AMERICAN BANKRUPTCY INSTITUTE

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Liquidity Crisis! Dealing with the Cash-Starved Chapter 11 Debtor Prior to and Through Chapter 11

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CONCURRENT SESSION

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ABI Annual Spring Meeting, April 20, 2021
Liquidity Crisis Panel

Understanding and Managing Cash in Distressed Companies

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Summary

- Executives must have the knowledge to identify and address impending cash shortages in time to avoid a crisis.
- Cash will drive most significant decisions, including timing, personnel, investment and value allocation in a restructuring.
- The mandate for implementing an effective cash management system needs to come from the top.

Managing Cash in a Distressed Company

- *Cash (vs. Accrual):* Rather than earnings per share or other accrual metrics, cash is what matters in a distressed situation.
    - Cash increases optionality in addressing operational problems and negotiating the terms of a financial restructuring; it allows offensive rather than defensive strategies.
- *Timely:* The outlook must be much more frequent than monthly or quarterly – weekly for the near term, daily if in a liquidity crisis.
- *Detailed:* Information must be detailed enough to enable a true understanding of the various sources and uses of cash.

Communication around Cash Forecasting

- *Internal Communication:* Companies must look beyond traditional reporting lines and involve organizational leaders across functional, operational and geographic areas.
    - Changes in both process and mindset are required.
    - Management should regularly re-examine spending decisions and balance priorities.
- *External Communication*: Lack of reliable information on cash and liquidity is often the first concern voiced by lenders and other creditor groups.
    - Lenders will expect a 13-week cash-flow forecast and regular reports of actual results and explanations of variances.
    - Providing reasonable projections, quickly addressing issues that are identified, and eliminating surprises help establish management's credibility.
    - For in-court restructurings, longer term cash forecasts will be the basis of sizing and covenants for debtor-in-possession (DIP) financing or cash collateral usage.
    - Forecasts determine the "length of the runway".

Implementing an Effective Cash Management System

- *Gaps in Traditional Tools:* Decentralized cash controls, compartmentalized management, and historic focus often fail to provide comprehensive and detailed liquidity information needed

for decision-making and can mask the real issues.

- *Internal Resistance:* Changes to "business as usual" may create tension among and within various internal functions.
    - Treasury may already prepare cash forecasts, which should be evaluated for enhancement. Running the new and old systems in parallel can allow time for adequate testing and modification and for obtaining "buy-in."
    - Finance often has responsibility for long-term earnings projections, operations for business forecasts, and treasury for short-term cash management – and all will have to coordinate.
    - Information technology may resist the reporting changes needed to extract new data in a different manner.
    - Departments will frequently have been downsized and may already be overtaxed.
- *Change Management:* Leaders should openly acknowledge these dynamics and emphasize the importance of the cash forecasting process to the success of the restructuring.
    - Creating accountability within each of the different functions is a key to obtaining cooperation.
    - Using the forecast for decision making will elicit greater effort in preparation and reporting.

Obtaining the Data

- *Current reporting*: The first step is determining what historical financial data and budgets/forecasts are available.
- *Timeliness*: Can information normally produced monthly, quarterly or annually be extracted more frequently?
- *Detail*: Can revenue be tracked by sources and expense by categories with sufficient detail?
- *Accessibility*: Is obtaining the information worth the time and cost? Can the data population and updates be automated?
- *Relevance and Reliability*: How are the operations managed? What internal and external factors have the most significant impact on the company's cash position?
    - The best cash forecasting processes combine accessible data with individuals who know how to interpret that data.

Preparing the Forecast

- *Forecasting Approaches:* Basis includes extrapolation of longer-range projections and historical run rate.
- *Timing:* Revenue and expense must be translated into receipts and disbursements, requiring identification of material periodic and irregular cash flows.
- *Working Capital:* Fluctuations in working capital often have a big impact on overall cash balances; asset-based lenders will focus on borrowing base.
- *Minimum Cash Balance:* Assumption should consider in-transit items, cash on hand, anticipated variability and one-time items.

Selected Drivers in cash-flow forecasting

Revenue/receipts – price, volume, growth, seasonality, billing cycle, accounts receivable, sales outstanding, bad debts.
Cost of sales/gross margin - product/materials, inventory purchases, direct labor, overheads, inventory balances, inventory turns, terms/days payable outstanding.
Payroll and benefits - headcount, wages, bonuses, commissions, payroll taxes, healthcare costs, benefits.
Operating expenses - sales, general and administrative (SG&A), occupancy, locations, fixed vs variable, percentage of sales, terms/ days payable outstanding.
Taxes - income tax rates, refunds.
Capital expenditures - maintenance level, remodels, acquisitions, dispositions.
Financing - revolver, borrowing base, debt service, letters of credit, interest, fees, refinancing.
Cash on hand - minimum levels, float, historical variability.

Reporting and Updating the Forecast

- *Reporting*: Both internal and external users of the cash forecast will expect reporting on a weekly basis and an explanation of variances.
    - Variances should be tracked weekly and cumulatively.
    - Explanations should indicate whether differences are timing or permanent.
- *Book vs. Bank*: Both book and bank cash balances are useful to track.
- *Frequency of Updates*: Presenting the most accurate possible picture of the company's cash horizon necessitates regular updates; measuring progress against the original forecast for the entire 13-week period allows for a thorough assessment of both accuracy and inputs.
    - Actual results can be compared to both the original and updated forecasts to achieve both reliability and accountability.
- *Scenario Analysis*: Assessing downside scenarios can be an important part of prudent contingency planning.

