Financing Insolvency Restructurings in the Wake of the Financial Crisis: Stalking Horses, Rogue White Knights and Circling Vultures

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Financing Insolvency Restructurings in the Wake of the Financial Crisis: Stalking Horses, Rogue White Knights and Circling Vultures

Janis Sarra*

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I. INTRODUCTION

The financing of financially distressed companies is challenging. While additional financing could be provided outside of formal insolvency proceedings, corporate statutes in many jurisdictions prohibit incurring of additional debt while insolvent unless there is notice to, and consent of, creditors. In such circumstances, absent special protection, creditors are reluctant to advance further financing. Where debt is held by multiple creditors, insolvency proceedings are usually necessary to

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prevent a race to the assets and to allow the debtor company a short period in which to determine whether a going concern business plan and financing are possible.

Different jurisdictions place greater or lesser importance on offering a restructuring solution to firms in financial distress in addition to liquidation procedures. Where a restructuring option is available, many, but not all, jurisdictions have realized that any going concern strategy requires a means of financing the business until the appropriate workout plan can be devised, whether it is a restructuring of debt and equity, a going concern sale or a liquidating sale. This financing is called debtor in possession ("DIP") financing in Canada, and post-commencement financing in other jurisdictions; it provides the financing to continue operations during the insolvency proceeding and to cover the costs of insolvency and legal professionals in that proceeding. It is often connected closely to "exit-financing," the capital that will be needed to exit protection under the stay or moratorium provisions of insolvency legislation, and to assist the debtor company in the first period after restructuring.

There are a number of sources of post-commencement financing. They include the sale of some of the debtor's assets or the willingness of suppliers to continue supplying on credit for a limited period. In many jurisdictions, such financing historically came primarily from pre-filing banking and other traditional operating lenders. Pre-filing creditors often have an incentive to continue to lend, based on a desire to preserve ongoing business relations, the need to protect already sunk costs, and the potential for longer term upside credit relationships. In some instances, pre-filing lenders extend financing to ensure that their interests are not trumped by new financing that receives a priority charge. Even where their claims are already covered by their secured charge on the debtor's assets, pre-filing secured creditors may agree to provide DIP financing where they want to ensure that their position is not compromised during the workout process; that the debtor restructures in a manner that maximizes protection of their interests; or to maintain some control over the debtor during the proceedings.

Whether the post-commencement financing lender is a pre-filing creditor or not, it is unlikely to lend absent a secured charge. While some jurisdictions only allow post-commencement financing on as yet unencumbered assets or as a lower priority security interest on already encumbered assets where the value of the encumbered asset is sufficiently in excess of the amount of the pre-existing secured
obligation,⁰ in Canada, priority secured charges for DIP financing can extend to already secured assets, if particular pre-conditions are met, such as notice to creditors.²

At the height of the financial crisis in 2008 and 2009, forbearance was a primary strategy for not forcing many businesses into insolvency, as manufacturing and other sectors were reeling from the ripple effects of the failure of financial institutions, the collapse of the asset-based commercial paper and mortgage markets, and the overall unavailability of credit. Banks and other lenders would grant extensions of time, renegotiate credit terms, or forbear on exercising their self-enforcement remedies for a specified period. As the worst of the crisis ended and credit continued to be tight, new strategies had to be developed to allow financing of insolvent debtors. This article explores some of those strategies for post-commencement financing, using Canadian insolvency law as illustrative of changes in the credit market. Part II discusses post-commencement financing generally, introducing some of the ongoing policy issues, the challenge of such financing for corporate groups and in cross-border proceedings, as well as recent changes to Canadian statutory language. Part III examines the growing trend of stalking horse proceedings as a mechanism to finance the workout or as a resolution to the debtor’s financial distress, including the recent introduction of credit bids. Part IV discusses the impact of the introduction of distressed debt lenders into the insolvency financing market in a number of jurisdictions, and their effect on workout dynamics, including one case of a “rogue white knight.” Finally, Part V discusses the impact of credit default swaps and other credit derivatives on the economic incentives in a restructuring proceeding.

II. POST-COMMENCEMENT FINANCING OF INSOLVENT DEBTORS

If there is to be a restructuring aspect to any insolvency law, it must address the issue of post-commencement financing. New finance is often required on a fairly urgent basis to ensure the continued operation of the business while it is determining its future. The UNCITRAL Legislative Guide on Insolvency Law suggests that workout financing can be funded out of the debtor’s existing cash flow through operation of a stay and cessation of payments on pre-commencement liabilities; or, where the debtor has no funds to meet immediate cash flow needs, financing may take the form of trade credit extended to the debtor by vendors of goods or services, or through loans or other forms of finance

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². See discussion in Part III, infra, of the statutory criteria.
extended by lenders.\textsuperscript{3} It observes that post-commencement finance needs to be balanced against the need to uphold commercial bargains; to protect the pre-existing rights and priorities of creditors; to minimize any negative impact on the availability of credit; and to consider the impact on unsecured creditors if remaining unencumbered assets are used to secure new lending, leaving nothing available for distribution if a reorganization were to fail.\textsuperscript{4}

In jurisdictions where court approval is required, the court often engages in a balancing of interests and prejudice between the parties. Secured creditors may be required to make some sacrifice because of the reasonably anticipated benefits for all stakeholders, including employees, trade suppliers and other creditors.\textsuperscript{5} Even on an urgent basis, notice should be given to creditors prior to subordinating their interests, in order to avoid their having to incur the additional costs of seeking to set aside an initial order approving financing. UNCITRAL suggests that the number of authorizations for such financing be kept to a minimum, generally preferring that decision making rest with the insolvency professional rather than with the court.\textsuperscript{6} In Canada, DIP financing requires court approval. While the courts have been fairly consistent in respecting the statutory hierarchy of creditors' claims, they have engaged in a balancing of multiple interests during consideration of financing requests, having regard to the express aims and language of the insolvency statute.\textsuperscript{7}

The courts have cautioned that there should be cogent evidence that the benefit of DIP financing clearly outweighs the potential prejudice to


\textsuperscript{4} Id. at 115.


\textsuperscript{6} UNCITRAL Legislative Guide on Insolvency Law 116 (New York: United Nations, 2005). The Guide notes that although requiring court involvement may generally assist in promoting transparency and provide additional assurance to lenders, in many instances the insolvency representative may be in a better position to assess the need for new finance. Similarly, where secured creditors consent to revised treatment of their security interests, approval of the court may not be required. UNCITRAL suggests that the court will generally not have access to expertise or information additional to that provided by the insolvency representative on which to base its decision. Id.

\textsuperscript{7} Both the Bankruptcy and Insolvency Act and the Companies’ Creditors Arrangement Act in Canada have provisions for restructuring and provisions for debtor in possession financing.
the lenders whose position is being subordinated. DIP financing requests in initial orders should be confined to what is reasonably necessary for the continued operation of the debtor corporation during a "brief but realistic period on an urgent basis." The granting of post-commencement financing may allow a corporation to keep operating in order to retain value while trying to negotiate a workout with creditors. For stakeholders, such as workers, trade creditors, or local governments, it may also result in preservation of their investments, at least for the period that a restructuring plan is being formulated. According super-priority financing has also been aimed at ensuring compliance with environmental obligations, in the public interest. The court, in balancing interests, will weigh the possibility of a going-concern solution that potentially creates long-term upside value for numerous stakeholders, with the risk of further depletion of value that may be able to satisfy claims on a short-term basis. This balancing of interest and prejudice is at the heart of most financing judgments. Notwithstanding these potential benefits to all stakeholders, absent careful scrutiny of the terms of the financing agreement, granting access to short-term capital can increase the risk of harm to stakeholders if the terms approved by the court lead to a restructuring plan that prejudices their interests more than a liquidation outcome.

