

Private Credit & Special Situations



WHAT IS IT?

Understanding and Negotiating a DIP Budget

Summary

In a typical chapter 11 bankruptcy, debtors will fund ongoing operations and the costs of their bankruptcy cases with a combination of cash on hand and/or debtor-in-possession (“DIP”) financing. Such cash is often subject to a prepetition secured party’s lien and constitutes cash collateral, which cannot be accessed by the debtor without providing “adequate protection”¹ to, or obtaining the consent of, such secured party.² Secured parties, whether prepetition secured parties with a lien on cash collateral or DIP lenders, will want to ensure that their cash collateral and/or DIP loan proceeds are deployed judiciously and in the service of broader case goals. Accordingly, the DIP budget is one of the most heavily negotiated and important terms of consensual cash collateral usage and/or DIP financing, as it affords a secured creditor/DIP lender invaluable influence over the pace, direction, and purpose of a chapter 11 case, and impacts the secured creditor/DIP lender’s recovery on their claims by prohibiting non-essential spending during the pendency of the chapter 11 case.

Understanding and Negotiating A DIP Budget (cont'd)

What is a DIP Budget?

A DIP budget is a cash flow budget containing a forecast of disbursements, receipts, and net cash flows for a negotiated period of time (usually 13 weeks). Typically, a bankruptcy court's order approving the terms of consensual cash collateral usage and/or DIP financing and/or the DIP credit agreement itself will (i) require that the DIP budget (and any periodic updates thereto) be in form and substance acceptable to the prepetition secured lenders and/or the DIP lenders and (ii) contain a covenant requiring the debtor to only use cash collateral, the proceeds of DIP financing (if any), and unencumbered cash on hand (if any) in accordance with the DIP budget. Failure to comply with the DIP budget may result in an event of default under the cash collateral order and/or DIP credit agreement and may allow the prepetition secured party or DIP lender to exercise remedies, including terminating the debtor's consensual use of cash collateral.

By way of example, attached hereto as an appendix is an annotated copy of the initial budget filed in the Revlon, Inc. chapter 11 cases filed on June 16, 2022, in the U.S. Bankruptcy Court for the Southern District of New York (Case No. 22-10760).

What Are the Key Issues and Considerations in Evaluating a DIP Budget?

- **What is the Purpose of the Chapter 11 Case?** As a threshold consideration, the particulars of a DIP budget will be heavily influenced by the stated purpose of the chapter 11 case (e.g., debt-for-equity restructuring, asset sale process, liquidation). For example, if the prepetition secured creditor and/or DIP lender intends on ultimately owning the debtor's business, then the DIP budget may permit certain capital expenditures necessary for such growth. Likewise, if the prepetition secured creditor/DIP lender is only willing to fund a sale process and/or liquidation, the DIP budget may only provide for maintenance of assets until an ultimate asset sale.
- **What is the Debtor's Funding Need?** An informed and realistic understanding of the debtor's cash needs during the pendency of a chapter 11 process is crucial. Considerations may include: (i) sales projections and collection estimates, which may be adjusted to reflect the anticipated impact of the chapter 11 case on the debtor's business, (ii) tighter vendor liquidity as a result of bankruptcy (e.g., vendors seeking cash on demand/delivery or tighter credit terms), (iii) actual timing and payment of overhead/SG&A, (iv) interim changes in business plan/model (e.g., layoffs, asset sales, facility closures), and (v) bankruptcy costs/expenses (e.g., professional fees, necessary court-related filings costs, US Trustee fees). The DIP budget may also contemplate "critical vendor" payments – those vendors holding pre-petition claims that are viewed as integral to the business whose unsecured claims must be paid to minimize operational disruptions and preserve estate value.

