A comparative study of the corporate bankruptcy reorganization law of the U.S. and China
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Document Version
Publisher's PDF, also known as Version of record

Publication date:
2011

Link to publication in University of Groningen/UMCG research database

Citation for published version (APA):

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5 The reorganization-fostering system: automatic stay and post-petition financing

This chapter introduces the US and Chinese reorganization-fostering system, analyzes the efficient and inefficient elements of both systems and finally proposes reform suggestions for the Chinese reorganization-fostering system.

5.1 The automatic stay system in the US and China

5.1.1 The US Automatic Stay System

5.1.1.1 Overview of the US Automatic Stay System

Under the current US bankruptcy Code, the automatic stay comes into force immediately upon the filing of a bankruptcy petition.509 The automatic stay prohibits creditors’ individual debt-collection activities vis-à-vis the debtor and preserves the debtor’s assets for the operation of the collective bankruptcy procedure.510 For secured creditors, the stay “suspending the terms of the original loan and in effect forces the creditor to make a new loan equal to the amount of the secured claim”.511 The automatic stay imposes risk on the secured creditors since the reorganization procedure takes time and during the reorganization procedure, the debtor continues to use the collateral in order to work on reorganization. “If the attempt at rehabilitation fails, the delay in enforcement of rights caused by the stay could have resulted in irreparable damage to a creditor.”512

Secured creditors may protect their interests by applying for relief from the automatic stay. First, the US Code requires the court to grant relief from the automatic stay on the ground that the debtor has no equity in the property and the property is not necessary to an effective reorganization. 513 In essence, the basis for this kind of relief is that neither the debtor nor the bankrupt estate will obtain an economic advantage by keeping the property, so the creditor’s

right to enforce its claim to the property should not be further suspended. Second, the current US Bankruptcy Code requires the court to grant relief from the automatic stay on the ground that the debtor fails to provide “adequate protection” to secured creditors’ interest in property. The US Code requires that if the debtor fails to provide adequate protection, the stay should be lifted by the court upon the request of the creditor. §362(d) of the US code provides three kinds of adequate protection, which are: (1) providing cash payment or periodic cash payment to reduce the debt and maintain the ratio between the claim and the collateral value; (2) providing additional or replacing the existing lien with a lien on collateral of greater value; (3) providing other kinds of protection that result in an indubitable equivalence of the security interest. The meaning of the term “indubitable equivalence” is ambiguous. It is considered that §361(3) “sets a standard for measuring the protection, rather than suggesting a means of providing it. It requires the court to decide whether a means of protection…ensures that the claimant will certainly receive no less than the value of its property interest.” §361(3) clearly provides that granting the compensation a priority that is equal to the administrative expense does not constitute adequate protection. The legislative material of the US Code states clearly that “the concept of adequate protection is based as much on policy grounds as on constitutional grounds. Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section recognizes the availability of alternate means of protecting a secured creditor’s interest. Though the creditor might not receive his bargain in kind, the purpose of adequate protection is to ensure that the secured creditor receives in value essentially what he bargained for.”

518 House Report, p. 6295.
5.1.1.2 Protection of the Secured Creditors’ Interest during the Pendency of the Automatic Stay

Whether time value compensation should be included in adequate protection

The statutory provision suggests that adequate protection of the secured creditor’s interest is the precondition of automatic stay over the collateral. Due to the ambiguity of the statutory provision on the content of adequate protection, there are opposing opinions on whether adequate protection includes time value compensation in addition to the compensation of physical depreciation of the collateral. 510 Time value compensation, sometimes called opportunity cost compensation, post-petition interest payment or pendency interest payment (payment of interest that accrue on creditors’ claims from the date of the filing of the reorganization petition to the effective date of the confirmed plan), 520 is the compensation paid to secured creditors for their loss resulting from being unable to foreclose the collateral, sell it and earn an interest by investing the proceeds of the sale. 521 Some courts refused to give secured creditors’ time value compensation 522 while some courts held that time value compensation should be included in adequate protection. 523 Courts


522 See e.g., In re Smithfield Estates, Inc., 48 Bankr. 910, 914 (Bankr. D.R.I. 1985) (noting that adequate protection is a protection against any depreciation or diminution in the value of the collateral and that opportunity cost, or interest on the value of money should not be included within the definition of adequate protection); General Elec. Mortgage Corp. v. South Village, Inc., 25 Bankr. 987, 1002 (Bankr. D. Utah 1982) (holding that “[a]dequate protection is the fulcrum upon which the rights of debtors and creditors are balanced in a reorganization case. Congress knew that the payment of interest would be an impossible burden for debtors, many of whom file because of cash shortages. Congress allowed “periodic cash payments” in Section 361(1), but these are keyed to depreciation, not interest, and they are optional, not mandatory. If interest were required, it would run afoul of the nonprescriptive character of Section 361, as well as other provisions of the Code.”).

523 See e.g., In re American Mariner Indus. 734 F.2d 426, 430-2 (9th Cir. 1984) (holding that the legislative history suggests clearly that what is covered by the adequate protection under §§ 361 and
denying time value compensation held that one goal of the US Code was to facilitate reorganization and that paying time value compensation would reduce the resources available to the debtor to make a successful reorganization.\textsuperscript{524} Courts that agreed to include time value compensation referred to the legislative history and the principal of “no bankruptcy windfall” to support their opinion. Those courts held that the legislative history, the House and Senate Reports clearly expressed the congressional intention to provide protection for secured creditors’ interests in the collateral and not merely the physical value of the collateral.\textsuperscript{525} Secured creditors’ interests should not go unprotected simply because they are involved in a bankruptcy proceeding. To the extent that in bankruptcy the debtor can prevent secured creditors from enforcing their rights and thus benefit from the use of the secured creditors’ money, the debtor and its unsecured creditors receive a windfall at the expense of the secured creditors. Discrepant treatment of secured creditors’ interests inside and outside bankruptcy results in a windfall for the debtor and unsecured creditors merely by reason of the happenstance of bankruptcy. Adequate protection prevents such a windfall and insures that secured creditors receive the benefit of their bargain.\textsuperscript{526} From the discussions above, one may infer that at bottom, the opposing opinions of the courts on time-value compensation are caused by their different opinions as to whether the goal of facilitating reorganization of the US Code could override secured creditors’ pre-bankruptcy entitlements and whether bankruptcy reorganization law could change secured creditors’ pre-bankruptcy entitlements without providing full compensation.

Although at the beginning of the application of the US Code there were different judicial judgments representing two distinct directions, several years after the US Code became effective denying time value compensation became the trend.\textsuperscript{527} Finally, in 1988, in \textit{United


\textsuperscript{525} In re American Mariner Indus., 734 F.2d 426, at 430 (9th Cir. 1984).

\textsuperscript{526} In re American Mariner Indus., 734 F.2d 426, at 435 (9th Cir. 1984).

\textsuperscript{527} Douglas G. Baird and Thomas H. Jackson (1984), Corporate Reorganizations and the Treatment of

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Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs. (“Timbers”), the Supreme Court provided an authentic answer to this question by holding that adequate protection is to protect the secured creditors’ interest in property and does not protect the creditor's right to immediate foreclosure and that secured creditors were not entitled to interest as compensation for delay caused by automatic stay in foreclosing on collateral. The Supreme Court further held that §506(b) permits post-petition interest to be paid out of the “security cushion” (hereinafter referred to as “the cushion”)—the value of the collateral in excess of the amount of the secured claim. From then on, the case law has come to the common conclusion that “‘adequate protection’ is meant only to assure that a secured creditor does not suffer a decline in the value of its interest in the estate's property, rather than to compensate the creditor for the bankruptcy-imposed delay in enforcing its rights in that property”; in the context of over-secured creditors, the term “secured creditor's interest in property” or the protectable value covered by the adequate protection is the amount of the claim instead of the total value of the collateral.

