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Kmart and Beyond: A "Critical" Look at Critical Vendor Orders and the Doctrine of Necessity

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I. Introduction

Phone calls like the one following take place on a regular basis between unsecured vendors and debtor's counsel in large Chapter 11 reorganizations.

"Are we on the list?"
"No."
"Will you put us on the list?"
"No."
"What can we do to be put on the list?"
"Maybe if you would stop calling!"

The unsecured vendors are asking the debtor's counsel to place them on the "critical vendor" list.[1] Pending court approval, the critical vendors will receive either partial or full payment of their pre-petition claims against the debtor in exchange for an agreement to continue to sell to the debtor on standard credit terms.[2] The other unsecured creditors will likely be paid a fraction of the value of their claims—around 5% to 10% in a typical case.[3]

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1. *See* Thomas J. Salerno, *"The Mouse that Roared" or, "Hell Hath no Fury like a Critical Vendor Scorned,"* 22 AM. BANKR. INST. J. 28, 29 (2003) (stating that "vendors frequently jockey for a place on the critical-vendor list").

2. *See* Bruce S. Nathan, *Critical Vendors: Elevating the Low-priority Unsecured Claims of Pre-petition Trade Creditors*, 21 AM. BANKR. INST. J. 14, 14 (2004) ("[C]ourts have approved the debtor's payment of certain critical vendor's pre-petition unsecured claims, usually in exchange for an agreement to continue shipping goods on the same credit terms during the chapter 11 case.").

3. *See* Joseph Gilday, *"Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code*, 11 AM. BANKR. INST. L. REV. 411, 414 (2003) (stating that paying the critical vendors "may result in a payment of mere pennies on the dollar" to the nonpreferred vendors); *id.* at 418 ("[U]nsecured creditors, of which trade vendors are a part, often collect less than they are owed or even nothing at all because the estate has been exhausted.").

Critical vendor orders have been attacked on several grounds including a perceived lack of legal authority for such court orders.[4] In *In re Kmart Corp.*,[5] the Seventh Circuit shocked the bankruptcy world by nearly undoing the statutory framework supporting critical vendor orders.[6] The Seventh Circuit held that Section 105(a)[7] of the Bankruptcy Code and the doctrine of necessity[8] did not provide the necessary authority for critical vendor orders. The court suggested that Section 363(b) might be sufficient to authorize the practice, though it explicitly declined to answer that question because the evidentiary record was incomplete.[9] The Supreme Court declined to hear the case,[10] leaving the circuits in disagreement over whether the Code currently authorizes critical vendor orders.[11]

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4. *See infra* Part III (describing the lack of legal authority for critical vendor orders).

5. *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004), *cert. denied*, 125 S. Ct. 495 (2004). In *Kmart*, the bankruptcy court approved three critical vendor orders on Kmart's behalf without notifying disfavored creditors or receiving any evidence. *Id.* at 868. The bankruptcy court gave Kmart "open-ended permission" to pay pre-petition debts owed to any vendor that Kmart deemed "critical" provided that the vendor agreed to furnish goods on "customary trade terms" for two years. *Id.* at 869–70. Kmart paid the pre-petition debts owed to 2330 critical vendors—totaling about $300 million—funded by $2 billion in debtor-in-possession financing. *Id.* at 869. The other 43,000 unsecured creditors not paid under the critical vendor orders eventually received about 10% of the value of their claims as stock in the newly reorganized Kmart. *Id.* The district court reversed the critical vendor orders, holding that neither Section 105(a) nor the doctrine of necessity authorizes such orders. *Id.* The district court's decision was affirmed by the Seventh Circuit. *Id.* at 874.

6. *See id.* at 872 (stating that Sections 364(b) and 503 were not sufficient to authorize critical vendor orders, while suggesting that Section 363(b) might possibly authorize the practice).

7. *Id.* at 871.

8. *See id.* (stating that common law doctrines pre-dating the 1978 Code, such as the doctrine of necessity, can "survive as glosses on ambiguous language" but not "as freestanding entitlements to trump the text").

9. *Id.* at 873–74.

10. Handleman Co. v. Capital Factors, Inc., 543 U.S. 987, 987 (2004) (denying certiorari).

11. *See* A. Mechele Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck?*, 11 AM. BANKR. INST. L. REV. 93, 110 (2003) ("[T]here is wide discrepancy among the Circuits as to whether courts have the authority to approve the payment of *any* pre-petition unsecured claim prior to confirmation of a chapter 11 plan."); *see also Kmart*, 359 F.3d at 873–74 (refusing to allow critical vendor orders because the evidentiary record was insufficient, though the court suggested that properly supported orders would be allowed); Chiasson v. J. Louis Matherne & Assocs. (*In re* Oxford Mgmt., Inc.), 4 F.3d 1329, 1334 (5th Cir. 1993) (refusing to allow the postpetition payment of a pre-petition claim); Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) (refusing to allow preplan payment to Dalkon Shield tort victims based on Section 105(a) even though the equities of the case weighed strongly in favor of allowing preplan payments); *In re* B & W Enters., Inc. 713 F.2d 534, 537 (9th Cir. 1983) (declining to extend the necessity of payment

Before *Kmart*, courts that were willing to authorize critical vendor orders often relied on the doctrine of necessity.[12] The doctrine of necessity allows a trustee or debtor-in-possession to pay the pre-petition debts of certain vendors who threaten to disrupt the debtor's reorganization by withholding critical goods and services until paid their pre-petition debts.[13] The doctrine of necessity grew out of the necessity of payment rule, a common law doctrine predating both the Bankruptcy Act of 1898 and the Bankruptcy Code of 1978.[14] Courts have disagreed whether the doctrine survived both enactments and, if so, in what form.[15] To authorize critical vendor orders, bankruptcy courts have also relied on their general equitable powers under Section 105,[16] in addition to Sections 363(b), 364, and 549(a).[17] After the Seventh Circuit dealt a blow to Section 105 in *Kmart*, Section 363(b) emerged as the strongest candidate to replace Section 105 as statutory authority for critical vendor orders.[18]

Once a rare phenomenon, critical vendor orders have increasingly become standard operating procedure in large Chapter 11 cases.[19] Aside from the

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rule to a trucking reorganization). *But see In re* Lehigh & New England Ry. Co., 657 F.2d 570, 581–82 (3d Cir. 1981) (describing the necessity of payment doctrine favorably, though the court did not apply it to the case at hand).

12. *See* Gilday, *supra* note 3, at 423 ("Debtors that request payment of critical vendors invariably cite the doctrine of necessity.").

13. *See infra* Part III.A (discussing the doctrine of necessity).

14. *See* Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV 1, 2–3 (1989) ("Although the two doctrines are different, the Doctrine of Necessity is a natural evolution of the Necessity of Payment Rule."); *id.* at 5 ("The Necessity of Payment Rule is not coextensive with the Doctrine of Necessity; rather, it is the historical basis from which courts have begun to fashion a legal principle responsive to the unique needs of parties in a Chapter 11 case.").

15. *See infra* Part III.A. (discussing whether either the doctrine of necessity or the necessity of payment rule survived the enactments of the Bankruptcy Act and Code).

16. *See infra* Part III.B (discussing whether Section 105(a) provides adequate statutory authority for critical vendor orders).

17. *See infra* Part III.D (discussing alternative statutory authority for critical vendor orders other than Sections 105(a) and 363(b)).

18. *See infra* Part III.C (discussing whether Section 363(b) provides adequate statutory authority for critical vendor orders).

19. *See* LYNN M. LOPUCKI & CHRISTOPHER R. MIRICK, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS 423 (4th ed. 2003) ("Although some courts have criticized distributions to pre-petition creditors other than pursuant to a confirmed plan as being inconsistent with the Bankruptcy Code, these payments are increasingly being authorized early in the case."); *see also* Robert A. Morris, *The Case Against 'Critical Vendor' Motions*, 22 AM. BANKR. INST. J. 30, 30 (2003) (stating that it has become common place for bankruptcy courts to approve critical vendor orders); Salerno, *supra* note 1, at 28 ("At one time, the postpetition payment . . . of prepetition, unsecured trade suppliers to . . . maintain the going-concern value of the distressed company would have been truly extraordinary. . . . Now it has become an inalienable right of debtors and trade vendors alike.").

question of their legality, courts and commentators have also criticized critical vendor orders for being overused and for unfairly favoring "critical" unsecured vendors at the expense of the noncritical unsecured vendors.[20] Additionally, critical vendor orders have been attacked as impinging on the "due process" rights of affected creditors.[21] Some commentators have called for a blanket prohibition against critical vendor orders.[22] Equally adamant, proponents of the practice maintain that detractors do not understand the "practical implications" that would flow if critical vendor orders were denied altogether.[23]

The scope and purpose of this Note is a bit unusual and needs to be explained. Ultimately, this Note does not stake out a position on whether Section 363 is sufficient to authorize critical vendor orders, but instead weighs the arguments for and against that section.[24] Recognizing, however, that critical vendor orders are currently permitted in several jurisdictions, it seeks to provide guidance to courts and practitioners regarding the limited circumstances under which such orders should be issued—at least until the Supreme Court or Congress speaks otherwise. This Note argues that the adoption of a heightened evidentiary standard by courts currently approving critical vendor orders will reduce at least some of the unfairness associated with such orders.[25] And like the proposal to prohibit critical vendor orders altogether, a heightened evidentiary standard will help decrease the pressure

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20. *See* Gilday, *supra* note 3, at 414 (calling critical vendor orders "unjust, unwise, and [an] illegal practice"); *see also* 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. OF BUS. L. 47, 47 (2004) ("[B]y dredging up arcane notions from a bygone era in the name of equity and expediency, they have circumvented the statutory priorities, paying certain favored creditors prematurely, often to the detriment of the general creditor body."); *id.* at 48 (calling the doctrine of necessity an "overworked and abused doctrine").

21. *See infra* Part II.C (discussing the procedural due process violations caused by issuing critical vendor orders without notifying the affected creditors).

22. *See* Charles Jordan Tabb, *Emergency Preferential Orders in Bankruptcy Reorganizations*, 65 AM. BANKR. L.J. 75, 75 (1990) (arguing that Congress should prohibit critical vendor orders altogether, or at a minimum, should only allow them where a "public interest is clearly at stake" and "after strict procedural protection of the rights of unsecured creditors").

23. *Cf.* Patricia L. Barsalou & Zack Mosner, *Preferential First-day Orders: Same Question, Different Look*, 22 AM. BANKR. INST. J. 8, 8 (2003) (stating that "many bankruptcy practitioners attribute . . . the failure of the circuit judges to understand the practical implications of their decisions as they affect bankruptcy cases" to "[t]he perceived 'disconnect' between the bankruptcy courts and the circuit courts").

24. *See infra* Part III.C (discussing whether Section 363(b) provides adequate statutory authority for critical vendor orders).

25. *See infra* Part V.B (discussing how a heightened evidentiary standard will reduce the impact of critical vendor orders on a debtor's estate).

placed on debtors by critical vendors to seek such orders, which in turn will decrease their excessive use.[26]

Part II of this Note discusses both the benefits and problems related to the use of critical vendor orders. Part III examines the common law and statutory basis for authorizing critical vendor orders, particularly Sections 105(a) and 363(b). Part IV reviews the different evidentiary standards employed by courts before authorizing critical vendor orders. Part V explores the market forces underlying critical vendor orders and develops an analytical framework for determining whether a critical vendor order is consistent with the interests of the estate. Where a critical vendor order is consistent with the estate's interest, this Note provides some guidance regarding the appropriate level of critical vendor payments. Part VI recommends that courts, currently willing to authorize critical vendor orders, should do so only after a debtor meets a heightened evidentiary standard like the one contained in *In re CoServ, L.L.C.*[27] Finally, this Note concludes by urging the Supreme Court or Congress to step into the fray and end the confusion surrounding the legality of critical vendor orders.

II. Description of the Problem

Two competing and conflicting policies are invoked by the use of critical vendor orders: facilitating reorganizations and treating similarly situated creditors equally.[28] By saving a failing business, a successful Chapter 11

26. *See* Gilday, *supra* note 3, at 421 (noting that "[d]emanding that the debtor prove that the vendor actually is essential would help stem the abuse [of critical vendor orders]"); Philip J. Hendel, *Is the Doctrine of Necessity in Peril?*, BCD NEWS AND COMMENT, June 27, 2003 ("[W]ithout a more restrictive interpretation of the court's emergency powers, a debtor is increasingly left at the mercy of those creditors who have the leverage to coerce payment.").

27. *See In re* CoServ, L.L.C., 273 B.R. 487, 496–97 (Bankr. N.D. Tex. 2002) (adopting a three-element evidentiary showing that a debtor must meet before the court would issue a critical vendor order); *infra* note 101 (discussing *CoServ* in more depth).

28. *See In re* Ionosphere Clubs, Inc., 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989) (describing the policies behind bankruptcy Judge Lifland's decision). "The policy of equality among creditors . . . may be of significance in liquidation cases under Chapter 7, however, the paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation of the debtor." *Id*; *see also* Bruce A. Henoch, *Postpetition Financing: Is There Life After Debt?*, 8 BANKR. DEV. J. 575, 577 (1991) ("The survival of the company is beneficial not only to the debtor, but to creditors as well, because the going-concern value of a corporation may exceed the liquidation value by a large margin."); Tabb, *supra* note 22, at 99 (suggesting that Judge Lifland "may be the leading judicial advocate of [the] philosophy" of flexibility in reorganization proceedings). Professor Tabb explained:

> Once [a] company becomes insolvent . . . another equitable principle comes into play: 'equality is equity.' In other words, all of the unsecured creditors (except

reorganization preserves jobs and stabilizes communities.[29] An approach favoring rehabilitation at any cost, however, may harm the unsecured vendors not receiving critical vendor payments, particularly if the reorganization fails and the assets are liquidated.[30] Courts and commentators have struggled to find the proper balance between these two conflicting policies.[31]

A. *Usefulness of Critical Vendor Orders*

Courts have recognized that there may be "rare instances in which the payment of a prepetition debt may be absolutely vital to the reorganization of a Chapter 11 debtor."[32] In these situations, "a *per se* rule proscribing the payment of prepetition indebtedness may well be too inflexible to permit the effectuation of the rehabilitation purposes of the Code."[33] In certain instances, the debtor's reorganization absolutely depends on goods or services supplied by one or a few key vendors, such as where a debtor is a retailer having customers who expect

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> those that enjoy a statutory priority) are entitled in equity to equal treatment. This translates into pro rata payments for all general unsecured creditors, who are determined as of the time of commencement of the bankruptcy reorganization case.

Id. at 77. *But see In re* Saybrook Mfg. Co., 963 F.2d 1490, 1496 (11th Cir. 1992) ("Rehabilitation is certainly the primary purpose of Chapter 11. This end, however, does not justify the use of any means.").

29. *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) ("The fundamental purpose of reorganization is to prevent the debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."); *see also* H.R. REP. NO. 95-595, at 1 (1977) (noting that business reorganizations represent a more economically efficient use of corporate assets than liquidations). The House report notes that:

> The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

Id.

30. *See* Tabb, *supra* note 22, at 115 (arguing that reorganizations that appear likely to fail should be dismissed or converted to Chapter 7). Professor Tabb continued:

> While concerns over preserving jobs and the like are cited as factors justifying [C]hapter 11, these interests are tangential. If it appears that the reorganization will fail and deplete the company's assets, reducing the dividend payable to creditors, then . . . the case either should be dismissed or converted to an immediate liquidation.

Id. at 76–77.

31. *See id.* at 115 (stating that the "[j]udges must weigh the immediate unfairness to non-preferred creditors against the hope of a greater benefit later in a successful reorganization").

32. *In re* Structurlite Plastics Corp., 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988).

