The death knell for critical vendor payments?

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A topic that has received much recent attention and invoked divided opinions among judges, bankruptcy attorneys and scholars is the issue of whether a bankruptcy court can authorise a debtor-in-possession to pay the pre-bankruptcy claims of certain “critical vendors” at a time when the claims of other pre-bankruptcy creditors cannot be paid. With growing frequency since the early 1990s, Chapter 11 debtors have asked bankruptcy courts, typically at the onset of cases, to approve payment of these critical vendors’ pre-petition claims. In theory, these vendors are indispensable to a debtor’s ongoing business and, therefore, to its reorganisation. It is also presumed that these vendors will not continue to provide goods or services to a debtor if their pre-petition claims are not paid. Payment of these claims has been widely allowed in the interest of enabling a reorganisation that is expected to benefit all creditors, including those that are not designated “critical vendors”. Of late, in many jurisdictions, a motion to authorise payment of critical vendors’ pre-petition claims has become a routine first-day motion in a Chapter 11 case. In fact, in some recent cases, debtors have been given limited discretion to decide on their own which vendors are critical, without the need to specify them or demonstrate that they are critical at the time the court authorisation is sought.

However, during the past two years, critical vendor payments have come under increased criticism by some courts, bankruptcy attorneys, and scholars. Some critics have noted that there is no provision in the United States Bankruptcy Code that expressly allows for payment of critical vendors ahead of other creditors. To the contrary, these critics have argued, critical vendor payments violate strict creditor payment priorities set out in section 507 of the Bankruptcy Code and therefore should not be allowed. This position was adopted by the United States Court of Appeals for the Seventh Circuit in Capital Factors, Inc v Kmart Corporation (2003) (In re Kmart Corporation) (“Kmart”). Other critics have maintained that the Bankruptcy Code may allow critical vendor payments, but have argued that this practice has been abused, with payments being authorised when they are not truly necessary to a debtor’s reorganisation. This position was taken by the United States Bankruptcy Court for the Northern District of Texas in In re CoServ, LLC (2002), which articulated a strict test to be met as a prerequisite to achieving critical vendor status. This position is also consistent with the Seventh Circuit’s recent decision in Kmart.
This chapter will discuss:

(1) the “doctrine of necessity” which courts have relied on to authorise critical vendor payments;

(2) recent criticism of this doctrine and critical vendor payments, including criticism by the courts in the Kmart and CoServ decisions; and

(3) authorities in the Bankruptcy Code outside of the doctrine of necessity and the courts’ general equitable powers under section 105(a), which may authorise critical vendor payments in appropriate cases.

The doctrine of necessity and critical vendor payments

Bankruptcy courts have most often relied on the “doctrine of necessity” to allow debtors to pay vendors whose cooperation is deemed essential to a debtor’s continued operations and reorganisation. The same doctrine has been routinely invoked to justify payment of other pre-petition claims, such as claims by a debtor’s employees for unpaid wages and benefits. The rationale underlying this doctrine is that if a critical vendor is not paid at the onset of a bankruptcy case, the vendor will refuse to provide goods or services and the debtor’s operations will suffer irreparable (and perhaps immediate) harm. The doctrine of necessity is believed by its proponents to be incorporated within a bankruptcy court’s general equitable powers under section 105(a) of the Bankruptcy Code. However, the roots of this doctrine originated nearly a century before the current Bankruptcy Code was enacted.

Historical development of the doctrine of necessity

Origin of the doctrine in nineteenth century railroad receivership cases

The doctrine of necessity is an extension of the “necessity of payment rule” that developed in railroad receivership cases of the nineteenth century. Because survival of the railroad industry was essential to a large segment of the economy and communities in many regions of the United States, courts were willing to be very flexible in allowing receivers overseeing reorganisations of railroads to exercise remedies necessary for a struggling railroad to survive. These measures included the necessity of payment rule, which allowed payment of certain claims that arose before receivers were appointed. Under this doctrine, claims made by suppliers and other entities essential to railroad operations could be paid ahead of claims that would otherwise have priority, including claims of secured lenders.

