"CRITICAL" ERROR: WHY ESSENTIAL VENDOR PAYMENTS VIOLATE THE BANKRUPTCY CODE

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INTRODUCTION

The hot, harsh sun beats down on the hundreds, perhaps thousands, waiting in the line snaked around a solitary well. Those who are fortunate will receive a cupful or two of relief; others will get nothing. Suddenly, a small group of figures push their way to the front.

"We'll each take a gallon," their leader says.

"But that's not fair. There's only so much to go around," the well keeper replies.

"We don't care. We're critical vendors."

Such is the scenario seen increasingly in bankruptcy courts across the country.[1] Often among the proposed "first day orders" filed with a chapter 11 bankruptcy petition is a request that so-called critical, or essential, vendors be paid all of their pre-petition debts immediately.[2] The debtor argues that these vendors are so essential to its continued operations that their accounts must be brought up to date now; otherwise the vendors will shun them and the reorganization will fail.[3]

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[1] The trend is especially prevalent in the Third Circuit. *See* Timothy R. Pohl, *The Delaware Alternative*, 840 PLI/COMM 141, 155 (2002) (noting recent Delaware bankruptcy cases), citing:

> *In re* U.S. Office Products Company, et al., Case No. 01-0646 (PJW) (Bankr. D. Del. March 28, 2001) (authorizing critical vendor payments including payment to single critical vendor of approximately $30 million); *In re* Trans World Airlines, Inc., et al., Case No. 01-0056 (PJW) (Order dated Jan. 10, 2001); *In re* Owens Corning, et al., Case No. 00-3837 (MFW) (Bankr. D. Del. Order dated October 6, 2000); *In re* United Artists Theatre Company, et al., Case No. 00-3514 (SLR) (Bankr. D. Del. Order dated Sept. 7, 2000); *In re* Ameriserve Food Distribution, Inc., et al., Case No. 00-0358 (PJW) (Bankr. D. Del. Order signed Jan. 13, 2000); *In re* Goss Graphic Systems, Inc., et al., Case No. 99-2756 (PJW) (Bankr. D. Del. Order signed July 30, 1999); *In re* Philip Services, Case No. 99-02385 (MWF) (Bankr. D. Del.); *In re* Harnischfeger Industries, Inc., et al., Case No. 99-2171 (PJW) (Bankr. D. Del. Order signed June 7, 1999); *In re* Penn Traffic Company, et al., Case No. 99- 462 (PJW) (Bankr. D. Del. Order dated March 1, 1999). In some cases, these payments have been to a small group of creditors or vendors whose goods or services were essential to the debtor and could not be compelled to do business with the debtors. *See, e.g., In re* Goss Graphic Sys., Inc., Case No. 99- 2756 (PJW) (Bankr. D. Del. July 30, 1999); *In re* Discovery Zone, Inc., Case No. 99-941 (JJF) (D. Del. April 21, 1999); *In re* Acme Steel Co., Case No. 98-2179 (MFW) (Bankr. D. Del. Sept. 29, 1998). In other cases, debtors have sought authority to pay the entirety of their trade debt. *See, e.g., In re* Grand Union Company, No. 95-84 PJW (Bankr. D. Del. Feb. 10, 1995) (authorizing payments to entire body of trade creditors up to $137.5 million).

Id.

[2] *See* Patricia L. Barsalou & Zack Mosner, *Preferential First Day Orders: Same Question, Different Look*, AM. BANKR. INST. J., Feb. 2003, at 8 (expressing caution at standard practice of "critical vendor" motions in today's courts); Bruce S. Nathan, *Critical Vendors: Elevating the Low-priority Unsecured Claims of Prepetition Trade Creditors*, AM. BANKR. INST. J., June 2002, at 14 (explaining cases where courts approved debtor's payment of certain critical vendors' pre-petition claims); Bruce H. White and William L. Medford, *The Doctrine of Necessity and Critical Trade Vendors: The Impracticality of Maintaining Post-Petition Business Relations in Mega-Cases*, AM. BANKR. INST. J., Sept. 2002, at 24 (explaining doctrine of necessity and its application and relation to critical vendors). *See generally* Jo Ann J. Brighton, *The Doctrine of Necessity: Is It Really Necessary?*, 10 J. BANKR. L. & PRAC. 107 (2000); Steven N. Cousins et al., *First Day Orders: An Examination*, 11 J. BANKR. L. & PRAC. 213 (2002).

[3] *See supra* note 2 and accompanying text.

Instead of reprimanding the vendors for engaging in "economic blackmail"[4] or suggesting that the debtor find alternative methods of obtaining needed products or services, courts will often acquiesce and issue orders based on the controversial "doctrine of necessity."[5] Without any provision of the Bankruptcy Code (hereinafter the "Code") expressly authorizing its action, a court may routinely violate one of the Code's basic canons: thou shall treat all similarly situated creditors equally.[6] While other creditors must wait until after the confirmation of a reorganization plan to receive the proceeds of their claim, which may result in a payment of mere pennies on the dollar, critical vendors blessed by the court receive some, and sometimes all, money due them at the beginning of the case, despite their unsecured status.[7]

This thesis will highlight the flaws inherent in the critical vendor doctrine. Part I will present the arguments used by its proponents when requesting court relief. Part II will trace its evolution from the extraordinary railroad reorganizations of yore to its cavalier use today in cases as large as *Enron* and *Worldcom*. Part II will also illustrate why the use of Code provisions by the doctrine's defenders, including the fabled section 105, is deficient. Part III will present the most recent case law dealing with the doctrine, including *In re CoServ, L.L.C.*[8] in the Northern District of Texas and the surprising reversal of Kmart's critical vendor order in the Northern District of Illinois.[9] Part IV will offer suggestions to remedy this unjust, unwise, and illegal practice.

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[4] *See In re* Structurlite Plastics Corp., 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988) (opining there are rare instances where payment of pre-petition debt is necessary for reorganization); s*ee also* Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad Co., 318 U.S. 523, 543 (1943) (holding reorganization plan was fair and did not discriminate unfairly against creditors).

[5] *See supra* note 2 and accompanying text; s*ee also* Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and its Parameters*, 73 MARQ. L. REV. 1, 1–2 (1989) (providing instructive history on doctrine of necessity); *Id*. at 2 (noting support for the doctrine is less than impressive, and stating, "[t]he Doctrine exists simply because it works. The proper use of the Doctrine helps to stabilize a debtor's business relationships without significantly hurting any party."). First of all, regardless of a judicial doctrine's utility, it should not stand absent Congressional consent. Secondly, unsecured creditors who are denied their claim because critical vendors, among others, deplete the estate likely would contest Eisenberg & Gecker's dismissal of their injury. *See generally In re* CoServ, L.L.C., 273 B.R. 487, 487 (Bankr. N.D. Tex. 2002) (holding debtor was authorized to pay off some critical vendors, while others were unauthorized under doctrine of necessity).

[6] *See* 11 U.S.C. § 1123(a)(4) (2002) (requiring same treatment for each claim of particular class unless otherwise agreed to). Trade creditors, which are usually unsecured, are almost always placed in the same class. Paying critical vendors before and in an amount larger than other vendors, then, clearly is discriminatory. *See also In re* Payless Cashways, Inc., 268 B.R. 543, 546 (Bankr. W.D. Mo. 2001) (stating Bankruptcy Code establishes priority in which claims are to be paid). *See generally* White & Medford, *supra* note 2, at 24 (explaining doctrine of necessity and its application and relation to critical vendors).

[7] *See supra* note 2 and accompanying text.

[8] 273 B.R. 487 (Bankr. N.D. Tex. 2002).

[9] Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 825 (N.D. Ill. 2003) (reversing bankruptcy court's orders granting debtor permission to pay certain vendors in order allowing debtor to maintain relationships essential to continued operation in accordance with doctrine of necessity). *See generally* Jonathan C. Lipson, *Directors' Duties to Creditors*: *Power Imbalance and the Financially Distressed Corporation,* 50 UCLA L. REV. 1189, 1229 (2003) (noting frequent implication of doctrine of necessity); 7 COLLIER ON BANKRUPTCY

I. THE CRITICAL VENDOR MOTION

A. Relief Requested

The debtor in a chapter 11 bankruptcy case must secure court approval before it may pay its "critical" vendors.[10] A motion requesting such approval is filed with the court, usually among the flurry of "first day" pleadings, which set the framework of the case.[11] First day orders are often unopposed because most creditors are unaware of the bankruptcy filing.[12] The critical vendor motion typically alleges that certain of the debtor's suppliers or service agents are instrumental to the operation of the debtor's business.[13] Absent immediate payment of the creditors' pre-petition claims, vendors threaten to sever their commercial relationship.[14] One wonders how often vendors actually intend to follow through on such threats.

Examples of critical vendors include:

- Suppliers of apparel and footwear of an athletic shoe retailer;[15]
- Lumber suppliers of a building material retailer;[16]

¶ 1122.03[1] (Lawrence P. King ed., 15th ed. 1996) (stating need for claims and interests to be substantially similar to be placed in same class).

[10] 11 USC § 549(a)(2)(B) (2002). The relevant section provides:

> (a) Except as provided in subsection (b) or (c) of this section, the trustee may avoid a transfer of property of the estate—
>
> (1) that occurs after the commencement of the case; and
>
> (2)
>
> (A) that is authorized only under section 303(f) or 542(c) of this title; or
>
> (B) that is not authorized under this title or by the court.

Id.; *see also In re* Mirant Corp., 296 B.R. 427, 492 (Bankr. N.D. Tex. 2003) (granting, in part, debtor's request to pay pre-petition claims to critical vendors); *In re Coserv*, 273 B.R. at 489 (allowing debtor to pay pre-petition claim in part).

[11] *See* Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 574 n.8 (3d Cir. 2003) ("Large corporate debtors routinely seek so-called 'first day' orders, in which they ask the bankruptcy court to approve . . . the payment of prepetition claims of critical vendors."); Barsalou & Mosner, s*upra* note 2, at 8 (noting routine filing of first day orders); Eisenberg & Gecker, *supra* note 5, at 26 (articulating same).

[12] *See* Cousins, *supra* note 2, at 215 (speaking of effect of first day orders, whereby authors claim, ". . . the debtor's evidence supporting the essential nature of the payments may be weak and go unchallenged."); Eisenberg & Gecker, *supra* note 5, at 26 (commenting on how fast pre-petition motions are made, stating "Heaven help a creditor's counsel who decides to take an afternoon off to play golf or cricket."); *see also* Barsalou & Mosner, *supra* note 2, at 8 (arguing lack of notice raises due process concerns).

[13] *See In re* Ionosphere Clubs, Inc., 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989) (explaining payment to vendors is necessary where such payment is essential to continued operation of business); *Capital Factors*, 291 B.R. at 822 (justifying payment of pre-petition claims when creditors' services were vital to debtor's "continued viability and reorganization."); *see also In re* Columbia Gas Systems, Inc., 171 B.R. 189, 192 (Bankr. D. Del. 1994) (discussing Third Circuit law that held pre-petition creditors get paid when debtor shows "payment is essential to the continued operation of the business.").

[14] *See* Barsalou & Mosner *supra* note 2, at 71 (arguing that debtors themselves are harmed by the ease by which critical vendor payments are made, as the Code's protection against manipulative vendors is minimized).

[15] *See ,e.g., In re* Just for Feet, Inc., 242 B.R. 821 (Bankr. D. Del. 1999).

[16] *See e.g., In re* Payless Cashways, Inc., 268 B.R. 543 (Bankr. W.D. Mo. 2001).

- Film distributors of a cinema;[17]
- Bill collectors and telecommunication service providers of a communications network;18 and
- Food suppliers, advertisement printers and music vendors of a department store chain.[19]

Debtor's counsel usually claims that losing such services or products would have, in the words of one, a "severely pernicious effect on [its] efforts to rehabilitate and reorganize."[20] The inability to operate its business as it normally does would decrease the debtor's cash flow and cripple its operations before it had a chance to propose a reorganization plan, according to its counsel.[21]

Presented with such a doomsday scenario, courts, particularly in the Second, Third and Seventh Circuits, often grant the motion.[22] Allegedly some courts support the motions to appear debtor-friendly, which helps attract high-profile cases like Enron and Worldcom.[23] It is evident that these courts believe that helping the debtor reorganize is more important than preserving the equal treatment of similar creditors. Such courts generally believe that doing so will serve the "fundamental purpose of reorganization[:]… to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."[24] Those

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[17] *See ,e.g., In re* Wehrenberg, Inc., 260 B.R. 468 (Bankr. E.D. Mo. 2001).

[18] *See ,e.g., In re* Startec Global Communications Corp., 292 B.R. 246, (Bankr. D. Md. 2003); *In re* Worldcom, Inc., No. 02-13533 (AJG), 2002 WL 1732647 (S.D.N.Y. July 22, 2002).

[19] *See e.g.*, Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818 (N.D. Ill. 2003).

[20] Motion of the Debtors Pursuant to Section 105(a) of the Bankruptcy Code for Authorization to Pay Pre-petition Claims of Critical Vendors at 5, *In re* Worldcom, Inc., 296 B.R. 115 (Bankr. S.D.N.Y. 2002).

[21] *Id*.; *see In re Wehrenberg*, 260 B.R. at 469 (discussing vendors refusal to deal with debtor until pre-petition debt is paid); *In re* NVR L.P., 147 B.R. 126, 127 (Bankr. E.D. Va. 1992) (noting negative impacts on debtor's business operations if debtor's motion not granted).

[22] *In re* CoServ, L.L.C., 273 B.R. 487, 495 (Bankr. N.D. Tex. 2002) (noting other courts that have authorized payment of pre-petition debt); *In re Just for Feet*, 242 B.R. at 826 (granting Debtor's motion to pay pre-petition claims of creditors in Third Circuit). *But see Capital Factors*, 291 B.R. at 823 (reversing bankruptcy court's motion approving critical vendor payments).

[23] *See* White & Medford, *supra* note 2, at 1 (noting courts will embrace doctrine of necessity to appear chapter 11 friendly, particularly in mega cases). *See generally In re Just for Feet*, 242 B.R. at 826 (finding pre-petition claims of certain creditors are essential to survival of debtor during chapter 11 reorganization and granting debtor's motion to pay pre-petition claims); *In re* Eagle-Picher Industries, Inc. 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (supporting principle that bankruptcy court can authorize payment of pre-petition claims where such payment is necessary to survival of debtor).

[24] NLRB v. Bildisco & Bildisco, 465 US 513, 528 (1984); *see also* Colortex Industries, Inc. v. Richardson, 19 F.3d 1371, 1377 (11th Cir. 1994), stating:

> Although section 503(b) should be read narrowly to preserve the debtor's scarce resources, the ultimate goal of Chapter 11 is to marshall those resources to provide the best possible opportunity for a successful rehabilitation which will ultimately redound to the benefit of all creditors.

