

Business funding in corporate rescue; the UK perspective

Thesis submitted for the degree of
Doctor of Philosophy
at the Nottingham Trent University

by

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December 2014

Abstract

This research aims at establishing the adequacy (or not), of the statutory framework available for business funding in the UK during corporate rescue, by undertaking a comparison between relevant laws in the UK, Canada and the United States of America. The thesis evaluates if the UK's provision for funding mirrors the functions of the well-established rescue funding structures found in Canada and the United States of America. The study begins with a historical analysis of the development of bankruptcy laws in order to establish the context within which a rescue culture developed within the comparator jurisdictions. It identifies a shift of focus from outright liquidation of companies to the rescue of parts or the whole of a distressed company. This forms the milieu within which the study undertakes an examination of statutory provisions for business funding. It explores both the formal and informal frameworks available for funding and does this by an in-depth comparative analysis of the theoretical and contextual factors responsible for the development of divergent rescue funding procedures. The research identifies the differences and similarities between the relevant laws of the three countries and attempts to identify a possible functionally equivalent solution to the common issue of funding rescues with the aim of ascertaining whether there are any weaknesses to the present statutory provisions for business funding in the UK and, if so, how they may be addressed.

Acknowledgement

I would like to thank my supervisors Prof Rebecca Parry and Prof David Burdette; my sincere gratitude goes to them for their patience, tolerance, contribution and advice to the writing of this thesis. Without their input I would not have been able to complete this study. Doing a PhD is tasking but they made it smooth-running. Special mention must be made of the effort Prof Burdette made in securing me an opportunity to carry out a two week research at Osgoode Hall Law School, York University Canada. Without this opportunity my research would have been flawed. I especially thank Prof Parry for patiently going through all my work including those meant for presentation and publications outside of my studies, all I can say is that, I had an amazing, supportive team.

My thanks also go Prof Adrian Walters for responding to my emails on American bankruptcy laws. I also wish to thank Mr. Hamish Anderson and Mr. Joe Banister for taking time out of their busy schedules to talk to me about the practical realities of business funding in the UK, their contributions helped to re-focus the direction of my research. To the staff at Osgoode Hall Law School Library, I also extend my gratitude. The same goes for the inter-library loan team at Boots Library, who chased materials as far as Canada for me. They are faceless to a lot of us, but their presence is very important.

To my husband Patrick; thanks for your support, patience and love.

To my kids; “Mummy is back!”

To my siblings, most especially my elder sister Eloho without whose support financially and morally, I would have given up, THANK YOU (Mummy will be so proud!).

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List of abbreviations

Bankruptcy and Insolvency Act (BIA)

Companies' Creditors Arrangement Act (CCAA)

Company Voluntary Arrangement (CVA)

Debtor-in-Possession (DIP)

American Bar Association (ABA)

Department of Trade and Industry (DTI) – (Now BIS; The Department for Business, Innovation & Skills)

European Bank of Reconstruction and Development (EBRD)

Confederation of British Industry (CBI)

General Security Agreement (GSA)

Personal Property Security Act (PPSA)

Statement of Insolvency Practice (SIP)

Uniform Commercial Code (UCC)

United Kingdom (UK)

United Nations Commission on International Trade (UNCITRAL)

United States (US)

Winding Up Act (WUA)

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Companies Act 2006
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Debtor Act 1869
Insolvency Act 1986
Insolvency Rules 1986
Law of Property Act 1925

Winding up Act 1844

US

Bankruptcy Act 1841

Bankruptcy Act 1867

Bankruptcy Act 1898

Bankruptcy Reform Act of 1978

Bankruptcy Amendments and Federal Judgeship Act 1984

The Chandlers Act 1938

Uniform Commercial Code (UCC) 2001

Chapter I: Introduction

Rescue financing plays a critical role in the successful reorganization of insolvent companies that have a high prospect of returning to viability. The presence of an avenue for rescue financing contributes to improving the prospects of these companies being preserved as ongoing concerns, rather than storehouses of assets awaiting liquidation.¹ The availability of finance is one of the major concerns faced by distressed companies wishing to reorganize their affairs. In some cases the company will be able to resolve its financial difficulties informally through private arrangements with its creditors without resorting to formal proceedings to achieve a rescue.² However, where the company relies on the formality of procedures³ under the Insolvency Act 1986, finance is of pivotal importance. It is essential that a distressed company has access to finance during the period between when the company commences insolvency proceedings and enters into any of the formal rescue procedures provided by legislation and a rescue plan is approved.⁴

At this point, it is likely that the company may have no liquidity and / or no collateral to act as security to obtain new or more financing.⁵ Also if the company is insolvent, lenders may be reluctant to advance funds to it. The importance of the role that funding plays in effecting a successful rescue was recognised by the United Nations Commission on International Trade Law (UNCITRAL) which stated that finance facilitates the achievement of the rescue

¹ J B Martin, K Nelson, E Rudenberg, and J Squires 'Freefalling with Parachute that May Not Open: Debtor-in-Possession Financing in the Wake of the Great Recession' (2009) 4 University of Miami Law Review, Vol. 63.

² See J Franks and O Sussman, 'The Cycle of Corporate Distress, Rescue and Dissolution: a Study of Small and Medium Size UK Companies' (2000) Institute of Finance and Accounting 306 Working paper <http://www.turnaround-sa.com/pdf/The%20cycle%20of%20corporate%20distress.pdf> accessed 7th June 2014.

³ Formal insolvency procedures in a majority of cases have a statutory stay attached to it which suspends all creditor actions against the debtor and ensures an orderly distribution of the debtor's assets.

⁴ United Nations Commission on International Trade Law Legislative Guide on Insolvency Law (2005), <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> accessed 24th September 2013 para 95 ("UNCITRAL Guide").

⁵ G McCormack, 'Super-priority New Financing and Corporate Rescue' [2007] J.B.L. 701-732.

objectives of the debtor company by ensuring that there are funds to meet the essential day to day monetary needs of the debtor company.⁶

A number of jurisdictions have acknowledged that funding plays an important role in achieving a favourable outcome during corporate rescue and have, as part of reforms to their insolvency laws, introduced one form or another of corporate rescue/post-commencement financing.⁷ This is a special type of financing available to insolvent companies that have formally filed for and commenced an insolvency procedure and are under court-supervised creditor protection.⁸ Examples of corporate rescue financing can be seen in countries all over the world; the United States of America (US) has Debtor-in-Possession (DIP) financing and priming liens to support the debtor's rescue; in France and Germany all creditors providing goods and services after the commencement of insolvency proceedings are classed as priority creditors;⁹ and Australia permits the debtor to borrow money on a super-priority basis after obtaining the consent of secured creditors.¹⁰

The availability of post-commencement financing¹¹ allows the debtor to carry on its business as a going concern,¹² thereby potentially increasing the value of the business. Post-commencement financing is facilitated by incentives that are put in place to encourage would-be creditors to lend money and / or provide goods and services to the debtor post-commencement. Without these incentives it might otherwise be near impossible for the

⁶ UNCITRAL Guide (n 4) at para 94, p113-114.

⁷ The term rescue financing and post-commencement financing would be used inter-changeably in the thesis to reflect the different terminologies found in existing literature. These terms refer to financing obtained by the insolvent debtor during rescue.

⁸ V Gaur, 'Post-petition Financing in Corporate Insolvency Proceedings: A Comparative Study Across Various Jurisdictions' [2012] 111 SCL 17.

⁹ Insolvency Service, 'A Review of Company Rescue and Business Reconstruction Mechanism, Report by the Review Group' (DTI, 2000) ("Review Report") p40.

¹⁰ *Ibid.*

¹¹ Post-commencement financing/corporate rescue financing (also known as debtor-in-possession "DIP" financing (US Chapter 11), interim financing (Companies' Creditors Arrangement Act "CCAA", Canada) is a specialized type of financing offered to insolvent companies during corporate rescue.

¹² Gaur (n 8).

debtor to continue trading, as it is likely that all credit sources would have dried up and existing assets would be fully encumbered. These incentives range from super-priority payment for lenders who advance money to the debtor during the rescue period, priority payment for creditors who provide goods and services during rescue and the recognition of some creditors as “critical suppliers”.¹³ Thus it can be said that the priority status given to creditors who provide money and / or goods and services acts as a form of guarantee where there are no available assets to be put up as security.

Whilst it appears to be fast becoming the norm for jurisdictions to incorporate post-commencement financing reforms into their insolvency laws, the US has a longer history than other jurisdictions of having post-commencement financing provisions, or debtor-in-possession (DIP) financing as it is called in that jurisdiction, as part of its Bankruptcy Code.¹⁴ The US’s provision for DIP financing has its roots in the 19th century railway equity receiverships, where notes that were raised to fund the receiverships enjoyed priority.¹⁵ Presently, the US appears to be the foremost jurisdiction with well-structured provisions for post-commencement financing and these provisions seem to be the ideal upon which other jurisdictions have modelled their post-commencement financing reforms.

In contrast, the United Kingdom (UK)¹⁶ appears to have a limited statutory framework for the purpose of facilitating rescue finance and the issue of how corporate rescues can be financed has attracted some debate in the past. The Cork Report,¹⁷ which laid the foundation for the rescue culture in the UK and brought about the enactment of the Insolvency Act in 1985, later consolidated as the Insolvency Act 1986, had been silent as

¹³ See 11 U.S.C., s 364, Companies Creditors Arrangement Act, R.S.C., 1985, c. C-36, (CCAA) s 11.2.

¹⁴ 11 U.S.C.

¹⁵ See *Fosdick v Schall*, 99 U.S. 235 (1878).

¹⁶ Reference to UK law in this thesis is, unless stated otherwise, a reference to the law as it applies in England and Wales.

¹⁷ Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982) (“Cork Report”).

to how the new rescue procedures which it proposed, and which were implemented under the Insolvency Acts of 1985-6, would be funded. The only reference in the report as to how the funding of corporate rescue can be accomplished is a recommendation that, where an administration order is discharged, creditors who advanced money, or gave credit to the administrator to enable the company's business to be carried on as a going concern, should enjoy priority of payment as part of the administration expenses.¹⁸ This particular recommendation can be said to form the basis for the super-priority status accorded to administration expenses under the Insolvency Act 1986. It is perhaps surprising that the issue of how corporate rescue would be funded was not considered more extensively by the Cork Committee in its Report, given that administration was intended as a vehicle for continuous trading while the company reorganizes itself.

The Insolvency Act 1986 underwent a major reform with the passage of the Enterprise Act 2002.¹⁹ The main objective of these reforms was to improve on the administration procedure by making it easily accessible to insolvent companies. It was also hoped that these reforms would align the administration procedure with, and replicate the functions of the US Chapter 11 rescue procedure;²⁰ however it arguably fell short in the area of incentives for post-commencement finance to aid corporate rescue as no express provision was made in that regard. This was despite the numerous consultations undertaken on the issue and, more importantly, the debates in the House of Lords.²¹

It was proposed during the House of Lords debates preceding the enactment of the Enterprise Act 2002 that in order to bring greater certainty to the process of funding rescues,

¹⁸ *Ibid*, para 514.

¹⁹ The provisions of the Enterprise Act 2002 came into force on the 15th of September 2003.

²⁰ L Conway, 'A Comparison: Company Rescue Under UK Administration and US Chapter 11' (SN/HA/5527) 18 May 2010, Home Affairs Section, House of Commons Library.

²¹ HL Deb 29 July 2002, vol 638, col 763-806.

there was a need to introduce DIP financing into UK insolvency legislation.²² However, Lord McIntosh of Haringey, a labour peer stated that DIP financing was essentially a commercial matter and one which ought to be left to the dictates of the parties involved.²³ In addition, Lord McIntosh opined that the introduction of DIP financing would be incompatible with the structure of lending in the UK which is built around fixed charge and floating charge security.²⁴ For the administrator to be able to obtain DIP financing, he would need the consent of the floating charge holder as the DIP finance would enjoy super-priority status as part of administration expenses in preference to the claims of the floating charge holder,²⁵ and UK courts were not disposed to interfering in contractual agreements,²⁶ where the floating charge holder withholds his consent.

As it is, the Insolvency Act 1986 provides a basic framework to support the provision of post-commencement financing by giving priority to the payment of the administrators' remuneration and expenses²⁷ and authorising the administrator to do all such things that are necessary for the management of the affairs, business and property of the company.²⁸ However it is not as well-defined a structure as may be found in some jurisdictions that have made post-commencement financing part of their insolvency legislation. Presently, distressed companies in the UK are more likely to secure new finance to support rescue procedures from existing secured creditors who agree to provide additional funds, or if the company is fortunate enough to have uncharged assets or charged assets with sufficient equity, it may offer these assets as fresh security in exchange for funds.²⁹ In the alternative,

²² *Ibid* at para 788 .

²³ *Ibid*, per Lord McIntosh of Haringey at para 789.

²⁴ *Ibid*.

²⁵ Insolvency Act 1986, Schedule B1, para 99.

²⁶ S J Taylor, 'Repair or Recycle? Some Thoughts on Dip Financing and Pre-Packs' (2010) 4 International Corporate Rescue 269-270.

²⁷ Insolvency Act 1986, Schedule B1, para 99.

²⁸ *Ibid*, Schedule B1, para 59.

²⁹ Review Report (n 9) at para 123.

companies could opt for pre-packed administration, which does not require the debtor, but rather the purchaser, to source for funds.

A pre-packaged administration (pre-pack) is a business sale which is negotiated and agreed on by a “proposed insolvency practitioner” (representing the company) and a buyer before the commencement of the administration process, and the appointment of the insolvency practitioner as administrator once the administration process commences.³⁰ The pre-pack evolved post-Enterprise Act 2002, and appears to be popular due to its ability to avoid the risk of publicity which could cause serious damage to the going concern value of a distressed company.³¹ In addition, it has the advantage of saving a good number of jobs and the burden of funding the company’s rescue is shifted to the new buyer who must have funding in place prior to the purchase of the company.³² Of relevance to this thesis is the ability of the pre-pack to remove the burden of funding business rescue from distressed companies.

In light of the fact that a large number of companies would be over-extended at the point of insolvency with no other source of finance, pre-packs appear to be a more attractive alternative in many instances. This then raises the question of whether it is truly necessary that there should be provisions in the Insolvency Act 1986 to incentivize the funding of continued trading by struggling companies. In effect, the high reliance on pre-packs by distressed companies means that more business rescues are achieved in the UK than company rescues. Franks and Sussman have shown in their study that in the UK, where company rescue is intended, this takes place outside formal insolvency proceedings³³ and

³⁰ See generally S Frisby, ‘The Second-chance Culture and Beyond: Some Observations on the Pre-pack Contribution’ (2009) *Law and Financial Markets Review* 242-247, see also, V Dennis, ‘Packing Case’ *The Lawyer* (London, 10 July 2011) 31.

³¹ S Manson, ‘Pre-packs from the Valuer’s Perspective’ (2006) *Recovery* (summer) 19.

³² M Hyde & I White, ‘Pre-pack Administration: Unwrapped’ (2009) *Law and Financial Markets Review*.

³³ See J Franks and O Sussman, ‘The Cycle of Corporate Distress, Rescue and Dissolution: a Study of Small and Medium Size UK Companies’ (2000) *Institute of Finance and Accounting* 306 Working paper

in most cases, formal rescue proceedings are used for business and asset sales, most especially where the removal of incumbent management is intended.³⁴ This domination of business rescue may be questioned as company rescue is the express primary objective of administration, as envisaged by legislation.³⁵ Might it be the case that if companies had an alternative source of funding through the backing of legislation, more company rescues would be achieved?

Comparatively, the US and Canada (which are the comparators that will be used to assess the adequacy of the UK's post-commencement financing provisions) have taken a divergent approaches to post-commencement financing. Both countries have made clear and incentivized provisions under legislation as to how rescues may be funded. Canada is of specific interest to this research, as this jurisdiction was in a position comparable to that in which the UK presently finds itself. Canada's insolvency legislation initially had no provision for post-commencement financing and debtor companies wishing to have access to some form of financing during a rescue had to rely on the discretion of the judges in order to obtain it.³⁶ The manner in which judges approached priority post-commencement financing later became the basis of the country's post-commencement financing provisions after the reforms in 2005.³⁷ The US on the other hand can be regarded as the pioneer of post-commencement financing as this jurisdiction has a long established history of

<http://www.turnaround-sa.com/pdf/The%20cycle%20of%20corporate%20distress.pdf> accessed 7th June 2014.

³⁴ J Armour and S Frisby, 'Rethinking Receivership' 21 (2000) *Oxford Journal of Legal Studies* 73-102.

³⁵ Lord McIntosh, while supporting the proposed Enterprise Bill in the House of Lords stated that company rescue formed the core of the revised administration procedure. It was the intention of Parliament that the focus of the administration procedure would be the rescue of companies, in order to create more incentive for management to act promptly and utilize the administration process before it became too late to save the company, see H.L. Deb. 29th July 2002, vol 638 at para 766; See also Insolvency Act 1986, Sch B1 para 3.

³⁶ J Sarra, 'Debtor in Possession Financing: the Jurisdiction of Canadian Courts to Grant Super-priority Financing in CCAA Applications' (2000) 23 *Dalhousie L.J* 337.

³⁷ CCAA 1985, s 11.2.

facilitating post-commencement financing. Presently, both countries offer incentives for the provision of rescue finance to distressed companies.

Continued trading can often enhance the level of going concern value. In the event of continued trading, it may be essential for the company to have access to some form of external funding. Where finance is lacking, there is a high probability that ongoing trading will not be possible and the company may be forced into liquidation.³⁸ The importance of incentives for the provision of finance in such circumstances has been internationally recognised. It is recommended in the *UNCITRAL Legislative Guide on Insolvency Law* that, where insolvency laws support insolvency proceedings that allow an insolvent business to continue trading, either for reorganization or the sale of the business in liquidation as a going concern, it is important that the issue of new funding is addressed.³⁹

It therefore seems that there is a general desirability for all jurisdictions which promote a rescue culture to have in place some sort of legislative structure as to how the process can be funded. UNCITRAL does not prescribe how this should be done, but stresses the importance of having some form of certainty regarding the issue of funding. On the other hand, UNCITRAL also recognises that any solution to rescue financing that is adopted must take into consideration the interests of the parties who will be affected by the introduction of post-commencement financing laws.

1.1 Research aims

The issue of rescue financing is essentially a commercial one involving banks and financial institutions. Although there have been some notable instances in which governments have

³⁸ Review Report (n 9) at para 112.

³⁹ UNCITRAL Guide (n 4) at para 97.

funded the rescues of some companies which it felt were “too big to fail”⁴⁰ (owing to the potential adverse impact of their failure on the society) this thesis focuses on private sector rescue financing.

This thesis therefore considers both the theoretical and practical issues underlying commercial post-commencement funding in the US, Canada and the UK. The main objectives of this research are to consider and analyse the statutory framework (if any) available for business funding in corporate rescue within the UK, to explore the possibility of adopting a more proactive framework for rescue funding within the UK through comparative analysis of the approach to funding in the US and Canadian jurisdictions, and to identify any conflict of interest that may arise as a result of any proposed reforms within the statutory framework available for rescue funding.

There is a need for this research as corporate rescue funding is arguably vital to the success of a distressed company’s rescue, and having funding provisions within the Insolvency Act 1986 may provide companies with the greater prospect of a trading administration⁴¹ as an alternative to pre-pack administration. The lack of availability of finance for a trading administration is often given as the reason why a pre-pack has been favoured in a particular case. Greater incentivisation of rescue finance would therefore perhaps lead to more rescues of whole companies rather than the business rescue/sale outcome that is currently prevalent.⁴²

⁴⁰ For example the bailout of GM Motors and Chrysler by the US and Canadian Governments respectively (Canada was only involved in the Chrysler bailout); the bailout of Canada Air and Algoma Steel Company by the Canadian Government and the bailouts offered by the UK Government to the banking sector (Royal Bank of Scotland, Lloyds TSB, HBOS).

⁴¹ In a trading administration, an administrator continues trading in an attempt to put the company back on sound footing.

⁴² S Frisby, ‘Report on Insolvency Outcomes’ presented to the Insolvency Service in August 2006.

Attempts have been made in the past by some interest groups to champion the introduction of post-commencement finance provisions within the UK,⁴³ but to date none have been successful. While the Insolvency Act 1986, Schedules 1 and B1 have provided the right foundation in enabling the administrator to raise funds which are repayable in priority even to his own remuneration, there is the possibility that this may not be enough to secure post-commencement funding. What is arguably key and missing from these provisions are the necessary incentives required to encourage lenders to advance funds that are essential to the successful rescue of the company as whole. Perhaps the attachment of incentives to Schedules 1 and B1 would improve the administration process, and more often enable the achievement of the outcome that administration was initially created to achieve, i.e. company rescue.

This research analyses and evaluates the framework for the funding of company rescue available in the UK, using the Canadian and the US's post-commencement provisions as comparators. With the aid of these comparators, the research attempts to establish either the adequacy of existing statutory provisions or the need for reform. This research will therefore shed more light on the suitability (or otherwise) of the present financing regime available for corporate rescue in the UK, while analysing its inter-relationship with lending structures and creditors' rights. While the research has as its main focus the funding of corporate rescue in the UK, it is hoped that more clarification will be gained regarding post-commencement financing in the US and Canada and its inter-relationship, impact and effect on other associated issues that arise when a company is on the brink of insolvency. These issues range from creditors' rights, the perceptions of debt in the jurisdictions under consideration, and how corporate rescues are funded. In this regard, it is envisaged that the

⁴³ L Qi, 'Availability of Continuing Financing in Corporate Reorganisation: the UK and US Perspective' (2008) 29 Comp. Law. 162-167.

research will identify areas of shortcomings and strengths not only within the UK, but also in the US and Canada.

1.2 Research methodology

The research takes a doctrinal law approach, which is an in-depth analysis, aimed at seeking new insights in order to broaden an understanding of the research area. The research has been conducted with the aid of primary and secondary sources of law, incorporating a comprehensive analysis of existing literature, official government publications, statutes and case law. The study is accomplished by means of a comparative legal analysis with a bias towards the functional equivalence thesis. In order to establish the validity of the choice of methodology, two fundamental questions need to be answered and these are; why comparative law and why the choice of jurisdictions?

1.2.1 Why comparative law?

Comparative law may be seen as a distinctive legal subject within the wider body of comparative disciplines⁴⁴ which enable the gathering of knowledge.⁴⁵ It is a genre of comparative analysis adopted by legal scholars to investigate law, through the examination of the similarities and differences of different social or cultural phenomena in order to broaden understanding of the law.⁴⁶ It acts as an important gateway to foreign cultures and

⁴⁴ N Jansen, 'Comparative Law and Comparative Knowledge, in M Reimann and R Zimmermann (eds) *The Oxford Handbook of Comparative Law* (Oxford 2008).

⁴⁵ E J Eberle 'The Method and Role of Comparative Law' (2009) 8 *Washington University Global Studies Law Review*, 451-486.

⁴⁶ J W Cairns, 'Development of Comparative Law in Great Britain' in M Reimann and R Zimmermann (eds) *The Oxford Handbook of Comparative Law* (Oxford 2008).

the insights gathered can provide useful clarification on the inner workings of a foreign legal system; these insights can then be applied to the legal system under investigation, helping to clarify different perspectives that may generate a deeper understanding of that legal order.⁴⁷

In employing comparative law, the foreign element (which in the present context is the foreign law) must first be understood and explained prior to creating a system of similarities and differences on which additional analysis can then be based.⁴⁸ Thus comparative law not only seeks to produce similarities between two distinct concepts but also to illustrate differences and highlight divergent characteristics between two phenomena, both in the nature and content of rules and in their operation. Differences in legal systems are often a result of economic, political, cultural and moral factors which are deeply entrenched within the foreign legal system and, more often than not, the foreign phenomenon or legal system is better explained from a historical standpoint.⁴⁹ This is not to say that comparative analysis merely reveals past legal history; but rather it uses these revelations to portray what the law may tend to be in years to come.⁵⁰

It has been argued that if laws are meant to accomplish a purpose and meet societal requirements, then it is essential to develop laws that meet these needs (commonly referred to as social engineering) and comparative law can aid the evaluation of the ability of different solutions to solve similar problems and encourage similar degrees of progress.⁵¹ In essence, comparative legal analysis is a comparison of different societies meeting

⁴⁷ See (n 45).

⁴⁸ Jansen (n 44).

⁴⁹ W Ewald, 'Comparative Jurisprudence (1): What was it like to try a Rat' (1995) 143 *University of Pennsylvania LR* 1889 ff & 1945 ff.

⁵⁰ F Pollock, 'The History of Comparative Jurisprudence' (1903) 5 *Journal of the Society of Comparative Legislation* 74.

⁵¹ R Michaels, 'The Functional Method of Comparative Law' in M Reimann and R Zimmermann (eds) *The Oxford Handbook of Comparative Law* (Oxford 2008).

comparable societal needs with different solutions in an attempt to stimulate improvements to the law.

There are two underlying theses popular in today's comparative analysis literature; the convergence thesis and the functional equivalence thesis. The convergence thesis is one which promotes internationalisation and globalisation.⁵² It supports the view that the laws of all nations are expected to converge towards parallel socio-economic structures.⁵³ Thus, as the world becomes a global village, there should be a uniformity of socio-economic structure as well as legal systems. The problem with this argument is that comparative law recognises and admits the fact that each legal system is influenced by economic, geographical, moral and cultural factors that cannot be replicated from one jurisdiction to another. It then seems that expecting each and every legal system to converge and have similar structures may not be practicable. Moreover the benefit of convergence can only be found in the formal improvement it makes⁵⁴ and it may be costly to implement.⁵⁵

The functional equivalence theory on the other hand, acknowledges that although each legal system originates from different traditional principles, rules and beliefs, they face similar problems which need solutions.⁵⁶ Consequently, different legal systems adopt different solutions to deal with similar problems,⁵⁷ and these solutions may only be similar in relation to the specific function that they perform within the society.⁵⁸ The functional equivalence theory calls for an understanding of society and its sub-systems made up of the relationship between its elements rather than independent elements that have no connections.⁵⁹

⁵² G Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends up in New Divergences' (1998) 1 MLR p 11-32.

⁵³ *Ibid.*

⁵⁴ U Mattei, 'Comparative Law and Critical Legal Studies' in M Reimann and R Zimmermann (eds) *The Oxford Handbook of Comparative Law* (Oxford 2008).

⁵⁵ Michaels (n 51).

⁵⁶ Teubner (n 52).

⁵⁷ *Ibid.*

⁵⁸ Michaels (n 51).

⁵⁹ *Ibid.*

Consequently, societies having the same societal problems can draw on other societies' solutions to come up with a functional equivalent to tackle their problems. This does not necessarily mean that the change or solution would come in the same form or within the same area of the society. The fundamental principle of functional equivalence is that solutions to similar problems can be remedied in different ways.

1.2.2 Why the choice of jurisdictions?

The decision to use the Canadian and the US jurisdictions as benchmarks lies in the fact that they are both common law jurisdictions that share some legislative history with the UK, and may potentially provide some insight as to why the UK, on the issue of post-commencement financing, has evolved differently. The US has a long history of having well established, incentive-based systems of post-commencement financing in place, which have evolved over time into the sophisticated system presently available. Canada, on the other hand, provides two approaches to rescue funding; the use of judicial fiat to assign funds during corporate rescue, and post-commencement statutory provisions which later replaced the earlier judge-made laws. In addition to Canada providing a more recent example of the development of post-commencement financing, it was also chosen because it gives a perspective on the ability of judges to bridge the gap where statute has left a vacuum, a position similar to that of the UK, with its history of judge-made rules through the use of precedents.

1.3 Summary of chapters

One of the arguments put forward by proponents of comparative analysis is that in order to have a robust comparative analysis, the phenomenon under investigation ought to be broken down into sub-components. The structure of this thesis reflects this approach. Comparative law, by definition, examines the relationship between legal systems and the most prominent aspect of this relationship is arguably historical. History uncovers the source of a body of laws, its affiliation with other laws and the influences that may have shaped the development of the laws or legal system under investigation.⁶⁰ As a result, Chapter II employs extensive comparisons in establishing the context of this thesis by tracing the history of bankruptcy laws in all three jurisdictions in order to ascertain when a corporate rescue culture came into existence in each of the countries. Having established the context, it examines the development of corporate rescue and the surrounding factors that influenced this development. Different factors influence the creation of laws, and this Chapter pinpoints a number of factors that may have influenced the development of a corporate rescue culture in each of the jurisdictions under investigation. This chapter also examines societal attitudes to debt and debtors in the UK, Canada and the US. Debt is central to bankruptcy, consequently laws that act as guidelines to administer issues arising out of bankruptcy may be influenced by how that society perceives the notion of debt. This chapter analyses the connection between these two concepts.

In-depth comparative analysis continues in the subsequent chapters which reflect the relevant components that underlie rescue funding in corporate rescue, and realise the aims and objectives of the research. These components are considered in Chapters III – V. Chapter III builds on the development of corporate rescue. It begins with an examination of the importance of corporate rescue funding; thereafter it looks at how the rescue process is funded. In order to provide a detailed analysis, this chapter provides a historical overview

⁶⁰ E M Wise, 'The Transplant of Legal Patterns' (1990) 38 Am. J. Comp. L. Supp. 1.

of the development of rescue funding in each of the jurisdictions to date, the players involved in rescue funding, and the incentives available to encourage access to different forms of rescue funding.

Chapter IV explores secured lending and its relevance to the availability of rescue funding. It begins by discussing the concept of security and how the type of security found in a jurisdiction determines its lending structure. This in turn raises consequential issues when a company becomes insolvent, such as an insolvent company's ability to access funds to continue trading during rescue. This chapter assesses the structure of lending in the UK and its capacity to support rescue funding. Creditors may be regarded as one of the key players in corporate rescue, particularly with regard to how the process can be funded. Chapter V considers the impact of post-commencement funding on creditors' rights. It examines the role of creditors in corporate rescue and analyses how creditors' rights could be affected during corporate rescue. The thesis ends with a conclusion and recommendation in Chapter VI and revisits the functional equivalence theory and the concept of legal transplants.

Chapter II: History of Corporate Rescue

Introduction

In order to undertake a thorough comparative analysis of business funding in corporate rescue within the United Kingdom (UK), United States (US) and Canada, there is a need to establish the origin of corporate rescue within these three jurisdictions. The history of corporate rescue is grounded deep within the history of bankruptcy laws. Although all three jurisdictions have a long and remarkable history of making bankruptcy enactments, some of which can be traced as far back as the reign of King Henry VIII (the United Kingdom), the act of making provisions for the rescue and rehabilitation of companies facing financial ruin cannot lay claim to such an extensive history. Statute-backed mechanisms for corporate rescue are of fairly recent origin when compared in the light of how long bankruptcy laws have been in existence, since companies were not formed until the early part of the 19th century. Consequently, the bankruptcy laws prior to the formation of companies were geared towards merchants and individuals.

As commerce evolved and companies were formed to tackle complex commercial undertakings, bankruptcy laws developed to make provisions for the collapse of these business structures. These provisions were tailored towards the liquidation of companies with the intention of making some returns to the companies' creditors. Subsequently, the financial and social impact of various economic depressions on companies and the society during the early part of the 20th century, in addition to the belief that creditors and the society had more to gain in avoiding liquidation, led to the adoption of rescue measures to assist debtor companies and in turn improve the economy. Presently, the main objective of most rescue systems is to preserve the company as a going concern regardless of its

financial troubles, on the condition that the company has the potential to become viable again.¹

Therefore this chapter is aimed at situating the origin and growth of corporate rescue. It considers the state of bankruptcy laws pre-and post-formation of companies and in doing so, it creates a trajectory of the development of corporate rescue from its inception until present time, while identifying the factors responsible for the shift of focus from liquidation of companies, to the rescue of businesses/companies within the UK, Canada and the US. In addition, it outlines the various rescue mechanisms available in the three jurisdictions and analyses how societal attitudes towards debt held by the three jurisdictions may have influenced the type of bankruptcy laws adopted by them. It does this by employing historical analysis so as to establish a context for the introduction of corporate rescue and the provision of enabling legislation to support the funding of rescues.

Of all the three jurisdictions, the UK has a more extensive history of making bankruptcy laws and due to its historical ties with both the Canadian and the US jurisdictions, in addition to being a major world power, it became the ideal upon which America and Canada modelled their bankruptcy laws.² This historical analysis forms the framework upon which an examination of business funding in corporate rescue and its related factors will be examined in the later chapters.

¹ Janis Sarra, *Creditor Rights and the Public Interest* (University of Toronto Press 2003) p 13-19.

² D A Skeel Jr., 'The Genius of the 1898 Bankruptcy Act' (1999) 15 Bank. Dev. J. 321.

2.1 Bankruptcy in the UK

2.1.1 Early bankruptcy laws (pre-1844)

The English jurisdiction has had a long history of having developed rules of bankruptcy and this can be traced to 1542 when the first such Act was enacted.³ As a result, the UK has played a prominent role in shaping both the Canadian and the US bankruptcy laws, as both jurisdictions had in the past looked to the UK for inspiration when drafting their respective bankruptcy laws. English bankruptcy law was an obvious choice because of the shared history of these jurisdictions as colonies of the UK.⁴ Up until 1844, commerce in the UK was largely conducted by merchants; as such the bankruptcy laws at the time were suited to deal with the collapses of the businesses of these merchants as well as issues of personal bankruptcy.⁵ Although these laws were mainly punitive in nature, as individual bankrupts were treated as criminals responsible for their bankruptcy,⁶ merchants however fared a lot better as they were not subjected to the same castigation as their non-trading counterparts.

The treatment of both trade debtors and individual bankrupts under one Act was to change in 1844 as bankruptcy provisions in the UK underwent sweeping changes. These changes, as will be discussed below, were as a result of the development of complex commercial structures. While the main focus of this chapter is on corporate bankruptcy, the development of corporate bankruptcy will be examined alongside changes made to bankruptcy laws generally. This is because issues of corporate bankruptcies were carried along under the earlier bankruptcy statutes which dealt with individual bankruptcy.⁷

³ Act Against Such Persons As Do Make Bankrupt 1542 (34 and 35 Henry VIII, ch.4).

⁴ Skeel (n 2).

⁵ See the various Bankruptcy Acts enacted in 1705, 1831, 1844, 1849, 1861 and 1869.

⁶ Bankruptcy Act 1542 (n 3).

⁷ Although there are no statutory provisions to back this position, it is inferred from court practices at the time.

2.1.2 1844 (formation of companies) to 1883

With the expansion of the British Empire and the growth of commerce, the need for a more complex structure to deal with trade became evident and this led to the birth of corporations with the passing of the Joint Stock Companies Act 1844 by Parliament. This Act recognised companies as distinct legal entities by drawing a distinction between a partnership and a joint stock company.⁸ Also the subsequent Joint Stock Companies Winding-Up Act 1844 made it possible for these companies to be made bankrupt albeit in the same way as individuals. This represented the first acknowledgement of corporate bankruptcy within the UK.

While changes were being made to bankruptcy laws by the recognition and introduction of laws dealing with corporate failures (Joint Stock Companies Winding-Up Act 1844), bankruptcy laws in general were undergoing some changes. One notable change which was effected by the Bankruptcy Consolidated Act 1849 was the introduction of voluntary bankruptcy which enabled a debtor petition for his own bankruptcy,⁹ a task which was usually carried out by one or more of the debtor's creditors. Therefore a debtor could for the first time, of his own volition, initiate proceedings when he is unable to meet the debt requirement of his creditors. The Act also created an avenue for the debtor trader to reach an agreement with his creditors on how claims would be settled.¹⁰ Also, like its predecessors, the Act dealt with bankrupt traders, however, it expressly excluded its

⁸ However, joint stock companies were still treated as partnerships and their members were all liable personally to creditors, although this liability came after the liability of the company itself. See C A Cooke *Corporation, Trust and Company: An Essay in Legal History* (Manchester University Press 1951) p146.

⁹ Bankruptcy Act 1849 (12 &13 Vict., c.106) s 93.

¹⁰ *Ibid*, s 76. It should be noted that the filing of an arrangement before filing for bankruptcy was regarded as proof of bankruptcy at the time. This is in sharp contrast to what obtains presently, as a company can make use of a scheme of arrangement under the Companies Act to re-organize its affairs without being bankrupt.

provisions from being applied to “members or subscribers to any incorporation, commercial or trading established by charter or Act of Parliament”.¹¹ This appeared to endorse the Joint Stock Winding-Up Act as the appropriate statute when it came to matters concerning the bankruptcy of complex commercial structures like corporations.¹²

In 1861, a well-structured bankruptcy statute was enacted by Parliament which established “officialism” within the English bankruptcy structure by making provisions for the appointment of an official assignee to take charge of the debtor’s assets.¹³ This new structure replaced the earlier system which was under the control of creditors and was used primarily as a collection device for individual creditors.¹⁴ While still a collection device as previous Acts were, the Bankruptcy Act 1861 moved the control of the bankruptcy system from individual creditors to a government appointed person.¹⁵ The Act also abolished the distinction between traders and non-traders¹⁶ thus all bankrupts were treated equally.

It was not until the enactment of the first modern company law statute in 1862, the Companies Act 1862, that distinct and separate provisions which treated companies as separate legal entities from members and shareholders were in place to deal solely with companies and their collapses. The Companies Act 1862 consolidated both the provisions relating to winding up and those respecting the formations of the company under one Act. The Act gave powers to the court to wind up a debtor company¹⁷ in addition to enabling the voluntary winding up by the company¹⁸ and giving the creditors a right to wind up a

¹¹ Bankruptcy Act 1849 (n 9) s 65.

¹² Section 4 of the Bankruptcy Act 1849 appeared to support this notion as it provided that the Act had no effect on actions carried out under the Joint Stock Winding-Up Act, therefore companies to which the Joint Stock Winding-Up Act applied to, were not covered by the Bankruptcy Act.

¹³ Bankruptcy Act 1861 (24 & 25 Vict., c.134), s 108. This section makes provisions for the appointment of an official assignee to take charge of the debtors’ estate until the appointment of a creditors’ assignee.

¹⁴ Skeel (n 2).

¹⁵ To be appointed as a commissioner of the Court of Bankruptcy, the individual had to be a serjeant-at-law, or a barrister-at-law, of not less than twelve years’ standing at the bar in England”. See Bankruptcy Act 1861, s 2.

¹⁶ See Bankruptcy Act 1861 (n 13), s 69.

¹⁷ Company Act 1862, s 79.

¹⁸ *Ibid*, s 129.

debtor company.¹⁹ It also introduced the appointment of an official liquidator to manage the winding up of the company.²⁰

Further changes to Bankruptcy laws in general came in 1869. As it became clear that some debtors were victims of misfortune rather than a deliberate attempt on their part to defraud creditors, the general attitude of treating debtors as charlatans underwent transformation; as such bankruptcy laws were modified to reflect this shift in attitude. The changes in the laws came in the form of a new Bankruptcy Act 1869 and the Debtors Act 1869. The Bankruptcy Act which was enacted in 1869, although mainly a collect and divide mechanism designed to satisfy claims made by creditors,²¹ provided an option for compromise for the debtor to come to some form of agreement with his creditors on how to satisfy their claims.²² The Act also clearly excluded its application to companies and large associations and partnerships registered under the Company Act 1862.²³ It was also at this point that the Debtors Act 1869, which was aimed at reforming the powers of court to detain creditors, was enacted. It abolished the arbitrary imprisonment of debtors by the courts,²⁴ taking away the threat of imprisonment which hung over debtors at the time. Thus, rather than face untold hardships, the laws were tailored in such a way as to assist the debtor to sort out his affairs.

2.1.3 Modern bankruptcy laws (1883 to date)

¹⁹ *Ibid*, s 145.

²⁰ *Ibid*, s 92.

²¹ D G Baird and T H Jackson, *Cases, Problems and Materials on Bankruptcy* (2nd edn, Little Brown 1989) chap1.

²² See Bankruptcy Act 1869 (32 & 33 Vict., c.62), s 126(composition with creditors) and s 125 (liquidation by arrangement).

²³ *Ibid*, s 5. This shows a clear recognition of the distinction between corporate and personal insolvency.

²⁴ Debtor Act 1869, s 4. This provision abolished the imprisonment for debts although ss 11 to 15 allowed for the punishment of fraudulent debtors.

At the later part of the 19th century, laws pertaining to bankruptcy were dealt with under the various Bankruptcy acts and Company acts and this is discussed below.

2.1.3.1 Bankruptcy Act

The Bankruptcy Act 1883 further consolidated the introduction of well-structured and comprehensive bankruptcy provisions. The only draw-back was that it dealt mainly with personal insolvency. As earlier stated, this did not preclude it from being used as a point of reference or when corporate bankruptcies were dealt with. It is interesting to note that the Act of 1883 was pivotal in the early reforms to bankruptcy laws that took place in Canada as that country relied heavily on the 1883 Act in enacting its Bankruptcy Act 1919.²⁵ However the US, which had always looked to the UK for guidance in the enactment of its bankruptcy laws was at this point (from 1883 onwards) radically deviating from the English precedents it had followed in the past with the enactment of its Bankruptcy Act 1898. This will be discussed in the second segment of this chapter.

The 1883 Act introduced an organized ranking of claims with its underlying *pari passu* principle to guide the satisfaction of the claims of unsecured creditors.²⁶ It also merged the specialist London Bankruptcy courts, which had exclusive jurisdiction to deal with bankruptcy matters, with the high court and therefore transferred jurisdiction to the High Court.²⁷ In addition, courts were given the power to make administration orders for small bankruptcies, in order to facilitate the instalment payment of a debt owed.²⁸ Further Amendments were made to the Act in 1914, which consolidated the provisions of the 1883 Act.²⁹ The 1883 Act remained in force until it was merged with the provisions of the

²⁵ L Duncan, *Law and Practise of Bankruptcy in Canada* 31, N.5 (Carswell Company, 1922).

²⁶ Bankruptcy Act 1883(46 & 47 Vict c. 52), s 40.

²⁷ *Ibid*, s 93-94.

²⁸ *Ibid*, s 121-122.

²⁹ Bankruptcy Act 1914 (4 & 5 Geo 5 c.59).

Companies Act 1929 to offer a well-structured bankruptcy regime which incorporated personal and corporate insolvency and made provisions for rehabilitation and winding-up of companies.

2.1.3.2 Companies Act

In 1908, amendments were made to enhance the 1862 Companies Act (the first statute to recognize companies as separate legal entities from their owners).³⁰ Whilst the Act essentially remained the same, section 120 of the consolidating Act of 1908 gave powers to the debtors to compromise with creditors before or during winding up. This could be seen in today's rescue culture as an attempt to rehabilitate debtor companies. Subsequently, bankruptcy as it relates to corporations was covered by the various Companies Acts³¹ which only made provision initially for winding up, but thereafter introduced provisions which gave debtors leave to reach a compromise with their creditors.³² The reliance of distressed companies on the provisions of the Companies Act was to continue until the enactment of the Insolvency Act 1985 (consolidated as the Insolvency Act 1986) which made comprehensive provisions for the administration of corporate bankruptcy and introduced a comprehensive framework under which companies could reach an agreement with its creditors on how to settle their claims, thus signalling the beginning of a rescue culture in the UK.

2.2 Corporate rescue in the UK

³⁰ See p21-22 of the thesis.

³¹ Such as the Companies Act 1908 & 1929.

³² See Companies Act 1862, s 136; Companies Act 1908, s 191.

The UK has a history of treating debtors as quasi felons and this can be traced as far back as the mid-16th century where the preamble to the UK's first Bankruptcy Act (1542)³³ portrayed debtors as criminals. The treatment of those who found themselves to be bankrupt and the society's belief that they ought to be punished did not make a good foundation for encouraging the rehabilitation of debtors. As such, the laws at the time reflected this attitude and tended to be punitive in nature.³⁴ Nevertheless the jurisdiction with the passage of time made provisions which were more sympathetic to debtors and this was first reflected in the 1705 Bankruptcy Act.³⁵ This supposed shift in attitude did not extend to the rehabilitation of debtors rather it acted to compensate debtors who did not hinder the administration of their estate.³⁶

Subsequent reforms to bankruptcy laws from 1884 upwards reflected a slow move towards a rescue culture, from provisions for compromise to the well-defined rescue structures provided by the Insolvency Act 1986. In the next sub-section, the thesis would examine how the shift in attitude from 1884 towards bankrupt debtors, gave way to favourable provisions which eventually cumulated in the adoption of a rescue culture in 1985 to facilitate the rehabilitation of debtors.

2.2.1 1844-1985

³³ An Act against Such Persons as Do Make Bankrupt 1542 (34 & 35 Hen VIII, c.4).

³⁴ J Dufrene, *A Treatise on the Law between Debtor and Creditors* (2nd edn, London 1820). The author was a bankrupt who had suffered under the harsh provisions of the bankruptcy laws in force. He referred to the Bankruptcy Act as a criminal code and mourned the fact that the legislature focused more on the interest of creditors. He went further to state that the best way to protect the creditor is to begin with doing justice to the debtor, for the same cause which makes it easy to oppress the debtor produces injury to the creditor.

³⁵ See an Act to Prevent Frauds Frequently Committed by Bankrupts 1705 (4 Anne, c.17). It should be noted that consumer debtors were treated quite different from merchant traders who all fell under the provisions of the Act. The law was more sympathetic to merchant traders.

³⁶ J D Honsberger, 'Philosophy and Design of Modern Fresh Start Policies: the Evolution of Canada's Legislative Policy' (1999) 37 Osgoode Hall L.J 171.

The UK jurisdiction until the enactment of the Insolvency Act 1985, had two separate statutes which dealt with bankruptcy; the Bankruptcy (Amendment) Act 1926 for personal insolvency (which also included the insolvency of merchant traders) and the Companies Act 1984 which dealt with the winding up of corporations. Although the sub-topic relates to corporations, a brief examination of the rehabilitation of debtors under the various Bankruptcy Acts during this time will be undertaken as the Bankruptcy Acts acted as a point of reference for corporate bankruptcy.

Notwithstanding that society began to acknowledge that, in a lot of cases, misfortune or the uncertain nature of economic tides may have had more to do with debtors failing than their innate desire to embark on a life of criminality, not much in way of rehabilitation was available to debtors. Most debtors ended up going through liquidation, with emphasis on the division of assets to satisfy the claims of creditors. Nevertheless, there were options for debtors to offer a compromise to creditors in order to gain some sort of reprieve in the form of having interests reduced, or an extension of time within which to pay their creditors' claims.

The provisions for composition within these Acts, while supporting the notion that debtors needed help sorting out the bankruptcy estate, also may have shown that debtors could be rehabilitated. Thus it could be assumed that the concept of rescue did exist at the time. A look at the Bankruptcy Act 1861 seems to support this theory. Section 109 states;

“At the creditors’ meeting a majority in value of the creditors present shall determine whether any or what support shall be made to the bankrupt.....”

Section 185 goes further to provide that;

“at the first meeting of creditors held.....or at any meeting to be called for the purpose and of which 10 days’ notice have been given.....three-quarter in number and value of the creditors present or represented.....may resolve that the estate ought to be wound up under a deed of agreement, composition or otherwise and an

application shall be made to the court to stay proceedings in bankruptcy for such a period as the court shall think fit.”

Succeeding Acts introduced more structure to the availability of compositions and schemes of arrangement to debtors. The Bankruptcy Act 1883 gave powers to creditors to accept and courts to approve compositions.³⁷ However it came with a *caveat*; the composition plan would not bind creditors except if it was confirmed by a resolution passed by three-quarter in value of all creditors who had proved their claim.³⁸ Thus compositions were not automatic and where there was none in place, the debtor’s assets were wound up without delay and thereafter sold off and distributed among the creditors to satisfy their claims.³⁹ The 1914 amending Bankruptcy Act reinforced these provisions by providing for liquidation and compositions or extensions as part of bankruptcy.⁴⁰ It also opened up a way for debtors to use composition to terminate or prevent a bankruptcy without liquidation.⁴¹ Even at that, the principal statute that regulated and managed the winding up of companies was the Companies Act 1913.

The Companies Act of 1862 was the first modern statute which had provisions that dealt with corporate bankruptcy.⁴² While it dealt with the winding up of companies, it also allowed creditors and debtors to reach a compromise. Subsequent Acts such as the Companies (Consolidated) Act 1908⁴³ also made provisions for debtors to come to some agreement with creditors on how to restructure their debt during winding up. These laws provided an avenue for debtors to agree on a plan with their creditors on how the debt could be restructured. Although not a rescue mechanism in the true sense, they seemed to have

³⁷ Bankruptcy Act 1883, s 18.

³⁸ *Ibid*, s 18(2).

³⁹ *Ibid*, s 18.

⁴⁰ Bankruptcy Act 1914 (4 & 5 Geo c.59), s 16.

⁴¹ *Ibid*.

⁴² Companies Act 1862, part 4.

⁴³ See Companies (Consolidated) Act 1908, s 120.

provided a sort of framework for rescue at the point of liquidation, but only with the view of making it easier for debtors to meet their obligations to creditors. This is relatively different from the underlying objective of corporate rescue which attempts rehabilitation at the point of bankruptcy with the aim of returning the business/company to viability.

Subsequent amendments to the Companies Act such as the 1948 Act dealt with reconstruction, compromises and arrangements of companies and gave companies the leeway to propose any plan as long as the scheme was not contrary to the general law or ultra vires the company.⁴⁴ Despite these attempts at encouraging the rehabilitation of companies, the prevalent approach at the time was liquidation of companies and this persisted until 1985⁴⁵ when a new insolvency law representing findings presented by the Cork Committee was passed into law. The new law incorporated specific provisions which facilitated corporate rescue.

It has been asserted that the reason why the UK was slow in adopting formal rescue procedures lay with the old receivership procedure.⁴⁶ This procedure was an equitable remedy available to creditors with a floating charge under the jurisdiction of the Chancery court, where a receiver and manager was appointed by the court to manage the affairs of the debtor company on behalf of a creditor.⁴⁷ Later, it became more convenient for the appointment of the receiver/manager to be done by the creditor concerned⁴⁸ and this custom and practice was subsequently given legislative backing by the Law of Property Act 1925.⁴⁹ Gradually the procedure evolved with the development of intricate provision of credit and, in order to provide stronger protection for the credit sought by businesses, the modern

⁴⁴ See Companies Act 1948, s 206.

⁴⁵ G Moss, 'Comparative Bankruptcy Cultures, Rescue/Liquidation? Comparisons of Trends in National Law- England' (1997) 23 Brook. J. Int'l.L. 115, 118.

⁴⁶ This can be deduced from the Cork Report where it acknowledged that the administrative receivership had been used in that manner.

⁴⁷ B. Hannigan, *Company Law*, (Butterworths 2003) p727.

⁴⁸ R Goode, *Principles of Corporate Insolvency Law* (3rd edn Sweet and Maxwell 2010) p247.

⁴⁹ Law of property Act 1925, s 101(i) (iii) and s 109.

debenture evolved.⁵⁰ The modern debenture created a fixed charge over fixed assets and floating charge over the remainder of the companies' assets.⁵¹ Thus it became the purview of the debenture holder holding a floating charge to appoint a receiver/manager to manage the business on his behalf when the company defaulted. Whilst not tailored specifically to the rescue of a company, the old administrative receivership could successfully be used for rescue purposes if this was in the interest of the principal creditor who appointed the receiver and he was not prevented from doing so by opposing parties.⁵² This procedure played a major role in insolvency in the UK until it was virtually abolished by the Enterprise Act 2002.⁵³

2.2.2 The law as it is now (1985 to date)

The facts which prompted major overhaul of the UK bankruptcy laws which occurred in the 1970s to 2000s included a combination of economic and social events.⁵⁴ This fusion of elements generated a lot of pressure for reforms to the insolvency laws which were regarded as inadequate at the time.⁵⁵ These factors were responsible for a shift in the way debtor companies were assisted and given a fresh start. The major catalyst for this change came in form of the report submitted by the Insolvency Review Committee headed by Sir Kenneth Cork which was set up by the Secretary of State for Trade in January 1977.⁵⁶ Amongst the terms of reference set out for the committee was the need to come up with less formal

⁵⁰ Goode (n 48) p248.

