The "Critical Vendor" Preference Defense Still Not a Panacea for Trade Creditors

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Through a preference claim, a debtor or trustee seeks to recover, subject to certain creditor defenses, payments that a trade creditor received within the 90-day period prior to a bankruptcy filing Preference claims have always been an unfortunate
creditor received within the 90-day period prior to a bankruptcy filing. Preference claims have always been an unfortunate reality for trade creditors. However, the frustration of having to return money has recently been exacerbated, because in many high-profile cases trade creditors' § 503(b)(9) claims and post-petition administrative claims that historically had been paid in full have been materially impaired to varying degrees, resulting in general unsecured claims being virtually worthless. Many trade creditors are familiar with the most common preference defenses: the new value and ordinary course of business defenses. However, there are other potentially valuable preference defenses about which creditors should be familiar that can help mitigate preference risk. These defenses relate to the post-petition payment of a pre-petition claim and/or the impact of the assumption of an executory contract on preference liability.

These defenses were recently addressed by the U.S. Bankruptcy Court for the District of Delaware in *Insys Therapeutics v. McKesson Corp.* At issue in Insys was whether the inclusion of McKesson Corp., d/b/a RX Crossroads by McKesson, Relay Health Pharmacy Solutions and McKesson Specialty Arizona, Inc. (collectively, the "defendants" or "McKesson"), as eligible creditors under a court-approved customer order,**[1]** without additional facts, was sufficient to establish a complete defense to a preference claim.

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The court held that there was no preference defense available to the defendants, for, or among other reasons, the debtors were merely authorized, but not required, to pay McKesson or any other creditor under the customer order.**[2]**

Procedural History

Insys Therapeutics and several affiliated debtors (collectively, the "debtors") filed for chapter 11 protection on June 10, 2019. The debtors were a specialized pharmaceutical company that developed and sold certain drugs and novel drug-delivery systems for targeted therapies. As part of the debtors' suite of first-day motions, the court entered an order approving a motion to (1) Maintain and Administer Prepetition Customer Programs, Promotions, and Practices and (2) Pay and Honor Related Prepetition Obligations (the "Customer Order"). The Customer Order authorized, but did not direct, the debtors to maintain and administer the underlying customer programs (as defined in the Customer Order).

On Feb. 23, 2021, the trustee, **William Henrich**, filed a complaint against the defendants, parties to several pre-petition, but not post-petition, agreements with the debtors, (1) seeking the recovery of the aggregate amount of $154,821.07 (the "transfers") as avoidable transfers pursuant to Bankruptcy Code §§ 547-550 (the "preference claims"), and (2) objecting to McKesson's claims filed in the chapter 11 cases. The defendants filed a motion to dismiss the preference claims, to which the trustee responded.

The Preference Statute

Pursuant to § 547(b) of the Bankruptcy Code, a trustee (or debtor) can avoid and recover a transfer as a preference by proving the following elements:

- The debtor transferred its property to or for the benefit of a creditor. The transfer of any type of property can be avoided, but the most frequent category of transfers is cash payments [§ 547(b)(1)];
- The transfer was made on account of an antecedent debt that the debtor owed to the creditor [§ 547(b)(2)];
- The transfer was made when the debtor was insolvent [§ 547(b)(3)]; **[3]**
- The transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a noninsider creditor, or a year if an insider [§ 547(b)(4)]; and
- The transfer enabled the creditor to receive more than the creditor would have received in a debtor's chapter 7 liquidation [§ 547(b)(5)] (the "*Fifth Element*").

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The Fifth Element is generally easy to satisfy, unless the recipient of the alleged preference can prove that it was fully secured by the debtor's assets, it was paid from the proceeds of its collateral, or all unsecured creditors' claims were (or will be) paid in full. Courts have also held that the Fifth Element cannot be satisfied where an order approving a pre-petition payment (1) unconditionally required payment, or (2) authorized the payment of a claim senior in priority to an unsecured claim. In addition, this element cannot be satisfied where a defendant was party to an assumed executory contract or a court-approved post-petition agreement (*e.g.*, a critical vendor agreement). The analysis of the Fifth Element was the main point of contention in the *Insys* decision.

The Parties' Arguments

The defendants argued that the preference claims should be dismissed because the customer order authorized the transfers, therefore the defendants would have been inevitably paid in full, even in a chapter 7 case. The defendants relied mainly on (1) the court's prior decision in *Official Committee of Unsecured Creditors of Medical Mutual of Ohio* (*In re Primary Health Care Systems), and (2) the Third Circuit's decision in In re Kiwi Int'l Air Lines Inc*. for the propositions that the Customer Order is the law of the case, and the trustee cannot avoid the transfers because they would have been otherwise paid pursuant to the order. **[4]**

On the other hand, the trustee relied upon a line of cases collectively standing for the proposition that orders like the Customer Order do not, without more, automatically foreclose on the prosecution of a preference claim. In addition, the trustee argued that the Customer Order was discretionary as it authorized, but did not require, any payments to be made. Finally, the trustee relied on specific language in the Customer Order stating that claims, including preference claims, were not being waived.

