Debtor in Possession Financing in Asia - Considerations for Financial Institutions

At first blush, it may seem counterintuitive for financiers to compete to provide loans to debtor companies that have just filed for protection under an insolvency or restructuring procedure, but they have been proven to do so on a large scale in US Chapter 11 cases and for a variety of reasons, whether to protect an existing loan position or taking an opportunity to garner significant, safe returns as a new lender.

As Singapore continues efforts to position itself as a restructuring hub in Asia, its adoption of debtor-in-possession financing, commonly known as DIP financing, is likely to generate increased interest. The availability of such post-petition financing, and the granting of special relief to its providers in the form of super-priority status, among other things, can better position a debtor for a well-managed and thoughtful reorganization.

Recently, Singapore amended its Companies Act (the "**Act**") and introduced a rescue financing regime via section 211E of the Act. The new regime came into effect in May 2017 and the first judgment that discussed the legislation (*Re Attilan Group Ltd* [2017] SGHC 283) was issued on 8 November 2017. The Singapore regime is predominantly modelled on relevant provisions from the US Bankruptcy Code and it incorporates concepts of DIP financing that are a hallmark of Chapter 11 reorganizations.

Whilst similar, the provisions are not identical, which may beg the questions whether any differences are material and whether US jurisprudence will be prevalent or departed from. Further, will investors continue to prefer the certainty of US precedent in this area and favour Chapter 11 or will more proximate (and possibly more cost-effective) opportunities encourage a faster take-up of proceedings in Asia? Financial institutions will want to consider strategies to protect and/or enhance their positions as appropriate when DIP financing looms over their debtors.

A Brief Overview of Debtor in Possession Financing – US Perspective

DIP financing is common practice in the United States, particularly in Chapter 11 where a reorganization of the debtor's business or the orderly sale of its assets remains the goal. There, such financing is often provided by a debtor's pre-petition secured lenders (i.e., "defensive" lenders) who are willing to advance additional sums with a view to guarding against a decline in the value of their collateral and in the enterprise value of the business. These lenders are also granted considerable protections discussed further below and have the additional benefit of a new credit facility with tight covenants and timelines allowing them to retain a loud voice in restructuring negotiations. In certain instances, DIP financing may be provided by third parties that do not have a pre-petition relationship with the debtor. These "offensive" or "new money" lenders find that such financings are often only feasible where there exists sufficient unencumbered collateral, or where the pre-petition lender has a considerable equity-cushion in its collateral or otherwise consents to being "primed" (that is, where the debtor grants the DIP lender security that has priority over pre-bankruptcy secured creditors).

Section 364 of the US Bankruptcy Code largely governs a debtor's ability to obtain post-petition financing, in certain instances allowing the Bankruptcy Court to authorize the granting of a super-priority claim, senior to the claims of virtually all other creditors, assuring repayment in full in all but a few unsuccessful restructuring efforts.

To outline the different parts of Section 364 of the Bankruptcy Code:

- Section 364(a) provides that the debtor may obtain unsecured credit as an administrative expense in the ordinary course of business (administrative expenses have a higher priority than unsecured claims in liquidation and they must be fully paid in order to confirm a reorganization plan). Traditional DIP financing would not be incurred in the ordinary course of business and therefore not incurred under this section.
- Section 364(b) provides that the debtor may obtain unsecured credit as an administrative expense outside the ordinary course of business subject to court approval. Because debt incurred under this section is unsecured, it is necessarily junior to any valid pre-petition liens and not often relied on for DIP financing.
- Section 364(c) provides that the court can authorize debt secured by an interest in unencumbered assets or by an interest that is junior to an existing lien on encumbered property, but only if the debtor is unable to obtain unsecured credit as an administrative expense (which is often easy to establish). These liens do not "prime" any existing liens on the debtor's assets.
- Section 364(d) provides that the court may authorize a lien that is senior or equal to an existing lien, but only if the debtor is unable to obtain such credit otherwise and the debtor demonstrates that the subordinate (or equal) pre-petition interest is adequately protected.

