

**CRITICAL VENDOR AND RELATED ORDERS:
KMART AND THE BANKRUPTCY ABUSE PREVENTION
AND CONSUMER PROTECTION ACT OF 2005**

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INTRODUCTION

A business that files a petition under chapter 11 of the Bankruptcy Code in an effort to reorganize its affairs generally may not make any payments or other distributions on account of pre-petition claims except pursuant to a plan of reorganization that has been confirmed by a bankruptcy court. Since a business reorganization case may last many months, pre-petition creditors frequently must wait an extended period of time before they receive any distributions from the reorganized entity.

It has long been argued, however, that there are several classes of pre-petition creditors whose claims must be paid in the ordinary course, prior to confirmation of a plan, if the business is to have any realistic chance of successfully reorganizing. For instance, pre-petition obligations to employees on account of accrued salaries, wages, vacation time, business expenses, insurance, and other benefits must be honored in the ordinary course, without interruption. If they are not, there is a significant risk that employee morale will be so negatively affected that key employees will depart and the business will suffer at a time when it needs the undivided attention and dedication of its employees.

The problem facing those who advance such arguments is that there has been disagreement among courts regarding whether the Bankruptcy Code authorizes a debtor to honor pre-petition obligations outside of a plan and, if so, what standard should govern payment of pre-petition claims in such circumstances. The legal justification for such payments has become the focus of increased attention and criticism by bankruptcy judges and practitioners in recent years, in part because of the Seventh Circuit's decision in *In re Kmart*¹ affirming the district court's reversal of a series of bankruptcy court orders authorizing the payment of pre-petition claims on the first day of the case.²

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¹ 359 F.3d 866 (7th Cir. 2004), *cert. denied*, 543 U.S. 986 (2004).

² See *id.* at 874 ("[P]referential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors. This record does not, so the critical-vendors order cannot stand."); see also *In re CEI Roofing, Inc.*, 315 B.R. 50, 53–60 (Bankr. N.D. Tex. 2004) (discussing holding of *Kmart* but refusing to extend its holding to case at bar); Hon. Roger M. Whelan, *Caveat Vendor: Doctrine of Necessity Down But Not Out*, AM. BANKR. INST. J., Apr. 2004, at 18 (discussing holding of *Kmart* and various foundations upon which it rests).

A number of practitioners and other restructuring specialists have suggested that the Seventh Circuit's decision represents not only a significant curtailment of a debtor's ability to pay pre-petition claims outside the context of a plan, but the possible end of this practice altogether.³ While the decision certainly is significant, some of these interpretations of the Seventh Circuit's decision are overdrawn. In fact, the *Kmart* decision is the only court of appeals ruling that clearly delineates, albeit in dictum, the circumstances under which payments may be made to pre-petition creditors outside the context of a plan.

One of the key concerns voiced by the Seventh Circuit and other courts in connection with debtors' proposals to honor unsecured, pre-petition obligations prior to plan confirmation is that such proposals, if allowed, accord a priority to creditors that is not sanctioned by the Bankruptcy Code. These concerns—which are entirely legitimate—warrant renewed examination in light of the recent enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") which, among other things, accords priority to certain pre-petition claims of creditors on account of goods shipped prior to the petition date, and which arguably expands the circumstances under which reclamation rights may be asserted.

This concern also warrants renewed examination in light of the Supreme Court's recent ruling in *Howard Delivery Service, Inc. v. Zurich American Insurance Co.*⁴ that an insurance carrier's pre-petition claim for unpaid workers' compensation premiums did not qualify for priority treatment under section 507(a) of the Bankruptcy Code, which accords a limited priority for claims for unpaid contributions to employee

³ See, e.g., *In re Am. Plumbing & Mech., Inc.*, 323 B.R. 442, 459 n.24 (Bankr. W.D. Tex. 2005) ("The propriety of paying any pre-petition claims post-petition has been called into serious question by the Seventh Circuit in *In re Kmart*."); Anthony Michael Sabino, *The Death of Critical Vendor Motions and the Potential Demise of the Doctrine of Necessity: Farewell to Two Misbegotten Doctrines*, 6 TRANSACTIONS: TENN. J. BUS. L. 47, 82 (2004) (analyzing Seventh Circuit's decision rejecting section 364(b) "as a valid basis for critical vendor payments," and refusing to follow "similar cases for their contrary reasoning."); James H. M. Sprayregen, et al., *Down, But Not Out: The Status of Critical-vendor Payments Post-Kmart*, AM. BANKR. INST. J., June 2004, at 26 (asserting despite Seventh Circuit's decision, allegations of abolition of critical-vendor doctrine are "exaggerated and without any merit."); H. Bradley Staggs, *Critical-vendor Orders: Has the Seventh Circuit Put Such Orders on the Critical List?*, AM. BANKR. INST. J., Apr. 2004, at 16, 66 (stating that while Seventh Circuit's decision "shut the door" to attempts by debtors to use doctrine of necessity to authorize entry of critical vendor orders, it may have "opened a window" for debtor to argue that section 363(b)(1) authorizes such entry); Whelan, *supra* note 2, at 18 (recognizing although decision of Seventh Circuit may preclude critical vendor payments under section 105(a), such payments may be made under section 363(b)(1)); Andrew J. Currie & Sean McCann, *Hold on to Those Payments, Critical Vendors: Capital Factors v. Kmart*, AM. BANKR. INST. J., June 2003, at 36 (alleging if decision by Seventh Circuit is upheld, it would eliminate critical vendors and treat them "just like every other unsecured creditor").

⁴ 126 S. Ct. 2105 (2006).

benefit plans.⁵ In support of its holding, the Court stated that "preferential treatment of a class of creditors is in order only when *clearly* authorized by Congress."⁶

This article provides an analysis of each of these and related issues. Specifically, Sections I and II provide a comprehensive, circuit-by-circuit overview of published case authority relating to the propriety of a debtor's proposed payment of pre-petition claims outside the context of a chapter 11 plan, including the standards enunciated by recent court decisions in this area. Section III summarizes certain sections of BAPCPA and analyzes how such sections arguably may make it easier for a debtor to obtain permission to honor certain pre-petition obligations prior to plan confirmation.

While BAPCPA may make it easier to obtain such authority in limited circumstances, there still is significant skepticism regarding the propriety of a doctrine that allows pre-plan payments to creditors who ostensibly are "critical" to the reorganization effort and how any such doctrine should be applied. Sections IV and V of this article, therefore, outline two arguments in support of the doctrine that practitioners can utilize when confronted by a court that is reluctant to recognize the viability of the doctrine, including arguments based on the history of the Code and BAPCPA. As pointed out in Section VI, however, the Supreme Court's recent admonitions in *Zurich American* against affording preferential treatment to creditors not sanctioned by the explicit language of the Bankruptcy Code could lead to even further restrictions on the practice of paying pre-petition claims prior to plan confirmation.

I. OVERVIEW OF CASES

Almost all of the published cases dealing with payment of pre-petition claims outside the context of a plan have arisen in only two contexts: those where a debtor sought authority to honor either (i) pre-petition obligations to employees⁷ or (ii) pre-petition obligations to so-called "critical" or "essential" vendors.⁸ However, there are other groups of creditors who may be equally essential to a debtor's reorganization efforts and whose pre-petition claims therefore may warrant payment, including customers holding pre-petition warranty or rebate claims; shippers or warehousemen with possessory liens on goods in transit; and foreign creditors who may not be easily subjected to the jurisdiction of the bankruptcy court and the strictures of the automatic stay.

The Bankruptcy Code makes no distinction among these various classes of creditors, at least insofar as the pre-plan payment of their claims is concerned. A court

⁵ *Id.* at 2109 (finding workers' compensation insurance premiums ineligible because they were more like "premiums paid for other liability insurance" than "contributions to secure employee retirement, health and disability benefits"). See generally 11 U.S.C. § 507(a)(5) (2006) (giving fifth order priority to "unsecured claims for contributions to an employee benefit plan"); 4 COLLIER ON BANKRUPTCY ¶ 507.06[1] (Alan N. Resnick et al. eds., 15th ed. rev. 2006) (discussing types of employee benefit plans eligible for priority status).

⁶ *Zurich Am.*, 126 S. Ct. at 2109 (emphasis added).

⁷ See *infra* note 37 and accompanying text.

⁸ See *infra* note 41 and accompanying text.

decision addressing only critical vendors or employee obligations, therefore, has much broader ramifications for all classes of creditors who may be essential to continued operation of a debtor's business. Thus, the authorities outlined herein are applicable to a larger range of circumstances than their facts may suggest.