33. *Id.*

certain name-brand goods.[34] Other times the "debtor's inability to substitute another vendor for the alleged critical vendor" is based on "specialized tooling and equipment, specialized knowledge, lack of industry capacity, or long lead times."[35] In some cases, the failure to pay a pre-petition claim may cause the bankruptcy of the critical vendor.[36] Finally, the debtor may not be able to locate adequate substitute goods at an acceptable price.[37]

Besides enticing vendors to continue to deal with the debtor postpetition, critical vendor orders represent an effective means of obtaining postpetition trade credit.[38] One problem with eliminating critical vendor orders altogether is that the alternatives of cash-on-delivery or cash-in-advance require large amounts of capital.[39] Without critical vendor orders, the debtor would have to pay for inventory up-front on a dollar-for-dollar basis.[40] In contrast, trade credit allows

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34. *See In re* Just for Feet, Inc., 242 B.R. 821, 826 (D. Del. 1999) (stating that the debtor "cannot survive unless it has name brand sneakers and apparel to sell in its stores" such as "Nike, New Balance, Fila, Reebok, Adidas, Asics, K-Swiss, and Converse"); *In re* Sportsfame of Ohio, Inc., 40 B.R. 47, 49 (Bankr. N.D. Ohio 1984) ("According to the evidence adduced at trial, many of plaintiff's individual and institutional customers have asked for certain Wilson goods by name. These same customers many times either refuse or are reluctant to accept as replacements other lines of goods carried by the plaintiff.").

35. *See* Morris, *supra* note 19, at 30 ("Lack of industry capacity does, in fact, create a true critical-vendor situation, because the vendor has near-term ability to recoup its sales volume with customers other than the debtor. This creates significant leverage for the vendor.").

36. *See* Andrew J. Currie & Sean McCann, *Hold on to Those Payments, Critical Vendors: Capital Factors v. Kmart*, 22 AM. BANKR. INST. J. 1, 1 (2003) ("[The] vendor will be unable to survive non-payment of pre-petition claims, and will thereafter cease to supply the debtor.").

37. *See id.* ("[T]he vendor provides essential goods or services at a significantly reduced price.").

38. *See* Dudley v. Mealey, 147 F.2d 268, 271 (2d Cir. 1945) (stating that as the debtor's "credit slowly wanes before final insolvency, it must begin to trade upon a cash basis, which may be difficult, or even impossible"); *see also* Lisa S. Gretchko, *How to Analyze a Trade Lien*, 21 AM. BANKR. INST. J. 14, 14 (2002) (stating that a "debtor becomes desperate for trade credit because its suppliers often withdraw it as soon as the bankruptcy is filed").

39. *See* Gretchko, *supra* note 38, at 14 ("From the debtor's perspective, COD and cash in advance terms are costly, impractical, and inimical to the debtor's reorganization efforts because they threaten the debtor's ability to maintain appropriate inventory levels.").

40. *Cf.* Thomas A. Korf, *Working Capital Basics: Liquidity and the Cash Cycle*, 20 AM. BANKR. INST. J. 10, 10 (2001) (describing the importance of cash to a financially distressed company). Korf emphasizes the importance of cash to a debtor:

> Nothing is as crucial to a financially distressed company as cash in the bank, and nothing affects cash as significantly as inefficient management of working capital. For financially distressed companies, or those considering a [C]hapter 11 bankruptcy filing, cash and continued liquidity take on corporate life or death importance. Money tied up in working capital is money that is not available to pay creditors or to fund operations.

Id. at 10.

the debtor to obtain needed goods and services without expending any cash for thirty or even sixty days. If critical vendor orders are used prudently, the debtor may be able to obtain credit representing 100% to 150%, perhaps more, of the value of the pre-petition debts paid.[41] As such, critical vendor orders have the potential to conserve the debtor's working capital, especially if pre-petition debts are only partially paid.[42]

Another benefit of allowing critical vendor orders is that they increase the overall transparency of the bankruptcy proceeding. If courts prohibited critical vendor payments or all payments of pre-petition debts as some commentators have suggested, then the parties might seek to accomplish the same results through indirect means.[43] For example, vendors with strong bargaining positions might raise the prices charged to the debtor in an attempt to recoup past losses.[44] Allowing the payment of pre-petition claims through critical vendor orders promotes transparency in bankruptcy proceedings by allowing the debtor, bankruptcy judge, and creditors' committee to accurately assess what the true cost to the estate will be for doing business with essential suppliers.[45]

B. *Unfairness of Critical Vendor Orders*

Commentators have argued that critical vendor orders violate one of the central tenets of bankruptcy—the absolute priority rule.[46] The absolute priority

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41. *See infra* Part V.D (describing the *Tropical Sportswear* case where the vendors extended postpetition trade credit to the debtor representing 124% of the value of their pre-petition debts paid).

42. *See infra* Part V.C (developing an analytical framework for evaluating when and to what extent critical vendor orders should be authorized).

43. *See* Tabb, *supra* note 22, at 97 (presenting an argument that the "same preferential result will be reached by indirect means" if the payment of pre-petition debts were prohibited altogether).

44. *But see In re* Kmart Corp., 359 F.3d 866, 873 (7th Cir. 2004) (discussing sunk costs and the decision to sell to the debtor postpetition). In *Kmart*, the Seventh Circuit suggested that firms, as profit-seeking entities, ignore sunk costs when making the decision whether to sell to the debtor in the future. *Id.* Though that might be true, it does not mean that firms always ignore sunk costs when they have sufficient pricing power to recoup losses by raising the prices charged the debtor postpetition. Critical vendor orders pay the pre-petition debts of critical vendors curing the debtor's default, which provides the vendors with greater incentive (even if only psychological) to deal favorably with the debtor in the future. *See infra* Part V.A (discussing the concept of cure in the executory contract and critical vendor order contexts).

45. *See* Tabb, *supra* note 22, at 98 ("[F]orcing the employee . . . or whomever to be direct and to state exactly what the price of playing ball is enables the court and the creditors' committee to assess more accurately whether the up-front price is worth the potential return benefit.").

46. *See, e.g.*, Morris, *supra* note 19, at 30 (stating that critical vendor orders "circumvent

rule requires that before junior claimants can receive any payment in a bankruptcy reorganization, claimants having priority must be paid in full or agree to other treatment.[47] Typically, unsecured creditors are the last level of claimants to receive any dividend at all—equity often receives nothing.[48] The final class of claimants receiving any payment are paid on a pro rata basis.[49] Critical vendor orders violate the absolute priority rule by paying certain unsecured creditors ahead of claimants having higher priority claims. Furthermore, as the last class paid, the other unsecured creditors receive an unequal, lesser amount instead of receiving their pro rata share.

Critical vendor orders, however, are only one category of pre-petition debt payments. Courts have also allowed debtors to pay pre-petition employee wage claims, consumer deposits, and warranty claims.[50] These claims are entitled to priority up to the limits specified under Section 507.[51] The Bankruptcy Code requires that a reorganization plan provide for the full payment of allowed priority claims before a court can approve the plan.[52]

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the absolute priority rule, one of the fundamental tenets of bankruptcy law").

47. *See* Anthony L. Miscioscia, Jr., *The Bankruptcy Code and The New Value Doctrine: An Examination into the History, Illusions, and the Need for Competitive Bidding*, 79 VA. L. REV. 917, 918 (1993) (describing the absolute priority rule). Miscioscia states that:

> The absolute priority rule provides that a junior claimant or interest holder may not receive or retain any property under a reorganization plan on account of such prior claim or interest unless all senior classes of creditors consent to the plan or are paid in full the allowed amounts of their claims.

Id.

48. *See* S.W. O'Donnell, *Toward a Better Understanding of New Value*, 108 PENN. ST. L. REV. 703, 707 (2004) (stating that the "common law rule of absolute priority" is that "creditors must be paid in full before pre-petition equity holders could retain any interest in the post-petition entity").

49. *See* Tabb, *supra* note 22, at 77 ("[A]ll of the unsecured creditors (except those that enjoy a statutory priority) are entitled in equity to equal treatment. This translates into pro rata payments for all general unsecured creditors."); *see also* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 81–82 (Foundation Rev. ed. 1993) (discussing the absolute priority rule in Chapter 11 reorganizations).

50. *See* LOPUCKI & MIRICK, *supra* note 19, at 421 (stating that courts have allowed the payment of the pre-petition debts customer warranties, customer deposits, and employee wage claims); *see also* Tom Morrow, *How to Improve Communication with Vendors: Careful Planning Is the Key to Success*, 19 AM. BANKR. INST. J. 20, 20 (2000) (noting that the most common group of creditors to receive payment of pre-petition claims are employees because "[w]ithout payment of their pre-petition wages, many employees would not continue to work for the debtor").

51. An employee is entitled to a priority claim of up to $4925 for unpaid wages and vacation, severance, or sick pay. 11 U.S.C. § 507(a)(3) (2000). Consumer deposits are protected up to $2225. 11 U.S.C. § 507(a)(6) (2000).

52. *See* 11 U.S.C. § 1129(a)(9) (2000) (requiring claims entitled to priority under Section 507(a)(1)–(2) be paid in cash on the effective date of the plan while claims entitled to priority

Paying priority claims prior to the confirmation of a reorganization plan is arguably less unfair than paying general unsecured claims early, but only when the amount paid does not exceed the amount allowed as a priority and the estate has enough money to pay the priority claims that are senior to the unsecured claims paid early.[53]

C. Procedural Due Process Violations & Critical Vendor Orders

An additional problem with critical vendor orders is that they have been issued by courts in situations that violate the procedural due process rights of affected creditors.[54] Critical vendor motions are usually among the many "first day" motions considered by the bankruptcy court at the start of the debtor's case.[55] As such, they are often approved before the affected creditors have notice or an opportunity to object. For example, in *Kmart*, Bankruptcy Judge Sonderby entered the critical vendor orders as proposed by Kmart "without notifying any disfavored creditors."[56] As a result, the orders are often issued, and critical vendor payments are made before the affected creditors even learn of the debtor's bankruptcy, let alone have sufficient time and notice to participate meaningfully. As a practical matter, once the critical vendor payments are made, it is with great difficulty that such payments can be recovered.

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under Section 507(a)(3)–(8) to be paid over time).

53. *See In re* CEI Roofing, Inc., 315 B.R. 50, 60 (Bankr. N.D. Tex. 2004) (stating that the "payment of prepetition wage claims of employees that qualify as priority wage claims under [§ 507(a)(3)] does not trigger the same concerns (i.e., upsetting priority under the Code and unfair discrimination among general unsecured claims)"); Tabb, *supra* note 22, at 95 (stating that "early payment should only be allowed if the court is confident that all higher priority claims later will be paid in full").

54. Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950) (holding that procedural due process requires "notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections"). The Bankruptcy Code protects the procedural due process rights of interested parties in bankruptcy proceedings by allowing certain actions only "after notice and a hearing." 11 U.S.C. § 363(b)(1) (2005). A full discussion of the "due process" implications of critical vendor orders are beyond the scope of this Note. For further discussion of this issue, see Tabb, *supra* note 22, at 103–06.

55. *See* Sabino, *supra* note 20, at 49 ("'Critical vendor' motions are generally grouped under the heading of 'first day orders' or 'first day motions.'").

56. *In re* Kmart Corp., 359 F.3d 866, 868 (7th Cir. 2004), *cert. denied*, 125 S. Ct. 495 (2004).

D. *Excessive Demand for Critical Vendor Orders*

Critical vendor orders are distinctive in that they represent a solution to a problem caused by their own existence. Trade vendors usually are not contractually bound to the debtor.[57] As such, trade vendors are free to renegotiate their relationship with the debtor based on postpetition circumstances.[58] Vendors request or, more accurately stated, demand critical vendor orders because they know that critical vendor orders are available.[59] Vendors can therefore require the payment of their pre-petition claims against the debtor as a prerequisite for postpetition dealings with the debtor.[60] Debtors usually want the unhampered discretion to pay the claims of certain vendors

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57. *See* LOPUCKI & MIRICK, *supra* note 19, at 417 ("[Often] the debtor needs or wants to continue doing business with the creditor during and after the reorganization case, but has no means of forcing the creditor to continue the relationship. Examples include employees who were not paid prepetition wages or suppliers with a high demand for their product."); Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 652 (1996) ("Trade creditors, for example, usually ship goods or provide services to a debtor on 'open account' terms, without signing a formal contract containing covenants.").

58. *See* LOPUCKI & MIRICK, *supra* note 19, at 417 ("Even though a creditor's claim is not entitled to any priority recognized by law, the creditor may have leverage or strong equities that suggest that the creditor's claim *should* have a priority.").

59. *See* Tabb, *supra* note 22, at 97 (describing how the availability of critical vendor orders increases the demand for them). Tabb argues that eliminating critical vendor orders would also eliminate their demand:

> If the possibility of preferential treatment is simply not available as a matter of law, ever, then prepetition creditors who attempt to extort such payments by threatening economic sanctions against the estate would be wasting their time. If those creditors knew *in advance* that preferential payments could not be made despite their threats of sanctions, they would be acting against their own self-interest (by reducing future dividends to their class) if they inflicted harm against the estate anyway. If, on the other had, those creditors know that the court does have the power to order preferential payments, then it is clearly in their interests to make the threat in virtually every case.

Id.; *see also In re* Mirant Corp., 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003) ("Because payment of prepetition claims outside of a plan has become commonplace in some jurisdictions, the court recognizes that a vendor might condition future dealings with [the debtors] on payment of its prepetition claim, whether or not payment of that claim could be justified under *In re CoServ*."); *In re* Revco D.S., Inc., 91 B.R. 777, 781 (Bankr. N.D. Ohio 1988) ("If all debtors in similar situations were to succumb to the threats of state taxing authorities, it would become the norm for debtors and taxing authorities to attempt to circumvent the bankruptcy statutes, which were enacted for the benefit of all creditors."); Morris, *supra* note 19, at 30 ("[V]endors demand critical vendor treatment because they know they can."); Salerno, *supra* note 1, at 29 ("The real problem . . . is that the exception to the rule (payment of unsecured, prepetition trade debt) has become the rule.").

60. *See* Baird & Jackson, *infra* note 208 (arguing that claimants who have goods or services the debtor needs are in a position to demand payment of their pre-petition debts).

without which its reorganization would be impaired, if not impossible.[61] But the availability of this broad discretion of the debtor gives the remaining trade creditors the incentive to make demands for payment of their pre-petition claims as well.[62]

III. Legal Bases for Critical Vendor Orders

Commentators and courts have criticized critical vendor orders as resting upon a weak legal foundation.[63] Because it is doubtful that the necessity of payment rule survived the enactment of the Bankruptcy Code, courts have searched to find a statutory basis.[64] Because no statute explicitly authorizes critical vendor orders, courts have become creative in stretching to find a statutory basis for their orders.[65]

A. Common Law Basis for the Doctrine of Necessity

The modern doctrine of necessity developed from the "necessity of payment rule"[66] first expounded by the Supreme Court in *Miltenberger v. Logansport Railway Co.*[67] The necessity of payment rule was created to help

61. *See* Salerno, *supra* note 1, at 28 n.1 (stating that Kmart sought "bankruptcy court approval to pay, in the aggregate, hundreds of million of dollars in pre-petition vendor claims . . . in the ordinary course of its business in its discretion").

62. *See* Morrow, *supra* note 50, at 20 ("[G]reat caution should be used in the use of this authority to pay pre-petition claims. Vendors will quickly learn that 'the squeaky wheel' gets paid. Soon all vendors will be refusing to ship unless they get their pre-petition claims paid.").

63. *See* Gilday, *supra* note 3, at 414 (calling critical vendor orders "unjust, unwise, and [an] illegal practice"); Salerno, *supra* note 1, at 28 (stating that "the articulated legal basis for [critical vendor] motions may . . . be suspect."); Tabb, *supra* note 22, at 115 (stating that "the legality and the wisdom of authorizing such preferential treatment is open to question, and no consensus has been attained").

64. *See infra* notes 76–81 and accompanying text (discussing whether the necessity of payment rule survived the enactment of the Code).

65. *See infra* notes 101–05 and accompanying text (discussing the *CoServ* court's creative approach to Section 105).

66. *See* 2 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW & PRACTICE § 42:11, at n.6 (2d ed. 2003) (stating that the terms "doctrine of necessity" and "necessity of payment rule" are used interchangeably, and they have no distinction, except the former is now more in vogue); *see also* Eisenberg & Gecker, *supra* note 14, at 2–5 (explaining the historical origins of the doctrine of necessity).

