Resolving insolvency

New funding and business survival

- New funding provided to an insolvent company after the start of insolvency proceedings—known as post-commencement finance—can enable the business to continue operating during insolvency.
- The authorization of post-commencement finance and the treatment of the claims of post-commencement creditors are two important areas that need to be addressed in insolvency law. But half the 189 economies covered by *Doing Business* have no provisions in these areas.
- Clear and effective regulations on post-commencement finance may improve the availability and terms of new funding for viable firms undergoing insolvency proceedings—funding that can support their successful reorganization or enable their sale as a going concern in liquidation.
- Financially distressed businesses are more likely to pursue reorganization—and more likely to emerge from insolvency proceedings as a going concern—in economies that have provisions on post-commencement finance.
- Many economies are introducing provisions on post-commencement finance as part of an overall effort to strengthen mechanisms for business rescue.

When Kodak filed for bankruptcy in January 2012, few were surprised. The company had dominated the U.S. photographic film industry for decades, but technology in the form of digital photography and camera-equipped smartphones had advanced faster than its ability to adapt. Yet 20 months later Kodak emerged from a successful reorganization with a new business focus. In between, Kodak had received $950 million in new loans that were crucial for paying vendors and suppliers and running its day-to-day business operations while it underwent reorganization.[1]

As the Kodak example shows, businesses in financial distress may need new money to survive. Yet lending to companies that are finding it difficult to honor promises made to existing creditors hardly seems a profitable venture. A framework is needed that allows access to new funds for financially distressed but potentially viable businesses while ensuring a high probability of repayment. Creating such a framework can be a challenge.

When a company becomes insolvent—when it cannot pay its debts as they fall due—either the company itself or its creditors may start insolvency proceedings. In an efficient insolvency system these proceedings will result in the reorganization of the insolvent company if it is viable or in its liquidation if it is not. Continued operation of the debtor's business during the insolvency proceedings is imperative for successful reorganization. It can also be important in liquidation, where the goal is to maintain and maximize the value of the debtor's assets.[2] But to continue operating, the insolvent company will need access to additional funds.[3] It is unlikely to be able to rely on internal sources to finance its costs—including payments for the goods and services needed to continue the business. So the company may need to seek external funding (figure 11.1).

New funding provided to an insolvent company after the start of insolvency proceedings is known as post-commencement finance.[4] It can become necessary at different stages of insolvency proceedings—immediately after the application for insolvency, during the preparation and approval of a reorganization plan or before the sale of assets in a liquidation. Besides paying for goods and services essential to continued operation, new funds are often used to cover labor costs, insurance, rent and other expenses necessary to maintain the value of the assets.[5] But it is important that post-commencement finance mechanisms be used judiciously. To avoid restricting the availability of credit in regular commercial transactions, the use of post-commencement finance should be limited to supporting the reorganization of viable firms or enabling the sale of businesses as a going concern in liquidation—and only if new credit would lead to higher returns to existing stakeholders in the distressed business (box 11.1).

WHAT ARE SOME GOOD PRACTICES?

Insolvency law can create a predictable and enforceable framework for lending to companies in insolvency proceedings through provisions explicitly allowing

FIGURE 11.1 Post-commencement finance can be critical in helping a business go from insolvency to recovery

post-commencement borrowing and providing some assurance of payment. Without such provisions, lenders are unlikely to make new funds available on acceptable terms—or indeed on any terms at all.[6]

Several competing interests come into play: the insolvent debtor aims to continue its operations or maximize the value of its assets (or both); existing creditors want to have their rights recognized and preserved; and potential new creditors need assurance that they will be paid. These concerns can be addressed through provisions in two areas: explicit authorization of post-commencement finance and treatment of the claims of post-commencement creditors. Good practices in these areas have been recommended by a range of international institutions, including the United Nations Commission on International Trade Law, the World Bank, the International Monetary Fund and the Asian Development Bank.

