

## Critical-vendor Orders: Has the Seventh Circuit Put Such Orders on the Critical List?

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**Editor's Note:** Also see the related article by ABI Resident Scholar Hon. Roger M. Whelan.

**T**he U.S. Court of Appeals for the Seventh Circuit recently weighed in on a bankruptcy court's authority to enter a first-day "critical-vendor order" that permits a chapter 11 debtor to promptly and fully pay all pre-petition claims of "critical" vendors. *In re Kmart Corp.*, No. 03-1956, 2004 WL 343520 (7th Cir. Feb. 24, 2004). Adopting a narrow interpretation of §105(a) of the Bankruptcy Code,<sup>2</sup> the Seventh Circuit affirmed the district court's decision and ruled that neither §105(a) nor the so-called "doctrine of necessity" authorizes the entry of a critical-vendor order. However, in so ruling, the Seventh Circuit suggested that §363(b)(1) of the Bankruptcy Code<sup>3</sup> could at least in theory serve as authority for the entry of a critical-vendor order provided that the debtor proves that (a) absent immediate payment of their pre-petition debt, "critical" vendors would stop providing goods to the debtor post-petition, and (b) the debtor's business would gain enough from continued transactions with the favored critical vendors to at least leave the disfavored non-critical vendors no worse off.

### Background of Kmart

On the first day of their bankruptcy case, Kmart Corp. and its 37 affiliates (collectively, Kmart) sought permission from the bankruptcy court to promptly and fully pay the pre-petition claims of any vendor that Kmart unilaterally deemed "critical," provided that the vendor agreed to continue to supply goods to Kmart on "customary trade terms" for the next two years. The theory underlying Kmart's request (and all requests for the entry of a critical-vendor order) was that certain vendors would be unwilling to continue to do business with Kmart post-bankruptcy if Kmart failed to promptly pay the vendor's pre-petition claims, and, if Kmart could not obtain the goods supplied by the vendor, Kmart would be unable to continue its business operations, thereby resulting in the liquidation of Kmart, which would injure all of Kmart's creditors. Relying on §105(a) as authority for the entry of the critical-vendor order, the bankruptcy court granted Kmart's request.

Pursuant to the critical-vendor order, Kmart paid approximately \$300 million in pre-petition debts to 2,330 vendors. The funds that were used to pay the critical vendors came from \$2 billion in debtor-in-possession (DIP) financing that Kmart obtained. Approximately 2,000 remaining vendors were not deemed "critical" by Kmart, and therefore such vendors' pre-petition claims were not paid pursuant to the critical-vendor order (ultimately, such non-critical vendors were paid approximately 10 percent of their pre-petition claims upon confirmation of Kmart's chapter 11 plan).

Upon appeal of the entry of the critical-vendor order by a factoring agent that held approximately \$20 million in pre-petition claims against Kmart, the U.S. District Court for the Northern District of Illinois reversed the bankruptcy court's entry of the critical-vendor order. *Capital Factors Inc. v. Kmart Corp.*, 291 B.R. 818 (N.D. Ill. 2003). The district court concluded that neither §105(a) nor the "doctrine of necessity" supports the entry of a critical-vendor order. The district court's decision was rendered after Kmart had paid all the pre-petition claims of critical vendors but shortly before Kmart's chapter 11 plan was scheduled to be considered for confirmation.

### The Seventh Circuit's Decision

In writing for the Seventh Circuit, Judge Easterbrook initially addressed the assertion of Kmart (as well as certain critical vendors that intervened in the appeal) that, by the time the district court rendered its decision, it was too late for Kmart to recover any potentially preferential payments from critical vendors inasmuch as the critical vendors relied on the existence of the critical-vendor order in continuing to do business with Kmart post-petition. The Seventh Circuit first observed that there is no Bankruptcy Code provision that protects court-approved payments made to pre-petition creditors from subsequent challenge (whether or not such creditors are determined to be "critical"). The Seventh Circuit noted that, while several provisions of the Bankruptcy Code expressly prohibit the subsequent challenge of a transaction that was authorized by a bankruptcy court (such as §364(e) of the Bankruptcy Code regarding obtaining credit), there is no parallel provision of the Bankruptcy Code with respect to critical-vendor orders. The Seventh Circuit next observed that, although the so-called critical vendors may have relied on the existence of the critical-vendor order in continuing to do business with Kmart, they did not *detrimentally* rely on such an order. Specifically, the Seventh Circuit reasoned that, inasmuch as the critical vendors were paid in full for any post-petition goods they provided to Kmart, the critical vendors' alleged reliance on the critical-vendor order in continuing to provide goods to Kmart post-petition was not "detrimental" to the critical vendors. Accordingly, the Seventh Circuit concluded that Kmart's prior payments to so-called critical vendors were not insulated from a preference attack.<sup>4</sup>

