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NOTES

Not-So-Critical Vendors: Redefining Critical Vendor Orders

BY CHRISTOPHER D. HUNT *

INTRODUCTION

Several recent cases, typified by In re Kmart Corp.1 and In re CoServ, L.L.C.,2 have significantly curtailed a debtor’s ability to pay the pre-petition debts of certain vendors that the debtor believes are "critical" to the continued operation of his business while in a chapter 11 reorganization.3 These rulings are reactions to the current state of affairs regarding first-day orders4 in a bankruptcy petition, namely courts’ routine approval of a debtor’s list of critical vendors with little or no scrutiny.5 This note will briefly lay out the history of critical vendor

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* J.D. expected 2006, University of Kentucky; B.A. 1992, University of Kentucky. The author would like to thank Professor Christopher Frost for his suggestion of this topic and invaluable assistance in writing this note. The author would also like to thank his wife, Mary Ellen Hunt. Without her love and support, the author would not be attending law school. Finally, the author thanks his parents, Eugene and Dorothy Hunt, and his brother Timothy for their support and encouragement. All of them knew the law was his first, best choice before he did.

1 In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004).
4 See, e.g., Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 574 n.8 (3d Cir. 2003) (stating that “first-day” orders involve a debtor asking the court to approve urgent matters affecting the ongoing viability of the business, including “key-employee retention plans, the payment of pre-petition claims of critical vendors, and, most important, going-forward financing”). For an additional general discussion of what issues most first-day orders address, see John D. Ayer et al., What Every Unsecured Creditor Should Know About Chapter 11, 23 AM. BANKR. INST. J. 16 (2004), and John D. Penn, First Days/Crazy Days or, “There’s Mischief in Them Thar’ Motions”, 19 AM. BANKR. INST. J. 30 (2000).
5 See, e.g., In re Kmart, 359 F.3d at 868. (“Bankruptcy Judge Sonderby entered a critical—vendors order . . . without receiving any pertinent evidence . . . and without making any finding of fact that the disfavored creditors would gain or come out even.”); Patricia L. Barsalou & Zack Mosner, Preferential First-Day Orders: Same Question, Different Look, 22 AM. BANKR. INST. J. 8, 8 (2003) (stating that “[s]ometimes the only judicial restriction is a monetary cap on the total amount paid to all critical vendors”); Joseph Gilday, “Critical” Error: Why Essential Vendor Payments Violate the
orders, examine the major problems with those orders, and explore some possible solutions. It will be argued that critical vendor orders are unnecessary and, by setting a priority list for paying creditors, violate a basic element of the Bankruptcy Code that provides stability and predictability. Such orders elevate certain creditors above higher priority ones with little justification.

I. OVERVIEW OF CRITICAL VENDOR ORDERS

A. Definition and Rationale

A critical vendor order is typically included among the flurry of first-day motions that accompany the filing of a bankruptcy petition. These orders allow some vendors, who are usually unsecured creditors, to move to the front of the line, trumping even secured creditors. This priority status allows them to receive payment for pre-petition debts. The debtor-in-possession ("DIP") argues that these vendors supply goods or services that are essential to the continued operation of his business and that those vendors will refuse to make future shipments or to continue furnishing services if the pre-petition debts are not paid.

The underlying rationale for granting such orders is that, by helping a business reorganize and become profitable again, even those creditors deemed "not critical" ultimately benefit because the business will be in a better position to pay those debts after reorganization. Debtors often support their motions by citing several specific sections of the Bankruptcy Code, 11 U.S.C. § 507.

Bankruptcy Code, 11 AM. BANKR. INST. L. REV. 411, 419 (2003) (stating that "critical vendor" motions are often granted after quickly scheduled hearings and with little representation from other creditors).


7 See Ayer et. al., supra note 4, at 16; Bruce H. White & William L. Medford, The Doctrine of Necessity and Critical Trade Vendors: The Impracticality of Maintaining Post-Petition Business Relations in Mega-Cases, 21 AM. BANKR. INST. J. 24, 24 (2002) ("When a corporate debtor files its chapter 11 petition, it usually includes a barrage of emergency ‘first-day motions.’").

8 See White & Medford, supra note 7, at 24. See also Gilday, supra note 5, at 415–16 ("Debtor’s counsel usually claims that losing [critical vendor services] would have... a ‘severely pernicious effect on [its] efforts to rehabilitate and reorganize.’"); Bruce S. Nathan, Critical Vendors: Elevating the Low-Priority Unsecured Claims of Pre-Petition Trade Creditors, 21 AM. BANKR. INST. J. 14, 14 (2002) (stating that payment for pre-petition debts is often exchanged for the supplier’s assurance it will continue to ship merchandise at pre-chapter 11 credit terms).

9 See In re Kmart, 359 F.3d at 872 ("If paying the critical vendors would enable a successful reorganization and make even the disfavored creditors better off, then all creditors favor payment whether or not they are designated as ‘critical.’").
Bankruptcy Code ("Code")\textsuperscript{11} and the common-law Doctrine of Necessity;\textsuperscript{12} however, the most common tactic is to rely on § 105(a) of the Code:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.\textsuperscript{13}

To bolster their motions for critical vendor orders under § 105(a), petitioners can rely on a doctrine that is not included in the Code—the Doctrine of Necessity.

\textbf{B. The Doctrine of Necessity}

Rooted in common law, the Doctrine of Necessity has not been clearly defined and has no explicit basis in the Code.\textsuperscript{14} Furthermore, no court has yet clarified under what circumstances the doctrine is to be employed.\textsuperscript{15} In the absence of more explicit guidance, § 105(a) of the current Code is used as the jumping off point to apply the doctrine in modern cases.\textsuperscript{16}

A version of the Doctrine of Necessity was initially used in railroad cases of the 19th Century. It derived from the "Necessity of Payment Rule," which was first adopted by the Supreme Court in \textit{Miltenberger v. Logansport}.\textsuperscript{17} Although the doctrines are distinct, the rationale for both is

\textsuperscript{11} Some of the sections typically relied upon include § 363(b) (granting trustee power to use, sell, or lease property of the estate other than in the ordinary course of business), § 364(b) (allowing court to authorize trustee to obtain unsecured credit or incur unsecured debt), and § 503 (allowance of administrative expenses). See Gilday, \textit{supra} note 5, at 423–26. This note will address these sections of the code and their use in first-day motions in more detail in Parts II through IV.