As a first step, insolvency law needs to include clear provisions authorizing post-commencement finance as well as efficient mechanisms for obtaining such finance.[7] The law can grant the power to obtain new loans either to the debtor or to the insolvency representative managing the debtor's assets. The law can address the form of the new money—loans and other forms of finance from new or existing lenders. And to ensure that the power to take on new loans is used prudently, the law may require that the court or the creditors approve all new borrowing.[8]

In Serbia the law gives bankruptcy administrators the power to obtain new loans during insolvency proceedings.[9] In Finland a debtor can take on new debt without the approval of the insolvency representative as long as the debt is connected with the debtor's regular activities and the amount and terms are not unusual; all other loans require the approval of the insolvency representative.[10] In Japan debtors in reorganization

BOX 11.1 New funding comes to the rescue

Marvel Entertainment Group—the company behind the Avengers, Spider-Man and the Fantastic Four—went through a tumultuous time in the late 1990s. A failed investment strategy and shrinking comic book market had left the company reeling, and its main investors could not agree on the best way forward. Unable to resolve its problems out of court, Marvel filed for reorganization in 1996. The proposed reorganization plan included large infusions of equity and credit to finance a new strategic investment program. But the company needed immediate assistance to pay its suppliers and employees and to meet its operating and investment needs during reorganization. The court approved a $100 million loan from a bank group led by Chase Manhattan. This loan helped keep the company operating during the several months of negotiations that followed. Marvel proved that it was worth the investment: its latest film, *Avengers: Age of Ultron*, had pulled in more than $1 billion at the worldwide box office only 24 days after its release in May 2015.

Sources: Marvel Entertainment Group 1996; Lambie 2015; *Variety* 1997; Pedersen 2015.

proceedings can seek the permission of the court to borrow money.[11] In liquidation proceedings the power to request the court's approval rests with the bankruptcy trustee.[12]

Besides explicitly authorizing post-commencement finance, insolvency law needs to establish clear rules for ranking the claims of existing and post-commencement creditors.[13] Ranking rules determine which creditors get paid first, second or last from the proceeds received from the sale of the debtor's assets. The higher a creditor's ranking priority, the greater the likelihood that the creditor will be paid. So it is no surprise that the ranking priority that a debtor (or an insolvency representative acting for the debtor) can offer to potential creditors is among the central issues in the regulation of post-commencement finance.[14] At the same time, the rights and priorities of existing creditors, especially secured creditors, must be upheld to the extent possible. This ensures fairness and predictability, important aspects of any credit system.[15]

Achieving a balance between providing incentives to potential lenders and respecting the rights of existing creditors is not easy. Two main practices are generally recommended. First, the law needs to explicitly allow debtors to obtain new funding by pledging assets as collateral to secure the loans, as a way to provide assurance of payment. But the provision of this new security should not affect the priority of existing secured creditors without these creditors receiving alternative protection—or at least notice of the change and an opportunity to be heard. Second, the law needs to enable debtors to obtain new funding without security. For this unsecured post-commencement finance, the law needs to grant the claims of post-commencement creditors priority over those of existing unsecured creditors.[16] As a general rule, granting post-commencement finance "super-priority" over all existing claims (secured and unsecured) is not recommended, because this approach risks disrupting the extension of secured credit in regular commercial transactions.[17]

In South Africa new financing may be either unsecured or secured by any asset of the company that is not already subject to existing claims. Post-commencement finance receives preference over all unsecured claims against the company except those related to employment and to costs of bankruptcy proceedings.[18] In Serbia post-commencement finance is treated as an expense of the bankruptcy estate and is paid first before other claims, including claims of existing creditors. But it does not affect prior rights of secured creditors unless these creditors agree otherwise.[19] In Belgium the law gives debts arising during judicial reorganization priority over all other unsecured debt in the event of a subsequent liquidation.[20] The aim is to support continued operation of the debtor's business and the availability of credit for the debtor during the reorganization proceedings.

CHANCES OF BUSINESS SURVIVAL

Economies around the world have undertaken reforms aimed at improving their insolvency systems (box 11.2). The majority of those recorded by *Doing Business* in the past five years focused on introducing or strengthening reorganization mechanisms.[21] Providing an effective and efficient framework for saving viable businesses is at the heart of internationally established good practices in the area of insolvency.[22]

Empirical evidence on how insolvency reforms affect credit markets is clear—they lead to greater access to credit for firms, at lower cost.[23] Empirical evidence on how these reforms affect the chances of business survival is limited, however. Objective data on business rescue are difficult to establish, and elements contributing to successful results are difficult to isolate.[24] But one vital factor appears to be the availability of post-commencement finance.[25] Indeed, adequate interim financing to ensure the continued operation of distressed businesses has been identified as one of four critical components of turnaround success—along with competent management, a viable core operation and a motivated labor force.[26] Real-life examples support this conclusion (box

