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**Cash Flow Statements, Budgets, Financial
Reporting: Watch Out for the Catches**

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Introduction

The panel will lead a discussion about financial reporting—including the preparation and review of budgets, forecasts, projections and financial statements. The panel will focus on financial reporting at the inception of the Chapter 11 case, during the pendency of the case and at the disclosure statement/plan confirmation stage of the case. We will discuss financial reporting issues from the court's perspective and that of the financial advisors and counsel for the different constituents in a Chapter 11 case—the debtor, secured creditor(s) and creditors' committees.

Financial Reporting at Case Inception

A. The Financial Advisor's Perspective

1. Cash Flow Statements and Preparation of Budget
 - a. What Constitutes Appropriate Foundation and Due Diligence
 - i. historical information—2–3 years
 - ii. comparison of historical to recent/current information
 - iii. prospective information
 - current environment—how does it affect projection
 - iv. assessment of achievability
 - v. review of working capital—is there availability of cash for the projected operations
 - b. Development of Projected Cash Flows Which Accurately Reflect Cash Receipts and Disbursements
 - i. presentation of borrowing base calculation which substantiates cash available
 - ii. cash flow—not revenue recognition (cash vs. accrual)
 - slow pays—*i.e.*, state/Medicare funds, repayment terms/prior customer history—understanding the business and cash flow cycle based on payment cycles and prior customer history

- other items to consider
 - expected discounts
 - contras/setoffs
 - customer pay cycle
 - over 90 day items
- iii. income generated from outside the normal scope of the business
 - sale of fixed assets
 - sale of scrap material
 - sale of business units
 - tax refunds
- iv. accurate estimate of expenses
 - reasonableness of expenses in comparison to projected income
 - consideration should be given to cash-in-advance/cash-on-delivery status that may apply at the inception of the case
 - determine whether labor cost is appropriate for the projected business level
 - schedule of debt service requirements
 - payments for operating expenses which are required to run the business in its current state
 - other items
 - administrative expenses
 - critical vendor payments
 - appropriate estimate for increased expenses and/or decreased revenues
 - contingencies
 - IRS negotiations
 - write-offs

B. The Secured Creditor's Perspective

1. The secured lender will seek clear and concise information in key categories in order to reach a business and legal arrangement regarding financing or use of cash collateral.
2. Most debtors cannot survive on the use of cash collateral alone, either because cash flow will not support such an approach or because the debtor is not able to provide adequate protection by replacing the cash collateral (as opposed to “using it up”). In any event, projections of cash flow, sales, expenses, income and collateral/borrowing base are critical to allow assessment of debtor's projected performance.
3. Secured lenders will focus on what impact the continued operation of debtor will have on prepetition collateral (with or without a roll-up) and what collateral will exist for prepetition and postpetition loans.
4. If there is a shortfall and need for an overformula, negotiations will center on which constituent(s) will fund that shortfall.
5. Existing or potential setoffs/recoupments are a critical factor in determining projections, especially in an automotive case where automotive customers may suffer damages if a production shut-downs occurs. Contrasts will add to the overformula need.
6. Other reserves must also be considered (*e.g.*, personal property taxes, tax liens, etc.)
7. Since the enactment of the BAPCPA, and the addition of § 503(b)(9) to the Bankruptcy Code, a new issue has arisen regarding the “funding” of administrative expenses. In some cases, courts have ruled that § 503(b)(9) claimants do not have to be paid until plan confirmation. Depending on the prospects of reorganization and the funding available to a debtor, these claimants can object to a cash collateral or financing order where they are not being paid.
8. In addition to the argument that there is no requirement to pay § 503(b)(9) claimants at the inception (or during) a Chapter 11, other defenses exist to these claims. Notable is a defense under § 502(d). Section 502(d) states:

“(d) Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 552, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549 or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.”

9. The Sixth Circuit has not addressed the application of this statute to administrative expense claims, including those arising under § 503(b)(9) of the Bankruptcy Code. Other courts have held that the term “claim” in § 502(d) includes administrative expense claims. See *In re Microage, Inc.*, 291 B.R. 503 (B.A.P. 9th Cir. 2002); *In re Georgia Steel, Inc.*, 39 B.R. 829 (M.D. Ga. 1984). Some jurisdictions have ruled to the contrary. See *In re Durango Georgia Paper Co.*, 297 B.R. 326 (Bankr. S.D. Ga. 2003); *In re Lids Corp.*, 260 B.R. 680 (Bankr. D. Del. 2001).