There was a growing practice in the five years preceding 2008 in Canada of arranging DIP financing in an amount far in excess of what the debtor corporation anticipated needing, ostensibly to increase market


12. Canadian courts have previously held that there are five principles operating in the court’s consideration of applications for DIP financing and priming charges: adequate notice of DIP financing and priming requests, so that creditors can fully assess the impact of DIP financing decisions; sufficient disclosure; timeliness of the request; balancing the prejudice to creditors and other stakeholders; and the principle of granting priority financing as an extraordinary remedy. Courts apply these principles in an effort to find the optimal balancing of prejudice in the exercise of their jurisdiction to grant DIP financing or other priority charges. The court must weigh the likely risks against the likely gains of authorizing such financing; with a view to creating certainty in credit transactions while meeting the objectives of insolvency legislation.
confidence and provide creditors with some assurance that their post-filing claims would be met. However, the size of the DIP facility generated increased up-front fees, higher costs associated with heightened reporting requirements to the DIP lender, and, in some cases, more control elicited as a condition of providing the financing.\textsuperscript{13} As the market for DIP financing started to increase, the competition meant that the margin on a DIP facility itself was not that great, but the DIP lender made its real profit on the up-front fees.

Canadian courts have granted “Drip DIPs,” that require the debtor to come before the court on notice to creditors each time it seeks to draw down another tranche of funds. The only exposure of the DIP lender is the amount already advanced, and creditors have more information on which to assess their positions as the process unfolds. Gradual release of funds in the first few weeks or months can generate a higher degree of accountability. Where stakeholders are provided with timely information of the financing requirements and the opportunity to provide their views to the court on the necessity of the draw down, it can act as a temper on any managerial slack that has arisen from a generous DIP facility.\textsuperscript{14} Drip DIPs frequently are structured so that the debtor can draw down according to an anticipated schedule; hence it is not necessary to come back before the court if there is no deviation from the schedule that would have adverse consequences for other creditors.

Where the lender is a pre-existing secured lender, such as a specific asset secured creditor, the creditor’s claim is often unaffected by a reorganization proceeding, and the creditor may not support additional financing as it means delay in realizing on its claim. However, in some cases, subordinated pre-filing lenders may benefit from financing that is aimed at satisfying senior secured claims at the outset or early in the process, as it may enhance their position in the hierarchy of claims.

There is a question of whether post-commencement financing should be granted at all when the circumstances indicate that the financing would consume considerable resources and that the debtor has a questionable ability to successfully negotiate a plan. The court may decline post-commencement financing on a primed basis where the debtor seeks only to prolong the period before an inevitable liquidation, or where there is no possibility for a plan. The challenge is to ensure that such a decision is not premature such that creditors become unwilling to come to the negotiation table. The cases that have declined to grant the

\textsuperscript{13} Sarra, \textit{supra} note 10, at 150.

financing have relied in part on the fact that there were not ongoing operations, and employees and trade supply relations to protect during an interim period.\textsuperscript{15} For example, the Alberta Court of Queen's Bench denied the application of a real estate company that had applied for \textit{Companies' Creditors Arrangement Act} protection as it was unable to make all of its mortgage payments as a result of the economic downturn and defaults on leases.\textsuperscript{16} The application was opposed by the majority of first mortgagees, who wanted to proceed with their foreclosure remedies. The Court concluded that it was not appropriate to grant relief; it appeared highly unlikely that any compromise or arrangement would be acceptable to creditors; the proposed costs were not appropriate given the circumstances; and there were not a large number of employees or significant unsecured debt in relation to the secured debt.

Thus, the policy issues in post-commencement financing can be summarized as the need to appropriately balance the interests of all creditors against the potential for a successful restructuring, with a view to the costs and benefits arising from the particular form and conditions of the proposed financing agreement. These policy issues arose first in the courts' exercise of their discretionary decision-making concerning DIP financing, and are now the subject of new Canadian legislative provisions.

\textbf{A. Codification of DIP Financing in Canadian Insolvency Legislation}

DIP financing in Canada was initially hotly contested based on jurisdictional grounds, given the previous lack of statutory language; however, it became widely endorsed by the courts as a measure to "keep the lights on" during the period of negotiations for a restructuring plan.\textsuperscript{17} With the amendments to Canadian insolvency legislation effective September 2009, the court's authority to authorize such financing was codified in both the \textit{Bankruptcy and Insolvency Act} ("BIA") and \textit{Companies' Creditors Arrangement Act} ("CCAA"), both statutes articulating criteria for assessing requests for financing on a primed basis.\textsuperscript{18}

\begin{itemize}
  \item \textsuperscript{15} Re Octagon Properties Group Ltd. (2009), 2009 CarswellAlta 1325, 2009 ABQB 500 (Alta. Q.B.); Re Shire International Real Estate Investments Ltd., 2010 CarswellAlta 234, 2010 ABQB 84 (Alta. Q.B.).
  \item \textsuperscript{16} Re Octagon Properties Group Ltd. (2009), 2009 CarswellAlta 1325, 2009 ABQB 500 (Alta. Q.B.).
  \item \textsuperscript{18} S. 11.2, CCAA; 2007, c. 36 proclaimed in force as of September 18, 2009.
\end{itemize}
UNCITRAL has recommended that an insolvency law should specify that the court may authorize the creation of a security interest having priority over pre-existing security interests if specified conditions are satisfied, including that existing secured creditors are given the opportunity to be heard by the court; the debtor can prove that it cannot obtain the finance in any other way; and the interests of the existing secured creditors will be protected.\(^{19}\)

The Canadian criteria have some similarities, but do not require the debtor to establish that it can find no other financing, and do not require the pre-filing secured creditor to be fully protected. The factors that the court is to consider include, but are not limited to: the period during which the company is expected to be subject to restructuring proceedings; how the business is to be managed during the proceeding; whether management has the confidence of the debtor’s major creditors; whether the loan would enhance the prospects of a viable compromise or arrangement being made; the nature and value of the company’s property; whether any creditor would be materially prejudiced as a result of the charge; and the monitor’s views.\(^{20}\) The monitor in \textit{CCAA} proceedings is a court-appointed officer that assists the court and parties in the restructuring process, and it can provide an impartial view of the need for, and efficacy of, any DIP financing requests.

The new statutory criteria for DIP financing essentially codify the tests used previously by Canadian courts but offer greater transparency for creditors and other stakeholders that are not repeat players in proceedings. The court is not restricted to consideration of only these factors,\(^{21}\) nor is it required to give them equal weight and consideration.\(^{22}\) The court has approved post-commencement financing with a corresponding charge where necessary to ensure that the business enterprise of the debtor would continue to operate as a going concern while it undergoes restructuring, having regard to the potential material prejudice to creditors, the preservation of employment and the prospects for a successful workout.\(^{23}\) The court has held that even if certain creditors are materially affected by the DIP loan, the court must look to the broader picture, and a compromise that the creditor may have to

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23. \textit{Id.}
accept can be outweighed by the positive effects of the financing on the total business of the debtor.\textsuperscript{24}

For example, in \textit{Re AbitibiBowater}, the Québec Superior Court approved a DIP financing facility where the benefits of the financing to all creditors, shareholders and employees outweighed the potential prejudice to some creditors.\textsuperscript{25} There was an urgent need for the financing due to a serious lack of liquidity to meet payroll or key suppliers' deliveries; the term of the financing was relatively short; there was a reasonable prospect of a successful restructuring; and most of the stakeholders and the monitor supported the proposed financing. In stabilizing the continued operations of the debtor, the Court held that the financing potentially added value to the objecting term lenders' claims and the opportunity to contest future borrowing alleviated in part the prejudice suffered by the term lenders. The Court also observed that in the current credit market, DIP financing would not be available absent a priming charge; however it reduced the amount of the charge for the DIP facility as the Court was not satisfied with the explanation provided to support the amount sought.

