

Response to Part 10 (Rescue Finance) of Review of the Corporate Insolvency Framework

This response to Part 10 (Rescue Finance) of the Consultation on Options for Reform of the Corporate Insolvency Framework is submitted on behalf of the Secured Transactions Law Reform Project (“STLRP”). Many leading practitioners, academics and policy makers are already involved in the project, as well as representatives of lenders and other financial institutions. The STLRP aims to examine the English law relating to secured transactions and to consider the need for and shape of legal reform, with the object of putting the law in this area into an up to date and coherent form which is easier and simpler to understand and operate than the existing system. One specific issue which the STLRP is considering is whether the current distinction between fixed and floating security in English law should be removed. Many of the questions in Part 10 of the Consultation (Rescue Finance) relate to the work which the STLRP is undertaking on this question, and this response is limited to the questions raised in that part.

As an introductory point, it is important to appreciate that there are two key sources of rescue financing. The Consultation concentrates on the raising of new finance but equally, if not more, important is the ability to use cash within the business to finance the rescue or insolvency proceedings. In many cases, the debtor will have granted security over cash at bank and its book debts, so that a question arises as to the ability to use the cash to finance the rescue or insolvency proceedings without creditor consent.

In Chapter 11 proceedings, a debtor which seeks to use cash which is the subject of a security interest granted to a creditor requires either the consent of that creditor or the consent of the court. Court consent will only be given if the court is satisfied that the creditor has been provided with “adequate protection” of its security interest. Section 361 of the US Bankruptcy Code provides a non-exclusive list of methods for providing adequate protection: (i) cash payments, (ii) replacement security, or (iii) other protection that will result in the realisation of the “indubitable equivalent” of the secured creditor's interest in the property. The way in which these methods can be used, alternative methods which may be available and whether or not adequate protection has been provided is largely decided on a case-by-case basis, and raises a number of difficult issues which different courts have decided in different ways (for an excellent critique, see the ABI Commission to Study Reform of Chapter 11 pp. 69-73). But the key point is that the requirement for the creditor or the court to be satisfied as to adequate protection does provide the creditor with the ability to dictate the terms on which the cash is used, or to force the matter into court with all the attendant litigation risk which that entails.

In contrast, in an English law administration an administrator can use assets secured by a floating charge without the consent of the creditor or of the court. Since the decision of the English House of Lords in *Spectrum Plus*, security over cash will often be floating. This means that in many cases the administrator will be able to use cash proceeds within the business to continue to trade, and the secured creditor will have no control over the use of charged cash. Of course, in reality the administrator is unlikely to pursue a course which the floating charge holder wholeheartedly dislikes, but this is “soft” and not legal comfort and there is evidence that US (and other overseas)

lenders remain concerned that they do not have a straightforward legal right to restrain the use of cash. Furthermore, there is renewed focus on security issues by UK banks as a result of the demands of the changing regulatory capital regime. The STLRP is working on understanding the various options for reform including:

- Providing the secured creditor with some control rights over charged cash. However, it is important to understand that the US approach developed when it was relatively rare for a lender or lenders to have security over all of the company's assets (a so-called “blanket lien”). As a result of legislative reform in 2005, it is now much more common for such a security package to have been granted in the US, and accordingly there is concern in the US that the ability of the secured creditor to control the use of secured cash provides that creditor with very powerful rights to steer the case in its own interests. Moreover, the US tests of “adequate protection” and “indubitable equivalent” have been the source of litigation expense and extensive ongoing controversy (ABI Commission Report pp. 70-73).
- Providing existing secured creditors with something akin to a "right of first refusal" to provide rescue financing.
- Abolishing the distinction between fixed and floating charges, so that both fixed and floating charged cash may be used.
- Providing a cap on the amount of charged cash proceeds which can be used.
- Abolishing the distinction between fixed and floating charges, but providing that cash proceeds can be used without consent. This would, insofar as rights over cash are concerned, preserve the *status quo* in England, but would reduce transaction costs in determining which assets fall within the floating charge and can be used and which do not. It also bears some similarity to recent suggestions for further reform to secured transaction law in Australia.