Maximizing Cash

- *Prioritization*: While not always sacrificing the long term for the short term, a distressed company must ensure that it lives to fight another day.
    - Expenditures should be prioritized by rate of return and payback.
- *Expense Reduction*: This is the time to eliminate waste and over-capacity and to consolidate support functions.
    - This process will entail renegotiating or terminating contracts and commitments.
    - Discounted cash settlements to avoid future obligations may be appropriate, such as buying out a lease for a closed facility.
    - Non-critical capital and other spending may need to be deferred to preserve cash, even if total cost will increase.
- *Working Capital*: Working capital management can contribute greatly to liquidity.
    - Negotiating longer vendor terms, eliminating excess or obsolete inventory, and aggressively pursuing customer collections will all help.
- *Spending Commitments*: Senior management should continually re-evaluate significant expenditures and commitments.
    - Spending authority should be reconsidered, with a bias towards decision-making at a more senior and centralized level.

Commitment Review Committee

- *Spending Discipline*: A commitment review committee meets regularly to review and approve, defer or decline all non-payroll operating and capital expenditures over a certain threshold.
- *Senior Management:* Members include the heads of operations, customer service, information technology, sales, marketing and supply chain management, as well as the CFO.
- *Goals:*
    - Increase organization focus and controls around cash usage through enhanced executive oversight.
    - Achieve stronger alignment between cash spending and strategic priorities.
    - Balance the needs of the business units in spending decisions.
    - Impact cost structure and improve profitability through reduced spending.
    - Achieve indirect spending reductions through greater employee awareness of spending discipline and a decrease in requests submitted.

Cash Requirements - Preparing for Bankruptcy

- *Incremental Cash Needs*: While the automatic stay prevents the collection of pre-petition debts, additional cash requirements accompany a bankruptcy filing.
- *Pre-Petition Payments*: To reduce uncertainty, a company preparing to file bankruptcy should consider making advance payments for items including:
    - Employee payroll, expense reimbursements and payroll taxes;
    - Insurance premiums and retirement benefit contributions;
    - Single-source vendors; and
    - Essential service providers.
- *Key Employee Retention and Incentive Plans:* Plans that compensate key employees for staying with the debtor for a certain period have been significantly restricted, but a debtor may obtain approval for incentive plans with appropriate targets.
    - Implementing such plans pre-petition may be advantageous.
- *Professional Fees:* Having competent attorneys and advisors is key; the debtor is responsible for paying its own professionals and those of certain creditors.
    - Providing adequate pre-petition retainers to all the debtor's legal and financial professionals ensures that unpaid fees do not create disabling conflicts.
- *Committee:* Payment decisions pre-petition will affect the composition of the Unsecured Creditors Committee, which will be influential in the reorganization.
- *COD/CIA:* Vendors may require cash on delivery (COD) or cash in advance (CIA).
    - Critical vendor agreements often require typical trade terms.
- *United States Trustee Fees*: Fees based on disbursement levels must be paid quarterly and can be material.
- *Utilities*: Utilities are entitled to a deposit, normally for two to four weeks of service, as assurance for payment for continued service after a bankruptcy.
- *Priority and Administrative Claims:* Certain claims require payment at or before confirmation, or other consideration authorized by the Bankruptcy Code:

- Section (503)(b)(9): Sellers of goods received by the debtor within 20 days before bankruptcy have administrative claim status.
- Reclamation Claims: Suppliers may demand return of goods received 45 days or fewer before bankruptcy.
- PACA/PASA Claims: Suppliers of perishable fruits and vegetables or unprocessed meats may be entitled to a priority claim.
- Employees: Employees may be entitled to a claim of up to $13,650 for unpaid wages and benefits.

Conclusion

- A company must manage its cash well to undertake a restructuring, particularly in a bankruptcy proceeding.
- A proactive approach should include an enhanced focus on preserving cash and improved tools for forecasting and reporting the cash position.
- Management needs liquidity and visibility to balance the needs of employees, customers, suppliers and capital providers.
- Knowing how to manage cash and doing it well will not necessarily ensure success for a distressed company, but not doing so will certainly engender failure.

Source: Kibler, Melissa S., et al. (2010) When cash is king: Understanding cash requirements for distressed companies and maintaining effective management and reporting systems, *Navigating Today's Environment: The Directors' and Officers' Guide to Restructuring.*

ABI Annual Spring Meeting, April 20, 2021
Liquidity Crisis Panel

Procedural and Practical Considerations Regarding the Use of Cash Collateral and DIP Financing[1]

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I. Use of Cash Collateral: 11 U.S.C. § 363.

A. Definition. "'[C]ash collateral' means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in [11 U.S.C. § 552(b)], whether existing before or after the commencement of a case under this title." 11 U.S.C. § 363(a).

B. Restrictions on the Use of Cash Collateral. A trustee or debtor-in-possession may not use cash collateral unless (i) each entity with an interest in the cash collateral consents or (ii) upon court authorization. *See* 11 U.S.C. § 363(c)(2).

C. Adequate Protection. Upon request, the trustee or debtor-in-possession must provide "adequate protection" to a party who has an interest in the cash collateral. 11 U.S.C. § 363(e). A creditor is only entitled to adequate protection to the extent of the anticipated or actual decrease in value of the collateral during the bankruptcy case. *See In re First South Savings Assoc.*, 820 F.2d 700, 710 (5th Cir. 1987). The adequate protection, therefore, "must not substantially exceed that to which the secured creditor is entitled." *In re Blehm Land & Cattle Co.*, 859 F.2d 137 (10th Cir. 1988). "The whole purpose in providing adequate protection for a creditor is to insure that the creditor receives the value for which the creditor bargained prebankruptcy." *In re O'Connor*, 808 F.2d 1393, 1396 (10th Cir. 1987).