\textsuperscript{12} See \textit{infra} notes 14–25 and accompanying text.

\textsuperscript{13} \textsc{11 U.S.C.} § 105(a) (2004).


\textsuperscript{15} \textit{Id.} Although no court has yet defined the Doctrine of Necessity, Eisenberg and Gecker characterize it as "a principle used in bankruptcy law which permits the use of certain provisions of the Code or common law ostensibly in contradiction to other law in order to accomplish a vital objective in a bankruptcy case." \textit{Id.} at 2.

\textsuperscript{16} See \textit{id}.

\textsuperscript{17} See \textit{Miltenberger v. Logansport}, C. & S.W.R. Co., 106 U.S. 286, 311 (1882). The \textit{Miltenberger} Court cautioned restraint in the use of the Necessity of Payment Rule and
the same, as both rely on the argument that favoring some creditors can ultimately benefit all creditors. While the Doctrine of Necessity stems from the Necessity of Payment Rule, the latter only applies to "railroad reorganizations and not to businesses generally." A related rule, also unique to railroad bankruptcies, is the Six Months Rule, codified in § 1171(b) of the Code. This rule "permits claims for services and goods supplied to a railroad six months before filing to be paid as administrative expense priority claims." The application of the Doctrine of Necessity, typically used in conjunction with § 105(a), is best illustrated by *In re Ionosphere Clubs, Inc.* *Ionosphere* involved the bankruptcy of Eastern Air Lines, during which striking employees sought to have their pre-petition wages, salaries, and medical benefits paid, just as Eastern had done for its active workers. The court denied the request, relying in large measure on the application of the railroad doctrine and a broad interpretation of § 105(a) and § 363(b)(1), although it did use the Doctrine of Necessity to uphold payment to the active employees. The *Ionosphere* court justified the use of the doctrine by citing *Dudley v. Mealey*, stating:

> Even if this case is not directly covered by the Railway Labor Act, the doctrine would still be applicable under the rationale of Judge Learned Hand who applied this rule to a non–railroad debtor in *Dudley v. Mealey* . . . . In that case, Judge Learned Hand held that a court was

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18 Eisenberg & Gecker, *supra* note 14, at 3.
19 *Id.* at 3–4.
20 *Id.* at 4.
23 *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989). For additional cases showing application of this Doctrine, see also *In re Just for Feet,* 242 B.R. 821, 826 (Bankr. D. Del. 1999) (holding that to invoke the necessity of payment doctrine through 11 U.S.C. § 105(a), debtor must show payment of pre-petition claims critical to its survival) and *In re Eagle–Picher Industries, Inc.*, 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (holding that a bankruptcy court may exercise its powers under § 105(a) "to authorize payment of pre-petition claims where such payment is necessary to permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately")
24 *See In re Ionosphere,* 98 B.R. at 175.
25 *Id.* at 175, 177.
26 *Dudley v. Mealey*, 147 F.2d 268 (2d Cir. 1945).
not “helpless” to apply the rule to non-railroad debtors where the alternative was a cessation of operations.\textsuperscript{27}

In sum, courts have, in some cases, allowed debtors to successfully argue that a limited doctrine meant only to be applied in railroad cases, and one that runs contrary to the tenets of the non-railroad sections of the Code, should allow them to violate both the letter and the spirit of the Code. While at times there may be valid reasons for departing from the Code, the next section illustrates why courts should resist this temptation.

II. CRITIQUING CRITICAL VENDOR ORDERS

A. Recent Cases

Within the past few years, critical vendor orders have come under increasing scrutiny by both courts and legal scholars.\textsuperscript{28} This section explores the issues raised by two of the more prominent cases: \textit{In re Kmart Corp.}\textsuperscript{29} and \textit{In re CoServ, L.L.C.}\textsuperscript{30} Some commentators usefully summarize the current legal status of critical vendor orders in federal courts in the following manner: “(1) The Seventh Circuit has limited the critical–vendor doctrine; (2) the Ninth, Fifth and Fourth Circuits have rejected the doctrine; and (3) the Third Circuit has consistently recognized the doctrine.”\textsuperscript{31} This Circuit split emphasizes the current uncertainty surrounding the critical vendor doctrine.

1. \textit{In re Kmart}

Kmart, in its petition for bankruptcy, asked for and was granted permission to pay approximately $300 million in pre-petition debts to

\textsuperscript{27} \textit{In re Ionosphere}, 98 B.R. at 176.
\textsuperscript{29} \textit{In re Kmart Corp.}, 359 F.3d 866 (7th Cir. 2004).
The money to pay these creditors came from $2 billion in DIP financing authorized by the bankruptcy court. Capital Factors, Inc., one of the 43,000 unsecured creditors that had been deemed "not critical," immediately challenged the critical vendors order, which moved the issue from bankruptcy court to the Seventh Circuit's general jurisdiction courts.

In his opinion, Judge Easterbrook devoted little discussion to the Seventh Circuit's core objection to granting the order: "The bankruptcy court's [overturned] order declared that the relief Kmart requested—open-ended permission to pay any debt to any vendor it deemed 'critical' in the exercise of unilateral discretion . . . was 'in the best interests of the Debtors, their estates and their creditors.' Focus on the scrutiny given to determining those vendors that are critical to the reorganizing business is the theme of the Seventh Circuit's stricter standard for granting such orders.

