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ARTICLE

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

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

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

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1 Introduction

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

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

2 Rationale of DIP Financing

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

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

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

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

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

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

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

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

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

[5] See Myers (1977).

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

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

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

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

[10] See Menezes et al. (2021).

[11] Armour et al. (2015).

[12] Ibid.

[13] Elayan and Meyer (2001).

[14] Ibid.

[15] Skeel Jr (2003).

[16] Ibid., at p 919.

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

3 Regulation of DIP Financing: A Comparative Perspective

3.1 The Treatment of DIP Financing

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

[17] Ibid., at p 931.

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

Table 1 Regulatory models of DIP financing

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

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

3.2 The Approval of DIP Financing

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

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

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

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

Table 2 Systems for the approval of DIP financing

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

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

3.3 A Closer Look at DIP Financing Regimes

3.3.1 Regimes with no DIP Financing Provisions

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

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

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

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

[24] Ibid.

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

[26] Ibid.

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

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

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

3.3.2 Regimes with Weak DIP Financing Provisions

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

[27] Companies Act 2016, s 368.

[28] Companies Act 2016, s 367.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[42] Gurrea-Martinez (2022b).

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

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

3.3.3 Regimes with Semi-strong DIP Financing Provisions

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

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

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

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

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

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

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

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

[49] Machado (2022), pp 13–14.

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

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

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

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

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

[52] Ibid.

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

[54] Ibid.

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

[56] Ibid., s 20(c).

[57] Ibid., s 25I.

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

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

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

[61] Ibid.

[62] Ibid.

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

3.3.4 Regimes with Strong DIP Financing Provisions

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[82] Cho (2018); Tung (2020).

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

[84] Chua et al. (2020).

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

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

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

[88] See Triantis (2020).

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

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

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

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

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

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

[92] Ibid.

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

[94] Ibid.

[95] See Triantis (2020).

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

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

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

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

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

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

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

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

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

4 The Perils of a DIP Financing Regime

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

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

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

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

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

[105] Triantis (2020), p 179.

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

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

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

5 Policy Recommendations for the Adoption of DIP Financing Provisions

5.1 Introduction

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

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

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

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

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

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

111 See Ayotte and Ellias (2021).

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

5.2 Optimal Design of DIP Financing Provisions

5.2.1 Rethinking the System of Approval of New Financing

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

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

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

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

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

[113] Gurrea-Martinez (2020a).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[121] Jackson (1986).

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

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

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

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

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

[123] Gurrea-Martinez (2020a).

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

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

[126] See n. 18.

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

6 Conclusion

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

The article has examined the risks and costs potentially created by a DIP financing regime, and has concluded by analysing whether, and if so how, countries should adopt DIP financing provisions. To that end, it has been argued that the adoption of DIP financing provisions should be considered a desirable policy even in countries with developed financial systems. Moreover, countries should ideally adopt a strong DIP financing regime. Thus, the key policy question to be addressed is not whether DIP financing provisions should be adopted but how. In this regard, it has been pointed out that the optimal design of DIP financing provisions should depend on the particular features of a country. In jurisdictions with sophisticated judges and insolvency practitioners, these actors may play a role in the approval of new

financing. Yet, since even sophisticated courts and insolvency practitioners can err and they might not have incentives to make value-maximising decisions, creditors should have the ability to veto the decision to authorise DIP financing. By contrast, in jurisdictions without sophisticated courts and insolvency practitioners, the decision to approve DIP financing should be exclusively made by the creditors. It has been argued that the type of creditors entitled to approve or veto the new financing should depend on the priority potentially granted to the DIP lender and therefore on the creditors most directly affected by the approval of DIP financing.

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Conflict of interest The author declares that he is not subject to any conflict of interest, he did not receive any funding to conduct this project and he did not use any database.

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