Critical Vendor Defense to a Preference Claim? Not so Fast!

Trade creditors face the risk of preference liability in too many bankruptcy cases. The Bankruptcy Code provides the subsequent new value, ordinary course of business and contemporaneous exchange defenses to preference liability. However, that has not stopped creditors from thinking outside of the box and asserting novel defenses to reduce their preference risk.

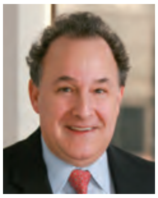
In a recent case, a creditor/preference defendant asserted a full defense to a preference claim based on the creditor's status as a "critical vendor," whose pre-petition claim was paid pursuant to an order approved by the bankruptcy court. The United States Bankruptcy Court for the Eastern District of New York, in *In re Personal Communications Devices, LLC*, rejected this novel "critical vendor defense." The court relied on the absence of a waiver of preference claims in the order approving the payment of the vendor's pre-petition claim. The court also rejected the creditor's creative "hindsight" argument that the bankruptcy court would have approved, as part of the critical vendor arrangement, the debtor's post-petition payment of the creditor's pre-petition invoices that were paid by the alleged preference payments if the debtor had not made these payments.

Bottom line folks, the creditor could not "hindsight" its way to defeat a preference claim.

The Elements of a Preference Claim and Defenses

According to Section 547(b) of the Bankruptcy Code, a trustee can avoid and recover a transfer as a preference by proving that: (a) the debtor transferred its property to or for the benefit of a creditor; (b) the transfer was made on account of antecedent or existing indebtedness that the debtor owed to the creditor; (c) the transfer was made when the debtor was insolvent, which is based on a balance sheet test of the debtor's liabilities exceeding its assets and is presumed during the 90-day preference period; (d) the transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to non-insider trade creditors; and (e) the transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor. A trustee cannot recover a preference if he or she cannot prove any of the above elements of a preference claim.

A creditor can assert multiple affirmative defenses contained in Bankruptcy Code Section 547(c) to reduce its preference exposure. Congress enacted these preference defenses to encourage creditors to continue doing business with, and extending credit to, financially struggling companies.



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One frequently invoked preference defense is the "subsequent new value" defense contained in Section 547(c)(4). A preference payment may not be clawed back by a bankruptcy trustee where a creditor gave new value to or for the debtor's benefit after a preference payment and (a) such new value was not secured by an otherwise unavoidable security interest and (b) the debtor did not make an otherwise unavoidable transfer to or for the creditor's benefit on account of such new value. The new value defense reduces a creditor's preference liability dollar for dollar based on the creditor's sale and delivery of goods and/or provision of services to the debtor on credit terms after the creditor's receipt of an alleged preference payment.

Another preference defense is the "ordinary course of business defense." This defense insulates a preference defendant from liability to the extent the payment in question was on account of a debt incurred by the debtor in the ordinary course of business, and was either made in the ordinary course of business between the debtor and the defendant (the subjective element of the defense) or was made according to ordinary business terms (the objective element of the defense). The ordinary course of business defense is intended to protect recurring transactions and encourage creditors to continue doing business with a financially distressed customer.

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The History Behind Critical Vendor Treatment

Prior to the enactment of the Bankruptcy Code, the courts had approved a debtor's payment of a creditor's pre-petition claim during the bankruptcy case based on the "necessity of payment" doctrine laid out by the United States Supreme Court in its 1882 decision in *Miltenberger v. Logansport Railway*. The Supreme Court had approved a debtor's post-petition payment of the pre-petition claims of those creditors who were found to be necessary for the reorganization and rehabilitation of the debtor's business.

Since passage of the Bankruptcy Code, the courts have reached conflicting decisions over whether to grant critical vendor status. Many courts have granted critical vendor relief based on the "necessity of payment" doctrine and/or Bankruptcy Code Section 105(a). Section 105(a) recognizes the bankruptcy court's equitable power to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title." These courts, particularly in Delaware and the Southern District of New York, have approved a debtor's payment of critical vendors' pre-petition claims without imposing onerous evidentiary requirements that the debtor has to satisfy.

