

# K&LNG Alert

SEPTEMBER 2006

## Bankruptcy

### The Doctrine of Necessity and Critical Vendor or Essential Supplier Status in Chapter 11 Reorganization Cases

This K&LNG Alert provides information to credit managers and commercial lawyers whose employers may be characterized as “critical vendors” or “essential suppliers” by a bankruptcy court. Section I discusses what is known in bankruptcy parlance as the doctrine of necessity. Section II examines the Seventh Circuit’s decision in *In re Kmart* and related decisions in other circuits.<sup>1</sup>

#### SECTION I: AN OVERVIEW OF THE DOCTRINE OF NECESSITY

When a debtor files for bankruptcy protection under Chapter 11 of the Bankruptcy Code and attempts to reorganize, the debtor often faces the difficult challenge of inducing its creditors to continue to supply goods and services.<sup>2</sup> Debtors have sought the issuance of critical vendor orders to convince a creditor to continue to do business with the debtor throughout a Chapter 11 reorganization. A so-called critical vendor order grants the debtor or debtor in possession the power to settle and pay unsecured creditor claims on the theory that those creditors are indispensable to the debtor’s or debtor in possession’s capacity to reorganize and that without the ability to prepay unsecured debt, the debtor will not be able to ensure further shipments of goods.

Critical vendor motions usually are filed by a debtor on the first day of its reorganization case. By filing a critical vendor motion, a debtor in possession asks the bankruptcy court to allow the debtor to make immediate and substantially full payments of prepetition debt to vendors whom the debtor deems vital to its continued business operations pursuant to Chapter 11 of the Bankruptcy Code.

Bankruptcy courts have limited the power of a debtor in possession to make critical vendor or essential supplier designations because the Bankruptcy Code contains no explicit authorization to grant such designations.<sup>3</sup> In addition, the debtor does not pay creditors equally once it has authority to pay certain creditors 100% of their claims early in the Chapter 11 case. Disfavored creditors, or those who are not deemed critical vendors by the debtor, have become more vocal in their objections to critical vendor or essential supplier designations. Bankruptcy courts have become hesitant to grant debtors in possession the power to characterize certain suppliers as so important to the debtor’s business that they should receive special treatment unless the supplier legitimately needs favored treatment to continue to supply the debtor with goods.<sup>4</sup>

Some bankruptcy courts have used their equitable powers under the doctrine of necessity to allow the debtor to designate some vendors as necessary to the debtor’s reorganization. The doctrine of necessity, which is derived from § 105(a) of the Bankruptcy Code, is an equitable provision that applies to all bankruptcies. Section 105(a) of the Bankruptcy Code states:

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...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.<sup>5</sup>

<sup>1</sup> *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004).

<sup>2</sup> The Bankruptcy Code is codified at 11 U.S.C. § 101 *et seq.* (2000).

<sup>3</sup> The terms “critical vendor” and “essential supplier” do not appear in the Bankruptcy Code.

<sup>4</sup> See, e.g., *In re Delphi Corp.*, No. 05-44481 (RDD) (Bankr. S.D.N.Y. Mar. 8, 2006) (Amended Final Order Under 11 U.S.C. §§ 105(a), 363, 364, 1107, and 1108 and Fed. R. Bankr. P. 6004 and 9019 Authorizing Continuation of Vendor Rescue Program and Payment of Prepetition Claims of Financially-Distressed Sole Source Suppliers and Vendors Without Contracts).

<sup>5</sup> 11 U.S.C. § 105(a) (2000).

However, courts have ruled that this section alone does not give a bankruptcy court authority to act in defiance of other provisions of the Bankruptcy Code. Because there is no provision in the Bankruptcy Code expressly authorizing critical vendor or essential supplier payments, and because such payments seemingly destroy the tenet that all similarly-situated creditors are to be treated equally under bankruptcy law, some bankruptcy courts have questioned the validity of critical vendor or essential supplier orders, while other bankruptcy courts refuse to enter the orders when requested.

