

The Critical Vendor Doctrine after Kmart

CAN YOU STILL GET PAID NOW, IN FULL,
ON YOUR BANKRUPT CUSTOMER'S ACCOUNT?

3rd Edition

The
Credit
Research
Foundation

The Critical Vendor Doctrine After Kmart

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ABOUT THE FIRM

Blakeley & Blakeley LLP represents its creditor clients in the areas of creditor rights, commercial litigation and collection, credit documentation, e-commerce, bankruptcy and out-of-court-workouts. B&B's collective experience and legal and practical understanding of vendors' rights results in cost-effective representation and develops solutions to vendors' problems. B&B's attorneys have extensive experience working with vendors. Members of the firm routinely speak to national industry groups and trade associations concerning creditors' rights and frequently publish articles in national and regional publications concerning creditors' rights.

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Other Credit Research Foundation Publications by Scott Blakeley

The Credit Research Foundation is grateful to Mr. Blakeley for his untiring quest to help credit professionals in the area of creditor's rights and legal matters. Scott has written several monographs that CRF has published in the last few years specifically involved with bankruptcy and dealing with distressed debtors.

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The Critical Vendor Doctrine After Kmart Can You Still Get Paid Now, In Full, On Your Bankrupt Customer's Account?

Scott E. Blakeley

The credit professional well knows that a customer's Chapter 11 means long delays before receiving any payment on the prepetition account; and worse, the payment is usually but a fraction of the claim. Furthermore, it is not uncommon for the creditor to receive stock in the reorganized debtor in exchange for its prepetition claim (as was the case in the Kmart Chapter 11). Traditionally, the creditor would file a proof of claim, perhaps serve on the creditors' committee and press for a meaningful payment on their prepetition claim. Does a creditor in this situation, especially one with a substantial trade relationship, have any recourse? *With the development of the critical vendor doctrine, the credit professional has had a meaningful alternative.*

On occasion a vendor may be a key supplier to a customer that files Chapter 11. Given this key supplier relationship, the creditor often holds a sizeable unsecured claim upon the Chapter 11 filing. The creditor, selling invoice by invoice (as opposed to a long term supply contract), may elect not to continue to sell the debtor postpetition. However, the creditor's product or service may be viewed by the debtor as essential to its continued operations, such as when the debtor cannot locate a substitute vendor. Without the product or service, the debtor may be forced to close, which, contrary to the principle of bankruptcy, may further harm the non-critical vendors. In this situation the debtor may request that the bankruptcy court authorize it to immediately pay a critical creditor's prepetition claim, in exchange for that critical vendor selling to the debtor post-bankruptcy on credit.

More and more bankruptcy courts throughout the country have been considering a debtor's request to treat certain vendors as critical, and have their pre-bankruptcy claims paid in exchange for postpetition trade credit. However, as a result of the Kmart ruling, the support of bankruptcy courts for critical vendor requests may change.

In the Kmart case, the Seventh Circuit Court of Appeals affirmed the district court's reversal of the bankruptcy court's authorization for critical vendor payments. The Supreme Court declined to hear the appeal from the Seventh Circuit. This raised the questions:

- ✧ What was the impact of the Kmart ruling on the critical vendor doctrine?
- ✧ Has the critical vendor doctrine survived?

- ✧ If so, in which courts; and what is the standard the debtor and critical vendor must establish?

A. History of the Critical Vendor Doctrine

Since the early 1990's, Chapter 11 debtors have asked bankruptcy courts to approve the payment of vendors' prepetition claims that the debtor believes are essential to its ongoing operations. Payment of these claims have been allowed in the interest of enabling a *reorganization that is expected to benefit all creditors*, including those that are not designated as a critical vendor. In some jurisdictions, a motion to authorize payment of critical vendors' prepetition claims has become a routine first day motion in a Chapter 11 case, wherein the debtor articulates its business judgment to support payment of critical vendors.

1. THE EQUALITY OF PAYMENT RULE FOR UNSECURED CREDITORS IN BANKRUPTCY

A central principle of the Bankruptcy Code is equality of treatment of unsecured creditors. The equality of treatment rule is embodied, for example, in the preference laws and treatment of creditors' claims under a plan of reorganization. Creditors of the same priority are generally not entitled to be paid on their prepetition claims in Chapter 11, except through a plan of reorganization; and creditors are to be paid the same pro-rata amount on their claims in both Chapter 7 and Chapter 11 cases.



2. DEVELOPMENT OF THE NECESSITY DOCTRINE

Notwithstanding the general rule of treating creditors of the same class equally, bankruptcy courts have often relied on the "doctrine of necessity" to allow insolvent debtors to pay vendors whose cooperation is deemed essential to a debtor's continued operations and reorganization. The same doctrine has been routinely invoked to justify payment of prepetition claims such as claims of a debtor's employees for unpaid wages and benefits.

The necessity doctrine was developed in railroad receivership cases of the nineteenth century. 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 reorganizations 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.*

3. THE NECESSITY DOCTRINE OUTSIDE OF RAILROAD REORGANIZATIONS

In the twentieth century, courts began applying the doctrine of necessity to reorganizations of businesses other than railroads, including businesses whose survival was not necessarily linked to the public interest. 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.

The legislative history of section 105(a) suggests that this section incorporates equitable powers that bankruptcy courts were previously understood to possess. The United States Supreme Court has stated that it will not read the Bankruptcy Code to erode the past bankruptcy practice absent a clear indication that Congress intended such a departure.

4. THE MODERN APPROACH TO CRITICAL VENDOR PAYMENTS

In the years leading up to Kmart, bankruptcy courts in a number of jurisdictions had been inclined to authorize debtors to pay the prepetition claims of creditors deemed critical, based on a debtor's business judgment. *The concept of "critical vendor" had gone from an extraordinary remedy to something that was simply done as a first day motion filed by debtors in chapter 11 cases.*

However, the prevalence and ease with which creditors obtained critical vendor payments came under increased criticism by some courts, bankruptcy attorneys and scholars. Some critics noted that there is no provision in the Bankruptcy Code that expressly allows for payment of critical vendors ahead of other creditors. Other critics maintained that the Bankruptcy Code may allow critical vendor payments, but argued that the practice had been abused with payments being authorized when a vendor is not truly necessary to a debtor's reorganization. *This criticism culminated in the Kmart appellate rulings.*

Although the Kmart opinion appeared to mark the beginning of the end for critical vendor relief, trade creditors in select districts have taken shelter under section 363(b)(1) of the Bankruptcy Code. This code section allows a debtor to use estate resources within the ordinary course of business, which can include the payment of pre-petition claims, with the approval of the bankruptcy court. Paramount to the approval of prepetition payments are evidentiary hearings, the absence of which was noted in the Kmart opinion. While

bankruptcy courts in New York and Delaware continue to permit payments to critical vendors with oversight from the court and creditor's committee, other courts have built upon the Kmart decision in creating restrictive tests that are unfavorable to potential critical vendors.