Id.; Bonner Mall P'ship v. U.S. Bancorp Mortgage Co., 2 F.3d 899, 915 (9th Cir. 1993) ("Chapter 11 has two major objectives: 1) to permit successful rehabilitation of debtors . . . and 2) to maximize value of the estate . . . ."); *In re* Teligent, Inc., 282 B.R. 765, 772 (Bankr. S.D.N.Y. 2002) ("[T]he fundamental goals of bankruptcy [are] rehabilitation, saving jobs and equality of distribution."); *In re* Ionosphere Clubs, Inc., 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989) ("[T]he paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation of the debtor."). *But see* Joint Eastern and

deciding a critical vendor motion "must decide whether the granting of preferential treatment to some creditors is a better result than closing the business, or allowing it to die slowly for lack of necessary supplies."[25] Typically creditors are not paid in a chapter 11 case until after a reorganization plan has been confirmed by the creditor body and approved by the court.[26] Absent consent of affected creditors, payments are distributed according to the priority schemes set forth in sections 506 and 507 of the Code.[27]

After the secured claims are settled, any debtors with a "superpriority" claim based on "inadequate adequate protection"[28] or a "supersuperpriority" post-petition security lien[29] are paid. Next, expenses incurred in the administration of the

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Southern District Asbestos Litigation v. Blinken, 982 F.2d 721, 751 (2d Cir. 1992) ("Reorganization is assuredly governed by equitable considerations, but that guiding principle is not a license to courts to invent remedies that overstep statutory limitations or to approve arrangements that some parties to reorganization proceeding find preferable to the arrangements incorporated in a confirmed and consummated plan."); Fruehauf Corp. v. Yale Express Sys., Inc. (*In re* Yale Express Sys.), 384 F.2d 990, 991 (2d Cir. 1967) ("[F]undamental purpose of reorganization proceedings [is] to enable the debtor to continue *operations as well as to protect rights of creditors.*") (emphasis added); *In re* Dow Corning Corp., 244 B.R. 634, 649 (Bankr. E.D. Mich. 1999) ("[C]hapter 11 reorganization process serves a number of important policy objectives, including 'debtor relief, a preference for feasible reorganizations as opposed to liquidations, equality among similarly situated creditors, and loss distribution in an equitable way among creditors and debtor.'") (emphasis in original).

[25] *In re* Payless Cashways, Inc., 268 B.R. 543, 547 (Bankr. W.D. Mo. 2001) (holding discrimination was preferable); *see In re* Equalnet Communications Corp., 258 B.R. 368, 369 (Bankr. S.D. Tex. 2000) (finding payment of pre-petition claims prior to confirmation of reorganization plan permitted where "business transactions which are at once individually minute but collectively immense and critical to the survival of the business of the debtor."); *In re Just for Feet*, 242 B.R. at 824 (noting courts use their equitable power under section 105(a) of the Code to authorize payment of pre-petition claims when such payment is "deemed necessary to the survival of a debtor in a chapter 11 reorganization.").

[26] *See In re Just for Feet*, 242 B.R. at 824 ("[G]enerally, filing a petition for reorganization under chapter 11. . . stays any act to collect, assess, or recover a claim against the debtor or that arose before the commencement of the case."); *In re* Gulf Air, Inc., 112 B.R. 152, 153 (Bankr. W.D. L.A. 1989) (noting pre-petition claims are normally dealt with in a reorganization plan and in accordance with statutory priorities). *See generally In re Payless Cashways*, 268 B.R. at 546 (explaining Code determines priority of claims pursuant to a chapter 11 plan or in the liquidation of a chapter 7 estate).

[27] 11 U.S.C. § 507 (2002) (listing priority of claims); 11 U.S.C. § 506(a) (2002) (defining secured and unsecured claims); *see In re Payless Cashways*, 268 B.R. at 546 (noting Code establishes order that claims are paid).

[28] 11 U.S.C. § 507(b). That is, whenever a secured creditor's collateral is used for the benefit of the estate, but by mischance "adequate protection" for such use proves inadequate, any remaining estate funds must be paid to said secured creditor by way of recompense for its dissipated collateral, ahead of any other priority claims and administrative expenses including fees of professionals such as attorneys for debtors. Such a claim for recompense for "inadequate adequate protection," given first priority among priority claims by section 507(b), is commonly referred to as a "superpriority." *In re* Wise Transportation, Inc., 148 B.R. 52, 54 (Bankr. N.D. Okla. 1992); *see In re* Wilson-Seafresh, Inc., 263 B.R. 624, 631 (Bankr. N.D. Fla. 2001) (explaining as constitutional matter, section 507(b) reflects Congress' concern of when section is applicable to given case, secured creditors have adequate protection for its claim and superpriority claim of a property interest must prevail).

[29] 11 U.S.C. § 364(c)(1) (2002) (specifying after trustee is unable to obtain secured credit as administrative expense, court may, after notice and hearing, authorize obtaining of credit or incurring of debt with priority over any or all administrative expenses of the kind specified in sections 503(b) or 507(b)); *see In re* Am. Res. Mgmt. Corp., 51 B.R. 713, 721 (Bankr. D. Utah 1985) (discussing how section 364(c)(1) superpriority rights may affect administrative claimants after financing order has been entered); *see also In re* Phase-I

bankruptcy estate are paid.[30] Finally, any expenses arising during the gap between an involuntary filing and the order for relief are to be paid.[31] The remaining priorities, in descending order, are as follows:

- Individual wages;
- Employee benefit plans;
- Grain farmers and United States fishermen;
- Consumer claims such as layaway plans;
- Alimony and support;
- Taxes; and
- Federal Deposit Insurance Corporation capital.[32]

A class of creditors may not be paid under a confirmation plan unless all creditors with higher priority are paid in full, or the creditors with higher priority consent to payment of the lower priority creditors.[33] Therefore, the unsecured creditors, of which trade vendors are a part, often collect less than they are owed or even nothing at all because the estate has been exhausted. An unsecured creditor receiving payment on its claim before even the secured creditors, then, is an extraordinary reversal of fortune.

Molecular Toxicology, Inc., 285 B.R. 494, 495 (Bankr. D. N.M. 2002) (listing requirements debtor-in-possession must fulfill in order to secure approval of post-petition financing as "proposed financing is an exercise of sound and reasonable business judgment; second, no alternative financing is available on any other basis; third, financing is in best interest of estate and its creditors, and as corollary to first three points, that no better offers, bids, or timely proposals are before the Court").

[30] 11 U.S.C. § 507(a)(1) (2002) ("The following expenses and claims have priority in the following order: (1) First, any administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28."); *see* 11 U.S.C. § 503(b) (2002) (specifying kinds of administrative expenses allowable in case under Bankruptcy Code); *see also* Brandt v. Lazard Freres & Co. (*In re* Healthco Int'l Inc.), 310 F.3d 9, 11 (1st Cir. 2002) (holding administrative expenses afforded highest priority under section 507(a)(1)).

[31] 11 U.S.C. § 507(a)(2) ("The following expenses and claims have priority in the following order: . . . Second, unsecured claims allowed under section 502(f) of this title."); 11 U.S.C. § 502(f) ("In an involuntary case, a claim arising in the ordinary course of the debtor's business or financial affairs after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief . . . shall be allowed . . . ."); *cf. In re* Monarch Capital Corp., 163 B.R. 899, 904 (Bankr. D. Mass. 1994) (holding broker was not entitled to second priority section 502(f) gap claim for fees and expenses acquired between date of involuntary filing and order for relief under chapter 11 was entered, where president merely recognized debtor's obligation was contingent upon bankruptcy procedures for professionals and president).

[32] 11 U.S.C. § 507(a)(3)–(9) (2002) (listing other unsecured claims which have priority); *see also In re* Chateaugay Corp., 102 B.R. 335, 353 (Bankr. S.D.N.Y. 1989) (claiming priorities should be narrowly construed and if one claimant is to be preferred it should be clear from statute, of which the bankruptcy court is without discretion to deviate from its narrow list of priorities); *In re* Revco D.S., Inc., 91 B.R. 777, 780 (Bankr. N.D. Ohio 1988) ("It is fundamental that in every bankruptcy case distributions to creditors are governed by the scheme of priorities established by the Bankruptcy Code. Section 507 of the Bankruptcy Code specifies the kinds of claims that are entitled to priority in distribution and the order of priority.").

[33] *See* 11 U.S.C. § 1123(a)(4), § 1129(b)(2)(B)(ii) (2002); FDIC v. Jenkins, 888 F.2d 1537, 1545 (11th Cir. 1989) ("Secured creditors get first priority according to their rank and the unsecured creditors follow. All members of a higher priority class must be paid in full before lower priority classes can be paid."); *In re Am. Res. Mgmt.*, 51 B.R. at 722 (holding bank, as secured creditor holding senior lien on all assets of debtor's estate and superpriority claim for all post-petition advances, was permitted to selectively waive its lien and superpriority claims in order to allow payment of certain administrative expenses).

1. How Critical is "Critical"?

Generally courts approving a critical vendor motion leave it to the debtor to decide which of its aggressive vendors are important enough to justify payment.[34] Sometimes the only judicial restriction is a monetary cap on the total amount paid to all critical vendors.[35] The definition of "critical" differs from court to court,[36] but it is usually amorphous. The precise standards utilized by the Northern District of Texas in *In re CoServ, L.L.C.*, examined at length in section III.A., are a refreshing alternative, as they have the effect of reducing the pool of potential critical vendors. An outright refusal to recognize such a designation would have been even more admirable.

2. Arguments Against Confirmed Plan Payments

It is understandable why vendors, who may have been waiting for payment of their invoices for months, desire to be paid as quickly as possible. Given the restrictions imposed by the Code on disposition of the debtor's assets, it is less clear how debtors can justify why their critical vendors should not wait like all others for confirmation of a plan and why, in the meantime, they cannot provide inventory. After all, under Code section 364(a), post-petition unsecured trade credit is considered an administrative expense[37] and such expense is a priority payment.[38]

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[34] *See In re* Payless Cashways, Inc., 268 B.R. 543, 546 (Bankr. W.D. Mo. 2001) ("Since enactment of the Code, various courts have permitted debtors-in-possession to pay pre-petition debts on the grounds that payment of such claims was necessary to effectuate a successful reorganization, or at least to give the debtor the opportunity to propose any type of plan at all."); *see also In re Chateaugay*, 80 B.R. at 287, stating:

> A rigid application of the priorities of § 507 would be inconsistent with the fundamental purpose of reorganization and of the Act's grant of equity powers to bankruptcy courts, which is to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately.

Id.; Order Authorizing Payment of Prepetition Claims of Critical Vendors at 1, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Dec. 3, 2001), *available at* http://bank.elaw.com/default.asp (authorizing debtors to pay, in their discretion, critical vendor claims against debtors which arose prior to petition date).

[35] *See In re Payless Cashways*, 268 B.R. at 545 (setting cap at $8 million); *In re* Worldcom, Inc., No. 02-13533(AJG), 2002 WL 1732647, at *1 (S.D.N.Y. July 22, 2002) (setting cap at $70 million); *see In re Enron Corp.* at 2 (setting cap at $48 million).

[36] *See In re Payless Cashways*, 268 B.R. at 547 (noting courts should consider "[w]hether approval of the borrowing is critical to the future of the business, given the condition of the business at the time the motion is heard, and given the status of its post-petition financing. . . ."); *In re* Just for Feet, Inc., 242 B.R. 821, 825 (Bankr. D. Del. 1999) ("[T]he court must determine whether the payment of pre-petition claims of trade vendors . . . is critical to the Debtor's reorganization.").

[37] 11 U.S.C. § 364(a) (2002) ("[T]he trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense."); *see In re* Husting Land & Dev., Inc., 255 B.R. 772, 777 (Bankr. D. Utah 2000), *aff'd*, 274 B.R. 906 (D. Utah 2002) (emphasizing debt must be incurred in ordinary course of business); *In re* Handy Andy Home Improvement Ctrs., Inc., 196 B.R. 87, 95 (Bankr. N.D. Ill. 1996) (noting post-petition creditors who choose to do business with debtor-in-possession after filing of bankruptcy petition receive administrative expense priority).

Why are these vendors willing to turn down profits when they can engage in business under such favorable circumstances? The reasons offered by debtors' counsel are varied, as discussed below.

a. Administrative Expense Treatment is Insufficient

One court noted that "[i]n a case such as this one, where the debtor does not have post-petition financing in place, the bare promise of a priority administrative expense claim, subject to the senior claims of lienholders, cannot be expected to induce suppliers to extend credit to a debtor."[39] Though an administrative expense claim is a priority, it is not a guarantee of payment if the estate is overextended.[40] If the case faces administrative insolvency, though, the case should be converted to a chapter 7 liquidation at the outset instead of letting it consume scarce judicial and estate resources. Perhaps the debtor should be required to demonstrate its financial health before its critical vendor motion is decided.

b. The Vendors Themselves Face Financial Difficulties

Sometimes debtor's counsel will allege that absent payment, the critical vendor itself will incur financial difficulty, especially if the vendor is a "mom and pop" operation.[41] At least one court found this irrelevant unless the vendor was facing collapse.[42] Requiring vendors to appear in court likely allows the judge to more accurately gauge the factors at play. Their direct testimony can be more instructive than a static affidavit. The added inconvenience and accountability related to appearing in court may also help vendors reconsider their decision not to cooperate with the debtor.

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[38] 11 U.S.C. § 507(a) (2002) ("The following expenses and claims have priority in the following order: (1) First, administrative expenses allowed under section 503(b) of this title . . . ."); *see* Stephen H. Hurd, *Re-Reading Reading: "Fairness to All Persons" in the Context of Administrative Expense Priority for Postpetition Punitive Fines in Bankruptcy*, 51 VAND. L. REV. 1459, 1461 (1998) (remarking that post-petition claims qualifying as administrative expenses will be paid in entirety before payment of any pre-petition claims, even if this exhausts estate); David M. Reeder, Note, *The Administrative Expense Priority in Bankruptcy – A Survey*, 36 DRAKE L. REV. 135, 135 (1986/1987) (noting administrative expenses have priority over all unsecured claims under Code).

[39] *In re Payless Cashways*, 268 B.R. at 547.

[40] *See id.* (observing debtors often have to offer other forms of preferential treatment to induce suppliers to extend them credit); *In re* Am. Res. Mgmt. Corp., 51 B.R. 713, 719 (Bankr. D. Utah 1985) ("As a general rule, expenses of administration must be satisfied from assets of the estate *not subject to liens*.") (emphasis added). *But see In re* Martinez, 92 B.R. 916, 918 (Bankr. D. Colo. 1988) (acknowledging guarantee of an administrative expense priority may constitute adequate assurance if estate is sufficiently liquid).

[41] *See In re* CoServ, L.L.C., 273 B.R. 487, 499 (Bankr. N.D. Tex 2002) (describing effects of such an argument on "mom and pop" shops).

[42] *Id*. at n.23.

c. Competitive Markets

One debtor "testified that, due to competitive conditions in the lumber industry, the debtor's primary sources of supply would be well able to sell their products elsewhere."[43] One wonders why a business would not attempt to maximize its customer base instead of restricting it.

d. Because It's There

Often counsel simply fail to disclose the reasons for the vendors' refusal to cooperate with the debtor. Instead they state that the doctrine of necessity exists, and that the debtor is entitled to take advantage of it.[44] If the court does not seek any explanation before it approves the motion, then it is unnecessary.[45] This situation exists because the burden of proof can often be light; though the burden is on the debtor to establish the vendor is critical, asserting that the vendor is critical, without more, may often be sufficient.[46] Demanding that the debtor prove that the vendor actually is essential would help stem the abuse, even where a court is convinced that it has the power to authorize such motions.[47]

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[43] *In re Payless Cashways*, 268 B.R. at 545.

[44] *See* Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 820 (Bankr. N.D. Ill. 2003) (explaining that when Debtor moved for pre-petition payments to critical vendors, it invoked "doctrine of necessity" and contended pre-petition payments were critical to its continued operation); Motion of the Debtors for Authorization to Pay Prepetition Claims of Critical Vendors at 10, *In re* Worldcom, Inc., (Bankr. S.D.N.Y. July 22, 2002) (No. 02-13533), *available at* http://bank.elaw.com/Worldcomdefault.asp (last visited November 21, 2003) (contending "necessity of payment" doctrine supported the motion); Motion for Authorization to Pay Prepetition Claims of Critical Vendors at 6–7, *In re Enron Corp.,* (Bankr. S.D.N.Y. Dec. 3, 2001) (Case No. 01-16034), *available at* http://bank.elaw.com/default.asp (arguing for debtor's operation to continue, it was necessary to pay critical vendor claims).