## SECTION II: **KMART AND RELATED CASES IN OTHER CIRCUITS: THE VALIDITY OF CRITICAL VENDOR AND ESSENTIAL SUPPLIER DESIGNATIONS**

### **The Seventh Circuit's Kmart Decision**

On February 24, 2004, the Seventh Circuit released its decision in *In re Kmart Corp.*<sup>6</sup> On the first day of its Chapter 11 reorganization case, Kmart sought permission to pay the full prepetition claims of all of its critical vendors immediately. Kmart did not present evidence to the Bankruptcy Court as to which vendors were critical to its reorganization. In considering the critical vendor motion, the Bankruptcy Court concluded that the equitable provisions of § 105(a) of the Bankruptcy Code allow bankruptcy courts to issue critical vendor orders. The Bankruptcy Court granted Kmart authority to pay any debt to any vendor that Kmart itself deemed critical so long as each vendor agreed to provide Kmart with goods for two years on customary trade terms.<sup>7</sup>

Kmart had tens of thousands of creditors, over four thousand of whom were trade vendors. Instead of naming a handful of creditors as critical vendors, Kmart designated 2,330 vendors (roughly 54% of all of its trade vendors) as critical vendors and paid their prepetition debts in full.<sup>8</sup> These 2,330 vendors received 100% of their prepetition claims in cash, totaling approximately \$300 million. Upon confirmation of Kmart's Chapter 11 plan, the 2,000 disfavored vendors received 10 cents on the dollar for prepetition claims, and most of those claims were

paid in stock of the reorganized Kmart. Because of the unequal treatment of creditors, the disfavored vendors and other unsecured creditors wanted Kmart to recover the payments made to critical vendors. When the case reached the Seventh Circuit, Judge Easterbrook issued a decision that now restricts the availability of critical vendor designations in the Seventh Circuit.

Judge Easterbrook determined that a critical vendor order cannot be upheld solely by the equitable provisions of § 105(a) of the Bankruptcy Code. He concluded that § 105(a) does not grant a court discretion to set aside the Bankruptcy Code's rules governing priority and distribution. Judge Easterbrook observed that no circuit-level court had ever explicitly allowed a bankruptcy court to use § 105(a) of the Bankruptcy Code to authorize full payment of any unsecured debt unless all unsecured creditors are paid in full.

The Seventh Circuit suggested that the only way that a debtor in possession in the Seventh Circuit may be able to justify a critical vendor order after the *Kmart* decision is through the use of § 363(b) of the Bankruptcy Code. Section 363(b)(1) states: "The trustee [or debtor in possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate."<sup>9</sup> Judge Easterbrook did not reject using § 363(b)(1) as a way to justify critical vendor orders because payment of prepetition debts to keep a supply of "critical" goods is a use of property of the bankruptcy estate that falls outside the ordinary course of business.<sup>10</sup>

In *Kmart*, Judge Easterbrook hinted at the type of evidence that a bankruptcy court in the Seventh Circuit should require before it issues a critical vendor order. Before granting a party critical vendor status in the Seventh Circuit, a bankruptcy court must first make factual findings that the disfavored creditors will be as well off with reorganization as with liquidation and that the critical vendor would have refused to deliver goods if the vendor's debts were left unpaid throughout the duration of the bankruptcy proceedings.<sup>11</sup> Judge Easterbrook

<sup>6</sup> *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004).

<sup>7</sup> *Id.* at 869.

<sup>8</sup> *Id.* The Bankruptcy Court issued an order that authorized Kmart to pay the prepetition claims of a food distribution company that provided substantially all Kmart's food products, the company's sole music supplier, vendors who supplied eggs and dairy products, and certain newspapers and printers who supplied goods and services relating to Kmart's advertising program. See *In re Kmart Corp.*, Case No. 02-B-02474, Motion Authorizing the Payment of Prepetition Claims of Certain Critical Trade Vendors (N.D. Ill. Jan. 22, 2002).

<sup>9</sup> 11 U.S.C. § 363(b)(1) (2000).

<sup>10</sup> *In re Kmart Corp.*, 359 F.3d at 872.

<sup>11</sup> *Id.* at 873.

stressed that most creditors do not need prepetition claims to be paid in full at an early stage because most companies will continue to do business with a debtor if the debtor pays for goods purchased postpetition. In order to be granted critical vendor status and to receive immediate payment of prepetition debt, however, a vendor must convince the court that it will actually cease doing business with the debtor unless the debt is paid.