To summarize, according to case law, for over-secured creditors, adequate protection means to keep the value of the collateral at the level equal to the principal amount of the claim; for under-secured creditors, adequate protection means to keep the value of the collateral against a decline; for both over- and under-secured creditors, adequate protection


11 U.S.C. § 506(b) provides:
To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

In re Addison Properties Limited Partnership, 185 B.R. 766, 784 (Bankr.N.D.Ill. 1995) (The court stated that although the implication of adequate protection was once in substantial doubt, it is now clear that adequate protection is to ensure the value of the collateral to the level of the principal amount of the secured claim and is not to compensate the creditors for the bankruptcy-imposed delay.) David Gray Carlson (1989), Postpetition Interest under the Bankruptcy Code, 43 U. Miami L. Rev. 577, p. 602 (noting that the Supreme Court has ruled out the possibility that adequate protection routinely implies post-petition interest).

In re Lane, 108 B.R. 6, at 7-8 (Bankr. D. Mass. 1989) (The court held that “[l]ack of adequate protection is decline in value of secured creditor's interest in property”; “Section 362(d)(1) of the Bankruptcy Code grants a party relief from the automatic stay ‘for cause, including lack of adequate protection of an interest in property of such party in interest’. .. in the context of an oversecured creditor, it is apparent that the value of the ‘interest in ... property’ .. is equal to the amount of the debt and not the value of the collateral”; “[t]here is no lack of adequate protection when equity cushion in excess of allowed amount of claim is eroding through decline in collateral value or increase in claim due to accrual of interest or expenses”; “[o]nce equity cushion disappeared, value of mortgage interest would begin to decline...mortgagor was entitled to adequate protection against that decline in value”).
does not mean time-value compensation for the delay caused by the automatic stay; it is based on §506(b) rather than the adequate protection provided in §361 as a result of which over-secured creditors can receive post-petition interest to the extent of the value of the cushion.

(2) When to value the collateral for the purpose of adequate protection

In order to determine whether there is a necessity to provide adequate protection, the court needs to establish a benchmark by establishing the value at a beginning point. Based on the benchmark, the court further needs to find out whether there is a risk that this value will decrease.\(^{533}\) Some courts held that the benchmark value should be the value of the collateral at the date of filing, i.e. the date of the bankruptcy petition. Since adequate protection is to protect the secured creditor against a decline during the automatic stay, in order to determine whether there is a need for adequate protection, the court must decide whether the value fixed on the date of filing will be subject to a risk of decline.\(^{534}\) However, some courts held that the benchmark value should be the value of the collateral on the motion date, i.e. the date that the creditor motioned for the adequate protection. These courts worried that the debtor might be forced to bear a large makeup payment burden if the date of filing is taken as the benchmark valuation date and the creditor files its motion of adequate protection later. If the debtor is unable to pay the unexpected adequate protection burden, the reorganization efforts may be seriously hindered.\(^{535}\) From this reasoning one may infer that the courts’ recognition of the bankruptcy policy of fostering the debtor’s reorganization has influenced them to choose the motion-date value as the benchmark value.

(3) Determining the proper interest rate

Where a creditor is over-secured and is entitled to post-petition interest payment, there is the


\(^{534}\) See e.g., In re Reddington/Sunarrow Ltd., 119 B.R. 809 (Bankr.D.N.M.1990) (The court held that since the collateral’s value fixed on the date of filing did not risk a decline, there was no need of adequate protection payment during the course of the case.)

\(^{535}\) See, e.g. In re Cason, 190 B.R. 917, 930 (Bankr. N.D. Alabama 1995) (“The creditor must affirmatively act in order to protect its interest after the debtor files its bankruptcy petition…. [v]aluation at the time of the motion would not reward the creditor for inaction, as would valuation at the time of petition …. if the creditor waited until late in the bankruptcy proceeding to file its motion, there could be a sizeable difference in value from the date of the petition until the date of the motion. If the date of petition is kept for valuation purposes, the debtor could be forced to deal with ‘sizeable makeup payments.’”).
problem of how to determine the proper rate for post-petition interest payment. Some courts adopted the market rate on the ground that the appropriate post-petition interest rate should be a rate that compensates the creditors’ loss caused by the delay or that would be charged by the creditor for a similar loan in the market.\textsuperscript{536} Some courts held that the proper post-petition interest rate should be decided according to the bankruptcy policy—an equitable distribution of the debtor’s assets.\textsuperscript{537} For instance, in re Vest Assoc., the court noted that in deciding the proper post-petition interest rate, courts generally adopt an equitable approach in deciding whether to use the contract default rate.\textsuperscript{538} “A court will refuse to enforce [contract default rates] if they are deemed to be penalties or forms of coercion instead of compensation for injuries that the lender incurred. In contrast, default rates with a much lower differential have been found reasonable subject to other equitable concerns.”\textsuperscript{539} “If a debtor is solvent, there is much more leeway to grant the default rate because other creditors will not be injured”; if a debtor is insolvent, a default rate, which is considered as significantly high, is often rejected by the court, because it “sweeps up virtually all proceeds in the estate for the secured creditor, leaving virtually nothing for other creditors” and conflicts with the aim of the bankruptcy process, which is an equitable distribution of the estate.\textsuperscript{540} “Nearly all courts agree that the basis for an equitable analysis of postpetition interest is rooted in the proposition that the Supreme Court set out long ago: ‘It is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of

\textsuperscript{536} See, e.g. In re Victory Constr. Co., 9 Bankr. 570, 574 (Bankr. C.D. Cal. 1981) (the appropriate rate should be a rate that equates to and protects against the creditor’ loss measured by a market rate); In re Landmark at Plaza Park, Ltd., 7 Bankr. 653, 657 (Bankr. D.N.J. 1980) (the appropriate rate should be the rate which would be charged by a creditor making a loan to a third party with similar terms, duration, collateral and risk); In Re Colegrove, 771 F.2d 119, 123 (6th Cir.1985)(noting that the appropriate post-petition interest rate should be the "prevailing market rate of interest on similar types of secured loans at the time of allowance of the creditors’ claim and the confirmation of the plan in bankruptcy with a maximum limitation on such rate to be the underlying contract rate of interest.").

\textsuperscript{537} See e.g., In re Hollstrom, 133 B.R. 535, 541 (Bankr. D. Colo. 1991) (noting that “[b]ankruptcy essentially is, after all, a process of equitably adjusting contending creditors’ claims and rights, and effectuating a fair distribution of a debtor’s property among those creditors.”) One situation in which courts consistently have declined to award the default rate of interest is where doing so would have diminished the recovery of junior creditors; In re Vest Assoc., 217 B.R. 696, 703-4 (Bankr. S.D.N.Y. 1998); Foss v. Boardwalk Partners (In re Boardwalk Partners), 171 B.R. 87, 92 (Bankr. D. Ariz. 1994).


\textsuperscript{539} Id.

\textsuperscript{540} Id, at 703.
equities between creditor and creditor or between creditor and debtor.\textsuperscript{541-542}

(4) Overall comments on the treatment of secured creditors’ interest under Chapter 11

Under Chapter 11, case law has made it clear that adequate protection, as a general rule, means preserving the value of the collateral at the level of the principal amount of the secured claim and does not include time value compensation. Although over-secured creditors are entitled to post-petition interest based on § 506(b), the post-petition interest payment may not compensate the creditors’ loss measured by the proper market rate, i.e. the rate that the creditors would charge for a similar loan on the market since under § 506(b) the overall amount of the post-petition interest payment is limited to the value of the cushion and the court may choose an interest rate lower than the proper market rate in order to achieve equitable distribution of the bankruptcy assets. Under-secured creditors can not receive any post-petition interest. In addition, some courts do not require the debtor to bear the adequate protection obligation for the period between the date of filing and the date of motion for adequate protection. To conclude, due to the reasons set out above, although Chapter 11 uses the term “adequate protection”, under Chapter 11 the protection of secured creditors’ interest is not really adequate.

5.1.1.3 The Delay Compensation to Unsecured Creditors of Solvent Debtors

Generally one would expect that debtors entering the bankruptcy procedure are insolvent and do not have enough assets to pay the total unsecured claims. According to the creditors’ bargain theory, the unsecured creditors of insolvent debtors would like to participate in a collective procedure to maximize their recovery because the delay they bear during the collective procedure is justified by the advantages they enjoy, i.e. receiving a higher distribution by maximizing the debtor’s overall value and reducing certain costs accompanying the recovery of their credit.\textsuperscript{543} Thus, in cases where there are not enough assets to pay the unsecured creditors, there is no need to talk about post-petition interest for the delay under the automatic stay. However, where the debtor is liquidation solvent (i.e. the

\textsuperscript{541} Vanston Bondholders, 67 S.Ct. 237 at 241.


