainly depend on the expertise, efficiency, independence and credibility of the actors in charge of deciding whether the new financing should be authorised. In countries

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with a strong institutional environment, this article has been pointed out that the new financing can be approved by courts or, if so, insolvency practitioners. Yet, since these actors can still err, the creditors should have the ability to veto the decision to authorise new financing. By contrast, in countries with weak institutional environments, as it generally occurs in emerging economies and some advanced economies, the decision to approve the new financing should always be made by the creditors. The type of creditor approving or, if so, blocking the authorisation of the new financing will depend on the super-priority eventually granted to the DIP lender. In the case of an administrative expense priority, new liens or junior liens, it has been pointed out that the new financing should be approved or vetoed by unsecured creditors. In the context of an administrative expense priority to be paid over other administrative expenses, the new financing should be approved or, if so, vetoed by both unsecured creditors and administrative expense claimants. Finally, when a DIP lender seeks to get a senior lien over an encumbered asset, the affected secured creditor should be allowed to approve or, if so, veto the new financing.

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