A typical financing provided by an existing lender will be secured by (i) a first priority lien on unencumbered collateral pursuant to Section 364(c), (ii) a junior lien on collateral that might be subject to a lien senior to the lender (e.g., a mechanics' lien), and (iii) a senior lien on the lender's pre-petition collateral (the lender is consenting to the priming of its own collateral).

In order to attract lenders (existing or new money) to participate in DIP financing by ensuring that they are in a favourable position, additional enhancements are sometimes seen in such lending arrangements. These include:

1. Super-priority claims: The DIP lender's administrative claim will be granted priority over all other administrative claims that may arise in the case. This is often granted subject to a "carve-out" for certain professional fees and administrative expenses owing to the court.
2. Adequate protection: Adequate protection is an important concept which provides that the debtor must protect the secured creditor's collateral from diminution such that at the end of the case the creditor's interest has been preserved. This may include cash payments to the pre-petition lender (often at the interest rate of the pre-petition loan) and additional or replacement liens. Over-secured creditors are sometimes deemed protected by the existence of an equity cushion (i.e., collateral values in excess of the debt).
3. Roll-ups: While not typical, a roll-up allows a lender's pre-petition secured debt to be repaid with the proceeds of new, post-petition financing, effectively "rolling" the pre-petition debt into a new DIP with administrative priority.
4. Waivers and acknowledgements: A debtor will often be asked to waive certain rights that it may otherwise hold against a lender (e.g., the right to surcharge collateral for the costs of maintenance) and provide acknowledgments regarding the amount of existing debt and validity of existing liens, among other things. While other creditors retain the rights to challenge, they must bring their actions within a limited timeframe.
5. Interest and fees: DIP loans often carry interest rates that are greater than those on other loans, along with commitment and other fees that make such financing particularly attractive. Additionally, the DIP lender will be entitled to current payment of the fees and expenses of its legal and financial advisers.
6. Tenor and conditions: DIP loans often have maturities or other triggers that are intended to keep the restructuring on a fast track. For example, defaults may include failure of the debtor to propose a plan of reorganization in a form reasonably acceptable to the lender by a certain date or the failure to commence a

marketing process with respect to a capital event within an agreed timeframe. Importantly, DIP loans frequently ease the path towards the exercise of remedies in the event of a default.

As a result of the many protections and enhancements available, DIP financing is very often viewed by lenders as a valuable commercial lending opportunity, separate from the additional benefits it may provide a lender in respect of a pre-petition loan. From the perspective of the debtor, having a committed DIP facility when filing bankruptcy not only provides access to critical financing at a time of great need, it also sends an important message to the marketplace that the debtor has the financial wherewithal to continue operating as a going concern.

New Developments in Singapore

Under Section 211E (1) of the Act, the court has the authority in the context of a proposed scheme compromise or moratorium to order one or more different kinds of priority status for the DIP financing, broadly: (a) to be regarded as part of the costs and expenses of the winding up; (b) to be given a higher priority than preferential and unsecured debts; (c) to be secured by a new security interest over unsecured property or by subordinate security on company property that is already subject to a security interest; and (d) to be secured by a new security interest over already secured property at the same priority as or higher priority to the existing security interest.

In *Re Attilan Group*, the applicant sought to convene a creditor's meeting to consider a proposed scheme of arrangement under section 210(1) of the Act, and to obtain rescue financing for the company via subscription of additional shares under a subscription agreement. The applicant relied on section 211E (1) (a) and (b) and asked the court to grant priority status to the "rescue financing".

The court held that in order to grant priority status under section 211E, (i) the proposed financing must be "rescue financing" according to section 211E (9); (ii) the condition(s) stipulated in section 211E (1) (broadly, that the company would not have been able to obtain the rescue financing from any person unless the debt arising from the rescue financing is given the relevant priority and/or is secured in the prescribed manner) must be satisfied; and (iii) the court must exercise its discretion to grant priority status.