The appellants, who at first benefited from the critical vendor order but were stripped of that benefit by the district court judge, argued on appeal that the Doctrine of Necessity, as authorized by § 105, § 363(b), § 364(b), and § 503 of the Code, allowed them to receive preferential treatment contrary to § 507's priority scheme. The Kmart court quickly dispensed with the Doctrine and the use of § 105 as support, holding that this section of the Code "does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by § 105(a) is one to implement rather than override." The court also dismissed the Doctrine of Necessity itself, calling it "just a fancy name for a power to depart from the Code." Finally, precedent cited by Judge Easterbrook noted that § 105 has been interpreted by all of the circuits to require that all unsecured creditors be paid in full if even one unsecured creditor is paid in full.

32 In re Kmart, 359 F.3d at 869. An example of a vendor receiving payment as a result of the critical vendor order was a "food and consumer products supplier to Kmart[,]" The Fleming Companies, to which the bankruptcy court approved a $76 million payment. Kmart Shipments Resumed, N.Y. TIMES, Jan. 25, 2002, at C15. Ironically, Kmart would later end the contract with Fleming and thus contribute to Fleming's petition for bankruptcy, since the retailer was Fleming's largest customer.

33 In re Kmart, 359 F.3d at 869.

34 Id. at 869.

35 Id. at 868 (emphasis added).

36 See id. at 872.

37 Id. at 871.

38 Id.

39 Id. at 871.
Appellants next argued that § 364(b)\textsuperscript{40} and § 503,\textsuperscript{41} taken together, authorize favoring payment of some creditors over others.\textsuperscript{42} These sections, the court noted, authorize a debtor to obtain post-petition credit to run the business (through § 364) and to pay administrative expenses (§ 503), but they do not allow a debtor to elevate certain creditors to favored status.\textsuperscript{43} To allow such debts to be classified as administrative expenses, the court reasoned, would mean pre-petition debts could continue to plague a business’s attempts to reorganize and become profitable.\textsuperscript{44}

Lastly, the court addressed the appellant’s reliance on § 363(b)(1), which states: “The trustee [or DIP], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.”\textsuperscript{45} The court considered this section to be the most promising argument for granting the critical vendor order, reasoning that payment of pre-petition debts “critical” to continuing the business was outside the ordinary course of business.\textsuperscript{46} The court’s definition of “business” is crucial, as it focused on administering the estate under the specialized rules of the Bankruptcy Code, not the buying and selling of merchandise on the open market (the business in which Kmart engages).\textsuperscript{47}

In upholding the district court’s denial of the critical vendor orders, the Seventh Circuit noted several alternatives for dealing with creditors owed pre-petition debts.\textsuperscript{48} First, Kmart could simply pay for deliveries as they are received, on a C.O.D. basis or similar arrangement.\textsuperscript{49} Judge Easterbrook supported this option by reasoning that while “[i]t... may be vital to assure [suppliers] that a debtor will pay for new deliveries on a current basis ... that assurance need not, however, entail payment for

\begin{itemize}
  \item\textsuperscript{40} “The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.” 11 U.S.C. § 364(b) (2004).
  \item\textsuperscript{41} “After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—(1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case.” 11 U.S.C. § 503(b)–(b)(1)(A).
  \item\textsuperscript{42} See In re Kmart, 359 F.3d at 872.
  \item\textsuperscript{43} See id.
  \item\textsuperscript{44} See id.
  \item\textsuperscript{45} 11 U.S.C. § 363(b)(1).
  \item\textsuperscript{46} In re Kmart, 359 F.3d at 872.
  \item\textsuperscript{47} See infra notes 93–96 and accompanying text (discussing the meaning of “ordinary course of business” as used in § 363(b)(1)).
  \item\textsuperscript{48} See In re Kmart, 359 F.3d at 873.
  \item Id.
Second, Judge Easterbrook noted that Kmart could use the $2 billion line of credit it secured after filing its petition as an assurance to vendors that payment for future shipments would be forthcoming. The court suggested the use of a "standby letter of credit on which the bankruptcy judge could authorize unpaid vendors to draw" to accomplish this assurance function. Judge Easterbrook went on to note that "if lenders are unwilling to issue such a letter of credit (or if they insist on a letter's short duration)," it is likely a signal that the debtor's prospects for effective reorganization are poor and that liquidation is therefore imminent. Finally, the court intimated that vendors, while positioning themselves as "critical" through threats of refusing to ship goods, are likely to continue doing business with debtors like Kmart even if they do not receive payment for pre-petition debts. This conclusion rests on the logic that those vendors need to do business with Kmart almost as much as Kmart needs to do business with them, and it would be foolish to turn down a sale.

2. In re CoServ

CoServ, at the time of filing its petition, consisted of six debtors, all communications businesses. The debtors sought a critical vendor order that would allow them to pay twenty-seven creditors approximately $2.2 million in pre-petition debts. After review by the judge, CoServ modified its request to include seven creditors and approximately $500,000 in payments.

After discussing the history of the Necessity of Payment Rule and the Doctrine of Necessity, the court addressed § 549 and § 363(b)(1) of the Code. CoServ argued that these sections permit unequal treatment of creditors. The court dismissed these arguments with little explanation,
concluding: "Only [§] 105(a) offers the equitable muscle that would allow a bankruptcy court to violate one of the principal tenets of Chapter 11: that pre-petition general unsecured claims should be satisfied on an equal basis pursuant to a plan." 60

Noting that the court's powers of equity under § 105(a) are "severely circumscribed,"61 Judge Lynn developed a three-prong test for approving payment of pre-petition general unsecured claims:

First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, 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 claimant's pre-petition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim. 62

To satisfy the first prong, the vendor or vendors in question must be "virtually indispensable to profitable operations or preservation of the estate." 63 A clear example is a vendor that is the sole supplier of a crucial product. 64 Paying a fee substantially less than the value of estate property in order to regain possession of that property from the claimant represents a situation that meets the court's second prong, 65 as it would be in keeping with a trustee's or DIP's fiduciary duty to maximize the value of the estate for creditors. The third prong would seem to be the most difficult to meet, as there are many alternatives to immediate, full payment of pre-petition debts; deposits, cash-on-delivery, letters of credit, and consignment are just a few. 66

