

Author Justin Parappally

Boom, bust, and DIP – a Canadian perspective on DIP financing

KEY POINTS

- The Canadian market for DIP lending remains strained.
- DIP financing may enable the lender to monitor the debtor company more closely than it could under traditional secured loans.
- Amendments to Canadian insolvency statutes codify the factors a court should consider in deciding whether to approve DIP financing.
- Cross-border DIP financing, and, in particular, guarantees provided in that context by Canadian subsidiaries of insolvent US parent companies, has become a hot button issue.

INTRODUCTION

Debtor-in-possession ('DIP') financing, a preferential form of secured lending to insolvent companies, has become increasingly important in light of the ongoing turmoil in global financial markets and Canada has been no exception. For example, recent decisions by well-established Canadian companies such as Nortel Networks and Masonite International Corporation (a Kohlberg Kravis Roberts & Co portfolio investment) to file for bankruptcy protection reflect the challenging economic environment through which Canadian businesses must navigate.

Moreover, the recent high-profile US bankruptcy protection filings by Chrysler LLC and General Motors Co and the general turmoil in the automotive industry foreshadow an increase in the number of distressed companies seeking access to DIP financing in order to restructure their operations to weather the current economic storm. However, despite the fairly recent successes of Canadian companies, such as, Abitibi-Consolidated Inc, Smurfit-Stone Container Canada Inc, and InterTAN Canada Ltd (a wholly-owned subsidiary of US-based Circuit City Stores Inc) in securing DIP financing, the Canadian market for DIP lending remains strained, with only a handful of lenders willing to extend credit on onerous terms and at high interest rates.

WHAT IS DEBTOR-IN-POSSESSION FINANCING?

DIP financing refers to credit financing provided to insolvent debtor companies to enable them to carry on business while operating under formal court protection from their creditors. The need for DIP financing stems from the inability of financially distressed companies either to obtain trade credit from existing suppliers or to raise fresh funds to finance their day-to-day operations.

Typically, by the time a company is insolvent, it has not only exhausted credit from existing lenders, but more importantly, it has invariably granted a security interest over all or substantially all of its

Debtor-in-possession ('DIP') financing is a specialised type of credit financing provided to insolvent companies operating under court-supervised creditor protection. A DIP loan permits the distressed company to carry on business as a going concern. Key incentives for DIP lenders include a court-ordered superpriority charge over other creditors as well as the ability to charge fees and interest rates substantially above normal non-distressed lending rates. DIP financing is usually negotiated just prior to an insolvent debtor entering creditor protection, and must be approved by court order immediately thereafter. Unlike the US, DIP financing in Canada is not currently codified and the factors considered by a court in approving DIP financing are a matter of judicial discretion. However, amendments to Canada's insolvency legislation will codify the ability of courts to grant DIP financing in Canada. Given the number of companies with business operations in both Canada and the US, DIP lenders often request that a Canadian subsidiary provide a cross-border guarantee of the obligations of a US parent in the context of a DIP financing; this has become a hot button issue in several recent cases given the potential prejudice to Canadian creditors.

current and future assets. The absence of unencumbered assets over which new lenders could be granted a first-ranking security interest severely hampers a distressed company's ability to secure new funding, since lenders are understandably reluctant to provide debt financing to an insolvent company in such circumstances.

As a result, in order to balance the financing requirements of troubled companies against the demands of lenders to have a first-ranking security interest over the assets of such companies, Canadian courts are requested, in certain circumstances, to approve 'superpriority' DIP financings.

DIP financings have been judicially approved within the statutory framework of the *Companies' Creditors Arrangement Act* ('CCAA'), a federal statute which permits insolvent companies of a certain size to negotiate a plan of arrangement or compromise with their creditors during a statutorily imposed 'stay period'. The stay period under the CCAA allows a company 'breathing room' to operate while its lenders' contractual and legal rights and remedies (eg collection of interest or principal payments, foreclosure or liquidation of collateral) are rendered temporarily unenforceable. A CCAA restructuring is generally preferable to a bankruptcy liquidation proceeding for the parties involved.