⁵¹ *Ibid.*

⁵² V Finch, *Corporate Insolvency, Law Perspectives and Principles* (Cambridge University Press 2002) p 253.

⁵³ It was heavily criticised for not being sufficiently accountable to all stakeholders and this was consequently thought to result in the wasteful closure of good businesses. See A Hsu and A Walters, 'The Impact of the Enterprise Act 2002 on Realisation and Costs in Corporate Rescue Proceedings', a Report prepared for the Insolvency Service, December 2006.

⁵⁴ M Hunter, 'The Nature and Function of a Rescue Culture' [1999] JBL 491-520.

⁵⁵ *Ibid.*

⁵⁶ Cork Report.

procedures where appropriate, which would act as an opt – out from the more conventional exit of winding-up.⁵⁷ This has been regarded as the first official indication of government’s willingness not only to encourage rescue culture⁵⁸ but also to provide the tools to actualise it.

The committee in its interim report acknowledged the inadequacies of the machineries available for the administration of bankruptcy in the UK and stated that there was need for a revamp.⁵⁹ The committee stated that it was fundamental to good insolvency practice for a balance to be achieved between providing an efficient way of administering the bankrupt’s estate and giving the debtor a chance for rehabilitation where appropriate.⁶⁰ It then follows that whilst the existing regimes at the time may have appeared to have achieved a modest amount of efficiency in the administration of the bankrupt’s estate, when it came to rehabilitation they were seemingly lacking. As earlier stated and acknowledged by the committee in its interim report, the bankruptcy system in the UK at the time had “a strong undercurrent of what can conveniently be described as retributive and punitive justice towards the debtor”.⁶¹

The committee in its final report sought to correct this inefficiency and defined what the aims of modern insolvency should be and in chapter 4 sub paragraph (j), the report states that modern insolvency should provide a way to preserve viable businesses. On the basis of this report, the UK Insolvency Act 1985 was enacted, providing unprecedented opportunities for corporate reorganisation. It introduced the administration procedure to support the rehabilitation or re-organisation of companies facing difficulties in order to

⁵⁷ *Ibid.*

⁵⁸ Hunter (n 54).

⁵⁹ Interim Report of the Review Committee on Insolvency Law and Practice (Cmnd 7968, 1980) (“Interim Report”).

⁶⁰ *Ibid*, chapter 1 at para 2.

⁶¹ *Ibid*, para 3.

enable them to be restored to profitability or viable elements of these companies to be preserved.⁶² Whilst the administration process might appear to have been fashioned after the US Chapter 11 procedure, it was in fact designed to emulate the old administrative receivership which the committee recognised as a valuable tool for the rescue of a company.

The committee in its report stated that;

“There is however, one aspect of the floating charge which we believe to have been of outstanding benefit to the general public and to society as a whole; we refer to the power to appoint a receiver and manager of the whole property and undertaking of a company. In some cases they have been able to restore an ailing enterprise to profitability, and return it to its former owners. In others they have been able to dispose of the business as a going concern. In either case, the preservation of the profitable parts of the enterprise has been of advantage to the employees, the commercial community, and the general public.”⁶³

As a result the committee proposed the appointment of an administrator with all powers normally bestowed on a receiver or manager appointed by a floating charge holder.⁶⁴ Thus the enactment of the 1985 Act, which combined provisions of the Companies Act and the Bankruptcy Act, made available a wide spectrum of mechanisms for debtor companies to effect rehabilitation. This Act was consolidated as the Insolvency Act 1986.

Insolvency in the UK was to undergo more transformation as a result of the influence of a report published by a review group which was set up by the Department of Trade and Industry and the Treasury in 2000.⁶⁵ The report was centred on the old administrative receivership. Although the Cork Committee had noted that the provision could enable the preservation of companies, it was a procedure which was essentially a debt enforcement mechanism employed by a floating charge holder to ensure that he got returns on his security. The floating charge holder typically had a fixed charge over fixed assets of the

⁶² A Revised Framework for Insolvency Law (Cmnd 9175, 1984) p19 at para 31.

⁶³ Cork Report, para 495.

⁶⁴ *Ibid*, para 497.

⁶⁵ Insolvency Service, ‘A Review of Company Rescue and Business Reconstruction Mechanism, Report by the Review Group’ (DTI, 2000) (“Review Report”).

company and a floating charge over all the rest of the company's assets. This gave him powers to appoint a receiver and manager who had the authority to run the business of the company on the debenture holders' behalf, dispose of assets or effect the sale of the business as a going concern.⁶⁶

What set this procedure apart from rescue mechanisms is the fact that the protection of the general interest of creditors was not the foremost aim of the old administrative receivership; rather its sole aim was to maximise realisation for the benefit of the debenture holder. The 2000 review group came up with recommendations to virtually abolish the appointment of an administrative receiver by a floating charge holder where the charge was created after 15 September 2003.⁶⁷ A new streamlined administration procedure was also recommended by the review group and these recommendations were set out in the Enterprise Act 2002 which amended the Insolvency Act 1986.⁶⁸ The new administration procedure has a hierarchy of three objectives which the administrator has to achieve in order to rescue a business.⁶⁹ As its main objective, the administration procedure should, where practicable, rescue the company as a going concern, failing which the second objective, which is achieving a better result for the company's creditors as a whole than would be likely if the company was liquidated without first being in administration, should be pursued.

Presently, there are three main statute-backed procedures for achieving corporate rescue in the UK; firstly there is the administration procedure⁷⁰ in which a company facing bankruptcy is placed under the management of a qualified insolvency practitioner as an

⁶⁶ Goode (n 48) p248.

⁶⁷ Exceptions were however allowed for the appointment of a receiver by a debenture holder such as large capital market arrangements, utility projects, public-private partnership projects incorporating step-in rights, urban re-generation projects, financial market charges, large-scale project finance incorporating step-in rights, collateral security charges, registered social landlords, system charges and protected railway companies. See Insolvency Act 1986, ss 72a- 72g and Sch. 2A.

⁶⁸ See generally Interim Report (n 59) para 73.

⁶⁹ See Insolvency Act 1986, Sch. B1 para.3.

⁷⁰ *Ibid*, part II.

external manager who manages the company with the help of the creditors' committee.⁷¹ The administration procedure is often used alongside either the company's voluntary arrangement (CVA) or scheme of arrangement to effect a compromise or arrangement with creditors with a view to rescue the company. Conversely, where the administration process is used on its own, it is often used as a pre-pack administration procedure.⁷²

Another rescue route which can be used by debtor companies is the CVA.⁷³ This is a composition made by a company with its creditors and members in satisfaction of its debt. It usually involves an agreement by the creditors to consent to a lesser amount of what is due them in satisfaction of their claims.⁷⁴ This process is often used as an exit route during the administration process but may stand on its own as a rescue tool. More often than not, CVAs can either be used as a quick-fix procedure whereby a sale of company's assets is achieved and the resulting proceeds distributed among creditors or a continuing process which involves the company remaining in business and making periodic remittance to creditors from its trading income. The focal point of most CVAs is the preservation and sale of the business of the company as a going concern.⁷⁵ This however does not prevent its use as a rescue tool aimed at returning the company to profitability.⁷⁶

An alternative to a CVA as a means to reach a compromise with creditors is a scheme of arrangement under section 895 of the Companies Act 2006. The provision allows courts to authorize a compromise or arrangement upon the approval of a majority amounting to 75 per cent in value of the creditors (class of creditors) or members (class of members) voting

⁷¹ Goode (n 48), p312.

⁷² G Yeowart, 'Encouraging Company Rescue: What Changes are required to UK Insolvency Law?' (2009) Law and Financial Market Review 517 -531. Pre-pack is a process whereby the sale of all or part of the company is negotiated with a buyer prior to the appointment of an administrator, and the company or parts of it, is sold off as a going concern immediately after the commencement of the administration procedure.

⁷³ Insolvency Act 1986, part I.

⁷⁴ Goode (n 48) p 87.

⁷⁵ *Ibid* at p396.

⁷⁶ *Ibid*.

at a meeting convened for that purpose. Although not a provision under the Insolvency Act 1986, it is accessible to all companies capable of being wound up under the Insolvency Act. Therefore a foreign company which is capable of being wound up under the Act can make use of the scheme of arrangement.

Whilst great strides have been made with formal provisions of rescue mechanisms by the legislature, the UK practitioners developed their own informal rescue mechanisms (workouts) before those provided by the Insolvency Act 1985-6. This they did through what is termed as the “London approach”. The “London approach” has been defined as;

“A non-statutory and informal framework introduced with the support of the Bank of England for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring.”⁷⁷

A lack of expansive information or literature on the operations of this mechanism makes it somewhat difficult to give a detailed explanation of the operations of this mechanism, but it is essentially a voluntary one which is organised by a consortia of banks to the debtor corporation and spearheaded by the bank with the largest exposure.⁷⁸ It provides a combined temporary support and stability base while permanent solutions are devised.⁷⁹ The use of the “London approach”⁸⁰ began in the 1970’s when the UK banking secondary sector was in crisis and the Bank of England intervened to support financial institutions.⁸¹ The expertise developed by the Bank of England in handling the crisis was put at the disposal of companies in need of restructuring.⁸² It was a procedure that was used by some

⁷⁷ British Bankers Association, description of the London approach, unpublished memo 1986 culled from John Armour and Simon Deakin, ‘Norms in Private Insolvency: the London Approach to the Resolution of Financial Distress’ (2001) 1 JCLS 21.

⁷⁸ Hunter (n 54).

⁷⁹ *Ibid.*

⁸⁰ Also discussed in section 3.5.2.1 of the thesis.

⁸¹ S Slater, *Corporate Recovery* (Penguin 1984) p254.

⁸² J Armour and S Deakin, ‘Norms in Private Insolvency: the London Approach to the Resolution of Financial Distress’ (2001) 1 JCLS 21.

large multi-banked companies to bypass formal insolvency procedures when faced with bankruptcy, to arrange a rescue on a contractual basis.⁸³ The decision of the Bank of England to support workout solutions that encourage going concern value was based on a number of policy decisions which included but was not restricted to⁸⁴;

- Reducing the losses suffered by banks as a result of unavoidable company failures.
- Preventing the unnecessary liquidation of viable companies facing short-term financial problems.
- Preservation of employment and the productive capacity of the corporate sector.
- Prevention of the immediate collapse of companies facing cash flow shortfalls by promoting the necessary tools needed to encourage the provision of interim financing to surviving companies.

The London Approach played a significant role in overcoming the recession of the early 1990s because, where it was successfully applied; it preserved value for creditors and shareholders, saved jobs and protected productive capacity.⁸⁵ Regrettably, its use has greatly declined since then and this has been due to a number of reasons, chief among which was the development of more complex structures⁸⁶ and introduction of rescue mechanisms by the Insolvency Act 1986.⁸⁷ Presently in the UK, there is a wide mix of procedures available for the rehabilitation of corporations.

⁸³ Goode (n 48) p407.

⁸⁴ E C Buljevich, *Cross-Border Debt : Innovative Approaches for Creditors, Corporate and Sovereigns* (Euromoney Books, 2005).

⁸⁵ *Ibid.*

⁸⁶ P Kent, 'Corporate Workouts – A UK Perspective' (1997) International Insolvency Review.

⁸⁷ G E Meyerman 'The London Approach and Corporate Debt in East Asia' available online at http://www1.worldbank.org/finance/assets/images/DL_2_3_chapter10.pdf.

2.3 Bankruptcy in the US

2.3.1 History of the US bankruptcy laws (1800-1898)

The US's earliest statutory approach to insolvencies was the Bankruptcy Act 1800 which established a uniform system of bankruptcy and was a federal enactment created as a response to the economic crises besieging the country.⁸⁸ The Act made provisions for personal bankruptcy but there were no clear provisions for corporate bankruptcy. The prevalent form of insolvencies at the time was personal bankruptcy and the Bankruptcy Acts that were in place between 1800 and 1841 gave attention to this. Aside from the fact that complex business structures, such as corporations which would have given rise to corporate bankruptcies, were not customary at the time, Congress relied on the US's colonial ties with the UK and borrowed heavily from the UK when it enacted the Bankruptcy Act 1800. The UK at the time had an established legislative structure that dealt with bankruptcy, although the bankruptcy laws at time were restricted to individuals and merchants. Consequently, the US bankruptcy laws mirrored the pattern set by the UK by focusing on personal insolvency.

The enactment of the Bankruptcy Act 1841 after the repeal of the 1800 Act in 1803 saw some notable changes brought into bankruptcy legislation. The Act made references to the bankruptcy of "all persons being merchants or using the trade of merchandise, all retailers of merchandise and all bankers, factors, brokers, underwriters and marine insurers" thus including a wide range of trading professionals.⁸⁹ In addition the Act introduced voluntary

⁸⁸ See generally D A Skeel Jr., *Debt's Dominion: a History of Bankruptcy Laws in America* (Princeton 2001). See also E H. Levi and J Wm. Moore, 'Bankruptcy and Reorganisation; a Survey of Changes' (1937) 5 U.Chi.bL.Rev.1.

⁸⁹ Bankruptcy Act 1841, s 1.

bankruptcy thereby opening up another option for debtors who were bankrupt. This Act acknowledged that the country was going through economic growth and as such needed to adjust to the likely failures that might occur. What is perhaps curious is the fact that the provisions of section 5 allowed for corporations to prove their claims against debtors yet no provisions were contained in the 1841 Act which recognised corporations and dealt with their bankruptcies. This is not to say the Act did not recognise the existence of business structures, the Act in fact did and made provisions for the insolvency of partnerships.⁹⁰

It was not until 1867 that directions were given by the Bankruptcy Act 1867 on how to deal with bankrupt partnerships, corporations and joint stock companies authorized to carry on any business with the aim of making profits.⁹¹ With this provision companies could be declared bankrupt and all their assets distributed. Although the Act recognised and allowed for the fact that companies could declare bankruptcy, no provisions for the division of the company's assets were included, instead the Act stated that corporate property and assets were to be distributed to creditors in the manner provided for natural persons.⁹² Therefore, whilst the Act recognised corporations, it treated the bankruptcies of these corporations as personal bankruptcies and did not truly embrace corporate bankruptcy.

This recognition by the US of corporate entities came twenty-three years after the UK had recognised and made separate provisions for corporations within the Joint Stock Companies Act 1844. It may not be farfetched to assume that once again the US relied on UK to distinguish between corporate and personal insolvency. However in this case amendments to the 1867 Act included the provisions dealing with corporations within the Bankruptcy Act itself rather than having a separate provision for them, as was done in the UK. Thus the

⁹⁰ *Ibid*, s 13.

⁹¹ Bankruptcy Act 1867, s 36 and s 37.

⁹² *Ibid*, s 37.

Bankruptcy Act 1867 marked the beginning of the recognition of a distinct legal entity within bankruptcy laws.

Hitherto, the Bankruptcy Acts in force were essentially collection and distribution mechanisms carried over from the administration of personal bankruptcy and were used to satisfy claims of debtors. This was despite the fact that corporations had gained recognition by 1867. Perhaps because the earlier federal bankruptcy statutes were mainly a response to the economic crises⁹³ they were not comprehensively equipped to take into consideration the more specialized aspects of either personal or corporate bankruptcy. Nevertheless, this was to change with further amendments to the Act in 1874. The amending Bankruptcy Act of 1874 revised the provisions of section 43 of the old Act and introduced compositions.⁹⁴ For the first time, a debtor could rely on a formal procedure backed by statute to propose a plan to his creditors on how his assets would be distributed to settle their claims. It should be noted at this point that debtor companies such as railway and utility corporations could rely on equity receivership which developed in 1846. While not statute backed, these receiverships had the support of all the key players in the field of bankruptcy. This procedure will be further dealt with under the history of corporate rescue.

The leeway allowed to debtors by the 1874 Act marked a turning point in bankruptcy legislations in the US. What this perhaps tells us is that, although the US had borrowed UK bankruptcy laws with their underlying cultural and social perceptions regarding debtors, attitudes had begun to change. While America made great strides in the administration of bankruptcy within the seventy-four years from when the first federal bankruptcy legislation was enacted in 1800, a halt was called to federal legislative involvement in the creation of

⁹³ Economic crises of 1837, 1857 and 1893 led to the enactment of the 1841, 1867 and 1898 Acts respectively; see also Skeel (n 2).

⁹⁴ Bankruptcy Act 1874, s 17.

bankruptcy provisions when the Bankruptcy Act 1867 was repealed in 1878. This marked the beginning of a federal hiatus from bankruptcy legislation that was to last until 1898.

Although federal bankruptcy laws were relatively unused and the jurisdiction went through long periods (between 1803 and 1841, 1878 and 1898) of having none at all, in times of national economic crises they were largely used as a tool to create economic stability.⁹⁵ Moreover, once the Bankruptcy Act had mitigated the fallout of an economic recession and conditions began to improve, Congress tended to repeal the federal legislation and left the enactment of bankruptcy laws to the individual states.⁹⁶ Thus in the intervening periods before the enactment and repeal of the various Bankruptcy Acts, issues of bankruptcy were chiefly administered by state legislation. The reason why the Federal Bankruptcy Acts did not survive beyond the end of any of the various economic recessions has been attributed to the lack of consensus among the various interested parties⁹⁷ on the need to have federal bankruptcy legislation.⁹⁸ These somewhat erratic federal provisions on bankruptcy came to an end in 1898 with the enactment of a comprehensive federal bankruptcy law.

2.3.2 Bankruptcy laws from 1898 to date

The enactment of the 1898 Act brought to an end a hundred years of transitory bankruptcy laws⁹⁹ which were to a large extent economy stabilisation tools. The Bankruptcy Act 1898 was radically different from the UK provisions which the US hitherto relied on. Whilst the

⁹⁵ J Honsberger, 'Bankruptcy; a Comparison of the Systems of the United States and Canada' (1971) 45 Am. Bankr. L.J. 129. Major bankruptcy laws were usually enacted when there were serious economic crises and were repealed when this passed e.g. 1800 Act, 1841 Act, 1867 Act and Chandlers Act of 1938.

⁹⁶ Skeel (n 2).

⁹⁷ This includes creditors, borrowers, commercial and rural farmers.

⁹⁸ T E Plank, 'Bankruptcy Professionals, Debtors Dominance and the Future of Bankruptcy: a Review and a Rhapsody on a Theme. Debt's Dominion: a History of Bankruptcy by David A Skeel' (2002) 18 Bankr. Dev. J 337.

⁹⁹ R C Sauer, 'Bankruptcy Law and the Maturing of American Capitalism,' (1994) 55 Ohio State Law Journal 291, 330-335.

UK bankruptcy laws were more inclined towards the protection of creditors, the 1898 Act placed the interest of debtors at the core of their provisions; this was despite the major influence the UK bankruptcy laws had on the initial development of bankruptcy laws in the US.¹⁰⁰

A close study of the various Acts prior to the 1898 Act suggests that company rehabilitation or corporate rescue was not an important consideration. What was of paramount interest at the time was the protection of the creditors' interests; therefore legislation was drafted in such a manner as to achieve the protection of these interests. Furthermore, debtors were generally regarded as rogues who needed to be punished for leaving their creditors out of pocket.¹⁰¹ Perhaps encouraging the rescue of a corporate debtor at the time may not have been viewed in a positive light especially as this would have defeated the purpose of ensuring retribution on debtors who to all intent and purpose, were regarded as criminals who needed to be punished. As it has been noted earlier, the laws changed with a shift in how debtors were perceived.

The Bankruptcy Act 1898, which was the result of intensive lobbying by national commercial interest groups and their representatives,¹⁰² consolidated and advanced the notion that debtors may possibly not be responsible for their bankruptcies and should be given a fair chance at sorting out the bankruptcy estate and perhaps be allowed to start afresh. What is more, the 1898 Act firmly established the presence of corporate bankruptcy within bankruptcy legislation by defining and recognising corporations as having powers and privileges distinct from individuals and other business structures such as partnerships.¹⁰³

¹⁰⁰ Skeel (n 2).

¹⁰¹ Bankruptcy Act 1898, ss 12-13, s 27.

¹⁰² Skeel (n 88) p36 -37.

¹⁰³ Bankruptcy Act 1898, s 1.

Extensive provisions for composition,¹⁰⁴ classes of creditors and their meetings¹⁰⁵ were to be found within the 1898 Act. Section 55(c) is of particular interest because it gave creditors the carte blanche to “take such steps that may be pertinent and necessary for the promotion of the best interest of the (bankrupt) estate and the enforcement of the Act”. This does suggest that creditors were given rather broad powers under this provision to influence the way the bankrupt estate was to be administered.

Additional amendments were made to the 1898 Act between 1933-34 with the introduction of a new section 77b which dealt with the re-organisation of railway corporations, companies and personal bankruptcy arrangements. The Chandler Act 1938 provided additional options for corporate re-organisation under Chapter X and arrangements under Chapter XI. The Chandler Act is regarded as being pivotal to the history of corporate bankruptcy as it relates to the rescue and rehabilitation of companies in the US. This is due to the well laid out provisions for providing a fresh start for debtors that could be found therein. After eight decades, the 1898 Act was finally replaced by the Bankruptcy Reform Act of 1978, popularly known as the Bankruptcy Code. The 1978 Act was based on reviews to the existing Bankruptcy Act conducted by the Bankruptcy Review Commission set up to look at reforms. Both the Chandler Act and the Act of 1978 introduced different innovations which will now be examined under the history of corporate rescue.

2.4 Corporate rescue in the United States of America

The origin and history of corporate reorganisation is quite distinct from that of bankruptcy laws despite having operated alongside general bankruptcy laws.¹⁰⁶ Earlier bankruptcy

¹⁰⁴ *Ibid*, ss 12 -13 & s 27.

¹⁰⁵ *Ibid*, ss 55 -58.

¹⁰⁶ Skeel (n 88).

laws, beginning from 1800 dealt mainly with personal bankruptcy, consequently their restricted scope of application, could not have taken into consideration a more sophisticated mechanism such as corporate reorganisation. It was not until the early part of the 20th Century, after the adoption of comprehensive bankruptcy laws, that the rehabilitation of debtors was given any thought.¹⁰⁷ Whilst these statutes had as their aim the provision of a fresh start for debtors and the maximisation of returns for creditors,¹⁰⁸ they were mainly focused towards individual debtors and not corporate entities.

2.4.1 Equity receiverships

The history of corporate rescue in the US can be traced to the railway equity receiverships of the 19th Century¹⁰⁹ which arose out of the need for railway companies to reorganize their businesses as a result of railroad failures. It evolved under common law when it became increasingly difficult for these railway companies to meet the obligations on their bonds and indentures as and when they fell due,¹¹⁰ a common plight of distressed companies. Furthermore, the nature of railway companies' assets, which were mainly rail tracks spread across different states, made it difficult for creditors to benefit from the collect and divide mechanism provided by the Bankruptcy Act to satisfy the debt owed them.¹¹¹

The lack of legislative direction on how such a bankruptcy scenario should be played out gave rise to ingenuity on the part of the railroad managers, their Wall Street bankers,

¹⁰⁷ See Bankruptcy Act 1874.

¹⁰⁸ J Davies, 'Bankruptcy Banking, Free Trade and Canada's Refusal to Modernize its Business Rescue Laws' (1991) 26 *Tex Int'l L.J.* 253.

¹⁰⁹ An example of which was the Wabash railway receivership of 1884, where the managers themselves requested a receivership. See B Hansen, 'The People's Welfare and the Origins of Corporate Re-organisation: The Wabash Receivership Reconsidered' (2000) 74 *B.H.R.* 377.

¹¹⁰ Baird and Jackson (n 21) chapter 12.

¹¹¹ *Ibid.*

lawyers and federal judges to create the equity receivership in order to resolve the financial and economic distress that affected the railroad companies.¹¹² Under equity receivership, secured creditors and railroad managers appointed a receiver (in most cases, a member of management) to manage the company while management and creditors negotiated a restructuring of the debt.¹¹³ Once a new and adequate credit arrangement was agreed upon by both parties, it marked the beginning of the rescue process that rehabilitated the company.¹¹⁴ The arrangement so reached was usually in favour of the debtor company or a new entity which succeeded the old company.¹¹⁵

The interests of creditors were best served by acquiescing to a compromise and allowing the railway company to carry on trading.¹¹⁶ The fact that equity receivership ensured that the distressed firm was kept intact to enable creditors get the best out of the realization of assets was one of its most redeeming features.¹¹⁷ Some of the features of this pioneer rescue mechanism are still being practised today. Elements such as “reorganisation”, “going concern value” and “preservation of jobs” may still be considered an integral part of the underlying principle of corporate rescue.

2.4.2 Bankruptcy Acts 1898-1938

The equity receivership which developed well before, and independently of, legislative interference was the basis on which future rescue mechanisms were structured. However

¹¹² M Albro, ‘Equity Receivership: an Essay on Institutional Change’ (1974) 34 *Journal of Economic History* 685-709. See also Skeel (n 80).

¹¹³ Plank (n 98).

¹¹⁴ Levi and Moore (n 88).

¹¹⁵ *Ibid.*

¹¹⁶ Other business operations which were of necessity to the public (mainly utilities companies) which were financially distressed also benefited from equity receivership as the nature of their services meant they could not be easily liquidated.

¹¹⁷ Baird and Jackson (n 21) chapter 1.

legislative attempts at providing respite for debtors began with the 1898 Act which not only made a clear demarcation between corporate and personal bankruptcy,¹¹⁸ but also may have had the markings of the beginning of corporate rescue. This may be presumed from the provisions of section 2(5) Bankruptcy Act 1898, which allowed the business of the debtor to be managed for limited periods by a receiver, bankruptcy marshal or trustees where necessary, in the interest of the debtors' holdings. It therefore follows that where it was advantageous to continue trading where a debtor was facing bankruptcy, the Act authorized a sort of respite instead of an outright liquidation. In continuation of its attempt to bring some sort of relief to the debtor, section 12 of the 1898 Act allowed a composition between the debtor and its creditors where a majority of the creditors agreed to the compromise.

The result being that, a debtor corporation could continue trading and therefore could meet its obligation to repay to all its creditors the amount that both parties had agreed on, which was usually a portion of the debt owed.¹¹⁹ The downside of composition allowed under the Act was that it did not bind secured creditors. In contrast the railway equity receivership was spearheaded by secured creditors and accordingly was binding on them. What is more, section 55(c)¹²⁰ made provisions for creditors to take "steps as may be necessary and pertinent for the promotion of the best interest of the estate." Therefore, where it became mandatory, creditors were permitted by the Act to take any action necessary that would promote the interest of the debtor's estate and therefore, invariably furthering their own interests. This action might include coming to an arrangement with the debtor to restructure his indebtedness to his creditors.

Thus the journey towards a more structured statutory provision for corporate rescue began with the 1898 Act and was further consolidated by the Chandlers Act in 1938. The

¹¹⁸ Bankruptcy Act 1898, s 1. In this section, the Act recognised the ability of a corporation to be a debtor.

¹¹⁹ Baird and Jackson (n 21) chapter 12.

¹²⁰ Bankruptcy Act, 1898.

intervening period saw amendments being made to the 1898 Act which kept its basic tenets. In 1932, Congress embarked on bankruptcy reforms which led to the insertion of a new section 77 to the 1898 Act to oversee the reorganisation of railroad corporations. A further section 77B was added in 1934 to govern the reorganisation of corporations and generally left corporate reorganisation in the hands of Wall Street bankers and their lawyers.¹²¹ The expansion of the reorganisation process to include corporations generally was indicative of government's recognition of the fact that financially distressed companies could be rescued and that this might very well be more beneficial to unsecured creditors than outright liquidation.¹²²

Corporate reorganisation subsequently underwent notable changes which led to the incorporation of Chapter X into 1898 Act by the Chandler's Act of 1938. The emergence of Chapter X fundamentally transformed the way in which large corporations were reorganised. It stripped existing management of the exclusive control of the reorganisation process which the equity receivership and a reorganisation under section 77(b)¹²³ allowed. In its place, an objective and independent trustee was appointed to manage the company¹²⁴ and the control of the reorganisation process was placed in the hands of the Security and Exchange Commission.¹²⁵ Few companies came to depend on Chapter X for their reorganisations as a result of this sweeping change; instead managers of financially distressed companies relied on Chapter XI which allowed a debtor company to propose a plan for the settlement or an extension of the time of payment of its unsecured debts. This provision was exploited for reorganisation purposes despite its restriction to unsecured

¹²¹ Skeel (n 88).

¹²² Davies (n 108).

¹²³ Chandler's Act 1938.

¹²⁴ *Ibid*, s 156, s 160 and ss 168 -169. The court could appoint a trustee where the debtor's indebtedness was above \$250,000. Even where the debtor remained in possession, the court could appoint an independent person to file the reorganisation plan.

¹²⁵ See Chandler's Act 1938, s 172 – 174 and s 265.

debts because it allowed the managers control over the process and the company.¹²⁶ Thus Chapter X suffered a steady decline¹²⁷ and was left to disuse. It is evident that the reforms made by Congress during the 1930's, were largely influenced by techniques derived from the railway equity receiverships.¹²⁸

It may therefore be safe to say that the railway equity receivership had a huge impact on how bankruptcy laws relating to corporate reorganisation were constructed. Equity receivership created a solid foundation on which corporate rescue laws could be established and modified with the passage of time. The influence of equity receivership shaped further reforms in 1970 when Congress consented to a study of the 1898 Act by the Commission on bankruptcy laws in the US with a view to proposing changes to the existing laws.¹²⁹ Three years later, the Bankruptcy Reform Commission came out with its report which proposed a new Bankruptcy Bill.¹³⁰ The proposed Bill amongst other things¹³¹ made provisions for business rehabilitation¹³² and it was enacted in 1978 as the Bankruptcy Reform Act.¹³³ The newly enacted laws, as codified in Title 11 of the United States Code (Bankruptcy Code), completely replaced prior statutes¹³⁴ with Chapter 11 regulating the reorganisation of businesses.¹³⁵ One of the foremost guiding principles of the new Bankruptcy Code was to promote and enhance business reorganisation.¹³⁶ Therefore, the reforms introduced by this new code returned the control of the reorganisation process to

¹²⁶ Plank (n 98).

¹²⁷ *Ibid.*

¹²⁸ Skeel (n 88).

¹²⁹ See Bankruptcy Study Commission, Pub. L.No. 91-354, 84 Stat. 468 (1970), reprinted in 1970 U.S.C.C.A.N.

¹³⁰ Report of the Commission on Bankruptcy Laws of the United States, H.R. Document No. 93-137, 93rd Congress, 1st session (1973).

¹³¹ Such as administrative organisation, consumer bankruptcy and business bankruptcy.

¹³² See n 129.

¹³³ Bankruptcy Reform Act 1978, Pub L. 95-598, 92 Stat. 2549 (codified as amended at title 11 of the US code).

¹³⁴ The old Chapter X and XI which was created by the 1898 Act and amended by Chandlers Act.

¹³⁵ 11 U.S.C. 1101-1174.

¹³⁶ Senate Report no 95-989, 9th Congress 2nd Session, 9-10 reprinted in 1978, US Code Congress and AD News 5795-96.

the management of financially distressed companies.¹³⁷ In so doing, Congress maintained the status quo as it was prior to the introduction of Chapter X by the Chandler's Act of 1938; making management the driving force in the rescue process. It was believed that the assurance of keeping their jobs would persuade the management to attempt reorganisation while the company could still be saved.¹³⁸

2.4.3 Modern provisions

The 1978 Act introduced a more effective process for reorganisation and this created a more conducive framework to facilitate compromise between the financially distressed company and its creditors. The new process gave management the exclusive right to propose a reorganisation plan to creditors and shareholders within 120 days¹³⁹ and this ensured greater control for the debtor managers over the reorganisation process albeit at the expense of creditors who suffered from the abuse of the process by some debtors.¹⁴⁰ Upon the confirmation of the plan by two-thirds in value of each class of creditors,¹⁴¹ the rescue process begins and the debtor is normally left in place¹⁴² instead of being replaced by a court appointee. The debtor's status is automatically transformed into that of a quasi-trustee in bankruptcy¹⁴³ status with all the powers of a bankruptcy trustee.¹⁴⁴ Consequently the pre-commencement debtor then becomes the debtor in possession (DIP), which is regarded as a separate legal entity from the pre-commencement debtor.¹⁴⁵ In addition, the Act

¹³⁷ Bankruptcy Act 1978; see also Plank (n 91).

¹³⁸ 11 U.S.C, s 1104(a). See also Plank (n 91) and generally Skeel (n 80).

¹³⁹ *Ibid*, s.1121(b).

¹⁴⁰ Plank (n 98).

¹⁴¹ 11 U.S.C, s 1126.

¹⁴² *Ibid*, s 1101(1).

¹⁴³ G McCormack, *Corporate Rescue Law-An Anglo-American Perspective* (Edward Elgar, 2008).

¹⁴⁴ 11 U.S.C, s 1107.

¹⁴⁵ S Davido, 'Making Sense of US Bankruptcy Laws' (1992) I.C.C.L.R 406.

encourages the funding of the rescue process by according priority/super-priority¹⁴⁶ to providers of new credit to the floundering business. The ability to access credit to fund the rescue process may possibly be regarded as fundamental to a successful rescue.

The 1978 Act has been summed up as having three basic aims¹⁴⁷ which are; the avoidance of the evil of liquidation, providing a fresh start for honest debtors and provision of a timely and efficient resolution of the bankrupt's estate within a limited time. Presently, the filing of a Chapter 11 procedure may signify the existence of financial difficulties thereby kick-starting the rescue process. Nevertheless the Chapter 11 procedure is not restricted to financially distressed companies and viable companies may also make use of the procedure for restructuring purposes.¹⁴⁸ The Chapter 11 procedure is the main formal mechanism for corporate rescue in America. It allows a corporation to seek the protection of the courts in the form of an automatic stay which acts to suspend the enforcement of creditors' rights while a plan of reorganisation is being put in place. The process is aimed at providing the company with a framework to enable the company to continue trading while it negotiates with its creditors on how to meet its liabilities to them.

The United States bankruptcy laws have gone through amendments since the coming into force of the Bankruptcy Code; this has not affected the provisions available for corporate rescue. What obtains in US today with regards to corporate rescue has come a long way from the early days of equity receivership. Although the equity receivership sowed the seeds of corporate rescue and formed the basic framework for legislation on corporate rescue, a lot has been put in place to shape corporate rescue into what it is today. There are similarities between railway equity receivership and Chapter 11 rescue procedure in that

¹⁴⁶ 11 U.S.C, s 364.

¹⁴⁷ J H Dalhaisen, 'Development of Bankruptcy Remedies in Western Europe and the United States in the 19th and 20th centuries, in Botwinik and Weinrib (eds), *European Bankruptcy Laws* (2nd ed. 1986).

¹⁴⁸ Goode (n 48) chap 10.

debtor management is left in charge of a new legal entity in both instances. On the other hand there are clear differences and these include; the protection the court gives under Chapter 11 to corporations to ensure the reorganisation plan succeeds by putting an automatic stay in place which suspends all creditors' rights to enforce security and also the "cram down" mechanism which enables the debtor corporation to obtain the approval of the plan over opposition by dissenting creditors.¹⁴⁹

2.5 Bankruptcy in Canada

2.5.1 History of bankruptcy laws (1869 to 1919)

Very little literature is available on the federal bankruptcy laws in Canada prior to the turn of the 19th century. At that time Canada was made up of different provinces with each province having its own bankruptcy or debtor-creditor legislation and little information is available on the laws of each province.¹⁵⁰ The earliest federal statutory provision for bankruptcy laws in Canada was the Constitution Act which conferred exclusive rights on the Canadian Parliament to make laws in relation to bankruptcy and insolvency.¹⁵¹ Following confederation, Parliament passed the Insolvent Act 1869.¹⁵² The Act consolidated the various Bankruptcy and Insolvency Acts in the several provinces of Ontario, Quebec, New Brunswick and Nova Scotia¹⁵³ and dealt exclusively with the

¹⁴⁹ E Warren and J Westbrook, *The Law of Debtors and Creditors: Texts, Cases and Problems* (4th edn, Aspen Law and Business 2001) at p399.

¹⁵⁰ Canada was made up of provinces before it became a federation, with each province having its own laws.

¹⁵¹ 30 & 31 Vict., c.3(UK), reprinted in RSC. 1986, AppII, No. 5, s 91(21).

¹⁵² An Act Respecting Insolvency 1869, SC 11869, C16.

¹⁵³ See preamble, Insolvent Act, 1869.

bankruptcy of traders.¹⁵⁴ It provided for voluntary and compulsory bankruptcies and compositions.¹⁵⁵

The 1869 Act was later repealed by the Insolvent Act 1875¹⁵⁶ which attempted to give creditors greater control over bankruptcy proceedings. Thereafter calls by bankruptcy law antagonists led the government to repeal the 1875 Act in 1880 and relinquish its jurisdiction over bankruptcy and insolvency laws.¹⁵⁷ The only recourse available to debtors was the individual debtor creditor legislation of each of the nine provinces in Canada¹⁵⁸ and the Winding-up Act (WUA)¹⁵⁹ which was adopted by Parliament in 1882.¹⁶⁰ The WUA was however restricted to the winding up of insolvent trading corporations, railways, banks and other financial institutions and did not apply to individuals.

2.5.2 Bankruptcy Act 1919

It would take a little over two decades for the Canadian Parliament to get involved in the enactment of bankruptcy laws again and this it did with the enactment of the Bankruptcy Act 1919.¹⁶¹ The Act resulted from the Canadian government bowing to pressure from creditor lobby groups after a series of commercial failures, to create national bankruptcy laws to ensure consistency in the administration of bankruptcy estates.¹⁶² The 1919 Canadian Bankruptcy Act which dealt with both personal and corporate insolvencies was

¹⁵⁴ Insolvent Act 1869, s 1.

¹⁵⁵ *Ibid.*, s 2 for voluntary assignment, s 13 for compulsory liquidation and ss 94-95 for composition.

¹⁵⁶ Insolvent Act 1875, SC 1875, C16.

¹⁵⁷ TGW Telfer, 'A Canadian World without Bankruptcy: the Failure of Bankruptcy Reform at the End of the 19th Century' (2004) 8 *Austl. J. Legal Hist.* 83.

¹⁵⁸ S W Jacobs, 'A Canadian Bankruptcy Act- Is it a Necessity?' (1917) 37 *Canadian Law Times* 604, 605, 606.

¹⁵⁹ This applied to joint stock companies.

¹⁶⁰ Winding-up Act 1882-83, Ch. 23, S.C. 114(45-46 Vict.)

¹⁶¹ An Act to repeal the Acts representing Insolvency now in force in Canada SC 1800 C1, Bankruptcy Act, SC 1919, C36.

¹⁶² Janis Sarra, *Creditor Rights and the Public Interest* (University of Toronto Press 2003) Chap 1-2.

largely influenced by the English Bankruptcy Act 1883 with additional contributions from a range of previous Canadian laws such as the Insolvent Act 1875, the Winding up Act 1806 and several other provincial¹⁶³ Assignments and Preference Acts.¹⁶⁴

The 1919 Act dealt mainly with liquidation and just like the early bankruptcy laws in UK and the US, it acted as a collection and distribution tool for the satisfaction of creditors' claims.¹⁶⁵ This was the state of affairs until the great depression of the 1930s saw the passing into law by the Canadian Parliament of two statutes; the Companies' Creditors Arrangement Act¹⁶⁶ and the Farm Creditors Arrangement Act.¹⁶⁷ These statutes adopted a different approach to bankruptcy in Canada and allowed for the negotiation of an arrangement under which creditors could compromise their claims and debtors could carry on the business or farming operation.

2.5.3 Modern framework

After numerous amendments and reforms in 1949, 1992 and 1997, the 1919 Bankruptcy Act still forms the conceptual framework for the current Bankruptcy and Insolvency Act.¹⁶⁸ Presently, Canada has three main insolvency statutes which have separate purposes. These are the Bankruptcy and Insolvency Act 1985 (BIA), Companies' Creditors Arrangement Act 1985 (CCAA) and the Winding-up and Restructuring Act 1985 (WUA). While the BIA provides for both personal and corporate insolvencies with options of outright liquidation

¹⁶³ Canada was previously divided up into provinces.

¹⁶⁴ Duncan (n 25).

¹⁶⁵ Bankruptcy Act 1919, c.36.

¹⁶⁶ S.C 1933, c.36.

¹⁶⁷ S.C 1934, c.53.

¹⁶⁸ J S Ziegel, 'Canada's Phased-in Bankruptcy Reforms' (1996) 70 Am. Bankr. L.J 383.

or reorganisation for corporations, the CCAA applies to the reorganisation of businesses which are over \$5million in debt.

2.6 Corporate rescue in Canada

Corporate rescue had no place within the early bankruptcy laws in Canada. As in the UK and the US there was an apparent reluctance to assist debtor corporations. This common aversion can be traced to the US and Canadian jurisdictions' reliance on English bankruptcy law for guidance in adopting their own insolvency laws respectively. At the time when the two North American jurisdictions were looking to the UK for guidance, the UK was prejudiced against debtors¹⁶⁹ and viewed them as charlatans and this was reflected in the UK bankruptcy laws at the time. Notwithstanding this, debtors in Canada could seek some form of relief from the provisions of existing statutes through a compromise with creditors¹⁷⁰ even though they were sketchy at best and could not comprehensively achieve corporate rescue.

Although the Canadian jurisdiction's foray into corporate rescue is fairly recent when compared to the US jurisdiction, it has created several avenues (both specialist and non-specialist)¹⁷¹ under which a debtor company can be rescued, however this chapter will be making mention of the non-specialist Bankruptcy Acts which include the Federal Winding-

¹⁶⁹ V M Lester, *Victorian Insolvency: Bankruptcy Imprisonment for Debt and Company Winding up in 19th Century England* (Clarendon Press 1995).

¹⁷⁰ For example the Insolvency Act 1869, s 49, Insolvent Act 1875 ss 94-95, Bankruptcy Act 1919, s 13 made provisions for debtors to enter into an arrangement with their creditors for the satisfaction of the creditors' claims.

¹⁷¹ Bankruptcy and Insolvency Act, Companies Creditors' Arrangement Act, Winding-up and Act, Farmers Creditors and Arrangement Act (later known as the Farm Debt Review Act) and Canada Business Corporation Act.

up Act (WUA), the Bankruptcy Act (later known as Bankruptcy and Insolvency Act (BIA), with particular emphasis on the Company Creditors' Arrangement Act (CCAA).

2.6.1 Corporate Rescue (pre 1933, BIA to the present)

Corporate rescue in Canada prior to the enactment of the CCAA in 1933¹⁷² was dependent solely on the sparse provisions found within the old Federal Winding-up Act¹⁷³ and the 1919 Bankruptcy Act. The WUA had its antecedent in the English companies' legislation and applied to companies incorporated under federal jurisdiction and to insolvent provincial companies.¹⁷⁴ The WUA was limited in its scope of application, since it was mainly aimed at liquidation with some allowance for the reorganisation of some selected companies. The reorganisation allowed under the Act was in respect of new companies which were formed to buy out the assets of old debtor companies.¹⁷⁵ Although the WUA underwent some reforms and later became known as the Winding-up and Restructuring Act,¹⁷⁶ its provisions only apply generally to the winding-up of financial institutions under federal jurisdiction with a small provision for the winding up of insurance companies.¹⁷⁷ Consequently, unlike the CCAA and BIA, the WUA does not play a major role in the rehabilitation of large corporations.

The Bankruptcy Act 1919 on the other hand, had as its main aim the effective administration and liquidation of the bankruptcy estate.¹⁷⁸ Despite its limited structure and

¹⁷² Companies' Creditors Arrangement Act 1933, 23-24 Geo.V, c. 36.

¹⁷³ Federal Winding-up Act 1927 R.S.C. c .213 as amended 20-21 Geo. V, c.49 as amended by the CCAA 1933, 23-24 GEO. 5, c.36 (1933) notwithstanding the fact that the Act mainly provided for court supervised liquidation of companies.

¹⁷⁴ R V Wright, 'Corporate Salvage: England and Canada' (1985) 34 int'l & comp. L.q. 25.

¹⁷⁵ Levi and Moore (n 88).

¹⁷⁶ (R.S.C., 1985, c. W-11).

¹⁷⁷ Winding up and Act 1985, s 159.

¹⁷⁸ Telfer (n 157).

scope of application, the Act made provisions for the debtor to make an offer of composition, extension or a scheme of arrangement with its creditors.¹⁷⁹ The plan of composition however, had to be sanctioned by three-fourths in amount of all proved claims before it was approved and the courts had complete discretion to approve or disapprove the plan on whatever grounds it deemed fit.¹⁸⁰

Further amendments were made to the Act in 1923. A proposal was made to introduce reforms to enable a restructuring or compromise prior to the occurrence of bankruptcy but this was rejected¹⁸¹ in favour of the post-bankruptcy compromise that the 1919 Act favoured. The post-bankruptcy restructuring, as intended by the amending Act, did not enjoy much success because it proved to be quite difficult to rescue a company when it became bankrupt and as a result some companies went into premature liquidation.

Despite its lack of use, in 1932, the Bankruptcy Act was amended to make room for debtor companies to propose a compromise with their creditors. Its aim was to provide respite for the company to enable it restructure its debt. This provision was further consolidated by section 27 of the Canadian Bankruptcy Act 1949 which allowed an insolvent company to make a proposal to its creditors for either a composition, extension of time or a scheme of arrangement. The aim of the proposal was to enable the debtor company to continue trading and to retain possession of its assets by going into an agreement with unsecured creditors to have its debt reduced or to seek an extension of time within which to meet its obligations.

Further amendments were made to the Bankruptcy Act (which became the Bankruptcy and Insolvency Act “BIA”) in 1992¹⁸² to cater for the restructuring of insolvent small and

¹⁷⁹ Bankruptcy Act 1919, s.18.

¹⁸⁰ *Ibid.*

¹⁸¹ L Duncan and W Reilley, *Bankruptcy in Canada* (2nd edn, Canadian Legal Authority 1933) p 168.

¹⁸² Bankruptcy and Insolvency Act (BIA), ch. 27, 1992 S.C.

medium-sized enterprises.¹⁸³ The erstwhile inability of the court under the previous Act to bind secured creditors under compositions and schemes of arrangement was rectified by the amendments introduced to the 1992 Act. In general, the provisions of the BIA are designed for the restructuring of small to medium sized companies but they can also be used by large corporate debtors. The BIA has since undergone various amendments, the most recent being in 2009 which introduced provisions on corporate rescue funding¹⁸⁴ and the assignment of priority to such funds. Nonetheless, the basic framework as it relates to corporate rescue still remains the same.

2.6.2 Corporate Rescue (CCAA, 1933 onwards)

The administration of bankruptcy in Canada changed with the introduction of the Companies' Creditors Arrangement Act (CCAA) in 1933. The CCAA was enacted in recognition of the limited procedures available under the existing statutes for restructuring.¹⁸⁵ Another factor that influenced the Act's coming into being was the economic depressions of the 1930s¹⁸⁶ which led to the failure of a lot of corporations. The aim of the CCAA, which was fashioned after the British Companies Act 1929,¹⁸⁷ was to facilitate corporate rescue by promoting compromises and arrangements between corporations and their creditors. The CCAA which was enacted in response to the economic realities at the time may be seen as an illustration that the economy of a country influences the creation and the type of bankruptcy laws in force at a particular time. The US

¹⁸³ Sarra (n 162).

¹⁸⁴ BIA 1985, s 50.6.

¹⁸⁵ Sarra (n 162) p13.

¹⁸⁶ J S Ziegel 'The Modernization of Canada's Bankruptcy Law in a Comparative Context' (1998) 33 Tex. Int'l J. 1, 5-6.

¹⁸⁷ Sarra (n 162).

jurisdiction also responded in like manner when faced with economic depression throughout its history of enacting bankruptcy laws.

The fundamental principle underscoring the 1933 CCAA was to provide an avenue for company rehabilitation as an alternative to liquidation.¹⁸⁸ The CCAA allowed companies to restructure their debt under heavy supervision by the courts which had the power to exercise their discretion at every stage of the reorganisation process. Additionally, the CCAA acted to bind all creditors in order to facilitate the rescue process and this ability to provide a mechanism which binds both secured and unsecured creditors was one of the main objectives behind the creation of the CCAA as other pre-existing bankruptcy provisions were unduly lacking in this feature.

Due to the dearth of a better option to effect a reorganisation under the CCAA and the courts' broad powers and its willingness to exercise those powers in interpreting the CCAA, the CCAA became an important instrument of choice for both large and small companies who needed to be bailed out of the financial difficulties they found themselves in.¹⁸⁹ The downside of rescue under the provisions of the CCAA also lay with the reason why it proved to be very attractive to corporations; the courts' discretionary powers. Whilst these powers could be used to interpret the CCAA favourably, it also meant that any stay of creditors' action was at the discretion of the court as this did not come automatically upon the initiation of the reorganisation process.¹⁹⁰ This stay, prior to or during the reorganisation process, is distinct from the binding effect of an approved proposal under the CCAA. What this then meant, was that a secured creditor, where the court had not utilized its discretion

¹⁸⁸ *Ibid.*

¹⁸⁹ J S Ziegel (n 168).

¹⁹⁰ See an Act to amend the Companies' Creditors Arrangement Act, 1933, Ch.3, 1952-1953 S.C. 7, s 11

to impose a stay, could enforce his security, even where a plan had been approved and it was binding on all creditors.

Criticisms of the potential for abuse under the CCAA led to amendments in 1953 which restricted debtor companies with an outstanding issue of bonds and a trustee representing the bondholders' interest from having access to the Act.¹⁹¹ The CCAA was largely abandoned for decades thereafter due to the restrictions imposed by the amendment and its inability to satisfactorily handle major reorganisations.¹⁹² The effects of the economic recessions of the 1980s and 1990s however brought out ingenuity on the part of the Canadian courts who adapted the Act to meet the crisis.¹⁹³ At this point a parallel could be drawn between what debtors, secured creditors and judges in the US jurisdiction did with the equity receivership and what the Canadian courts resorted to when faced with financial crisis and not enough legislative clout to handle it, due to the rigid approach adopted by the Bankruptcy Act in dealing with corporate insolvencies.

On the whole, what the Canadian courts did was to assume inherent powers¹⁹⁴ under the CCAA to ensure that Parliament's intention to create a successful rescue culture for companies facing insolvency was met.¹⁹⁵ Consequently, the Canadian jurisdiction was able to develop a set of power and practices which emulated the US Chapter 11 rescue mechanism devoid of the formal safeguards and restrictions imposed for the protection of creditors' rights which the latter provided for.¹⁹⁶ Subsequent amendments to the CCAA by Bill C-36 in 1997 still maintained the basic elements of the CCAA, but introduced some

¹⁹¹ An Act to amend the Companies' Creditors Arrangement Act, 1933, Ch.3, 1952-53 S.C.7.

¹⁹² Advisory committee on Bankruptcy and Insolvency, Report of the Advisory Committee on Bankruptcy and Insolvency (2nd edn, 1986) p 50-51.

¹⁹³ Ziegel (n 168).

¹⁹⁴ This included granting automatic stays restraining all litigations against the debtors and compelling suppliers to continue to supply goods and services even where there was no guarantee of payment.