Throughout its decision, the court viewed the allowance of critical vendor orders as an extraordinary step, requiring reliance on "catchall" sections like § 105(a):

In summary, even a cursory review of the law makes clear that this Court does not possess the broad powers advocated by Debtors for approving payment of prepetition claims. The question for the Court,

60 Id. at 493.
61 Id.
62 Id. at 498.
63 Id.
64 Id.
65 Id. This example is the inverse of one offered on this prong by the court: "It is obviously a bad bargain to pay $100,000 to recover $10,000 of estate property of which a claimant has possession." Id.
66 See id. at 494. See generally, Henoch, supra note 51 (discussing details of post-petition financing under the Code).
then, is whether, in this circuit, a bankruptcy court may ever authorize payment of general unsecured prepetition claims.\textsuperscript{67}

In the court’s opinion, the “bridge” between § 105 and the Doctrine of Necessity was rooted in the DIP’s (or trustee’s) fiduciary duty to operate the business for the benefit of all the estate’s creditors.\textsuperscript{68} The court answered its question with a “yes”—critical vendor orders may be approved so long as the three-prong test is satisfied. As the next section demonstrates, however, there are problems with critical vendor orders that are beyond statutory interpretation.

B. Problems with Critical Vendor Orders

In addition to the code–specific problems with critical vendor orders, there are several more practical complications to applying equity–based rules such as the Doctrine of Necessity. First, evaluating which vendors are critical becomes increasingly difficult in “mega cases” like Kmart where there are thousands of vendors to consider. It is difficult, at best, for a bankruptcy judge to review the often quite intricate financial information of those thousands of vendors in an attempt to determine if a debtor identified vendors that are actually “critical” to the continued operation of the business.\textsuperscript{69} The evidentiary and procedural requirements for such an examination would be burdensome and would likely recreate the scramble to collect from the debtor that the Code in general, and the automatic stay in particular, was designed to stop.\textsuperscript{70}

Second, when the time does come to face financial reality, matters are hectic. Creditors have likely given ultimatums in the form of notices that they will no longer ship supplies or provide services unless debts are paid.\textsuperscript{71} This circumstance begs the question: are certain vendors critical because the business cannot operate without the product or service provided by that particular vendor, or has the debtor failed to line up an alternative vendor that can enable his business to continue?\textsuperscript{72} This type of

\textsuperscript{67} In re CoServ, 273 B.R. at 496.
\textsuperscript{68} See id. at 496–97.
\textsuperscript{69} Cf. Gilday, supra note 5, at 419 (noting that “[g]enerally courts approving a critical vendor motion leave it to the debtor to decide which of its aggressive vendors are important enough to justify payment”).
\textsuperscript{70} The automatic stay takes effect when a petition in bankruptcy is filed and stops all attempts to collect from the debtor. See 11 U.S.C. § 362 (2004).
\textsuperscript{71} See Gilday, supra note 5, at 415.
\textsuperscript{72} Concern over this question is evident, to an extent, in the three–prong test enunciated by the CoServ court, stating that “it [is] critical that the debtor deal with the claimant.” In re CoServ, 273 B.R. at 498.
situation, where time could be a significant factor, makes it even more difficult for judges diligently to evaluate the evidence before them to determine properly the importance of a particular vendor. To make matters even more pressing, the judge’s decision can have implications beyond the beginning of a bankruptcy case and the period of a company’s reorganization:

First-day issues now include “interim” rulings that can effectively become final and determinative of key parts of the case. How egregious the “first-day goodie grab” becomes can be the difference between a company’s life and death. Knowing this, the parties with first-day issues sometimes reach for too much at the outset, either hastening the demise of a reorganizable business or loading on so much administrative expense that no company could emerge from chapter 11.73

Third, there is the question of who is being represented by business managers—shareholders of the debtor corporation or creditors? Courts are in a unique position to protect shareholders’ interests against those who may favor business relationships with certain vendors over financially prudent steps that would reduce a business’ pre-petition debts.74 Another wrinkle is the argument that vendors, acting prudently, would not turn down present and future profits simply out of displeasure at not receiving timely, complete payment of pre-petition debts.75 With this in mind, managers of debtor corporations should be encouraged to define narrowly critical vendors and seek alternative suppliers in those cases in which a vendor with a pre-petition claim refuses to do business with the debtor.

Finally, vendors that are deemed “not critical” by the debtor are rarely, if ever, informed that such orders are being considered by the court.76 This raises questions about whether a judge can be expected to fully evaluate the critical vendor motion without hearing from those adversely affected by it.77 Questions regarding whether rules of civil

73 Penn, supra note 4, at 30.
75 See In re Kmart Corp., 359 F.3d 866, 873 (7th Cir. 2004); Gilday, supra note 5, at 420.
76 See Eisenberg & Gecker, supra note 14, at 25–26; Gilday, supra note 5, at 415.
77 See Gilday, supra note 5, at 448.
procedure are violated by not serving notice on those affected by the decision also arise in this context.\textsuperscript{78}

\section*{III. Solutions}

\subsection*{A. Eliminate the Doctrine}

Critical vendor orders trace their lineage directly from the Necessity of Payment Rule, which was created over a hundred years ago specifically for railroad bankruptcies.\textsuperscript{79} Over the past century, Congress has chosen not to extend the specific provisions of that doctrine beyond the section of the Code covering railroad petitions:

The legislative history of section 105(a) is not illuminating as to the limits of the court’s equitable power. The section’s drafters were primarily concerned with establishing the independence of the newly restructured bankruptcy court system. There is no mention of critical vendors, or the ability of courts to act in opposition to the payment priority scheme elsewhere in the Code.\textsuperscript{80}

To apply this concept, which violates the Code’s goal of treating all similarly situated creditors alike,\textsuperscript{81} debtors and courts have resorted to strained interpretations of the Code.\textsuperscript{82}