How creditors bear the costs of post-commencement financing is an important question. The Canadian court has approved allocation of financing charges based on the following principles: that all secured creditors should contribute to the cost of restructuring; a strict accounting on a cost-benefit basis was impractical and not necessary or desirable for allocation purposes; security arrangements and priorities should not be readjusted as part of this process; the proportion each creditor should be allocated need not be equal; and the allocation should be equitable, rather than equal.\textsuperscript{26} The Court held that while it is unfair to ignore the degree of potential benefit that each creditor might derive, the nature of proceedings under the \textit{CCAA} makes a strict accounting on a cost-benefit basis impractical and ultimately defeating.\textsuperscript{27}

\textbf{B. Corporate Groups and Cross-Border Proceedings}

The challenge for post-commencement financing becomes more acute for debtors operating as a corporate group in multiple jurisdictions. Often the related businesses have highly integrated financial systems and interrelated debt and equity structures, yet the entities are registered in

\begin{itemize}
\item \textsuperscript{24} \textit{Id.}
\item \textsuperscript{25} \textit{Re AbitibiBowater Inc.} (2009), 58 C.B.R. (5th) 62 (Que. S.C.).
\item \textsuperscript{26} \textit{Re Winnipeg Motor Express Inc}, (2009), 2009 CarswellMan 383, 2009 MBQB 204 (Man. Q.B.).
\item \textsuperscript{27} \textit{Id.} Where the allocation is \textit{prima facie} fair, the onus is on an objecting creditor to demonstrate that the proposal was unfair or prejudicial. The court relied heavily on the monitor's expertise and involvement in approving the allocation.
\end{itemize}
different jurisdictions with different statutory language covering post-commencement financing. The policy issue is whether and to what degree can the assets of the group in one jurisdiction be used as part of the financing in insolvency proceedings to the benefit of group members in another jurisdiction.

Special purpose entities ("SPE") are often created within corporate groups to manage risk in the acquisition and financing of specific assets. Corporate entities often have inter-entity financing arrangements involving loans and guarantees. The supply relationships between the entities may mean that there is short-term debt in the form of receivables granted from one entity to another. A restructuring may not be possible without a highly integrated workout strategy across multiple jurisdictions; and it is the interim financing that may be particularly challenging, given that different jurisdictions have different priorities and different degrees of willingness to allow post-commencement financing. In a number of jurisdictions, a significant method of enterprise group financing is cross-guarantee financing, where each company within a group guarantees the performance of the others. UNCITRAL observes that cross-guarantees can operate to reduce the regulatory burden on companies by granting accounting and auditing relief to related entities, operating as a form of voluntary contribution or pooling in the event that one or more of the companies becomes financially distressed. One advantage of this arrangement is that creditors can focus on the consolidated position for those entities, rather than on the individual financial statements of the wholly owned subsidiaries.

UNCITRAL suggests that insolvency laws should permit an enterprise group member in insolvency proceedings to advance post-commencement finance to other enterprise group members subject to insolvency proceedings; grant a security interest over its assets for post-commencement finance provided to another enterprise group member; and provide a guarantee or other assurance of repayment for post-commencement finance provided to another enterprise group member. The insolvency law should specify that such financing may be provided where it is necessary for the continued operation of, or the preservation of the value of, the enterprise group member; and where any harm to creditors of that group member is likely to be offset by the benefit to be

29. Id. at 29.
30. Id.
31. Id. at 37.
derived from advancing financing or a security interest. There should be appropriate protection for the providers of post-commencement finance and for those parties whose rights may be affected; and there should be fair apportionment of the benefit and detriment associated with the financing among all group members involved. UNCITRAL recommends a balancing of the interests of individual enterprise group members with what is required for the reorganization of the group as a whole. A solvent group member might have an interest in the financial stability of related entities in order to ensure its own financial stability, particularly where it is closely integrated with or reliant on insolvent members for ongoing business activity. UNCITRAL observes that the interest of a group member providing finance may relate more to the insolvency outcome for the group as a whole than to commercial considerations of profit or short-term gains, especially where there is a high degree of reliance between the businesses of the group members. The Nortel Networks case is one such example. Issues include the priority and extent to which inter-group financing should be allowed, the extent to which it encumbers the assets of one entity in furtherance of the restructuring of the entire corporate group, and how both secured and unsecured creditors’ interests are to be assessed in considering the quantum and priority of the financing.

In Canada, one relatively new development is the approval of DIP financing charges that encumber assets of Canadian debtor entities to meet financing needs of related entities in the United States. The genesis of this change is both the increasingly interrelated nature of global business enterprises and the lack of financing during the worst of the financial crisis in 2008 and 2009. The downside risk for such financing is that Canadian creditors that may have had access to the value of those assets may lose that claim. The potential upside is the preservation of the business, jobs and trade relationships, which overall may be more valuable.

For example, in Re InterTAN Canada Ltd., the Ontario Superior Court of Justice approved a DIP financing facility, the terms of which required the debtor to provide security for the borrowings of its US
parent in its Chapter 11 filing.\footnote{Re InterTAN Canada Ltd. (2008), 2008 CarswellOnt 8040, 49 C.B.R. (5th) 248; additional reasons at (2009), 2009 CarswellOnt 687, 49 C.B.R. (5th) 260 (Ont. S.C.J. [Commercial List]).} The Court expressed concern about inadequate notice to creditors regarding the request to use the debtor’s assets as a basis for obtaining finance for a related entity, and observed that if debtors are going to request such extreme relief on an initial application, with little or no notice, it is up to the applicant to establish the evidentiary basis for the requested relief. In the absence of such evidence, parties should have no expectation that the court will grant such extraordinary relief. Justice Morawetz did approve the DIP facility on the basis that the potential upside of a going concern operation was preferable to liquidation, notwithstanding that provisions of the DIP facility effectively transferred assets from the Canadian debtor to another member of the enterprise group. He took into account the prospect of continued going concern operations; the continued employment of over 3,000 individuals; the benefits of continued operation for other third-party stakeholders; the fact that certain creditor groups would be largely unaffected by the CCAA proceedings; and the creation of an unsecured creditors’ charge that provided a degree of protection to them.

In Nortel Networks,\footnote{Re Nortel Networks Corp., 2010 CarswellOnt 1044 (Ont. S.C.J. [Commercial List]).} Canadian and US courts approved a series of agreements between the inter-related Nortel entities that provided the debtors with ongoing funding.\footnote{Re Eddie Bauer of Canada Inc. (2009), 2009 CarswellOnt 3657 (Ont. S.C.J. [Commercial List]).} The Canadian court held that the scope of review must take account of the complex and interrelated funding agreements that had been developed over a period of years. It was appropriate to place reliance on the views of the monitor who had the benefit of intensive involvement for over a year, and to take account of extensive negotiations among the debtors and creditors. The Court was satisfied that the financing was fair and reasonable, and that the financial stability of the Canadian debtor was in jeopardy and would not improve without the approval of financing.

Cross-border entities and cross-border guarantees extend not only to interim financing but have been used as mechanisms to finance a sale process. For example, the Canadian Court approved a DIP facility in which US debtor entities advanced financing to Canadian debtors.\footnote{Re Eddie Bauer of Canada Inc. (2009), 2009 CarswellOnt 3657 (Ont. S.C.J. [Commercial List]).} The US debtors were granted a charge over the assets of the Canadian debtor, limited to the amount of inter-company advances. The DIP facility was predicated on the US debtors’ carrying out a sales process that would include the marketing of the businesses and assets of both sets of debtors,
to be subject to approval by both the *CCAA* court and the US bankruptcy court. Both courts were satisfied that the proposed DIP facility and creation of the inter-company charge were appropriate in the circumstances.

In another proceeding, an extensive process to obtain new debt financing had been undertaken, and the debtors, having thoroughly canvassed the market, did not have any satisfactory alternative financing arrangements available. The Ontario Superior Court approved a cross-border DIP facility that provided that the Canadian debtors would guarantee loans to the US debtors and vice versa. The Court was satisfied that the business was fully integrated, making it impracticable in the existing credit environment to secure alternate financing on a stand-alone basis. The Court held that the successful restructuring of the Canadian and US entities appeared to be inextricably intertwined and that financing was needed to continue day-to-day operations.

In granting a motion for DIP financing in another proceeding, the Ontario court was satisfied that secured creditors had received notice; the amount of the facility was appropriate having regard to the debtor's cash-flow statement; management had the confidence of the major creditors; there was no material prejudice to any of the creditors that would arise from the granting of the DIP charge; and the facility would enhance the prospects of a restructuring. The Court held that continued timely supply of US services was necessary to preserve going concern value and that commencement of Chapter 15 proceedings to have the *CCAA* proceedings recognized as “foreign main proceedings” was a prerequisite to the DIP facility.

