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Opening the Door for the Opportunistic Use of Interim Financing: A Critical Assessment of the EU Draft Directive on Preventive Restructuring Frameworks

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Abstract

The European Union Draft Directive on a Preventive Restructuring Framework and Second Chance (the 'Draft Directive') provides rules for adopting reorganisation plans in order to avoid insolvency. The Draft Directive also provides rules on the related problem of interim financing. According to the Draft Directive, interim financing should be encouraged and not be made subject to claw back unless parties have committed fraud or acted in bad faith. The Draft Directive thereby fails to recognise that finance transactions are too diverse in nature to provide the company and its financial creditors with a transaction avoidance free period. If the Draft Directive is adopted in its current form, it will open the door for opportunistic use of interim financing by both debtors and professional lenders. It will allow debtors to make final bets with other people's money and will also allow for conduit pipe financing reducing the exposure of existing shareholders. Lenders will also be able to make opportunistic use of the rules, most notably in the form of cross-collateralisation and aggressive loan-to-own strategies under the guise of interim financing.

There are several possible solutions to the potential for opportunistic use. The courts could be involved *ex ante*. This would, however, turn the Draft Directive into a fully fledged court supervised procedure instead of the currently intended preventive restructuring procedure which avoids such court procedures. An alternative would be to simply take out the provisions on interim financing. Another

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possibility would be to limit the protection offered in the Draft Directive to cases of new security against new money necessary and used for the continuation of the business.

I. Introduction

The defining feature of the efforts of the European Union (EU) to harmonise substantive insolvency law is the move away from liquidation towards more reorganisation-friendly insolvency regimes. In November 2016, the European Commission presented its proposal for a Draft Directive on Preventive Restructuring Frameworks and Second Chance[1] (the 'Draft Directive'). The Draft Directive provides for the possibility of reorganising already prior to and outside of a full court-supervised insolvency procedure. The Draft Directive envisions that such preventive restructurings should enable enterprises to restructure at an early stage and to avoid the opening of formal insolvency procedures. Restructuring here is to be understood in a legal sense, meaning a reordering of the capital structure. Typically, this means that creditors accept that they are not paid in full or more vividly put, they accept 'a haircut'. These preventive restructurings should maximise the total value to creditors, owners and the economy as a whole and should prevent unnecessary job losses and losses of knowledge and skills.[2] In short, reorganisation procedures, whether preventive as in the Draft Directive or as part of a full insolvency procedure, seek to capture the going concern surplus over the liquidation value by preventing the actual liquidation of the company while saving jobs.

In order to capture the going concern surplus, it will often not be sufficient to only rework the capital structure of the company. The company will also need to make changes in its day-to-day operations, which regularly involve one-off costs. Furthermore, the company might already be facing a liquidity shortage. Therefore, depending on the level of financial distress the company is facing, the company might need additional credit while working towards a reorganisation plan. Such additional credit for continuing operations and working towards the implementation of a reorganisation plan is referred to as 'interim financing' in the proposed Draft Directive. Because it is clear that the debtor is facing financial difficulties, the lender of such interim financing will normally demand additional safeguards, most commonly security rights in assets in case the reorganisation procedure fails.

Although a successful reorganisation might actually provide a win–win situation, there is no certainty that the reorganisation will be successful. If the reorganisation fails, either because of adverse business developments or simply because a plan presented is not accepted and made binding, the creditors may be even worse off compared with a situation in which the company would have

1. Proposal of 22 November 2016 for Draft Directive of the European Parliament and of the Council on Preventive Restructuring Frameworks, Second Chance and Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures and Amending Draft Directive 2012/30/EU, COM(2016) 723.

2. Draft Directive, Preamble Recital 2.

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entered a liquidation procedure much earlier. Because of the additional finance attracted to continue operating and to work towards the implementation of a reorganisation plan, the creditors may see an increase in debts and therefore a reduction in the payout they receive. Of course, this effect is all the stronger if the additional finance takes priority over their claims. Distressed finance is usually reviewed under rules of transaction avoidance in different national systems in Europe. The Draft Directive, however, seeks to foster both preventive restructuring procedures and interim financing by providing in Article 16 of the Draft Directive that rules on transaction avoidance do *not* apply and that the detrimental effects of interim financing can only be reversed if the interim financing has been granted 'in bad faith or in a case of fraud'.

This article discusses the risks related to interim financing and provides a critical assessment of the Draft Directive as it relates to harmonising rules on interim financing. Section II discusses different possibilities of use and abuse of interim financing, clarifying these by introducing a distinction between opportunistic use by the debtor and opportunistic use by the lender. Section III discusses different types of assessment frameworks, ranging from *ex post* application of transaction avoidance rules to *ex ante* judicial checks. Section IV discusses US law as a well-developed jurisdiction in relation to interim financing, commonly referred to there as debtor-in-possession (DIP) finance. Section V discusses the Draft Directive relating to interim financing. Section VI sets out the current position of three jurisdictions within the EU, namely, England, Germany and the Netherlands. Section VII evaluates the Draft Directive, and Section VIII concludes.

The conclusion is that the European Draft Directive is overreaching where it seeks to harmonise rules on creditor protection against opportunistic interim financing by basically disapplying the rules on transaction avoidance without replacing them with a check by the courts or any other relevant check. The preferred way forward is not necessarily a redrafting of the proposed rules on interim financing in the Draft Directive. Instead, the way forward can simply be to remove the flawed rules on interim financing and then implement the remaining provisions from the Draft Directive. If a provision on interim financing were to be included in the Draft Directive because it would be held that some cases of interim financing need to be awarded more protection because they are overall beneficial but hampered by overly strict rules on transaction avoidance, such protection should be limited to new security against new money that is both necessary and used for the continuation of the business.

The focus throughout the article will be on interim financing. The article will not discuss in detail the nature of reorganisation procedures versus liquidation procedures nor the intricacies of reorganisation procedures in general, such as class formation and voting procedures.[3] Furthermore, the focus will be on secured interim financing with security rights on otherwise non-encumbered assets. Only

3. On the elements of offering a plan, voting and adopting a plan and cram down, refer to Nico Tollenaar, 'The European Commission's proposal for a Draft Directive on preventive restructuring proceedings' (2017) 30 *Insolvency Intelligence* 5.

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brief mention will be made of the US possibility of granting super priority also known as priming. Because this option does not seem to be on the European table, only limited attention will be devoted to it here.

II. The Balancing Act under the Draft Directive on Preventive Restructuring

The design of rules on interim financing requires a balancing act. The possible benefits of a successful reorganisation need to be weighed against the potential risks. The possible benefits are to be found in a potential successful reorganisation in which the going concern value is captured and liquidation is warded off. This potential upside needs to be balanced against the risks associated with interim financing.

There are two main categories of risks specifically related to interim financing. The first is opportunistic use by the debtor and the second opportunistic use by the lender.[4] The term opportunism[5] is used broadly here to identify actions regardless of whether they are addressed by different legal systems or not. It encompasses clear abuse, bad faith and fraud but is considerably broader than that. Opportunism in this setting is understood to occur if either the debtor or the lender is knowingly externalising[6] business risks to third parties, without providing proper compensation or allowing affected parties to have a say in the matter.[7]

A. The risk of opportunistic use by the debtor

This first risk of opportunistic use of interim financing is opportunism by the debtor. The formal debtor is the company. However, in identifying the risks associated with interim financing, one has to look beyond the company itself. The company ultimately has no interests of its own nor hopes, desires or fears for that matter. In discussing debtor's opportunistic use, this should be understood as shorthand for opportunistic use by the persons controlling the debtor, namely, the shareholders and the management of the debtor.

4. On the risks associated with interim financing, refer to Jennifer Payne and Janis Sarra, 'Tripping the light fantastic: a comparative analysis of the European Commission's proposals for new and interim financing of insolvent businesses' (2017), available at: <https://ssrn.com/abstract=2976446>. On the clear distinction between risks from the debtor's side and the lender's side, refer to M. Barsoum, 'The dilemma of reorganisations: how to finance reorganisations while protecting unsecured creditors' (VU/UvA 2016) (unpublished, on file with author).

5. Mackaay defines opportunism as follows: "a party to a contract or other bilateral relationship may be said to act opportunistically where it seeks, by stealth or by force, to change to its advantage and to the disadvantage of the other party the division of the joint profits that party could normally look forward to at the time of entering into the relationship. It tries, in other words, to get 'more than its share'." Refer to E. Mackaay, *Law and Economics for Civil Law Systems* (Northampton MA) (Edward Elgar Publishing, 2013), 117.

6. Externalisation is any welfare effect felt by one party as a result of another actor's production or consumption decisions that is not mediated via the price system. Refer to John Armour, 'Share capital and creditor protection: efficient rules for a modern company law' (2000) *The Modern Law Review* 363.

7. For the importance of including affected parties in insolvency and acquiring their consent, refer to Jonathan Lipson, 'The secret life of priority: corporate reorganisation after *Jevic*' (2018) 90 *Washington Law Review*, available at: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3056522>.

The first risk inherent to distressed finance in general, as well as interim financing, is the risk of debtors gambling with other people's money. If a financially distressed company is balance sheet insolvent and if liquidation is opted for, the shareholders will typically not receive anything. This follows from the basic corporate and insolvency law maxim that 'equity is wiped out first'. Management staff will also lose their jobs. In a reorganisation plan, management may stay in place, and the shareholders can possibly retain part or all of the equity. In the realm of insolvency law, there is often a much stronger divergence of the interests of creditors and shareholders than occurs outside of insolvency.[8] In the case of a healthy growing company, both shareholders and creditors acquire what they bargained for. In insolvency, the divergence is demonstrated by the fact that in successful reorganisations, shareholders and management may benefit the most.

In the case of failure, the additional losses will be borne only by creditors, who will see a further decrease in their payout. Even if the chances of actually turning the business around might be very slim, a small chance of success for the shareholders and management is much better than no chance and having to accept the losses. Even projects with a negative expected value might become very worthwhile for the debtor and its shareholders to pursue. This first risk can simply be identified as gambling with other people's money. When looking at this first risk, the rescue attempt is still assumed to be sincere, but there is ample room for externalising risks. In general, care should be undertaken to prevent a reorganisation attempt from turning into a wild goose chase putting other people's money at risk without a realistic chance of success.[9] Insolvency law typically provides checks and balances against the overly opportunistic use of attracting new finance, going – as will be seen – well beyond an assessment of whether there was fraud or bad faith.

There is a second risk of debtor abuse or opportunistic use in reorganisation attempts. A known risk of secured finance, especially in situations with distressed debtors, is the problem of what some English scholars and judges have referred to as 'conduit pipe finance'.[10] Here, the finance granted to the company is never intended to actually be put to use in the company. The sole purpose is to provide the company with liquidity to enable the debtor to pay off certain kind of debts. The risk is that the company attracts finance and uses it to pay off debts for which the shareholder and/or the management assumed some kind of liability under a guarantee. The money then just goes through the company, and the company

8. On the divergence of interests between shareholders and creditors, refer to John Armour, Gerard Hertig and Hideki Kanda, 'Transactions with creditors', Chapter 5 in Reinier Kraakman *et al.* (eds), *The Anatomy of Corporate Law. A Comparative and Functional Approach* (Oxford University Press, 2017), 109–143 (more specifically 111–112).