¹⁹⁵ Ziegel (n 168).

¹⁹⁶ *Ibid.*

changes which included the requirement that a ‘monitor’ be appointed to oversee the business and financial affairs of the company.¹⁹⁷

2.6.3 Post- CCAA reforms

The corporate rescue procedure under the present CCAA¹⁹⁸ remains relatively the same with the exception of the provision on interim financing¹⁹⁹ introduced by the 2009 amendment. This provision gives judges express powers to approve corporate rescue funding and to assign priority in the hierarchy of claims as it relates to both pre-commencement financing and post-commencement financing. In the past, this was one area in which judges had to rely on their discretionary powers to approve corporate rescue funding and to assign priority in respect of it.

The Canadian jurisdiction presently has two main statutes governing insolvency and bankruptcy, one is the BIA which deals with insolvent small to medium sized businesses and is mainly concerned with the structured sharing of assets among creditors upon a company’s bankruptcy.²⁰⁰ The CCAA on the other hand deals with the large corporations and is intended for the period in which the company becomes insolvent and is making reorganisation plans.²⁰¹ These two statutes provide distinct but corresponding procedures by which companies can facilitate a rescue through proposals, plans of arrangement and compromises with the aim of restructuring their debt and returning to viability.²⁰² This model of having two statutes dealing with insolvency was practised in the UK before the

¹⁹⁷ M Smith, Bankruptcy Law Update (88-16E) Library of Parliament, Parliamentary Research Branch. 18TH May 1999.

¹⁹⁸ CCAA.

¹⁹⁹ CCAA, s 11.12.

²⁰⁰ J Sarra, ‘Debtor in Possession Financing: The Jurisdiction of Canadian Courts to Grant Super-Priority Financing in CCAA Applications’ (2000) 23 Dalhousie L.J. 378

²⁰¹ *Ibid.*

²⁰² Sarra (n 162) chap 1.

enactment of the Insolvency Act 1985 which saw the unification of corporate bankruptcy and personal bankruptcy under one statute. This is where the similarity ends as the Canadian jurisdiction administers both corporate (albeit small companies) and personal bankruptcy under the BIA with the CCAA dealing exclusively with big corporations.

Apart from these statute backed rescue mechanisms, the Canadian jurisdiction makes use of private workouts to facilitate the rescue of a company and oftentimes this is the first option that corporations adopt (usually companies with few creditors).²⁰³ One of the major advantages of private workout is that it does not easily draw attention to the company's financial difficulties.²⁰⁴ Such workouts are often quicker, faster and cheaper than the court supervised process. However, one of their major drawbacks is that the procedure is best suited to small companies and in most cases, corporate insolvency involves large corporations.²⁰⁵

It appears that in most jurisdictions, there are opportunities for companies to effect private restructuring when faced with financial difficulties. Oftentimes, it is done in conjunction with major creditors (in most cases, banks) to the companies, who come to a form of agreement to restructure the debt owed them. These efforts are usually confidential in nature and are more often than not, exhausted as a means of corporate rehabilitation before these companies attempt the statute backed mechanisms.

2.7 Perception of debt and its influence on bankruptcy laws

²⁰³ J Honsberger, *Debt : Principles and Practice* (Aurora Canada Law Book 1993).

²⁰⁴ *Ibid.*

²⁰⁵ *Ibid.*

Free enterprise enables the creation of credit and as a result increases the risk of insolvency.²⁰⁶ Insolvency/bankruptcy is a legal concept but the issues arising from it extend beyond the law. A country's attitude to bankruptcy is often a consideration of a multitude of broader issues.²⁰⁷ The earliest concept of bankruptcy and a punitive societal attitude to debt was very much centred on personal bankruptcy and this seems to have somehow transcended to corporate entities.²⁰⁸ While it remains important to punish the dishonest or reckless insolvent, it is also important to devise a system of law to deal compassionately with the honest though unfortunate debtor. The system must arguably enable the insolvent to extricate himself from a situation of hopeless debt as quickly and as cheaply and with as little fuss as possible.²⁰⁹ The perception of a society concerning the forgiveness of debts may impact on the success of a second chance opportunity given to a debtor. This is so, because law is a mirror of society²¹⁰ and is often a reflection of the influence of the accepted social morality.²¹¹ Often these laws reflect what is happening in the society and assume the shape of these societies. Therefore it may be presumed that a society's insolvency laws, especially as they relate to corporate rescue, are a reflection of its attitude towards debt and in most cases its moral view on the subject has some bearing on this attitude.

Each of the three jurisdictions, the UK, Canada and the US, have approached corporate rescue in different ways and their laws reflect this. It is remarkable that the three countries have chosen to tackle issues of bankruptcy differently, considering that Canada and the US had previously transplanted English laws on a large scale. When viewed from the

²⁰⁶ Cork Report at para 23.

²⁰⁷ K Gross, 'Demonizing Debtors: A Response to the Honsberger-Ziegel Debate' (1999) 37 *Osgoode Hall L.J.* 263

²⁰⁸ An example of society's punitive attitude towards corporate insolvency can be glimpsed from the Insolvency Act 1986, which strips management of their powers once a company becomes insolvent and the various provisions under which directors of an insolvent company can be held liable (wrongful trading, fraudulent transactions).

²⁰⁹ Cork Report at para 23.

²¹⁰ B Z Tamanaha, *A General Jurisprudence of Law and Society* (Oxford University Press, 2001).

²¹¹ H L A Hart, *The Concept of Law* (1st edn. Oxford University Press, 1961) at p 199.

standpoint of what the intended aims of these laws are, it does appear that all three have a similar objective; that is to rescue a failing company which has a good forecast of returning to viability. However, an in-depth examination reveals a clear difference in the structures put in place and what is actually achieved; business rescue as opposed to company rescue in the UK and company rescue in most cases in the US and Canada. Although both the US and Canada borrowed heavily from English laws,²¹² the US for one, did not adopt the unforgiving and highly administrative English bankruptcy process.²¹³ This may be attributed to the fact that the US economy evolved into a much more competitive and capitalistic one and therefore needed to encourage debt forgiveness which was seen as critical to a vibrant US economy.²¹⁴ The focal point of the US system shifted to one of attempting to achieve a balance between the desires of creditor groups and debtor groups and promoting commerce.²¹⁵

Presently, the US Chapter 11 regime is, on the surface, debtor centred²¹⁶ and is more considerate and accommodating of the management when the company runs into financial troubles.²¹⁷ The process of rescue is initiated by the management of the debtor company (except where a trustee is appointed) who retains his position and functions as the debtor-in-possession (DIP), on the commencement of the re-organisation of the company (albeit with a newly acquired legal status as a quasi-trustee in bankruptcy).²¹⁸ The DIP continues to run the business of the company, but has no say over major decisions without the approval of the bankruptcy court.²¹⁹ Despite this, the DIP is given a lot of powers under

²¹² N Martin, 'Common-law Bankruptcy Systems: Similarities and Differences' (2003) 11 Am. Bankr. Inst. L. Rev. 367.

²¹³ Skeel (n 88).

²¹⁴ G E Brunstad, 'Bankruptcy and the Problems of Economy Futility: a Theory on the Unique Role of Bankruptcy' (2000) 55 Bus. Law. 499, 521-22.

²¹⁵ Skeel (n 88).

²¹⁶ In recent times creditors have been able to wrestle control through DIP finance.

²¹⁷ See generally, R Parry, *Corporate Rescue* (Sweet & Maxwell, 2008).

²¹⁸ G Moss, 'Chapter 11; An English Lawyer's Critique' (1998) 11 Insolvency Intelligence 17 at 18-19.

²¹⁹ See 11 U.S.C. s 329 (hiring and payment of fees and expenses to attorneys), s 363 (assets sale), s 365 (executory contracts).

Chapter 11. The most important of these is an exclusive period of 120 days in which to file a re-organisation plan²²⁰ with a further extension of 180 days²²¹ up to a maximum of 18 months. In essence the DIP is the pivot on which the whole rescue process rests.

In the US it has been observed that debtors are celebrated as savvy businessmen for undertaking risky business ventures while creditors are scorned for being greedy.²²² The Chapter 11 regime is intensely focused around the prevention of the social cost of liquidation and the preservation of the company as a going concern.²²³ As a result, society is more accepting of debtors. The procedure has the full backing of the courts in the US, which have been praised for their efforts regarding the debtor in possession procedure. The US judiciary's efforts towards the procedure have been regarded as "pragmatic and compassionate, facilitating enterprise and initiative and contributing to the creation of the most successful economy in the world".²²⁴

In the UK, business failure has tended to be viewed negatively²²⁵ and an early example of this attitude towards debt is rooted in the first English bankruptcy law²²⁶ which was enacted in 1542. The preamble to the 1542 Bankruptcy Act which read thus; "*where divers and sundry persons, craftily obtaining into their hands great substance of other men's goods...*" describing the debtor as an anti-social, immoral character who often took advantage of others.²²⁷ These early laws were designed solely for the benefit of the creditor,²²⁸ in debt enforcement and were highly retributive in nature.²²⁹ In effect they

²²⁰ 11 U.S.C., s 1121 (b).

²²¹ *Ibid*, s 1121(c) (3).

²²² Moss (n 218).

²²³ V Finch, *Corporate Insolvency Law* (2nd edn, Cambridge, 2009).

²²⁴ Hunter (n 54) at 519.

²²⁵ Skeel (n 88) at p37-38.

²²⁶ Although these laws were geared towards personal insolvency, it gives an overview of how debt was viewed generally

²²⁷ 1542-43 (34 & 35 Hen. 8, c.4).

²²⁸ R Weisberg, 'Commercial Morality, the Merchant Character and the History of the Voidable Preference' (1986) 39 Stan. L. Rev. 3, 21.

²²⁹ C J Tabb, 'The Historical Evolution of the Bankruptcy Discharge' (1991) 65 Amer. Bankr. L.J. 325, 336.

became a tool used by creditors against a debtor.²³⁰ Whereas bankruptcy laws have changed and appear to be more magnanimous towards debtors, the underlying attitude towards debtors has not arguably evolved at the same rate. It has been observed that English society still to a large extent remains unforgiving about financial failure²³¹ and generally considers it a weakness of character regardless of what caused the failure.²³²

This attitude continued in diminishing strength until the 1985-6 reforms to insolvency law.²³³ The Cork Committee²³⁴ which deliberated on insolvency reforms observed that previously, within the policy of the UK insolvency laws, two major objectives existed.²³⁵

These were;

- Debt collection, under which insolvency laws were treated essentially by the trading community as tools for debt recovery, as a weapon of persuasion to induce defaulting debtors to pay or make proposals for the settlement of debts.
- Upholding commercial morality through the investigative processes of insolvency laws and the imposition of disciplinary measures against debtors who the investigations revealed were culpable.

While the Cork Committee de-emphasised these objectives, it nevertheless supported what these policies aimed to achieve.²³⁶ The Insolvency Act 1986, influenced by the Cork Report and which was further amended by the Enterprise Act 2002, reformed the administration process which appeared to give the debtor a second chance. However, a study of the

²³⁰ *Ibid.*

²³¹ L Kemeny and G Alexander, 'Blair chases American Dream' *Times* (London), 18 February 2001).

²³² L Hoffman, 'Cross-border Insolvency: a British perspective' (1996) 64 *Fordham L. Rev.* 2507. See also, K Kwasi, P Patel, D Raab, C Skidmore & E Truss, *Britannia Unchained: Global Lessons for Growth and Prosperity* (Palgrave Macmillan, 2012) p 92-92.

²³³ N A Aminoff, 'The Development of American and English Bankruptcy Legislation-from a Common Source to a Shared Goal' (1989) 10 *Statute L. Rev.* 124.

²³⁴ Cork Report at p235.

²³⁵ *Ibid* at 235.

²³⁶ *Ibid* at para 238-240.

administration process paints a different picture. Management is displaced and an insolvency practitioner is appointed to run the affairs of the company during the rescue process.²³⁷ Administration gives more priority to creditors, as can be seen from the objectives of the administration order which an administrator is duty bound to achieve.²³⁸ While the company is under administration, the administrator takes over all management functions and may do anything necessary to manage the assets, business and affairs of the company.²³⁹ An administrator has powers to take control and possession of the company's properties, to sell and dispose of them, to bring and defend any legal action on behalf of the company. The administrator also has powers to dismiss and appoint directors to the company.²⁴⁰

It has been observed that in the UK, debtors are liable to be punished as risk takers²⁴¹ who must be made to pay for whatever financial troubles a company finds itself and this is supported by provisions in the Insolvency Act 1986²⁴² and the Company Directors Disqualification Act 1986.²⁴³ The provisions of these statutes bring a threat of court actions against the company directors in the event that the company becomes insolvent,²⁴⁴ and if it is discovered inter alia that the directors continued trading after becoming aware that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Also creditors in the UK have a propensity to firmly believe that once a company faces financial ruin, the management of the company should be taken out of the debtor's hands and put into those of professionals.²⁴⁵ This perception is documented by authors such as

²³⁷ Insolvency Act, 1986, Sch B1.

²³⁸ *Ibid*, Sch.B1 para 3.

²³⁹ *Ibid*, Sch B1 para 59(1).

²⁴⁰ *Ibid*, Sch B1 para 61.

²⁴¹ G Moss (n 218) at 18-19.

²⁴² Insolvency Act, 1986, s 214.

²⁴³ *Ibid*, s 6, s 8.

²⁴⁴ It should be noted that the operation of the Company Directors Disqualification Act is not restricted to directors of insolvent companies alone.

²⁴⁵ Insolvency Act, 1986 s 6, s 8.

Goode who stated that insolvency law in the UK is based on the premise that where a company is in financial difficulties, it is as a result of mismanagement and therefore those responsible for the company's financial woes should not be left in control of the company.²⁴⁶

The Canadian bankruptcy system on the other hand, while sharing the same historical origin as the US system, did not adopt the same sympathetic stance as in the US, rather English law and its underlying retributive attitude was integrated into Canadian laws.²⁴⁷ Although discharge was available for traders,²⁴⁸ in general the issue of debt was not looked upon favourably. Bankruptcy was regarded as “commercial immorality and fraud which brought disgrace to Canada in the eyes of other nations.”²⁴⁹ Things have however improved since then; there has been a gradual shift from an intolerant attitude towards debt to a more forgiving one. The Canadian system has evolved to one that aspires to ensure fairness for the debtor and the introduction of rescue mechanisms under the BIA and the CCAA bears testament to this. The aim of these mechanisms is to provide debtors with tools to avoid bankruptcy and this is balanced against fairness to creditors who expect full payment on a timely basis.²⁵⁰

The review committee²⁵¹ set up in 2003 to look at improving the insolvency procedures available in Canada, acknowledged that insolvency is not always as a result of financial mismanagement and that risk taking behaviour contributes to success in a market-based

²⁴⁶ Goode (n 48).

²⁴⁷ Brunstad (n 214).

²⁴⁸ See generally T G W Telfer, ‘Ideas, Interests, Institutions and the History of Canadian Bankruptcy, 1867-1880’ (Spring, 2010) University of Toronto Law Journal.

²⁴⁹ Letter from Arthur James Johnes, (Judge of the county courts (Midlands Wales Circuit)) in response to proposed reforms to abolish the imprisonment of debtors (1st March 1886).

²⁵⁰ Report of the Standing Committee on Banking, Trade and Commerce, ‘Debtors and Creditors sharing the Burden: a Review of the Bankruptcy and Insolvency Act and the Companies’ Creditors Arrangement Act (2003).

²⁵¹ *Ibid.*

economy, despite some attendant failures. Therefore, while encouraging responsible behaviour, opportunity must be given to the debtor to recover.

The CCAA plays a major role in the rehabilitation of debtors and was essentially enacted for that purpose. It stands between the UK administration and US Chapter 11 procedures in the sense that management is not displaced, but a monitor is appointed to assist management during reorganisation.²⁵² Provision is also made within the Act to enable the debtor raise funds to possibly ensure the success of the company's reorganisation. It therefore appears that Canada seems to have completely moved away from its retributive past.

2.8 Comparative analysis

It is interesting that the early history of bankruptcy laws in the three jurisdictions under comparison shows that at one time Canada and the US relied on the UK bankruptcy law as a point of reference and guide to draw up their respective bankruptcy laws. These bankruptcy laws were mainly directed at traders and non-traders and they all had similar provisions with an underlying notion of retribution for the wrongs of debtors. Corporate bankruptcy was not officially recognised within these early laws because complex commercial structures, whose collapse would have warranted the adoption of a framework to deal with their collapses, were not in existence during the period when those early bankruptcy laws were in force.

In the UK, the Joint Stock Company Act 1844 along with its corresponding Winding-Up Act represented the first acknowledgement of corporate bankruptcy. This was the first

²⁵² CCAA, s 11.7.

legislative attempt by the UK to formally address the problem of corporate failures. The US on the other hand recognized corporate failures for the first time with the Bankruptcy Act 1867 which made provisions for the collapse of partnerships, corporations and joint stock companies authorized to carry on any business with the aim of making profits. In Canada, the Winding-Up Act 1882 was the first legislative acknowledgement of corporate bankruptcies. The Act dealt the winding up of insolvent trading corporations, railways, banks and other financial institutions.

A review of the history of corporate rescue shows that all three jurisdictions had provisions for compromise in their early bankruptcy laws, which seem to indicate that the early bankruptcy statutes provided an opportunity for a debtor company to re-organize its affairs. However, the US was the first to incorporate a corporate rescue culture into their bankruptcy laws in 1898 and the 19th century railway equity receivership had a huge impact on how bankruptcy laws relating to corporate reorganisation were constructed. Canada followed with the enactment of the CCAA in 1933 which facilitated corporate rescue by promoting compromises and arrangements between corporations and their creditors. In the UK, the enactment of the Insolvency Act 1986 represented the first official legislative implementation of a rescue culture.

The three jurisdictions share one common feature in their adoption of rescue mechanisms, which is ingenuity in the creation and application of the procedures which facilitate corporate rescue. While the US's equity receivership was a result of the initiative of creditors, judges and lawyers, the judges while interpreting the provisions of the CCAA were able to rely on ingenuity to adapt the laws so as to successfully rehabilitate companies. The UK on the other hand, had through the Chancery Courts developed the administrative receivership which, when used as a rescue tool, was effective in its application. This move towards rescue-oriented bankruptcy laws by all three jurisdictions demonstrates a shift from

the hitherto collection and distribution mechanism for creditors that previous bankruptcy laws represented. With corporate rescue, debtors were given a chance not only to come to an agreement on how creditors' claims would be met but also an opportunity for a fresh start.

When it comes to corporate rescue mechanisms, the three jurisdictions display variety in the ways in which they have created tools of corporate rescue. While the US relies mainly on the Chapter 11 procedure for rehabilitation of companies, the UK and Canada make available a variety of options to the debtor. Canada, as earlier discussed, relies chiefly on the CCAA and the BIA, giving debtors a choice of which to adopt to suit their purposes. The UK on the other hand, has a variety of procedures available for debtors to follow and like Canada; these procedures can be found in two different statutes. In the management of the rescue process, the UK and Canada have to some extent adopted comparable styles, in that they have chosen to have an independent party to manage the rescue process.²⁵³ However, in Canada, management continues to direct the affairs of the company, whereas in the UK management is displaced. In the US, management is left at the helm of affairs and is given exclusive powers to start the rescue process. Whilst it does appear that the debtor has an overwhelming influence on the rescue process in the US, it must be noted that the courts play a supervisory role in the rescue process and can exert a lot of influence on how the process is managed.²⁵⁴

An analysis of bankruptcy provisions in the three jurisdictions appears to portray the US and Canada as having a more debtor-friendly bankruptcy law than the UK which is seen as still seemingly less debtor- friendly. Whilst reforms which have been made within the UK

²⁵³ An assumed trait of a creditor-friendly system which holds the directors liable for ruining the company, yet the Canadian jurisdiction has chosen to adopt this feature of having an independent party run the rescue process.

²⁵⁴ See generally, 11 U.S.C. s 329 (hiring and payment of fees and expenses to attorneys), s 363 (assets sale), s 365 (executory contracts).

with the introduction of the rescue culture, paint a picture of a jurisdiction willing to leave behind its historical antecedence of treating debtors as pariahs, the strict provisions²⁵⁵ relating to directors' liability in the Insolvency Act 1986 before and during the bankruptcy seem to undermine the view that the perceptions about debtors have changed. However a closer analysis of directors' liability in insolvency shows that a director who has taken every step by entering into a formal/informal insolvency procedure so as to minimise losses to creditors, need not fear liability.

The reason behind these three jurisdictions taking different approaches to corporate bankruptcy, considering they all had a common philosophy at some point within their history, has its roots in politics. The move by the US and Canada from a creditor-friendly system to a more debtor-friendly system was influenced by intense lobby groups made of businessmen, farmers (in the case of Canada) and politicians²⁵⁶ who favoured such an approach. These lobbyists were able to rally enough support to push their ideas forward. Mention must also be made of the role that the American Bar Association (ABA) and the Commercial Law League played in shaping the bankruptcy laws in the US. These two groups, most especially the ABA, exerted a lot of influence and were actively involved in advocating and expanding bankruptcy laws over the years.²⁵⁷

In addition to the political impetus driving reforms, a combination of economic necessities and the existence of a government in favour of these changes assured a shift in paradigm. It should be pointed out here that while the US and Canadian bankruptcy laws may be regarded as children of economic depressions, the UK does seem to have, amongst the numerous provisions it had on bankruptcy, enacted just one in response to an economic depression i.e. the Insolvency Act 1985 which was consolidated as the Insolvency Act

²⁵⁵ See Insolvency Act 1986, ss 212 & 214. See also Companies Act 1985, s 488.

²⁵⁶ Telfer (n 157); also Sarra (n 1) Chap 1-2 and Skeel (n 82).

²⁵⁷ Skeel (n 88) p 44-45.

1986. It therefore seems probable that economic depressions are likely to lead to bankruptcy law reforms; however reforms appears to be dependent on the ability of interested parties to successfully lobby for change and the government's willingness to see such reforms passed into law. In the past, banks in the UK have been able to exert their influence²⁵⁸ on changes that have been made to insolvency laws. The status of banks as one of the major providers of credit makes them key players in bankruptcy. Nevertheless, it remains to be seen if future reforms to UK insolvency laws will come under the steam of creditor lobby groups (made up generally of banks) or debtor lobby groups.

Concluding remarks

It is clear from history that the creation of laws supporting corporate rescue is an ongoing process which will continue to be fine-tuned through the years. The US is well on its way to its next phase with the creation of the Chapter 11 Commission which was set up in April 2012 to look at ways in which the Chapter 11 process could be reformed to meet present economic realities.²⁵⁹ There have also been consultations on the possibility of reforms to the Insolvency Act 1986 (UK). History shows that legislative reform is a gradual process that checks the workability of what is available at a particular point in time and different factors which cannot be duplicated have made corporate rescue laws what they are. Each jurisdiction has been able to adopt a functional equivalence of these rescue mechanisms to suit its own underlying cultural, economic and political nuances. One thing is clear; a

²⁵⁸ See generally, Cork Report.

²⁵⁹ P Moffat, 'Conference Report (INSOL Europe Academic Forum & Nottingham Law School Joint international Insolvency Conference, Nottingham, 28 & 29 June 2012)
<http://www.ntu.ac.uk/nls/document_uploads/123423.pdf>accessed 10th June 2014.

country's economy, politics and the ability of interested parties to assert sufficient influence are key factors in shaping corporate rescue laws.

Also, societal needs have an immense influence on political, economic, social and legal structures that are put in place and a great part of this is dependent on perceived notions held by the society. Most times, laws are a reflection of the society. Generally, the UK, Canada and the US started off with an approach of retributive justice against debtors, but as societal needs changed, their perception of debt did, albeit in varying degrees. A great divide seems to exist in how the UK, on the one hand, and Canada and the US on the other hand, perceive debt. The result of this is that, corporate rescue is conducted differently in all three jurisdictions, more so when it comes to how rescues are funded.

In encouraging corporate rescue all three jurisdictions have recognised the importance of the availability of continuing finance to support the process. Both Canada and the US have made clear provisions in their quest to facilitate the effective rescue of companies by enacting enabling laws which incentivize and so encourage debtor-in possession financing (DIP financing). This is a process whereby debtors can offer super-priority to new credit obtained after the onset of bankruptcy, to enable them access much needed funds to continue trading. DIP financing and its associated elements which is the particular focus of this thesis will form the basis of the next and subsequent chapters.

Chapter III: Funding of the corporate rescue process¹

Introduction

‘An army may march on its stomach, but for companies, it is liquidity that keeps the business going’.² Continuing finance is fundamental to any corporate rescue plan and often when a company is financially distressed it inevitably finds itself in a situation where access to finance is limited. The distressed state of the company may disincentivize existing and potential lenders from lending money to the company, as it is likely that at this point the company’s assets may be heavily leveraged and lending money to an insolvent company without any form of security may be counter-productive. Negotiating for the much needed finance becomes a challenging task as the conflicting interests of all stakeholders³ must be taken into account.

Consequently an established provision that clearly incentivizes prospective post-commencement financing, i.e. funds needed by the debtor company to enable it continue trading during the rescue period,⁴ and which outlines how these new creditors (who often demand priority payments over pre-existing creditors) will fit into the debtor’s repayment plans,⁵ is important in achieving an effective rescue of the company. Therefore, this chapter

¹This chapter has been previously incorporated into two articles published in the Annual review of Insolvency Law 2013 and the IALS Student Law Review 2014. See appendix for details.

² B Eisenbach, ‘DIP Financing: How Chapter 11’s Bankruptcy Loan Rules Can Be Used To Help A Business Access Liquidity’ (In the Red®- The Business Bankruptcy Blog, 5th November 2013) <http://bankruptcy.cooley.com/2013/11/articles/business-bankruptcy-issues/dip-financing-how-chapter-11s-bankruptcy-loan-rules-can-be-used-to-help-a-business-access-liquidity/> accessed 13th July 2014.

³ Rescue funding comes with some attendant issues, foremost of which is the ability of the courts to adjust creditors’ priorities within the hierarchy of claims. Rescue funding can interfere with the rights and interests of pre-existing creditors. Pre-existing rights and priorities of existing lenders/creditors are often displaced by the claims of post-commencement lenders/creditors. See section 5.3 of the thesis for an in-depth discussion on how rescue funding re-assigns creditors’ priorities.

⁴ However, it should be noted that where it is a pre-packed administration such funds are not needed as the business would have been sold off prior to the administration commencing. This is discussed in further details in section 3.4.2.1 of the thesis.

⁵ L Qi, ‘Availability of Continuing Financing in Corporate Reorganisation: the UK and US Perspective’ (2008) 29 Comp. Law. 162-167.

examines how statutory frameworks may provide incentives to encourage creditors to make available new money or additional funds during the rescue process.

The need for post-commencement financing is not only restricted to statutory frameworks for formal rescue proceedings; it also extends to quasi-formal rescue frameworks.⁶ Quasi-formal rescue frameworks such as private workouts play an important role as the first point of call for struggling businesses. In most cases, the opportunities for rescue provided by informal frameworks may have been exhausted by the debtor company before the debtor company enters into any of the formal statutory-backed frameworks for rescue. As a result, the interrelationship between quasi-formal rescue frameworks such as the pre-pack administration and private workouts and the availability of post-commencement funding will also be evaluated.

Many jurisdictions have come to the realisation that employing rescue strategies to tackle insolvency requires finding a way of funding the business of the company until a favourable outcome can be achieved.⁷ UNCITRAL recognized this fact when it stated that new finance is a vital requirement needed to ensure the continued operation of the business while its future is being determined.⁸ While some governments have been known to offer financial bailouts to rescue failing companies,⁹ the private sector is where most businesses look to for support.¹⁰ From what has already been stated, it seems clear that in most instances a

⁶ See section 3.4.2 of thesis for detailed definition of quasi-formal rescue frameworks.

⁷ This could either be a restructuring of debt and equity, a going concern sale or a liquidating sale. See J Sarra, 'Financing Insolvency Restructurings in the Wake of the Financial Crisis: Stalking Horses, Rogue White Knights and Circling Vulture' (2010-2011) 29 Penn St. Int'l Rev. 581.

⁸ UNCITRAL Guide.

⁹ See D Teather, 'US bails out General Motors-related Company GMAC with further \$3.8 bn' *The Guardian* (London, 1 January 2010) <<http://www.guardian.co.uk/business/2010/jan/01/us-bails-out-gmac-general-motors>> accessed 12TH October 2012. The US Government has given financial bailouts to both Chrysler and GM Motors. Note that while the UK government have in the past been able to bail out failing banks such as RBS, this was done under strict adherence to EU Regulations as the provision of state aid is strictly monitored and controlled in the EU.

¹⁰ R D Vriesendorp and M A Gramatikov, 'Funding Corporate Rescue: The Impact of the Financial Crisis' (2010) Int. Insolv. Rev. Vol. 19: 209-237.

successful rescue cannot be divorced from the issue of new funding being obtained during the rescue process.

The discussion in this chapter will begin with a brief explanation of the importance of corporate rescue funding. This will be followed by an analytical discussion of rescue funding in the three jurisdictions that have been selected for this study, beginning with the US.

3.1 The importance of funding in corporate rescue

Bankruptcy procedures have evolved from being tailored towards the winding up of a debtor company in order to satisfy creditors' claims, to having, at their core, the rescue of a company or its business, as the case may be. However, this does not detract from the fact that some companies are simply not suited to corporate rescue proceedings or re-organization because they are not economically viable, and therefore creditors are better served if those companies are liquidated.¹¹ Generally speaking, the main theory underpinning corporate rescue is that a company may be worth significantly more if preserved or, where this is impracticable, sold, as a going concern¹² as opposed to the piecemeal sale of its assets.¹³ While this is a laudable goal in light of the potential for job preservation and retaining the company within the economy, there are sundry issues that make up the rescue regime and with which the debtor company has to contend with in order to achieve a successful rescue.

¹¹ UNCITRAL Guide.

¹² A company rescue is achieved where the company is rescued as a whole as opposed to a business rescue where the business or parts of the business is sold as a going concern, leaving the empty shell that is the company behind.

¹³ G McCormack, *Corporate rescue law- an Anglo American Perspective* (Edward Elgar, 2008).

Corporate rescue is a multi-faceted procedure. Each facet must be dealt with appropriately in order to achieve the overall aim of rescuing the company, its business or parts thereof. First and foremost, the debtor company has to decide which of the available rescue procedures is appropriate to its circumstances, taking into account the nature and magnitude of the problem and the type of resources available to the company.¹⁴ Whilst the choice of rescue mechanism forms the foundation of the rescue process, other ancillary matters, such as the business plan which is the blueprint for the rescue process, creditors' rights and the availability of funds to manage the rescue process, are the structures needed to build a successful rescue.

While all the various elements of a corporate rescue process undeniably play an important role, the main focus of this chapter will be on funding the rescue process. Creditors' rights in relation to the availability and accessibility of funds during the rescue process will be discussed in Chapter five (V). What is key in the rescue process is the ability of the debtor company to continue trading, and this is premised on the availability of credit.¹⁵ At the point of insolvency, it is likely that the company's assets will be fully subject to security held by existing creditors; the debtor company may have exhausted all available lines of credit and may need to source funds to manage its rescue.¹⁶ Even existing lenders may terminate whatever arrangements they have with the debtor so as to limit any additional exposure to losses.¹⁷

The point that the provision of additional funding during the rescue process will be required in order to enable struggling companies to continue operations is further reiterated by

¹⁴ R Parry, *Corporate Rescue* (1st edn, Sweet & Maxwell 2008) chap 3.

¹⁵ UNCITRAL Guide. The use of the term credit in relation to corporate rescue in this thesis extends to goods and services supplied by trade creditors.

¹⁶ G McCormack, 'Super-priority New Financing and Corporate Rescue' [2007] J.B.L. 701-732.

¹⁷ R J Mokal, 'The Authentic Consent Model: Contractarianism, Creditors' Bargain and Corporate Liquidation' (2001) 21 *Legal Studies* 400, 440-443.

Westbrook and Gottlieb¹⁸ who state that a successful restructuring entails meeting liquidity needs and obtaining post-commencement financing. Additionally, it has been suggested that there is strong support globally for super-priority new financing¹⁹ forming part of insolvency reforms.²⁰ This apparent global consensus is evidenced by the proposals put forward by the European Bank for Reconstruction and Development (EBRD) in its 10 Core Principles for an Insolvency Law Regime. The EBRD advocate that where restructuring is the appropriate remedy, new priority finance should be permitted.²¹ The United Nations Commission on International Trade Law (UNCITRAL) also affirms that the continued operation of the debtor's business is crucial to reorganization, and additional finance is vital to this objective.²² It was recommended in the *UNCITRAL Legislative Guide on Insolvency Law* that, where insolvency laws support insolvency proceedings that allow an insolvent business to continue trading, either for reorganization or the sale of the business in liquidation as a going concern, it is important that new funding is considered. Research conducted in the past showed that obtaining financing during the rescue had a correlative effect on the reduced possibility of liquidation.²³ While it is recognised that finance is pivotal to corporate rescue, access to such finance still poses considerable challenges. The impact that its availability and terms may have on stakeholders and the overall integrity of the insolvency system may be significant.²⁴

¹⁸ J Westbrook & L Gottlieb, 'Reorganisations, Exemption of Financial Assets' (2009) 27 ABIJ 10.

¹⁹ See section 3.6 of the thesis for detailed meaning of super-priority financing.

²⁰ M Uttamchandani, 'The Case for DIP Financing in Early Transition Countries; Taking a DIP in The Distressed Debt Pool' (2004) LIT <<http://www.ebrd.com/downloads/research/law/lit042.pdf>> See, in particular, text accompanying fnn. 19-22) accessed 24th September 2012.

²¹ European Bank for Reconstruction and Development (EBRD) Core principle 8. <<http://www.ebrd.com/russian/downloads/legal/insolvency/principle.pdf>> accessed 24th September 2012.

²² United Nations Commission on International Trade Law Legislative Guide on Insolvency Law (2005), <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> accessed 24th September

²³ This research was conducted in America, see A Elayan & T Meyer, 'The Impact of Receiving Debtor-in-Possession Financing on the Probability of Successful Emergence and the Time Spent Under (CHAP 11)' (2001). 28(7), BJBFA 905-942.

²⁴ Sarra (n 7).

Differing approaches to rescue finance can be seen in the three jurisdictions considered in this thesis. In the US, the problem of attracting funding during the rescue process has been surmounted by statutory provisions²⁵ that incentivize rescue funding to assist the rescue. Corporate rescue funding provisions, along with the automatic stay,²⁶ are undeniably the most important parts of the US Chapter 11 procedure. Section 364 of the Bankruptcy Code provides a hierarchy for obtaining funds and incentives in the way of super-priority so that lenders may be more amenable to the idea of advancing new money at a time when the company is already in financial distress. Canada, on the other hand, initially addressed the problem of funding rescues through judicial fiat, whereby judges relied on their inherent jurisdiction to assign super-priority to lenders of new funds, over existing creditors.²⁷ This was the position until recent reforms gave statutory backing to corporate rescue funding. While the UK provisions for corporate rescue funding are not as comprehensive as the US and Canadian provisions, they do make provision for the borrowing of funds as part of the administration expenses.

3.2 Rescue funding in the United States of America (US)

Rescue funding or ‘debtor-in-possession (DIP) funding as it is known in the US, is financing authorised by the court for a bankrupt firm which has sought the protection of the Chapter 11 rescue procedure.²⁸ The availability of this type of financing does not take place in a vacuum; the presence of an ‘automatic stay’²⁹ and the granting of super-priority to

²⁵ 11 U.S.C., s 364.

²⁶ *Ibid.*, s 362; L Qi (n 4); see also S J Davido, ‘Making Sense of US Bankruptcy Law’ (1992) 3 I.C.C.L.R 12, 406-413.

²⁷ This is discussed in detail under section 3.3.1 of the thesis.

²⁸ L J Abbot, S Parker & G F Peters, ‘The Effect of Post-bankruptcy Financing on Going Concern Reporting’ (2000) 21 AICPA.

²⁹ An automatic stay is a self-activating injunction which suspends the commencement or continuation of any action, or proceeding by creditors against the debtor. See 5.2 of the thesis for more discussion on automatic stays.

potential lenders by the court are what make this type of financing possible.³⁰ DIP funding is not a product of modern insolvency laws. It has a long history which is rooted in the 20th century railway equity receiverships which laid down the foundation for the Chapter 11 rescue procedure.

3.2.1 Historical development of DIP funding

Many of the changes in the political economy³¹ of the 19th century US can be traced back to the railroads.³² The railway equity receivership may be regarded as one of the notable changes introduced by the development of railroads as it formed the foundation upon which the US Chapter 11 is based. DIP financing has its origin in the equity receiverships that were used to reorganize distressed railway companies.³³ It arose out of the need for funds to support the reorganization of the railway companies.³⁴ These loans were known as receiver's certificates and enjoyed special priority from the courts to the lenders who were willing to advance funds to aid the reorganization efforts of the railway companies.³⁵

3.2.1.1 How railway receiverships worked

The railway equity receivership was very much an informal procedure developed by railway companies and their secured creditors with the aid of the courts. As such, the approach to financing during the reorganization process was in effect the result of judge

³⁰ 11 U.S.C., s 362.

³¹ Reference is made to industrialization and the growth of capitalism.

³² A Martin, 'Railroads and The Equity Receivership: an Essay on Institutional Change' (1974) *The Journal of Economic History*, vol.34, pp. 685-709

³³ D Skeel Jr., 'The Past, Present and Future of Debtor-in-Possession Financing' (2003-2004) 25 *Cardozo L. Rev.* 1905.

³⁴ See section 2.4.1 of the thesis for the history of the development of the railway equity receiverships.

³⁵ Skeel (n 33).

made rules. The courts developed “super-priority” through the creation of a “six months rule” which authorized the debtor to satisfy suppliers’ claims in full, ahead of other creditors, provided that the supplies were made within six months of the commencement of a receivership.³⁶ The courts based this rule on the assumption that the railway companies’ predominant creditors would concede that suppliers were essential to the continued running of the railway company, and were likely to cease supplies at the first sign of trouble. It was for this reason that these creditors were paid first.³⁷

In the initial stages of the application of the six month rule adopted by the courts, it only applied to supplies, wages and essential services. The rule was later adapted to incorporate the “doctrine of necessity”, thereby also covering important trade creditors.³⁸ While the six month rule took care of the problem of preserving supply lines, the most pertinent problem was raising actual cash to fund the receivership.³⁹ To this end the courts approved the issuing of “receiver’s certificates” by the receiver.⁴⁰ These certificates were used by the receiver to borrow money from investors for a short term against the whole of the assets of the railway company.⁴¹ These funds were then used to fund the receivership. The receiver’s certificates enjoyed priority because they were classed as the receiver’s responsibility and not the debtor’s, despite the fact that they interfered with existing mortgages.⁴²

The access that a receiver had to fund-raising facilities did not mean that he could arbitrarily request the authorization of the court to issue receiver’s certificates. The receiver had to identify the pressing cash needs of the railway company, and this was often based on projected expenses.⁴³ The reason why courts were willing to authorize the issuance of

³⁶ See *Fosdick v Schall*, 99 U.S. 235 (1878).

³⁷ *Ibid.*

³⁸ B Wham, ‘Preference in Railroad Receiverships’ (1928) 23 ILL.L.REV.141, 147.

³⁹ Skeel (33).

⁴⁰ *Ibid.*

⁴¹ *Ibid.*

⁴² *Ibid.*

⁴³ *Ibid.*

receiver's certificates was based on the principle that there was a public interest in sustaining the continued operation of distressed railway companies.⁴⁴ However, in cases where there was no possibility of a successful rescue, the court sometimes rejected the receiver's request for the sale of certificates to raise funds.⁴⁵ It was upon this innovation by the courts that the process of DIP funding was ultimately founded.

Statutory backing for DIP funding came with the inclusion of the railroad receivership in the Chandler Act of 1938.⁴⁶ The Act clearly stated that courts could authorize a receiver, trustee or debtor-in-possession to issue certificates of indebtedness for cash, property, or other consideration upon such terms and conditions and with such security and priority in payment, over existing obligations.⁴⁷ DIP funding enjoyed a reformation with the enactment of the 1978 Bankruptcy Code. The Act introduced a well-defined funding provision which enabled the debtor-in-possession manager to fund the rescue process.⁴⁸ To date, this provision is still relied on by DIP managers to obtain funding for the rescue process.

3.2.2 The modern day funding process

It has been asserted that the reason why DIP financing was codified was to provide companies with all the necessary tools required to give them a fighting chance of survival.⁴⁹ The impact of the failure of a company is felt in the loss of income and revenue to both individual employees and society at large. Conversely, a company's survival benefits the

⁴⁴ H J Baker, 'Certificates of Indebtedness in Reorganization Proceedings: Analysis and Legislative Proposals' (1976) 50 AM.BANKR. L.J. 18-16.

⁴⁵ Skeel (n 33).

⁴⁶ Section 77 for Railroad Receivership and Section 77(b) for non-railroad companies.

⁴⁷ 11 U.S.C., s 116(2) & s 516(2).

⁴⁸ *Ibid*, s 364.

⁴⁹ B A Henoch, 'Post petition Financing: is There Life After Debt?' (1991) BANKR. DEV. J. 575.

society,⁵⁰ the debtor and creditors most especially, as the going concern value of the company may exceed the liquidation value.⁵¹

Although there is general consensus that DIP funding is vital to the rescue process,⁵² it is a highly risky venture for a lender due to the possibility of the company not having a successful rescue and therefore not being able to repay the lender. Thus the capacity to raise such funds would have been near impossible because of the risk involved, if there were no statutory provisions for incentives such as super-priority and priming liens as contained in section 364.

Even where a debtor does not have an immediate need for the DIP funding, it may be essential to its survival to secure authorization from the courts to establish credit lines for future use.⁵³ In addition, the possibility of new money being put into the business may inspire confidence in the vendors to keep supply lines open, skilled manpower to remain in their jobs and customers to keep patronising the debtor for goods and services.⁵⁴

3.2.3 The DIP financing process

The current process for approval for DIP financing is typically a two stage one.⁵⁵ The debtor begins by filing a motion⁵⁶ for authorization to obtain credit (at this point a DIP lender will already have been arranged). The motion may be filed at the same time as the Chapter 11

⁵⁰ This is in terms of generation of revenue and creation of jobs.

⁵¹ Hensch (n 49).

⁵² See p74-76 of thesis.

⁵³ S D Cousins, 'Post-petition Financing of Dot-coms' (2002) 27 Del. J. Corp. L 759.

⁵⁴ *Ibid.*

⁵⁵ S Dahiya, K John, M Puri & G Ramirez, 'Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidences' (2003) 69 JFE 259-280.

⁵⁶ This is brought pursuant to Federal Rules of Bankruptcy Procedure 2010, r 4001(b) (1) (b) and r 4001(c) (1) (b). These rules cover relief from automatic stay; prohibiting or conditioning the use, sale or lease of property.

petition, or immediately thereafter. The final hearing on the motion may commence not earlier than 14 days after service of the motion on the bankruptcy trustee⁵⁷ and any creditor's committees.⁵⁸ Thereafter the request for DIP financing moves on to the second stage, where a permanent financing order is entered by the court in the amount requested. At this point there is room for the court to entertain any objections from creditors.⁵⁹

3.2.3.1 Potential lenders in DIP funding

In most cases, the financing of the rescue process is provided by pre-bankruptcy secured, under-secured and unsecured creditors⁶⁰ who already have an existing relationship with the debtor⁶¹ and are in the best position to understand the debtor's finances.⁶² DIP financing attracts high fees⁶³ due to the risks involved, and it also enjoys priority which ensures that DIP lenders are entitled to be paid first.⁶⁴ As a result, most pre-bankruptcy secured creditors would rather advance more money to the distressed company to protect their security than have their rights over existing security subordinated in favour of new creditors. In addition, maintaining support for the business would ensure that the pre-commencement creditor's collateral retains its value as opposed to the possibility of it being worthless upon liquidation.⁶⁵ For the unsecured and under secured pre-commencement creditor, loaning

⁵⁷ A bankruptcy trustee is a person appointed by the court (or creditors in some cases) to act on behalf of the debtor to ensure that both the creditors' and debtor's interest are upheld.

⁵⁸ See Federal Rules of Bankruptcy 2010, r 4001(c) (2). However where there is a risk of irreparable damage, then the court can hear the motion before the expiry of the 14 days limit.

⁵⁹ *Ibid*, r 4001(c) (2) & (3).

⁶⁰ More often than not, these pre-bankruptcy creditors are banks and financial institutions.

⁶¹ Bankruptcy Bulletin, 'A Roundup of Decisions' (Mar/April 1993-1994) 3 Bus. L. Today 46.

⁶² Skeel (n 33).

⁶³ Cost of DIP financing would typically include a fee at the initial stage when the debtor and the DIP lender commit to a DIP financing agreement, further fees are paid at the end of the DIP loan agreement, ongoing commitment fees and interest on the DIP loan itself, see M S Huebner, 'Debtor-in-Possession Financing' *The RMA Journal* April 2005 p32.

⁶⁴ D Baird & M Bienenstock, 'Debtor-In-Possession Financing (Pre-petition & Lock-Up Agreements)' (2002-2003) 1 *DePaul Bus. & Comm. L.J.* 589.

⁶⁵ J M Landers & K A Dunwoody, 'Post-petition Credit: Why and How' (1990) 2 *Faulkner & Gray's Bankr.L.Rev.* 13-14. It should be noted that under Chapter 11 reorganization, the company typically keeps doing business and this may maintain the value of the company's assets including those it has given out as collateral. On the other hand, when a company files for liquidation, it stops trading and secured creditors

money to the debtor may open up an opportunity to cross-collateralize.⁶⁶ Cross-collateralization in bankruptcy terms is the securing of an under-secured pre-commencement debt with post-commencement assets from the debtor company's assets.⁶⁷ In this regard, DIP loans provided by pre-existing creditors can be regarded as defensive DIP loans⁶⁸ because the DIP loan secures the pre-existing creditor's pre-commencement exposure.

Trade creditors also play a part in the funding of the rescue process, irrespective of the fact that they may be doing so reluctantly. This is because trade creditors provide goods and services for which they may not be paid and this can be equated to providing funding as the company cannot operate or re-organize its affairs without the continued supply of goods and services.⁶⁹ Their continued support during the rescue process may be perceived as a tactical one, as keeping supply lines open may keep the rescue process going and in turn result in a higher probability of recovery of their pre-commencement claims⁷⁰ if the rescue is successful.

3.2.3.2 Lending under 11 U.S.C., section 364

would have their collateral returned to them or, where the assets are sold off, the proceeds of the sale. In some cases the value of the assets would have depreciated.

⁶⁶ Hensch (n 49). This process of cross-collateralisation is being frowned upon as it places a pre-commencement creditor in an advantageous position post-bankruptcy.

⁶⁷ *Saybrook Manufacturing Co.* 936 F.2nd 1490 11th Cir. 1992. See section 3.2.5 of the thesis for more discussion on cross-collateralization.

⁶⁸ A Carlsson, 'DIP financing: a rough road to recovery. A summary of developments covered by PLC US' (Practical Law Company, 20-July-2009) < <http://uk.practicallaw.com/3-386-6889?q=dip+financing:+a+rough+road+to+recovery> > accessed 31st October 2012.

⁶⁹ Bankruptcy Bulletin (n 61).

⁷⁰ *Ibid.*

One of the factors that may contribute to the ease with which funds can be obtained via DIP lending is the presence of an automatic stay.⁷¹ The automatic stay⁷² puts on hold, as soon as a Chapter 11 petition is filed, the right of **all** creditors to enforce their security⁷³ and this stay remains in place until the end of the Chapter 11 proceedings. The automatic stay mitigates the financial distress confronting the debtor prior to filing for a Chapter 11 protection.⁷⁴ This is because it defers the accumulation of interest on all claims that are not over secured⁷⁵ as well as putting a hold on creditors' rights to enforce their claims on the debtor's assets.⁷⁶ The automatic stay, which acts to suspend all contractual and legal rights of a pre-commencement lender,⁷⁷ can only be waived by the courts.

The automatic stay, as well as the power of the court to consent to funding arrangements that undermine the rights of pre-commencement creditors without first obtaining their consent, makes for easy accessibility to finance.⁷⁸ It has been held that requiring a precondition to obtain the consent of pre-commencement creditors before giving judicial authorization to a DIP loan would subvert the authority of the bankruptcy court.⁷⁹ Also, the judge's approval would be based on the best interest of all the parties involved, as opposed to a creditor's consent which would in all probability, be based on self-interest.⁸⁰ It is plausible that the absence of these two components would mean that the DIP manager may likely not have access to secured assets as permitted under the Bankruptcy Code, to raise the much needed funds.

⁷¹ D D Moore, 'How to Finance a Debtor in Possession' (1990-1991) 6 com. Lending Rev. 3.

⁷² Also known as the moratorium in the UK.

⁷³ 11 U.S.C., s 362.

⁷⁴ G Trantis, 'A Theory of the Regulation of Debtor-in-financing' (1993) 46 Vand. L. Rev. 901.

⁷⁵ 11 U.S.C., s 502(b) (2).

⁷⁶ *Ibid*, s 362(a).

⁷⁷ See generally 11 U.S.C., s 105; Abbot, Parker & Peters (n 27).

⁷⁸ 11 U.S.C., s 364.

⁷⁹ See *Burchinal v Central Washington Bank (In re Apple, Inc.)* 82 F. 2d 1484, 1491 (9th Cir. 1987).

⁸⁰ *Ibid*.

The nature of DIP financing a debtor has access to, is determined by the structure of the assets and liabilities it has.⁸¹ One of the attractions of the provision for DIP funding within the Bankruptcy Code, is that it creates different avenues for borrowing money during the rescue process. Section 364 of Bankruptcy Code, which provides for DIP financing, takes into consideration, and makes provision for, four major classes of loans with reference to the debtor's assets and liabilities. These are;

- Section 364(a); under the provisions of this paragraph an unsecured loan can be obtained by the debtor in the ordinary course of business without the need for the court's approval. It enjoys priority, as part of the administrative expenses, over other priority claims and unsecured claims.⁸² More often than not, trade creditors and suppliers rely on the provisions of this section to keep supply lines open.⁸³ This is the only circumstance under which a debtor could obtain DIP funding without prior judicial authorization.⁸⁴
- Section 364(b); under this paragraph debtors are allowed to obtain unsecured credit for expenses that fall outside the ordinary course of the debtor's business. However, the court's approval (after notice and a hearing) is needed before the debtor can borrow money under this section, and the debt incurred, or credit obtained, enjoys priority as an administration expense. Typically, charges of vendors of products and services such as insurance premiums and fees of non-professional consultants,

⁸¹ Moore (n 71). For example, a company whose assets are fully encumbered would require a different type of DIP funding arrangement (e.g. a priming lien) from a company that has some free assets that can used as collateral.

⁸² 11 U.S.C, s. 503(b) (1).

⁸³ P B Jones & C E Cutler, 'Chapter 11 Bankruptcy Revisited' (2002), <http://www.fredlaw.com/articles/banking/bank_0203_pbj.html> accessed 23rd October 2012.

⁸⁴ 11 U.S.C, s 364(a).

which do not form part of the ordinary course of the debtor's business fall within this provision.⁸⁵

- Section 364(c); this provision takes care of circumstances where the debtor cannot obtain unsecured credit for administrative expenses.⁸⁶ Under this paragraph, after authorization by the court, the debtor can obtain credit which will;
 - have priority over all administrative claims,⁸⁷ thereby enjoying super-priority, or
 - be secured by a lien⁸⁸ on the debtor's unsecured assets, or
 - secure a junior lien⁸⁹ on the debtor's property which is already subject to a lien.

