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## Critical-Vendor Status: An Additional Preference Defense?



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For trade creditors, being designated a “critical vendor” at the outset of a chapter 11 case often serves as an avenue of payment for some or all of a vendor’s pre-petition claims. In exchange, trade creditors must generally commit to continuing to provide goods or services to the debtor post-petition on “customary” or agreed-upon terms. Many vendors may assume that obtaining critical-vendor status and the debtor’s corresponding payment of outstanding pre-petition invoices means that they are immune from preference lawsuits. However, a recent decision from the U.S. Bankruptcy Court for the District of Delaware in *In re Maxus Energy Corp.*<sup>1</sup> serves as a reminder that a debtor’s designation of a creditor as a “critical vendor” is insufficient by itself for the creditor to carry its burden on summary judgment in a preference lawsuit.

### Facts of the *Maxus Energy Case*

On June 17, 2016 (the “petition date”), Maxus Energy Corp. and its affiliated debtors (collectively, the “debtors”) filed chapter 11 cases.<sup>2</sup> Prior to the petition date, the debtors and Vista Analytical Laboratory Inc. had entered into a services agreement through which Vista analyzed organic contaminants in water samples in connection with the debtors’ environmental-remediation obligations monitored by a regulatory authority.<sup>3</sup> The services that Vista provided to the debtors were unique and could not be performed by other vendors. Vista used an older methodology for water sampling that was required by the administrative order issued by the regulatory authority.<sup>4</sup> Other vendors used newer technologies for analyzing water that could not provide the analysis required by the existing order. Accordingly, changing vendors would require requesting modifications to the administrative order, causing significant delays and expense to the debtors.<sup>5</sup>

During the 90-day preference period prior to the petition date, the debtors made six transfers to Vista on account of invoices issued under the services agreement in the aggregate amount of approximately \$217,410 (the “transfers”).<sup>6</sup> In the weeks following the petition date, the debtors advised Vista that they

would pay Vista’s outstanding invoices. In exchange, Vista agreed to perform analyses on the debtors’ water samples in Vista’s possession.<sup>7</sup> On July 19, 2016, Vista filed a proof of claim for \$233,840 on account of the invoices that remained unpaid by the debtors.<sup>8</sup>

On Aug. 17, 2016, the debtors filed a motion for entry of an order authorizing, but not directing, the debtors to pay pre-petition claims of critical vendors, up to a \$2 million cap.<sup>9</sup> In their motion, the debtors described the water sample testing services that Vista provided, and why the debtors could not easily replace them, but never identified Vista by name.<sup>10</sup> On Sept. 2, 2016, the bankruptcy court entered an order granting the critical-vendor motion (the “critical-vendor order”).<sup>11</sup>

The critical-vendor order stated that the debtors were authorized — but not directed — to pay pre-petition critical-vendor claims upon the critical vendor’s agreement to continue supplying goods or services on customary or negotiated trade terms for the duration of the chapter 11 cases by executing a trade agreement.<sup>12</sup> After entry of the critical-vendor order, the debtors paid approximately \$1.4 million on account of the pre-petition claims of critical vendors, including all amounts owed to Vista on account of its proof of claim (the “post-petition payments”).<sup>13</sup> The debtors and Vista never entered into a trade agreement.<sup>14</sup>

The debtors ultimately confirmed a chapter 11 plan, which created a liquidating trust administered by a liquidating trustee possessing authority to prosecute causes of action on behalf of trust beneficiaries.<sup>15</sup> On June 14, 2018, the liquidating trustee commenced an adversary proceeding against Vista, seeking to avoid and recover the transfers as preferences.<sup>16</sup>

### The Liquidating Trustee’s Preference Claim

Under § 547(b) of the Bankruptcy Code, a trustee must prove all of the following elements in

7 *Id.* at 65-66.

8 *Id.* at 66.

9 *Id.*

10 *Id.* at 67.

11 *Id.*

12 *Id.*

13 *Id.*

14 *Id.* at 67-68.