B. The Critical Vendor Doctrine

A Chapter 11 debtor that is an operating business must decide which vendors they need most, and then negotiate a payment to them on their prepetition debt. Often, the debtor places the "critical vendors" on a list. Those vendors that do not make the list will receive payment through a confirmed plan of reorganization or Chapter 7 liquidation, often years after the bankruptcy filing. The payment a "non-critical" vendor receives is but a fraction of the claim owed; or, perhaps, stock in the reorganized debtor.

The critical vendor motion is filed by the debtor with the bankruptcy court and provides that the vendor will receive payment on their prepetition claim. *The motion also binds the vendor to continue to sell the debtor on terms equal to or better than prepetition terms.* Prior to Kmart, the critical vendor dollar amounts sought were often high. WorldCom, Inc., for example, was authorized to pay vendors up to \$70 million. The average relief granted to a midsized debtor ranged from \$8 million to \$25 million. The responsibility to define the vendors who are critical is usually placed in the hands of the debtor. When a company files for bankruptcy, it reviews its list of vendors and uses its business judgment to decide which vendors are critical in order to stay in business.

1. TYPES OF PRODUCTS OR SERVICES THAT MAY BE DEEMED CRITICAL

Below are classes of products and services offered by vendors considered for critical vendor status.

a. Vendors Providing Unique Product

A vendor providing a unique product, such as customized tooling, may qualify as a critical vendor. This type of vendor provides some unique part for which there is no immediate substitute vendor for the debtor. The creditor's threat to refuse to continue to provide its unique product creates leverage to be selected as a critical vendor. These vendors fall into the following categories:

Sole Source Vendors: Some vendors may be a debtors' only providers of certain materials or services. There may be no replacement vendors for sole source vendors. Even should competing vendors exist, a debtor may classify certain vendors as sole source vendors where the transition to a new vendor may interrupt a debtor's operations.

Where a vendor is the only sole source vendor who readily can provide a debtor with materials or services, it may refuse to continue materials or services due to the prepetition indebtedness, and the debtor's operations could be disrupted while the debtor seeks to locate a substitute vendor, in excess of the amount of sole source suppliers' prepetition claims.

Capacity Vendors: Some vendors of materials may be the only vendors to produce such materials in quantities sufficient to meet a debtor's demands, even though there may be vendors that produce some of the materials.

Quality Vendors: Some vendors may be deemed critical as they are the only vendors that provide the debtor with certain high-quality materials. In some cases a debtor may have customer contracts that require the high quality materials.

Knowledge Vendors: Some vendors may be deemed critical because they have unique knowledge of a debtor's business, or have been responsible for certain aspects of a debtor's business. These vendors have maintained the debtors operations for a period of time and have acquired unique knowledge of the business. Vendors Providing Unique Service
Specialized service vendors are similar to unique product vendors, except that their uniqueness lies in their service instead of their goods.

b. Lack of Competition within Industry

Lack of competition within an industry may give vendor leverage over the debtor and result in critical status for the vendor. Rather than a unique product or service that a vendor may provide, the mere fact that the vendor lacks competition creates the critical vendor situation.

c. Foreign Vendors

Vendors that provide their product from overseas may create a critical vendor situation. Offshore vendors may find that the debtor cannot find a replacement vendor in a timely manner.

d. Vendors Selling to Companies Subject to Mass Tort Claims

Over the last few years, companies that used or consumed asbestos in their operations (as opposed to manufacturers of asbestos) have been shocked to find themselves the target of mass asbestos litigation and personal injury claims.

This mass asbestos litigation has resulted in at least two-dozen companies filing Chapter 11 to stay this litigation. In the asbestos and mass tort cases, debtors generally have

sought critical vendor status for a large portion of its vendor class.

e. Small Vendors

Those vendors whose financial survival is dependent on the debtor paying their prepetition claim have qualified as a critical vendor.

2. THE TRADE CLAIMS CAP

The critical vendor doctrine has evolved from the debtor requesting a particular vendor be paid immediately as a critical vendor, to the debtor requesting a class of vendors qualify as critical vendors, to the debtor requesting the bankruptcy court establish a critical vendor "trade claims cap." For example, in the United Airlines Chapter 11, the carrier requested that the bankruptcy court pay trade claims totaling \$35 million as critical. United Airlines did not identify the vendors it would deem critical. Rather, United Airlines requested the court authorize payment of a class of vendors it deemed critical, which represented about 14% of vendors with unsecured claims. United Airlines did not propose to pay in full each vendor deemed critical, but only the minimum for the vendor to continue selling on credit. In the trade claims' cap request, the debtor may not disclose those vendors it has selected as critical. If the debtor does dissolve, it may be limited to disclose only to the creditors' committee those vendors it has selected as critical. The debtor uses its business judgment as to which vendor should be deemed critical.

C. Criticism of the Critical Vendor Doctrine

The critical vendor doctrine may be viewed as conflicting with the fundamental principle of bankruptcy, which is equal treatment for the same class of unsecured creditors' claims. In bankruptcy, the general rule is that vendors may be paid on their unsecured claims only through a confirmed plan of reorganization or court authorized liquidation. Other critics argue that courts may have the authority to allow such payments in appropriate cases, but this practice has been over used, which has led to abuses.

Other criticism is that there are very few true critical vendors; rather, the debtor may use the critical vendor motion to favor certain vendors. Thus, these vendors could be substituted with limited harm to the debtor's ongoing operations. Furthermore, if there are indeed true vendors whose product or service is indispensable, those vendors may have economic self-interest to continue to sell especially if the debtor has a vendor lien program or debtor in possession financing in place. These critical vendors may sell to the debtor with or without critical vendor status.