Negotiations for DIP financings usually occur in the days or weeks leading up to a CCAA filing to ensure that the debtor

company will have access to funds in order to sustain its operations during the restructuring period. The need to secure post-filing funds exists because suppliers and creditors generally have no obligation to advance money or extend credit to a distressed debtor company after it makes a CCAA filing.

As a result, once the distressed company files under the CCAA, its lenders will likely terminate any existing financing facilities and its suppliers will generally alter payment terms and require the troubled company to pay for products and services on a 'cash-on-delivery' or 'cash-in-advance' basis.

Consequently, securing DIP financing prior to a CCAA stay filing ensures that cash will be available to meet the insolvent company's short-term post-filing cash requirements. DIP financing can also function as a means of maintaining supplier and consumer confidence at a time when the fortunes of the insolvent company may hang in the balance. Ultimately, when the restructuring is completed and the debtor company emerges from bankruptcy protection, it will require 'exit financing' to retire the DIP facility and resume operations.

LEGAL STATUS OF DEBTOR-IN-POSSESSION FINANCING IN CANADA

DIP financing in Canada has its origins in American law under Chapter 11 of the *US Bankruptcy Code*. However, unlike the *US Bankruptcy Code*, neither the CCAA nor Canada's federal bankruptcy statute, the *Bankruptcy and Insolvency Act* ('BIA'), currently contemplate DIP financings. (This paper was submitted for publication on August 17, 2009. The author notes that amendments to the CCAA and BIA which are to come into force on 18 September 2009 will codify the ability of a Canadian court to authorise interim DIP financings and to grant super priority security for such post-filing loans.)

However, in the absence of express statutory authority, Canadian courts have invoked their 'inherent jurisdiction' to create superpriority charges, giving DIP lenders a superpriority first-ranking security interest. This allows a DIP lender to stand at the front of the line in terms of priority of payment if the restructuring fails and the process shifts into a liquidation and winding-up proceeding.

Given that DIP financing in Canada is a judicially created tool, the courts have formulated their own approach to approving DIP facilities. Although the approach is fact-specific and will vary on a case-by-case basis, existing judicial decisions suggest that a superpriority DIP financing will generally be approved where all or substantially all of the existing secured creditors consent or acquiesce to the DIP financing, or where it can be demonstrated that existing secured creditors whose security interests are being 'primed' or subordinated, will not be materially prejudiced by the DIP financing. The court will also consider the importance of the business to the economic and social fabric of the community.

It should be noted that amendments to both the BIA and CCAA (Bill C-55) which are to come into force on 18 September 2009 provide that a Canadian court may in certain circumstances authorise first priority ranking security for DIP financings and set out the factors that

a court must consider when asked to approve a DIP charge.

The amendments seek to codify the existing judicial guidelines concerning the approval of DIP financing for insolvent debtors. In particular, the amendments will require courts to consider factors, including:

- the period during which the debtor is expected to be subject to proceedings under the BIA or the CCAA;
- how the debtor's business and affairs will be governed during the proceedings;
- whether the debtor's management has the confidence of its major creditors;
- under the BIA, whether the loan will enhance the debtor's prospects as a going concern if the proposal is approved and, under the CCAA, whether the loan will enhance the prospects of a viable compromise or arrangement being made;
- the nature and value of the debtor's assets;
- whether any creditor will be materially prejudiced as a result of the debtor's continued operations; and
- under the BIA only, if notice of the application was given to secured creditors, whether the debtor has provided a cash flow statement that projects out at least 120 days.

It is important to note that the amendments do not permit a court to grant a superpriority charge to secure pre-filing debt obligations.

PRINCIPAL FEATURES OF DEBTOR-IN-POSSESSION FINANCING

The primary incentive for a lender to provide DIP financing is that it allows lenders to charge higher rates with spreads comparable to other distressed debt instruments and collect a variety of fees for arranging a DIP loan. The higher spreads and fees associated with DIP loans are intended to compensate the DIP lender for the greater implicit default risk and monitoring costs associated with managing distressed loans. It should be noted, however, that the losses associated with defaults on DIP loans are often not as severe as other distressed debt instruments, due to a DIP loan's superpriority status.