Courts in all but the District of Columbia, the First and the Tenth Circuits have published decisions relating to the propriety of a debtors' payment of pre-petition claims outside the context of a plan. However, the reasoning and standards utilized by the courts that have spoken on the issue are not uniform, and many of the decisions have been rendered by lower courts rather than Circuit courts. Courts in the Second and the Third Circuits have long recognized that reorganizing debtors may honor pre-petition obligations outside the context of a plan if necessary to the reorganization.⁹

Courts in the Fourth Circuit have issued rulings that are difficult to reconcile with one another, with the court of appeals holding that section 105(a) of the Bankruptcy Code affords no authority for a debtor to pay pre-petition claims prior to plan confirmation, and two lower courts recently holding that such payments may be made in limited circumstances.¹⁰ There is a similar conflict in the Fifth Circuit, where the court of appeals took a relatively dim view of section 105(a) of the Bankruptcy Code

⁹ See, e.g., *In re Lehigh & New Eng. Ry. Co.*, 657 F.2d 570, 581 (3d Cir. 1981) (authorizing payment to creditors under "necessity of payment" doctrine where payment "is in the interest of all parties . . . [and] will facilitate the continued operation of the railroad"); *Dudley v. Mealey*, 147 F.2d 268, 271 (2d Cir. 1945) (granting priority status to supply creditors where services or goods were necessary to ensure continued operation of hotel); *In re Just for Feet, Inc.*, 242 B.R. 821, 826 (D. Del. 1999) (authorizing payment of pre-petition claims to specific trade vendors that were "essential to the survival of the debtor during the [c]hapter 11 reorganization"); *Billmire vs. Scharffenberger (In re Allegheny Health, Educ. & Research Found.)*, 313 B.R. 673, 678 (Bankr. W.D. Pa. 2004) (requiring showing of "extraordinary circumstances" in order to warrant authorization of post-petition payment of pre-petition debt and finding such circumstances lacking); *In re C.A.F. Bindery, Inc.*, 199 B.R. 828, 834-35 (Bankr. S.D.N.Y. 1996) (explaining "mere convenience, without necessity" is not enough to warrant authorization of payment of pre-petition claims under "doctrine of necessity"); *In re Columbia Gas Sys., Inc.*, 171 B.R. 189, 192 (Bankr. D. Del. 1994) (adhering to "necessity of payment doctrine" and denying "best interests of the estate" as standard to authorize payment of pre-petition refund obligations to customers); *Pension Benefit Guar. Corp. v. Sharon Steel Corp. (In re Sharon Steel Corp.)*, 159 B.R. 730, 736-37 (Bankr. W.D. Pa. 1993) (justifying debtor's payment to pre-petition wage claimants under "the 'necessity of payment' doctrine [as] a narrow exception to the rule prohibiting such payments . . ."); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175-76 (Bankr. S.D.N.Y. 1989) (recognizing policy and goal of chapter 11, which is to rehabilitate debtor, is same as rationale for "necessity of payment rule . . . authoriz[ing] a debtor in a reorganization case to pay pre-petition claims where such payment is essential to the continued operation of the debtor."). But see, e.g., *So. Ry. Co. v. Johnson Bronze Co. (In re Johnson Bronze Co.)*, 758 F.2d 137, 141 (3d Cir. 1985) (denying authority of bankruptcy courts to "create rights not otherwise available under applicable law").

¹⁰ Compare Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) (holding Bankruptcy Code does not authorize any payment to unsecured creditors prior to reorganization), and *In re United Am., Inc.*, 327 B.R. 776, 784 (Bankr. E.D. Va. 2005) (acknowledging ability of a debtor to make pre-plan payments but finding debtor did not meet its burden on the facts before the court), and *In re FCX, Inc.*, 60 B.R. 405, 410 (Bankr. E.D.N.C. 1986) (reversing decision authorizing pre-petition payment because it would subordinate remaining unsecured creditors' claims absent requisite inequitable conduct on part of creditors), with *In re Synteen Techs., Inc.*, No. 00-02203-W, 2000 WL 33709667, at *2 (Bankr. D.S.C., Apr. 14, 2000) (requiring moving party to demonstrate that pre-petition payment would be essential to debtor's continued operation in order for court to authorize it), and *In re NVR L.P.*, 147 B.R. 126, 128 (Bankr. E.D. Va. 1992) (declaring pre-petition payment could be justified if in the best interests of both debtor and creditors).

as authority for this doctrine.¹¹ However, there are several lower court opinions in the Fifth Circuit that have authorized pre-plan payments under one or more of sections 105(a), 362(a), 363(b), 1107, and 1108 of the Bankruptcy Code. The trend of these decisions is to require satisfaction of a set of stringent standards, each of which is discussed in the next section of this article.¹²

Sixth Circuit decisions uniformly have held that pre-plan payments may be made under certain circumstances, relying in each instance on section 105(a) and the so-called "necessity of payment" rule.¹³ On the other hand, the Seventh Circuit's opinion in *Kmart* held that neither section 105(a) nor the necessity of payment rule provides authority for pre-plan payments, but stated in dictum that section 363(b) may provide an alternative basis for such authority.¹⁴ Lower courts in the Eighth Circuit, like lower courts in the Sixth Circuit, are uniform in their published decisions holding that the Code authorizes pre-plan payments.¹⁵ The Ninth Circuit has issued two separate rulings

¹¹ See *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt., Inc.)*, 4 F.3d 1329, 1334 (5th Cir. 1993) (observing Bankruptcy Code did not give bankruptcy courts authority to debtor to use post-petition funds to satisfy pre-petition claims); *United States v. Sutton*, 786 F.2d 1305, 1306 (5th Cir. 1986) (affirming district court's conclusion that Bankruptcy Code does not authorize family support payments in chapter 11 reorganization proceeding); see also *First Sw. Corp. v. Tex. Consumer Fin. Corp. (In re Tex. Consumer Fin. Corp.)*, 480 F.2d 1261, 1265 (5th Cir. 1973) (reinforcing maxim that Bankruptcy Court's equity powers must be strictly confined within prescribed limits of Bankruptcy Code).

¹² See *In re CEI Roofing, Inc.*, 315 B.R. 50, 61 (Bankr. N.D. Tex. 2004) (permitting pre-petition payment of wage claims to necessary employees under section 105 and section 507(a)(3) and (4)); *In re Mirant Corp.*, 296 B.R. 427, 429–30 (Bankr. N.D. Tex. 2003) (allowing payments to "critical vendors" outside plan subject to specified conditions); *In re CoServ, L.L.C.*, 273 B.R. 487, 498–502 (Bankr. N.D. Tex. 2002) (formulating three step "test of 'necessity' that must be met before [the court] will approve payment of a general unsecured pre-petition claim," and, accordingly, allowing portion of debtor's request). But see, e.g., *In re Equalnet Commc'ns. Corp.*, 258 B.R. 368, 370–71 (Bankr. S.D. Tex. 2000) (treating requested pre-plan payments to "necessary" contract employee as priority wage claims and applying statutory cap for such claims).

¹³ See, e.g., *In re Quality Interiors, Inc.*, 127 B.R. 391, 396 (Bankr. N.D. Ohio 1991) ("A general practice has developed . . . where bankruptcy courts permit the payment of certain pre-petition claims, pursuant to 11 U.S.C. § 105, where the debtor will be unable to reorganize without such payment."); *In re Eagle-Picher Indus. Inc.*, 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (permitting pre-petition payment of unsecured claims under section 105 where "necessary to avert a serious threat to the [c]hapter 11 process."); *In re Structurlite Plastics Corp.*, 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988) (recognizing possibility of circumstances which would necessitate authorizing payments of pre-petition claims yet declining to exercise such power in absence of exigent circumstances).

¹⁴ See *In re Kmart Corp.*, 359 F.3d 866, 871–74 (7th Cir. 2004), *cert. denied*, 543 U.S. 986 (2004) (referring to "doctrine of necessity" as merely "a fancy name for a power to depart from the Code," yet suggesting section 363 might have supported critical-vendor payments had record "shown the prospect of benefit to other creditors"). See generally Brandi McCoy, Comment, *The Last Day for First Day Orders: Attacks on the Practice of Paying Pre-petition Claims of Certain "Critical Vendors"*, 3 DEPAUL BUS. & COM. L.J. 321, 326–28 (2005) (reviewing procedural course of *Kmart*); Sprayregen, *supra* note 3, at 26, 54 (analyzing impact of Seventh Circuit's affirmation of district court's reversal of bankruptcy court order allowing pre-petition payments and suggesting *Kmart* merely raised the "procedural and evidentiary standards" for pre-petition payments to critical vendors). After the Seventh Circuit rendered its decision, *Kmart* brought suit against numerous recipients of critical vendor payments seeking recovery of amounts paid to them as improper transfers pursuant to section 549 of the Code. See *In re Kmart Corp.*, No. 02 B 02474, 2006 WL 952042 at *34 (Bankr. N.D. Ill. Apr. 11, 2006) (denying defendants' motions to dismiss because recipients of critical vendor payments, made pursuant to order later reversed, are not immune from suit demanding disgorgement of payment).