\textsuperscript{543} Thomas H. Jackson (1982), Bankruptcy, Non-Bankruptcy Entitlement, and the Creditors' Bargain, 91 Yale L. J. 857, pp. 860-8.
debtor’s liquidation value, after paying the secured debt, is higher than the principal amount of its unsecured debts), or where the debtor is reorganization solvent but liquidation insolvent (i.e. the debtor’s liquidation value, after paying the secured debt, is lower than the principal amount of its unsecured debts, but its reorganization value, after paying the secured debt, is higher than the principal amount of its unsecured debts), the question of whether unsecured creditors are entitled to post-petition interest payment is pressing and requires a clear legal provision.

Chapter 11 does not contain any statutory provision directly dealing with this question. Some courts held that based on the principle of equity, unsecured creditors of solvent debtors should be awarded post-petition interest. In re Manville Forest Products Corp., the court first quoted that “the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditors and the debtor” and then held that where the debtor is solvent, it would be unfair and inappropriate to return all the surplus after paying the principal amount of the creditors’ claims to the debtor without paying post-petition interest to creditors.

Some courts drew the same conclusion by holding that equity indicates that the priority order in Chapter 7 and Chapter 11 should remain the same. In re Gaines, the court held that although section 726(a)(5) does not directly apply to Chapter 11 cases, if in Chapter 11, unsecured creditors of solvent debtors could not receive post-petition interest, the priority level in Chapter 11 would be different from that in Chapter 7 and the debtor would receive a windfall at the expense of creditors by using Chapter 11. Equity dictates that the Chapter 11 windfall should not happen.

Some courts came to the same conclusion by a systematic explanation of §726(a)(5) and §1129(a)(7). In re San Joaquin Estates, the Ninth Circuit Bankruptcy Appellate Panel held that a bankruptcy court abused its discretion by not

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544 See e.g., In re Beverly Hills Bancorp, 752 F.2d 1334, 1339 (9th Cir.1984) (“the award of post-petition interest is dependent upon the equities of the case.”); In re Manville Forest Products Corp., 43 B.R. 293, 299-300 (Bankr.S.D.N.Y.1984).

545 Vanston Bondholders, 67 S.Ct. 237 at 241.


547 In re Gaines, 178 B.R. 101, 103-4 (Bankr. W.D. Va. 1995). See also, In re Shaffer Furniture Co., 68 Bankr. 827, 829 (Bankr. E.D. Pa. 1987) (holding that “there are numerous guideposts and unanimity among the precedents that exist which establish that the distribution priorities in Chapter 11 cases should be the same as that expressly established by §§ 726(a)(5) and (a)(6) in Chapter 7 cases.”);


549 See e.g., In re San Joaquin Estates, Inc., 64 Bankr. 534 (Bankr. 9th Cir. 1986)

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awarding post-petition interest to an unsecured claimant when the debtor is “very solvent, [and] similar creditors in Chapter 7 would receive post-petition interest on their claims.”

§726(a)(5) provides that where the debtor is solvent and there is surplus left after paying the principals of unsecured claims according to the priority order, the surplus should be used to pay post-petition interests to unsecured creditors before the debtor may retain any value from his estate. §1129(a)(7) provides the best-interest test as one of the plan confirmation requirements in a Chapter 11 procedure, which is that every dissenting creditor should receive no less than what they would receive under a hypothetical liquidation. If a dissenting unsecured creditor of a solvent debtor would receive post-petition interest in liquidation proceeding, the Chapter 11 plan, which does not provide post-petition interest to him, fails to meet with §1129(a)(7) and should not be confirmed.

In cases where the debtor is liquidation insolvent but reorganization solvent, it is uncertain whether a class of unsecured creditors of a reorganization solvent debtor should receive the payment of post-petition interest. Some courts used the fair and equitable requirement provided in §1129(b) to reach the decision that post-petition interest should be paid to unsecured creditors before shareholders get anything. However, the fair and equitable requirement is too broad a standard and can only be used to protect the dissenting classes of unsecured creditors. It remains uncertain whether the other courts will adopt this approach and whether an assenting class of unsecured creditors of a reorganization solvent debtor should receive the payment of post-petition interest. This uncertainty may cause heated debate during the plan-drafting stage and costly litigation in the plan confirmation phase.

In addition to the ambiguity concerning whether post-petition interest is required for unsecured creditors, there remains the problem of how to determine the proper interest rate for unsecured creditors of solvent debtors. Courts have adopted different interested rates,

550 Id. at 536.
551 Id (“We look to a liquidation analysis under §§ 726(a)(5) and 1129….A Chapter 11 creditor is entitled to at least as much as it would receive under Chapter 7.”).
552 11 U.S.C. §1129(b) requires that a plan to be crammed down must be fair and equitable to a dissenting class. See Secion 4.1.2.1 for the detailed discussion.
such as the federal legal rate\textsuperscript{555} or statutory interest of the state law\textsuperscript{556}. The lack of clear and uniform provisions on the proper interest rate may cause debate and litigation.

To conclude, all the ambiguity discussed above leads to uncertainty and inconsistency with respect to post-petition interest payments to unsecured creditors of solvent debtors and may cause prolonged and costly bargaining and litigation.\textsuperscript{557}

5.1.1.4 The Efficient Elements of the US Automatic Stay System

The automatic stay is efficient in that it provides the foundation for the collective bankruptcy procedure and helps to maximize the value of the debtor and minimize the debt-collection costs. Automatic stay, which protects the bankruptcy estate from harassment, pursuit and dismemberment, is an essential component of bankruptcy law. Without automatic stay, all the creditors would try to pursue individual debt collection under non-bankruptcy law and the collective bankruptcy procedure would be neither orderly nor effective. Automatic stay, by staying individual debt-collection activities, provides the foundation for the operation of a collective procedure. According to the creditors’ bargain theory, bankruptcy, regardless of whether the procedure is one of liquidation or reorganization, is just a way to maximize the debtor’s overall value.\textsuperscript{558} Only when the bankruptcy assets are kept from being dismembered, will the claimholders, under the supervision of the court, be able to conduct an orderly liquidation or reorganization that maximizes the debtor’s overall value and their recovery as a group.\textsuperscript{559} In a reorganization procedure, if the creditors’ individual collection activities were not stayed, the debtor’s assets would be dismembered and the interested parties would not be able to bargain collectively, reach an efficient rescue plan or maximize the debtor’s overall value through the implementation of the plan. Judged against the value-maximization standard proposed by the creditors’ bargain theory, the automatic stay is efficient in that the

\textsuperscript{555} See e.g., In re Gaines, 178 B.R. 101, 106 (Bankr. W.D. Va. 1995).
\textsuperscript{556} See e.g., In re Shaffer Furniture Co., 68 Bankr. 827, 831 (Bankr. E.D. Pa. 1987).
\textsuperscript{557} Alexander F. Porter (2008), Postpetition Interest on Unsecured Claims in the Case of a Solvent Debtor: Toward a More Consistent Statutory Regime, 81 S. Cal. L. Rev. 1341, pp. 1358-60.
\textsuperscript{559} Brian A. Blum (2006), Bankruptcy and Debtor/Creditor: Examples and Explanations, Aspen Publishers, 4th Ed., p. 238 (commenting that the automatic stay gives the debtor sanctuary from creditor pressure so that orderly liquidation can be arranged or a plan can be produced for the debtor’s rehabilitation).
automatic stay, by stopping the creditors’ individual collections and establishing the collective
procedure, helps to maximize the debtor’s value and minimize the creditors’ debt-collection
costs.\textsuperscript{560}

5.1.1.5 The Inefficient Elements of the US Automatic Stay System

The inefficient elements of the automatic stay mainly lie in that it creates wealth redistribution,
which may cause interested parties to have skewed incentives when they decide whether to
use the reorganization procedure or when they bargain over the content of the plan during the
plan drafting and voting process. A detailed analysis is below.