III. STALKING HORSE PROCEEDINGS

Given the ongoing problems with credit availability, other means of post-commencement financing have been pursued, including the sale of some of the debtor's assets. However, these sale processes may raise issues of fairness to stakeholders and the misuse of inside information similar to those raised by mergers and acquisitions outside of an insolvency proceeding. Recently, a number of insolvency proceedings have used various bidding or auction techniques to sell all or part of the enterprise to raise both post-commencement and exit financing. Stalking horse proceedings are one such strategy. The term “stalking horse”

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41. Re Smurfit-Stone Container Inc. (2009), 2009 CarswellOnt 391, 50 C.B.R. (5th) 71 (Ont. S.C.J. [Commercial List]). The court approval limited the amount of borrowings under the facility pending further order of both the U.S. and the *CCAA* court.

42. Re Canwest Global Communications Corp., (2009), 2009 CarswellOnt 6184 (Ont. S.C.J. [Commercial List]).
comes originally from hunters using a horse to serve as a screen as camouflage when they stalked their prey. In the insolvency context, it is used to signify a situation where the debtor makes an agreement with a potential bidder for a sale of the debtor’s assets or business, and that agreement forms part of a process whereby an auction or tendering process is conducted to see if there is a better and higher bidder that will result in greater returns to creditors. The premise is that the stalking horse has undertaken considerable due diligence in determining the value of the debtor corporation and that other potential bidders can rely, to an extent, on the value attached by that bidder based on that due diligence.

“Stalking horse auction” processes have been used recently in Canadian-US cross-border proceedings, in part as a response to the tightening of credit and the need to generate higher bids for the value of some or all of the assets or business. In an auction, a preliminary bid by the stalking horse bidder is disclosed to the market and becomes the base amount that parties can then outbid, driving up the price and hence the value to meet creditors’ claims. The stalking horse bidder in an insolvency proceeding enters the process knowing that it may not be the eventual purchaser. Hence it negotiates a price for its participation and its due-diligence activities, usually in the form of a “break fee,” which it will receive if it is not ultimately successful in its bid for the debtor company. In this sense, it is similar to a white knight in a takeover transaction, in that the size of the break fee must be large enough to be auction-generating and small enough not to be auction-inhibiting.

In Nortel Networks, the Canadian and US courts approved a bidding procedure and asset-sale agreement for the purposes of conducting a “stalking horse” bidding process, including a break fee and expense reimbursement. The hearing was conducted by video conference with the US Bankruptcy Court for the District of Delaware in accordance with the provisions of a cross-border protocol previously approved by the courts. The Canadian court held that it had jurisdiction under the CCAA to approve a sales process in the absence of a formal plan of compromise

44. Re Nortel Networks Corp. (2009), 2009 CarswellOnt 4467, (2009), 56 C.B.R. (5th) 74 (Ont. S.C.J. [Commercial List]). See also Re Eddie Bauer of Canada Inc. (2009), 57 C.B.R. (5th) 241 (Ont. S.C.J.). Previously, the US bankruptcy court has held that it will take the following factors into account in determining whether to approve a break fee: whether the fee correlated with a maximization of value to the estate; whether the request is arm’s length; the degree of stakeholder support; whether the proposed fee is a fair and reasonable percentage of the proposed purchase price; any potential chilling effect on the market; the existence of safeguards; and whether there is an adverse impact on any opposing unsecured creditors; Re Hupp Industries, 140 B.R. 191 (Bankr. N.D. Ohio 1992).
or arrangement and a creditor vote, on the basis that the CCAA must be given a broad and liberal interpretation to achieve its objectives. The Court held that a sale by the debtor that preserved the business as a going concern was consistent with those objectives. Factors to be considered included, but were not limited to: is a sale transaction warranted at this time; will the sale benefit the whole “economic community”; do any of the debtor’s creditors have a bona fide reason to object to the sale of the business; and is there a better viable alternative?

In another proceeding, the Ontario Superior Court of Justice approved a stalking-horse auction process in a CCAA proceeding where the proposed stalking horse, which was an insider and related party, had been scrutinized by the financial advisors, the independent committee of the board and the monitor. With respect to a contested break fee, the Court held that the fee was a business decision that had been considered by the debtor and key creditor groups and that the amount of the break fee was consistent with break fees that had been approved in other proceedings. In the circumstances of this case, the court found it unnecessary to substitute its business judgment for that of the applicants.

Canadian courts have generally supported sealed competitive bidding processes that allow submission of independent, self-contained bids, finding that bidders are entitled to fair compliance with such procedures. The courts have supported insolvency professionals rejecting referential bids on the basis that they would frustrate a sealed competitive bidding process, as it would create unfairness if a party could introduce into the sealed bid system elements of a public auction without any risk of being outbid by another party. Where parties intended a fixed bid process, the court was satisfied that the receiver’s rejection of a referential bid in favour of another bid was commercially fair and reasonable in the circumstances and should be accepted.

Dowdall and Dietrich have argued that stalking-horse proceedings conducted by the debtor and not a neutral court-appointed officer raise concerns about the process, in that the stalking horse can exert considerable control over timelines, making them so tight that other bidders do not have a meaningful opportunity to undertake their due

45. Re Brainhunter Inc., 2009 CarswellOnt 8207 (Ont. S.C.J. [Commercial List]), adopting the tests used in Re Nortel Networks Corp. (2009), 55 C.B.R. (5th) 229 (Ont. S.C.J. [Commercial List]),
46. Id.
47. Fifth Third Bank v. MPI Packaging Inc., 2010 CarswellOnt 29 (Ont. S.C.J. [Commercial List]).
48. Id.
diligence. Stalking horse bidders may insist on restrictive terms in respect of who may be treated as a qualified bidder. Management may also have a conflict of interest where they are negotiating key employee retention packages, bonuses or other perquisites; and while these are ostensibly subject to some control in terms of the court’s approval, the tight timeliness may create pressure to approve such plans, even where the court might otherwise have concerns.

These concerns may be difficult to discern where the issues are complex and time is of the essence. However, courts have indicated that they will scrutinize such transactions. In *Re Mecachrome International Inc.*, Justice Gascon of the Québec Superior Court dismissed a motion to approve a plan-funding agreement proposed by the DIP lenders to fund a proposed *CCAA* plan, under which the DIP lenders would acquire all the shares of the Canadian debtor company in exchange for payment, including some funds to be directed to unsecured creditors to recover approximately 12% of their claims. The Court held that the *CCAA* is aimed at enabling a debtor company, with the support of its creditors, to weather its financial difficulties and continue to operate in the interests of parties and society in general, and that a plan that is supported by creditors must be achieved at the best cost and under the best possible conditions for the creditors that inevitably suffer the consequences. Here, the fundamental goal of the *CCAA* in the circumstances was best served by refusing to approve the plan-funding agreement. The Court held that the cumulative effect of the absence of any legitimate and open process to canvass funding proposals; the narrow definition of what constituted a superior proposal under the plan-funding agreement and the lack of flexibility given to the board of directors to qualify a superior proposal as superior; the chilling effect of the high break fee; and the lack of evidence of a value maximizing process, all worked against the objective of a sufficient, transparent and open process. As well, the process contemplated by the proposed funding agreement would usurp the exercise of the right to vote belonging to creditors, and the agreement unnecessarily tied the hands of the Canadian debtor with respect to potential consideration of available alternative solutions that could benefit creditors. The Court held that the funding agreement closely resembled a stalking horse bid process with no real canvassing of the market. While the DIP lenders may have had a head start in any acquisition because of the inclusion of an exclusivity clause of limited


50. *Id.*

duration in the DIP financing agreement, the Court held that such a clause did not, and could not, have the impact of relieving the Canadian debtors and the monitor of their duties, in terms of fairness, transparency, and openness towards all stakeholders. The Court found that the proposed break fee of 4.5% was too high, the evidence before it suggesting that the average break fee in a merger or acquisition is about 2.9%; and that the debtor had failed to show that the break fee was reasonable or adequately related to the costs of the DIP lender or its risk. The Court noted that while the approval of the monitor is an important factor, it is not decisive in and of itself.52

There is also the issue of the degree to which the DIP financier is, through terms of its facility, determining outcomes in other aspects of the CCAA proceeding. For example, in Re AbitibiBowater Inc., the interim funding was provided on the basis that the funds could not be used towards the payment of special contributions to pension plans; and as a result, the Court concluded that it was necessary to suspend the special contributions to the pension plan.53 While the DIP lender should be able to negotiate the terms of the facility, the courts need to be cognizant of the degree to which such terms will bind the court in future decisions. Tighter credit conditions have given DIP lenders greater leverage and the ability to exert more control. An alternative process that may offer better results for existing creditors is a credit-bid process.