15 *Id.* at 68.

1 615 B.R. 62 (Bankr. D. Del. 2020).

2 *Id.* at 64.

3 *Id.*

4 *Id.* at 66-67.

5 *Id.*

6 *Id.* at 65.

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order to avoid a transfer as a preference: (1) the transfer of an interest of the debtor in property to or for the benefit of a creditor (§ 547(b)(1)); (2) made on account of an antecedent debt owed by the debtor to the creditor before the transfer (§ 547(b)(2)); (3) made when the debtor was insolvent (§ 547(b)(3)); (4) made within 90 days of the bankruptcy filing if the transferee is a non-insider (and between 90 days and one year of the filing if the transferee is an insider) (§ 547(b)(4)); and (5) that enabled the creditor to receive more than the creditor would have recovered in a chapter 7 liquidation of the debtor (§ 547(b)(5)). Vista did not dispute that the liquidating trustee had satisfied the first four elements of § 547(b).<sup>17</sup> The only issue in dispute was whether the liquidating trustee had proved the fifth element.<sup>18</sup>

Vista moved for summary judgment, contending that the liquidating trustee had failed to satisfy § 547(b)(5) for the following reasons: (1) the debtors made the post-petition payments pursuant to the critical-vendor order; (2) the amount of the post-petition payments exceeded that of the transfers; (3) had the transfers not been made, the debtors had authority to pay the \$217,410 without adjusting the \$2 million critical-vendor cap; and (4) the debtors had not reached the \$2 million cap.<sup>19</sup>

The liquidating trustee opposed Vista's motion for summary judgment, arguing that there was a genuine issue of material fact concerning whether Vista's pre-petition general unsecured claim would have been paid in full under a hypothetical chapter 7 liquidation. The liquidating trustee also asserted that there is no critical-vendor defense to preference liability in the Bankruptcy Code, but to the extent such a defense exists, it applies only in narrow circumstances not present here.<sup>20</sup>

### The Maxus Court's Analysis

The Maxus court's analysis of whether the critical-vendor order shielded Vista from the liquidating trustee's preference claim included a review of *HLI Creditor Trust v. Export Corp.*<sup>21</sup> The HLI court approved an order that permitted, but did not direct, the debtors to pay certain critical vendors, up to a cap of \$1.6 million.<sup>22</sup>

After confirmation of the HLI debtors' chapter 11 plan and creation of a liquidating trust, the trust commenced an adversary proceeding against a creditor, Export, seeking to recover preferential transfers totaling approximately \$286,000.<sup>23</sup> Export filed a motion to dismiss, arguing that the alleged preferential transfers were immune from attack by virtue of the critical-vendor order.<sup>24</sup>

Export argued that as a critical vendor, it should receive full payment of its pre-petition claim in exchange for pro-

viding post-petition services to the HLI debtors.<sup>25</sup> The trust responded that the critical-vendor order did not include a blanket waiver of the HLI debtors' preference claims against vendors, including Export.<sup>26</sup> The trust further argued that Export had not entered into a post-petition trade agreement with the debtors, and the debtors did not pay Export under the critical-vendor order.<sup>27</sup>

In denying Export's motion to dismiss, the HLI court noted that the debtors paid Export prior to even filing the critical-vendor motion. The HLI court also found that a disputed issue of fact existed over whether the debtors considered Export to be a critical vendor, and concluded that any payments under the critical-vendor order were permissive, not mandatory, and thus Export was not entitled to full payment of its pre-petition claim.<sup>28</sup>

The Maxus court also reviewed the decision in *Zenith Indus. Corp. v. Longwood Elastomers Inc.*,<sup>29</sup> where the critical-vendor order at issue authorized the debtor to pay certain pre-petition vendor claims up to a \$1 million cap.<sup>30</sup> The debtor later commenced an adversary proceeding against another creditor, Longwood, seeking to recover payments made during the preference period, including a payment exceeding \$500,000, made on the eve of the debtor's bankruptcy filing.<sup>31</sup> Longwood filed an answer in which it asserted various affirmative defenses, including that the critical-vendor order protected Longwood from preference risk.<sup>32</sup>