Under the automatic stay system, creditors are prohibited from pursuing individual
debt-collection and thus bear time-value cost for the delay in receiving payment. It is however,
difficult to provide reasonable compensation to creditors for this delay.\textsuperscript{561} As discussed above
in Section 5.1.1.2 and 5.1.1.3, under Chapter 11, over-secured creditors may bear substantial
time-value cost because of the problems in respect of the post-petition interest payment;
unsecured creditors of solvent debtors may also bear time-value cost for the delay because of
the ambiguity concerning their entitlement to post-petition interest payment.

According to the creditors’ bargain theory, creditors’ pre-bankruptcy entitlements should be
respected inside bankruptcy. Otherwise, bankruptcy wealth redistribution would be created,
which may cause a series of inefficient effects. In the context of automatic stay, respecting
creditors’ pre-bankruptcy entitlements means that both over-secured and under-secured
creditors should get time-value compensation for the delay caused by the automatic stay since
they have bargained to be paid by the value of the collateral; unsecured creditors of solvent
debtors should get time-value compensation before shareholders receive any remaining value
since they have bargained to be paid before shareholders. Under the current provisions of
Chapter 11, there is bankruptcy wealth redistribution. Creditors receive insufficient
compensation for the delay while the debtor and its shareholders benefit from the automatic
stay by continuing to use the creditors’ money without paying the corresponding interest and
receive a reorganization windfall. The wealth redistribution may cause the interested parties to

\textsuperscript{560} See Section 2.1.1.1.

\textsuperscript{561} Thomas H. Jackson (2001), The Logic and Limits of Bankruptcy Law, Bear Books, p. 216.
have skewed incentive when they decide whether to enter the reorganization procedure. On the one hand, the shareholders or the debtor may try to use the reorganization procedure with as a means of using the creditors’ money without paying the corresponding interest. On the other hand, creditors may try to avoid the use of the reorganization procedure to avoid the time-value cost. Even after the reorganization procedure has been initiated, creditors may try to apply to the court to terminate the reorganization procedure to avoid their time-value cost. Moreover, the wealth redistribution may give rise to skewed incentives in the reorganization bargaining and distort the operation of the bargaining mechanism. On the one hand, creditors may be forced to accept a compromise in the form of an inefficient reorganization plan in order to avoid the time-value cost. On the other hand, junior classes may try to use the delay strategy to extract more distribution when they bargain during the plan-drafting and voting process even if they think the plan facing them is an efficient plan.

5.1.2 The Chinese Automatic Stay System

5.1.2.1 Overview of the Chinese Automatic Stay System

Under the EBL, once the court accepts a bankruptcy case, creditors’ individual debt collections are automatically stayed. Paragraph two of Article 75 of the EBL provides that during the reorganization procedure, secured creditors should suspend enforcement of their

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562 "Junior classes, be they equity holders or unsecured creditors, resort to reorganization in bankruptcy because they want the opportunity to sort things out for their benefit and to capture any upside potential in giving their firm a future, however uncertain. The precise nature of that uncertainty is irrelevant, but if the choice between liquidation and reorganization of the firm is not to be skewed, the residual classes must pay for the opportunity they seek. Such a requirement does not violate any well-conceived notion of fairness or equity. After all, someone must bear the risk that the reorganized firm will fail. To insist that the residual class bear the burden by way of a rule that provides secured creditors with the value of their rights under state law does not prevent desirable reorganizations. To the contrary, it encourages junior owners to put the firm's assets to the use that the owners as a group would prefer."

563 See Thomas H. Jackson (1982), Bankruptcy, Non-Bankruptcy Entitlement, and the Creditors' Bargain, 91 Yale L. J. 857, p. 876. The EBL, Article 19. This article provides that all the enforcement proceedings against the debtor’s assets should be stopped.
security rights. With regard to the protection of secured creditors’ interest during the automatic stay, paragraph two of Article 75 of the EBL provides that secured creditors may apply to the court for relief from the automatic stay if there is probability that the collateral may be damaged or the value of the collateral may decrease and that the damage or decrease in value will be big enough to affect the secured creditors’ interest. The EBL does not provide time-value compensation for the delay caused by the automatic stay.

5.1.2.2 Efficient Elements of the Chinese Automatic Stay System

Just as the automatic stay under Chapter 11, the automatic stay under the EBL is efficient in that it provides the foundation for the operation of the collective bankruptcy procedure and helps to maximize the overall value of the debtor. For the purpose of avoiding duplicated discussion, in this part of the book, the efficient elements of the automatic stay are not discussed in detail again. 566

5.1.2.3 Inefficient Elements of the Chinese Automatic Stay System

(1) The lack of time-value compensation to secured creditors

Recall that under Chapter 11, although time-value compensation to secured creditors as a general principal is rejected, over-secured creditors may receive post-petition interest for the delay under the automatic stay and the total amount of the compensation is limited to the value of the collateral in excess of the secured claim. 567

The EBL does not contain a provision dealing with the time-value compensation to secured creditors for the delay caused by the automatic stay. Item (i) of paragraph two of Article 87, which provides the cram down requirements for secured creditors’ distribution, requires that a dissenting class of secured creditors should receive “fair compensation for the delay in receiving payment”. 568 Should this provision be broadly interpreted as including compensation for the delay under the automatic stay and the delay under the plan? With this question in mind, the author studies the crammed down plans. Among the four crammed

566 For the detailed analysis on the efficient elements of the automatic stay, please refer to Section 5.1.1.4.
567 See Section 5.1.1.2.
568 See Section 4.2.2.1 for the complete provision of Article 87 of the EBL.
down plans, the plan of Jinhua, Guangming, and Dixian was objected to by the class of secured creditors. A study of these three plans showed that the court did not require the debtor to pay secured creditors compensation for the delay under the automatic stay. To conclude, there is no delay compensation for automatic stay. Thus, under the EBL, the debtor may pursue rehabilitation by continuing to use the assets of secured creditors without paying the corresponding interest. According to the creditors’ bargain theory, failure to provide time-value compensation to secured creditors will cause wealth transfer from the secured creditors to the debtor and the junior classes, which may cause the interested parties to have skewed incentives when they decide whether to use the reorganization procedure and when they bargain over the content of the reorganization plan.

(2) Problems in the protection of secured creditors’ security interest

Similar to Chapter 11, the EBL intends to protect secured creditors’ security interest. The EBL provides that a secured creditor may apply for a relief from the stay if there is a risk of a decline in the collateral’s value that is big enough to affect the secured creditors’ interest.

The EBL’s provision concerning the protection of secured creditors’ security interest is ambiguous, incomplete and inflexible due to the following reasons. The provision is ambiguous in that it does not prescribe in detail which kind of risk constitutes the eligible risk for relief from the stay. For instance, if the value of the collateral exceeds the amount of the secured claim, i.e. there is an equity cushion in the collateral, then does a risk of a decline in the value of the cushion but not in the part of the collateral’s value equal to the principal amount of the secured claim constitute a valid basis for relief from the stay? In order to avoid inconsistent results in similar cases, the EBL should provide whether

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569 See Appendix B.
570 The Plan of Jinhua was a plan crammed down over the objections of the class of secured claims and the class of general unsecured claims. The plan stated that the amount of the confirmed secured claims was RMB 1,023,445,518.51; the estimated value of the collateral was RMB 400,724,297.05; assume that the proceeds from the sale turned out to be RMB 400,724,297.05, the actual amount of secured claims should be RMB 400,724,297.05, secured creditors receive full payment from the value of the collateral, and the unpaid amount of RMB 622,721,221.46 should be classified into the class of general unsecured claims. The same kind of treatment was provided to the dissenting class of secured creditors in the plan of Guangming and Dixian. Clearly, in these three cases, although the plan was crammed down over the dissenting class of secured creditors, “fair compensation for the delay in receiving payment” provided in Article 87 was not interpreted to include the time-value compensation for the delay caused by the automatic stay.. See Jinhua’s Public Notice issued on August 3, 2010; Guangming’s Public Notice No.2010-047; Dixian’s Public Notice No. 2008-06.
571 Please refer to Section 5.1.1.5 for detailed analysis of the negative effects of wealth transfer.
572 The EBL, Art. 75.
the risk of a decline in the collateral’s total value or in the part of the collateral’s value that equals the principal amount of the secured claim constitutes the eligible risk for relief from the stay.