9. One could also consider rules on subordination of shareholders' loans to address the same problem of externalising business risks while reaping the full profits. Because there is no mention of also harmonising rules on subordination of shareholder loans in the Draft Directive, while the topic was listed previously as a possible topic for harmonisation, it should be understood that the rules on interim financing do not apply to shareholder finance.

10. On the problem of conduit pipe, refer to Howard Bennett, 'Late floating charges' in John Armour and Howard Bennett (eds), *Vulnerable Transactions in Corporate Insolvency* (Hart Publishing, 2003) 183–215, 201.

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functions as a conduit pipe to reduce the exposure of shareholders and/or management.

What might be presented to the outside world as a rescue attempt could boil down to little more than an attempt to prolong the suffering of the company to arrange matters and reduce the exposure of management and/or shareholders. Although there are ample examples where the main motives of the directors and shareholders can be traced back to their desire to reduce their own exposure, practice often shows a more complicated picture. In practice, management and shareholders are often doing two things at the same time; on the one hand, they are working on a rescue attempt, and on the other, they are looking for ways to reduce their exposure, in case the attempt might not be successful. So even if part of the interim financing might be used in a reorganisation plan, there is the very real risk that the new money borrowed will in part be used to pay off the creditors who have some kind of guarantee from management or shareholders.

B. The risk of opportunistic use by the lender

There are also at least three instances in which interim financing poses a risk of opportunistic use, not so much by the debtor, but instead by the lender. Before getting to these risks and in order to fully grasp their dynamics, a further distinction between different types of interim financing needs to be introduced. This is the distinction between 'defensive lending' and 'offensive lending', identified in US bankruptcy practice.[11]

Interim financing can be provided by existing lenders. The interim financing will then chiefly be provided in order to safeguard the previously created position as much as possible. This type of interim financing is called defensive financing. A much bolder type of interim financing is granted if the lender is not yet a creditor. Notwithstanding the difficult financial position of the debtor, the lender might see this as an attractive lending opportunity. This financing by a new lender is referred to as offensive lending. This distinction can be used to distinguish the kinds of risks of opportunistic behaviour by the lender.

The first risk of opportunistic behaviour by the lender is the problem of cross-collateralisation.[12] Here, the interim lender was already a creditor before any discussion on interim financing arose, and the finance will qualify as defensive lending. If the old credit was not secured, the interim lender will typically try to not only have the interim financing secured but also the thus far unsecured old credit. The question of what the main incentives are for the interim lender of course arises. Does the interim lender primarily want to grant interim financing because of the strength of the business case, or is the interim lender primarily using the interim financing as a carrot to persuade the debtor to also grant security rights for

11. Refer to Marshall Heubner, 'Debtor-in-possession financing' (April 2005) *RMA Journal* 30: 'In common bankruptcy parlance, a DIP loan provided by the existing secured lenders is referred to as a defensive DIP while a loan from a new third-party lender is called an offensive or new money DIP.'

12. On the problem of cross-collateralisation, refer to the paragraph below on US law.

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old credit. This skewed incentive structure might lead financers to provide interim financing where they would otherwise not be willing to do so. As will be seen, transaction avoidance law commonly provides checks and balances against such practices, which also go well beyond fraud and bad faith.

The second risk of opportunistic interim financing by the lender is the problem of seeking waivers. A secured creditor often finds itself subject to investigations as to its previous dealings, most notably as to whether its security rights could be disqualified on the basis of transaction avoidance. If the creditor extends new credit, it is quite normal for a secured creditor to expect and demand an end to debates about the past. This, however, becomes problematic if the main reason or one of the main reasons to grant interim financing is to obtain such comfort. This again is a problem that will only arise in case of defensive lending. The problem is inherent to any defensive interim financing of reorganisation procedures. Whether the debtor in possession or the trustee in the case of a fully court-supervised procedure can actually grant such a waiver, will depend on the governance model and the extent to which the debtor can make binding agreements which can also be upheld if the reorganisation fails.[13]

The third risk coming from the interim lender is that the interim lender is embarking on a so-called loan-to-own strategy. Under such a strategy, the lender does not lend money with the aim of repayment with interest but instead seeks to gain control over either the debtor itself or its assets.[14] In a pure loan-to-own strategy, the lender anticipates a default.[15] It can then try to acquire the assets if it has a security right to by credit bidding on the assets.[16] It can also try to become the shareholder through a debt for equity swap. Here, the lending decision is paradoxically driven not by the credit worthiness of the debtor but by the credit

13. Refer, in summary, also to Section VII.A. Because the debtor under the Draft Directive will presumably not be able to grant such waivers, the problem should not arise in the context of the envisioned preventive restructuring framework.

14. A related problem in the USA is a DIP lender trying to gain control over the insolvency process. The lender could negotiate, for example, the right to appoint one or more managers in the company. In US legal practice, this is increasingly viewed as a problem, as the secured lender gains too much control over the debtor and the reorganisation process in a Chapter 11 procedure, which in its essence is a collective procedure. An example can be found in the US case of the DIP lender making further lending dependent on the debtor being able to negotiate a reduction in employee rights. On this case and further on such dynamics, refer to Payne and Sarra, aforementioned Note 4. The problem is similar in nature to loan-to-own strategies and can also be combined with a loan-to-own strategy. In essence, the problems can be distinguished, where loan-to-own seeks legal control by becoming the owner either by means of a credit bid or by means of a debt for equity swap. In a loan-to-control setting, the control mechanism is contractual and focused on the insolvency process. On the problem of the DIP lender seeking control over the insolvency process, refer further to Lipson, aforementioned Note 7.

15. On loan-to-own strategies and a plea for transparency as is common in normal acquisition strategies, refer to Moritz Brinkmann, 'Zum Anschleichen bei schuldenbasierten Übernahmen. Ein Plädoyer für die Einführung vor Transparenzregeln im Hinblick auf Loan-to-own-Strategien' (2017/22) *WM* 1033.

16. In the case of a credit bid, the lender makes a bid not in cash but with the nominal amount of its claim. No money is actually paid. On the strategy in general, refer to Timothy Belton, 'The venture industries credit bid: a template for effective "loan to own" acquisitions' (2006 Spring) *Journal of Private Equity*, *Special Turnaround Management Issue* 115. On the loan-to-own strategy under US law, refer to Randall Klein and Danielle Juhle, 'Majority rules: non-cash bids and the reorganisation sale' (2010) 84 *Am. Bankr. L. J.* 297; Lipson, aforementioned Note 9, paragraph 4.3.2. On credit bids (in Dutch), refer to Rolef de Weijs and Geza Orban, 'Loan-to-own meets credit bid: credit bidding naar Amerikaans en Nederlands recht' (2016/15) *Tijdschrift voor Insolventierecht.*

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unworthiness. The insolvency of the debtor is not a risk but rather the primary driver of the decision.

Where traditionally insolvency meant losses and grief for the creditors, for creditors, embarking on a loan-to-own strategy, the insolvency of the debtor, which allows the lender to take over, is the desired outcome. The problem is that the debtor might be well aware of this strategy, but hopes to turn the tide. If the debtor does not succeed, the additional losses are borne by the other creditors. Therefore, the problem of aggressive loan-to-own strategies by means of interim financing[17] and the problem identified under debtor's abuse as gambling with other people's money may feed into each other. The debtor and its shareholders are more than willing to attract financing for one final attempt. At the same time, the lender is willing to provide such financing. There is, however, no sensible check from the lender's perspective, because the lender actually anticipates that the debtor will default while exacerbating the losses of other creditors. The risk of opportunistic loan-to-own strategies can present itself in both the case of offensive lending and defensive lending but more typically is a risk related to offensive lending.

III. Different Assessment Frameworks

The risks identified earlier are only one side of the coin. The other side is the potential gain from a successful reorganisation. The law should provide some kind of framework to balance the interests of creditors against prejudice on the one hand and the interests of a more diffuse group (including the same creditors) on the other hand in a successful reorganisation. Three possible assessment frameworks present themselves; (i) creditors' say *ex ante*; (ii) transaction avoidance *ex post* and (iii) court involvement *ex ante*.

A. Assessment *ex ante*: creditors' say

Ideally, the decision of whether to attract interim financing would rest with those primarily affected. That is typically those creditors that are affected the most by the negative consequences of the interim financing if the reorganisation fails. Upon insolvency, in economic terms, creditors become the new residual claim holders[18] or even 'the new equity investors'.

The creditors are the first to benefit from additional value and the first to suffer from setbacks. Ideally, these creditors would also have the final say on the matter.

17. A distinction can be made between different loan-to-own strategies. The loan-to-own to own strategies discussed here are those under which the lender grants new money. This strategy should be distinguished from far less aggressive strategy by means of which the loan-to-own investors acquires already existing claims at a discount. Although such strategies receive ample attention and criticism, it should be understood that any reduction of the powers of such acquirer will also be at the expense of the original creditor. Therefore, the maxim that one cannot transfer more than one has should probably also be upheld the other way, in the sense that creditors should be able to transfer all that they have. Any reduction of the powers of the loan-to-own investor will be at the expense of existing creditors looking for a way out. If the original creditor could be qualified as a non-adjusting creditor, this becomes especially problematic.

18. Refer to Armour and Bennett, aforementioned Note 10, 109: 'At this point, the creditors change roles: they become in a meaningful sense, the owners of the firm's assets.'

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If they do not support the reorganisation over liquidation, they could refuse the opportunity to reorganise with its related risks and simply liquidate the company. In that sense, the creditors would very much be in the same position as shareholders outside insolvency, where shareholders can by and large at any moment decide to stop and liquidate the company.

Of course, there are many difficulties in such an approach of actually giving the creditors the final say on interim financing. Before turning to the drawbacks, it should however be realised that, regarding the acceptance of a reorganisation plan, the law does give the final say primarily to the affected creditors. They get to vote on the plan, and as a starting point, the creditors have to accept the plan.[19] Because interim financing has the potential to affect the final outcome for the creditors much more than the reorganisation plan itself, one should not move past actual creditor involvement too quickly.

There are undeniable difficulties in creating and respecting the creditors' democracy at the stage of interim financing. Creditor positions are increasingly fragmented, leading to many different scenarios in which the creditor is affected as a result of various outcomes. Even if their positions and the impact thereon would be perfectly clear, there are still problems of timing and coordination. Furthermore, the Draft Directive provides for a preventive framework seeking to avoid insolvency, and it leaves the debtor in possession. It would be at odds with these goals to transfer governance entirely to the creditors already at this early stage. Instead of leaving it to the creditors, one could also apply a different governance structure or assessment framework altogether.