[45] *See* Andrew J. Currie & Sean McCann, *Hold on to Those Payments, Critical Vendors: Capital Factors v. Kmart*, AM. BANKR. INST. J., June 2003, at 35 (detailing list of approaches to critical vendor motions from debtor's perspective). *But see In re Coserv*, 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002) (explaining three conditions must be met in order for pre-petition claim to be authorized); Nathan, *supra* note 2, at 33 (finding court may require debtor to prove pre–petition payment is critical).

[46] *See* Robert A. Morris, *The Case Against "Critical Vendor" Motions,* AM. BANKR. INST. J., Sept. 2003, at 30 (providing reasons why critical vendor motions are so prevalent although "there are few truly critical vendors."); Bruce H. White, *The Doctrine of Necessity and Critical Trade Vendor: The Impracticality of Maintaining Post–petition Business Relations in Mega–cases*, AM. BANKR. INST. J., Sept. 2002, at 37 (explaining that on first day hearings in emergency filings, the debtor may not have been able to contact all of its critical vendors or obtain the appropriate affidavits). *But see* Currie & McCann, *supra* note 45, at 14 (stating where courts approved critical vendor pre-petition claim, it usually required agreement by vendor that it would continue to ship goods on same credit terms during the case).

[47] *See In re* Coserv, L.L.C., 273 B.R. 487, 498 (Bankr. N.D. Tex 2002) (concluding three conditions must be met in order for a pre-petition claim to be authorized); *In re* Just for Feet, Inc., 242 B.R. 821, 826 (Bankr. D. Del. 1999) (explaining necessity of payment doctrine can only be invoked if a debtor shows "that payment of the pre-petition claims is 'critical to the debtor's reorganization.'"); Cousins, *supra* note 2, at 221 (stating that debtor must show, by a preponderance of the evidence, that if pre-petition claim is not approved, rehabilitative effort would be aborted).

e. Reorganization Requires Flexibility

Some say the demanding nature of corporate reorganization requires a system that can adapt to multiple variables.[48] The Third Circuit found that "flexibility" is "essential to a reorganization proceeding."[49] In what the court believed was then the largest American bankruptcy case in history, the Bankruptcy Court for the Southern District of New York allowed a debtor, LTV Corporation, to pay preplan, pre-petition employee expenses.[50] In authorizing the payments, the court stated:

> A rigid application of the priorities of section 507 would be inconsistent with the fundamental purpose of reorganization and of the Act's grant of equity powers to bankruptcy courts, which is to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately.[51]

Some debtors and trade creditors may deride a Code without the doctrine of necessity as a "straightjacket" that reduces their options, but the doctrine can function as a garment that can keep other unsecured creditors warm. Even the most flexible of dancers has a spine that must, under no circumstances, be allowed to break. So, too, must the Code have agreed upon parameters that allow it to function without grotesquely harming its participants. Such parameters provide certainty and transparency, two valuable characteristics of an insolvency code. Until Congress provides otherwise, exercising the doctrine of necessity is one move best left unmade.

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[48] *See In re* Federated Dep't Stores, Inc., 1990 Bankr. LEXIS 122, at *5 (Bankr. S.D. Ohio 1990) (finding restrictive interpretation of section 507 defeats purpose of chapter 11 cases); *In re* FCX, Inc., 60 B.R. 405, 409 (Bankr. E.D.N.C. 1986) (stating under its equitable powers, bankruptcy court can "deviate from the rules of priority.").

[49] *In re* Penn Cent. Transp. Co., 452 F.2d 1107, 1108 (3d Cir. 1971); *see In re* Transtexas Gas Corp., 303 F.3d 571, 580 (5th Cir. 2002) ("Certainly, the unique nature of bankruptcy proceedings, combined with the public policy interest in promoting successful reorganizations, often favors tolerance of greater procedural flexibility in bankruptcy cases."); Bartee v. Tara Colony Homeowners Assoc. (*In re* Bartee), 212 F.3d 277, 282–83 (5th Cir. 2000) (supporting flexible approach to finality in bankruptcy proceedings); Moody v. Amoco Oil Co., 734 F.2d 1200, 1217 (7th Cir. 1984) ("To interpret the Code so as to minimize flexibility and rush the debtor into what may be an improvident decision [regarding contract assumption] does not further the purposes of the reorganization provisions."); *In re* Bloomingdale Partners, 170 B.R. 984, 990 (Bankr. N.D. Ill. 1994) ("The idea behind Chapter 11 of the Code was to combine the speed and flexibility of Chapter XI [of the Bankruptcy Act] with some of the protection and remedial tools of Chapter X.").

[50] *In re* Chateaugay Corp, 80 B.R. 279, 287 (S.D.N.Y. 1987) (authorizing same).

[51] *Id*. at 287.

f. All Creditors Benefit

Some critical vendor proponents posit that when critical vendors are paid prematurely, all creditors win, because when the debtor remains operational, it avoids the ill effects of liquidation.[52] This is only true, however, when the reorganization actually succeeds and when the confirmed plan adequately compensates all creditors. No one can guarantee with a straight face at the onset of reorganization that these results will come to pass months later.

B. Grounds for Relief

1. The Doctrine of Necessity and Section 105(a)

Debtors that request payment of critical vendors invariably cite the doctrine of necessity.[53] The doctrine of necessity states that courts have the power pursuant to Code section 105(a), the source of the court's catch-all equitable power, to authorize payments of pre-petition claims before the approval of a reorganization plan when such payments are necessary to keep the debtor afloat.[54] The most common use of the doctrine is the payment of pre-petition employee wages so that they do not engage in a mass exodus from the company.[55] Critical vendor proponents argue that the doctrine is also applicable to trade vendors, as keeping critical vendors satisfied is necessary to maintain the debtor's equilibrium.[56] Their opponents say that the doctrine has limits and that favoring certain vendors over others goes too far.[57]

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[52] *See In re* Payless Cashways, Inc., 268 B.R. 543, 544 (Bankr. W.D. Mo. 2001) ("Prior to the enactment of the Code. . . courts recognized that in certain circumstances it was in the best interest of all concerned to pay certain pre-petition creditors out of turn. . . .").

[53] *See supra* note 13 and accompanying text.

[54] 11 U.S.C. § 105(a) (2002) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title"); s*ee In re Payless Cashways*, 268 B.R. at 546 (Bankr. W.D. Mo. 2001) (stating "doctrine of necessity" justified payment to certain pre-petition creditors); *In re* Just for Feet, Inc., 242 B.R. 821, 824 (Bankr. D. Del. 1999) (explaining although "necessity of payment" doctrine was not codified in the Code, courts, using their equitable powers under § 105(a), have authorized pre-petition claims when necessary); *In re* Ionosphere Clubs, Inc., 98 B.R. 174, 176 (Bankr. S.D.N.Y 1989) (finding "necessity of payment" doctrine permitted courts to pay pre-petition claims when essential).

[55] *See* Eisenberg & Gecker, *supra* note 5, at 8 (noting while section 507(a)(3) and (4) give priority to employee payments, these provisions do not allow payments to be made at beginning of case); s*ee also In re* Gulf Air, Inc., 112 B.R. 152, 153 (Bankr. W.D. La. 1989) (describing how pre-petition payments to employees in airline industry are necessary for airlines to continue operation); Karen Gross & Matthew S. Barr, *Bankruptcy Solutions in the United States: An Overview*, 17 N.Y.L. SCH. J. INT'L & COMP. L. 215, 239 (1997) (explaining under doctrine of necessity, courts commonly allow payments to employees to "assure continuity and support of debtor's labor force.").

[56] *See supra* note 2 and accompanying text.

[57] *Id*.; *see also* Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 DICK. L. REV. 267, 296 (suggesting that vendors not deemed "critical" may be resentful and therefore not as willing to cooperate with the debtor when a confirmation plan is proposed.).

2. Other Code Sections

Debtors and judges sometimes point to other sections of the Bankruptcy Code to support pre-petition payments.

a. Section 364(b)

In *In re Payless Cashways, Inc.*,[58] the Bankruptcy Court for the Western District of Missouri relied on one of the Code's provisions regarding trade credit to approve critical vendor payments.[59] Section 364(b) gives the court power to approve the debtor's lending transactions.[60] The *Payless* court declared that this provides it the power to swap pre-petition payments to vendors for extension of favorable credit terms.[61] This decision is examined in greater detail in section III.B. of this paper.[62]

b. Section 549

The *Payless* court also found support for its decision in section 549, which allows the reversal of certain post-petition transfers of property.[63] Pursuant to section 549 of the Code, a chapter 7 trustee may reverse satisfaction of pre-petition debt that has not been authorized by the Code or the court.[64] The bankruptcy court

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[58] 268 B.R. 543 (Bankr. W.D. Mo. 2001).

[59] *In re Payless Cashways*, 268 B.R. at 546–47 (relying on section 364(b), which gives courts authority to approve debtors lending transactions under certain circumstances); *see also infra* note 60 and accompanying text.

[60] 11 U.S.C. § 364(b) (2002) ("The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense."); *see also In re Payless Cashways*, 268 B.R. at 544, 546–47 (stating section 364(b) gives courts broad authority to "approve borrowing arrangements that are found to be in the best interests of the debtor, its estate, and its creditors."); *In re* Regensteiner Printing Co., 122 B.R. 323, 326 (Bankr. N.D. Ill. 1990) (noting court is authorized to approve debtor's lending transactions).

[61] *In re Payless Cashways*, 268 B.R. at 546–47 (noting court had power to "approve granting of preferential treatment to suppliers, in exchange for the granting of credit out of the ordinary course.").

[62] *See* discussion *infra* Section III. B. *But see* Transamerica Commercial Fin. Corp. v. Citibank (*In re* Sun Runner Marine, Inc.), 945 F.2d 1089, 1093 (9th Cir. 1991) ("Section 364 does not, however, authorize the debtor to pay the lender's *pre- petition* unsecured claim as a condition precedent to the post-petition financing.") (emphasis in original).

[63] *In re Payless Cashways*, 268 B.R. at 546 (stating section 549(a)(2) authorizes trustee "to set aside only those post-petition payments of pre-petition obligations that are 'not authorized under this title or by this court."); *see also infra* note 64 and accompanying text.

[64] 11 U.S.C. § 549(a)(2) (2002) ("Except as provided in subsection (b) or (c) of this section, the trustee may avoid a transfer of property of the estate – that is authorized only under section 303(f) or 542(c) of this title; or that is not authorized under this title or by the court."); *see also In re Payless Cashways*, 268 B.R. at 546 (relying on language of § 549(a)(2)). *See generally* Krol v. Wilcek (*In re* H. King & Assocs.), 295 B.R. 246, 291 (Bankr. N.D. Ill. 2003) (discussing application of section 549 and related four-part inquiry); Dzikowski v. Southtrust Bank of Fla., N.A. (*In re* Family Health Food U.S.A., Inc.), 223 B.R. 250, 251 (Bankr. S.D. Fla. 1998) (citing section 549(a)).

extrapolated authority to approve pre-petition payments from this clause, even though the Code doesn't mention such specific power elsewhere.[65] Another debtor argued elsewhere that section 549 granted the court the power to approve critical vendor payments, but that court was not convinced.[66]

c. Section 363(b)

In support of its authorization of pre-petition payments, the Bankruptcy Court for the Southern District of New York has cited section 363(b) in tandem with section 105(a).[67] The former provision lets the debtor use estate property outside the

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[65] *In re Payless Cashways*, 268 B.R. at 544, 548 (authorizing debtor to pay pre-petition claims up to amount of credit extended post-petition). *But see In re Sun Runner Marine*, 945 F.2d at 1093 ("Section 364 does not, however, authorize the debtor to pay the lender's *pre- petition* unsecured claim as a condition precedent to the post-petition financing." (emphasis in original)); *In re* FCX, Inc., 60 B.R. 405, 410–11 (Bankr. E.D.N.C. 1986) (concluding court authorizing pre-petition claims was "legally improper.").

[66] *See In re* CoServ, L.L.C., 273 B.R. 487, 492 (Bankr. N.D. Tex. 2002). The debtor cited *In re* Isis Foods, Inc., 37 B.R. 334, 336 n.3 (Bankr. W.D. Mo. 1984) as support. *In re Isis* did not deal with critical vendors, but it did address payment of bank checks presented pre-petition and cashed post-petition. The *Isis* court stated, "[i]t would appear that proposed transfers could be presented in advance to a bankruptcy court for its approval and would thereafter be insulated from attack under section 549; however, that procedure was simply not followed here." *Id.*

[67] *In re* Ionosphere Clubs, Inc., 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989) (citing section 363(b) and section 105(a) concurrently as means of effectuating "policies and provisions of the Bankruptcy Code."); *see also* 11 U.S.C. § 363(b) (2002), providing in relevant part:

> (1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.
> (2) If notification is required under subsection (a) of section 7A of the Clayton Act in the case of a transaction under this subsection, then–
> > (A) notwithstanding subsection (a) of such section, the notification required by such subsection to be given by the debtor shall be given by the trustee; and
> > (B) notwithstanding subsection (b) of such section, the required waiting period shall end on the 15th day after the date of the receipt, by the Federal Trade Commission and the Assistant Attorney General in charge of the Antitrust Division of the Department of Justice, of the notification required under such subsection (a), unless such waiting period is extended–
> > > (i) pursuant to subsection (e)(2) of such section, in the same manner as such subsection (e)(2) applies to a cash tender offer;
> > > (ii) pursuant to subsection (g)(2) of such section; or
> > > (iii) by the court after notice and a hearing.

Id.; 11 U.S.C. § 105(a) (2002), providing:

> The court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, to prevent and abuse of process.

Id.

ordinary course of business with court approval.[68] The court decided that this included payments of pre-petition debts.[69]

The Sixth Circuit of Appeals disagreed on the statute's relevance in *In re White Motor Corporation*.[70] "The bankruptcy court properly stated that '[u]nder no circumstances can the debtor's authority… to use property of the estate in the ordinary course of business under section 363 be interpreted or extended to permit the transformation of pre-petition debt to an administrative expense.'"[71]

II. THE ARGUMENTS EXAMINED

A. The Doctrine of Necessity

1. History

The roots of the doctrine predate the Code and even the first Bankruptcy Act of 1898.[72] Two similar common law doctrines, the Necessity of Payment rule and the Six Months Rule, were used in railroad reorganizations since then.[73]

The Six Months Rule allows a railroad receiver to use post-petition revenues to pay pre-petition expenses.[74] It grants claims for materials and services provided six months before the petition administrative expense priority status.[75] In a 1945

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[68] 11 U.S.C.§ 363(b) (2002).

[69] *See In re Ionosphere Clubs*, 98 B.R. at 175 (applying what is commonly referred to as "doctrine of necessity" or "necessity of payment rule," which recognizes power of courts to "authorize a debtor in a reorganization case to pay pre-petition claims" under certain circumstances); *see also In re* Lehigh & New England Ry., 657 F.2d 570, 581 (3d Cir. 1981) (discussing development of "necessity of payment doctrine"). *But see In re* Chandlier, 292 B.R. 583, 588 (Bankr. W.D. Mich. 2003) (discussing "necessity of payment doctrine" and stating, "[t]he Doctrine itself is a violation of 11 U.S.C. § 507 and in fact, is not authorized by any Bankruptcy Code section."); *In re CoServ*, 273 B.R. at 491 (cautioning "doctrine of necessity" may only be used in "extraordinary circumstances" and increased willingness of courts to apply doctrine may not be warranted by any change of existing law"). *See generally* Miltenberger v. Logansport, 106 U.S. 286, 311–12 (882) (establishing "necessity of payment doctrine").