BOX 11.2 New provisions on post-commencement credit in Mexico

Mexico initiated an important financial reform in 2013 with the aim of increasing the availability of credit for businesses and encouraging economic growth. This effort culminated in the Financial Reform Act of 2014. Some of the changes targeted the country's Insolvency Law. Adopted in 2000, this law had been part of a series of measures aimed at modernizing Mexico's insolvency framework—which had been in place for more than half a century—and promoting business rescue in the wake of the 1994 peso crisis. But its effects fell short of expectations: by 2013 less than a thousand insolvency cases had been filed under the new law.[a]

It became apparent that if distressed businesses were to preserve their financial viability and the jobs they create, changes were needed to make insolvency proceedings more attractive to both debtors and creditors. Several new features were introduced. These include the possibility for a debtor to obtain new finance during reorganization proceedings, to enable continued operation of its business. The new credit would have priority over existing credit, both secured and unsecured.

a. De la Rosa 2014.

BOX 11.3 New funding can save companies with viable operations

Fruit of the Loom, a manufacturer of leisure clothing, was struggling in the late 1990s. The company filed for reorganization after suffering steep losses in 1999. This step allowed the company certain protections from creditors while it attempted to restructure the business. At the time, Fruit of the Loom was a Chicago-based company with operations in several countries and 40,000 employees. Although the company's U.S. branch was going through insolvency proceedings, its Canadian and European subsidiaries continued operating. So it was imperative that the company receive interim financing to fund operations. A $625 million loan led by Bank of America was key in ensuring a successful resolution. The company was purchased in 2001 by Warren Buffett's Berkshire Hathaway for $835 million in cash.

Sources: Gamble 2003; *Florida Times-Union* 1999; *Chicago Tribune* 2001.

11.3). Research also provides support, showing that constraints on external financing—arising as a result of events such as a financial crisis—impede successful restructuring.[27]

Every year the *Doing Business* team collects data on the efficiency of insolvency proceedings in economies around the world. One aspect captured by the data is the type of proceeding that a distressed business is most likely to encounter in each economy. Another is the likelihood that a distressed but potentially viable business can survive insolvency and continue operating as a going concern. The data are collected through questionnaires that ask insolvency experts in each economy to estimate the most likely type of insolvency proceeding and the most likely outcome of such proceeding based on specific assumptions about the debtor and the creditors. Starting with last year's report, the team has also collected data on certain aspects of insolvency laws and regulations in each economy, including the availability and priority of post-commencement finance. The data are collected through readings of the law and through consultations with insolvency experts in each economy.[28]

The *Doing Business* data show possible connections between the existence of regulations on post-commencement finance and the likelihood of business survival. While these connections do not necessarily establish a causal relationship, they do show that business rescue is more likely in economies where the law provides for post-commencement finance. So it is possible that having a predictable and enforceable framework for post-commencement lending improves the availability and terms of new funding for viable businesses during insolvency proceedings, thus allowing such businesses to successfully reorganize and continue operating. This reasoning also applies to liquidation proceedings, where post-commencement finance can support the temporary continuation of a business to enable its sale as a going concern.

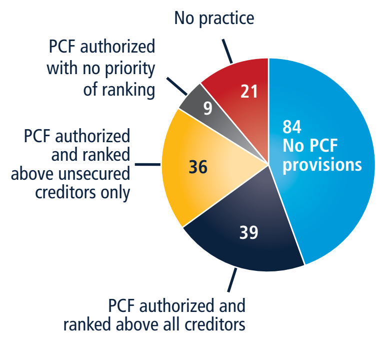
Of the 189 economies covered by *Doing Business*, 84 have explicit provisions authorizing post-commencement finance in their laws while 84 do not. (The other 21 economies have no recorded insolvency practice and are therefore excluded from the analysis.)[29] Of the 84 economies that have provisions authorizing post-commencement finance, only 9 have no special provisions on how the claims of post-commencement creditors should be ranked relative to existing claims. The other 75 economies establish priority in the applicable insolvency law: 36 rank the claims of post-commencement creditors above those of existing unsecured creditors only, and 39 rank such claims above those of all existing creditors (figure 11.2).

Provisions on post-commencement finance are often part of a larger mechanism of corporate reorganization. In Finland, for example, the Restructuring of Enterprises Act includes such provisions while the Bankruptcy Act is silent on this subject.[30] The reason is that the purpose of post-commencement finance is to encourage and facilitate the continued operation of a business during insolvency proceedings, which is particularly important in reorganization. More than 90% of economies that have provisions on post-commencement finance also have specific provisions on corporate reorganization as part of their insolvency law.

