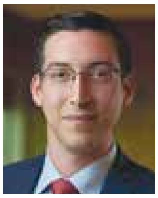
business CREDIT
SEPTEMBER/OCTOBER 2020
THE PUBLICATION FOR CREDIT & FINANCE PROFESSIONALS $9.00

Critical Vendor Treatment May Not Absolve Trade Creditors from Preference Risk

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As any trade creditor familiar with bankruptcy cases is aware, a customer's bankruptcy filing comes with the frustrating reality that any payment made by that customer within 90 days of the bankruptcy filing may be clawed back as an avoidable preference. This reality is particularly frustrating where the customer designated the creditor as a critical vendor and induced the creditor to continue providing goods and/or services on credit terms following the customer's payment of the creditor's prepetition claim pursuant to a critical vendor order. Debtors frequently seek, and obtain, authority to pay the prepetition claims of "critical vendors" on the premise that the debtors' business would be irreparably disrupted, and the debtors' efforts to maximize value for their estates and creditors would be severely impaired, if a critical vendor refuses to provide goods and services to the debtors post-petition.

When defending against a preference complaint, critical vendors have asserted their critical vendor status as a full defense to the claim. Vendors raising this "critical vendor defense" have argued that the plaintiff cannot prove one of the required elements of a preference claim—that the prepetition payment resulted in the creditor receiving more than it would have received in a hypothetical Chapter 7 liquidation—because the debtor had previously obtained court approval to pay the creditor's outstanding prepetition invoices during the bankruptcy case. However, successfully asserting this "critical vendor defense" is a difficult task, as illustrated by the recent decision of the United States Bankruptcy Court for the District of Delaware in the bankruptcy cases of *Maxus Energy Corporation, et al.* (*"Maxus Energy"*).

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 the payment of claims 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.

Preference Claims and Defenses

Pursuant to section 547(b) of the Bankruptcy Code, a trustee or debtor-in-possession may avoid payments made to creditors within 90 days of the debtor's bankruptcy filing (or within one year of the bankruptcy filing, if the recipient is an insider of the debtor) as preferences. A trustee or debtor-in-possession must prove each of the following elements to prevail on its preference claim:

- 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 type of transfer is the debtor's payment from its bank account to a creditor [section 547(b)(1)];
- The transfer was made on account of antecedent or existing indebtedness, such as outstanding invoices for goods sold and delivered and/or services rendered, that the debtor owed to the creditor [section 547(b)(2)];
- The transfer was made when the debtor was insolvent [section 547(b)(3)], 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;
- The transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor, such as a trade creditor [section 547(b)(4)]; and
- The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor [section 547(b)(5)]. This "greater than liquidation" requirement was at issue in the in the *Maxus Energy* case.

Additionally, the Small Business Reorganization Act of 2019, which became effective on February 19, 2020, amends section 547(b) to require a trustee or debtor-in-possession, as part of its burden of proof, to allege that its preference claim is based on reasonable due diligence under the circumstances of the case and having taken into account the creditor's known or reasonably knowable affirmative defenses.

Bankruptcy Code section 547(c) contains multiple affirmative defenses that a creditor can assert to reduce its preference exposure. For example, a creditor may assert the "new value" defense under section 547(c)(4), which 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 debtor's receipt of an alleged preference payment. Alternatively, a creditor may assert the "ordinary course of business" defense to reduce its preference liability. This defense generally requires the creditor to prove that the alleged preference payment satisfied a debt incurred by the debtor in the ordinary course of business and the alleged preference payment was made either in the ordinary course of business between the creditor and debtor or according to ordinary business terms in the applicable industry.

Creditors granted "critical vendor" status, like the creditor in the *Maxus Energy* case, have argued that the plaintiff cannot prove section 547(b)(5)'s requirement that the alleged preferential transfer had enabled the creditor to receive more than the creditor would have received in a hypothetical Chapter 7 liquidation. Though this "critical vendor defense" might have different nuances depending on the facts of the case, the basic premise is that the creditor did not receive more than it would have received in a Chapter 7 liquidation because the bankruptcy court ultimately authorized the debtor to pay the creditor's unpaid prepetition invoices, which include the invoices paid by any alleged preference.