Section 364(c) acts as a "catch-all" net for all DIP funding that cannot be obtained under section 364(a) and (b). Apparently the majority of DIP funding is obtained and agreed upon pursuant to the provisions of this section.⁹⁰ Before this type of funding is made available, the debtor must show that it cannot obtain unsecured credit under paragraphs (a) or (b) of section 364 and, regardless of the fact that the pre-commencement creditors' consent is not needed prior to the court giving its approval, a hearing must be held and notice given to pre-commencement creditors. Lenders advancing money pursuant to this section may (and

⁸⁵ Jones & Cutler (n 83).

⁸⁶ 11 U.S.C., s 364(b)(1).

⁸⁷ These are administrative expenses found in section 503(b) and section 507(b) and this includes costs of preserving the estate, including taxes, wages and fines, compensation, various expenses incurred by creditors, professional fees, and trustees' expenses amongst other things.

⁸⁸ A lien is a security interest granted in a property to secure the payment of a debt or the performance of an obligation.

⁸⁹ A junior lien is a subordinate security interest granted in a property that has an existing lien on it.

⁹⁰ Henoch (n 49).

often do) secure the loan with a junior lien on encumbered assets or first lien on unsecured assets in addition to having a super-priority over all other administrative expenses.⁹¹

- Section 364(d); one of the possible reasons for DIP funding provisions is that, at the point of the commencement of the rescue process, most debtors have few or no unencumbered assets. The provision of this paragraph comes into its own in such situations. This provision allows the court, after notice and a hearing, to authorize DIP funding which is then secured by a senior or equal lien on assets that are already subject to pre-existing liens. This is known as a priming lien within bankruptcy parlance. Before the court will permit this form of DIP funding, the debtor must demonstrate⁹² its inability to obtain DIP funding under one of the other paragraphs of section 364 and that the existing lien holders will suffer no prejudice⁹³ as their interest will be adequately protected.⁹⁴ The existing lien holders need not establish the facts, as the burden of proof rests on the debtor.⁹⁵

There are conflicting views concerning what constitutes “adequate protection” under section 364(d). Section 361⁹⁶ defines “adequate protection” to include cash payments or periodic payments to the existing lien holder, providing an additional or replacement lien and any other compensation.⁹⁷ However “adequate protection” within the perspective of this provision could also be interpreted to mean an over-collateralization of the existing lien,⁹⁸ whereby the value of the assets exceeds the value of the pre-existing lien on it. The

⁹¹ *Ibid*; also Jones & Cutler (n 83).

⁹² 11 U.S.C., s 364(d)(1).

⁹³ Such as the depreciation in value of his security interest.

⁹⁴ *Ibid*, s 364(d) (1b).

⁹⁵ *Ibid*, s 364(d) (2).

⁹⁶ 11 U.S.C.

⁹⁷ See *In re Debbie Reynolds Hotel & Casino, Inc.*, 255 F.3d 1061, 1064 (9th Cir. 2001), where post-commencement financing was approved under s 364(c), based on the fact that the super-priority loan did not alter the rights of secured creditor and this constituted an adequate protection of existing creditors' interest .

⁹⁸ Jones & Cutler (n 83).

courts have also held that what constitutes “adequate protection” is a matter of judicial decision and a question of fact which is embedded in the measurement of value and the credibility of witnesses.⁹⁹

The definition provided by section 361 does present some complications as it may be near impossible to meet the criteria laid down in that section; a debtor seeking additional finance is not likely have the means to make cash payments or the assets to put up as replacement collateral. The alternative would be for the pre-existing lien holder to consent to the devaluation of its security by allowing another lender in. The possibility of this occurring is quite slim, as no creditor is likely to give up the value of its security without any corresponding compensation. The restrictive nature of this provision may therefore mean that funding under this provision may have to come from the pre-existing lien holders and, where this is not forthcoming and the lien holder withholds his consent, the restructuring may fail.¹⁰⁰

The US Senate Judiciary Committee¹⁰¹ explained the reasoning behind “adequate protection”. The Committee acknowledged the fact that there may be situations where it may undermine the policy of bankruptcy laws, or make it near impossible to honour the secured creditors’ rights, and in order to protect creditors’ interests, this section makes available a means of ensuring that the secured creditor gets value for his lien. Whatever the case may be, it does provide a powerful tool for the debtor to obtain funding. With this provision, two options are open to the debtor, either he uses it to find a new post-commencement lender or he uses it as a leverage to negotiate with pre-commencement

⁹⁹ See *Re Snow Shoe Co.*, 789 F.2d at 1008 (4th Cir. 1986).

¹⁰⁰ K S Atlas & K E Andersen, ‘DIP Super-priorities and Secured Creditors’ Dilemma’ (2009) ANNREVINSOLV 6.

¹⁰¹ US Rep No. 989, 95th Congress 2d Session 53(1978).

lenders for fresh funding. For the pre-existing creditor, the aim of the “adequate protection” clause is to ensure that he is not denied the value which he initially bargained for.¹⁰²

Although the provisions of section 364 is drafted mainly from the perspective of securing the loan, under section 364(e) adequate provision is also made for the protection of the lender, after the DIP funds have been secured, from variation or reversal of the DIP loan agreement. The importance of this protection has been emphasised by the courts¹⁰³ which have held that the protection offered by section 364(e) gives lenders the assurance that, as long as they relied in good faith on the approval of the DIP funding agreement given by the court, a challenge under which a creditor is trying to have the agreement reversed on appeal will have no bearing on their priority status. The key here is for the lender to have acted in good faith.

3.2.4 Conflicts in Section 364

The drafting of section 364 threw up two often conflicting objectives of the rescue process which Congress had to resolve; the need for the fair treatment of creditors and the need for rehabilitation of struggling but viable debtors.¹⁰⁴ There was a need to reconcile and balance the effect that DIP funding would have on the rights of creditors as the framework for DIP funding is constructed such that these two conflicting objectives are dependent on each other. The rescue process would rely on the creditor advancing further credit or having his security being subjugated to raise additional funds, in return for the creditors getting better value for their money after a successful reorganization.¹⁰⁵ This inter-dependency acts to

¹⁰² McCormack (n 13).

¹⁰³ See *In Re EDC Holding Co.*, 676 F.2D 945, 947 (7th Cir. 1982).

¹⁰⁴ See *Re Ames Department stores*, 115 Bankr. 34, 37 (Bankr. S.D.N.Y. 1990).

¹⁰⁵ *Re Roblin Industry Inc.* 52 Bankr. W.D.N.Y. 1985). It is often the case that this is the only way for unsecured creditors to recover any part of their claim.

balance the conflicting rights. The danger in this balancing act is that, in some circumstances, the scale may tilt to favour the opposing side.

3.2.5 A critique of the DIP funding mechanism

The US bankruptcy process is viewed as more debtor friendly in contrast to the UK insolvency process which may be regarded as having a bias for creditors.¹⁰⁶ Whilst the wording of Chapter 11 under the Bankruptcy Code appears to support this position, the reality appears to be quite different, especially when taking into consideration the hold that creditors have over the rescue process through the funding they provide. The Bankruptcy Code clearly allows the suppression of creditors' rights by way of "cram down",¹⁰⁷ authorising the judge to approve DIP funding without the prior consent of all classes of creditors, amongst other things. This therefore puts the debtor's interest above that of the creditors. Nonetheless secured creditors tend to wrestle back control through the influence that they exert with the DIP funding agreements.¹⁰⁸ These agreements have been converted by creditors into valuable corporate governance tools.¹⁰⁹ Consequently, it is not unusual for lenders to secure preferential treatment of both their pre-commencement and post-commencement debts in addition to the high interest rates and fees they demand.¹¹⁰

One area in which the creditor's control can be felt is in the management of the rescue process. If the lender thinks that the debtor's management needs to be replaced, he will insist on this change as part of the terms of the loan.¹¹¹ In other words, a lender can use the

¹⁰⁶ See section 2.7 of this thesis for analysis on the perception of debt and its influence on bankruptcy laws.

¹⁰⁷ 11 U.S.C., s 1129(b).

¹⁰⁸ G W Kuney, 'Hijacking Chapter 11' (2004-2005) 21 *Emory Bankr. Dev J.* 19.

¹⁰⁹ D Skeel Jr., 'Creditors' ball: the "New" New Corporate Governance in Chapter 11' (2003-2004) 152 *U. Pa. L. Rev.* 917.

¹¹⁰ Kuney (n 108).

¹¹¹ Skeel (n 109).

terms of a loan to usurp existing management and supplant them with his minion as head of the company. This effectively portends loss of control of the rescue process by the debtor and its management while the creditor directs the rescue process through his control over the debtor.

Criticisms of DIP financing have arisen in relation to the “cross-collateralization” of pre-commencement and post-commencement loans. Although not authorized by the Bankruptcy Code, the courts have defined “cross-collateralization” as the securing of pre-commencement debt by post-commencement assets.¹¹² This occurs when the pre-commencement and post-commencement lender is the same and he uses a cross-collateralization¹¹³ clause to cover his pre-commencement exposure. What happens is that, in order to secure both the pre-commencement and post-commencement loans, the lender is given liens and security interests in either of the debtor’s pre-commencement or post-commencement assets.¹¹⁴

The controversy behind cross-collateralization lies in the fact that it goes against the bankruptcy principle of equal treatment of pre-commencement creditors of the same class.¹¹⁵ It is arguably unfair that a pre-commencement unsecured or under-secured creditor, who is in a position to loan money during the rescue, would use that as a leverage to better place his pre-commencement claim within the hierarchy of claims. On the other hand, if viewed from the position of the creditor/lender, DIP funding does tend to be high risk with no absolute certainty of success attached. So, therefore, using all available means to shield the lenders’ exposure may be tolerated. As a result a number of courts in the past have authorised cross-collateralization clauses in DIP funding agreements.

¹¹² See *Otte v Manufacturers Hanover Commercial Corp (In re Texlon Corp.)* 596 F.2D 1092, 1094.

¹¹³ Cousins (n 53).

¹¹⁴ *Ibid.*

¹¹⁵ Trantis (n 74).

In *Texlon Corp*¹¹⁶ it was held that cross-collateralization could be authorized on the basis that adequate notice and hearing provided procedural protection for creditors, or a better option of financing was not available, or the survival of the estate was dependent on the loan and it was in the best interest of all the creditors. However the Eleventh Circuit Court in the case of *Shapiro v Saybrook Manufacturing Co. (In re Saybrook Manufacturing Co.)*,¹¹⁷ held that using a cross-collateralization clause to obtain funding was not authorised by the Bankruptcy Code and it went against the priority classification¹¹⁸ in the Bankruptcy Code. The position in *Saybrook* has been viewed as going against the very foundation of the Chapter 11 philosophy, which is the rehabilitation of debtors.¹¹⁹

The criticism of the decision in *Saybrook* raises the question of how conflicting interests in the administration of the debtor's rescue should be addressed in order to give the debtor's rescue purpose. In balancing these opposing interests in an attempt to ensure that no prejudice is suffered by interested parties, some flexibility will have to be allowed, this perhaps explains the rationale behind the courts' permission of cross-collateralization. The position in *Saybrook* still remains in place, although some courts¹²⁰ have continued to honour cross-collateralization clauses as long as they fulfilled the pre-requisite conditions laid down in the *Texlon* case.

DIP funding has come a long way since the receivership certificates of the 19th century. It is clear that funding the rescue of a company has evolved into a more sophisticated concept. While the Bankruptcy Code covers all the bases under section 364 by providing different avenues for the debtor to raise funds, it also comes with the risk of abuse, which perhaps is

¹¹⁶ *Otte v Manufacturers Hanover Commercial Corp*, *supra* (n 111).

¹¹⁷ 936 F.2nd 1490 (11th Cir. 1992).

¹¹⁸ 11 U.S.C., s 507.

¹¹⁹ See C J Tabb, 'Requiem for Cross Collateralisation?' (1993) 2 J Bankr. L. & Prac. 109, 109-10 at 111.

¹²⁰ See *Bland v Farmworker Creditors* 308 B.R. 109 (Bankr. S.D. Ga. 2003; *In re Fla. W. Gateway, Inc.*, 147 B.R. 817 (Bankr. S.D. Fla. 1992). It should be noted here that this is not of general application but an example of how cross-collateralisation is still being made use of as the circuit courts in America adopt different approaches.

not surprising. Despite the risk of abuse, section 364 plays an important role in the success of the rescue process. Skeel acknowledges the importance of funding during the rescue process as more companies rely on section 364 to raise much needed funds. He attributes this reliance on the fact that, unlike during the 1980's when companies had little secured debt, a lot of companies presently have most of their assets heavily encumbered prior to bankruptcy and thus have to rely on DIP funding.¹²¹

Furthermore, Congress, in factoring the DIP provision into the Bankruptcy Code, has created an avenue for a debtor to be effectively rehabilitated while at the same time offering protection to potential lenders by including caveats in the section. It can also be argued that the inclusion of a financing provision within the Bankruptcy Code represents the underlying aim of bankruptcy laws in the US, which is the total rehabilitation of the debtor.

3.3 Rescue funding in Canada

Rescue funding in the Canadian context is financing which is made available in the interim period between filing a proposal under the CCAA and the development of a viable and acceptable business plan.¹²² Whilst interim financing is not exclusive to the CCAA, for the purpose of this thesis it will be analysed from the standpoint of the CCAA because the CCAA has been used in every major Canadian restructuring in the last 25 years.¹²³ The issue of rescue funding, or interim financing¹²⁴ as it is termed in Canada, is two pronged and is better understood if viewed from both perspectives. These perspectives examine rescue funding from the pre-statutory and the post-statutory reform angle. Canada has

¹²¹ Skeel (n 109).

¹²² *Crystallex (Re)* 2012 ONCA 404 (CanLII).

¹²³ J Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Thomson Carswell 2007).

¹²⁴ The court in *Cow Harbour Construction Ltd., Re* (28 April 2010), Edmonton 1003 05560 EVQ10COWHARB (*Alta QB*) opposed the use of the US term 'DIP Financing'. The court stated that the use of the term in Canadian proceedings is incorrect from a Canadian perspective and wrong from the American standpoint.

always made provisions for interim financing,¹²⁵ however it was not until reforms in 2009 that Canada introduced statutory provisions for interim financing into both the CCAA and BIA. Prior to the reforms, debtors who required some form of interim finance had to rely on the discretion of bankruptcy judges to permit it. The judges relied on their inherent jurisdiction to assign the necessary funds to debtors.

Presently, the courts have the backing of legislation to perform this function. Although not as exhaustive as section 364 of the US Bankruptcy Code, the CCAA does offer some form of guidance to judges while explicitly recognising the importance of finance to rescue. In order to fully understand the Canadian position, it is necessary to examine how it all started, i.e. with the exercise of pre-statutory judicial discretion.

3.3.1 Judicial discretion to assign funds

In recognition of the potential value that rescuing an insolvent company can have in negating the social and economic consequences of firm failure, and that financing can be the key ingredient of a successful rescue, Canadian courts in the past relied on their inherent jurisdiction to approve such financing.¹²⁶ This was because the CCAA which was, and still is, the principal restructuring legislation, provided the courts with little guidance as to how the restructuring process could be financed.

The granting of interim financing plays an important role in the negotiation of a plan of arrangement or compromise under the CCAA. The reasons being that, financing would allow the debtor to continue trading until an effective plan is worked out.¹²⁷ A company

¹²⁵ At least from the time of renewed interest in the use of the CCAA for restructuring.

¹²⁶ J Sarra, 'Debtor in Possession Financing: the Jurisdiction of Canadian Courts to Grant Super-priority Financing in CCAA Applications' (2000) 23 Dalhousie L.J 337.

¹²⁷ *Ibid.*

which has no pre-filing credit readily available or any access to post-commencement funds would only be delaying liquidation by filing a CCAA petition.¹²⁸ While it is a recognized fact that the provision of interim financing can compromise creditors' well established rights,¹²⁹ the Canadian courts in the past assumed jurisdiction to make orders which included interim financing on a super-priority basis, which furthered the intrinsic purpose of the CCAA.¹³⁰

3.3.2 How judicial discretion to assign funds worked

The CCAA pre-reform was very much a court-supervised process wherein a debtor was allowed to propose a plan of arrangement or compromise with its creditors. Under such a plan, a debtor could carry on its business for its benefit and that of the creditors, and at the same time avoid bankruptcy.¹³¹ The initial application to propose a plan of compromise or arrangement was either done by the debtor or a creditor; however it is was commonly done by the debtor. The CCAA made provisions for the court to grant an automatic stay to accompany a plan of compromise at the initial application or for the court to grant an order for a stay at any time other than the initial application.¹³² The objective in granting the stay was to maintain the *status quo* for a limited period so that a plan could be negotiated with the creditors.¹³³

Before the 2009 reforms, Canadian judges, in acknowledgement of the debtor's need for finance during the interim phase while it sorted out its affairs with its creditors, and in the

¹²⁸ *Ibid.*

¹²⁹ *Re Skydome Corporation, Skydome Food Services and SAI Subco* (1998) Toronto 98-CL-3179 (Ont.Gen.Div [Commercial list]).

¹³⁰ K Yamauchi, 'The Courts' Inherent Jurisdiction and the CCAA: a Benefit or Bad Doctrine?' (2004) 40 *Can. Bus. L.J.* 250.

¹³¹ Sarra (n 126).

¹³² CCAA 1985, s 11.

¹³³ *Re Northland Properties* (1988), 73 C.B.R. (N.S.) 146 (B.C. S.C.).

absence of legislative direction, construed their equitable or inherent jurisdiction to include the ability to approve interim financing.¹³⁴ What was ill-defined under the CCAA plan of arrangement, prior to reforms that brought in statutory backing for interim financing, was how the process of application for interim financing actually worked. Since interim financing was not a product of statutes in Canada at this point, it remains unclear how it all started. It has been proffered that interim financing in Canada owed its origin to the US Chapter 11 process.¹³⁵ In the US an application for a Chapter 11 protection is often accompanied by an application for DIP financing. At first glance this appears to be so; on the other hand, a general look at the history of DIP funding in the US situates the Canadian experience prior to statutory reforms which introduced interim financing, within the period where rescue funding during equity receivership relied on the courts to approve receivership certificates.¹³⁶

A review of Canadian cases which were decided during this timeframe gives some understanding as to the mechanism of applying for interim financing. Evidently, a debtor company could apply for an order pursuant to the CCAA and in so doing seek reliefs including a stay and “debtor in possession super-priority financing”.¹³⁷ One thing which is clear is that the courts, in the absence of statutory provisions, granted relief in the form of interim financing and on a super-priority basis while relying on their inherent jurisdiction. *Re Fairview Industries Ltd*¹³⁸ was one of the first cases that considered the issue of financing under the CCAA. An initial court order issued by the court in a CCAA proceeding in respect of Fairview Industries and five other related companies included amongst other things permission for the bankruptcy monitor and other restructuring professionals to be

¹³⁴ Sarra (n 126).

¹³⁵ J Parappally, ‘Boom, Bust, and DIP—A Canadian Perspective on DIP Financing’ (2009) 5 CRI 208.

¹³⁶ See generally D A Skeel Jr., ‘The Past, Present and Future of Debtor-in-Possession Financing’ (2003-2004) 25 Cardozo L. Rev. 1905.

¹³⁷ *Royal Oak Mines Inc.*, 6 C.B.R. (4th) 314, (1999) O.J. No. 709, 96 O.T.C. 272.

¹³⁸ [1991] N.S.J No. 453 (QL), 11 C.B.R. (3d) 43 (T.D.).

paid in priority to all creditors. Upon the application of some creditors, the court rescinded its earlier order on the basis that it did not have the authority to subordinate pre-existing secured claims.¹³⁹

In the subsequent case of *Re Westar Mining Ltd*¹⁴⁰ the court's position on granting priority over secured claims changed. In this case, an initial order was granted by the court requiring suppliers of goods and services to extend further credit to Westar beyond the date of the initial order. The court subsequently held that it did not have the power to make that particular order to secure further credit from suppliers which granted a first charge over Westar's interest in the Greenhills mine. The court reviewed and upheld its earlier order which created the charge and established that where a company had a viable basis for restructuring, it could borrow money for administration expenses and grant security which would rank ahead of unsecured creditors.

Another case which showcased the courts' reliance on its inherent jurisdiction, in this instance over the express objection of an existing creditor, was *Re Dylex Ltd*.¹⁴¹ Dylex had established that it needed 30 million Canadian dollars as a loan to meet its operating needs during restructuring. The Royal Bank of Scotland and Bank of Montreal were Dylex's existing lenders and the obvious sources of the 30million Canadian Dollars facility. At the time of the CCAA application, Dylex owed both banks 90 million Canadian Dollars and both banks held comprehensive security over virtually all of Dylex's assets. When approached for DIP financing the Royal Bank of Scotland said that it was prepared to provide the DIP loan as long as the Bank of Montreal agreed to be part of the arrangement. The Bank of Montreal refused to extend any further loan to Dylex, but was willing to agree to a charge ranking equally with existing security held by both banks for any loans given

¹³⁹ Fairview (see footnote above) at 59-10.

¹⁴⁰ (1992) 14 C.B.R. (3d) 88.

¹⁴¹ [1995] O.J. No. 595 (QL), 31 C.B.R. (3d) 106 (Gen. Div. - Commercial List).

by the Royal Bank of Scotland to Dylex during the restructuring period. Dylex and the Royal Bank of Scotland applied to court for an order permitting the Royal Bank of Scotland to provide the DIP loan which would be secured by a first charge on inventory and receivables ranking in priority over the existing security over such assets in favour of both banks, as well as a charge on all other assets of Dylex ranking behind the other security held by both banks. The Bank of Montreal opposed the application. The court approved the DIP loan and held that the Bank of Montreal would not be adversely affected by the order approving the DIP loan.

3.3.2.1 Inherent jurisdiction

There have been different definitions of the term “inherent jurisdiction” and conflicting views on the source of the courts’ reliance on their inherent jurisdiction has been put forward. Sarra makes reference to the definitions of inherent jurisdiction found in the *Black’s Law Dictionary*¹⁴² and *Halsbury’s Laws of England*¹⁴³ as the possible meanings of “inherent jurisdiction” in Canada,¹⁴⁴ this is however far from how the Canadian courts have viewed inherent jurisdiction. To the courts, inherent jurisdiction and statutory jurisdiction are mutually inclusive¹⁴⁵ and the courts may rely on their inherent jurisdiction to deliberate on matters regulated by statute as long as it does not infringe or conflict with the statutory provisions.¹⁴⁶

¹⁴² B A Garner, *Black’s Law Dictionary* (3rd edn, Sweet & Maxwell 2006). Black law defines inherent jurisdiction as the exercise of those powers that are reasonably necessary for the administration of justice.

¹⁴³ Vol. 37 (4TH edn, Butterworths, 1982) at para 14. Halsbury describes “inherent jurisdiction” as referring more to the administration of justice rather than substantive law.

¹⁴⁴ Sarra (n 126).

¹⁴⁵ *Societe des Acadiens du Nouveau-Brunswick v Association of Parents for Fairness in Education* (1986) 1 S.C.R. 549 at 94-95.

¹⁴⁶ *Baxter Student Housing v College Housing Co-operative*, (1976)2 S.C.R. 475 at 480.

The support for this position embraced by the court appears to be located within legislation. One relevant provision is section 12 of the Interpretation Act (still in force)¹⁴⁷ which provides that every enactment is considered beneficial and should be given fair, large and liberal construction and interpretation that best ensures that its objectives are met. It therefore followed that in order to give full rein to the intention of Parliament in creating the CCAA provisions, the court had to ensure that it did everything within its power to effectively maintain the *status quo* of an insolvent company while it endeavoured to reach a compromise with its creditors.¹⁴⁸ If approving an order for interim financing ensured the fulfilment of the objectives of the CCAA, then it was well within the courts' powers to approve interim financing. Another statutory provision which the courts exploited to support their ability to grant interim financing order was section 11(3) and section 11(4) (now section 11 of the current statute) of the CCAA.¹⁴⁹ The provisions permitted the court to make "orders on such terms as it may impose...." therefore the courts could rely on this provision to grant an order for interim financing.

In addition to the reliance on statutory provisions to determine the source of the courts' jurisdiction, Sarra states that a detailed analysis of the courts' motive for acting without statutory provisions reveals that the courts' authority stemmed from their inherent jurisdiction to deal with matters pertaining to fairness of processes and also to look to principles of equity to grant exceptional remedies in order to effectively ensure that the aims of the legislation are achieved.¹⁵⁰ Consequently, the courts had jurisdiction over procedural matters which were intended to ensure fairness and judicious resolution of applications under the CCAA.¹⁵¹

¹⁴⁷ R.S.C. 1985, c. 1-21.

¹⁴⁸ *Re Smoky River Coal Ltd* (1999), 12 C.B.R. (4th) 94 at p109.

¹⁴⁹ R.S.C. 1986, c-36.

¹⁵⁰ Sarra (n 126).

¹⁵¹ *Ibid.*

Furthermore, the courts, in authorising interim financing acted under their equitable jurisdiction on the basis that where a statute is silent on an issue or fails to address some risk or harm, equity bridges the gap.¹⁵² The test for determining if the courts could, under their equitable jurisdiction, authorise interim financing required that the debtor demonstrated that the financing was essential to the continued operation of the business, and this would in turn enable the debtor to effectively reorganize its affairs.¹⁵³

In employing their inherent jurisdiction the courts followed two principles. To begin with, the subject matter had to be within the jurisdiction of the courts and secondly, the courts had to take into consideration all the relevant factors.¹⁵⁴ In applying these principles to interim funding, the courts were able to authorise interim funding because, firstly, issues of insolvency fell within their jurisdiction and secondly, to ensure fairness in the CCAA process, the debtor ought be given every opportunity to attempt an advantageous outcome before senior creditors sought to enforce their claims through liquidation.¹⁵⁵

3.3.3 Factors the court considered when granting interim financing (pre-reforms)

One important factor which the court considered when approving interim financing or financing on super-priority basis, was the balance of prejudices between the parties.¹⁵⁶ The court, in so doing, ensured that any outcome reached was what would have been within the reasonable expectations of all stakeholders.¹⁵⁷ The implication of this was that some sacrifices had to be made, usually on the part of secured creditors¹⁵⁸ who may have their

¹⁵² *Re United Used Auto & Truck Parts* (1999), 12 C.B.R. 144 at para 29.

¹⁵³ *Ibid.*

¹⁵⁴ *C.H.R.C. v Canadian Liberty Net* (1998) 1 S.C.R. 626 at para. 10, 32.

¹⁵⁵ Sarra (n 126).

¹⁵⁶ *Skydome Corp.*, *supra* (n 129) at 123.

¹⁵⁷ *Royal Oak Mines*, *supra* (n 137).

¹⁵⁸ *Ibid.*

claims subjugated by super-priority financing. Therefore, courts were admonished to grant an order for interim financing only where there were reasonable forecasts of successful restructurings.¹⁵⁹ While this was the central premise upon which the courts acted in granting interim financing, a case-by-case approach was also adopted¹⁶⁰ to ensure that a “one-cap-fits all” system was not applied to an issue as sensitive as interim financing.

Additionally, the courts over time developed some additional principles through their judgements which not only acted as a guide for parties, and created a level of certainty in the process, but also aided the courts in the balancing of parties’ interests.¹⁶¹ These principles are still relevant today and aid the courts in decisions regarding super-priority interim financing. These principles can be summarised as follows;

- A company with a feasible chance of restructuring will be allowed to borrow money for operational capital and grant security for such loans ranking ahead of unsecured claims.¹⁶²
- Super-priority DIP financing will be approved where all or substantially all the existing secured creditors agree.¹⁶³
- The interests of existing secured creditors can be prejudiced by the granting of super-priority DIP financing only if the court is satisfied that the granting of the DIP financing is warranted in the particular circumstances of the case before it.¹⁶⁴
- Deciding whether to grant super-priority DIP financing is an exercise of balancing the interests of all interested parties, but “cogent evidence” will be have to be shown

¹⁵⁹ *Skydome Corporation, supra* (n 129).

¹⁶⁰ M B Rotsztain, ‘Debtor-in- Possession Financing in Canada: Current Law and a Preferred Approach’ (2000) 33 Can. Bus. L.J 283.

¹⁶¹ Sarra (n 126).

¹⁶² *Westar Mining Ltd., Re* (1992) 14 C.B.R. (3d) 88.

¹⁶³ *Willann Investments Ltd v Bank of America Canada* [1991] O.J. 721 (QL) (Ont. Ct. (Gen. Div.)).

¹⁶⁴ *Skydome supra* (n 129).

that the benefit of the DIP financing clearly outweighs the potential prejudice to secured creditors before the court will exercise its jurisdiction.¹⁶⁵

- The requested DIP financing should be kept to what is reasonably necessary to allow the company to continue to trade and to meet expenses required to “keep the lights on” while the company is trying to restructure its affairs.¹⁶⁶
- Sufficient notice had to be given to the creditors. In exceptional circumstances the requirement for notice was waived by the courts and only in relation to a restricted amount of money and for a limited time. But a debtor seeking to compromise claims, no matter the circumstances, was required to give adequate notice to creditors.¹⁶⁷

Generally, where the court was satisfied these principles and a significant number of all the existing secured creditors had consented to the interim financing, or where it could be established that secured creditors whose security interests were being subordinated were not immensely disadvantaged by the interim financing, the order for financing was approved.¹⁶⁸

These principles have in no small measure guided the hands of the courts to abridge the need for interim financing. Although it created a support system for both the courts and all other parties involved, concerns were raised regarding the court’s practice of weighing prejudice in order to grant interim financing. It was suggested that the practice in some ways lacked certainty.¹⁶⁹ If viewed in light of the fact that the CCAA process involves the weighing of interests of and prejudices to all parties concerned, from the order to seek

¹⁶⁵ *Royal Oak Mines, supra* (n 137).

¹⁶⁶ *Ibid.*

¹⁶⁷ *Royal Oak Mines, supra* (n 137).

¹⁶⁸ M B. Rotsztain, ‘Debtor-in-Possession Financing in Canada: Current Law and a Preferred Approach’ (2000) 33 Can. Bus. L.J. 283.

¹⁶⁹ *Ibid.*

CCAA protection, to the conclusion of the process,¹⁷⁰ it does appear that the consideration of all factors measured against the impact on all the parties is a thread that runs through the CCAA. Accordingly, the balancing of prejudices is an integral part of the CCAA process.

Secured lenders also expressed dissatisfaction over the possible loss of priority to super-priority financiers.¹⁷¹ Not only were they reluctantly giving up their fundamental property rights, there was also the spill-over effect that super-priority financing could have on the availability and/or cost of loans.¹⁷² Despite these legitimate concerns raised regarding the courts' reliance on their inherent jurisdiction to approve interim financing, generally the courts were resourceful and displayed remarkable determination in ensuring that the underlying principles of the CCAA were fulfilled.

3.3.4 Reforms to the CCAA

In November 2005 Canada's Bill C-55, which proposed sweeping reforms to existing laws, received Royal Assent. While this could be seen as kick-starting the process of change, it was not until 2009 that reforms bearing transformation in the form of interim financing, amongst other things, came into force. The main focus of the reforms was to bring clarity to the scope of judicial discretion in insolvency matters so as to create certainty and consistency to Canada's insolvency system. One area, which it had been suggested lacked clarity and certainty, was the approval of interim financing by the court. It was claimed that the court's reliance on statutory discretion or inherent jurisdiction gave rise to ambiguity as to the scope and extent of the court's power to grant the interim financing

¹⁷⁰ *Ibid.*

¹⁷¹ I Berl Nadler, D W Phillips, Vineberg LLP & K De Champlain, 'Debtor-in-possession Financing: The Dark Lending Hole' (2005) 17 Comm. Insol. R. p29-40.

¹⁷² Rotsztain (n 168).

order.¹⁷³ Consequently, one of the reforms introduced by Bill C-5 was statutory support for the grant of interim financing. It was believed that the uniformity and certainty provided by statute would protect the rights of new lenders and the pre-existing creditors that could be primed by super-priority charges.¹⁷⁴

The background for the introduction of interim financing reforms was set by various lobby groups which prepared and presented papers detailing areas within the Canadian insolvency laws that needed to be addressed. One such report was prepared by the Joint Task Force on Business Insolvency Law Reform of the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals.¹⁷⁵ One of the focal points of the report was the need to provide express statutory power to authorize “DIP Loans” and to grant security in specific amounts for post-filing expenses in CCAA cases. Suggestions were also made on the nature of benchmarks¹⁷⁶ which the judges could rely on before authorizing interim financing, some of which were later incorporated in section 11(4) of the CCAA.

The Report of the Standing Committee on Banking, Trade and Commerce supported the call for reforms permitting interim financing. The committee was of the view that Canadian laws needed to be drafted to ensure high predictability for all stakeholders as this would

¹⁷³ L Rogers, ‘Canada Looks Forward to Insolvency Reforms’ (2006) 25 Int’l Fin. L. Rev. 46.

¹⁷⁴ *Ibid.*

¹⁷⁵ The Insolvency Institute of Canada & Canadian Association of Insolvency and Restructuring Professionals, ‘Final Report of the Joint Taskforce’ (CAIRP March 1, 2002) <<http://www.cairp.ca/publications/submissions-to-government/law-reform/index.php> > accessed 31st October 2012.

¹⁷⁶ *Ibid.* The reform proposal suggested that in deciding to authorize a DIP loan, the court should consider amongst other things the following factors; (a) what arrangements have been made for the governance of the debtor during the proceedings; (b) whether management is trustworthy and competent, and has the confidence of the creditors; (c) how long it will take to determine whether there is a going concern solution, either through a reorganisation or sale, that creates more value than a liquidation; (d) whether the DIP loan will enhance the prospects for a going concern solution or rehabilitation; (e) the nature and value of the assets of the debtor; (f) whether any creditor will be materially prejudiced during that period as a result of the continued operations of the debtor; and (g) whether the debtor has provided a detailed cash flow for at least the next 120 days.

enable stakeholders to make suitable choices. The report¹⁷⁷ called for amendments to permit interim financing and for jurisdiction to be given to the courts to authorize super-priority financing, by allowing the new lender to rank prior ahead of other existing security interests.

Furthermore, it suggested that notice of the court hearing to authorize a super-priority loan should be given to any secured creditor affected by such priority. Whilst the final report supported the need for super-priority financing, the Canadian Bankers Association¹⁷⁸ dissented on the issue of super-priority. In supporting most parts of the recommendations of the joint task force, the Association also expressed concern regarding the potential for super-priority financing to create uncertainty and limit the accessibility of pre-insolvency lending because of its subjugation of pre-existing rights.

The report¹⁷⁹ also recommended that the seven factors outlined by the joint task force on Business Insolvency Law Reforms in its report¹⁸⁰ should be compulsorily considered by the courts before authorizing interim financing loans. These were to provide some guidance for the courts in deciding whether to approve interim financing. It was the committee's belief that ensuring availability of interim financing, providing criteria to guide the court's decision making, putting secured creditors on notice and giving priority to lenders would meet the fundamental principles of fairness, predictability and efficiency.¹⁸¹

¹⁷⁷ Canadian Parliament, Senate standing Committee on Banking, Trade and Commerce, *Debtors and Creditors Sharing the Burden, a Review of the Bankruptcy and Insolvency Act and the Companies Creditors Arrangement Act* (Nov 2003) <http://www.cfs-fcee.ca/html/english/campaigns/Senate_Cmte_Report_2003_11-a.pdf> accessed 31st October 2012. ("Review of CCAA & BIA").

¹⁷⁸ See Commercial Insolvency Law Reform: Recommendations by the Standing Committee for Amendments to the Companies' Creditors arrangement Act and the Bankruptcy and Insolvency Act. http://www.mcmillan.ca/Files/Commercial%20Insolvency%20Law%20Reform_Kent_Maerov_0104FR.pdf accessed 7 June 2014.

¹⁷⁹ Review of CCAA & BIA (n 177).

¹⁸⁰ Final Report of the Joint Taskforce (n 175).

¹⁸¹ *Ibid.*

The proposals put forward by the Joint Task Force of Business Insolvency Reforms appear to be a skeletal representation of the Chapter 11 DIP financing requirements. While it seemed that Canada borrowed a few elements from their US neighbour, it can be argued that these were in any event ideologies that the courts pursued under their inherent jurisdiction. What was lacking was the certainty that a statute would create. The Canadian system, being one which substantially favours secured creditors,¹⁸² would most likely oppose the importation of the Chapter 11 concept as the American scheme stems from a highly rehabilitative debtor oriented regime which is at variance with the Canadian system.¹⁸³

3.3.5 Current Canadian approach to interim financing

The 2005/2007 amendments empowers the courts to authorize interim financing by codifying their erstwhile powers to grant interim financing orders.¹⁸⁴ The amended CCAA authorizes the court, after notice has been given to the affected secured creditor, to approve a charge over all or part of the debtor's assets in an amount it considers appropriate, in favour of a person who agrees to lend an amount which is approved by the court as being required by the company, having deduced this from the cash-flow statement.¹⁸⁵ Therefore a debtor could make an application for interim financing, which the courts would approve after perusing the debtor's cash-flow statement. It is on the basis of this statement that the court determines how much the debtor needs and approves the loan.

¹⁸² J Sarra, *Creditor Rights and the Public Interest* (University of Toronto press, 2003).

¹⁸³ K S Atlas & K E Andersen, 'DIP Super-Priorities and the Secured Creditor's Dilemma' (2009) ANNREVINSOLV 6.

¹⁸⁴ CCAA 1985, s 11.2.

¹⁸⁵ *Ibid*, s 11.2(1).

Likewise the court holds the power to determine how much of the debtor's assets can be subject to a security charge. This clearly points to the fact that the court holds the decision as to how much of the pre-existing secured creditor's interest can be subordinated to that of the DIP lender.¹⁸⁶ Therefore much of the authority of the courts to grant interim financing under the CCAA still remains discretionary. This has been confirmed by the courts which have recognized that their powers to order super-priority financing, are discretionary and not mandatory.¹⁸⁷

With the codification of the ability of the courts to authorize interim financing, the statute identifies various super-priority financing measures that the courts can authorize. A close study of the CCAA identifies two main forms of such financing. Under section 11.2(1),¹⁸⁸ the first super-priority charge authorized by the statute over all of or part of the debtor's assets, is the one given to post-commencement lenders who are willing to advance the money that the company needs to support the restructuring process. The Act goes further to provide that, where there has been a previous order made under section 11.2(1) for interim financing, the court may order that a new charge or security ranks in priority to the previous order with the consent of the person in whose favour the previous order was made.¹⁸⁹ This provision seems to indicate that, where a previous order for interim financing has been made and there is need for further finance, the court may make an order priming¹⁹⁰ the pre-existing charge or security from the previous interim financing order. Therefore in cases where all of the debtor company's assets are fully encumbered and the debtor is unable to obtain financing, subsection (3) provides the debtor with an opportunity to get finance by giving would-be lenders priority over an existing super-priority charge. In

¹⁸⁶ The issue of creditors' subordination is discussed in full detail in sections 5.3 and 5.4 of the thesis.

¹⁸⁷ *Trimminco Limited and Becancour Silicon Inc., Re* (20 July 2012) Ont M41062 & M41805 (Ont. C.A).

¹⁸⁸ CCAA 1985, s 11.2 (1&2).

¹⁸⁹ *Ibid*, s 11.2(3).

¹⁹⁰ A term used to describe the subordination of a pre-existing lien or security interest.

essence, what this provision appears to give the lender is an “elevated” super-priority charge.

Section 11.2 appears to be a catchall provision that covers most rescue expenses that may arise during the process. While the section makes no detailed mention of what these items are, it is clear from section 11.4 that credit needed to fund essential/critical supplies required by the debtor is excluded; however this credit also enjoys super-priority over secured creditors’ interests. According to section 11.4,¹⁹¹ a critical supplier is a person who supplies goods or services which are critical to the company’s continued operation. Where the court acknowledges a person as a critical supplier and gives an order requiring the person to supply goods and services,¹⁹² the court may grant a security or charge in favour of the critical supplier over all or part of the debtor’s assets.¹⁹³ Suppliers play an important role in the success of a rescue operation. This is evidenced by the priority that they are commonly given by bankruptcy laws during restructuring. Typically, suppliers may be classified as unsecured creditors, however the debtor may need to rely on their continued support, and as a result they may sometimes be accorded super-priority status¹⁹⁴ to ensure that supply lines are kept open.

Prior to amendments to the CCAA, suppliers were under no obligation to keep the lines of supply of goods and services open and could not be coerced by the debtor to ensure supply,¹⁹⁵ a position which could prove detrimental to a successful rescue. The 2009 amendments reversed this previous stance and recognized the importance of critical suppliers during corporate rescue by giving powers to the court to order a supplier which the court has designated as critical to the business of the company to keep lines of supply

¹⁹¹ CCAA 1985.

¹⁹² *Ibid*, s 11.4(2).

¹⁹³ *Ibid*, s 11.4(3).

¹⁹⁴ See 11 U.S.C. s 364(a) which also makes provisions for critical suppliers.

¹⁹⁵ See CCAA 1985, s 11.3. Law in force between 2002-12-31 to 2003-03-31.

of goods and services open. In return the critical suppliers are allowed super-priority payments and/or a charge over the company's assets.

The importance of critical suppliers to the success of a company's restructuring effort has been reiterated by the courts in some recent post-amendment restructuring cases. In *Re Catalyst Paper Corporation*¹⁹⁶ certain subsidiaries of Catalyst Paper obtained a further order from the Supreme Court of British Columbia which declared some named suppliers of the company to be "critical suppliers". The order required that the suppliers continue to supply goods and/or services on the existing terms and conditions it had with the company. The order also gave the critical suppliers a charge to secure amounts that they extended to the company. Also, in *Re Northstar Aerospace, Inc.*,¹⁹⁷ the Ontario Superior Court of Justice ordered that a critical supplier should be paid in priority to secured creditors in order to ensure that lines of supply were kept open and the restructuring efforts of the debtor company kept on course.

3.3.6 Factors that a court would consider under the CCAA before granting interim financing

Whilst the Canadian criteria have some similarities with their US counter-part,¹⁹⁸ they do not require the debtor to establish that there are no other sources of financing available, nor is it required that the pre-commencement secured creditors are adequately protected. The CCAA¹⁹⁹ lists a number of factors for the Canadian courts to take into consideration. These are (but not limited to);

¹⁹⁶ *Re Catalyst Paper Corporation*, 2012 CarswellBC 883.

¹⁹⁷ *Re Northstar Aerospace Inc.*, 2012 ONSC 4546 (CanLII).

¹⁹⁸ See sections 3.2.2 and 3.2.3 of the thesis for discussion on US DIP funding requirements.

¹⁹⁹ CCAA 1985, s 11.2(4).

- The timeframe in which the company is likely to be subject to the restructuring proceeding;
- How the management of the business is to be carried out during the proceeding;
- Whether the management has the backing of the debtor's major creditors;
- Whether the loan would improve the chances of a viable compromise or plan of arrangement being made;
- The nature and value of the company's property;
- Whether any creditor would be materially prejudiced as a result of the charge;
- The monitor's view, which is usually an objective examination of the need for and effectiveness of any interim financing request.

The statutory conditions provided by CCAA, while not an exact replica of the pre-reforms judicial principles, mirror the principles developed by the courts in relation to what needs to be established and confirmed before approving interim financing. The principles stated in the CCAA offer greater transparency and predictability for creditors and new players in the proceedings,²⁰⁰ as opposed to the judge-made rules. The overall aim of the CCAA principles is to prevent any prejudice, failing which, to ensure that a balance is achieved between what will be lost and what is to be gained.

3.3.7 Why DIP?

²⁰⁰ J Sarra, 'Financing Insolvency Restructurings in The Wake of The Financial Crisis: Stalking Horses, Rogue White Knights and Circling Vulture' (2010-2011) 29 Penn St. Int'L. Rev 581

Generally, in deciding whether to lend money to a company, financial institutions take into consideration a number of factors and these range from interests and fees offered and the creditworthiness of the borrower.²⁰¹ The principal motive behind a lender providing interim financing is profit as is the case with all financing agreements. Interim financing allows lenders to charge higher than normal interest rates in addition to a variety of fees associated with the arrangement of the financing.²⁰² The higher risk associated with interim financing,²⁰³ allows the lender to demand a higher fee and this offsets the risk associated with interim financing. The provision of super-priority status also helps to significantly reduce the lender's exposure to the debtor's default. Therefore, where the rescue fails and the company inevitably ends up in liquidation, the lender can realise his claims in priority to other claimants because of his super-priority status.²⁰⁴ Super-priority status appears to be an important factor for lenders who provide the interim financing. It was noted by Morawetz J. in *Re Trimminco*²⁰⁵ that it is unrealistic to expect any DIP lender to advance funds without receiving a super-priority charge. It has consequently become an expected part of a DIP financing arrangement.

Another reason why interim financing may hold some attraction is that it can be used as a defensive mechanism to protect the lenders' existing position, or to prevent another lender from gaining a perceived advantage.²⁰⁶ This may inadvertently amount to cross-collateralization which is expressly forbidden by section 11.2 (1) of the CCAA.²⁰⁷ The

²⁰¹ P H Zumbro, 'An Overview of Debtor-in-Possession Financing' in *Debtor-in-Possession and Exit Financing: Leading Lawyers on Securing funding and Analysing Recent Trends in Bankruptcy Financing* (Inside the Minds Series) (Aspatore Books 2010) p8-9.

²⁰² Parappally (n 135).

²⁰³ This could include lack of security or failure of the rescue process.

²⁰⁴ Parappally (n 135).

²⁰⁵ *Trimminco Limited supra* (n 187).

²⁰⁶ CCAA 1985, s 11.2; See also LW Houlden & G B Morawetz, 'Debtor in Possession Financing' HMANALY no. 93.

²⁰⁷ Prior to reforms to the CCAA, cross-collateralization was permissible in DIP financing in Canada. In the *Air Canada* (2003) 42 C.B.R. (4th) 173, CCAA proceedings, the DIP lender General Electric Capital Canada was able to cross-collateralize through the granting of a DIP facility of US\$700 million.

inclusion of the provision that expressly bars a creditor's ability to cross-collateralize has been viewed as an apparent attempt to avoid abuse,²⁰⁸ a situation which is likely due to the ability of cross-collateralization to place a creditor in a more advantageous position. However, in *Re Cow Harbour Construction Ltd.*,²⁰⁹ the court concluded that, so long as the interim financing is used to fund the debtor's rescue, section 11.2(1) is not flouted by the collection of pre-filing and post-filing receivables being used to permanently reduce a secured pre-filing capital line.²¹⁰

Control of the debtor's management may be viewed as a probable advantage for providing DIP finance. A pre-commencement lender (who becomes a post-commencement lender) or post-commencement lender, who advances funds to the debtor, may use the financing contract to his advantage by writing in clauses which further his objectives or exert control over the management with the aid of the finance agreement.²¹¹ To the creditor, this provides him with some amount of control over the restructuring. But from a policy standpoint, this may not be a good outcome since it potentially gives more room than is necessary for lenders to have a considerable amount of control or influence over the restructuring.²¹² It is worth mentioning that it is funding from post-commencement lenders that gives the company a chance to be rescued, therefore benefitting other pre-commencement lenders. But for super-priority, the post-commencement lender would get insufficient reward.

3.3.8 Critique

²⁰⁸ Sarra (n 126).

²⁰⁹ (28 April 2010), Edmonton 1003 05560, EVQ10C0WHARB (Alta QB).

²¹⁰ See also *Re Angiotech Pharmaceuticals Inc.*, 2012 CarswellBC 124 (SC).

²¹¹ Sarra (n 126) p113-117.

²¹² LW Houlden & G B Morawetz, 'Debtor in Possession Financing' HMANALY no. 93.

The guidelines set down by the CCAA for the authorization of interim funding by the courts was viewed as a welcome development because it introduced certainty and predictability which was previously lacking. However, it has been faulted for failing to provide clear tests on which the courts may rely on when faced with a decision as to whether to grant a priming lien,²¹³ over the objections of the secured creditors whose rights are being primed.²¹⁴ It has been asserted that this shortcoming brings with it a certain amount of ambiguity which increases the risk to secured lenders.²¹⁵ The knock-on effect of this will be uncertainty in making credit decisions in the acquisition of both new and old loans, which will bring about stiffer terms and stricter lending controls that could further tighten the availability of credit.²¹⁶

This shortcoming is one that could have been addressed by Parliament during the enactment of the CCAA. Whilst the CCAA appears to have re-confirmed the pre-reform guiding principles developed by the court, it stopped short of providing a comprehensive framework for managing the authorization of interim financing by the courts. The CCAA gives the court broad discretion to authorize interim financing with no clear limits²¹⁷ as to the extent of its powers. It is within this unrestricted authority that judges have been able to prime the liens of secured creditors. The only consideration that the Act gives to their rights lies with one of the factors that the court needs to ascertain prior to authorizing DIP financing. It directs the court to ensure that the secured creditor does not suffer any material loss as a result of the super-priority finance.²¹⁸ The statement seems a bit all-embracing to offer any concrete form of protection for secured creditors. While it gives a broad allusion to the

²¹³ See section 3.2.3.2 of the thesis for meaning of priming lien.

²¹⁴ K S Atlas & K E Andersen, 'DIP Super-priorities and the Secured Creditor's Dilemma' (2009) ANNREVINSOLV 6.

²¹⁵ *Ibid.*

²¹⁶ *Ibid.*

²¹⁷ *Ibid.*

²¹⁸ CCAA 1985, s 11.2(4)(f).

prospect that a secured creditor may suffer materially, there are no provisions to guard against this. The US Chapter 11 procedure, in contrast, requires that the debtor must show that the interest of the secured creditor is adequately protected²¹⁹ and that the debtor could not obtain any other form of finance before the court can approve a priming lien.

The issue of adequate protection for the interest of secured creditors in super-priority financing was one of the items debated prior to and during the Canadian reform process.²²⁰ It was argued that the concept of adequate protection was an American one which might not fit in with the peculiarities of the Canadian system.²²¹ Furthermore, the Joint Task Force on Business Insolvency Reforms in its paper rejected the adoption of the concept of adequate protection and viewed it as being “time consuming, litigious and inflexible”.²²² While it is not being advocated that a strict adoption of the US concept should have been undertaken by Canada, it was arguably a missed opportunity on the part of the Canadian Parliament to provide a control mechanism which would guide the courts in adequately establishing that the secured creditor will not be materially affected by a priming lien. It can be argued that the failure of Parliament to address the issue of adequate protection may have a correlative effect on the cost of lending generally, as potential lenders may demand high interest or include very strict conditions that may not be favourable to borrowers, and this may also extend to post-commencement financing. Consequently, while the codification does appear to bring predictability and certainty to the process, the broad discretion given to the court seems to challenge this notion.

²¹⁹ 11 U.S.C., s 364(d) & s 361.

²²⁰ It was discussed by the court in *Royal Oak Mines (supra)* at 322 and the Joint Task Force on Business Insolvency Reforms.

²²¹ *Royal Oak Mines supra* (n 137).

²²² Final Report of the Joint Taskforce (n 175).

3.4 Corporate rescue funding in the UK

The process of corporate rescue funding in the UK is not as developed as it is in the US or Canada. The latter jurisdictions have individually made clear and identifiable provisions with incentives attached, to enable the funding of the rescue process. The process in the UK is unique in the sense that it appears to combine a mixture of both formal and quasi-formal procedures. The formal procedure encompasses legislative efforts which are manifested in statute, while the quasi-formal routes touch on other policies or strategies developed by the debtor, their lawyers and / or creditors and / or bankers. When it comes to rescue funding in the UK, a lot of important factors are operative and these factors need to be analysed, in order to have a clear picture of how rescues are funded.