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[1] These materials were first used at the 38th Annual ABI/UMKC Midwestern Bankruptcy Institute in a presentation entitled "Show Me the Money: Procedural and Practical Considerations Regarding the Use of Cash Collateral and DIP Financing." The Panel would like to acknowledge Devon Eggert for his assistance in preparing the earlier materials and the Hon. Katherine Constantine and her law clerks, Will Martin and Jessica Nin, for their insights in the preparation of the 2018 version of these materials.

[2] DISCLAIMER: These written materials and the presentation made by the panelists are intended for educational and discussion purposes only. The panelists/authors are involved in cases regarding the various issues addressed in these materials and presentation. Any view or opinion expressed during the course of the presentation or in the materials is not intended to be attributable to the court, the clients of the authors, panelists or their respective firms, and are not intended to bind any of the authors, panelists, their firms, or their clients to any position or decision they may or may not take in those cases or in future cases.

1. **Types of Adequate Protection (11 U.S.C. § 361).** Adequate protection can take many forms including cash payments, additional and replacement liens, and an "indubitable equivalent." *See* 11 U.S.C. § 361. *See also O'Connor*, 808 F.2d at 1396-97 ("[C]ourts have considered 'adequate protection' a concept which is to be decided flexibly on the proverbial 'case-by-case' basis.")(citing *In re Martin*, 761 F.2d 472 (8th Cir. 1985); *In re Monroe Park*, 17 B.R. 934 (D.C. Del. 1982)). "Indubitable Equivalent" has been defined as follows:

> The phrase "indubitable equivalent" originated in the context of a plan cramdown. Courts have used the plain meaning of "indubitable equivalent" in applying it to determine confirmation standards under Section 1129, and the definition is relevant here. "Indubitable means 'not open to question or doubt', WEBSTER'S THIRD NEW INT'L DICTIONARY 1154 (1971), while equivalent means one that is 'equal in force or amount' or 'equal in value', ID. at 769.... Thus the 'indubitable equivalent' under [Section 1129(b)(2)(A)(iii)] is the unquestionable value of a lender's secured interest in the collateral." *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 310 (3d Cir. 2010); *Richfield 81 Partners II, LLC v. SunTrust Bank (In re Richfield 81 Partners II, LLC)*, 447 B.R. 653, 657 (Bankr. N.D. Ga. 2011).

In re Bay Circle Properties, LLC, 577 B.R. 587, 595-96 (Bankr. N.D. Ga. 2017).

2. **Equity Cushion**. An equity cushion, in and of itself, may constitute adequate protection. *See, e.g., In re Campbell Sod, Inc.*, 378 B.R. 647, 653 (Bankr. D. Kan. 2007)("A sufficient equity cushion may constitute adequate protection."); *In re Polaroid Corp.*, 460 B.R. 740, 744 n. 9 (8th Cir. B.A.P. 2011)("An equity cushion can afford adequate protection."); *In re Brown*, 78 B.R. 499 n. 4 (Bankr. S.D. Ohio 1987) (stating "[s]ome courts have held that the existence of an equity cushion, standing alone, can provide adequate protection.") (citing *In re San Clemente Estates*, 5 B.R. 605 (Bankr. S.D. Cal. 1980); *In re Tucker*, 5 B.R. 180, 182 (Bankr. S.D.N.Y. 1980)); *see also Shaw Indus. V. First Nat'l Bank (In re Shaw Indus., Inc.)*, 300 B.R. 861, 865 (Bankr. W.D. Pa. 2003) (stating "[t]he existence of an equity cushion alone can constitute adequate protection.").

3. **Failure of Adequate Protection.**

   a. **11 U.S.C. § 507(b)**. In certain circumstances, a secured creditor may be entitled to a super priority administrative claim when adequate protection fails. Generally, three requirements must be met:

> (1) adequate protection must have been provided originally, and must have proven over time to be inadequate; (2) "the creditor must have an allowable claim under § 507(a)(2) (which in turn requires that the creditor have an administrative expense claim under § 503(b));" and (3) "the claim must have arisen from either the automatic stay under § 362; or the use, sale or lease of the collateral under § 363; or the granting of a lien under § 364(d)."

MICHAEL J. HOLLERAN, ET AL., BANKRUPTCY CODE MANUAL § 507:45 (May 2018)(quoting *Ford Motor Credit Co. v. Dobbin*s, 35 F.3d 860, 865(4th Cir. 1994)). In order to qualify for an administrative claim, it is important these requirements are satisfied. *See In re Blankenship Farms, LP*, 612 B.R. 570, 590-91(Bankr. W.D. Tenn. 2019)("This Court simply cannot conclude that a debtor's ex parte agreement to allow an equity cushion that existed at the time of filing to serve as adequate protection qualifies as a post-petition inducement that would entitle a creditor to receive an administrative expense claim…. Had the Debtors agreed to provide additional adequate protection to [the secured lender] after the case was filed, the result would be different.").

b. Court Approval of Adequate Protection Necessary? Court approval of an *ex parte* adequate protection agreement may not be required in order to qualify for Section 507(b) expense, but such agreements are subject to close scrutiny. *See In re Blehm Land & Cattle Co.*, 859 F.2d 137, 140 (10th Cir. 1988)("We note, however, that prior court approval of adequate protection agreements is the more prudent and preferred approach.").