¹⁵ See, e.g., *In re Payless Cashways, Inc.*, 268 B.R. 543, 544–45, 547 (Bankr. W.D. Mo. 2001) (citing section

on the matter that arguably conflict with one another.¹⁶ And while the Eleventh Circuit has held that section 105(a) of the Code may not be utilized to alter the Bankruptcy Code's priority scheme,¹⁷ a recent lower court decision arguably did just that when it authorized critical vendor payments pursuant to both sections 105(a) and 363(b) of the Bankruptcy Code, following the Seventh Circuit's dictum in *Kmart*.¹⁸

II. THE LEGAL STANDARDS

For years, there has been little attention paid by courts to the precise standard that a debtor was required to satisfy when seeking to honor pre-petition claims of essential creditors. If the debtor established that the creditor was "critical" to its operations or "essential" or "necessary" to a successful reorganization under the "doctrine of necessity," the creditor's claim could be paid as long as the creditor agreed to provide favorable trade terms post-petition.¹⁹ Authority for such relief arguably is provided by section 105(a) of the Code, which authorizes entry of any order "necessary or appropriate" to carry out the provisions of the Code.²⁰

364(b) of Bankruptcy Code as basis for approving debtor's lending transactions in addition to authorizing debtor to pay its critical lumber vendors' pre-petition claims); *In re Wehrenberg, Inc.*, 260 B.R. 468, 469 (Bankr. E.D. Mo. 2001) (authorizing payment of pre-petition claims enabling debtor to continue receiving motion pictures for exhibition, which were necessary for debtor's successful reorganization).

¹⁶ Compare *Burchinal v. Cent. Wash. Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 1490 (9th Cir. 1987) (noting that goal of debtor rehabilitation may warrant overriding Code's general policy of equality of creditor treatment, thereby justifying payment of "pre-petition wages to key employees" and "debts to providers of unique and irreplaceable supplies"), with *B&W Enters., Inc. v. Goodman Oil Co. (In re B&W Enters., Inc.)*, 713 F.2d 534, 537 (9th Cir. 1983) (rejecting notion that pre-petition critical vendors could be paid pursuant to necessity of payment rule). At least one other bankruptcy court in the Ninth Circuit has followed *B&W*. See, e.g., *In re Timberhouse Post and Beam, Ltd.*, 196 B.R. 547, 550 (Bankr. D. Mont. 1996) (holding that priority of pre-petition unsecured claims cannot be changed by elevating them to administrative expenses).

¹⁷ *Shapiro v. Saybrook Mfg. Co., Inc. (In re Saybrook Mfg. Co., Inc.)*, 963 F.2d 1490, 1496 (11th Cir. 1992) (stating cross-collateralization (obtaining post-petition financing secured by pre-petition and post-petition assets) is inconsistent with priority scheme of Bankruptcy Code). But see Craig R. Bucki, *Survey: Cracking the Code: The Legal Authority Behind Extrastatutory Debtor-in-Possession Financing Mechanisms and Their Prospects for Survival*, 2005 COLUM. BUS. L. REV. 357, 371-72 (2005) (analyzing *Saybrook's* prohibition on cross-collateralization to be "strict textualist reading of the Code . . .").

¹⁸ See *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005). There, the court stated:

This Court finds that a bankruptcy court may utilize sections 105(a) and 363 of the Bankruptcy Code to justify the grant of critical vendor status under appropriate circumstances. Bankruptcy courts recognize that section 363 is a source for authority to make critical vendor payments, and section 105 is used to fill in the blanks.

Id.; see also *Osborne v. Howell Elec. Motors (In re Fultonville Metal Prods. Co.)*, 330 B.R. 305, 313 (Bankr. M.D. Fla. 2005) (stating payments to critical vendors are warranted in certain situations but courts should grant them sparingly because basic bankruptcy principles prescribe that creditors in the same class should be treated equally). See generally Travis N. Turner, *Kmart and Beyond: A "Critical" Look at Critical Vendor Orders and the Doctrine of Necessity*, 63 WASH. & LEE L. REV. 431, 453-54 (2006) (comparing cases in which courts have cited section 363(b) of the Bankruptcy Code when authorizing debtors to pay certain pre-petition debts).

¹⁹ See *supra* note 12 and accompanying text.

²⁰ See 11 U.S.C. § 105(a) (2006) ("The court may issue any order, process, or judgment that is necessary or

This approach has led to a stance towards critical vendor payments that can be relatively lenient. For instance, in *In re Just for Feet*,²¹ a debtor that operated retail stores specializing in the sale of athletic footwear requested authority to pay the pre-petition claims of all of its trade vendors in exchange for favorable trade terms.²² The Delaware district court granted the motion, although it limited the requested relief to vendors of athletic footwear and apparel. The critical vendor motion was granted, as modified, notwithstanding objections by major creditor constituencies and the U.S. Trustee.²³ Based on this type of approach, a debtor arguably could obtain authority to pay the pre-petition claim of almost any supplier, regardless of creditor views and the anticipated net benefit to the estate.

In *In re Payless Cashways*,²⁴ a debtor that operated stores specializing in the sale of building materials requested authority to pay the pre-petition claims of its lumber suppliers in exchange for favorable trade terms.²⁵ The bankruptcy court granted the motion, although it adopted a more restrictive approach than that adopted in *Just for Feet*.²⁶ The *Payless Cashways* court held that "the views of the creditor body are critical" in considering a critical vendor motion, and that since the official committee of unsecured creditors had endorsed the debtor's request, the motion would be granted.²⁷ Additionally, unlike *Just for Feet*, the court imposed a dollar cap on the total amount of critical vendor payments.²⁸

The current judicial stance towards reorganizing debtors' requests to honor pre-petition claims of essential creditors is much stricter than the approaches taken in *Just for Feet* and *Payless Cashways*, and is exemplified by the Seventh Circuit's decision in *Kmart*; the decisions of the Northern District of Texas in the *In re CoServ*²⁹ and *In re Mirant*³⁰ cases; and the decision of the Eastern District of Virginia in the *In re United American*³¹ case. These cases establish far tougher standards for the pre-plan payment of pre-petition claims. A creditor's promise to provide a debtor with favorable trade terms is insufficient, by itself, to satisfy these standards.

appropriate to carry out the provisions of this title . . .").

²¹ 242 B.R. 821 (D. Del. 1999).

²² *Id.* at 823–24.

²³ *Id.* at 826.

²⁴ 268 B.R. 543 (Bankr. W.D. Mo. 2001).

²⁵ *Id.* at 544.

²⁶ *See id.* The court relied upon § 364(b) as legal authority for the motion rather than § 105(a), upon which the *Just for Feet* court relied. Section 364(b) permits a debtor "to obtain credit, out of the ordinary course of business," but only after several specific factors are considered and analyzed by court. *See id.*; *see also* Joseph Gilday, L.L.M. Thesis, "Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code, 11 AM. BANKR. INST. L. REV. 411, 424, 443 (2003) (citing court's decision to approve debtor's motion to make critical vendor payments pursuant to section 364(b)).

²⁷ *See In re Payless Cashways*, 268 B.R. at 547.

²⁸ *See id.* at 544 (limiting the total credit authorized to \$10 million).

²⁹ 273 B.R. 487, 491 (Bankr. N.D. Tex. 2002) (asserting court may permit debtors to pay pre-petition claims prior to confirmation of plan only "under extraordinary circumstances.").

³⁰ 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003).

³¹ 327 B.R. 776, 792 (Bankr. E.D. Va. 2005).

For instance, in *Kmart*, the Seventh Circuit suggested in dictum that section 363(b) of the Code could serve as authority for pre-plan payments, but only if a debtor proves (i) that the creditors will cease doing business with the debtor if not immediately paid their pre-petition claims³² and (ii) that "the business will gain enough from continued transactions with the favored vendors to provide some residual benefit to the remaining, disfavored creditors, or at least leave them no worse off"—i.e., they must be "as well off with reorganization as with liquidation."³³

In *CoServ*, the court acknowledged that allowing a debtor to make pre-plan payments of unsecured debt conflicts with the general policy of equality of treatment of similarly-situated creditors.³⁴ It further noted that a creditor's refusal to ship solely because of a debtor's inability to pay the creditor's pre-petition claim might constitute improper "economic blackmail" in violation of the automatic stay³⁵ and also might, in appropriate circumstances, warrant equitable subordination of the creditor's claim.³⁶ However, the court stated that there are occasions when a debtor can fulfill its fiduciary duty to maximize value only through the pre-plan payment of certain unsecured claims.³⁷

The court therefore formulated the following three-part test for determining whether a pre-petition creditor is critical: pre-petition claims of such creditors may be paid, but only if the debtor establishes that (i) continued dealing with the creditor "is virtually indispensable to profitable operations"; (ii) failure to deal with the creditor

³² See *In re Kmart Corp.* 359 F.3d 866, 868 (7th Cir. 2004), cert. denied, 543 U.S. 986 (2004); see also *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 17–18 (Bankr. M.D. Fla. 2005) (permitting pre-plan payments to creditors who are necessary to reorganization and refuse to do further business with debtor absent payment).

³³ *In re Kmart*, 359 F.3d at 868, 873.

³⁴ 273 B.R. at 493 n.9 ("[T]o pay pre-petition claims is generally inconsistent with rather than in furtherance of the provisions of the Bankruptcy Code"); see also *In re Kmart*, 359 F.3d at 874 (asserting preferential payments to certain creditors are allowed only if record shows other creditors would probably be benefited); Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 96 (2004) ("The debtor has to explain why honoring the pre-petition obligation will in fact make the general creditors as a group better off.").