While most debtors filing bankruptcy certainly find themselves in dire straits, the Code provides them with ample protection from creditors and with many additional tools to remedy their financial problems. For example, a debtor may obtain an automatic stay to prevent creditors from pursuing collection against the debtor,\textsuperscript{83} or the debtor may invoke various

\begin{footnotesize}
\begin{enumerate}
\item See Eisenberg & Gecker, supra note 14, at 24.
\item See discussion supra Part I.
\item Gilday, supra note 5, at 431–32.
\item See 11 U.S.C. § 507 (2004). Section 507 sets out the priority by which nine categories of claims and expenses are paid: 1) “administrative expenses”; 2) “unsecured claims allowed under section 502(f)”; 3) “allowed unsecured claims,” including “wages, salaries, or commissions”; 4) “unsecured claims for contributions to an employee benefit plan”; 5) claims by persons “engaged in the production or raising of grain” or “engaged as a United States fisherman”; 6) “allowed unsecured claims of individuals”; 7) “claims for debts to a spouse, former spouse, or child of the debtor”; 8) “unsecured claims of governmental units” such as taxes; and 9) “allowed unsecured claims based upon any commitment by the debtor to a Federal depository institution’s regulatory agency . . . .” Id.
\item See, for example, the discussion of In re Kmart and In re CoServ, supra Part II. The Code sections commonly relied upon by debtors to reach the desired result are: 11 U.S.C. §§ 105(a), 363(b)(1), 364(b), 503, 549 (2004).
\item See generally § 362 (detailing which activities are stayed upon the filing of a petition in bankruptcy).
\end{enumerate}
\end{footnotesize}
“avoiding powers” to cancel or rework contracts and recover some pre-petition payments.\textsuperscript{84} Furthermore, debtors have knowledge that bankruptcy will be filed, and therefore are able to plan for post-petition financing.\textsuperscript{85} In exchange for these advantages, or perhaps to compensate creditors likely to receive partial or no payment on debts owed them, the Code provides some order and predictability via its priority list of creditors.\textsuperscript{86} Critical vendor orders ignore these provisions\textsuperscript{87} and introduce an element of uncertainty for creditors and debtors which the Code was crafted to eliminate.

It comes as no surprise that § 105(a) is the most commonly cited supporting reference for critical vendor orders because it provides judges with powerful and broadly defined authority.\textsuperscript{88} However, this is precisely why § 105(a) should not be used to allow debtors and select creditors to ignore the equitable measures set forth by the Code. As Judge Easterbrook persuasively argued, § 105(a) was inserted to facilitate application of the Code’s provisions, not to allow interested parties to circumvent express proscriptions of acceptable conduct.\textsuperscript{89} Perhaps the most convincing argument against the use of § 105(a) as the basis for critical vendor orders is the section’s language itself,\textsuperscript{90} which states: “[t]he court may issue any order . . . necessary or appropriate to carry out the provisions of this title.”\textsuperscript{91} Since critical vendor orders, or anything resembling such orders, are decidedly contrary to relevant sections of the Code, such as § 507’s priority scheme, it would be nonsensical to suggest this phrase was intended to be anything other than an admonishment to adhere to the Code’s specifics.

Of all the sections used by debtors to justify a critical vendor order, Judge Easterbrook highlighted § 363(b)(1) as the best candidate.\textsuperscript{92} That section allows a trustee (or DIP) to “use, sell, or lease, other than in the ordinary course of business, property of the estate.”\textsuperscript{93} Judge Easterbrook

\textsuperscript{84} A number of Code sections grant avoiding powers to various entities. See, e.g., §§ 544–548 (covering a variety of avoiding powers granted to the trustee to preserve the estate).

\textsuperscript{85} Post-petition financing must be obtained in accordance with § 364.

\textsuperscript{86} See supra note 81 (summarizing the Code’s priority provision at § 507).

\textsuperscript{87} See Gilday, supra note 5, at 414.

\textsuperscript{88} See discussion supra Part IV.A, Part I.B.

\textsuperscript{89} See supra Part II.A.1; supra note 37 and accompanying text.

\textsuperscript{90} Thomas G. Kelch presents an analysis of a “plain meaning” approach to reading the Code that is pertinent to this argument. See Thomas G. Kelch, An Apology for Plain-Meaning Interpretation of the Bankruptcy Code, 10 BANKR. DEV. J. 289 (1994).

\textsuperscript{91} 11 U.S.C. § 105(a) (emphasis added).

\textsuperscript{92} See In re Kmart, 359 F.3d 866, 872 (7th Cir. 2004).

\textsuperscript{93} 11 U.S.C. § 363(b)(1).
reasoned that the "ordinary course of business" referred to was that of a trustee or DIP managing an estate while in bankruptcy.\(^9\)

However, this approach necessarily adopts a meaning of "ordinary course of business" different than that used in other sections of the Code. The phrase typically is used as a measuring stick for what is normally done in the non-bankruptcy business world of the debtor. Judge Easterbrook's version would, of course, be necessary to permit critical vendor orders. Only then would the Code allow the debtor to bar creditors from pursuing collection of debts and allow the debtor unfettered discretion to cherry-pick the creditors it wishes to pay in full, leaving the others with either no hope of payment or a mere fraction of the debt owed them.

The key problem with Easterbrook's version of "ordinary course of business" is that it begs the question: what exactly is the ordinary course of business for a bankruptcy trustee or DIP? Nowhere in the Code is there a definition of this phrase. Even § 323, entitled "Role and capacity of trustee," offers no help in answering this question.\(^9\) In order to make § 363(b)(1) conform to Judge Easterbrook's interpretation, a trustee's tools must be defined by the trustee or judge through case law and practice. This approach would eliminate the need for numerous sections of the Code, as any specific grants or restrictions upon trustee power could be swept aside by defining "ordinary course of business" either narrowly or broadly.