B. Assessment *ex post*: fitting interim financing into transaction avoidance

Another assessment framework is to evaluate *ex post* the granting of security rights applying rules on transaction avoidance, possibly combined with directors' liability. This is still by and large the European approach. Although from a European perspective, it is quite common to approach the potential opportunistic use of interim financing from the perspective of transaction avoidance; one should also understand how problematic this is. Rules on transaction avoidance have great difficulties in providing an apt framework for the assessment of interim financing. The basic reason for this is that transaction avoidance can be divided conceptually into two broad basic categories: preferences and transactions at an undervalue. As will be explained, the problem of interim financing does not fit either.

Transactions at an undervalue are typically those acts in which the debtor sells something for too low a price or makes a gift. Such actions are detrimental to the debtor and, in a subsequent insolvency procedure, detrimental to the creditors. Preferences are acts which improve the position of a creditor, compared with the position this creditor would have been in without that act. Examples include the

19. Under the Draft Directive, Article 9(4), a majority per class of not higher than 75% of the outstanding amount is envisioned.

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payment of a single creditor before other creditors or the granting of a security right to an existing creditor. In its essence, interim financing does not fit into either category. It is not an act at an undervalue. If anything, the creditor (interim lender) could argue that it has been the one receiving too little interest or security rather than receiving too much. Pure interim financing, understood as providing new money against a new security rights, is also not a preference. The lender was not a creditor prior to granting the new interim financing.[20] Also, in pure interim financing, the joint creditors may be prejudiced, but the lender itself does not gain a direct advantage as is typically the case with transactions at an undervalue and preferences. Furthermore, while prejudice by means of transactions at an undervalue and preferences is direct, granting new money against new security is always indirect, because it does not occur until the actual use of the newly granted interim credit facility.

Listing these drawbacks is not meant to say that interim financing should not be covered by rules of transaction avoidance. It does, however, justify the warning that one should be extra careful in applying these rules. In its essence, the problem with interim financing is that it can facilitate prejudice to creditors by the debtor. Furthermore, some opportunistic uses of interim financing do fit quite easily within transaction avoidance, most notably cross-collateralisation, where the lender is preferred as a creditor as far as the old credit is concerned.[21] Although pure interim financing can only be fitted into transaction avoidance with some difficulty, legislatures and courts have by and large developed a working framework curbing opportunistic uses of finance.

Applying transaction avoidance *ex post* has the benefit of allowing significant freedoms to the parties involved without burdening them with procedural hurdles causing delays at a time of financial crisis and where speed may very well be of the essence. At the same time, all parties are working under the threat that their actions will be reviewed at a later stage, posing a threat of avoidability as to security rights granted to lenders and the threat of liability for directors.

C. Assessment *ex ante*: court involvement

A third possible method of assessment provides parties with certainty at the point when finance is granted. Instead of letting the creditors decide, one could let the court decide, possibly, while providing creditors with the possibility to argue their point of view. Although the procedure becomes more formal and more time consuming, it provides parties with the comfort that interim financing granted on the basis of a court decision cannot be unwound later on.

20. Although in the abstract, clear distinctions can be made, in practice such distinctions will be gradual, with banks having a relatively small or relatively large pre-existing claim.

21. The conduit pipe cases can also be constructed as a preference, where the guaranteeing shareholder and/or director is preferred as a contingent creditor. Under English law, preference law is addressed in the Insolvency Act 1986, Section 239, which explicitly extends not only to direct creditors but also to guarantors.

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IV. The US System of Debtor-in-Possession Finance

The US insolvency law system is best known for its Chapter 11 procedure. Chapter 11 provides for a reorganisation procedure which leaves the DIP. Although both the Draft Directive and Chapter 11 provide for the possibility to come to a plan and to make this binding on dissenting creditors, Chapter 11 cannot be qualified as a preventive process but should be seen as a formal insolvency procedure allowing for reorganisation. In the USA, a tested system for interim financing has developed, better known as DIP financing. The system distinguishes between four types of DIP finance.[22]

The first type of DIP finance is one which allows the debtor to obtain finance in the normal course of business. Examples include the extension of credit by sellers as they also normally do. The DIP financer's resulting claim will qualify as a claim against the estate. This category of unsecured DIP finance in the normal course of business does not require any court involvement.[23] Because such finance is normally not available for reorganising debtors, the relevance of this type of DIP finance is limited. Furthermore, because the financing has to be in the normal course of business, if extended, the impact on other creditors will also be limited if the reorganisation fails.

The second type of DIP finance attracts unsecured DIP finance outside the normal course of business, for example, short-term credit to meet salary payments. The resulting claim will again be a claim against the estate. Here, it is required on the basis of Section 364 of the Bankruptcy Code that the court is asked for permission, with the requirement of a notice to creditors and the possibility of a court hearing.[24] The court must be satisfied that the transaction is on fair and reasonable terms, that it is likely to further the interests of the estate and that it will not impose an unjustifiable burden or risk on parties in interest.[25] This broad test would allow a creditor to object to DIP financing on the basis of all the identified possibilities of both creditor and lender opportunistic use.

The third type, and the most relevant for the analyses at hand, is one in which credit is obtained while a security right is granted on unencumbered assets.[26] Here, the claim itself will not only qualify as a claim against the estate, but also the DIP financer will also have a security right in a liquidation procedure if the reorganisation fails. Section 364 of the Bankruptcy Code means that the court is asked for permission, with the requirement of a notice and the possibility of a court

22. On the working of the system in general with comparative analyses, refer to Payne and Sarra, aforementioned Note 4. Refer further to Brian Blum, *Bankruptcy and Debtor/Creditor* (Aspen Publishers, 2006), 387–391. On the practical steps taken, refer to Heubner, aforementioned Note 11, 30–33. For the development of the DIP Market, refer to Paul Zumbro, 'DIP and exit financing. Trends and strategies in a changing marketplace' in *Inside the Minds: Recent Trends in Debtor-in-Possession Financing* (Thomson Reuters/Aspatore, 2016). Refer to also the empirical academic work in Kenneth Ayotte and Edward Morrison, 'Creditor control and conflict in Chapter 11 (Columbia University Center for Law & Economics Research Paper No. 321/2008) (2009) 1 *J. Legal Analysis* 511.

23. US Bankruptcy Code, Section 364(1)(a).

24. US Bankruptcy Code, Section 364(b).

25. Refer to Blum, aforementioned Note 22, 388.

26. The same goes for providing a junior security right on an already encumbered asset.

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hearing. The court has to apply the same substantive test of fairness and reasonableness of the DIP financing as mentioned directly earlier.[27]

The fourth possibility, the most subject to criticism but for the moment less relevant for the comparative analyses at hand, is the possibility to provide a security right that is actually higher in rank than an existing security right in the same asset, also known as priming. First of all, it is required that the court is asked for permission, with the requirement of notice and the possibility of a court hearing. In addition, it is a statutory requirement that the existing secured creditor receives adequate protection.[28]

In 2014, the American Bankruptcy Institute (the ABI) presented its recommendations for a reform of Chapter 11. The ABI committee also addressed the issue of DIP finance and more specifically the issue of cross-collateralisation.[29] Under current US law, whether a court can approve cross-collateralisation[30] is subject to debate[31] and also depends, due to a divergence in case law, on the jurisdiction in which the Chapter 11 case is pending.[32] As to cross-collateralisation, the ABI basically recommends that a court should not approve any agreement to that extent.[33]

27. US Bankruptcy Code, Section 364(c).

28. US Bankruptcy Code, Section 364(d).

29. In addition to the problem of cross-collateralisation, the ABI also addresses the problem of DIP financer control. In its recommendations, the ABI clearly seeks to push back against this practice. Refer to ABI Report, 79–80. Although not elaborating on the issue itself, the ABI also pushes back against allowing for any waiver or representation regarding the validity if the existing rights as part of a co-called interim order. It recommends (80) that the court should not approve representations regarding the validity or extent of the creditor's liens on the debtor's property or property of the estate in such an interim order. This, however, does not mean a full ban on such waivers if they are part of the final order. Refer on the concept of interim order and final order (81).

30. Refer also to ABI Report for the related topic of roll-up provisions. These demonstrate similar dynamics as cross-collateralisations. In case of a roll-up, the focus is on the formal ranking and qualification of a claim. Under a roll-up provision, the lender has already extended credit in the past of say USD 2 million. The lender will grant an additional loan of USD 1 million. The DIP financing will however be USD 3 million, with the express agreement that USD 2 million thereof will be used to pay off the old secured debt. The benefit is that now the DIP lender has a full secured claim of USD 3 million which in its entirety qualifies as a claim against the estate. A benefit of the full claim now qualifying as a claim against the estate is that claims against the estate are exempt from cram down. Refer on the specific topic of roll-ups: <https://business-finance-restructuring.weil.com/DIP financing/roll-up-roll-up-read-all-about-it/>. The Commission is explicit on the relative room for abuse (ABI Report, 78): 'With respect to cross-collateralisation, the Commissioners discussed its uses and the split in the case law regarding the permissibility of cross-collateralisation. The Commissioners articulated concerns similar to those expressed in the roll-up context. In fact, some of the Commissioners viewed cross-collateralisation as subject to greater abuse because of the ability of prepetition lenders to improve their prepetition position through the use of cross-collateralisation in postpetition facilities.'

31. For a critical view against such a possibility, refer to Blum, aforementioned Note 22, 390.

32. Refer to ABI Report, 78.

33. The only exception the ABI envisions is that the old pre-petition debt should not in any way suffer from any post-petition finance either. In general, US Bankruptcy Code, Section 361 provides a rule of adequate protection of existing secured creditors against subsequent use of the encumbered assets or subsequent DIP finance. Section 361 provides that already encumbered assets can be sold or subjected to security rights, provided that the old secured creditor is granted adequate protection. The ABI recommendation against allowing cross-collateralisation should be read against this background: ABI Report, 68, which reads as follows (italics added): 'A court should be able to approve a provision to cross-collateralise a secured creditor's prepetition debt with the debtor's or the estate's post-petition property *only* for the purpose of providing adequate protection under section 361 and only to the extent that such cross collateralisation covers any decrease in the value of the secured creditor's collateral as of the petition date.'

With this intricate system of DIP finance, the USA applies a check *ex ante* by the court and not a check *ex post*, providing the parties involved with certainty from the start.[34]

V. Interim Financing in the European Draft Directive

A. General working and goals of the Draft Directive on a preventive restructuring framework

The Draft Directive provides rules for a preventive restructuring framework. It is aimed not only at preventing the liquidation of the entity but also at preventing the need to open a fully fledged insolvency procedure supervised by the courts and coordinated by an external trustee or insolvency practitioner.[35]

There are several key features of the preventive restructuring framework. The most important feature is that the legal entity remains in place throughout the entire process and also survives the process. The second feature has to do with the level of court involvement. The Draft Directive provides for a preventive restructuring framework allowing the company to restructure outside a fully court-supervised procedure while keeping the debtor in possession (Article 5 of the Draft Directive). The Draft Directive makes it clear that one of the key features is the absence of court involvement at every instance, as is typically the case in full insolvency procedures.[36]

Addressing the effects of the restructuring process itself, the Draft Directive provides for a reordering of the capital structure of the company. There is no magic here, and for the non-initiated, the term might be confusing or even misleading. Although there will be no liquidation of the company and not even a formal court supervised insolvency procedure, there will be parties, most frequently creditors, whose legal rights will be curtailed against their wishes and without their consent. The basic rule as to when this is allowed is the majority rule. If a class accepts a plan, other creditors in the same class are bound to such a plan as well. It is only after this stage of creditors voting that the court has a clear role.