Moreover, compared with Chapter 11, the EBL’s provision is incomplete in that it does not provide that a secured creditor may apply for relief from the automatic stay where the collateral is not necessary for an effective rehabilitation and the debtor has no equity in the collateral.\textsuperscript{573}

Finally, the EBL’s provision is inflexible in that it does not provide the debtor with the opportunity of providing “adequate protection” in exchange for keeping the collateral under the automatic stay. Under Chapter 11, if the debtor provides “adequate protection” of the secured creditors’ interest in the collateral, such as providing periodic cash payment, additional or replacement lien, the debtor may still keep the collateral and use it.\textsuperscript{574} Compared with the EBL, Chapter 11’s provision concerning the protection of secured creditors’ security interest is more flexible. Through the provision of “adequate protection”, Chapter 11 may achieve the goal of helping the debtor’s reorganization and protecting the secured creditors’ security right in the meantime. To the extent that there is no such a flexible method available for the debtor provided in the EBL, the debtor in an EBL case may be hindered from using the necessary collateral for the pursuit of an efficient reorganization even if the secured creditors’ interest may be protected by other ways, such as periodic cash payment, additional lien or replacement lien.

(3) Lack of provision on the post-petition interest for unsecured creditors of solvent debtors

Although the EBL allows a solvent debtor to file the reorganization petition and enter into the reorganization procedure,\textsuperscript{575} it does not contain any provision on the post-petition interest payment for the delay caused by the automatic stay to unsecured creditors of a debtor that is solvent at the time of bankruptcy filing. Moreover, it does not provide whether unsecured creditors of liquidation insolvent but reorganization solvent debtors may receive post-petition interest payment for the period of the automatic stay. In cases where the debtor is solvent or liquidation insolvent but reorganization solvent, the fact that unsecured creditors can not

\textsuperscript{573} This is provided in 11 U.S.C. § 362 (d)(2).
\textsuperscript{574} This is provided in 11 U.S.C. § 361.
\textsuperscript{575} The EBL, Art. 7.
receive any time-value compensation for the delay under the automatic stay will result in a wealth transfer from the unsecured creditors to the shareholders.

5.1.3 Reform Suggestions for the Chinese Automatic Stay System

5.1.3.1 Providing Adequate Protection of the Secured Creditors’ Interest

(1) The content of adequate protection of secured creditors’ interest

It is proposed that the EBL adopt adequate protection of the pre-bankruptcy interests of secured creditors as the basic principle for the treatment of secured creditors under the automatic stay. Recall that under the US law, the term “adequate protection” implies that the debtor should maintain the value of the collateral to a level that is equal to the principal amount of the secured claim and that time-value compensation is not included in adequate protection. It is necessary to note that the term “adequate protection” in the reform suggestion means time-value compensation and protection of the security interest (maintaining the value of the collateral to secure the payment of both the principal amount and the post-petition interest). It is suggested that the EBL may provide that if the debtor fails to provide adequate protection, the court shall, upon application from the relevant secured creditors, grant the secured creditors relief from the automatic stay.

Outside of bankruptcy, secured creditors have bargained to realize their collateral and reinvest the proceeds at the market interest rate. Adequate protection is to ensure that secured creditors will receive what they would receive under a hypothetical foreclosure and thus will be as well off as they would be if there was no automatic stay. Adequate protection, as a device for respecting and protecting secured creditors’ interest under non-bankruptcy law, should include time-value compensation as part of its content. In addition, before entering into the bankruptcy reorganization procedure, secured creditors have bargained for a collateral to secure the payment of the principal amount and the interest. Respecting the negotiated security interest requires the value of the collateral to be maintained to secure the payment of

576 See Section 5.1.1.2.
577 “The difference between the real value and the nominal value of the secured creditor's protected fund is measured by interest. Hence, postpetition interest should accumulate on behalf of secured creditors, regardless of whether they are over- or under-secured.” Omer Tene (2003), Revisiting the Creditors’ Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 Bankr. Dev. J. 287, p. 349.
the principal amount and the expected amount of post-petition interest. During the automatic stay, if there is any risk of the value of the collateral declining to a level below the principal amount and the expected amount of post-petition interest the debtor should provide adequate protection of the security interest by feasible means, such as providing an additional lien, a replacement lien, periodic cash payment etc.

(2) Reasons for the adequate protection of secured creditors’ interest

According to the creditors’ bargain theory, bankruptcy law should respect the interested parties’ pre-bankruptcy entitlements. Otherwise, there would be wealth redistribution that would cause a distorted use of the reorganization procedure and strategic bargaining behaviors. By providing adequate protection of secured creditors’ interest, bankruptcy law respects the pre-bankruptcy entitlements of secured creditors and prevents the inefficient effects of wealth redistribution. A detailed analysis is below.

First, adequate protection prevents wealth transfer from the secured creditors to the junior classes and prevents the junior classes from pursuing inefficient reorganization at the cost of secured creditors. Adequate protection to secured creditors will serve as a device that filters out the inefficient rehabilitation. It will force the junior classes and the debtor to calculate whether the rehabilitation will yield returns in excess of the time-value compensation plus the decline of the collateral’s value. If a rehabilitation project produces a return that is less than the value that secured creditors would gain by foreclosing the collateral and reinvesting the money, the rehabilitation project is not efficient for the economy as a whole. Adequate protection of the secured creditors sets up a basic profit threshold for the rehabilitation project and restrains the junior classes and the debtor from pursuing an inefficient rehabilitation at the cost of secured creditors. Moreover, if bankruptcy law fails to provide adequate protection, secured creditors would try to avoid the use of the reorganization procedure before the debtor enters into the reorganization process and apply to the court to terminate the reorganization procedure after the debtor has embarked upon reorganization with the incentive of reducing their cost. In addition, secured creditors, who know how their security right will be treated if the debtor enters into the reorganization procedure, will take market strategies to counterbalance the risk they foresee. For instance, they may increase the interest or refuse to

578 See Section 2.1.1.2.
give loans to debtors that they think run the risk of going bankrupt. The increased secured loan interest or the increased difficulty in getting a secured loan may damage the whole economy by making it more expensive or difficult for corporations to get secured loans.  

Second, on the one hand, the lack of adequate protection will lead to the effect that secured creditors may be forced to agree a compromise in the form of an inefficient and unfair plan in order to cut off their time-value cost. On the other hand, the lack of adequate protection may induce junior classes to extract more in their collective bargaining in the reorganization procedure by using the delay strategy. Adequate protection can help to avoid these inefficient effects.

(3) Details of the design of the adequate protection

How should we calculate the post-petition interest payment or time-value compensation? The time period for paying the post-petition interest should be the period during which the automatic stay lasts less the average time for a secured creditor to realize the security right. How we should choose the proper interest rate for calculating the time-value compensation is another important detail that is discussed in Section 5.2.3.3. Recall that in US case law there are two different opinions on the bench mark value used to determine the adequate compensation paid as protection against the decline of the value of the collateral. If there were no automatic stay, the secured creditors would have the collateral’s value at the beginning of the automatic stay as the security. Since the adequate protection against the decline of the collateral’s value is intended to protect the secured creditors’ bargained-for security interest and to maintain the collateral’s value for the purpose of securing the payment of the principal amount and the interest, it is suggested that the bench mark value should be the value of the collateral at the beginning of the automatic stay. Under this suggested method, the debtor is forced to be vigilant regarding the decline of the value of the collateral and the efficiency of the reorganization efforts. Where the value is expected to decline rapidly during the automatic stay, the debtor has to calculate whether its continued

business will produce income that overcomes the decline of the collateral’s value; if not, the debtor has to stop pursuing such an inefficient reorganization. If the application time, i.e. the time that the creditors applied to the court for debtor’s payment against the decline of the collateral’s value, is taken as the bench mark, a debtor may try to hide the fact that the value of the collateral is declining to delay the creditors’ application and the debtor will not voluntarily abandon an inefficient reorganization plan since it is the secured creditor who bears the loss of the decline of the collateral’s value that happened before the date that the creditor files application for the protection of the collateral’s value. Therefore, taking the collateral’s value on the date on which the automatic stay commenced as the bench mark is efficient since this method respects the secured creditors’ pre-bankruptcy entitlements, avoids wealth transfer from the secured creditors to the debtor and forces the debtor to pursue an efficient reorganization that produces more income than the cost incurred by the reorganization.