Another criticism is those courts that grant critical vendor motions with a claims' cap, turn the approval of critical vendors over to the debtor, perhaps without creditor oversight.

D. The Kmart Rulings: From the Bankruptcy Court to the Supreme Court

Kmart's Chapter 11 was one of the largest filings by a retailer. In an effort to obtain unsecured credit from its vendors and maintain key vendor relationships, Kmart, in the opening days of the bankruptcy, rewarded certain key domestic and foreign vendors with payment on their pre-bankruptcy claims under the critical vendor doctrine. As part of its first-day motions, Kmart filed a motion seeking authority to pay prepetition obligations to its critical vendors. Kmart served its critical vendor motion on about 65 of its key creditors; notwithstanding it had thousands of vendor creditors. Kmart argued these payments were necessary to maintain business relationships with the respective vendors, and the vendors' goods were essential to Kmart's continued operations and a successful reorganization.

1. BANKRUPTCY COURT'S AUTHORIZATION TO PAY CRITICAL VENDORS

Vendors supplying a range of products from food to music to publishing services were paid on their prepetition claims in exchange for these vendors providing postpetition trade credit. The critical vendors agreed to provide credit on customary trade terms for two years. The bankruptcy court authorized payments to the critical vendors totaling \$327 million under the "doctrine of necessity" using its equitable powers of section 105 of the Bankruptcy Code. The bankruptcy court was satisfied with Kmart's business judgment that without paying vendors their prepetition debt, the vendors would not make shipments postpetition; and without these goods Kmart's reorganization would be threatened.

2. CAPITAL FACTORS OBJECTION TO PAYING CRITICAL VENDORS

Capital Factors (CF), a company that had factored certain vendors' accounts receivables, held \$20 million in claims against Kmart, and was not included among the vendors to be paid pursuant to the critical vendor motion.

CF appealed the bankruptcy court's critical vendor order. CF complained that the bankruptcy court had no legal basis to discriminate paying certain vendors prepetition claims. Under Kmart's plan of reorganization, non-critical vendors received ten cents on the dollar, payable in Kmart stock. *The District court reversed the bankruptcy court.*

3. THE DISTRICT COURT REVERSES THE BANKRUPTCY COURT

The district court acknowledged that the bankruptcy court's application of the "doctrine of necessity" was well intended and may even have had some beneficial results. *However, the district court concluded there was no authority under the Bankruptcy Code to afford priority status for the payment of certain prepetition obligations to vendors.*

In reversing the bankruptcy court's decision, the district court determined that such payments were, (1) not authorized by Bankruptcy Code section 105(a)'s broad grant of equitable power; and (2) the critical vendor payments were contrary to the Bankruptcy Code's priority scheme. *The district court rejected the debtor's contention that should the critical vendor order be reversed, it would then have to file thousands of postpetition preference actions to collect the critical vendor payments.* The debtor then appealed to the Seventh Circuit Court of Appeals.

4. SEVENTH CIRCUIT COURT OF APPEALS AFFIRMS THE DISTRICT COURT AND LIMITS THE CRITICAL VENDOR DOCTRINE

The Seventh Circuit Court of Appeals affirmed the district court's reversal of the bankruptcy court's approval of the debtor's critical vendor motion. The Seventh Circuit's decision does not flatly reject the critical vendor doctrine, but it does indicate that a debtor seeking authority to pay its critical vendors must be prepared to satisfy heightened procedural and evidentiary standards. The Seventh Circuit noted that the bankruptcy court ruling: "open-ended permission to pay any debt to any vendor it deemed 'critical' in the exercise of unilateral discretion, provided that the vendor agreed to furnish goods on 'customary trade terms' for the next two years — was 'in the best interests of the Debtors, their estates and their creditors'"¹ was overbroad. *In other words, a debtor may not request broad authority to pay critical vendors at its request. Rather, the debtor must identify which vendors are critical.*

The Seventh Circuit found that a court should make a determination that discrimination among unsecured creditors is the only way to facilitate reorganization, and that the disfavored creditors were at least as well off as they would have been had the critical vendor motion not been approved. The bankruptcy court in Kmart addressed neither of these issues. The Seventh Circuit also stated that the non-critical vendors should have received notice of the critical vendor motion, noting that of the thousands of creditors of Kmart, only 65 creditors were noticed.

The Seventh Circuit's decision indicates that a bankruptcy court within this circuit may

¹ Capital Factors Inc. v. Kmart Corp., 359 F.3d 866,868-69 (7th Cir. 2004).

grant a critical vendor motion pursuant to section 363 of the Bankruptcy Code, provided the four elements (discussed in section 5 below) can be met. The Seventh Circuit has fielded a large share of mega-chapter 11's, such as Kmart and United Airlines, which may require a debtor to reconsider a filing in the Seventh Circuit given the heightened standard.



5. THE SUPREME COURT REQUESTS BY CREDITORS TO CONSIDER THE SEVENTH CIRCUIT'S RULING IN KMART.²

The Seventh Circuit's denial of certiorari (appeal) did little to clarify the uncertainty regarding the critical vendor doctrine. In the Seventh Circuit, if a debtor seeks to pay critical vendors, the debtor should seek an order pursuant to Section 363(b)(1) of the Bankruptcy Code.

The debtor must establish:

- (1) Such payments are in fact critical to their reorganization;
- (2) Discrimination among unsecured creditors is the only way to facilitate a reorganization;
- (3) Non-critical vendors will be at least as well off as they would otherwise be if the critical vendor order is not entered;
- (4) Such payments will not diminish the amount of funds that ultimately will be available for payment to non-critical vendors. In addition, the Seventh Circuit has expressed concerns about notice of a critical vendor motion to non-critical vendors.

A debtor should also provide broader notice of such motion so that non-critical vendors have a better opportunity to respond to such motions. In the years following the Kmart ruling, scrupulous debtors have worked with vendors in establishing the critical nature of the product or service based on the heightened court scrutiny of critical vendor requests. Also, given the split in the circuit courts, the Kmart ruling has prompted debtors to consider filing bankruptcy petitions in favorable court venues that have declined to follow the Seventh Circuit such as the district of Delaware and the Southern District of New York.