³⁵ See *In re Coserv*, 273 B.R. at 494 n.12 ("[A] vendor's absolute refusal to supply the debtor absent payment of a pre-petition claim would be in violation of [s]ection 362(a)(6) of the Code (which would warrant sanctions, not a mandate to sell to the debtor) . . ."). See generally 11 U.S.C. § 362(a)(6) (2006) (staying "any act to collect, assess or recover a claim against the debtor . . .") (emphasis added). In *Mirant*, the court entered an order providing that any entity which refused to provide post-petition goods or services "by reason of non-payment of any pre-petition debt" would, absent good cause, be found to have violated the automatic stay. 296 B.R. at 430; see *In re Delphi Corp.*, No. 05-44481, at *2 (S.D.N.Y. Oct. 8, 2005) (granting order to show cause why supplier should not be held in violation of section 362 for willfully threatening to withhold goods from debtors); *In re Structurlite Plastics Corp.*, 86 B.R. 922, 932 (Bankr. S.D. Ohio 1998) ("Selective [repayment] of pre-petition debt should not be authorized as a result of threats or coercion by disgruntled creditors. Such activity is violative of the automatic stay . . . and, if tolerated, would negate the fundamental principle of equality of treatment among similarly situated creditors.").

³⁶ See 11 U.S.C. § 510(c) (2006) (allowing subordination by court of all or part of claim to all or part of another interest after notice and hearing).

³⁷ According to the court, examples of creditors whose pre-petition claims may warrant payment include employees, foreign vendors, sole source suppliers, customers with warranty or rebate claims, governmental units who may exercise their police powers to revoke licenses and other necessary permits, and vendors who may go out of business if their claims are not paid and whose financial survival is necessary to the debtor's own rehabilitation efforts. *In re Coserv*, 273 B.R. at 499 n.23.

will eliminate "an economic advantage disproportionate to the amount of the claim";³⁸ and (iii) there is "no practical or legal alternative" to payment of the claim.³⁹

Portions of the *CoServ* test appear to be similar to the Seventh Circuit's two-part test.⁴⁰ Specifically, if a debtor establishes, as required by the Seventh Circuit, that critical vendors will cease doing business with the debtor if not immediately paid for pre-petition goods and services and that its business will gain enough from continued transactions with critical vendors so that creditors, as a whole, will be at least as well off with the payments as without them, then a debtor has probably also established, as required under the *CoServ* test, that the creditor is "virtually indispensable"; that the debtor's failure to deal with the creditor will eliminate a "disproportionate economic advantage"; and that there is, therefore, no legal or practical alternative to paying the creditor.⁴¹

An example of a recent application of these standards is afforded by the opinion of the Bankruptcy Court for the Eastern District of Virginia in *In re United American, Inc.*⁴² In that case, a contractor filed chapter 11. It was unable to complete a construction project—and thereby receive a significant payment from the owner—because it was precluded from paying the pre-petition claims of two of its subcontractors. It therefore sought authority to pay them, but the court ruled that the contractor failed to satisfy the tests established in *Kmart*, *CoServ*, and other cases. With respect to one subcontractor in particular, the court was unpersuaded by the fact that a successor subcontractor would be required to undertake significant work at

³⁸ With regard to this prong of the test, the court specifically "question[ed] whether favorable credit terms alone ever would meet the net benefit requirement." *In re Coserv*, 273 B.R. at 498 n.20; see Gilday, *supra* note 26, at 441 (analyzing second prong of *Coserv*'s test as "necessity" test for payment of pre-petition debts by creditor).

³⁹ *In re Coserv*, 273 B.R. at 499; see *In re United Am. Inc.*, 327 B.R. 776, 782 (Bankr. E.D. Va. 2005) (summarizing three-part "necessity prong" test established in *Coserv*); *In re CEI Roofing, Inc.*, 315 B.R. 50, 56–57 (Bankr. N.D. Tex. 2004) (describing three-part test for determining when payment of pre-petition claim should or could be authorized pre-confirmation as defined in *Coserv*); Bruce S. Nathan, *Critical Vendors: Elevating the Low-priority Unsecured Claims of Pre-petition Trade Creditors*, AM. BANKR. INST. J., June 2002, at 14, 33 (analyzing *Kmart*'s payment of pre-petition claims to certain critical vendors).

⁴⁰ One aspect of the Seventh Circuit's test that appears to depart somewhat from the *CoServ* test is the requirement that the debtor establish that the critical vendor will stop shipping to the debtor absent payment. See Staggs, *supra* note 3, at 16, 66–67 (demonstrating how Seventh Circuit's test departs from *Coserv* test). This requirement may, in practice, prove to be more lenient than the *CoServ* requirement that the vendor be "virtually indispensable" to the debtor's operations. It also may be relatively easy to establish this prong as a matter of fact: the vendor's representative could simply appear before the bankruptcy court and state that, absent payment, it will not ship. See *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 21–22 (Bankr. M.D. Fla. 2005).

⁴¹ *In re Coserv*, 273 B.R. at 498–99. The third prong of the *Coserv* test also is essentially identical to a statement by the Seventh Circuit that critical vendor payments must be "the only way to facilitate a reorganization." See *In re Kmart Corp.*, 359 F.3d 866, 874 (7th Cir. 2004), *cert. denied*, 543 U.S. 986 (2004) (stating that critical vendor payments must be "the only way to facilitate a reorganization."). In other words, if paying a critical vendor is the "only way to facilitate a reorganization" (Seventh Circuit), then there is "no practical or legal alternative" but to do so (*CoServ*).

⁴² 327 B.R. at 782–83 (Bankr. E.D. Va. 2005) (discussing and utilizing three-part test for determining necessity of pre-petition payments to critical vendors); see *Osborne v. Howell Elec. Motors (In re Fultonville Metal Prods. Co.)*, 330 B.R. 305, 313 (Bankr. M.D. Fla. 2005) (explaining three-part test used to establish pre-petition payment of critical vendors); *In re CEI Roofing*, 315 B.R. at 54, 56–57 (reviewing recent standards implemented in cases considering pre-petition payment of critical vendors).

"perhaps significant expense" to the estate, and that the subcontractor had no obligation to turn over necessary shop drawings that had already been approved by government agencies and that a successor would have had to re-create.⁴³

In denying critical vendor status to the subcontractor, the court pointed out that there was "no evidence" that the debtor had made any effort to find a substitute contractor, despite the fact that an expert had raised a question whether *any* other contractor would be willing to step into the shoes of the original subcontractor. The proposed terms for payment of the subcontractor also were unsatisfactory to the court in that they did "not provide for a binding obligation on the part of [the subcontractor] to complete its contract."⁴⁴

The lesson to be gleaned from *Kmart*, *CoServ*, *Mirant*, and *United American* is clear: debtors who seek to make pre-plan payments to unsecured creditors may face very difficult standards under which they must affirmatively prove their cases with thorough and convincing evidence that there simply are no realistic alternatives to payment of the claims and that absent payment, the estate's value will be seriously and substantially jeopardized. The possibility of favorable trade terms will not, by itself, satisfy this standard. Without this sort of proof, critical vendor and related motions undoubtedly will be denied by courts who follow these more stringent standards.

III. EFFECTS OF THE BAPCPA

As noted above, courts' primary concern about pre-plan payments of unsecured claims is that they effectively elevate some creditors over others in violation of the Code. The Seventh Circuit, in suggesting section 363(b)(1) of the Code as a source of legal authority for critical vendor and other pre-plan payments, therefore stated that "it is prudent to read, and use, [section] 363(b)(1) to do the least damage possible to [the] priorities established by contract and by other parts of the Bankruptcy Code."⁴⁵ As a consequence, a debtor who proposes to make pre-plan payments to holders of priority claims may have an easier burden to meet. Since priority claims must be paid in full under a plan, there is little harm to other creditors by paying them at the inception of the case if circumstances warrant (and discounting the potential for administrative insolvency).

⁴³ See *In re United Am.*, 327 B.R. at 783 (finding subcontractor, although important, was not critical). The court strongly suggested that a threat to withhold delivery of the drawings would violate the automatic stay. See *id.* (implying subcontractor can only withhold delivery of drawings if drawings are owned by subcontractor); see also *Knaus v. Concordia Lumber Co., Inc. (In re Knaus)*, 889 F.2d 773, 775 (8th Cir. 1989) (indicating creditor is obligated to return property to debtor upon learning of debtor's bankruptcy proceedings); *Williams v. Gen. Motors Acceptance Corp. (In re Williams)*, 316 B.R. 534, 538 (Bankr. E.D. Ark. 2004) (holding creditor violated automatic stay by withholding property pending receipt of protection).

⁴⁴ *In re United Am.*, 327 B.R. at 784.

⁴⁵ *In re Kmart*, 359 F.3d at 872 (alteration in original); see *In re Tropical Sportswear*, 320 B.R. at 20 (affirming use of section 363 as authority for payment of pre-petition claims prior to plan confirmation); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989) (same).