> ➢ ***Committee Practice Pointer.*** *The committee must be certain that the proposed form of adequate protection is appropriate under the circumstances. The purpose of adequate protection "is to insure that the creditor receives the value for which he bargained pre-bankruptcy. See O'Connor, 808 F.2d at 1396; see also In re Medcorp. Inc., 472 B.R. 444, 452 (Bankr. N.D. Ohio 2012) (stating "[t]he purpose of adequate protection is to guard a secured creditor against any decrease in the value of its collateral resulting from depreciation, destruction or the debtor's use of cash collateral."). Adequate protection thus ensures that a creditor's collateral is not depreciating or diminishing in value during the bankruptcy case. See O'Connor, 808 F.2d at 1397. A secured creditor must "prove this decline in value –or the threat of a decline—in order to establish a prima facie case." In re Gunnison Ctr. Apts., LP, 320 B.R. 391, 396 (Bankr. D. Colo. 2005).*

D. CAUTION: Post-Petition Effect of Security Interest.

1. General Rule. Property acquired post-petition by the bankruptcy estate may not be subject to pre-petition security agreements. *See* 11 U.S.C. § 552(a).

2. Exceptions. There are certain limited exceptions where the security interest will continue to attach: (a) proceeds, products, offspring, or profits from pre-petition collateral; (b) rents from prepetition property; and (c) hotel fees, charges, and payments for lodging, if covered by prepetition agreement. 11 U.S.C. § 552(b).

> ➢ ***Lender Practice Pointer***. *If a secured creditor's collateral consists of receivables or inventory, it cannot simply rely upon its after acquired property clause in its loan documents. See In re Local Service Corporation, 503 B.R. 136, 140 (Bankr. D. Colo. 2013)("The Bankruptcy Code very clearly cuts off the operation of 'after acquired' property clauses, but it does so expressly only in the context of consensual liens."). Thus, at a minimum, the secured creditor should obtain replacement liens in such collateral as part of any order approving cash collateral.*

E. Mechanics: Bankruptcy Rule 4001(b).

1. Motion. The use of cash collateral must be made by motion. FED. R. BANKR. P. 4001(b)(1)(A).

a. Required Contents. The motion must contain the material provisions and address the following items:

i. "[T]he name of each entity with an interest in the cash collateral;"

ii. "[T]he purposes for the use of the cash collateral;"

iii. "[T]he material terms, including duration, of the use of the cash collateral;" and

iv. "[A]ny liens, cash payments, or other adequate protection that will be provided to each entity with an interest in the cash collateral or, if no additional adequate protection is proposed, an explanation of why each entity's interest is adequately protected."

FED. R. BANKR. P. 4001(b)(1)(B)(i)-(iv).

b. Summary. A concise summary of the material provisions is required if the motion is more than 5 pages long. FED. R. BANKR. P. 4001(b)(1)(B).

2. Service. The movant is required to serve the motion on the following entities:

a. "[A]ny entity with an interest in the cash collateral;"

b. "[A]ny committee elected under §705 or appointed under §1102 of the Code, or its authorized agent, or, if the case is a chapter 9 municipality case or a chapter 11 reorganization case and no committee of unsecured creditors has been appointed under §1102, the creditors included on the list filed under Rule 1007(d);" and

c. "[A]ny other entity that the court directs."

FED. R. BANKR. P. 4001(b)(1)(C).

> ➢ ***Practice Pointer***. *Service is an essential part of any cash collateral motion. A motion to seeking the use of cash collateral is a contested matter under Bankruptcy Rule 9014. See FED. R. BANKR. P. 4001(b)(1)(A). As such, practitioners should keep in mind that the service rules found in Bankruptcy Rule 7004 apply. See FED. R. BANKR. P. 9014(b). Special attention should be given to service on the government and insured depository institutions. See FED. R. BANKR. P. 7004(b)(4) and (h).*

3. Hearing.

a. Final Hearing. The court cannot have a final hearing on cash collateral before the expiration of a 14 day notice period. The period begins to run upon service of the motion. FED. R. BANKR. P. 4001(b)(2).

b. Preliminary Hearing. The court, however, may authorize the limited use of cash collateral before the expiration of 14 day notice period upon showing of ***immediate and irreparable harm*** to the bankruptcy estate. As such, in a Chapter 11 case, a motion to use cash collateral should generally be on the list of "First Day Motions" given the importance of continued access to cash for continued operations.

> ➢ ***Practice Pointer***. *Sometimes there can be weeks, if not months, between when the interim order of cash collateral was entered and the final hearing. During this time, the debtor, the secured lender, the committee, and other parties-in-interest will be negotiating the various parameters of the Orders. Creditors should take special note of what changes have been made to the order since the entry of the interim order and serving the proposed final order. For instance, are these changes material such that the debtor should be required to provide further notice to parties-in-interest*.

4. Burdens of Proof

a. The trustee or debtor-in-possession has the burden of proof on adequate protection. 11 U.S.C. § 363(p)(1).

b. The secured creditor has the burden of proof on validity, priority, or extent of security interest. 11 U.S.C. § 363(p)(2).

F. Common Cash Collateral Order provisions. The following non-exclusive list includes common cash collateral order provisions: (1) Budget and Reporting Mechanisms; (2) Cash Payments; (3) Additional and Replacement Liens; (4) Section 507(b) Acknowledgment; (5) Carve-Outs (see below for more discussion); and (5) Duration Limitations. Generally, there is not a "one size fits all" for all cases. Debtors, creditors and parties-in-interest should be thoughtful about the complexities and demands of each case and whether certain provisions are appropriate and feasible.