[70] 831 F.2d 106 (6th Cir. 1987).

[71] *Id*. at 111–12.

[72] *See Miltenberger*, 106 U.S. at 311–12 (enunciating Doctrine of Necessity).

[73] *See* B & W Enters., Inc. v. Goodman Oil Co. (*In re* B & W Enters., Inc.), 713 F.2d 534, 535–36 (9th Cir. 1983) (declining to extend Six Months Rule and necessity of payment rule to non-railroad reorganizations and stating Six Months Rule has been traditionally applied solely in railroad cases); *In re* Boston & Maine Corp., 634 F.2d 1359, 1366 (1st Cir. 1980) (noting Six Months Rule was traditionally applied in railroad cases); *see also* Eisenberg & Gecker, *supra* note 5, at 4 (explaining that Six Months Rule and necessity of payment rule apply only to railroad reorganizations).

[74] 11 U.S.C. § 205(b) (1976) (repealed 1978); 11 U.S.C § 1771(b) (2002) (codifying Six Months Rule, which allows debtor to pay pre-petition debts from post-petition operating funds); *see also In re B & W Enters.*, 713 F.2d at 536 (granting authorization to pay pre-petition debts for labor, equipment and supplies from post-petition operating receipts); *In re Boston & Maine*, 634 F.2d at 1366 (explaining ability of railroad receiver to pay certain expenses from operating receipts).

[75] *See In re B & W Enters.*, 713 F.2d at 536 (detailing Six Months Rule and its application); *In re Boston & Maine*, 634 F.2d at 1366 (stating that receiver can make authorized payments for period up to eight months

decision, *Dudley v. Mealey,*[76] Judge Learned Hand surmised that the Six Months Rule could be extended to chapter X reorganization cases other than those involving railroads.[77] It can be argued, though, that the structure of chapter X and the case's emphasis on classification within a reorganization plan make the opinion inapplicable to modern law.[78] Congress codified the Six Months Rule in section 77(b) of the Bankruptcy Act and then section 1171(b) of the Code.[79] The Code made clear that the provision is applicable only to cases involving railroads.[80]

The Necessity of Payment Rule is more closely related to the doctrine of necessity. Unlike the Six Months Rule, it deals not with priority, but with the payment of disgruntled vendors who will stop servicing a railroad in receivership if their pre-receivership debts are not satisfied.[81] In 1882, the United States Supreme Court in *Miltenberger v. Logansport Railway Company*[82] allowed the receiver of a railroad company to pay, before the company was reorganized, claims made by suppliers before the receivership began.[83] The vendors threatened to deprive the railroad of its supplies if they were not paid.[84] In a densely worded opinion the Court wrote:

> [t]he payment of unpaid debts for operating expenses . . . in the interests both of the property and of the public . . . where a

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prior); Eisenberg & Gecker, *supra* note 5, at 3–4 (stating that rationale for Six Months Rule is that suppliers' post-petition claims also receive administrative expense priority).

[76] 147 F.2d 268 (2d Cir. 1945).

[77] *Id*. at 271 (permitting broader basis for Six Months Rule by extending it to non-railroad reorganizations).

[78] *See In re* CoServ, L.L.C., 273 B.R. 487, 496 (Bankr. N.D. Tex. 2002) (stating *Dudley* provides little if any support for debtor's argument); *In re* McLean Industries, Inc., 103 B.R. 424, 426–27 (Bankr. S.D.N.Y. 1989) (explaining that in the Second Circuit, *Dudley* has been sharply limited to its facts and circumstances).

[79] 11 U.S.C § 1771(b) (2002); 11 U.S.C. § 205(b) (1976) (repealed 1978) (codifying Six Months Rule); *see also In re B & W Enters.*, 713 F.2d at 536 (stating statutory recognition was given to Six Months Rule in section 77(b) of the Bankruptcy Act and later continued by Congress in section 1171(b) which was same in substance).

[80] *See In re McLean*, 103 B.R at 425 (stating Six Months Rule applies only to railroad reorganization cases); *In re B & W Enters*., 713 F.2d at 536–37 (holding Six Months Rule applicable only in cases concerning railroads); *In re Boston & Maine*, 634 F.2d at 1366 (noting Six Months Rule was traditionally applied in railroad cases).

[81] *See In re B & W Enters*., 713 F.2d at 537 (holding necessity of payment rule may be invoked for payment of pre-petition debts paid under duress to secure continued operation during reorganization); *In re Boston & Maine*, 634 F.2d at 1382 (recognizing necessity of payment rule authorizes payment for goods or services necessary to continuing railroad service); *see also In re* Penn. Cent. Transp. Co., 458 F.Supp. 1234, 1326 (E.D. Pa. 1978) (stating rule not applicable to grant priority where creditors did not threaten to make continued operations impossible); Eisenberg & Gecker, *supra* note 5, at 4 (explaining necessity of payment rule applies to avoid creditors' threatened economic sanctions).

[82] 106 U.S. 286 (1882).

[83] *Id*. at 313 (allowing for payment of fair rental value of land, as well as payment of necessary operating supplies such as steel rails); *see also* Carpenter v. Wabash Ry. Co., 309 U.S. 23, 27–28 (1939) (recognizing there can be pre-petition unsecured claims having superior equities, thus giving them priority over other claims); Wallace v. Loomis, 97 U.S. 146, 162–63 (1877) (stating it is within power of court of equity to allow repayment of creditors necessary for preservation of company).

[84] *Miltenberger*, 106 U.S. at 311 (stating actions of defendant were both careful and judicious).

> stoppage of the continuance of such business relations would be a probable result . . . also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien.[85]

The Court cautioned, however, that the "discretion to do so should be exercised with *very great care*." (emphasis added).[86]

The Ninth Circuit Court of Appeals understood this when it refused to extend either the Six Months Rule or the Necessity of Payment Rule to the trucking industry in *B & W Enterprises, Inc. v. Goodman Oil Company*.[87] After the chapter 11 debtors made post-petition payments toward the pre-petition debts of vendors to maintain delivery of supplies, the cases were converted to chapter 7.[88] The trustee sought to recover the payments and the vendors asserted the rules in their defense.[89] The court rejected the vendors' argument.[90] It noted the rules' continuous role in only railroad reorganizations and wrote that "[a]bsent compelling reasons, we deem it unwise to tamper with the statutory priority scheme devised by Congress."[91] The

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[85] *Id.* at 311–12; *see* Warren v. Palmer, 310 U.S. 132, 139 (1940) (stating when court has custody of property, it can require paying of expenses, which have contributed to its creation or its preservation); Barton v. Barbour, 104 U.S. 126, 136 (1881) (stating it is in best interest of all parties to upkeep property and manage it in its ordinary manner).

[86] *Miltenberger*, 106 U.S. at 312; *see In r re* CoServ, L.L.C, 273 B.R. 487, 493–94 (Bankr. N.D. Tex. 2002) (stating bankruptcy court's discretion in allowing priority treatment for unsecured creditors has been curtailed); *see also In re* Boston & Maine Corp., 468 F. Supp. 996, 1000 (Bankr. D. Mass. 1979) (stating court's power in determining priority among creditors has been reduced by the authority of the ICC).

[87] 713 F.2d 534, 536–37 (9th Cir. 1983) (holding Six Months Rule and necessity of payment rule could not be extended outside realm of railroad cases); *see In re* Timberhouse Post & Beam, Ltd., 196 B.R. 547, 549 (Bankr. D. Mont. 1996) (holding bankruptcy court does not have authority to alter priority scheme of Code by applying necessity of payment rule to non-railroad cases); *see also In re* N. Am. Coin & Currency, Ltd., 767 F.2d 1573, 1574–75 (9th Cir. 1985) (stating Ninth Circuit Court of Appeals has acted with caution when deciding whether to favor one group of creditors at expense of others).

[88] *In re B & W Enters.*, 713 F.2d at 535 (noting debtors agreed to continue receiving parts, repair services, and fuel, in exchange for payment of debt, after they had filed for chapter 11).

[89] *Id*. at 536 (explaining vendors asserted that Six Months Rule and necessity of payment rule both justified payment of creditors crucial to the companies' existence).

[90] *Id.* at 537 (rejecting debtors argument on basis that Six Months Rule and necessity of payment rule is restricted to railroad cases); *see also In re CoServ*, 273 B.R. at 492 (stating Six Months Rule was codified in 11 U.S.C. § 1171 (b), dealing exclusively with railroads). *See generally In re* Boston & Maine Corp., 634 F.2d 1359, 1365–66 (1st Cir. 1980) ("The Six Months Rule emerged out of the practice of initiating railroad receiverships with an order appointing a receiver and authorizing or directing him to pay from operating receipts certain expenses incurred in the period immediately preceding the receivership.").

[91] *In re B & W Enters.*, 713 F.2d at 537; *see In re* FCX, Inc., 60 B.R. 405, 409 (Bankr. E.D.N.C. 1986) (stating bankruptcy court can deviate from priority rules only under compelling circumstances in order to serve justice and equity); *see also In re* Wilnor Drilling, Inc., 29 B.R. 727, 729 (Bankr. S.D. Ill. 1982) (explaining while bankruptcy court is flexible in its rules of priority, this flexibility should not be used to rank priorities within priorities).

court refused to allow subordination of the other creditors' claims under Code section 510(c).[92]

The Bankruptcy Court for the Southern District of New York was not as reserved in its 1989 decision, *In re Ionosphere Clubs, Inc.*[93] In *In re Ionosphere*, the court approved debtor Eastern Airlines' payment of pre-petition salaries and benefits to active employees.[94] A union for striking employees attacked the order providing for these payments because it thought that all employees should be treated equally regardless of their work status.[95] The court upheld the order, stating that Code section 363(b) gave it the power to expend estate assets outside the ordinary course of business provided the debtor has a reasonable business reason.[96] Eastern's interest in reorganizing and in promoting employee morale was sufficient, the court decided.[97]

The court then cited section 105(a) and *Miltenberger v. Logansport* in support of its position.[98] "Clearly the 'necessity of payment' doctrine is applicable to the instant dispute which is related in some aspects to the Railway Labor Act[,]" the court wrote.[99] The court then claimed that even absent the Act, Judge Hand's

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[92] *In re B & W Enters.*, 713 F.2d at 537–38; *see* 11 USCS § 510(c), providing:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

[93] 98 B.R. 174 (Bankr. S.D.N.Y. 1989).

[94] *Id.* at 178–79 (holding only active employees rather then all employees may recover because union failed to demonstrate beneficial value of paying non-active employees).

[95] *Id*. at 174–75 (noting union requested benefits and wages for non-working employees such as sick leave benefits and medical expenses).

[96] *Id.* at 175 (stating mere appeasement of major creditors was not justifiable reason); *see also In re* Cont'l Air Lines, Inc., 780 F.2d 1223, 1225–26 (5th Cir. 1986) (stating when sale is outside ordinary course of business, property according to Code becomes property of the estate); *In re* Lionel Corp., 722 F.2d 1063, 1069–70 (2d Cir. 1983) (explaining using, selling or leasing property within ordinary course of business would not be an adequate justification).

[97] *See In re Ionosphere Clubs*, 98 B.R. at 175 (accepting justification that preservation of employee morale was essential to maintaining company's stability and ensuring possibility of future reorganization).

[98] *Id.* at 175–76; *see infra* note 107 and accompanying text; Sears, Roebuck & Co. v. Spivey, 265 B.R. 357, 371 (E.D.N.Y. 2001) (relying on Bankruptcy Code § 105(a) to further equitable principles, such as justice and fairness). *See generally* Lerch v. Fed. Land Bank, 94 B.R. 998, 1000 (N.D. Ill. 1989) (affirming court order to dismiss over protests that judicial bankruptcy discretion is not unbridled); *In re* Rubenstein, 71 B.R. 777, 778–79 (B.A.P. 9th Cir. 1987) (recognizing Congressional intent by enabling courts to act with respect to parties in interest).

[99] *In re Ionosphere Clubs*, 98 B.R. at 176; *see* Miltenberger v. Logansport R.R. Co., 106 U.S. 286, 310–12 (1882) (articulating necessity of payment rule in reorganization frameworks in order to pay those claims essential to ongoing railroad operations); *In re* Penn Cent. Transp. Co., 467 F.2d 100, 102 n.1 (3d Cir. 1972) (recognizing importance of first satisfying those creditors who supply services and materials vital to debtor's business); *In re* New York, New Haven & Hartford R.R. Co., 278 F. Supp. 592, 602 n.15 (D. Conn. 1967)

Dudley v. Mealey opinion extended the Necessity of Payment doctrine to non-railroad debtors.[100] Railroad reorganizations and chapter 11 cases share the same principle: rehabilitating the debtor company.[101] When the necessity of payment doctrine was extended outside the railroad industry, it more properly became known as the doctrine of necessity.[102] This doctrine has been used countless times since to justify preplan, pre-petition payments.[103]

As seen above, the doctrine of necessity sprang from pre-Code cases at a time when the railroad industry was vitally important to an adolescent nation, a time before motor vehicles and airplanes were invented. Even assuming for the sake of argument that such a compelling public interest justified the doctrine, it no longer exists. The United States is an established economic superpower and the importance of railroads in commerce has been eclipsed by other industries such as trucking, airlines and telecommunications. The proliferation of such companies means that if some fall into bankruptcy, their competitors stand ready to absorb the market share.

Furthermore, the executive and legislative branches of the federal government are more willing to bail out troubled industries than they were in the 1800s.[104] Although airlines, for example, do file for bankruptcy protection, it is inconceivable that the Oval Office would ever allow a significant number of airlines to file contemporaneously without offering assistance. The nation could not allow a huge portion of its economic future to wind its way through the overburdened court system.

(finding temporary or permanent termination of railroad services would have detrimental affects upon all creditors alike).

[100] *In re Ionosphere Clubs*, 98 B.R. at 176 (stating same); *see* Dudley v. Mealey, 147 F.2d 268, 271 (2d Cir. 1945) (holding that because private businesses lose much of their value with abrupt termination of their core operations, doctrine of necessity is likewise applicable to non-railroad cases). *But see Keelyn v. Carolina Mut. Tel. & Tel. Co.*, 90 F. 29, 29–30 (D.S.C. 1898) (clarifying why necessity doctrine is inapplicable to privately held companies that do not affect trade and public interest to same degree as public services such as railroads and telegraph companies).

[101] *See In re Ionosphere Clubs*, 98 B.R. at 176–77 (stating same); NLRB v. Bildisco & Bildisco, 465 U.S. 513, 527 (1984) (stating policy and goal of chapter 11 is to successfully rehabilitate debtor); United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983) (suggesting Congress viewed "the assets of the debtor…more valuable [when] used in a rehabilitated business than [when] 'sold for scrap.'").

[102] *See* Eisenberg & Gecker, *supra* note 5, at 4–5 (recognizing "necessity of payment," while born in railroad reorganization cases, came to encompass chapter 11 business reorganizations under "doctrine of necessity" title). *Compare In re* Lehigh & N. E. Ry. Co., 657 F.2d 570, 581 (3d Cir. 1981) (stating "necessity of payment" doctrine applies to continuing operations during railroad's reorganization) *with In re Ionosphere*, 98 B.R. at 175–76 (interchanging "necessity of payment" and "doctrine of necessity" in discussion of chapter 11 business reorganization).