It is up to the court to make a plan accepted by the prescribed majority binding on the dissenting minority (Articles 9 and 10 of the Draft Directive). Notwithstanding the limited involvement of the court, the Draft Directive does provide for the possibility to go one big step further. Even if entire classes object, the Draft Directive provides the courts with the power to make a plan binding against the vote by the creditors. Such a court order is much more drastic than simply confirming a plan adopted by the majority, because it actually goes against the majority in one or more classes. This power is referred to as 'cross-class cram-down' (Article 11 of the Draft Directive). Both the majority rule and the cross-class cram-down provision seek to overcome harmful holdout behaviour either by individual

34. A court ruling can be appealed by an affected creditor. But even if the order is reversed, rights already created are maintained in case the DIP financer acted in good faith.

35. Refer to Draft Directive, Article 4 on 'avoiding insolvency'.

36. Preamble Directive Recital 18 (stating the background desire to actively limit court involvement).

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creditors or even by a class of creditors, frustrating a viable reorganisation plan that would be beneficial to all.

The preventive restructuring procedure does form part of insolvency law[37] but, at the same time, seeks to prevent the opening of a fully fledged insolvency procedure. As already explained earlier, insolvency replaces shareholder primacy with creditor primacy. Compared with strict insolvency laws in liquidation procedures, reorganisation procedures are much more flexible. While a liquidation procedure can be qualified as rule-based, reorganisation procedures are more principle-based. The outcome of reorganisation procedures is much more open-ended and often depends on multiparty negotiations. In order to prevent other interests from trumping the interests of creditors, there are certain protections in place in the Draft Directive which are to a large extent inspired by US law. The first line of protection is easily understood and provides that in the situation of a reorganisation plan, no single dissenting creditor can be made worse off compared to what its position would be in a liquidation. This test is normally referred to as the 'best interest of the creditors' test' or 'the no-creditor-worse-off test'.

The Draft Directive at Article 10(2)(b) implements this rule using the term 'best interest of creditors'. Then, there is a second principle protecting the interests of creditors most specifically against shareholders: the Absolute Priority Rule. This principle seeks to ensure that the going concern surplus is divided in accordance with the statutory order. This principle basically seeks to ensure that the shareholders do not usurp the going concern value and leave the creditors with little more than the liquidation value. If the creditors as a class, however, consent to the shareholders holding on to all or part of the shares of the reorganised company, such a plan can be made binding on all creditors. Creditors might consent to such retention of all or part of the equity by the old shareholders, because they may well wish to provide an incentive to the old shareholder and management to remain involved. What the absolute priority rule seeks to prevent is that a court uses its cram-down powers to cram down a plan against the vote of creditors as a class, where the shareholder retains value. The absolute priority rule is aptly summarised by US scholars Baird and Jackson. They write that the effect of the Absolute Priority Rule in an insolvency procedure is that "when a firm owes more than its assets are worth, the shareholders receive nothing unless the creditors consent".[38] The Draft Directive provides for the Absolute Priority Rule as a measure of creditor protection as part of the cross-class cram down in Article 11(1)(c).

37. The Draft Directive provides not only for a majority rule per class but also for a cross-class cram-down and in addition thereto to the possibility to adopt a stay of enforcement. On the more principled problem of the Draft Directive trying to be in essence a *preventive insolvency procedure* and thereby not a proper insolvency procedure, refer to Tollenaar, aforementioned Note 3, 71: "On the other hand, in terms of its consequences, the procedure is nothing but an insolvency procedure ('if it's not called a duck, but looks like a duck, swims like a duck and quacks like a duck, it probably is a duck')."

38. For similar wording, refer to Douglas Baird and Thomas Jackson, 'Bargaining after the fall and the contours of the Absolute Priority Rule' (1988) 55 *University of Chicago Law Review* 738. For a more recent view on the working of the Absolute Priority Rule under US law and the implications of the 2017 US case of *Jevic*, refer to Lipson, aforementioned Note 7.

One more feature follows from the special characteristic of the Draft Directive providing for a preventive restructuring process. That is the type of companies the Draft Directive is actually targeting, or more precisely, the kind of problems those companies are facing. The problems should primarily be financial problems and not so much that the company is facing an outdated business concept. The typical company that the Draft Directive is written for is a financially overleveraged company with a sound underlying business. Pursuing financial leverage is a very attractive strategy for shareholders. By financing the larger part of the activities with debt, instead of equity, the return for shareholders increases significantly.[39] If the company succumbs to its debts, there is little need to enter full insolvency proceedings, let alone to liquidate the company, if the underlying business is sound. Here, an insolvency-light regime could suffice, especially if the restructuring would only target financial creditors that have actively financed the overleveraged capital structure.

The Draft Directive caters to this need by allowing for tailor-made restructuring plans. Whereas fully fledged insolvency procedures affect all creditors, the preventive restructuring framework can be limited to certain groups of creditors (Article 14 of the Draft Directive) and thereby limit the scope of affected creditors and leave trade creditors, for example, out altogether. The Explanatory Memorandum also seems to suggest that this is the preferred way of restructuring. The Explanatory Memorandum discusses the benefits of restructuring over liquidation:

> A successful restructuring plan will turn non-performing loans into loans a company can actually pay back. In liquidation, secured creditors have to consider the possibility of substantial reduction in the value of their claims. In restructuring, on the other hand, insolvency is avoided, contract debts are in general paid, and negotiations concern in most cases only the financial debt.[40]

Indeed, a reorganisation of a financially overleveraged company should primarily be an affair between the shareholders and the financial creditors. The majority

39. For a graphic illustration of the effects of leverage, refer to Rolef de Weijs, 'Harmonisation of European Insolvency Law: preventing Insolvency Law from turning against creditors by upholding the debt-equity divide' (Centre for the Study of European Contract Law Working Paper Series No. 2017–03), available at: <https://ssrn.com/abstract=2932097>. The following numerical example leaving out taxes and depreciation can be given. If a company has a balance sheet total of EUR 1000 and is fully equity financed, equity amounts to EUR 1000. At the start, the company makes EUR 80 in profit. The return on equity (ROE) is then 8%. On each euro invested, the shareholder has made EUR 0.08. If the company takes on debt of EUR 350 and has to pay 4% over this amount, this leads to an increase in the ROE. Of the EUR 80 in profit, the first 4% over the amount borrowed must be paid, being EUR 14. Therefore, for the shareholder of the EUR 80 in profit, 'only' EUR 66 remains. The amount of equity is reduced from EUR 1000 to EUR 650 because the company is now partly equity and partly debt financed. Thereby, the ROE has increased to 10.2% (EUR 66 earned with an equity of EUR 650). If the company borrows an additional EUR 400 for 4%, the same dynamics repeat themselves. Out of the EUR 80 in profit, first interest of EUR 30 (4% over EUR 750) needs to be paid. Of the EUR 80 in profit, now 'only' EUR 50 remains for the shareholder. This, however, results in an ROE of 20%, because the shareholder has now earned EUR 50, by only investing EUR 250. At the level of EUR 900 in debt against a 4% interest rate, the interest payments have risen to EUR 36, leaving EUR 44 for the shareholder whose equity is now reduced to EUR 100, yielding a ROE of 44%. This strategy is of course only attractive if the money taken out of the company is again invested in similarly leveraged companies and not if the money taken out of the company would be placed in a bank account yielding no or very little interest.

40. Explanatory Memorandum, 13.

should be able to bind the minority, outside of formal court-supervised insolvency proceedings, especially if a minority of financial creditors is frustrating a reorganisation that is beneficial for all. The same goes for shareholders that are out of the money. Given the attractiveness of leveraged finance and overleveraging being a problem which can easily be resolved among the financial creditors and shareholders, a preventive insolvency-light regime is well placed to deal with those problems.

One of the problems of the Draft Directive is, however, that is not clear how preventive restructuring procedures will relate to normal insolvency procedures. Although there undeniably is a suggestion that the Draft Directive provides a quick remedy for financially overleveraged companies, there is no clear limitation of its application. Furthermore, although the Explanatory Memorandum seems to suggest that trade creditors will preferably be left out of the restructuring, there is no rule in the Draft Directive providing that this is the preferred route of restructuring. This in itself does raise the question of which are the companies and problems that the Draft Directive is actually seeking to provide a way out for.

Tollenaar concludes that the Draft Directive is schizophrenic in nature because on the one hand, it seeks *not* to be an insolvency instrument, while on the other in terms of the procedure and its effects, it is nothing but an insolvency procedure.[41] Eidenmüller is also critical and concludes that the Draft Directive is a twisted and truncated insolvency proceeding.[42] The Draft Directive indeed lacks clarity as to its scope and goals. Because the Draft Directive provides for a light-touch[43] preventive restructuring framework, with little court involvement, it should already be understood that the Draft Directive is really targeting financially overleveraged companies with a sound and working business concept. Furthermore, the effects of such a light-touch regime should also primarily target the financial creditors.

B. Interim financing under the Draft Directive

The Draft Directive in its very essence provides for the possibility of making a plan which binds dissenting minorities. In addition, the Draft Directive also tries to pave the way to such a plan by further enabling interim financing. It does not provide clear rules, instead it requires that interim financing is facilitated and even encouraged.[44]

Before getting to the technicalities of the rules, one should bear in mind the overall framework of the Draft Directive. The preventive restructuring framework provides for an insolvency light process, without real court involvement, which seeks to help overleveraged companies address their financial problems.

41. Tollenaar, aforementioned Note 3, 71.
42. Eidenmüller is critical as to the lack of checks and balances on which companies will be allowed to use the preventive framework. He is especially critical because the Draft Directive does not distinguish between viable and non-viable businesses. He fears the proposed Draft Directive will 'attract non-viable firms like light attracts mosquitos': Horst Eidenmüller, 'Contracting for a European insolvency regime' (2017) 18(2) *European Business Organisation Law Review* 273, 288.
43. For the term light-touch regime, as opposed to more traditional heavy handed insolvency procedures, refer to Tollenaar, aforementioned Note 3, 77.
44. For an in-depth view of the provisions, refer also to Payne and Sarra, aforementioned Note 4.

