business
CREDIT
NOVEMBER/DECEMBER 2023
THE PUBLICATION FOR CREDIT & FINANCE PROFESSIONALS $9.00

Critical Vendor Payments Are No Sure Thing in the Ninth Circuit


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As many in the trade are well aware, Chapter 11 debtors frequently seek bankruptcy court approval to pay the prepetition claims of vendors the debtor has deemed critical to the continued operation of its business and success of its Chapter 11 case. Debtors seek this relief based, in part, on the "necessity of payment" doctrine—that is, their business would be irreparably disrupted and their efforts to maximize value for their estates and creditors would be severely impaired if the "critical vendors" refuse to continue providing goods and services post-petition. While many courts routinely grant critical vendor relief on this basis, the Bankruptcy Code does not explicitly provide for the necessity of payment doctrine.

"Critical vendor" relief is very commonplace in the districts where the country's most active commercial Chapter 11 dockets can be found. However, this is not necessarily true everywhere—particularly in bankruptcy courts on the West Coast and other states and territories that are bound by or inclined to follow precedent set by the U.S. Court of Appeals for the Ninth Circuit. The Ninth Circuit has held that bankruptcy courts cannot rely on the necessity of payment doctrine or a bankruptcy court's broad equitable powers to approve payment of a vendor's prepetition unsecured claim where other general unsecured creditors have to wait to receive payment (if at all) until the end of the case. This was recently illustrated by an Oregon bankruptcy court decision, *In re MacMillan*, where the bankruptcy court denied the debtor's request to pay a critical vendor's unsecured prepetition claim largely because the court could not rely on the necessity of payment doctrine due to the Ninth Circuit's precedent.

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 bankruptcy 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.

But since the enactment of the Bankruptcy Code, courts have reached conflicting decisions over whether to approve a debtor's post-petition payment of critical vendors' prepetition unsecured claims ahead of other non-priority prepetition unsecured claims. Many courts approve such payments 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 Districts of New York and Texas, tend to routinely grant debtors' requests to pay critical vendors' prepetition unsecured claims without imposing any onerous evidentiary requirements on the debtor. In fact, in 2020, the U.S. Bankruptcy Court for the Southern District of New York, in the *Windstream Holdings* Chapter 11 cases, granted critical vendor status to certain creditors over a non-critical vendor's objection, largely relying on the doctrine of necessity. The U.S. District Court for the Southern District of New York affirmed this holding on appeal.[1]

Other courts have denied a debtor's request to pay critical vendors' prepetition claims—including the United States Court of Appeals for the Ninth Circuit, whose law is binding on federal courts in Alaska, Arizona, California, Guam, Hawaii, Idaho, Montana, Nevada, the Northern Mariana Islands, Washington and Oregon (which issued the *MacMillan* decision). In its 1983 decision in *In re B & W Enters., Inc.*, the Ninth Circuit held that a bankruptcy court cannot rely on the necessity of payment doctrine or section 105(a) to approve a debtor's payment of a critical vendor's prepetition claim where the debtor was not also paying the prepetition claims of other general unsecured creditors. The Ninth Circuit and other courts that have rejected critical vendor requests have noted that the Bankruptcy Code does not provide any explicit exception to its claims priority rules, which generally preclude paying one vendor's prepetition general unsecured claim ahead of other similarly situated prepetition general unsecured claims. A creditor's prepetition unsecured claim for goods or services sold to a debtor is generally last-in-line under the Bankruptcy Code's priority rules. As such, the creditor's claim can only be paid after the debtor's full payment of other higher priority claims, such as secured claims, administrative claims (e.g., claims that arose post-petition), and statutory priority claims (e.g., certain wages and other employee benefits and taxes). Critical vendor payments are an exception to the Bankruptcy Code's priority scheme, and courts denying critical vendor requests find no basis to make such an exception.

A third group of courts has approved critical vendor payments if the debtor satisfies stringent requirements. For instance, the United States Court of Appeals for the Seventh Circuit (which includes bankruptcy courts in the federal districts of Illinois, Indiana and Wisconsin), in its watershed 2004 *Kmart* ruling, rejected Kmart's payment of 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 cannot rely on its equitable power under Bankruptcy Code section 105(a) to approve a debtor's payment of critical vendors' prepetition claims. The Seventh Circuit concluded that even if critical vendor orders are permissible, a debtor seeking approval of the post-petition payment of a critical vendor's prepetition claim must 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.

Background Regarding the *MacMillan* Decision

The facts of the *MacMillan* case are as straightforward as they come. The Debtor, Roy MacMillan, filed a Chapter 11 case on Jan. 25, 2023. The Debtor raised cattle on his property, and grew the hay necessary to feed the cattle so as to minimize costs.