[103] *See In re* Just for Feet, Inc., 242 B.R. 821, 824–26 (Bankr. D. Del. 1999) (recognizing need for pre-petition payments when debtor's survival during chapter 11 depends on such payments); *In re* Fin. News Network, Inc., 134 B.R. 732, 735–36 (Bankr. S.D.N.Y 1991) (discussing necessity doctrine and cases that authorized and criticized pre-planned, pre-petition payments critical to the debtor's reorganization*)*.

[104] *See, e.g.*, Shailagh Murray, *Republicans Propose $2.8 Billion in Airline Aid*, WALL ST. J., Mar. 31, 2003, at A1 (discussing federal government's contribution to failing airline industry).

In short, these are different times. Railroad reorganizations are governed by their own sections of the Code,[105] and other companies are not important enough to the economy to justify such a risky doctrine. Though some may argue that companies like Worldcom are so massive that their continuation is vital to the nation, this author disagrees: where there is money to be made, American business has shown the willingness and ability to adapt and restructure itself into smaller pieces, if necessary.

It is also noteworthy that even though Congress codified the Six Months Rule, it did not give the same treatment to the Necessity of Payment Rule, despite ample opportunity to do so.[106]

B. Section 105(a)

1. Legislative History

The relative brevity of section 105(a) belies its expansive scope. Section 105(a) provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.[107]

The legislative history of section 105(a) is not illuminating as to the limits of the court's equitable power. The section's drafters were primarily concerned with establishing the independence of the newly restructured bankruptcy court system.[108]

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[105] 11 U.S.C. §§ 1161–1174 (2002); *see* Hileman v. Pittsburgh & Lake Erie Props. (*In re* Pittsburgh & Lake Erie Props.), 290 F.3d 516, 519 (3d Cir. 2002) (recognizing subchapter IV of chapter 11 applies only in cases concerning railroad (quoting 11 U.S.C. § 103(h))); *In re* CoServ, L.L.C., 273 B.R. 487, 492 n.7 (Bankr. N.D. Tex. 2002) (noting subchapter IV of chapter 11 deals specifically with railroad reorganizations); *In re* Eureka S. R.R., 177 B.R. 323, 324 (Bankr. N.D. Cal. 1995) (recounting case commenced as railroad reorganization case under subchapter IV of chapter 11).

[106] *See* 11 U.S.C. § 1171(b) (2002) (codifying Six Months Rule); *In re Just for Feet*, 242 B.R. at 824 (stating necessity of payment rule was not codified); Charles J. Tabb, *A Critical Reappraisal Of Cross-Collateralization In Bankruptcy*, 60 S. CAL. L. REV. 109, 161 (1986) (analyzing Congress's codification of Six Months Rule in section 1171(b), which does not include necessity of payment rule).

[107] 11 U.S.C. § 105(a) (2002).

[108] *See id*. (explaining how bankruptcy judges' powers were increased (quoting S. REP. NO. 95–989)); Celotex Corp. v. Edwards, 514 U.S. 300, 330 n.20 (1995) (Stevens, J., dissenting) (noting section 105 allows bankruptcy courts to take action on their own); Gurney v. Arizona Dep't of Revenue (*In re* Gurney), 192 B.R. 529, 537 (B.A.P. 9th Cir. 1996) (stating section 105(a) allows bankruptcy courts to inject traditional equitable principles into bankruptcy system to prevent abuse of drafter's intent).

There is no mention of critical vendors, or the ability of courts to act in opposition to the payment priority scheme elsewhere in the Code.[109]

C. Counter-Arguments

1. Use Equitable Power Sparingly

"[T]he rule is a rule of necessity and not one of convenience."[110] Several courts have noted that the doctrine of necessity is not one to be used routinely.[111] Furthermore, its use should benefit not just the debtor, but all creditors.[112] The Fourth Circuit Court of Appeals in *Official Committee of Equity Security Holders v. Mabey*[113] stressed that a bankruptcy court's "equitable powers must be strictly confined within the prescribed limits of" bankruptcy legislation.[114] The district court had ordered the creation of a $15 million emergency treatment fund for claimants as part of the A.H. Robins Co.'s bankruptcy case.[115] The fund was designed to help claimants who became infertile from use of Robins' Dalkon Shield intrauterine device.[116] Money from the fund was to be disbursed before the confirmation of Robins' reorganization plan.[117] The Fourth Circuit Court of Appeals found that the fund gave "preferential treatment" to infertile claimants over other Dalkon Shield claimants and other unsecured creditors and, therefore, could not be justified under 105(a).[118] Because unsecured creditors are to receive disbursements only pursuant to an approved reorganization plan, the allowance of "piecemeal, pre-confirmation

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[109] *See In re* Startec Global Communications Corp., 292 B.R. 246, 248 (Bankr. D. Md. 2003) (recalling court ordered payment of critical vendors pursuant to section 105(a)); *In re* Wehrenberg, Inc., 260 B.R. 468, 469 (Bankr. E.D. Mo. 2001) (authorizing debtor to pay pre-petition claims of critical vendors pursuant to section 105(a)); *In re Just for Feet*, 242 B.R. at 824 (Bankr. D. Del. 1999) (using section 105(a) to authorize payment of pre-petition claims of critical vendors).

[110] *In re* NVR L.P., 147 B.R. 126, 128 (Bankr. E.D. Va. 1992).

[111] *See In re* Chandlier, 292 B.R. 583, 588 (Bankr. W.D. Mich. 2003) (stating doctrine of necessity allows payment in chapter 11 case under very extraordinary circumstances); *In re* CoServ, L.L.C., 273 B.R. 487, 491 (Bankr. N.D. Tex. 2002) (explaining doctrine of necessity is to be used only in rare cases); *In re* Babcock & Wilcox Co., 274 B.R. 230, 256 n.208 (Bankr. E.D. La. 2002) (noting doctrine of necessity is to be used by courts in limited circumstances); *In re* C.A.F. Bindery, 199 B.R. 828, 835–36 (Bankr. S.D.N.Y. 1996) (mentioning doctrine receives limited application).

[112] *See* Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 823 (Bankr. N.D. Ill. 2003) (explaining beneficial results of doctrine of necessity); *In re CoServ,* 273 B.R. at 497 (indicating section 105(a) benefits creditors by authorizing satisfaction of pre-petition claims so debtor may perform his fiduciary obligations owed to creditors); Jason A. Rosenthal, Note, *Courts of Inequity: The Bankruptcy Laws' Failure To Adequately Protect The Dalkon Shield Victims*, 45 FLA. L. REV. 223, 239 (1993) (stating doctrine's basic premise of immediate payment to certain creditors will benefit all creditors).

[113] 832 F.2d 299 (4th Cir. 1987).

[114] *Id*. at 302 (quoting Guerin v. Weil, Gotshal & Manges, 205 F.2d 302, 304 (2d Cir. 1953)).

[115] *Id*. at 299–300.

[116] *Id*. at 300.

[117] *Id.* at 301.

[118] *Mabey*, 832 F.2d at 300; *see In re* Interstate Motor Freight Sys., IMFS, Inc., 86 B.R. 500, 503 (Bankr. W.D. Mich. 1988) (finding employer may not make owed contributions to employee benefit fund before confirmation of plan as it would favor the employees over any other unsecured creditor).

payments to certain unsecured creditors," the court wrote, "violates the clear policy of chapter 11 reorganizations."[119] In reaching its conclusion, the Court elaborated on the limits of 105(a):

> While the equitable powers emanating from 105(a) are quite important in the general bankruptcy scheme, and while such powers may encourage courts to be innovative, and even original, these equitable powers are not a license for a court to disregard the clear language and meaning of the bankruptcy statutes and rules.[120]

The Fifth Circuit Court of Appeals agreed with this assessment in *Chiasson v. J. Louis Matherne and Associates* (*In re Oxford Management, Inc.*),[121] in which real estate brokers sued the debtor for pre-petition lease commissions.[122] The bankruptcy court used section 105 to order Oxford to pay the brokers from its post-petition property.[123] The Fifth Circuit Court of Appeals reversed the order, finding that "the powers granted by [105] must be exercised in a manner that is consistent with the Bankruptcy Code."[124] Advancing the brokers ahead of the debtor's other unsecured creditors "deviated from the pro rata scheme envisioned by the Code."[125]

In another case, the District Court for the Eastern District of North Carolina decided that allowing a debtor to pay pre-petition expenditures for payroll and grain shipments would subordinate the claims of other unsecured creditors.[126] The court found that only misconduct of those creditors could justify such a result.[127] Section

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[119] *Mabey*, 832 F.2d at 302; *see In re* Crowe & Assocs., 713 F.2d 211, 214 (6th Cir. 1983) (finding union strike violates the Bankruptcy Code if designed to collect pre-commencement debt), *In re* Organic Conversion Corp., 259 B.R. 350, 355 n.5 (Bankr. D. Minn. 2001) ("[N]o provision of the Bankruptcy Code authorizes a reorganizing debtor to make a post-petition, pre-confirmation payment on account of an unsecured claim.").

[120] *Mabey*, 832 F.2d at 302. For criticism of the *Mabey* court's approach, see Rosenthal, *supra* note 112. Rosenthal argues that the court should have employed "a relaxed approach to the doctrine of necessity" in order to compensate the victims. *Id.* at 245.

[121] 4 F.3d 1329 (5th Cir. 1993).

[122] *Id.* at 1332.

[123] J. Louis Matherne & Assocs. v. Oxford Mgmt., Inc., 1992 WL 394706, at *2 (E.D. La. 1992), *rev'd*, 4 F.3d 1329 (5th Cir. 1993).

[124] *In re Oxford Mgmt.*, 4 F.3d at 1334. *See generally In re* Sybaris Club Intern., Inc., 189 B.R. 152, 156 (Bankr. N.D. Ill. 1995) ("Section 105 may not be used to create new law. The bankruptcy court does not have 'free floating discretion,' to create rights outside the Code but the court may exercise its equitable powers in a manner consistent with the Code.").

[125] *In re Oxford Mgmt.*, 4 F.3d at 1334.

[126] *In re* FCX, Inc., 60 B.R. 405, 410 (Bankr. E.D.N.C. 1986); *see also In re* Columbia Gas Sys., Inc., 136 B.R. 930, 941 (Bankr. D. Del. 1992) (holding debtor may not pay pre-petition "upstream charges"); *In re* Revco D.S., Inc., 91 B.R. 777, 780 (Bankr. N.D. Ohio 1988) (deciding Bankruptcy Code does not permit payment of pre-petition trust fund taxes before confirmation of reorganization plan).

[127] *In re FCX*, 60 B.R. at 410; *see also* Mission Bay Campland, Inc. v. Sumner Fin. Corp., 731 F.2d 768, 772 (11th Cir. 1983) (applying *Multiponics* test to find cross-appellant had engaged in "fraudulent" or "inequitable" conduct to justify subordination); *In re* Multiponics, Inc., 622 F.2d 709, 713 (5th Cir. 1980) (announcing proper test for error in subordination cases). The court reasoned the proper test of error in

105 "does not authorize [the bankruptcy court] to create rights not otherwise available under applicable law."[128]

According to another bankruptcy court, the rationale for a "bright line test" forbidding critical vendor payments is "quite obvious."[129] "The Code itself has provided vehicles to the debtor-in-possession to obtain credit, use cash collateral and otherwise obtain financial assistance under sections 363 and 364, so long as the classification of creditors is not undone."[130] That court also cited as controlling precedent the Supreme Court's decision in *United States v. Noland,*[131] one of a pair of 1996 cases discussed in the next section where the Court forbade judicial reclassification of bankruptcy claims.[132]

2. Prohibition of IRS Claim Subordination

Though the Supreme Court has not yet ruled on the legality of critical vendor payments, it did address the inability of courts to ignore the Code's payment priority scheme in *United States v. Reorganized CF & I Fabricators of Utah, Inc.*[133] and *United States v. Noland.*[134] In each case the lower courts, pursuant to section 510(c), attempted to equitably subordinate claims of the Internal Revenue Service to a position lower than that allowed by the Code.[135] Each such claim was considered to be a penalty outside the scope of section 507(a)(8).[136] Both distributions were part of reorganization plans.[137]

In *Noland*, the post-petition tax penalty still enjoyed priority claim status as an administrative expense under section 507(a)(1)[138] and in *CF & I,* the nonpecuniary loss penalty was an unsecured claim.[139] Because of the nature of the claims, the bankruptcy court in each case equitably subordinated the penalty to general unsecured claim status in *Noland*[140] and below the claims of other unsecured creditors in *CF & I.*[141] The Supreme Court found both actions impermissible because the courts' use of their equitable powers under 510(c) treaded on areas

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subordination cases is: (I) the claimant must have engaged in some type of inequitable conduct. (II) misconduct must result in injury to creditors or an unfair advantage on claimant and (III) subordination must not be inconsistent with Code. *Id.* at 713.

[128] *In re FCX*, 60 B.R. at 410–11.

[129] *In re* Timberhouse Post & Beam, Ltd., 196 B.R. 547, 551 (Bankr. D. Mont. 1996).

[130] *Id.*; *see* 11 U.S.C. §§ 363–364 (2002).

[131] 517 U.S. 535 (1996).

[132] *Id.*; United States v. Reorganized CF & I Fabricators of Utah, Inc., 518 U.S. 213, 229 (1996).

[133] 518 U.S. 213, 229 (1996) (discussing same).

[134] 517 U.S. at 543 (noting Congress had opportunity, yet refrained from allocating first priority to post-petition tax penalties).

[135] *Reorganized CF & I*, 518 U.S. at 227 (discussing same); *Noland*, 517 U.S. at 537 (discussing same).

[136] *Reorganized CF & I*, 518 U.S. at 226 (rationalizing classification of penalty due to "patently punitive function of [section] 4971."); *Noland*, 517 U.S. at 536 (holding same).

[137] *Reorganized CF & I*, 518 U.S. at 216 (noting same); *Noland*, 517 U.S. at 536 (noting same).

[138] *Noland*, 518 U.S. at 541–42 n.3.

[139] *Reorganized CF & I*, 518 U.S. at 226.

[140] *Noland*, 517 U.S. at 537.

[141] *Reorganized CF & I*, 518 U.S. at 227.

reserved to Congress.[142] The Court noted that if courts were allowed to act as the lower courts in *Noland* and *CF & I* did, "the distinction between characteristic legislative and trial court functions would simply be swept away, and the statute would delegate legislative revision, not authorize equitable exception. We find such a reading improbable in the extreme."[143] Furthermore, both cases stand for the "principle…that categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination under 510(c)."[144]

Though these decisions are not exactly on point and did not address section 105, they do illustrate the limitations of equitable power and the importance the Court places on the actual text of the Code. At least one court has attempted to distinguish the cases, saying that they apply only to tax claims and not pre-petition payments to vendors.[145]

III. RECENT DEVELOPMENTS

A. In re CoServ, L.L.C.

The novel approach of Judge Dennis Michael Lynn in the Northern District of Texas Bankruptcy Court's 2002 *In re CoServ, L.L.C.* decision has garnered attention.[146] While the court refused to prohibit critical vendor payments outright, it did struggle to restrict them by tightening its evidentiary standards.[147]

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[142] *Reorganized CF & I*, 518 U.S. at 229 (noting same); *Noland*, 517 U.S. at 541 (stating courts cannot adversely usurp those policy decisions Congress seeks to accomplish).

[143] *Noland,* 517 U.S. at 540–41.

[144] *Reorganized CF & I*, 518 U.S. at 229.