For instance, one reason many courts historically have had little hesitation in authorizing the pre-plan payment of pre-petition employee obligations is because the Code affords a limited priority with respect to accrued wages, salaries, vacation, severance, sick leave pay, and contributions to employee benefit plans.⁴⁶ For similar reasons, courts have been less reluctant to authorize pre-plan payments to suppliers who have the right to assert mechanics', artisans, warehouseman's, or shipping liens.⁴⁷ Such persons frequently have possession of inventory, tooling, or other items that a reorganizing debtor needs. Since their claims have priority over other claims, there is little harm in paying them prior to plan confirmation in order to obtain release of the property. In fact, the estate and all creditors presumably benefit by such payment because payment ensures the debtor's uninterrupted receipt of inventory and other items necessary to its business.

Additionally, BAPCPA may make matters easier with respect to the pre-plan payment of certain claims held by trade and reclamation vendors. In a rather remarkable amendment, Congress has provided that any claim for the value of goods received by a debtor in the ordinary course of business within twenty days *prior* to commencement of its case will be entitled to administrative expense priority status, rather than just general unsecured status.⁴⁸ This amendment is not necessarily beneficial to debtors seeking to compromise their liabilities—administrative claims must be paid in full as a condition to confirmation of a plan,⁴⁹ whereas unsecured claims receive distributions dictated by the value remaining after payment of lienholders and holders of administrative claims.

While this change may hinder debtors' ability to compromise unsecured liabilities, debtors facing circumstances warranting the payment of pre-petition trade vendor claims may be better able to support their position if such claims pertain to goods

⁴⁶ See 11 U.S.C. §§ 507(a)(3) & (4) (2006) (describing third and fourth order priorities). For this very reason, the creditor who appealed the critical vendor orders in *Kmart* did not appeal other orders authorizing payment of priority claims, including orders relating to priority wage and similar claims. See also *In re Colad Group, Inc.*, 324 B.R. 208, 214 (Bankr. W.D.N.Y. 2005) (granting motion to pay wages and benefits to employees under section 507(a)(3) and (4)); Daniel Keating, *The Fruits of Labor: Worker Priorities in Bankruptcy*, 35 ARIZ. L. REV. 905, 907 (1993) (speaking generally about Bankruptcy Code's wage and benefit priorities under sections 507(a)(3) and (4)).

⁴⁷ Sections 362(b)(3) and 546(b) of the Code afford limited exceptions to the automatic stay that allow a creditor to perfect state law liens after the petition date. See 11 U.S.C. § 362(b)(3) (2006) ("The filing of a petition . . . does not operate as a stay . . . of any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection . . ."); see also 11 U.S.C. § 546(b) (2006) (discussing perfection rights and how rights are maintained and continued in regard to notice and seizure); 229 Main St. Ltd. P'ship, 262 F.3d 1, 8–9 (1st Cir. 2001) (explaining split in courts on the issue of post-petition exceptions); *In re Summit Ventures, Inc.*, 135 B.R. 483, 492 (Bankr. D. Vt. 1991) (stating lien falls within section 362(b) exception providing for post-petition perfection).

⁴⁸ 11 U.S.C. § 503(b)(9) (2006) ("[T]here shall be allowed administrative expenses . . . the value of any goods received by the debtor within 20 days before the date of commencement of a case . . . in which the goods have been sold to the debtor in the ordinary course of such debtor's business"). See generally Alan N. Resnick, *The Future of the Doctrine of Necessity and Critical-Vendor Payment in Chapter 11 Cases*, 47 B.C.L. REV. 183, 203–05 (2005) (discussing claim for value of goods received in ordinary course of business).

⁴⁹ See 11 U.S.C. § 1129(a)(9)(B) (2006) (providing requirements that must be met before court approval of a plan); 11 U.S.C. § 507 (2006) (explaining priority of creditor claims).

delivered twenty days before the case commenced. This is because a request to pay priority claims does not raise the historical concern that payment of non-priority unsecured creditors unfairly favors them to the potential detriment of other creditors who are not paid.⁵⁰

It is possible that the same line of reasoning may be applicable with respect to reclamation claims, especially considering that BAPCPA expanded the rights of reclaiming vendors. Specifically, BAPCPA provides that a vendor who has sold goods that a debtor receives within forty-five days before commencement of the case may give a written reclamation demand to the debtor within forty-five days after the debtor receives the goods or within twenty days after commencement of the case, whichever is later.⁵¹ However, BAPCPA repealed the option afforded under the 1978 Code to afford reclaiming vendors a lien or an administrative expense claim in lieu of return of the goods.

The deletion of these options arguably may mean that a court cannot compel a reclaiming vendor to accept a lien or administrative expense claim in lieu of return of its goods. As a practical matter, however, there likely will be many reclaiming vendors willing to agree to such treatment or prompt payment. Thus, a motion that proposes to pay such vendors in exchange for the debtor's ability to keep the goods presumably will be acceptable to such vendors and should not entail concerns about favoring reclaiming vendors so long as they establish the validity of their claims in accordance with the requirements of the Code and state law.

IV. WHETHER CRITICAL VENDOR PAYMENTS SHOULD EVER BE ALLOWED: MAXIMIZATION OF VALUE

The fact that numerous published decisions acknowledge that pre-plan payments may be made in certain circumstances, and the fact that BAPCPA should enhance the prospects for obtaining such relief in certain cases, together have not been sufficient to foreclose debate about the wisdom of allowing debtors to make pre-plan payments of unsecured claims.⁵² Indeed, there are several writers who vigorously advocate adoption of a hard and fast rule that outlaws such payments in all cases, regardless of the circumstances.⁵³ There are certain courts that appear to have adopted this position as

⁵⁰ See *In re United Am., Inc.*, 327 B.R. 776, 781 (Bankr. E.D. Va. 2005) ("Pre-confirmation payment of select non-priority unsecured creditors violates the equal treatment principle.").

⁵¹ See 11 U.S.C. § 546(c)(1) (2006) (providing conditions under which a seller may reclaim goods sold to an insolvent debtor); Stephen E. Snyder & Lawrence Ponoroff, *COMMERCIAL BANKRUPTCY LITIGATION* § 10:7 (2006) (analyzing seller's right of reclamation under common law, the U.C.C. and section 546(c)(1)).

⁵² See, e.g., McCoy, *supra* note 14, at 342–44 (suggesting need for legislation authorizing payment of pre-petition claims before confirmation of a reorganization plan); Resnick, *supra* note 48, at 203–10 (discussing BAPCPA).

⁵³ See, e.g., Joshua A. Ehrenfeld, *Quieting the Rebellion: Eliminating Payment of Pre-petition Debts Prior to Chapter 11 Reorganizations*, 70 U. CHI. L. REV. 621, 638 (2003) (providing reasons for eliminating pre-plan payments); Gilday, *supra* note 26, at 414 (calling critical vendor orders "unjust, unwise, and illegal."); Robert A. Morris, *The Case Against "Critical Vendor" Motions*, AM. BANKR. INST. J., Sept. 2003, at 30 ("The whole

well.⁵⁴ As discussed in the following section, the argument undoubtedly will be made that the Supreme Court's recent ruling in the *Zurich American* case could signal the end of the practice of debtors making pre-plan payments to pre-petition creditors.

In light of this continuing uncertainty, practitioners presenting critical vendor and related motions must be prepared to address whether pre-plan payments should ever be allowed as a matter of law. This section and the following section outline two possible arguments in support of a rule that authorizes pre-plan payments in certain circumstances. In particular, this section expands upon a point made by the court in *CoServ* that the duty to maximize value sometimes can be fulfilled only if a debtor is afforded this flexibility. The significance of this point, which also was made—albeit in a different fashion—by the Seventh Circuit in *Kmart*, has been almost completely overlooked by most courts and commentators. The next section outlines an argument based on the history of the Code and the enactment of BAPCPA.

* * *

As a general matter, in light of the complexities and uncertainties surrounding most business reorganizations, an unqualified rule that precludes the pre-plan payment of pre-petition claims—*without exception of any kind*—is difficult to square with the rehabilitative purposes of the Code. As the Seventh Circuit implicitly recognized, reorganizing businesses must be afforded limited flexibility to pay selected pre-petition claims prior to confirmation of a plan if the alternative—i.e., non-payment of such claims—would cause drastic disruption to the business that would jeopardize value for all constituencies collectively.⁵⁵

critical-vendor approach currently accepted by the bankruptcy courts is flawed in practice."); Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 115 (1991) (urging judges to adopt blanket prohibition against preferring pre-petition claims).

