

Critical Vendor Motions After Kmart

**Lisa E. Herrington and Donald J. Gentile
Choate, Hall & Stewart LLP, Boston, Massachusetts**

Historically, in order to keep a debtor's supply lines open and to preserve the value of the estate, courts often allowed debtors to pay the prepetition claims of those creditors designated as "critical vendors." However, the Seventh Circuit Court of Appeals' opinion in In re Kmart, 359 F.3d 866 (7th Cir. 2004), threatened to increase the burden of proof on debtors and drastically curtail the practice of paying the prepetition claims of certain vendors in advance of a plan. When the Seventh Circuit Court of Appeals issued the Kmart opinion, commentators and practitioners widely speculated that the Kmart test might be adopted by other circuit courts or serve as persuasive authority in bankruptcy courts nationally.

But five years later, the Kmart decision has not had the far-reaching impact that many predicted. Debtors routinely cite pre-Kmart authority to support critical vendor motions in the jurisdictions outside of the Seventh Circuit. While bankruptcy courts continue to approve critical vendor motions on a regular basis, they often require that suppliers provide goods and services on prepetition terms and, in some cases, permit debtors to require vendors to enter into postpetition supply contracts, the terms of which are preapproved by the court. In any event, when a bankruptcy court issues an order approving the payment of prepetition claims, suppliers must comply with the order in all respects to not only ensure timely payment but also avoid having to relinquish payments in the future.

Pre-Kmart Case Law

Historically, courts considered critical vendor motions on a case-by-case basis, without looking to any one legal framework or test. Before the Kmart decision, bankruptcy courts routinely exercised their discretion and granted critical vendor motions under the "necessity of payment doctrine." See, e.g., In re Lehigh & New England Ry. Co., 657 F.2d 570, 581 (3d Cir.

1981); In re Just for Feet, 242 B.R. 821, 822 (D. Del. 1999); In re Ionosphere, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989).

In Ionosphere, the bankruptcy court explained the rationale behind allowing a chapter 11 debtor to pay prepetition claims. Id. at 174. There, the debtor airline had already obtained court approval to pay the prepetition salaries and benefits of active employees and the question before the court was whether striking employees were entitled to receive commensurate payments. Id. at 175. The bankruptcy court ultimately ruled against the striking employees, but in so doing, noted that Section 363(b) gives courts broad discretion in allowing debtors to pay prepetition claims in the ordinary course of business when the debtor “articulate[s] *some* business justification.” Id. at 175 (emphasis supplied). Further, the court explained that equal distribution to creditors may be significant in the chapter 7 context, but in chapter 11, “all other bankruptcy policies are subordinated [to] the rehabilitation of the debtor.” Id. at 176.

In Just for Feet, the debtor operated a chain of retail stores selling athletic footwear and apparel. Id. at 822. The debtor relied on trade vendors such as Nike, Adidas, Reebok and Asics to stock more than 300 stores. Id. at 823. The debtor filed a critical vendor motion, under Section 105(a), to pay all of its trade creditors in exchange for similar or better credit terms than the debtor was offered in the past. Id. at 824.

In support of the motion, the debtor’s president and CEO testified that it was critical that the company receive \$50 million in new inventory before Thanksgiving to allow for a successful holiday season. Id. at 823. Several creditors and the United States Trustee objected, arguing that the court could not authorize the motion as a matter of law because Section 105(a) does not allow the court to alter priorities set by the Bankruptcy Code. Id. at 825. In overruling the objections, the bankruptcy court explained that, under the “necessity of payment doctrine,” a

court can use its “equitable power under Section 105(a) to authorize the payment of prepetition claims when such payment is deemed necessary to the survival of a debtor in a chapter 11 reorganization.” Id. at 824 (citing Miltenberger v. Logansport, 106 U.S. 286 (1882)). The court found that, based on the testimony of the president and CEO, paying the claims of the footwear and apparel vendors was essential to the debtor’s survival, especially given the approaching holiday season. Id. at 826. The court granted the motion as to these vendors and invited the debtor to offer additional evidence as to its other suppliers. Id.

The Kmart Decision

In 2004, the Seventh Circuit Court of Appeals articulated a two-pronged test that placed a high burden on debtors and caused much hand-wringing over the future of critical vendor motions.