67. Miltenberger v. Logansport Ry. Co., 106 U.S. 286 (1882). In *Miltenberger*, the holder of a second mortgage on the railroad foreclosed on the obligation and requested that a receiver be set up. *Id.* at 288. In administering and managing the railroad, the receiver paid

trustees of railroad equity receiverships deal with "threats to the continued operation of the line during reorganization."[68] The rule allowed the trustee to pay the pre-petition debts of suppliers who threatened to disrupt the continued operation of the railroad by withholding essential goods or services.[69] In *Miltenberger*, the Supreme Court warned, however, that the discretion to pay pre-petition debts should "be exercised with very great care."[70]

The necessity of payment rule is often confused with the "six months rule," which granted trustees the authority to pay trade creditors for goods and services provided to the debtor in the six months immediately preceding the formation of an equity receivership, the historical precursor to bankruptcy reorganizations.[71] The six months rule was first incorporated into Section 77(b) of the Bankruptcy Act and then into Section 1171(b) of the Bankruptcy Code.[72]

$10,000 to connecting railroad lines for materials, freight balances, and repairs because the creditors had threatened to discontinue providing supplies on credit unless the arrearages were paid. *Id.* at 311. The receiver claimed that paying these claims was "indispensable to the business of the road, and that, unless the receiver was authorized to provide for them at once, the business of the road would suffer great detriment." *Id.* The Supreme Court stated that "[h]is action, sanctioned by the court, in allowing items within the scope of the orders of the court, appears to have been careful, discriminating, and judicious, so far as the facts can be arrived at from the record." *Id.* Furthermore, the Court stated:

> Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay preexisting debts of certain classes . . . under the order of the court. . . . Yet the discretion to do so should be exercised with very great care. . . . It is easy to see that the payment of unpaid debts for operating expenses . . . due by a railroad company suddenly deprived of control of its property, due to operatives in its employ, whose cessation from work simultaneously is to be deprecated, in the interests both of the property and of the public . . . where a stoppage of the continuance of such business relations would be a probable result, in the case of nonpayment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise. . . .

Id.

68. *In re* B & W Enters., Inc. 713 F.2d 534, 537 (9th Cir. 1983).

69. *See id.* ("The rule may be invoked by trustees as justification for the payment of pre-petition debts paid under duress to secure continued supplies or services essential to the continued operation of the railroad.").

70. *Miltenberger*, 106 U.S. at 311.

71. *See In re* Boston & Maine Corp., 634 F.2d 1359, 1366 (1st Cir. 1980) ("The Six Months Rule emerged out of the practice of initiating receiverships with an order appointing a receiver and authorizing or directing him to pay from operating receipts certain expenses incurred in the period immediately preceding the receivership."); *see also* Eisenberg & Gecker, *supra* note 14, at 3 (stating that the necessity of payment rule "is periodically confused with another principle of railroad reorganizations, the Six Months Rule").

72. *In re B & W Enters.*, 713 F.2d at 536.

Prior to the enactment of the Bankruptcy Code, Judge Learned Hand extended the six months rule outside the railroad context to a hotel reorganization in *Dudley v. Mealey*.[73] After the enactment of the Code, however, courts have declined to extend the six months rule outside of the railroad context because Section 1171(b)—the section codifying the six months rule—was placed in a subchapter made applicable only to railroad reorganizations.[74] This change reflects Congress's adoption of a recommendation by the National Bankruptcy Review Commission to limit the doctrine to railroad reorganizations.[75]

There is considerable doubt whether the necessity of payment rule survived the enactment of the Code.[76] In its brief before the Seventh Circuit in

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73. Dudley v. Mealey, 147 F.2d 268 (2d Cir. 1945). In *Dudley*, in response to a foreclosure action, the debtor voluntarily filed for reorganization under Chapter X of the Bankruptcy Act. *Id.* at 269. A bondholder objected to the reorganization plan because it gave priority to certain unsecured creditors who had furnished $10,276 in supplies to the hotel a short time before the receiver was set up. *Id.* at 271. The trustee argued that the "'six months rule,' applicable to railroads and other public service companies, applied." *Id.* The court accepted this argument, stating:

> It is undoubtedly true that a number of instances courts have refused to extend this doctrine to private corporations. It is also true that it was the interest of the public in the continued operation of railroads—afterwards extended to other public-service companies—on which the priority primarily rested. The doctrine may nevertheless have a larger basis. Just as it is recognized that, after insolvency, the expenses of continued operation of a business may be necessary to preserve its value for the secured creditors themselves, and for that reason that the receiver's creditors have priority, so it may be before insolvency. To take the case at bar, upon the continued operation of a hotel its good will depends; let it once shut down, and it will lose much of its value. . . . While the interests of the public were no doubt the paramount consideration in the origin of the rule, the interests of the lienors themselves may make equally imperative some protection to supply creditors. . . . [T]his is a particularly apt consideration in a reorganization, where the debtor is not to be liquidated, and when the very purpose of the action is to continue the existing business in the interest of the secured creditors and as here, of them alone.

Id. The court held that "so far as the supply of creditors furnished their goods [or] their services within" six months prior to receivership and such goods and services "were necessary to keep the hotel open," they were properly preferred claims. *Id.*

74. *In re* B & W Enters., Inc., 713 F.2d 534, 537 (9th Cir. 1983) ("The intent of Congress could hardly be more clear. It has deliberately limited the application of the Six Months Rule to the area of railroad reorganizations, the focus of concern to which it traditionally has been limited."); *see also In re* Mclean Indus., Inc., 103 B.R. 424, 426 (Bankr. S.D.N.Y 1989) (stating that Congress chose to limit the six month rule to Section 1171(b)).

75. Tabb, *supra* note 22, at 100 (stating that the "Commission Report recommending the rejection of the *Dudley* rationale was followed by Congress").

76. *In re B & W Enters.*, 713 F.2d at 537 (declining to extend the necessity of payment rule to a trucking reorganization). The court stated:

> [I]t is not clear that the Necessity of Payment Rule has been retained in the Bankruptcy Act of 1978. . . . We need not reach the question whether the Necessity

Kmart, Capital Factors, the unsecured vendor appealing the critical vendor orders, argued that the few post-Code cases[77] extending the necessity of payment rule outside the railroad context inappropriately relied on *Dudley* for two reasons: (1) "*Dudley* was a six months rule case, not a doctrine of necessity case," and (2) "*Dudley* itself is no longer good law outside the railroad context."[78] The Seventh Circuit agreed with Capital Factors and summarily dismissed the doctrine by stating that it did not survive the 1898 and 1978 enactments of the Bankruptcy Act and Code.[79] According to the Seventh Circuit, the Bankruptcy Act of 1898 and the Bankruptcy Code of 1978 displaced such common-law doctrines.[80] Older common-law doctrines, such as the doctrine of necessity, can "survive as glosses on ambiguous language" in the Code, but not "as freestanding entitlements to trump the text" of the Code.[81] Because it is doubtful, at best, that the doctrine of necessity survived the enactment of the 1978 Code, courts have sought statutory support before authorizing critical vendor orders.

B. Section 105(a)

Many courts, including the bankruptcy court in *Kmart*, have based their authority to issue critical vendor orders on Section 105(a) of the Bankruptcy

> of Payment Rule has survived the 1978 Act, however, for if it has, we would decline to apply it beyond the context of railroad reorganizations. . . . Because the Necessity of Payment Rule does not concern priorities of creditor claims, it is not included by reference in section 1171(b). Therefore, the limitation to railroad cases imposed by section 103(g) is not applicable.

Id.

77. *See In re* Ionosphere Clubs, Inc., 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989) (extending the necessity of payment rule to an airline reorganization); *In re* Gulf Air, Inc., 112 B.R. 152, 154 (Bankr. W.D. La. 1989) (extending the necessity of payment rule to an airline reorganization).

78. Brief of Appellee Capital Factors, Inc. at 47–48, *Kmart*, Nos. 03-1956 et al.; *see also In re B & W Enters.*, 713 F.2d at 537 ("The Necessity of Payment Rule was created for and has been applied only to railroad cases. Absent compelling reasons, we deem it unwise to tamper with the statutory priority scheme devised by Congress in the 1978 Act."); Tabb, *supra* note 22, at 100 ("*Dudley* is not a valid precedent, however, first, because it involved the Six Months Rule, and not the distinct Necessity of Payment Rule, and second, because the Commission Report recommending the rejection of the *Dudley* rationale was followed by Congress.").

79. *In re* Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004), *cert. denied*, 125 S. Ct. 495 (2004) ("Older doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text."); *id.* (describing the doctrine of necessity as "just a fancy name for a power to depart from the Code").

80. *Id.*

81. *Id.*

Code.[82] Section 105(a) provides the bankruptcy court with certain equitable powers:

> 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 . . . 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 prevent an abuse of process.[83]

The Seventh Circuit defined the scope of these equitable powers as "not creat[ing] discretion to set aside the Code's rules about priority and distribution; the power conferred by Section 105(a) is one to implement rather than override."[84] Furthermore, the equitable nature of bankruptcy proceedings "does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be."[85] The Seventh Circuit's interpretation of Section 105 is strongly supported by a warning from the Supreme Court. In another context, the Supreme Court cautioned in *Norwest Bank Worthington v. Ahlers*[86] that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."[87]

Case law from the other circuits also strongly supports the Seventh Circuit's restricted interpretation of Section 105.[88] For example, the Fifth

82. *Id.* at 869 (stating the bankruptcy court relied on Section 105(a) when approving Kmart's critical vendor orders); *see also In re* CoServ, L.L.C., 273 B.R. 487, 496–97 (Bankr. N.D. Tex. 2002) (authorizing critical vendor orders based on Section 105(a) combined with Section 1107); *In re* Just for Feet, Inc., 242 B.R. 821, 824 (D. Del. 1999) (authorizing critical vendor orders under Section 105(a) and the doctrine of necessity).

83. 11 U.S.C. § 105(a) (2000) (emphasis added).

84. *In re Kmart Corp.*, 359 F.3d at 871.

85. *Id.* (quoting *In re* Chi., Milwaukee, St. Paul & Pac. R.R. Co., 791 F.2d 524, 528 (7th Cir. 1986) (internal quotations omitted)); *see also* United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986) (stating that Section 105(a) "does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity").

86. Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988). In *Ahlers*, the debtors filed for protection under Chapter 11 to stay replevin proceedings to obtain possession of their farming equipment. *Id.* at 200. Debtors filed a proposed reorganization plan under which they retained an equity interest in the farm property, even though their interest was "junior to the creditors' unsecured claims." *Id.* Debtors argued that they were entitled to an equity interest because they were going to provide "new value" in the form of labor, experience, and expertise in running the farm. *Id.* at 203. The Supreme Court declined to decide whether the new value exception to the absolute priority rule survived the enactment of Section 1129(b), but instead found that, even if it did, the debtors contributions did not qualify as new value. *Id.*

87. *Id.* at 206.

88. *See In re* Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004) ("Every circuit that has

Circuit stated that a court's equitable powers under Section 105(a) must be "exercised in a manner that is consistent with the Bankruptcy Code."[89] Similarly, in *Official Committee of Equity Security Holders v. Mabey*,[90] the Fourth Circuit declined to authorize emergency payments to pre-petition tort claimants under Section 105 even when the equities of the case weighed heavily in favor of the emergency payments.[91]

In an earlier case, a court within the Second Circuit defined a court's equitable powers more liberally than did the Seventh Circuit in *Kmart*. In *In re Chateaugay Corp.*,[92] the District Court for the Southern District of New York held that rigidly adhering to the priorities contained in Section 507 "would be inconsistent with the fundamental purpose of reorganization and of the Act's grant of equity powers to bankruptcy courts, which is to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately."[93] The Bankruptcy

considered the question has held that [Section 105(a)] does not allow a bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full.").

89. Chiasson v. J. Louis Matherne & Assocs. (*In re* Oxford Mgmt., Inc.), 4 F.3d 1329, 1334 (5th Cir. 1993) (reversing a bankruptcy court order based on Section 105 that had compelled the debtor to use postpetition funds to pay pre-petition claims).

90. Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299 (4th Cir. 1987). In *Mabey*, the district court issued an order establishing a fifteen million dollar emergency fund for providing tubal reconstruction or in-vitro fertilization to eligible claimants. *Id.* at 300. The claimants had been injured by the debtor's Dalkon Shield contraceptive device and rendered infertile. *Id.* Costs of any surgery or treatment were to be deducted from the full amount due the claimant under the plan. *Id.* at 301. Claimants were not required to repay advanced funds, however, if their claim was disallowed. *Id.* The Fourth Circuit found that the creation of the Emergency Treatment Fund could not be "justified as an exercise of the court's equitable powers under Section 105(a)" even though equity would strongly favor the plan. *Id.* at 302. Furthermore, Sections 1122 through 1129 do not "authorize the payment in part or in full, or the advance of monies to or for the benefit of unsecured claimants prior to the approval of the plan of reorganization." *Id.*

91. *Id.* at 302.

92. *In re* Chateaugay Corp., 80 B.R. 279 (S.D.N.Y. 1987). In *Chateaugay*, the bankruptcy court issued an order allowing the debtor-in-possession to pay selected pre-petition wages and salaries, reimbursement expenses, and employee benefits. *Id.* at 280. The debtor-in-possession, based on its business judgment, resumed payment of workers' compensation claims in certain states but not others. *Id.* at 281. The State of Michigan argued that the bankruptcy court's order constituted a distribution inconsistent with Section 507. *Id.* at 286. The district court found that Section 507 applied only to the final plan of distribution, and not to "interim payments by the debtor." *Id.* at 287. Michigan also argued that all members of a class of claims under Section 1122 must be treated in the same manner throughout the bankruptcy proceeding if a distribution is made under Section 507. *Id.* at 286. The court also found that Section 1122 did not apply in the pre-plan stages of bankruptcy. *Id.* at 288.

93. *Id.* at 287.

Court for the Southern District of New York has continued to allow critical vendor orders in recent mega-cases.[94]

The strongest support for authorizing critical vendor orders under Section 105 comes from courts within the Third Circuit. In *In re Just for Feet, Inc.*[95] the District Court of Delaware claimed that the court's equitable powers under Section 105(a) were sufficient to authorize the payment of pre-petition claims.[96] In support of this claim, the district court also cited *Miltenberger* and the necessity of payment doctrine.[97] The district court admitted, however, that the current Bankruptcy Code did not explicitly codify the doctrine of necessity.[98] The district court then suggested that even though *Miltenberger* was not codified in the current Code, a court's equitable powers under Section 105 likely includes the power to authorize the payment of pre-petition debts.[99] Considering the Supreme Court's cautious view in *Ahlers*, however, in a future case it is likely to adopt a restrictive view of Section 105 similar to the Seventh Circuit's view.[100]

Perhaps the most creative statutory justification for critical vendor orders came from a bankruptcy court within the Fifth Circuit. In *In re CoServ Corp.*,[101] after stating that Section 105 could only authorize orders carrying out

94. *In re* Worldcom, Inc., No. 02-13533, 2002 Extra LEXIS 505, at *3 (S.D.N.Y. July 22, 2002) (authorizing critical vendor orders, not to exceed in aggregate $70 million, based on Section 105(a)); *In re* Enron Corp., Doc. No. 01-16034, 2001 Extra LEXIS 313, at *36–37 (S.D.N.Y. Dec. 10, 2001) (authorizing critical vendor orders, not to exceed $48 million, based on Section 105).

95. *In re* Just for Feet, Inc., 242 B.R. 821 (D. Del. 1999). In *Just for Feet*, several of the largest trade vendors demanded cash-in-advance and informed the debtor that they would not ship merchandise without payment of their pre-petition claims. *Id.* at 823. The debtor proposed to pay the pre-petition and postpetition claims of its critical trade vendors as they become due in exchange for a written agreement to extend credit on the same or better terms than in the past. *Id.* at 823–24. The debtor claimed that even with $25 million in postbankruptcy financing, it did not have enough money to pay cash-in-advance for merchandise already ordered. *Id.* at 823. The court approved the debtor's motion on an expedited basis after finding that it was necessary to pay the critical vendors in order for the debtor to obtain inventory for the upcoming Christmas season. *Id.* at 826.

96. *See id.* at 825 (stating that the "Supreme Court, the Third Circuit and the District of Delaware all recognize the court's power [under Section 105(a)] to authorize payment of prepetition claims when such payment is necessary for the debtor's survival during chapter 11").

97. *Id.* at 824.

98. *Id.* ("While [the doctrine of necessity] was not codified in the Bankruptcy Code, courts have used their equitable power under section 105(a) of the Code to authorize the payment of prepetition claims.").