### **Section 105(a) and the "Doctrine of Necessity"**

After determining that there was no prohibition on recovering preferential payments made to Kmart's so-called critical vendors, the Seventh Circuit next addressed whether the bankruptcy court had the authority to enter the critical-vendor order. The Seventh Circuit initially noted that §105(a), which was relied on by the bankruptcy court as authority for entry of the critical-vendor order, "does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by §105(a) is one to implement rather than override." *Kmart*, 2004 WL 343520, at \*4. As a result, the Seventh Circuit concluded that §105(a) does not permit a bankruptcy court to authorize full payment of any pre-petition debt (regardless of whether the holder of the debt is a "critical" vendor) unless all pre-petition creditors of the same class are paid in full.<sup>5</sup>

Likewise, the Seventh Circuit concluded that the "doctrine of necessity" does not serve as authority for a bankruptcy court to enter a critical-vendor order because the "doctrine of necessity is just a fancy name for a power to depart from the Code." *Id.* (internal quotations omitted). Upon observing that the "doctrine of necessity" pre-dated the Bankruptcy Act of 1898, the Seventh Circuit concluded that "[a]nswers to contemporary issues must be found within the [current Bankruptcy] Code (or legislative halls)." *Id.*

### **Does §363(b)(1) Serve as Authority for the Entry of a Critical-vendor Order?**

In their appeal to the Seventh Circuit, the appellants asserted for the first time that §363(b) of the Bankruptcy Code serves as a source of authority for the entry of a critical-vendor order.<sup>6</sup> As set forth above, §363(b)(1) provides that "[t]he trustee [or DIP], after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate." The Seventh Circuit analyzed §363(b)(1) as a possible statutory justification for a critical-vendor order because, according to the Seventh Circuit, "satisfaction of a pre-petition debt in order to keep 'critical' supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy." *Id.* at \*5. The Seventh Circuit considered the argument that §363(b)(1) should be limited to the commencement of capital projects and the like rather than the payment of pre-petition debts inasmuch as paying pre-petition debts would be "in the ordinary course" of a debtor's business but for the intervening bankruptcy. Moreover, the Seventh Circuit also considered the argument that, if §363(b)(1) were to be interpreted as permitting the payment of pre-petition debt, such a section would effectively authorize a bankruptcy court to reorder priorities among creditors in derogation of the Bankruptcy Code's priority scheme for the payment of claims. However, notwithstanding such arguments, the Seventh Circuit concluded that a bankruptcy court can in fact reorder priorities among creditors if a statute specifically authorizes a bankruptcy court to do so and that "if §363(b)(1) is such

a statute, then there is no insuperable problem." *Id.* Indeed, the Seventh Circuit noted that if the language of §363(b)(1) "is too open-ended, that [it] is a problem for the legislature." *Id.* Nevertheless, the Seventh Circuit also recognized that it is "prudent to read, and use, §363(b)(1) to do the least damage possible to priorities established...by other parts of the Bankruptcy Code." *Id.*

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*[I]t appears that §363(b)(1) may become the new §105(a), which will enable a chapter 11 debtor to invoke such section as authority to justify actions that may not be otherwise specifically permitted by the Bankruptcy Code.*

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Ultimately, however, the Seventh Circuit refused to decide whether §363(b)(1) could be relied on as authority to pay pre-petition critical vendor debts because the Seventh Circuit concluded that, in Kmart's case, the bankruptcy court's critical-vendor order was not supportable regardless of how one were to interpret §363(b)(1). Specifically, the Seventh Circuit concluded that any use of §363(b)(1) to authorize the entry of a critical-vendor order would require that the debtor demonstrate that the disfavored non-critical vendors would be as well off with a chapter 11 reorganization (and the attendant payments to critical vendors) as with a chapter 7 liquidation (the Seventh Circuit recognized that this requirement is similar to the requirement relating to the "cramdown" of a chapter 11 plan). Importantly, however, the Seventh Circuit concluded that Kmart failed to make the necessary factual showing.

Furthermore, the Seventh Circuit concluded that any use of §363(b)(1) to authorize the entry of a critical-vendor order would require that the debtor demonstrate that the alleged critical vendors "would have ceased deliveries if old debts were left unpaid." *Id.* As explained by the Seventh Circuit, if a vendor will supply goods post-petition solely in exchange for payment of such goods, then the debtor can continue to operate and eventually reorganize, thereby benefiting all pre-petition creditors without preferring any particular pre-petition creditor. The Seventh Circuit observed that many alleged critical vendors will in fact continue to do business with the debtor even without a critical-vendor order because such vendors are obligated to continue to do business as a result of a contract with the debtor (the Seventh Circuit noted that the automatic stay imposed by §362 of the Bankruptcy Code ordinarily prevents vendors from terminating a contract with the debtor).<sup>7</sup> Furthermore, the Seventh Circuit observed that, even in the absence of a contract with the debtor, a well-managed vendor would not likely cease doing business with the debtor in the absence of a critical-vendor order as long as the vendor is assured that the debtor will pay for any post-petition goods provided by the vendor.<sup>8</sup> As a result, the Seventh Circuit concluded that Kmart failed to demonstrate that any vendor would have ceased doing business with Kmart if its pre-petition debt was not paid in full.