The necessity of payment rule was recognised by the United States Supreme Court in Miltenberger v Logansport C & SWR Co et al (1882). In Miltenberger, the Circuit Court of the United States for the District of Indiana appointed a receiver to “operate and manage” a debtor-railroad. The Circuit Court authorised the receiver to pay certain debts of the railroad, incurred before the receiver’s appointment, for materials, repairs and use of connecting railroads. The Circuit Court made this accommodation based on the receiver’s representation (as paraphrased by the Supreme Court) that “payment of that class of claims was indispensable to the business of the [rail]road, and that, unless the receiver was authorised to provide for them at once, the business of the road would suffer great detriment.” It was also noted that certain creditors of the railroad had “threatened not to furnish any more supplies on credit unless they were paid the arrears” owed to them. Secured lenders of the debtor-railroad objected to the payment of these claims ahead of their own. The Supreme Court affirmed the lower court’s decision to allow these payments. It explained that payments of certain pre-receivership debts of railroads were appropriate because maintaining operation of railroads was in the public interest. The court stated, “This view of the public interest in such a highway for public use as a railroad is, as bearing on the maintenance and use of its franchises and property in the hands of a receiver, with a view to public...
convenience…” (Nearly a century later, the United States Court of Appeals for the First Circuit would explain in *In re Boston & Maine Corp* (1981), “Miltenberger is concerned… with the more general authority of the receivership court to accord priority status to pre-receivership claims in order to prevent the stoppage of a business impressed with the public interest.”)

**Expansion of the doctrine of necessity outside of railroad reorganisations and the public interest**

In the twentieth century, courts began applying the doctrine of necessity to reorganisations of businesses other than railroads, including businesses whose survival was not necessarily linked to the public interest. This departure was signalled by *Dudley v Mealy*, a 1945 opinion authored by Judge Learned Hand, in the reorganisation of a hotel under Chapter X of the Bankruptcy Act. In *Dudley*, the United States Court of Appeals for the Second Circuit upheld an order of a district court confirming a plan of reorganisation that prioritised payment of claims of certain unsecured creditors that had furnished supplies to the hotel shortly before a receiver was appointed. A secured creditor objected to this preference. The Second Circuit upheld the preference given to these creditors, on grounds that extended the scope of the doctrine of necessity. The court recognised that in a number of earlier cases, courts had refused to extend this doctrine to private corporations. The court also noted that this doctrine existed primarily to serve the public’s interest in the continued operation of railroads, afterwards extended to other public service companies. However, the *Dudley* court reasoned further that a debtor’s creditors may also be served by protection of certain essential supply creditors. The court therefore held that if supply creditors furnished their goods or services within a short period of the receivership and these were necessary to keep the hotel open, these claims were properly preferred.

Supporters of the doctrine of necessity have argued that Congress incorporated this doctrine in section 77B(a) of the Bankruptcy Act of 1898, which was amended in 1934 to provide that the court “shall have and may exercise all the powers… which a Federal court would have had it appointed a receiver in equity of the property of the debtor by reason of its inability to pay its debts as they mature.”

**The doctrine of necessity under the Bankruptcy Code**

Most of today’s proponents of the doctrine of necessity and courts’ power to authorise critical vendor payments contend that the doctrine is now incorporated in section 105(a) of the Bankruptcy Code. This section states, in pertinent part, “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”

The legislative history of section 105(a) suggests that this section does incorporate equitable powers that bankruptcy courts were previously understood to possess. A report of the United States House of Representatives on the Bankruptcy Reform Act of 1978 states that section 105 is similar in effect to the All Writs Statute, which was also applied to the bankruptcy courts by an amendment to 28 USC 451.

The United States Supreme Court has similarly stated that it “will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.”