Metaphorically, one could say that the Draft Directive does not seek to perform open heart surgery on the company but rather seeks to bring down the excess weight that is threatening the company's heart. The treatment requires the patient to move around as freely as possible outside a sterile and heavily supervised court environment. This raises the question of whether this insolvency-light preventive regime really needs to pave the way for interim financing as well. As long as there is a stay of enforcement, the underlying business should be able to pay its operational running expenses.[45] It is the overleveraging and its related interest payments that presumably are the problem. If the problem is much more severe, the question arises of whether this problem should also be dealt with in the open-air ambience instead of the more closely monitored full insolvency procedure.

The Draft Directive distinguishes between new financing on the one hand and interim financing on the other. This article focuses on what in the Draft Directive is referred to as 'interim financing', namely, financing to get to the stage of offering a plan. More precisely, interim financing in the Draft Directive means

> any funds, whether provided by an existing or new creditor, that is reasonably and immediately necessary for the debtor's business to continue operating or to survive, or to preserve or enhance the value of that business pending the confirmation of a restructuring plan.[46]

'New financing', in turn, is the financing which will be attracted on the basis of the plan and which creditors also have a say on.

The key provision in the Draft Directive in this respect is Article 16 which addresses 'Protection for new financing and interim financing'. It provides for the following (emphasis by authors):

i Member States shall ensure that new financing and interim financing are adequately encouraged and protected. In particular, new and interim financing shall not be declared void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures, unless such transactions have been carried out fraudulently or in bad faith.

ii Member States may afford grantors of new or interim financing the right to receive payment with priority in the context of subsequent liquidation procedures in relation to other creditors that would otherwise have superior or equal claims to money or assets. In such cases, Member States shall rank new financing and interim financing at least senior to the claims of ordinary unsecured creditors.

45. Of course, a company faced with financial problems might also be faced with an immediate cash squeeze, because, for example, suppliers are only willing to make deliveries against direct payment. Although this risk is very real, the question remains how to respond. First of all, existing rules on transaction avoidance have not been identified as being overly restrictive on pure working capital finance, also not if the working capital (gap) abruptly increases. So even if one is of the opinion that at least new money to simply be able to continue operating the business and to keep the lights on should be protected, there is no clear argument that such finance currently is subject to overly strict scrutiny. Furthermore, allowing for a transaction avoidance free period not only removes the incentives for parties to prevent the need to enter preventive insolvency proceedings but provides a strong incentive to enter preventive proceedings with the forced curtailment of creditors' right rather than sort things out truly consensual.

46. Draft Directive, Article 2(12).

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iii The grantors of new financing and interim financing in a restructuring process shall be exempted from civil, administrative and criminal liability in the context of the subsequent insolvency of the debtor, unless such financing has been granted fraudulently or in bad faith.

The Draft Directive's basic approach is to try to prevent normal rules of creditor protection from interfering too much. One could even say that these rules on creditors' protection are almost completely disapplied.[47] The main restraint is that there should be 'no fraud or bad faith'.[48] This, however, leads to a very strong mismatch between the wording used in the actual provisions of Article 16 of the Draft Directive and that of the Preamble. The Preamble is far less facilitative of interim financing than the provisions themselves are. In the Preamble, the following is put forth as to what kind of finance should be protected as interim financing (emphasis added by authors).

> As opposed to new financing which should be confirmed by a judicial or administrative authority as part of a restructuring plan, when interim financing is extended the parties do not know whether the plan will be eventually confirmed or not. Limiting the protection of interim financing to cases where the plan is adopted by creditors or confirmed by a judicial or administrative authority would discourage the provision of interim financing. To avoid potential abuses, only financing that is reasonably and immediately necessary for the continued operation or survival of the debtor's business or the preservation or enhancement of the value of that business pending the confirmation of that plan should be protected.[49]

The restrictions mentioned in the Preamble have not however found their way into the text of Article 16 of the Draft Directive. The result is a big difference between the Preamble and the text, from only protecting financing necessary for the continued operation of the business to allowing all financing that does not qualify as being fraudulent or in bad faith.

One can only speculate as to the causes of the mismatch between the preamble and the provisions. Is it simply poor drafting? Or has there been a change in underlying policy and does the commission really want to basically abolish rules on transaction avoidance in the field of interim financing by simply disapplying them? Overall, it seems that the problem has not been thought through properly. Interim financing in the sense of new money flowing to financially distressed companies appears to be viewed as something that can only be beneficial to all stakeholders. It appears that there has been insufficient understanding in both drafting the

47. Preamble Directive Recital 31, explicitly stating: 'New financing or interim financing should therefore be exempt from avoidance actions which seek to declare such financing void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures.'

48. At first sight, the Draft Directive seems to match the recommendations of the ELI Report of only allowing clawback for 'interim financing if lenders acted in bad faith', for which see Bob Wessels and Stephan Madaus, 'Instrument of the European Law Institute - rescue of business in Insolvency Law' (2017), available at: <https://ssrn.com/abstract=3032309>, no. 355. The ELI Report uses the term interim financing however also for financing court supervised restructuring proceedings (no. 337), which have of course a different governance model than the non-court supervised preventive restructuring framework altogether.

49. Draft Directive, Preamble Recital 31.

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preamble and the actual provision of the diverse risks of abuse and opportunistic use of finance.

VI. National Laws in Europe

A. England

English law on transaction avoidance has no specific provisions on interim financing or more general rescue financing.[50] English law on transaction avoidance is in itself already quite conducive to rescue finance in general. This can be explained by the fact that English law relating to transaction avoidance is primarily targeting an unfair advantage at the expense of the creditors and not focusing so much on the prejudice to the collective interests of the general body of creditors (or simply, the joint creditors).[51] These two approaches to transaction avoidance of focusing either on the advantage of the counterparty or on the prejudice to the joint creditors can diverge,[52] especially in the case of rescue finance.[53] Where the granting of new credit against new security rights will be prejudicial to the joint creditors if the rescue attempt fails, there is no clear advantage for the lender. As a consequence, rescue finance in its pure form of new credit against new security is not typically regarded as something subject to transaction avoidance under English law. It fits neither the category of transactions at an undervalue nor qualifies as a preference.

Of course, the entire perspective changes insofar as the terms of the rescue finance themselves become blurry. There are two types of cases in relation to distressed finance that typically are reviewed under the rules of transaction avoidance.

The first are cases in which new security rights are granted not only just for new credit but also for old credit. In this case, the transaction does qualify as a preference because, to the extent that new security rights relate to old credit, the position

50. On current English law on rescue financing in general, refer to Payne and Sarra, aforementioned Note 4, 4–5. On the workings of the provisions on transaction avoidance in general, refer to Roy Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell, 2011), 521; Rebecca Parry, James Ayliffe and Sharif Shivji, *Transaction Avoidance in Insolvencies* (2nd ed) (Oxford University Press, 2011); Armour and Bennett, aforementioned Note 10.

51. Refer to Goode, aforementioned Note 50, 521: 'The conditions of avoidance vary according to the particular ground of avoidance involved but are for the most part dictated by a common policy, namely to protect the general body of creditors against a diminution of the assets available to them by a transaction which confers an unfair or improper advantage on the other party. All but two of the grounds of avoidance known to insolvency law involve the unjust enrichment of a particular party at the expense of the general body of creditors. Once this crucial point is grasped much of the legislative structure falls into place.'

52. Another and slightly easier example of how these approaches diverge is the sale of an asset against the market price, after which the proceeds are not available for the joint creditors, because they might have been dissipated. Following the approach where a requirement for transaction avoidance is an unjust or unfair advantage of the counterparty, such cases would basically fall outside the scope of transaction avoidance. In case a legal system focuses on the prejudice cause to the joint creditors, such cases could be subject to transaction avoidance because one can construct that the joint creditors are prejudiced by the sale. In order to connect the subsequent dissipation of the proceeds to the sale itself, there will need to be a connecting factor, which can be found in subjective elements such as that the buyer already knew that the proceeds would not be available.

53. For a further elaboration on the distinction between the approach of focusing on the prejudice to the joint creditors on the one hand and focusing on an unfair gain on the counterparty's side, refer to Section VI.B on German law. German law takes the other approach by focusing on the prejudice.

of the lender is improved compared with the position it would have been in otherwise. It is then reviewed under the criteria in Section 239 of the Insolvency Act 1986 ('IA'). Because of the high burden on the administrator to prove that the debtor was influenced by the desire to prefer,[54] this still offers little protection to the joint creditors. Insofar, as the security right securing the new finance is a floating charge, Section 245 of the IA applies. Section 245 of the IA provides that a floating charge created in the 12 months[55] prior to the 'onset of insolvency' is not valid *unless* and to the extent that it secures certain specified forms of new value.

The second is a whole line of cases on conduit pipe financing. Where the company is no more than a conduit through which the money flows, the charge will not be valid.[56] In such cases, English courts will look at the substance rather than the form of the transaction.[57]

When viewed as a whole, the entire framework of English law is therefore rather conducive to genuine rescue finance. It places checks and balances on the use of rescue finance in situations where there are mixed incentives. One could critique English law as being rather too facilitative already.[58] There are no specific rules on interim financing in cases of preventive restructuring attempts and also no clear requirements as to the feasibility of a rescue plan. Furthermore, English law does not have rules on automatic subordination of shareholder loans nor on secured shareholder loans notwithstanding pleas in favour thereof by the Cork Committee.[59] Under English law, rescue finance can therefore be granted on a secured basis by the shareholders themselves.

In as far as finance is provided within an actual administration procedure, there is a possibility of extending new credit. It should be noted that administration can be combined with a scheme of arrangement but that the administration procedure already does qualify as a full insolvency procedure and can therefore not be considered to be the English equivalent of a preventive restructuring procedure. Payne and Sarra note the following regarding the dynamics of financing in administration:

> Typically, new funding in administrations is provided by the existing floating charge holder, who has no need to vary its existing security, and any assets not covered by

54. For the strict interpretation of the subjective criteria 'influenced by a desire to prefer' under Insolvency Act 1986, Section 239, refer *Re MC Bacon Ltd* [1990] BCC 78.

55. In addition to the requirement as to the relevant time itself, where the security taker is not connected with the debtor, the debtor must already have been insolvent or become insolvent as a result of the transaction for the floating charge to become subject to transaction avoidance.

56. *Re Destone Fabrics Ltd* [1941] Ch 319 (per Simonds J): 'It is also quite clear, I think, that, so far as he was concerned, the transaction was a mere subterfuge, and, to use the words of an authority to which I shall refer, that the company was a mere conduit pipe through which a sum was paid, part of which was paid out afterwards to him.' On this issue, refer also to Armour and Bennett, aforementioned Note 10, 201; Goode, aforementioned Note 52, 604.

57. Refer to Rolef de Weijs *et al.*, 'Financing in distress against security from an English, German and Dutch perspective: a walk in the park or in a minefield?' (2012/3) *International Insolvency Law Review* 21.