The best answer to the question of what the ordinary course of business is for a bankruptcy trustee or DIP is also the one that undercuts § 363(b)(1) as supporting critical vendor orders: the Code specifically defines a trustee's duties and powers, yet one of the major tenets of the Code is that creditors should be treated similarly.\(^9\) Under this view, "ordinary course of business" would take the same meaning in this situation as in all other sections of the Code: a company operating in the marketplace just as it would absent a bankruptcy petition, not a trustee or DIP running a business in bankruptcy. Nevertheless, all is not lost should critical vendor orders be eliminated.\(^9\)

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\(^9\) See In re Kmart, 359 F.3d at 872 (stating that "satisfaction of a pre-petition debt in order to keep 'critical' supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy").

\(^9\) 11 U.S.C. § 323 provides: "(a) The trustee in a case under this title is the representative of the estate. (b) The trustee in a case under this title has capacity to sue and be sued." Id.

\(^9\) See, e.g., § 507.

\(^9\) Some other concepts that may be related in narrow or limited circumstances are those of setoff and recoupment. See generally Drew S. Norton, Recoupment: From Last in Line to First in Line, 16 AM. BANKR. INST. J. 32 (1997).
outlines ways in which a debtor may address unsecured creditors without resorting to critical vendor orders.

B. Increase Use of Post-Petition Security Interest

Section 364 of the Code provides the mechanism by which a debtor may secure post-petition financing to carry out a reorganization plan. Section 364(a) permits a debtor to first attempt to obtain unsecured credit "in the ordinary course of business" and to characterize this as an administrative expense under § 503(b)(1). Failing this, a debtor may, after notice and a hearing, obtain financing "secured by a lien on property of the estate not otherwise subject to a lien," or "secured by a junior lien on property of the estate that is subject to a lien." Credit obtained in this manner has priority over other administrative expenses, as outlined in § 503(b) and § 507.

Using § 364, a debtor would extend to a vendor a security interest in the supplies and accounts receivable purchased with the new credit. A debtor could also use any other property to secure the credit, so long as it met the criteria of § 364(c). This is an effective solution to the problem of critical vendor orders since those vendors considering extending credit to a debtor while also having pre.petition claims will have the assurance that these new, secured claims gain priority above all other claims and, thus, have the highest probability of being paid.

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100 § 364(c)(2)--(3).

101 § 364(c)(1). Section 503(b) lays out the categories of allowed administrative expense and § 507 sets the priority list that is so integral to the Bankruptcy Code. See §§ 503(b), 507(b).

102 § 364(c)(1)--(3), in pertinent part, reads as follows:

If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt—

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.

Id.

Section 364 also persuasively refutes cases like *In re Payless Cashways, Inc.*, where a debtor sought permission to elevate the pre-petition claims of certain lumber vendors to the level of an administrative expense in exchange for post-petition unsecured credit.\(^{104}\) The court allowed payment of pre-petition debts, holding that "the proposed arrangements are critical to the continued operation of the debtor."\(^{105}\) In so holding, the court noted that "where the debtor does not have post-petition financing in place, the bare promise of a priority administrative expense claim... cannot be expected to induce suppliers to extend credit to a debtor."\(^{106}\) However, this case involved unsecured credit, not the proposal here where a creditor would receive a security interest.

Should the debtor secure a line of credit from a bank, for example, the court could employ the suggestion made by the Seventh Circuit in *In re Kmart*;\(^{107}\) that is, use of a "standby letter of credit" where the court would allow unpaid vendors with post-petition claims to receive payment from this pool of money.\(^{108}\) While not exact, *In re Ike Kempner & Bros., Inc.* serves to illustrate this concept.\(^{109}\) The debtor, a shoe retailer in chapter 11, was the sole retail store selling a line of shoes supplied by U.S. Shoe Corporation.\(^{110}\) This line of shoes was a significant source of profit for Ike Kempner Bros.\(^{111}\) U.S. Shoe conditioned future shipments on Ike Kempner paying its pre-petition debts in full, which the court found to be in violation of the Code.\(^{112}\) The court, apparently influenced by Ike Kempner's efforts to effectively reorganize,\(^{113}\) ordered U.S. Shoe not only to fill pre-petition orders but also to fill future orders:

(discussing steps that vendors can take to increase the likelihood that their post-petition goods deliveries will be eligible for administrative priority).


\(^{105}\) *Id.*

\(^{106}\) *Id.* at 547.

\(^{107}\) *In re Kmart Corp.*, 359 F.3d 866, 872 (7th Cir. 2004).

\(^{108}\) See discussion of *In re Kmart supra* Part II.A.1.


\(^{110}\) *Id.* at 32.

\(^{111}\) *Id.*

\(^{112}\) *Id.* ("[D]efendant refused to complete orders of plaintiff unless debts incurred prior to filing of the Chapter 11 case be paid in full, which is tantamount to harassment prohibited by Chapter 11.").

\(^{113}\) "[T]he [debtor] engaged... an expert in aiding companies with financial difficulties, who has made substantial and positive changes in the debtor's operation and has arranged an accord with practically all of plaintiff's trade creditors except the defendant herein." *Id.*
The defendant should be ordered to fill orders for shoes applied for prior to filing of this case, conditioned that plaintiff issue its debtor in possession check prior to shipment unless the parties agree otherwise, conditioned further that plaintiff be given the usual trade discounts.

The Court further finds that under the unique circumstances of this case, the defendant should be required to fill future orders upon assurances of payment and that defendant will be required to accept a debtor in possession check prior to the shipment of said orders as adequate assurance of payment unless the parties agree otherwise.\footnote{14}

This order closely resembles the Seventh Circuit's suggestion of a standby letter of credit from \textit{In re Kmart}.\footnote{15} An added wrinkle in \textit{In re Ike Kempner & Bros.} was that U.S. Shoe had not fully performed the pre-petition deal, and the Code allows a trustee (or DIP) to require fulfillment of such deals.\footnote{16}