II. Post-Petition Financing: 11 U.S.C. § 364.

A. Types and Authorization.

1. Administrative Expense Status.

a. ***Without notice or hearing***, a trustee and debtor-in-possession can incur debt ***in ordinary course of business*** and will be treated as an administrative expense under 11 U.S.C. § 503(b)(1). 11 U.S.C. § 364(a).

b. ***With notice and hearing***, a trustee or debtor-in-possession can incur debt ***not in the ordinary course of business*** and such debt can obtain administrative expenses status. 11 U.S.C. § 364(b).

2. Enhanced Protections. If a trustee or debtor in possession cannot obtain unsecured credit allowed as an administrative expense, the court may authorize credit: (a) with superpriority administrative status; (b) secured by unencumbered property; or (c) secured by junior liens on encumbered property. 11 U.S.C. § 364(c).

3. Super Protections. If the trustee or debtor in possession cannot obtain credit any other way, then the court may authorize senior or equal liens on encumbered property, but only upon showing the existing lien holder is adequately protected. 11 U.S.C. § 364(d)(1).

4. Burden of Proof. The trustee or debtor-in-possession has burden of proof on adequate protection. 11 U.S.C. § 364(d)(2).

B. Mechanics: Bankruptcy Rule 4001(c).

1. Motion. Authority to obtain credit must be made by motion. FED. R. BANKR. P. 4001(c)(1)(A).

a. Required Contents. The motion should attached the proposed credit agreement and proposed order, and must contain the material provisions and address the following items:

i. "[I]nterest rate, maturity, events of default, liens, borrowing limits, and borrowing conditions;"

ii. "[A] grant of priority or a lien on property of the estate under § 364(c) or (d);"

iii. "[T]he providing of adequate protection or priority for a claim that arose before the commencement of the case, including the granting of a lien on property of the estate to secure the claim, or the use of property of the estate or credit obtained under § 364 to make cash payments on account of the claim;"

iv. "[A] determination of the validity, enforceability, priority, or amount of a claim that arose before the commencement of the case, or of any lien securing the claim;"

v. "[A] waiver or modification of Code provisions or applicable rules relating to the automatic stay;"

vi. "[A] waiver or modification of any entity's authority or right to file a plan, seek an extension of time in which the debtor has the exclusive right to file a

plan, request the use of cash collateral under § 363(c), or request authority to obtain credit under § 364;"

vii. "[T]he establishment of deadlines for filing a plan of reorganization, for approval of a disclosure statement, for a hearing on confirmation, or for entry of a confirmation order;"

viii. "[A] waiver or modification of the applicability of nonbankruptcy law relating to the perfection of a lien on property of the estate, or on the foreclosure or other enforcement of the lien;"

ix. "[A] release, waiver, or limitation on any claim or other cause of action belonging to the estate or the trustee, including any modification of the statute of limitations or other deadline to commence an action;"

x. "[T]he indemnification of any entity;"

xi. "[A] release, waiver, or limitation of any right under §506(c);" and

xii. "[T]he granting of a lien on any claim or cause of action arising under §§544, 1 545, 547, 548, 549, 553(b), 723(a), or 724(a).Concise summary of material provisions if motion is more than 5 pages long"

FED. R. BANKR. P. 4001(c)(1)(B). As detailed further below, many of these provisions will be heavily scrutinized and/or challenged by the Court, United States Trustee, Creditors Committee, and/or other creditors.

b. Summary. A concise summary of the material provisions is required if the motion is more than 5 pages long. FED. R. BANKR. P. 4001(c)(1)(B).

2. Service. The movant is required to serve the motion on the following entities:

a. "[A]ny committee elected under §705 or appointed under §1102 of the Code, or its authorized agent, or, if the case is a chapter 9 municipality case or a chapter 11 reorganization case and no committee of unsecured creditors has been appointed under §1102, the creditors included on the list filed under Rule 1007(d);" and

b. "[A]ny other entity that the court directs."

FED. R. BANKR. P. 4001(c)(1)(C).

> ➢ ***Practice Pointer***. *Service is an essential part of any post-petition financing motion. A motion to seek post-petition financing is a contested matter under Bankruptcy Rule 9014. See FED. R. BANKR. P. 4001(c)(1)(A). As such, practitioners should keep in mind that the service rules found in Bankruptcy Rule 7004 apply. See FED. R. BANKR. P. 9014(b). Special attention should be given to service on the government and insured depository institutions. See FED. R. BANKR. P. 7004(b)(4) and (h).*

3. **Hearing.**

   a. **Final Hearing**. The court cannot have a final hearing on cash collateral before the expiration of a 14 day notice period. The period begins to run upon service of the motion. FED. R. BANKR. P. 4001(c)(2).

   b. **Preliminary Hearing**. The court, however, may authorize interim post-petition financing before the expiration of 14 day notice period upon showing of ***immediate and irreparable harm*** to the bankruptcy estate. Generally, a DIP financing motion will be a "First Day Motion" and the debtor will operate on an interim basis until final hearing.