Because of the type of evidence the Seventh Circuit now requires before a bankruptcy court is permitted to issue a critical vendor, there are some situations where it appears a creditor will not qualify for critical vendor status. For example, the automatic stay provisions of § 362 of the Bankruptcy Code prevent a vendor with a long-term contract with the debtor from refusing to make postpetition deliveries if the debtor pays for the postpetition deliveries.<sup>12</sup> Additionally, a court is unlikely to find that a large financially-stable vendor who provides goods to a debtor that can be easily obtained from another source will refuse to make postpetition deliveries of goods for which it is being paid. However, a small financially-distressed vendor who makes an integral component specifically for the debtor should be able to prove to a bankruptcy court that it will refuse to continue to deliver products to the debtor postpetition unless it receives payment on prepetition debt. In that situation, the vendor's own financial affairs might force it to stop producing goods until it receives the debtor's payment. In such a case, following Judge Easterbrook's discussion in Kmart, the bankruptcy court should be satisfied that the vendor will refuse to make future deliveries postpetition unless it receives immediate payment of its prepetition claims.

Another important wrinkle in the Kmart decision is that Judge Easterbrook declared that the trustee could recover payments previously made to critical vendors under the critical vendor order. The court stated that when critical vendor orders are later overturned by an appellate court, the trustee or debtor in possession can recover the money already paid to those creditors. Therefore, even if a vendor receives full

prepetition payment of its claims under a critical vendor order, an appellate court may reverse the decision of the trial court and order that the payments made to those critical vendors be returned to the bankruptcy estate.

### **The Doctrine of Necessity in Other Circuits Second Circuit**

Recent orders in the Delphi and Dana bankruptcy cases in the Southern District of New York show that trade creditors can still obtain critical vendor or essential supplier status in the Second Circuit. On March 8, 2006, the Bankruptcy Court for the Southern District of New York entered an amended final order authorizing Delphi Corporation to pay up to \$90 million of its prepetition debts to financially-distressed sole source suppliers and vendors who did not have enforceable contracts with Delphi. To make payments under the essential supplier order, Delphi is required to make a diligent effort to enter into a trade agreement with an essential supplier. The trade agreement requires the essential supplier to make certain concessions, including:

- (1) the essential supplier will continue to offer customary trade terms to Delphi which are at least as beneficial to Delphi as those extended in the twelve-month period before Delphi's petition date;
- (2) the essential supplier will not seek payment for reclamation claims outside of its essential supplier negotiations with Delphi; and
- (3) the essential supplier will not file a lien for any remaining unpaid portion of its prepetition claim against Delphi.<sup>13</sup>

It should be noted that the Bankruptcy Court allowed Delphi to grant essential supplier status to financially-distressed suppliers who made unique goods. The essential vendor order in Delphi shows that the financial status of the essential supplier is relevant to the Bankruptcy Court for the Southern District of New York's determination of whether it should grant preferential treatment to a supplier of unique goods.

<sup>12</sup> Id.

<sup>13</sup> In re Delphi Corp., No. 05-44481 (RDD) (Bankr. S.D.N.Y. Mar. 9, 2006) (Amended Final Order Under 11 U.S.C. §§ 105(a), 363, 364, 1107, and 1108 and Fed. R. Bankr. P. 6004 and 9019 Authorizing Continuation of Vendor Rescue Program and Payment of Prepetition Claims of Financially-Distressed Sole Source Suppliers and Vendors Without Contracts). If the essential supplier refuses to enter into the requisite trade agreement with Delphi, Delphi is permitted to pay an essential supplier's prepetition claims if Delphi determines that failure to pay the claims is likely to result in irreparable harm to its business operations. Id.