58. Furthermore, English law has no rules on automatic subordination of shareholder loans nor on secured shareholder loans notwithstanding passionate pleas in favour thereof by the Cork Committee (Review Committee on Insolvency Law and Practice). Under English law, rescue finance can therefore be granted on a secured basis by the shareholders themselves.

59. Refer to Sir K. Cork (Chairman), *Insolvency Law and Practice. Report of the Review Committee* (HMSO, 1982), 435.

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the floating charge will already be subject to fixed charges. In practice in the UK, if the business is judged to be viable, additional funding will generally be provided by existing creditors on a consensual basis or by using a scheme of arrangement, without the need for specific legislation. The absence of particular protection for interim financing arrangements enables creditors to signal, via their willingness to continue to support the company, that the company is judged to have value as a going concern.[60]

B. Germany

German law also has no clear provisions on interim financing or more general rescue financing.[61] Lenders providing financing to ward of formal insolvency face considerably more scrutiny under German law than is the case under English law.[62] On a general level, this can be explained by the fact that German law on transaction avoidance is centred around the question whether the joint creditors have been prejudiced and not on the question of whether the lender has gained an unfair advantage.[63]

The main provision that is threatening rescue finance is the general provision in Section 133 of the German Insolvency Code (*Insolvenzordnung*, 'InsO'), commonly referred to as intentional prejudice (*vorsätzliche Benachteiligung*).[64] This provision provides for the avoidance of those acts conducted by the debtor with the intent (*Vorsatz*) to prejudice its creditors while the counterparty knew thereof. Here, conditional intent (*dolus eventualis*) on the side of the debtor suffices, thereby lowering the bar for an administrator considerably. The counterparty in turn must have had knowledge of this 'diluted' intent.

In general, to stay away from avoidability if financing a rescue attempt with new money against new security, it is required that there is a solid and reliable reorganisation plan, the goal of which must be saving the company. If such a plan

60. Payne and Sarra, aforementioned Note 4, 5.

61. There are two procedures which bear traits of preventive restructuring procedures, being the provisional self-administration in InsO, Section 270a (*Eigenverwaltung*) and the protective shield procedure in InsO, Section 270b (*Schutzschirmverfahren*). In both procedures, the debtor can conduct legal acts which will qualify as claims against the estate, albeit only with permission of the court. These procedures have, however, not developed into the kind of procedure envisioned by the Draft Directive. On this, refer to Stephan Madaus, 'Zustand und Perspektiven der Eigenverwaltung in Deutschland (Shortcomings in the Current German Insolvency Law on Debtor-in Possession Proceedings)' (2014), available at:<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2648860>. The most relevant for the analyses at hand is the fact that the courts have held the normal rules on transaction avoidance to apply also to legal acts conducted by the debtor subject to the procedures in InsO, Sections 270a or 270b. Refer to Bundesgerichtshof 16 June 2016, *ZIP* 2016, 1295; OLG Dresden 18 June 2015, *ZIP* 2014, 1294; 'Das Insolvenzanfechtungsrecht nach §§ 129 ff. InsO is auch auf Rechtshandlungen im vorläufigen Eigenverwaltungs- und Schutzschirmverfahren anwendbar.' The procedures of InsO, Sections 270a and 270b, have not developed into a kind of safe harbour for interim financing against security of restructurings.

62. For a detailed overview of the working of the German provisions, refer to Reinhard Bork, *Rescuing Companies in England and Germany* (Oxford University Press, 2012), paragraph 11.22 *et seq*.; de Weijs *et al*., aforementioned Note 57, 21–44.

63. Refer to InsO, Section 129 as the central provision providing for the avoidability of acts prejudicing (in German *benachteiligen*) creditors in accordance with InsO, Sections 130–147.

64. This presumes that there is a direct temporal and factual connection between the new credit and the security rights granted, making it more difficult for the administrator to intervene. In case there is a delay between the granting of credit and the creation of security rights, other provisions come into play, most notably the German provisions on preference law to be found in InsO, Sections 130–131, which provide more possibilities to reverse transactions.

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exists, there is an indication that the debtor has no intention to prejudice its creditors. It is not required that the plan succeeds. It is however required that the restructuring plan seemed, on the basis of specific identified grounds, to be executable and to provide a solution.[65] A positive outcome under the restructuring plan has to be rather likely from an *ex ante* perspective. Typically, such a restructuring plan will be approved by an auditor.[66]

In case the bank is granted a security right for both old and new credit, the validity of the security right is tested against different provisions.[67] If the restructuring attempt fails within 3 months, the creation of the security right for the old credit will usually be qualified as an incongruent performance and can be subject to avoidance on the basis Section 131 of the InsO. The provisions of Section 131 of the InsO are very strict, and this is why such a transaction is regularly subject of avoidance actions. Additionally, if the bank is granted a security right for both old and new credit and the reorganisation fails after more than 3 months, the bank stands great risks of losing its security rights under Section 133 of the InsO. To the extent that the security right secures new credit and its creation passes the test of Section 133 of the InsO as set out earlier, the security right will be upheld. However, if the parties make no such clear distinction, there is a high risk that an office

65. Refer to Bork, aforementioned Note 62, 234–235. Refer to Godehard Kayser, *Münchener Kommentar zur Insolvenzordnung*, 2013, no. 37: 'Reicht, wie für § 133 Abs. 1, eine bloß mittelbare Gläubigerbenachteiligung aus, kann ein ernsthaftes, wenngleich letztlich erfolgloses Sanierungsbemühen im Einzelfall – nicht generell– den Gläubigerbenachteiligungsvorsatz mit Bezug auf die zu diesem Zweck erbrachten Schuldnerleistungen ausschließen. Das gilt auch für das Grundkonzept vor einer Unternehmensgründung. Der Vorsatz kann nach der Lebenserfahrung (…) insbesondere fehlen, wenn der Sanierungsversuch für den Schuldner zwar erkennbar mit Risiken belastet ist, die Bemühungen um eine Rettung des Unternehmens jedoch ganz im Vordergrund stehen und auf Grund konkret benennbarer Umstände eine positive Prognose nachvollziehbar und vertretbar erscheint.' Refer also to BGH 12 May 2016, *ZIP* 2016, 1235 for a similar test for congruent preferences and the extent to which a creditor receiving payment in a manner and at a time as was due can rely on a reorganisation plan to negate knowledge of intent.

66. InsO, Section 142, provides additional rules on 'contemporaneous exchange of value' (*Bargeschäfte*) and was modified in April 2017. It now provides that in cases of contemporaneous exchange of value, legal acts are only subject to transaction avoidance in case the debtor acted in bad faith and the counterparty knew thereof ('*der andere Teil erkannt hat, dass der Schuldner unlauter handelte*'). The background of this provision offering more protection to counterparties providing new value is to be found in the desire to protect suppliers receiving payment as was due and protecting employees. Refer on the background of these amended provision, Christoph Thole, 'Das Reformgesetz zur Insolvenzanfechtung' *ZIP* 2017, 401; 'Die Reglung des § 142 InsO wird durch das Reformgesetz ergänzt, um einerseits kongruente Deckungen weitergehend vor der Vorsatzanfechtung zu schützen und andererseits die Anfechtung von Arbeitsnehmerlöhnen zu erschweren.' It is subject to debate whether courts will actually also use this reasoning to provide more leniency to banks financing rescue attempts and whether courts will thereby deviate from the steady line of cases as developed thus far. Although rescue finance (*Sanierungsversuche*) could well be brought under the letter of InsO, Section 142, it is rather unlikely that courts will do so. Case law has been very well developed and in the explanatory notes to the new section InsO, Section 142, there is no mention of any desire to alter these cases as well. Rather, the reverse is the case. The German legislature almost explicitly excludes credit facilities from the new rules in InsO, Section 142. As to its scope, it provides that there should be a contemporaneous exchange of value and therefore not a *de facto* extension of credit. Refer to Regierungsentwurf 18/7054: "Bereits bei Schaffung der Insolvenzordnung hatte der Gesetzgeber ausgeführt, dass das Erfordernis der 'Unmittelbarkeit' zwar voraussetze, dass zwischen Leistung und Gegenleistung ein enger zeitlicher Zusammenhang bestehe. Der Annahme eines Bargeschäfts stehe aber nicht entgegen, dass zwischen Leistung und Gegenleistung eine gewisse Zeitspanne liege. Die Zeitspanne dürfe nur nicht so lang sein, dass das Rechtsgeschäft unter Berücksichtigung der üblichen Zahlungsbräuche den Charakter eines Kreditgeschäfts annehme (…)."

67. InsO, Section 142, would thus not apply since there is no longer a 'contemporaneous exchange of value'.

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holder may set aside the security right in full. Cross-collateralisation is therefore not so much banned in Germany but does create very significant risks, also spilling over to the security rights financing new credit.[68]

Furthermore, German law has strict rules on shareholder loans. Basically, all loans granted by a shareholder are subordinated,[69] except if the shareholder has less than 10% of the shares and is not involved in the management of the company. These rules also apply to new rescue finance by shareholder in the form of loans.[70] In addition, security rights granted to secure shareholder loans cannot be invoked.[71] Under German law, it is also well recognised that in the period leading up to the declaration of insolvency, directors might be tempted to repay shareholder loans or those loans which have been guaranteed by shareholders. German law basically provides that all repayments of shareholder loans in the year prior to the request to open insolvency procedures are subject to transaction avoidance.[72] In addition, all repayments by the company of loans guaranteed by the shareholders can also be recouped from the *shareholders* directly, regardless of any subjective criterion having been met.[73]

There is no clear line of cases under German law on conduit pipe cases and whether a trustee can also turn to a bank that provided liquidity against security as well. Because banks should already be careful in granting new money for new security, it can only be expected that if a bank would somehow realise that the money lend would not really benefit the company but be used to pay off loans guaranteed by shareholders, that there would be very great risks for transaction avoidance in relation to the bank as well. Banks will therefore typically not finance conduit pipe cases.

The rather detailed German rules can be summarised as follows. Under German law, rescue finance in its purest form is protected, provided that there was a reasonable plan of which a positive outcome must have been rather likely. If, however, the rescue finance is also used as an occasion to grant security rights for old credit, there are significant risks at least for the security rights securing old credit and possibly spilling over to the new credit as well. If the rescue finance has been granted by shareholder in the form of loans, such loans are subordinated, and security rights for such loans cannot be invoked. Furthermore, in case all or part of the new money is siphoned away, this can easily be reclaimed if this has led to repayments of shareholders or a reduction of shareholder exposure. Banks that would finance such an attempt will themselves also be at risk of losing their security rights.

No real market[74] for offensive interim financing has developed in this respect, and rescue finance is mostly defensive rescue finance. Or in the words of Schultze

68. Refer to de Weijs *et al.*, aforementioned Note 57.
69. InsO, Section 39 I No. 5.
70. There is an exception in InsO, Section 39, in the case where the shareholder acquired the shares as part of a previous debt for equity swap conduct to rescue the company.
71. InsO, Section 135 I No. 1.
72. InsO, Section 135 I No. 2.
73. InsO, Sections 135 II and 143 III.
74. There is another element that can explain the German current position and that is the possibility to obtain a form of emergency liquidity basically prefinanced out of the money to be paid to employees under the insolvency wage insurance (*Insolvenzgeld*). This insurance can already be used inside an insolvency procedure to pay employees. The burden of paying employees is thereby lifted from the office holder which reduces liquidity losses considerably. Refer to Bork, aforementioned Note 64, 153.