Other courts have refused to grant preferred "critical vendor" status. These courts relied on the absence of any Bankruptcy Code provision that carves out an exception to the claims priority rules. The claims priority rules require the payment of claims based on where they are situated on the claims priority ladder. Secured creditors sit at the top of the priority ladder governing claims and are entitled to payment of the proceeds of their collateral. Creditors providing goods and services to a debtor in bankruptcy have administrative priority claims that sit on the next lower rung of the priority ladder. Creditors at the next lower priority level include wage, salary, benefit, and tax claimants. Pre-petition general unsecured claims occupy the lowest creditor rung of the priority ladder and are not entitled to receive any distribution from the debtor until the higher priority creditors are paid in full.

A third group of courts have granted critical vendor status if the debtor satisfies stringent requirements. For instance, the United States Court of Appeals for the Seventh Circuit, which includes bankruptcy courts in Illinois, Indiana and Wisconsin, in its watershed 2004 *Kmart* ruling, rejected the debtor's request to pay pre-petition unsecured claims in the aggregate amount of approximately $300 million asserted by 2,330 of Kmart's trade creditors. The Seventh Circuit had held that the "necessity of payment" doctrine no longer applies under the Bankruptcy Code and a bankruptcy court could not rely on its equitable power under Bankruptcy Code Section 105(a) to approve a debtor's payment of critical vendors' pre-petition claims. Under the *Kmart* test, a debtor seeking court approval of the post-petition payment of a critical vendor's pre-petition claim had to prove that (a) the creditor would not do business with the debtor on any terms (even on cash terms) without the debtor's payment of the creditor's pre-petition claim, and (b) the non-participating creditors would be better off if the debtor paid the critical vendor's pre-petition claim.

The Facts of the *Personal Communications Devices* Case

The debtors, Personal Communications Devices, LLC ("PCD") and Personal Communications Devices Holdings, LLC (collectively the "Debtors") were wireless telecommunications companies that acted as intermediaries between domestic wireless carriers and various foreign wireless headset manufacturers. PCD was a leading distributor of wireless communication devices and accessories. Each wireless device that PCD had sold was accompanied by a comprehensive warranty that required PCD to provide certain repair services. PCD also repaired and refurbished devices that were returned outside of their warranty period. Certain third-party repair service vendors had performed more than 90% of PCD's warranty repair work. Defendant, KMT Wireless LLC ("KMT") was one of the third-party repair service vendors that PCD had used to perform a substantial amount of the warranty repair services and out-of-warranty repairs. KMT was an electrical service provider that specialized in manufacturer warranty services and re-manufacturing or repair of mobile phones, supporting devices and other ancillary devices.

The Debtors had filed their Chapter 11 cases on August 19, 2013, (the "Petition Date"). During the 90 days prior to the Petition Date, from May 21, 2013 to August 19, 2013 (the "Preference Period"), the Debtors had made payments totaling $3,824,194.36 (the "Alleged Preference Payments") to KMT.

On August 20, 2013, the Debtors moved for court approval of the sale of their business assets. That same day, the Debtors moved for approval of a customer programs motion (the "CPM") that authorized PCD to pay its repair service vendors' pre-petition claims in an effort to maintain PCD's business until consummation of the sale. The requested relief in the CPM was akin to critical vendor relief. PCD stated in the CPM that the repair service vendors were critical to PCD's ongoing business operations and, in particular, to PCD's ability to honor warranty claims and refurbish phones returned out of warranty. It was uncontested that KMT was a repair service vendor. PCD specifically alleged that the loss of any of its repair service vendors would have severely disrupted PCD's business and its proposed sale. On the Petition Date, PCD owed the repair service vendors, including KMT, approximately $975,000.