3.4.1 Formal mechanism for post-commencement funding

The Cork Report²²³ led to the introduction of the administration procedure which is aimed at supporting the rehabilitation or re-organisation of companies facing difficulties in order that they might be restored to profitability or that viable elements of the company's business might be preserved as a going concern.²²⁴ However, the Cork Report, which shaped corporate rehabilitation and rescue in the UK, was silent on how the administration process would be funded. Nonetheless, the report considered that, where an administration order is discharged, creditors who advanced money or gave credit to the administrator to enable the company's business to be carried on as a going concern should enjoy priority of payment.²²⁵ It therefore follows that post-commencement credit which is used to fund the rescue

²²³ Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982) ("Cork Report"). See section 2.2 of thesis which discusses the beginning of corporate rescue in the UK.

²²⁴ A Revised Framework for Insolvency Law (Cmnd.9175 1984) p 19 at para 31.

²²⁵ Cork Report, chap 9 para 514.

process, will form part of expenses incurred by the administrator to enable a going concern value to be preserved and so it should enjoy priority payment. This notion was consolidated in the Insolvency Act 1986 which gives priority to the payment of the administrators' remuneration and expenses.²²⁶

The Act also authorises the administrator to do all such things that are necessary for the management of the affairs, business and property of the company.²²⁷ Accordingly, when an administrator is appointed, he assumes all the management powers in respect of the company including the power to borrow money and grant security.²²⁸ Therefore, if borrowing money is necessary for the continued running of the business of the company during the rescue, the administrator has the power to do so and lenders who advance the necessary funds will enjoy priority payments.

It has been suggested by McCormack²²⁹ and Finch²³⁰ that section 19(5) and schedule B1 paragraph 99 of the Insolvency Act 1986 provide a potential route to post-commencement financing. Although retroactive in nature, the provisions deal with contracts entered into by the administrator in the course of carrying out his functions. These debts enjoy priority payment over the administrator's remuneration, expenses and all other claims except secured creditors.²³¹ These provisions provide a framework that gives administrators the authority to enter into loan agreements with post-commencement lenders. Presently, the provisions deal with post-commencement contracts in a general way and do not make specific reference to post-commencement financing as is done under US Chapter 11 and the Canadian CCAA.

²²⁶ Insolvency Act 1986, Schedule B1, para 99.

²²⁷ *Ibid.*, Schedule B1, para 59.

²²⁸ See generally Insolvency Act 1986, Schedule 1, para 14 & 15.

²²⁹ McCormack (n 13).

²³⁰ V Finch, 'The Dynamics of Insolvency Law: Three Models of Reform' [2009] Law and Financial Markets Review 438-448.

²³¹ Insolvency Act 1986, Schedule B1, para 99(3), (4)-(6).

Rescue funding seems to be a *company rescue* issue and Canada and the US took that into consideration in their rescue framework. In the UK, administration, which was initially framed as a company rescue mechanism, in practice achieves more of a *business rescue*²³² and makes no mention of how the process can be funded. Consequently, the elaborate set-up found in the US and Canada is absent in the UK. It is these well laid provisions found in the US and Canada that make for an organised corporate rescue funding structure. Perhaps the reason behind the absence of well-defined rescue financing provisions in the Insolvency Act 1986 (especially as it relates to administration) can be traced to the old receivership having provided the foundation for the creation of the administration procedure. The old receivership, despite being used in some cases to achieve a rescue, was not created primarily for that purpose²³³ and so would not have taken into consideration the need for rescue funding.

Be that as it may, the courts have in the past relied on the administrator's powers to enter into contracts to approve super-priority financing, for example *Bibby Trade Finance Ltd v McKay*.²³⁴ Also in *Freakley v Centre Reinsurance International Co*²³⁵ the House of Lords stated that it was within the administrator's powers to determine which expenses are necessary for the purposes of the administration and which should, subject to the court's supervision, receive priority. In view of this, it is possible for courts to rely on schedule B1, paragraph 99 of the Insolvency Act 1986 and their inherent jurisdiction to approve post-commencement financing and, just like their Canadian counter-parts, establish precedents

²³² See S Frisby, 'Report on Insolvency Outcomes', a Report Presented to the Insolvency Service, 26th June 2006 at pg 58, 62 & 64.

²³³ R J Mokal, 'Administrative Receivership and Administration - an Analysis' (2004) 57 Current Legal Problems 355.

²³⁴ [2006] All ER 266.

²³⁵ [2006] BCC 971.

and court practices to take care of post-commencement financing and ensuing super-priority incentives.

This possibility is not being fully explored by the courts. The reason for this has been attributed to the rise of pre-packaged administrations which have reduced the need for a creative interpretation of paragraph 99, given that pre-packs are likely to come with their own funding arrangements already taken care of by the prospective buyers.²³⁶ Notwithstanding this, there will be some occasions where a pre-packaged administration is not utilized; instead what will be in place may be a trading administration. In a situation such as this, rescue funding is primarily important as the administrator will need funds to continue trading during the process. The question is whether a well-developed and incentivising approach to rescue finance will facilitate greater efforts towards corporate rescue, rather than pre-packaged business sales. However prior to a consideration of statutory provisions for rescue funding in the UK, it is necessary to consider possible routes to corporate rescue funding without the need for statutory insolvency frameworks.

3.4.2 Quasi-formal mechanism for post-commencement funding

In most cases a company going through insolvency will have exhausted all available informal processes of restructuring before resorting to the statute-backed regimes. There are different avenues for informal restructuring and these are commonly categorized as private workouts. An informal process could be in the form of a private arrangement with major creditors, who in most cases are banks and financial institutions. The focus here is going to be briefly on private workouts and then an in depth analysis of pre-packed

²³⁶ See generally V Finch, 'Pre-packaged Administrations: Bargaining in the Shadow of Insolvency or Shadowy Bargains' (2006) J.B.L. 568; P Walton, 'Pre-packaged Administrations—Trick or Treat?' (2006) 19 *Insolvency Intelligence* 113.

administrations. This analysis is going to be undertaken on account of the importance of these forms of rescue in business funding.

3.4.2.1 Private workouts

Informal rescue mechanisms have long played an important role in corporate rescue and in most cases the informal avenue for rescue is driven by secured creditors who take the view that the company is worth saving.²³⁷ In the past, large companies with complex multi-lender debts relied on the “London Approach”, which was an informal framework introduced with the support of the Bank of England, to restructure their debts and rescue the company.²³⁸ This approach involved two distinct stages in order for it to become fully operational.²³⁹ Firstly, the debtor would notify its banks that it was in financial difficulties and would like to commence a workout. Thereafter, by mutual consent the banks would agree to a “standstill”²⁴⁰ which would stay all enforcement action against the debtor and all existing lines of credit would be left open to the extent to which they had been expended.²⁴¹ The banks would also agree to extend more working capital where it was necessary for the continued survival of the debtor. The new credit extended to the debtor would be accorded priority over existing loans.²⁴²

²³⁷ J Amour, A Hsu & A Walters, ‘The Impact of the Enterprise Act 2002 on Realisation and Costs in Corporate Rescue Proceedings, a Report Prepared for the Insolvency Service (December 2006).

²³⁸ J M Garrido, *Out-of-Court Debt Restructuring* (World Bank, 2012) p40-41.

²³⁹ J Amour & S Deakin, ‘Norms in Private Insolvency: the “London Approach” to the Resolution of Financial Distress’ (2001) 1 J.Corp. L. Stud. 21.

²⁴⁰ The Bank of England was the facilitator of the standstill. It was able to achieve a standstill, by relying on its authority and prestige to call participating banks together under the auspices of a lead bank and persuading those banks which wished to call on their loans not to do so. See P Kent, ‘The London Approach: Distressed Debt Trading’ (1994) Bank of England Quarterly Bulletin for more details.

²⁴¹ See generally, P Kent, ‘The London Approach: Distressed Debt Trading’ (1994) Bank of England Quarterly Bulletin.

²⁴² Armour and Deakin (n 239) at p34-35.

Although the “London Approach” was popular during the 1990s recession, the use of it has since declined. The reason for its decline has been attributed to its possible incompatibility with the current financing structures in existence.²⁴³ Suggestions have been made for some key factors such as the standstill, its unanimity and priority payment to be adapted in order to make it more relevant to today’s restructuring issues.²⁴⁴

Private workouts presently available may involve multiple creditors and it has been asserted that they often achieve faster rescues of businesses than formal procedures.²⁴⁵ Also, debtors tend to rely more on these measures²⁴⁶ at the initial onset of insolvency rather than formal frameworks. Basically, a private workout is an agreement between the company and some of its financial creditors.²⁴⁷ Its aim is to create an effective framework for negotiations between the debtor and its creditors. In most cases it comes with a voluntary standstill and, if necessary, interim financing.²⁴⁸ The difference between private workouts presently used by distressed companies and the “London Approach” is the supervision process. The Bank of England was directly involved in the restructurings that occurred under the “London Approach” and acted in a supervisory and advisory role. At present, private or informal workouts are conducted without the active participation of the Bank of England. Generally, workouts are often viewed by experienced practitioners as the best option for restructuring a company where it is deemed viable.²⁴⁹ The financial creditors and the debtor are able to

²⁴³ EHYA UCL Roundtable Discussion’ ‘Is it Time for the UK to Adopt a Formal Proceeding for Restructuring Distressed Companies?’ (4th March 2009)

<http://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/policychange/Roundtable%20-%20Insolvency%20Discussion%20Record%2017032009.pdf> accessed 31st October 2012.

²⁴⁴ *Ibid.*

²⁴⁵ G Yeowart, ‘Encouraging Company Rescue: What Changes are required to UK Insolvency Law?’ (2009) Law and Financial Market Review 517 -531.

²⁴⁶ Armour, Hsu & Walters (n 237).

²⁴⁷ See INSOL, *Statement of Principles for a Global Approach to Multi-creditor Workouts* (1st edn, INSOL 2000).

²⁴⁸ The Policy Development and Review and Legal Departments, International Monetary Fund (IMF), ‘Involving the Private Sector in the Resolution of Financial Crises- Corporate Workouts’ (2001) <<http://www.imf.org/external/pubs/ft/series/04/>> accessed 7 June 2014.

²⁴⁹ Yeowart (n 245).

agree how new money will be provided to enable the business to continue as a going concern. Where new credit is secured, the debtor can continue to pay its trade creditors.²⁵⁰

3.4.2.2 Pre-packs

A pre-pack is basically a method of selling the business of an insolvent company as a going concern.²⁵¹ It is generally used hand in hand with the administration process and can be traced to the old receivership regime.²⁵² There is no express provision for the use of pre-packs under the Insolvency Act 1986, but it has enjoyed extensive judicial support.²⁵³ The use of pre-packs gained popularity following the reforms to the Insolvency Act 1986 under the Enterprise Act 2002.²⁵⁴

For the most part, pre-packs take place where there is a need to sell the business quickly without publicity in order to avoid negative reactions from staff and / or customers and suppliers.²⁵⁵ An insolvency practitioner negotiates the sale of the business or its assets prior to the onset of the insolvency process²⁵⁶ and the sale is then executed shortly after the commencement of an administration.²⁵⁷ Consequently, in most cases a buyer, who may be new to the company, or a competitor, or the existing management,²⁵⁸ is quickly found, and the business sold off before the knowledge of the debtor's financial distress is made public.

²⁵⁰ *Ibid.*

²⁵¹ S Frisby, 'The Second-chance Culture and Beyond: Some Observations on the Pre-pack Contribution' (2009) *Law and Financial Markets Review* 242-247.

²⁵² M Haywood, 'Pre-pack Administrations' (2010) *Insolv. Int.* 23(2), 17-22. The new Administration process is the one provided for under Insolvency Act 1986 Schedule B1.

²⁵³ See *DKLL Solicitors v Her Majesty's Revenue and Customs* (2007) EWHC 2067 (Ch), here the court appeared to support the use of a pre-pack as a legitimate technique. See also *RE Kayley Vending Ltd* [2009] EWHC 904(Ch).

²⁵⁴ S Manson, 'Pre-packs from the Valuer's Perspective' (2006) *Recovery* (summer) 19.

²⁵⁵ C Swain, 'Mind the Pre-pack' *The Lawyer* (London, 3 July 2006) 32.

²⁵⁶ V Dennis, 'Packing Case' *The Lawyer* (London, 10 July 2011) 31,

²⁵⁷ L Conway, Pre-pack administration procedure, Briefing Paper (SN/HA/5035) <www.parliament.uk/briefing-papers/SN05035.pdf>.

²⁵⁸ *Ibid.*

One of the effects of pre-packs is that they blur the boundary between formal and informal²⁵⁹ procedures because they combine the use of an unofficial process (pre-administration negotiation for a business sale) with a statutory mechanism (administration) to achieve their aim. A distressed company, when confronted with impending insolvency, has to make a decision as to which statutory strategy to adopt in order to effectively tackle the financial distress. However, a combination of factors may make it imperative for a debtor to adopt a mechanism such as the pre-pack which combines a statutory mechanism with an informal process. The most important of these factors are;²⁶⁰

- Absence of funding to enable trading in administration;
- Preservation of goodwill;
- Employee retention; especially in relation to highly skilled staff who are in demand and where the businesses depend heavily on their skills;
- Reduction of liability arising from debts.

Thus, the pre-pack has become a very useful corporate rescue tool, particularly because a continuing business is worth more to its stakeholders than one that is fully distressed and out of trading.²⁶¹ What the pre-pack does is to achieve a rescue of the business, with the onus for funding the rescue on the new buyer who will be tasked with injecting fresh funds into the business. Perhaps the fact that funding is somewhat assured with a pre-pack, is one

²⁵⁹ V Finch, 'Corporate Rescue: Who is interested?' (2012) 3 J.B.L. 190-212.

²⁶⁰ M Hyde & I White, 'Pre-pack Administration: Unwrapped' (2009) Law and Financial Markets Review.

²⁶¹ *Ibid.*

of its redeeming features. Frisby, in her report on pre-packaged administrations,²⁶² noted that one of the driving forces behind the increased use of pre-packs is the scarcity of resources with which to trade, through the duration of the administration. She also noted that continued trading is essential if there is to be any prospect of a going concern sale, and a lack of funding will, in many cases, act as a barrier to continued trading.

Pre-packs are not the result of any legislative exercise; therefore there are no express guidelines on their application to be found in statute books. The relevant document that provides guiding principles on its application is the Statement of Insolvency Practice 16 (SIP 16). SIP 16 is not a statement of law on pre-packs, but a policy document that provides professional guidance on how pre-pack sales should be managed. SIP 16 is based on procedures agreed upon by the insolvency regulatory authorities acting through the Joint Insolvency Committee, and was produced by the Association of Business Recovery Professionals with the authorization of the Joint Insolvency Committee.²⁶³ While not a body of laws in the strictest sense, it sets out basic principles and essential procedures which insolvency practitioners are required to follow,²⁶⁴ and compliance with SIP 16 is monitored by the Insolvency Service. On the whole, SIP 16 is centred on the principle of full disclosure.²⁶⁵ In other words, the administrator must make known, and justify, the reason for the pre-pack to the creditors, most especially the unsecured creditors. The requirement of full disclosure arises because by their nature pre-packs do not give unsecured creditors the opportunity to consider the sale before it takes place.²⁶⁶

²⁶² S Frisby, 'A Preliminary Analysis of Pre-packaged Administration' (2007) Report to the Association of Business Recovery Professionals

<http://www.r3.org.uk/media/documents/publications/press/preliminary_analysis_of_pre-packed_administrations.pdf> accessed 7 June 2014.

²⁶³ Statement of Insolvency Practice 16 "SIP 16" (E&W) 2009 p1.

²⁶⁴ *Ibid.*, at p2.

²⁶⁵ *Ibid.*, para 8-10.

²⁶⁶ *Ibid.*, para 8.

SIP16 contains a list of required information which must be disclosed to creditors in all cases and this includes, amongst other things; the source of the administrator's initial introduction, the extent of the administrator's involvement prior to his appointment, marketing activities or valuation carried on in respect of the business or its assets, the name of the purchaser and the price paid.²⁶⁷ The requirement of full disclosure is meant to guard against dishonesty and fraud in the sale of the business and to ensure that creditors are fully informed about the process. However the process has been heavily criticised for its lack of transparency.²⁶⁸

These criticisms and the fact that it appeared that the SIP 16 had not done enough to assuage concerns, led the Department of Business, Innovation and Skills on the 31st of March 2011 to announce proposals to introduce greater transparency and engender confidence in the process. On the 26th of July, 2011, the draft Insolvency (Amendment) (No 2) Rules (the Draft Rules) were published as a result of a consultation on the modernisation of the Insolvency Rules. The Draft Rules were intended to amend the Insolvency Rules 1986 to include extra regulations dealing with pre-pack insolvency cases.²⁶⁹ Under the proposed amendments, insolvency practitioners would have had to give three days' notice to creditors prior to the pre-packaged sale of a significant part of a company's assets, or its business to a connected party, so as to enable creditors challenge the sale if the need arises.²⁷⁰ Following consultation with stakeholders and having taken into consideration all the issues, the Government decided not to introduce new legislative control on pre-packs.

²⁶⁷ *Ibid.*, para 9 for detailed list of required information.

²⁶⁸ Swain (n 255) at 32; S Frisby, 'Report on Insolvency Outcomes' (2006) <<http://webarchive.nationalarchives.gov.uk/+http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/InsolvencyOutcomes.pdf>> p72, accessed 1st June 2014; Hyde & White (n 259) for further information on these criticisms.

²⁶⁹ Available online at <<http://www.legislation.gov.uk/ukSI/2011/785/made>

²⁷⁰ See Ministerial Statement on Improving Transparency and Confidence in Pre-packed Sales in Administration (Pre packs) 31st March 2011.

The Government was concerned that the new measures would have impacted on other businesses aside from micro-businesses, the sector in which most of the concerns relating to pre-packaged administration rested.²⁷¹ Rt. Hon. Edward Davey MP, the Minister in charge of Business, Innovation and Skill at the time, stated that;

“The Government is not convinced that the benefit of new legislative controls outweighed the overall benefit to business of adhering to the moratorium on regulations affecting micro-business”.²⁷²

As a result, the Government choose not to implement the proposed changes. Nevertheless, the Government was of the opinion that, if used appropriately, pre-pack sales can offer a flexible and speedy framework within which a business can be rescued and they can maximise returns for creditors.²⁷³ It has however been suggested that a suitable alternative to pre-packs in the form of DIP financing would ensure transparency in addition to providing the much needed liquidity.²⁷⁴ The belief is that funds injected through DIP financing would enable a more organised and open sale process for the benefit of the creditors²⁷⁵ and the possible rescue of the company.

In 2013, the UK government launched an independent review headed by Teresa Graham into the use of pre-pack administration. In her review report published on the 16th of June 2014, Teresa Graham acknowledged that while pre-packs could save jobs and cut insolvency costs, there was a need to address the lack of transparency and boost creditor confidence.²⁷⁶ She rejected the idea of having legislative control over pre-packs and

²⁷¹ See Ministerial statement on Pre-Packaged Sales in Insolvency, 26th January 2012.

²⁷² G Ruddick, ‘Pre- pack Administration Overhaul Dropped’ *The Telegraph* (London, 26 January 2012).

²⁷³ See Ministerial Statement on Improving Transparency and Confidence in Pre-packed Sales in Administration (Pre packs) 31st March 2011.

²⁷⁴ Swain (n 255) at 32.

²⁷⁵ Haywood (n 252).

²⁷⁶ See Graham Review into Pre-pack Administration – Report to the Rt. Hon V Cable, June 2014 available online at <<https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration> > accessed 17-07-2014.

advocated a series of voluntary measures²⁷⁷ to oversee how pre-packs are managed. These measures were primarily targeted at sales to connected parties such as a director, shadow director or company officer of the insolvent company; an associate of a director, shadow director or company officer of the insolvent company; and an associate of the insolvent company who becomes a director, officer of the new company or exercises control over the new company or an associate of a director of the new company or an associate of the new company. This is because research had shown that creditor pay-outs were often worse and the new business was less likely to succeed following pre-pack sales to connected parties.²⁷⁸ It is expected that a revised SIP16 would be introduced in May 2016 which would ensure that pre-packs can only be done with strong justification.

3.4.3 Calls for reforms to the UK corporate rescue procedures

²⁷⁷ The Graham Review's six recommendations were: (a) Create a pre-pack pool of experienced business people where, on a voluntary basis, details of a proposed sale to a 'connected party' could be disclosed to an independent person prior to the sale taking place. The aim of this recommendation is to increase transparency and give greater confidence to creditors that the deal has undergone independent scrutiny. (b) Request connected parties to complete a 'viability review' for the new company, stating how the company will survive for at least the next 12 months. A short narrative will also be provided, detailing what the new company will do differently from the old company in order that the business does not fail again. (c) The Joint Insolvency Committee to consider, at the earliest opportunity, a redrafted SIP 16 (found in Annex A of the Graham report). It is proposed that the documents required by the preceding two recommendations (i.e. a report by a pre-pack pool member and a viability review by a 'connected party') be sent with the redrafted SIP 16 statement. (d) All marketing of pre-pack businesses to comply with six 'good marketing' principles (stated in the report) in order to maximize sale proceeds and that any deviation from these principles be brought to creditors' attention. (e) SIP 16 to be amended to require valuations to be carried out by a valuer who holds professional indemnity insurance ('PII'), to increase confidence that the sale is for a fair price. (f) The Insolvency Service to withdraw from monitoring SIP 16 statements. Monitoring to be picked-up instead by the recognized professional bodies (RPBs), as they have the right level of practical experience to further improve compliance rates.

²⁷⁸ See P Walton, C Umfreville & P Wilson, 'Pre-pack Empirical Research: Characteristic and Outcome Analysis of Pre-pack Administration- Final Report to Graham Review, April 2014. See also The Insolvency Service, 'Annual Report on the Operation of Statement of Insolvency Practice 16' January/December 2011 which states that nearly 80 % of pre-pack sales were to connected parties.

The UK Insolvency regime has been criticised for being too biased towards creditor interests when compared to other jurisdictions, and for not offering enough protection and opportunity for troubled companies to rehabilitate.²⁷⁹ Consequently there have been calls for reforms to UK insolvency laws. One of the subjects that has generated a lot of controversial debate and a call for reforms, has been super-priority post-commencement financing. Although the Insolvency Act 1986 makes provisions for priority financing within the purview of the administration expenses, there are no provisions for Chapter 11 style super-priority financing that would encourage new and pre-existing lenders to extend credit to the company.

A system of funding was proposed by the Department of Trade and Industry (DTI) and the Insolvency Service in 1993. After consultations, the initiative was abandoned in 1995 on the grounds that it might encourage large ineffective incentives to lend and unjustifiable financing.²⁸⁰ In 2000, a review group was set up by agreement between the Chancellor of the Exchequer and the Secretary of State for Trade and Industry to review company rescue and business reconstruction mechanisms. Their terms of reference included reviewing and recommending the means by which businesses could resolve short to medium term financial difficulties in order to preserve maximum value, avoid liquidation and, where this was not possible, preserve as many businesses as possible as going concerns.²⁸¹

In its report the review group acknowledged that the issue of financing was central to any discussion of a rescue culture in the UK²⁸² and unless finance was made available, businesses would fail and assets would have to be sold piecemeal with the end result being

²⁷⁹ L Hiestand & C Pilkington, 'Time for (some) Chapter 11' (2008) 27 Int'l Fin. L. Rev. 40.

²⁸⁰ DTI Consultative Documents, 'Company Voluntary Arrangements and Administration Orders' (1993) & 'Revised Proposals for a New Company Voluntary Arrangement Procedure' (1995).

²⁸¹ Insolvency Service, 'A Review of Company Rescue and Business Reconstruction Mechanism, Report by the Review Group' (DTI, 2000) ("Review Report").

²⁸² *Ibid.*

that the company would be forced into liquidation.²⁸³ While companies can raise new funds to sustain the rescue process with the support of existing creditors and unencumbered assets, the dominance of fixed and floating charges makes the availability of unencumbered assets a rarity in corporate insolvencies.

In making recommendations on how to finance companies or business rescues, the committee looked to Chapter 11 for guidance. It was acknowledged by the committee that a direct transplant of the DIP funding mechanism would be unsuitable to the business culture and environment in the UK. Nonetheless, the basic principle of providing additional finance to a distressed business in a properly considered recovery plan in order to enhance its value would fit in with the purpose of financing business rescue in the UK. This therefore formed the basis of their recommendations to introduce super-priority financing.

In spite of the recommendations of the review Group, the initial draft of the Enterprise Bill neglected the issue of post-commencement finance.²⁸⁴ During the debates prior to the passing of the Enterprise Act, Lord Hunt (Parliamentary Under-Secretary (Department of Health) who was in support of the introduction of super-priority financing, argued that if an enhanced form of administration was to be used successfully as a rescue tool, it was necessary to tackle the issue of funding as it was important to have a mechanism that provides companies with access to on-going finance during the rescue process.²⁸⁵ He further proposed provisions for super-priority financing, where priority is given to a lender who is willing to advance money to a business to keep it going while a rescue is being worked out, and he stated that a failure to introduce super-priority financing would undermine the ability of administration to operate as an effective tool.²⁸⁶

²⁸³ *Ibid.*

²⁸⁴ *Ibid.*

²⁸⁵ HL Deb 29 July 2002, vol 638, cc763-806 at para 788.

²⁸⁶ *Ibid.*

In contrast, the House of Lords decided that the issue of lending to a company in administration was purely a commercial one, which was best left to the dictates of the lending market. It was felt that the issue of super-priority was beyond the abilities of the courts and the presence of floating charges made it impossible to have free unsecured assets, which would have made the idea of DIP financing more attractive.²⁸⁷ As to the availability of sources of post-commencement financing, the company's existing bankers and asset financiers were suggested as possible suppliers of credit.²⁸⁸ On the whole, the Government was cautious of creating a situation whereby guaranteed priority payments would encourage lenders to advance funds regardless of the viability of the rescue proposal.²⁸⁹

The unwillingness of Parliament to delve into the issue of super-priority financing did not put an end to calls for its introduction. Following the enactment of the Enterprise Act 2002, and with the economic recession biting hard with more businesses failing, the debate for and against the introduction of super-priority financing was revived. The issue of super-priority financing attracted political attention when Prime Minister David Cameron, at the time leader of the opposition, called for US-style bankruptcy protection laws as well as super-priority financing in a speech to the Confederation of British Industry (CBI)²⁹⁰ on the 15th of July 2008.²⁹¹

In addition, the Insolvency Service in its 2009 consultation on 'Encouraging Business Rescue – a Consultation'²⁹² put forward two main proposals aimed at increasing the availability of rescue finance. Firstly, it proposed that a range of increasingly enhanced

²⁸⁷ *Ibid*, per Lord McIntosh of Haringey at para 789. In the US there are no floating charges to hamper the availability of free assets.

²⁸⁸ *Ibid*.

²⁸⁹ HL Deb 21 October 2002, vol 639, cc1098-143 at 1116.

²⁹⁰ The UK's top business lobbying organisation.

²⁹¹ See Speech by David Cameron on the 15th of July 2008; F Elliot & G Gilmore, 'David Cameron Calls for US-style Bankruptcy Rules' *The Times* (London, 16 July 2008).

²⁹² June 2009. Available online at

http://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/con_doc_register/compresc/compresc09.pdf accessed online on the 25th of October 2012.

security should be offered to lenders of rescue finance as an incentive to lend to companies that would otherwise have difficulty attracting finance,²⁹³ and that finance costs properly incurred during the rescue process²⁹⁴ should have priority over administration expenses.²⁹⁵ In addition, the review group²⁹⁶ opined that the attachment of super-priority repayment to new credit would attract banks, other financial institutions and trade and services suppliers to extend credit to the company.²⁹⁷ It was suggested by the review group that this would make it easier for the rescue of the business as opposed to a piecemeal sale.²⁹⁸

Secondly, the review group suggested that an administrator should be able to secure new post-commencement financing against any unencumbered property or an additional fixed charge on any property and this will be subordinate to the original charge on the property. It was also recommended by the review group that there should be scope for the administrator to place a first charge or equal charge on a property which is already subject to a fixed charge.²⁹⁹ Views were also sought as to whether prior to securing new finance, the administrator must be satisfied that (a) the granting of such security for rescue finance is necessary in order to obtain the finance (b) the interest of existing secured creditors are adequately protected (c) obtaining the rescue is in the best interests of creditors as a whole.³⁰⁰

²⁹³ See The Insolvency Service, 'Encouraging Company Rescue – a Consultation' (2009) para 54 <http://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/con_doc_register/compresc/compresc09.pdf> accessed 30th October 2012.

²⁹⁴ This already attracts priority payment as part of administrative expenses

²⁹⁵ Encouraging Company Rescue - a Consultation (n 293) proposal C, para 60.

²⁹⁶ Led by officials from the DTI, Insolvency Service and HM Treasury and assisted by Alan Bloom, an insolvency practitioner and partner in Ernst and Young and President of the Society of Practitioners of Insolvency, 1999-2000; Richard Brakewell, a businessman from Lancashire; Julian Franks, Corporation of London Professor of Finance, the London Business School; Gary Klesch, Chairman, Klesch and Company; Harry Rajak, Professor of Law, University of Sussex; and David Singleton, Managing Director, Business Banking, Lloyds TSB.

²⁹⁷ Encouraging Company Rescue – a Consultation (n 293) para 61.

²⁹⁸ *Ibid.*

²⁹⁹ *Ibid.*, at para 65. This suggestion would bring the UK insolvency regime in line with both the Canadian CCAA and the US Chapter 11 which allow for the creation of new secured charges on encumbered assets.

³⁰⁰ *Ibid.*

An underlying theme runs through most of the proposals put forward regarding the introduction of rescue funding into the UK insolvency system, and this theme is identifiable in three main areas. Firstly, there is a recognition that a vacuum exists regarding post-commencement funding. While the Insolvency Act 1986 has, in a roundabout way, made provisions for post-commencement funding, these provisions are not as detailed as the US Chapter 11 or the CCAA provisions on interim financing in Canada. The lack of expansive case law on issues of rescue financing under the Insolvency Act 1986, means that the UK rescue funding provisions have not been put to rigorous test to assess its adequacy and to ascertain if it measures up to its US Chapter 11 and Canadian CCAA counter-parts.

Secondly, it does appear that there is a general pre-disposition towards the US Chapter 11 style financing as most of the recommendations are fashioned after it. Perhaps the reason why the US Chapter 11 style financing is being advocated as the model to emulate lies in its detailed provisions for the diverse financing needs of the debtor. Not only does section 364 of the US Bankruptcy Code offer incentives to encourage would-be lenders, it also protects the debtor from dubious DIP lenders, thereby offering, to some extent at least, a balanced platform for DIP financing. Besides, a system which has been tested overtime may be the pertinent model to follow.

Thirdly, those calling for reforms to UK rescue funding provisions have advocated a change in the priority accorded rescue funding. It was proposed that finance which has been properly incurred during the course of the rescue should enjoy super-priority over other administrative expenses and remunerations and not rank *pari passu*. The danger in introducing this sort of priority in the UK lies in its greater creditor focus and the fact that the rescue is managed by an administrator, unlike the US Chapter 11 which retains management at the helm of the rescue process and is more debtor-oriented. Thus if rescue funding is made to enjoy super-priority, it may have a far-reaching effect on continued

trading during the rescue process because it would rank ahead of important trading expenses, and this may result in parties being less willing to continue to trade with the company.³⁰¹ The adoption of super-priority status for rescue funding may also impact on the cost of ordinary credit which may rise in view of the danger of losing priority to post-commencement financiers. Also, administrators may be reluctant to take up appointments if they feel their fees may be in jeopardy as a result of super-priority finance.³⁰²

Whilst the proposed reforms appear to advocate a change that would bring the Insolvency Act 1986 in line with the other jurisdictions that have adopted super-priority rescue funding, there are underlying logistics which would make the implementation of super-priority rescue financing challenging. In the US there are specialised bankruptcy courts which deal with bankruptcies and its attendant issue. Consequently, bankruptcy judges in the US are versed in the complexities of DIP financing, unlike the judges in the UK³⁰³ who may have no experience in such complex financial dealings.

3.5 Is the UK ready for the US Chapter 11-style rescue funding?

The idea of introducing super-priority financing into the UK insolvency regime has been criticised for trying to impose a feature of the debtor-friendly US Chapter 11-style proceeding³⁰⁴ upon the creditor-friendly UK system. On the other hand, it has been stated that the idea of looking to the US Chapter 11 is not premised on a wholesale duplication of it, but an adoption of only the best features of the process,³⁰⁵ which would complement and

³⁰¹ Response of the Insolvency Law Committee of the City of London Law Society to the Consultation Document on Proposals to Encourage Company Rescue (8th September 2009).

³⁰² *Ibid.*

³⁰³ In the UK there were specialist bankruptcy courts (the London Bankruptcy courts) which had exclusive jurisdiction to deal with bankruptcy matters until the Bankruptcy Act 1883 merged these courts with the high courts. See section 2.1.3 (p23-24) of the thesis.

³⁰⁴ Hiestand & Pilkington (n 279).

³⁰⁵ Speech by David Cameron (n 291).

add value to the administration process.³⁰⁶ There are difficulties associated with transplanting a legal system or norm from one society to another as no one legal system is an exact model of another.³⁰⁷ While it is acknowledged that legal transplants bring about legal change, there are only two options to legal transplants; an adoption and assimilation of the transplanted law or total rejection and failure of the transplant.³⁰⁸

Most legal systems are shaped by historical, political and economic factors that cannot necessarily be duplicated in another jurisdiction.³⁰⁹ Attempting a direct transplant may have unintended negative consequences which may cut across other social structures.³¹⁰ The practical implication of this may be a failure of the transplant of the intended legal norm; this then defeats the initial purpose of reforming the existing laws. During the House of Lords debates on the Enterprise Bill in 2002, it was recognised that the judicial structure in the UK may not be able to support the introduction of rescue financing because of the absence of specialist courts and / or judges with experience in such complex financial matters.³¹¹ In addition, Lord McIntosh alluded to the impact the introduction of super-priority rescue financing could have on business and economic structures, and stated that the decision to lend money to a distressed company during the rescue period should be left to the commercial judgement of the lending market.³¹² It can therefore be argued that the differences between the economic, business and legal structures of the UK and the US may make it impracticable to attempt a direct transplant of the US Chapter 11-style rescue funding.

³⁰⁶ Hiestand & Pilkington (n 279).

³⁰⁷ UNCITRAL Guide, p15 at para 17

³⁰⁸ M Graziadei, 'Theoretical Inquiries in Law' (2009) 10 *Theoretical Inq. L.* 723.

³⁰⁹ M Graziadei, 'Comparative Law as the Study of Transplants and Receptions' in M Reimann & R Zimmermann (eds.) *Oxford Handbook on Comparative Law* (Oxford, 2008).

³¹⁰ D Berkowitz, K Pistor, J Richard, 'The Transplant Effect' (2003) 51 *Am. J. Comp. L.* 163.

³¹¹ HL Deb 28 July 2002, vol 638, cc763-806 at 789.

³¹² *Ibid.*

Those against Chapter 11-style reforms have always reiterated that the Insolvency Act 1986 already makes provisions for rescue funding. Under the 1986 Act, an administrator has access to unencumbered assets and floating charge assets³¹³ which he may deal with to raise money. This asset pool has further been augmented as a result of the decision of the House of Lords in *Re Spectrum Plus*³¹⁴ which changed book debts from fixed charges to floating charges, making them available for administrators as a possible source of finance. Moreover, it has always been pointed out that the administrator can secure loans on behalf of the company, and these will enjoy priority repayment as part of the administration expenses.³¹⁵ The priority of administration expenses under the Insolvency Act is not materially different from the priority of payment that takes place under the US Chapter 11 procedure and the Canadian CCAA. Under the US Bankruptcy Code, a DIP manager is authorized to obtain unsecured loans during the ordinary course of business and these loans enjoy priority as part of administrative expenses over other priority claims and unsecured claims.³¹⁶ Likewise, under the Canadian CCAA post-commencement lenders who advance money to a debtor company to support its restructuring process enjoy priority repayments over other claims.³¹⁷ The cost of managing a company's rescue therefore enjoys the same priority repayments across the three jurisdictions.³¹⁸

Supporters of a Chapter 11-style reform have contended that there should be scope for “priming liens”. In other words, the administrator should be able to grant security over encumbered assets. While the 1986 Act³¹⁹ authorises the administrator to raise or borrow money over the company's property, it is not clear if this can be extended to encumbered

³¹³ See generally, *Re Spectrum Plus*, [2005] UKHL 41. He still has powers to deal with these assets during the ordinary course of business until it crystallises.

³¹⁴ [2005] UKHL 41.

³¹⁵ Insolvency Act, Sch. B1 para 69, 99 and Schedule 1.

³¹⁶ 11 U.S.C., s 364(2).

³¹⁷ CCAA 1985, s 11.2(1).

³¹⁸ See section 3.6 of the thesis, where a detailed analysis of the different types of priority repayments during rescue is discussed.

³¹⁹ See Insolvency Act 1986, para3, Schedule B1.

assets. It has been suggested that, in principle, nothing stops an administrator from being able to secure new financing by means of a subordinate fixed charge, a possibility which the administrators may already be exploring on a consensual basis, with the permission of the pre-existing secured creditor.³²⁰ The same principle can arguably also be applied to priming the existing rights of a secured creditor for that of a new lender, as long as it is agreed upon by all parties involved. It may be an uphill task getting senior creditors to agree to such an arrangement, as no creditor may be willing to give up their place of priority, especially in an insolvent company. However if an “adequate protection” concept,³²¹ similar to the one provided for by the US Bankruptcy Code, is adopted to recompense senior creditors for their loss of priority, it may encourage them to give up their place of priority to a new post-commencement lender.

In addition, DIP financing is well entrenched within the US legal system and it has been forged from the tracks of railway receiverships to modern day corporate re-organisation, such that the US judiciary has a wealth of experience to draw from and the judges are accustomed to dealing with commercial decisions. The UK may have a long way to go in order to attain the level of expertise needed to handle such complex commercial matters, especially considering that there are no specialised bankruptcy courts and judges as is the case in the US. The position of the bankruptcy judge in the US has been in existence since 1978, when Congress established the position as part of reforms to bankruptcy legislation.³²² Bankruptcy judges in the US develop their expertise on the job as there is no requirement for prior experience in bankruptcy or commercial matters for a judge to be

³²⁰ Yeowart (n 245).

³²¹ See 11 U.S.C., s 364(d). See also p87-89 of the thesis for a detailed discussion on “adequate protection” under the Bankruptcy Code. Adopting the CCAA style of granting a priming lien over the objections of senior creditors may not work in the UK as the jurisdiction is creditor-friendly and may not wish to introduce a concept which interferes with creditors’ interests. Moreover, priming a lien over the objections of senior creditors may increase the cost of borrowing for healthy companies and more so for distressed companies.

appointed to the bankruptcy courts.³²³ Arguably, spending fourteen years³²⁴ as a bankruptcy judge presiding exclusively on bankruptcy matters might develop specialist knowledge and skill in that area, an advantage bankruptcy judges in the US have over judges who handle bankruptcy matters in the UK.

Typically, in the UK, corporate insolvency disputes are heard in the High Court with the Chancery Division specifically assigned to handle bankruptcy matters. The Chancery Division is not a specialist bankruptcy court. It also deals with a range of other cases relating to business, trade and industrial disputes; the enforcement of mortgages; disputes relating to trust property; intellectual property matters, copyright and patents and contentious probate matters relating to wills and inheritance.³²⁵ Therefore judges assigned to the Chancery division may have to sit on a wide range of cases unrelated to insolvency, unlike their US counterparts, making it difficult for these judges to get specialist experience or knowledge in complex issues such as DIP financing.

3.6 Does the UK offer super-priority financing?

One of the incentives that make DIP financing attractive is the super-priority status it gives post-commencement lenders.³²⁶ By attaching priority status to post-commencement loans, prospective lenders are given an assurance of repayment. Black's Law Dictionary defines priority as the situation where two persons have comparable rights in relation to the same subject matter and one of them is entitled to exercise his right to the exclusion of the

³²³ See Bankruptcy Amendments and Federal Judgeship Act 1984, s 120(c) (2)-(7).

³²⁴ The tenure for bankruptcy judges in the US is fourteen years, see 28 U.S.C., s 152 (a) (1).

³²⁵ Information available at <http://www.judiciary.gov.uk/you-and-the-judiciary/going-to-court/high-court/> accessed 19th July 2014.

³²⁶ 11 U.S.C, s 364.

other.³²⁷ Although there is no evident definition of super-priority under insolvency laws, from the wording of section 364 of the US Bankruptcy Code,³²⁸ super-priority is used to describe a claim which has precedence over another claim that has priority over other claims. Stated differently, where there are two conflicting interests in an asset and one of these interests has precedence over the other, the holder of the preferred right is forced to give up its priority to another party who may, or may not be part of the initial network of interests.³²⁹

Super-priority financing has been identified as one of the features of model insolvency laws³³⁰ and while the UK insolvency regime provides a modest avenue for funding rescues within the purview of the administration expenses and the administrator's power to enter into contracts, at first glance, the Insolvency Act 1986 appears not to have made provisions for super-priority financing. This is because the provisions which deal with post-commencement funding under the Insolvency Act 1986 is not as structured as the US Chapter 11 post-commencement financing provisions which clearly provides for super-priority financing. In keeping with the functional equivalence thesis of the research, it is pertinent to examine if the UK post-commencement financing provisions suffices as super-priority financing.

Under the Bankruptcy Code, the US Chapter 11 gives super-priority status to unsecured credit obtained as part of administrative expenses over all other claims except secured claims³³¹ and where it is not possible to attract finance for administrative expenses on this basis, it gives an "elevated" super-priority³³² status to credit obtained for this purpose, over

³²⁷ B A Garner, *Black's Law Dictionary* (3rd edn, Sweet & Maxwell 2006).

³²⁸ 11 U.S.C.

³²⁹ See section 5.3 of the thesis for a detailed analysis of creditors' interest and the rule of distribution.

³³⁰ McCormack (n 13) p176.

³³¹ 11 U.S.C., s 364(a)-(b).

³³² A priority which takes precedence over a super-priority status.

all administrative claims³³³ as well as secured creditors' interests in some cases.³³⁴ In Canada, the CCAA makes mention of interim financing having super-priority over the interests of secured creditors³³⁵ and critical suppliers having the same priority as interim financing, ahead of secured creditors.³³⁶ In addition, the CCAA provides that where a previous order for interim financing has been made and there is need for further finance, the court may make an order priming³³⁷ the pre-existing charge or security from the previous interim financing order, thus conferring an "elevated" super-priority status on the additional finance.

While not detailed in the scope of its application, section 19(5) and schedule B1 paragraph 99(3)-(4) of the Insolvency Act 1986 give room for manoeuvre and may arguably be relied on as a basis for super-priority repayments. Under the Insolvency Act 1986, administration expenses and the administrator's remuneration have equal priority over all other claims except secured claims.³³⁸ This confers super-priority status on expenses (which may include post-commencement financing) incurred in respect of the administration order. Section 19(5) and schedule B1 paragraph 99(4) of the Insolvency Act 1986 also provide that contracts entered into by the administrator in the course of carrying out his functions will enjoy priority payment over the administrator's remuneration, administration expenses and all other claims except secured claims.³³⁹ This seems to indicate that if an administrator enters into a contract which may include post-commencement financing, the contract will enjoy an "elevated" super-priority status over all other claims including the administration expenses and the administrator's remuneration. McCormack acknowledged this window of

³³³ 11 U.S.C., s 364 (c) (1) & (d). s 364(d) covers priming liens which has already been discussed under section 3.2.3.2 of the thesis .

³³⁴ See *In re National Litho, LLC*, 2013 WL 23037865, 5 (Bankr. S.D. Fla. 2013).

³³⁵ CCAA 1985, s 11.2(2) (3).

³³⁶ *Ibid.*, s 11.4(1-4).

³³⁷ A term used to describe the subjugation of a pre-existing lien or security interest.

³³⁸ Insolvency Act 1986, Schedule B1, para 99(3), (4)-(6).

³³⁹ *Ibid.*, Schedule B1, para 99(3), (4)-(6).

opportunity and argues that interest and capital repayments under a loan can be classed as liabilities arising out of a contract³⁴⁰ and can be charged on and be payable out of property under the administrator's control³⁴¹ thus enjoying super-priority over administration expenses and the administrator's remuneration.

While this provides a sound argument for recognition of the presence of a means for super-priority financing within the Insolvency Act 1986, an argument can be made to the contrary. One of the rules of statutory interpretation requires that when a law is ambiguous without any clear or direct meaning, an interpretation can be adduced from the intentions of Parliament at the time of drafting the law. It is clear from debates preceding the enactment of the Enterprise Act that it was never the intention of Parliament to create provisions for super-priority financing. According to Lord Hunt, quoting Lord Sainsbury;

“... the government's position is essentially that the decision to lend to a company should be left to the commercial judgement of the lending market...”³⁴²

Despite government's refusal to give legislative backing to super-priority financing, in theory there is nothing that precludes English judges from relying on paragraph 99(4) to assign super-priority financing, just as their Canadian counterparts did prior to the introduction of interim financing statutes. The use of precedents has played a considerable role in the creation of laws in the UK. It therefore seems that relying on history, paragraph 99(4) and the inherent jurisdiction of the courts; progress can be made in the area of super-priority financing.

Superficially, it appears that all three jurisdictions accord the same kind of priority to post-commencement finance. On further analysis, there are slight variances in how super-

³⁴⁰ G McCormack, *Corporate Rescue Law- an Anglo American Perspective* (Edward Elgar, 2008) p198-199.

³⁴¹ Insolvency Act 1986, Schedule B1 para 99(4) (a).

³⁴² HL Deb 21 October 2002 vol 639 cc1098-143 at 1114.

priority status is conferred in all three jurisdictions. Generally, under the CCAA post-commencement finance may be granted precedence over the claims of secured creditors.³⁴³ However in the US, it is only under special circumstances, where the company has not been able to borrow under section 364 (a) & (b) of the Bankruptcy Code that super-priority finance is given precedence over secured claims. Under the UK Insolvency Act, there is no provision for special circumstances under which post-commencement financing or administration expenses may take precedence over secured claims. Secured creditors maintain their place of priority and do not lose their position to any other claim including administration expenses/post-commencement financing.³⁴⁴ This is not unexpected as the UK is known for giving precedence to creditors' claims and interests,³⁴⁵ therefore any action which will undermine the interests of creditors will not be readily adopted.

3.7 Comparison of financing available under the Insolvency Act 1986, the CCAA 1985 and the Bankruptcy Code

In comparing and analysing the relevant statutes, i.e. the UK Insolvency Act 1986, the US Chapter 11 and the Canadian CCAA, expenses incurred during the ordinary course of the debtor's business are classified as administrative expenses, and such expenses enjoy some sort of priority. As a result, it is fair to state that all three statutory frameworks recognise the importance of maintaining the status quo of the business, and they have made allowances for its basic expenses to be met. In the US, provision is also made for expenses, other than those usually classified as administrative expenses,³⁴⁶ to be borrowed with the

³⁴³ CCAA 1985, s 11.2(1) (2).

³⁴⁴ The effect of funding on the ranking of creditors' claims is discussed in section 5.4 of the thesis.

³⁴⁵ See section 2.7 of the thesis for discussion of the UK's preference for creditors' rights.

³⁴⁶ Administrative expenses under the US Bankruptcy Code may include taxes, wages, penalties and fines. See 11 U.S.C., s 503(b) & s 507 (b). See also section 3.2.3 (p85-86) of thesis for detailed description of the difference between administrative expenses incurred during the ordinary course of business and that incurred outside the ordinary course of business.

court's permission during the rescue process,³⁴⁷ and this expense enjoy the same priority as administrative expenses. In the UK, on the other hand, the situation is quite different. Expenses such as credit obtained for expenses incurred outside the ordinary course of the debtor's business, are lumped together with administrative expenses and enjoy the same level of priority as the administrator's remunerations.³⁴⁸

Canada appears to have categorised its administrative expenses in the manner in which the US has. However, Canada recognises two forms of expenses, namely "critical suppliers" and "required expenses". "Required expenses" may constitute part of the administrative expenses incurred during the ordinary course of the debtor's business. Conversely, a "critical supplier" (as described by the Canadian CCAA) is a person who supplies goods and services that are critical to the company's continued operations and these suppliers enjoy priority over secured creditors. What the CCAA has done by this classification can be seen as an inclination to ensure that all factors necessary to ensure a company's successful rescue are in place.

In contrast, the Bankruptcy Code does not distinguish critical suppliers from the general body of administrative expenses. Expenses for critical supplies may be inferred from the provisions of section 364(a)³⁴⁹ which takes care of administrative expenses incurred during the ordinary course of business. Administrative expenses could be termed as operating costs incurred during the rescue process which are essential to its continuity. Arguably, critical suppliers play a vital role in the day to day running of a distressed company and it may not be far-fetched to say that their continued support ensures that the company keeps on trading during the rescue process. Therefore expenses incurred to ensure that supply lines are kept open can be classed as administration expenses and the provisions of section 364(a) would

³⁴⁷ 11 U.S.C., s 364(b). An example of this kind of expense could be insurance premium.

³⁴⁸ Insolvency Act 1986, Sch B1, para 99 & Insolvency Rules 1986, r 2.67.

³⁴⁹ 11 U.S.C.

apply. Critical suppliers could easily be classed under section 364(b). However it may be ill-advised to do so because the provision of section 364(b) requires authorization from the courts before expenses under this section can be incurred. The term “Critical” engenders the need for speed, and arguably, the debtor may need immediate access to cash to keep supply lines open. Waiting to get the court’s approval may cause unnecessary delays.

In recognition of the important role suppliers play in the rescue of the debtors’ company the UK Business Minister, in a consultation launched on the 8th of July 2014, announced a series of proposals aimed at preventing suppliers from holding insolvent companies to ransom by demanding increased charges and payment of existing debts owed as a condition of the continued supply of services.³⁵⁰ Consequently, suppliers of critical utilities will now have to continue providing their services during the rescue process and safeguards that “adequately protect” suppliers have also been introduced.³⁵¹ While the present consultation relates to utilities suppliers and IT providers, it is hoped that eventually the proposals will be extended to all other suppliers that are critical to the rescue of insolvent companies. This is because the continued support of critical suppliers would ensure that the debtor continues trading while it restructures.³⁵² With these new proposals relating to critical suppliers, it is hoped that funding corporate rescues in the UK will gain some common ground with the Canadian CCAA and the US Chapter 11 procedures.

Further comparison between the Canadian CCAA and the US Bankruptcy Code shows that their funding provisions allow for the priming of existing liens with the court’s permission, in order to raise the required funds. Detailed analysis throws up a clear difference in how existing interests can be primed. Under the US Code, a lien can be primed where the debtor

³⁵⁰ J Brazier, ‘New Insolvency Measures Announced’ *Insolvency News* (London, 8th July 2014). Available online at <http://www.insolvencynews.com/article/17219/industry/new-insolvency-support-measures-announced-> accessed 5th August 2014.

³⁵¹ *Ibid.*

³⁵² *Ibid.*

cannot obtain unsecured credit, and this is often the case where, at the point of commencement of the rescue process, the debtor has little or no unencumbered assets. Section 364(d) permits the priming of an existing lien or granting of a lien on an equal basis to an existing lien. This is different from what is permissible under the Canadian CCAA. Section 11.2 allows the priming of an existing lien as allowed under the US Bankruptcy Code, but it makes further provisions for the priming lien permitted under section 11.2(1)-(2) to be primed by another lien. It is not clear if this ability of “double priming” is permissible under the US Bankruptcy Code.