A subsequent case, \textit{In re Sportfame of Ohio, Inc.},\footnote{17} illustrates another alternative to critical vendor orders. Sportfame, a sporting goods retailer, sold the Wilson Sporting Goods product line for some years before filing a bankruptcy petition.\footnote{18} Prior to Sportfame's filing, Wilson stopped shipments to the retailer because of nonpayment.\footnote{19} While in a chapter 11 reorganization, Sportfame repeatedly requested that Wilson ship products, offering to pay cash in advance of delivery or to work out some cash-on-delivery arrangement.\footnote{20} Nonetheless, Wilson refused to make deliveries under any arrangement unless Sportfame paid its arrearage in full or submitted a plan that would result in payment of all pre-petition debt owed Wilson.\footnote{21} The court found that Wilson's actions violated the automatic stay and entered an injunction requiring Wilson to "ship goods to Sportfame of Ohio, Inc. on its order upon receipt of cash in advance or upon arrangement for cash on delivery . . . ."\footnote{22} This case also provides a good example of the proper use by a court of § 105's equitable powers. The opinion noted that Wilson's refusal to do business with Sportfame on a cash basis "can only be explained by

\begin{footnotes}
\item[14] \textit{Id.} at 32–33.
\item[15] \textit{See supra} notes 51–53 and accompanying text.
\item[16] \textit{In re Ike Kempner & Bros.}, 4 B.R. at 32.
\item[18] \textit{Id.} at 48.
\item[19] \textit{Id.} at 49.
\item[20] \textit{Id.}
\item[21] \textit{Id.}
\item[22] \textit{Id.} at 50. (The relevant section of the Code used by the court was 11 U.S.C. § 362(a)(6) (2004)).
\item[23] \textit{In Re Sportfame, Inc.}, 40 B.R. 47, 56 (Bankr. N.D. Ohio 1984).
\end{footnotes}
spite or ill-will towards the debtor and its effort to emerge as a successfully reorganized entity. An injunction in this case pursuant to section 105(a) of the Code is thus ‘necessary or appropriate’ to carry out the provisions of Title 11.”

C. Cross-collateralization

While generally disfavored by the courts, “cross-collateralization” is another alternative to critical vendor orders, related to granting post-petition security interests. Cross-collateralization “secur[es] a pre-petition obligation with new or additional collateral post-petition in connection with a new post-petition loan.” There are, however, problems with the use of this alternative.

First, cross-collateralization runs against § 507’s priority scheme, which is a fundamental tenet of the Code. The second criticism poses a more practical problem. Take, for example, a home improvement retailer that sells various kinds of lumber. This company finds itself in chapter 11 reorganization and has pre-petition claims from a lumber supplier. In an effort to keep business going, the debtor company approaches that same lumber supplier and negotiates a new deal to receive lumber. The lumber supplier requires that the debtor grant a security interest in its entire lumber inventory. The result of this arrangement is that the pre-petition claim of the lumber supplier, which was likely unsecured or undersecured, is rolled into the new secured claim and also acquires secured status, placing it at the top of the bankruptcy code’s priority list.

This state of affairs arises for two main reasons. First, the vendor has been burned once and wants to salvage as much of the pre-petition claim as it can. Second, the logistics of a debtor separating the inventory acquired pre-petition from that which is acquired post-petition are

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124 Id. at 53.
125 See, e.g., Shapiro v. Saybrook Mfg. Co. Inc., 963 F.2d 1490 (11th Cir. 1992) (holding that cross-collateralization is not authorized under the Bankruptcy Code); In re Texlon, 596 F.2d 1092 (2d Cir. 1979) (finding that a bankruptcy court should not have granted an ex parte order authorizing cross-collateralization, largely because such a scheme of financing is contrary to the spirit of the Bankruptcy Act).
128 See discussion supra Part III.B for a description of how this is done via § 364(c) and § 507(b) of the Code.
difficult at best. The two inventories are often commingled, and it becomes nearly impossible to sort them out should the debtor default on the post-petition deal. If the vendor, however, would be satisfied in receiving a junior or secondary lien, this approach would become more feasible, though it is not likely to satisfy the vendor since it would afford little additional security in most instances.

D. Define “Critical” Strictly

If critical vendor orders are to be retained, their parameters should be clearly set and their applications circumscribed. As discussed above, critical vendor orders constitute a radical addition to the Code, signifying a departure from the Code’s basic tenets. Even cases supporting critical vendor orders recognize the special nature of granting such orders. For example, in Dudley v. Mealey, Judge Learned Hand employed critical vendor orders as the exception, not necessarily the rule. In addition, the bankruptcy court in In re Chandlier referred to “extraordinary” circumstances:

The Doctrine of Necessity is inapplicable. That Doctrine is a rule of payment that allows trustees to pay pre-petition debts in order to obtain continued supplies or services essential to a debtor’s reorganization. The Doctrine itself is a violation of 11 U.S.C. § 507 and[,] in fact, is not authorized by any Bankruptcy Code section. When it has been applied it allows payment in a Chapter 11 case under very extraordinary circumstances of a few critical vendors who furnish the debtor with unique and vital supplies so that the debtor can operate and reorganize.

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129 WARREN & WESTBROOK, supra note 126, at 581–86.
130 See discussion of In re CoServ supra Part II.A.2.
131 Gilday, supra note 5, at 432.
132 Dudley v. Mealey, 147 F.2d 268, 271 (2d Cir. 1945); see also Gilday, supra note 5, at 426–27:

In a 1945 decision, Dudley v. Mealey, Judge Learned Hand surmised that the Six Months Rule could be extended to chapter X reorganization cases other than those involving railroads. It can be argued, though, that the structure of chapter X and the case’s emphasis on classification within a reorganization plan make the opinion inapplicable to modern law. Congress codified the Six Months Rule in section 77(b) of the Bankruptcy Act and then section 1171(b) of the Code. The Code made clear that the provision is applicable only to cases involving railroads.

Id.
Thus, defining "critical" should focus on hard economic data and market analyses rather than on the general sense of a debtor in a tight financial spot. Merely asserting that a vendor is crucial to a business's survival should not be enough.  

If a powerful tool like critical vendor orders is to be used, the test for its use should be objective, not subjective. The debtor should be required to show that the vendor either supplies a unique product, is necessary to avoid debilitating lead times in delivery, or is the only vendor in the market willing to do business with the debtor, and that it supplies a good or service the debtor absolutely must have to continue operating.