C. The Creditors’ Committee’s Perspective

1. As part of the Chapter 11 process in a small or medium size case, creditors and creditors’ committees bring a different view to the table than the other parties-in-interest. Creditors’ interests—and their perspective of what the process affords them and, therefore, what the process is ultimately worth to them and their constituencies—are different than the debtor’s, and different than that of secured creditors.
2. Creditors and creditors’ committees can also play an active or passive role in the Chapter 11 process. Committees are formed by the United States Trustee’s office at the inception of the proceeding. Committee membership is voluntary. Committees are typically comprised of the largest creditors in the case. Committees hire their own counsel and can also hire their own financial advisors/accountants as the perceived need arises.
3. Financial advisors/accountants when hired by a creditor or creditors’ committee, perform a variety of functions. At a minimum, the financial representative must review all documents related to financial reporting generated by the debtor and provide its analysis to the committee. This can include a variety of documents beginning with the debtor’s schedules and statement of financial affairs filed with the court.
4. Often, the committee has just formed when the cash collateral/financing budgets are being submitted to the court at the inception of the case. These financial documents are reviewed for their initial disclosure of the debtor’s operations and how the debtor is satisfying its “cash collateral” obligations to the secured creditor. The committee, as much as the secured creditor, is very interested in the preservation of the collateral base of the business during this process.

D. The Court’s Perspective

1. The primary issue for the court at case inception is whether the cash flow projections and other financial information supplied by the debtor establish the viability of its business?
 - a. Short-term viability

- i. Do the cash flow projections establish that the debtor has the ability to adequately protect creditor(s) with lien(s) on cash collateral (i.e., will there be no material shrinkage of the debtor's current asset base)?
 - ii. Do the projections establish that the debtor has the ability to adequately protect other secured creditors (e.g., equipment financiers)?
 - iii. Do the cash flow projections establish that the debtor has the ability to repay the DIP financing?
 - iv. Do the cash flow projections establish that the debtor has the ability to operate through completion of a § 363 sale process?
 - b. Long-term viability
 - i. Do the cash flow projections establish the debtor's financial ability to operate through plan confirmation?
 - ii. Can the debtor pay current operating expenses—e.g., taxes, utilities, insurance, trade creditors?
 - iii. Can the debtor pay Chapter 11 expenses—e.g., professional fees (attorneys/financial advisors/investment bankers, United States Trustee fees, etc.)?
 - c. Reasonableness of cash flow projections
 - i. How do they square with historical results?
 - ii. Upon what assumptions are they based?
 - iii. Do they comport with financial reality?
2. Other issues at the outset of the case
- a. Legal issues raised by terms of proposed cash collateral/DIP financing arrangement (*see* S.D. Ohio Form 4001-2 "Cash Collateral/Postpetition Financing Provisions").
 - b. Reasonableness of management compensation.
 - c. Reasonableness of fees paid to DIP lenders.
 - d. Reasonableness of projected professional fees (attorneys/financial advisors/investment bankers/liquidation specialists).

Financial Reporting During the Pendency of the Case

A. The Financial Advisor's Perspective

1. utilization of appropriate format for presentation of cash flow schedules (daily, weekly, monthly) which is consistent with the reporting of the outset of the case
 - requirements from secured lenders and other parties
2. monthly operating reports required by the bankruptcy court
 - adherence to prescribed court forms and reporting requirements

B. The Secured Creditor's Perspective

1. Reporting requirements will be contained in cash collateral/financing order.
2. Secured lenders will rely on borrowing case reporting (daily or weekly), account receivable and payable agings, inventory reports and its auditors to monitor progress during a case.
3. Focus also will be on budget vs. actual to test performance and validity of projections.

C. The Creditors' Committee's Perspective

1. The monthly operating reports provide a view of the debtor's operations. The reports are a combination of cash basis income and expense of the business as well as accrual-based information, such as accounts receivable balances in total, inventory and accounts payable (postpetition).
2. Creditors and committees look to see if the operation of the business is decreasing its collateral base and whether the business is operating in line with the debtor's past results.
3. Creditors and committees also review the monthly operating reports to determine whether there are any unusual or unauthorized transactions by the debtor that would cause concern over its ability to continue to function on behalf of the best interest of creditors.

D. The Court's Perspective

1. Have the monthly financial reports been filed? Have they been filed on a timely basis? *See* § 1112(b)(4)(F).
2. Do the financial reports reflect that the debtor's business is viable or, alternatively, a "substantial or continuing loss or diminution of the estate" and the

“absence of a reasonable likelihood of rehabilitation”? *See* § 1112(b)(4)(A). The debtor’s monthly cash flow statements are generally a much better indicator of viability than its accrual-based income statements.