In acknowledgment that approval of a priming lien interferes with a secured creditor’s interest, which is not permissible under the US law of security interests,³⁵³ the US Bankruptcy Code places a *caveat* on the priming of liens by debtors. The Bankruptcy Code requires that the debtor must show its inability to obtain any other loan, and that the existing lien holder’s interest is adequately protected. It is not a requirement under the Canadian CCAA to demonstrate an inability to obtain loans, neither is it required for a debtor to show that the existing lien holder is adequately protected. All that the debtor needs to do is to put the existing lien holder on notice³⁵⁴ and, in the case of a “double priming lien”, obtain the lien holder’s permission.³⁵⁵ The only concession the CCAA gives to the existing lien holder’s interest is the prohibition of cross-collateralization,³⁵⁶ which acts to improve the new priming lien holder’s pre-insolvency unsecured/under-secured position. Therefore, lenders hoping to use DIP financing to consolidate their pre-commencement exposure will not be permitted to hitch this exposure to the DIP super-priority charge. It does appear unfortunate that the US Bankruptcy Code does not expressly forbid cross-collateralization,

³⁵³ Chapter 4 discusses security interests in the US, UK and Canada.

³⁵⁴ See CCAA 1985, s.11.2.

³⁵⁵ *Ibid*, s.11.2(3).

³⁵⁶ *Ibid*, s 11.2 and p112 of the thesis for the Canadian stance on cross-collateralization.

which could undermine the “adequate protection” requirement. It has been left to the courts to reject the practise of cross-collateralization under DIP financing.³⁵⁷

How then does the UK funding system measure against this structure of super-priority priming lien financing found in Canada and the US? Under the UK structure, there are no provisions for priming liens. This is not surprising considering that creditors’ interests have historically been paramount during insolvency in the UK,³⁵⁸ and any provision that will interfere with this interest may likely not be welcomed. What is available under the Insolvency Act 1986 is the power of the administrator to raise or borrow money and grant security.³⁵⁹ Whilst there is no provision for priming liens within the UK framework, the administrator can grant security over the company assets. To this extent, all three jurisdictions share a commonality. Furthermore, any money borrowed by the administrator during the rescue process enjoys priority over floating charge holders and unsecured interests as part of the administration expenses, alongside the administrator’s remuneration.

Two things may be pointed out here. Firstly, unlike the Canadian CCAA and the US Bankruptcy Code which gives priority over secured interest to some classes of rescue expenses, administration expenses in the UK enjoy no such priority and, secondly, it can be deduced that rescue funding under the Insolvency Act 1986 acknowledges two types of funds;

- General administration expenses incurred during the ordinary course of business and

³⁵⁷ See *Otte v Manufacturers Hanover Commercial Corp (In re Texlon Corp.)* 596 F. 2D 1092, 1094; *Shapiro v Saybrook Manufacturing Co.* 936 F. 2nd 1490 (11th Cir. 1992). See also section 3.2.5 for discussion on cross-collateralization under Chapter 11 DIP funding.

³⁵⁸ See section 2.7 of thesis for discussion on the UK’s preference for creditors’ rights..

³⁵⁹ Insolvency Act 1986, Sch B1para 99 (3).

- Money that can be borrowed by the administrator which may be used for expenses which fall outside the ordinary course of business.

It can therefore be assumed that, although the UK system does not have specific categories of expenses, all essential funds needed for the rescue are provided for under the provisions set out in the Act.

As regards the issue of priority, before the enactment of the Enterprise Act 2002 the expenses of administration were debts and liabilities incurred under contracts entered into by the administrator, and no provision was made for the order in which they could be paid.³⁶⁰ However, the issue of priority is addressed under rule 2.67(1) of the Insolvency Rules, 1986. The Insolvency Rules 1986 has a list of administration expenses payable in order of priority; it begins with expenses properly incurred by the administrator in performing his functions in the administration of the company,³⁶¹ and followed closely by the cost of any security provided by the administrator in accordance with the Act or Rules.³⁶² Thereafter, the Rules list seven other expenses which are to be paid in order of priority.³⁶³

Whilst it appears that the Insolvency Act 1986 has in place a general provision that permits an administrator to raise funds for the rescue process, there are no incentives (such as the ability to prime existing charges, or accord “elevated” super-priority status without the consent of the creditor concerned), to open up more avenues in accessing rescue funding. On the other hand, it can be argued that the provisions of paragraph 99(4) of Schedule B1 of the Insolvency Act provide an opportunity for super-priority financing in the UK. This

³⁶⁰ *Re Atlantic Computer Systems plc* [1990] BCC 859 and *Centre Reinsurance International Co v Freakley* [2006] UKHL 45.

³⁶¹ Insolvency Rules 1986, r 2.67(1) (a).

³⁶² *Ibid.*, r 2.67(1)(b).

³⁶³ *Ibid.*, r 2.67(1)(b)-(i). It should be noted that the order of priorities laid down by the Rules are subject to the power of the court.

provision permits a debt or liability arising out of a contract entered into by an administrator (albeit after he has left office) to be paid in priority over administrator's remuneration and administration expenses.³⁶⁴ Although retroactive in principle, nothing prevents the existing administrator from taking advantage of this provision to obtain super-priority financing by entering into a contract with a potential lender.³⁶⁵

In light of the above, it appears that all three jurisdictions offer, or may have an avenue to offer, priority payment as incentives for credit obtained (be it administrative or otherwise) post-commencement. By implication there is arguably room for super-priority repayments within the administration procedure. It can be argued that paragraph 99(4) of the Insolvency Act 1986 acts as the functional equivalent of the super-priority financing found in US Chapter 11 procedure and the Canadian CCAA, with the exception of priming liens. The major difference to be found between paragraph 99(4) of the Insolvency Act 1986 on the one hand and super-priority financing under US Chapter 11 and the Canadian CCAA is the required supervision of the courts in super-priority financing in the US and Canada. While the supervision of the courts may be viewed as an advantage because it adds structure and consistency to the whole process, the lack of court intervention in paragraph 99(4) may be seen as advantageous in that a post-commencement financing arrangement could be quickly reached between an administrator and a proposed post-commencement lender.

Conclusion

³⁶⁴ See section 3.4.1 of the thesis for discussion on statutory provisions for post-commencement financing in the UK and section 3.6 above for the super-priority nature of post-commencement funding in the UK.

³⁶⁵ See *Powdrill v Watson* [1994] 2 All ER 513 at 522.

As it has been argued above, one of the most fundamental issues relevant to the success of corporate rescue is the availability of funds.³⁶⁶ Post-commencement financing provides the debtor company with working capital which gives it leeway to continue trading while it identifies and remedies the source of its financial distress.³⁶⁷ It is clear that all three jurisdictions in drafting frameworks for corporate rescue have taken this into consideration and, in varying degrees, have made provision for how the rescue process can be funded. Although the mechanisms available within the US and Canada are not without their disadvantages,³⁶⁸ despite some obvious failings they have been able to provide a means which compliments their individual economic, cultural and political environment for the effective funding of the rescue of failing businesses.

The UK, on the other hand, lacks the same structured statutory provisions. Arguably, what is available is a skeletal foundation for super-priority financing which the Government may have missed various opportunities to build on. Examples such as *Bibby Trade Finance Ltd v McKay*³⁶⁹ and *Freakley v Centre Reinsurance International Co*³⁷⁰ have shown that super-priority financing is something that can be done. It may however be argued that the prevalence of pre-packs negates the urgent necessity for post-commencement financing, as these arrangements will have been concluded before the formal administration process begins. This is based on the assumption that all issues of financing rest with the buyer who will have made his own arrangements. However, pre-packs are not suitable in all cases and in some instances a trading administration will be desirable. Consequently, it may be

³⁶⁶ See introduction to thesis and p74-77 of the thesis for the relevance and importance of rescue funding.

³⁶⁷ J Sarra, 'Governance and Control: The Role of Debtor-in possession Financing under the CCAA' (2004) ANNREVINSOLV p 118- 172.

³⁶⁸ Post-commencement funding may increase the cost of lending because of its interference with the hierarchy of distribution to creditors and in the case of priming liens, creditors' interests in security. Also, under the US Chapter 11 DIP financing, post-commencement lenders could gain an unfair advantage over other creditors through cross-collateralization. The lack of adequate compensatory protection for senior creditors, whose liens are primed under the CCAA, is another drawback.

³⁶⁹ [2006] All ER 266.

³⁷⁰ [2006] BCC 971.

beneficial to have a clearly defined alternative in place to fund the rescue process, a possibility highlighted by UNCITRAL;

“An insolvency law can recognise the need for . . . post-commencement finance, provide authorisation for it and create priority or security for repayment of the lender, the central issue is the scope of the power, and in particular, the inducements that can be offered to a potential creditor to encourage lending”.³⁷¹

The major difference that can be identified from all three jurisdictions is that both Canada and the US have incentivised their funding framework by attaching priority over existing secured creditors’ interests to such funds, and in so doing have structured the availability of funds. Incentivized rescue funding such as that provided in Canada and the US opens up different avenues on how the rescue process can be funded.

Equally, it can be argued that while the UK offers super-priority repayments by default, there is no scope for priming liens under its statutory framework. The ability to prime existing liens may be regarded as an important mechanism for raising rescue funds, as it opens up avenues for post-commencement funding where all the company’s assets have been encumbered. It may be assumed that the lack of such an incentive means that presently new secured finance is only available to support a rescue procedure in the UK to the extent that existing secured creditors agree, and / or if the company has uncharged assets (or charged assets with sufficient equity) that can be offered as fresh security.³⁷²

In addition, the use of pre-packs, despite their perceived failings, has in some cases taken away the need for incentivised rescue funding. Despite calls for super-priority financing to be introduced in the UK, there have not been any substantive moves to do so. Presently, the existing post-commencement funding mechanism in the UK takes sufficient care of the

³⁷¹ UNCITRAL Guide.

³⁷² Review Report (n 281).

need for post-commencement finance. Rescue funding appears to be a *company* rescue issue and more often than not, a *business* rescue as opposed to a company rescue is achieved in the UK and this perhaps fits into the existing funding framework. Another important consideration is how the introduction of post-commencement funding will fit into existing lending structures in the UK, which is quite different from the lending structures in the US and Canada.

Chapter IV: Secured lending and its relevance to rescue funding

Introduction

During the House of Lords debates prior to the enactment of the Enterprise Act 2002, it was suggested by one of the Lords that the lending structure in the UK made it impracticable to introduce DIP financing provisions into the Insolvency Act 1986.¹ In the UK, security which forms the basis of lending, is structured differently from its US and Canadian counterparts and as such, when a company becomes insolvent, these security interests are treated differently by the laws of these countries. The presence of these security interests play an important role in the resolution of the company's insolvency especially as it relates to an insolvent company's ability to raise funds to support continuous trading during rescue. Consequently, it is essential to evaluate the lending structures of the three jurisdictions. While it is acknowledged that credit can be extended on an unsecured basis, the use of collateral is crucial to lending and plays an important role in how credit is accessed.² In addition, the use of collateral as security appears to be highly prevalent in corporate borrowing, therefore this chapter will focus on secured lending. Particular emphasis would be on the effect of the UK's lending structure on the accessibility of rescue funding.

In line with comparative legal analysis, which not only seeks to produce similarities between two distinct concepts, but also to illustrate differences and highlight divergent characteristics between two phenomena,³ both in the nature and content of rules and in their operation, the ensuing discussion will revolve mainly around the floating charge. This is

¹ *Per* Lord McIntosh of Haringey, HL Deb 29 July 2002, vol 638 cc763-806 at para 788-789, especially at 789.

² F Lopez-de-Silanes, 'Turning the Key to Credit: Credit Access and Credit Institutions in F Dahan & J Simpson (eds), *Secured Transactions Reform and Access to Credit* (Elgar Publishing, 2008) p 9-10.

³ J W Cairns, 'Development of Comparative Law in Great Britain' in M Reimann and R Zimmermann (eds) *The Oxford handbook of Comparative Law* (Oxford, Oxford, 2008).

because the floating charge stands as a clear disparity in the lending practice in all three jurisdictions and this difference was acknowledged by Lord McIntosh during the House of Lords debates prior to the enactment of the Enterprise Act 2002.⁴

The chapter begins with a general outline of secured lending, followed by an examination of secured lending structures in all three jurisdictions. Thereafter a comparative evaluation of lending structures in the three jurisdictions is carried out to establish the differences and similarities that underline secured lending in the UK, US and Canada. This is followed by an examination of the UK lending structure to ascertain if it can support a US-style super-priority funding or any form of rescue funding.

4.1 Secured Lending

The US Uniform Commercial Code (UCC) defines a security interest as an interest in personal property that secures either a payment of money or the completion of an obligation and, also the interest of a buyer of accounts.⁵ The UK, on the other hand, has no statutory definition for security interest; however security has been held by the courts to have been created, where a creditor acquires rights against the debtor's property in order to enforce the discharge of the debtor's obligation to the creditor.⁶ In Canada, a security interest is defined as an interest that secures payment or performance of an obligation.⁷

Generally, creditors insist on having security interests in real and personal property in exchange for allowing debtors to obtain access to goods, services, land and money on credit.⁸ Accordingly, security taking is seen as the norm in the majority of commercial loan

⁴ HL Deb, see n1.

⁵ Uniform Commercial Code (UCC), 2001, article 1-201(37).

⁶ Per Browne-Wilkinson V-C in *Re Paramount Airways Ltd* [1990] BCC 130 at 149.

⁷ Personal Property Security Act, RSO 1990, c P.10 (PPSA), s.1.

⁸ PR Moo, 'The Secured Creditor in Bankruptcy' (1973) 47 Am. Bankr. L.J 23.

arrangements agreed to by banks.⁹ The fundamental principle of secured credit is that the debtor's proprietary interest in one or more of his assets is assigned to a creditor as an indemnity against any subsequent default¹⁰ of the loan.

Obtaining security/collateral as part of a loan agreement gives the creditor a superior claim to payment of the debt out of the debtor's assets in the event of the debtor's insolvency.¹¹ This is because the rules of distribution in insolvency provides a hierarchy of payment of creditors' claims out of the debtor's assets and secured creditors' claims are at the top of the hierarchy. Therefore, taking security minimises risk as far as the creditor is concerned and maximizes his prospects of recovery in the event of the debtor's insolvency.¹² Debtors also benefit from the use of collateral as its inclusion in a loan agreement may lower the cost of servicing the loan¹³ in terms of interest payable on the loan.¹⁴

4.2 Secured lending practices in the UK¹⁵

Secured lending in the UK is centred on two major types of security; the fixed charge and floating charge.¹⁶ A fixed charge confers real rights on the creditor over a class or classes of the debtor's assets, and in secured lending this offers the most protection to the creditor, most especially during insolvency. This is because the assets which are subject to the fixed charge cannot be dealt with or disposed of without the permission of the fixed charge

⁹ Cork Report, ch 34.

¹⁰ RCC Cuming, C Walsh & R J Wood, *Personal Property Security Law* (2nd edn, Irwin, 2012) p1.

¹¹ G McCormack, 'Secured Transactions Law Reforms, UNCITRAL and the Export of Foreign Legal Models' in N Orksun Akseli (ed) *Availability of Credit and Secured Transactions in a Time of Crisis* (Cambridge University Press, 2013) p35-36.

¹² G McCormack, *Secured Credit under English and American Law* (Cambridge University Press, 2004) p5.

¹³ G McCormack, 'Reforming the Law of Security Interests: National and International perspectives' (2003) *Sing. J. Legal Stud.* 1.

¹⁴ Creditors are likely to charge a higher interest rate in the absence of collateral because of the high risk involved in leaving themselves exposed to the debtor's default or insolvency.

¹⁵ Material in this section and ensuing sub-sections (4.2- 4.2.2) has previously been incorporated in an article published in the *Annual Review of Insolvency Law 2013*. See appendix for details.

¹⁶ McCormack (n13) at p39 - 58.

holder.¹⁷ This acts as a source of encouragement for financial institutions such as banks to make funds available to companies. Added to this, at the point of insolvency, enforcement issues are quite simple,¹⁸ as the secured creditor may be able to enforce his security with the permission of the court.¹⁹

While the fixed charge plays an important role in how security supports lending practices in the UK, the floating charge has traditionally been regarded as the workhouse of secured credit²⁰ and its significance in English lending practice was acknowledged by the Privy Council in *Agnew v Commissioner of Inland Revenue*.²¹ The Cork Report²² also recognized the importance of the floating charge when it noted that its use was so prevalent that a high portion of credit obtained by companies involved a floating charge. Notwithstanding the significant role the floating charge plays in lending practices in the UK, its presence has generated so much debate; some have called for its abolition while its advantages have been exalted by those who see it as a beneficial security device.²³ Its use has since declined with the virtual abolition of administrative receivership, but it is still a well-established part of lending practices in the UK and stands as a distinctive feature in comparison to lending practices in the US and Canada.

4.2.1 Floating charges

¹⁷ R Goode, *Legal Problems of Credit and Security* (3rd edn, Sweet & Maxwell, 2003) p12-14.

¹⁸ See generally I Snaith, *The Law of Corporate Insolvency* (Waterlow, 1990).

¹⁹ Insolvency Act 1986, Sch B1 para 43(2). It should be noted that in company liquidation, creditors who are fully secured can remove their security from the pool of assets and realise it to satisfy their claim with any surplus going to the liquidator. However when the company is in compulsory liquidation certain restrictions apply, see R Goode, *Principles of Corporate Insolvency Law* (3rd edn Sweet and Maxwell 2010) p206. When a company is in liquidation and a creditor wishes to institute proceedings against the company he must obtain leave of court to do so, see Insolvency Act 1986, s 130(2).

²⁰ McCormack (n 13).

²¹ [2001] 2 AC 710.

²² Cork Report.

²³ See section 4.2.2 of the thesis for further discussion on the abolition of floating charge security.

A floating security is a type of secured lending which has its origin in equity.²⁴ It developed as a response to the growing needs of commerce. As the UK economy evolved from one focused on agriculture to a more industrialized one, there were few assets such as buildings and immovable equipment available as collateral for secured lending. Assets which were readily available were raw materials, manufactured goods or goods yet to be manufactured and due to their transient nature, this could not form the basis upon which secured lending could be procured. In addition to this change, industrialization meant that limited liability companies were formed.²⁵ Extending credit to these companies on an unsecured basis was precarious as partners or investors could not be held personally liable for the debts and obligation of the company in the event that these could not be met.²⁶ These developments formed the setting for the emergence of the floating charge. This charge was developed at a time when there was a strong need to bridge a gap in how credit could be secured, and it did this by making it possible to create a security interest over the present and future assets of a debtor.²⁷

*Ryall v Rolle*²⁸ was the first case that showed equity's intervention in bridging the gap created by the common law.²⁹ Although the case had the markings of a floating charge security, it was not recognized as a floating charge at the time.³⁰ An assignment of machinery and implements of his mill was made by a debtor to a trustee for his creditor. The deed of assignment had a redemption clause and provided that the trust so created, would extend to all other future machinery and implements which should be brought into the mill, in addition to or in replacement of the original items. Some of the items were

²⁴ G Fuller, *Corporate Borrowing: Law and Practice* (3rd edn, Jordans, 2006).

²⁵ Limited Liability Act 1855.

²⁶ *Ibid.* For further discussions, see also, McCormack (n 13) p47.

²⁷ *Re Panama, New Zealand and Australian Royal Mail Co* [1870] 5 CH App 318.

²⁸ (1749) 1 Atk. 165.

²⁹ R Pennington, 'The Genesis of the Floating Charge' (1960) 23 Mod.L.Rev.630 at 634.

³⁰ *Ibid.*

thereafter seized by a judgement creditor of the debtor and the ownership of those items was called into question. The question was whether the secured creditor, who had never taken possession of the new machinery, had a prior claim. The House of Lords held that the secured creditor had a prior claim to the machinery.

A floating charge is said to be “floating” because it does not attach to any particular asset and it hovers over assets which are not subject to a fixed security. Although not defined,³¹ because the creditor cannot precisely state that the assets are the subject of a loan agreement, the security floats over the debtors’ assets both present and future.³² Nevertheless, it is an existing security which is real and present³³ despite the fact that some of the assets it may cover are future assets which have not yet been acquired by the debtor.

The floating charge is a comprehensive and effective security over some or all of the debtor’s company and assets³⁴ and the fundamental feature of a floating security which sets it apart from a fixed security is the ability of the debtor to deal freely with the assets covered by the security in the ordinary course of its business, without interference from the creditor.³⁵ The ability of the debtor to deal with the charged assets during the ordinary course of business does not act to negate the security interest, but simply delays its attachment as long as the debtor’s power of management continues.

In spite of the importance of the floating charge as a component in the security available to creditors, it is seldom taken on its own. It is usually taken in conjunction with fixed charges over assets.³⁶ Historically, the floating charge security acted as a control device in the UK as most assets of value could be covered by fixed security, which was preferable because

³¹ Floating charge assets are not ascertainable because of the ever changing nature of the class of assets that make up a floating charge.

³² *Evans v Rival Granite Quarries Ltd* [1901] 2 KB 979.

³³ *Ibid*, at 999 per Buckley LJ.

³⁴ *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710.

³⁵ *Ashborder BV v Green Gas power Ltd* [2004] BCC 634.

³⁶ R Calnan, *Taking Security: Law and Practice* (2nd edn, Jordan, 2011) p135.

of the priority status it gave creditors therefore the floating charge assets were more function than security assets.³⁷

Whilst the floating security, at its creation, hovers over the assets of the debtor, it has the capability to transcend from a floating security to a fixed security. It becomes a fixed charge over relevant assets³⁸ upon the occurrence of an event³⁹ (in most cases insolvency) or where the creditor takes steps to “crystallize” the security. However, due to the fact that the floating security is a creation of equity, the resultant fixed security only takes effect in equity.⁴⁰ It must be mentioned here that crystallization does not necessarily put an end to a company’s ability to continue its business. The consequence of crystallization is that the authority of the debtor to deal with the assets is brought to an end. What this then means is that the debtor relinquishes his quasi-ownership of the assets while the creditor assumes authority over the assets. Therefore, without the consent of the creditor (who cannot give a blanket permission without re-floating the charge), the debtor cannot dispose of the charged assets.⁴¹

Crystallization can only mutate a floating security into a fixed security at the point of insolvency or upon the occurrence of a specified event and not otherwise. Once the debtor embarks on any insolvency procedure, either with the intention to rehabilitate or liquidate, and a moratorium is in place, crystallization cannot occur.⁴² It has been argued in favour of the floating charge that, it gives a broad spread of security together with priority over unsecured creditors.⁴³ In addition, because it permits the creation of security over the

³⁷ See generally R Mokal ‘The Floating Charge- An Elegy’ in S Worthington (ed) *Commercial Law and Commercial Practice* (Hart, 2003) p483-485.

³⁸ *Ferrier v Bottomer* [1972] 126 CLR 597.

³⁹ *Re Yorkshire Woolcombers Association Ltd* [1904] AC 355 at 358.

⁴⁰ Fuller (n 24).

⁴¹ Calnan (n 36). It should be noted that an administrator is authorized by the Insolvency Act to dispose of floating charge assets after the company enters into administration, see Insolvency Act 1986, Sch. B1 Para. 70.

⁴² Insolvency Act 1986, Sch B1, para 42 & 43.

⁴³ See V Finch, ‘Security, Insolvency and Risk: Who Pays the Price?’(1999) *Modern Law Review* 5 at 643.

debtor's entire property, it provides the company with an easy and effective way to borrow money, thus making it an attractive way to secure loans. Coupled with this is the fact that it is less intrusive in the debtor's operation and management.⁴⁴

4.2.1.1 The Enterprise Act 2002 and its effect on floating charge

Before the coming into force of the amendments to the Insolvency Act 1986 introduced by the Enterprise Act 2002, the floating charge played a very important role in lending practices in the UK. The impact that floating charges had on lending practice was influenced by the possible insolvency of the debtor. Prior to the amendments, a floating charge holder could, on the default of the debtor, appoint an administrative receiver whose main function was to maximise economic value for the appointing creditor, thereby protecting the creditor's position to the possible detriment of other parties.⁴⁵

As a result, it became common practice prior to the Enterprise Act 2002 for lenders who were already heavily secured by fixed charge over the debtor's most valuable assets, to take a floating charge over those same assets.⁴⁶ Lenders relied on this duo-combination because, while the fixed security gave superior cover to their exposure to a debtor, the possession of a floating security meant that the holder of that security could forestall the appointment of an administrator and appoint an administrative receiver. The resulting effect of this legislative provision was the strengthening of the floating charge in lending practices in the UK,⁴⁷ however, this creditors' paradise was short-lived.

⁴⁴ *Ibid.*

⁴⁵ Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982).

⁴⁶ *Re Croftbell Ltd* [1990] BCLC 844; F Oditah, 'Lightweight Floating Charges' [1991] JBL 290.

⁴⁷ McCormack (n 13).

The Enterprise Act 2002, in a bid to reform the administration process into a more collective corporate rehabilitation procedure, significantly restricted the powers a floating security holder had over the debtor. With the introduction of the new administration procedure into the Insolvency Act 1986, the main focus shifted from protecting the interest of one creditor to those of the general body of creditors. The reforms stripped the floating charge holder of the ability to appoint an administrative receiver except for floating charges created before 15th September 2003 and specifically narrow exceptions such as those securing lending agreements in respect of utility companies.⁴⁸

In addition, the Enterprise Act 2002 introduced the ring-fencing of a portion of floating charge recoveries (the prescribed part) for distribution to unsecured creditors in the event of a company's insolvency.⁴⁹ Whilst the ring fencing of a portion of the floating charge assets appear to have placed the floating charge holder at a disadvantage, in reality what it did, was to prevent the inadvertent benefit of the abolition of crown preference⁵⁰ going to floating charge holders;⁵¹ thereby maintaining neutrality (i.e. neither better nor worse off) for the floating charge holder.⁵² Although the amendments brought by the Enterprise Act appear to have stripped the floating charge holder of some enviable powers, they did not eliminate all the appeal that a floating charge holds for both creditor and debtor. It may not be wrong to presume that taking away such a major source of control from the floating charge holder would sound the death knell. This appears not to be the case; the lure for the sustained presence of the floating charge can be traced to the fact that some assets are

⁴⁸ The holder of a qualifying floating charge has the power to appoint an administrator out of court under a fast track procedure. See Insolvency Act 1986 Sch B1, para 14. In addition where an administrator has been appointed by the directors of the company or the company itself, the holder of a qualifying floating charge has the power to veto such appointment and appoint his own. See Insolvency Act 1986, Sch B1 para 36.

⁴⁹ Ring-fencing is not applicable to all insolvency proceedings. See Insolvency Act 1986, s 176 A (3)-(5) for a list of circumstances under which a ring-fencing of a prescribed part will not take place.

⁵⁰ The abolition of the crown preference was also part of the measures introduced by the Enterprise Act 2002 to reform the insolvency proceedings in the UK.

⁵¹ Enterprise Act 2002, s 252 and the Insolvency Act (Prescribed Part) Order 2003.

⁵² R Goode, *Principles of Corporate Insolvency Law* (3rd edn Sweet and Maxwell 2010) p167-168.

unsuitable for fixed charge security. For the debtor, the power it gives to continue dealing with charged assets in the course of its business seems to make it an attractive option, and the unsecured creditors are not left out from the benefits ensuing from a floating charge, as the prescribed part due to them is carved out from proceeds of a floating charge security.⁵³

4.2.1.2 Changes to the floating charge over book debts in the UK

Book debts owing to a company are an important asset to a company, especially small and medium sized enterprises.⁵⁴ This is because, a meaningful fraction of the company's wealth can be tied up in its debt and a creditor who is able to take a fixed charge over these debts will be able to acquire its full value, rather than queuing behind the administrator's expenses, preferential creditors and unsecured creditors.⁵⁵ As a result, charges over book debts, while not a conventional form of collateral, proved to be a standard form of obtaining fixed security. Although charges over book debts appear to be fixed charges on paper, in reality they operated as floating charges because the debtor may, as part of the ordinary course of doing business, require the use of the proceeds of their debt. The decision in *Re Yorkshire Woolcombers Association Ltd*⁵⁶ supported the notion that where a debtor is free to deal with proceeds of a debt, then it is a floating charge.

The position of treating a charge over book debts as a floating charge (*Re Yorkshire Woolcombers Association Ltd*) was rejected by the court in *Siebe Gorman v Barclays Bank Plc*⁵⁷ when it supported the practice adopted by banks to circumvent the debtor's ability to

⁵³ Calnan (n 36) p134-135.

⁵⁴ Report of the Law Commission on Company Security Interests (Cm 6654, 2005) page XII at no 14.

⁵⁵ *Ibid.*

⁵⁶ [1904] AC 355 at 358.

⁵⁷ [1979] LLoyds LR 42.

deal with proceeds of debts. Banks as major creditors produced charge documents which were aimed at giving them control over the book debts, by requiring the debtor to pay the proceeds of its debt into its account with the bank. In *Siebe Gorman's* case, the court held that a debenture which required the proceeds of book debts to be paid into the company's general trading account, with no express restrictions on the company's ability to withdraw deal with the account, created a fixed charge over book debts. This decision diminished the value of floating charges by recognizing that it was possible to create a fixed charge over book debts.

The issue of book debts has continued to be a contentious element of creditors' security as the decision in *National Westminster Bank v Spectrum Plus*⁵⁸ reverted back to the earlier decision in *Yorkshire Woolcombers'* case. The House of Lords stated that although a charge over book debts was expressed to be fixed charge, because the debtor was able to deal with the proceeds, it was in fact a floating charge. With the decision in *Spectrum Plus*, it is theoretically possible to create a fixed charge over book debts as long as the debtor has no power to deal with the proceeds. But where the debtor has free rein over the proceeds and can remove them from the security until enforcement, then the charge is a floating charge even if expressed to be otherwise.⁵⁹

4.2.2 Possible abolition of floating charge

Despite the genius of its origin and its expediency as a financing tool, the floating charge has become weighed down with case law and as a result has given rise to complexities.⁶⁰

⁵⁸ [2005] 2 AC 680.

⁵⁹ Calnan (n 36) p142.

⁶⁰ A good example is the issue with book debts.

This has led to calls for the UK to abolish the floating charge security⁶¹ and abolishing the floating charge would have placed the country at par with Canada and some other jurisdictions⁶² which have abolished the floating charge. It has been argued that, considering that the floating charge is a product of judge made laws (which consisted of a patchwork of cases), it has done remarkably well, however it cannot serve as a substitute for a well-defined personal security law.⁶³ Goode states that, despite all its advantages, the floating charge has become a relic and this is due to the fact that English personal property security is made up mainly of a combination of judicial artefacts with unique legal characteristics⁶⁴ which makes the floating charge unsuitable in this modern era. It therefore appears to be that English personal security law is stagnated and may not represent modern commercial realities.

The possible abolition of the floating charge has been a fiercely debated topic with the proponents equally divided on the pros and cons of abolishing or retaining the floating charge. A 1971 committee on Consumer Credit in considering the issue of abolishing the floating charge observed that the floating charge plays an important role in commercial lending practice; accordingly its abolition should not be seriously contemplated.⁶⁵ More recently the City of London Law society issued a discussion paper on the need to reform secured transactions and one of the areas touched on was the uncertainty attached to drawing a distinction between a floating charge and fixed charge security. While not necessarily pushing for the abolition of the floating charge, they were of the opinion that a clear distinction had to be made classifying which assets fall under which security, and this

⁶¹ It was one of the issues raised during consultations prior to the publication of the Report of the Committee on Consumer Credit, (Cmnd 4596, 1971). Roy Goode has also called for a unified concept of security which would mean the end of the floating charge security, see R Goode, 'The exodus of the floating charge' in D Feldman & F Meisel (eds) *Corporate and Commercial Law; Modern Developments* (LLyod's of London Press, 1996).

⁶² New Zealand for example.

⁶³ Calnan (n 36).

⁶⁴ Goode (n 61).

⁶⁵ Report of the Committee on Consumer Credit, (Cmnd 4596, 1971) at para 5.7.7.7.

should perhaps be done within a statutory framework, as existing case laws have come up with conflicting classifications.⁶⁶

The observation of various commentators has been that the floating charge is integral to the secured-credit industry with most banks' lending reliant on it.⁶⁷ It therefore seems that its total abolition may have a negative effect on access to credit. On the other hand, in Canada, where a unitary concept was introduced after the abolition of the floating charge, there seems to be no adverse effect on access to credit.⁶⁸ Therefore, it is possible that the abolition of the floating charge in the UK may not have any adverse effect on lending structures. Perhaps a consensus could be reached on how the floating charge could be adapted to fit modern commercial needs. This view is supported by McCormack who suggests that the benefits of the floating charge,⁶⁹ in terms of its comprehensiveness, simplicity and uncomplicated process could be retained if English law adopted the Uniform Commercial Code article-9 style reforms.⁷⁰

4.3 Secured lending practices in the US

The concept of secured and unsecured lending in the US appears relatively more structured in general when compared to the arrangement found in the UK. Article 9 of the Uniform Commercial Code (UCC) is the body of laws which governs securities/lending and it establishes a unitary conceptual structure for security interests in personal property and fixtures. As a result, article 9 UCC does not distinguish between fixed and floating security

⁶⁶ The City of London Discussion Paper: Secured Transactions Reform 21st November 2012.

⁶⁷ J Ziegel, 'The New Provincial Chattel Security Regimes' [1991] 70 Canadian Bar Reviews 681 at 712.

⁶⁸ J Ziegel, 'Floating Charges and the OPPSA: a Basic Misunderstanding' (1994) 2 Canadian Business Law Journal 470.

⁶⁹ Historically, the floating charge security acted as a control device in the UK as most assets of value could be covered by fixed security, which was preferable because of the priority status it gave creditors therefore the floating charge assets were more function than security assets.

⁷⁰ McCormack (n 13).

interests. Whilst the floating charge, as it is found in the UK, is absent in the US, article 9-202 UCC, recognises and authorizes a security concept similar to the floating charge in the form of a blanket security interest on shifting collateral.⁷¹ The acceptance and recognition of a floating security device within the US lending practices is a clear departure from their pre-article 9 stance.

Before the introduction of the UCC, US law did not accept the concept of a security which floated without attaching to any assets, on the grounds that the freedom it gave the debtor to deal with the secured assets without interference from the creditor conflicted with the nature of a security interest.⁷² It is quite easy to appreciate why the US choose to reject the floating charge as a fixed security. A security interest is seen as a right *in rem* which gives the creditor the right to dispose of or remove the assets subject to the security from the possession of the debtor.⁷³ But with the floating charge that right is suspended until the occurrence of an event, therefore in the US's thinking, the floating charge does not tick all the right boxes to fit into the definition of a fixed security.

In addition, the idea that a security interest could be created by a debtor over property he did not already own was unacceptable under US law.⁷⁴ The argument that a debtor should have some assets free upon which general creditors could depend for payments also contributed to the rejection of a floating security,⁷⁵ by the Americans because the presence of a floating charge meant that all assets may be encumbered. Consequently, what existed at the time was a proliferation of diverse devices such as the trust receipt and factor's lien which allowed the debtor to give security over stock.⁷⁶ The 1950s however saw the

⁷¹ G Gilmore, 'Security Law, Formalism and Article 9' (1986) 47 Nebraska LR 659 at 672.

⁷² *Benedict v Ratner* (1925) 268 US 354.

⁷³ H E Smith, 'Property as the Law of Things' (2011-2012) 125 Harv. L.Rev. 1691.

⁷⁴ *Zartman v First National Bank of Waterloo* [1907] 189 NY 267.

⁷⁵ *Ibid.*

⁷⁶ RJ Wood, 'The Floating Charge in Canada' (1988-89) 27 Alta. L. Rev. 191.

adoption of a unitary concept of security which synthesized these devices under article 9 of the UCC.⁷⁷

What the introduction of article 9 did was to acknowledge that the freedom of the debtor to deal with secured property in the ordinary course of business was not fundamentally incompatible with fixed security interests.⁷⁸ The Code recognises a debtor's right or ability to "use, commingle, or dispose of all or part of the collateral; collect, compromise, enforce or otherwise deal with collateral;⁷⁹ accept the return of collateral or make repossession; or use, commingle or dispose of proceeds".⁸⁰ This flexibility of the debtor to deal with secured assets is broadly what constitutes a floating charge. In effect, the security interest granted under article 9 is a fixed charge with a license to deal⁸¹ and acts as a functional equivalent of the English floating charge except that it avoids all the complication of a floating charge by allowing the immediate attachment of the security interest.

Therefore a debtor can acquire a floating lien, as it is termed in the US, but this device will have the features of a fixed charge. It is usually taken over proceeds, after acquired property or collateral subject to future advances⁸² and it plays a very important role in modern lending.⁸³ Under the floating lien, the debtor agrees to grant a security interest to the creditor in the future property he is to acquire, to secure a present debt.⁸⁴ Once the property is acquired, it attaches automatically.

⁷⁷ *Ibid.*

⁷⁸ McCormack (n 13).

⁷⁹ See UCC 2001, article 9-205; see also McCormack (n 16).

⁸⁰ UCC 2001, article 9-205.

⁸¹ McCormack (n 13).

⁸² R L Miller, *Fundamentals of Business Law, Summarized Cases* (Cengage, 2013); See also UCC 2001, art 9-204.

⁸³ A J Harrington, 'Insecurity for Secured Creditors - the Floating Lien and Section 547 of the Bankruptcy Law (1980) *Marquette Law Review* vol 63:447 pg. 447-488.

⁸⁴ *Ibid.*

What characterises it as a fixed security is the fact that it attaches automatically and does not hover over the debtor's assets until crystallization occurs.⁸⁵ Consequently, what is available under article 9 is a synthesis of the virtues of a floating security and a fixed charge. This is so because a debtor may be able to dispose of assets which are subject to a fixed charge during the ordinary course of business; a trait which is elementary to floating security. The distinction here between the article 9 security and the floating charge is that article 9 embraces the concept of attachment, which is; once a security interest attaches to collateral it becomes a fixed security interest notwithstanding the nature of the original collateral.⁸⁶

4.4 Secured lending practices in Canada⁸⁷

Early lending practices in Canada mirrored the system found within the UK and this is not surprising considering that Canada is a common law country and relied largely on the UK for guidance on most of its laws.⁸⁸ The effect of this reliance by Canada on the UK for law-making directions was the exportation of the same lending concepts to Canada and a wholesale acceptance of English authorities.⁸⁹ As a result, lending practices in Canada entailed fixed security with the floating charge as a sub-component. It was recognised by the Canadian courts that a fixed specific interest may be taken in future goods.⁹⁰ The courts

⁸⁵ UCC 2001, art 9-204(1).

⁸⁶ J Ziegel, 'The Nature of Floating Charges' (1994) Can. Bus. L.J 474.

⁸⁷ Material in this section has previously been incorporated in an article published in the Annual Review of Insolvency Law. See appendix for details.

⁸⁸ G McCormack, 'The Floating Charge in England and Canada' in De Lacy (ed.) *The Reform of the United Kingdom Company Law* (Cavendish, 2002) p 398.

⁸⁹ Wood (n 76).

⁹⁰ *Holroyd v Marshall* [1862] 10 H.L.C. 191, II E.R. 999 (applied by the court in *Fraser v Imperial Bank of Canada* [1912] S.C.R. 313).

in Canada also recognized the possibility of a fixed charge over stock which gave the debtor licence to dispose of the charged assets during the course of business until default.⁹¹

Whilst the basic concept of English personal security law was borrowed by the Canadians, it was not a wholesale adoption of the English practices. A major difference could be found in how secured charge was categorized. In the UK, the practice was to have a fixed security and/or a floating charge security. In Canada on the other hand, a close study of the cases⁹² reveals a clear distinction in the securities available. The security devices previously available in Canada were; fixed charge assets, a floating charge on book debts and a fixed and specific charge on book debts with a licence that allows the collection of the debt free from charge.⁹³ Thus unlike the UK, in Canada there was a clear distinction between a floating charge and a fixed charge with licence to deal.

Another significant difference was how the boundary between a fixed charge and floating charge was determined. In the UK, it was (and still is) clear that what sets a fixed charge apart from a floating charge was (and is) the debtor's power to deal with the charged assets.⁹⁴ This was far from the case in Canada which relied on the intention of the parties to determine if a floating charge or a fixed charge with licence to deal was created.⁹⁵ Accordingly, while the floating charge in Canada shared a common ancestry with its English counterpart, they were to some extent different in theory.⁹⁶ This untenable test, which relied on the parties' intention rather than the ability of the debtor to deal with the

⁹¹ *Graveley v Springer* (1898) 3 Terr. L.R. 120; see also *J.I Case Threshing Machine Co. v Gouley* [1914] 7 WWR. 584 (Sask. Dist. Ct.).

⁹² See *Nourse v Canadian Cannery Ltd.* [1935] O.R. 361 (C.A.); see also *Meen v Realty Development Co. Ltd.* [1954] 1 D.L.R. 649 (Ont. C.A.); *Re Zegalski* [1973] 1 WWR 728 (Man.Q.B.)

⁹³ Wood (n 76).

⁹⁴ *Ashborder BV v Green Gas power Ltd* [2001] 2AC 710.

⁹⁵ In the UK, it is the debtor's ability to deal with the charged property that creates a floating charge and not the intention of the parties, see *National Westminster Bank v Spectrum Plus* (Supra).

⁹⁶ Wood (n 76).

assets, was later abandoned and the courts in Canada reverted to the English way of determining the difference between a floating charge and a fixed charge.⁹⁷

Sweeping reforms to personal property security legislation enacted in the style of the US UCC article 9 brought to an end the existence of the floating charge as it was in Canada.⁹⁸

The new legislation, the Personal Property Securities Act, R.S.O 1990 (PPSA), got rid of the distinction between fixed and floating charges (even in cases where parties may have relied on the old law).⁹⁹ It should be noted that each of the provinces in Canada have enacted their own provincial PPSA. For ease of analysis, and because Ontario appears to be one of the first provinces to reform its security laws and was the model upon which other provinces carried out reforms, in the discussion that follows reference will be made to the Ontario legislation unless otherwise stated. The new Canadian property legislation followed in the footsteps of the article 9 in adopting a fixed charge which allowed the debtor licence to deal with the assets during the ordinary course of business. The position of the courts on this issue, as could be implied from the relevant law, is that, as a matter of public policy, it is not abhorrent to have a fixed charge which gives the debtor licence to deal with the assets.¹⁰⁰

The various PPSAs across Canada radically changed the way the concept of a “security interest” is defined in Canada. It changed the definition by adopting a practical approach which focused on the substance rather than the form that a particular security took.¹⁰¹ It effectively eliminated the distinction between floating and fixed charges, all security interests including those previously characterized as floating charges, would attach

⁹⁷ *R in Right of British Columbia v Federal Business Development Bank* [1987] B.C.L.R. (2d) 273.

⁹⁸ G McCormack (n 13).

⁹⁹ *R v Sparrow* [1990] 1 SCR 1075.

¹⁰⁰ *Ibid.*

¹⁰¹ See PPSA Ontario, R.S.O 1990.

immediately upon the satisfaction of statutory requirements for attachment.¹⁰² This unitary concept of security replaced the pre-existing common law's complex system of security forms and devices and, in doing so, adopted the US framework which supported the notion that all security devices perform a similar purpose and should therefore function under a common legal framework.

The courts also endorsed the change to a unitary concept of security. In *Credit Suisse Canada v 1133 Yonge Street Holdings*,¹⁰³ the court stated that the floating charge was a liability which did not meet the financial needs of the 19th century. Therefore it was considered that there was no justification or historical basis, for including the floating charge security in the new PPSA, as the Act creates a flexible single security interest which accommodates all the needs of the business community. Although it is an acknowledged fact that the US UCC article 9 had a huge influence on the structure and a lot of the fundamental concepts of the Canadian PPSA, some commentators have observed that it would be a mistake to assume that the introduction of article-9 style reforms revolutionised Canadian security provisions.¹⁰⁴

Despite the presumed abolition of floating charge security, an instrument, the General Security Agreement (GSA), which mimics the functions of a floating charge as a blanket security over real and personal property is still in use in some parts of Canada.¹⁰⁵ Although the PPSA provides no definition of this form of security, it may be assumed that recognition

¹⁰² C Walsh, 'The Floating Charge is Dead; Long Live the Floating Charge- a Canadian Perspective on the Reform of Personal Property Securities Law in A Mugasha (ed) *Perspectives on Commercial Law*, (Prospect Media, 1999) p129-150. See also *Credit Suisse Canada v 1133 Yonge Street Holdings* (1996) 28 O.R. (3d) 670 (Gen.Div.), reviewed (1988) 41 O.R. (3d) 632 (C.A.), where the Court of Appeal held that the PPSA treated floating charge security as it would any other security however it does not recognise the concept of crystallization.

¹⁰³ (1998) 14 P.P.S.A.C. (2d) 61 (Ont. C.A.); *Affinity International Inc. v Alliance International Inc.* (1995) 9 P.P.S.A.C. (2d) 174 (Man. C.A.).

¹⁰⁴ R CC Cuming, 'Personal Property Security Law' (1981) 31 U Toronto L.J 249.

¹⁰⁵ See *Nova Scotia v. IPS Invoice System Corporations* 2010 ONSC 2101 (Ont. S.C.J.); *Silverman Jewellers Consultants Canada Inc. v. Royal Bank of Canada* 53 O.R. (3d) 97, 143 O.A.C. 375, 2001 CarswellOnt 633 (Ont. C.A.).

of its validity is on the basis that section 2 of the PPSA¹⁰⁶ states that the Act will “apply to every transaction without regard to its form and without regard to the person who has title to the collateral, that in substance creates a security interest”. Also the PPSA recognizes the ability for a security agreement to secure future advances;¹⁰⁷ one of the elements that characterize a charge as a floating charge. What is more, the PPSA allows the debtor a reasonable amount of control over collateral within its possession, an important feature of a floating charge agreement.¹⁰⁸ In a similar vein, the occurrence of an event such as the debtor ceasing to carry on its business has a crystallizing effect on the GSA.¹⁰⁹ Accordingly it can be argued that the GSA and the floating charge are one and the same except in name because they have the same attributes and functions.¹¹⁰

4.5 Comparative analysis

The nineteenth century development of personal property security law in the US took a remarkably divergent path from its UK counterpart.¹¹¹ The American courts’ strong distrust of a mortgage over stock-in-trade (which they regarded as a fraudulent conveyance) may be responsible for what led the Americans down a different route.¹¹² In the UK, in contrast, the courts proved to be quite receptive of a device that could give security over the debtor’s entire undertaking (both present and future). Although no tangible reason has been given for the US rejection of the floating charge, one of the suggestions put forward is that the UK may have been more understanding than their US

¹⁰⁶ Personal Property Security Act Ontario, R.S.O 1990.

¹⁰⁷ *Ibid.*, s 13.

¹⁰⁸ *Ibid.*, s 17(1) &(2) and s 17.1.

¹⁰⁹ *A & B Landscaping & Interlocking Ltd. v Bradsil Ltd* (1993) 6 P.P.S.A.C (2d) 141 (Ont. Gen. Div.)

¹¹⁰ (a) They are blanket securities (b) They secure future assets (c) They can be crystallized upon the occurrence of an event, like the debtor’s insolvency.

¹¹¹ Wood (n 76).

¹¹² G Gilmore, *Security Interest in Personal Property* (Little Brown & Co 1965) 2 Vols. Pp. xxxiv, xiii, 1508 at 39-47.

counterparts towards banks' and other financial institutions' attempts to obtain security over stock-in-trade¹¹³ and as such were more accommodating to their needs.

While the American lending practices enable the disposal of assets subject to a fixed charge during the ordinary course of business,¹¹⁴ in the UK such practices are not permissible under typical lending terms. A debtor who attempts to dispose of assets which are the subject of a fixed charge may be held liable for a breach of a covenant in the loan agreement. In addition, the English courts have clearly reiterated that a floating charge is distinct from a fixed charge and should not be regarded as a fixed charge with a license to deal.¹¹⁵ The license attached to the floating charge permits the debtor to dispose of properties in his possession which are the subject of a floating charge.

It is interesting that Canada and the US are both common law countries which borrowed laws from the UK, but took divergent paths. While Canada initially adopted the floating charge security, as is found in the UK, the Americans questioned the validity of such a security interest and did not acknowledge it until the introduction of article 9 of the UCC, which accepted the concept of a floating lien or blanket security, albeit ingrained with the fixed charge concept of automatic attachment. The requirement of automatic attachment with regards to floating liens is one of the things that distinguish the US floating lien from the English floating charge. Auxiliary to this is the lack of the element of crystallisation; a floating charge would in most cases crystallize (i.e. attach) upon the debtor's insolvency, but because of the requirement that the article 9 floating lien attaches upon creation, the main element (the ability to hover over assets) that characterizes a charge as floating, is

¹¹³ Wood (n 76).

¹¹⁴ UCC 2001, article 9-205.

¹¹⁵ *Evans v Rivals Granite Quarries Ltd* [1910] 2KB 979 at 999.

missing. It then appears to beg the question, if indeed the article 9 floating lien can be classed as a floating security.

Canada has experienced two sides of the coin; the English style floating charge was initially adopted by the Canadians in substance but not in form, as there was a clear deviation from the English model in the test applied by the Canadians courts to determine what constitutes a floating charge. Thereafter Canada adopted a UCC style article-9 style personal property securities law. With this new law, the distinction between a floating charge and the fixed charge is extinguished and all security interests are expected to attach automatically or, where postponed, a definite date has to be set for the charge's attachment. Notwithstanding this, the GSA¹¹⁶ which mimics the floating charge is still in operation in some parts of Canada and appears to derive its authenticity from the PPSA.

There have been calls for the UK to abolish the floating charge security and jump on the article 9 train as Canada and a host of other jurisdictions have done. A lot of questions have to be considered by the UK before any reforms can take place. The most pertinent being; will an article 9-style reform be conducive to economic and commercial realities in the UK? According to Zeigel, apart from the high cost of reforming security laws in the UK, there are so many other factors at play as to why the UK has resisted the introduction of comprehensive reforms.¹¹⁷ He further stated that the powerful interest of City of London law firms have "a huge intellectual and professional investment through their mastery of the intricacies of the existing English rules"¹¹⁸ and may be hesitant adopt new and untested statutory regimes.

¹¹⁶ See p167-168 of the thesis for discussion on the GSA.

¹¹⁷ See R Calnan, 'What is wrong with the Law of Security?' in J De Lacy (ed) *The Reform of UK Personal Security Law: Comparative Perspectives* (Cavendish, 2010) p162-187.

¹¹⁸ J Ziegel 'A Canadian Academic's Reaction to the Law Commission's Proposals' in J De Lacy (ed) *The Reform of UK Personal Security Law: Comparative Perspectives* (Cavendish, 2010) p119.

The floating charge may have lost a major part its appeal after the virtual abolition of a floating charge holder's power to appoint an administrative receiver, but it still has some appeal because there may be situations¹¹⁹ where it may appear to be the only type of security available for the creditor to rely on to raise funds.