⁵⁴ See, e.g., *In re Timberhouse Post & Beam, Ltd.*, 196 B.R. 547, 550–51 (Bankr. D. Mont. 1996) ("[A] pre-petition unsecured claim cannot be elevated to an administrative expense since the scheme of the 1978 Bankruptcy Code does not allow this Court to change the classification of claims set by Congress in the Code."); *In re Revco D.S., Inc.*, 91 B.R. 777, 781 (Bankr. N.D. Ohio 1988) (concluding debtors failed to establish authority under the Bankruptcy Code to pay pre-petition trust fund taxes prior to confirmation of plan); *In re FCX, Inc.*, 60 B.R. 405, 410 (Bankr. E.D.N.C. 1986) (holding payments of pre-petition expenses unlawfully subordinates claims of other unsecured creditors). This was also the position of the district court in the decision preceding the Seventh Circuit's holding in *Kmart*. See *Capital Factors, Inc. v. Kmart Corp.*, 291 B.R. 818, 823 (N.D. Ill. 2003) ("[I]t is clear that however useful and practical these payments may appear to bankruptcy courts, they simply are not authorized by the Bankruptcy Code."); see also Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) (stating applicable Bankruptcy Rules do not allow payment prior to approval of reorganization plan); *S. Ry. Co. v. Johnson Bronze Co. (In re Johnson Bronze Co.)* 758 F.2d 137, 142 (3d Cir. 1985) (finding bankruptcy courts had no authority to elevate creditor's unsecured claim).

⁵⁵ *In re Kmart Corp.*, 359 F.3d 866, 868 (7th Cir. 2004), cert. denied, 543 U.S. 986 (2004) (discussing how payment of pre-petition claims to critical vendors could in theory make disfavored creditors better off); see also *In re Just for Feet*, 242 B.R. 821, 824 (D. Del. 1999) (noting courts use their equitable power under Bankruptcy Code to authorize payment of pre-petition claims when such payment is necessary for certain debtors to survive); *In re Equalnet Commc'ns. Corp.*, 258 B.R. 368, 369 (Bankr. S.D. Tex. 2000) (finding payment of pre-petition claims permitted where "business transactions which are at once individually minute but collectively immense and critical to the survival of the business of the debtor."). As one court has stated, sometimes "the granting of

The Bankruptcy Court for the Northern District of Texas in *CoServ* elaborated on this notion when it held that the unavoidable business fact is that sometimes, value can be maximized only if a debtor is given authority to pay the pre-petition claims of persons who are critical to the enterprise, without whose goods and services the debtor simply cannot survive.⁵⁶ The Seventh Circuit in *Kmart* captured the essence of this notion by using slightly different phraseology, suggesting that pre-plan payments could be authorized if there is evidence that "the business will gain enough" from the payment that everyone will be better off, and certainly no worse off, than if the payments were not made.⁵⁷

For example, a debtor's ability to honor most pre-petition employee obligations in the ordinary course typically can be expected to preserve and enhance enterprise value for the benefit of all stakeholders, leaving no one worse off. Indeed, if a debtor is not authorized to pay its employees and honor its other employee benefit policies, there is a material risk that it will find itself *in extremis* almost immediately. Even if one assumes that the risk is small, if it materializes, there likely will be wholesale disruption among the employee ranks and severe, irreparable damage to the value of the enterprise.⁵⁸

A rule that imposes this sort of risk on a company in distress, without exception of any kind, clearly is not a value-maximizing principle and therefore has no place in bankruptcy law and practice. Yet that is precisely the consequence of the proposition that the Code should prohibit *all* pre-plan payments, regardless of the circumstances.

The same line of reasoning easily can be employed with respect to other classes of pre-petition claims. For example, a company that has just filed chapter 11 cannot realistically expect to ignore outstanding obligations to customers like frequent flyer

preferential treatment to some creditors is a better result than closing the business." See *In re Payless Cashways, Inc.*, 268 B.R. 543, 547 (Bankr. W.D. Mo. 2001). In supporting the notion that pre-plan payments sometimes are warranted, the Third Circuit stated that "flexibility" is "essential to a reorganization proceeding." *In re Penn Cent. Transp. Co.*, 452 F.2d 1107, 1108 (3d Cir. 1971); see also *Mich. Bureau of Workers' Disability Comp. v. Chateaugay Corp. (In re Chateaugay Corp.)*, 80 B.R. 279, 287 (S.D.N.Y. 1987) (determining rigid application of Code's priority scheme is inconsistent with fundamental purpose of reorganization law, "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"); *In re Structurlite Plastics Corp.*, 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988) (cautioning against *per se* rules prohibiting payment of pre-petition claims since they would be too inflexible to effectuate rehabilitative purposes of Code).

⁵⁶ *In re CoServ, L.L.C.*, 273 B.R. 487, 497 (Bankr. N.D. Tex. 2002) (stating "this court is prepared to apply the Doctrine of Necessity to authorize payment of pre-petition claims in appropriate cases").

⁵⁷ *In re Kmart*, 359 F.3d at 868 (noting debtor must not merely allege, but rather prove business will gain enough).

⁵⁸ See, e.g., *Chateaugay*, 80 B.R. at 289 (affirming order authorizing debtor to pay pre-bankruptcy wages, salaries, employee benefits and reimbursements, and workers' compensation claims and premiums); *In re CEI Roofing, Inc.*, 315 B.R. 50, 53 (Bankr. N.D. Tex. 2004) (analyzing *Kmart* and authorizing payment of pre-petition wage and related claims); *In re Equalnet Commc'ns.*, 258 B.R. at 371 (authorizing payment of pre-petition employee priority claims); *Pension Benefit Guar. Corp. v. Sharon Steel Corp. (In re Sharon Steel Corp.)*, 159 B.R. 730, 737 (Bankr. W.D. Pa. 1993) (authorizing payment of pre-petition wages where necessary to effectuate rehabilitation of debtor); *Gulf Air*, 112 B.R. at 154 (authorizing debtor to pay pre-bankruptcy wages, salaries, medical benefits, and business expense claims); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 179 (Bankr. S.D.N.Y. 1989) (authorizing payment of pre-petition wage and benefit claims of working employees).

miles, product warranty claims, return policy claims, rain checks, rebates, coupons, and other customer practices.⁵⁹ Similarly, a manufacturing debtor cannot allow its processes to be disrupted by mechanics' lienors, artisans, materialmen, shippers, warehousemen, and other holders of possessory liens on raw materials necessary to keep the debtor's plant operating. A debtor also may not be able to risk disruption caused by the failure of sole-source vendors to deliver unique, machined parts that require long lead-times to produce.⁶⁰ In short, failure to honor these types of pre-petition obligations in the ordinary course likely would significantly impair creditor value. A hard and fast rule that sanctions this result, contrary to the goal to maximize value, simply is not consistent with the purpose of chapter 11.

There are three aspects of this argument, however, that warrant caution. First, it is easy to overstate. Although the value-maximizing goal is important, it does not and cannot trump other requirements imposed by the Code or applicable non-bankruptcy law. Thus, for example, while a debtor may determine that it can maximize value for creditors if it is excused from paying post-petition taxes, it cannot do so. The Code specifically requires a debtor to comply with applicable non-bankruptcy law, including paying its post-petition tax obligations.⁶¹ Practitioners, therefore, must take care not to

⁵⁹ See *In re Nat'l Tour Assoc. Inc. v. Nordstrom* (*In re Nordstrom*), No. 02-82350, 2004 Bankr. LEXIS 17, at *4 (Bankr. C.D. Ill., Jan. 7, 2004) (requiring debtor to refund customer deposits in bankruptcy proceeding); *In re Federated Dep't Stores, Inc.*, Nos. 1-90-00130 through 1-90-00196, 1990 Bankr. LEXIS 102, at *2 (Bankr. S.D. Ohio January 15, 1990) (ordering debtor to recognize pre-petition obligations including refunds, returns, and warranty claims); Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV. 1, 15-16 (1989) (describing allowable debtor payments to customers). A particularly stark example of the necessity for honoring pre-petition obligations to customers is afforded by the reorganization case of *Marvel Entertainment, Inc.*, distributor of Spiderman comic books and related items:

In the chapter 11 of *Marvel*, the largely teenage subscribers to the business's comic books had paid their subscriptions in advance and were therefore general creditors. Their subscriptions should be put on hold, and they should await the plan of reorganization. They must participate in the process like any other creditor. [However, t]he sheer silliness of asking thousands of 13-year-olds to participate in a chapter 11 reorganization may have kept the issue from arising.

Baird, *supra* note 34, at 96.

⁶⁰ See, e.g., *In re Just for Feet*, 242 B.R. at 826 (finding that payment of pre-petition claims to certain vendors is essential to survival of debtor); *In re Eagle-Picher Indus., Inc.*, 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (approving pre-plan payments of pre-petition debt of toolmakers whose unique skills were critical to debtor's continued operation). But see Gilday, *supra* note 26, at 416-17 (suggesting courts are overly debtor-friendly when allowing payments for pre-petition obligations to certain creditors).

⁶¹ See 28 U.S.C. § 959(b) (2006):

[A] debtor in possession, shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

Id.; see also *Minn. Pollution Control Agency v. Gouveia* (*In re Globe Bldg. Materials, Inc.*), 345 B.R. 619, 634 (Bankr. N.D. Ind. 2006) (discussing requirement of § 959(b) to manage and operate property in accordance with existing laws); Walter A. Effross, *Grammarians at the Gate: The Rehnquist Court's Evolving "Plain Meaning"*

present the value-maximizing argument as a cure-all or as a goal that trumps all other goals of the Code.