² Knight-Ridder, Inc. v. Capital Factors, Inc., WL 2050509; Handleman Co. v. Capital Factors, Inc., 2004 WL 2050510; Irving Pulp & Paper, Ltd. v. Capital Factors, Inc., 2004 WL 2068456.

6. KMART'S CLAW BACK (REACH BACK) OF CRITICAL VENDOR PAYMENTS

In light of the reversal of the critical vendor order, Kmart demanded that critical vendors return the critical vendor payments they received. Kmart was forced to sue hundreds of vendors in an attempt to recover these transfers.

E. Special Issues with the Critical Vendor Doctrine

1. REORGANIZING VERSUS LIQUIDATING DEBTORS

As already pointed out, a central element of the critical vendor doctrine is that critical vendors provide an essential product or service that, if provided, will assist the debtor's reorganization. If the debtor is liquidating its assets, the critical vendor doctrine is not met, and such a request should be denied.

2. MAKING THE CRITICAL VENDOR LIST

A Chapter 11 debtor that is an operating business must decide which vendors they need most, and then negotiate a payment. The debtor places the "critical" vendors on a list. Those vendors that do not make the list will receive payment through a confirmed plan of reorganization or Chapter 7 liquidation, often years after the filing, even after the Bankruptcy Reform Act that pressures debtors to exit bankruptcy earlier.

The critical vendor motion is filed by the debtor with the bankruptcy court and provides that the vendor will receive payment on the prepetition claim. The order approving the motion also binds the vendor that agrees to critical vendor status to continue to sell with the debtor on terms equal to or better than pre-petition terms. The responsibility to define the vendors typically has been placed in the hands of the debtors. When a company files for bankruptcy, it reviews a list of its vendors and decides which ones are critical in order to stay in business.

Another strategy for a debtor is not identifying their critical vendors in court pleadings, which are public documents, to avoid alienating those vendors who don't make the list. It seems the leverage of the critical vendor request may be shifting from the vendor to the debtor. The vendor may hold out continued sales to the debtor thereby threatening the debtor's ongoing operations, perhaps only to find a replacement vendor who qualifies as a critical vendor.

a. *Proving-Up Your Critical Vendor Status (very important information)*

Although the debtor files the motion with the bankruptcy court to approve critical vendor status, following the Kmart decision vendors are expected to provide specifics for the bankruptcy court, as well as creditors, as to why the vendor is so valuable to justify



paying its claim ahead of other vendors. To that end, the vendor should review the debtor's motion to pay critical vendors and determine whether the debtor has classified vendors. For example, if the debtor proposes to pay a class of vendors based on their providing a unique product, the vendor should be prepared to provide documents or a statement from a competent witness explaining the uniqueness of the product. Likewise, if the debtor defines a class of vendors as critical based on their knowledge of the debtor's operations, the vendor should be prepared to provide documents or a statement from a competent witness as to this unique relationship.

b. Dealing with the Automatic Stay

The automatic stay is an injunction that automatically and immediately goes into effect upon the bankruptcy filing. It is filed, whether the bankruptcy filing is one under Chapter 7 or 11. The automatic stay prohibits any creditor from taking action against the property of the estate and against the debtor, unless relief from the stay is obtained. For example, a vendor is barred from seeking or levying writs of attachments or garnishments, and also stays the vendor from a judicial lien against the debtor, but has not yet levied on any property.

The creditor needs to be mindful when requesting critical vendor status that the manner in which the request is made does not violate the automatic stay. To that end, the creditor should consider contacting the customer (debtor) and determine who within the company is responsible for the critical vendor program. Once that contact is identified, the vendor may negotiate with the representative to make the list.

c. Timing of Critical Vendor Request:

(i) Prepetition Critical Vendor Request

A vendor may learn that a debtor is considering filing Chapter 11. To that end, a vendor may approach the customer and request critical vendor status should the customer file Chapter 11. The vendor may request the customer sign a contract recognizing that the vendor would be deemed a critical vendor upon a Chapter 11 filing. Even if the customer signs the contract, there is no assurance that the vendor will be given critical vendor status. Creditors may object and the court ultimately must approve the request.

(ii) Postpetition Critical Vendor Request

A debtor usually requests bankruptcy court approval of its critical vendor motion as part of its first day motions. The vendor should request that the debtor select them as a critical vendor. The trend is for the debtor to request critical vendor approval of a claims

cap. The debtor does not disclose the vendors it has selected as critical in its motion. Rather, the debtor designates those vendors it deems critical after the court approves the motion.

d. Alternatives to Immediate Payment in Full:

(i) Payments of Less than 100%

In a claims' cap situation, a debtor may attempt to have its critical vendor dollars go further by offering vendors only a percentage of their prepetition claims paid, for example 70%. There is no legal basis that requires a debtor to pay critical vendors 100% on their prepetition claims.

(ii) Payments Over Time

Another alternative a debtor may offer to immediate payment in full of its critical vendors, is to pay those vendors prepetition claims over time, for example over several months. As with the percentage payment, there is no legal basis that requires a debtor to pay the vendors' prepetition claim immediately.

(iii) Cross-Collateralization Provisions

A debtor may insist that the critical vendor payments be paid through the vendor's future shipments. In other words, when the vendor ships postpetition, the debtor's payment on the postpetition sale pays down the prepetition debt. The vendor's postpetition debt builds up, which is entitled to administrative priority, and is ultimately paid down after the prepetition debt is paid.

3. SELLING TO A CHAPTER 11 DEBTOR INVOICE BY INVOICE COMPARED WITH AN EXECUTORY CONTRACT

A vendor that has sold a debtor on an order-by-order basis has no continuing obligation to sell the Chapter 11 debtor. Because of this, the vendor has leverage on whether to sell the debtor. An element of the debtor's critical vendor request is that the vendor provides a product or service that is indispensable for its continued operations. Should the critical vendor decide not to provide the product or service, the prospects for the debtor's reorganization is diminished.