Background Regarding the *Maxus Energy* Decision

On June 17, 2016, Maxus Energy Corporation ("Maxus") and its affiliated debtors (collectively, the "Debtors") filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. Prior to the bankruptcy filing, the Debtors had entered into a services agreement with Vista Analytical Laboratory, Inc. ("Vista"), pursuant to which Vista had tested samples for contaminants in connection with the Debtors' environmental remediation obligations owed to third parties. Specifically, Vista tested the Debtors' samples using a methodology that, while required to be used for the Debtors' project(s), was outdated and had been replaced by a new methodology by Vista's competitors.

The Debtors had paid approximately $217,410 to Vista within 90 days of the bankruptcy filing on account of six invoices that had been issued by Vista to the Debtors. On July 16, 2016, Vista had filed a proof of claim against the Debtors in the amount of $233,840, reflecting at least 14 unpaid invoices owed to Vista.

In August 2016, the Debtors moved for authority to pay critical vendors up to an aggregate cap of $2,000,000. Though the Debtors' motion and proposed order did not name Vista explicitly, the pleadings included descriptions of Vista's services that made clear that Vista was one of the critical vendors contemplated by the motion. The bankruptcy court entered an order granting the critical vendor motion on September 2, 2016 (the "Critical Vendor Order"). Pursuant to the Critical Vendor Order, the Debtors had paid the fourteen invoices owed to Vista and approximately $1.4 million in prepetition claims owed to critical vendors in total.

On May 22, 2017, the bankruptcy court entered an order confirming the Debtors' Chapter 11 plan of liquidation. A liquidating trustee was appointed to administer the plan by, among other things, asserting causes of action held by the Debtors' estates. On June 14, 2018, the liquidating trustee filed a complaint against Vista, asserting a preference claim to avoid and recover the $217,410 paid by the Debtors to Vista during the 90-day period before the bankruptcy filing.

Vista moved for summary judgment, arguing that the liquidating trustee could not prove his preference claim as a matter of law. Vista argued that even if the Debtors had never paid the $217,410 in alleged preference payments to Vista prior to the bankruptcy filing, the Debtors had authority to pay the invoices that were paid by the alleged preference payments pursuant to the Critical Vendor Order entered in the bankruptcy case. Therefore, Vista argued, the liquidating trustee's preference claim must fail since the liquidating trustee could not satisfy its burden of proving section 547(b)(5)'s "greater than liquidation requirement" because Vista had not recovered more from its receipt of the alleged preference payments than it would have received in a hypothetical Chapter 7 liquidation.

In response, the liquidating trustee argued that a genuine issue of material fact existed as to whether Vista's prepetition general unsecured claim would have been paid in full during a Chapter 7 liquidation. The liquidating trustee also argued that, to the extent any "critical vendor defense" (such as the defense Vista had asserted) exists, the defense applies only in very narrow circumstances that were not present with respect to Vista.

The Bankruptcy Court's Decision

The *Maxus Energy* court denied Vista's motion for summary judgment. The court ruled that Vista could not rebut the applicability of Bankruptcy Code section 547(b)(5)'s "greater than liquidation requirement, finding a genuine issue of material fact existed as to whether Vista would have recovered the $217,410 that was paid during the preference period in a hypothetical Chapter 7 liquidation.

The *Maxus Energy* court considered several prior court decisions in cases where the creditor had asserted the "critical vendor defense" to avoid preference liability. In *AFA Inv. Inc. v. Trade Source, Inc.* ("*AFA*"), the Delaware bankruptcy court granted summary judgment in favor of a preference defendant where the debtors had designated the defendant as a critical vendor and the debtors and defendant had entered into an agreement that required the debtors to pay the defendant's prepetition claim in exchange for the defendant's agreement to continue to provide services to the debtors post-petition. The *AFA* court relied on a prior holding of the U.S. Court of Appeals for the Third Circuit (the "Third Circuit"), in *Kimmelman v. The Port Auth. Of N.Y. & N.J.* ("*Kimmelman*"), that payments required to be made to contract counterparties to cure defaults under contracts that a debtor assumes under Bankruptcy Code section 365 are not subject to preference liability. The *AFA* court analogized payments made under an agreement entered into between a debtor and a critical vendor that requires the debtor to pay the vendor's prepetition claim to payments required to be made to contract counterparties under executory contracts that a debtor assumes under Bankruptcy Code section 365. The *AFA* court concluded that in the event the debtors had not made the alleged preference payment to the creditor, the creditor would have received that payment post-petition pursuant to the agreement it had entered into with the debtors and the critical vendor order.