A second note of caution with respect to the value-maximizing argument arises from certain language utilized in the *CoServ* opinion that easily could be misconstrued.

While there is little dispute among courts that debtors and estate representatives have a fiduciary duty to maximize value, no one would suggest that a debtor's decision to pay some, all, or no pre-petition claims should give rise to a breach of fiduciary duty claim if, in hindsight, the decision did not achieve the desired result. Yet this suggestion arguably is hinted at in the *CoServ* opinion.⁶²

Although this clearly was not the court's holding, opportunistic stakeholders could attempt to seize on the opinion to exert improper leverage at the inception of a case. Any such attempt can and should be easily rebuffed. The general rule is that if estate fiduciaries follow a reasonable *process* in deciding on a particular course of action, a process governed by good faith, loyalty to the enterprise, and due care in assessing alternatives, then they should not be held liable for the *substantive results* of their decisions, no matter how far awry they may go.⁶³ Thus, if the board or management of a distressed company following a rational process makes certain decisions with respect to the payment of some, all or no pre-petition claims, they should be protected by the business judgment rule, regardless of whether their decision proves in hindsight to have been improvident.⁶⁴

A final note of caution concerns business considerations. This article focuses primarily on the *legality* of allowing pre-plan payments of unsecured debt, not on whether such payments make sense as a *business* matter. Whether a particular class of payments should be made as a business matter will depend upon the particularized circumstances of each case. Of course, there are certain classes of creditors about which generalizations can be made. For instance, there appears to be little dispute that,

Approach to Bankruptcy Jurisprudence, 23 SETON HALL L. REV. 1636, 1642–43 (1993) (stating trustee who manages debtor's property must follow state laws).

⁶² *In re Coserv*, 273 B.R. at 497 ("There are occasions when this [fiduciary] duty can only be fulfilled by the pre-plan satisfaction of a pre-petition claim."); see *Baird*, *supra* note 34, at 96 (stating current trend in bankruptcy courts looks towards whether debtors have sufficiently explained "why honoring the pre-petition obligation will in fact make the general creditors as a group better off"). But see *In re Mirant Corp.*, 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003) (arguing court did not want to further damage debtors' businesses from delays where creditors needed to be paid their "pre-petition claim outside of a confirmed plan").

⁶³ See, e.g., *In re Walt Disney Co. Derivative Litig.* No. 15452, 2005 Del. Ch. LEXIS 113, at *192 n.487 (Del. Ch., Aug. 9, 2005), *aff'd* No. 15452 (Del., June 8, 2006). See also *Roselink Investors, L.L.C. v. Shenkman*, 386 F.Supp.2d 209, 221 (S.D.N.Y. 2004) (holding courts do not substitute their own views for those of board members, especially if board member's decision can be "attributed to any rational business purpose."); *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (determining no liability may be imposed under business judgment rule as long as the process of coming to a decision was "either rational or employed in good faith to advance corporate interests").

⁶⁴ For this reason, it is important for a debtor requesting permission to make pre-plan payments to present evidence of the decision-making process and rationales for its chosen course. While this may not be sufficient to satisfy the burdens of proof established by recent case law respecting the pre-plan payment of pre-petition claims, it certainly is a necessary condition.

as a general matter, pre-petition obligations to employees and customers should be honored in the ordinary course.

Matters can become more complicated, however, when a company that is preparing for bankruptcy begins to consider whether to make payments to suppliers and other vendors. While the legal analysis in this situation should be the same as it is with respect to employees and customers, the factual circumstances and business wisdom of paying the pre-petition claims of vendors and suppliers are more difficult for business persons and courts to assess. For example, debtors frequently argue that sole-source vendors have the power to shut down the debtors' operations if the vendors are not paid. But do they really, in every instance? And even if they have this power, is there a realistic chance of this happening as a business matter? There are not always simple answers to such questions. It also may be very difficult to affirmatively prove that these contingencies likely will come to pass.

Moreover, vendor relations can be badly damaged when some vendors realize that they do not qualify as "critical" enough in the eyes of the debtor to warrant payment of their pre-petition claims. This can lead to enough vendor unrest and dissension that some debtors may find it smarter, as a business matter, simply to tell all vendors the same thing: no one can get paid anything on account of pre-petition claims until a plan is proposed and confirmed. In other words, equality of treatment may, in many cases, be the best business policy.⁶⁵

V. WHETHER CRITICAL VENDOR PAYMENTS SHOULD EVER BE ALLOWED: THE CODE'S HISTORY AND BAPCPA

A debtor faced with a court that is skeptical of the legal propriety of pre-plan payments can argue that the historical necessity of payment rule, buttressed by section 105(a) of the Code and BAPCPA, likewise serve as authority for the payment of pre-petition claims outside the context of a plan. While the Seventh Circuit in *Kmart* and other courts and writers have concluded that the necessity of payment rule either did not survive enactment of the Code or that it is limited only to railroad cases,⁶⁶ the evidence actually is to the contrary.

⁶⁵ For a discussion of similar and other business reasons why critical vendor motions may not always be wise business strategy, see Morris, *supra* note 53, at 30, stating that "[r]arely does a vendor in this situation want to risk losing the future sales volume . . . as well as any chance to recover on its pre-petition receivables by shutting down its customer." Cf. *In re Kmart Corp.*, 359 F.3d 866, 873 (7th Cir. 2004), *cert. denied*, 543 U.S. 986 (2004) ("To abjure new profits because of old debts would be to commit the sunk-cost fallacy; well-managed businesses are unlikely to do this. Firms that disdain current profits because of old losses are unlikely to stay in business. They might as well burn money or drop it into the ocean.").

⁶⁶ See P.L. Barsalou, *Preferential First-Day Orders: Same Question, Different Outlook*, AM. BANK. INST. J., Feb. 2003, 8, at 8. (expressing doubt as to whether necessity of payment rule survived enactment of Bankruptcy Code); Ehrenfeld, *supra* note 53, at 627 (arguing necessity of payment rule "was not expanded beyond its application to railroads" under Code). See generally 2 COLLIER ON BANKRUPTCY ¶ 105.04 (5)(a) (Alan R. Resnick & Henry J. Sommer eds., 15th ed. rev. 2006). The courts that have approved such payments have relied on the "doctrine of necessity" or the "necessity of payment" rule. This rule has its roots in a provision of the Railway Labor Act, which permits railroad debtors to pay creditors for goods delivered within six months before

In 1882, the Supreme Court decided an important railroad receivership case named *Miltenberger v. Logansport, C. & S. W.R. Co.*⁶⁷ In *Miltenberger*, the Court acknowledged the basic duty of an equity receiver "to protect and preserve the trust funds in its hands" for the benefit of all creditors.⁶⁸ More importantly, the Court held that, consistent with this duty, "[m]any circumstances may exist which may make it *necessary and indispensable* to the business . . . and the preservation of the property, for the receiver to pay *pre-existing debts* . . . out of the earnings of the [debtor] . . . under the order of the court . . ."⁶⁹ This statement was the first formulation of the necessity of payment rule.

By the 1930's, the necessity of payment rule had become an established tool in railroad receivership cases. In 1934, Congress imported the techniques courts employed in railroad receivership cases, including the necessity of payment rule, into general corporate reorganizations by enacting section 77B of the Bankruptcy Act. Specifically, section 77B provided that a court "shall have and may exercise *all* the powers, not inconsistent with this section, which a Federal court would have had it appointed a receiver in equity of the property of the debtor by reason of its inability to pay its debts as they mature."⁷⁰ At the time that section 77B was drafted, equity receivers had the power to pay the pre-petition debts of indispensable creditors pursuant to the rule announced in *Miltenberger*. By virtue of section 77B, courts therefore had this power in general corporate reorganization cases as well.

Corporate reorganizations also were made subject to section 2 of the Bankruptcy Act, which empowered bankruptcy courts to "[m]ake such orders, issue such process, and enter such judgments, in addition to these specifically provided for, as may be necessary for the enforcement of the provisions of this Act."⁷¹ This language is almost identical to the current version of section 105(a) of the Code, which authorizes a court to enter any order "necessary or appropriate" to carry out the other provisions of title 11.⁷²

In fact, the legislative history of section 105(a) confirms the unmistakably clear intent of Congress to continue pre-Code practice: "The section is repeated here for the sake of continuity from *current law* and ease of reference, and to cover any powers *traditionally exercised by a bankruptcy court* . . ."⁷³ These "traditional powers" included the power to authorize payment of pre-petition debts of indispensable

the filing, where the goods were necessary to keep the railroads in business. *Id.*

⁶⁷ 106 U.S. 286 (1882).

⁶⁸ *Id.* at 310 (quoting *Wallace v. Loomis*, 97 U.S. 146, 162 (1877)).

⁶⁹ *Id.* at 311 (alteration in original) (emphasis added).

⁷⁰ Act of June 7, 1934, ch. 424, § 77B (a), 48 Stat. 911, 912 (1934).