99. *Id.* at 825.

100. *See supra* notes 86–87 and accompanying text (discussing the Supreme Court's warning in *Ahlers*).

101. *In re* CoServ, L.L.C., 273 B.R. 487 (Bankr. N.D. Tex. 2002). In *CoServ*, a group of

the Code, the court searched for a Code provision that would make the issuance of a critical vendor order necessary to carry out the purposes of the Code.[102] The *CoServ* court claimed it found one in Section 1107, which charges the debtor-in-possession with fiduciary duties to preserve the value of the estate.[103] The *CoServ* court speculated that "[t]here are occasions when this duty can only be fulfilled by the preplan satisfaction of a prepetition claim."[104] While the *CoServ* court was innovative in its attempt to splice Sections 105 and 1107 together, it is less promising than Section 363 as a potential solution to the lack of statutory authority supporting critical vendor orders.[105]

C. *Section 363(b)*

In *Kmart*, the Seventh Circuit suggested that Section 363(b) might authorize critical vendor orders, though it explicitly left the question unresolved.[106] Section 363(b) allows the trustee or the debtor-in-possession to use the property of the estate outside of the ordinary course of business.[107] Section 363 provides that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate."[108] The Seventh Circuit speculated that the "satisfaction of a prepetition

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telecommunications providers (CoServ) collectively filed for relief under Chapter 11. *Id.* at 489. CoServ requested a critical vendor order to pay roughly $2.2 million in pre-petition debts of twenty-seven creditors. *Id.* at 490. After the bankruptcy court expressed concern over the size and extent of the proposed payments, CoServ proposed instead to pay about $563,000 to seven creditors. *Id.* The court authorized the motion based on Sections 105(a) and 1107. *Id.* at 496–97.

102. *See id.* at 496–97 ("To get from Section 105(a) to the Doctrine of Necessity, the Court must find a bridge that makes application of the Doctrine of Necessity 'necessary or appropriate to carry out the provisions of' the Bankruptcy Code.").

103. *See id.* at 497 (noting that debtor-in-possession has the fiduciary duty "to protect and preserve the estate, including an operating business's going concern value"); *see also* 11 U.S.C. § 1107 (2000) (stating that a "debtor in possession shall have all the rights . . . and shall perform all the duties . . . of a trustee serving in a case under this chapter").

104. *CoServ*, 273 B.R. at 497.

105. *See* Gilday, *supra* note 3, at 442 ("Though Section 1107(a) does indeed mandate that the debtor in possession act as a fiduciary, it is unlikely that substituting this catalyst for the concept of 'necessary' in the Section 105 equation is an improvement."); *id.* (describing this line of reasoning as "puzzling").

106. *In re* Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004), *cert. denied*, 125 S. Ct. 495 (2004).

107. 11 U.S.C. § 363(b)(1) (2000).

108. *Id.*

debt in order to keep 'critical' suppliers flowing is a use of property other than in the ordinary course."[109]

Capital Factors argued that to interpret Section 363(b) as broad enough to authorize critical vendor orders would allow a "judge to rearrange priorities among creditors (which is what a critical-vendors order effectively does), even though the Supreme Court has cautioned against such a step."[110] In *United States v. Noland*[111] and in *United States v. Reorganized CF&I Fabricators of Utah, Inc. (Fabricators)*,[112] the Supreme Court addressed the scope of a bankruptcy court's equitable powers to categorically subordinate tax priority claims under Section 510(c), which codifies the common law principles of equitable subordination.[113] In *Noland*, the Supreme Court held that "the

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109. *Kmart*, 359 F.3d at 872. The court rejected Capital Factor's argument that "paying vendors would be 'in the ordinary course' but for the intervening bankruptcy petition." *Id.*

110. *Id.*

111. United States v. Noland, 517 U.S. 535 (1996). In *Noland*, the debtor filed for bankruptcy under Chapter 11 but then converted to Chapter 7 two years later. *Id.* at 536. After the conversion, the IRS filed claims for taxes, interest, and penalties accruing after the initial filing, but before the conversion. *Id.* at 537. The parties agreed that the IRS's claims constituted administrative expenses under Sections 503(b), 507(a)(1), and 726(a)(1), though they disagreed whether the penalties could be equitably subordinated under Section 510(c). *Id.* The bankruptcy court subordinated the tax penalty claim to the claims of the general unsecured creditors, and the decision was affirmed by the district court and the Sixth Circuit. *Id.* The Supreme Court reversed stating that Section 510(c) "permits a court to make exceptions to a general rule when justified by particular facts." *Id.* at 540. However, if that provision allowed a court "to conclude on a general, categorical level that tax penalties should not be treated as administrative expenses . . . it would empower a court to modify the operation of the priority statute at the same level at which Congress operated when it made its characteristically general judgment to establish the hierarchy of claims in the first place." *Id.* Furthermore, the "distinction between characteristic legislative and trial court functions would simply be swept away, and the statute would delegate legislative revision, not authorize equitable exception." *Id.*

112. United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996). In *Fabricators*, the debtor filed for relief under Chapter 11 because of its inability to meet pension obligations. *Id.* at 216. The IRS filed a tax claim based on 26 U.S.C. § 4971(a), imposing a 10% tax on any "accumulated funding deficiency" on certain pension plans. *Id.* The bankruptcy court allowed the claim but then denied it priority under Section 507(a)(7). *Id.* at 217. The bankruptcy court, instead, subordinated the tax claim (now a general unsecured claim) under Section 510(c) to those of the other unsecured creditors, and the district court and the Tenth Circuit affirmed. *Id.* at 218. The Supreme Court reversed, stating that "*Noland* passed on the subordination from a higher priority class to the residual category of general unsecured creditors . . . whereas here the subordination was imposed upon a disfavored subgroup within the residual category." *Id.* at 229. The principle in *Noland* "has nothing to do with transfer between classes, as distinct from ranking within one of them." *Id.* Instead, the "principle is simply that categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination under § 510(c)." *Id.*

113. *See* 11 U.S.C. § 510(c) (2000) (providing that "the court may . . . under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed

bankruptcy court may not equitably subordinate claims on a categorical basis in derogation of Congress's scheme of priorities."[114]

In *Kmart*, the Seventh Circuit was concerned about the unfettered discretion given by the bankruptcy court to Kmart to pay critical vendors. In the Seventh Circuit's view, the critical vendor orders as authorized by the bankruptcy court basically amounted to a categorical subversion of the priority scheme by allowing some unsecured creditors to receive different treatment than provided by Congress. The solution, according to the Seventh Circuit, was not to prohibit critical vendor orders altogether, but instead to authorize them under Section 363(b) on a case-by-case basis, whenever supported by a proper evidentiary showing that paying such claims would actually benefit the debtor's estate, or at least not harm it.[115] By authorizing orders on a case-by-case basis when supported by a proper evidentiary record, a court arguably does not *categorically* subvert the priority scheme created by Congress.

The Seventh Circuit's narrow view of *Noland* and *Fabricators* is questionable, particularly in light of other courts' interpretations of those cases.[116] For example, the *CoServ* court stated that "[w]hile preferring 'critical vendors' may not equate to subordination of a tax or tax penalty, it has the smell of a similar inappropriate adjustment of congressionally established priorities and therefore is at odds with the rationale of *Noland* and *Fabricators*."[117] The Seventh Circuit in *Kmart* read *Noland* and *Fabricators* as limiting a court's *equitable* powers to authorize critical vendor orders. Courts are not necessarily powerless, however, to reorder statutory priorities when armed with proper *statutory* authority: "[P]riorities do not change unless a

claim"); *Fabricators*, 518 U.S. at 229 (stating that the "categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination under § 510(c)"); *Noland*, 517 U.S. at 540 (stating that equitable subordination "permits a court to make exceptions to a general rule when justified by particular facts").

114. *Noland*, 517 U.S. at 536; *see also Fabricators*, 518 U.S. at 229 ("The principle is simply that categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination under Section 510(c).").

115. *See In re* Kmart Corp., 359 F.3d 866, 874 (7th Cir. 2004), *cert. denied*, 125 S. Ct. 495 (2004) (suggesting that even if Section 363(b)(1) allows critical vendor orders, the record still must show the "prospect of benefit to the other creditors").

116. *But see In re* Just for Feet, Inc., 242 B.R. 821, 825 (D. Del. 1999) (stating that *Noland* and *Fabricators* "do not hold that a bankruptcy court may never use its equitable powers to authorize payment to vendors when such payment is critical to the reorganization"). Instead, those cases "prohibit a court from subordinating tax claims under § 510(c) without *sufficient justification* for reordering the statutory priorities established by the Code." *Id.* (emphasis added).

117. *CoServ*, 273 B.R. at 496.

statue supports that step; if Section 363(b)(1) is such a statute, then there is no inseparable problem. . . . Nonetheless, it is prudent to read, and use, Section 363(b)(1) to do the least damage possible to [the] priorities" contained in Section 507.[118]

Although the Seventh Circuit in *Kmart* declined to hold that Section 363(b) provided a sufficient statutory basis for critical vendor orders,[119] a few other courts have held that Section 363(b) authorizes a debtor to pay pre-petition debts.[120] In *In re Ionosphere Clubs, Inc.*,[121] the bankruptcy court for the Southern District of New York allowed the debtor to pay certain pre-petition wage, salary, medical benefit, and business expense claims of its active employees based on Section 363(b).[122] The court relied on *In re Lionel Corp.*[123] for the proposition that a "bankruptcy court is empowered pursuant to

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118. *Kmart*, 359 F.3d at 872. The Code requires priority claims to be paid in full before unsecured creditors receive any payments (unless priority claimants otherwise agree). 11 U.S.C. §§ 507, 726(a)(1), 1129(a)(9) (2000).

119. *Kmart*, 359 F.3d at 873–74.

120. *See In re* Ionosphere Clubs, Inc., 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989) (authorizing payment of certain pre-petition claims of active employees based on Sections 363(b) and 105(a)); *In re* Tropical Sportswear Int'l Corp., 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005) (authorizing payments to critical vendors under Sections 105(a) and 363(b)).

121. *In re* Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989). In *Ionosphere*, the bankruptcy court approved Eastern Airlines's motion to pay certain pre-petition wage, salary, and medical benefits of its active workers without paying the identical claims of striking workers. *Id.* at 174. The court approved this motion based on Section 363(b), which it interpreted to allow the debtor to expend funds outside of the ordinary business course. *Id.* at 175. The debtor, however, must "articulate some business justification, other than mere appeasement of major creditors, for using, selling, or leasing property out of the ordinary course of business . . . ." *Id.* The court found that debtor's business reasons of retaining working employees and maintaining positive employee morale were critical to its reorganization efforts. *Id.*

122. *Id.* at 174–75.

123. *In re* Lionel Corp., 722 F.2d 1063 (2d Cir. 1983). In *Lionel*, the company filed a petition under Chapter 11. *Id.* at 1065. Lionel filed a motion to sell its 82% stock ownership interest in Dale for $43 million in cash (eventually sold for $50 million), which was to be distributed among Lionel's creditors. *Id.* The Dale investment accounted for 34% of Lionel's assets. *Id.* The bankruptcy judge found that "there must be some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business" before a judge could authorize such act under Section 363(b). *Id.* at 1070. Such business justifications might include:

> [T]he proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-à-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and . . . whether the asset is increasing or declining in value.

Id. at 1071.

§ 363 . . . to authorize a debtor to expend funds in the bankruptcy court's discretion outside of the ordinary course of business."[124] The debtor, however, "must articulate some business justification, other than mere appeasement of major creditors, for using, selling, or leasing property out of the ordinary course of business, before the court may permit such disposition under [S]ection 363(b)."[125] Paying a critical vendor when the estate is benefited likely satisfies the *Lionel* court's requirement under that section for a "business justification" beyond the "mere appeasement of major creditors." Additionally, Professor Douglas Baird has observed that where paying pre-petition creditors will "increase the return to general creditors, it is arguably a use of assets within the ambit of [S]ection 363."[126]

Recently, the bankruptcy court for the Middle District of Florida authorized a critical vendor order based on Sections 363 and 105.[127] After finding the debtor's evidentiary showing to be sufficient, the court found that it was a "proper exercise of its equitable powers under Sections 105 and 363" to

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124. *Ionosphere*, 98 B.R. at 175.

125. *Id.*

126. DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 192 (3d ed. 2001); *see also* Richard Cieri et al., *Forum Shopping, First Day Orders, and Case Management Issues in Bankruptcy*, 1 DEPAUL BUS. & COM. L.J. 515, 535 (2003) (discussing Section 363(b) as possible authority for critical vendor orders). At a recent symposium on large bankruptcies, Professor Baird stated:

> Better arguments may exist. Some people are trying to make Doctrine of Necessity arguments using [S]ection 363. All we're doing is using the assets of the estate to enhance the value of the estate. Section 363 authorizes that. Hence, there's authority via [S]ection 363 to have critical vendor orders. But Capital Factors [(the district court opinion)] doesn't address them.

Id. at 536; Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANK INST. L. REV. 69, 96 (2004) [hereinafter Baird, *The New Face of Chapter 11*] (discussing Section 363). Professor Baird noted that:

> The uncertainties around the doctrine of necessity have led some courts to refuse to sign any critical vendor orders and instead require the debtor to file a motion under Section 363 in which it asks the court for permission to buy assets outside of the ordinary course of business. In such a case, the debtor is not honoring a prepetition debt at all, but rather striking an unusual bargain by which it is getting post-petition goods or services. The Bankruptcy Code has no ban on such payments.

Id. But see Sabino, *supra* note 20, at 89–90 ("[S]tatutes like Sections 363 and 364 have their own jobs to do. It does violence to their plain statutory text to twist them into vehicles to justify critical vendor relief, a task for which they were never intended."); *id.* ("One should not torture plain statutory provisions to justify results. The end does not justify the means in "critical vendor" motions."); H. Bradley Staggs, *Critical-Vendor Orders: Has the Seventh Circuit Put Such Orders on the Critical List?*, 23 AM. BANKR. INST. J. 16, 16 (2004) (stating that the Seventh Circuit's interpretation of Section 363(b) "is seemingly at odds with the traditional use and interpretation" of that section).

127. *In re* Tropical Sportswear Int'l Corp., 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005).

allow payment of a critical vendor in circumstances that "benefit . . . the debtor's estate and the creditor body as a whole."[128]

Although only a few courts have authorized the payment of pre-petition debts based on Section 363(b), courts have approved analogous uses of estate property under the same section after finding that the proposed use would benefit the estate. In *In re Montgomery Ward Holding Corp.*,[129] the court approved the creation of employee-retention programs to retain key employees and stabilize turnover rates.[130] These retention programs did not pay the pre-petition debts owed to employees, but instead increased employee postpetition compensation because their salaries were comparatively low by industry standards.[131] The court noted that approving the programs was necessary to end the debtor's downward spiral towards liquidation and to "enhance the prospects for a successful reorganization."[132] This case represents using property of the estate to maximize the value of the estate, though it arguably lacks the preferential aspect inherent in critical vendor orders of paying one similarly situated unsecured creditor more than another.

Another analogous use of property of the estate is the approval of break-up fees under Section 363(b). Courts have authorized sizeable break-up fees, paid to a disappointed "stalking horse" as compensation for the stalking horse's due diligence in preparing a bid in a Section 363 asset sale.[133] The theory is that stalking horses maximize the value of the estate by enhancing the bidding process.[134] This analogy is only valid, however, where the value added by the

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128. *Id.* at 20. *See infra* Part V.D (discussing the *Tropical Sportswear* case in depth).

129. *In re* Montgomery Ward Holding Corp., 242 B.R. 147 (D. Del. 1999). In *Montgomery Ward*, the district court affirmed the decision of the bankruptcy court, which granted the debtor's motion to establish various employee incentive programs. *Id.* at 149. The debtor's executive vice-president of human resources testified that competitors were recruiting the debtor's most valuable employees and offering them employment contracts. *Id.* at 150. Unless its turnover rate could be reduced, the debtor would incur large expenses in replacing these employees such as "search fees, hiring bonuses, relocation expenses, and disruption at the store and corporate levels." *Id.* The bankruptcy court found that the proposed programs were "absolutely essential" and that approving the motion was "the best thing that [could] be done at this stage to enhance the prospects for a successful reorganization." *Id.* at 152.