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and Braun on the financing of the administrator inside a formal insolvency procedure:

> Under insolvency, DIP financing is often provided by German banks which already have exposure to the debtor. Banks are often prepared to finance the administrator, because they do not want to risk the administrator closing down the business. Unlike in the US there are no German banks specialising in DIP financing. German banks consider DIP financing more as a necessary evil than a form of business they are willing to promote.[75]

C. The Netherlands

The Dutch legislature has been working on its own bill for a preventive restructuring framework. It initially presented a draft bill entitled Continuity of Enterprise Act II in 2014 and thereby well prior to the Draft Directive.[76] Most notably missing from this first bill was the Absolute Priority Rule, thereby failing to offer sufficient protection to creditors against shareholders. After the publication of the current draft, EU Draft Directive in November 2016, the Dutch legislature redrafted its original bill and relaunched it for consultation in September 2017, also under a slightly different name. Now, the bill is entitled 'Act on the confirmation of a private restructuring plan in order to prevent bankruptcy'[77] (or in Dutch Wet Homologatie Onderhands Akkoord, better known by its acronym WHOA).

Both the 2014 and 2017 versions of the Dutch proposals for preventive restructuring procedures also contain rules which seek to create some kind of safe harbours for rescue financing. Thus far, such rules do not exist under Dutch law. In the Netherlands, as is the case in Germany, banks providing new rescue finance against new security find themselves under considerable scrutiny, especially when compared with English law. Dutch law, however, can be described as unbalanced in this respect. Dutch law has manoeuvred itself into a position where banks by and large have complete freedom to receive payments and security rights for old credit, while at the same time, new rescue financing is put under significant scrutiny. Dutch law on transaction avoidance makes it much easier for old creditors to take something out of the company than for new creditors to make an approach towards the company. Of course, this is not conducive to a restructuring-friendly climate. The problematic nature of such an approach becomes all the clearer if one

75. Schultz and Braun, *German Insolvency Law in a Nutshell*, available at: <https://www.schubra.de/downloads/broschueren/0027_en.pdf>.
76. Continuity of Enterprise Act I (Wet Continuiteit Ondernemingen I) (Consultation Document, August 2014).
77. For an unofficial English translation, refer to<http://www.resor.nl/eventbanner/RESOR_Amendment_to_the_Bankruptcy_Act.pdf>.

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views the prevention of a too early dismemberment of a viable company[78] as one of the policy goals of transaction avoidance, which goal ideally would coincide with the goal of restructuring and rescue itself.

The background of this unbalanced approach is to be found in the overall structure of Dutch law on transaction avoidance. In as far as banks receive payment or security rights for old credit, this constitutes a preference which is to be reviewed under Section 47 of the Insolvency Act (Faillissementswet, 'Fw') in as far as the act qualifies as an obligatory legal act. In short, obligatory legal acts are those payments of, or creations of a security right for, an existing debt in a manner and at a time as was agreed previously. Preferences qualifying as obligatory legal acts are mostly not susceptible to transaction avoidance outside related parties. To be able to successfully invoke Section 47 of the Fw, the trustee has to prove either that (i) the parties colluded or (ii) that the creditor already knew of a pending request to open insolvency proceedings. The trustee can, however, be successful, also in case of obligatory legal acts, if the creditor is a connected party[79] or if the bank has pressured a debtor into making payments or granting new security rights by already invoking personal guarantees of directors or shareholders for any remaining shortfall of the bank.[80]

The granting of a security right for old debts is very difficult to reverse, provided the granting is structured properly, most notably that the bank invokes a positive pledge clause. As to new credit against new security rights, the analysis as to the avoidability under Dutch law very much resembles the one under German law discussed earlier. The dealings are then reviewed under Section 42 of the Fw, and it is sufficient for reversing the security rights that both the debtor and the financer knew that the creditors would be prejudiced. This is held to be the case if

> at the time the act is performed the opening of the insolvency procedure and a deficit in the insolvency procedure were foreseeable with a reasonable amount of probability for both the debtor and its counterparty.[81]

78. On encouraging workouts as a policy goal of transaction avoidance, refer to International Monetary Fund, *Orderly & Effective Insolvency Procedures: Key Issues* (IMF, 1999), 25: 'In addition, strong avoidance rules may, in some cases, assist the debtor in its out-of-court negotiations since it creates a disincentive for a single creditor to take legal action to obtain an advantage, thereby facilitating collective creditor action.' Refer to, in similar terms, the UNCITRAL Legislative Guide on Insolvency Law, 136: 'Transactions are typically made avoidable in insolvency (…) in some States, to create a framework for encouraging out-of court settlement-creditors will know that last-minute transactions or seizures of assets can be set aside and therefore will be more likely to work with debtors to arrive at workable settlements without court intervention.' On the development of this policy goal, refer to Andrew Keay, 'The Harmonisation of the Avoidance Rules in European Union Insolvencies' (2017) 66 *ICLQ* 5.

79. Supreme Court, 7 March 2003, *JOR* 2003/102 (*Cikam/Siemon q.q.*).

80. District Court Utrecht, 6 June 2007, *JOR* 2008/19 with case note by Faber (*Aerts q.q./Rabobank and FGH*). This has not yet developed into a clear line of cases. Trustees by and large do not sufficiently include the analyses *why* a debtor creates security rights for banks well after the point in time at which liquidation has become inevitable.

81. Supreme Court, 22 December 2009, *NJ* 2010, 273 (*Van Dooren q.q./ABN Amro III*). On this case and the scope it should have, refer to Robbert van der Weijden, 'Wetenschap van benadeling in de zin van section 42 Fw en de voorzienbaarheid van het faillissement van de schuldenaar' *MvV* 2017/10, 285; Niels Pannevis, 'Een rationale benadering van kansen en uitkomsten bij reddingspogingen' *TvI* 2017/37.

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From case law, it follows that banks have to actively inform themselves of the viability of a rescue plan. Banks financing debtors in distress are under an obligation to make an assessment of the financial data in order to establish whether or not an insolvency procedure was foreseeable with a reasonable amount of probability. Furthermore, if the bank combines old and new credit and has secured both old and new credit by a single security right, the bank risks being faced with a presumption of proof of the required knowledge as to the full security right.[82] Cross-collateralisation is therefore not banned in the Netherlands but does create very significant risks, also spilling over to the security rights granted for new credit.[83]

Current Dutch law is thereby rather restrictive as to new rescue financing by banks. This restrictive approach is not duplicated in as far as shareholders are concerned. In contrast to German law, Dutch law has no automatic subordination of shareholder loans nor a ban *per se* on security rights for shareholder loans, although there is some lower case law subordinating shareholder loans.[84] Insofar, as a debtor would attract new external finance in order to pay off debts as to which the shareholder has a kind of exposure to (conduit pipe cases), this would fall well within the scope of transaction avoidance. The Supreme Court has held that prejudice to creditors does not need to be direct but can also be indirect. It has also held that creditors can be prejudiced by a sale at an arm's length price if the money is paid into a bank account with a deficit, as a result of which the value is no longer available to creditors.[85] As an extension of this, conduit-pipe financing can be addressed rather easily under transaction avoidance, also targeting banks that have lent money on a secured basis.

The legislature has been and still is struggling with how to approach rescue finance. In its first version in 2014 of Continuity of Enterprise Act II, it basically created a time period without any checks and balances, by simply providing that security rights created while the debtor was preparing a reorganisation plan that would not be subject to transaction avoidance. It did not seek to distinguish between security for old or new credit nor did it limit this transaction avoidance free period to new credit. It simply provided that the granting of a security right for claims arising between offering a plan and the voting on a plan could not be reversed. This approach of providing a safe harbour for all types of rescue finance simply because parties qualify it as such very much resembles the current approach in the Draft Directive. In the more recent 2017 WHOA proposal, the scope of protection is significantly more limited. The Dutch Professor Verstijlen agrees with a narrower scope of protection. He writes 'that finance transactions are too diverse in nature to allow for a general amnesty, even if such amnesty would be limited

82. Supreme Court, 22 December 2009, *NJ* 2010, 273 (*Van Dooren q.q./ABN Amro III*).

83. It has therefore been suggested that two separate security rights be granted, the first as an obligatory legal act for old debts on the basis of a positive pledge clause and a second as a right for the new credit. This would significantly improve the position of the bank because the presumption of proof would no longer apply, as it applies to voluntary granting of security rights for non-due old debts. Refer to Ilan Spinath, 'ABN Amro/Van Dooren – (nog) geen happy end' *Insolad Jaarboek 2010* 143, 144.

84. Refer to District Court Breda, 7 July 2010, *JOR* 2010/93 (*Louwerier q.q./Oude Grote Bevelsborg q.q*).

85. Supreme Court, 22 May 1992, *NJ* 1992, 526 (*Montana I*).

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to new money.'[86] He mentions the granting of new money against security with the explicit condition that the money would be used to pay off old unsecured debt to the lender or third parties as a possible legal act that should not go unchecked.

The current WHOA bill provides the following as a new Section 42a:

> Where the debtor, prior to the bankruptcy order, has created a right of pledge or mortgage as security for obligations under a new loan that was extended to the debtor for the purpose of enabling payments to be made that were reasonably necessary for the continuation of the enterprise during an effort to implement a restructuring plan as referred to in section 370, in the absence of proof to the contrary, it is presumed that there was no prejudice to creditors nor knowledge thereof within the meaning of section 42.[87]

The scope of protection offered to rescue finance in the draft WHOA (2017) is now explicitly limited to new finance. In addition, the new finance must have been extended in order to enable payments that were reasonably necessary. One can see here that the scope of the transactions covered is narrowed down significantly. The actual protection granted is illusory, however. The provision only provides that there is a presumption that there is no prejudice or knowledge. Lacking any statutory presumption the other way, this is already the default rule.[88] It is likely that the legislative proposals wanted to go one step further and provide that security rights for new money necessary and also used for the continuation of the enterprise would be exempt from transaction avoidance all together.[89] If this is intended, one could already see that the protection offered would not be complete but rather would be limited to new finance actually needed and also used for the continuation of the enterprise.

VII. Assessment of the Draft Directive and Interim Financing

In order to assess the Draft Directive as far as interim financing is concerned, two main questions need to be answered. The first question is to what extent the Draft Directive strikes the right balance between creditors' protection on the one hand and facilitating worthwhile rescue attempts on the other. The second question is whether the Draft Directive should actually go as far as harmonising rules on interim financing.