The STLRP has been researching these questions for some time. It is in the process of developing a detailed research paper, and is planning a seminar for the autumn to draw together industry professionals, academics, legal practitioners and other interested parties to discuss this and other issues arising from abolishing the distinction between fixed and floating security.

These questions also impact the issues discussed directly in the Consultation. As before, turning first to Chapter 11, section 364 of the US Bankruptcy Code permits the distressed company to obtain financing after it has petitioned for Chapter 11 on either an unsecured basis, or after notice and a hearing in exchange for priority. Priority may be (i) a super-priority administrative claim, ranking after existing secured lenders, (ii) a secured claim in unencumbered property, (iii) a junior secured claim, or (iv) a senior secured claim which takes priority over or “primes” pre-petition senior secured creditors.

Our initial impression is that the last of these (priming) is relatively difficult to achieve because it requires the company to show that no other financing is available and that the interests of pre-petition secured creditors that would be primed by the new facility are adequately protected. It is, therefore, our anecdotal impression that true “priming” is comparatively rare, and that more usually security is granted over unencumbered property or ranks as an administrative claim. This is something which we are currently exploring as part of our research. Given the difficulties in developing the concept of “adequate protection”, it may be that it would only be worth importing some sort of priming mechanism into English law if it transpires that it is relatively widely used in the US.

The Consultation refers to a “broad and long-established market in specialist rescue finance” in the US. However, our impression is that the market for provision of Chapter 11 financing has declined in the US (see p.75 fn 296 ABI Commission Report and accompanying text). It may be that this is a direct result of the growth of the “blanket lien”, so that there are fewer unencumbered assets available for post-petition finance security, or as a result of the financial crisis, or a combination of factors. We also understand that the Chapter 11 financing agreement is now often used to enable secured lenders to gain higher priority for pre-petition debt (see ABI Commission Report pp.74-79), or to impose contractual provisions enabling lenders to better control the case (see ABI Commission Report pp.76-77). We are also aware of a growing body of literature exploring how DIP lenders of different institutional types aim to use the DIP financing contract. We are currently exploring all of these points, in order to inform the UK debate.

Assuming it is the case that Chapter 11 financing in the US often ranks as a super-priority administrative claim or as a junior security interest, as the Consultation highlights it would appear that in many cases a rescue financier may currently be in a better position as a matter of English law. This is because a security agreement entered into by an administrator may rank as an expense of the administration for the purposes of paragraph 99(4) of Schedule B1 of the Insolvency Act 1986, a position somewhat supported by the case law (*Bibby Trade Finance v McKay* [2006] AER 2666) and in the scholarly literature. In this case, the rescue financier in England has two principal advantages over her US counterpart. First, whilst a US DIP loan which ranks as a super priority administrative expense would rank behind secured lenders, in English law the rescue finance would rank behind fixed charges but would rank ahead of the floating charge holder. Secondly, no court hearing is necessary so that the transaction costs involved in putting the financing in place are lower.

We agree, however, with the implication in the Consultation that the analysis is not easy to understand, is not clearly articulated in legislation, has not been thoroughly tested in the courts and still raises some questions such as the implications of negative pledge clauses. It may be, therefore, that there would be benefit in crystallising the position clearly in the Insolvency Act 1986 so that it is beyond doubt. However, any changes would need to dovetail with other steps taken in the reform (such as the proposal to treat the costs of the preliminary moratorium in the same way as administration expenses), and with the overall policy decision on the relative ranking of insolvency finance and floating charge holders. Any changes may also raise new issues such as the ability to contract out of the statutory scheme (see ABI Commission Report pp.78-79), and we are aware of specific issues around negotiation of invoice financing arrangements in administration which would benefit from clarification.. We would suggest that the issues would, therefore, better be tackled comprehensively and in detail, once some of the ongoing research which the project is undertaking has been completed to inform the policy response.