130. *Id.* at 149–51; *see In re* Am. W. Airlines, Inc., 171 B.R. 674, 678 (Bankr. Ariz. 1994) (approving bonuses to the debtor's executives and employees as a valid exercise of its business judgment, though without specifically referring to Section 363(b)).

131. *Montgomery Ward*, 242 B.R. at 150.

132. *Id.* at 152.

133. *See In re* Marrose Corp., No. 89 B. 12171, 1992 WL 33848, at *5 (Bankr. S.D.N.Y. Feb. 15, 1992) ("Agreements to provide breakup fees or reimbursement of fees and expenses are meant to compensate the potential acquirer who serves as a catalyst or 'stalking horse' which attracts more favorable offers.").

134. *See In re* Integrated Res., Inc., 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992) (discussing

bidding enhancement is actually larger than the break-up fees paid.[135] In light of this dispute, one bankruptcy court stated that it would approve break-up fees on Section 363(b) sales, but only when it was in the best interests of the estate.[136]

Both analogous uses mentioned above—employee retention bonuses and break-up fees—represent a different use of the estate's property than critical vendor orders on at least one ground. Although both employee retention bonuses and break-up fees represent attempts to maximize the value of the estate using Section 363, neither do so by paying pre-petition debts. Courts have tried to avoid the questions surrounding the doctrine of necessity and the payment of pre-petition debts by "requir[ing] the debtor to file a motion under Section 363 in which it asks the court for permission to buy assets outside of the ordinary course of business."[137] The argument is that "[i]n such a case, the debtor is not honoring a prepetition debt at all, but rather striking an unusual bargain by which it is getting post-petition goods or services. The Bankruptcy Code has no ban on such payments."[138] It remains to be seen how the circuit courts will rule on this question.

But even assuming that Section 363 is sufficient legal authority, critical vendor orders must be authorized in accordance with that section and the Bankruptcy Rules.[139] Because of the practical difficulties involved in providing notice to all affected creditors early on in the bankruptcy proceedings, many courts have approved critical vendor motions along with the other, less controversial first day motions without requiring any notice to affected

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the circumstances under which break-up fees should be approved). The court stated:

> [T]he dominant issue that faces a court when determining the propriety of a break-up fee is whether the offer made by the party seeking the fee will enhance or hinder the bidding process. If the break-up fee encourages bidding, it will be approved, if it stifles bidding, it will not be approved.

Id.

135. Likewise, courts should only authorize critical vendor orders where the value created by authorizing the orders exceeds the actual cost of the order. *See infra* Part IV.D (discussing the economic standard required before a court can authorize critical vendor orders).

136. *See In re* S.N.A. Nut Co., 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995) ("Therefore, bankruptcy courts should carefully scrutinize breakup fees to be sure that, following the underlying policy guiding § 363, revenues will be maximized."). As another court stated, albeit in a different context, "[t]he prime criterion for assessing the interests of the estate is the maximization of its value." *Id.* at 104 (quoting *In re Clark*, 1995 U.S. LEXIS 11868, at *12 (N.D. Ill. 1995)).

137. Baird, *The New Face of Chapter 11*, *supra* note 126, at 96.

138. *Id.*

139. *See* FED. R. BANKR. P. 6004 ("Notice of a proposed use, sale, or lease of property . . . not in the ordinary course of business shall be given pursuant to Rule 2002(a)(2) . . . .").

creditors.[140] However, Bankruptcy Rule 2002(a)(2) requires that "the clerk . . . shall give the debtor, the trustee, all creditors and indenture trustees at least 20 days notice by mail of . . . a proposed use, sale, or lease of property of the estate other than in the ordinary course of business, unless the court for cause shown shortens the time or directs another method of giving notice."[141] And while this rule provides the court with the discretion to shorten the notice period or to allow notice by alternative means, this Note argues that, at a minimum, courts should not issue any critical vendor orders until after the creditors' committee is fully functional and has the opportunity to object. And as will be explained later, requiring the debtor to meet a heightened evidentiary standard affords additional protection to the affected noncritical vendors.

D. Other Statutory Arguments

Courts have based critical vendor orders on statutory grounds other than Sections 105 and 363. Section 549(a) allows courts to reverse postpetition transfers not properly authorized by the Code or the bankruptcy court.[142] Courts have used Section 549(a) to authorize critical vendor orders, though those same courts often relied on Sections 363(b) or 364(b) for additional statutory support.[143] Because Section 549(a) does not provide explicit support for paying pre-petition debts, courts using it have argued from the negative implication.[144] That is, because a bankruptcy court can reverse a postpetition transfer made to a pre-petition claimant, the court must also be able to authorize

140. *See generally* Tabb, *supra* note 22.

141. FED. R. BANKR. P. 2002(a)(2).

142. 11 U.S.C. § 549(a) (2000).

143. *See In re* Payless Cashways, Inc., 268 B.R. 543, 546–47 (Bankr. W.D. Mo. 2001) (authorizing payment of pre-petition debts based on Sections 549(a) and 364(b)); *In re* Federated Dep't Stores, Inc., Doc. No. 1-90-00130, 1990 Bankr. LEXIS 122, *3–7 (Bankr. S.D. Ohio 1990) (authorizing the payment of pre-petition debts based on the doctrine of necessity and Sections 549(a) and 363(b)).

144. COLLIER ON BANKRUPTCY § 549.04[4] (15th ed., rev. vol. 2004) ("One court found a negative implication in this section to justify the so-called 'doctrine of necessity' and, with the support of the creditors' committee, granted administrative priority status to the claims of critical vendors and payment of their prepetition claims." (citing *Payless Cashways*, 268 B.R. at 548)); *see also Payless Cashways*, 268 B.R. at 546 ("Indeed, Section 549 authorizes a Chapter 7 trustee to set aside only those postpetition payments of prepetition obligations that are 'not authorized under this title or by the court.' Thus, the Code recognizes that the court has some limited power to authorize preferential treatment to certain creditors."). *But see* Isis Foods, Inc., 37 B.R. 334, 337 (Bankr. W.D. Mo. 1984) (stating that "this court cannot conclude that authorizing postpetition transfers for prepetition debts" is a valid use of Section 549(a)).

one.[145] As for statutory authority under Section 364(b), the Seventh Circuit in *Kmart* correctly stated that this section "authorizes the debtor to obtain credit (as Kmart did), but has nothing to say about how the money will be disbursed or about priorities among creditors."[146] In summary, of all the sections used to authorize critical vendor orders, Section 363 is the best candidate as statutory authority for critical vendor orders.

IV. Evidentiary Standards for Authorizing Critical Vendor Orders

Once a court finds a legal basis for critical vendor orders, it must decide what evidentiary showing it will require before granting such an order. Courts have often authorized critical vendor orders after the debtor has made a general showing of need for an order. Examples of general showings include standards like: "essential to the continued operation of the debtor,"[147] "needed to facilitate the rehabilitation of the debtor,"[148] or critical to the debtor's reorganization.[149] Another general standard, though arguably more stringent, requires that absent "payment of the prepetition debt in question, the debtor's rehabilitative effort would be immediately aborted."[150] Courts have criticized general standards, whether lax or strict, as failing to provide "meaningful guidance to practitioners, leading to the filing of pleadings . . . requesting relief far beyond any reasonable concept of necessity."[151] In contrast to general

145. *See supra* note 144 (describing various Section 549 arguments).

146. *Kmart*, 359 F.3d at 872. The question of whether Section 364 supports cross-collateralization of pre-petition and postpetition financing is beyond the scope of this Note. For a discussion of the issue, see generally Charles Jordan Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. CAL. L. REV. 109 (1986).

147. *In re* Just for Feet, Inc., 242 B.R. 821, 825 (D. Del. 1999).

148. *In re* Ionosphere Clubs, Inc., 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989).

149. *In re* Financial News Network Inc., 134 B.R. 732, 736 (Bankr. S.D.N.Y. 1991) (refusing to extend the doctrine of necessity to allow the collection pre-petition attorney's fees by the debtor's bankruptcy attorneys).

150. *In re* Structurlite Plastics Corp., 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988). The *Structurlite* court sought to protect the other unsecured creditors by also requiring that "the court should be convinced, on the basis of the record before it, that authorizing the payment of the pre-petition debt creates 'the greatest likelihood of . . . payment of creditors in full or at least proportionately.'" *Id.* (quoting *In re* Chateaugay Corp., 80 B.R. 279, 287 (S.D.N.Y. 1987)); *see also In re* Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) (finding that payment of pre-petition debts is "necessary to avert a serious threat to the Chapter 11 process").

151. *In re* CoServ, L.L.C., 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002); *see also* Dickerson, *supra* note 11, at 109 (stating that appellate courts that "have approved such payments have struggled when deciding how to define the standard lower courts should apply when deciding whether to approve these payments").

standards, the *Kmart* and *CoServ* courts required debtors to make a more exacting evidentiary showing that the critical vendor orders are necessary under the circumstances and will benefit the nonpreferred creditors, or at least, leave them no worse off.[152]

The next two sections will discuss the evidentiary standards contained in *Kmart* and *CoServ*. Both the *Kmart* and *CoServ* standards seek to preserve the "estate and the going concern value of business, while not unfairly preferring one general unsecured creditor over others."[153] Furthermore, instead of accepting conclusory statements by debtor-in-possession management that critical vendor orders are necessary, as under a general evidentiary standard, both the *Kmart* and *CoServ* standards require the debtor to prove and quantify the supposed benefit to the debtor's estate in an effort to protect the other unsecured creditors.[154]

A. Evidentiary Standard in Kmart

In *Kmart*, the Seventh Circuit proposed two elements that a debtor must prove before a court could approve critical vendor payments.[155] First, the debtor must prove that "the disfavored creditors will be as well off with reorganization as with liquidation."[156] Second, the debtor must prove that the vendors in question would have ceased postpetition dealings with the debtor absent payment of pre-petition debt.[157] The first showing will be addressed in Part IV.D.

To meet the second showing, the debtor must show that possible alternatives to critical vendor orders would not work; in other words, the debtor must demonstrate that "discrimination among unsecured creditors [is] the only way to facilitate a reorganization."[158] The Seventh Circuit gave several reasons

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152. *Compare* Part IV.A (discussing the evidentiary standard in *Kmart*) *with* Part IV.B (discussing the evidentiary standard contained in *CoServ*).

153. *CoServ*, 273 B.R. at 499.

154. *See Kmart*, 359 F.3d at 873 (stating that it is "necessary to show . . . that the disfavored creditors will be as well off with reorganization as with liquidation"); *CoServ*, 273 B.R. at 498 (stating that a "debtor must show that meaningful economic gain to the estate or the going concern value of the business will result").

155. *Kmart*, 359 F.3d at 868. The bankruptcy court did not make either of these proposed factual showings before it authorized the critical vendor orders. *Id.* at 874.

156. *Id.* at 873. This first showing is addressed in conjunction with the economic component of *CoServ* evidentiary standard in Part V.D.

157. *Id.* at 873.

158. *Id.* at 874.

why most creditors would likely continue to do business with the debtor even without payment of their pre-petition claims.[159] First, the automatic stay prevents suppliers from ceasing performance under long-term contracts provided that the debtor pays for the postpetition deliveries.[160] For example, Fleming Companies, recipient of the largest critical vendor payment, should not have received a critical vendor payment because it was already contractually obligated to provide supplies to Kmart.[161] Even absent a legal obligation to continue providing goods, most firms (assuming they are rational profit-maximizers) would continue to sell to the debtor because "[e]ach new delivery produced a profit; as long as Kmart continued to pay for new product, why would any vendor drop the account?"[162] The fact that Fleming collapsed when Kmart stopped buying their products upon termination of the supply contract lends some support to this point.[163] Second, most firms would continue providing goods even when there are outstanding pre-petition debts, so long as the debtor provides assurances of payment of postpetition goods.[164] This could be accomplished by cash-on-delivery terms or standby letters of credit upon which unpaid vendors could draw.[165]

B. Evidentiary Standard in CoServ

In *CoServ*, a bankruptcy court in the Northern District of Texas formulated its own three-element evidentiary test for determining when critical vendor motions should be granted.[166] First, the debtor must show that it is "critical that the debtor deal with the claimant."[167] This element is satisfied where vendors are the "sole suppliers of a given product" or where creditors have "control over

159. *Id.* at 873.

160. *Id.*

161. *Id.* Fleming received a critical vendor payment in attempt to keep Fleming in a position where it could continue to supply Kmart. *See also* Cieri, *supra* note 126, at 533 (stating that Fleming was paid on the basis that it "was so critical to Kmart's existence that if they didn't make this payment, Fleming would eventually file for bankruptcy").

162. *Kmart*, 359 F.3d at 873.

163. *See id.* (stating that "Kmart had accounted for more than 50% of [Fleming's] business").

164. *Id.*

165. *See id.* ("If lenders are unwilling to issue such a letter of credit (or if they insist on a letter's short duration), that would be a compelling market signal that reorganization is a poor prospect and that the debtor should be liquidated post haste.").

166. *CoServ*, 273 B.R. at 498. The debtor is required to establish the three elements by a preponderance of the evidence. *Id.*

167. *Id.*

valuable property of the estate."[168] Second, the debtor must show that "meaningful economic gain to the estate or the going concern value of the business will result" from the order.[169] Alternatively, the debtor can also meet the second element by showing that "serious economic harm will be avoided through payment of the prepetition claim, which itself is materially less than the potential loss to the estate or business."[170] Under either approach, the debtor must show either a profit or cost savings resulting in a "net economic benefit" to the estate.[171] Finally, the debtor must show that "there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim."[172] As the Seventh Circuit stated in *Kmart*, vendors having contracts with the debtor will not qualify for critical vendor orders because they are already legally bound to perform, provided the debtor continues to perform postpetition.[173] Furthermore, the debtor can use alternatives such as payment upon delivery and letters of credit.[174]

C. Comparison of the Noneconomic Components of the Evidentiary Standards

The similar *Kmart* and *CoServ* standards can be divided into economic and noneconomic components.[175] This section addresses the standards' noneconomic components. The *Kmart* court required the debtor to show that a critical vendor would have ceased dealing with the debtor if its pre-petition debt was not paid.[176] For example, a vendor bound by an executory contract would not qualify as a critical vendor because it was already contractually required to continue to sell to the debtor.[177] The *CoServ* court, however,

168. *Id.*

169. *Id.*

170. *Id.* at 498–99.

171. *Id.* at 498.

172. *Id.*

173. *Id.* at 499; *Kmart*, 359 F.3d at 873 (stating that vendors with long-term contracts with the debtor must continue to perform if the debtor does as well). The debtor must cure pre-petition defaults, or provide adequate assurances of a prompt cure, before the debtor can assume an executory contract. 11 U.S.C. § 365(b)(1)(A) (2000).

174. *CoServ*, 273 B.R. at 499; *see also Kmart*, 359 F.3d at 873 (stating that the debtor can pay creditors with cash-on-delivery, cash-in-advance, or standby letters of credit).

175. *See infra* Part IV.D (discussing the economic component of the *Kmart* and *CoServ* evidentiary standards).

176. *Kmart*, 359 F.3d at 873.

177. *Id.*

divided this cessation-of-dealing component into two parts. First, the debtor must show that the vendor is actually critical.[178] A debtor could likely prove that a particular vendor is critical by offering an explanation of why the vendor's continued performance is vital to the debtor's reorganization. Though this showing is arguably vague and conclusory, it is nonetheless important as it marks a dividing line between critical and noncritical vendors. Requiring this showing limits the number of vendors that have the incentive to demand critical vendor status as noncritical vendors would quickly realize the futility of such an attempt.[179] Once the debtor overcomes this evidentiary hurdle under *CoServ*, it still must show that alternatives to critical vendor orders such as letters of credit or cash-on-delivery terms would not work.[180] This second showing helps ensure that the debtor actually pursues other alternatives when negotiating with vendors before asking the court to approve a critical vendor motion. The clarity of the *CoServ* standard makes it preferable to the *Kmart* standard. Rather than deal with the amorphous question of whether a vendor would have ceased dealing with the debtor, the noneconomic component of the *CoServ* standard has two parts that are distinct and provable.[181]

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178. *See CoServ*, 273 B.R. at 498 ("[I]t must be critical that the debtor deal with the claimant.").