In Kmart, the retailer and thirty-eight of its affiliates and subsidiaries moved, on the first day of the bankruptcy case, to pay the prepetition claims of 2,330 vendors. Id. at 868. The debtors argued that the suppliers, if not paid overdue prepetition debts, would likely cease shipping goods to the retailer. Id. As a result, its reorganization would fail, to the detriment of all creditors. Id. The bankruptcy court granted the motion and the debtors paid approximately \$300 million to vendors on account of prepetition claims. Id. at 869. Meanwhile, all other unsecured creditors received only about \$.10 on the dollar. Id. Certain disfavored vendors appealed the bankruptcy court’s ruling and the district court reversed. Id. On further appeal, the Seventh Circuit Court of Appeals ruled that the critical vendor order could not stand and affirmed the district court. Id. at 874. In its opinion, the court reasoned that the bankruptcy court had allowed the motion without considering evidence as to whether such relief would benefit, or at least not harm, disfavored creditors. Id. at 869.

The Seventh Circuit Court of Appeals rejected the argument that a bankruptcy court can disregard the Bankruptcy Code's rules of priority and grant a critical vendor motion pursuant to Section 105(a). *Id.* at 871 (“A ‘doctrine of necessity’ is just a fancy name for a power to depart from the Bankruptcy Code”). The court did, however, find that Section 363(b)(1) allows preferential payments to vendors in limited circumstances. *Id.* at 873. The Seventh Circuit Court of Appeals stated that, in order to justify paying prepetition claims under Section 363(b), the debtor must show that: 1) the vendors in question would have ceased doing business with the debtor if the outstanding debts were not paid; and 2) disfavored creditors would be better off, or at least not worse off, as a result of the preference. *Id.* at 863, 873.

The Post-Kmart Landscape

Despite some early predictions of the end of critical vendor motions, a review of recent decisions demonstrates that, in the five years since the Kmart decision, bankruptcy courts have not adopted a test similar to that set forth in Kmart. Instead, many courts have continued to use a less formulaic analysis and allow critical vendor motions under Sections 105(a) and 363(b)(1). Recent successful critical vendor motions cite the pre-Kmart cases to support the argument for preferential payments.

That is not to say, of course, that bankruptcy courts have not determined that, in some situations, it is inappropriate to grant a critical vendor motion. In the First Circuit, the only published decision discussing the critical vendor issue is In re Zenus Is Jewelry, Inc., rendered by the United States Bankruptcy Court for the District of New Hampshire. 378 B.R. 432 (Bankr. D. N.H. 2007). In Zenus, the debtor, a jewelry retailer, sought to pay the prepetition claims of five vendors in return for extensions of credit. *Id.* at 433. The court declined to allow the payments, explaining that the case did not pose a critical vendor question because the evidence showed that

vendors would provide inventory on a C.O.D. basis. Id. at 434. Further, there were other sources of the same product available to the debtor. Id. The bankruptcy court did, however, note that the “necessity of payment” doctrine should only be applied in rare instances and cited, among other cases, Kmart. Id.

However, as demonstrated in some of the recent large chapter 11 cases, many bankruptcy courts continue to grant critical vendor motions where a debtor has made the appropriate showings. A brief discussion of some recent critical vendor motions is set forth below.

a. In re Foamex International, Inc., Chapter 11 Case No. 09-10560-KJC, pending in the United States Bankruptcy Court for the District of Delaware.

On February 18, 2009, Foamex International, Inc. and its affiliated debtors (collectively, “Foamex”) filed petitions for relief under chapter 11 in the United States Bankruptcy Court for the District of Delaware. Foamex is a leading manufacturer of foam products used in, among other things, the furniture and automotive industries, supplying, among others, General Motors, Ford, Chrysler, Honda and Nissan. Foamex maintains twenty-three domestic and eight international manufacturing facilities and had net sales of \$980 million in the four quarters ending September 2008.

Along with its various first-day pleadings, Foamex filed the *Motion for an Order Authorizing the Debtors to Honor Prepetition Obligations to, and Continue Prepetition Practices with, Certain Critical Vendors* [Docket No. 15] (the “Foamex Motion”). Foamex sought authority to pay prepetition obligations to critical chemical, cloth, and maintenance, repair and operations suppliers in the aggregate amount of \$29 million. (Foamex Motion ¶¶ 29, 31.) Foamex contemplated paying only those vendors that would agree to continue to supply goods to the debtors on normal prepetition trade terms. (Foamex Motion ¶ 29.) Foamex stated that any interruption in necessary supplies would grind its operations to a halt. (Foamex Motion ¶ 32.)