5.1.3.2 Providing Time-value Compensation to Unsecured Creditors of Solvent Debtors

According to the creditors’ bargain theory, bankruptcy, be it liquidation or reorganization, is simply a procedure for maximizing the debtor’s value. Although the debtor may realize a higher value in the reorganization procedure than in the liquidation procedure or a private restructuring, the distribution order in the reorganization should remain the same as that in a liquidation procedure or under non-bankruptcy law. The creditors’ bargain theory emphasizes that bankruptcy law should respect interested parties’ non-bankruptcy entitlements in order to avoid wealth redistribution during bankruptcy. Respecting non-bankruptcy entitlements requires that the bankruptcy priority order should be the priority order bargained for by the interested parties under non-bankruptcy law. Since unsecured creditors have bargained for being paid before shareholders under non-bankruptcy law, in both the liquidation and reorganization procedure, unsecured creditors should be paid post-petition interest before shareholders receive any payment in order to fully respect the interested parties’

non-bankruptcy entitlements. It should be noted that in a case where the debtor is liquidation insolvent but reorganization solvent, the fact that the debtor is liquidation insolvent does not constitute a sufficient reason for denying post-petition interest to unsecured creditors, since in a reorganization procedure, the value to be achieved and distributed is the debtor’s reorganization value while the liquidation value is just a hypothetical estimation for proving the efficiency of the reorganization operation scheme. Denying unsecured creditors post-petition interest payment means that shareholders are allowed to use unsecured creditors’ assets for reorganization without paying the corresponding interest. Thus, wealth transfer from unsecured creditors to shareholders is created. According to the creditors’ bargain theory, wealth transfer from unsecured creditors to shareholders under bankruptcy law will cause inefficient effects.\(^{582}\) Thus, it is proposed that the EBL should provide time-value compensation to unsecured creditors of solvent debtors, i.e. debtors that are liquidation solvent or reorganization solvent.

5.1.3.3 The Practical Method of Determining the Proper Interest Rate

In a reorganization procedure, under the automatic stay, secured creditors are actually making a forced secured loan to the debtor. The ideal interest rate for providing time value compensation should be the market rate, i.e. the rate that the creditors would charge for a similar loan on the market. “[I]t is consistent with the reason for granting interest during the automatic stay to use the market interest rate as opposed to the contract rate or state interest rate ceiling. The market rate fully compensates the secured creditor for his loss due to the debtor’s remaining in possession of the collateral and thereby gives him ‘in value essentially what he bargained for.’”\(^{583}\) “The market rate fully compensates the secured creditor because, had he been allowed to foreclose and realize the collateral’s value, he could have loaned the proceeds at the current market interest rate. Compensation at less than the market rate would result in a subsidy to the debtor's reorganization,”\(^{584}\) a “bankruptcy windfall” to the junior classes and the debtor, or wealth redistribution inside bankruptcy which, according to the

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\(^{582}\) Please refer to Section 5.1.1.5 for a detailed analysis of the negative effects of wealth transfer from unsecured creditors to shareholders.


\(^{584}\) Id, at 323.
creditors’ bargain theory, will cause inefficient effects.\textsuperscript{585}

However, it is difficult to determine the proper market rate. The court needs to consider the factors peculiar to the case, such as the debtor’s character, the stability of the value of the collateral, the expected length of the automatic stay etc., and further examine how these factors influence the risk of the loan to the debtor and the rate to be determined. Because the factors in each case are specific and complicated, the rate determined by the court in a case on the basis of the judge’s subjective weighing of the specific and complicated factors of the case might very well be arbitrary. “Ideally, the court would provide the creditor with the ‘rate of interest which would be charged . . . by a creditor making a loan to a third party with similar terms, duration, collateral and risk.’ The difficulty in effecting this level of compensation is that the court, rather than the borrower and lender operating in an open market, must determine how factors peculiar to the transaction should affect the rate charged. Such effects are difficult to gauge outside of the market, and, as a result, the court's determination is likely to be inaccurate.”\textsuperscript{586}

Since it is difficult and costly for the court to find the ideal market rate, a practical solution is to adopt a fixed method, i.e. using a standard prime rate plus a risk premium to determine the rate.\textsuperscript{587} For example, the law may set the rate for a one-year Treasury bond as the prime rate and further provide a risk premium, such as 3%, or 4%. Although such a formula rate does not really match the specific risk in the forced loan in a specific case, it does have the advantage of certainty and predictability and it saves the debtor and creditors the cost in the determination of the proper market rate. Therefore, it is suggested that this fixed method may be adopted as a practical way for calculating the proper market rate.\textsuperscript{588}

\textsuperscript{585} Please refer to Section 5.1.1.5 for a detailed analysis of the wealth transfer from secured creditors to the junior classes.


\textsuperscript{587} Waltraud S. Scott (1988), Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest, 63 Wash. L. Rev. 1041, p. 1061 (“A case-specific market interest rate that reflects the characteristics of the debtor, the creditor, or the loan is a costly requirement…. Costs are not limited to the expense of expert testimony to establish market interest rates. They also include the cost of increased litigation and loss of private control over outcomes as a result of unpredictable court decisions. On balance, a uniform, predictable interest rate better serves the purposes of the bankruptcy system.”)

Similar to secured creditors, unsecured creditors of solvent debtors are also providing a forced unsecured loan to the debtor. Where the debtor is liquidation solvent or liquidation insolvent but reorganization solvent, unsecured creditors are entitled to receive post-petition interest. According to the creditors’ bargain theory, the rate for a similar unsecured loan in the market ("the market rate") should be the proper rate. A rate less than the market rate would cause wealth transfer from unsecured creditors to shareholders, which could cause inefficient effects. However, as discussed in the two preceding paragraphs, since it is difficult and costly to find the proper market rate, the fixed-rate method may be adopted as a practical solution.

5.2 The Post-Petition Financing system in the U.S. and China

5.2.1 The US Post-Petition Financing System

5.2.1.1 Overview of the US Post-Petition Financing System

Post-petition financing is often called debtor-in-possession financing ("DIP financing") in the American bankruptcy academia, since Chapter 11 adopts a debtor-in-possession model. In order to help the debtor to get post-petition financing, Chapter 11 provides attractive priority to post-petition financiers. Under Chapter 11, a debtor may get post-petition financing with different kinds of priority levels. First, the debtor may, without getting the court’s authorization, borrow on an unsecured basis and provide the post-petition financier with priority equal to the administrative expenses ("administrative-expense-priority") in the ordinary course of its business. Second, if the debtor can not get post-petition financing by providing the post-petition financier with administrative-expense-priority, the debtor may, after getting the court’s authorization, provide the post-petition financier with priority superior to the administrative expenses ("super-administrative-expense-priority") or provide the post-petition financier with a lien on unencumbered assets or a lien on encumbered assets junior to that of the prepetition creditors ("new lien"). Third, the debtor may, after getting the

589 See Section 5.1.1.5.
court’s authorization, provide the post-petition financier with a lien on encumbered bankruptcy property equal or senior to that of the prepetition secured creditors (“equal-lien or super-lien”). To do so, the debtor must show that it cannot get credit otherwise and that it has provided adequate protection to the existing secured creditor. The third kind of post-petition financing, which provides enhanced security to post-petition lenders, is the most noteworthy aspect of the US post-petition financing system. Although the law requires that when the debtor provides the DIP financing with an equal- or super-lien, the debtor must prove that there is adequate protection of the existing lien holder’s interest, it is difficult to achieve this “adequate protection” goal since establishing an equal security, especially a superior security on the same collateral, reduces the security level of the pre-petition lien holders. The requirement of “adequate protection” is quite problematic in this context. If the value of the collateral is really sufficient to provide adequate protection, the post-petition lender will not specifically ask for a super-lien. The new lender’s objection to lending without a super-lien shows that the collateral’s value is not enough for paying the new lenders after paying the old lenders and thus there is no adequate protection. In practice, courts rely on the value of the collateral to see if there is adequate protection of the pre-petition secured creditor’s interest.