[145] *See, e.g., In re* Just for Feet, Inc., 242 B.R. 821, 825 (Bankr. D. Del. 1999) (noting distinction of this pair of cases due to tax claims). For a discussion of *Noland* and *Reorganized CF & I*, see Rafael Ignacio Pardo, *Beyond the Limits of Equity Jurisprudence: No-Fault Equitable Subordination*, 75 N.Y.U. L. REV. 1489 (2000).

[146] *See* In re Coserv, L.L.C., 273 B.R. 487 (Bankr. N.D. Tex. 2002); A. Mechele Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck?*, 11 AM. BANKR. INST. L. REV. 93, 109–10 (2003) ("Despite the apparent clarity of the *CoServ* opinion, there is wide discrepancy among the Circuits as to whether courts have the authority to approve the payment of any pre-petition unsecured claim prior to confirmation of a chapter 11 plan . . . ."); Patrick M. Jones, *Critical Vendors Face High Noon in In re CoServ*, 29 MONITOR (Supp. Sept. 2002), *available at* http://www.gtlaw.com/pub/articles/2002/jonespat02b.asp (last visited November 21, 2003) ("[u]nlike so many courts before it, the *CoServ* court carefully located a statutory basis for granting such relief, examined the supporting rationale, and outlined a three-step analysis that should ensure that such relief is limited to circumstances consistent with its rationale."); Nathan, *supra* note 2, at 16 ("The court in *In re CoServ L.L.C.* made clear that it would not rubber-stamp a debtor's request to pay the pre-petition claims of certain favored vendors during the chapter 11 and would carefully scrutinize such requests."); White & Medford, *supra* note 2, at 24 (stating *CoServ's* "strict evidentiary prerequisites for granting relief…are impractical for today's mega-cases.").

[147] *In re CoServ*, 273 B.R. at 498 (crafting "its own test to be applied in resolving whether a general unsecured prepetition claim should be paid" and applying a three element test where, by a preponderance of the evidence, the party seeking relief must show: first, the debtor must deal with the claimant; second, unless

The six debtors, all of which provided telecommunications services, had initially requested permission to pay twenty-seven critical vendors.[148] After the court expressed reservations, the number was reduced to seven.[149] Of those, the court designated only one as a critical vendor, approved the payment of another on other grounds, and denied the remaining payments.[150] Such a result is preferable to the open-ended authorization some courts give debtors to decide which of its vendors are critical. The court's application of the doctrine of necessity is still suspect, though.

The court's opinion began promisingly, as it recognized that pre-petition claims should be paid "only under extraordinary circumstances."[151] There have been thousands of reorganized debtors that did not need to rely on pre-petition payments, the court noted.[152] "Despite the increasing willingness of courts . . . to allow pre-petition claims long prior to consummation of a plan, this Court does not believe there has been a sea change in the law that would warrant such a drastic expansion of the 'Doctrine of Necessity,' a device to be used only in rare cases."[153]

Though the debtors cited cases in which various Code sections were offered in support of critical vendor payments, the court discounted many of them, stating that "[o]nly Section 105(a) offers the equitable muscle that would allow a bankruptcy

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the debtor deals with the claimant the likelihood of harm to the debtor is disproportionate to the claimant's pre-petition claim; and third, there is no practical or legal alternative other than payment of the claim by the debtor to continued dealings with the claimants).

[148] *Id.* at 490 ("At the time of the initial hearing, Debtors sought authority to expend $2,272,265.93 in payment of prepetition claims of 27 creditors.").

[149] *Id.* ("The Court expressed concern with the nature and extent of the Motion, and, by December 20, Debtors had narrowed the list of 'critical vendors' to seven creditors to whom Debtors wished to pay $563,183.00 of prepetition indebtedness.").

[150] *Id.* at 499–501 (denying critical vendor motions for payments ranging from $2,803 to $500,000 to Bart Construction, BMC, Minn-Tex Technologies, Sunbelt Telecommunications, Temple, Inc.; granting conditional "critical vendor" status to Comsource, Inc. subject to continuation of existing relationship; and granting critical vendor motion to Mr. Terry Morris, "a contract employee," owed $3,500 as "either wages or the cost of assumption of a contract. In either event, it is payable under a legal theory other than the doctrine of necessity.").

[151] *Id.* at 494.

[152] *In re CoServ*, 273 B.R. at 491 ("Thousands of debtors have successfully navigated through chapter 11 in the past without paying the prepetition claims of 'critical' vendors."). *See generally* Robert A. Morris, Jr., *The Case Against "Critical Vendor" Motions*, AM. BANKR. INST. J., Sept. 2003, at 30 (believing as "[a legal practioner] who lives on the front line with debtors as a CRO and financial advisor: Most of these critical vendor payments don't need to be made.").

[153] *In re CoServ,* 273 B.R. at 491; *see id.* at 492 n.7 (examining historical development of doctrine of necessity as "an outgrowth of case law under and preceding the bankruptcy act."); *see also In re* Mirant Corp., 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003) ("As previously expressed in its opinion in *In re CoServ*, this court has reservations about granting such relief [to critical vendors] when to do so could result in certain favored unsecured creditors receiving treatment preferential to that received by other unsecured creditors under a plan."); 2 WILLIAM L. NORTON, JR., NORTON BANKR. L. & PRAC. § 42:11 (2d ed. Supp. 2002) (reviewing doctrine of necessity's development, predicting "[i]n the near future, the courts are likely to continue to disagree about the availability and proper application of the Necessity of Payment Rule" and noting "'[t]he "necessity of payment" rule and the practice of paying claims on the grounds of business policy are subject to grave abuse. An equity court should be reluctant to lend its aid to these "hold-up" claimants.'") (quoting Thomas O. FitzGibbon, *The Present Status of the Six Months' Rule*, 34 COLUM. L. REV. 230, 254 (1934)).

court to violate one of the principal tenets of chapter 11: that pre-petition general unsecured claims should be satisfied on an equal basis pursuant to a plan."[154] The court recognized that section 105(a)'s power was limited.[155] It stated that to approve payment of unsecured pre-petition claims, they must enjoy priority under the Code and receive senior creditor approval or fully protect their interests.[156] Otherwise "the most extraordinary circumstances"[157] must exist. The court pointed to the following Code sections to show that Congress had explicitly provided for those circumstances in which it approved of creditor preferences[158]:

- 507 (a): prioritizes creditor claims;
- 1171(b): gives priority status to unsecured creditors who would have had such status if a receiver had been appointed the day bankruptcy relief was granted;
- 546(c) and (d): grants rights of reclamation to vendors;
- 547(c)(3): allows the perfection of a purchase money security interest; and

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[154] *In re CoServ,* 273 B.R. at 493.

[155] *Id.* at n.9 ("The equitable power that the Court may exercise under Section 105(a) is severely circumscribed" and listing cases confirming limited equitable powers sourced in § 105 (a)); *see also* Graves v. Myrvang (*In re* Myrvang), 232 F.3d 1116, 1124–25 (9th Cir. 2000) ("More recent opinions at the circuit level are equally insistent that a bankruptcy court's application of § 105(a) is limited to those situations where it is 'a means to fulfill some specific Code provision.'") (quoting *In re* Fesco Plastics Corp., 996 F.2d 152, 154 (7th Cir. 1993)); IRS v. Kaplan (*In re* Kaplan), 104 F.3d 589, 597–98 (3d Cir. 1997) (affirming "'[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness'") (quoting *In re* Chicago, Milwaukee, St. Paul & Pac. R.R., 791 F.2d 524, 528 (7th Cir. 1986)). *See generally* Celotex Corp. v. Edwards, 514 U.S. 300, 327–31 (1995) (examining legislative history of 11 U.S.C. § 105, from 1898 Bankruptcy Act through to 1986 amendments of the Bankruptcy Code, and noting various limitations on bankruptcy court authority per Congressional exercise of power under U.S. CONST. art. I, § 8, cls. 4, 9); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) ("Whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.").

[156] *In re CoServ,* 273 B.R. at 493–94 (holding pre-petition "critical" vendor claims not to be granted "[e]xcept 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."); *see also In re Mirant Corp*., 296 B.R. at 429 (stressing preferential treatment to unsecured "critical" vendors determined on claim-by-claim basis and granted only when pre-petition claims meet the court's three-pronged test by preponderance of the evidence). *But see* Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 823 (Bankr. N.D. Ill. 2003) (finding "doctrine of necessity" provides no power enabling bankruptcy courts to sidestep Code's statutory order of priority in creditor claims).

[157] *In re CoServ,* 273 B.R. at 494.

[158] *Id.* ("Congress clearly knew how to place some unsecured claims ahead of others in right to payment" and "Congress also knew how to give a general unsecured pre-petition creditor special protections which might lead to post-petition, pre-plan satisfaction of its claim."); *see also In re* Michael, 183 B.R. 230, 238 (Bankr. D. Mont. 1995) (observing "the automatic stay is designed to protect the debtor, the assets of the estate, and the interests of other creditors in those assets" and "Congress knew how to create exceptions to the stay, but did not include as an exception debtors seeking to create exemptions.") (quotations omitted). *See generally* Gebser v. Lago Vista Indep. Sch. Dist., 524 U.S. 274, 293–94 (1989) (Stevens, J., dissenting) ("As long as the intent of Congress is clear, an implicit command has the same legal force as one that is explicit."); Midlantic Nat. Bank v. New Jersey Dep't. of Env't Prot., 474 U.S. 494, 501 (1986) (stating "[t]he normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific.").

- 366: allows utility companies to demand adequate assurance of payment before they initiate service.

"On the other hand, the entire scheme of the Bankruptcy Code favors equal (and simultaneous) treatment of equal allowed claims (*see, e.g.,* USC s. 362(a), 726, 1122 and 1129(b)(1))[,]"[159] the court wrote. It noted that "Section 362(a)(6) on its

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[159] *In re CoServ,* 273 B.R. at 494; *see* Bentley v. Boyajian (*In re* Bentley), 266 B.R. 229, 240 (B.A.P. 1st Cir. 2001) ("We begin with the premise that the theme of the Bankruptcy Act is 'equality of distribution.' 'If one claimant is to be preferred over others, the purpose should be clear from the statute.'" (citations omitted)); *see* also 11 U.S.C. § 362 (a) (2002), which provides:

> Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of—
>
> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
>
> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
>
> (4) any act to create, perfect, or enforce any lien against property of the estate;
>
> (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
>
> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
>
> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
>
> (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

Id.; 11. U.S.C. § 726 (2002), which provides:

> (a) Except as provided in section 510 of this title, property of the estate shall be distributed—
>
> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed before the date on which the trustee commences distribution under this section;
>
> (2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which is—
>
> (A) timely filed under section 501(a) of this title;
>
> (B) timely filed under section 501(b) or 501(c) of this title; or
>
> (C) tardily filed under section 501(a) of this title, if—
>
> (i) the creditor that holds such claim did not have notice or actual knowledge of the case in time for timely filing of a proof of such claim under section 501(a) of this title; and

(ii) proof of such claim is filed in time to permit payment of such claim;

(3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and

(6) sixth, to the debtor.

(b) Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6), (7), or (8) of section 507(a) of this title, or in paragraph (2), (3), (4), or (5) of subsection (a) of this section, shall be made pro rata among claims of the kind specified in each such particular paragraph, except that in a case that has been converted to this chapter under section 1009, [FN1] 1112, 1208, or 1307 of this title, a claim allowed under section 503(b) of this title incurred under this chapter after such conversion has priority over a claim allowed under section 503(b) of this title incurred under any other chapter of this title or under this chapter before such conversion and over any expenses of a custodian superseded under section 543 of this title.

(c) Notwithstanding subsections (a) and (b) of this section, if there is property of the kind specified in section 541(a)(2) of this title, or proceeds of such property, in the estate, such property or proceeds shall be segregated from other property of the estate, and such property or proceeds and other property of the estate shall be distributed as follows:

(1) Claims allowed under section 503 of this title shall be paid either from property of the kind specified in section 541(a)(2) of this title, or from other property of the estate, as the interest of justice requires.

(2) Allowed claims, other than claims allowed under section 503 of this title, shall be paid in the order specified in subsection (a) of this section, and, with respect to claims of a kind specified in a particular paragraph of section 507 of this title or subsection (a) of this section, in the following order and manner:

(A) First, community claims against the debtor or the debtor's spouse shall be paid from property of the kind specified in section 541(a)(2) of this title, except to the extent that such property is solely liable for debts of the debtor.

(B) Second, to the extent that community claims against the debtor are not paid under subparagraph (A) of this paragraph, such community claims shall be paid from property of the kind specified in section 541(a)(2) of this title that is solely liable for debts of the debtor.

(C) Third, to the extent that all claims against the debtor including community claims against the debtor are not paid under subparagraph (A) or (B) of this paragraph such claims shall be paid from property of the estate other than property of the kind specified in section 541(a)(2) of this title.

(D) Fourth, to the extent that community claims against the debtor or the debtor's spouse are not paid under subparagraph (A), (B), or (C) of this paragraph, such claims shall be paid from all remaining property of the estate.

face appears to prohibit [the] 'economic blackmail'" posed by critical vendors pressuring the debtor.[160]

After summarizing the line of cases in other jurisdictions criticizing the payment of critical vendors and expressing reservations concerning the court's power under two Supreme Court tax cases discussed above in section II.C.2. of this paper, [161] the court distinguished and downplayed the cases cited by the debtors.[162] "[E]ven a cursory review of the law makes clear that this Court does not possess the broad powers advocated by Debtors."[163] Though the court denied that it could authorize pre-petition payments as a matter of course, it claimed that it could approve them under special circumstances.[164] A "bridge", the court wrote, stretches between sections 105(a) and 1107(a).[165] Under the latter provision, the debtor in possession has a fiduciary duty to preserve the bankruptcy estate; therefore, it must maximize the estate's value as a going concern.[166] Because section 105(a) allows the

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Id; 11 U.S.C. § 1122 (2002), which provides:

> (a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.
>
> (b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.

Id.; 11 U.S.C. § 1129(b)(1) (2002), which details requirements for confirmation of a plan, stating:

> Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

Id.

[160] *In re CoServ,* 273 B.R. at 494; *see also In re* Structurlite Plastics Corp., 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988) (recognizing "re-payment of pre-petition debt should not be authorized as a result of threats or coercion by disgruntled creditors. Such activity violates the automatic stay imposed by 11 U.S.C. § 362(a) and, if tolerated, would negate the fundamental principle of equality of treatment among similarly situated creditors."). *See generally* Mason v. Official Comm. of Unsecured Creditors (*In re* FBI Distrib. Corp.), 330 F.3d 36, 41–42 (1st Cir. 2003) (observing "the fundamental principle of bankruptcy law [is] that the debtor's limited resources are to be distributed equally among similarly situated creditors . . . [which in turn means] statutory priorities are narrowly construed, and the burden of proving entitlement rests with the party seeking it."); *In re* Loewen Group Int'l, Inc., 274 B.R. 427, 434–35, 437 n.22 (Bankr. D. Del. 2002) (noting same).

[161] *See* United States v. Reorganized CF&I Fabricators of Utah, 518 U.S. 213, 229 (1996) (noting judicial authority does not extend to equitable subordination under section 510(c)); United States v. Noland, 517 U.S. 535, 543 (1996) (rejecting judicial assertion of categorical determination under guise of equitable subordination).

[162] *See In re CoServ*, 273 B.R. at 495–96 (reiterating question before court, as contrasted with different issues of law in cases cited by debtor which are rejected as not analogous to present situation).

[163] *Id*. at 496.

