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A Victory Notched for Critical Vendors in *Windstream Holdings*



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It is common practice for a company that files for bankruptcy protection to immediately seek, in its "first day" motions, authority to pay the prepetition claims of certain vendors that the debtor deems to be critical to the success of its bankruptcy case. A debtor seeks this authority on the premise that its business would be irreparably disrupted and its efforts to maximize value for its estate and creditors would be severely impaired if these "critical vendors" refuse to provide goods and services post-petition.

Though bankruptcy courts in various districts approach "critical vendor" motions somewhat differently from one another, the routine of approving critical vendor motions is alive and well in the districts that handle some of the country's largest Chapter 11 cases—*i.e.*, the Southern District of New York and the District of Delaware. This is illustrated by the recent decision of the United States District Court for the Southern District of New York (the "District Court"), in the bankruptcy cases of *Windstream Holdings Inc., et al.*, where the District Court affirmed the Bankruptcy Court's order authorizing the debtors' payment of the prepetition claims of critical vendors over the objections raised by one of the Debtors' unsecured creditors, GLM DFW, Inc. ("GLM"). That said, the *Windstream* case will provide a rare opportunity for the United States Court of Appeals for the Second Circuit (the "Second Circuit") to chime in on "critical vendor" issues, as GLM has appealed District Court's decision.

The History Behind 'Critical Vendor' Treatment

Prior to the enactment of the Bankruptcy Code, courts had approved a debtor's payment of a creditor's prepetition claim during

the bankruptcy case based on the "necessity of payment" doctrine that the United States Supreme Court had adopted in its 1882 decision in *Miltenberger v. Logansport Railway*. The Supreme Court had approved a debtor's post-petition payment of the prepetition claims of those creditors who were found to be necessary for the reorganization and rehabilitation of the debtor's business.

Since the enactment of the Bankruptcy Code, 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 Section 105(a) of the Bankruptcy Code. 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' prepetition 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 claims to be paid based on where they are situated on the ladder governing claims priority. Secured creditors sit at the top of the claims priority ladder and are entitled to payment from 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. Prepetition 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 has granted critical vendor status if the debtor satisfies stringent requirements. For instance, the United States Court of Appeals for the Seventh Circuit (which covers bankruptcy courts in the federal districts of Illinois, Indiana and Wisconsin), in its watershed 2004 *Kmart* ruling, rejected the debtor's request to pay prepetition unsecured claims in the aggregate amount of approximately \$300 million asserted by 2,330 of Kmart's trade creditors. The Seventh Circuit held that the "necessity of payment" doctrine does not apply to cases filed 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' prepetition claims. Under the *Kmart* test, a debtor seeking court approval of the post-petition payment of a critical vendor's prepetition claim has 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 prepetition claim, and (b) the non-participating creditors would be better off if the debtor paid the critical vendor's prepetition claim.

Relevant Background Regarding the *Windstream* Critical Vendor Order

On Feb. 25, 2019 (the "Petition Date"), Windstream Holdings, Inc. and its affiliated debtors (collectively, the "Debtors") filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. That same day, the Debtors filed a number of "first day" motions that are frequently filed in large Chapter 11 cases. Among these first day motions was a motion (the "Critical Vendor Motion") seeking interim and final orders authorizing the Debtors to pay the prepetition claims of certain "critical vendors," lien claimants, and Section 503(b)(9) claimants.

The Debtors had identified approximately 263 "critical vendors"—collectively owed approximately \$80 million in prepetition claims—and argued that the loss of these

vendors would immediately and irreparably harm the Debtors' businesses by shrinking their market share, reducing enterprise value and impairing the Debtors' viability as a going concern. Thus, the Debtors sought authority to pay these prepetition claims because the potential harm of losing these critical vendors far outweighed the cost of payment of their claims.

On Feb. 28, 2019, the Bankruptcy Court entered an order granting the Critical Vendor Motion on an interim basis and setting a hearing date and objection deadline with respect to final approval of the motion. As is common in Chapter 11 cases, neither the Critical Vendor Motion nor the order disclosed the identities of critical vendors, but the Debtors were required to share the critical vendor list with the Bankruptcy Court, the United States Trustee and the creditors' committee for their review.