However, with the vendor who is a party to an executory contract, such as a long-term supply contract, the debtor may seek to compel the vendor to comply with the terms of the contract. The automatic stay bars the vendor that is a party to an executory contract with the debtor from terminating the contract postpetition, without bankruptcy court

authorization. Thus, only those vendors selling invoice by invoice should have the leverage to seek critical vendor status. Having said that, debtors have given critical vendor status to vendors that have executory contracts.

4. NON-CRITICAL CREDITORS AND SHAREHOLDERS VIEWPOINTS

a. *Unsecured Creditors*

A vendor who has not been selected by the debtor to be a critical vendor may oppose the critical vendor motion. The vendor may complain to the bankruptcy court or debtor that it is also willing to provide credit to the debtor postpetition in exchange for payment on its prepetition claim. The reason that the unsecured creditor complains is that the alternative to immediate payment is to often wait years for payment and eventually receive a mere percentage of the amount owed. Indeed, a debtor may propose that the creditor receive stock in the reorganized debtor on account of the prepetition claim.

With debtors now requesting approval of critical vendor motions without identifying which vendors are critical, unsecured creditors are less like to object. Where a debtor has requested a claims' cap, the court may approve a pot of money to be paid to critical vendors. The debtor thereafter selects vendors it deems critical. In this situation, the vendor may be able to negotiate critical vendor standing.

b. *Creditors' Committee*

In Chapter 11, the creditors' committee comprises the major unsecured creditors of the debtor and is a watchdog for the interests of all unsecured creditors of the debtor.

The creditors' committee, if appointed, may object to the critical vendor proposal, or request changes to amount requested, or the criteria for a vendor to qualify. A conflict of interest may emerge where a committee member may also be considered as a candidate for critical vendor status. A committee member in this situation should abstain from voting on this request.



Before filing a critical vendor motion, a debtor should seek the support of the creditors' committee. Bankruptcy courts are more willing to grant a motion if a creditors' committee does not object, or where there is an objection, if the debtor and creditors' committee can reach a compromise over such issues as the degree of oversight of critical vendor payments.

c. Bondholders and Unsecured Bank Debt

Bondholders and unsecured bank debt holders may oppose a critical vendor proposal, as the bondholders and unsecured bank debt holders do not get such preferred treatment even though they would share pro rata any payments under a plan of reorganization. The bondholders are likely trapped creditors that will not provide the debtor any postpetition financing and thus not qualify as a critical vendor. Therefore, they complain that this class of creditor is unjustifiably preferred.

d. Asbestos and Mass Tort Claimants

Like the bondholder and unsecured bank debt holder, the asbestos and mass tort claimant may protest the preferred treatment of a critical vendor given that they may be treated as an unsecured creditor if their claim has been settled. Alternatively, the asbestos claimant may be grouped under a trust for payment and therefore see key vendors continuing to supply the debtor as central to maximizing the prospects for a debtor to exit Chapter 11.

e. Office of the United States Trustee

As an adjunct to the Justice Department, the Office of the United States Trustee is in a position to object to the critical vendor motion. The U.S. Trustee may oppose the critical vendor request if it is made in the opening days and creditors have not had an opportunity to respond.

5. PERSUADING THE BANKRUPTCY COURT

The bankruptcy court must approve a debtor's critical vendor motion. Even if no party objects to the motion, the court may deny the request. In light of *Kmart*, a debtor requesting approval of a critical vendor motion in the Seventh Circuit will include the elements considered by the Seventh Circuit (previously mentioned). However, debtors requesting approval of critical vendor motions outside of the Seventh Circuit will have to look to recent decisions in the district of their bankruptcy court for guidance.

a. Regional Divide between Bankruptcy Courts

Depending on the district, bankruptcy courts either tend to approve or tend to reject motions for critical vendor payments. While bankruptcy courts in Delaware and New York have applied lenient criteria in regularly approving critical vendor motions, other bankruptcy courts, including those in Kentucky and Georgia, have adopted and further developed the criteria from the *Kmart* opinion in limiting critical vendor motions.

b. Delaware

In Delaware, bankruptcy courts have granted motions permitting payment for prepetition claims for critical vendors while imposing conditions on the terms of the repayment. In the 2009 chapter 11 bankruptcy for Foamex International Incorporated³ (Foamex), the debtor moved to honor prepetition obligations with certain critical vendors in the district of Delaware. Citing cases pre-dating Kmart including *Ionosphere*⁴ and *Just for Feet*⁵, Foamex targeted prepetition obligations to chemical, cloth, maintenance, repair, and operations suppliers. Relying on sections 363(b) and 105(a), the court granted Foamex's motion, noting that by accepting payment, a vendor was agreeing to provide goods and services on the same terms that were in place prepetition. The court further noted that if a vendor refused to abide by prepetition terms, the estate may recover the payment.

Delaware bankruptcy courts have gone so far as to order prepetition payments for a critical vendor against the debtor's wishes. In 2007, the Delaware bankruptcy court presiding over *In re Orion Refining Corp.* found in favor of a vendor seeking to enforce an agreement by the debtor to pay prepetition claims⁶. The vendor contended that the debtor had agreed to pay prepetition claims in full in exchange for both performing repair services at the debtor's place of business and continuing to accept work orders. The bankruptcy court determined that despite the absence of a written agreement, the parties had formed an enforceable agreement. Therefore, the debtor's refusal to pay the vendor for its services constituted a breach of the agreement. The bankruptcy court ordered full payment of prepetition claims and went so far as to modify the pre-existing cap of critical amounts payable to allow for the payment.

c. New York

In 2009, Charter Communications, Inc. (Charter) filed a motion in its Chapter 11 bankruptcy in the Southern District of New York to authorize payment of prepetition claims in the ordinary course of business under sections 363(b)(1) and 105(a)⁷. Charter contended that the uninterrupted supply of goods and services provided by the selected trade creditors was essential to the continued success of the company. The court granted Charter's motion but limited from the order relief for any reduction or offset of intercompany accounts. Notably, the court did not specify that vendors had to act in accordance with the prepetition course of

³ *In re Foamex Int'l, Inc.*, No. 09-10560, 2009 Bankr. LEXIS 4945 (Bankr. D. Del. Feb. 20, 2009).

⁴ *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989).

⁵ *In re Just for Feet, Inc.*, 242 B.R. 821, 822 (Bankr. D. Del. 1999).