A. Comparison of the Draft Directive in relation to other systems

The Draft Directive is very lenient in its approach towards interim financing, especially when compared with US, German and Dutch laws. Only fraud and

86. Frank Verstijlen, 'Flankerende voorzieningen in de Wet Homologatie onderhands akkoord ter voorkoming van faillissement', in *Preadviezen van de Vereniging Handelsrecht* (Uitgeverij Paris, 2017), 137.
87. WHOA, Section 42a.
88. For a similar criticism, refer to Verstijlen, aforementioned Note 86, 119.
89. Refer also to the draft explanatory notes as to the new WHOA, Section 42a, where the following is provided (translated): 'Avoidance in a subsequent insolvency procedure will still be possible, but the trustee will have to prove that (i) the money lend has not been used for payments necessary in relation to continuation of the business with the aim of realising a plan, which resulted in the prejudice of creditors and (ii) the lender knew or should have known hereof and could have foreseen that an insolvency procedure with a deficit would be a result hereof.'

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transactions conducted in bad faith are targeted. In doing so, the Draft Directive does not match the underlying premises from the preamble to the same Draft Directive. Where the preamble seeks to grant protection to only those cases of interim financing that are reasonably and immediately necessary for the continued operation or survival of the debtor's business,[90] the text of Article 16 of the Draft Directive goes much further and provides a free pass for all transactions in the absence of fraud and bad faith. Verstijlen already noted that that finance transactions are too diverse in nature to allow for a general amnesty, even if such amnesty would be limited to new money.[91] The Draft Directive does not fare well in curbing risks of opportunism related to interim financing identified earlier in Section II. The risks of opportunism identified from the debtor's side are (i) gambling with other people's money and (ii) conduit pipe finance. The risks identified from the lender's side are (iii) cross-collateralisation, (iv) seeking waivers and (iv) loan-to-own strategies as part of the lending decision.

Both German and Dutch laws place responsibility on the lender regarding the risk of debtor abuse and the problem of gambling with other people's money. This provides incentives to banks not to finance ill-founded rescue attempts by solely looking at the value of available collateral. Both German and Dutch laws require banks to inform themselves about the strength of the rescue plan. Under US law, the court is also under the obligation to assess that the

> transaction is on fair and reasonable terms, that it is likely to further the interests of the estate and that it will not impose an unjustifiable burden or risk on parties in interest.

English law, on the other hand, does not provide many checks and balances, because it basically does not view new finance against new security as a problem of transaction avoidance. Checks or a basic viability assessment by the interim lender are also not required under the proposed Draft Directive. Thus, the Draft Directive does not address the problem of gambling with other people's money, because protection is limited to cases of fraud or bad faith. It does not put any limitation on the debtor being overly optimistic, even if this unfounded optimism is fuelled by shareholders that are otherwise out of the money.

The risk of attracting new finance as secured debt in order to reduce the exposure of management and/or shareholders (conduit pipe finance) is clearly recognised and addressed under English law. It can also be curtailed under German and Dutch laws if the lender was aware that money would be siphoned away and also under US law if recognised in a timely manner. Again, the Draft Directive will fall short of protecting creditors, especially if the finance is attracted for the purposes of both trying to save the company, while at the same time, reducing the exposure of management and/or shareholders if the rescue attempt fails.

The risk of lender's opportunism in the context of cross-collateralisation is addressed in the different legal systems but not under the Draft Directive. Under the English law, floating charges granted in the period leading up to insolvency

90. Draft Directive, Preamble Recital 31.

91. Verstijlen, aforementioned Note 86, 137.

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are only upheld *to the extent* that new money flows to the company. German and Dutch laws create significant risks for defensive interim lenders that are granting new finance in order to have old debts secured as well. US law is also restrictive regarding cross-collateralisation.

The problem of seeking waivers is a problem related to DIP financing and financing if the debtor is in formal insolvency. Because the debtor will presumably not be able to grant a waiver if the procedure is a preventive procedure as envisioned by the Draft Directive, the problem should not arise in the context of a preventive restructuring framework.

Another risk of opportunistic use by the lender is the risk of a loan-to-own strategy. This risk resembles opportunistic use by an overly optimistic debtor, also referred to as gambling with other people's money discussed earlier. In the case of debtor abuse, the main problem is an overly optimistic debtor not sufficiently kept in check by secured lenders because they might not sufficiently recognise the default risk. In the case of loan-to-own, the lender is actually anticipating and hoping that the debtor will fail. The practice of loan-to-own is only a recent phenomenon and has not been tested under the different provisions on transaction avoidance under German and Dutch and English insolvency laws. A case of opportunistic interim financing as part of a loan-to-own strategy could, however, be reviewed under German and Dutch transaction avoidance, because insulating transactions from transaction avoidance require a sensible rescue plan and a viability assessment thereof by the banks. Under the Draft Directive, aggressive loan-to-own strategies by offensive lenders would largely go unchecked because it would be difficult to argue that there has been fraud or bad faith in arm's length negotiations.

The current position of the Draft Directive is untenable due to its lack of checks and balances. In addition, the question has already been raised in Section V.B earlier of whether the envisioned insolvency-light preventive regime really needs to pave the way for interim financing as well. If the problem is an overleveraged company and this is recognised in a timely fashion, the company should be able to pay the running expenses out of the income of the company. It would suffice to have a collective enforcement stay, especially for aggressive financial creditors, during which period parties can work towards a plan and a solution.

There is one more conceptual flaw in the current approach or at least an element which should bring considerable unease. If the problem of the company is primarily financial in nature, namely, the problem of being overleveraged, it should be recognised that leveraged finance and its related risks are risks that are well understood and priced in by financial creditors. If the risks of a drop in income or an increase in interest payments materialises, it makes little sense to afford the financial creditors and the company with a time slot in which their dealings are not tested against general rules on creditor protection. Not only does this make little sense in a specific case, this can also be deemed undesirable at a more general level. If professional lenders grant loans knowing that if risks materialise, they have very significant freedom to renegotiate and restructure without the limitations of transaction avoidance; this not only provides an incentive for interim financing

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but also, at the same time, provides a further incentive for granting risky loans in the first place. The cure the Draft Directive seeks to provide in facilitating restructuring attempts and interim financing is likely to fuel the underlying problem of granting risky loans which end up being non-performing loans.

B. Should interim financing form part of the preventive restructuring framework at all?

There are several grounds on which the current draft as it relates to interim financing can be criticised, most notably inadequate protection of creditors against opportunistic behaviour, the lack of demonstrating the need for such a rule as part of a preventive restructuring framework and the undesirable effect of rewarding the parties that have been the architects of the overleveraged capital structure with a transaction avoidance free period. The question is, therefore, how to proceed from here. There are basically three possibilities if one accepts that the current proposal is untenable and one does not want to delay the implementation of the Draft Directive until substantive European law on transaction avoidance itself can be harmonised. The first approach would be to strengthen the governance model by introducing a Chapter 11-like court involvement. The second is to simply take out the rules on interim financing. The third is to provide some very limited rules on specific types of financing deemed desirable.

The approach of introducing court involvement has been advocated by Payne (UK) and Sarra (Canada) and also seems to be supported by Verstijlen (the Netherlands).[92] Payne and Sarra reach the conclusion that the current provisions are potentially of significant benefit to the debtors and the new lenders of finance but contain too much potential for abuse of existing creditors. Based on their comparative analyses of English, Canadian and US laws, they suggest strengthening the governance model of Article 16 of the Draft Directive by introducing a US-style notification requirement combined with court involvement *ex ante*. In their assessment of the Draft Directive, they write:

> The Commission's proposals are inspired by Chapter 11's substantive rules, but not its costs. However, one lesson evident from the experience in the US and Canada is the central importance of the court in balancing the various competing interests where interim and new financing is provided, and particularly where existing creditors' claims are overridden in favour of creditors that provide rescue finance.[93]

Involving the court *ex ante* could indeed take away many concerns. Full court involvement would, however, move the Draft Directive even closer to a full insolvency procedure. If the aim is to let the Draft Directive become the European equivalent of Chapter 11, it should also take this last step forward and introduce adequate governance with court involvement. If the Draft Directive, however, wants to remain true to its modest ambitions of providing a preventive restructuring framework, it should simply take a step back. The essence of the Draft Directive is to be found in facilitating plans under which overleveraged

92. Verstijlen, aforementioned Note 86, 121.

93. Payne and Sarra, aforementioned Note 4, 35.

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companies can restructure by overcoming holdout behaviour. The essence is by no means to be found in the problem of interim financing.[94]

If, however, the European Commission wants to include some protection for interim financing, it should also be modest in this respect. It should not seek to disapply many functioning rules. It should really target the kind of financing that can be considered the most desirable and the least intrusive. That is simply the basic case of lending new money against new security for money that is both necessary and used to continue operations. The member states could still, if so desired, grant additional protection, which would be in line with the Draft Directive providing for minimum harmonisation.[95]

VIII. Conclusion

The Draft Directive on Preventive Restructuring Frameworks provides for the possibility of reorganising the capital structure outside of a formal insolvency procedure. It does so by means of a light-touch procedure with as little court involvement as possible. The Draft Directive also contains rules on interim financing. It provides that member states should facilitate interim financing and protect it from transaction avoidance. If a distressed debtor attracts rescue finance and grants security rights in return, these should only be subject to reversal in case of fraud or bad faith according to the Draft Directive. The Draft Directive thereby does not so much harmonise the rules on transaction avoidance but simply disapplies them in the context of interim financing.

The current position of the Draft Directive should be considered as untenable. First of all, the Draft Directive offers too little protection against abuse and opportunistic use of interim financing by both debtor and interim lender. In this respect, the text of the provisions in the Draft Directive is far more facilitative than its preamble, because the preamble limits the need for protection to finance that is reasonably and immediately necessary for the continued operation or survival of the debtor's business. Furthermore, the Draft Directive itself is insufficiently clear as to what kind of problems it seeks to provide a solution for. If the problem is indeed the case of a financially overleveraged company with a sound business concept, the company should be able to pay for the running expenses necessary for its continued operation out of its income. Furthermore, the Draft Directive should not reward the architects of the overleveraged structure, being the company itself and the financial creditors, with a transaction avoidance free period.

Payne and Sarra have proposed introducing a system akin to Chapter 11 with a notification requirement and an *ex ante* check by the courts as a way out of the faulty governance framework. Such increased court involvement is, however, difficult to reconcile with the nature of a preventive restructuring framework. Another solution, more in line with the character of the Draft Directive, would be to simply

94. Tollenaar, aforementioned Note 3, 66, refers to the measures on interim financing as one of the 'flanking measures'.

95. Refer to Explanatory Memorandum, 16.

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take out the provisions on interim financing, and focus on the provisions on the reorganisation plan itself. If, however, there was any real need for a provision on protecting interim financing, it should be considerably more modest in scope. Instead of providing a carte blanche for all practices that do not involve fraud and bad faith, only the most basic case should be granted protection and that is the provision of new security against new money both necessary and used for the continuation of the business.

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