A. Credit Bids

A very recent development in financing workouts of insolvent businesses is the use of credit bidding, which has occurred in cases such as Canwest and White Birch.54 A credit bid allows a creditor to essentially use its debt to bid for the equity of the company, often in a stalking horse process. Although there is no express language in the CCAA that allows credit bidding, as there is in the US Bankruptcy Code, Canadian courts have accepted credit bids as a reasonable means of financing the workout. There are a number of issues raised by this new financing. First, a creditor may have access to considerable information as a result of its position as a senior secured lender; thus, it is important to ensure that any bidding process is fair and transparent in terms of the financial and other disclosures. If the bidding creditor is also the DIP financier, it may pressure the debtor for a truncated process that does not

52. Id.
generate a true market for bids; or it may pressure for a lower value to be attributed to the business, given that pricing is difficult to determine at the point of insolvency. There is an important role for the monitor and the court in ensuring that the process is fair, that information is available that allows competitive bids to come forward, and that any conflicts of interest are controlled as much as possible. While credit bids may offer a helpful alternative to financing a workout, particularly in the tighter post-financial crisis credit market, their further development must be undertaken in a manner that ensures that the integrity of the CCAA process is maintained.

In the Canwest case, the credit bid was topped by a junior lender working in conjunction with other parties, generating increased value. Unlike new parties to insolvency proceedings, pre-filing secured creditors were already privy to confidential information, and generally such lenders are entitled to see other bids and proposals. The challenge was how to create a transparent and fair process that was truly open enough to generate other bids where appropriate. Another case upheld a creditor agreement that had provided for creditor bids, although the judgment did not expressly address the issues associated with credit bids. The Ontario Court approved a sale transaction involving transfer of the business and sale of real property of the applicants in both Canada and the US under a court-approved marketing process.55 The Ontario debtor operated from businesses located in Canada and the United States. The selection of purchaser was based on a thorough analysis of all of the financial and commercial terms presented in all of the bids, and was recommended by the monitor and approved by the first lien lenders steering committee and the independent directors committee.56 A 2007 inter-creditor agreement ("ICA") was found to be binding on the group of companies, including a provision that the first lienholders could credit bid their debt. The Ontario Superior Court of Justice found that by its terms and the definition of "bankruptcy code" in the ICA, the parties recognized that Canadian or US insolvency law might apply. Justice Campbell held that once a process has been put into place by court order for the sale of assets of a failing business, that process should be honoured, excepting extraordinary circumstances. To permit an "invitation" to reopen that process not only would destroy the integrity of the process, but would likely doom the transaction that had been

55. Re Grant Forest Products Inc. (2010), 2010 CarswellOnt 2445 (Ont. S.C.J. [Commercial List]). Objections were raised by the subordinate secured creditor who questioned the jurisdiction of the court to convey real property assets located in the US.
56. Id. The second lien lenders had been consulted, and their views and questions were taken into account in the final selection of purchaser.
achieved.\textsuperscript{57} The Court was satisfied that, by operation of the credit agreement, the first lienholders were entitled to exercise their remedies and the Canadian court had jurisdiction to provide the relief requested.\textsuperscript{58}

The US caselaw on credit bids is extensive and has highlighted a number of policy issues in respect of this tool for generating post-commencement and exit financing. As Canadian parties develop these strategies, it will be important to study some of the problems that have arisen in the US context in terms of transparency and fairness of the process.

IV. CIRCLING VULTURES AND ROGUE WHITE KNIGHTS

Traditional pre-commencement creditors who offer post-commencement financing are seen to have a stake in the long-term success of the business. However, constraints on credit granting by these institutions have lessened their ability to finance restructuring of insolvent companies. Other sources of financing may not have the same incentives in a restructuring proceeding. Is this shift in incentives a matter that should concern policymakers or the courts?

Distressed debt purchasers, often called vulture funds, have increasingly used strategic purchases to assert control in restructuring proceedings, by buying up debt across multiple classes at a discounted value or buying in sufficient quantity to obtain an effective veto over particular proposals and hence influence the outcome. Generally, Canadian courts have not been concerned with debt purchase transactions that may offer liquidity for trade suppliers, banks and other traditional creditors by creating a market for their devalued claims during insolvency proceedings.\textsuperscript{59} Distressed debt purchasers offer creditors an opportunity for early exit and in some cases can lend their expertise to the development of viable business plans. Such lenders may also provide post-commencement financing such that the debtor obtains some

\textsuperscript{57} Id., which was the product of the marketing process that was not only approved by the Ontario Court but not objected to by any party when it was initiated. The aggregate consideration being paid by the Canadian purchaser for the transferred assets and the U.S. purchasers for the Grant US Partnership assets was $403 million, subject to adjustment. It was urged that the proposed structure would maximize the value of the Grant U.S. Partnership assets.

\textsuperscript{58} Id. They may then release their security over the assets to be transferred in connection with the exercise of their remedies and by doing so, the security of the second lienholders over the transferred assets would be automatically and simultaneously released. Campbell J. accepted that the effect of the transaction may indirectly be a transfer of US real property assets and the release of a security over them of the second lienholders. The effect of the transaction was such that the claims of local creditors of the business of the US mills remained unaffected.

financial breathing space in which to devise a going-forward strategy to address its insolvency. Canadian courts do not generally distinguish in insolvency proceedings between creditors’ claims acquired through normal credit transactions and creditors’ claims acquired at a discounted value at the point of a firm’s financial distress.

Certain equity sponsors may organize their strategy to shift control early in the process towards their interests. They buy up the debt across classes at a severely discounted value and provide the post-commencement financing under stringent controls. Alternatively, they can buy most of the debt from a single class but purchase that debt through several entities and thus control the vote of the class through the “head count” numbers as well as the total value of claims. This strong creditor position then allows them to put in the equity bid and to be assured that it is accepted across the classes of creditors. While parties are entitled to conduct their affairs to maximize value, this strategy creates new challenges for the court in exercising its supervisory powers in terms of its ability to balance stakeholder interests.

The limited pool of DIP lenders often provides them with considerable bargaining power in negotiations for a post-commencement financing agreement. Given the thinness of the post-commencement financing market, lenders have been able to secure both extremely favourable financing terms, as well as extensive control rights in the provisions of the financing agreement. An example was the Teleglobe DIP financing agreement, in which the DIP lender was expressly given the right to approve any form of order coming before the court. It is a normal practice of a DIP lender to protect its interest, but such control rights can also serve to prevent the debtor from considering strategies or bringing motions that better serve the interests of multiple stakeholders. Canadian courts have endorsed these financing agreements because they have been persuaded that the agreement is the only realistic means for the debtor corporation to keep operating while it attempts to negotiate a viable restructuring plan with its creditors. Often the court is advised that all the jobs will be lost if the DIP agreement is not approved. Control terms in a DIP agreement can create serious risk of prejudice to stakeholders. For example, the DIP lender can threaten to declare default on the agreement if particular motions are brought before the court or if the debtor takes particular positions where creditors bring motions. Other provisions can specify default of the DIP financing agreement if the court makes particular orders. The growth of distressed debt investors in insolvency workouts has created new pressure for timely

60. In the matter of the Companies’ Creditors Arrangement Act and Teleglobe Inc. (May 15, 2002), Doc. 02-CL-4528 (Ont. S.C.J. [Commercial List]).
turnaround and workout plans that generate short-term returns on their investments and sometimes little interest in the long-term viability of the business enterprise.\(^6\)

If the debtor is able to secure capital from existing senior operating lenders, the governance structure may not change, except that the lender imposes more stringent monitoring and, in some cases, control rights on the use of the financing. Governance of the debtor business enterprise plays a significant role in the potential success and, hence, upside value that may be generated by a successful workout, and post-commencement financing has been utilized as a tool in Canada, the US and elsewhere to influence governance.\(^6\)

Where creditors have confidence in the oversight and management of the debtor corporation and they determine that a going-concern outcome to the insolvency proceeding maximizes value for them, they are likely to provide the DIP facility.\(^3\) However, where the party acquiring the distressed debt engages in abuse of its position or lacks good faith in its dealings with parties to an insolvency proceeding, the court may limit the ability of that creditor to veto an outcome to the proceedings, in keeping with the overall objectives of insolvency legislation. Canadian courts may consider the motives and conduct of a distressed debt purchaser where there is evidence of abuse of process or a lack of good-faith dealings.