179. *But see* 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) (describing problems associated with a heavy evidentiary burden for critical vendor motions at the beginning of a case). The authors argued:

> Furthermore, courts must consider the burdensome task of gathering evidence of the business relations between each 'critical' vendor and the mega-debtor. Such vendors could aggregate to hundreds or even thousands. Contacting each such vendor to obtain affidavits or request live testimony is virtually impossible considering the strain management is already under. Thus, the practical ramifications of overly burdensome evidentiary requirements can be counter-productive in a mega-case.

Id. This is the view of critical vendor orders that the courts in *Kmart* and *CoServ* intended to abolish. It is extremely unlikely that a debtor would have hundreds of vendors that were truly "critical." The economic component of the *Kmart* and *CoServ* tests serves to further reduce the number of vendors deemed critical.

180. *CoServ*, 273 B.R. at 498 (stating that the debtor must show that "there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim").

181. *See supra* notes 178–180 (describing the two parts of the noneconomic component).

D. Comparison of the Economic Components of the Evidentiary Standards

Although the economic component of the evidentiary standards in both *Kmart* and *CoServ* attempts to protect the nonpreferred unsecured vendors from the overreaching of critical vendors, the respective courts approached the issue from different angles: *Kmart* from the viewpoint of unsecured creditors and the estate, and *CoServ* solely from the perspective of the estate. Under *Kmart*, the nonpreferred unsecured creditors, at a minimum, must not be worse off because of the critical vendor orders.[182] The Seventh Circuit compared this showing to a liquidation cram-down analysis: "[I]f the impaired class does at least as well as it would have under a Chapter 7 liquidation, then it has no legitimate objection and cannot block the reorganization."[183] Proving what the unsecured creditors will eventually receive not only involves a very detailed calculation requiring numerous different assumptions each supported by evidence,[184] but

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182. *Kmart*, 359 F.3d at 873.

183. *Id.* at 872–73; *see also* Staggs, *supra* note 126, at 16 (suggesting that the *Kmart* evidentiary standard would prove very difficult to meet early on in a Chapter 11 proceeding). Stagg continued:

> [A]lthough not specifically addressed by the Seventh Circuit, potentially it would require that in the first few days of its bankruptcy the [C]hapter 11 debtor present a liquidation analysis to the bankruptcy court that would reflect a lower percentage recovery for pre-petition creditors (including non-critical vendors) as compared to the recovery such creditors would receive under a theoretical [C]hapter 11 plan that may eventually be confirmed after the debtor makes payments to critical vendors. If the Seventh Circuit actually would require such a detailed showing, the likelihood that a debtor would be able to obtain a critical-vendor order pursuant to [S]ection 363(b)(1) would be remote given the difficulty of making such a showing in the early stages of a [C]hapter 11 case.

Id. (emphasis removed).

184. Thomas A. Morrow et al., *A Simplified Approach to the Best-Interests Test in Complex Bankruptcies*, 22 AM. BANKR. INST. J. 36, 36 (2003) (explaining how to calculate a hypothetical liquidation analysis of the debtor). The authors offered the following formulation of a liquidation analysis:

Recoveries from Liquidation of Balance Sheet Assets

Add: Recoveries from Avoidance Actions and Litigation

Add: Other Proceeds from any Non-Balance Sheet Assets

Gross Proceeds

Less: Corporate Wind Down Expenses

Less: Employee Retention and Severance Plans

Less: Trustee and Liquidation Fees

Less: Professional Fees

Estimated Proceeds Available for Distribution

Less: DIP Facility Claims (Principal plus Letters of Credit) also depends on whether the reorganization is ultimately successful, which is difficult to predict at the start of the case.[185]

Under *CoServ*, the requirement of a net economic benefit is calculated by comparing the benefits gained from paying pre-petition claims against the costs of paying those claims.[186] As such, orders should only be authorized when additional cash will flow into the estate, even after paying critical vendors.[187] For example, "[i]f paying a critical vendor $10,000 at the beginning of a case for prepetition debts may net the estate $20,000 over the course of the case, permitting critical vendor order payments likely benefits all parties concerned and increases the likelihood of a successful reorganization."[188]

To meet the net economic benefit standard, it might be necessary to increase the amount of cash flowing into the estate. The debtor could accomplish this by extracting price concessions from a vendor or by obtaining

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Less: Secured Claims

Less: Administrative Claims

Less: Priority Claims

Estimated Proceeds Available for Unsecured Claims

Id. "The best-interests analysis is therefore focused on performing a hypothetical liquidation analysis of the debtor, commencing at the effective date of the plan. The results obtained from this hypothetical liquidation are then compared to the distributions proposed under the plan." *Id.*

185. *See* Gilday, *supra* note 3, at 423 (stating that all creditors benefit only when "the reorganization actually succeeds and when the confirmed plan adequately compensates all creditors" and that "[n]o one can guarantee with a straight face at the onset of reorganization that [a successful reorganization] will come to pass months later").

186. *CoServ*, 273 B.R. at 498 (discussing the economic component). The *CoServ* court tangentially addressed the degree of a net economic benefit required when it stated: "a debtor must show [a] *meaningful economic gain* to the estate . . . or that serious economic harm will be avoided through payment of the prepetition claim, which itself is *materially less* than the potential loss to the estate or business." *Id.* at 498–99 (emphasis added). The court explained that favorable credit terms should be approved only after a "careful analysis that shows net economic benefit" (referred to as the "trade credit approach"). *Id.* at 498. The phrase "net economic benefit" can also be defined as the dollar benefit to the estate after accounting for the actual cost of the critical vendor order (referred to as the "accounting approach"). *See infra* Part V.C.1–2 (explaining the accounting and trade credit approaches to "net economic benefit").

187. *See CoServ*, 273 B.R. at 498 ("It is obviously a bad bargain to pay $100,000 to recover $10,000 of estate property of which a claimant has possession."); *see also* Cieri, *supra* note 126, at 529 (stating that the *CoServ* standard is satisfied "if you paid a dollar prepetition claim, the debtor's estate grows by more than a dollar, a dollar fifty, for example").

188. *See* Currie & McCann, *supra* note 36, at 1 ("Moreover, there may be situations in which not paying a critical vendor will result in a loss to the estate far exceeding the cost of bringing that vendor current."). Another example of a qualifying situation would be where a "replacement provider charges twice as much for the same essential good or service, or a foreign vendor seizes an asset notwithstanding the stay." *Id.*

favorable credit terms.[189] As a practical matter, the debtor has more control over the size of the critical vendor payment than over the benefit flowing to the estate as a result of such orders.[190] Most of the time, a debtor will only be able to meet the net economic benefit standard by paying a smaller portion of the pre-petition claims of critical vendors.[191]

An illustration will help show that a debtor that meets the *CoServ* net economic benefit standard would also meet the *Kmart* standard—that the nonpreferred creditors are no worse off because of the critical vendor payments. For example, suppose the debtor's estate has $50,000 in cash. This debtor also has four unsecured creditors each owed $25,000, of which only one is critical. Now, suppose this debtor pays the critical vendor's $25,000 claim and realizes $30,000 in profits (not revenues) from sales directly attributable to paying this claim. In this scenario, the estate realizes a net economic benefit of $5,000. Instead of having $50,000 in cash, the debtor's estate will have $55,000 to divide among the remaining three unsecured creditors for an average payout of 73% instead of 50%. In this scenario, the *Kmart* standard would be met so long as the estate realizes a net economic loss that is no more than $12,500 as a result of authorizing the critical vendor order, thus leaving $37,500 to be divided among the remaining three creditors for a payout of 50%.[192]

Adopting the *CoServ* net economic benefit standard will cause debtors less evidentiary problems because it involves a simpler calculation and fewer assumptions than the hypothetical liquidation analysis required under *Kmart* while still achieving the purposes of the *Kmart* standard.[193] Additionally, the *CoServ* standard uncouples the determination whether to authorize critical vendor orders from the eventual success or failure of the reorganization. It is conceivable that a debtor could show a large benefit occurring early on in the case that is sufficient by itself to justify some level of critical vendor payments, even if the reorganization were eventually to fail. Requiring the debtor to meet a heightened evidentiary standard before courts issue critical vendor orders is more consistent with the view of Section 363 as a statutory vehicle to maximize

189. The court questioned, however, whether "favorable credit terms alone ever would meet the net benefit requirement." *CoServ*, 273 B.R. at 498 n.20. *See infra* Part V.C.1 (explaining the trade credit approach to defining "net economic benefit").

190. Currie & McCann, *supra* note 36, at 1 (noting that partial payment of pre-petition debt may be in the debtor's interest).

191. *See infra* Part V.C.1–2 (arguing that critical vendors will continue to deal with the debtor even when only partially paid).

192. The estate would realize a net economic loss of $12,500 if it was only benefited $12,500 by paying the critical vendor's claim of $25,000.

193. *See supra* note 179 (discussing a practitioner's criticism of the *Kmart* standard as being too difficult to meet at an early stage in a reorganization proceeding).

the value of the estate than is current practice, where such orders are issued without sufficient consideration of whether the estate is actually benefited.[194]

V. Critical Vendor Orders & Market Forces

Courts have failed to adequately examine the market forces driving vendors to seek critical vendor status. Once those market forces are revealed and understood, one sees that critical vendors would likely continue to provide goods and services and extend credit to debtors even if paid considerably less than the full amount of their pre-petition debts. To better understand these forces, however, it is useful first to examine the concept of "cure" in the executory contract context.

A. Curing Defaults on Executory Contracts & Voluntary Trade Relationships

Congress gave debtors enormous power to restructure their postpetition operations by allowing them to assume advantageous executory contracts while rejecting burdensome ones.[195] As a condition of assumption, however, Congress required debtors to cure pre-petition monetary defaults owed the other party to the contract.[196] The debtor must fully perform contracts so assumed while remaining liable for rejected contracts, but those damages will be paid in "bankruptcy dollars."[197] To assume a contract, the debtor must undertake

194. *See supra* Part III.C (discussing whether Section 363 authorizes critical vendor orders).

195. *See* 11 U.S.C. § 365(a) (2000) (stating that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor"); *see also* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) ("[T]he authority to reject an executory contract is vital to the basic purpose of a Chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization.").

196. *See* 11 U.S.C. § 365(b)(1)(A) (2000) (stating that "[i]f there has been a default in an executory contract . . . the trustee may not assume such contract . . . unless, at the time of assumption of such contract . . . the trustee cures or provides adequate assurance that the trustee will promptly cure, such default").

197. *See* Daniel Keating, *Offensive Uses of the Bankruptcy Stay*, 45 VAND. L. REV. 71, 84 (1992) (stating that "under the Code's current system, debtors in bankruptcy can choose to breach prepetition executory contracts and pay damages in bankruptcy dollar rates"); *see also* 11 U.S.C. § 365(g)(1) (2000) (stating that the "rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease . . . immediately before the date of the filing of the petition"); 11 U.S.C § 502(g) (2000) (stating that a "claim arising from the rejection, under § 365 . . . of an executory contract or unexpired lease of the debtor that has not

"performance of the entire contract, as if bankruptcy had never intervened."[198] If the debtor assumes a contract, the other party must continue to perform under the original terms of the contract.[199] Courts defer to the debtor's decision to assume or reject contracts so long as the decision has some business justification.[200] The debtor undertakes a limited economic analysis when deciding which contracts to reject and which to assume.[201] By allowing the debtor to select which executory contracts to assume and which to reject, Congress implicitly placed part of the burden of the debtor's reorganization on the holders of rejected executory contracts.[202] In doing so, Congress allowed debtors to treat contract holders differently based on whether the debtor desired to continue postpetition business with them.[203]

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been assumed shall be determined . . . the same as if such claim had arisen before the date of the filing of the petition").

198. *Id.* at 547 (quoting GATX Leasing Corp. v. Airlift Int'l, Inc. (*In re* Airlift Int'l, Inc.), 761 F.2d 1503, 1508 (11th Cir. 1985)); *see* MARK E. BUDNITZ & GARY M. SHAPIRO, COUNSELING AND REPRESENTING FINANCIALLY DISTRESSED BUSINESSES 159 (1993) (stating that "the debtor is liable for performing under the contract as though the company were not in bankruptcy").

199. *See Kmart*, 359 F.3d at 873 ("[Vendors] may, for example, have long term contracts, and the automatic stay prevents these vendors from walking away as long as the debtor pays for new deliveries.").

200. *See* William M. Winter, Note, *Preserving the Benefit of the Bargain: The Equitable Result*, 13 BANKR. DEV. J. 543, 546 n.19 (2003) ("In evaluating a trustee's decision to assume or reject, a bankruptcy court will apply a 'business judgment' standard to determine if assumption would be beneficial to the estate."); *see also In re* Orion Pictures Corp., 4 F.3d 1095, 1099 (2d Cir. 1993) (stating that a "bankruptcy court reviewing a trustee's or debtor-in-possession's decision to assume or reject an executory contract should examine a contract and the surrounding circumstances and apply its best 'business judgment' to determine if it would be beneficial or burdensome to the estate to assume it." (citing *In re* Minges, 602 F.2d 38, 43 (2d Cir. 1979))).

201. Winter, *supra* note 200, at 545.

202. *See* Keating, *supra* note 197, at 84–85 ("[T]he Code's current rule on contract assumptions leaves an uneasy sense that the nondebtor party to the contract is receiving a preference. . . . At the point of the debtor's bankruptcy, the creditor who possesses an ability to confer some special future benefit on the debtor is not in the same position as the creditor who has nothing to offer the debtor.").

203. *See id.* at 83–84 (discussing the assumption of contracts). Professor Keating commented:

> In creating the executory contracts section of the Code, why did the drafters decide to condition the debtor's ability to assume existing contracts on the cure of prepetition defaults . . . ? In rejecting such a "no-cure" system of contract assumption, the Code drafters may have wished to avoid the effect such a regime would have on the willingness of nondebtor parties to make contracts with financially struggling entities. . . . Alternatively, rather than refusing to deal with debtors on the brink, nondebtor parties might charge financially unstable companies a significant premium that reflects the risk inherent in performing the

Just as debtors cure pre-petition monetary defaults before assuming executory contracts, critical vendor orders are used to "cure" pre-petition monetary defaults.[204] Rather than curing contractual pre-petition defaults, however, the debtor is seeking to cure defaults with selected trade vendors with whom it is not contractually bound.[205] These vendors have no legal duty to continue selling to the debtor postpetition, even if the debtor guarantees full payment of postpetition sales.[206] By paying a pre-petition claim, the debtor is able to entice a vendor to continue selling to the debtor by voluntarily curing the debtor's pre-petition default.[207]

The dynamics involved in authorizing critical vendor orders are very different from those involved in the assumption or rejection of executory contracts. When the debtor assumes or rejects a contract, the debtor makes a case-by-case decision where the outcome of one decision does not affect the outcome of another. Moreover, because the holders of executory contracts are already contractually bound to the debtor, they cannot modify their bargaining demands based on whether the debtor has assumed or rejected the other executory contracts.[208] In contrast, when a debtor pays one critical vendor, it

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> bargain in full while the debtor offers something much less in return.

Id.

204. *See id.* at 88–92 (comparing the curing of pre-petition defaults using the doctrine of necessity with the assumption of executory contracts); *id.* at 90–91 (comparing the cost-benefit analysis undertaken by a debtor-in-possession before assuming an executory contract with the decision to pay the pre-petition debts of a critical vendor).

205. Schwarcz, *supra* note 57, at 652 ("Trade creditors, for example, usually ship goods or provide services to a debtor on 'open account' terms, without signing a formal contract containing covenants."). Debtors would have a contract to pay for the particular goods shipped or services provided, but neither the debtor nor vendor would be under any contractual obligation to continue to deal with the other party in the future, as would be the case if the parties were bound by a long-term supply or purchase requirements contract. *See infra* note 206.

206. *See CoServ*, 273 B.R. at 494 n.12 (stating that a "supplier has as much right to refuse to deal with a debtor as a lender to refuse to advance a debtor additional funds"); *Kmart*, 359 F.3d at 873 ("Some supposedly critical vendors will continue to do business with the debtor because they must. They may, for example, have long term contracts, and the automatic stay prevents these vendors from walking away as long as the debtor pays for new deliveries."); Morrow, *supra* note 50, at 20 ("Unless there is an executory contract, there is little the debtor can do to force the vendor to provide services.").

