DO NOT SHOOT THE PIANIST! PROTECTION FOR INTERIM FINANCING OF DISTRESSED COMPANIES

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Abstract: *The increasing use of alternative methods of resolving insolvency disputes has been associated with the need to reduce the number of insolvency cases and ensure stability in the business market. In the last decade the reform of the insolvency legislation enacted the evolution of the concept of insolvency from bankruptcy to that of "Corporate Rescue Culture". To overcome the difficulties it faces, a distressed company needs additional financing. The success of reorganization is related to the possibility of financing the business, but once the business meets difficulties, the access to money becomes critical. In order to encourage creditors to finance distressed companies, in many states the legislation offers different possibilities to protect or even to give super-priority in repaying loans to creditors who, in good faith, help troubled companies to continue their business.*
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INTRODUCTION

In 2020, global corporate insolvencies are forecast to increase by 26% because of the Coronavirus pandemic (Atradius). Insolvency litigation has long been limited to the courts. This ensures equal creditors' claims (*pari passu*), the fair collection and distribution of the debtor's assets and the prompt liquidation of the bankrupt company. In recent decades, this perception has changed, with many insolvency disputes being resolved not only through enforcement, but also through alternative methods. In general, the legislator chooses a pro-debtor or pro-creditor insolvency regime (Lechne, 2002). Alternative

methods encourage the parties to reach an agreement through negotiations and avoid enforcement.

The increasing use of alternative methods of resolving insolvency disputes has been associated with the need to reduce the number of insolvency cases and ensure stability in the business market. Insolvency law is one of the key elements for a functioning civil and corporate law system and has a significant impact on the entire economic structure (Wessels, et al., 2009).

In the last decade the reform of the insolvency legislation enacted the evolution of the concept of insolvency from bankruptcy to that of "Corporate Rescue Culture". It is important to understand the purpose of legislative reform. What is pursued through "Corporate Rescue Culture"? It seems that the reform only aims to encourage the maintenance of activity in viable companies facing financial difficulties. On the other hand there are voices arguing against these trends. The essence of capitalism is business dynamics: "Businesses and competitive advantage are in general temporary and changed, failed and dissolved businesses are the essence of capitalism, reasons not to interfere and to facilitate business rescue" (Verdoes and Verweij, 2015). " The failure rate of organization may not be an indication of system failure but of system success – just as an abundance of refutations may be a sign of rapid scientific progress" (Loasby,1986).

INTERIM FINANCING

To overcome the difficulties it faces, a distressed company needs additional financing. The success of reorganization is closely related to the possibility of financing the business. The problem is, that once the business meets difficulties, the access to money becomes more critical (Vriesendorp and Gramatikov, 2010).

The new EU Directive 2019/1023 contains some provisions for facilitating distressed companies accessing funds. The directive defines the concept of financing from the outset. It distinguishes from the beginning, between new financing on the one hand and interim financing on the other[1]. New financing refers to funds attracted on the basis of the restructuring plan. Title I, art.2, alin.1, point 8 states that "interim financing means any new financial assistance, provided by an existing or a new creditor, that includes, as a minimum, financial assistance during the stay of individual enforcement actions, and that is reasonable and immediately necessary for the debtor's business to continue operating, or to preserve or enhance the value of that business".

In order to help distressed companies with a real chance of surviving, the directive provides that Member States should adopt regulations allowing companies in difficulty to benefit, under certain conditions, from an infusion of money during the stage of the development of the reorganization plan.

To make infusion of new money possible, the Directive recommends that each state may adopt: i) protective measures for creditors that provide interim financing as well as ii) rules of priority for loans repayment in the event of the insolvency of distressed company. In this respect, paragraph 68 states that "Member States shall not limit the protection of funding to cases where the plan is adopted by creditors or confirmed by the administrative or judicial authority".

The Directive also sets out the conditions under which such financing may be granted, namely: a company in difficulty may receive interim financing when the

reorganization plan is confirmed but also when the financing has been approved (*ex ante* control*)* by either a practitioner in insolvency, either by the creditors' committee or by an administrative or judicial authority.