To date, there have been few judgments that have addressed this type of behaviour. The court has observed that there are different types of vulture funds, some that have objectively concluded that the debtor has value and hence they purchase debt such that there is increased liquidity in the market for those who have a desire to cut their losses, and other vulture funds that are “somewhat more antisocial and may in certain circumstances be said to hold the affected parties to ransom.”\(^6\)

The Court in *Curragh* held that while legally there is no difference in these claims, the court may question the effect on those traditional creditors who had put 100 cents on the dollar into the situation only to be caught in a credit crunch, and those who have “speculated” at pennies on the pound knowing that the situation is risky.\(^5\) In *Re Canadian Airlines Corp.*, the Alberta Court held that the good faith of a distressed investor

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61. *Id.*
62. *Id.*
63. Existing creditors can often make a decision on post-commencement financing quickly, given that they have already acquired knowledge of the debtor’s financial position and may have sector-specific information that has informed previous credit decisions. Hence, they may have lower transaction costs in conducting the due diligence required in post-commencement financing decisions.
65. *Id.*
may be a factor in considering approval of a CCAA plan. There, the creditor continued to purchase a substantial amount of highly distressed debt when it was well aware of the financial deterioration of the debtor in order to leverage its position in the negotiations for a workout. Canadian courts will consider the motives of distressed debt purchasers in weighing the benefits and prejudice in particular restructuring cases.

Where the DIP lender is not a pre-filing creditor, it may have different timelines in terms of satisfying its claims. As a consequence, the DIP creditor may encourage the debtor corporation to consider liquidation prematurely, when there is still value in the debtor that could accrue to junior secured and unsecured creditors. Similarly, it may press for a going-concern sale to third parties when a sale to existing creditors would satisfy a greater percentage of claims or produce less prejudice to claims overall. A new post-commencement finance lender may have little concern about the outcome of the insolvency proceeding, since its claims are fully protected by the priming charge and it has no pre-filing debt that may be underwater. Given the controls that it extracts in the financing agreement, the post-commencement financing lender may unduly pressure the debtor corporation to consider its interests above those of other creditors. It may also pressure the debtor company to engage in particular bargaining or litigious conduct that unnecessarily prejudices pre-filing creditors and dictates the outcome of bargaining, confident that the size of the facility and the conditions under which it was granted will prevail. Since an objective of Canadian CCAA proceedings is to facilitate a process whereby the debtor is given the opportunity to devise a viable plan of arrangement, the courts should consider the potential prejudice to these objectives where DIP lenders have imposed control rights that prevent directors and officers from decision-making in the interests of the firm and all its stakeholders.

In Canada, the debtor corporation remains in control during the workout process, as the legislative scheme envisions, but not necessarily the directors and officers, who might be replaced or encouraged to resign. The ability of directors and officers to bargain for the terms of the DIP facility may allow them more room to negotiate overall with

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other stakeholders in finding the most appropriate plan of arrangement or compromise. The difficulty is where there is a lack of confidence in governance by the vast majority of creditors, but the DIP facility has the effect of entrenching the directors and officers. In some cases, corporate officers negotiate a specific provision that the debtor cannot change management and that such a change would be considered a default of the DIP agreement. Creditors are not given full access to the terms of the agreement and, thus, do not know of the existence of such terms at the point that the court endorses the DIP agreement. The control issue in respect of DIP lenders has become important because the market for such lenders has been particularly thin since autumn 2008.

Hence, while distressed debt lenders have often provided needed capital, their ability to purchase at a discounted value and their short term profit horizon can sometimes result in workouts that are not aimed at maximizing overall creditor value or at maximizing the overall value of the business enterprise.

A. Rogue White Knights

There is one case that illustrates some of the challenges of these new financing strategies. In Minco-Division Construction Inc., a distressed debt buyer had acquired the debt at a significant discount in order to gain strategic control of the CCAA proceedings, and the Québec Superior Court held that it had jurisdiction to take into account the circumstances under which distressed debt is acquired in insolvency proceedings, especially in situations where the purchaser of such distressed debt is pursuing a hidden agenda, is acting in bad faith, or "tramples on the rights and expectations of others." Minco-Division Construction Inc. was an owner-developer of a mixed residential and commercial condominium project under construction in Québec, which filed for court protection under the CCAA, owing its creditors more than $32 million. The first ranking Canadian bank granted DIP financing to the debtor, to be used to fund the restructuring process and to maintain and preserve the project. An interim receiver was appointed at the bank's request, to determine whether it was prepared to fund the sums required to complete construction. Over the course of the restructuring process, the DIP loan grew to approximately $5 million. The debtors had sought a "white knight" to buy out the bank's interest at a steep discount

69. Id.
in order to allow the debtor to seek permanent financing to fund a plan of arrangement and complete construction of its project. The white knight was found among three shareholders and another party, and the debtor had the expectation that the white knight would support the debtor’s restructuring efforts and not assert claims for the full value of the debt that it had acquired. Disagreement among the principals resulted in the white knight purchasing the rights of the mezzanine lender and numerous construction liens in order to control the class of creditors and defeat the debtor’s restructuring efforts. The Court concluded that no party intended that the white knight would take over the project; rather, its initial role was confined to putting the bank claim in friendly hands while looking for longer term financing to complete the project. The Court held that white knights usually have an interest when intervening to save a debtor from its creditors.  

In finding that the distressed debt buyer was a “rogue white knight,” the Court held that “threatening to hijack the project and frustrate a plan intended to bring a measure of relief to many creditors, including the purchasers of units, does not square with the good faith conduct required of contracting parties by article 1375 Code civile du Québec (CCQ).” In finding the white knight’s interest to be akin to litigious rights, the Court ordered that the debtor could satisfy and discharge all claims owing to the white knight by paying it, in the context of its plan of arrangement, the amount that the white knight had itself paid to acquire the subject debt claims. The Court further declared that on such payment by the debtors to the white knight, the debtors would be fully discharged in respect of the claims and the white knight would be deemed to have accepted Minco’s plan of arrangement.

Hence on the particular facts of the case, the Québec Court exercised its general authority under insolvency legislation, drawing on

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71. Here, the white knight investor was to have profited from its intervention at least to the extent of 30% or a fifty-fifty basis; instead the white knight used its position to try to take over the debtor on the strength of the giving in payment option contained in the security provisions of the bank claims. It was in this sense that the Court described it as a “rogue white knight.”

72. Id. ¶ 36. Article 1375 specifies that “the parties shall conduct themselves in good faith both at the time the obligation is created and at the time it is performed or extinguished.” In the circumstances, the Court decided to treat the claims of the white knight as if they were “litigious rights” because that was what the parties intended at the time that the bank debt was acquired at a discount. Id. ¶ 40. The Court drew from “litigious right,” which is described in article 1782 CCQ as: “A right is litigious when it is uncertain, contested or contestable by the debtor, whether an action is pending or there is reason to presume that it will become necessary entitling a debtor of such right to be fully discharged by paying to the buyer the sale price, the costs related to the sale and interest on the price . . . per article 1784 CCQ.”