207. *See* Keating, *supra* note 197, at 90–91 (stating the debtor must "assess the relative advantage of pursing future dealings with the recalcitrant prepetition creditor").

208. *But see* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, *in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 115 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996) (suggesting that junior claimants may be in a position to renegotiate their initial bargain if they have something the debtor needs). Professors Baird and Jackson argued:

encourages the other vendors, who ordinarily would be content with assurances of postpetition payment, to demand payment of their pre-petition debts as well.[209] Trade vendors are free to modify their demands based on the debtor's postpetition circumstances because they are not normally bound to the debtor by contract.[210] Because vendors are free to renegotiate their postpetition dealings with the debtor, any potential solutions to the problems caused by allowing critical vendor orders must somehow decrease the demand for such orders.

B. Effect of a Heightened Evidentiary Standard

Courts have failed to adequately scrutinize the size of critical vendor payments.[211] Critical vendors have the incentive to threaten the debtor in order to extract full payment of their pre-petition debts, particularly because most courts authorizing critical vendor orders have allowed full payment in the past.[212] The debtor-in-possession, though bound by fiduciary duties to consider the interests of the estate, tends to be motivated by the self-preservation instincts of management and, as such, is not willing to call the vendor's bluff.[213]

> When some of the old owners are to remain involved with the firm after the accounting, they may be in a position to renegotiate their original bargain. The supplier who is owed money may condition delivery of further supplies on its past debts being paid in full. . . . To the extent that the junior owners can offer new supplies, expertise, or capital on terms more favorable than anyone else, it is in everyone's interest that they do so. In negotiations involving prior owners who are also future suppliers, striking a deal requires distinguishing between their rights as existing owners of the firm and their ability to provide a new input to the firm on favorable terms.

Id.

209. *See* Morrow, *supra* note 50, at 20 ("[G]reat caution should be used in the use of this authority to pay pre-petition claims. Vendors will quickly learn that the 'the squeaky wheel' gets paid. Soon all vendors will be refusing to ship unless they get their pre-petition claims paid.").

210. *See id.* ("Unless there is an executory contract, there is little the debtor can do to force the vendor to provide services.").

211. *See* Baird, *The New Face of Chapter 11*, *supra* note 126, at 96 ("For a time, too many bankruptcy judges seemed inclined to issue critical vendor orders without much inquiry.").

212. *See* Cieri, *supra* note 126, at 529 (suggesting that most critical vendor orders fully pay pre-petition debts); Gilday, *supra* note 3, at 421 ("Often counsel simply fail to disclose the reasons for the vendor's refusal to cooperate with the debtor. Instead they state that the doctrine of necessity exists, and that the debtor is entitled to take advantage of it."). The *Kmart* and *CoServ* standards stand to change the expectations of critical vendors in regard to the size of the critical vendor payments.

213. *See* Cieri, *supra* note 126, at 531 ("If you are a debtor's lawyer, you're dealing with a

The result is that courts have been authorizing the full payment of the claims of critical vendors in situations where critical vendors would have been willing to accept less—possibly much less, had courts shown more vigor in protecting the noncritical creditors.[214]

Some commentators have suggested that eliminating critical vendor orders altogether will reduce the economic incentives of suppliers to demand critical vendor payments.[215] While conceding that this proposition is true, this Note argues that a heightened evidentiary standard will also do much to reduce the demand for critical vendor orders.[216] By raising the required evidentiary standard, a bankruptcy court actually helps the debtor by strengthening the debtor's bargaining position by clearly defining the boundaries of a deal, acceptable to the approving court, in the debtor's favor.[217] If courts consistently

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company that is very inexperienced in bankruptcy, scared of what is going to happen, and so your view is that everybody is a critical vendor."); Morris, *supra* note 19, at 30 (stating that "management has little incentive to say no" to critical vendors because management is "spending creditor's money" and "has to work with vendors beyond the bankruptcy horizon"); Salerno, *supra* note 1, at 28 (stating that "no debtor's counsel wants to call their bluff, because the consequences are severe"); Tabb, *supra* note 22, at 79 ("While the managers supposedly owe a fiduciary duty to the creditors, management decisions almost inevitably are biased in favor of survival.").

214. *See* Dickerson, *supra* note 11, at 111 (arguing that critical vendor payments should be capped to minimize the unfairness to the other creditors). Dickerson explained:

> [B]ecause of the risk that paying pre-petition unsecured claims outside of the normal priority scheme may cause other creditors to receive less than their pro rata share in the bankruptcy distribution, courts should compare the amount of the proposed payment to the likely amount of funds available to pay other similar ranked claims, and should, if necessary, place a cap on the amount of payments pre-petition creditors can receive. In formulating such a cap, the court should consider the amount of payments the creditor received pre-petition and the amount of pre-petition payments debtors make to creditors who are *not* viewed as "critical vendors."

Id.; *see also* Mette H. Kurth, *First Among Equals? Maybe Not—The Search for 'Critical Vendor' Status*, BUSINESS LAW TODAY, Sept./Oct. 2004, at 17 ("As is common, these payments were conditioned on the vendors' agreement to continue furnishing goods to Kmart on customary trade terms. A more conservative program might have sought to pay the claims of critical vendors only at some discount.").

215. *See* BAIRD, *supra* note 49, at 230 ("[I]f the Bankruptcy Code flatly forbade the trustee or the debtor in possession from paying prepetition obligations to creditors, [critical vendors] would be much less likely to threaten to cut off supplies. A demand does no good if the trustee or debtor in possession is disabled from succumbing to it."); Tabb, *supra* note 22, at 97 (arguing that completely prohibiting paying the pre-petition claims of debtors will remove the economic incentive for those creditors to make threats).

216. *See* Gilday, *supra* note 3, at 421 (noting that "[d]emanding that the debtor prove that the vendor actually is essential would help stem the abuse" of critical vendor orders).

217. *See* Hendel, *supra* note 26 (stating that "[w]ithout a more restrictive interpretation of the court's emergency powers, a debtor is increasingly left at the mercy of those creditors who

require debtors to meet a heightened evidentiary standard, then debtors increasingly will be able to negotiate deals with vendors that benefit both the debtors' estate and the critical vendors.[218]

C. Defining Net Economic Benefit

Courts that issue critical vendor orders should do so only when the orders will result in a net economic benefit to the estate. Accurately defining and measuring what constitutes a "net economic benefit," however, is a difficult task. Traditionally, when courts have authorized critical vendor orders, they have required critical vendors to continue to extend postposition trade credit on the same pre-petition terms.[219] This Note proposes two views of net economic benefit: the "trade credit" approach considers only the agreement to extend credit to the debtor while the "accounting" approach evaluates how paying the critical vendor order changes the estate's financial position. The *CoServ* court alluded to these two views of net economic benefit:

> It is obviously a bad bargain to pay $100,000 to recover $10,000 of estate property of which a claimant has possession [(accounting approach)]. Likewise, payment of a large claim in the hope of favorable credit terms merits careful analysis that shows net economic benefit before superceding [sic] the prohibition against payment of prepetition claims [(trade credit approach)].[220]

This Note argues that the accounting approach is conceptually more relevant than the trade credit approach; however, the trade credit approach is more feasible as an evidentiary showing. Furthermore, this Note seeks to develop an analytical framework that courts may employ in deciding whether to issue critical vendor orders.[221]

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have the leverage to coerce payment").

218. *Cf.* Morris, *supra* note 19, at 30 ("Rarely does a vendor in this situation want to risk losing the future sales volume/profits . . . as well as any chance to recover on its pre-petition receivables by shutting down its customer.").

219. *See* Cieri, *supra* note 126, at 529 (stating that vendors must agree to ship on credit terms that are the same or better than the pre-petition terms); Nathan, *supra* note 2, at 14 ("[C]ourts have approved the debtor's payment of certain critical vendor's pre-petition unsecured claims, usually in exchange for an agreement to continue shipping goods on the same credit terms during the [C]hapter 11 case.").

220. *CoServ*, 273 B.R. at 498.

221. As a disclaimer, this Note lays out a simple framework for evaluating the circumstances under which critical vendor orders should be approved. Additional scholarship would be helpful in developing the contours of this or a similar framework.

1. Trade Credit Approach

The trade credit approach views critical vendor orders as a method to persuade vendors to continue to sell to the debtor postpetition in addition to extending postpetition trade credit.[222] Under this approach, the estate recognizes a net economic benefit where the vendor extends more in postpetition trade credit than it was paid on account of its pre-petition claims. Whether a vendor would be willing to extend more in postpetition credit than paid on a critical vendor order depends on what the vendor expects to receive from its pre-petition and postpetition dealings with the debtor. That is, if the vendor believes its prospects for repayment are higher postpetition, then, all things being equal, it would prefer to convert its pre-petition claims against the debtor into postpetition credit obligations.[223] The better the prospects for repayment postpetition, the more a vendor would be willing to extend in postpetition credit.

Several factors influence whether the debtor will better be able to repay its debts postpetition. For example, a debtor with some unprofitable store locations and some lucrative ones will emerge from bankruptcy stronger by rejecting the unfavorable leases under Section 365.[224] Likewise, in cases where the debtor's bankruptcy is caused by a liquidity crunch, the restructuring of debt obligations and securing of postpetition debtor-in-possession financing will help the debtor repay its postpetition obligations. The presence of adequate debtor-in-possession financing is the predominate factor relied on by trade creditors in deciding whether to extend postposition financing.

The trade credit approach assumes that critical vendors will seek to minimize the total amount of cash that is at risk in the debtor's bankruptcy.[225]

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222. *Cf.* Morrow, *supra* note 50, at 20 (stating that the goal "from the perspective of the debtor is usually" to "return to normal trade terms, return to normal returns policy, return to rebate and quantity discount programs, elimination of any product or quantity rationing, and timely completion of works-in-progress and delivery to the job site").

223. *See* Nathan, *supra* note 2, at 14 ("[L]ow-priority, pre-petition general unsecured claims can be converted to higher-priority administrative claims arising from post-petition credit sales to the debtor.").

224. *See generally* 11 U.S.C. § 365 (2005).

225. *Cf.* Gilday, *supra* note 3, at 420 ("Though an administrative expense claim is a priority, it is not a guarantee of payment if the estate is overextended."); *see also* Gretchko, *supra* note 38, at 14 (discussing administrative claims and the potential for administrative insolvency). Gretchko explained:

> [T]he post-petition supplier gets an administrative expense claim, which will get paid before pre-[C]hapter 11 unsecured and priority claims, but after all secured creditors (both pre- and post-petition) get paid. If a [C]hapter 11 reorganization plan is confirmed, then pursuant to 11 U.S.C. § 1129(a)(9) all allowed

This approach also assumes that critical vendors minimize that amount by comparing their prospects for recovery on pre-petition claims with their perceptions of the debtor's postpetition credit risk.[226] Example 1 illustrates a hypothetical case in which a critical vendor would be willing to extend $100,000 in postpetition trade credit to the debtor after receiving $60,000 of its $100,000 pre-petition claim as a critical vendor payment.

Example 1

	With Deal:	**Without Deal:**
Pre-petition Expected Recovery:	60%	10%
Postpetition Expected Recovery:	55%	N/A
Pre-petition Claim:	$100,000	$100,000
Critical Vendor Payment:	$60,000	$0
Dividend:	$0	$10,000
Net Pre-petition Loss:	**$40,000**	**$90,000**
Postpetition Credit Extension:	$100,000	$0
Postpetition Credit Recovery:	$55,000	N/A
Net Postpetition Loss:	**$45,000**	**$0**
Total Loss:	**$85,000**	**$90,000**

> administrative expense claims must be fully paid (unless administrative expense claimant consents to a different treatment). In reality, however, not all [C]hapter 11 cases result in a confirmed plan. If the [C]hapter 11 estate is administratively insolvent, then administrative expense claims won't get fully paid, and the post-petition suppliers effectively get burned twice—once on their pre-petition claims and against on their post-petition claims. It is this—the fear of getting burned twice—that often causes post-petition suppliers to withdraw credit and demand COD or cash-in-advance as soon as the debtor files [C]hapter 11.

Id.

226. *Cf.* Mark M. Jaffe, *Chapter 11 Strategies and Techniques—Creditors Committees, Effective Use of Plan Provisions, Objections to Confirmation, Financing a Chapter 11 Case, "Cramdown" and How It Works*, 59 TUL. L. REV. 1298, 1323–24 (1985) (describing the effect of the trade creditors' perception of the debtor's chances of a successful reorganization). Jaffe states:

> If trade creditors strongly believe the debtor will survive reorganization, they may be willing to extend new credit even if they are not accorded administrative priorities. If, however, there is doubt about the debtor's ability to survive even in reorganization, trade credit will be withheld, financing will have to be found to replace trade credit, and the debtor may have to operate on a "cash as you go" basis.

Id.

Without the deal, the vendor will lose $90,000—its pre-petition claim of $100,000 less a dividend of $10,000. With the deal, the vendor will lose $40,000 pre-petition—its $100,000 pre-petition claim less the critical vendor payment of $60,000. With the deal, the vendor will lose $45,000 postpetition—its $100,000 extension of credit less the expected recovery of $55,000. Overall, the debtor will lose $85,000 with the deal, or $5,000 less than the debtor would have lost without the deal.

If the prospects for postpetition payment are better, then the vendor will fare even better. For example, the presence of $2 billion in debtor-in-possession financing in *Kmart* improved the expected recovery of vendors on unsecured postpetition trade credit at least for the near future. Because the vendor's prospects for payment were better postpetition, the *Kmart* court could have paid the critical vendors much less as critical vendor payments while still expecting them to extend postpetition trade credit. Example 2 illustrates this point by assuming that the vendor's prospects for recovering on postpetition trade credit are higher than in Example 1. As a result, the vendor receives a critical vendor payment that is $20,000 less than in Example 1, yet remains willing to extend the same amount of postpetition trade credit as in Example 1. The vendor is still willing to accept the deal because it is still better off with the deal than without it.

Example 2

	With Deal:	**Without Deal:**
Pre-petition Expected Recovery:	40%	10%
Postpetition Expected Recovery:	75%	N/A
Pre-petition Claim:	$100,000	$100,000
Critical Vendor Payment:	$40,000	$0
Dividend:	$0	$10,000
Net Pre-petition Loss:	**$60,000**	**$90,000**
Postpetition Credit Extension:	$100,000	$0
Postpetition Credit Recovery:	$75,000	N/A
Net Postpetition Loss:	**$25,000**	**$0**
Total Loss:	**$85,000**	**$90,000**

Without the deal, the vendor will lose $90,000 of its $100,000 pre-petition claim. With the deal, the vendor is paid $40,000 of its $100,000 pre-petition claim, for a pre-petition loss of $60,000. The vendor extends $100,000 in postpetition trade credit of which it expects to recover $75,000, for a postpetition loss of $25,000. Overall, the vendor expects to lose $85,000 with the deal compared to $90,000 without the deal. Thus, the deal reduces the vendor's loss by $5,000 even though it is extending credit that is more than double the size of its critical vendor payment.

These examples demonstrate that circumstances exist under which a trade creditor would be willing to extend more in postpetition trade credit than paid on its pre-petition debts. Example 2 illustrates an extreme case where the vendor extends postpetition trade credit double the size of the critical vendor payment. This Note argues that, more commonly, vendors would be willing to extend as postpetition trade credit between 100% to 150% of the amount they received as a critical vendor payment. These examples suggest that courts should allow only smaller critical vendor payments while still expecting vendors to extend sizeable amounts of postpetition credit to the debtor.

For the purposes of simplicity, the fact that critical vendors profit from postpetition sales to the debtor was excluded from the two examples. A critical vendor, however, earns profits only on the portion of the credit sales on which it actually collects. In the last example, assuming a 10% gross margin, the vendor would have earned an extra $7,500 on postpetition sales actually collected with the deal, reducing its total loss by the same amount.