## **Ramifications of Kmart**

The Seventh Circuit's decision in *Kmart* creates further uncertainty as to a bankruptcy court's authority to enter a critical-vendor order. Although the Seventh Circuit essentially shut the door with respect to any attempt by a debtor to rely on §105(a) or the "doctrine of necessity" as authority for the entry of a critical-vendor order, the Seventh Circuit apparently opened a window for a debtor to argue that §363(b)(1) authorizes the entry of such an order. Indeed, under the Seventh Circuit's analysis, it appears that §363(b)(1) may become the new §105(a), which will enable a chapter 11 debtor to invoke such a section as authority to justify actions that may not be otherwise specifically permitted by the Bankruptcy Code.

The Seventh Circuit's apparent standard for entering a critical-vendor order pursuant to §363(b)(1) is similar to the standard certain bankruptcy courts have used for entering critical-vendor orders pursuant to §105(a) and the "doctrine of necessity"—that critical-vendor orders are permissible if (a)

"critical" vendors would stop providing goods to the debtor post-petition in the absence of immediate and full payment of their pre-petition debt and (b) entry of the critical-vendor order is in the best interests of the debtor's estate because creditor recoveries (including recoveries by the non-critical vendors) will be maximized through a successful reorganization of the debtor. *Cf. In re Just For Feet Inc.*, 242 B.R. 821 (D. Del. 1999); *In re Coserv L.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002). Although the Seventh Circuit's standard for entering a critical-vendor order appears to be relatively straightforward, it remains to be seen how stringent the Seventh Circuit will be with respect to the type of evidentiary record that must be created by the debtor to satisfy the standard. For example, although not specifically addressed by the Seventh Circuit, potentially it would require that *in the first few days of its bankruptcy* the chapter 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 chapter 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 §363(b)(1) would be remote given the difficulty of making such a showing in the early stages of a chapter 11 case.

It must be stressed that the Seventh Circuit's comments regarding §363(b)(1) are nothing more than *dicta*. As a result, it would be foolish for a critical vendor to rely on the existence of a critical-vendor order entered by a bankruptcy court pursuant to §363(b)(1), especially given that the Seventh Circuit's interpretation of §363(b)(1) is seemingly at odds with the traditional use and interpretation of §363(b)(1). Compounding the confusion regarding the entry of a critical-vendor order is the fact that the Seventh Circuit's decision makes it clear that a vendor cannot rely on the existence of a critical-vendor order to insulate "preferential" payments received by such vendor from subsequent attack.<sup>9</sup> As such, although a creative debtor's counsel may be able to convince a bankruptcy court to enter a critical-vendor order pursuant to §363(b)(1), a vendor who decides to cease doing business with the debtor in the absence of immediate payment of the pre-petition debt may wish to think twice before continuing to do business with the debtor, as there is no guarantee that the payment of the pre-petition debt would not be subject to subsequent avoidance.

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## Footnotes

<sup>1</sup> Board Certified in Business Bankruptcy Law by the American Board of Certification. [Return to article](#)

<sup>2</sup> Section 105(a) permits a bankruptcy court to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. [Return to article](#)

<sup>3</sup> Section 363(b)(1) provides that "[t]he trustee [or debtor-in-possession], after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate." [Return to article](#)

<sup>4</sup> The Seventh Circuit indicated, however, that had Kmart become administratively insolvent and therefore unable to pay the post-petition claims of its critical vendors, the court's conclusion may have been different. [Return to article](#)

<sup>5</sup> The Seventh Circuit noted that every circuit appeals court that has considered such an issue has reached the same result. *See, e.g., Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt. Inc.)*, 4 F.3d 1329 (5th Cir. 1993); *Official Comm. of Equity Sec. Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987); *B&W Enter. Inc. v. Goodman Oil Co. (In re B&W Enter. Inc.)*, 713 F.2d 534 (9th Cir. 1983). [Return to article](#)

<sup>6</sup> The appellants also asserted that §§364(b) and 503 of the Bankruptcy Code serve as authority for the entry of a critical vendor order, but the Seventh Circuit summarily rejected such arguments. [Return to article](#)

<sup>7</sup> The Seventh Circuit did not address whether a vendor's contract with a debtor that purportedly obligates the vendor to deliver goods to the debtor could be considered to be a contract "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor," which would therefore prevent the debtor from assuming such contract. See 11 U.S.C. §365(c)(2). [Return to article](#)

<sup>8</sup> The Seventh Circuit noted that Kmart could have used a portion of its \$2 billion in post-petition financing to provide a standby letter of credit to demonstrate certainty of payment to post-petition vendors. [Return to article](#)

<sup>9</sup> Although the Seventh Circuit repeatedly refers to the payment of critical vendors' pre-petition debts as "preferences" or as "preferential transfers," it is unclear whether the Seventh Circuit believed that the payments were "preferences" under §547 of the Bankruptcy Code given that §547(b)(4) limits the applicability of §547 to transfers that occurred before the petition date. [Return to article](#)

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