**The modern approach to critical vendor payments**

During the past ten years, bankruptcy courts in a number of jurisdictions have grown more willing to authorise debtors to pay the pre-petition claims of critical vendors deemed to be “critical”. This is evident in several published opinions and many more unpublished orders. As one commentator has observed, “The concept of ‘critical vendors’ has gone from an extraordinary remedy to something that is simply done as a matter of course in almost all cases.” At the very least, the practice has become commonplace among first-day motions filed by debtors in sizeable Chapter 11 cases.

Today, most debtors that seek authority to pay the pre-petition claims of critical vendors and most
bankruptcy courts that grant such authority rely on the courts’ general equitable powers under section 105(a) of the Bankruptcy Code. However, both before and since the decision of the United States District Court for the Northern District of Illinois in Kmart, discussed below, some courts have begun to bolster their grants of critical vendor status by referring to other sections of the Bankruptcy Code.

**Criticism of the doctrine of necessity and critical vendor payments**

During the past two years, some courts, bankruptcy attorneys and scholars have turned up the heat in rejecting or limiting the now routine practice of allowing critical vendor payments. Some critics argue that courts have no authority under the Bankruptcy Code to authorise critical vendor payments, and that early payment of certain vendors’ claims offends the priority scheme under section 507 of the Bankruptcy Code. Others maintain that courts may have authority to allow such payments in appropriate cases, but that this practice has been over-used, which has led to certain abuses. Two recent court opinions exemplify these two lines of criticism: Kmart and In re CoServ, LLC (“CoServ”).

**Argument that the doctrine of necessity does not exist under the Bankruptcy Code, and that critical vendor payments offend the Bankruptcy Code priorities**

The strongest critics of critical vendor payments contend that there simply is no authority under the Bankruptcy Code to authorise them. For example, Joshua A Ehrenfeld argues in “Quieting the Rebellion: Eliminating of Payment of Prepetition Debts Prior to Chapter 11 Reorganizations” (2003) that since the enactment of the Bankruptcy Code, if the doctrine of necessity exists at all, it exists “only to assist in the narrow category of cases involving railroad reorganisations.” He maintains that “although the doctrine’s existence and history were known to Congress, this rule was not expanded beyond its application to railroads when the Bankruptcy Code was last substantially amended.” More significantly, these critics maintain that critical vendor payments violate a principal tenet of the Bankruptcy Code, that pre-petition, general unsecured claims should be satisfied on an equal basis, pursuant to a plan of reorganisation, and consistent with priorities established under section 507 of the Bankruptcy Code.

**Capital Factors, Inc v Kmart Corporation (In re Kmart Corporation)**

In Kmart, the United States Court of Appeals for the Seventh Circuit rejected the existence of the doctrine of necessity altogether, and stated that if critical vendor payments are authorised at all, this is only under limited circumstances and only under section 363(b) of the Bankruptcy Code. The bankruptcy court had granted the debtors’ motion, filed on the first day of the cases, to make critical vendor payments. The debtors and the bankruptcy court relied solely on section 105(a) of the Bankruptcy Code as authority for these payments. Capital Factors, a Kmart creditor that was not designated as a “critical” vendor, appealed this decision to the district court.

The district court held that the bankruptcy court had no authority under section 105(a) to authorise critical vendor payments. The court acknowledged that the application of the doctrine of necessity through § 105 in the situation was well-intended and may even have some beneficial results, in that pre-plan payment of certain pre-petition claims would allow the debtor to minimise disruptions in doing business, and thus may further reorganisation. Nevertheless, it was clear to the district court that however useful and practical these payments may appear to bankruptcy courts, they simply are not authorised by the Bankruptcy Code. The court observed that Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment of pre-petition unsecured claims.

On further appeal, the Seventh Circuit affirmed the district court’s decision. The Seventh Circuit held that section 105(a) of the Bankruptcy Code “does not create discretion to set aside the Code’s rules about
priority and distribution…” The court held that the doctrine of necessity does not exist under the Bankruptcy Code and that it is “the Bankruptcy Code rather than the norms of the nineteenth century railroad reorganisations that must prevail.”