5.2.1.2 The Efficient Elements of the US Post-petition Financing System

(1) Helping the debtor to gain post-petition finance by lifting the priority level of

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593 James J. White (2004), Death and Resurrection of Secured Credit, 12 Am. Bankr. Inst. L. Rev. 139, p. 170. See e.g., In re Snowshoe, 789 F.2d 1085, 1090 (4th Cir. 1986) (approving district courts’ permission to allow trustee in bankruptcy to obtain additional credit by granting senior lien on property of estate pursuant to 364(d) over objection of Snowshoe's major creditor Shenandoah). Shenandoah claimed that their interest in the estate was not adequately protected, and that Snowshoe had not made sufficient efforts to secure additional credit. Id. at 1087-88. The appellate court approved the district courts’ authorization to incur up to $2 million in debt, based on the findings that: Snowshoe owed Shenandoah between $13 and $14 million dollars, the estate was worth over $19 million dollars, and the trustee made a good faith effort to secure credit without granting the super-priority. Id. at 1089. See also Anchor Sav. Bank FSB v. Sky Valley, Inc., 99 B.R. 117, 119 (N.D. Ga. 1989) (district court approving bankruptcy court's authorization for super-priority financing of approximately $425,000). The objecting creditor had a first priority security interest on collateral worth $8 million to secure a loan of $3 million. The creditor's objection was that, "the debtor has no equity in its property, considering all encumbrances against all assets, and because the debtor has sustained negative cash flow and is not likely to reorganize." Id. at 118. The district court affirmed the bankruptcy court's finding that the creditor was adequately protected by the equity cushion and approved the financing. Id. at 119.
post-petition finance

A troubled debtor generally does not have enough cash on hand. If it intends to avoid liquidation and pursue reorganization, it often needs new finance to keep its business going. However, new lenders are often reluctant to lend since there is great risk of payment failure. The US post-petition financing system helps the debtor to gain post-petition finance by providing the post-petition finance priority, which may override or prime the pre-bankruptcy security rights. Because Chapter 11 offers “so much protection for lenders who provide post-petition financing, there is an active market for DIP financing.”

5.2.1.3 The Inefficient Elements of the US Post-petition Financing System

(1) Inducing inefficient post-petition financing

By allowing the DIP financier to enjoy a super-lien, Chapter 11 may induce inefficient post-petition financing, which relies on the cushion created by earlier investments instead of on the improved operation of the debtor’s business for receiving repayment. It is difficult and costly to define whether the collateral’s value is greater than the existing secured credit, because even if there is a large cushion for existing secured creditors, existing creditors need this cushion to ensure the post-petition interest payment for the delay under the automatic stay. The total amount of these payments is uncertain since the time period of automatic stay is often uncertain at the time of deciding the post-petition financing transaction. Therefore, allowing post-petition financing to leap over existing secured creditors damages the existing secured creditors’ pre-bankruptcy entitlements. According to the creditors’ bargain theory, this provision is inefficient since damaging pre-bankruptcy entitlements without compensation generates bankruptcy forum shopping and wasteful strategic behaviors. For instance, the debtor and its shareholders may choose to use the reorganization procedure with a view to acquiring new finance at the cost of pre-petition secured creditors. A new lender may choose

596 See Section 2.1.1.2.
to provide new finance given an incentive of being able to rely on the value contributed by the pre-petition lenders for repayment. Pre-petition secured creditors may try to save their interest by becoming the pre-petition lenders who control the debtor’s managers and push the debtor’s managers to serve their interest.  

(2) Being used as a controlling device for inefficient goals

Against the background that a Chapter 11 debtor is often in dire need of new finance, the post-petition financiers often use short-term, restrictive financing contracts to control the debtor’s business operation through a series of stringent contractual terms. For instance, the financing contract require the debtor to make a periodic financial report to the lender; restrict the debtor’s operating activities, use of the loan, disposition of assets, and cash payout; require the debtor to maintain specific financial ratios; require a significantly high interest rate. In addition, they may control the debtor’s bankruptcy reorganization through oppressive contractual terms. The post-petition financing contract may provide for the appointment of a specific chief restructuring officer as a condition for providing new finance. If they want to keep on the current managers, the contract may provide that the debtor will default if the debtor’s managers change. A post-petition financing contract may stipulate that the debtor defaults if the debtor fails to arrange for a sale of some or all of its assets or business by a specific date. It may also prescribe that the debtor shall not seek confirmation of a plan objected to by the lender. Post-petition lenders may, through their power to influence, help the debtor's managers to stay on and/or obtain a bonus agreement, which incentivizes the managers to act in line with the preferences of the lenders. For instance, if they prefer a quick sale, they may try to link the debtor’s managers’ bonus to the time used in the sale.

597 See the two paragraphs below for the pre-petition secured creditors’ strategic behavior for saving their interest.
and/or the price gained in a sale. To summarize, the post-petition lenders have adopted the post-petition financing as a tool with which they can exert substantial control over the debtor’s business operation and serve their own interest. If the post-petition financing arrangement, while serving the interest of the post-petition lenders, enhances the debtor’s value, it is efficient. However, if the post-petition financing arrangement serves the interest of the post-petition lenders but reduces the debtor’s value, it brings inefficient effects.

Post-petition financiers are often prepetition secured creditors. When a post-petition lender is also a pre-petition lender, he may try to enhance the prospects for repayment of his prepetition debt by including specially designed terms, such as a cross-collateralization clause and roll up clause, in the post-petition financing contract and enhance the recovery of his interest as a pre-petition secured creditor. One reason that pre-petition lenders choose to provide pre-petition financing may be that they generally know the debtor better than the other lenders and are willing to provide new finance when they see a going concern surplus in the debtor. Another possible reason is that since the debtor may provide a post-petition financier with a super-lien, prepetition secured creditors fearing that their security interest will be damaged, may choose to take action to save their interest. Through the post-petition financing contract, pre-petition secured creditors are able to bargain for a high interest and exert control over the debtor’s managers and ensure the repayment of both post- and pre-petition loan. If the pre-petition lenders’ control over the debtor’s managers through

604 Empirical study found that fifty-eight percent of DIP financiers were pre-petition lenders. Sandeep Dahiya et al., Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence, 69 J. Fin. Econ. 259, 265 (2003).
605 Cross-collateralization is a design under which the lender obtains security not only for postpetition loans, but also for its prepetition loans. A roll up clause provides that the post-petition finance is used, in whole, or in part, to pay prepetition secured debt. George W. Kuney (2004), Hijacking Chapter 11, 21 Emory Bankr. Dev. J. 19, pp. 60-3.
post-petition financing contracts enhances their own interest but reduces the debtor’s overall value, this leads to inefficient results.

5.2.2 The Chinese Post-petition Financing System

5.2.2.1 Overview of the Chinese Post-petition Financing System

With respect to post-petition financing, the EBL provides that the debtor-in-possession or the administrator may obtain a post-petition loan in order to continue the debtor’s business and may provide security to the post-petition lender. The EBL does not contain special provisions which grant administrative-expense-priority, super-administrative-expense-priority, equal lien or super-lien to post-petition financiers. According to Chinese security law, i.e. the law on the various kinds of security being used to ensure the payment of debts, generally, the priority order among the different lien holders on the same collateral should be determined by the time that the lien contract came into effect. The earlier the lien contract came into effect, the higher priority the lien holder enjoys. While it is possible for the DIP or administrator to provide a post-petition lender with a lien on unencumbered assets, or a junior lien on encumbered assets, it is not possible to provide a post-petition lender with administrative-expense-priority, super-administrative-expense-priority, equal-lien or super-lien (a lien equal to or superior to pre-petition lien on the same collateral), since the EBL does not provide these special kinds of priority. Therefore, an EBL post-petition lender can not get an equal-lien or super-lien on encumbered assets unless the pre-petition lien holder voluntarily abandons his priority right and agrees to give the post-petition lenders special benefits.