Understanding and Negotiating A DIP Budget (cont'd)

What Are the Key Issues and Considerations in Evaluating a DIP Budget? (cont'd)

- **What Claims and Expenses Need to be Paid, and When?** To confirm a plan of reorganization (or liquidation),³ such plan must pay in full in cash on the plan effective date all claims afforded “administrative expense” priority under the Bankruptcy Code unless the holder of such claim agrees to different treatment.⁴ In a case where substantially all of the debtor’s assets are to be sold pursuant to Section 363 of the Bankruptcy Code and a plan of reorganization (or liquidation) is not a certainty, a DIP budget might only provide for the immediate payment of certain “current” administrative expenses (such as professional fees, post-petition rent for leased locations the debtor occupies,⁵ and pre-petition critical vendor claims and post-petition vendor claims), while leaving non-current administrative expenses unpaid (e.g., unpaid 503(b)(9) claims⁶ relating to goods received by the debtor within 20 days of the bankruptcy filing held by non-critical vendors or post-petition rent owed under lease locations to be rejected by the debtor). Often, creditors that would be adversely affected by the debtor’s decision not to promptly pay non-current administrative expense claims (e.g., landlords and vendors) and their representative body, the official committee of unsecured creditors (the “Committee”), may object to court approval of cash collateral use and/or DIP financing on the grounds that the budget does not show administrative solvency (i.e., sufficient assets available to pay all administrative expense claims) and, as a result thereof, may specifically challenge the appropriateness of the DIP budget for not showing sufficient cash available for payment of such claims. In addition, the Committee or individual creditors may challenge, among other things, the customary 506(c) surcharge waiver in the cash collateral/DIP order.⁷
- **How Much Flexibility to Provide the Debtor Regarding Budget Compliance?** Cash collateral/DIP orders and/or DIP credit agreements typically provide that the applicable debtor must comply with the DIP budget, subject to certain negotiated “permitted variances”. The scope and breadth of variances and other terms of budget compliance are heavily negotiated, but may include, among other things, (i) the quantum of the variance (e.g., 5%, 10%, etc.), (ii) how the variance is calculated (e.g., per line item, aggregate calculation or select line items, or on a total net cash flow basis), (iii) what items are subject to the variance (if any) (e.g., operating sales, net cash flow, cash balance), (iv) how often the budget must be updated (e.g., every 4 weeks), (v) whether or not favorable variances can be carried forward to off-set future unfavorable variances, and (vi) how often the debtor is required to test/report budget compliance (e.g., weekly, monthly, etc.). A breach of the budget covenant typically constitutes an “Event of Default” under the DIP credit agreement and/or a “termination event” under the order approving consensual use of cash collateral.

Understanding and Negotiating A DIP Budget (cont'd)

What Are the Key Issues and Considerations in Evaluating a DIP Budget? (cont'd)

- **How Do You Address Debtor/Committee Professional Fees and Investigation Costs?**

Typically, prepetition secured creditors/DIP lenders agree to subordinate their claims and liens to debtor and Committee professional fees, which is referred to as a “carve-out”. Depending on the case, prepetition secured creditors/DIP lenders may be able to negotiate caps on professional fees paid from the “carve-out” to the professional fee amounts set forth in the budget. In other cases, debtor professionals will push hard for their professional fees to be uncapped (and, in some cases, excluded from any test of budget covenant compliance altogether).⁸ Usually, within the carve-out there is a cap on the amount of Committee professional fees that can be used to investigate the validity of the prepetition secured creditors’ claims and liens. Note that a cap on the professional fee carve-out does not limit the debtor’s estate from paying allowed debtor and/or Committee professional fees from non-collateral proceeds.

What Does this Mean for Prepetition Secured Creditors/DIP Lenders?

A properly negotiated DIP budget, with benchmarks for when certain events need to occur, provides the prepetition secured creditor/DIP lender with control over the timing of the chapter 11 process – allowing a secured creditor/DIP lender to tailor disbursements to the particulars of a given case objective while minimizing downside exposure. On the other hand, providing some flexibility to a debtor for business fluctuations while also accounting for sufficient professional fees and carveouts can avoid unnecessary covenant breaches, related fees, and litigation expenses. Ultimately, the particulars of a negotiated DIP budget will directly impact the speed and efficiency of a case and should be carefully weighed and evaluated with the assistance of experienced advisors.