Unlike the district court in Kmart, the Seventh Circuit held out the possibility that, under limited circumstances, critical vendor payments may be authorised under section 363(b) of the Bankruptcy Code. This section of the Seventh Circuit’s opinion is discussed below.

**Argument that the doctrine of necessity may exist, but that critical vendor payments are authorised too frequently, without sufficient scrutiny**

Other critics of critical vendor payments concede that the Bankruptcy Code may authorise these payments under appropriate circumstances. However, these critics argue that critical vendor payments are being allowed too frequently today, and that this has led to certain abuses. One commentator, Thomas J Salerno, has argued that the concept of “critical vendors” is clearly subject to abuse, and that vendors frequently jockey for a place on the critical vendor list. While this sometimes helps a debtor immensely, it is frequently viewed as an entitlement by the trade creditors. Salerno points out that thus, “the decision reaches all vendors – the truly ‘critical vendors’ where there really are very limited, if any, choices for substitution, as well as the pseudo-critical vendors who simply scream the loudest to get on the list.”

Another critic of the current critical vendor practice, Robert A Morris, contends that “[c]ritical vendor motions are unnecessary in most cases” because there is generally no merit to the usual arguments that vendors are “critical”. He suggests that vendors possessing specialised tooling and equipment are most frequently cited by crisis managers as critical. However, he notes that these vendors will usually have as much to lose as the debtor if their business relationships are severed, due to the low number of substitute customers for such customised products, and they will likely continue to supply even without critical vendor status. The Seventh Circuit expressed similar views in its recent opinion in Kmart.

**In re CoServ, LLC**

In the recent case In re CoServ, LLC, the United States Bankruptcy Court for the Northern District of Texas provided case authority to those critics who acknowledge that the doctrine of necessity may exist, but believe a debtor should make a greater showing that a vendor is truly indispensable before its pre-petition claims can be paid ahead of those of other unsecured creditors. In CoServ, the debtors filed a first-day “Emergency Motion for Order Authorising Payment of Pre-petition Claims of Critical Vendors,” seeking authority to expend approximately US$2.2m in payment of pre-petition claims to 27 creditors. After the bankruptcy court expressed initial scepticism, the debtors narrowed their list to seven creditors they wished to have designated as “critical vendors” and paid a total of US$563,183. By this point, the motion was unopposed. However, the court remained unsatisfied.

The court agreed that under the doctrine of necessity and section 105(a), it “can allow the debtors to pay pre-petition debt other than pursuant to a plan,” but held that “it may do so only under extraordinary circumstances.” The court stated that “the equitable power that the Court may exercise under section 105(a) is severely circumscribed.” It continued, “Except where an unsecured claim, non-payment of which could impair a debtor’s ability to operate, has been accorded priority treatment by Congress and existing senior creditors consent or are clearly provided for, a bankruptcy court may order payment of unsecured pre-petition claims only under the most extraordinary circumstances.”

The CoServ court set out guidelines for determining when critical vendor payments can be authorised, holding that a debtor must prove three elements by a preponderance of the evidence to obtain this relief:
(1) The debtor must deal with the claimant.

To meet this requirement, the debtor must show that, for one reason or another, dealing with the claimant is virtually indispensable to profitable operations or preservation of the estate. The debtor’s customers, sole suppliers of a given product, and creditors having control over valuable property of the estate would satisfy this element of the court’s standard.

(2) A failure to deal with the claimant risks probable harm or eliminates an economic advantage disproportionate to the amount of the claim.

Payment of a large claim in hope of favourable credit terms merits careful analysis that shows net economic benefit before superseding the prohibition against payment of pre-petition claims. To meet the second element of this court’s test, a debtor must show that meaningful economic gain will result or that serious economic harm will be avoided through payment of the pre-petition claim, which itself is materially less than the potential loss to the estate or business.