Also in March 2006, the Bankruptcy Court for the Southern District of New York granted Dana Corporation's essential supplier motion to pay its essential suppliers up to \$52.1 million.<sup>14</sup> In order to receive payments under the essential supplier order, trade creditors are required to extend normalized trade credit and provide other business terms which are at least as favorable as those extended prepetition until Dana emerges from its Chapter 11 case. If a trade creditor accepts payment under the essential supplier order but does not provide Dana with the requisite trade terms, the Bankruptcy Court will deem the payment an unauthorized postpetition transfer under § 549 of the Bankruptcy Code and will allow the debtor to recover the funds. Another power that the Bankruptcy Court granted Dana in the essential supplier order is the authority to pay administrative priority claims under § 503(b)(9) immediately. The ability to pay administrative priority claims and essential supplier claims at the beginning of the case gives Dana leverage to negotiate favorable trade terms with its creditors. While no bankruptcy court in the Second Circuit has expressly stated a standard by which critical vendor motions will be judged, it appears that the Bankruptcy Court for the Southern District of New York is willing to issue essential supplier orders in situations where the essential supplier is financially distressed to the point that it requires the payment of its prepetition claims in order to produce goods to ship to the debtor.

### Third Circuit

The status of critical vendors has not been litigated in the Third Circuit since Kmart was decided. Though a bankruptcy judge deciding whether or not he or she should grant a critical vendor motion would probably consider Judge Easterbrook's opinion, precedent would currently permit prepetition payments to a critical vendor by virtue of the doctrine of necessity under § 105(a).<sup>15</sup> In its decision to grant the debtor's critical vendor motion in In re Just for Feet, the Bankruptcy Court for the District of Delaware explicitly rejected an argument that § 105(a) did not permit the court to issue a critical vendor order that authorizes prepetition claims. Indeed, according to the Bankruptcy Court, the only issue that the court

must decide in determining if it should exercise its equitable powers and grant the debtor's motion is whether the debtor has met its burden of demonstrating that the payment of the prepetition claims is "critical to the debtor's reorganization."<sup>16</sup> While the Third Circuit likely will reevaluate critical vendor designations in light of Kmart, there have been no recent decisions from the Third Circuit which discuss a more restrictive approach to critical vendor orders.

### Fourth Circuit

The Bankruptcy Court for the Eastern District of Virginia cited Kmart in a recent decision that significantly limits the application of the doctrine of necessity to critical vendors. The Bankruptcy Court declared that in order to use the doctrine of necessity as a basis for the pre-confirmation payment of a critical vendor's prepetition claim:

- (1) the vendor must be necessary for the successful reorganization of the debtor;
- (2) the transaction must be in the sound business judgment of the debtor; and
- (3) the favorable treatment of the critical vendor must not prejudice other unsecured creditors.<sup>17</sup>

In order to satisfy the first prong of the test, the debtor must show both that there is no substitute vendor available, even at a greater price, and that the critical vendor will refuse to deal with the debtor unless it is paid in full for its prepetition claims. The Bankruptcy Court stated that evidence will be heavily scrutinized and that courts are generally skeptical of a vendor's statement that it will refuse to continue to supply goods and services to the debtor. As such, the Bankruptcy Court requires solid evidence as to why the creditor would refuse to deal with the debtor postpetition.

While the Bankruptcy Court did not fully explain why paying some unsecured creditors 100% of their prepetition claims would not prejudice the disfavored unsecured creditors, the Bankruptcy Court did state that if a critical vendor refuses to conduct business with the debtor until its prepetition claim is paid, the

<sup>14</sup> In re Dana Corp., No. 06-10354 (BRL) (Bankr. S.D.N.Y. Mar. 29, 2006) (Amended Final Order, Pursuant to Sections 105(a), 363(b), 364(b) and 503(b)(9) of the Bankruptcy Code, Authorizing the Debtors to Pay Prepetition Claims of Certain Essential Suppliers and Administrative Claimholders and Granting Certain Related Relief).

<sup>15</sup> In re Just for Feet, Inc., 242 B.R. 821, 825 (Bankr. D. Del. 1999); see also In re Lehigh and New England Ry. Co., 657 F.2d 570, 581 (3d Cir. 1981); In re Penn Cent. Transp. Co., 467 F.2d 100, 102 (3d Cir. 1972); In re Columbia Gas Sys., Inc., 171 B.R. 189, 191-92 (Bankr. D. Del. 1994).

