THE BLACK HOLE OF INTERIM FINANCE UNDER INSOLVENCY AND RESTRUCTURING REGIME

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Companies undergoing corporate insolvency resolution process tend to be in dire need of funds to meet their working capital expenses. Interim finance can be an important tool for effective reorganization so as to prevent liquidation.

The Insolvency and Bankruptcy Code, 2016 ("Code") creates several opportunities for lenders looking to invest in distressed assets. One such area pertains to the provision of 'interim finance'. Interim finance essentially refers to short-term loans required to keep a company under the corporate insolvency resolution process running as a going concern. The Code defines interim finance to mean any financial debt raised by an interim resolution professional ("IRP")/resolution professional ("RP") during the corporate insolvency resolution process.

The Code allows an IRP/RP to raise interim finance in order to protect and preserve the value of the property of a corporate debtor and to manage its operations as a going concern. An IRP as well as an RP have unfettered rights to raise interim finance provided that - (a) the finance raised is below the monetary threshold set by the Committee of Creditors ("CoC"), if any; and (b) the conditions mentioned in point no. 2 below are met.

In the Code, the term 'insolvency resolution process cost' includes any interim finance raised for a corporate debtor along with the cost of raising such interim finance. The payment towards such costs gets the highest priority in a resolution plan or during liquidation and is paid out prior to any recoveries being made by any creditor. This payment includes interim finance, including principal and interest, which also gets this priority. However, since interim finance forms part of such costs, its payment is pari passu to other such costs like fees due to an RP. Similarly, during liquidation, the distribution waterfall provides for the highest priority to be given to insolvency resolution process costs, which need to be paid out of the liquidation estate.

The article seeks to set out the legal provisions governing interim finance in the sphere of insolvency and restructuring and sheds light on the practical considerations which govern the decisions of lenders in providing interim finance.

1. Consents / Authority to raise interim finance

Although an IRP is permitted to raise interim finance without the approval of the CoC, there are restrictions on the IRP with respect to creating security. An RP is permitted to raise interim finance after taking charge of a corporate debtor from the IRP under the Code. However, in the event that the CoC has placed a limit on the amount of interim finance that may be used during the corporate insolvency resolution process, this right of the RP is subject to their approval.

2. Creation of security

IRPs and RPs are permitted to create security while raising interim finance in limited circumstances which are: (i) on unencumbered assets of a corporate debtor, or (ii) on encumbered assets of a corporate debtor after taking approval of the requisite lender who has a prior security interest over those assets (provided that no prior consent of such secured creditor is required where the value of such encumbered assets is not less than the amount equivalent to twice the amount of the debt).

3. Accrual of interest

In the event that a liquidation order is passed against a corporate debtor, a lender of interim finance may only be able to claim interest as accrued and unpaid up to the liquidation commencement date, i.e., the date of the order. This is a factor that lenders should necessarily keep in mind while negotiating a commercially viable interest rate. Although there are different views in the market to achieve a viable commercial structure, including redemption premium and other such structures, there is no judicial precedent which could shed light on whether such structures are valid.

4. Priority in payment

As mentioned above, the distribution waterfall provides for the highest priority to be given to interim finance. However, once a liquidation order is passed against a corporate debtor, the moratorium that is in place during the insolvency process is lifted. Thus, secured creditors are free to enforce their security interest outside of this process.

Typically, in distressed companies, almost all assets of a corporate debtor are encumbered. In such situations, if all secured creditors, individually or separately, enforce their security after the moratorium is lifted, there may not be much left to distribute from the liquidation estate. Although interim finance has the highest priority as per the Code, lenders risk not being fully paid out as the liquidation estate does not comprise many estates in such situations. The Code attempts to remedy this by providing that the amount of insolvency resolution process costs due from secured creditors who realize their security interests would be deducted from the proceeds of any realization by the creditors. Such amounts need to be transferred to a liquidator to be included within the liquidation estate. This seeks to alleviate the difficulty but does not clarify what can be considered 'due' from the secured creditors.

The intent of the Code is that to the extent that there is no asset left in the liquidation estate to pay out insolvency resolution process costs, secured creditors enforcing their security outside the liquidation process are obligated to pay out these costs.

While jurisprudence on this point is yet to develop, certain concerns still remain, such as: the manner in which the share that each secured creditor must pay back to the liquidation estate should be determined, the timing of payouts by such secured creditors to the liquidation estate, the amount of time taken by interim finance lenders or a liquidator to persuade recalcitrant secured creditors to make these payouts and legal costs incurred by the interim finance lenders to persuade recalcitrant secured creditors.

5. Payouts

In a resolution plan and during liquidation, all lenders who have provided interim finance will rank pari passu to other insolvency resolution process costs. However, during the corporate insolvency resolution process, a lender may be able to negotiate priority payments over other interim financiers. In the event that the whole facility is not paid out during the corporate insolvency resolution process and there are any outstanding amounts at the time that the resolution plan is approved or the corporate debtor is in the process of being liquidated, such outstanding amounts will rank pari passu with other insolvency resolution process costs. Thus, lenders may negotiate a higher priority in repayment during the corporate insolvency resolution process but have no such right during the formulation of a resolution plan or in liquidation.

6. Trust and retention accounts

There are many instances in which existing lenders of a corporate debtor set up trust and retention accounts in order to ensure that all cash flows of the corporate debtor are only operated through such accounts. In such situations, all cash flows of the corporate debtor are blocked and may not even be treated as the property of the corporate debtor but may be treated as the property of the trust. However, there is a difference of opinion regarding whether an IRP or an RP would be able to control such property. Although more jurisprudence is required to have a definitive view on this issue, it is advisable that lenders providing interim finance be aware of this issue while lending.

7. Representations and warranties

Since interim finance is provided to companies that are financially distressed, it is important that lenders be aware that such companies will not be able to provide strong or reliable representations and warranties, which are seen in a usual financing transaction.

Since interim finance tends to be last-mile financing for cash-strapped companies, lenders can charge higher-than-normal rates of interest and earn handsome returns. However, at the same time, those providing interim finance should be aware of some of the legal and practical issues discussed above.