By Donald E. Rothman

"It's the Economy, Stupid!"[1]

In Bankruptcy, It's Actually the Budget

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Chapter 11 cases come in many shapes and sizes, and involve companies in every industry and sector of the economy. A key component common to nearly every bankruptcy case — and indeed a gating issue for most — is developing an acceptable budget that will serve as the lifeblood of estate administration. While the list of pre-filing preparation activities is often extensive and challenging, perhaps no single pre-filing element presents a greater hurdle to the prospects for a successful restructuring than securing the support of the relevant constituencies of a final budget, without which it is untenable to commence or administer a case.

Fundamentally, the budget determines the length of a debtor's "runway" in a case. Among other things, the budget will dictate how long a company projects an ability to meet its obligations in the ordinary course during the case. The budget also determines whether a case may remain in chapter 11 and not be converted to a liquidation under chapter 7 due to impending administrative insolvency. With many (if not most) cases these days being cases that culminate in § 363 sales, the budget often determines the length of the sale process and, therefore, how fulsome that process can be.

Contents of the Budget

While both the Bankruptcy Code and some courts afford debtors some flexibility in the timing of payments of post-petition obligations, as a general proposition debtors in a chapter 11 case must pay their post-petition obligations as they arise and in the ordinary course of business. A budget should demonstrate reasonable and achievable projections of receipts and disbursements, usually in a 13-week cash-flow forecast that can be updated over time, as appropriate. Certain fundamental items must be included as line items in the budget, such as, without limitation, payroll, rent, utilities and other ordinary-course disbursements required for the continued normal-course operation of the debtor's business.

Certain other items, such as "stub rent" and administrative claims arising under § 503(b)(9) of the Bankruptcy Code, while not statutorily required, have nevertheless risen to a level of importance — whether through creditor influence or judicial decree — to the early-stage administration of an estate.[2] In fact, notwithstanding that a bankruptcy court cannot order what is effectively a carve-out from a senior secured creditor's collateral, there is a growing trend among many courts that require these types of claims to not only be *included* in the budget, but also that they be *funded* ahead of senior secured claims by conditioning approval of a debtor-in-possession (DIP) financing facility or a § 363 sale process upon the satisfactory treatment (in the court's view) of these types of claims.[3] These additional expense categories, the treatment of which can vary among jurisdictions, can lead to conflict and competing claims and jeopardize a debtor's restructuring prospects, particularly in circumstances where the continued operation of the business or its disposition in a § 363 sale context fails to yield proceeds that can pay all of the budgeted items in full.

Accelerated Sale Process

When the budget is extremely tight, a debtor and other interested parties generally seek to implement an expedited sale process under § 363 in order to maximize the value of the debtor's assets "as the ice cube melts." In many recent cases, the timeline and sale milestones have spanned only a single month, or even fewer than 30 days. Courts, the U.S. Trustee and committees frequently view such expedited sales processes as unreasonably short. In response, the Local Bankruptcy Rules in Delaware were revised to address this very issue by limiting the availability of such aggressive sale processes absent a demonstration of "compelling circumstances" or other "exigencies":

> Del. Bankr. L.R. 6004-1(c). The Court will only schedule a hearing to consider approval of bidding and sale procedures in accordance with the notice procedures set forth in Del. Bankr. L.R. 9006-1, unless the requesting party files a motion to shorten notice which may be heard at the first hearing in the case and presents *evidence at that hearing of compelling circumstances*.

1 The title of this article is a play on a phrase coined by James Carville in 1992. *See* https://en.wikipedia.org/wiki/It%27s_the_economy,_stupid.

2 *See* Ryan T. Routh, "Twenty-Day Claims: The Anticipated and Unanticipated Consequences of Code Section 503(b)(9)," *ABI Journal* (November 2006), *available at* abi.org/abi-journal.

3 *See, e.g.*, Final Order Approving the Use of Cash Collateral, Gordman's Stores Inc., Case No. 17-80304, Docket Entry 335 (Bankr. D. Neb.); Final Order Approving the Use of Cash Collateral, Advanced Sports Enterprises Inc., Case No. 18-80856, Docket Entry 498 (Bankr. M.D.N.C.).

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Del. Local Rule 9006-1(e). No motion will be scheduled on less notice than required by these Local Rules or the [Federal Rules of Bankruptcy Procedure] except by order of the Court, on written motion (served on all interested parties) *specifying the exigencies justifying shortened notice*. The Court will rule on such motion promptly without need for a hearing.

Expanded Concept of the Carve-Out

As previously noted, practitioners have historically understood that a "carve-out" includes only amounts for the debtor's professionals' fees, the statutorily required fees of the U.S. Trustee and a committee's professionals' fees. More recently, experience in various jurisdictions has seen an expansion of the traditional carve-out as a condition to approval of the budget and corresponding DIP-financing facility or sale process by elevating the status of certain other administrative and unsecured claims. Stub rent, § 503(b)(9) claims and pre-petition payroll, among others, are routinely receiving preferred treatment equivalent to a carve-out, and in the process effectively subordinating perfected, pre-petition (and in some instances post-petition) secured claims, with the effect being a reordering of statutory priorities. Courts struggle with competing claims to limited resources in their efforts to manage the cases over which they preside, and as an example, commentators have noted that some courts do not consider § 503(b)(9) claims to be true administrative claims.[4] These struggles often lead to unpredictability in what will or will not be required by the court to approve an acceptable financing facility, and these struggles result in the court having to make difficult rulings. As such, practitioners are encouraged to develop a good understanding of market terms and trends in the relevant jurisdiction.