GLM—an unsecured creditor of the Debtors who, as of the Petition Date, was providing services to the Debtors pursuant to an executory contract—objected to the interim critical vendor order on three grounds: (i) the Bankruptcy Court should have determined critical vendor status, not the Debtors; (ii) the Debtors were required to disclose the identities of the critical vendors; and (iii) the Bankruptcy Court failed to impose or identify a permissible standard for determining which creditors were critical vendors. No other party objected to the Critical Vendor Motion.

The Bankruptcy Court heard testimony from the Debtors' consultant that set forth the facts and analysis behind the Debtors' identification of critical vendors. The consultant testified that he and his team had considered whether the Debtors' business would be disrupted by a critical vendor's decision to cease providing goods or services to the Debtors and whether such disruption would irreparably harm the Debtors. They had also checked on the availability of other vendors who could have provided the same goods or services.

The Bankruptcy Court entered, over GLM's objection, a final order authorizing the Debtors to pay unpaid prepetition "critical vendor" claims (the "Critical Vendor Order"). The court concluded that the relief granted

would "provide a material net benefit to the Debtors' estates and creditors after taking into account the Bankruptcy Code's priority scheme."

GLM appealed the Critical Vendor Order to the District Court. GLM argued that the Debtors had impermissibly usurped the Bankruptcy Court's authority to decide which vendors were critical. GLM also argued that it was improper for the Debtors to keep the list of critical vendors, lien claimants and 503(b)(9) claimants confidential. Third, GLM argued it was denied due process. And finally, GLM argued that the Bankruptcy Court had failed to apply the correct legal standard in determining the vendors granted critical vendor relief.

The District Court Affirms the Bankruptcy Court's Critical Vendor Order

The District Court upheld the Bankruptcy Court's approval of the Critical Vendor Motion.¹ The District Court rejected GLM's argument that the Bankruptcy Court had impermissibly delegated authority to the Debtors to determine which creditors would have "critical vendor" status. The District Court noted that courts require payments to critical vendors to be "in the sound business judgment of the debtor." The District Court concluded that the Bankruptcy Court was correct in deferring to the Debtors' exercise of their business judgment—using the proper criteria and a capped dollar amount—to maximize estate assets for the Debtors' and their creditors' benefit. The Debtors' reasonable business judgment was evidenced by the facts that they had designated only 263 out of approximately 16,000 vendors as critical, utilized an outside consultant to assist in selecting such critical vendors, and had negotiated effectively enough to use only a small fraction of the funds allotted for critical vendors between entry of the interim and final "critical vendor" orders. And, as the District Court explained, requiring court supervision of each individual critical vendor designation would be impractical and unnecessary where the United States Trustee and the creditors' committee were overseeing the critical vendor selection and payment process.

The District Court also held that the Bankruptcy Court was correct in not

ordering the Debtors to publicly file their critical vendor list, relying on numerous cases in which bankruptcy courts did not require debtors to file such lists. Moreover, even if the Debtors were required to file their critical vendor list, they would likely have been permitted to redact the names of the critical vendors under the “commercial information” exception to public disclosure pursuant to Section 107 of the Bankruptcy Code. The District Court reasoned that releasing the names of critical vendors would harm the Debtors’ estates by reducing the Debtors’ negotiating leverage with the critical vendors and raising the risk of a potential “run on the bank” where all critical vendors would demand immediate payment of their claims.

Third, the District Court rejected GLM’s due process argument. The District Court found no indication that the Bankruptcy Court did not consider the various arguments raised by GLM. The fact that GLM did not win on the merits “is not a matter of process at all.”

Finally, the District Court held that the Bankruptcy Court’s approval of the Critical Vendor Order was authorized under Bankruptcy Code Sections 363(b) and 105(a). Section 363(b) allows the Debtors to use estate assets outside the ordinary course of business if the Debtors provide some business justification. Further, Section 105(a) empowers the Bankruptcy Court to enter any order that is necessary or appropriate to carry out the provisions of the Bankruptcy Code.