⁶ *In re Orion Refining Corp.*, 372 B.R. 688 (Bankr. D. Del. 2007).

⁷ *In re Charter Commc'ns., Inc.*, No. 09-11435, 2009 Bankr. LEXIS 5207 (Bankr. S.D.N.Y. Apr. 15, 2009).

dealing. However, vendors in similar situations looking to alter payments from prepetition terms to their advantage should proceed with caution to avoid the risk of creating grounds for the withholding or disgorgement of payments made under the order.

In 2005 in the Southern District of New York, Delphi Corporation (Delphi) filed several related motions regarding pre-petition claims its in Chapter 11 bankruptcy⁸. The debtor worked out a compromise with the committee of creditors, which had laid out of several objections to the motion. The court approved pre-petition payments subject to the debtors reporting to the committee of creditors on a monthly basis and seeking immediate approval for transactions greater than one million dollars.

c. Regions outside of New York and Delaware

In 2009, a bankruptcy court in the Western District of Kentucky applied a variation of the Kmart criteria in reviewing a critical vendor motion in Corner Home Care Inc.'s chapter 11 bankruptcy⁹. The court applied a strict three-part test that required the debtor to prove 1) the vendor was necessary for reorganization 2) the debtor was exercising sound business judgment in selecting the vendor and 3) the debtor was not prejudicing other unsecured creditors by favoring the selected creditor. In denying critical vendor treatment for creditor H.D. Smith, the court noted that the debtor was unable to prove the creditor's unwillingness to sell their product on any possible terms, such as cash terms. Moreover, other vendors had indicated a willingness to sell identical goods on a cash basis. Additionally, the court found that the debtor failed to exercise sound business judgment when making payments on prepetition accounts of over \$140,000 without obtaining an agreement with the vendor for continued services over an extended term. Finally, the court determined that the debtor had failed to prove the absence of prejudice against other creditors, especially where other creditors had objected to the unfavorable treatment and claimed a willingness to provide identical services.

In 2013, the Northern District of Georgia adopted a test similar to the one outlined in Kmart for critical vendor motions in the News Publishing Company chapter 11 bankruptcy¹⁰. The debtor was unable to satisfy the bankruptcy court's three part test requiring proof of 1) the necessity of the prepetition payments for the debtor's reorganization 2) the vendors' refusal to

⁸ In re Delphi Corp., Ch. 11 Case No. 05-44481 (Bankr. S.D.N.Y. Oct. 8, 2005).

⁹ In re Corner Home Care, Inc., 438 B.R. 122 (Bankr. W.D. Ky. 2010).

¹⁰ In re News Publ'g. Co., 488 B.R. 241 (Bankr. N.D. Ga. 2013).

continue to provide services without critical vendor payments 3) non-prejudicial treatment of other unsecured creditors. Despite testimony from the debtor's president in support of the critical vendor motion, the court rejected prepetition payments for all of the vendors except a staffing agency that supplied employees to the debtor. The court pointed out that the vendors had not expressed an unwillingness to continue business on any level, such as cash terms, if prepetition payments were not made, nor had the debtor stated how the payments were necessary to the debtor's reorganizations. Moreover, the court found the president's testimony regarding the creditors' unwillingness to do business vague and unsubstantiated.

d. Takeaway

In the years following Kmart, bankruptcy courts in New York and Delaware have typically approved vendor motions brought under section 363(b)(1) and 105(a) when supported by evidence such as testimony from the debtor's key personnel. Where corporate officers, such as CFOs, have testified to the necessity of a critical vendor to the debtor's reorganization and an absence of alternative vendors, the court has acquiesced to the debtor's business judgment. Still, a favorable order for prepetition payments to critical vendors may be contingent on the creditors' committee approval and oversight. Debtors should work with the creditors' committee and seek prior approval from the U.S. Trustee and post-petition lenders to avoid objections to the motion. Upon entry of an order approving critical vendor payments, vendors should abide by the terms of the agreement with the debtor or risk court ordered disgorgement of the prepetition payment.

Outside of New York and Delaware, bankruptcy courts have stringently applied tests in the vein of the Kmart test much to the dismay of debtors and potential critical vendors. In particular, debtors have struggled to adequately demonstrate the necessity element. Debtors would be well advised to collect and document evidence that critical vendors are unwilling to continue to do business on prepetition terms or any other terms, such as on a cash basis. Debtors should substantiate assertions that affordable alternatives to the vendor are unavailable. When a debtor can prove a critical vendor is both necessary and unique, courts have determined there is no prejudice against other creditors because the debtor's estate is maximized and even the disfavored creditors will ultimately receive greater payments on their respective claims.¹¹

¹¹ In re Tropical Sportswear Int'l Corp., 320 B.R. 15 (Bankr. M.D. Fla. 2005).

6. 503(B)(9) CLAIMS AND EARLY PAYMENT IN EXCHANGE FOR TRADE CREDIT

Following the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCA”) of 2005, there was a new type of administrative priority claim established under § 503(b)(9). The § 503(b)(9) claim presents an opportunity for vendors to recover where there might not have been one otherwise. To succeed on a § 503(b)(9) claim, a vendor must prove:

- a) that it sold goods to the bankrupt customer;
- b) that these goods were received by the debtor within 20 days prior to the bankruptcy filing;
- c) that goods were sold in the ordinary course of the debtor’s business; and
- d) the value of the goods that were sold to the debtor¹²

As such, § 503(b)(9) gives vendors an administrative priority claim for “the value of any goods received by the debtor within 20 days” before the bankruptcy petition date as long as the goods were sold to the debtor “in the ordinary course of such debtor’s business.”¹³ On occasion, a vendor may find that the product or service they provided to the customer prepetition is necessary and key to the debtor’s continued operations. If the product or service is unique in any way, the vendor may have some leverage when conducting negotiations in the post-bankruptcy sales. In this situation, the debtor may request that the bankruptcy court allow it to immediately pay the vendor’s prepetition claim in the opening days of the case, in exchange for the vendor selling to the debtor post-bankruptcy on comparable credit terms for the duration of the bankruptcy case.