4.6 Is the secured lending structure in the UK an obstacle to rescue funding?

The analysis in this section is centred on the lending structures in the UK and the US. This is because of the disparity in how lending is structured in both countries with particular reference to the floating charge, which was one of the reasons given by Lord McIntosh¹²⁰ during the debates prior to the enactment of the Enterprise Act 2002, as to why DIP financing may not be suitable in the UK. The UK secured lending structure is currently made up of two main devices; the fixed charge and the floating charge. The US structure on the other hand, recognizes and operates a unitary concept of security, which is the fixed charge.¹²¹ Nevertheless, the US secured lending structure accommodates a type of security device which mirrors the UK floating charge's ability to hover over future and existing assets of the debtor,¹²² therefore giving an outward appearance of similarity.

A closer examination of the functions of the two charges reveals 'a false similarity' between the charges. Whilst the UK floating charge hovers over all of the debtor's uncharged assets and only attaches by agreement, on the debtor's default or insolvency,¹²³ the US floating liens is treated as a fixed charge and attaches immediately to a class of assets.¹²⁴ The key

¹¹⁹ For example where there are no existing assets, expected future assets may be used as collateral.

¹²⁰ HL Deb 29 July 2002, vol 638 cc763-806 at para 789.

¹²¹ See section 4.3 above for discussion on secured lending in the US.

¹²² UCC 2001, article 9-202.

¹²³ See section 4.2.1 of thesis for discussion on floating charge security.

¹²⁴ UCC 2001, article 9-203.

difference in both charges lies in how they operate with regards to available assets after a company becomes insolvent. In the US, future assets acquired after a debtor becomes insolvent do not form part of the assets that are covered by a floating lien held by a creditor.¹²⁵ Once the company becomes insolvent, the scope of the floating lien does not extend beyond the point of insolvency; therefore all assets which are not subject to a fixed charge belong to the company free and clear. McCormack sees this as advantageous and suggests that the limitation of the floating lien over after acquired property may be one of the factors which encourage a pre-commencement lender to continue funding the company, thus encouraging post-commencement financing.¹²⁶

In the UK, once a company becomes insolvent, the floating charge crystallizes and fastens on all existing and future assets of the company,¹²⁷ most likely leaving the company with virtually no free assets. Arguably, this is likely to result in the company having no uncharged assets to offer as collateral to raise money to fund its rescue. This distinct feature of the UK lending structure gives credence to Lord McIntosh's view that the UK lending structure may not be suitable to super-priority financing. However it can be argued that US Chapter 11 DIP funding provisions does not necessarily apply to only debtor companies that have collateral to offer potential lenders. There are various financing options¹²⁸ available under section 364 which insolvent companies can take advantage of, including those with heavily leveraged assets.¹²⁹

Whilst the presence of the floating charge reduces the likelihood of the company getting potential lenders to raise money, the floating charge can also be a potential source of

¹²⁵ See 11 U.S.C, s 552 of the Bankruptcy Code There are however exceptions to this. See 11 U.S.C., s 552(b) (1)-(2) for list of exceptions.

¹²⁶ G McCormack, 'Super-priority New Financing and Corporate Rescue' [2007] JBL 701-732.

¹²⁷ L Gullifer & J Payne, 'The Characterization of Fixed and Floating Charges in J Getzler & J Payne (eds) *Company Charges Spectrum and Beyond* (OUP 2006) at p61.

¹²⁸ See section 3.2.3 of the thesis for discussion the various financing options available under section 364.

¹²⁹ See 11 U.S.C, s 364(c) & (d).

funding corporate rescues. The Insolvency Act gives the administrator the *carte blanche* to deal with floating charge assets for the benefit of the company.¹³⁰ This in effect means that all floating charge assets are within the sole control of the administrator. The significance of this is that, while a creditor maintains his interest in the fixed charge due to the restrictions on the ability of an administrator to wilfully trade off secured assets without leave of the court,¹³¹ the administrator can make use of funds or assets resulting from the floating charge to continue to run the business during administration proceedings.¹³² The Insolvency Act does provide some protection for the floating charge holder by requiring that the floating charge holder shall have the same priority in respect of acquired property of the company which directly or indirectly represents the property disposed of.¹³³

Floating charge assets especially book debts, may be crucial to the administrator's ability to successfully run the business during corporate rescue unless he has access to other external sources of funding, which may be difficult or expensive to find.¹³⁴ The Review Group, of the former Department of Trade and Industry and HM Treasury in its report published in 2000, recognised this by suggesting that a statutory reversal of the decision in *Siebe Gorman*¹³⁵ could be achieved by doing away with the fixed charge on the class of a company's present and future book debts.¹³⁶ The group said this would mean that at the commencement of insolvency proceedings, all the book debts due to a company and any

¹³⁰ Insolvency Act 1986, Sch B1, para 70.

¹³¹ *Ibid*, Sch B1, para 70-72; where the administrator disposes of assets subject to a fixed charge without the permission of the court, he is liable to be sued personally in tort for conversion, see *Hachette UK Ltd v Borders(UK) Ltd* [2009] EWHC 3487 (Ch). However there are exceptions where an administrator can dispose of secured assets. The court would approve such disposal if it considers that disposal will serve the purpose of the administration, see Sch B1, para 71(2) (b), 72(2)(b). Nevertheless, the priority of secured creditors is still preserved as regards the proceeds of such disposals which must be turned over to the secured creditor.

¹³² This is analysed in section 3.5 of the thesis.

¹³³ Insolvency Act Sch B1, para 70(2)-(3).

¹³⁴ L Guillifer & J Payne (n 127).

¹³⁵ See p158-159 of the thesis for the discussion on *Siebe Gorman* case.

¹³⁶ Insolvency Service, 'A Review of Company Rescue and Business Reconstruction Mechanism, Report by the Review Group' (DTI, 2000) ("Review Report") at para 134.

arising thereafter would be available to finance continued trading.¹³⁷ The Review Group added that crystallising the fixed charge on book debts could possibly be an efficient way of ensuring that additional finance is available for financing company rescues. This is because crystallization would function as a means of identifying the book debts that were subject to a fixed charge security¹³⁸ so that book debts arising after this can be channelled towards funding the rescue process.

Another alternative could be the arrangement suggested by the City of London Law Society. The Society acknowledged the possibility of funding the administration process out of assets subject to security in its consultation on secured transactions.¹³⁹ The City of London Society was of the view that to some degree administrations will need to be funded out of secured assets; however the difficulty in relying on this source of funding lay in the identification of what those assets should be.¹⁴⁰ The Society came up with at least three possible ways to ascertain what portion or class of the debtor's assets can be used to fund administrations and these are;¹⁴¹

- Clarifying the distinction between fixed and floating charges (especially as it relates to areas not covered by existing case law or where court decisions have introduced ambiguity).
- Identifying specific classes of assets which would be available to the administrator.
- Allowing the administrators to use a percentage of all of the company's charged assets up to a fixed limit.

The option of allowing the administrator to use a percentage of the company's charged assets would mirror the priming lien found in the US and Canada which allows the debtor

¹³⁷ This has effectively now been done as a result of the decision in *Spectrum Plus*.

¹³⁸ Review Report (n 136) at 133 & 134.

¹³⁹ The City of London Discussion Paper (n 66).

¹⁴⁰ *Ibid.*, at para 4.22.

¹⁴¹ *Ibid.*, at para 4.23.

create another security interest in a charged property.¹⁴² There is some advantage to be gained from this, because giving the administrator powers to create another security interest in a charged property would open up an alternative for companies whose assets are fully charged, to raise funds. However it is debateable if this can take root in the UK without some measure of protection¹⁴³ for the pre-existing security holder as UK is a jurisdiction that upholds the interest of the creditor above others.

Concluding remarks

The issue of security interests and corporate rescue are closely related, as the presence or absence of one (security) may determine the success or failure of the other (corporate rescue). To successfully achieve a rescue, a debtor company may need to have access to ready cash. One way of doing this will be to rely on company assets to raise these funds. In Canada and the US, there are clear provisions in the Bankruptcy Code and CCAA respectively, enabling the debtor to raise funds. The absence or presence of leveraged assets does not stand in the way of the debtor's ability to raise funds because of the presence of concepts like priming liens. In this, the two jurisdictions clearly stand apart from the UK.

Arguably, the lending structures in these jurisdictions (the US and Canada) facilitate the provision of funding as there are no floating securities to crystallise upon insolvency and this may or may not leave the debtor with some free assets which can then be used to fund the rescue process. A good argument can however be made on behalf of the English

¹⁴² See section 3.2.3(US) and section 3.3.5 (Canada) of the thesis.

¹⁴³ In the US, the Bankruptcy Code provides that where an existing lien is primed, the debtor company must adequately protect the pre-existing lien holder. See p87-88 of the thesis for discussion on the US position on adequate protection. This is in contrast to Canada which does not offer any protection, but requires that the court in approving a priming lien takes into consideration whether a creditor would be "materially prejudiced" as a result of approving the charge.

jurisdiction that the presence of the floating charge assets is not an impediment to rescue operations in the UK; rather it aids the administrator in raising funds for rescue procedures as the administrator has powers under the Insolvency Act 1986 to dispose of floating charge assets as if it was not the subject of a charge. Arguably, floating charge assets provide a convenient means for funding the rescue process and until statutory alternatives are found, it may provide a useful avenue for funding rescues

On the other hand, the recommendations made by the City of London Law Society suggest that administrators should be given more powers to be able to use charged (secured) assets to raise rescue finance. This would bring the UK in line with the US and Canada where rescue funding can be raised from charged assets by way of priming liens.

On the whole, each jurisdiction has its own distinct lending practice which is supported by enabling laws which gave rise to them. The security interests created within these three jurisdictions by their individual lending practices confer rights which are attached to the debtor's assets, on creditors. A debtor's insolvency in more ways than one impacts on these rights. For example the secured creditor's right to enforce his security is waived when a debtor enters into any of the formal rescue procedures available under US Chapter 11, the CCAA and the Insolvency Act 1986. Conversely, some rights are acquired by creditors at the point of the debtor's insolvency e.g. the right of a creditor to place a debtor in any of the rescue proceeding or even liquidation. Selected aspects of creditors' rights are explored in the succeeding chapter.

Chapter V: Selected aspects of creditors' rights and participation in the corporate rescue process

Introduction

Insolvency proceedings bring a suspension of many of the entitlements of creditors to enforce their claims. This suspension is necessary in the collective interest of all creditors; however creditor interest should not be unduly exploited. Arguably, in order to give purpose to insolvency legislation as it relates to corporate rescue, a balance has to be achieved between ensuring the success of the rescue process and mitigating any impact the process may have on creditors' rights. Therefore, creditors may have to adjust some of their rights for the overall success of the rescue.

Challenges to creditors' rights during corporate rescue can be seen from the time when the debtor signifies an intention to commence any of the rescue processes¹ to the time when a plan is put in place. It is acknowledged that in order to ensure the successful rescue of a distressed company, an enabling environment which facilitates the rescue needs to be created. Concepts such as DIP/rescue/interim financing and statute-backed mechanisms which suspend creditors' rights to enforcement of their security make this possible. However these mechanisms pose some challenges to the rights that creditors would otherwise enjoy.

On the other hand, the important interest of creditors can be seen to give rise to various entitlements in the rescue process and this extends from the initial proposal of a plan of reorganization to funding the rescue process. Arguably, without their vital support rescue may be an unattainable goal. This is because a debtor company which has securitized most

¹ This is in relation to the interim moratorium put in place when an application to court is made for an administration order.

of its available assets² and is without cash to continue in business while it is devising a reorganization plan, may find that liquidation may be the only option left to it without the support of creditors. Support from creditors can come in the form of agreeing to compromise their claims and/ or being a source of rescue funding for the debtor company. The aim of this chapter therefore, is to analyse the inter-relationship between creditors' rights and the corporate rescue process. The first part of this chapter will focus on identifying the role of creditors during corporate rescue; this will be followed by an analysis of mechanisms such as the "moratorium", "automatic stay" and "cram down" which are used to restrict the rights of creditors during the rescue process. An evaluation of the impact of rescue funding on creditors' rights and a consideration of its inter-relationship with the ranking of creditors' claims will also be undertaken, followed by a conclusion.

5.1 The role of creditors in corporate rescue

5.1.1 Canada

Under the CCAA, a debtor company proposes to its creditors a compromise or arrangement with the intention of achieving a rescue/reorganization of its affairs.³ For this purpose creditors are typically divided into two main classes; unsecured⁴ and secured.⁵ The legal rights held by claimants determine the class within which the various claimants are grouped.⁶ As such, creditors with similar claims are classed together as a group. A court order is then sought for the purpose of calling a creditors meeting to approve the plan. Under the CCAA, creditors do not have an inherent right to a meeting or to put forward a

² See generally L R Lupica, 'Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic' (2001) 9 A.B.I.L. Rev. 287 at 291.

³ See generally CCAA 1985, s 4.

⁴ *Ibid*, s 4.

⁵ *Ibid*, s 5.

⁶ *San Francisco Gifts Ltd.* (2004), 5 C.B.R. (5th) 92 (Atla. Q.B.).

proposal, what is available to creditors is a right to seek a court order, to call for a creditors' meeting.⁷ Once a meeting has been called and in deciding whether to approve a plan, each class of creditors will evaluate what they are being offered in comparison to what they could obtain in liquidation.⁸ If a majority in number representing two thirds in value of the creditors, present or voting by proxy at the meeting approve the plan, and the court then sanctions the plan,⁹ the plan becomes binding on all creditors.¹⁰ This therefore means that all dissenting creditors' rights, which can make up a minority of up to one third, will be compromised and those creditors will be bound by the terms of the plan as sanctioned by the court. Once a plan has been approved by the requisite majority it may permanently modify the contractual rights of creditors who dissented.¹¹

Whilst the underlying theme of the CCAA is to assist financially distressed companies to come to a sort of compromise or arrangement with their creditors with the aim of returning to profitability,¹² under the CCAA, the rights of creditors may only be comprised in the following circumstances;¹³

⁷ Although this order is generally sought by the debtor, see CCAA 1985, ss 4 & 5. See also *Canadian Red Cross Society (Re)* (1998) 5 C.B.R. (4th) 299 (Ont. S.C.J.). It is interesting to note that under the PPSA, a creditor can appoint a private receiver who functions very much like the old English administrative receiver. The disadvantage of a privately appointed receiver is the lack of protection from the court as his appointment does not come with an automatic stay and other creditors can bring enforcement proceedings, see PPSA 1990, s 60. The alternative would be to seek the appointment of a court ordered receiver by virtue of s 46 or s 47 of the Bankruptcy and Insolvency Act and this comes with an automatic stay.

⁸ R J Wood, *Bankruptcy and Insolvency Law* (Irwin Law 2009).

⁹ CCAA 1985, s 6(1). The CCAA does not identify any factor the court must consider before sanctioning the plan. Nevertheless, it has been established through case laws that the court must ensure that the plan is reasonable and fair, all legal requirements have been fulfilled and it is in the best interests of the creditors.

¹⁰ *Ibid*, s 6(1) (a).

¹¹ See *Re Smoky River Coal Ltd* (1999), 12 C.B.R. (4th) 94 (Atla. C.A.). On the other hand, the courts have held that if a creditor belongs to two different classes for the purpose of approving a plan and the plan is approved in one class while being rejected in another class, the creditor is not bound with respect to his claim which falls into the class that voted against the plan. See *Olympia & York Development Ltd* [1995], 34 C.B.R. (3d) 93, 1995 Carswell Ont 340 (Ont.Gen.Div.).

¹² CCAA 1985, s 1.

¹³ LW Houlden & GB Morawetz, 'Houlden & Morawetz Bankruptcy and Insolvency analysis. Introduction to the Companies Creditors Arrangement Act' (2008) HMANALY N1.

- Where the creditor has exercised his right to vote in the appropriate class on a proposed rescue plan;
- Where the creditor's votes are in conformity with the value of a claim approved by a court procedure;
- Where the creditor has been placed in the appropriate class which voted by a majority in number and two-thirds in value in favour of the plan; and
- Where the court, in consideration of the creditors' votes, has approved the plan as being fair and reasonable.¹⁴

Undoubtedly creditors are important to the rehabilitation of a debtor company as, without their approval to have their rights to payment or security compromised, the debtor cannot proceed with saving its business or the company as a whole. In most cases creditors would be reluctant to give their approval where they feel they are not getting enough in return for compromising their claims. In a situation such as this, courts will be reluctant to approve a plan if creditors have rejected it.

5.1.2 US

When it comes to steering the rescue process under Chapter 11, the debtor company plays a major role and this can be seen in the exclusive right initially granted to the debtor under the Code to propose a reorganization plan.¹⁵ The proposal is usually expected to take place within the first one hundred and twenty (120) days of filing a Chapter 11 petition.¹⁶ The

¹⁴*Menegon v Philip Services Corp.* [1999]11 C.B.R (4th) 262, 1999 Carswell Ont 3240 (Ont.S.C.J.)[Commercial list].

¹⁵ 11 U.S.C 1994, s 1121(c) (3).

¹⁶ *Ibid*, s 1121(b)(2).

Bankruptcy Code permits the debtor to obtain a further extension of this period to no more than eighteen months after the initial filing of a Chapter 11 petition.¹⁷ Where the debtor fails to propose or file a plan within this time scale, it loses its exclusivity to commence a Chapter 11 procedure and a creditor is then allowed to file a plan¹⁸ to commence the rescue of the company.

For the purpose of approving the reorganization plan and getting the court's endorsement of the debtor company's reorganization plans, creditors are categorized into classes of substantially similar claims.¹⁹ This is so that each class of creditors may vote for or against the debtor company's reorganization plans. Creditors' votes play a very important role in facilitating the debtor's reorganization. The Chapter 11 Creditors' voting procedure does appear somewhat complex when compared with those applicable in the UK and Canada. Under a Chapter 11 reorganization, an entire class of creditors is deemed to accept a plan if at least two-thirds in value and more than one-half in number of the allowed claims within the class vote to approve the plan.²⁰

Conversely, where there are impaired classes of claims, the reorganization plan will not be endorsed by the court unless it has been accepted by at least one class of impaired creditors.²¹ Impaired creditors are those creditors who do not stand to receive the full value of their claim because they have had their legal rights against the debtor company changed by the reorganization plan.²² The minimum requirement for the endorsement of a Chapter 11 plan is that at least one class of impaired creditors votes to accept the plan.²³

¹⁷ *Ibid*, s 1121(d)(2)(a).

¹⁸ *Ibid*, s 1121(c).

¹⁹ *Ibid*, s 1122 & s 1123(a).

²⁰ *Ibid*, s 1126(c).

²¹ *Ibid*, s 1129(a).

²² see 11 U.S.C s 1124

²³ *Ibid*, s 1129(a) (10).

It does appear logical to have a clause that makes it imperative for impaired creditors to approve a plan before a court can endorse it. If a creditor's right is to be altered he should be given a say in how this is done, especially where the creditor's claim would be manifestly affected by the debtor's plan.

At first glance, it appears that creditors under Chapter 11 do wield a very influential stick post-insolvency/pre-reorganization,²⁴ through their voting rights. This however is not strictly the case. Under Chapter 11, courts in specific circumstances have the power to "cram down" objecting creditors who are in opposition to the plan, thus forcing the creditors into accepting the plan. However, as will be discussed below in section 5.2.3.1 of the thesis, at least one class of impaired creditors must be among the accepting creditors otherwise the courts cannot "cram down".

5.1.3 UK

One philosophy that may be identified behind the UK corporate rescue structure, particularly the administration process, which acts as a conduit for some of the rescue mechanisms to be found in the UK,²⁵ is that, where possible, there should be minimal interference with secured creditors' rights.²⁶ A close study of the purpose of administration as advanced by the Insolvency Act 1986²⁷ illustrates this philosophy. On the whole, the interests of creditors are paramount and an administrator must place these interests above

²⁴ This distinction is made to demarcate the variety of influence creditors wield during corporate rescue. While it appears that Chapter 11 creditors get the short end of the stick, they have been able to, through the provision of debtor-in-possession funds sway the control of the corporate rescue process to their side as will be seen later in the chapter.

²⁵ Such as the company voluntary arrangement (CVA) and scheme of arrangement, see also p 33-34 for explanation of the administration procedure.

²⁶ R Goode, *Principles of Corporate Insolvency Law* (3rd edn, Sweet and Maxwell 2010) p 329 at 10-23.

²⁷ Insolvency Act 1986, Sch B1 Para. 43.

others.²⁸ The debates in the House of Lords prior to the enactment of the Enterprise Act 2002 formed the context of this duty placed on the administrator.

During the debates, Lord McIntosh, a labour party peer was of the view that an administrator should not rescue a company if it is to the detriment of creditor value.²⁹ Consequently, Schedule B1, section 3(1) (b) of the Insolvency Act 1986 enjoins the administrator to achieve a better result for the company's creditors as a whole than would be likely if the company was liquidated without first being administration. This duty on the administrator is further augmented by the overall obligation placed on the administrator of a company to perform his functions in the interests of the company's creditors as a whole.³⁰

It therefore comes as no surprise that an administrator can in some circumstances, be appointed by or at the behest of creditors in the UK. There are two routes by which creditors can appoint an administrator; out of court appointments (i.e. without a court order) and court ordered appointments. Powers to appoint an administrator out of court are however restricted to creditors who are qualifying floating charge holders.³¹ This is in contrast to the procedure for court ordered appointments which permits any one or more creditors of the company to petition the court to appoint an administrator.³² Once an administrator has been appointed, a proposal for achieving the aims of the administration is prepared by the administrator and a copy is sent to the Registrar of Companies, every creditor and member³³

²⁸ *Ibid.*

²⁹ HL Deb 29 July 2002, vol 638 cc 763-806 at 765.

³⁰ Insolvency Act 1986 Sch B1 s 3(2). This provision is subject to the administrator performing his functions as quickly and efficiently as reasonably practicable, see Insolvency Act 1986, Sch B1 s 4.

³¹ See Insolvency Act 1986, Sch B1, para 14(1) & (2). A qualifying charge is one created by an instrument which (i) states that para 14 of Sch B1 of the Insolvency Act 1986 applies to the floating charge (ii) aims to empower the holder of the floating charge to appoint an administrator of the company or (iii) aims to empower the holder of the floating charge to make an appointment which would be the appointment of an administrative receiver within the meaning of s 29(2) of the Insolvency Act 1986. See also p159 of the thesis which discusses reforms by the Enterprise Act 2002 to floating charge.

³² Insolvency Act 1986, Sch B1 para 12(1)(c).

³³ *Ibid.*, Sch B1 para 49(4).

as soon as is reasonably practicable³⁴ or within a maximum of eight weeks³⁵ after the company has entered into administration. At this point the administrator calls the initial creditors' meeting³⁶ at which he presents the proposal to the creditors.³⁷

At the meeting, the creditors deliberate on the proposal and either approve or modify the proposal.³⁸ Where the aim of the administration is to act as a conduit for corporate rescue, the proposal may incorporate a proposal for a company voluntary arrangement (CVA) under Part 1 of the Insolvency Act 1986 or a scheme of arrangement under section 895 Companies Act 2006.³⁹ It is the administrator's duty to prepare and present a proposal to creditors, and the proposal cannot be modified by the creditors without his consent, however the proposal may not include any act which would interfere with the right of a secured creditor or would amount to one preferential creditor getting a smaller return on his debt than another preferential creditor.⁴⁰ However where the creditor consents to such modification or the proposal includes a scheme of arrangement, then such alteration of the creditor's rights would be permitted.⁴¹

Voting to approve an administrator's plan is an important part of the rescue process and it is in this area that the creditor's influence can be felt. A creditor who is entitled to vote can use his vote to influence the direction that the rescue process takes.⁴² His vote⁴³ is one of the deciding factors that determine if a debtor company goes ahead with its rescue plans.

³⁴ *Ibid*, Sch B1 para 49(5)(a).

³⁵ *Ibid*, Sch B1 para 49(5)(b).

³⁶ *Ibid*, Sch B1 para 51(1).

³⁷ Where it is a pre-pack administration, these procedures are significantly eroded as the sale of the company is negotiated before the appointment of an administrator who concludes the sale shortly after his appointment and presents the pre-pack sale to the creditors' meeting.

³⁸ *Ibid*. Sch B1 para 53. Any modification to the proposal must be done with the consent of the administrator. See para 53(1) (b).

³⁹ Insolvency Act 1986, Sch B1 para 49(3).

⁴⁰ *Ibid*, Sch B1 para 73(1)(a)&(c).

⁴¹ *Ibid*, Sch B1 para 73(2)(a)-(c).

⁴² Goode (n 26) p 393 at 10-120.

⁴³ And that of members in the case of CVA, see Insolvency Rules 1986, r.1.20 (1). However it is permissible for a decision approving the administrator's plan to be made by only the creditors' meeting and this is subject to an order of court made under s 4A(2)(b) Insolvency Act.

Generally, at the creditors' meeting a majority vote by the creditors is required for a resolution approving the proposal to be passed in support of the debtor company's rescue. The required majority is dependent on the rescue mechanism contained in the proposal and this could either be a CVA or a scheme of arrangement.⁴⁴ For ease of analysis, the thesis will focus on the CVA.

Where the administration order is in conjunction with a CVA, creditors voting in the creditors' meeting must vote to approve the terms of the CVA in a majority exceeding three-quarters in value of the creditors voting in person or by proxy.⁴⁵ All creditors entitled to vote,⁴⁶ voting to pass a resolution approving the administrator's proposal are bound by their votes,⁴⁷ even where a creditor is entitled to vote and did not receive notice of the meeting or received notice but chose not to attend or to vote by proxy, he is bound by the decision of the other creditors entitled to vote.⁴⁸ Therefore once a CVA has been approved,⁴⁹ it binds creditors who voted in its favour, creditors who attended the creditors' meeting but did not vote, creditors who were entitled to vote but did not attend the meeting and creditors who were not given notice of the creditors' meeting, even though they were entitled to be notified.⁵⁰ The effect of an approved CVA is such that it also binds dissenting creditors who voted against it.⁵¹ On the other hand, a creditor not entitled to vote is not bound by the by the CVA⁵² but may have his right to obtain any leave required to enforce his claim affected by the terms of the CVA.⁵³

⁴⁴ Under the scheme of arrangement, the approval of at least 75% in value of each class of the members or creditors, also being a majority in number in each class is required. See Companies Act 2006, s 899(1).

⁴⁵ Insolvency Rules 1986, r.1.19 (2).

⁴⁶ Those who have filed a claim.

⁴⁷ Insolvency Act 1986, s 5 (2) (b).

⁴⁸ *Ibid.*

⁴⁹ See n 43 for requirement for the approval of a CVA.

⁵⁰ Insolvency Act 1986, s 5 (2) (b).

⁵¹ It should be noted that secured and preferential creditors cannot be bound without their consent; therefore this rule is not applicable to them, see Insolvency Act 1986, s 4(3) & (4).

⁵² Insolvency Act 1986, s 5 (2) (b).

⁵³ Goode (n 26) p 400 at 10-127. Generally CVAs do not alter the rights of secured creditors. However where the creditor is an unsecured creditor, the court may be reluctant to grant him leave to pursue his claim

Whilst it does appear that once a CVA has been approved creditors entitled to vote are bound by the CVA, provisions have been made by the law to allow creditors to challenge the CVA on grounds of unfair prejudice or material irregularity in relation to the creditors' meeting.⁵⁴ A creditor who wishes to challenge the CVA must make an application to the court within twenty-eight (28) days of the court receiving the report on the CVA, from the nominee appointed for the purpose of supervising the implementation of the CVA.⁵⁵ The court can revoke or suspend any decision made by the meeting and/or direct that further meetings be held where it is satisfied that the creditor had sufficient grounds to challenge the CVA.⁵⁶

5.2 Analysis of mechanisms that impede creditors' rights to enforce security

The main objective of most corporate rescue mechanisms is to save the company or its business. However it is expected that the position of creditors should not be worsened and as a result of this process, the creditor is expected to obtain more than they would have received in liquidation.⁵⁷ Creditors are therefore asked to support the rescue proposal. The success of a company's rescue depends on a variety of factors and the debtor company's ability to guard against a race by creditors to realise their securities and strip the debtor of a possible means of financing the rescue process, is an important factor. In recognition of

without reference to the terms of the CVA, because if the creditor pursues his claim to judgment and is allowed to enforce the judgment without reference to the CVA, he may be placed in a more advantageous position at the expense of the general body of creditors. See also *Re TBL Realisations Ltd, Oakley-Smith v Greenberg* [2004] B.C.C. 81.

⁵⁴ Insolvency Act 1986, s 6(1)(2).

⁵⁵ *Ibid*, s 6(3).

⁵⁶ *Ibid*, s 6(4).

⁵⁷ See G McCormack, *Corporate Rescue Law- an Anglo-American Perspective* (Edward Elgar 2008) p3-6. Liquidation of a company results in the cessation of business, sale of the company's assets and proceeds from the sale is then used to settle its debts and liabilities, after which, the company ceases to exist. Corporate rescue on the other hand is aimed at enabling the survival of a company as a whole or parts of it. The principle behind rescue mechanisms is that a business may be worth more if preserved or sold off as a going concern than if sold on piecemeal basis as the case would be in liquidation.

the importance of providing a more conducive environment for potential rescue to take place, a lot of jurisdictions have made provisions for a restriction of creditors' rights during the rescue process⁵⁸ especially as it relates to the enforcement of their claims.

To achieve an effective rescue of a company or its business, creditors' rights are often compromised and one notable example is the stay on a creditor's ability to enforce his security or to demand repayment from the debtor. The suspension of a creditor's right of enforcement is an important aspect of the process of ensuring that the debtor is given all available opportunities, where feasible, to explore all avenues for rescue. This can only be effectively done when the debtor is given a reprieve from creditors' demands, which, if yielded to, may sound the death knell for the debtor. UNCITRAL has also recognised the need for debtors to be protected from the immediate demands of creditors when a company is facing insolvency and wishes to reorganize its affairs. The *UNCITRAL Legislative Guide on Insolvency Law* proposes that a company rescue can be funded from the debtor company's existing cash flow through the operation of a stay and the termination of payments on pre-commencement liabilities.⁵⁹

In the UK, US and Canada, insolvency legislations have in place measures which check creditors' ability to strip the debtor of assets through the enforcement of securities, or, where applicable, act to postpone demands for payment. In essence the debtor is provided with a statute-backed protective shield which restricts creditors' rights to enforce security or make demands on the assets of the debtor company. This restriction lasts for a fixed timescale or the duration of the rescue process and this insulates the debtor company from

⁵⁸ For example German Insolvency Code 1994, s 89 and France which gives management opportunity to apply for a stay where creditors attempt to enforce claims.

⁵⁹ UNCITRAL Guide at 114.

creditors' demands. Two arguments have been put forward which underline the overall benefit to creditors of having a protective shield in place.

The utilitarians argue that to permit a frantic free-for-all grab of the debtor company's assets to occur at a time when it is apparent that the debtor company cannot meet its obligations, is not in the interests of the general body of creditors.⁶⁰ Their argument is founded on the utilitarian philosophy that accepts the 'rightness' of an action when it contributes to general happiness, to the greatest number of people.⁶¹ Therefore the presence of a stay, which interferes with creditors' rights, sometimes to the detriment of a few, is viewed as the right action to take because, in the final analysis, the presence of a stay is justified by potentially higher returns to creditors than would perhaps have been the case without the stay. To this end, having a protective shield in place to preserve the debtor's assets for the general body of creditors should not be viewed solely as an infringement of the rights of a few affected creditors.

Collectivists proffer an argument which is not entirely different from the utilitarian argument; they argue that a well-ordered determination of the various claims from creditors may result in the most cost-effective outcome.⁶² Their argument is based on the premise that bankruptcy provides a collective mechanism for unscrambling rights and liabilities that has its origin outside of bankruptcy. Also, a collective distribution is in the interests of the body of creditors because it prevents the pool of assets from shrinking when a debtor becomes insolvent.⁶³ In other words, individual claims should be subject to the overall goal of making distributions to creditors under the collective scheme and this may only be

⁶⁰ D Milman, 'Moratoria in UK Insolvency Law: Policy and Practical Implications' [2012] Co. L.N. 317, 1-4.

⁶¹ LB Curzon, *Jurisprudence* (Macdonald & Evans, Plymouth, 1979) p93-94.

⁶² Milman (n 60).

⁶³ T H Jackson, 'Translating Assets and Liabilities to the Bankruptcy Forum' in J S Bhandari and L A Weiss (eds), *Corporate bankruptcy, economic and legal perspectives* (Cambridge University Press 1999) p59.

effective with a stay in place to prevent a diminution in returns to the general body of creditors. Accordingly, it becomes imperative that the collective desire of the group is put before individual claims, so that distribution to creditors is then done efficiently.

The utilitarian and collectivist arguments emphasize the underlying tenet of corporate rescue, which is the creation of a framework within which a debtor could resolve his financial difficulties. This framework acts as a collective medium through which the debtor reaches a compromise with his creditors. On the other hand, it has been stated that while bankruptcy laws should collectivize the distribution of assets among creditors in fulfilment of rights created by non-bankruptcy law, it should not modify or nullify these rights and duties except where it is necessary to facilitate collective distribution.⁶⁴

5.2.1 The UK moratorium

In the UK, the administration procedure is designed to give the debtor a framework within which to achieve a rescue, and this is enhanced by the presence of a statutory moratorium which prevents creditors from enforcing their rights against the debtor without prior authorization. This limitation placed on the rights of creditors, especially secured creditors who, in the ordinary course of corporate dealings, should be able to rely on their security as buffer against perceived losses, is given legislative backing in the Insolvency Act 1986 under paragraph 43, Schedule B1. The effect of this piece of legislation is such that, once a debtor company enters into administration, creditors are barred from pursuing claims against the debtor and all the creditors' rights of enforcement are frozen by the automatic presence of a statutory moratorium.⁶⁵ The moratorium provides the debtor with breathing

⁶⁴ *Ibid* at p72.

⁶⁵ Insolvency Act 1986, Sch B1 para 42-44.

space in which to reorganize its affairs without interference from its creditors who may want to enforce security. The effect of the moratorium is absolute and covers all rights including the commencement of an alternative insolvency proceeding.⁶⁶

The effect of the moratorium is intended to be comprehensive in nature;⁶⁷ nevertheless its effect can be lifted with either the prior consent of the administrator or the court.⁶⁸ Although the 1986 Act has not made clear the conditions under which the court may lift the effect of a moratorium and grant leave to a creditor to enforce security, a set of guidelines has been established by the Court of Appeal in *Re Atlantic Computer Systems plc*.⁶⁹ What the law aims to do with the moratorium is to suspend creditors' rights of enforcement and not to alter their substantive rights.⁷⁰ Consequently, whatever rights a creditor had prior to an administration order are left unchanged by the effect of a moratorium.

The main objective of administration is the rescue of the company as a going concern and where this is not feasible, the second objective is resorted to; that is, the achievement of better results for creditors as a whole than would be likely if the company was immediately liquidated. Where these two objectives are not practicable, the administrator is enjoined to realise property in order to make a distribution to one or more secured or preferential

⁶⁶ Insolvency Act 1986, Sch B1 para 42(3).

⁶⁷ When a moratorium is in place, no resolution may be passed or order made for the liquidation of a company which is in administration, except under s 124B (SEs), s 124A (public interests) and s 367 of the Financial Services and Market Act 2000 (petition by Financial Services Authority), see Insolvency Act 1986, Sch B1 para 42. Also, when a moratorium is in place, no action may be taken to enforce security over the company's property except with the consent of the administrator, or with the permission of the court, see Insolvency Act 1986, Sch B1 para 43(2). It also bars the appointment of an administrative receiver, see Insolvency Act 1986, Sch B1 para 43(6A).

⁶⁸ Insolvency Act 1986, Sch B1 para 42(2). Note that it is possible to obtain a retrospective consent from the court or administrator, see *Bank of Ireland (UK) plc. v Colliers International UK plc*. [2012] EWHC 2942 (Ch).

⁶⁹ [1992] Ch 505 at 542-544. Nicholls L.J listed eleven guidelines which the court may take into consideration before granting leave to enforce security and they include but are not restricted to; (a) the party seeking leave of court to lift stay must prove his case. (b) If granting leave to a lessor of land or a lessor of goods to exercise his right is unlikely to interfere with the achievement of the purpose of the administration, leave would be given. (c) Where significant loss will occur, the court is more likely to lift the stay. (d) Conduct of the parties. (e) The financial position of the company etc. On the whole, moratoria are lifted where the proprietary rights of a creditor is at stake and not a personal claim. In other words, it is done to protect proprietary claims.

⁷⁰ *Barclays Mercantile Business Finance Ltd v SIBEC Developments Ltd* [1993] BCLC 1077.

creditors.⁷¹ In most cases it is the second purpose that is achieved. Where it is possible to save the company as a going concern or a substantial part of its business, continuing finance is pivotal to this happening⁷² and one of the possible sources of finance for any company going through the rescue process are its available assets.⁷³

Consequently it is important that the administrator has access to the debtor's assets without interference from creditors.⁷⁴ Either way, for the administrator to effectively carry out the purpose of an administration order, whether it is the survival of the company as a going concern or making returns to creditors, it is essential that creditors' rights to enforce their security are placed on hold so that assets which could be used to raise funds to continue the business as a going concern are not eroded, or where the second purpose of the administration is pursued, an equitable distribution is then achieved for the general body of creditors. The UK moratorium plays an important role in ensuring that the purpose of administration is achieved by the administrator.

Consequently, it appears that in order to get returns from the debtor, creditors are expected to concede some of their rights to the debtor; however this is done in the collective interest of the body of creditors. Although it appears that creditors are deprived of their fundamental rights of enforcement, it has been held that the presence of a moratorium does not affect the fundamental rights of the creditors, but restricts the exercise of these rights.⁷⁵ The implication of this therefore, is that, whilst creditors retain the rights to their security, the

⁷¹ Insolvency Act 1986, Sch B1 para.3.

⁷² See section 3.1 of this thesis for discussion on the importance of corporate rescue in general.

⁷³ In most cases, these assets are fully encumbered and do not provide any source of finance for the debtor. In the US and Canada both of which allow priming liens, this may not be a problem. In the UK, priming liens are not part of the insolvency process; however, assets subject to a floating charge can be disposed of by the administrator thereby providing a source of finance, see Insolvency Act 1986, Sch B1, para 70(1). It should be noted that where a floating charge asset is disposed of in reliance of para 70(1), the floating charge holder retains his priority, see Insolvency Act 1986, Sch B1, para 70(2).

⁷⁴ *Bristol Airport v Powdrill* [1990] Ch 744 at 758-759.

⁷⁵ *Barclays Mercantile Business supra* (n 70).

inherent automatic entitlement to exercise that right is suspended by the presence of a moratorium.

5.2.2 Interim stay in Canada

A debtor making an initial application under the CCAA is afforded some protection under section 11.02(a)-(b). The Act authorizes the court to make an order⁷⁶ suspending all proceedings, action or suits against the debtor for an initial period of thirty (30) days thereby giving the debtor respite from creditors' claims and an opportunity to come up with a rescue plan.⁷⁷ In effect, a creditor's right to make demands on the debtor is put on hold while the *status quo* is maintained. The stay suspending creditors' claims or actions against the debtor does not automatically come into operation on the filing of a CCAA petition by the debtor, the court has to make an order before a stay can take effect.⁷⁸ Generally, the application of the stay is more challenging for secured creditors whose rights to the seizure and realisation of specific assets for their recovery, are directly curtailed by the presence of the stay.⁷⁹ Whilst the purpose of the stay is to preserve things the way they are, it is also aimed at enabling the successful rescue of the debtor company.⁸⁰

In addition to this, the stay checks any undue advantage which any creditor may attempt to get or gain over the other creditors while debtor tries to restructure its affairs.⁸¹ It has been suggested that the purpose and effect of the stay is to re-balance the negotiating power between the debtor and the creditors.⁸² Debtor companies are afforded a level playing field

⁷⁶ This order to stay proceedings is usually granted at the same time an order is granted to commence a CCAA proceeding.

⁷⁷ *Sairex GmbH v Prudential Steel Ltd* [1991] 8 C.B.R. (3d) 62, 1991 Carswell Ont 215(Ont.Gen.Div.).

⁷⁸ See CCAA 1985, s 11.02.

⁷⁹ K P McElcheran, *Commercial Insolvency in Canada* (2nd edn, Lexis Nexis 2011) at 7-10

⁸⁰ *Re Stelco Inc.* [2005] 2005 CarswellOnt 6283, 15 C.B.R. (5TH) 288 (Ont. C.A.)

⁸¹ *Re Woodward's Ltd* [1993] 17 C.B.R. (3d) 236, 79 B.C.L.R. (2d) 257, 1993 CarswellBC 530 (S.C.).

⁸² J Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Thomson Carswell 2007) p33.

in which to negotiate with their creditors, since the power of creditors to enforce claims which if unchecked would inevitably drive the debtor into liquidation, is temporarily curtailed. On the other hand, it can be argued that the re-balancing of negotiating powers interferes with the legal rights of creditors, particularly those rights acquired prior to insolvency in heavily negotiated security agreements and commercial documents.⁸³

Although the initial stay is intended to last for a period of thirty days,⁸⁴ the debtor can bring an application to have the stay extended for a further period; the length of the subsequent stay is usually at the discretion of the court.⁸⁵ It has been held by the courts that a stay would only be ordered where there is a good possibility that the debtor company can carry on its business as a going concern.⁸⁶ Attention must be drawn to the fact that although the stay order provided for under the CCAA is aimed at creating an enabling environment for rescue, by suspending all actions which may interfere with the rescue of the debtor; the stay order is not all embracing.

Unlike secured creditors, who often endure the full effect of a stay⁸⁷ under section 11.01 of the CCAA, the rights of suppliers are exempted from the effect of the stay. The section provides that where a person supplies goods or services after an order has been made by the court regarding the debtor, any such order or a section 11.02 stay order cannot prohibit that person (the supplier) from making demands for immediate payment for such goods and services or prevent him from the use of leased or licensed property or other valuable consideration⁸⁸ or prevent the requirement for further advance of money or credit.⁸⁹

⁸³ McElcheran (n 79) p8.

⁸⁴ CCAA 1985, s 11.02.

⁸⁵ *Ibid*, s 11.02(2)(a).

⁸⁶ *Re Stephanie's Fashions Ltd* [1990] 1 C.B.R.(3d) 248, 1990 CarswellBC 373 (B.C.S.C.).

⁸⁷ A stay has a more direct effect and limits the rights of secured creditors who would want to rely on their right to seizure of certain assets as a means to recoup.

⁸⁸ CCAA 1985, s 11.01(a.)

⁸⁹ *Ibid*, s 11.01(b).

It would seem that any supply or provision of credit post-insolvency and during the rescue period is exempt from the effect of the stay. Therefore it appears that the debtor's entry into insolvency is the cut-off point, thus any claims arising from supply made prior to this time would be affected by the stay. The implication of this provision appears to reiterate the emphasis that Canada places on suppliers as important elements in ensuring the successful rescue of the debtor. More examples of how highly rated suppliers are, can be found in the interim/rescue financing provisions found in the CCAA.⁹⁰ Arguably, a supplier who is willing to maintain a business relationship with a debtor company by ensuring that critical lines of supply are left open, should be given the option of demanding advance or immediate payment from the debtor without interference. Without this protection, the rescue would be effectively carried out at the expense of the supplier. In addition, a supplier may hold a monopoly on goods or services which are vital to the continued operation of the debtor's business and this may make it near impossible for the debtor to restructure without a guarantee that these goods or services will continue to be available.⁹¹ Therefore, giving suppliers the right to demand payment may prevent the supplier holding the debtor's rescue to ransom.

Although there is no statutory provision as to when or under what conditions a stay may be lifted, it has been suggested by the Canadian courts that regard should be had to the objectives of the CCAA, balance of convenience, the relative prejudice to the parties and the actions of the debtor company.⁹² In *Re Canwest Global Communication Corp*,⁹³ the

⁹⁰ See p108-109 for discussion on critical suppliers' priority as DIP financiers.

⁹¹ Wood (n 8).

⁹² *Re Canwest Global Communications Corp.* (2009), 2009 CarswellOnt 7882, 61 C.B.R. (5th) 200 (Ont. S.C.J.

4 [Commercial List]; *Re Azure Dynamics Corp.* (2012), 2012 CarswellBC 1545, 2012 BCSC 781 (B.C.S.C.

⁹³ (2009), 2009 CarswellOnt 7882, 61 C.B.R. (5th) 200 (Ont. S.C.J. [Commercial List].

court outlined several circumstances under which the court may lift a stay order and these include where;

- the plan is likely to fail.
- the party proposing that the stay be lifted shows hardship.
- the applicant shows necessity for payment.
- the applicant would suffer substantial prejudice if the stay is kept in place and there would be no consequential hardship to the debtor company or the position of other creditors.
- it is essential to allow the applicant take necessary steps to protect a right which could be lost by the passage of time.
- the debtor company is no closer to a proposal after the lapse of a significant time following the commencement of the stay period.
- there is a real risk that the creditors' loan will become unsecured during the stay period.
- it is essential to allow the applicant to perfect a right which existed prior to the commencement of the stay.
- it is in the interests of justice to do so.

Two core principles appear to be highlighted by these circumstances identified by the court in *Re Canwest* and they are fundamental to any rescue operation by the debtor. Firstly, the plan put in place for the company's rescue should have a high forecast of succeeding. Where the court is convinced that the rescue plan would not achieve its purpose, it may lift the stay. Justification for this circumstance can be found in the fact that, stays are put in

place to suspend creditors' rights while the company is being rescued. Therefore if the purpose of placing a stay on creditors' rights is not achievable (i.e. the rescue of the company is not feasible), it becomes futile to have one in place and this may amount to an imposition on creditors' right to demand satisfaction of their claims.

Secondly, the court in identifying these circumstances recognizes that there are occasions where a stay could have an adverse impact on a creditor and this could place the creditor in an inauspicious position. Thus, where a creditor can show that he would suffer an irreparable wrong that cannot be redressed, the court may, within that context, lift the stay. Generally the court will try to act in the interest of fairness and justice in relation to both the creditor and debtor and will ensure that if the stay is to be lifted, it would have no consequential hardship on the debtor.

5.2.3 Automatic stay under US Chapter 11

The filing of a Chapter 11 petition by the debtor⁹⁴ acts as an automatic stay which suspends the commencement or continuation of any action, or proceeding by creditors against the debtor.⁹⁵ Essentially the Chapter 11 stay freezes all actions or claims by creditors against the debtor which arose before the commencement of the Chapter 11 petition.⁹⁶ It therefore means that the filing of the petition acts as a cut-off point and all creditors' claims and actions originating from the debtor's pre-filing state would be estopped. On the other hand, the blanket effect of the automatic stay does not impede post-commencement actions by creditors against the debtor.⁹⁷ This is because the provision of section 362(1) generally applies to actions which were commenced or could have commenced before the debtor

⁹⁴ See 11 U.S.C 1978, s.301.

⁹⁵ 11 U.S.C 1978, s 362 (a) (1).

⁹⁶ See generally, 11 U.S.C 1978, s 362 (a) (1-8).

⁹⁷ *Holland Am. Ins. Co. v. Succession of Roy*, 777 F.2d 992 (5th Cir. 1985).

filled a Chapter 11 petition. Thus any claim arising after the filling of a Chapter 11 petition is not affected by the stay.

As is the case in the UK, no court order is needed for the operation of an automatic stay under Chapter 11. The automatic stay is regarded as an integral part of the Chapter 11 process which acts to further the objectives of Chapter 11 reorganization and these are; the maximization of going concern value and equal distribution among similarly placed creditors.⁹⁸ The stay furthers going concern value by preventing the stripping of the debtors' assets by creditors. The prevention of any act of seizure on the part of creditors means that the existing value of the debtor company's assets is kept as a whole and the debtors' business is given a shot at survival. Flowing from this, creditors too, do not lose going concern returns. The automatic stay protects the body of creditors by ensuring that no one creditor is placed in a more advantageous position over another creditor with similar claims.⁹⁹ Unlike that which obtains in Canada, the Chapter 11 automatic stay does not have a time limit. It perpetuates until the assets which are the subject of the stay cease to be part of the company's property¹⁰⁰ or until the case is closed,¹⁰¹ dismissed¹⁰² or a discharge is denied or granted.¹⁰³ To all intents and purposes, creditors' rights to demand recompense are effectively silenced, but US creditors have been able to compensate for this in other areas.¹⁰⁴

⁹⁸ J A Ayer, M Bernstein & J Friedland, 'An Overview of the Automatic Stay' (2004) vol 22 ABI Journal.

⁹⁹ *Ibid.*

¹⁰⁰ 11 U.S.C 1978, s 362(c) (1).

¹⁰¹ *Ibid.*, s 362(c) (2a).

¹⁰² *Ibid.*, s 362(c) (2b). See also s 362(C) (4-5) for more condition where the duration of a stay can be limited.

¹⁰³ *Ibid.*, s 362 (c) (2c). It should be noted that even where an automatic stay has been terminated due to a Chapter 11 confirmation process, s 524 (a) which stays pre-commencement actions against the debtor comes into operation when the reorganization plan becomes effective.

¹⁰⁴ See section 3.2.5 of this thesis for discussion of the use of DIP finance by creditors as a corporate governance tool to control management. See also the same section (3.2.5) which discusses the use of collateralization by creditors as a defensive mechanism against pre-commencement exposures.

Although the underlying purpose of the automatic stay is to defer all actions and proceedings¹⁰⁵ against the debtor company in order to provide the debtor with breathing space in which to effectively restructure, Chapter 11 recognises that there may be occasions where there may be a need for the stay to be vacated. It therefore makes provision for grounds under which creditors may seek relief from the effect of an automatic stay. Section 362(d) permits a creditor to file a motion seeking relief from an automatic stay and the courts must within thirty days hold a preliminary hearing¹⁰⁶ with the final hearing concluded within thirty days of the conclusion of the preliminary hearing.¹⁰⁷ There are three grounds under which the court can terminate, annul, modify or condition the automatic stay, however only the two which are relevant to this analysis will be examined¹⁰⁸ and these are;

- Relief from the stay may be granted for “cause”, including the lack of adequate protection of an interest in property.¹⁰⁹ The requirement for “cause” as a basis for granting relief appears all-encompassing with no clear boundary as to the parameters of what constitutes “cause”. It therefore leaves the courts a discretion to determine what constitutes “cause”. The most likely benefactors of the “adequate protection” provision are secured creditors, who have interests in the debtor’s assets and are accordingly entitled to adequate protection to guard against reduction in value of their security.¹¹⁰ Therefore, where the debtor is incapable of, or reluctant to, provide adequate protection to the creditor or where the creditor thinks his interest is being eroded, the court can grant relief.

¹⁰⁵ There are situations where an automatic stay will not be effective, see generally 11 U.S.C, s 362(b).

¹⁰⁶ See 11 U.S.C, s 362 (e) (1).

¹⁰⁷ *Ibid.* s 362 (e) (1), it should be noted that under this section there is scope for extension of the thirty day period.

¹⁰⁸ *Ibid.* s 362 (d)(3) which is the third ground and is centred on single-assets real estate bankruptcy cases involving less than \$4 million in secured debt.

¹⁰⁹ 11 U.S.C, s 362 (d)(1).

¹¹⁰ Ayer, Bernstein & Friedland (n 98).

- The court may grant to a secured creditor relief from an automatic stay where there is an act against assets which make up the debtor's estate.¹¹¹ For a creditor to obtain relief on this ground, the property must be free of any equitable interest belonging to the debtor and must not be required for the effective reorganization of the debtor company.¹¹²

The court is most likely to grant immediate relief from the stay in order to prevent irreparable damage to the creditor's interest.¹¹³ Thus, whilst the automatic stay functions mainly to protect the debtor's interest above that of creditors, the court has to strike a balance between creating an enabling environment for the debtor's rehabilitation and protecting creditors' interests from permanent damage, which may in most cases, be a devaluation of secured assets.