<sup>16</sup> In re Just for Feet, Inc., 242 B.R. at 826.

<sup>17</sup> In re United Am., Inc., 327 B.R. 776, 782 (Bankr. E.D. Va. 2005).

debtor might be forced to breach other contracts because it lacks necessary supplies. If breaching another contract would be more costly to the debtor and the bankruptcy estate than paying the critical vendor's prepetition claims, thereby increasing the proceeds to distribute, the disfavored creditors are not prejudiced from the critical vendor payments.

### **Fifth Circuit**

Even courts that disagree with the Seventh Circuit's reasoning in Kmart have established high standards for granting a critical vendor order. In In re CEI Roofing, Inc., the Bankruptcy Court for the Northern District of Texas declared that the combination of §§ 105 and 362(a)(6) can serve as a basis for a debtor to make payment on prepetition payments prior to the confirmation of the Chapter 11 plan. The Bankruptcy Court expressly rejected the Seventh Circuit's position that sections other than § 363(b) of the Bankruptcy Code could not be used as a basis for critical vendor payments.<sup>18</sup>

The Bankruptcy Court's decision in CEI Roofing allows a bankruptcy court to use § 362 of the Bankruptcy Code to justify a critical vendor order. Section 362 of the Bankruptcy Code establishes the automatic stay, which virtually cuts off a creditor's ability to deal with the debtor outside of the formal bankruptcy process. Section 362(a)(6) provides that the filing of the petition acts as a stay of "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case."<sup>19</sup> The Bankruptcy Court stated that under the Bankruptcy Code, a court could terminate, annul or modify the stay "for cause." A debtor in possession and its critical vendors can request relief from the automatic stay "for cause."

In order to show proper cause for the lifting of the automatic stay to pay the prepetition claims of critical vendors, the Bankruptcy Court in CEI Roofing declared:

- (1) it must be critical that the debtor deal with the [critical vendor];
- (2) unless the debtor deals with the [critical vendor], the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going-concern value, which is disproportionate to the

amount of the [critical vendor's] prepetition claim; and

- (3) there is no practical or legal alternative by which the debtor can deal with the claimant other than by the payment of the claim.<sup>20</sup>

The court in CEI Roofing also left open the possibility of using § 1107(a) of the Bankruptcy Code as a basis by which courts can order the payment of prepetition debts before the confirmation of the Chapter 11 plan of reorganization. Section 1107(a) contains an implied duty of the debtor in possession to "protect and preserve the estate, including an operating business' going-concern value."<sup>21</sup>

### **Eleventh Circuit**

The Bankruptcy Court in the Middle District of Florida followed the Seventh Circuit's lead and held that a critical vendor order can be issued only if the evidentiary record establishes that:

- (1) payments are necessary to the debtor's reorganization;
- (2) sound business justification exists for such payment, in that critical vendors will refuse to continue to do business with the debtor unless they are afforded critical vendor status; and
- (3) the disfavored creditors are at least as well off as they would have been had a critical vendor order not been entered.<sup>22</sup>

In In re Tropical Sportswear Int'l Corp., the Bankruptcy Court upheld the debtor's critical vendor designation of four vendors. The vendors had informed the debtor that they would cut off delivery of goods unless the debtor agreed to pay 77.5 percent of the prepetition debts immediately, pay any valid reclamation claims in full and waive any potential preference claims it had against the critical vendors. In addition to continuing to deliver goods to the debtor, the critical vendors agreed to waive all claims for the remaining 22.5 percent of the prepetition debts. The Bankruptcy Court noted that while § 363(b) of the Bankruptcy Code can be used for payments made to critical vendors, the court has a duty to limit critical vendor payments "to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code."<sup>23</sup>

<sup>18</sup> In re CEI Roofing, Inc., 315 B.R. 50, 59 (Bankr. N.D. Tex. 2004).

<sup>19</sup> 11 U.S.C. § 362(a)(6) (2000).

<sup>20</sup> In re CEI Roofing, Inc., 315 B.R. at 57.

<sup>21</sup> Id.