In support of the motion, Foamex argued that the court had discretion to allow such payments pursuant to the “doctrine of necessity” under Sections 105(a) and 363(b)(1) and relied primarily on Ionosphere and Just for Feet. (Foamex Motion ¶¶ 44-45.)

On February 20, 2009, Foamex’s second lien lenders, lead by the Law Debenture Trust Company of New York (the “Law Debenture Trust”), filed an objection to the Foamex Motion [Docket No. 41] (the “Foamex Objection”). The lenders asserted that the “doctrine of necessity,” does not exist in non-railroad cases under chapter 11. (Foamex Objection ¶ 8.) In support, they relied on Kmart and other cases. (Foamex Objection ¶ 8.) The lenders also argued that Congress intentionally omitted from the Bankruptcy Code a provision allowing debtors to pay prepetition claims outside of bankruptcy. (Foamex Objection ¶ 9.) Finally, they argued that Section 105(a) does not give a court discretion to alter the priority or payment scheme of the Bankruptcy Code. (Foamex Objection ¶ 10.)

On March 18, 2009, the court issued its final order granting Foamex’s critical vendor motion [Docket No. 189] (the “Foamex Order”). The court granted the relief under both Sections 105(a) and 363(b) and overruled the lenders’ objection. (Foamex Order at p. 2.) The court stated in its order, however, that by accepting payment, a vendor was agreeing to provide goods and services on the same terms that were in place prepetition. (Foamex Order at p. 2.) If a vendor refuses to comply with the prepetition terms, the payment may be recovered by the estate. (Foamex Order at p. 2.) As of the writing of this article, the Law Debenture Trust has filed a notice of appeal but no decision has been rendered. The Foamex example shows how bankruptcy courts can place strict conditions on the ability of a supplier to collect and retain critical vendor payments. It is crucial that, when providing goods or services to a debtor-in-possession, suppliers read the court’s order carefully and comply with all of its requirements.

b. In re Charter Communications, Inc., Chapter 11 Case No. 09-11435-JMP, pending in the United States Bankruptcy Court for the Southern District of New York.

Charter Communications, Inc., (“Charter”) one of the largest providers of broadband services in the United States, filed a petition for relief under chapter 11 on March 27, 2009. Charter submitted with its petition a plan that provides for all general unsecured creditors to be paid in full.

Also on March 27, 2009, Charter filed the *Motion for Entry of an Order Authorizing Payment of Prepetition Claims of Trade Creditors in the Ordinary Course of Business* [Docket No. 28] (the “Charter Motion”). Pursuant to the Charter Motion, Charter sought to pay approximately \$471.5 million in undisputed trade claims as they become due consistent with prepetition terms. (Charter Motion ¶¶ 10, 13.) Charter stated that the agent for the lenders, whose cash collateral would be used, supported the payment of the claims. (Charter Motion ¶ 11.) Like Foamex, Charter stated in its motion that the court had the discretion to grant relief under Sections 105(a) and 363(b)(1) and relied principally on Ionosphere and Just for Feet. (Charter Motion ¶¶ 14, 16.) Charter argued that the uninterrupted supply of goods and services of the trade creditors was imperative to its ongoing operations and viability. (Charter Motion ¶ 14.)

On April 13, 2009, the Law Debenture Trust, this time in its capacity as indenture trustee of \$479 million in convertible secured notes issued by Charter, again found itself opposing a critical vendor motion and filed a limited objection to the Charter Motion [Docket No. 142] (the “Charter Objection”). The Law Debenture Trust stated that the grounds on which Charter requested relief were questionable, but only objected to the extent that the payments purported to relieve Charter’s operating companies of intercompany obligations. (Charter Objection ¶ 1.) Unlike in Foamex, the Law Debenture Trust did not argue that the court lacked authority under

Sections 105(a) and 363(b)(1) to grant the relief or that the “doctrine of necessity” does not exist outside of the railroad context. Instead, citing Kmart only once parenthetically, it argued that Charter had not adequately shown that the vendors were critical to its reorganization under Ionosphere and Just for Feet. (Charter Objection ¶¶ 4-5.)