The Directive provides the cases in which the protection of interim financing creditors is ensured[2]:

- the payment of fees and costs for negotiating, adopting or confirming a restructuring plan;
- the payment of fees and costs for of seeking professional advice closely connected with the restructuring;
- the payment of workers' wages for work already carried out without prejudice to other protection provided in Union or national law;
- any payments and disbursements made in the ordinary course of business other than those referred to in points (a) to (c).

The protective measures provided for in the Directive cover the cases where the debtor subsequently becomes insolvent. In the case of subsequent insolvency, Member States shall ensure that the interim financing will not be ”declared void, voidable or unenforceable on the ground that such transactions are detrimental to the general body of creditors, unless other additional grounds laid down by national law are present.” Also, the Article 17 pt. 3 exclude from the application of paragraph 1 interim financing which is granted after the debtor has become unable to pay its debts as they fall due.

Related to the priority for the loans repayment the Directive recommends that Member States should provide for the priority of the payment of new or interim financing grantors in relation to other creditors, in the context of subsequent insolvency procedures[3]. In France, a significant innovation of the Law issued in 2005[4] gives super-priority to creditors who have injected funds into the troubled company or continued to provide goods or services during the conciliation process. This priority entitles the aforementioned creditors to rank above all debts incurred before the opening of conciliation. Similarly, the same priority will be given to those creditors in the context of any formal insolvency proceedings opened, following the non-approval of the conciliation agreement[5].

The new cash contribution to the debtor to ensure the continuation of the company's activity and its sustainability, is refunded, before all other receivables, according to the rank provided in paragraph II of Article L. 622-17 and paragraph II of Article L. 641-13[6]. Unless there are flagrant frauds, creditors who make funds available to continue the business in difficulty cannot subsequently be held liable for the offer made to the debtor ("inadequate support"). The doctrine imposes on the creditor the responsibility for knowingly expanding the debtor's financial incapacity, contributing to the aggravation of the company's dangerous situation and leading to its subsequent insolvency. As mentioned above, the French Safeguard Law 2005-845 of 26 July 2005 restricts the creditor's liability for improper support. This proved necessary to protect creditors who, in the context of the conciliation process or a rescue plan, offered after the start of the pre-insolvency proceedings.

In Belgium, creditors were not involved in negotiations regarding interim financing because they feared possible claw back actions if the reorganization had not been successful and the company it was going to go bankrupt. As a result, the Act of 31 January 2009 on the Continuity of Companies (Loi relative à la continuité des enterprises/Wet

betreffende de continuïteit van de ondernemingen, the "Act") entered into force on 1 April 2009.

Provides legal protection for such amicable agreements under specific conditions. In cases where the insolvency proceedings are opened within six months of the amicable settlement, the liquidator will not be entitled to take claw-back action under Articles 17, no. 2 or Article 18 of the Belgian Bankruptcy Code. This means that the liquidator will not be able to challenge the agreement on the grounds that the payment to one creditor was made before the maturity of the claim, thus preferring one creditor to the others (Article 17, paragraph 2). Also, the liquidator will not have the right to challenge the agreement on the ground that the payment was received by a single creditor, who was clearly aware of the company's difficulties, to the detriment of other creditors who did not receive the payment (Article 18). The condition for obtaining this legal protection is that the agreement expressly states that it is intended to improve the financial health of the company, subject to control by the court. The amicable settlement must be submitted to the court.

In Germany, lending to a company that is in financial distress can be risky (Weijs, et al., 2012), as the lender who makes the loan can be held liable by other creditors for delaying the entrance in the insolvency proceeding if the company failed to reorganize. For this reason, the infusion of funds during the out-of-court reorganization is chosen only if there is a third authorized opinion (*Sanierungsgutachten*) which officially confirms before the infusion of funds that the business has a chance to be reorganized. But here, too, measures have recently been introduced to facilitate much-needed funds in the pre-insolvency period[7]. If the company has entered the formal procedure and wants to restructure, then the new credit can be accessed by the administrator only after the court approval. The credit thus obtained becomes a privileged credit.