> ➢ ***Practice Pointer***. *Similar to cash collateral, creditors should take special note of what changes have been made to the final order since the entry of the interim order. Also, interim orders may contain certain protections that will be difficult to set aside even if final relief is not granted. As such, parties-in-interest should be vigilant as to what provisions are contained in the interim order and the overall impact to the case.*

> ➢ ***Debtor Practice Pointer***. *As part of its presentation to the court, the debtor should be prepared to provide testimony as to what steps it took in securing post-petition financing including seeking out various alternative lenders. While in many instances the debtor's options may be limited, the debtor should nevertheless seek out alternative financing options and be prepared to discuss why such options were not ultimately pursued. The debtor should also be prepared to explain and/or demonstrate why it cannot continue to operate on cash collateral alone.*

4. **Good Faith Protections.** "The reversal or modification on appeal of an authorization under [11 U.S.C. § 364] to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal." *See* 11 U.S.C. § 364(e).

C. **DIP Financing Provisions (Non-Exhaustive).** Many of the following provisions would be considered "extraordinary provisions" which will be heavily scrutinized by the Court and other parties in interest. To the extent a party is seeking such provisions, the debtor and/or DIP lender will need to be prepared to justify their inclusion. *See* HENRY P. BAER, JR., ET. AL., DEBTOR-IN-POSSESSION FINANCING: FUNDING A CHAPTER 11 CASE 128-30 (Felicia Gerber Perlman ed. 2012) (identifying common extraordinary provisions and support for the same).

1. **Sale/Refinancing Milestones**. Lenders oftentimes seek provisions that set specific deadlines for debtors to reach certain stages in a sale process. While these provisions can be helpful to move a bankruptcy case along and avoid the waste of vital estate

resources, any sale milestones should be reasonable in light of the circumstances. *See* ID. at 76-77.

> ➢ ***Debtor/Committee Practice Pointer***. *Debtors should avoid being set up for failure by agreeing to unrealistic deadlines. With that said, the debtor may have a little choice especially if the business cannot run on cash collateral alone and nothing compels the lender to continue to lend. Accordingly, time is of the essence and the debtor should have a developed plan on how it intends to meet the various deadlines and exit the case.*

2. **Plan Veto Rights**. Lenders may insert provisions that provide a plan will not be confirmed unless it is acceptable to the lender. *See* ID. at 75-76.

> ➢ ***Committee Practice Pointer***. *Committees should be very cautious of such provisions as they give lenders even greater control in chapter 11 cases.*

3. **Budget and Reporting Mechanisms.** Budget and reporting mechanisms will be found in almost every post-petition financing order (and cash collateral order). These will generally require a budget with acceptable variances and either a weekly or semi-monthly reporting. It may also provide for inspection rights by the lender of the collateral. *See* ID. at 73-74, 77-78.

> ➢ ***Debtor Practice Pointer***. *The debtor should expect to be held to its budget and reporting obligations. As a result, putting together the budget should not be done in a haphazard manner. Rather, the debtor and its professionals should be a thoughtful in preparing the budget and negotiating reasonable variances. The debtor should also be cognizant that there will be many demands on its personnel during a case, so it must make sure that it can keep up with the reporting demands.*

4. **DIP Interest Rates and Loan Fees.** Loan fees should be proportionate to the amount of the loan facility. Interest rates should be evaluated and compared to other rates in other similar chapter 11 cases and evaluated with the risks and complexities of the current case.

5. **Rights Upon Default.** DIP Orders and Cash Collateral Orders may provide that upon default, the lender is entitled to relief from the stay automatically or under some shortened time limit.

> ➢ ***Committee Practice Pointer.*** *The committee should carefully consider default provisions in cash collateral and DIP orders. Potentially troubling provisions include: (i) defaults without notice to the committee; (ii) events of default that are overly subjective; (iii) immediate stay relief upon an event of default without the need for further court order.*

6. **Carve Outs.** "The term 'carve out' is one of those uniquely bankruptcy phrases, much like "cram down," that appears nowhere in the bankruptcy statute but connotes definite meaning to parties. It is an agreement by a party secured by all or some of the assets of the estate to allow some portion of its lien proceeds to be paid to others, i.e., to carve out of its lien position." *In re White Glove, Inc.*, 1998 WL 731611 at *6 (Bankr. E.D. Pa. Oct. 14, 1998).

   a. **Types**. The following are the types of fees generally covered by a carve-out: (i) Debtor's Professional Fees; (ii) Committee's Professional Fees; (iii) United States Trustee Fees; and (iv) Burial Fees. A burial fee is usually some type of set aside for a chapter 7 trustee if the case is converted, so the trustee generally has some ability to evaluate and administer the chapter 7 estate.

   b. **Perspectives.**

      i. **Committee Perspective.** A carve out sets the budget for professional fees in a chapter 11 case. Lenders may seek to marginalize a committee by refusing to give the committee a carve out, or alternatively, providing the committee with a nominal amount in comparison to the amounts provided to the debtor's professionals.

      "The carve out for committee professionals and the limited period to challenge the lender's prepetition secured position is important." *Open Letter of the Hon. Peter J. Walsh to Delaware Bankruptcy Counsel*, ¶ 12, Apr. 2, 1988. This carve out is the price of admission to the bankruptcy court to obtain the benefits of preserving the assets of the estate, which preservation typically first benefits secured parties. *Id*.