<sup>22</sup> In re Tropical Sportswear Int'l Corp., 320 B.R. 15, 17 (Bankr. M.D. Fla. 2005).

<sup>23</sup> Id. at 16.

## CONCLUSION

When deciding whether to grant a critical vendor or essential supplier order, it appears that bankruptcy courts are becoming increasingly concerned with the financial affairs of the vendor. If a vendor is in financial peril to the extent that it will be unable to provide unique goods essential to a debtor's business unless it receives full payment for its prepetition claims, a court may be likely to grant that vendor preferred status. However, a large financially-stable vendor who provides products to a debtor that can be easily obtained from another source will be unlikely to receive critical vendor or essential supplier status. In those cases, courts are likely to force the vendor to decide whether it wants to continue to supply the debtor with goods without being granted any priority status.

While the Seventh Circuit's Kmart decision limits the use of critical vendor orders in the Seventh Circuit, a creditor should still consider the availability of critical vendor protection in its own jurisdiction.

Though many jurisdictions have begun to limit critical vendor orders since Kmart, no court deciding the issue has altogether rejected critical vendor orders. Indeed, while critical vendor protection appears to be more difficult to obtain, creditors prefer to obtain full prepetition payment of their claims rather than receiving pennies on the dollar in a final distribution. Credit managers should consider whether critical vendor protection is appropriate and available when one of the creditor's customers files for bankruptcy.

---

David A. Murdoch  
412.355.6472  
dmurdoch@klng.com

Jamie A. Bishop  
412.355.8227  
jbishop@klng.com

Jeffrey N. Kinsey  
412.355.8231  
jkinsey@klng.com

---

If you have questions about this topic or would like more information on Kirkpatrick & Lockhart Nicholson Graham LLP, please contact one of our lawyers listed below:

**BOSTON**

John C. Hutchins 617.951.9165 jhutchins@kIng.com

**HARRISBURG**

Andrew L. Swope 717.231.4512 aswope@kIng.com

**LONDON**

Tony Griffiths 44.(0)20.7360.8195 agriffiths@kIng.com

Robin B. Tutty 44.(0)20.7360.8112 rtutty@kIng.com

**LOS ANGELES**

William J. Bernfeld 310.552.5014 wbernfeld@kIng.com

**MIAMI**

Jeffrey T. Kucera 305.539.3322 jkucera@kIng.com

**NEW YORK**

Jeffrey N. Rich 212.536.4097 jrich@kIng.com

Edward M. Fox 212.536.4812 efox@kIng.com

Robert N. Michaelson 212.536.4098 rmichaelson@kIng.com

Elizabeth H. Singer 212.536.4800 esinger@kIng.com

**PITTSBURGH**

George M. Cheever 412.355.6544 gcheever@kIng.com

David A. Murdoch 412.355.6472 dmurdoch@kIng.com

**WASHINGTON**

Judith Sturtz Karp 202.778.9222 jkarp@kIng.com



BOSTON • DALLAS • HARRISBURG • LONDON • LOS ANGELES • MIAMI • NEWARK • NEW YORK • PALO ALTO • PITTSBURGH • SAN FRANCISCO • WASHINGTON

---

Kirkpatrick & Lockhart Nicholson Graham (K&LNG) has approximately 1,000 lawyers and represents entrepreneurs, growth and middle market companies, capital markets participants, and leading FORTUNE 100 and FTSE 100 global corporations nationally and internationally.

K&LNG is a combination of two limited liability partnerships, each named Kirkpatrick & Lockhart Nicholson Graham LLP, one qualified in Delaware, U.S.A. and practicing from offices in Boston, Dallas, Harrisburg, Los Angeles, Miami, Newark, New York, Palo Alto, Pittsburgh, San Francisco and Washington and one incorporated in England practicing from the London office.

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

Data Protection Act 1988—We may contact you from time to time with information on Kirkpatrick & Lockhart Nicholson Graham LLP seminars and with our regular newsletters, which may be of interest to you. We will not provide your details to any third parties. Please e-mail london@kIng.com if you would prefer not to receive this information.

© 2006 KIRKPATRICK & LOCKHART NICHOLSON GRAHAM LLP. ALL RIGHTS RESERVED.