On April 15, 2009, the court granted Charter’s motion to pay trade claims in the ordinary course as they become payable [Docket No. 172] (the “Charter Order”). Resolving the Law Debenture Trust’s limited objection, the order also provided that the order shall not be construed to authorize the reduction or offset in any intercompany account based on payments of trade claims. (Charter Order p. 3.) While Charter sought in its motion to pay the vendors’ ongoing claims consistent with prepetition terms, the order itself does not expressly require that vendors act in accordance with the prepetition course of dealing. In a situation like this, when the debtor seeks to do business on prepetition terms but the order is silent on the issue, vendors may be well advised to continue to provide goods to the debtor on prepetition terms. This will deprive the debtor both of an excuse to withhold payment and grounds on which to seek return of a payment made pursuant to the order.

c. In re Chrysler LLC, et al., Chapter 11 Case No. 09-50002-AJG, pending in the United States Bankruptcy Court for the Southern District of New York.

On April 30, 2009, Chrysler and 24 of its subsidiaries (collectively, “Chrysler”) filed petitions for relief under chapter 11 of the Bankruptcy Code. Among the pleadings filed on the first day of its case, Chrysler filed the *Motion of Debtors and Debtors in Possession, Pursuant to Sections 105(a), 363(b) and 503(b)(9) of the Bankruptcy Code, for Interim and Final Orders Authorizing them to Pay the Prepetition Claims of Certain Essential Suppliers and Administrative Claimholders, Continuing the Debtors’ Troubled Supplier Program and Granting related Relief* [Docket No. 41] (the “Chrysler Motion,” a copy of which attached hereto as

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Exhibit A). Pursuant to the Chrysler Motion, Chrysler sought, among other things, authority to pay, in full, the prepetition claims of certain so-called “essential suppliers.” (Chrysler Motion ¶ 16.) In its memorandum of law filed in support of the Chrysler Motion and other motions filed by Chrysler [Docket No. 44] (“Memorandum of Law,” a copy of which is attached hereto as Exhibit B), Chrysler argued that the payment of the prepetition claims of its essential suppliers was justified under the “necessity of payment” doctrine described in Ionosphere, as well as the more stringent standard set forth in Kmart. (Memorandum of Law ¶¶ 8, 16-17.)

A group of Chrysler’s secured lenders, known as the “Non-TARP Lenders,” objected to the Chrysler Motion [Docket No. 202] (the “Chrysler Objection”). The Non-TARP Lenders argued that Chrysler sought to violate the Bankruptcy Code’s priority scheme by paying certain unsecured claims in full, while secured creditors are expected to receive only a portion of what they are owed. (Chrysler Objection ¶ 17.) The Non-TARP Lenders argued that payment of prepetition claims should be authorized only in extraordinary circumstances and that Chrysler had not met its burden. (Chrysler Objection ¶ 17-18.)

On May 5, 2009, the bankruptcy court overruled the Non-TARP Lenders’ objection and granted the Chrysler Motion on an interim basis [Docket No. 358] (the “Chrysler Order”). Pursuant to the Chrysler Order, each recipient of an “Essential Supplier Payment” must agree to several conditions, including (a) to continue its existing business relationship with Chrysler prior to and following the anticipated sale of Chrysler’s assets, (b) to continue to extend trade credit to Chrysler, and (c) not to contest the assumption by Chrysler of any open purchase order with such Essential Supplier (other than on adequate protection grounds). (Chrysler Order ¶ 4.) A vendor that accepts payment from Chrysler and then fails to adhere to the conditions set forth in the order may see the payment recovered by Chrysler as an unauthorized postpetition transfer under

Section 549 of the Bankruptcy Code or offset against any outstanding administrative claim owed to the vendor. (Chrysler Order ¶ 5.)

What Should a Trade Creditor Consider in Connection with Critical Vendor Status?

A creditor that finds itself with a debtor-in-possession for a customer might be well-served to ask whether the debtor intends to get authority to pay the prepetition claims of its important vendors. Even after Kmart, in many situations, a bankruptcy court may well approve the payment of prepetition claims of so-called critical vendors prior to plan confirmation. Before accepting such a payment, however, a creditor should obtain and review the order approving such payment. Vendors must be sure to comply with the terms of the court order and any postpetition supplier agreements to ensure valid and irreversible payment of their prepetition claims.