Outside the space of European Union, similar measures were enacted in order to guarantee the interim financing. In the USA, Chapter 11 from the American Bankruptcy Code - which serves as a model for the European Directive (Inacio, 2019; Becker, 2019) - should be seen as a formal insolvency procedure allowing for reorganization, although cannot be qualified as a preventive process (Weijs and Baltjes, 2018) There was developed a debtor in possession financing system that comprises four types of DIP[8] finance: the first one which allows the debtor to obtain finance in the normal course of business, the second one is a short-term credit for salary payments, the third type refers to a credit that obtained while a security right is granted on unencumbered assets, and finally the fourth type provides a security right that is higher in rank than an existing security right in the same asset. The last three types need the court approval (Weijs and Baltjes, 2018). It can be concluded that when a Chapter 11 debtor needs working capital, he may be able to obtain it from a creditor by giving the creditor a “super-priority” approved by the court over other unsecured creditors or a right of ownership over the company's assets[9].

In Argentina, injection of new money to save companies that are in financial difficulty is usually done after the judicial approval of extrajudicial restructuring, and at the same time, the Argentine Bankruptcy Law does not give any super priority to new money, whether they are injected in a reorganization procedure or out-of-court restructuring (Tutzer, 2019).

In Brazil, the Bankruptcy and Reorganization Law issued in 2005 provides that the infusion of new money is an option to save struggling businesses. During the restructuring process new money can be injected in a variety of ways (e.g. loan agreements, bond

issuance, etc.). If the debtor has been deprived of the right to run the company, then it is the responsibility of the Creditors' Committee to borrow new money necessary for the continuation of activities during the period prior to the approval of the reorganization plan. It should be noted that the lending of new money can only be done with the approval of the court. The main purpose of the financing must be to compensate for the lack of cash to cover operating expenses such as: payment of suppliers, salaries, administrative expenses, etc. Due to its characteristics, this type of financing should take precedence over the payment of other loans.

In order to encourage creditors to finance distressed companies, in many states, the legislation offers different possibilities to protect creditors who in good faith help troubled companies to continue their business. In some states it has been necessary to approve the financing by the court (USA, Belgium), in other states the opinion of a third specialist in the field (Germany) is required, other states have gone further and given super-priority in repaying these loans (USA, France).

CONCLUSION

The recommendations of the new European Directive 2019/1023 aim to harmonize the legislation on interim financing of companies in difficulty and provides for the facilitation and protection of interim financing. In order to encourage creditors to finance distressed companies, in many states the legislation offers different possibilities to protect creditors who, in good faith, help troubled companies to continue their business. In some states have been granted super-priority in repaying these loans while in others, the court approval or of a third specialist in the field is required for the validity of interim financing.

Notes:
1. Directive (Eu) 2019/1023 of the European Parliament and of the Council of 20 June 2019, Official Journal of the European Union Title I, art.2, alin. 1, point 7 and 8.
2. Directive (Eu) 2019/1023 of the European Parliament and of the Council of 20 June 2019, Official Journal of the European Union: Chapter 4, Article 18, paragraph 4.
3. Directive (Eu) 2019/1023 of the European Parliament and of the Council of 20 June 2019, Official Journal of the European Union: Article 17, paragraph 4.
4. French Safeguard Law 2005-845 of 26 July 2005.
5. Article L. 611–12 of the French Commercial Code.
6. Articles of the French Commercial Code, amended by Ordinance n°2014-326 din 12 martie 2014.
7. The European Law Institute: Rescue of Business in Insolvency Law, p.217. Available at: https://www.europeanlawinstitute.eu/fileadmin/user_upload/p_eli/Publications/Instrument_INSOLVENCY.pdf [Accesssed 1 October 2020].
8. Debtor in possesion.
9. Chapter 11, Art. 364 American Bankruptcy Code.

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