5.2.3.1 Cram down

Under Chapter 11, bankruptcy courts in some situations may impose a plan over the objections of creditors and this is referred to as "cram down".¹¹⁴ While the court's power to cram down is conditional on the rescue plan complying with the "absolute priority rule",¹¹⁵ it is otherwise discretionary and not mandatory; consequently a court may or may not exercise its cram down powers. It can be argued that the thinking behind the cram down procedure is to make provisions for situations where objections of creditors, which are perceived as likely to unreasonably derail the reorganization of the debtor, are crushed. It is a powerful tool used by the courts to compel dissenting classes of both secured and

¹¹¹ 11 U.S.C, s 362 (d) (2).

¹¹² *Ibid*, s 362 (d) (2)(a)&(b).

¹¹³ *Ibid*, s 362 (f).

¹¹⁴ 11 U.S.C, s 1129 (B).

¹¹⁵ The rule dictates how distribution in order of priority is to be made to creditors.

unsecured creditors to accept the plan.¹¹⁶ Authorizing the courts to come down on dissenting creditors may imply a sort of heavy handedness on the part of the law on creditors, in favour of the debtor company.

In order to mitigate any negative impact of a cram down on creditors, the courts are required to ensure that a number of conditions¹¹⁷ are met by the reorganization plan proposed by the debtor. Chief among these is that the repayment plan is “fair and equitable” and not unjustly prejudicial.¹¹⁸ In addition to this, secured creditors must retain their security or the entire value of their claim.¹¹⁹ It should be noted that a cram down cannot be imposed if dissenting unsecured creditors have been fully paid or the holder of a claim with less priority receives some property as a result of a claim or interest. This requirement protects members of a dissenting class of unsecured creditors by enabling dissenting unsecured creditors to be provided for in full if any junior class to them is to receive anything at all.¹²⁰ This acts as a sort of check and balance to ensure that the cram down provision is not arbitrarily abused.

Although the cram down appears to intrude on creditors’ rights, when balanced against the need to ensure that a reorganization plan attains the requisite number of votes to ensure that it sees the light of day, it does seem to be a fair trade off which may be advantageous to the general body of creditors and the debtor as well. On the other hand, it could be argued that only the debtor company stands in an advantageous position with regards to a cram down as dissenting creditors are made to fall in line, although this is done on fair and equitable grounds. It is arguable that it is only dissents which are objectively unreasonable which are effectively overridden by a cram down. Some commentators view cram down as an

¹¹⁶ D R Wong, ‘Chapter 11 Bankruptcy and Cram downs: Adopting a Contract Rate Approach’ (2012) vol 106, No. 4, North Western University Law Review pg. 1927-1958; see also *In Re Armstrong World Industries., Inc.*, 432 F. 3d 507, 509-10 (3d Cir. 2005).

¹¹⁷ See generally 11 U.S.C, s 1129(B).

¹¹⁸ *Ibid*, s 1129 (b)(1).

¹¹⁹ *Ibid*, s 1129(b)(2)(a)(i); see s 1129(b)(2)(b) for other requirements.

¹²⁰ K N Klee, ‘All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code’ (1979) 53 ABLJ 133-171.

advantageous mechanism to have in Chapter 11 corporate rescue because it favours settlement,¹²¹ effectively ensuring that the debtor company's reorganisation is given every chance of success.

Unlike the bankruptcy courts in the US, the courts in Canada and the UK do not have cram down powers to compel dissenting creditors to accept a rescue plan.

5.3 Creditors' rights and the funding process

5.3.1 US

In the US, creditors play a major role in how the rescue process is financed. This may be due to the incentivised structure laid down in the Bankruptcy Code which can be seen to provide rewards for creditors who take the risk of funding the rescue process.¹²² Not only that, where there is an over-exposure to risk on the part of the creditors, the Bankruptcy Code makes it a requirement that the debtor must adequately protect the creditor.¹²³ These provisions encourage willing creditors to fully participate in funding corporate rescues in the US. The incentivised structure of rescue funding found within the Bankruptcy Code when considered in line with the principles which underpin the distribution of assets during insolvency,¹²⁴ throws up a number of issues with regards to the ranking of creditors' claims during the corporate rescue process.

¹²¹ See R F Broude, 'Cram Down and Chapter 11 of the Bankruptcy Code: The Settlement Imperative' (1984) 39 Bus. Law 441; P Coogan, 'Confirmation of a Plan under the Bankruptcy Code' (1982) 32 Case W. Res. L. Rev. 301; I M Pachulski, 'The Cram Down and Valuation under Chapter 11 of the Bankruptcy Code' (1980) 58 N.C.L. Rev. 925.

¹²² See section 3.2.3 of the thesis for detailed explanation.

¹²³ 11 U.S.C, s 361.

¹²⁴ The rule requires a *pari passu* distribution, i.e. all creditors in each class are treated equally in accordance with priorities.

The two main principles which govern distribution to creditors during insolvency are that the hierarchy of claims must be followed¹²⁵ and that there must be a *pro rata* allocation of returns to creditors in satisfaction of their claims. Theoretically, the funding provision under the Code which allows for super-priority payments to creditors willing to advance funds to the debtor company as well as the priming of an existing lien¹²⁶ appears to be inconsistent with these principles. However, in practice it seems this is rarely the position, because in most cases, existing creditors who already have an on-going relationship with the debtor company provide the necessary funds.¹²⁷ Accordingly, the issue of usurping the position of other creditors who rank ahead in the hierarchy of distribution by new creditors may not be commonplace. In any case, where it does occur the court ensures that the creditor who loses priority is not left worse off than he would have been if the debtor had not obtained super-priority funding.

Perhaps the most likely source of threat to creditors during the funding of the rescue process is from co-creditors. There is an apparent risk in relying on existing creditors as the source of post-commencement financing, and this risk lies in the potential for existing creditors to use their willingness to provide post-commencement funding to shore up their previous exposure to the debtor. Creditors have used the advantage of negotiating post-commencement funding to re-negotiate their pre-commencement dealings with the debtor company, and this they have done as a cross-collateralization of pre and post-commencement exposure.¹²⁸ For instance, in *Re Vanguard Diversified, Inc.*,¹²⁹ the debtor-in-possession, *Vanguard*, after filing for reorganization under Chapter 11, sought the

¹²⁵ In insolvency a scheme of priority is followed during distribution to creditors. Secured creditors are generally first in line, followed by the expenses of the insolvency proceedings, then unsecured creditors (preferential and floating charge holders come before unsecured creditors in the UK).

¹²⁶ 11 U.S.C. s 364(a)-(c).

¹²⁷ D Skeel Jr., 'The Past, Present and Future of Debtor-in-Possession Financing' (2003-2004) 25 *Cardozo L. Rev.* 1905.

¹²⁸ See section 3.2.5 of this thesis.

¹²⁹ 31 B.R 364 (1983).

court's approval for a financing order which provided for the cross-collateralization of its present and future indebtedness to one of its major creditors; Bank Leumi Trust Company of New York. One of the reasons put forward by *Vanguard* was that Leumi bank considered itself under-secured on its pre-commencement loans to *Vanguard* and therefore sought to rectify this. The order was granted by the court after it was shown that the bank would not finance *Vanguard's* operations unless it received the protection presented by cross-collateralization. It should be noted that once cross-collateralization has been properly noticed and approved by the court, the financing agreement will be protected under section 364 (e) of the Code.¹³⁰

A cursory evaluation of the Chapter 11 rescue process paints a picture of a procedure which is very much debtor driven and this can be garnered from the various provisions such as the automatic stay, cram down and rescue funding incentives which to all intent and purposes relegate creditors to the back seat. However, because debtor companies require funds to finance their rescue, and in most cases it falls on existing or new creditors to be the source of such finance¹³¹ creditors have gradually taken control of the rescue process. In exchange for credit, debtor companies often have to cede control of the rescue process to the creditor(s) who is financing the process. Chapter 11 has become an instrument of corporate governance wielded by creditors.¹³² The rescue process begins with the debtor company being in total control of the whole process; however at some point during the rescue process there is a power shift from the debtor to one or more creditors.¹³³

¹³⁰ *Khan & Nate's Shoes No 2 v First Bank of Whiting* 908 F.2d 1351, 1355 (7th Cir. 1990). The decision in *Saybrook* (see section 3.2.5 of the thesis) which opposed cross-collateralization is still very much in force and not permitted within the districts that make up the US Court of Appeals for the Eleventh Circuit.

¹³¹ As was the case in *Re Vanguard Diversified Inc.* 31 B.R. 364 (1983).

¹³² See generally, D Skeel Jr., 'Creditors' Ball: The 'New' New Corporate Governance in Chapter 11' (2003) 152 *Uni. Penn. L. Rev.* 917, 918.

¹³³ D G Baird & R K Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' (2006) 154 *U.P.A.L.REV.* 1209, 1226-28.

The instruments of this shift of control are covenants and rights in credit documents which set out the basis on which funds are advanced to the debtor company to fund the rescue process.¹³⁴ A number of studies have highlighted the role of covenants as an important instrument of control by senior lenders who rely on stringent covenant terms to exert a significant amount of control.¹³⁵ Gibson *et al* state that a sizable percentage of amended bank loan covenants grant banks powers to censure a great majority of managerial decisions such as capital expenditures, assets disposition, pay-outs and total borrowing in companies.¹³⁶ Consequently, DIP loan agreements provide powerful corporate governance leverage for DIP lenders.

5.3.2 Canada

The Canadian position has some similarity to that of the US since they both have statutory provisions for super-priority financing and priming liens. While the CCAA provisions may not be as detailed and well-structured as section 364 of the US Bankruptcy Code, which provides comprehensive alternatives for post-commencement financing, it allows for two types of post-commencement financing; super-priority and a priming lien.¹³⁷ Although there are comparable effects on creditors' rights¹³⁸ during the funding of the rescue process, Chapter 11 makes clear and precise the need for the debtor company to adequately protect the creditors' exposure to any loss that may occur as a result of depreciation in the value of his security; a possible effect of priming liens. The issue of adequate protection of the

¹³⁴ M M Harner & J Marincic, 'Behind Closed Doors: The Influence of Creditors in Business Reorganizations' (2010-2011) 34 Seattle U. L. REV 1155.

¹³⁵ K Ayotte and ER Morrison, 'Credit Control and Conflict in Chapter 11' (2009) 2 The Journal of Legal Analysis, pp 511-551.

¹³⁶ S Gilson, J Kose and LHP Lang, 'Troubled Debt s' (1990) Journal of Financial Economics, 27, 315-353.

¹³⁷ See CCAA, s 11.2.

¹³⁸ In terms of the subjugation of existing pre-commencement rights by post-commencement rights.

creditor from the effect of post-commencement financing had drawn a lot of debate in Canada,¹³⁹ as a result of what is required under the CCAA when compared to equivalent US laws.

The CCAA requires that the court takes into consideration whether a creditor would be “materially prejudiced” as a result of approving a charge.¹⁴⁰ While the CCAA recognises that a creditor’s right may be materially affected by the approval of post-commencement financing, no clear remedy has been provided to ameliorate any disadvantage the creditor may suffer. The reason for this may not be unconnected to the fact that a lot of the powers the courts have to assign funds under the CCAA are discretionary. Therefore where a creditor may be significantly affected by the assignment of post-commencement funds, it does appear that the courts have discretionary powers to protect creditors by disallowing post-commencement financing; this however is reliant on a balance of prejudice.¹⁴¹ Another point worth mentioning is that under the CCAA, post-commencement financing is meant to be a temporary measure designed to keep the debtor trading between when he files under CCAA and when a rescue plan is approved.¹⁴² Under Chapter 11, DIP financing has no particular time slot and can be sustained at any point during the course of the rescue. For this reason, it may perhaps seem necessary under US law to have an elaborate framework which adequately compensates a creditor who may have to suffer an impairment of his right over a substantial period of time.

As noted, creditors in the US have taken advantage of post-commencement financing contracts to favourably re-position their exposure to the debtor company through cross-

¹³⁹ See section 3.3.8 of the thesis.

¹⁴⁰ *Ibid.*

¹⁴¹ CCAA 1985, s 11.2(4).

¹⁴² *Crystallex (Re)* 2012 ONCA 404 (CanLII). See also CCAA 1985, s 11.2. The act recognises the fact that there may be situations where, funding may be needed beyond this point and it allows for the priming of any lien gotten during the window period between filing and the approval of a rescue plan. This acts as an avenue for the debtor to raise more funds.

collateralisation.¹⁴³ This loophole is not available in a CCAA funding arrangement as the CCAA expressly forbids the use of cross-collateralisation to achieve a more favourable position.¹⁴⁴ While the ability to cross-collateralize does appear to act as an inducement for post-commencement funding, it may have an impact on other creditors and this seems to go against the supporting philosophy of the CCAA; which is to act in the interest of the general body of creditors, as opposed to placing one creditor in advantageous position over other like creditors. In light of this, the insertion of section 11.2 (4) is a reasonable move which ties in with this philosophy and offers some protection to creditors.

It can be suggested that the advantages which accompany corporate rescue funding prejudice creditors, however an argument has been made that, because the CCAA aims to further the debtor company's reorganization and protect a broad range of creditors (such as employees, suppliers, and landlords) it cannot be said to be disadvantageous to creditors collectively.¹⁴⁵ In addition, the outcome of the rescue process is determined by creditors who, in the majority, representing two-thirds of the value of credit in each class, must approve any planned reorganization before it can be endorsed by the court. Sarra has pointed out that the power to approve a plan of reorganization which creditors have over the debtor forms the context within which an understanding can be reached about the rescue funding debate.¹⁴⁶ In other words, creditors control the debtor's reorganization through their ability to approve and finance the process and, in the final analysis, determine collectively which creditor's rights will be prejudiced for the sake of a successful

¹⁴³ Although this is not expressly provided for under statute and the courts have expressly frowned at this practice.

¹⁴⁴ CCAA 1985, s 11.2.

¹⁴⁵ The CCAA has in place different measures which protect not just the interest of secured creditors, but also unsecured creditors. S 11.2(4) lists a number of factors which the court must take into consideration before approving post-commencement financing and one of such conditions is that where any creditor would be materially prejudiced as a result of the security or charge, the court will not approve an application for post-commencement financing. See J Sarra, 'Debtor in Possession Financing: The Jurisdiction of Canadian Courts to Grant Super-priority Financing in CCAA Applications' (2000) 23 Dalhousie L.J. 337.

¹⁴⁶ Sarra (n 145) above.

reorganization. In any case, if a plan cannot be formulated, the hierarchy of creditors' claims will be maintained in the realization of the debtor company's assets,¹⁴⁷ thus maintaining the *status quo* prior to post-commencement financing.

The approval of rescue funding as part of the reorganization plans of the debtor company tends to impinge on creditors' traditional rights¹⁴⁸ in the sense that some creditors may have to compromise their priority in order for the debtor to have access to rescue funding. Ultimately, the disadvantage suffered by the creditors is usually only of a comparatively small dollar value¹⁴⁹ and it has been observed that creditors are generally inclined to conceding a portion of their claims if they are convinced that the reorganization plan has a reasonable prospect of viability.¹⁵⁰ Moreover, creditors may be willing to accept losses in reorganization mainly because they will lose more in liquidation.

5.3.3 United Kingdom

The UK funding provisions as they are, stand in stark contrast to what obtains in the US and Canada. Unlike the CCAA and Chapter 11, which provide clear incentives for creditors to get involved in the funding process, the Insolvency Act 1986 deals with the matter somewhat cryptically. The Act authorizes an administrator to enter into contracts in the course of carrying out his functions and this contract and the administrator's expenses has priority payment over all other expenses and claims except secured creditors' claims.¹⁵¹ Thus a contract for post-commencement financing can be inferred to fall under this

¹⁴⁷ *Ibid.*

¹⁴⁸ *Re Skydome Corporation, Skydome Food Services (SAI Subco)* (27 November 1998), Toronto 98- CL-3179 (Ont.Gen.Div. [Commercial List]).

¹⁴⁹ Sarra (n 145).

¹⁵⁰ The Insolvency Institute of Canada, Canadian Association of Insolvency and Professionals, Joint Task Force on Business Insolvency Law Reform Report, March 15, 2002. "Joint Task Force on Business Insolvency Law Reform Report"

¹⁵¹ See Insolvency Act 1986, s 19(5) & Sch B1 para 99.

provision and on this basis it would enjoy super-priority.¹⁵² Therefore, the UK appears to have created an avenue for the debtor to fund the rescue process, albeit that the legislation is a bit skeletal when compared to that of the other jurisdictions. There is a dearth of case law in interpretation of this provision as administrators have only relied on this provision in a few cases¹⁵³ to apply for post-commencement financing, thus the issues which have arisen in Canada and the US in relation to creditors and statute-backed post-commencement funding may not be prevalent in the UK.

This is not to say that creditors are not involved in the funding of the rescue process in the UK, in most cases it is done through private workouts¹⁵⁴ and there is little or no literature on what the terms of these workouts are. They may involve super-priority payments¹⁵⁵ but it is doubtful if the option of priming liens is permissible without the consent of the secured creditor who loses priority. This is because the UK rescue processes is heavily creditor driven and insist on a hierarchy of distribution to creditors¹⁵⁶ and the introduction of priming liens would interfere with this scheme.

In addition, a factor which may have hampered a reliance on paragraphs 59 and 99 of Schedule B1 of the Insolvency Act 1986 may be the rise in the dependence on pre-packs by debtor companies.¹⁵⁷ Pre-packs may eliminate the need for the debtor to seek for money

¹⁵² i.e. a priority which has priority over another priority.

¹⁵³ See *BibbyTrade Finance Ltd v McKay* (2006) All E.R. 266; *Freakley v Centre Reinsurance International Co* (2006) B.C.C 971.

¹⁵⁴ See J Armour, A Hsu and A Walters, 'The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings', a report prepared for the Insolvency Service, December 2006.

¹⁵⁵ The London Approach involved the use of super-priority as one of its terms for bailing out struggling companies.

¹⁵⁶ See below (section 5.4 of this thesis) for discussions on the impact of rescue funding on the hierarchy of creditors' claims.

¹⁵⁷ See generally V Finch, 'Pre-packed Administrations: Bargaining in the Shadow of Insolvency or Shadowy Bargains' [2006] J.B.L. 568. In recent times, a number of companies have relied on pre-packs, for example Dreams the bed company, Power Play Textiles which produces Levis jeans, Blacks Leisure, EMI the record company etc. information available on <<http://www.insolvencynews.com/browse/55-78/corporate-recovery>>, on the 9th of May 2013.

to fund the rescue process as the responsibility of turning the company round shifts to the new owners who would have possibly made their own financial arrangements.

5.4 Rescue funding and its effect on the ranking of creditors' claims

The availability of funds during the rescue process may contribute to the continued existence of the debtor's company or at least that of its business. Also, it is acknowledged that inducements may be offered to potential creditors to encourage them to lend, however what is in question is the scope of power the insolvency law has to facilitate rescue funding and the extent of the inducement offered.¹⁵⁸ Admittedly, while there are protections in place for creditors who suffer the effect of a debtor applying for and being granted post-commencement financing, one of the low points of post-commencement financing is the effect it has on pre-existing creditors' rights especially as they relate to a creditor's place in the hierarchy of claims. The importance of this facet of the creditor/debtor relationship is that the ranking or position of a creditor's claim determines when and how much he recoups from the debtor.

The UNCITRAL Guide recognizes that post-commencement funding may have an adverse impact on pre-existing creditors' rights and states that to the extent that rescue funding has an impact on the rights of existing secured creditors, or those holding prior interests in assets, it is necessary that rescue funding provisions are balanced against a number of factors which include; the general need to maintain commercial bargains, protecting the pre-existing rights and priorities of creditors and curtailing any negative effect on the

¹⁵⁸ UNCITRAL Guide.

availability of credit, particularly secured credit which may result from tampering with pre-existing security rights and priorities.¹⁵⁹

Essentially, for a company going through reorganization, it is expected that the company would be restored to profitable trading or sold off as a going concern. For the company's creditors, it can be assumed that their main objective in agreeing to a compromise with the debtor is a chance to recoup on credit extended to the debtor. This perceived aim of the general body of creditors appears to tie in with Baird and Jackson's point of view. They argue that insolvency law has one principal objective, which is; to distribute the debtor's common pool of assets in such a way as to maximise benefits for the general body of creditors.¹⁶⁰ For this reason, most insolvency regimes have an established criterion for ranking the claims of creditors. This ranking is usually done in order of a priority which stems from pre-bankruptcy assets and liabilities which bankruptcy laws observe and recognise.¹⁶¹

In the US, creditors who have their interests subjugated to make room for DIP financing are protected by statute. Section 364 of the Bankruptcy Code requires that the debtor provides adequate protection to guard against any diminution of the value of creditors' collateral which may ensue from DIP financing. This provision appears to be linked to the idea that secured creditors should not be denied the benefits of the agreements they have

¹⁵⁹ *Ibid.*, at para 97.

¹⁶⁰ D G Baird and T H Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: a Comment on Adequate Protection of Secured Creditors' (1984) 51 *Univ. of Chicago Law Rev.* 97.

¹⁶¹ T H Jackson, 'Translating Assets and Liabilities to the Bankruptcy Forum' (1985) 14 *Journal of Legal Studies* 73.

entered¹⁶² and therefore the interests of secured creditors are not to be forfeited for the benefit of the debtor or junior creditor.¹⁶³

The provision of adequate protection is not easily achievable because of the stringent requirements¹⁶⁴ imposed by the Bankruptcy Code. Consequently, the security interests of senior creditors are seldom subjugated against their will. In any case, a great majority of DIP financing is granted by existing creditors who have agreed to subordinate their existing security and, where they fail to provide the finance or agree to a subordination of their interests, the reorganization is likely to fail.¹⁶⁵

In the UK, the ranking of creditors' claims is done in order of priority in simplified terms beginning with the secured creditors, administration expenses, preferential creditors, the prescribed part (i.e. a portion of any realisation made from floating charge assets set aside for unsecured creditors), floating charge holders and then the ordinary secured creditors who rank *pari passu*.¹⁶⁶ Generally the *pari passu* principle of distribution is limited to liquidation because this is the only collective insolvency process that primarily aims to distribute the assets of the debtor company among the general body of creditors in accordance with a statutory *pari passu* rule that cannot be excluded by contract.¹⁶⁷

However, Schedule B1 para 65 of the Insolvency Act 1986 and r.2.69 of the Insolvency Rules 1986, permits an administrator to seek leave of court to apply the *pari passu* principle to administration. Thus an administrator can make distributions in order of priority to both

¹⁶² A Resnick & H J Sommer, 'Collier on Bankruptcy 1' (15th edn, Matthew Bender & Company 2008) at 341.

¹⁶³ D Light, 'Involuntary Subordination of Security Interests to Charges for DIP Financing under Companies' Creditors Arrangement Act' 30 C.B.R. (4th) 245 at 4

¹⁶⁴ See p82-83 of the thesis for detailed discussion of the concept of adequate protection.

¹⁶⁵ M J Ferron, 'The Constitutional Impairment of the Rights of Secured Creditors in Canada and the United States' Q.C60 CBR-ART 146, para 84.

¹⁶⁶ Insolvency Act 1986, s 175.

¹⁶⁷ See Insolvency Act 1986, s 107; see also R Goode, *Principles of Corporate Insolvency Law* (3rd edn Sweet and Maxwell 2010) p176.

secured creditors, preferential creditors without leave of court and to unsecured creditors on *pari passu* basis with leave of court. Goode states that in practice, the *pari passu* rule of distribution followed in liquidation is not adopted in distributions to unsecured creditors under the administration process.¹⁶⁸ Instead, what is followed is distribution according to CVAs under Part 1 of the Insolvency Act 1986 or scheme of arrangements provided for under section 895 of the Companies Act 2006. The distribution to creditors would then be governed by the terms of either the CVA or scheme of arrangement as the case may be, and has to be approved by a requisite majority rather than the *pari passu* rule of distribution.

The US on the other hand, ranks its creditors' claims under two broad categories; secured and unsecured. Under the unsecured category, claims are structured in order of priority¹⁶⁹ and rank on a *pari passu* basis within each class, as in the UK. Under the CCAA the ranking of creditors begins with secured creditors, preferred creditors, ordinary creditors, and then deferred creditors. Generally the statutory hierarchy of creditors' claims is maintained and respected with secured creditors receiving preferential treatment.

A debtor who grants security to a creditor is entering into a pledge not to engage in wealth reducing transactions¹⁷⁰ and as a result, secured creditors are entitled to priority repayment and control of their security.¹⁷¹ However, the rescue funding process in the US and Canada appears to challenge this position. This is because the positions of priority and control rights of creditors in both jurisdictions tend to become vulnerable to subordination as a result of the secondary effects of funding corporate rescues and its' ability to re-assign creditors' priority.¹⁷² The re-assignment of priority is triggered by claims made as a result of the

¹⁶⁸ Goode (n167) at p177.

¹⁶⁹ 11 U.S.C, s.507.

¹⁷⁰ G G Triantis, 'Secured Debt under Conditions of Imperfect Information' (1992) 21 Journal of Legal Studies 225.

¹⁷¹ J Armour, 'Should We Redistribute in Insolvency?' in Joshua Getzler and Jennifer Payne (eds), *Company Charges, Spectrum and Beyond* (Oxford 2006) p 206-214.

¹⁷² See CCAA, s 11.2 and 11 U.S.C s 364(b)-(d), which allows a creditor's priority for repayment prior to post-commencement financing to be subjugated in favor of the post-commencement financiers.

super-priority incentive given to post-commencement lenders¹⁷³ who have lent money to the debtor to finance his rescue. Thus super-priority means that, all other claims would rank behind post-commencement lenders and what is more creditors who already have security interest in the debtor's assets are susceptible to having their priority in those assets suppressed by a new post-commencement creditor.

Conversely in Canada, where there is a request for rescue funding, the courts in balancing the interest of all stakeholders, could grant rescue financing which may by implication mean the subjugation of some creditors' security interests. As a result, courts have cautioned that compelling evidence that the benefit of rescue funding greatly outweighs the disadvantages suffered by subordinated creditors should be shown.¹⁷⁴ In other words, it must be shown that rescue funding would not place creditors at a significant disadvantage and even when it does that, its benefit would offset any burden suffered by the creditors. The issue of priority in relation to rescue financing under the CCAA has in recent times faced uncertainty. This uncertainty is due to the decision in *Re Indalex Limited*,¹⁷⁵ which had called into question the ability of a lender to rely on a court ordered super-priority charge granted pursuant to a CCAA application.¹⁷⁶

Ordinarily under insolvency proceedings, the rule is that all unsecured creditors share rateably in any available asset after higher priority claims have been satisfied. However in *Re Indalex* the Ontario Court of Appeal enforced a constructive trust on behalf of pension fund beneficiaries who were classed as unsecured creditors, thus effectively giving them priority over other creditors, who included a guarantor who had become a DIP lender. It was observed that the decision reached in *Re Indalex* suggested that questions of priority

¹⁷³ See 11 U.S.C, s 362; CCAA 1985, s 11.2 and Insolvency Act 1986, para 99.

¹⁷⁴ *Re Royal Oakes Mines Inc.* (1999) CarswellOnt 792 (Ont.Gen.Div.) [Commercial List] 22.

¹⁷⁵ 2011 ONCA 265, 104 OR (3d) 641

¹⁷⁶ R I Thornton & K Thompson, 'The Implication of *Indalex* on Restructuring in Canada' (2011) A.R.I 2.

needed to be addressed by stronger and more precise language drafted into CCAA orders which include DIP financing.¹⁷⁷ A further appeal to the Supreme Court,¹⁷⁸ settled this issue as the super-priority status of the DIP lender was affirmed by the court, thus putting an end to the precarious position that the Court of Appeal had placed DIP lenders in by its decision. Failure to reverse the decision of the lower court could have resulted in some adverse effect on the ability of a debtor company to access funding during rescues, as the previously guaranteed priority attached to DIP lending would have become unreliable.

Conclusion

Creditors play an important role in corporate rescue, from the initiation of a rescue procedure (in some jurisdictions) to the approval of a rescue plan and the funding of the rescue process and this role is likely to have some influence on the successful rescue of an insolvent company. As noted earlier, in Canada, there is no provision for creditors to propose a compromise with the debtor company and so cannot initiate a debtor's rescue without an order of court authorizing them to do so. Consequently, the debtor company seem to have exclusive rights to propose a compromise (restructure) under the CCAA.

This is in sharp contrast to both the US and UK jurisdictions where the rescue process can be initiated by a creditor. While it is not the obvious first choice in the US, there is room for a creditor to present an involuntary petition under Chapter 11¹⁷⁹ as well as file a plan, after the debtor's exclusivity period has lapsed without a plan being filed by the debtor.¹⁸⁰ It is remarkable that Canada, which is seen as a jurisdiction which upholds the interests of

¹⁷⁷ *Ibid.*

¹⁷⁸ *Sun Indalex Finance, LLC v United Steelworkers* 2013 SCC 6.

¹⁷⁹ Under 11 U.S.C, s 303, a creditor can file an involuntary petition

¹⁸⁰ 11 U.S.C, s 1121(c).

creditors, has no option under the CCAA for creditors to initiate the filing of a CCAA petition.

All three jurisdictions have in common a type of restriction which suspends a creditors' ability to enforce his security or to demand repayment from the debtor and this restriction appears to impede the rights of creditors during the rescue process. However there are some differences in the manner in which these different restrictions operate. In the UK, the moratorium, which puts an embargo on the ability of creditors to pursue claims against the debtor, comes into effect automatically as soon as a petition for administration is filed. The moratorium subsists initially on an interim basis and thereafter lasts for the duration of the rescue process.

In Canada, the stay on creditors' rights of enforcement does not operate in the same manner as the UK moratorium. A court order is required in order for a stay to take effect; the debtor company makes an application for a stay of all creditors' actions and claims along with an application for compromise under the CCAA. This stay has a time limit of thirty days with an option of further renewal at the discretion of the court. Remarkably, the stay has no effect on the rights of suppliers to demand payment after a stay order has been put in place. This stands out as a distinctive attribute under the CCAA.¹⁸¹

Conversely the restriction on creditors' rights in the US operates in a similar manner as in the UK; both jurisdictions operate their stay in the same manner by imposing a comprehensive stay on the ability creditors to pursue claims against the debtor. Both countries do not single out any class of creditors for exception to the effect of this stay. However, all three jurisdictions recognise that there are situations wherein the presence of

¹⁸¹ In the UK, proposals have recently being recommended to compel some class of suppliers to continue providing services to an insolvent company during rescue, see p137 of thesis for discussion on critical suppliers in the UK.

a stay may manifestly affect the rights of a creditor and in such cases the court may lift the stay.

Generally in all three jurisdictions, secured creditors' rights cannot be interfered with, without their prior approval and this approval is usually given during creditors' meetings where the required majority of creditors vote to approve the rescue plan. However the US goes a step further by putting in place a system where the court has the discretion to force dissenting creditors into accepting a plan. The "cram down" provision can be viewed as both prejudicial and beneficial. This is because the "cram down" may be construed as being very intrusive on the rights of some creditors because it forces a few unreasonable dissenting creditors into accepting a plan. On the other hand, it can be viewed as a useful tool in ensuring that the debtor's rescue is not hijacked by a few dissenting creditors. Moreover it can be argued that "cram down" ensures that the debtor company is given every chance of survival.

The role played by the court in the debtor's rescue differs between the UK on the one hand and Canada and US on the other. The courts in both the US and Canada appear actively involved in the rescue process, with their supervision and approval essential for every stage of the debtor's rescue. The same cannot be said of the UK, as the courts appear to have an arm's length approach to the debtor's rescue, with a leading role played by the administrator.

When it comes to funding the rescue process, creditors play a major role in the US and Canada, encouraged by the provisions which incentivize corporate rescue funding in these jurisdictions. The US Chapter 11 and the CCAA, makes provisions for a company commencing corporate rescue to borrow funds where needed, for working capital, and in order to encourage lenders to loan money to distressed companies wishing to restructure, incentives such as priority/super-priority over existing creditors, is given to the rescue

funding lenders. In the UK, there is an absence of a well-structured, rescue funding incentivising provision like the DIP funding provisions under Chapter 11 or the interim financing provisions under the CCAA. Nevertheless paragraph 99 of Schedule B1 of the Insolvency Act 1986 appears to create an opportunity through which administrators can assume powers to obtain post-commencement financing and this financing if acquired, will enjoy priority repayment as part of administration expenses (as an incentive) almost in the manner of the priority found in Chapter 11 and the CCAA rescue financing.¹⁸²

Although creditors are involved in the ad-hoc funding of the rescue process through private arrangements, this is not reflected in any formal rescue funding process under the Insolvency Act 1986. This Act lacks precise rescue funding provisions which clearly provide a structure under which incentivized rescue funding can be accessed. Arguably, creditors will be more inclined to fund corporate rescues if there are benefits to be gained from the incentives attached to such funds.

While it has been suggested that paragraph 99 of Schedule B1 of the Insolvency Act 1986 provides a possibility for creditors in the UK who advance funds to an administrator to enjoy priority payment,¹⁸³ the lack of expansive case laws suggests that this possibility has not been put to rigorous test. It has also been suggested that rescue funding is a feature of company rescue¹⁸⁴ and what has dominated the UK in recent years is business rescue, therefore a structured framework like that found in Chapter 11 and CCAA may not be necessary in the UK.¹⁸⁵ Arguably, the rise in business rescues in the UK may be linked to the increased reliance of distressed companies on pre-packaged administrations, and with

¹⁸² See section 3.6 of this thesis for a discussion on the different types of priority available in rescue funding.

¹⁸³ G McCormack, 'Super-priority New Financing and Corporate Rescue' [2007] J.B.L. 701-732.

¹⁸⁴ Amour, Hsu & Walters (n 154).

¹⁸⁵ An elaborate financial structure like that supported by Chapter 11 and CCAA seems excessive, if a business sale is what is achieved.

the pre-packaged administration, the need for rescue funding is jettisoned. On the other hand it can be argued that if the Insolvency Act 1986 had well-structured, incentivized funding provisions, perhaps there might be an increased possibility for company rescues as opposed to business rescues.

It is without a doubt that post-commencement financing comes with some attendant issues, foremost of which is the ability of the courts to adjust creditors' priorities within the hierarchy of claims. Arguably, rescue funding can interfere with the rights and interests of creditors under the provisions that facilitate post-commencement financing. Pre-existing rights and priorities of existing lenders are often displaced by the claims of post-commencement lenders. This potential loss of priority may negatively affect the availability of credit. The US has counteracted this problem by requiring that in situations where pre-existing creditors' rights are to be subordinated by the claims of new post-commencement creditors, the debtor company must show that the pre-existing creditor is adequately protected.

Canada on the other hand, does not have an "adequate protection" clause, rather it places a fair and equitable requirement on the actions of the debtor before a pre-existing creditor's interest can be subordinated. Canada is unlikely to incorporate an "adequate protection" remedy when it comes to the issue of mitigating the prejudice suffered by pre-existing creditors as a result of post-commencement funding, because the clause is viewed as a purely American innovation best suited to that jurisdiction.¹⁸⁶ Notwithstanding this, it does appear to be a very useful provision to have, because of the assurance it gives to pre-existing creditors that any prejudice suffered as a result of the subordination of their claims would be adequately compensated.

¹⁸⁶ Joint Task Force on Business Insolvency Law Reform Report (n 150).

Arguably, the insolvency legislations in the three jurisdictions promote a fair and equitable resolution of an insolvent company's obligations to its creditors by ensuring a collective process of distribution based on priorities. However, concepts like post-commencement financing which facilitate the insolvent company's rescue come with a price which undermines the scheme of equitable distribution to creditors, and unfortunately, creditors seem to bear the brunt. Nevertheless, the benefit of creditors having better returns from a rescue than if the company is liquidated, perhaps, outweighs any prejudice creditors may suffer as a result of the debtor relying on post-commencement financing.

Chapter VI: Conclusion and recommendations

The rescue culture is well established in each of the three jurisdictions considered in this thesis. As far as the UK is concerned, in recent years outcomes have been dominated by business rescue, rather than corporate rescue, in spite of the place of corporate rescue in the hierarchy of objectives of administration proceedings, as set out in the Insolvency Act 1986, Schedule B1, para 3. This raises the question whether a more well-developed system of rescue finance is required. One of the most fundamental issues relevant to the success of corporate rescue is the availability of funds to support the rescue process. Such funding is important where the distressed company is still viable, to enable it to continue trading; not only will continued trading send out a positive message to its creditors and customers, it will add to the inflow of cash to the company coffers, thereby improving its liquidity. Debtor in possession financing provides the debtor company with working capital which enables it to continue trading while it identifies and remedies the source of its financial distress.¹ Notwithstanding the potential benefits of rescue funding to the debtor and its creditors, the issue of rescue funding is not specifically addressed in the UK Insolvency Act 1986.

What is available in the UK may be regarded as a skeletal foundation for rescue financing; administrators are empowered under the Insolvency Act 1986 to borrow money on behalf of the company, by entering into contracts to do so, and such expenses enjoy priority as administration expenses.² Various opportunities have been missed by the Government to build on what little scope there is for funding within the 1986 Act. The ability of an

¹ J Sarra, 'Governance and Control: The Role of Debtor-in possession Financing under the CCAA in Annual Review of Insolvency Law, 2004 (Carswell 2005) p118- 172.

² Insolvency Act 1986, s 19(5) & Sch B1 para 99.

administrator to obtain rescue funding is potentially bolstered by the legislative provision that such funding may attract priority payment as an administrative expense. This priority has not been put to rigorous test, although there is case law authority³ that it is something that can be done.

It has been stated that where insolvency laws support the continued trading of an insolvent business, either in reorganization or in a business sale in liquidation as a going concern, it is important that the issue of funding is addressed.⁴ It is unsurprising that the UK, US and Canada (the countries under comparison) in drafting frameworks for corporate rescue have taken the importance of rescue funding into consideration, and in varying degrees, have made provisions for how the rescue process can be funded. The rescue provisions found in the US and Canada are far from perfect;⁵ however, despite some perceived failings they have been able to provide means which complement their individual economic, cultural and political environments, for the effective funding of the rescues of failing companies.

The UK lacks the same structured statutory provisions found in the US and Canada. Both of those countries have statute-backed, incentivised rescue funding provisions which provide the debtor with different avenues for facilitating funding to meet the various needs that the debtor may have, for example the continued delivery of goods and services by critical suppliers.⁶ These incentives include priming of liens to make available encumbered assets as collateral for post-commencement credit. The major incentive for would-be lenders to provide the necessary funding is the priority/super-priority payment they stand to enjoy as a result. This type of incentivized rescue funding opens up different avenues on

³ See *Bibby Trade Finance Ltd v McKay* [2006] All ER 266. See also *Freakley v Centre Reinsurance International Co* [2006] BCC 971.

⁴ UNCITRAL Guide, para 97 at p 114.

⁵ See section 3.2.5 of this thesis for a critique of rescue funding in the US and section 3.3.8 of this thesis for a critique of rescue funding in Canada.

⁶ The UK has recently taken steps towards recognising the importance of critical suppliers.

how the rescue process can be funded. While the UK cannot lay claim to such a precise rescue funding structure, it appears evident that the UK does offer priority payments for rescue funding.

The ability to offer some sort of priority is an important consideration in promoting the availability of rescue funding. It may not be far-fetched to say that the availability of rescue funding revolves around priority as it appears to be the major basis upon which potential lenders would advance funds to the debtor. If this is the case, rescue funding in the UK which has priority under the administrator's powers to enter into contracts which are classed as part of administrative expenses ought to encourage potential lenders to advance money to an insolvent company; however this has not been the case. The answer may lie in societal attitudes to debt. The UK appears to have some residual negative view of debtors and lenders may be reluctant to financially support a business which is in trouble. This is in contrast to the US and Canada where there is more of a view that business failures are inevitably a part of a market economy and society is therefore more tolerant of business failures.

The major difference that can be identified in the legislation of all three jurisdictions is the way in which rescue funding provisions are structured within their individual insolvency/bankruptcy legislations. Canada and the US have well defined rescue funding structures and have clearly incentivised their funding frameworks. In Canada and the US, the absence or presence of leveraged assets does not stand in the way of the debtor's ability to raise funds because of the presence of the priming lien. The ability to prime an existing lien may be regarded as an important mechanism for raising rescue funds, as it opens up an alternative avenue for post-commencement financing, especially where all of the company's assets have been encumbered. Admittedly, while not statutorily provided for, nothing precludes an administrator in the UK from going into a private arrangement with

creditors to raise funds through a charge which resembles in effect a priming lien;⁷ however, statutory backing would authenticate such arrangements. However, since the UK, may be regarded as a creditor-friendly jurisdiction, with secured creditors enjoying a place of primacy; it does not come as a surprise that any mechanism which would interfere with the rights of secured creditors may not be appreciated.

In the UK, creditors, while involved in the ad-hoc funding of the rescue process through private arrangements, have not formally done so through the provisions of the 1986 Act. The tools are there but they have not been used in the manner in which the Canadian and the US jurisdictions have utilised theirs. Perhaps, this is as a result of the skeletal nature of the provisions. The importance of facilitating rescue funding may have been reduced since rescue funding is a feature of company rescue and what has dominated the UK in recent years is business rescue. However this does not mean that a more developed statutory scheme for rescue funding is not required. A well-structured, incentivized framework like that found in Chapter 11 and relevant provisions of the CCAA may be worth implementing in the UK even if it enables a few companies to be rescued.

The presence and availability of security can be of pivotal importance to the availability of rescue finance. Generally a country's commercial needs determine the sort of security devices available in that country. A major difference between the three countries lies in their approaches to floating charge security. Canada has a similar security device to that of the UK. However the Canadian charge crystalizes into a fixed charge upon the debtor's insolvency; unlike the UK's floating charge which does not. It is uncertain if the absence of a floating charge security facilitates the provision of rescue funding in Canada and the US. The presence of floating charges in the UK calls into question how such charges would

⁷ G Yeowart, 'Encouraging Company Rescue: What Changes are required to UK Insolvency Law?' (2009) *Law and Financial Market Review* 517-531.

be treated if the UK had clearly structured rescuing framework like Canada and US. Despite the ambiguity that the floating charge security creates, it does not impede rescue operations in the UK.

Although the introduction of post-commencement financing may solve the perceived problem of how company rescues can be funded, it inadvertently introduces some impediments, in particular where there is an ability to re-assign creditors' claims within the hierarchy of claims. Pre-existing rights and priorities are often displaced by those of post-commencement lenders and this in turn may negatively affect the availability of credit. The US has counteracted this problem by requiring that in situations where pre-existing creditors' rights are to be subordinated by the claims of new post-commencement creditors, the debtor company must show that the existing creditor is adequately protected. Canada on the other hand, does not have an "adequate protection" clause, rather it places a fair and equitable requirement on the actions of the debtor before a pre-existing creditor's interest can be subordinated. Although differing in wording these provisions arguably ensure that creditors are adequately compensated for any injustice suffered. Moreover, the benefit potentially accruing to creditors after the successful conclusion of the rescue process appears to far outweigh any prejudice they may have suffered as a result of the incentivisation of post-commencement financing.

Is the UK ready for super-priority rescue funding?

There have been calls in the past for super-priority financing to be introduced in the UK and these calls have not been heeded. Perhaps the reason for the UK's reluctance may be that the funding mechanisms which exist within the UK in practice sufficiently take care of the jurisdiction's needs. Added to this, is the increased reliance by companies on pre-pack

administration. It may be argued, that the existence of pre-pack administration in the UK removes the necessity for post-commencement financing, as the burden of financing the rescue would shift to the buyer(s) after the sale of the company via pre-pack administration. This is based on the assumption that all issues of financing rest with the buyer who would have made his own arrangements for the acquisition of the company's business and financing of its continued trading.

It might be contended that pre-pack administration addresses the issue of funding, since it achieves a business rescue and takes care of funding issues. Nevertheless, the intention of Parliament in adopting the recommendations of the Cork Report regarding administration and further reforming the Act via the Enterprise Act 2002 was first and foremost to encourage and achieve company rescues. While an argument can be made that a pre-pack achieves a business rescue, the use of pre-packs is not in the spirit behind the introduction of the administration process, which is to achieve the rescue of a company as a whole.

There seem to be a conflict of purpose as most company rescues in the UK are achieved "informally" without resort to formal insolvency structures. In most cases when companies have to look to the 1986 Act to reorganize their affairs, the best option available at that point may likely be a business sale, asset sale or liquidation, a case in point is JJB Sport.⁸ While pre-packs have obvious advantages, such as the preservation of the company's assets, the pre-pack is notably not a vehicle for the rescue of a company, as most buyers would rather cherry-pick the profitable parts of the company and reject whatever debt it feels it cannot assume. Although UK rescue proceedings have been dominated in recent years by the pre-pack administration, there will not always be pressing reasons why a

⁸ See W Smale 'What went wrong at JJB Sport' (*BBC News*, 1 October 2012) < www.bbc.co.uk/news/business-19635988> 8th June 2014. At the beginning of its financial woes following the global financial crisis in 2008, JJB sold off some of its subsidiaries, restructured its debt twice and negotiated with its shareholders, all of this outside of formal insolvency procedures.

business must be the subject of a pre-pack sale and corporate rescue may be feasible in some instance with appropriate finance. Consequently, alternatives need to be put in place to fund the rescue process where pre-packs are not used.

An important consideration in the call for DIP funding, is how the introduction of DIP funding will fit into existing lending structure in the UK, which is quite different from the US and Canadian structures respectively. It is acknowledged that transplanting laws directly from other jurisdictions which have established these laws and tested their feasibility, makes for easy reforms to laws. The borrowing of legal rules and legal systems has always been part of the history of law, with lawmakers relying on foreign models, with some modification, rather than creating entirely new laws.⁹ However laws do not happen in a vacuum, laws sit within a culture and derive their nuances from the culture and society from which they originate.¹⁰

The UK has distinct economic, political and social structures from those in Canada and the US, societal needs have an immense influence on political, economic, social and legal structures that are put in place and a great part of this is dependent on perceived notions held by the society. Most times, laws are a reflection of the society; therefore it may be foolhardy to advocate a direct transplant of an exact replica of the funding provisions found in either of the comparator jurisdictions into the UK. The flaw in the direct transplant approach is that the surrounding elements such as history, economic necessities, judicial, political and legislative factors which sculpted the funding provisions in Canada and the US cannot be precisely replicated in the UK so as to provide an environment in which the same funding provisions may be transplanted. This notion is supported by the *UNCITRAL Legislative Guide on Insolvency Law* which states that there is no one model for the design

⁹ A Watson, *Legal Transplant: An Approach to Comparative Law* (University of Georgia Press 1974) p107.

¹⁰ E J Eberle 'The Method and Role of Comparative Law' (2009) 8 Washington University Global Studies Law Review 451-486.

of insolvency law because of the significant differences in the needs of every country and these differences extend to their laws on other matters of strategic significance to insolvency.¹¹

Recommendations

Pre-pack administration which appears to be the preferred tool for business rescue in the UK will be undergoing some changes in the nearest future when the recommendations made by the Graham Review¹² are implemented. The Review recommends a series of reforms¹³ which are intended to increase transparency and assuage creditors' concern. Though it is expected that these recommendations will be adopted voluntarily, the UK government has suggested that it agrees with the reports' conclusions that if the recommendations are not voluntarily complied with, legislation may follow to enforce compliance. As a result, the Small Business, Enterprise and Employment Act 2015 if passed will give the Secretary of State the power to make regulations prohibiting or enforcing requirements or conditions on sales by administrators to connected parties.

Some industry players have raised concerns on the cost effectiveness and the time efficiency of some of the recommendations proposed by the Graham Review. Majority of the concern raised by industry players is focused on the creation of the pre-pack pool, its composition and the ability of members to speedily review a pre-pack sale to a connected party and give their stamp of approval.¹⁴ Added to this is the requirement of a viability

¹¹ UNCITRAL Guide, p15 at para 17.

¹² Graham Review into Pre-pack Administration – Report to the Rt. Hon V Cable, June 2014.

¹³ See p126 of the thesis (at n 277) for discussion on proposed reforms to pre-pack sales.

¹⁴ I Johnson, T Vickers, R De Carle & N Ellis, 'Unpacking the Pre-pack Review', Slaughter and May, June 2014.

review of the new company (prior to sale to a connected party) showing how it proposes to remain in business for at least 12 months from the date of the viability review.

Unfortunately these requirements do not augur well for the cost effectiveness and time efficiency of pre-pack administrations as one of the main attractions of pre-pack administration is that it is cheap, efficient and it enables a business sale quickly without attracting too much attention. This contributes to some extent in maximising brand value and facilitating staff retention. The Graham reforms may be counter-productive and undermine the very elements that make pre-pack administrations attractive and this could likely lead to a decline in its use. If this happens, it will become more imperative that reforms to funding provisions should be introduced to the Insolvency Act to ensure that access to credit to fund corporate or business rescues is readily available as debtor corporations may have no other choice than resorting to the administration procedure or any other statutory rescue procedure.

Whilst a direct transplant is not being advocated by this thesis, it may be beneficial to have any future reform shaped by international best practices. These practices can then be adapted into national insolvency regimes, after considering the realities of the adopting system and available human material resources.¹⁵ Consequently, in terms of future reforms to the funding provisions of the Insolvency Act 1986, the following features found in the funding provisions available in the Canadian CCAA and the US Chapter 11 are worth considering;

- From the US Chapter 11, the ability to grant priming liens during rescue. This will provide administrators of distressed companies with overleveraged assets with a means of raising rescue funds, where there are no other alternatives. In addition, if

¹⁵ UNCITRAL Guide at p16 at para 19.

a provision enabling the granting of priming lien is to be adopted, it would be beneficial to have an “adequate protection” clause in place to dispel the fears of secured creditors who may feel threatened as a result of the subjugation caused by priming liens.

- From the Canadian CCAA, a provision which gives special recognition to critical suppliers/creditors whose support is needed by the company to continue trading and this should be distinct from administration expenses. This would ensure an obligation on the part of suppliers to keep supply lines open and prevent suppliers from holding insolvent companies to ransom by demanding increased charges and payment of debts owed, as a condition of continued supply of services.

Overall, any proposed reforms should adopt a well-structured funding provision which clearly facilitates rescue funding through appropriate incentives. Also institutional reforms in terms of specialised bankruptcy courts should be re-introduced in order to give full effect to any rescue funding reforms which will require specialised commercial judgment.¹⁶

At present, each jurisdiction has been able to adopt a functionally equivalent scheme of rescue funding provisions to suit its needs. Whilst relevant provisions may appear not to be very effective in the UK, reforms to existing laws may come at a huge cost as other underlying issues may have to be taken into consideration. Chief among this is how the introduction of DIP funding would impact on the administration process. A balance has to be found between assuring administrators of their remuneration and offering post-commencement lenders priority in return for advancing monies during corporate rescue. It appears that the reason why this has not been an issue in the US and Canada is because the rescue process is managed by the debtor in those jurisdictions.

¹⁶ The UK at a point in its bankruptcy history had specialized bankruptcy courts. See section 2.1.3.1 of the thesis. Also see Bankruptcy Act 1883(46 & 47 Vict c. 52, s 93-94.

History has shown that a reform to laws is often a gradual process that checks the workability of what is available at a particular point in time. Society is constantly evolving; insolvency laws cannot remain static, but require reappraisal at regular intervals to ensure that they meet current societal needs. As corporate rescue increasingly gives way to pre-packaged business rescue, this raises the question whether sufficient incentives are provided to encourage lenders to support a company's continued trading in administration. Canada and the US arguably point the way as to how this might be done.

Appendix I: Published Articles.

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