¹ “Adequate protection” is defined in Section 361 of the Bankruptcy Code, but conceptually intended to compensate secured creditors for the diminution in value of their collateral through use of same during a chapter 11 case. As set forth in Section 361, it can take many forms, including, without limitation, periodic cash payments and additional or replacement liens.

² “Cash collateral” is defined under Section 363(a) of the Bankruptcy Code to also include “proceeds products, offspring, rents, or profits of property and the fees, charges, accounts” derived from non-cash collateral (i.e., non-cash assets subject to a security interest).

³ Debtors can exit a chapter 11 bankruptcy case through a confirmed plan of reorganization or liquidation, through dismissal of the chapter 11 case, or by conversion to a chapter 7 liquidation case.

⁴ See 11 U.S.C. 1129(a)(9)(A).

⁵ Section 365(d)(3) of the Bankruptcy Code provides, in part, that a debtor must timely perform all of the obligations of the debtor arising after the petition date until such lease is assumed or rejected. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period.

⁶ Section 503(b)(9) of the Bankruptcy Code provides that vendors have an administrative expense claim priority with respect to their prepetition claim on account of goods shipped to the debtor prior to its commencement of bankruptcy in an amount equal to the value of any goods received on credit from such vendor by the debtor within 20 days before the commencement of the bankruptcy case.

⁷ Bankruptcy Code section 506(c) allows a surcharge against a secured party’s collateral for the costs and expense of preserving such collateral during the bankruptcy case. The waiver of the surcharge is usually a negotiated provision of DIP financing/cash collateral usage.

⁸ Use of the carve-out to pay debtor and Committee professional fees is typically limited to a specified dollar amount following notice of termination of consensual cash collateral or acceleration of the DIP following an Event of Default. This is often referred to as the “Carve-Out Trigger Notice Cap”.

Revlon, Inc. – Interim DIP Budget

Payments made to vendors and other trade creditors, typically for post-petition rent, supply of goods and other expenses accruing post-petition to operate the business. May include payments in respect of prepetition claims to the extent authorized by court order to be paid as part of "critical vendor" relief or afforded administrative expense priority under Section 503(b)(9).

Indicates when the borrower is expected to draw DIP Loans under the applicable DIP. Here, the DIP financing includes ABL borrowings, so it is contemplated that there will be significant DIP draws each week. In cases where there is only term loan DIP financing, the budget may only show two DIP draws – one draw upon entry of an interim DIP Order, and a final draw upon entry of a final DIP order.

Professional fees may be separated into multiple categories (e.g., debtor professional fees, committee professional fees and DIP lender/prepetition secured lender professional fees) or aggregated into one line item (as is the case here). Some DIP/cash collateral orders may provide that the debtor and/or committee's professional fees cannot exceed the amounts set forth in the budget for purposes of using DIP collateral to satisfy those claims.

Typically limited to operating revenue.

All interest, amortization, and/or fees payable in cash payable under the DIP, as well as any current payment of cash interest (or other cash payments) the debtors have agreed (or, following litigation, have been ordered) to pay as adequate protection in respect of prepetition secured debt.