The Debtor had about a dozen general unsecured creditors on the bankruptcy filing date—one of which was John Keicher Ranch & Farm LLC (the "Critical Vendor"). The Critical Vendor had cut the Debtor's hay prepetition, but refused to continue cutting hay for the Debtor during the Chapter 11 case unless the Debtor paid the Critical Vendor's approximately $12,000 unsecured claim for unpaid prepetition services. The Debtor sought to fully pay the Critical Vendor's claim (while all other general unsecured claims would not be paid unless and until a Chapter 11 plan was confirmed) because he had no alternative service provider to replace the Critical Vendor and, therefore, concluded the Critical Vendor's services were necessary to minimize costs and maximize the value of his bankruptcy estate. The Debtor relied on the doctrine of necessity, the court's equitable powers under section 105(a), and the court's ability to authorize the Debtor's use of property (e.g., making payments) outside the ordinary course of business under section 363(b) of the Bankruptcy Code.

The Bankruptcy Court's Decision

The bankruptcy court denied the Debtor's motion, relying on the Ninth Circuit precedent established in the *B & W* decision. The bankruptcy court held that it lacks the authority to approve the immediate full payment of one general unsecured creditor's prepetition claim while all other general unsecured creditors would not receive distributions until confirmation (if at all). In so holding, the bankruptcy court shot down various arguments the Debtor had asserted in support of critical vendor treatment:

- **Necessity of Payment Doctrine.** The bankruptcy court concluded it was bound by *B & W*'s holding that courts cannot rely on the necessity of payment doctrine to grant critical vendor relief. The court, relying on *B&W*, noted that the necessity of payment doctrine is not codified in the Bankruptcy Code and may only be applied in railroad cases.[2]

1 The *Windstream* decision was further appealed to the U.S. Court of Appeals for the Second Circuit, but the Second Circuit dismissed the appeal as equitably moot since critical vendor payments had already been made and the debtors' plan had been confirmed.

2 The bankruptcy court also held it could not rely on the "six months rule" to grant critical vendor relief. The "six months rule" is an equitable rule historically applied in pre-Bankruptcy Code railroad-related receiverships to pay necessary expenses incurred in the sixth months before the commencement of a railroad's receivership. While the six months rule has been codified in the Bankruptcy Code, it only applies in railroad cases.

- **General authority under section 105.** Relying on the Seventh Circuit's *Kmart* holding, the bankruptcy court held that it cannot invoke section 105's equitable powers to contravene the Bankruptcy Code's claims priority rules. The bankruptcy court held that section 105 alone does not bestow authority that is not otherwise provided in the Bankruptcy Code, such as the authority to approve critical vendor payments where all other non-priority prepetition unsecured creditors are not paid in full.
- **Section 363(b).** The bankruptcy court held that this Bankruptcy Code provision only authorizes payments outside of the ordinary course of business—*not* payments that violate the Bankruptcy Code's priority rules. The bankruptcy court noted that even the Seventh Circuit recognized in its *Kmart* decision that section 363(b) should be read "to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code."
- **Priority Wage Provisions.** The bankruptcy court rejected the Debtor's argument that payment of the Critical Vendor's claim could be approved under the same standard applied to the Debtor's post-petition payment of prepetition employee wages and other employee benefits. As the bankruptcy court noted, the Bankruptcy Code grants prepetition employee wages and other benefits priority status (up to a cap), and requires the full payment of such claims before any payments are made on account of general unsecured claims. The Bankruptcy Code does not provide any express authority for a bankruptcy court to approve the payment of the Critical Vendor's prepetition unsecured claim where other unsecured creditors' prepetition unsecured claims are not being paid.

Conclusion

The *MacMillan* decision is certainly a loss for trade creditors doing business on the West Coast and in other states and territories bound by Ninth Circuit precedent. The court's denial of critical vendor status is particularly noteworthy where no party in the case had filed an objection to the Debtor's request to pay the Critical Vendor. And the decision will stand since no appeal has been filed.

However, trade creditors can take solace that this decision will likely have minimal impact on the practice of routinely granting critical vendor relief in the districts where the majority of large commercial Chapter 11 cases are filed (e.g., in Delaware and the Southern Districts of Texas and New York). Those districts are not bound by the Ninth Circuit's *B & W* decision and, therefore, may grant critical vendor relief based on the bankruptcy court's broad equitable powers under section 105 of the Bankruptcy Code and the doctrine of necessity. And they will likely continue to do so, as illustrated by the U.S. District Court for the Southern District of New York's written decision affirming the bankruptcy court's approval of critical vendor payments in *Windstream Holdings*—which was reported on in the June 2020 and May/June 2021 editions of NACM's *Business Credit* magazine.