The Zenith debtor then moved to strike Longwood's critical-vendor defense.<sup>33</sup> Because Longwood had failed to respond to that motion, the Zenith court entered an order granting the motion and striking Longwood's critical-vendor defense.<sup>34</sup> Longwood subsequently moved for reconsideration of the order to strike, arguing that even if the debtor had not made the pre-petition transfers, Longwood would have nevertheless been paid under the critical-vendor order because the debtor considered Longwood to be a critical vendor.<sup>35</sup>

The Zenith court denied Longwood's motion for reconsideration, holding that even if Longwood were a critical vendor, the debtor's payment of approximately \$500,000 to Longwood would likely have drawn objections, because the payment comprised over one-half of the \$1 million cap under the critical-vendor order.<sup>36</sup> The court also relied on the critical-vendor order only authorizing, but not directing, the debtor to pay critical-vendor claims.<sup>37</sup>

Finally, the Maxus court considered *AFA Investment Inc. v. Trade Source Inc.*,<sup>38</sup> wherein the AFA court approved a critical-vendor order authorizing the debtors to pay essential

<sup>25</sup> *Id.* at 192.

<sup>26</sup> *Id.* at 193.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 193-94.

<sup>29</sup> 319 B.R. 810 (Bankr. D. Del. 2005).

<sup>30</sup> *Id.* at 812.

<sup>31</sup> *Id.* at 812.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 814.

<sup>36</sup> *Id.* at 817-18.

<sup>37</sup> *Id.* at 815.

<sup>38</sup> 538 B.R. 237 (Bankr. D. Del. 2015).

<sup>17</sup> *Id.* at 70.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 70-71.

<sup>20</sup> *Id.* at 71.

<sup>21</sup> 313 B.R. 189 (Bankr. D. Del. 2004).

<sup>22</sup> *Id.* at 193.

<sup>23</sup> *Id.* at 191.

<sup>24</sup> *Id.*

suppliers up to an aggregate cap of \$6 million.<sup>39</sup> The debtors and Trade Source then executed a letter of agreement that required that the AFA debtors pay Trade Source's pre-petition claim in exchange for Trade Source continuing to provide post-petition services on pre-petition terms.<sup>40</sup> The AFA debtors subsequently sought to avoid and recover an approximately \$25,000 preference payment made to Trade Source.<sup>41</sup> The debtors sought summary judgment, arguing that Trade Source was an unsecured creditor, and that unsecured creditors would receive less than a 100 percent distribution in a hypothetical chapter 7 liquidation.<sup>42</sup> Trade Source responded that even in a hypothetical chapter 7 liquidation, it would have still received 100 percent payment of its claim under the critical-vendor order and letter agreement.<sup>43</sup>

The AFA court granted summary judgment in favor of Trade Source. The court relied on the Third Circuit's decision in *In re Kiwi Int'l Air Lines Inc.*,<sup>44</sup> which held that when assuming an executory contract under § 365 of the Bankruptcy Code, a debtor's obligation to make cure payments satisfying a contract counterparty's pre-petition claim is a full defense to a preference claim against the counterparty.<sup>45</sup> Relying in part on *Kiwi*, the AFA court found that it was appropriate to analogize a debtor's payment under its agreement with a critical vendor, which requires full payment of the vendor's pre-petition claim, to a debtor's payment under an assumed contract.<sup>46</sup>

The AFA court also considered the large disparity between the approximately \$25,000 preference payment at issue and the \$6 million critical-vendor cap.<sup>47</sup> The court reasoned that the AFA debtors' request for payment of an additional \$25,000 to Trade Source in the critical-vendor motion would likely not have drawn an objection or resulted in the court's refusal to enter the order.<sup>48</sup> By contrast, in *Zenith*, the preference payment at issue accounted for more than half of the cap amount.