      Carve outs for committee professionals should be commensurate with those provided to debtors' professionals. *See In re Ames Department Stores, Inc.*, 115 B.R. 34, 38 (Bankr. S.D.N.Y. 1990) ("[I]t has been the uniform practice in this court …to insist on a carve out from a super-priority status and post-petition lien in a reasonable amount designed to provide for payment of the fees of debtor's and the committees' counsel and possible trustee's counsel in order to preserve the adversary system. Absent such protection, the collective rights and expectations of all parties-in-interest are sorely prejudiced."); s*ee also In re Evanston Beauty Supply, Inc.*, 136 B.R. 171, 176 (Bankr. N.D. Ill. 1992) (stating that carve-outs are necessary to foster the reorganization process and designed to accommodate all classes of creditors, not just the pre-petition lender).

      ii. **Lender Perspective**. Generally speaking, professional fees should get no better treatment than any other administrative creditor. *See In re Morning Star Ranch Resorts*, 64 B.R. 818, 822 (Bankr. D. Colo. 1986)("Thus absent compliance with 11 U.S.C. § 363(c)(2) the debtor should not be in a position to use the funds to pay the attorney for the estate, to pay for accounting services for the estate, or to pay other expenses of administration of the

[c]hapter 11 estate unrelated to the operation, care, preservation and maintenance of the property.").

With that said, depending upon the circumstances of the case, the lender may ultimately be benefitted by having a good debtor's and committee's counsel engaged and focused on the case. However, a carve out should not be a blank check and in agreeing to a carve out, the lender should be cognizant of its overall collateral package and the direction of the case. The lender should also be thoughtful in considering limitations on the carve out being used to investigate and prosecute claims against the lender. *See* BAER, DEBTOR-IN-POSSESSION FINANCING at 130, 167-68.

7. **Priming, Senior and Junior Liens.** When providing financing, it is not uncommon for the post-petition lender to take a blanket lien on all assets of the bankruptcy estate. Further, the liens provided to the post-petition lender may prime existing liens, but such priming liens are an extraordinary provision and require a showing the existing lien holder is adequately protected. For a discussion on liens on chapter 5 causes of action, *see infra* Section II.C.9.

> ➢ ***Creditor Practice Pointer.*** *If a creditor has existing liens, it should be cognizant of any grants of additional liens to a post-petition lender and confirm: (1) that such liens do not prime its liens; and (2) if there are priming liens, that its position is adequately protected. In many instances, chapter 11 bankruptcy cases can move fast and a creditor should not assume that its lien priority will not be impacted. As such, these provisions should be reviewed immediately especially those provisions that define what is considered a "permitted lien."*

> ➢ ***Lender Practice Pointer****: The Order should provide that any liens provided to the lender should be deemed automatically perfected, without need of filing.*

8. **Stipulations as to the Nature, Extent, and Validity of Debt and Liens**

   a. **Waivers of Claims and Defenses including surcharge rights and automatic stay.** Cash collateral and DIP orders oftentimes contain waiver of Section 506(c) surcharge rights. These surcharge claims can be valuable in certain cases, and Section 506(c) waiver provisions have been deemed unenforceable because they "operate as a windfall to the secured creditor at the expense of administrative claimants." *In re Lockwood Corp.*, 223 B.R. 170 (8th Cir. B.A.P. 1998); *see also In re The Colad Group, Inc.*, 324 B.R. 208, 224 (Bankr. W.D.N.Y. 2005); *In re Willingham Invs., Inc.*, 203 B.R. 75, 80 (Bankr. M.D. Tenn. 1996).

   b. **Adequate Challenge Periods.** A reasonable amount of time for parties to challenge any stipulations should be provided. Such periods will generally run from either the appointment of a committee or entry of a final order. Generally, some portion of financing will need to be available for a committee to investigate. *See* BAER, DEBTOR-IN-POSSESSION FINANCING at 130. However, in some cases, a carve out can only be used to investigate, but not actually litigate liens.

- ***Committee Practice Pointers.***
  - ***Challenge Period.*** *The committee must be given a reasonable timeframe to perform its investigation, discuss with the parties-in-interest, and if necessary, obtain standing and file a complaint. The committee should immediately consider the breadth and cost of its investigation into the liens and claims of lenders in order to ensure an appropriate challenge period is provided.*
  - ***Stipulations.*** *Committees should carefully review the stipulations, which will be binding on them after the challenge deadline, to determine what stipulations could reasonably be evaluated during the challenge period.*

- ***Lender Practice Pointer****. The lender should have its loan documents, including evidence of perfection, ready to supply to the committee and any requesting party. Failure to timely provide such documentation could result in the challenge period being extended.*

9. Liens on Chapter 5 Causes of Action. Chapter 5 causes of action are oftentimes the primary source of recovery for unsecured creditors. As a result, any attempt to collateralize such claims will be heavily scrutinized. *See In re Texas General Petroleum Corp. v. Evans (In re Texas General Petroleum Corp.)*, 58 B.R. 357, 35 (Bankr. S.D. Tex. 1986)("[N]either a trustee in bankruptcy, nor a debtor-in-possession, can assign, sell or otherwise transfer the right to maintain a suit to avoid a preference.").

Even when in exchange for valuable consideration and where contracts explicitly provide for the assignment of an avoidance action, certain courts have refused to give any effect to such assignment. *See United Capital Corp. v. Sapolin Paints, Inc. (In re Sapolin Paints, Inc.)*, 11 B.R. 930, 937 (Bankr. E.D. N.Y. 1981); *Official Comm. of Unsecured Creditors v. Goold Elecs. Corp. (In re Goold Elecs. Corp.)*, 1993 WL 408366, at *3-*4 (N.D. Ill. Sept. 22, 1993) (vacating bankruptcy court order approving post-petition financing "to the extent that the order assigns to the bank a security interest in the debtor's preference actions").