E. Notice

When a debtor files a bankruptcy petition, it makes all of its creditors parties to the suit. As with all other federal suits, a debtor is required to give notice to those creditors when the petition is filed:

Rule 4(a), (b), (c)(1), (d)(1), (e)--(j), (l), and (m) F.R.Civ.P. applies in adversary proceedings. Personal service pursuant to Rule 4(c)--(j) F.R.Civ.P. may be made by any person at least 18 years of age who is not a party, and the summons may be delivered by the clerk to any such person.

The Code also mandates that bankruptcy petitions follow Rule 5 of the Federal Rules of Civil Procedure, which states:

Except as otherwise provided in these rules, every order required by its terms to be served, every pleading subsequent to the original complaint unless the court otherwise orders because of numerous defendants, every paper relating to discovery required to be served upon a party unless the court otherwise orders, every written motion other than one which may be heard ex parte, and every written notice, appearance, demand, offer of judgment, designation of record on appeal, and similar paper shall be served upon each of the parties.

Thus, the argument could be made that debtors filing critical vendor motions should be required to notify all affected creditors that such a

134 See supra note 5 and accompanying text for an example.
135 See discussion supra Parts II.A.1--2 for illustrations.
136 FED. R. BANKR. P. 7004.
137 FED. R. BANKR. P. 7005 ("Rule 5 F.R.Civ.P. applies in adversary proceedings.").
138 FED. R. CIV. P. 5(a).
motion is pending before the court. The fundamental reasons for demanding this notice need not be repeated here, but they include the basic arguments taught to all first-year law students and are grounded in the American judicial system's notions of fairness and equity.\footnote{See, e.g., Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306 (1950).}

Critical vendor motions are certainly of great interest to all creditors, particularly those who may be deemed "not critical." It would seem unjust to deprive them of the opportunity to protect their interests.\footnote{For a summary of important tips and strategies for unsecured creditors, see Ayer et. al., supra note 4, at 16.} This was an issue contemplated by the court in \textit{In re Kmart}, where concerns for non-critical vendors were noted.\footnote{See Sprayregen et al., supra note 3, at 26.} In the past, while consideration of such orders may have been considered routine and administrative, \textit{In re Kmart}, \textit{In re CoServ}, and many other cases now seem to indicate the contrary. Critical vendor motions create a textbook "adversarial hearing," and it is impossible to have such a hearing without adversaries, which in this case are the vendors who may be deemed non-critical.

Requiring notice would also help judges by supplying them with a more comprehensive body of data and affording them more arguments upon which to base a decision:

Requiring vendors to appear in court likely allows the judge to more accurately gauge the factors at play. Their direct testimony can be more instructive than a static affidavit. The added inconvenience and accountability related to appearing in court may also help vendors reconsider their decision not to cooperate with the debtor.\footnote{Gilday, \textit{supra} note 5, at 420.}

\textbf{IV. CONCLUSION}

Critical vendor orders should be eliminated. The only place in the Bankruptcy Code where their use can be justified is in railroad company petitions. Yet, Congress has never seen fit to extend doctrines such as the Necessity of Payment Rule or the Six Months Rule beyond those specific cases in the hundred–plus years they have been in existence. Even sections like \textsection{} 105(a), with its broad grant of equitable authority, specifically limit exercises of that power to situations mandated by provisions of the Code.

Employing critical vendor orders and the Doctrine of Necessity requires judges to cast aside two fundamental tenets of the Bankruptcy Code: 1) \textsection{} 507's priority list of creditors, and 2) the automatic stay of
§ 362, which prohibits "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title . . . ."144 In the end, critical vendor orders benefit unsecured creditors who knew the risks of non-payment when they extended the credit. To rewrite or to ignore an extensive federal law like the Bankruptcy Code because a creditor freely took a chance and now wants a "do over" is largely indefensible.

Debtors who would benefit from critical vendor orders have only slightly better legs to stand on in defending such orders. While some vendors may be very important to a business, the Code provides debtors with many tools to facilitate reorganization, including some instances in which debtors can force vendors to deal with them. Cases such as In re Ike Kempner and In re Sportfame illustrate situations in which a vendor that has an ongoing business relationship with the debtor can be forced into post-petition dealings with that debtor.145 This is accomplished via the provisions of the Code itself, not by using doctrines that run contrary to the spirit or letter of the Code.

Problems with fairness to creditors either deemed "not critical" or who are not given notice that a critical vendor motion is being considered are other reasons for eliminating critical vendor orders and the Doctrine of Necessity. At least four circuits have either rejected or severely limited critical vendor orders,146 and the effects of the Seventh Circuit ruling in In re Kmart continue to persist today.147

In certain respects, the debate on critical vendor orders reaches to core philosophical ideas behind the American adjudicative system. First is the role of judges and whether that role includes the power of judicial "activism." When faced with a difficult decision regarding whether a vendor will refuse future dealings with the debtor and scuttle reorganization if pre-petition claims are not paid, should a judge be able to take actions not allowed under the law based on equity or on some similar justification? While there are certainly some instances when laws should be overturned by courts, bankruptcy does not appear to be one of these instances. Businesses start and fail in the market every year, yet no injustice results. Further, critical vendor orders are certainly not a debtor's sole recourse in implementing an effective plan of reorganization. Many alternatives are available.

One of the primary functions of the Bankruptcy Code is to bring order and predictability to cases where a business is failing—to stop the

145 See discussion supra Part II.B.
146 See Sprayregen et al., supra note 31, at 26.
147 See id.
scramble by creditors to collect what they can before there is nothing left. Another purpose is to give creditors notice of what to expect in the event that a business to which they are contemplating extending credit is not be able to pay the debt. Those creditors can more effectively evaluate their risks and benefits if they can accurately predict what will happen should a debtor file for bankruptcy. Critical vendor orders bring disorder to this arrangement, and thus have no place in the law.