Documentation Addressing the Expanded Carve-Out

The marketplace for DIP financing and the § 363 sale process has responded to changes in what must be included in the budget, with documentation in pre-petition credit and intercreditor agreements that recognizes this new landscape. Below is representative language from a DIP credit agreement and an intercreditor agreement, both of which have been employed in a number of recent financings. The ability to negotiate and include these types of provisions is becoming more widespread as the parties-in-interest recognize what will be required to be funded in the event of an insolvency proceeding.

In credit agreements, the lender customarily has the ability and negotiating leverage with its customer to require that these types of provisions be included. With respect to pre-petition intercreditor agreements, the nature of the relationship between — and the identity of — the lenders that are party to an agreement will affect these negotiations. For example, two money center banks will agree on an intercreditor agreement that will be markedly different from an intercreditor agreement between a money center bank and a private commercial lender or an insider of the borrower. Nevertheless, these provisions have proven useful in many cases in facilitating the negotiation of the budget as a case is prepared for filing, and once filed, they have been recognized by the courts.

> **[W]hen entering into a new financing facility well before a bankruptcy case has even been considered (much less commenced), lenders recognize that in the event of an insolvency proceeding, the budget might require payment of an expanded list of payables.**

DIP Credit Agreement Sample

Lenders have come to recognize that the debtor's budget might well require payment of an expanded list of claims. In order to ensure that sufficient liquidity is available to satisfy those claims, expanded "reserves" might be imposed in the borrowing base:

> *"Availability Reserves"* means (a) *the Carve Out Reserve*, (b) a reserve in an amount sufficient to fund in full all amounts required to be on deposit in the Pre-Petition Indemnity Account (as defined in an Order) in accordance with the Interim Order or the Final Order, as applicable, and (c) such reserves as the Administrative Agent from time to time determines in the Administrative Agent's reasonable discretion as being appropriate to reflect the impediments to the Agents' ability to realize upon the Collateral. Without limiting the generality of the foregoing, Availability Reserves may include (but are not limited to) (x) reserves based on (i) rent (but in no event to exceed two months' rent) for leased locations in the states of Virginia, Washington, Pennsylvania and any other state in which Applicable Law provides a landlord with a Lien for unpaid rent having priority over the Lien of the Collateral Agent and for distribution centers for which the Loan Parties have not delivered a landlord's waiver to the Collateral Agent; (ii) Gift Certificates and Merchandise Credit Liability; (iii) customs, duties, and other costs to release Inventory which is being imported into the United States; and (iv) past due Taxes and other

4 *See* Kenneth A. Rosen & Michael Papandrea, "Are Section 503(b)(9) Claims Being Taken Seriously?," *Turnaround Mgmt. Ass'n J.* (March 2017).

governmental charges, including, *ad valorem*, real estate, personal property, sales, and other Taxes which might have priority over the interests of the Collateral Agent in the Collateral, and (y) *reserves to reflect the amount of any priority or administrative expense claims that, in the Administrative Agent's reasonable determination, require payment during the Cases.*

"Carve Out" has the meaning specified therefor[e] in the Orders.

"Carve Out Reserve" means an Availability Reserve established by the Administrative Agent in the amount of the Carve Out.

Intercreditor Agreement Sample

Similarly, when entering into a new financing facility well before a bankruptcy case has even been considered (much less commenced), lenders recognize that in the event of an insolvency proceeding, the budget might require payment of an expanded list of payables. In order to ensure a smoother process for structuring a DIP financing facility, the lenders often agree in advance on the method for addressing the likely budgetary requirements:

A. In connection with the approval of any DIP Financing, (i) the First-Lien Agent and the First-Lien Secured Parties may consent, in their commercially reasonable discretion, to the use of cash collateral or use of DIP Financing proceeds to pay *"Section 503(b)(9)" claims, "stub rent" claims*, claims of creditors having or claiming to have Liens having priority over the Liens securing the First Lien Obligations and Second Lien Obligations, and *other similar types of administrative, unsecured, or pre-petition claims that may be customarily paid in connection with the approval of such DIP Financing*; and (ii) any Liens on the Collateral held by the First-Lien Agent and the First-Lien Secured Parties may be subject to a carve-out amount granted with respect to professional fees and expenses, court costs, filing fees and fees and costs of the Office of the United States Trustee, as approved by the bankruptcy court (collectively, the "Carve Out"). In such circumstances, the Second-Lien Agent and the Second-Lien Secured Parties shall not object to the payment of any of the foregoing amounts nor to the imposition of such Carve-Out, and the Liens on the Collateral of the Second-Lien Agent and the Second-Lien Secured Parties shall be subject to such Carve-Out to the same extent as, and maintaining the same relative priority to, the Liens on the Collateral of the First-Lien Agent.

B. If, in connection with any such cash collateral use or debtor-in-possession financing, any Liens on the ABL Priority Collateral held by ABL Collateral Agent or the other ABL Secured Parties to secure the ABL Debt are subject to a surcharge or are subordinated to an administrative priority claim, a professional fee "carve-out," or fees owed to the United States Trustee, then the Liens on the ABL Priority Collateral of the other Secured Parties securing the other Secured Obligations shall also be subordinated to such interest or claim and shall remain subordinated to the Liens on the ABL Priority Collateral of the ABL Collateral Agent or the other ABL Secured Parties consistent with this Agreement.

Conclusion

This article discussed the central role that the budget plays in virtually every chapter 11 case. It also highlighted the ever-changing financing environment, and identified evolving requirements that must be accounted for in developing a budget to support the administration of a chapter 11 estate, and how the marketplace has begun to adapt and address some of these changing requirements. All parties-in-interest in a chapter 11 case will benefit by keeping themselves apprised of these developments, which will lead to greater predictability of results at the hearing on the first-day motions and throughout the case. abi