(3) There is no practical or legal alternative to payment of the claim.

If payment is intended to assuage the claimant’s concern about future dealings, then a deposit, collect-on-delivery terms, payment-on-shipment terms and countless other devices are available, which will not offend the general principle that pre-petition claims should not be paid.

Applying these guidelines to the case at hand, the CoServ court denied the debtors’ motion with respect to all but one of the vendors the debtors had alleged to be “critical” (a vendor employing an information technology professional who was intimately familiar with the debtor’s systems). The court found that most of these vendors could easily be replaced by the debtor with little harm to the debtor’s going-concern value.

The CoServ decision had an immediate impact on critical vendor motions throughout the country. For example, later that year, the United States Bankruptcy Court for the Northern District of Illinois refused to grant the debtor’s critical vendor motion in In re Clark Retail Enterprises, Inc (2002). In that case, the debtors, operators of a chain of gas stations and related convenience stores, presented a motion to pay the pre-petition claim of a critical vendor that supplied the debtors with all of the snacks sold in the debtors’ convenience stores, which generated a significant portion of the debtors’ revenue. No party objected to the motion. At the hearing on the motion, however, the bankruptcy judge raised the CoServ requirements with the debtors’ counsel. The bankruptcy judge was not convinced that the third CoServ requirement was met, ie that the vendor would cease providing goods and services to the debtor, and therefore denied the request.

Alternative sources of authority for critical vendor payments

Several courts have held that there are other sources of authority, apart from the doctrine of necessity and section 105(a) of the Bankruptcy Code, which authorise payments to pre-petition claimants when these are necessary to the continued operation of a debtor’s business. For example, in In re Ionosphere Clubs, Inc (1989), the United States Bankruptcy Court for the Southern District of New York relied on section 363(b) of the Bankruptcy Code to authorise the debtor to pay certain pre-petition wage, salary, medical benefit and business expense claims of its active employees. More recently, in the case In re Kasper ASL Ltd, et al (2002), the same court relied on section 363(b) to authorise payment of the pre-petition claims of certain foreign and critical vendors. In Kmart, the Seventh Circuit expressly reserved this issue, but stated that the argument that some critical vendor payments may be authorised under section 363(b)(1) is “more promising” than arguments based on other sections of the Bankruptcy Code.
In the case *In re Payless Cashways, Inc* (2001), the United States Bankruptcy Court for the Western District of Missouri relied on section 364(b) of the Bankruptcy Code to authorise payments of the claims of a debtor’s critical vendors where these were necessary to induce these vendors to extend post-petition trade credit. The court granted this relief over an objection by the US Trustee based on the priority scheme for creditors under the Bankruptcy Code.

More recently, in *In re UAL Corp* (2002) (“United Air Lines”), the debtors filed two critical vendor motions, for their domestic and international vendors. Parroting the forms used in preceding cases, the UAL motions cited only the doctrine of necessity as the statutory authority for the requested relief. At the first-day hearings, the bankruptcy judge appeared to surprise the debtors’ attorney by re-characterising the debtors’ motions as motions to pay claims of certain pre-petition vendors in the ordinary course of business pursuant to sections 363 and 364 of the Bankruptcy Code. The court granted the motions as re-characterised.

**Conclusion**

It will likely be years before there are consistent, nationally recognised standards governing whether, under what authorities, and under what circumstances critical vendor payments can be authorised. Perhaps until the United States Supreme Court rules on this issue or Congress intercedes, a debtor’s ability to obtain authorisation to make critical vendor payments may vary from court to court and district to district.

In the meantime, because of recent criticism of applications of the doctrine of necessity during the past decade, debtors seeking this relief (and creditors working with debtors to seek this relief) would be well advised to rely on more than section 105(a) of the Bankruptcy Code as authority, and to present more evidence than many debtors have in the past that a creditor for which critical vendor status is sought is truly indispensable to the debtor’s continued business and reorganisation.

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