A vendor can certainly claim critical vendor status as opposed to settling for a § 503(b)(9) claim. The former allows for some form of payment plan for all the pre-petition amounts owed, whereas the latter only deals with the goods sold within the 20-day period before the petition date. However, the more § 503(b)(9) claims there are, the less funds are available to pay the critical vendors. Since the development of § 503(b)(9), courts are less inclined to grant critical vendor status .

However, in order to ensure payment of their entire pre-petition amount, a vendor with a § 503(b)(9) claim may still prefer the critical vendor status. Although, vendors are generally required to extend credit terms in exchange for attaining critical vendor status. Section 503(b)(9) claimants can also use the critical vendor status to ensure a payment plan option for the pre-petition balance or allowing a discount to the debtor. If the payments from the

¹² 11 U.S.C. § 503(b)(9) (2008).

¹³ *Id.*

debtor have been made under the ordinary course, it is possible that a § 503(b)(9) claim will be covered for the critical vendors on all the owing pre-petition amounts.

7. POSTPETITION CREDIT SALES: HOW MUCH CREDIT AND TERMINATING THE CREDIT RELATIONSHIP

The Bankruptcy Code does not specify the amount of trade credit the vendor must provide to qualify as a critical vendor. However, debtors customarily condition critical vendor status on the vendor providing comparable credit terms that the vendor provided within the year prior to the bankruptcy filing. Generally, the debtor forwards a letter agreement reciting the terms of the postpetition agreement.

Recent trade credit agreements approved by courts have required vendors to provide postpetition credit through confirmation of the Chapter 11 proceeding. If the vendor breaches the postpetition credit agreement, that may be cause for the vendor to disgorge the payment on account of the prepetition claim.

If the postpetition trade credit agreement does not contain a provision that allows for the vendor to terminate the trade relationship should the debtor fail according to the credit terms, the vendor should write in such a provision. Further, the vendor may want to include a provision that permits the vendor to terminate the trade relationship if the debtor falls below key ratios, even if the debtor has not defaulted on the postpetition credit agreement. This would allow the vendor to hold orders in the face of a debtor's deteriorating financial condition.



8. WAIVING ALLEGED PREFERENCE CLAIMS

A vendor that is deemed critical may find that it had already been paid on a portion of its prepetition claim during the preference period. *Even though the vendor may be deemed a critical vendor, that designation does not protect the critical vendor from a preference suit for payments received during the preference period.*

A vendor may consider insisting on a preference waiver as part of being appointed as a critical vendor. The court should approve the preference waiver.



9. INTERPLAY OF RECLAMATION

Article 2 of the Uniform Commercial Code, and the Bankruptcy Code, recognize that a vendor may be permitted to reclaim goods that were shipped within a specified time period of the bankruptcy filing. Most bankruptcy courts recognize that reclaiming creditors are entitled to administrative priority. Under the critical vendor doctrine, many

debtors will pay vendors their prepetition claims that are not reclamation claims, which are entitled to administrative priority. The reclamation claims will be paid pursuant to a global reclamation order.

10. A DEBTOR'S OR TRUSTEE'S RIGHT TO CLAW BACK CRITICAL VENDOR PAYMENTS UPON REVERSAL OR CONVERSION TO CHAPTER 7

Kmart has raised the issue of whether a vendor that is selected as a critical vendor may later be sued to recapture the critical vendor payment in the event the critical vendor order be reversed, even if the vendor extended credit to the debtor as required under the critical vendor order. A vendor should consider including a provision in the critical vendor order that bars a claw back of the critical vendor payment should the order be reversed. The most effective way to gauge this risk is whether the critical vendor order was appealed. The general rule is that the critical vendor order must be appealed within 10 days of entry. Should a party fail to timely do so, the appeal is lost.

Does the critical vendor face risk that the critical vendor payment may be clawed back if the Chapter 11 be converted to Chapter 7 liquidation? If the critical vendor order provides that the vendor is free from such claims if the case converts from a Chapter 11 to a Chapter 7, that language should protect the vendor from any later claims asserted by a Chapter 7 trustee.

11. FAILING TO QUALIFY AS A CRITICAL VENDOR; OR, THE CRITICAL VENDOR PROGRAM IS NOT APPROVED

a. *Selling on Credit Postpetition*

To encourage vendors to sell a debtor postpetition on credit, the Bankruptcy Code provides that should the debtor default on the credit sale, the vendor is entitled to an administrative claim for the unpaid balance. Unlike the critical vendor doctrine, a postpetition credit sale does not allow for payment on the vendor's prepetition claim.

b. *The Catch Up Issue*

If the vendor does not qualify as a critical vendor, the vendor may decide to find an alternative to have its prepetition claim paid. A vendor may not be paid on its prepetition claim post bankruptcy. However, a creditor may attempt to have the debtor pay down its prepetition debt by inflating its postpetition invoices. This "catch up" scheme may be illegal, and can result in disgorgement of the inflated invoices and, possibly, criminal action.



c. Junior Lien Sales

To those vendors who do not qualify as critical, a debtor may offer a junior lien on assets in exchange for their selling on credit. The purpose of the junior lien is to reduce the risk that if the debtor fails to pay for the credit sale, the vendor may have some assets to look to for payment. However, the junior lien sale does not pay a vendor's prepetition claim. Therefore, this alternative is more risky for the vendor.



d. Sale of Claim

A vendor that is not selected as critical may elect to sell its prepetition claim. Third parties, unrelated to the debtor, offer to purchase a trade creditor's prepetition claim, at a discount. Unlike the critical vendor doctrine, a vendor does not have a continuing obligation to sell the debtor on credit when it sells its claim to a third party. Also, unlike the traditional critical vendor doctrine, a vendor selling its claim does so usually at a steep discount.



12. OTHER CONSIDERATIONS FOR A CRITICAL VENDOR

a. Is it Worth It?

Critical vendors are, by definition, imperative to the continued operation of the debtor company. But identifying whether the debtor's business is necessary to the vendor's viability may be an equally critical calculation to the vendor. In making this assessment, vendors should compare the relative size of their pre-petition claim versus the post-petition credit exposure that may result from an administratively insolvent case or from a clawed back payment in a trustee suit. The vendor should also consider whether the debtor anticipates a 100 percent payout plan. If the risks outweigh the benefits, a vendor may consider moving on and cutting its losses.