The court noted that super priority (under section 211E (1) (a)) should not be granted unless it was strictly necessary. The rationale is that "it is only where there is some evidence that the company cannot otherwise get financing that it would be fair and reasonable to reorder the priorities on winding up, giving the rescue financier the ability to get ahead in the queue for assets." Therefore, the applicant should prove to the court that "reasonable attempts at trying to secure financing" were made in order to seek super priority status.

In the judgment, the court concluded that the new capital from the share subscription was "rescue financing". However, the court refused to exercise its discretion and did not grant priority status to the proposed financing under section 211E(1)(a) because there was insufficient evidence from the applicant that it had made efforts to secure financing without any special priority.

Similarly, the applicant was unable to show that, according to section 211E (1)(b), it "would not have been able to obtain the rescue financing from any persons unless the debt arising from the rescue financing is given the priority". The court therefore refused to grant super priority status.

The current *Hyflux* restructuring, relating to a water treatment group in Singapore, has seen the debtor company reportedly engage with more than 20 potential rescue lenders with a view to utilising the new DIP financing legislation.

Considerations for Lenders

Clearly the courts in Singapore will be seeking to balance between promoting the objective of "rescue financing" and protecting the interests of existing creditors. However, financiers may note that Singapore's legislation does include some protections in favour of existing lenders, as demonstrated in the *Re Attilan* case, broadly:

1. Necessary for rescue: The DIP financing should be necessary for the survival of the company.
2. Demonstration of super priority requirement in order to obtain DIP loan: If the debtor company is requesting super priority for its DIP lender, it will need to show it would not be possible to obtain DIP financing without according super priority status.

3. Adequate protection: As with the US process, an existing secured creditor can only be primed if its position is adequately protected, which may include cash compensation for any decrease in value of its existing security, receipt of additional or replacement security or non-compensation relief that will result in the existing secured creditor's realisation of the "indubitable equivalent" of its existing security interest.

Critical will be the question of valuation for the purposes of determining either the relevant diminution in value of existing security and/or the value of proposed replacement security.

What is also not clear is whether the Singapore courts will permit or are empowered to permit the enhancements to rescue financing mentioned earlier and which are commonly seen in the US. Either way financial institutions must start considering their strategy when opportunities for DIP financing are likely to be considered. For example, if secured, financial institutions may challenge proposed priorities on the basis of inadequate protection, or perhaps see it as an opportunity to provide financing in terms that enhance and protect their position. In practice, secured lenders may well consent to being primed if the value of their security and recoveries will otherwise dip sharply if new money is not lent to maintain the going concern and provide confidence for the debtor's customer counterparties.

Of course, DIP financing in Singapore remains in its infancy and it remains unclear if the legislation will allow for cross-collateralisation, roll-ups and avoidance protection, each of which has become a part of the fabric of DIP lending in the US. Nonetheless, a financial institution facing a troubled borrower should assess its ability and willingness to provide DIP financing and the terms and conditions of doing so to create the best "defensive" and credit enhanced position; and if the conditions necessary for an offensive DIP facility exist (the implications of which are in its view undesirable), it must quickly arm itself with the necessary arguments to challenge the threat in order to preserve its interests as an existing creditor whilst still working towards a successful restructuring of the troubled borrower.

*Any views presented in this article in connection with Singapore law are based on our knowledge and understanding of Singapore laws and regulations obtained from our past experience in handling matters and by conducting our own research, and also from informal consultations with Singapore lawyers from time to time. As such, this article does not constitute (and should not be construed as constituting) an opinion or advice on the laws and regulations of Singapore.

Contact Us

For enquiries related to this Legal Update, please contact the following or your usual contact at our firm.

John Marsden
Partner, Hong Kong
T: +852 2843 2584
E: john.marsden@mayerbrownjsm.com

Tom Pugh
Partner, Hong Kong
T: +852 2843 2309
E: tom.pugh@mayerbrownjsm.com

Rick Hyman
Partner, New York
T: +1 212 506 2664
E: fhyman@mayerbrown.com

Ian Roebuck
Partner, Singapore
T: +65 6922 2311
E: ian.roebuck@mayerbrownjsm.com