But, as noted by the *Maxus Energy* court, other courts have rejected the critical vendor defense to preference liability. For example, in *HLI Creditor Trust v. Export Corp.* ("*HLI*"), a critical vendor that received approximately $286,000 in alleged preference payments had moved to dismiss a preference action asserted against it because the critical vendor order approved by the bankruptcy court had protected the critical vendor from preference liability. The critical vendor order had authorized the debtors to pay up to an aggregate amount of $1.6 million in prepetition shipping and warehouse charges in order to assure continued services by critical vendors on prepetition credit terms. The vendor argued that by virtue of the critical vendor order and supporting motion, the court had determined that the vendor was entitled to receive full payment of its prepetition claim.

The Delaware bankruptcy court rejected this argument because the defendant/critical vendor was not guaranteed to receive payment in a hypothetical Chapter 7, despite the authority provided under the critical vendor order. The critical vendor order did not protect the debtors' prepetition payments to the vendor from preference risk because, among other things, the order authorized, but did not direct, the debtors to pay critical vendor claims and neither the critical vendor order nor the supporting motion identified the defendant as a critical vendor. The court distinguished this from Bankruptcy Code section 365's requirement that a debtor must pay all prepetition obligations owing to the contract counterparty as a condition of the debtor's assumption of an executory contract.

Similarly, in *Zenith Indus. Corp. v. Longwood Elastomers, Inc.* ("*Zenith*"), the Delaware bankruptcy court rejected a critical vendor's argument that the debtor could not avoid an approximately $500,000 alleged preference payment made on the eve of the debtor's bankruptcy filing where the debtor had obtained authority to pay up to $1,000,000 in critical vendor claims. The court concluded that the critical vendor order did not direct the debtor to make payments to its critical vendors, in contrast to Bankruptcy Code section 365's requirement that a debtor seeking to assume an executory contract must pay all outstanding prepetition claims owing to the non-debtor contract counterparty. The court also noted that objections would have been filed in the event the debtor had sought authority in the critical vendor motion to pay an additional approximately $500,000 to the vendor, since the payment exceeded 50% of the $1,000,000 cap on critical vendor payments.

The *Maxus Energy* court denied Vista's summary judgment motion, relying on the court decisions in *HLI* and *Zenith*. The court noted that the Debtors' disclosure statement filed in connection with their Chapter 11 plan projected that general unsecured creditors would receive a 2.7% to 11.5% recovery. Therefore, it was clear that Vista would have received less than a full recovery had it not received the $217,410 in preference payments prior to the bankruptcy filing.

Additionally, the *Maxus Energy* court noted that, unlike in the *AFA* case, Vista and the Debtors had not entered into a trade agreement that required the Debtors' payment of Vista's prepetition claims pursuant to the Critical Vendor Order. Though there was an email exchange between Vista and the Debtors prior to the entry of the Critical Vendor Order that indicated the Debtors' intent to pay Vista's prepetition claims, the email exchange did not constitute a formal trade agreement that required full payment of Vista's prepetition claims under the Critical Vendor Order. Moreover, the Critical Vendor Order only authorized, but did not require, the Debtors to pay Vista's prepetition claims.

The court further noted that an attempt by the Debtors to pay the $217,410 (representing the invoices paid by the alleged preference payments) under the Critical Vendor Order would have plausibly drawn objections because the payments constituted approximately 11% of the $2,000,000 aggregate cap on critical vendor payments. The bankruptcy court cited the *Zenith* decision's emphasis on the relatively large size of the approximately $500,000 preference payment compared to the $1,000,000 critical vendor cap.

Conclusion

While a trade creditor granted "critical vendor" status has the significant perk of receiving partial or full payment of its outstanding prepetition invoices, the *Maxus Energy* decision illustrates that critical vendor status does not eliminate preference risk. Trade creditors would be wise to remain cognizant of their potential preference liability even after they have been granted critical vendor status. A creditor can protect itself from preference risk by insisting that the critical vendor order include a waiver of preference claims against critical vendors. Alternatively, a creditor can require the debtor to enter into a trade agreement that requires the debtor to fully pay the creditor's prepetition claim, thereby resulting in the critical vendor payments being mandatory rather than permissive. However, even the existence of such a trade agreement is no guaranty that the critical vendor can avoid preference liability.