F. Conclusion

The application of consistent and standardized rules governing the critical vendor doctrine continues to take shape. Regional differences between bankruptcy courts regarding the approval of critical vendor payments continue to solidify and provide some direction for debtors seeking critical vendor friendly courts. *But until the United States Supreme Court rules on this issue, or Congress intercedes, a debtor's ability to obtain authorization to make critical vendor payments may vary from court to court and district to district.* A debtor seeking this relief, and creditors working with debtors to seek this relief, should rely on more than mere equitable grounds as authority, and present more evidence that the critical vendor is truly indispensable to the debtor's continued business

and reorganization.

Exhibit A: Pre-bankruptcy Critical Vendor Agreement

CRITICAL SUPPLIER AGREEMENT

THIS AGREEMENT between [vendor] ("[vendor]") and [customer], a _____ corporation ("[customer]") takes effect on _____, 201_.

Background:

[vendor] is a supplier of one or more necessary and critical products or services that [customer] uses in connection with its operations.

Without this product or service, [customer] would face a possibly irreparable impact on its ability to continue operations and retain customers.

[customer] 's recent purchases of this product or service from [vendor] on open account has averaged approximately \$_____ on a monthly basis.

[customer] has asked [vendor] to continue to extend credit to [customer] to permit [customer] to continue to purchase this product or service on open account and, in addition, to extend ___ day payment terms to _____.

Subject to the terms and conditions of this agreement, [vendor] is willing to extend this additional credit to [customer] for an agreed time period in consideration of entering into and performing this agreement.

The Agreement:

In consideration of the covenants and agreements herein contained, the parties agree:

1. The recitals above are made a part of this agreement.
2. [customer] agrees that if a bankruptcy proceeding is instituted or a finding that [customer] is adjudicated a debtor as a result of an involuntary petition filing, then [customer] will use its best efforts to seek full relief for [vendor] as a "critical supplier" or "critical vendor" of [customer].
3. [vendor] agrees to extend ___-day payment terms to _____ through _____, 201_. [customer] agrees that its strict compliance with such payment terms constitutes a fundamental term of this agreement and that its failure to so comply constitutes a material breach of this agreement. Notwithstanding anything to the contrary contained herein, [customer] agrees that if a Proceeding occurs and the appropriate court does not designate [vendor] as a "critical supplier" or "critical vendor" and order payment of [vendor]'s pre-Proceeding debt, [vendor]'s obligation to extend credit and such payment terms in connection with post-Proceeding sales to [customer] is null and void without prior notice. [Customer] further agrees that these provisions and any deemed termination or modification thereof are not conditioned on any of the events or conditions referred to in section 365(e) of the U.S. Bankruptcy Code or any similar law.
4. [Vendor] agrees to waive its rights under section 365(c)(2) of the U.S. Bankruptcy Code provided [vendor] is named a critical vendor and paid as to its prepetition claim within 30 days of the Chapter 11 filing.
5. [Vendor] can in its sole discretion terminate its postpetition credit line if it becomes financially insecure with [customer] ability to honor the terms of the postpetition credit sales.
6. No waiver by [vendor] of any default shall be effective unless in writing nor shall it operate as a

waiver of any other default or of a similar default on a subsequent occasion. [vendor] has the right at all times to enforce the provisions of this agreement in strict accordance with the terms hereof, notwithstanding any conduct or custom on the part of [vendor] in refraining from so doing at any time or times. The failure of [vendor] at any time or times to enforce its rights under said provisions strictly in accordance with the same shall not be construed as having created a custom in any way or manner contrary to the specific provisions of this agreement or as having in any way or manner modified the same.

7. This agreement is governed by, and shall be construed in accordance with, the law of [vendor's location], without reference to conflicts of law principles.

8. This agreement may be executed in any number of counterparts each of which when executed and delivered will be an original, but all the counterparts together will constitute one and the same instrument.

Dated: _____

ATTEST

[vendor] COMPANY

ATTEST

[customer]

Exhibit B: Post-bankruptcy Critical Vendor Agreement

[DEBTOR]

_____, 201__

TO: [Critical Trade Vendor]
[Name]
[Address]

Dear Vendor:

As you are no doubt aware, [DEBTOR NAME] and certain of its affiliates (“Debtors”), filed a voluntary petition under chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy court for the District of _____ on _____ (the “Petition Date”). On the Petition Date, we requested the Bankruptcy court’s authority to pay certain suppliers. On _____201__, the Bankruptcy Court authorized us to pay prepetition claims of certain trade creditors that agree to the terms set forth and to be bound by the terms of the Order.

In order to receive payment on prepetition claims, each selected trade creditor must agree to continue to supply goods to the Debtors based on “Customary Trade Term.” Customary Trade Terms are defined as the normal and customary trade terms, practices and programs (including, but not limited to, credit limits, pricing, cash discounts, timing of payments, allowances, rebates, coupon reconciliation, normal product mix and availability and other applicable terms and programs) in effect between such trade creditor and the Debtor for the period prior to the Petition Date or such other trade terms that are at least as favorable as those that were in effect during such time.

For purposes of administration of this trade program as authorized by the Bankruptcy court, the Debtors and you agree as follows:

1. The balance of the prepetition trade claim (net of any setoffs, credits or discounts) (the “Trade Claim”) that the Debtor will pay you is \$_____.

2. You will provide open credit terms as follows:

3. The open trade balance or credit line that you will extend to the Debtor for shipment of postpetition goods is \$_____ : ((a) on _____201__, or; (b) on normal and customary terms on a historical basis for the period immediately before the Petition Date).

4. Payment of your claim may only occur upon execution of this letter by a duly authorized representative of your company and the return of this letter to the Debtor.

Sincerely,
[Applicable Debtor]

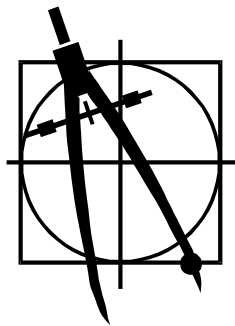
By: _____

Its: _____ -

Agreed and Accepted by:
[Name of Trade Vendor]

By: _____

Its: _____ Dated: _____



Credit Research Foundation

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Sources	
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Summary Report	Word	End
Include Change Detail Report	Word	Separate
Document View	Word	Print
Remove Personal Information	Word	False