But the availability of a reorganization mechanism does not guarantee that it can or will be used in practice. The German Insolvency Code, for example, provides a mechanism for business rescue, yet only a small percentage of financially distressed businesses use this mechanism with successful results.[31] What role might be played by the existence of provisions on post-commencement finance? One way to look at this

FIGURE 11.2 Half the economies studied have no provisions on post-commencement finance

Economies by treatment of post-commencement finance

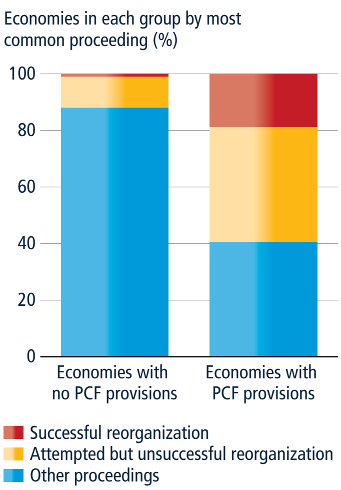


Source: Doing Business database.
Note: PCF = post-commencement finance.

question is to compare two sets of data collected by *Doing Business*: the data on which economies have provisions on post-commencement finance and the data on which insolvency proceeding is most common in each economy.

The results suggest that distressed businesses are more likely to pursue reorganization in economies that have provisions on post-commencement finance. Successful reorganization is the most common insolvency proceeding in 19% of these economies, while attempted but unsuccessful reorganization is the most common in 40% (figure 11.3). By contrast, among economies with no explicit provisions on post-commencement finance, attempted but unsuccessful reorganization is common in only 11%, and successful reorganization is unlikely (recorded in only one economy). The positive correlation between provisions on post-commencement finance and the likelihood of attempted or successful reorganization holds even after taking into account differences in the income level of economies.[32]

FIGURE 11.3 Distressed businesses are more likely to pursue reorganization in economies with post-commencement finance provisions

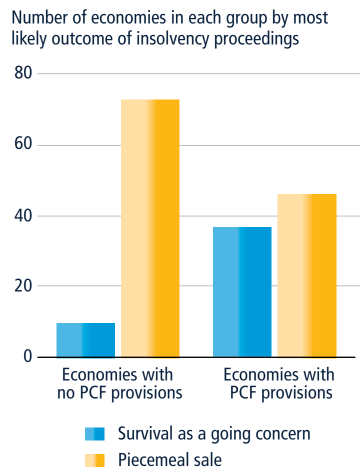


Source: Doing Business database.
Note: PCF = post-commencement finance. *Other proceedings* include liquidation, foreclosure and receivership.

Moreover, the *Doing Business* data show that survival of distressed businesses at the end of insolvency proceedings is more likely in economies with provisions on post-commencement finance. Survival as a going concern is the most common outcome of insolvency proceedings in only 47 of the 189 economies studied. This outcome can be a result of either reorganization proceedings or the sale of an existing business as a going concern to new owners at the end of liquidation or foreclosure proceedings.[33] Of the 47 economies where survival is the most common outcome, 37 have explicit provisions on post-commencement lending while the other 10 do not (figure 11.4).

The existence of post-commencement finance provisions does not guarantee business survival, however. In South Africa, for example, amendments to the Companies Act in 2011 included detailed rules on post-commencement finance and its priority.[34] Yet the most common outcome of insolvency proceedings in the country continues to be liquidation of the distressed business and its piecemeal sale. Indeed, the *Doing Business* data show that this is the most common outcome in the majority of economies with provisions on post-commencement finance. Survival of the business as a going concern is likely in only 44% of economies with such provisions. Even so, this represents a significantly higher probability of survival than in economies without provisions on post-commencement finance: survival as a going concern is the likely outcome of insolvency proceedings in only 12% of these economies. The positive correlation between post-commencement finance provisions and the outcome of proceedings holds even after taking into account differences in the income level of economies.[35]

FIGURE 11.4 Businesses are more likely to emerge from insolvency proceedings as a going concern in economies with post-commencement finance provisions



Source: Doing Business database.
Note: PCF = post-commencement finance.