[164] *Id*. at 497 (laying out certain factual situations wherein courts could appropriately authorize pre-petition payments). *But see In re* Mirant Corp., 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003) (citing *CoServ* as having potential for justification, yet expressing reservations regarding such authorizations).

[165] *In re CoServ*, 273 B.R at 497 (commenting on requisite "bridge" in order to apply the doctrine of necessity).

[166] *See* 11 U.S.C. § 1107(a) (2002) ("[A] debtor in possession shall have all the rights . . . and powers, and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter."); *In re*

court to do whatever is "necessary or appropriate to carry out the provisions of" the Code, "it is only logical that the bankruptcy court be able to use Section 105(a)…to authorize satisfaction of the pre-petition claim in aid of preservation or enhancement of the estate."[167]

Finding in previous cases the lack of a "clear standard"[168] regarding the appropriate time to follow this rule, the *CoServ* court created a three-pronged test to determine when "necessity" exists.[169] The debtor must demonstrate the following by a preponderance of the evidence:

1. Vendor is "virtually indispensable to profitable operations or preservation of the estate"[170]
    a. Claimants who would meet this prong would include some, but not all, of "[t]he debtor's customers, sole suppliers of a given product and creditors having control of valuable property of the estate[.]"[171]
2. Realization of "meaningful economic gain[172] or avoidance of "serious economic harm"[173]
    a. The court found that it must calculate the net cost of the payment, using as an example the foolishness of paying $100,000 to realize $10,000 in property.[174] It expressed doubt that the receipt of advantageous credit terms alone would be sufficient to satisfy this prong.[175]
3. Lack of "practical alternatives"[176]
    a. The court in its opinion listed several of the "countless other devices" the debtor could utilize to induce its vendors instead of paying them immediately.[177] These include COD terms, paying a deposit, and consignment.[178]

CoServ, 273 B.R. at 497 (stating maximization of estate value as included in fiduciaries' duties). *See generally* Orion Pictures Corp. v. Showtime Networks, Inc. (*In re* Orion Pictures Corp.), 4 F.3d 1095, 1098 (2d Cir. 1993) (emphasizing importance of trustee or debtor-in-possession sorting through valuable contracts to determine which would be most beneficial for estate).

[167] *In re CoServ*, 273 B.R. at 497; *see, e.g., In re* J.T. Rapps, Inc., 225 B.R. 257, 262 n.9 (Bankr. D. Mass. 1998) (asserting court's authority under section 105(a) to implement appropriate remedy under Code).

[168] *In re CoServ*, 273 B.R. at 497 (commenting on other courts' applications of doctrine of necessity principles and noting no clear standard existed). *Compare* Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir.1987) (mentioning court's ability to use innovative solutions regarding equitable powers from section 105(a)) *with In re* Chicago, Milwaukee, St. Paul & Pacific R.R., Co., 791 F.2d 524, 528 (7th Cir. 1986) (warning of limits to court's "free-floating" discretion in equitable proceedings).

[169] *In re CoServ*, 273 B.R. at 498.

[170] *Id*. at 498 (recognizing not all will satisfy said requirement).

[171] *Id*.

[172] *Id*. at 498–99 (requiring debtor show payment of pre-petition claim will provide gain).

[173] *Id.* (mandating debtor show payment of pre-petition claim will prevent harm).

[174] *In re CoServ*, 273 B.R at 498–99 (utilizing example as illustrative of second test prong).

[175] *Id*.

[176] *Id.* (establishing satisfaction of pre-petition payments as last resort to be granted by court when no other "devices" are available).

[177] *Id.* (noting payment could be in form of "a deposit, collect on delivery terms and payment on shipment.").

[178] *Id.* (noting availability of mechanisms to shirk immediate monetary obligations).

One wonders, however, whether the court is naïve about operating capital needs. COD and deposits require cash, which often is in short supply after filing. Additionally, consignment may draw the objection of the Unsecured Creditors Committee. Though this situation should not justify pre-petition payments, the alternative "devices" realistically may be not as unlimited as the court believes.

Applying the test to the facts at hand, the court found that: 1) alternatives to payment existed in most cases, 2) certain vendors did not plan to discontinue service to the debtors, or 3) alternative suppliers for certain products could be used.[179] The vendors who were denied payment included a construction firm, a credit card payment processor, software consultants, a warehouse operator and a telecommunications service provider.[180] A sixth claimant was an employee under contract owed $3,500.[181] The court approved what it considered to be a small payment as either a contract assumption or a wage payment.[182] The sole critical vendor was a traffic engineer with specialized knowledge of the debtors' operations.[183] The likely deciding factor in approving payment, the court wrote, was the fact that the engineer provided his services at cost.[184] It is unclear from the decision why the engineer, a former employee of the debtor, requested no profit for his efforts, but, the court found, the debtor would unlikely be able to enter into such a favorable arrangement elsewhere.[185] The court's elusive practical alternative prong was therefore met by this vendor.[186] Payment was conditioned on the continuation of the service agreement through calendar year 2002.[187]

While this author applauds the *CoServ* court's insight, some of its reasoning remains puzzling. Though section 1107(a) does indeed mandate that the debtor in possession act as a fiduciary,[188] it is unlikely that substituting this catalyst for the concept of "necessity" in the section 105 equation is an improvement. Both concepts, properly argued, can be used to justify a seemingly endless series of court

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[179] *In re CoServ*, 273 B.R. at 499–501 (explaining why debtors have failed to demonstrate prepayment of claim is necessary).

[180] *Id.* at 500–01 (indicating situations in which pre-petition payment was denied).

[181] *Id*. at 501 (noting claimant in this instance was employee to which $3500 was owed).

[182] *Id.* (stating motion granted as to payment for this contract employee given the small amount of claim).

[183] *Id.* at 500 (illustrating critical nature of this vendor as he possessed unique knowledge of debtor's operation thus payment was approved).

[184] *In re CoServ*, 273 B.R. at 500. (mentioning engineer provided services for cost, deriving no profit from inimitable relationship with debtor).

[185] *Id*. (relaying debtor unlikely to find another such agreement in which vendor provides services at cost).

[186] *Id.* (emphasizing debtor demonstrated lack of practical alternatives to vendor who provided his services to debtor without deriving profit).

[187] *Id*. (providing pre-petition payment subject to debtor maintaining existing relationship with vendor throughout 2002 at a minimum). The Southern District of Texas has also restricted pre-petition payments. *See, e.g., In re* Tri-Union Dev. Corp., 253 B.R. 808, 815 (Bankr. S.D. Tex. 2000) (indicating payment denied because debtor had no authority to pay interest owners), *In re* Equalnet Communications Corp., 258 B.R. 368, 369–71 (Bankr. S.D. Tex. 2000) (explaining payment relief limited to situations falling within exceptions to nonpayment rule).

[188] 11 U.S.C. § 1107(a) (2002) (providing debtor in possession has all the duties of a trustee with three exceptions; *see* 11 U.S.C. § 1106 (2002) (enumerating trustee duties).

actions that would improve the debtor's position. What matters most is the court's initial argument: the Code does not list within its many exceptions one for critical vendors.[189]

B. Payless Cashways, Inc.

The proponents of critical vendor payments were given a new arrow in their quivers with the 2001 decision of the Bankruptcy Court for the Western District of Missouri in *In re Payless Cashways, Inc*.[190] The judge approved the debtor's motion pursuant to the lending provisions of Code section 364(b).[191] "That section grants the Court broad authority, at the outset of a case, to approve borrowing arrangements that are found to be in the best interest of the debtor, its estate and its creditors."[192] In exchange for at least partial, immediate payment of their pre-petition claims, the debtor's suppliers agreed to extend industry standard trade credit in an amount at least equal to each of its claims, with payment due one or two months after delivery.[193] No mention was made of section 105(a) or the doctrine of necessity.[194]

The *Payless* court also found support for its actions in Code section 549, which allows the trustee in a chapter 7 case to reverse "only those post-petition payments of pre-petition obligations that are 'not authorized under this title or by the court.'"[195] From this, the court claimed that it "has some limited power to authorize preferential treatment to certain creditors."[196] The court conveniently failed to explain why this was relevant in the chapter 11 matter before it.

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[189] *In re Coserv*, 273 B.R. at 493–94 (finding nothing in the Code supports payment of pre-petition claims for critical vendors). *But see In re* Payless Cashways Inc., 268 B.R. 543, 544–47 (Bankr. W.D. Mo. 2001) (mentioning Code recognizes and thus courts have permitted, where appropriate, pre-petition payment to creditors when services are deemed critical); *In re* Just For Feet Inc., 242 B.R. 821, 826 (Bankr. D. Del. 1999) (granting motion for pre-petition claims for creditors whose products were deemed essential to the maintenance of debtor's business).

[190] 268 B.R. 543, 544 (Bankr. W.D. Mo. 2001).

[191] *Id*. at 544 (approving debtor's motion to grant priority to certain vendors pre-petition claims); *see* 11 U.S.C. § 364(b) (2002) ("The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.").

[192] *In re Payless Cashways*, 268 B.R. at 544.

[193] *Id.* at 545 (explaining debtor's proposed plan to pay critical vendors debtor claimed to be necessary to continuance of debtor's business).

[194] *Id.* 543–48 (making no reference to either section 105(a) or to necessity doctrine); *see also* Nathan, *supra* note 2, at14 (stating *In re Payless Cashways* decision was not based upon section 105(a)); WILLIAM J. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE § 85:6 (2d ed. 2003) (describing how court in *Payless* authorized pre-petition claims on different basis than section 105(a) or doctrine of necessity).

[195] *In re Payless Cashways*, 268 B.R. at 546; *see also* Baxter Dunaway, 2 THE LAW OF DISTRESSED REAL ESTATE § 24:92 (2002) ("Section 549(a)(B) (sic) allows a court to authorize a transfer from the bankruptcy estate."); Duncan E. Osborne & Elizabeth Morgan Schurig, 1 ASSET PROTECTION: INTERNATIONAL LAW AND POLITICS, § 3:18 (2003) (stating trustee can avoid certain pre-petition transactions).

[196] *In re Payless Cashways*, 268 B.R. at 546.

The substitution of 364(b) for 105(a) does not solve the underlying shortcomings of this approach. Though the Code confers considerable power to the court in various areas, this power cannot legally be used to achieve a result otherwise prohibited by the Code.[197]

C. *Enron, Worldcom* and *Kmart*: Attack of the Clones

These high-profile cases did not advance any new legal theories, but their inclusion here demonstrates the pervasiveness of requests for critical vendor payments. Each of the three companies, whose filings and astounding levels of debt were front page news, made similar motions for pre-petition payment relief, and all were granted easily.[198] This despite the admission of the *Kmart* court that "[m]otions to pay certain critical trade creditors always present difficult questions for courts. We're seeing more and more of them, and our problem is that we have to stretch to find some authority to do them."[199] The court decided that section 105 was sufficient to authorize the payment of Kmart's trade creditors.[200]

1. Kmart's Order Reversed: A New Hope

An encouraging development is the reversal on appeal of that particular order.[201] Fourteen and a half months after the debtor's critical vendor motion was approved, the District Court for the Northern District of Illinois reversed the order and directed the return of the monies paid.[202] The appellant, Capital Factors, Inc., was a factoring agent that purchased accounts receivable from some of Kmart's clothing vendors.[203] Its unsecured claims were valued at $20 million.[204] Appellant objected to the critical vendor motion in the bankruptcy court.[205]

The district court cited Seventh Circuit and Supreme Court precedent to support its assertion that a court using section 105 may enforce the Bankruptcy Code but not

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[197] *See* Dunivent v. Schollett (*In re* Schollett), 980 F.2d 639, 645 (10th Cir. 1992) (holding court did not have power of review in area where discretion granted to Attorney General); U.S. v. Wood, 161 B.R. 17, 21 (Bankr. D.N.J 1993) (holding Court has no power to review fees set by Attorney General); *see also supra* note 153.

[198] *See In re* Worldcom, Inc., 2002 WL 1732647 at *1–2 (S.D.N.Y. Jul 22, 2002) (No. 13533(AJG)) (granting motion for payment of pre-petition debts); Order Authorizing the Payment of Prepetition Claim of Certain Critical Trade Vendors, *In re* Kmart Corp., (Bankr. N.D. Ill. Jan. 25, 2002) (No. 02 B 02474 (SPS)) (granting motion for payment of pre-petition debts); Order Granting Motion to Pay Prepetition Claims of Critical Vendors; *In re* Enron Corp. (Bankr. S.D.N.Y. December 3, 2001) (Case No. 01-16034 (AJG)), *available at* http://bank.elaw.com/default.asp (granting motion for payment of pre-petition debts).

[199] Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 820 (N.D. Ill. 2003).

[200] *Id*.

[201] *Id.* at 820 (reversing bankruptcy court's orders to pay pre-petition obligations).

[202] *Id.* at 825.

[203] *Id.* at 820.

[204] *Capital Factors,* 291 B.R. at 820.

[205] *Id.*

amend it.[206] The court pointed to the Code's claim priority scheme and noted that the bankruptcy court's order rewrote that scheme.[207] After briefly noting the decisions of some bankruptcy and district courts favoring the authority to pay pre-petition claims prior to the plan,[208] the court listed decisions from the Fourth, Fifth and Ninth Circuit Courts of Appeal and those of lower courts that reached a different result.[209] The district court sided with the latter group, citing a decision in its own circuit regarding equitable power, which stated, "[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be."[210] The court recognized that paying critical vendors is "well-intended and may have some beneficial results"[211] regarding the debtor's reorganization plans but warned, "[n]evertheless, it is clear that however useful and practical these payments may appear to bankruptcy courts, they simply are not authorized by the Bankruptcy Code. Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment of pre-petition unsecured claims."[212]

Kmart argued that the issue was "'equitably moot'" because many of the critical vendor claims had already been paid.[213] It claimed that the third party vendors had

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[206] *Id.* at 822 (citing *In re* Fesco Plastics Corp., 996 F.2d 152 (7th Cir. 1993) and Gouveia v. Tazbir, 37 F.3d 295 (7th Cir. 1994), which itself cited Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988), which denied the retention of an equity interest by chapter 11 debtors due to absolute priority).

[207] *See Capital Factors*, 291 B.R. at 822.

[208] *Id.*; s*ee also In re* CoServ, L.L.C., 273 B.R. 487, 493–94 (Bankr. N.D. Tex. 2002) (indicating payment of pre-petition claims is inconsistent with Bankruptcy Code but nevertheless appropriate in extraordinary circumstances); *In re* Wehrenberg, Inc., 260 B.R. 468, 469 (Bankr. E.D. Mo. 2001) (holding payment of pre-petition claims was necessary to realize possibility of successful reorganization); *In re* Just For Feet, Inc., 242 B.R. 821, 826 (Bankr. D. Del. 1999) (stating retail shoe store chain could not survive without making pre-petition payments to brand-name shoe vendors under 11 U.S.C. § 105(a)); *In re* Chateaugay Corp., 80 B.R. 279, 280 (S.D.N.Y. 1987) (affirming bankruptcy court decision allowing pre-petition payment of wages, salaries and employee benefits).