A Decision the Court Did Not Rely Upon

Neither the court nor the trustee focused on **[5]** another relatively recent decision by the court, *AFA Investment Inc. v. Trade Source Inc.*, which was decided in the context of a summary judgment motion. *AFA* stands for the proposition that "an unsecured creditor whose claim is *paid in full* post-petition pursuant to a court order, or a court-approved stipulation, cannot then be compelled in a preference action to turn over amounts related to pre-petition payments."

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Specifically, the court held that due to the parties' *entry into a court-approved and fully executed post-petition services agreement* that the parties performed under the creditor would have received the challenged payment post-petition and recovered the same amount whether or not the alleged preferential payments were made pre-petition. Also relevant was that the alleged preference claim reflected a "mere fraction" of the critical vendor payment cap imposed by the order, rendering it unlikely that the inclusion of the alleged preference payment in the motion would have been objectionable.

The Court's Analysis and Decision

After dismissing certain technical notices pleading related arguments made by the defendants, the court concluded that the defendants did not have a cognizable defense to the preference claims solely because all or a portion of **[6]** their pre-petition unsecured claims were paid pursuant to the Customer Order.

Relying primarily on the court's prior decision in *In re Hayes Lemmerz Int'l Inc. (2004)*, the court determined that the Customer Order on its own was insufficient to provide McKesson with a defense to the preference claim because the transfers were made *before* entry of the Customer Order. In addition, the court observed that the result would not have been different even had certain or all of the transfers been made pursuant to the Customer Order. This is because McKesson would not necessarily have been entitled to payment in full of its pre-petition claim, as the Customer Order (1) was permissive as to payment and not mandatory, (2) did not specifically identify McKesson as a critical vendor, and (3) explicitly stated that claims and causes of action (*e.g.*, preference claims) were not being waived.

The court also distinguished *Primary Health*, which granted a motion to dismiss a preference claim due to the plaintiff's inability to satisfy the Fifth Element. In *Primary Health*, the defendant received post-petition payment on account of a claim for pre-petition wages, salary and other employee benefits pursuant to a first-day wages order. The court held that the Fifth Element could not be satisfied because the claims at issue were entitled to priority status and, because of the absolute priority rule, had to be paid in full in a chapter 7 case before unsecured claims could be entitled to any recovery. As McKesson unquestionably did not have a priority claim, the court could not conclude, at the motion-to-dismiss stage, that McKesson would be paid in full in a chapter 7 liquidation.

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Relying on the *Kiwi, Primary Health, Hayes Lemmerz* and other decisions, the court then provided a very helpful high-level primer on how courts in the Third Circuit have analyzed the "critical vendor defense." Specifically, the court observed that the only time the defense has been recognized is where (1) a debtor is obligated to pay a pre-petition claim, "either by order, stipulation, agreement or statute," including through the assumption of a contract, that requires a cure of all amounts due, or where a debtor has court authorization to enter into a post-petition agreement requiring payment, or (2) where the creditor holds a priority claim that would have to be paid in a chapter 7 liquidation before general unsecured claims. In conjunction with this primer, the court also recognized how courts have also considered the size of the proposed critical vendor payment versus the total amount authorized by an order.

Conclusion

The *Insys* holding is not surprising. The "critical vendor defense," while appealing at a very high level, has historically been very narrowly construed. *AFA*'s holding, albeit very fact-specific, provided general unsecured creditors with a glimmer of hope that courts may be more willing than previously to broadly construe the defense. However, potentially because *AFA* was decided in the context of a summary-judgment motion, or because it involved a post-petition court-approved critical-vendor agreement where the creditor was paid in full, the court ignored the decision.

The payment of a material portion of a trade creditor's pre-petition claim may be a victory based on recent general unsecured creditor recoveries, even if this larger recovery comes with the attendant preference risk. Based on that risk, trade creditors must balance the benefit of a superior recovery versus potentially being sued later for a preference claim. While *Insys* held that the "critical vendor defense" did not apply, its analysis of the defense should provide trade creditors with another data point, in addition to the ordinary course of business and new value defenses, to balance the risk of future preference exposure when making decisions early on in a bankruptcy case about whether to accept payment of all or a portion of their pre-petition claims and whether to extend post-petition credit.

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[1] Customer motions generally allow a debtor to continue providing its customers with access to gift cards, loyalty programs, discounts, rebates and other incentives to encourage loyalty, good will and customer satisfaction. The orders approving these motions are generally self-effectuating, meaning that the creditor's pre-petition claims can be paid upon entry of the order without the need to enter into a separate post-petition agreement.

[2] The court generally refers to all orders approving the payment of pre-petition claims as "critical vendor orders." This collapsing of all such orders into a single category is a bit of a misnomer, because courts have observed that there are important differences between actual critical vendor orders, which often require the creditor's entry into a post-petition agreement as a prerequisite to the payment of a pre-petition claim, and other types of orders authorizing the payment of a pre-petition claim without entry into a separate agreement (*e.g.*, customer orders).

[3] Insolvency is based on a balance-sheet definition of liabilities exceeding assets. The debtor's insolvency is presumed during the 90-day preference period.

[4] McKesson also argued that the preference claims were barred because they were not sufficiently described in the debtors' disclosure statement, but the court summarily dismissed that argument.

[5] The court only cited the decision once for a discrete proposition, and the trustee did not cite the decision in his brief.

[6] It is unclear from the *Insys* decision and related briefing what percentage of the defendants' pre-petition claims were paid under the Customer Order.

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