⁷¹ Bankruptcy Act of 1898, ch. 541, 55th Cong., 30 Stat. 544, 545–46 (repealed 1978). See generally *Cont'l Illinois Nat'l Bank & Trust Co. of Chicago v. Chicago*, 294 U.S. 648, 671–73 (1935) (establishing limits on Congress' power under Bankruptcy Act).

⁷² See 11 U.S.C. § 105(a) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.").

⁷³ H.R. REP. NO. 95–595, at 316–17 (1977) (emphasis added).

creditors pursuant to the Supreme Court's necessity of payment rule enunciated in *Miltenberger* and section 77B of the Act.⁷⁴

Consistent with this legislative history, the Supreme Court has held that it "will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure."⁷⁵ Moreover, the Court "has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history."⁷⁶ Based on these basic propositions of statutory construction, there is *no* evidence, much less a "*clear* indication" that Congress ever intended to abolish the necessity of payment rule when it enacted the Code in 1978.

As pointed out above, however, there are those who have argued that the history of the various bankruptcy laws, up to and including the Code enacted in 1978, is ambiguous with respect to Congress's intent regarding the viability of the necessity of payment rule.⁷⁷ Assuming the pre-Code history on this point is ambiguous, there is nothing ambiguous about bankruptcy practice between enactment of the Code in 1978 and BAPCPA in 2005. Specifically, while BAPCPA does not speak directly to the validity of orders authorizing payment of pre-petition claims outside the context of a plan, Congress enacted BAPCPA in light of a long history under the 1978 Code of bankruptcy courts consistently interpreting section 105(a) as authorizing such payments. There has been an equally long history of courts relying on the necessity of payment rule to authorize such payments, and a more limited, but very recent, history of courts authorizing such payments under section 363(b)(1) of the Code.⁷⁸

The legality of such orders has been the focus of significant discussion and controversy in recent years, especially after the Seventh Circuit's decision in *Kmart*. BAPCPA, in turn, was the product of intense lobbying efforts by numerous creditor groups, including lenders and landlords. Yet *none* of these groups pressed Congress to adopt any legislation prohibiting the long-standing practice of critical vendor and similar orders. In fact, no such proposal was ever made at any point during the multi-year period that bankruptcy reform legislation was under consideration.

⁷⁴ See *supra* note 69 and accompanying text; *Miltenberger*, 106 U.S. at 311 (describing necessity of payment rule).

⁷⁵ *Cohen v. De La Cruz*, 523 U.S. 213, 221 (1998).

⁷⁶ *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992); see also *United States v. Ron Pair Enters. Inc.*, 489 U.S. 235, 244–45 (1989) (considering legislative history and pre-Code practice); *United Sav. Ass'n of Tex. v. Timers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 380 (1988) (discussing legislative history and stating major changes will not be made unless provided for in statutory language).

⁷⁷ See, e.g., Jeff Bohm, *The Legal Justification for the Proper Use of Cross-Collateralization Clauses in Chapter 11 Bankruptcy Cases*, 59 AM. BANKR. L.J. 289, 300 n.39 (1985) (noting necessity of payment rule was never codified); Gilday, *supra* note 26, at 431 (recognizing Congress has had opportunities to codify necessity of payment rule but has refused to act). See also Victor Vilaplana, *Stretching the Code for Critical Vendors: Necessity is the Mother of Invention*, 862 PLI/COMM 491, 528 (2004) (suggesting there is little evidence Code continues "traditional powers" of equity courts, while also conceding there is little evidence to indicate Congress intended to abrogate necessity of payment rule under Bankruptcy Code).

⁷⁸ See *supra* note 9 and accompanying text.

As a consequence, there is no discussion in the legislative history of BAPCPA that Congress intended to effectuate any change, let alone a "major change," with respect to the long-standing practice of bankruptcy courts entering critical vendor and related orders. There is, therefore, no "clear indication that Congress intended . . . a departure" from this practice when it enacted BAPCPA.⁷⁹ While it may not be clear that Congress intended to endorse this practice when it enacted BAPCPA, there certainly is no evidence that it meant to abrogate the practice.

At least one commentator has suggested otherwise.⁸⁰ According to that commentator, in light of Congress's determination to afford administrative expense priority status for claims representing the value of goods received by a debtor twenty days prior to the petition date, there should be a negative inference that Congress intended to abolish any principle that allowed the pre-plan payment of other pre-petition claims. However, with no legislative history to suggest that this was Congress's intent, this purported inference is a stretch. In particular, since the Supreme Court has held that it "will not read the Bankruptcy Code to erode past bankruptcy practice absent a *clear* indication that Congress intended such a departure"⁸¹ or that is "the subject of at least some discussion in the legislative history,"⁸² there is no basis for concluding that BAPCPA abolished the practice of pre-plan payments. To the contrary, if the Supreme Court's holdings are to be given their plain meaning, it could be argued that BAPCPA implicitly endorsed the practice.

However, can this line of Supreme Court holdings be squared with the Court's recent statements in *Zurich American* that "preferential treatment of a class of creditors is in order only when clearly authorized by Congress?"⁸³ As stated above, the Court held in *Zurich American* that an insurer's pre-petition claim against a debtor for unpaid workers' compensation premiums did not constitute an unpaid contribution to an employee benefit plan under section 507(a)(5) of the Bankruptcy Code.⁸⁴ Section 507(a) of the Code affords priority status to several specific classes of pre-petition claims, including claims for wages, salaries, commissions and related items. While *Zurich American* had nothing to do with the propriety of debtors' proposals to pay pre-petition critical vendor or other claims, the Court clearly took a dim view of the broader notion of affording preferential treatment to some creditors, but not others, absent explicit sanction in the Bankruptcy Code.

⁷⁹ See *De La Cruz*, 523 U.S. at 221.

⁸⁰ See, e.g., Resnick, *supra* note 48, at 203–10 (discussing BAPCPA provisions).

⁸¹ *De La Cruz*, 523 U.S. at 221 (emphasis added) (quoting *Pa. Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 563 (1990)); see also *Lamie v. U.S. Tr.*, 540 U.S. 526, 539 (2004) (defending consultation of congressional record for clear indication of intention as to possible alteration of longstanding bankruptcy practice); cf. *Jewish Kosher Provision Corp. v. Gottfried*, 63 N.Y.S.2d 160, 162 (N.Y. City Ct. 1946) ("The intent of Congress with respect to these provisions must be determined in the light of the results sought to be achieved by the Congressional enactment.").

⁸² *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992).

⁸³ *Howard Delivery Serv. v. Zurich Am. Ins. Co.*, 126 S. Ct. 2105, 2109 (2006).

⁸⁴ See *supra* note 5 and accompanying text.

Specifically, in construing the wording of section 507(a)(5) to exclude from its scope the claim asserted by the insurance carrier, the Court said that it was guided by the "principle that provisions [of the Bankruptcy Code] allowing preferences must be tightly construed."⁸⁵ Indeed, to "give priority to a claimant not clearly entitled thereto is not only inconsistent with the policy of equality of distribution; it dilutes the value of the priority for those creditors Congress intended to prefer."⁸⁶ To the extent there is any doubt about the proper way to interpret a provision of the Code according a certain class of claims priority, the doubt "is best resolved in accord with the Bankruptcy Code's equal distribution aim."⁸⁷

Notwithstanding these statements, if one presumes that the Court in *Zurich American* had no intention of overruling its numerous previous holdings regarding interpretation of the Bankruptcy Code in light of pre-Code practice—and there is nothing in the Court's opinion to suggest otherwise—then *Zurich American* cannot be construed as abolishing the ability of reorganizing debtors to make pre-plan payments in limited circumstances. This argument ultimately may prove to be an incorrect limitation on the scope of the Court's statements in *Zurich American*. Until the Court speaks directly to the critical vendor issue, however, it arguably is the only way to reconcile *Zurich American* with the Court's other precedents relating to interpretation of the Bankruptcy Code in light of past practice.

CONCLUSION

Requests by reorganizing debtors to make pre-plan payments of pre-petition debt will continue. The debate about the propriety of doing so, and the applicable standards, likely will continue as well. However, with the heightened evidentiary standards and other safeguards outlined in cases like *Kmart*, *Mirant*, and *CoServ*, the business needs of reorganizing debtors can be met while simultaneously ensuring that pre-plan payments of pre-petition debt are made only when essential to benefit the business and creditors as a whole, consistent with the goal to maximize value. Accordingly, a rule that allows pre-plan payments under the right circumstances continues to be the better view, and courts should not accede to the short-sighted demands of limited creditor constituencies for a hard and fast rule prohibiting such payments in all cases, regardless of the circumstances.

⁸⁵ *Zurich Am.*, 126 S. Ct. at 2116 (alteration in original).

⁸⁶ *Id.* at 2109 (quoting *In re Mammoth Mart, Inc.*, 536 F.2d 950, 953 (1st Cir. 1976)).

⁸⁷ *Id.* at 2116; cf. Charles Seligson, *Preferences Under the Bankruptcy Act*, 15 VAND. L. REV. 115, 115 (1962) (explaining equal distribution is cornerstone of the bankruptcy structure).