73. Id.
concepts in the Québec Civil Code to prevent an abuse of process by a distressed-debt purchaser in the course of restructuring proceedings. Having regard to the overall legislative objectives, the Court balanced the interests of multiple creditors and limited the effects of the conduct of the rogue white knight by limiting the value of its claims to the purchase price of those claims plus costs of proceedings and interest costs. The white knight did not suffer any financial loss, but it was not able to take advantage of control rights to hijack the debtor’s efforts for a viable workout plan. The judgment in Minco-Division Construction Inc. indicates that where a creditor provides financing to support a debtor’s restructuring and receives a control or veto position in the restructuring process, the court may consider whether the creditor has acted in a manner that is abusive, in bad faith or that is inconsistent with the reasonable expectations of the debtor and other creditors at the time that such funding was agreed upon. The competing consideration—that a party to commercial agreement is entitled to pursue all legal rights that it has acquired in the transaction—was subject to the considerations of abuse, bad faith and inconsistency with reasonable expectations in the context of the insolvency proceeding.

The willingness of the courts to intervene in the effects of commercial transactions when they threaten the policy behind the applicable insolvency legislation will be tested in the treatment of credit derivatives in insolvency proceedings. Like the development of distressed debt markets, credit derivatives alter the economic incentives and motivations of stakeholders in insolvency proceedings so that they are unrecognizable in the traditional model of creditors’ incentives in insolvency proceedings.

V. CREDIT DEFAULT SWAPS AND THE EFFECT ON POST-COMMENCEMENT FINANCING

While a full discussion is beyond the scope of this paper, financing issues in insolvency proceedings cannot ignore the incentive effects of credit default swaps and other credit derivatives on insolvency restructuring proceedings. Credit derivatives are financial instruments that allow parties to manage credit exposure. A credit derivative can be

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75. There are numerous kinds of credit derivatives, such as credit default swaps, collateralized debt obligations (“CDOs”), full and index trades, and credit-linked notes. Elizabeth Murphy, Janis Sarra and Michael Creber, “Credit Derivatives in Canadian Insolvency Proceedings, ‘The Devil will be in the Details,’” in Annual Review of Insolvency Law, 2006 (Toronto: Carswell) at 187-234. Credit derivatives are classified as
a privately negotiated agreement that explicitly shifts credit risk from one party to the other; or it can be collateralized and housed within a special purpose vehicle that resells debt contracts in various tranches at differing prices, quality and risk. CDO can be cash-flow based, whereby the vehicle issues its own financial instruments to finance purchase of debts of different corporate entities, ensuring a fixed flow of loan repayments that are used to pay investors in the various tranches; or CDO can be synthetic, whereby the entity does not directly purchase debts but, rather, enters into credit default swaps with a third party, creating synthetic exposure to the debt of a number of corporate entities.\textsuperscript{76} The most common credit derivative, a credit default swap ("CDS"), is a credit derivative contract in which one party, the "protection buyer," pays a sum of money periodically to the "protection seller," usually referable to the amount of protection provided by the contract. The protection seller's obligation to pay arises on the occurrence of a credit event, most frequently, the reference entity's failure to pay, bankruptcy, or restructuring. The reference entity is not a party to the credit default swap. The protection buyer that is a creditor of the reference entity hedges the risk of default by that entity and takes on the risk of default by the protection seller. The protection seller acquires the default risk of the reference entity. Unlike insurance, the amount of compensation that can be claimed under a credit derivative is not related to the actual losses suffered by the protection buyer.\textsuperscript{77}

Credit derivatives emerged in the early 1990s as a tool for banks to manage their credit risk in respect of entities in which they had directly invested through their lending activities, diversifying their risk on loan default. In this respect, credit derivatives were initially effective in cushioning the commercial banks' losses in notable cases such as Enron and Parmalat. The market grew in less than two decades to an estimated $62 trillion in outstanding credit default swaps alone at the end of 2007. However, how such financial products work in practice bumps up against insolvency restructuring regimes that allow for the development of viable business plans that maximize enterprise value, preserve economic activity and save jobs. The existence of credit derivatives may


\textsuperscript{77} Credit derivatives do not require either the protection seller or protection buyer to actually hold an interest in the referenced asset; therefore the protection purchased by the protection buyer can be more than, less than, or completely unconnected to its underlying exposure to the reference entity. The protection buyer need not suffer an actual loss to be eligible for compensation if a credit event occurs.
perversely affect the motivation and behaviour of stakeholders of a financially distressed entity, and may cause greater complexity and uncertainty in a restructuring proceeding, as the real economic interests of claimants are not transparent.

Commercial banks as operating lenders traditionally had a strong role in monitoring the financial status of debtor companies, particularly in the period leading up to insolvency. However, their hedging of risk through derivatives has reduced the incentive to engage in oversight and monitoring, notwithstanding that they are best placed through loan covenants, access to information and in-house resources to engage in that monitoring. While arguably that hedging of risk freed up capital for other market participants seeking to borrow, the previous reliance that creditors and other market participants often had on banks to engage in such monitoring and the resultant signalling of a firm's financial health, have diminished considerably. Given the weaker covenants under which some debtor companies have financed their operations in recent years, creditors may be unable to assert control over a debtor until there has been a significant deterioration in its financial position, leading to deferred liquidation or restructuring and consequent lower recovery to creditors. It may no longer be feasible for the bank or other traditional operating lender to take a lead in restructuring negotiations, given that they have little or no remaining economic interest due to their credit default swaps.

On insolvency, one moral hazard is that a creditor that has material holdings of credit derivatives may have economic interests that encourage it to cause a default to occur so that there is a credit event. There are many factors that can affect the motivation and behaviour of stakeholders in an insolvency restructuring, given their economic interests; yet the creditor that has hedged its risk through a credit derivative is arguably in a different position in the restructuring proceeding, as there is a lack of transparency in respect of whether, in fact, there are economic interests at risk. This observation is not to suggest that credit derivatives drive behaviour in all cases; rather, it is a growing phenomenon with the move to cash settlements and growth of the market.

Under physical settlement of a CDS, the single institution from which a debtor company borrowed and believed it had a relationship results now in multiplicity of intermediaries and counterparties as CDS settle. The insolvent company may not even appreciate before commencing a restructuring proceeding that it is a reference entity. Cascading swaps means multiple rapid changes to who holds the claim,
making it difficult for a debtor company to establish who has a claim.\textsuperscript{78} It can suddenly be dealing with literally hundreds of new claimants. Given settlement time lags where the protection seller with each physical settlement becomes the party at the restructuring bargaining table, the company’s ability to devise a viable business plan can be hindered. This effect is particularly problematic if there is urgency in devising a plan because of a liquidity crisis or the need to maintain customer goodwill. Physical settlement of multiple CDS has the potential to cause a revolving door effect, making it hard for the company to build consensus and garner requisite support of creditors for a going forward viable business-restructuring plan.\textsuperscript{79}

A number of jurisdictions have granted exemptions for derivatives from stays under insolvency laws because of the important public-policy goal of global financial stability. However, the continued trading of derivatives can cause further financial instability of the market in the name of preserving liquidity and makes restructuring increasingly difficult for particular debtors. In this respect, there is a tension between two broader public-policy goals. On the one hand, Basel II capital rules require the ability to terminate, net and realize on collateral in order to allow institutions to take offsetting transactions into account for capital purposes.\textsuperscript{80} If parties cannot close out, they face exposure on their off-setting trades, which can cause greater financial problems in the market. On the other hand, the move towards rehabilitation in insolvency laws globally is driven by the recognition that liquidation can often leave value on the table that would have meant greater realizations for subordinated secured creditors, unsecured creditors and employees, as well as positive ripple effects in the local economy that can be realized by preservation of economic activity in the community.

Many restructurings are almost completely negotiated before any formal proceedings are taken, the UK being one such jurisdiction where this practice occurs. Yet creditors who may be obliged to assign their claims to protection sellers may not be able to bind their claims to an agreed restructuring plan, removing a valuable public policy tool to preserve economic activity.