[209] *See Capital Factors*, 291 B.R. at 822–23; *see also* Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) (holding creation of pre-plan fund to benefit claimants purportedly injured by Dalkon Shield contraceptive device violated clear language and intent of Bankruptcy Code); Chiasson v. J. Louis Matherne & Assocs. (*In re* Oxford Mgmt. Inc.), 4 F.3d 1329, 1334 (5th Cir. 1993) (rejecting bankruptcy court decision allowing debtor to pay real estate broker for pre-petition claims using post-petition funds); B & W Enters., Inc. v. Goodman Oil Co. (*In re* B & W Enters., Inc.), 713 F.2d 534, 538 (9th Cir. 1983) (affirming district court's ruling in favor of trustee seeking to avoid and recover payments made to creditors on pre-petition debts); *In re* Timberhouse Post & Beam, Ltd., 196 B.R. 547, 550-51 (Bankr. D. Mont. 1996) (indicating debtor's post-petition request to pay pre-petition claims was inconsistent with Bankruptcy Code); *In re* FCX, Inc., 60 B.R. 405, 412 (Bankr. E.D.N.C. 1986) (rejecting bankruptcy court holding allowing debtor to pay certain pre-petition debts such as payroll taxes).

[210] *Capital Factors,* 291 B.R. at 823 (quoting *In re* Chicago, Milwaukee, St. Paul & Pac. R.R. Co., 791 F.2d 524, 528 (7th Cir. 1986)).

[211] *Capital Factors,* 291 B.R. at 823.

[212] *Id.*

[213] *Id.* at 823–24; *cf. In re* S.S. Retail Stores Corp., 216 F.3d 882, 884–85 (9th Cir. 2000) (stating disgorgement of claims already paid by debtor to bankruptcy counsel was not equitably moot but other equitable considerations prevented such disgorgement).

relied to their detriment on the payments.[214] The doctrine of equitable mootness calls for consideration of how equitable relief will affect third parties.[215] The court rejected the argument because where, as here, the reorganization plan had not been approved, there was still time to recover the payments.[216]

The court also was not swayed by the debtor's "doomsday speculations" that it would have to bring suit against thousands of vendors.[217] The court noted that the bankruptcy court itself should have sufficient power to demand repayment.[218] The court also overturned lower court orders authorizing other pre-petition payments to foreign vendors and letter of credit issuers.[219] Kmart subsequently filed a complaint with the court against at least one of its vendors for the return of money paid.[220]

Kmart's plan of reorganization was confirmed in April, 2003, two weeks after it appealed the reversal of the critical vendor order.[221] Oral arguments in the appeal will likely proceed in late 2003 or early 2004.[222]

IV. RECOMMENDATIONS

A. Utilize Alternatives

This author finds the arguments against critical vendor payments thoroughly convincing. While filing for chapter 11 must be incredibly taxing for troubled companies, they, and not their creditors, bear the most fault for their predicament.

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[214] *See Capital Factors*, 291 B.R. at 824.

[215] *Id.* at 823; *see also In re* PWS Holding Corp. 228 F.3d 224, 235–36 (3d Cir. 2000) (stating appeal should be dismissed under doctrine of equitable mootness even if court has jurisdiction and can provide relief but implementation of such relief would be inequitable); *In re* Cont'l Airlines, 91 F.3d 553, 560 (3d Cir. 1996) (stating foremost consideration in determining whether matter is equitably moot is whether reorganization plan has been substantially consummated).

[216] *Capital Factors*, 291 B.R. at 823.

[217] *Id*. at 823–24 (applying standard established in *In re* Envirodyne Indus., 29 F.3d 301 (7th Cir. 1994) and *In re* UNR Indus., 20 F.3d 766 (7th Cir. 1994), and finding substantial payment of vendor's pre-petition claims did not render creditor's appeal moot); *see also In re* Envirodyne, 29 F.3d at 304 (refusing to grant equitable relief in cases where it would bear unduly on innocent); *In re UNR*, 20 F.3d at 769 (banishing "equitable mootness" from local lexicon and deciding to grant equitable relief when prudent and fair).

[218] *Capital Factors*, 291 B.R. at 824 (noting debtor did not cite to a case prohibiting bankruptcy court from ordering return of money).

[219] *Capital Factors*, 291 B.R. at 825. The doctrine of necessity is applied to support payments to foreign vendors, against which courts have little leverage due to a lack of jurisdiction. Technically, though, section 362's automatic stay provisions are applicable worldwide; *see* Eisenberg & Gecker, *supra* note 5, at 16–17; Allan L. Gropper, *The Bankruptcy Code's Approach to Multinational Bankruptcies: Basic Legal Framework*, 628 PLI/COMM 49 (1992) (focusing on developing practice strategies for international bankruptcy); *see also In re* Startec Global Communications Corp., 292 B.R. 246 (Bankr. D. Md. 2003) (dealing with intersection of critical vendor orders and issuance of letters of credit).

[220] Press Release, Kmart Corporation, Kmart Seeks Recovery of Payment, *available at* http://www.kmartcorp.com/corp/story/pressrelease/news/pr030630.stm (June 30, 2003).

[221] *See* Thomas J. Salerno, *"The Mouse That Roared" Or, "Hell Hath No Fury Like a Critical Vendor Scorned"*, AM. BANKR. INST. J., June 2003, at 29 (noting plan was confirmed on April 22, 2003).

[222] *See generally* Court Calendar, United States Court of Appeals for the Seventh Circuit, *available at* http://www.ca7.uscourts.gov (last visited November 21, 2003).

A corporate debtor enjoys many advantages under the Code that its unsecured creditors, most of whom may receive nothing, do not. One such advantage stems from the pre-petition period, which can last up to several months, during which the debtor can plan its bankruptcy. This lead time should allow debtors to extensively explore its alternatives. Chief among them is the option to secure adequate post-petition financing. It is disconcerting that apparently a substantial number of debtors seeking payment of critical vendors lack such financing.[223] Having sufficient cash on hand would seem to go a long way toward easing trade vendor disputes. Surely only the most spiteful of suppliers would refuse to do business on a cash on demand basis.

The credit provisions under section 364 are expansive, but not broad enough to override section 507 according to the court in *Payless*.[224] It is this author's belief that a debtor that cannot borrow money under 364's favorable terms has little hope of restructuring itself, regardless of whether its critical vendors are paid or not. It is a sad fact that some corporate patients are too sick to recover,[225] and prolonging the inevitable is wasteful. It is better to convert the case to a chapter 7 liquidation instead of further squandering estate assets.

On the importance of considering all possible alternatives to critical vendor payments, this author concurs with the *CoServ* court wholeheartedly. It is admittedly unclear, though, how fruitful those alternatives would be, in the most dire of cases.

B. Washington Should Intervene

This author also agrees with commentators who urge Congress and the Supreme Court to address this issue.[226] The issue is highly controversial and judicial opinion

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[223] *See In re* Payless Cashways, Inc., 268 B.R. 543, 545 (Bankr. W.D. Mo. 2001) (failing to secure any post-petition financing, debtor sought to use cash collateral in paying pre-petition claims); *In re* Just For Feet, Inc., 242 B.R. 821, 823 (Bankr. D. Del. 1999) (having received $25 million in post-petition financing, debtor was nevertheless unable to conduct business on cash advance basis and sought, therefore, sanction of pre-petition payments in order to secure favorable credit terms).

[224] *In re Payless Cashways*, 268 B.R. at 546–47 (finding section 346(b) grants broad discretion and listing factors courts should consider in approving preferential payment to suppliers).

[225] *See In re* Jones, 115 B.R. 351, 352–53 (Bankr. N.D. Fla. 1990*)* ("Bankruptcy Code does not guarantee successful reorganization, nor does it provide framework within which debtor may indefinitely operate; rather, it only provides breathing period for debtor to attempt to reorganize."); *In re* BGNX, Inc., 76 B.R. 851, 853 (Bankr. S.D. Fla. 1987) ("Chapter 11 provides reasonable opportunity for corporate reorganization, it does not guaranty reorganization nor does it permit indefinite suspension of creditors' rights and remedies pending unsuccessful attempts of any party to effect reorganization of debt."); *In re* Witt, 60 B.R. 556, 561 (Bankr. N.D. Iowa 1986) ("The Bankruptcy Code does not guarantee a successful reorganization, nor does it provide a framework within which a debtor may indefinitely operate. It only provides a breathing period for a debtor to attempt to reorganize.").

[226] *See generally* Patricia L. Barsalou, *Preferential First Day Orders – A Question for Congress,* 13 AM. BANKR. L. J.19 (1994) (describing courts of appeal's strict adherence to Bankruptcy Code as compared with lower courts that often authorize payment, and speculating whether lower courts are asking Congress to intervene); Barsalou & Mosner, *supra* note 2, at 52 (calling on courts to enforce Code as written in order to

is in flux. The growing popularity of essential vendor motions means that at least some parties in interest are enduring treatment that the drafters of the Code did not intend.[227] This aspect of bankruptcy should be receiving the attention of U.S. bankruptcy reformers instead of chapter 7 means testing.[228] The Code is not perfectly drafted but it still is a finely tuned document. Had Congress intended critical vendors to enjoy preferential treatment, it could have easily provided for such, as it did when it established the Code's payment priority scheme. To maintain that courts were given the power to act contrary to the Code's specific restrictions is nonsensical.

C. Creditor Consent[229]

While the analysis of courts affirming the critical vendor doctrine is flawed, some deserve credit for at least considering the wishes of creditors adversely affected by critical vendors. Payment in full of critical vendors reduces the estate available to other creditors upon confirmation of a plan. Hardest hit are the other unsecured creditors, as they may collect nothing if higher priority claims are paid first. The Unsecured Creditors Committees, in some of the cases cited herein, assented to the debtors' critical vendor motions.[230] When deciding whether to pay critical vendors, "the views of the creditor body are critical."[231]

Though the *CoServ* court would disagree,[232] this author maintains that in the rare instances when all parties agree that critical vendor payments would be acceptable, then they should be able to fashion an alternative to the requirements of the Code. Creditors should not be prohibited from waiving their legal rights if they

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draw Congress's attention to pre-petition payments); White & Medford, *supra* note 2, at 24 (recognizing call by some for Congress to consider codifying doctrine of necessity for all chapter 11 cases).

[227] Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) (rejecting doctrine of necessity and holding Bankruptcy Code does not permit selective pre-petition payments to unsecured creditors); *In re* Revco D.S., 91 B.R. 777, 780 (Bankr. N.D. Ohio 1988) (denying motion to authorize pre-petition claims finding no authority under Bankruptcy Code or case law to permit payment); *In re* FCX, Inc., 60 B.R. 405, 412 (E.D.N.C. 1986) (reversing order allowing pre-petition payments, holding it "inequitable to settle certain claims prior to filing reorganization plan.").

[228] For discussions on recent efforts to revise the Bankruptcy Code, see Kent Hoover, *Bankruptcy Reform May Find That its 'Loser' Label is Hard to Shake,* PITTSBURGH BUSINESS TIMES (December 6, 2002), *available at* http://pittsburgh.bizjournals.com/pittsburgh/stories/2002/12/09/focus7.html and Paul Gores, *Bankruptcy Reform Likely to Surface Again Next Year,* MILWAUKEE JOURNAL SENTINEL (November 23, 2002), *available at* http://www.jsonline.com/bym/news/nov02/98044.asp?format=print.

[229] The author concedes that this argument is his weakest, as it would be unwieldy at the beginning of a large case to solicit the approval of the entire creditor body, and because it softens his hard-line stance against critical vendor payments. It is offered for the purpose of discussion and in an attempt to offer a solution, that while not perfect, is better than some currently practiced**.**

[230] *See In re Payless Cashways*, 268 B.R. at 546 (noting committee agreed to modified proposal); *In re* Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (discussing persuasive element of motions supported by committee); *see also In re* Coserv, L.L.C*.,* 273 B.R. 487, 490 (Bankr. N.D. Tex. 2002) (where committee suggested expansion of "critical vendors" category).

[231] *In re Payless Cashways*, 268 B.R. at 547.

[232] *See In re CoServ,* 273 B.R. at 490–91 ("[T]he Court has an independent obligation to ensure that the Bankruptcy Code is complied with," even when the motion is unopposed).

so wish. Section 1129(a)(7)(A)(i), after all, in the context of plan confirmation, allows an impaired class to collect less than that to which it is entitled, if all members of the class consent.[233] Presumably there will be circumstances that will arise in which all unsecured creditors will believe that paying critical vendors will assist in the debtor's reorganization and increase the chances of an eventual payout to other creditors. Allowing pre-petition payments may then be warranted.

The bankruptcy case need not be hamstrung by the Code if informed negotiation may benefit all relevant parties. But where there are objections to the payments, including those of the US Trustee in the case, the scheme should not stand. To that end, the critical vendor motions should not be presented without adequate notice to all creditors, even if it means separating them from other "first day" motions, which are often *ex parte*.[234] One must guard against relying solely on the consent of the Unsecured Creditors Committee, which will likely number among its members alleged critical vendors.[235] It would seem removal from the committee is a reasonable remedy for such vendors, as their interests clearly conflict with some they represent.[236]

CONCLUSION

The pace at which critical vendor motions are being approved does not seem to be abating. The Enron and Worldcom cases demonstrate that as the size of bankruptcy estates increases, so does the injustice of courts paying so-called critical vendors upon the commencement of the case. In certain cases, paying pre-petition claims gives the debtor a sorely needed boost in its bid to survive. But at what cost? As shown above, this casual extension of the doctrine of necessity rests on quicksand— the Code does not provide for it, and it flies in the face of the Code's insistence that all similarly situated creditors be treated equally.[237] Section 507 explicitly lists the priority scheme for payment of unsecured claims.[238] Nowhere in that section or anywhere else in the Code is there a preference for critical

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[233] 11 U.S.C. § 1129 (a)(7)(A)(i) (2002).

[234] *See supra* note 2 and accompanying text.

[235] *In re CoServ*, 273 B.R. at 490.

[236] *See In re* Am. W. Airlines, 142 B.R. 901, 902 (Bankr. D. Ariz. 1992) (granting U.S. Trustee authority to remove members of official committees); *In re* Seaescape Cruise, Ltd., 131 B.R. 241, 242–43 (Bankr. S.D. Fla. 1991) (discussing factors in determining whether an unsecured creditor is adequately represented); *In re* Walat Farms, Inc., 64 B.R. 65, 69–70 (Bankr. E.D. Mich. 1986) (warning of potential for conflicts of interests when unsecured creditor sits on committee).

[237] *See* Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 823 (N.D. Ill. 2003) (noting Congress has not elected to codify "doctrine of necessity"); *see also* Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) (holding clear language of statutes and Bankruptcy rules did not permit creation of Emergency Treatment Fund); *In re* B & W Enters., Inc., 713 F.2d 534, 537 (9th Cir. 1983) (declining to extend necessity of payment rule to non-railroad organizations because Code does not provide for it).

[238] 11 U.S.C. § 507 (2002).

vendors.[239] Unsecured creditors are unsecured creditors, regardless of the instrumental value of their products. Though section 105(a) is designed to further the goal of reorganization in chapter 11 cases,[240] it should not shatter the system carefully designed by its drafters.

Until and unless Congress amends the Code to give vendors with extraordinary leverage the right to jump the line for claim payments, courts have no business rewriting the Code themselves in misguided attempts to save the debtor. Debtors, while vulnerable, have access to an arsenal of impressive resources under the Code as it is written. If these are not sufficient, then either the business is not worth saving or Congressional intervention is needed. A Supreme Court ruling on the matter, in the meantime, would also help restore common sense to the bankruptcy courtroom and provide stability to the Code.

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[239] *See Capital Factors*, 291 B.R. at 823 (noting Congress has not elected to codify "doctrine of necessity"); *Mabey*, 832 F.2d at 302 (holding clear language of statutes and the Bankruptcy rules did not permit creation of Emergency Treatment Fund); *In re B & W Enters.*, 713 F.2d at 537 (declining to extend necessity of payment rule to non-railroad organizations because Code does not provide for it).

[240] *See* Eisenberg & Gecker, *supra* note 5, at 4; *supra* notes 106–129 and accompanying text.