10. Roll-Ups.

a. ***What is a "roll-up"?*** A roll-up is when "[t]he proceeds of the post-petition financing are used to pay, in whole or in part, the post-petition lender's pre-petition claim (in other words, the net "new money" available to the debtor is reduced by application of the proceedings of the DIP borrower to satisfy pre-petition obligations." *See* BAER, DEBTOR-IN-POSSESSION FINANCING at 84, 129-30. A similar concept is a "creeping roll-up," pursuant to which the lender makes post-petition advances over time that result in the rollover of pre-petition debt into post-petition debt.

b. ***Subject to Scrutiny***

i. A roll-up can circumvent the priority scheme set forth in the Bankruptcy Code. *See In re Saybrook Mfg. Co., Inc.*, 963 F.2d 1490, 1494-1496 (11th Cir. 1992) (noting that a roll-up is inconsistent with bankruptcy law because (a) it is not authorized as a means of post-petition financing pursuant to Section 364, and (b) it is directly contrary to the fundamental priority scheme of the Bankruptcy Code); *In re Monarch Circuit Industries, Inc.,* 41 B.R. 859, 862 (Bankr. E.D. Pa. 1984).

ii. Courts have specifically prohibited a roll-up where the secured creditor sought to pay off a pre-petition loan balance with a post-petition loan. *In re Equalnet Commcn's Corp.*, 258 B.R. 368, 369 (Bankr. S.D. Tex. 2000); *In re Berry Good LLC*, 400 B.R. 741, 745 (Bankr. D. Ariz. 2008); *Official Comm. Of Unsecured Creditors of New World Pasta Co. v. New World Pasta Co.*, 322 B.R. 560, 569 n. 4 (M.D. Pa. 2005).

11. Super Priority Administrative Claim and Cross-Collateralization.

a. Super Priority Administrative Claims. Pursuant to Section 364(c)(1), as claims have priority over all other administrative claims including professional claims. Further, since these super priority claims arise under Section 364(c)(1) and not Section 507(b), there is a split in authority regarding whether it would take priority over the chapter 7 estate's administrative expenses. *See In re Packaging Systems, LLC*, 559 B.R. 123, 127-29 (Bankr. D. N. J. 2016)(finding that authority holding that Section 364(c)(1) primes Section 726(b) more persuasive). *See also In re Visionaire Corp.*, 299 B.R. 530 (B.A.P. 2003)(indicating that chapter 11 Section 364(c)(1) administrative claims can have priority over chapter 7 claims if the Orders so provide).

b. Cross-Collateralization. This can occur when the DIP Order provides that that the post-petition collateral also secures pre-petition debt. *See* BAER, DEBTOR-IN-POSSESSION FINANCING at 129-30.

> ➢ ***Committee Practice Pointer.*** *Super priority administrative claims and cross-collateralization provisions can have the same effect as roll-ups. Some DIP provisions grant super priority administrative claims automatically, so the Committee should be vigilant in requiring lenders to prove-up these claims.*

D. Final Perspectives: Appropriateness of DIP Financing, In General.

1. Committee Perspective

a. The committee should assess whether the DIP financing is appropriate in the case. Before a Court may grant priming, adequate protection liens or other liens and superpriority status to a DIP lender pursuant to Sections 364(c) and (d) of the Bankruptcy Code, the debtor must demonstrate that: (i) their decision to enter into

the proposed DIP facility is a sound exercise of their business judgment; (ii) no alternative financing is available on better terms; (iii) the proposed financing is in the best interests of the estates and creditors; and (iv) as a corollary to the first three points, that no better proposals are before the court. *In re Farmland Indus., Inc.*, 294 B.R. 855 (Bankr. W.D. Mo. 2003); *In re Phase-I Molecular Toxicology, Inc.*, 285 B.R. 494, 495 (Bankr. D. N.M. 2002); *In re Western Pac. Airlines*, 223 B.R. 567, 572 (Bankr. D. Colo. 1997).

b. A "bankruptcy court's discretion to authorize incentives to post-petition lenders is not unfettered." *Resolution Trust Co. v. Official Unsecured Creditors Comm. (In re Defender Drug Stores)*, 145 B.R. 312, 317 (B.A.P. 9th Cir. 1992). Rather, because "[d]ebtors in possession generally enjoy little negotiating power with a proposed lender…lenders often exact favorable terms that harm the estate and creditors. *Id.* For this reason, post-petition financing should not be approved where it "convert[s] the bankruptcy process from one designed to benefit all creditors to one designed for the unwarranted benefit of the postpetition lender," *see Resolution Trust*, 145 B.R. at 317, or where the proposed terms would unduly leverage the chapter 11 process and prejudice the rights and powers the Bankruptcy Code confers for the benefit of all creditors. *See In re Ames Dep't Stores, Inc.*, 115 B.R. 34, 37 (Bankr. S.D.N.Y. 1990).

c. Courts may reject a proposed DIP facility when it includes terms and conditions that serve no valid business purpose except to benefit a pre-petition lender. *See In re Ames Dep't Stores, Inc.*, 115 B.R. at 39 ("[A] proposed financing will not be approved where it is apparent that the purpose of the financing is to benefit a creditor rather than the estate."); *In re Tenney Village Co*., 104 B.R. 562 (Bankr. D.N.H. 1989).

2. Lender Perspective. In many cases, a debtor cannot survive on cash collateral alone. A pre-petition lender should not reject requests from a debtor for further assistance out of hand. The pre-petition lender should assess, among other things, the value of preserving the debtor as a going concern versus liquidation. However, if the lender is willing to advance new money, it should do so fully cognizant of the risks involved and seek the appropriate protections that will optimize its recoveries.

Faculty

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