Revlon, Inc.
13-Week Cash Flow - Summary
 Date: June 15, 2022
 \$ in 000s

Week:	WK-1 Post	WK-2	WK-3	WK-4	WK-5	WK-6	WK-7	WK-8	WK-9	WK-10	WK-11	WK-12	WK-13	13-Week
Actual/Forecast:	Fcst	Fcst	Fcst	Fcst	Fcst	Fcst	Fcst	Fcst	Fcst	Fcst	Fcst	Fcst	Fcst	Fcst
Week Ending Date:	06/17/22	06/24/22	07/01/22	07/08/22	07/15/22	07/22/22	07/29/22	08/05/22	08/12/22	08/19/22	08/26/22	09/02/22	09/09/22	Total
DEBTOR CASH FLOWS														
RECEIPTS														
Operating Receipts	\$ 6,112	\$ 11,034	\$ 11,961	\$ 14,759	\$ 22,209	\$ 19,151	\$ 19,751	\$ 16,231	\$ 17,874	\$ 21,935	\$ 23,980	\$ 11,014	\$ 25,619	\$ 221,630
DISBURSEMENTS														
Vendor Disbursements	\$ -	\$ (31,579)	\$ (35,679)	\$ (26,457)	\$ (27,731)	\$ (20,826)	\$ (22,945)	\$ (25,833)	\$ (26,285)	\$ (26,285)	\$ (25,003)	\$ (19,215)	\$ (16,868)	\$ (304,707)
Other Disbursements	-	(300)	(871)	-	-	-	(2,219)	-	-	-	(367)	-	-	(3,757)
Payroll	-	(1,920)	(8,375)	(1,920)	(6,150)	(1,920)	(6,625)	(3,670)	(6,450)	(1,920)	(6,150)	(3,670)	(6,150)	(54,920)
Professional Fees	-	(794)	(190)	-	(6,473)	-	-	(607)	(4,548)	(6,473)	-	(190)	-	(19,275)
Other Restructuring Activities	(17,384)	(16,469)	(8,373)	(8,030)	(5,353)	(2,677)	(2,677)	(12,710)	(10,168)	(7,626)	(9,126)	(7,626)	(5,084)	(113,303)
Debt Service	(28,649)	-	(2,062)	-	(111)	-	(2,901)	-	(2,503)	-	-	(5,365)	(31,110)	(72,702)
Total Disbursements	\$ (46,033)	\$ (51,062)	\$ (55,551)	\$ (36,407)	\$ (45,819)	\$ (25,423)	\$ (37,368)	\$ (42,819)	\$ (49,954)	\$ (42,305)	\$ (40,646)	\$ (36,066)	\$ (59,211)	\$ (568,664)
Intercompany Receipts / (Disbursements)	-	(15,283)	(3,514)	(13,998)	(8,716)	(10,167)	(1,502)	2,045	1,035	3,691	1,248	10,469	(2,362)	(37,054)
Net Cash Flow	\$ (39,920)	\$ (55,311)	\$ (47,104)	\$ (35,646)	\$ (32,327)	\$ (16,439)	\$ (19,119)	\$ (24,544)	\$ (31,045)	\$ (16,679)	\$ (15,418)	\$ (14,583)	\$ (35,954)	\$ (384,088)
Beginning Cash - Debtors	\$ 6,349	\$ 217,354	\$ 137,196	\$ 96,994	\$ 61,020	\$ 33,671	\$ 12,339	\$ 190,098	\$ 148,719	\$ 130,155	\$ 124,775	\$ 107,337	\$ 70,762	\$ 6,349
(+/-) Net Cash Flow	(39,920)	(55,311)	(47,104)	(35,646)	(32,327)	(16,439)	(19,119)	(24,544)	(31,045)	(16,679)	(15,418)	(14,583)	(35,954)	(384,088)
(+/-) ABL Tranche A Borrowings / (Paydown)	(36,700)	(24,847)	6,902	(329)	4,978	(4,893)	(1,123)	(16,835)	12,480	11,300	(2,019)	(21,992)	10,489	(62,589)
(+) DIP Borrowings	287,625	-	-	-	-	-	198,000	-	-	-	-	-	-	485,625
Ending Cash - Debtors	\$ 217,354	\$ 137,196	\$ 96,994	\$ 61,020	\$ 33,671	\$ 12,339	\$ 190,098	\$ 148,719	\$ 130,155	\$ 124,775	\$ 107,337	\$ 70,762	\$ 45,298	\$ 45,298

Refers to in-flows and outflows from or to non-debtors.

This shows how much cash the debtors are expected to have at the end of each week. Failure to show a positive and material cash balance at the end of the 13-week budget period may result in a creditor or other party-in-interest seeking to convert the case to chapter 7 or dismiss the chapter 11 case on the basis that the estate is administratively insolvent (i.e., it does not have sufficient liquidity to pay its current administrative expenses).