Finally, the AFA debtors entered into the letter agreement with Trade Source that obligated the debtors to pay Trade Source's pre-petition claim.<sup>49</sup> Accordingly, the AFA court was able to distinguish the *Zenith* decision and denied the AFA debtors' motion for summary judgment, ruling that Trade Source would have received a 100 percent recovery in a hypothetical chapter 7 liquidation.<sup>50</sup>

Relying on these cases, the *Maxus* court denied Vista's summary-judgment motion, finding that a genuine issue of material fact existed concerning whether the full amount of the transfers would have been paid to Vista in a hypothetical chapter 7 liquidation.<sup>51</sup> The *Maxus* court reasoned that chapter 7 liquidations often result in general unsecured creditors being paid less than 100 percent, if they are paid anything at all.<sup>52</sup> The *Maxus* court also distinguished the AFA case

on the basis that the AFA debtors and Trade Source entered into a trade agreement, while Vista and the debtors had no such agreement.<sup>53</sup> Unlike the facts in *AFA*, but similar to the situation in *Zenith*, if the debtors had not made the transfers, a request to pay Vista approximately \$217,410 would have plausibly drawn objections, as such payments would have accounted for approximately 11 percent of the \$2 million cap authorized by the critical-vendor order.<sup>54</sup>

## The *Maxus* holding appears consistent with the reasoning of cases within the District of Delaware and elsewhere that have addressed the issue [of critical-vendor status].

Finally, and most important to the *Maxus* court, the critical-vendor order only authorized, but did not require, the debtors to pay any particular vendor's pre-petition claim.<sup>55</sup> The debtors retained complete discretion to decide which vendor they would pay, along with the amount of payment, in exchange for the vendor's agreement to provide post-petition trade terms.<sup>56</sup> As such, the post-petition payments made to Vista were not required under the critical-vendor order. Accordingly, it was plausible, for purposes of summary judgment, that the liquidating trustee could prove at trial that the transfers would not have been paid in a hypothetical chapter 7 liquidation, and thereby satisfy § 547(b)(5).<sup>57</sup>

## Conclusion

The *Maxus* holding appears consistent with the reasoning of cases within the District of Delaware and elsewhere that have addressed the issue.<sup>58</sup> Accordingly, creditors considering providing post-petition goods or services to a debtor in exchange for the payment of pre-petition claims pursuant to a critical-vendor order should carefully review how the debtor's critical-vendor program is structured and whether it leaves open the possibility that a critical vendor may still have preference risk.

In particular, creditors should consider the following: (1) whether the critical-vendor motion or order identifies the critical vendors or the goods and/or services they provide to the debtor; (2) whether critical vendors may enter into a post-petition agreement with the debtor that provides for full payment of their claims in exchange for their agreement to continue providing goods and/or services on credit terms to the debtor; (3) whether the order specifically includes a waiver of avoidance claims against critical vendors; and (4) if the order requires, or merely provides discretion for, the debtor to make payments to critical vendors. **abi**

53 *Id.* at 74.

54 *Id.*

55 *Id.*

56 *Id.*

57 *Id.* at 74.

58 Although not cited in the *Maxus* decision, the U.S. Bankruptcy Court for the Eastern District of New York in *In re Personal Commc'ns Devices LLC* rejected a preference defendant's critical-vendor defense. The court rejected the defendant's "hindsight analysis" that a hypothetical preference waiver would have been granted in the defendant's favor because the critical-vendor order (1) was permissive, (2) did not identify the defendant as a critical vendor, and (3) did not include a waiver of preference liability. 588 B.R. 691 (Bankr. E.D.N.Y. 2018).

39 *Id.* at 244.

40 538 B.R. at 239.

41 *Id.* at 240.

42 *Id.* at 243.

43 *Id.*

44 344 F.3d 311 (3d Cir. 2003).

45 *Id.* at 321.

46 538 B.R. at 243-44.

47 *Id.* at 244.

48 *Id.*

49 538 B.R. at 244.

50 *Id.* at 243.

51 615 B.R. at 73.

52 *Id.*