On August 21, 2013, the bankruptcy court approved the CPM on an interim basis, authorizing, but not requiring, the Debtors to maintain and administer customer programs and honor related pre-petition obligations to customers. The interim order approving the CPM included a cap of $1 million on payments to the repair service vendors. On September 10, 2013, the bankruptcy court approved the CPM on a final basis, which also allowed, but did not require, the Debtors to maintain and administer customer programs and honor related pre-petition obligations to customers. The final order approving the CPM did not include any cap on the Debtors' payments to its repair service vendors. In addition, the interim and final orders approving the CPM did not include any waiver of preference and other avoidance claims against any repair service vendor.

On October 17, 2013, the bankruptcy court approved the sale of substantially all of the Debtors' business assets. On April 29, 2014, the court approved a Chapter 11 plan of liquidation. The plan included the creation of a liquidation trust (the "Liquidation Trust"), that was authorized to pursue preference claims, including the preference claim against KMT.

Thereafter, the Liquidation Trust sued KMT, seeking to avoid and recover the Alleged Preference Payments. KMT filed an answer that raised several affirmative defenses, including KMT's "critical vendor" defense. As part of this defense, KMT argued that a Chapter 7 trustee would have paid 100% of KMT's pre-petition invoices because KMT was a critical vendor whose services were necessary to preserve the enterprise value of PCD's business. As such, KMT asserted the Liquidation Trust could not prove one of the elements of a preference claim contained in Section 547(b)(5) that KMT had received more on account of the Alleged Preference Payments than KMT would have received in a hypothetical Chapter 7 liquidation.

KMT then filed a motion for summary judgment dismissing the complaint. KMT provided supporting affidavits stating that its services were critical to the Debtors' continued business and proposed sale. KMT then used a hindsight analysis, that the bankruptcy court would have approved, as part of the CPM, (i) the Debtors' payment of KMT's pre-petition invoices in the event they were not paid pre-petition by the Alleged Preference Payments, and (ii) a waiver of preference claims against KMT, all on the assumption that no one would have objected to this relief. KMT also relied on the absence of a cap in payments to the repair service vendors in the final order approving the CPM.

The Liquidation Trust opposed KMT's summary judgment motion. The Liquidation Trust relied on the absence of any provision in the orders approving the CPM that compelled the Debtors to make any payments to repair service vendors, such as KMT. The Liquidation Trust also submitted proof that if the Debtors had provided notice of a waiver of its approximately $4 million preference claim against KMT, creditors of the Debtors would have objected to the inclusion of a preference waiver in the orders approving the CPM.

The bankruptcy court made it clear that a prospective critical vendor seeking protection from preference risk should make sure that the order approving critical vendor relief includes a waiver or release of preference claims against the vendor.

The Bankruptcy Court's Denial of KMT's Summary Judgment Motion

The bankruptcy court denied KMT's summary judgment motion, thereby allowing the Liquidation Trust to continue to prosecute its preference action against KMT. The court enforced the orders approving the CPM, which did not require the Debtors to make payments to any of its repair service vendors. The orders approving the CPM also did not provide any release of preference claims against KMT and did not approve the assumption and/or assignment of the Debtors' contracts with KMT that would have resulted in a waiver of preference claims against KMT.

The court also rejected KMT's hindsight argument that speculated what the court might have done at the inception of the bankruptcy case if the Debtors had sought to both pay the pre-petition claims of repair service vendors totaling approximately $975,000 and waive preference claims totaling $3,824,194.36 against KMT. The court was simply unwilling to speculate over whether the Debtors might have sought such relief; whether following the Debtors' notice of such requested relief, any creditor or other interested party might have objected to such relief, and whether the court would have ultimately granted such relief.

Conclusion

The bankruptcy court made it clear that a prospective critical vendor seeking protection from preference risk should make sure that the order approving critical vendor relief includes a waiver or release of preference claims against the vendor. While such relief is rarely granted, a vendor with substantial leverage over the debtor might successfully negotiate the inclusion of a preference waiver in the critical vendor order.