3. Is the debtor current with its postpetition tax obligations? *See* § 1112(b)(4)(I).
4. Is the debtor current with its other postpetition operating expenses—*e.g.*, rent, trade payables, etc.? Aging of postpetition receivables—how does it compare to debtor’s historical (prepetition) track record?
5. Has the debtor maintained insurance (including workers compensation insurance) in effect? *See* § 1112(b)(4)(C).
6. Has the debtor used cash collateral, paid professional fees, or transferred property without court authorization? *See* § 1112(b)(4)(D) and (E).
7. Is the debtor in compliance with the covenants contained in the postpetition financing agreement with its DIP lender?
8. Is the debtor current with the payment of its quarterly fees to the United States Trustee? *See* § 1112(b)(4)(K).
9. Appropriateness of management compensation/expense reimbursements.
10. Check registers appended to financial reports often provide a fertile source of information, particularly in smaller cases. *E.g.*, NSF charges, unauthorized/inappropriate payments to insiders and other evidence of “gross mismanagement of the estate.” *See* § 1112(b)(4)(B).

**Financial Reporting at Disclosure Statement/Plan
Confirmation Stage of the Case**

A. The Financial Advisor's Perspective

1. Liquidation analysis
 - a. reasonableness of the assumptions utilized for the valuation of assets on liquidation
 - i. appraisals of fixed assets and real estate, where available
 - b. going concern vs. Chapter 7 presentation
2. review of other assets, such as accounts receivable and inventory, cash flow projections and sources and uses of funds, to assess plan feasibility
 - a. once again, due professional care should be taken in assessing the reasonableness of the plan
 - i. inflation factors for income and expenses applied to plan
 - ii. timely receipt of information from the debtor to access current financial situation in comparison to the plan assumptions
 - b. adherence to plan—are they paying who they said they were going to pay?
 - c. creditor payment and feasibility

Monitoring should continue during post-confirmation reporting to confirm that the debtor is operating as proposed under the plan. Pro-active monitoring ensures that any problems are recognized immediately.

B. The Secured Creditor's Perspective

1. What is secured lender's administrative expense claim (was there a roll-up)? Must be paid in full upon confirmation, unless otherwise agreed.
2. Standard, "new loan" underwriting for exit financing.
3. Feasibility, cram-down and realization of adequate protection.

C. The Creditors' Committee's Perspective

1. As part of the debtor's plan of reorganization and disclosure statement, the debtor will include several financial documents that are actively reviewed by the financial advisors/accountants of the creditors. These documents often include financial projections of operations as well as projected cash flow analyses, *i.e.* projected sources and uses of funds statements.
2. These statements of the debtor reflect the structure and operations of the proposed post-confirmation entity as well as the proposed repayment plan of the company. The creditors review these statements for feasibility as well as what is being proposed to the creditor body.
3. The creditors and their financial advisors/accountants may initiate their own analyses based upon their knowledge of the business and what deal they may propose. In many situations, this process takes place prior to formalizing the document until a "consensual" plan is developed. There are not as many "competing" creditors plans in small and medium Chapter 11's as their might occur in larger and mega cases.
4. The liquidation analysis often attempts to project what the creditors ultimately would receive if the debtor's plan is not confirmed and the business is liquidated in a Chapter 7 proceeding. Financial advisors/accountants often review these documents and try to gain an understanding to either accept the analysis or propose their own analysis of the situation.
5. Creditors and creditors' committees throughout this process are trying to both maximize the recovery of the amounts owed to them while at the same time analyzing what benefit they may achieve if the debtor successfully reorganizes and continues to do business with them.

D. The Court's Perspective

1. Do the projections accompanying the disclosure statement establish that the plan of reorganization is feasible? *See* § 1129(a)(11).
2. Are the assumptions underlying the projections reasonable?
3. How do the projections compare with the debtor's prepetition operating results and the debtor's operating results during the pendency of the case?
4. Are the assumptions on which the liquidation analysis is based reasonable? *E.g.*, hypothetical costs of sale, projected liquidation value of assets (including real estate, inventory and receivables) versus going-concern value of the assets, Chapter 7 burial costs and avoidance recoveries.

5. Are plan projections accurate—*i.e.*, do they square with the substantive terms of the plan and the confirmation requirements set forth in § 1129. Most accuracy issues arise in small Chapter 11 cases. *E.g.*, amortization period/interest rate for priority tax claims and secured claims, proposed balloon payments, etc.