CONCLUSION

Data collected by *Doing Business* show that well-structured provisions on post-commencement finance are important. By establishing predictable and enforceable rules on lending during insolvency proceedings, these provisions may encourage creditors to lend to viable businesses capable of reorganization—and to do so on better terms. They may also encourage creditors to provide the necessary bridge financing to enable the sale of businesses as a going concern in liquidation. When financially distressed businesses have legally sanctioned access to new funds, they may be more likely to attempt reorganization and to emerge from the process successfully. The data validate the emphasis put on the continuation of business operations during insolvency proceedings as a way to facilitate reorganization and to preserve and maximize the value of the debtor's assets.

These results also explain why a growing number of economies are amending their insolvency laws to include or improve provisions on post-commencement finance. One of these is Mexico, whose Financial Reform Act of 2014 introduced the possibility of requesting post-commencement finance during reorganization proceedings and gave the claims of post-commencement creditors priority over those of existing creditors. Similarly, in the past two years Cyprus, Jamaica, the Seychelles, and Trinidad and Tobago introduced provisions on post-commencement finance and its priority as part of an overall effort to strengthen and modernize mechanisms for business rescue.

Nevertheless, half the economies covered by *Doing Business* have no provisions on post-commencement finance. And even economies that do have such provisions often see little or no use of them in practice. *Doing Business* data show that focusing on post-commencement finance as part of the effort to facilitate and promote business rescue can lead to more attempts at reorganization and higher rates of business survival.

NOTES

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1. Kodak 2012.
2. UNCITRAL 2004a, p. 113.
3. Clift 2011.
4. Post-commencement finance as described in this case study differs from trade credit extended by vendors that continue to trade with a debtor during the insolvency process. The rules and priorities for trade credit often differ from those for post-commencement finance.
5. UNCITRAL 2004a, pp. 113-14, and World Bank 2011, principle C9.
6. See comment to global principle 31 in American Law Institute (2012).
7. UNCITRAL 2004a, p. 118.
8. UNCITRAL 2004a, pp. 113–15, 117–18.
9. Law on Bankruptcy (Law 104/09 of December 16, 2009), article 27(2).
10. Restructuring of Enterprises Act (Act 47/1993, as subsequently amended), section 29.
11. Civil Rehabilitation Act (Act 225 of December 22, 1999), article 41.
12. Bankruptcy Act (Act 75 of June 2, 2004), article 78(v).
13. See standard 5.6 in Asian Development Bank (2000, p. 35).
14. IMF, Legal Department 1999.
15. See principle C12 in World Bank (2011, pp. 18–19).
16. See recommendations 63–68 in UNCITRAL (2004a, pp. 113–19).
17. IMF, Legal Department 1999.
18. Companies Act 2008 (Act 71 of 2008), section 135.
19. Law on Bankruptcy (Law 104/09 of December 16, 2009), article 27.
20. Loi relative à la continuité des entreprises (law related to companies' continuation), article 37.
21. In the five years from 2009 to 2014, 60 economies implemented 87 reforms affecting the *Doing Business* indicators on resolving insolvency. Reforms in the area of corporate reorganization were the most common: 10 economies introduced a new reorganization proceeding, and 21 promoted reorganization or made improvements to their existing reorganization framework.
22. See, for example, World Bank (2011) and UNCITRAL (2004a).
23. Armour and others 2015.
24. Vriesendorp and Gramatikov 2010.
25. See comment to global principle 31 in American Law Institute (2012).
26. Bibeault 1982, p. 112.
27. Vriesendorp and Gramatikov 2010.
28. For a detailed description of the methodology for the resolving insolvency indicators, see the data notes.
29. For a definition of "no practice" economies as recorded by the resolving insolvency indicators, see the data notes.
30. Restructuring of Enterprises Act (Act 47/1993, as subsequently amended), sections 29, 32 and 34.
31. According to Germany's Federal Statistical Office, 24,085 businesses filed for insolvency in the country in 2014. *Doing Business* respondents estimate that less than a quarter of businesses filing for insolvency successfully undergo restructuring proceedings.
32. The correlation between the score that economies receive on explicit authorization of post-commencement finance and the most likely type of proceeding as measured by *Doing Business* is 0.49. The relationship is significant at the 1% level after controlling for income per capita.
33. For a detailed explanation of the methodology used to determine the outcome of insolvency proceedings, see the data notes.
34. Companies Act 2008 (Act 71 of 2008), section 135.
35. The correlation between the score that economies receive on explicit authorization of post-commencement finance and the outcome of insolvency proceedings as measured by *Doing Business* is 0.36. The relationship is significant at the 1% level after controlling for income per capita.