The District Court explained that a bankruptcy court can authorize payment of prepetition debts to facilitate the debtor’s rehabilitation based on the “doctrine of necessity” or “necessity of payment doctrine.” According to the District Court, the Debtors must satisfy three requirements when applying the “doctrine of necessity” in the critical vendor context: (1) The vendor must be necessary for the debtor’s successful reorganization; (2) the transaction must be in the debtor’s sound business judgment; and (3) the favorable treatment of critical vendors must not prejudice other unsecured creditors.

The District Court rejected GLM’s argument that the decision to pay critical vendor claims was improperly left to the Debtors’

sole discretion. The District Court noted that the Critical Vendor Order approved payments to critical vendors “up to the amount set forth for each category of Vendor Claims set forth in the [Critical Vendor] Motion.” The Bankruptcy Court set the amount of critical vendor payments after the Debtors had provided their criteria for identifying the critical vendors, which satisfied their burden of proving that particular vendors were critical. The District Court relied on this to conclude that the Bankruptcy Court did not grant the Debtors sole discretion in determining the critical vendors and the amount of payments to them, but, instead, had appropriately deferred to the Debtors’ business judgment on the identity of and the amount of payments to the critical vendors.

Additionally, the District Court rejected GLM’s argument that the Bankruptcy Court erred by failing to consider whether (i) a critical vendor would refuse to provide goods or services without being paid, (ii) the goods or services that the critical vendors were providing were critical to the Debtors’ business, and (iii) the Debtors had any meaningful alternative to the vendor. The court noted that approval of a “critical vendor” motion does not require proof of a vendor’s refusal to provide goods or services. And, in any event, the record of the case indicated that the Bankruptcy Court had considered these inquiries.

The District Court was swayed by the Debtors’ consideration of whether a vendor would refuse to provide goods or services to the Debtors post-petition without payment, whether the goods or services were critical to the business and whether the Debtors had meaningful alternatives to the vendor. The District Court concluded that the Bankruptcy Court had properly approved procedures for the Debtors to follow, including oversight by the creditors’ committee and the United States Trustee, to determine the identities of and the amount of payments to critical vendors, without having to hold a hearing to consider approval of payments to each of the 263 critical vendors. These procedures ensured that the Debtors were not paying the prepetition claims of certain preferred creditors.

Bottom line, the District Court held the Bankruptcy Court had appropriately applied

the doctrine of necessity and utilized its broad equitable power to ensure the rehabilitation of the Debtors and viability of the estate for *all* creditors by enabling the Debtors to pay the critical vendors.

Conclusion

The *Windstream* decision makes clear that “critical vendor” relief will likely continue to be granted in large Chapter 11 cases, particularly in the Southern District of New York. However, the *Windstream* critical vendor saga is not over yet. GLM’s pending appeal presents an opportunity for the Second Circuit to chime in on the propriety of critical vendor relief. The Second Circuit will hopefully weigh in on the issues GLM has raised as to whether the Bankruptcy Court had impermissibly delegated its exclusive judicial function by permitting the Debtors to determine which vendors were “critical” vendors and the amount of payments to them, and whether the Bankruptcy Court had the authority and discretion to not disclose the list of critical vendors to GLM and other creditors. The Second Circuit’s decision here will have direct impact on the common practice in large Chapter 11 cases where debtors routinely seek approval of payments to certain “critical vendors,” while keeping those vendors’ identities confidential. Stay tuned!

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1 Before delving into GLM’s arguments, the District Court concluded that GLM had standing to assert its appeal. The Debtors had argued that GLM lacked standing to appeal because a reversal of the Critical Vendor Order would not directly affect GLM’s pecuniary interest since its unsecured claim was junior in priority to the lien claims and Section 503(b)(9) priority claims regardless of the relief granted in favor of the critical vendors. The District Court rejected this priority-based argument as irrelevant—GLM had standing simply because it asserted a valid and impaired general unsecured claim.