Cash settlement of CDS poses different kinds of challenges for restructuring. Unlike insurance, no title to the claim passes, and there is no right of subrogation. With cash settlement, the protection buyer that is a creditor of the insolvent company continues to be the party with the

\textsuperscript{78} Murphy, Sarra & Creber, \textit{supra} note 75, at 10.
\textsuperscript{79} Id.
legal claim, although at a reduced or eliminated financial exposure. The debtor and other creditors have no notice or knowledge of the reduced exposure. If the creditor is fully hedged, there will be little incentive to engage in constructive negotiations for a restructuring plan. This level of disengagement may be problematic for the restructuring. While in some cases there can be an active market for derivatives during a restructuring where credit-derivatives holders are also direct creditors and take an active and constructive role in workout negotiations, the converse can also occur. The financial institution with which the debtor company has had an operating lending relationship may be less interested in advancing further credit in the form of post commencement or exit financing if it has no ongoing financial interest in the debtor. The creditor may actually have over-coverage and thus a negative economic interest, materially benefitting if the restructuring fails. Yet parties to the restructuring currently have no information on the economic interest held by those parties hedged through a credit derivative.

Accordingly, a debtor company may find the creditor that is hedged under a CDS adamant in its refusal to agree to amendments to its credit documentation (such as a payment change or deferral) and changes to covenants that would otherwise trigger a default or obligation acceleration. In addition, protection-buying creditors will be unlikely to consent to the extension of the maturity date beyond the protection period unless a credit event has already occurred or the extension itself qualifies as a credit event. These motivations may complicate the efforts of distressed companies to negotiate arrangements with their creditors at the early stages of distress in an attempt to restructure outside of formal insolvency proceedings. Moreover, a claims-trader creditor may be seen as having a new, speculative and short-term interest in the debtor. Having acquired its position when the debtor company is already in financial difficulty, it is often hedging against the speculative outcome of the restructuring process. Such a creditor, perhaps holding a deciding vote, has little interest in the long-term viability of the company.

Moreover, the normative justification for carving out derivatives from stays under restructuring proceedings is unclear, given the shift from their risk-management function to speculative product. The failure to stay derivatives claims creates a statutory preference for particular creditors, over the claims of traditional secured creditors, employees, trade suppliers, and tort claimants. Considering the general insolvency

81. Where there are cash settled credit default swaps, on occurrence of a credit event, the CDS may be settled by determining the value of the underlying debt instrument through an ISDA-run or similar auction, whereby the protection seller pays the protection buyer for its estimated loss based on the value established in the auction or where a value can be determined based on post-credit-event bids for the debt product.
law goals of transparency, timeliness, and certainty, such exclusion must be revisited. As the bailouts of 2008-2009 illustrated, there is a broader public interest in how the global derivative market is to operate effectively, and adjustments to the system must be made after public-policy discussion among stakeholders broader than industry participants. Interests affected are beyond capital-markets participants, and regulation is needed to ensure that there is transparency in the nature of economic exposure and underlying risk. There should be a public-policy debate on whether there is a need to design new principles to account for the separation of economic and legal interest in the context of insolvency proceedings.

These observations are not to suggest that the market has failed to address some of its flaws itself. CDS protocols and index auctions have helpfully assisted in facilitating cash settlements. The purpose of such protocols is to offer market participants an efficient way to settle credit derivative transactions referencing. The protocol mechanism facilitates industry-wide net settlement of CDS referencing an insolvent entity. While these innovations are important, they address only one aspect of the settlement process. There continues to be a lack of transparency as to who is bearing the ultimate costs of the deficiencies in value when all the CDS settlements are completed. There are also significant issues in respect of central counterparty clearing facilities and the need for regulatory intervention that are beyond the scope of this discussion.

Some jurisdictions have statutorily created unsecured creditors’ committees, where representative creditors have a role in the negotiations for an insolvency workout, paid out of the insolvency estate, and such

82. ISDA Protocols, supra note 3. For example, when Collins & Aikman filed for bankruptcy in 2005, there were concerns that there were not enough deliverable bonds to settle all the existing index-related contracts. To address this issue, the ISDA published the first protocols to amend the existing contracts for index-related trades to cash settlement from physical settlement on a multi-lateral basis, rather than through counterparty-to-counterparty negotiations, and to participate in an auction to determine the cash-settlement price of the defaulted bonds. With the CDS outstanding greater by multiples than the volume of bonds issued, the bonds would have to be bought and sold numerous times in the market to settle the CDS, which would have created pressure to source bonds, raising the price of the bonds higher than the likely recovery value. Hence, the market developed credit event auctions, first to facilitate cash settlement and more recently, to allow for physical settlement on net open positions. Nomura, CDS Recovery Basis, ISDA, 2006.

83. ISDA Auction Process, 2008, http://www.isda.org. The Lehman Brothers Holdings’ auction illustrated that the market can price the value of CDS and allow cash settlement for counterparties to CDS trades. The auction set a price and resulted in protection sellers paying ninety-one cents on the dollar to protection buyers. More than 350 organizations adhered to the 2008 Lehman CDS Protocol, which provided a settlement procedure for approximately $6 billion of net CDS exposures; ISDA 2008 Lehman CDS Protocol, id.
committees often have strong normative sway with the court. In some jurisdictions, courts recognize ad hoc committees of creditors for similar purposes. In thinking about the disconnection between economic interest and legal claim, it may be that the price for participation on such committees should be that such creditors are required to disclose the extent to which their economic risk has been hedged, with the court given authority to refuse to let the creditor participate where there is little or no economic interest.

Arguably, there should be mandatory disclosure during a restructuring proceeding of the real economic risks at stake, including disclosure of the amount of debt that has been hedged by creditors that seek to exercise their voting or oversight rights in a restructuring proceeding. Lack of transparency now means that the debtor company and other creditors are not aware of who is bearing the real economic risk of firm failure, inhibiting the potential for a viable business restructuring plan. The court should be granted authority to determine the scope and timing of disclosure, including making determinations in respect of confidentiality, limiting access only to parties in the proceeding, and determining any exceptions, such as for de minimus holdings. The court’s consideration of any restructuring plan should take account of economic interests at stake. This weighing of interest could be accomplished in two different ways: voting on a restructuring plan could be premised on the real economic interests in the firm’s insolvency, or alternatively, legal voting rights could be unaffected, but the court could be granted authority to weigh actual economic interests when considering parties’ positions and exercise of voting rights. It is also helpful to consider amending insolvency-restructuring legislation to include credit derivatives within the mandatory stay of proceedings, except with leave of the court on the basis of unfair prejudice, the standard currently used for other creditors to be exempted from the stay. The court could then exercise oversight of the clearing process in a measured way that assists with the risk-management aspects of the products and slows the speculative market. Such an approach could ensure that derivatives continue to settle where they are not adversely affecting the workout process, but could be stayed where the court was persuaded that the stay would prevent inappropriate conduct or would preserve going concern value pending negotiations for a restructuring plan.

84. See, e.g., Rule 2019 of the US Bankruptcy Code.
85. Sarra, supra note 75, at 8.
VI. CONCLUSION

Post-commencement and exit financing in insolvency proceedings continue to pose significant challenges, both in respect of attracting such financing and in considering how its availability and terms affect other stakeholders and the overall integrity of the insolvency system. While stalking horse proceedings, credit bids and other strategies to generate higher value have been a helpful response to financing in a period of global financial uncertainty and tightened credit conditions, they pose new challenges for other aspects of the insolvency system, such as the need for transparency and fairness; the need to consider multiple stakeholder interests; and the public interest in encouraging viable businesses with workable and fair business plans. The uncoupling of interest that has accompanied credit derivatives and their influence in insolvency proceedings has not yet garnered the attention of governments to date in any meaningful way, and the current extensive reforms proposed in the US and elsewhere have failed to address the issues raised by these products within insolvency restructuring proceedings. Post-commencement and exit financing are critically important to the restructuring goals of insolvency legislation. The challenges posed require considerably more attention over the next period.