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608 The EBL, Art. 75.
610 Detailed provisions are as follows. According to Art. 42 and 54 of Guaranty Law of China, mortgage contracts in which the collateral is land-use right, buildings, forest, airplane, vessel, vehicle, or the facilities and/or inventory of a company ("special collateral"), may take effect only after the mortgage contract is officially registered. The priority of mortgage holders that hold a mortgage right on a special collateral should be determined according to the time of registration. Mortgage contracts in which the collateral is not a special collateral, may take effective on the date when the contract is formed or signed, and the priority among mortgage holders based on this kind of contracts should be determined according to the date on which the mortgage contract becomes effective. However, the contractual parties of a mortgage contract that takes effect upon the parties’ signing may choose to register their contract. Under this circumstance, the holder of registered mortgage should be paid before a mortgagee who did not register his mortgage contract.
5.2.2.2 The Efficient and inefficient elements of the Chinese Post-petition Financing System

Compared with its US counterpart, the EBL’s provision on post-petition financing has both efficient and inefficient elements. The Chinese post-petition financing system is efficient in that it does not modify the existing lien holders’ pre-bankruptcy bargained-for rights and will not cause inefficient post-petition financing that relies on the cushion created by previous investment instead of debtor’s improved operation for repayment. The inefficient elements of the Chinese post-petition financing system mainly lie in that it does not provide special priority to post-petition financing and thus provides no special help to the debtor in obtaining post-petition financing and can not foster the debtor’s rehabilitation as powerfully as its US counterpart.  

5.2.3 Reform suggestions for the Chinese Post-Petition Financing System

How to achieve a good balance between the protection of the old investors and the attraction of new finance for a financially distressed is a quite difficult problem. A tentative suggestion is proposed here with the aim of attracting better ideas. The tentative suggestion is that the EBL may add a provision, which provides that the DIP or the administrator may, after getting the court’s permission, provide new financing administrative-expense priority (priority equal to the administrative expense); or super-administrative-expense priority (priority superior to the administrative expense); or an equal lien (a lien equal to pre-petition lien on the same collateral). Where administrative-expense priority or super-administrative-expense priority is provided to the post-petition financier, the DIP or the administrator should provide to the court and interested parties a valuation report proving that the post-petition financing project is essential to the debtor’s rehabilitation and will enhance the debtor’s overall value and that the debtor’s pre-petition unsecured creditors and shareholders will receive from the debtor no less than what they would receive under hypothetical liquidation; Where specific security

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611 Hon. Samuel L. Bufford (2007), The New Chinese Bankruptcy Law Text and Limited Comparative Analysis, 16 J. Bank. L. & Prac. 5 Art. 3 (“Unlike U.S. bankruptcy law, there is nothing in the EBL to authorize financing that primes existing secured creditors. This is an important omission because it is very difficult to find DIP financing unless the lender can obtain priority over existing secured creditors.”)  
612 This is to ensure that the post-petition lender receives payment from the improved operation and the enhanced profit instead of from the old investment made by the unsecured creditors and shareholders and that the interest of the classes junior to the post-petition lender is not damaged by the post-petition
is provided to the post-petition financier, the DIP or the administrator should provide to the court and the interested parties a valuation report proving that the post-petition financing project is essential to the debtor’s rehabilitation and will enhance the debtor’s overall value; that the collateral’s value is sufficient enough for securing the repayment to pre- and post-petition secured creditors’ principal and interest. The reasons for the reform suggestions are discussed below.

First, the proposed system, by providing special protection to post-petition lenders, helps the debtor attract new finance. In the context of bankruptcy reorganization, granting special protection to the new lenders is necessary, since corporations in a reorganization procedure are often insolvent and in dire need of new financing and may not be in a position to obtain additional loans unless they can ensure that the new finance will not flow directly into existing creditors’ hands. The importance of post-petition financing to the debtor’s rehabilitation is commonly recognized and providing post-petition financing with special priority is a part of global consensus on bankruptcy law reform.\footnote{UNCITRAL Legislative Guide on Insolvency Law (2004) states that, “[t]he insolvency law should establish the priority that may be accorded to post-commencement finance, ensuring at least the payment of the post-commencement finance provider ahead of ordinary unsecured creditors, including those unsecured creditors with administrative priority.” Available at: http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf. World Bank, Principles and Guidelines for Effective Insolvency & Creditor Rights System (Apr. 2001) recommends in principle 18 that “[t]he law should provide for a commercially sound form of priority funding for the ongoing and urgent business needs of a debtor during the rescue process, subject to appropriate safeguards.” available at: http://siteresources.worldbank.org/GILD/PrinciplesAndGuidelines/20162797/Principles%20and%20Guidelines%20for%20Effective%20Insolvency%20and%20Creditor%20Rights%20Systems.pdf.}

Second, the proposed system tries to achieve a delicate balance between the attraction of efficient post-petition finance and protection of pre-petition claimholders’ interests. Some scholars commented that providing new finance to a debtor in reorganization is similar to salvaging a vessel in distress. An analogy may be drawn between post-petition financiers and the “salvors” under admiralty law. The Admiralty law generally grants priority to salvors’ claims over existing mortgages, based on the reason that there would have been no vessel for creditors to seize if the salvors had not invested in a rescue operation.\footnote{Hideki Kanda and Saul Levmore (1994), Explaining Creditor Priorities, 80 Va. L. Rev. 2103, pp. 2118-20. 2118-21. Omer Tene (2003), Revisiting the Creditors’ Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations, 19 Bankr. Dev. J. 287, pp. 376-7.} However, it should be noted that there is a difference between bankruptcy reorganization and vessel salvage. In financing arrangement.
the context of vessel salvage, because without the salvor’s help, the collateral for post-petition mortgagees, i.e. the vessel, would disappear, it is reasonable to grant super-security to the salvors. In the context of reorganization, without new finance, the debtor can not realize its going-concern surplus, but the collateral and the debtor’s liquidation value, unlike the distressed vessel, will not disappear. Thus, in the reorganization context, while providing protection to the post-petition lenders, there is a need to protect the value that the pre-petition lenders would realize under liquidation. The requirement of the valuation report and the cancellation of the super-lien serve this purpose. Only when the new financing transaction enhances the debtor’s overall value and does not encroach upon the pre-petition investors’ money, will it be accepted.

With respect to the protection of the pre-petition secured creditors, the US post-petition financing system is problematic. The US system allows the new lenders to leap over old lenders under the condition that existing secured creditors are adequately protected. It implies that if the collateral has sufficient value to pay both the old and the new lenders, the law does not damage the old lenders’ interest even if the law ranks the old lenders below the new ones. However, if there is really adequate protection of the old lenders’ interest, there is no need to put the old lenders below the new lenders. The new lenders’ objection to being ranked below the old lenders proves that there is actually no adequate protection of the old lenders. Because it is difficult for the court to make an accurate valuation of the collateral, providing new lenders super-lien creates room for inefficient post-petition finance whose lenders rely on the contribution of the pre-petition investors to receive repayment. Since the rationale for providing a lien on an encumbered property to new lenders is that the value of the collateral is sufficient enough for paying both the old and the new loan, the reform suggestion, which provides the new lender with an equal lien, reduces the room of inefficient post-petition financing without materially lowering down the protection of post-petition lenders’ interest. The fact that the new financer agrees to the equal lien is a signal that there is sufficient value to pay the old financiers since they rank at the same level.

According to the creditor’ bargaining theory, pre-bankruptcy entitlements should be fully respected and damaging pre-bankruptcy entitlements without compensation generates
bankruptcy forum shopping and inefficient strategic behavior.\textsuperscript{615} Bankruptcy law, while fostering the collective reorganization efforts, should respect pre-bankruptcy entitlements of the interested parties in order to avoid the inefficient results. By refusing to provide post-petition lenders a super-lien and requiring the valuation report obligation on the business decision-maker, the reform suggestion tries to achieve a delicate balance between the attraction of efficient post-petition finance and the protection of pre-petition claimholders’ interests.