Defining net economic benefit by using the trade credit approach has a few weaknesses. One weakness is that it fails to take into account the underlying profitability of the deal—that is, whether the debtor is actually able to turn a profit on the goods obtained on credit from the critical vendor.[227] The *CoServ* court implicitly recognized this weakness when it questioned "whether favorable credit terms alone ever would meet the net benefit requirement."[228] A second weakness is that the approach is based on the perceptions of vendors regarding their recovery of pre-petition and postpetition obligations owed by the debtor. To the extent that vendors do not have sufficiently accurate

227. Dallin Oaks, a former Utah Supreme Court Justice, relayed the following anecdote, used here to show the importance of examining the underlying profitability of the business deal:

> Two men formed a partnership. They built a small shed beside a busy road. They obtained a truck and drove it to a farmer's field, where they purchased a truckload of melons for a dollar a melon. They drove the loaded truck to their shed by the road, where they sold their melons for a dollar a melon. They drove back to the farmer's field and bought another truckload of melons for a dollar a melon. Transporting them to the roadside, they again sold them for a dollar a melon. As they drove back toward the farmer's field to get another load, one partner said to the other, "We're not making much money on this business, are we?" "No, we're not," his partner replied. "Do you think we need a bigger truck?"

Dallin Oaks, *Focus and Priorities*, ENSIGN, May 2001, at 82. In the critical vendor order context, extending more trade credit would be the "truck." A "bigger truck" is only helpful where the debtor's underlying business is actually profitable. Hence, a court also needs to consider the profitability of the underlying deal under the accounting approach.

228. *CoServ*, 273 B.R. at 499 n.20.

information or are generally unable to accurately assess these risks, they would demand more as critical vendor payments or extend less postpetition credit to guard against this uncertainty. Additionally, as the trade credit approach relies on the perceptions of risk by vendors, courts may have difficulty assessing those risks as part of their obligation to signal the parameters of an acceptable deal.

Despite these weaknesses, the trade credit approach is still useful as an evidentiary standard because a court can easily compare the proposed size of the critical vendor payments to the amount of postpetition trade credit to be extended by the critical vendors. Courts can improve the "benefit" to the estate by authorizing smaller critical vendor payments and requiring larger extensions of postpetition trade credit.[229]

2. *Accounting Approach*

The accounting approach defines "net economic benefit" as where the estate's cash position is improved as a result of the critical vendor order and payments—that is, where the dollar benefit exceeds the dollar cost of the critical vendor order. The main strength of the accounting approach is that it addresses the most relevant question—whether the critical vendor order provides the debtor with a "meaningful economic gain" that is larger than the critical vendor payment. While it is important for the debtor to have sufficient postpetition trade credit, if the goods the debtor buys on credit cannot be sold at a profit, then the reorganization is futile and should be converted to a liquidation.[230]

In simplest terms, the dollar benefit of authorizing a critical vendor order would be gross margin of the goods sold less the variable costs associated with producing the additional sales. The dollar cost would be the amount paid under the critical vendor order. Example 3 and the following formulas will help clarify this point.

Example 3

A debtor manufactures a particular piece of medical equipment. To manufacture the equipment, this debtor needs a particular component made

229. *See* Morrow, *supra* note 50, at 20 ("Typical plans for implementing pre-petition payments might include a cap on the percentage of any vendor's claim that would be paid and a formula relating post-petition trade credit to the amount of pre-petition payment.").

230. *See* Oaks, *supra* note 227 (presenting an analogy that contrasts the trade credit approach to the accounting approach).

by only one supplier. Without the component, the debtor will not be able to manufacture its product, and therefore, will have no revenues. Paying the prepetition claims of the supplier, therefore, will yield the debtor significant revenues that the debtor would not have otherwise realized. Because the debtor continues to manufacture and sell its product, the debtor will incur additional variable costs such as marketing, shipping, and distribution that it would not have incurred "but for" the critical vendor order.

Net Economic Benefit = Dollar Benefit less Dollar Cost
Dollar Benefit = Gross Margin less Variable Costs of the "additional" sales
Gross Margin = Revenues less Cost of Goods Sold
Variable Costs = extra labor, shipping, and other costs attributable to the order
Dollar Cost = amount paid to critical vendor under an order

	With Deal:	**Without Deal:**
Revenues	$50,000	$0
Cost of Goods Sold:	($20,000)	$0
Gross Margin:	$30,000	$0
Variable Costs:	($5,000)	$0
Dollar Benefit:	$25,000	$0
Dollar Cost:	($15,000)	$0
Net Economic Benefit:	**$10,000**	**$0**

In this example, the critical vendor order allows the debtor to earn $50,000 in revenues that it would not have earned without the order. The cost of goods sold is $20,000, leaving a gross margin of $30,000. From this amount, the variable costs of $5,000 are deducted, leaving a dollar benefit of $25,000. In this example, the variable costs would be the additional marketing, shipping, and labor costs that the debtor incurred as a result of these additional sales. The dollar cost of the order is $15,000, leaving a net economic benefit of $10,000. This example shows a situation where the estate benefits as a result of the critical vendor order. There would be an extra $10,000 to distribute among the noncritical vendors than if there had been no deal struck between the debtor and the critical vendor.

One drawback of the accounting approach as an evidentiary standard is that it requires information that may be inaccessible at the beginning of the debtor's case when critical vendor motions are typically filed. This drawback might be lessened if courts were to hold the Section 363 hearing somewhat later in the case, as previously suggested. A second drawback is that it assumes, at least in this example, that all revenues earned are collected and that these revenues would have not occurred "but for" the authorization of the critical vendor order. Proving what revenues the debtor would have earned with and without the order tends to be highly speculative, though in certain circumstances those numbers would be quite clear. The accounting approach is better suited for situations where the volume of sales is quantifiable, like where the debtor is going to sell the goods to customers with purchase contracts. In the retail sales context, it is only as useful as the accuracy of the sales and profit margin forecasts. Additionally, the variable costs that result from authorizing the critical vendor order would be difficult to identify and accurately measure, though they probably could be estimated to a reasonable degree of certainty, perhaps as a given percent of a firm's sales and administrative expenses. Finally, this example does not address the time value of money, implicated where the net economic benefit, in the form of cash, flows into the estate much later in the case than the critical vendor payments.

As previously mentioned, both the trade credit and accounting approaches have certain strengths and weaknesses. Because the accounting approach examines the underlying profitability of the critical vendor order in relation to the debtor's business, it is preferable to the trade credit approach. However, the trade credit approach is still useful as a secondary test to ensure that the estate is benefited as a result of the critical vendor orders. If the underlying deal is profitable for the debtor, then favorable credit terms on that deal provide the estate with additional benefit. By using both approaches together, courts can increase the likelihood that the estate will actually realize a net economic benefit. Despite any practical difficulties associated with applying these two approaches, it is better for courts to at least grapple with the questions they raise, and attempt to answer them, rather than approving critical vendor orders under a vague notion of general benefit to the estate.

D. A Heightened Evidentiary Standard in Action: In re Tropical Wear Int'l Corp.

The recent decision in *In re Tropical Sportswear Int'l Corp.*[231] shows the benefits that flow from a court's adoption of a heightened evidentiary

231. *In re* Tropical Sportswear Int'l Corp., 320 B.R. 15 (Bankr. M.D. Fla. 2005). In *Tropical Sportswear*, the debtor, a clothing designer and distributor, filed for Chapter 11. *Id.* at 18. The debtor filed a critical vendor motion seeking to pay 77.5% of the pre-petition debts (totaling $6,518,354) of four critical vendors. *Id.* The court found that the vendors were critical because they provided the debtors with "unique products and services used in the production of pants." *Id.* Furthermore, it would take at least four to six weeks to the replace the vendors with alternate suppliers, which interruption would constitute a major threat to the debtor's ability to conduct business. *Id.* The bankruptcy approved the critical vendor orders under Sections 105 and 363(b). *Id.* at 19–20.

standard.[232] The bankruptcy court authorized the debtor to pay four critical vendors 77.5% of their pre-petition claims in exchange for an agreement to continue to sell to the debtor and extend postpetition trade credit.[233] The court found that the suppliers were actually critical because replacing them would disrupt the debtor's business.[234] Furthermore, the court found that the critical vendors' threats to cease selling to the debtor were credible given the critical vendors' low profit margins on these particular sales.[235] In exchange for paying $5.05 million[236] in pre-petition claims, the critical vendors agreed to sell to the debtor on sixty-day terms with a revolving credit cap aggregating $6.25 million dollars.[237] The court found that "the net effect to the debtors, their estates, the disfavored creditors, and the creditor body as a whole is still positive."[238] In support of this conclusion, the court found that the deal was negotiated at arms-length between the parties, including the creditors' committee.[239]

An important reason that the court allowed critical vendor payments was because the debtor had executed an asset purchase agreement with Perry Ellis International (Perry Ellis) under which Perry Ellis agreed to purchase substantially all of the debtor's assets for $88.5 million though a Section 363 sale.[240] Under the terms of the agreement, the debtor was required to maintain its business—the failure to do so would serve as grounds for Perry Ellis to terminate the agreement.[241] The court found that if the critical vendors ceased business with the debtor, it would "substantially jeopardize the debtor's ability to conduct business."[242]

232. In *Tropical Sportswear*, the court adopted the *Kmart* evidentiary standard. *Id.* at 20.

233. *Id.* at 21.

234. *See id.* at 18 ("The Debtors estimate that it would take approximately four to six weeks to replace the Critical Vendors with alternate suppliers, and interruption in the flow of services will substantially jeopardize the Debtor's ability to conduct business."); *id.* at 19 ("Each of the Critical Vendors supplies unique goods and services to the Debtors, the continued uninterrupted supply of which is absolutely necessary to the maximization of the value of the Debtor's estate for all creditors, including the disfavored creditors.").

235. *See id.* at 20–21 ("[D]ue to the slim profit margins involved in the manufacture of the goods that the Critical Vendors supply the Debtor, the Court is persuaded that the Critical Vendors' stated refusal to further conduct business with the Debtors absent payments of 77.5% of [prepetition debts] is credible.").

236. The author estimated this number by multiplying the aggregate pre-petition claims of the critical vendors of $6,518,254 by the percent paid (77.5%).

237. *Id.* at 21.

238. *Id.*

239. *Id.*

240. *Id.* at 19.

241. *Id.*

242. *Id.* at 20.

The deal negotiated in this case between the debtor and the critical vendors would have been acceptable under the trade credit approach. The debtor paid the critical vendors $5.05 million dollars in critical vendor payments. In exchange, the critical vendors extended $6.25 million in postpetition trade credit. Using the trade credit approach, the estate was benefited because the debtor received 123% of the value of the pre-petition claims paid as postpetition trade credit.

The critical vendor deal in this case may also have been acceptable under the economic component of the *CoServ* standard.[243] *CoServ* requires that the estate either receive an economic benefit (like under the accounting approach) or avoid an economic harm that is materially larger than the amount paid to critical vendors.[244] Paying the critical vendors enabled the debtor to continue its business and thereby earn additional revenues. In this case, however, it was the harm avoided to the ongoing value of the business that would satisfy the *CoServ* requirement for a net economic benefit. Paying the critical vendors $5.05 million was necessary to ensure that the debtor's business would not be disrupted, and thereby terminate the agreement with Perry Ellis to buy the debtor's assets for $88 million. It is quite likely that the value of the debtor's business would have decreased by much more than $5 million had the business been disrupted.

Two additional features of *Tropical Sportswear* are noteworthy. First, the court authorized the critical vendor orders under Sections 105 and 363. Second, the critical vendor orders were not issued in *Tropical Sportswear* until a month into the debtor's case.[245] The creditors' committee actually had the opportunity to object to the debtor's motion in addition to participating in the negotiations between the debtor and the critical vendors.[246] Because the *Tropical Sportswear* court adopted a heightened evidentiary standard, the

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243. There was insufficient information in the *Tropical Sportswear* opinion to analyze this case under the accounting approach. Instead, the more general approach to net economic benefit as used in the *CoServ* case is employed.

244. *See CoServ*, 273 B.R. at 487 ("To meet the second element of this Court's test, a debtor must show that meaningful economic gain to the estate or the going concern value of the business will result or that serious economic harm will be avoided through payment of the prepetition claim, which itself is materially less than the potential loss to the estate or business.").

245. The debtors filed voluntary Chapter 11 petitions on December 16, 2004. *In re Tropical Sportswear Int'l Corp.*, 320 B.R. at 18. The creditors' committee filed an objection on January 11, 2005. *Id.* The court held a final evidentiary hearing on January 12, 2005. *Id.* The court did not issue its final order until January 28, 2005. *Id.* at 22.

246. *Id.* at 18.

debtor was able to negotiate a deal that benefited the estate,[247] yet was still acceptable to the critical vendors and the creditors' committee.[248]

VI. Towards a Solution

As discussed in Part III.C, this Note recognizes that whether Section 363 is sufficient statutory authority to authorize critical vendor orders is indeed an open question.[249] Nonetheless, that section is still the best candidate for authority under the Code. Working from the assumption that Section 363 may be valid legal authority, this Note examined how and where that section should be used. After all, the *Kmart* court admonished that it is still "[n]onetheless, prudent to read, and use [S]ection 363(b)(1) to do the least damage possible to the priorities established by contract and by the other parts of the Bankruptcy Code."[250] Adopting a heightened evidentiary standard like the *CoServ* standard strengthens the validity of the argument that Section 363 is being used to maximize the value of the estate.[251] Additionally, efforts by the *Kmart*, *CoServ*, and *Tropical Sportswear* courts to reduce the excessive use of critical vendor orders helps bring the practice closer in line with its historical origin in *Miltenberger*, where the Supreme Court warned that the discretion to pay pre-petition debts should be "exercised with great care."[252]

This Note argued that the result obtained in the *Tropical Sportswear* case will become more common if courts require the debtor to meet a heightened evidentiary standard.[253] Furthermore, the three-element *CoServ* evidentiary standard is better suited as an evidentiary standard than the *Kmart* standard because of its clarity.[254] Courts should issue a critical vendor order only after the debtor proves that the estate will be better off as a result under the accounting approach or under a similar approach.[255] The trade credit approach

247. *See id.* at 21 ("[T]his Court finds that the net effect to the Debtors, their estates, the disfavored creditors, and the creditor body as a whole is still positive.").

248. *See id.* ("The Court also finds that the terms of the Critical Vendor status were negotiated at arms-length by and between the parties, including the Creditors Committee.").

249. *See supra* Part III.C (discussing whether Section 363 is adequate authority).

250. *Kmart*, 359 F.3d at 872.

251. *See* Baird, *The New Face of Chapter 11*, *supra* note 126, at 192 (stating that where paying pre-petition creditors will "increase the return to general creditors, it is arguably a use of assets within the ambit of § 363").

252. Miltenberger v. Logansport Ry. Co., 106 U.S. 286, 311 (1882).

253. *See supra* Part V.D (discussing the *Tropical Sportswear* decision).

254. *See supra* Part IV.B (discussing the *CoServ* evidentiary standard).

255. *See supra* Part V.C.2 (discussing the accounting approach).

is still useful as a secondary, supplemental test to guide courts in marking the boundaries of an acceptable deal.[256] Finally, this Note suggested that critical vendor orders should not be issued until sufficient notice is given to affected creditors, or at least until the creditors' committee has an opportunity to object.[257]

Professor Douglas Baird has declared that the "Achilles heel for critical vendor orders has always been the absence of explicit statutory authorization."[258] Ultimately, the Supreme Court or Congress needs to end the divisions among the circuits by addressing the statutory authority question.[259] Legislative action is preferable to judicial action because of Congress's inherent ability to create a uniform national standard.[260] And if Congress believes that orders are not as "necessary" as their proponents suggest, then Congress should amend the Code to explicitly prohibit the orders.[261]

256. *See supra* Part V.C.1 (discussing the trade credit approach).

257. *See supra* notes 139–41 and accompanying text (discussing the notice issues surrounding Section 363 hearings).

258. Baird, *The New Face of Chapter 11*, *supra* note 126, at 97.

259. *See* Sabino, *supra* note 20, at 91 ("No doubt, Kmart has not outlawed critical vendor relief, but it brings order to the chaos. In so doing, Kmart achieves a greater goal of limiting success in such adventures to only those debtors and vendors truly worthy of such relief.").

260. *See* Tabb, *supra* note 22, at 115 (stating that "given the importance of the issue and the prevalence with which it comes up, it is important that the law be uniform and clear"); *id.* ("The fate of a [C]hapter 11 case should not hinge on the district in which it is filed or the judge to whom it is assigned.").

261. *See id.* (stating that Congress should amend the Code to clarify whether critical vendors are permitted).