Court-approved DIP loans also give the DIP lender a first-ranking security interest over the assets of the distressed debtor company by subordinating the interests of other creditors, including pre-filing bank lenders. The superpriority feature of DIP loans greatly reduces a DIP lender's exposure to the debtor company's default risk by enabling the DIP lender to realise a priority recovery in the event of a liquidation. However, despite their superpriority status, DIP loans generally still rank behind other court-ordered charges in favour of the debtor company's advisors, directors and officers. The superpriority feature of a DIP loan often encourages existing secured creditors to provide fresh DIP funds in what is known as 'defensive DIP lending'. In this way, existing lenders can protect their pre-filing loans and existing priority status over the collateral of the troubled company. In addition, defensive DIP lending allows existing creditors that have extended DIP funds to maintain (or even gain)

International Feature

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Justin Parappally is an associate practising in Stikeman Elliott's Corporate Group in Toronto with a focus on banking, restructuring and commercial insolvency. He has expertise in acquisition financing, debtor-in-possession financing and asset-based lending transactions.

significant control over the debtor company's operations during the restructuring period. This may be viewed as preferable to ceding control to a third party DIP lender.

Moreover, the credit agreements under which DIP loans are structured often incorporate a number of affirmative and negative covenants, permitting the lender to closely monitor the debtor company. Affirmative covenants typically require debtors to prepare more frequent and detailed financial reports and allow lenders to examine company books and conduct physical inventory checks. Negative covenants, on the other hand, may restrict specified payments and distributions, operating activities, capital expenditures and disposition of assets.

Negative covenants may also prohibit a debtor company from granting liens over its assets in favour of other creditors. Overall, the affirmative and negative covenants, together with the detailed reporting requirements, enable the lender to monitor the debtor company more closely than it could under traditional secured loans, thus providing the DIP lender with a significant degree of control over the operations of the debtor company and increasing the likelihood of timely repayment.

CROSS-BORDER ARRANGEMENTS

Given the great number of Canadian companies with US based operations and assets, it is often the case that a DIP lender may request that a Canadian subsidiary provide a secured guarantee of the obligations of a US parent.

One of the concerns surrounding such guarantees is that a cross-border DIP financing secured by assets of a Canadian subsidiary could in effect transfer assets to creditors of the US parent that could otherwise be available to unsecured Canadian creditors. In a recent high-profile court decision, *Re Indalex Ltd* (2009), 52 CBR (5th) 61 (Ont SCJ), the court set out those factors which a court should consider in determining whether to allow a cross-border DIP financing guarantee:

- the need for additional financing by the Canadian debtor to support a going concern restructuring;
- the benefit of the breathing space afforded by the CCAA protection;
- the availability (or lack thereof) of any financing alternatives, including the availability of alternative terms to those proposed by the DIP lender;
- the practicality of establishing a stand-alone solution for the Canadian debtors;
- the contingent nature of the liability of the proposed guarantee and the likelihood that it will be called on;
- any potential prejudice to the creditors of the entity if the request is approved, including whether unsecured creditors are put in any worse position by the provision of a cross-guarantee of a foreign affiliate than as existed prior to the filing, apart from the impact of the super-priority status of the new advances to the debtor under the DIP financing;
- the benefits that may accrue to the stakeholders if the request is

approved and the prejudice to those stakeholders if the request is denied; and

- a balancing of the benefits accruing to stakeholders generally against any potential prejudice to creditors.

Though only recently decided, insolvency and restructuring lawyers in Canada are already referring to the foregoing as the *Indalex* principles.

CONCLUSION

The deterioration in the Canadian economic outlook, combined with high corporate debt levels amassed under more favourable credit conditions, suggests that the number of distressed Canadian companies that will require funds to restructure and reposition their operations will likely increase.

Accordingly, the number of companies requiring DIP financing and the opportunities for lenders to provide DIP loans is expected to rise in the coming months. The tight credit conditions due to the continuing global credit crunch, however, suggest that the market for Canadian DIP financings will remain strained, as distressed companies continue to face a challenging lending environment. Amendments to the Canadian insolvency statutes, together with recent case law on the authorisation of cross-border guarantees in connection with proposed DIP financing, should provide some guidance to courts, insolvent companies and their advisors going forward. ■